

# **THE BRITISH UTILITY REGULATION MODEL: BEYOND COMPETITION AND INCENTIVE REGULATION?**

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# Introduction and Context

- In 2003, a conference was held in London to mark the 20<sup>th</sup> anniversary of the publication of the Littlechild Report
- The UK model of regulation for infrastructure industries seemed to be doing well
  - Forward looking incentive regulation (and RPI-X) was still the norm in the UK and was spreading to other developed and some developing countries
  - Competition where possible was unchallenged for non-monopoly industries (telecoms) and industry segments (energy)
  - In the UK, 'light-handed' regulation still seemed to be present as regulatory agencies were still (relatively) small.
- BUT, there were threatening clouds on the horizon
  - With repeat price controls, price cap regulation and rate of return regulation seemed increasingly like opposite sides of the same coin
  - Regulation (especially price reviews) were becoming more bureaucratic and legalistic

**So, where are we now, 30 years after the Littlechild Report?**

# The British Utility Regulation Model: Key Characteristics I

The key characteristics of the British utility regulation model are

## 1) Independence

- Independence from both Government and regulated companies

## 2) Forward looking incentive regulation

- Resetting of regulated prices (physical network use prices, some wholesale and retail prices) at regular intervals (e.g. 5 years). RPI-X was one method of doing this but there are others and 'simple' RPI-X is heavily in decline.
- Prices reset in light of forward looking investment requirements and earning a reasonable cost of capital on existing assets (financeability)

# The British Utility Regulation Model: Key Characteristics II

## 3) Focus on consumers

- Maximising consumers' welfare is main objective of regulation
- Consumers defined in primary legislation as present and future consumers (link with investment)

## 4) Competition seen as best means of maximising consumers' welfare other than where significant market power (monopoly networks)

- Mainly competition *in* the market for wholesale and retail customers but sometimes competition *for* the market (train franchises)
- Economic regulation lodged within a competition policy perspective (most developed for telecoms but important for other regulated utility industries)

# The British Utility Regulation Model: Key Characteristics III

## 5) Private Ownership

- The utility regulation model established for telecoms, energy, etc was very much a product of the 1980s and subsequent privatization programmes
- With the exception of railways, private ownership and an absence of operational subsidies continues (with a few exceptions)

## 6) Strong legal processes and well-defined appeal rights

- Role of Competition Commission (now CMA) in regulatory appeals
- Regulators have Stage 1 competition powers ('concurrency') as well as regulatory remedies
  - Increased emphasis (and pressure) to use competition powers

## 7) 'Light-handed' regulation

- A key component of Littlechild Report but now much less obvious because of policy and legal process pressures

# Pressures on British Utility Model over Last Decade I

The main pressures have arisen since 2008. They include:

1. The major economic recession which led to a major squeeze on incomes – particularly of low income households
  - Crucial for ‘essential product’ utility regulation, particularly those with health threats from insufficient consumption
  - Most of concern for energy (especially electricity) and water
  
2. Sharp increases in retail energy prices after long period of low and falling prices, mainly because of reversal in world fossil fuel prices
  - Also continued increases in (a) water and sewerage prices because of investment programmes (rising environmental requirements) and (b) passenger rail fares (subsidy burden)

# Pressures on British Utility Model over Last Decade II

3. Clear reduction in confidence by public that markets and competition are the best way of providing utility services – especially for essential goods and to low income households
  - Energy supplied by large oligopolistic firms with vertical integration by contract – companies apparently earning good profits
  - Water and sewerage supplied by regional monopolies on not very transparent basis
4. Impact on energy markets and prices from active climate change agenda – introduction of a major new externality reason for active policy intervention and “managing” competition.
5. Major impact of 2008 EU Agreement to reduce emissions and (more importantly) greatly increase renewable generation.
  - Has led to greatly increased government policy interventions in electricity generation and retail markets
  - Has further reduced political and public support for lightly regulated competition in electricity and water industries

# Main Changes in British Regulation Since 2005: Independence

- Shift in policy-regulation boundary from regulators to government
  - Explicitly signalled by Coalition Government in 2010
  - Relevant Government Department issues (once-per Parliament) Strategic Policy Statement to regulatory agencies
- Major increase in Government intervention in energy regulation – especially electricity
  - Consequence of (a) ‘toxicity’ of energy prices and (b) major shift to renewable and nuclear generated electricity
- Continued major government involvement in rail and airport investments (and ongoing rail subsidy)
  - Some intervention in ICT (e.g. rural broadband rollout) but much less than other infrastructure industries

# Main Changes in British Utility Regulation Since 2005: Competition

Some reduction in scope of competition – but not as much as first impressions might suggest.

- Main impact on electricity and energy
  - Partial re-regulation of retail household market and return to competition *for* the market (single buyer) in electricity generation
  - BUT, pressures for more vertical separation and transparent trading and for a major competition inquiry
- Some impact on water supply industry where Ofwat push for more competition has been received with great caution and nervousness
  - Most obvious in upstream competition and abstraction – desire to retain vertical integration by many players and politicians
- In other regulated infrastructure industries, competition has not been under significant threat and there are pressures to enhance it (e.g. from Enterprise and Regulatory Reform Act 2013)
  - The key distinction is between those industries supplying goods/services with and without (a) major health and low income links and (b) climate change policy issues

# Main Changes in British Regulation Since 2005: Repeat Regulation I

- Repeat regulation identified as a problem area for incentive regulation and RPI-X at 2003 Conference
  - Issue of rate of return on existing assets – rise of RAB
- Problems have become more acute since 2003
  - Issues of information asymmetry between regulator and companies
    - Strategic gaming and ‘wars of (benchmarking) models’ used by companies to try to turn regulatory determinations into a negotiation
  - Problems for ORR, Ofgem where regulating a single national network (rail network and electricity/gas transmission system)
- Much greater legalisation and bureaucratisation of price reviews – pressures for legal certainty
  - Plans for next review announced at time of completion of existing review

# Main Changes in British Regulation Since 2005: Repeat Regulation II

- There have been proposals – and actions – to develop new methods:
  - Menu regulation and similar regulatory/procurement information revelation devices (IRDs) - pioneered by Ofgem; and
  - Contracts negotiated directly between facility developers and users (e.g. CAA and airports 2009)
  - Both of these encourage active risk-reward choices by companies rather than regulator-company negotiations
- Menu regulation regularly denounced as ‘wonkish’ and over-complicated but has been greatly extended since introduction in 2004 for electricity distribution
  - Now used (with other IRDs) for electricity and gas distribution and transmission + Ofwat + Suggested for rail
- Direct negotiation of contracts has made less progress but WICS has gone a long way towards it with its Customer Forum approach
  - Approach has also promoted far more consumer involvement in companies’ business planning for all regulated utilities

# Main Changes in British Regulation Since 2005: 'Light-Handedness'

Numbers of staff in British regulators quite large – but only Ofgem growing substantially.

- (i) **Ofcom:** 2012-13 = 780 but that includes TV regulation and 48 postal regulatory staff
  - Oftel in 2002 = 230 but Oftel + ITC etc = 1,152 in 2003-04.
  
- (ii) **Ofgem:** 2012-13 = 729 (including E-serve)
  - Ofgem in 2003 = 291
  
- (iii) **Ofwat:** 177 Full-time equivalents
  - Ofwat in 2003 = 240 FTEs
  
- (iv) **ORR:** 2012-13 = 271 – of whom 111 for economic regulation
  - ORR in 2003 = 117 (all on economic regulation)

**NOTE: OFT + Competition Commission = 825 in 2012-13**

# Is There Still a Distinctive British Utility Regulation Model?

- The British model of independent utility regulation seems to be largely intact but less distinctive than 10 years ago because of:
  - Legal process pressures and the problems of repeat regulation;
  - Changed government priorities (especially on energy) and the challenges of the Great Recession;
  - Evolution of EU and government policy on energy, telecoms/ICT and transport industries.
- Further changes likely to arise from
  - Closer integration with competition policy
  - Greater devolution to Scotland and Wales – and possible Scottish independence
  - EU related developments (whether UK countries In or Out)
  - Greater 2/multi-way regulatory interactions between countries
- Pure uncertainty: **“Events, dear boy, events.”**  
(Harold Macmillan – attrib, 1950s)