Regulatory Policy Institute: 26th April 2013

What of the Regulation of Utilities?

Utilities comprise roads: railways: water, gas, electricity: trams, buses & urban railways: retail banking. Not, this morning, health & education.

A history of change, showing the shift, backwards and forwards between competition & regulation, & within regulation, between franchising, ex ante regulation & private & local authority/state control.

[**Early C19th** believed that, as elsewhere, competition was sufficient, but in water & gas, this led to duopoly/oligopoly and price agreements. Public policy responded with dividend control.

Middle C19th experimented with ex ante regulation though Acts of Parliament, setting out (some) service obligations (Parliamentary train), but no monitoring of results.

Late C19th developed systematic time-limited private sector franchises (tramways 1870s, electricity 1880s) in county areas, smaller towns & West London & Newcastle: & the beginning of "municipal socialism" (gas, electricity, water, trams) in the bigger municipalities, e.g. Birmingham, Glasgow, Leeds, Liverpool, Manchester. Sheffield.

Early C20th saw consolidation (electricity & London transport) & beginnings of public corporations (LPTB, BBC, transition from GPO to Post Office)

Middle C20th saw nationalisation (post-war railways, gas, electricity, subsequently, 1974, water).

Late C20th saw privatisation (telecom, gas, electricity, water, railways) with some revival of competition, regulation linked to incentives for improving efficiency and regulators independent of ministers.]

Early C21st time for more change?

The UK system of RPI-X, initially devised by Stephen Littlechild, has been much admired internationally as preferable to both nationalisation & cost of service regulation. It has, of course, developed, e.g. into RPI+/-K in Water, where (K=+Q-X) & RIO, a similar concept, in energy.

Privatisation also involved some disaggregation of the vertical electricity monopoly and this was followed by a breakup of the British Gas vertical monopoly. In Rail, track and trains were separated (and are separately regulated). In telecom an alternative (mobile) network developed as a result of technology. Water remains vertically integrated, save for retail activities in Scotland.

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Since the liberalisation of the 1980s, there has been re-conquest by ministers. They have “taken back” - and created - policy. Regulators, rather than industries, have been "nationalised"; as much under the Coalition as under Labour.

In **telecoms**, ministers are promoting high speed internet access, and there are to be EU "reforms".

In **energy**, government is specifying generation outcomes, such as wind power and nuclear. Ofgem has become an agent of ministers, with provision for ministers to give it social duties, and proposals for it to report on its impact on ministerial policy.

Railways never fully escaped ministers; investment is a political objective (HS2) & ToC franchising is more about reducing subsidies than customer welfare. Charging for road space has stalled.

Water regulation has become largely concerned with financing environmental investment; the Thames tunnel is an outstanding case, where ministers are now specifying the solution as well as the objectives.
Competition policy remains in flux, but with some recent progress.

The entry of private equity infrastructure funds into the water industry has posed some problems and intensified existing ones. The governance of these funds is more complex and less transparent than the management of a Plc, with its Board and code of practice. They have paid very large dividends[1] which call into question the strength of the ring-fence round the utility operations.

In the case of Thames Water, apparent regulatory acquiescence in these dividends has apparently, albeit misguidedly, helped Thames to make a case for government guarantee for the financing of the £4 billion Thames tunnel. [The fact that their borrowing carries tax advantages does not make for the legitimacy necessary to justify private financing of public projects.]

For me, as a former regulator, this makes me want to re-open the case for re-imposition of dividend controls of one kind or another. I think that we should look again at the excellent article by Phil Burns and Ralph Turvey that drew on CXIX experience. Perhaps we should re-instate a sliding scale, whereby higher dividends for investors could only be accompanied by lower prices for customers.

[1] See Figure 2 in *Observations on the Regulation of the Water sector* Lecture by Jonson Cox to Royal Academy of Engineering 5th march 2013

What of **retail banking**? Cruikshank drew attention to payments systems as a utility and Kay, Vickers & Lawson have argued for retail banking separation, with implications, yet to emerge, for regulation. EU Banking supervision proposals seem to be going down the wrong route - looking at the banking sector as a whole, with a huge potential cost to taxpayers.

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Regulation, which was supposed to be simple and to rely on competition & incentives, has become increasingly detailed, requiring an ever increasing volume of information, & ever more complex analysis. Micro-management has thrived, driven by multiple objectives.[2]

Regulation has been cluttered by nerdish schemes such as "menu-regulation" and "tariff-specification" to the extent that the details of the trees seem almost designed to keep people's eyes off the wood.

[2] The train franchising system has become ever more protracted, expensive and less effective, while successive governments have taken more and more control of the process, See Chris Stokes (deputy franchising director at the office of passenger Rail Franchising from 1993 to 2000) *Why the franchising system is bust* FT 2012

The Competition Commission has not developed as an appeal mechanism, setting precedents. Individual regulators have ploughed their own sectoral furrows, agreeing licence changes with their regulated companies. In telecoms, issues are increasingly being settled in the Courts, including the CAT; but do they (yet) mobilise sufficient economic expertise?

Transparency has suffered. Consultation papers have gained length, while losing clarity. They circulate in the techno-structure but are rarely, if ever, the subject of general discussion in the media.[3]

Outside telecoms, empowerment of customers has not developed as far or as fast as expected by the advocates of privatisation, although retail competition has given some choice to energy customers, and in water, regulation has been used to reflect customer's views on the provision of services.

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Despite these downsides, when compared with the nationalised days, we have seen a huge improvement in efficiency. 25 years ago we knew that nationalised industries were inefficient: we did not know **how** inefficient.

[3] When Ofgem published an analysis of the costs of green energy policies, it was told that a little silence would be in order.

The creation of regulators has improved the knowledge available for decisions. Regulatory tools such as the Regulatory Asset base (RAB/RCV) have been developed and finance and economics have become more closely linked. We better understand the role that competition can have in opening up areas previously considered natural monopolies to competition. Tariffs with better incentive effects have emerged.

There are also interesting developments in customer empowerment, whereby customers (or their representatives) are consulted as part of a utility's price control submission.[4] But how would, or should, this relate to the government policies that are becoming increasingly intrusive? If prices are driven by government policy, should customers work through the political or regulatory processes?

Most of the cost drivers come from ministerial policy, not from improvements in customer service. If customers cannot challenge ministerial policy, are they having their expectations raised, only to see them dashed?

[4] See Stephen Littlechild [insert ref]

As a former regulator, running Ofwat on a budget of £11m a year, I approve of the main thrust of John Penrose's arguments. I hope that he stirs up the relevant government departments as well as the relevant regulators. I say this because the "Big Consumer" approach has to start in Whitehall. Most of the expensive obligations being placed on the water companies, and even more the electricity companies, come directly from government. Obligations are, moreover, imposed without out any proper costing, with inadequate analysis and all too little structured discussion.[5]

The Thames tideway tunnel offers an excellent example of these failings.[6]

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Are we seeing the phase, as under nationalisation, where arms-length arrangements are in recession, and where formal separation between government and industries is overturned by pursuit of political objectives?

If so, why has this happened? Is it inevitable? Is it driven by the pressures of democracy?

[5] Anna Walker's valuable report [ref] argued that new obligations should be costed and customers consulted, **before** decisions were made.
[6] See Simon Hughes & Ian Byatt *Why should Londoners pour money down the drain?* Times November 2012

Economics and politics give rise to different suggest pressures. Economic pressures derive from innovation, changing circumstances and different preferences - brilliantly characterised by Schumpeter as the "gale of creative destruction". Political pressures are more concerned with the protection of groups vulnerable to change and more widely with issues of the distribution of income & wealth.

The universal coverage of the utilities makes distributional policies a constant issue; the sector regulators are under pressure to dabble, especially when bills are rising. Yet the pursuit of social policies over-complicates regulation & damps economic incentives.

We have also seen the development of numerous lobbies and factions, arguing the case for policies that are economic as well as political. Environmental groups have been successful in creating myths that have clear economic agendas, ranging from anti-growth Malthusianism to proposals for "Saving the Planet".[7]

[7] See Rupert Darwell *The Age of Global Warming; A History* London 2013

[When a myth has been created, critics become heretics, or in CXXI language, "deniers".[8]] The public finds it difficult to unravel these matters; its inadequate scepticism makes a mockery of transparency and analysis. Meanwhile politicians, who can jump to conclusions only too quickly, claim the divine right of the ballot box.

Back in the 80s, privatization and regulation was seen as a rolling back of the state & the replacement of politicians by un-elected persons independent of ministers, able to use economic expertise to increase efficiency & improve choice for customers. Frank Vibert, in his *Rise of the Unelected,* talks of a new separation of powers.[9]

Has this agenda stalled? There now seems a bi-partisan policy to make regulators agents of ministers - a great contrast with the policies of the Thatcher & Major governments.

In the case of the coalition's growth policies, project appraisal has gone out of the window; the emphasis is on how to finance projects whose economic return is uncertain. This would involve further extension of off-government-balance-sheet debt, accompanied by rising charges to consumers. Unfortunately, ministers have found a handy credit card, where customers and taxpayers pay make the monthly payments.

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[8] See Bjorn Lomborg *the Skepiical Environmentalist* Cambridge 2001
[9] Frank Vibert *The Rise if the Unelected* Cambridge 2007

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So where might we go from here?

First, the poor state of the economy points to the need for reductions not increases in utility bills. Stealth taxes, in the form of rising utility bills are damaging to economic growth.

Secondly, much more public debate is needed on the trade-offs between environmental and economic objectives. At last this is now happening in energy policy, but the debate needs to be enhanced and extended to other utility areas. Ministers are unlikely to initiate such a debate, so regulators, as in the 1990s, should play a bigger role in exposing the issues. This requires presentational skills to make better use of the technical expertise that already exists.

Thirdly, we need a merger of economic and political thinking. Economists have tried to avoid politics, and try to produce "value-free" analysis. This may be helpful in terms of pure analysis - although it suffers the dangers of assuming that Humans are Econs.[10] But when it comes to regulation, it leads to clever but useless techniques such as menu regulation and a retreat from strategy into compliance with political agendas.

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[10] See Kahneman,*Thinking, fast and slow* I & Richard Thaler & Cass Sunstein *Nudge; Improving Decisions about Health, Wealth, and Happiness* New Haven 2008

That ministers should be able to give Directions, as in the nationalised days sounds a good approach to the separation of powers. But it never happened; ministers preferred more subtle - and less transparent - ways of influencing results.

If they speak out, even in Mandarin tones, regulators risk the Thomas a Beckett treatment. But better strategic analysis is in the public interest. Perhaps Parliament (Committees comprising those from both Houses on the lines of the current Banking investigation?) should look across the utility area. Now is the time to switch from examining regulatory techniques to illuminating wider issues of policy in the utility sector.

But I am not optimistic. Parliament, especially the House of Commons, is not good at challenging government. At least regulators should use consultation to raise more strategic issues and go easy on long technical disputations with no clear outcomes.

Fourthly, I would like to see a Competition Commission investigation into the challenges and opportunities facing utility regulators and an assessment of progress towards strengthening competition and achieving benefits for customers though the use of economic incentives.

Fifthly, there should be a much more sceptical approach to "growth" projects, insisting on systematic analysis of how they might contribute to growth, or indeed, retard it by pre-empting resources: ill-advised capital projects, such as wind turbines, HS2 & the Thames tunnel **reduce** the capacity of the economy.

At the moment the focus is too much on financing projects rather than considering whether they are value for money in the first place. Indeed cost:benefit analysis has been, as I see it perverted so that it now relates only to value for public expenditure on the assumption that the project will go ahead in one form of other.

I conclude with Chateaubriand's recollection of his life, and his boyhood in St. Malo - "How often ...have I thought myself building for all eternity castles that have crumbled faster than my palaces of sand!"[11]

But go on trying!

26th April 2013 Ian Byatt

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[11] George D Painter C*hateaubriand* p.23