

Regulation, over-regulation and some alternative approaches¹

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1. Introduction

Regulation is always controversial. But by harnessing the market process, incentive regulation of privatised utility networks has enabled significant efficiency improvements. However, setting new price controls is becoming more complex and burdensome, and regulators find it difficult to identify appropriate investment programmes for the future. Some other jurisdictions offer alternative ways of approaching this challenge. They refocus regulation as a means of helping the market process to work rather than replacing it.

2. Concerns, achievements and limitations of regulation

Free market economists have traditionally been concerned that price controls will lead to rationing and reduced investment, thereby making conditions worse rather than better. They accepted that this need not be the case if such controls reduced monopoly prices to a competitive level, but argued that in practice it was vain to attempt to calculate such competitive prices.³

In practice, however, network utilities have such market power that there is considerable scope for preventing or reducing monopoly prices without the need for detailed calculation of competitive price levels. Regulation has provided the needed assurance to customers to enable privatisation of utilities in the UK and many other countries. Where relevant it has also enabled extensive competition to supply services over the monopoly networks.

Moreover, regulation of the RPI-X incentive price cap form has proved more effective than traditional US rate of return control. It does not seek to identify and enforce a particular cost or price or rate of return as equal to the competitive level. Nor does it seek to eliminate excess profits. Instead, it links allowed prices to the rate of inflation and some broad estimate of the scope for efficiency improvements and other movements in cost. It protects customers and at the same time provides the incentive for the regulated company to increase efficiency because it keeps the resulting profits for the specified term of the price control. Companies are encouraged to discover

³ E.g. Ludwig von Mises, *Human Action*, Henry Regnery, chapter 30.

better methods of production. Customers benefit from further price reductions over successive price control periods.

This approach has been adopted in all UK utility privatisations and in many European and other international markets. There have been initial concerns about excessive profits. But over time there have been significant increases in efficiency, reductions in costs and prices, improvements in quality of service, and increases in the investment programme. The network price control review process is also increasingly familiar and standardised, resulting in a low cost of capital. UK regulators see the process as flexible and evolving over time.

Yes this approach increasingly has limitations, as some UK regulators themselves have acknowledged, and indicated an interest in alternative approaches.⁴ It is burdensome, intrusive and a cause of conflict between companies, customers and regulators within each industry. There is minimal role for users and customers. Regulators are increasingly required to specify or approve investment programmes on the basis of limited knowledge. Regulatory uniformity limits the ability to tailor regulation to particular circumstances. There is less innovation, less learning from experience.

Why has regulation run into such problems? Originally, price cap regulation invited the company to discover the most efficient products and methods of production. Now, the regulator is required or presumed to know the answers, which the company is then encouraged to replicate. Regulation has neglected the discovery process.

What is the solution? Alternative approaches make greater use of the discovery process. They encourage market participants to discuss and discover the preferred products and investment programmes, and agree prices for delivering these. Consider the examples of the Public Contest method in Argentina, constructive engagement in the UK and negotiated settlements in the US and Canada.⁵

⁴ For example, Alistair Buchanan, (Chief Executive of Ofgem), "Facing up to the Better Regulation Challenge", Speech to the Institute of Economic Affairs, London, 29 November 2005; "Ofgem's 'RPI at 20' Project", speech at SBGI, 6 March 2008, p. 7; "Is RPI-X still fit for purpose after 20 Years?", Beesley Lectures on Regulation, Series XVIII, London, 2 October 2008.

⁵ More extensive expositions of these ideas, with reference to the underlying research, are available in my papers "Some alternative approaches to utility regulation", *Economic Affairs*, September 2008, and "Some applied economics of utility regulation", *Energy Journal*, September 2008.

3. The public contest method in Argentina

When Argentina privatised its electricity sector in 1992, the Government considered it unwise to entrust decisions about transmission expansion to the transmission companies or the regulator. Instead, new investment proposals had to be proposed, voted for and paid for by users. Construction and operation of approved proposals were then put out to competitive tender. This determined the charges to users.

There were some teething troubles and critical remarks, but generally the approach worked well.⁶ Economic investments have been implemented (albeit delayed in recent years by the macroeconomic crisis). Uneconomic investments have been prevented (or funded by taxation where government deemed this appropriate for political reasons). The regulatory framework determined the approach and the shares of each user in each expansion, then users worked together effectively to decide on investments. Transactions costs have not been a problem in practice.

4. Constructive engagement in the UK

In response to concerns about UK regulation, the Civil Aviation Authority (CAA) in 2005 invited the airports and airlines to take forward some of the work usually carried out by the regulator, under a process of “constructive engagement”.⁷ This included traffic forecasts, quality of service requirements, and the investment programmes. The CAA would retain responsibility for assessing operating costs, cost of capital and the final price control. It would ensure that the interests of passengers and future airlines were safeguarded, and would retain final responsibility for decisions. “But if an agreement can be better reached by the parties, the regulator is likely to have a preference for it.”

The CAA considers that the outcome was generally satisfactory at Heathrow and Gatwick. Several broad agreements were reached. There was also an improvement in consultation and regulatory discourse.⁸

⁶ S C Littlechild, “Symposium on electricity reform in Argentina: Preface”, *Energy Economics*, 30 (2008), 1279-1283, and numerous articles in the Symposium volume.

⁷ Airport regulation: the process for constructive engagement, CAA, May 2005.

⁸ Harry Bush, *Some Issues in Airport Regulation*, presentation at Hertford Seminars in Regulation, 11 May 2007.

The Competition Commission is more critical, though it is also critical of BAA's own planning procedures.⁹ It was particularly concerned about significant increases in BAA's capex programme during its inquiry, about information and resource asymmetries, and the absence of a dispute resolution or arbitration procedure at each stage. (The CAA does not accept these criticisms.) Nevertheless, the Commission saw substantial merits in the process and noted that the airlines did too. It concluded that constructive engagement should be a continuous process.

5. Negotiated settlements in the US and Canada

Whereas the CAA proposed constructive engagement, allocating to the parties certain elements of the price control calculation and retaining other elements for itself, in parts of the US and Canada, by contrast, user groups and utilities have taken the initiative. Without prompting, they negotiate settlements covering pricing and any other relevant issues such as investment, quality of service, generally without having to agree in detail each input into the calculation. Such negotiations have been the means of introducing significant price reductions, a series of fixed-term efficiency incentive programmes, and many other innovations over the last two decades.¹⁰

It might seem ambitious to attempt to negotiate the whole of a price control. Against that, the Competition Commission, in commenting on constructive engagement, was concerned about a lack of focus on the implications for overall price. Requiring the parties to look at the whole picture would reduce the scope for such concerns. It would also provide additional 'degrees of freedom' to facilitate negotiation and agreement.

Settlements would enable the parties to discuss and where possible agree a variety of other issues. Examples include indexation of the cost of debt, menu regulation and benefit sharing, the use and funding of renewable energy, the structure of tariffs and the impact of metering and demand management. Opinions on these issues differ between the parties and

⁹ *BAA Ltd. (Heathrow and Gatwick Quinquennial Review, Final Report)*, published 3 October 2007. Former BAA executive Mike Toms also expresses a critical view in "Airports regulation: a case of destructive engagement?" Beesley Lectures on Regulation, Series XVIII, 9 October 2008.

¹⁰ See Joseph Doucet and Stephen Littlechild, "Negotiated settlements: The development of legal and economic thinking", *Utilities Policy*, 14(4), December 2006. My research papers on experience in Florida and Canada are available at <http://www.electricitypolicy.org.uk/pubs/index.html>.

between companies. In most cases the regulator has to prescribe a uniform view. Settlements would allow different approaches, more innovation and better evidence on the merits of each approach.

6. General Principles

Common to all these alternative approaches is that the regulatory framework has sought to encourage and enable market participants themselves to discover the preferred products and investment programmes and prices. It has not sought to replace the market process by the decisions of the regulator.

The examples typically refer to network monopolies. But monopoly does not mean that the regulator itself has to take all the price and quantity decisions. If the regulator removes the element of market power, the market participants can negotiate a preferred solution.

There are different ways of removing market power. In Argentina the transmission company cannot make investment decisions or set prices: users determine the expansions, competition determines who builds and operates the expansion (which can be the incumbent if it wins the tender). In the US and Canada, if the regulated company is intransigent the case is determined by the regulatory body using standard public hearings.

Return on capital is always a controversial issue. To avoid the need for explicit agreement, some settlements simply specify a set of prices and quality of service. To remove the utility's market power, the National Energy Board in Canada has announced a generic cost of capital formula, indicating the rate of return it would allow unless the parties agree another rate. A European regulator could do the same. In a recent case, parties agreed all the issues except the rate of return, leaving that for the regulator to decide after formal public hearings.

The attitude of the regulatory body is critical. The National Energy Board issued Guidelines that declared, in essence, that if all interested parties had an opportunity to be involved in a settlement, if there was no opposition to the settlement, and if it was not inconsistent with the relevant Act, then the NEB would normally be able to conclude that the settlement was acceptable. The emphasis is thus on ensuring acceptable processes rather than on second-guessing the outcomes negotiated by the market

participants.

A regulator would, of course, need to satisfy itself that the interests of those not at the table – notably final customers and potential competitors – were fully protected. There would seem to be scope to involve in the process some actual customers who pay the utility bills, such as large users and organisations such as the Major Energy Users Association or local Chambers of Commerce.

Regulators could be formally encouraged to promote settlements. The Alberta Energy and Utilities Board has a statutory duty to “recognize or establish rules, practices and procedures that facilitate negotiated settlement”. It would be straightforward to add such a duty to the existing duties of the utility regulators in the UK, and probably elsewhere. It seems eminently consistent with the concepts of Better Regulation.

7. Conclusions

Although some economists have understandably been concerned about price controls, they have largely proved their worth in the privatised utility networks. They have reassured customers during privatisation and facilitated competition across those networks. RPI-X incentive price caps have been effective in encouraging greater network efficiency, lower costs and prices, improved quality of service, and greater investment where appropriate.

However, it is becoming more difficult to set those incentive price caps, because the information on which to base them is increasingly difficult to obtain. There is a consequent danger of over-regulation, distortion in investment, enforced uniformity and less innovation and learning from experience.

With alternative approaches to regulation, market participants can play a more active role than they presently do. The resulting outcomes are more innovative and more closely aligned to the interests of customers and users. Companies benefit from the reduced regulatory uncertainty. Relations in the industry are generally more informed and constructive. The key is to refocus regulation on facilitating the market process instead of replacing it.