Regulatory design and evolution

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Which competition policy for regulated utilities?
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Outline

- Utility privatisation and regulation in UK
- Achievements of incentive regulation
- Its limitations re network monopolies
- Some alternative approaches
- The transition to competition
- The limitations of regulatory policy
- Consistent with competition policy?
- Conclusions

Utility privatisation & regulation

- Privatisation UK utilities 1983 - 1996
- Market power so need for sector regulation
- Dissatisfaction with US rate of return control
    - Focus on reasonable profit – distributional concern
    - Neo-classical view, takes demand & costs as given
    - Provided no incentive to efficiency and innovation – but that was a major aim of UK utility privatisation
- What alternative model could be used?
- SCL asked to assess options for BT 1983

RPI-X incentive regulation

- Increased scope for competition would minimise need for regulation
- Transitional RPI-X price cap
- RPI-X reassures investors and customers
- Incentive to increase efficiency
- For company to work out how to increase efficiency, not for regulator to specify this
- Reflects view of competition as discovery process, not as equilibrium state

Achievements of RPI-X

- Adopted in all UK utility privatisations
- And many overseas markets
- Some initial concerns about excess profits
- But significant increases in efficiency, reductions in costs and prices, increases in quality and in investment
- For network monopolies, price control review process now standard - building block approach on 5 yearly basis

Limitations of present approach

- Burdensome, intrusive, cause of conflict
- Does it yield right investment programs?
    - Reflects a toothpaste model of capex
    - Regulator allows enough for 5 years, company squeezes where and when needed
    - What about tooth whitening & cosmetic dentistry?
    - Increasing challenge is *what* to build
- No or minimal role for users & customers
- Regulatory uniformity limits ability to tailor to each situation and reduces innovation

Alternative approaches

- Why has regulation run into problems?
- It now presumes that regulator knows the answers – back to neoclassical economics
- Has abandoned the discovery process
- Alternative approaches try to remedy this
- By giving a greater role to market participants to discover preferred products and prices and investment programmes

Constructive engagement

- UK Civil Aviation Authority (CAA) specified issues for airlines & airport to try to agree
    - Quality of performance standards, traffic forecasts and investment programme
    - CAA retained responsibility for opex, cost of capital, financing and price control
- Largely achieved at Heathrow & Gatwick
    - Plus improved relationships and understanding
- CC critical of some aspects of process
    - Availability of info, CAA arbiter, capex growth
    - But supportive of the principle & scope for learning

Public Contest method

- Argentina electricity privatisation 1992 – did not trust companies or regulator
- Existing transmission grid RPI-X price cap
- New investment proposals had to be proposed, voted for and paid for by users
- Then put out to tender to determine cost
- Initial problem but generally worked well
- Users work together to decide investments

US energy regulation

- US federal energy regulators encouraged parties to settle to deal with backlog
- 1994-2000: 41 gas pipeline cases, 34 settled in full, 5 in part, only 2 litigated
  - Minimal savings time, cost, uncertainty
- Main gain: different process led to innovative rate freezes – better security and efficiency incentives – that regulator could not legally impose (Wang 2004)

Pipelines in Canada

- Lengthy hearings at National Energy Board
- Since 1997 almost all rate cases settled
  - Especially multi-year incentive systems
  - Also provision of info, quality of service provisions
  - Pipeline expansion, transition to deregulation
- Board refrained from cherry-picking
- Generic cost of capital to aid negotiation
- Policy: if process sound, accept outcome
  - Don't substitute own view of public interest

Consumer advocate in Florida

- Traditional Public Service Commission
- Office of Public Counsel (OPC) has negotiated settlements with utilities
  - Over 30% of earnings reviews since 1976
  - Over ¾ of total rate reductions worth $4bn electric
- Utilities got greater accounting flexibility
- And revenue-sharing efficiency price freezes instead of rate of return control

Scope to apply elsewhere?

- Possibilities of applying in UK?
  - E.g. water price control review process
  - Quadripartite Working Groups involve all parties (utility, consumer body, environmental agencies)
  - Similar to constructive engagement discussions?
  - Could Ofwat indicate cost of capital and invite agreement on capex programme and prices?
  - May need to add paying consumers?
- General principle: regulation to facilitate market discovery process not replace it

The transition to competition

- RPI-X price cap initially transitional: to hold the fort until competition arrives
- But timing & extent of removal variable
  - Electricity & gas retail caps removed after 4 yrs
  - BT’s RPI-X cap 1984 removed 2006: 22 years
  - Royal Mail’s special delivery cap removed 2006 but majority of RM products still subject to control
- Have RPI-X price caps discouraged competition from arriving?

Price controls and competition

- Should regulator set price cap equal to efficient cost until competition arrives?
- This is more onerous than normal market
    - Removes element of monopoly profit
    - Removes variations in costs and in prices
    - Reflects projected future (not present) efficiency
    - May not reflect competitive cost of capital
    - May reflect historic costs not opportunity costs
    - Added risk of predicting what regulator will do
- All this tends to discourage new entry

Judging market performance

- What prices reasonable or unreasonable?
- Regulators have taken WACC 6 – 8% real
- Price caps set to achieve this sort of return
- Compare Competition Commission 2000
    - Supermarkets WACC 13% (or about 10% real)
    - IRR 17%, ROCE 17.6% (average 1993-99)
    - UK commercial/industrial returns about 19%
- Consistent with competitive market process
    - Profits ok unless substantially above cost of capital

What is reasonable profit?

- Grout and Zalewska survey CC cases 1973-98
  - Companies referred: ave 40% ROCE
  - Companies referred for excessive prices: ave 65%
  - Companies not guilty of excessive prices: ave 30%
  - Companies guilty of excessive prices: ave 100%
- Consistency between views of reasonable profit?
  - regulators (<10% OK) compared to
  - OFT (40-65% questionable) and CC (30% OK,100% Not OK)?
- Accept comparability & measurement problems
  - different cost & profit concepts, HCA v CCA, inflation, etc
  - maybe halve CC figures? Still a difference remains
- Price caps too severe, may deter competition?

Conclusions

- RPI-X incentive network price caps effective
  - better network efficiency, prices, quality, investment
- But setting network price caps now harder
- Transition price caps may deter competition
- Need to refocus regulation again, to reflect competition as a discovery process
- Help market process to work, not replace it
- In monopoly networks & competitive sectors