Regulatory credibility and the irresistible urge to meddle

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When the great utilities were being privatised, one of the key objectives was to establish a regulatory regime which would be credible to investors and fair to customers. The way it worked was that the companies would be given fixed contracts *ex ante*, and these would be reset on a periodic basis. Within the period, prices would be fixed by an RPI-X formula.

The logic was very clear: the only way in which the performance of the companies could be improved was to incentivise them to do so. Fixed-price, fixed-period contracts gave them the chance to outperform, and it was this outperformance which managers would chase after in the interests of their shareholders. The regulators would re-base the prices at the end of the period as the companies revealed what they could actually deliver, rather than what they told the regulators *ex ante*.

It was all very simple, and that was its attraction. But it never worked out as intended, for the very good reason that regulators and politicians could not resist the urge to intervene. Faced with the chance to curry favour with the customers, politicians kept up the pressure and most regulators eventually obliged. Indeed it is hard to think of many periods when there has not been some form of intervention, and the companies quickly learned that there was, in effect, a tolerable band of outperformance, beyond which the risk of intervention would be high.

It started in the early to mid 1990s. The first water regulator Ian Byatt quickly reduced the period from 10 to 5 years for the water companies and started constructing an immensely detailed reporting and accounting framework. After

1995 he pushed through "voluntary" profit sharing. Whilst his successor, Philip Fletcher, largely kept his hands off the companies within periods, Johnson Cox came up with "gainshare" and "painshare", pushed the companies into foregoing the price increases they were entitled to under the periodic settlement, and then added a vision of the roles and responsibilities of the company directors within which dialogue would steer them to moderate price increases in the future - in other words to "share" the "gains".

Electricity was not far behind. Its first regulator, Stephen Littlechild, reopened his first determination of the price caps for the regional electricity companies, and the process of driving competition into the core of the network monopolies meant that, at an early stage, meters were spilt off and eventually significantly stranded.

Though water and electricity were the major examples, other regulators could not resist the temptations. The rail regulator started life intervening and never stopped. The airports regulator was more circumspect, but the early days of OFTEL were dominated by interventions. Its successor, OFCOM, has continued in this vein.

In retrospect the simplicity of the fixed-price/fixed-period approach was illusory. The licence functions were subject to continuous revision. In many cases it was the duty on regulators to promote competition which undid the solidity of the regulatory contracts. The price caps were set on a moving target, and the regulators had a clear duty to move it. Thus, within periods, regulators got on with "reforming" their sectors, they developed "forward plans", and with budgets to defend they were - and had to be seen to be - busy.

There was no chance that they would fix the prices, and simply go away for a few years. On the contrary, each regulatory body has massively expanded its activities since the early days of privatisation. Back in the late 1980s, OFGAS had just 20 people. Today across the utilities there are literally thousands of regulatory staff. To justify budgets and staff levels, they have indeed been busy, and busy-ness begets intervention. Regulators have websites, press officers, publicity officers, press releases, plans, reviews, consultants and lots of lots of media announcements to make. Some even issue daily email updates. Institutions tend to grow, and regulatory bodies are no exception. There is always "more" to do. The regulatory state has expanded beyond all bounds that the originators back at the time of privatisation could have imagined. Occasional economy drives, austerity and retrenchments do not undermine this trend.

Credible periods

It is naïve in the extreme to believe that these pressures to intervene within periods are going to go away. The challenge is to come up with ways to limit and channel that intervention, and to make it as predictable as possible to maintain the incentives. One regulator – OFGEM – has managed to alleviate some of these pressures, partly by accident and partly by design.

After the first couple of decades, OFGEM set up a major review of regulation, called the RPI@20 project. Led by Hannah Nixon, the review did two fundamental things: it indexed the cost of debt; and it lengthened the period to 8 years from 5. Innocuous and evolutionary though both of these may have seemed at the time, they had two big advantages.

Indexing the cost of debt meant that the profits of the companies would not be exogenously boosted or harmed by changes in interest rates. They would be neutralised. This was incredibly important – for the major reason for the outperformance of the utilities in the 1990s and 2000s has been that, in a world of declining real interest rates, the regulators systemically overestimated the interest rate for the next period. The big profits that resulted – without much managerial input from the companies and their managers – were effectively windfalls. Politicians noticed and so did customers, and the obvious question was asked: why should shareholders pocket large profits as a result of external events over which they had no control? Why should customers not benefit – immediately?

Indexing the cost of debt largely solves this problem, and it takes away a major incentive to intervene – but only in those utilities where the cost of debt has been indexed. OFGEM got this right – but the others did not. OFWAT stuck to its fixed cost of debt – and the result is that water company share prices are as much a punt on the expected real interest rate as they are on the managements' ability to run their companies efficiently.

The second big advantage came from the longer periods, though it remains to be seen whether OFGEM can keep its hands off and resist the temptation to do a "mini" "interim" review after 4 years. For what an 8 year period means is that the CAPEX and OPEX cannot be well defined for the whole period at the outset. Lots of things are going to happen in 8 years, and in a competitive market these would result in changes in costs and prices. In the case of electricity, the government has a long-term plan to decarbonise the whole sector, and this may have radical impacts on the networks in ways which cannot all be foreseen. There will be lots of innovation and change, and regulators have to focus on outputs rather than inputs.

OFGEM's 8 year period therefore requires a much more sophisticated contract, and it needs flexibility. Rigidity and change do not sit well together. Instead of pretending that everything can be bolted down once every five years, the 8 year period allows for flexibility where it matters. It is much harder to intervene opportunistically in the electricity and gas network periodic determinations than it is in water – and indeed before the ink has dried, this is already apparent. In water, OFWAT is already in the major revisionist mode, whereas OFGEM is not.

In the water case, the period is only 5 years, the cost of capital is fixed, and the regulator is already talking about a "dialogue", "trust" and "partnership" between the regulator and the companies. They will "manage" the period between themselves, with their boards taking a much more public interest approach to their prices and the way they spend their money. Cox wants "higher standards of board leadership" who would take a "revised thinking about sharing the pain and gain in the light of shareholder returns" in the context of "high inflation, falling real incomes and substantial outperformance for shareholders". He recognises that he is "going beyond the role of economic regulation as it's sometimes been narrowly defined" yet in the same speech he says "it is equally important as a regulator that we do not create uncertainty in the regulatory framework by continual change, especially within the AMP period". One interpretation of his speech suggests that is exactly what he is doing.

Having been forced to concede that the RCV was "safe" for the current period, OFWAT suggests it is now up for revision. As the OFWAT's previous chief executive Regina Finn had intimated, the concept of the RCV might have outlived its purpose. Although the regulatory licences provide for "interim determinations" in the event of explicitly listed exogenous changes, here again OFWAT now has a track record of intervening endogenously, putting pressure on the overall position.

The irony of the contrast between the two approaches is obvious: OFWAT's rigid fixed-price contract for 5 years is much less robust than OFGEM's more sophisticated 8 year contract. If the cost of debt remains very low, there will be pressure to claw back the gains. If it rises later in the period sharply, then the companies will scream for relief.

The lesson is clear: the broader regulatory regime should adopt the OFGEM approach – indexing the cost of capital and longer periods – if within period intervention is to be minimised.

The political pressures and the proper role of politicians

It is easy to point the finger at particular regulators, but they exist in a broader political context, and the concept of "independent" regulators has always been a relative one. The government has managed to get round them in the past, most notoriously in bypassing Tom Winsor at ORR over the administration of Railtrack and the creation of Network Rail. The forms of political "control" are many and various. At one level, there are Parliamentary Select Committees and ministerial “discussions”. At another, and despite the reforms to public appointments, in the end the government effectively does the appointing, whatever the procedures. Regulators too may even be interested in honours and subsequent roles, and there could be incentives to play to the political gallery.

It might be argued that what matters is making sure that the *right* people with the *right* values are appointed. This is what I once described as “good chaps regulation”. Find a high quality, independently minded individual, and he or she will then stand up to government. There have been lots of these – Britain has been blessed with some outstanding regulators. But where there have been robust public clashes – for Stephen Littlechild, for Clare Spottiswoode and for Tom Winsor – the results have not been as clear cut as some may have hoped. There have been times when government policy and the independence of the regulators have become blurred: for example the support for NETA from Callum McCarthy, later regulator at the FSA when the financial crisis hit. It is of course great to have really good chaps, but no regulatory regime should be built upon this basis. Rather there needs to be some extra scaffolding around the regulatory regime to sort out the relevant domains of regulators and politicians.

The Labour Party’s policy on direct intervention on electricity prices and its proposal to abolish OFGEM is a clear example to think about. Ed Miliband is not the first political leader to propose intervention and it has been extremely popular. David Cameron proposed to reform OFCOM in the run up to the 2010 general election and suggested directly limiting electricity tariffs to put all customers on the cheapest tariff. Tony Blair was going to have a major regulatory reform, and indeed his first government imposed a windfall tax. Populist political interventions are the norm, not the exception.

At one level, why shouldn’t a political leader propose change? This is entirely legitimate – indeed it would be very worrying if they could not. But such changes should go through *legislation* – changing the role and duties of the regulators, and indeed even fixing prices. Democracies can encourage politicians to do many things, some of which are less than optimal.

But what is less attractive is the use of the *existing* powers, and the *existing* regulatory structure to push through changes as a result of being in power rather than as a result of changing the law. It is here that the rationale of independence gets muddled. Regulators act independently *within the law*. The ways to tackle this incentive to manipulate outcomes is to shine a torch on what goes on – to make it as transparent as possible.

An example which comes to mind occurred in the early days after electricity privatisation. In 1992 there was a great coal crisis, as a result of plans to close lots of uneconomic pits. The Select Committee on Energy got in on the act and summoned Stephen Littlechild the regulator to try to put pressure on him to "do something". At the hearing, Littlechild was asked how his meetings with the then Secretary of State, Michael Heseltine were going. He replied that there had been no meetings at all, to the amazement of the Committee and its politicians. But in retrospect Littlechild was right: it was for the politicians to decide whether the government should subsidise the mines, not the regulator to help twist the arms of the power companies to buy more British coal.

Transparency – who is talking to who about what – is essential. There should be no behind-the-scenes arm-twisting, and the way to avoid this is to make it impossible to do so. The obvious solution is to treat it like the requirement to declare any conflicts of interest. Any meetings and discussions should be disclosed. This does not mean that there should not be meetings and that ministers and regulators should not discuss regulatory matters. On the contrary, these may be highly desirable, but the declaration means that both sides will have more regard to their roles and functions: ministers can change the rules through Parliament; but should not bend the regulators' interventions within periods.

Restructuring and simplifying the regulatory architecture

It is not enough to put the spotlight on the increased scope of the regulatory state, and to make piecemeal proposals for retrenchment. Rather, given the political economy which pushes regulators to "do more", the design of the economic borders of the state needs something more robust and resilient. There needs to be a *leaning into the wind* of these expansionary pressures.

More radical surgery would involve merging a number of the network regulators together. They don't all need to employ consultants to separately work out the cost of capital, have separate efficiency analyses and there own separate boards and "partners" and "executives". Not only would the merger of OFGEM's network regulation with OFWAT's, ORR's and CAA's save very considerable costs, but it would also force through consistency.

Consistency has a particular great merit in this context. It undermines special pleading and the day-to-day exercises in corporate lobbying and regulatory capture. It would make political interventions and populist interventions much more difficult. The example is the CMA – neither companies nor politicians have succeeded in lobbying this single competition authority.

To these benefits can be added the impact of a lot less staff. Less staff is not just a cost reduction for the regulatory bodies, but it also reduces the burden on companies. More regulatory staff needs to be matched by more company staff. More staff does more stuff. More is not necessarily better. More staff means more interventions.

The CMA appeals - the immediate challenges

In the last couple of years, almost all utility sectors have had their periodic reviews concluded – notably for electricity and gas, water, rail and the airports. They are all different, and there is little coherence across the sectors. Some are indexed and some are not. Some have 5 year periods, and some have 8. They can't all be right, and now is the time to think hard about what happens next.

But next means when the prices are reset at the *next* periodic reviews, not tomorrow or any time that seems opportunistic between now and then. Unfortunately that is not what some of the regulators – and many of the politicians – have in mind. Jonson Cox's recent speech at the Policy Exchange in March 2015 could herald a radical departure now, not after 2020.

Matters are complicated by the multiple appeals to the CMA. Northern Powergrid has appealed against what it regards as too harsh a settlement, as has Bristol Water. There is also the new play by Centrica, challenging the DNO reviews as a whole on the grounds that they are too generous. This appeal is not based upon any damage imposed on Centrica, but because it thinks customer interests have been damaged.

The problem with the company appeals is that the CMA has to decide each on the merits of *each* individual case, and it is not really in the business of "compare and contract" or indeed recommending changes across the companies which have not appealed. This is difficult territory. Back in 1994, South West Water appealed its periodic determination, and the result was to create a glide-path for its returns. Ian Byatt followed up by encouraging the other companies to follow suit – by agreeing to "voluntary" reductions. It is hard to predict what happens this time around to other companies if the CMA finds the regulators have been too harsh or too soft in the particular cases. A deal may not be a deal.

The Centrica case raises much bigger questions. The right of third party appeals has been a contentious and much debated issue since privatisation. If companies can appeal because they think the regulator has been too tough on them, it is reasonable to argue that customers should be able to as well. But not all appeals are the same. It is one thing to argue that the regulator got something "wrong" and therefore there was an *error of fact*. It is another to open up the *judgment* of the regulator more broadly.

The irony of the Centrica appeal is that OFGEM has indexed the cost of debt, whereas OFWAT has not. OFWAT's cost of capital is wide open to challenge. OFGEM can have got the debt premium wrong, but this is a much narrower matter. The irony is further reinforced by the role of Centrica as the appellant: Centrica itself is being investigated alongside the other "big 6" companies by the CMA in relation to the treatment of customers in the wider wholesale electricity case. Would it be possible for the DNOs to appeal the outcome of the CMA investigation into the retail market if they think the CMA has not been tough enough on Centrica? Centrica is clearly not the representative of customers: but then to be fair to Centrica it is a good question to ask who is – who can claim to represent customer interests other than OFGEM, which has a statutory duty to look after them? And therefore, who can appeal on their behalf?

A fork in the road

Whatever the merits and demits of these CMA appeals, wider claims to intervene in the price caps should be resisted until at least the end of the periods. Whilst the water outcome lacks the robustness of the energy networks outcome, there are great perils in having "one-off" claw-backs now. It is always tempting to claim that at some point there are "exceptional" circumstances, as indeed Jonson Cox might argue in the highly politically charged atmosphere in water a year ago when companies "voluntarily" forewent their price increases. His intervention might have saved the industry from more overt political intervention. Yet it is not his job to shield companies from politics, but to draw a sharp line between them.

There are inescapable consequences which should not be ignored. The regulators know this, and most politicians know this too. The strategy of "Oh Lord, I know I am sinning, but I promise not to do it again" rings hollow. Once they fall for the temptation, the chances are that they will again – and again, and again. Credibility is hard to build up, and easy to destroy. Any investor in water who reflects on what happened in the last year of the previous period, and reads

Jonson Cox's two major speeches should have little confidence that the prices agreed at the periodic review will necessarily materialise over the next five years as fixed at the periodic review.

If, notwithstanding the costs of opportunism, it is concluded that it is inevitable, then there is only one way to go: give up on the incentives and go back to rate of return regulation. That way everyone would know where they stand. But there should be no illusions: such a regime would not be one conducive to incentives for efficiency, and indeed proper rate of return regulation is little different from renationalisation, and a nationalised company offering contracts to the private sector to deliver. That is what has happened already in the case of Network Rail, and the introduction of a central buyer for electricity has many of the features that the CEGB once had. The intentions of the regulators and the politicians may be benign, but they are at risk of paving the way for a return to of the state. Some might see this as a good thing, but it should not be allowed to happen by default.