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Agenda

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Best-practice principles in regulation: part 2—the regulators

In the January 2010 issue of *Agenda*, Mike Toms, Non-executive Director of Oxera, proposed a number of guiding principles for the effective management of regulation by regulated utilities. These were based on his experience as both the Regulation Director of a large company and an adviser to regulated companies. *Agenda* readers challenged him to do the same for regulators, taking account of his experience of their work, and advice given to them from time to time. The temptation proved irresistible, and what follows is a personal view of the principles of best practice for regulators

The issue

Why should regulators worry about the niceties of best practice? They are given a large amount of discretion in the way they do their jobs so long as they operate within the framework of generally accepted models of regulation (typically the building-block approach), and well-established procedural norms (from issues paper, through consultants' reports on technical issues, to draft and final determinations with consultation at each stage). Judicial review offers very limited protection to companies, and in the current climate references to the Competition Commission are likely to be contemplated only by the brave, the foolhardy, or the outraged.

So regulators have great scope to do what they want, and the old anarchist axiom that all power corrupts might be expected to come into play. However, there are very good reasons why good regulators consciously seek to conduct themselves with discipline, according to high standards of professional practice. Wilful or mercurial regulation—of which there have been some examples—can lead to loss of confidence by companies in the regulatory system. This can invite perverse behaviours, predicated on mitigating or taking advantage of the regulator's shortcomings. And most directly, regulatory processes and decisions which are inconsistent, incoherent or just plain prejudiced will unnerve investors and raise the cost of capital unnecessarily.

So what might best practice look like?

Understanding the industry

Executives often bemoan the fact that their regulator doesn't understand their industry. Normally it can be taken with a pinch of salt. Most of the UK regulators employ technical experts to engage on the technical details, and there is an understandable caution by regulators about being captured by the complexities of their industries. One of the greatest regulators of the past 50 years, Professor Alfred Kahn, confessed to regarding aircraft as no more than 'marginal costs with wings', as he boldly, and successfully, deregulated the airline industry. But there are some circumstances where the regulator really does need to understand the business.

One is in those industries where the customers are well-informed wholesale buyers. Airlines and power suppliers come to mind. In these cases both sides will advance technical propositions, especially about capital investment priorities, costs and service levels, and the regulators have to adjudicate on where the truth lies. To do so, they have to be able to judge the force of competing industry positions.

Another case is where the regulator has to make a trade-off between costs, service quality and resilience. The simple process of tightening the screws on costs has proved generally hugely beneficial to consumers over the past 20 years. However, with most of the easy gains now banked, excessive cost controls can deliver unintended consequences if companies respond by

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focusing on the regulator's formal service requirements at the expense of other softer areas. Regulators need to develop a sufficient feel for their industry to sense the likelihood, scale and nature of these accidental by-products of their decisions.

A third case is where the balance between regulation and competition is on the agenda. Regulators can often appear to assume that where there is some prospect of a degree of competition, deregulation will deliver optimal outcomes. But all markets are to a greater or lesser extent imperfect, and for regulators to understand the consequences of their actions, it is necessary to appreciate the nature and scale of the imperfections in that particular market.

Airports are a case in point. The recent decision by the Competition Commission to introduce competition into the London airports market was predicated on the basis that competition would bring forward a greater hunger from competing airports to build new runways. So far the only result from the newly separated Gatwick Airport has been an announcement that it will not be building a second runway, while both the Stansted and Heathrow runways remain bogged down, as they always were, in political, planning and legal issues which distort their markets.

Finally on this point, regulators should not entirely discount the simple and unnecessary damage to relationships caused by a manifest lack of interest in the industry they regulate. The managements of most regulated companies actually do care passionately about their business. They are frankly offended to be faced with individuals who hold great power over them and their customers but who appear indifferent to the specific challenges they face.

Open-mindedness

In criminal trials jurors are rigorously screened to ensure that they are not prejudiced before the case opens. No such safeguards are in place in regulation. Some regulators take up their posts apparently already knowing the answer.

Most price control reviews now start, rightly, with a broadly based consultation paper on the issues to be considered in the review. This is a critical point for the company. The management knows that the conclusions on this consultation will narrow down the potential outcomes massively. As a consequence, if it believes in the validity of the process it will normally invest a great deal of effort in ensuring that the review is framed appropriately. However, for some regulators this appears to be little more than going through the motions. One regulator once told me that he never consulted until he was pretty sure that he knew the right answer. Another company found itself berated by the regulator for being unhelpful, because its submission exposed a series of market imperfections which were inconsistent with the regulator's a priori model of the industry.

This presents a recurring problem: that of the regulator who consults with a firm view and then has the prospect of losing face if he or she changes that view. In fact, the gracious alteration of proposals in response to consultation actually strengthens the reputation of most regulators. The most destructive regulatory environments are often found where regulators give every sense of not listening.

Admitting to prejudices

Some regulators are of course put in place by governments precisely because they have a mission. Others enter the job with a well-advertised track record of taking a particular approach. If that is the case it is best if everyone knows about it from the start, and accepts that there are some areas where there is no point in dialogue. Regulators would do well to be as clear as they can about the limits of discussion. Otherwise companies may invest large amounts of time in trying to prove a point which is just not going to stick, no matter how well argued it is. Not only will they waste resources, but they will become disillusioned with the process at an early stage.

The early regulation of BT was a case in point. Sir Bryan Carsberg came to the job in 1984 with a well-known view on current cost accounting. He had used academic publications and industry occasions to make it clear. BT had no grounds for complaint when his regulatory determination reflected his frustration at their reversion to historical costs.

Asking the right questions

One development in regulatory practice which has addressed the points above is the trend for regulators to invite comments on specific questions in their consultation papers. Doing so gives the industry a clear steer as to what is on the table and what is not.

It is of course important to get the questions right. (An issues paper by one of the regulators, in an otherwise highly professional review, set out all the issues simply and clearly but then invited the industry to comment on only the review process and timetable.) The very process of constructing the questions is a useful discipline, and allows the respondents to flag where they are asking the regulator to open up the debate.

Treating responses seriously

It almost goes without saying that regulators need to show that they have taken the comments they receive seriously. This is undoubtedly a chore, but bearing in mind the high investment of time by companies in shaping their positions, it is critical for those companies to see that their comments have been properly considered. The practice by regulators of publishing comprehensive responses to consultations is welcome, so long as the responses do cover all the main points, and avoid being dismissive in tone.

Of course some responses will challenge the regulator's strongly held views. It is tempting to dismiss such propositions as 'They would say that, wouldn't they?' But not every challenge is made for reasons of self-interest and even if it is self-interested, it could still in fact be valid.

I have heard several times recently complaints by companies that the very act of disagreeing with the regulator has appeared to be a punishable offence. This of course really should not be the case, and the very impression weakens trust in the system, and invites gaming behaviour.

Consistency and surprises

One of the most difficult issues for investors in regulated companies is inconsistency. In making investment decisions they cannot foretell the future regulatory environment. They are inevitably largely guided by past determinations for the company, and current best practice in regulatory decisions for related industries. They face particular difficulties if they observe regulators apparently disregarding their own policies. Similarly, confusion follows when different regulators in the same jurisdiction deal with similar issues in materially different ways. There is a legitimate question about the extent to which regulators should sacrifice some independence for greater consistency. This does not mean that regulators should be totally constrained by precedent, but it does mean that due weight should be given to what has gone before, and that big changes to policy or practice should be well flagged so that markets do not suffer from shock. On two occasions I have observed a company lose £1 billion of market value in an hour as a result of an unanticipated regulatory announcement. The result of shock announcements to an unprepared market can be an unnecessary rise in the cost of capital and greater difficulty in accessing funds.

Information

A running sore in the relations between regulators and companies is the demand for information placed on companies, sometimes at short notice. This is not a complaint I am naturally sympathetic to. Regulators are under an obligation to minimise asymmetry of information, and data is one of their key tools in developing their understanding of a business. However, many regulatory reviews appear to be beset with recriminations about data, so a few guiding principles are worth considering.

- First, the earlier the information request is formulated, the easier it will be to comply, and if the regulator is looking for a time series it is always best if the data demand can be formulated before the events being measured occur.

- Second, data is usually most useful, and most easily provided, if it falls out of the company's information systems, rather than having to be manufactured to order. Dialogue with the industry before the data format is specified is likely to save a good deal of time and produce a more useful product.

- Third, the more specific the request, the more likely that what is submitted will be fit for purpose at the first iteration.

In my January 2010 article I argued that companies should start preparing for their next review as soon as they have received their price determination. In the case of information, the same applies to regulators. By the time a formal review process starts, all the information needs should have been explicit, and the timetable for submission made clear. This includes not just systematic management information but also bespoke material, such as benchmarking evidence and business plan forecasts.

Understanding the consequences for customers

When General Mengistu was the dictator of Ethiopia in the 1980s, he was reported as saying that implementing the right system of government was more important than meeting the needs of the population. In a rather less dramatic way, regulators can be guilty of devoting more attention to the processes and methodologies of decision-making than to the actual outcomes. They can be tempted to establish regulatory structures which reflect their understanding of economic principles and regulatory theory and practice, with the belief that these will lead inexorably to the best interests of end-consumers, but without rigorously testing what the actual consequences will be for those customers. The increased emphasis on constructive engagement and negotiated settlements, where the regulator may endorse a capital programme agreed between the companies and wholesale users without assessing the implications for end-consumers, illustrates this bias.

Ofwat, the water regulator for England and Wales, has met this issue head on by requiring water companies to systematically test the costs and benefits of their plans for users. While there is scope for experts to differ on the precise methods used, the general principle must be a good one, including transparency as to how regulators have concluded that their determinations best meet the interests of households and individuals.

Incidentally, Mengistu was overthrown and exiled to Zimbabwe.

Considering the long term

One area which has received a limited amount of attention is the relationship between price control periods and the long-term interests of customers. This is particularly surprising given the fixed long-term costs of many price-controlled industries, and the lumpiness of investment, which can lead to big differences between short- and long-run costs.

These features give rise to two dangers which have been under-examined: the optimal timing of investment, and the need for prices to give appropriate long-term price signals. Few regulatory determinations appear to incorporate a structured longer-term view of the industry, or to be designed to provide appropriately smoothed investment signals. Indeed, in the case of airports, regulation has gone backwards. The 2003 price determinations were based on charges to be smoothed across a ten-year capital programme, but the 2008 outcome was founded on a view of the industry focused only five years out.

Again Ofwat has grasped this issue, with its requirement that companies set their five-year business plans within a long-term strategic plan. It is, however, not clear how the short and long term were brought together in the final determination. Similarly, Ofgem, the GB energy regulator, has recognised the problem in its RPI – X@20 review, and is proposing to deal with it by lengthening the price control period and by considering the companies' historical track record for delivery more explicitly at price review.

Off-piste regulation

Good regulators take ideas from a wide variety of sources, but real distortions can occur when informal avenues of debate subvert the formal process. There are few less edifying sights than industry participants shadowing regulators on the Whitehall warm white wine circuit in the hope of bending their ears. While normal social intercourse is part of the system, the credibility of regulation is damaged where regulators allow themselves to appear to be too open to policy-making by cocktail party. This is not an argument for teetotal solitude (which I would not be qualified to make), but rather one for a measure of circumspection.

Judicial deportment

Most executives coming from a sales-oriented environment in the private sector attach huge importance to personal-relationship building. They read a great deal into the tone of their interactions with business partners. This can cause confusion in a regulated environment. If they believe they have forged warm personal relations with key regulatory staff they will expect it to show in positive results. This can lead to misplaced effort, and the consequence is likely to be disappointment. Conversely, regulators can develop confrontational personal relations with executives. I am probably not the only person who has listened to regulators making comments about individuals in companies they regulate which would not read well in print. The challenge for regulators is to project themselves as what they are: public appointees charged with operating a quasi-judicial process according to strict rules of natural justice. In that way, they may get fewer invitations to good restaurants, but they will add to their own authority.

'Victory more damaging than defeat'

There is of course one way for a regulator to avoid most of the dangers I've mentioned above. That is to be a light-touch, industry-sensitive regulator issuing determinations which give companies clear headroom to prosper in a difficult world. That is, to be soft. But this is not what companies need. Soft regulation is normally unsustainable. Generous determinations lead companies to expect the same for the future, while next-generation regulators feel bound to correct the charity of their predecessors. Much of the hostility to BAA in the last regulatory review originated in the feeling that customers had been let down by the regulator in the previous RPI + 6.5 determination. The challenge for regulators is to make determinations which will still seem to have been reasonable when their successors set off on the succeeding review.

Mike Toms

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Gunnar Niels: tel +44 (0) 1865 253 000 or email g_niels@oxera.com

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