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Agenda

Advancing economics in business

Living with price regulation: how do the best companies do it?

It is now increasingly common for sectoral regulators to review periodically their organisation and process for determining price controls. But with regulation being the biggest single determinant of profitability in most regulated industries, shouldn't companies also think hard about their management of the regulatory process? Mike Toms, Non-executive Director of Oxera, and former Planning and Regulation Director of BAA, gives his views on how regulated companies should organise themselves to respond to the regulatory process

Direct and systematic price regulation for utilities was first imposed in the UK in 1984, when British Telecom was privatised, and the first sector regulator, Oftel, was established to set price controls. Since then, regulation has spread hugely: airports, water, electricity and gas networks, air traffic control and postal services fell under the new system of RPI – X formulae. Further sector regulators were created for energy, water, postal services, rail and aviation, with an additional regional multi-sector regulator for Northern Ireland and a regional water regulator for Scotland. The Competition Commission was drawn in as an appeal mechanism for companies that felt aggrieved by their treatment, and a set of processes for conducting reviews has evolved through trial and error by regulators. All in all, about 40 companies are now price-regulated in the UK with controlled revenues of about £38 billion per year (amounting to £640 for every man, woman and child).[1]

Over this period a thirst has developed for guidance on what is best practice for companies in terms of managing their regulatory processes. How should they organise themselves? What should their priorities be, and how should they respond to the unexpected? Oxera has advised many companies and regulators on their price reviews, while until 2005 I directed the process from inside one of the UK's most controversial regulated businesses, airport operator BAA plc. The recent conclusions of the sector reviews for water, electricity distribution, BT Openreach and Network Rail have given us additional insight into what works and what does not.

Of course every situation is unique, but what follows is a set of general principles which have been seen to succeed, and a number of positions which tend to precede disaster.

The first rule: recognise the importance of regulation

The price settlement is the biggest single determinant of profitability in most regulated companies. It is therefore surprising that, in many companies, regulation is regarded as an offline activity, dealt with by the intellectuals on the fourth floor. It may not be reported regularly to the main board, and the directors are not close enough to the issues. Operations, marketing and capital expenditure are seen as much more pressing and exciting business issues. Regulation only becomes a board-level issue when things start to go wrong, and it then becomes an exercise in crisis management, rather than doing business.

In the most successful regulated companies, the chief executive takes the time to understand regulation, to develop relationships with the regulator, and to provide leadership to the regulation team before problems emerge. They ensure that there is a senior manager directly accountable for delivering the regulatory result, and that the executive team supports the regulation team and accepts its part in delivering the result.

The second rule: planning is everything

Some of the worst regulatory situations for companies occur when management is taken by surprise by the demands of a price review. Executives who enter the industry from fast-moving competitive sectors can sometimes put their faith in the light-touch model, that between reviews the company should just get on with running the business. Regulation can be left until the regulator starts the formal process. Herein lies the road to disaster: the company starts the review without a robust, regulator-friendly strategy, without a clear and tested proposition, and without the data to justify its demands. Companies in this position find themselves without a durable story: they have to make up their message on the run and they become overwhelmed by the process, with staff running around gathering data to answer questions from the regulator which could easily have been anticipated, rather than pressing home the strategy.

The most successful companies realise that a price review starts on the day the previous review finishes. In the first couple of years of the regulatory period, they take time to shape their regulatory proposition, build up disciplined and structured processes which demonstrate their managerial effectiveness, decide on the key content of their evidence base, and then collect the necessary data to produce a compelling time series. They also ensure that they are appropriately resourced and that the key staff are settled in their roles before the regulator appears.

(As an adviser, some of the most depressing calls I receive are to recommend names for a replacement regulation director for a company in difficulties while in the middle of a review. The notion that someone parachuted in to the business can rebuild its regulatory position between draft and final determinations is a victory of optimism over realism).

The third rule: regulation and strategy are the same

The most successful regulated businesses integrate their business and regulatory strategies. By this, I do not mean that they simply try to do what the regulator would have done if they were managing the business: I mean that, when they make operating and capital decisions, they should ask themselves what regulatory consequences may follow. If there is regulatory risk, it needs to be understood and managed actively. The key is to deal with this issue at the time it arises: trying to spin a story after the decision is a very high-risk approach. The Competition Commission, in particular, is quite likely to look at the record of how major decisions were made at the time. It will ask to see the company's internal papers, and is unlikely to be fooled by ex post justifications contradicted by the record.

The classic example of this is the takeover situation, where the bidder produces a business plan assuming capital and operating expenditure cuts and low funding costs, and then attempts to apply more conservative assumptions in the next price control submission.

Another case is that of efficiency: some of us can recall a regulation team struggling to persuade a regulator that their company has little scope for cost savings when their chief executive had told the trade unions publicly that they were massively inefficient.

The fourth rule: technical mastery is money in the bank

The greatest strength of the regulated company is its superior knowledge of the business. Regulators know this, and it fuels both a healthy scepticism of anything companies say, and a will to challenge everything the company submits. Realistic managements just have to live with regulatory scepticism—it is healthy, and regulators would be failing in their duty if they took managements purely on trust. For this reason, a smart management makes sure that it speaks with authority and command of the detail on all its business issues. Each submission will be crawled over by the regulator's analysts, who are employed to unearth poor or conflicting propositions. The company has to survive testing both by the regulator and potentially by the Competition Commission. The demand forecasts have to be robust, the cost–benefit analysis has to be solid, and the benchmarking has to cover all the angles. Every time the regulator finds analytical flaws, the company's credibility is damaged, and every other number is weakened. No company survives testing totally unscathed, but maintaining a reputation for robustness is a key factor in success.

This might seem an obvious point, but I have been surprised at how often a company's propositions have collapsed under quite light testing. Usually, it reflects a failure by the Executive Team to establish their own quality standards with their technical staff, and a disinclination to spend time on the detail. In my experience, a great deal of credit is earned with the regulator by directors who can show that they understand their own case in some detail. Conversely, a management which cannot meet basic technical challenges to its evidence in a regulatory hearing is unlikely to get what it wants.

The fifth rule: beware the soundbite

It is not unknown for chief executives to believe they are demonstrating leadership of regulation by building the company's thinking around a few simple truisms. This can be good or bad. Sir John Egan at BAA was extremely successful in reducing a complex point to a few compelling words appropriate for a chief executive. Others start by asserting a common-sense statement, which actually bears no scrutiny by regulators. 'This settlement is bad for customers' sounds straightforward, but it often turns into 'the settlement is bad for shareholders' under the regulatory magnifying glass. In the best companies, the chief executive encourages their own views to be challenged by their team—better that than to be embarrassed at a hearing.

The sixth rule: get onto the regulator's agenda

In competitive businesses, companies always focus on what the customer wants. In regulated businesses the regulator stands in the place of the customer. Most regulators have their own missions: outcomes they want, in terms of either the ultimate delivery of services by the industry, or how the regulatory system itself evolves. Smart executives manage this situation. Without sacrificing their own responsibility to make good decisions, they try to frame everything they do in terms of helping the regulator to achieve their goals, often by using the regulator's own language. Regulators would not be human if they did not look kindly on companies that set out to help them achieve their own objectives. The company may feel significantly 'soft' benefits in terms of the regulator's disposition towards it, which translates invisibly into hard cash.

The examples of very best practice involve those companies which do more than follow the regulator's agenda; they help to shape it, by engaging the regulator in their own thinking. This, of course, is only normally effective before the formal process starts. By the time the review is under way, the regulator's constructs will already be framed.

The converse is also true. Companies which adopt an agenda manifestly in conflict with the regulator will have difficulty, and that difficulty becomes exacerbated if the company fails to realise when it is time to shut up. I can freely plead guilty to refusing to let go of points which had been lost, and re-stating cases which had been rejected. It never did me any good—and in at least one case, did a good deal of damage.

The seventh rule: it's not a negotiation

This misunderstanding is endemic in executives who are new to regulated businesses. They believe that, in the end, regulatory settlements are achieved by give-and-take, and closed with a phone call or a handshake across the table. Some even believe in holding back 'the chairman's sixpence': the last small concession to seal the deal. This may indeed be true sometimes, but it is not a sound basis for planning. The simple reason is that the company has little negotiating power—ultimately the regulator will make a determination, not strike a deal. Best practice is therefore found where companies understand that at the core of regulation is an evidential process—and the best tool for success is good evidence.

The eighth rule: life's not fair

Many executives have an understandable belief that regulators should aim for a 'fair' or equitable result, in which both customers and the company share in the outcome. This tends to lead to anger and frustration which can then taint important relationships. Our advice to companies is normally to get this notion out of their heads as soon as possible. Regulators have no duty to be fair: their duty is normally to see that the customer pays no more than is necessary for the regulated service. Regulators measure success by how far they can push down prices, and the company's challenge is to argue this number upwards—a point I return to below.

The ninth rule: appeals to a greater authority

Companies under regulatory stress look for friends, or to others who will fix the regulator for them. Typically they go to the minister, or they talk to the press, or threaten the regulator with the courts. This strategy is akin to tiptoeing through a minefield. Clearly, it helps to have friends, and for other participants in a review to be supportive of the company's position. But asking the government or the media to force the regulator to change their mind is fraught with danger. Regulators rightly guard their independence and do not welcome interference from the government. In fact, this behaviour tends to annoy them, with obvious implications for the company's standing. There have been cases of successful political intervention, especially outside the UK, but they do not make a reliable basis for regulatory strategy, since the long-term fallout will be significant (and the government will extract its own price for its support).

Appeals to the media are even more fraught. There is no natural love for privately owned utilities, and the press do enjoy a good row. Public regulatory disputes are rarely positioned on the company's side, but they do, dangerously, push the regulator into a corner—which makes it more difficult for the regulator to compromise at a later date. Managements are probably best advised to think of price reviews as like dancing to old Rolling Stones songs—best done in private.

Threats to go to law, or appeal to the Competition Commission, are the staple diet of regulation. Regulators expect threats, and very few are intimidated by them. Usually, they peter out, leaving the regulator strengthened. In particular, the threat of judicial review is often made without companies realising how narrow the grounds are, and how unsatisfactory the results will be.

Of course, in some cases recourse to law does work. In the 1990s, Northern Ireland Electricity overturned a regulator's decision at the Monopolies and Mergers Commission and in the courts. BAA has just disrupted implementation of its break-up requirement at the Competition Appeal Tribunal. If legal action looks likely, companies will maximise the opportunity if they make sure their own house is in order—they can be undone in a second by a 'smoking gun' internal paper—and issue the threat, so that it does not simply act as an early reminder to the regulator to tidy up its own position.

There is one greater authority who will weigh heavily with any good regulator—the customer. Any company which can show it has its customers' goodwill, and even their support, is hugely strengthened. No company can afford to enter a review without showing that it has energetically and systematically listened and responded to its customers' priorities. But the distinction needs to be made between real, rooted goodwill, and superficial messages spun by the company in the course of a review. Any impression of glibness concerning its customers is extremely damaging.

The last rule: don't cheat

With large amounts of money at stake, there is always a temptation to bend the rules or to fix the figures. This could manifest itself in misreporting performance, or in operating to a business strategy at odds with the submitted plan. Maintaining concealment for the two years of a review is almost impossible. A manager makes an unguarded comment in a meeting with the regulator; a disaffected staff member blows the whistle; and the Competition Commission issues a legal demand for internal papers. The scope for embarrassment is huge, and the consequences are dire. The company's credibility is lost and can take years to recover.

Conclusion: the promise and the threat

Rising above the practicalities, the regulation process is very simple. The company is asking the regulator to give it someone else's money. The regulator will not wish to give any more than they have to—no regulator will earn a knighthood or a Harvard chair for being soft. So the company has to make a very straightforward case on two points:

- what good things will only happen if the right price settlement is granted;
- what bad things will happen if the regulator gives less?

I am continually surprised at how little attention these two questions receive from many companies, since they are at the core of a good outcome. Quite often, managements rely on motherhood statements about the benefits they can deliver with the right result, and the losses to consumers from a bad result are often couched in very general terms supported by patchy evidence.

Finally, a word on gaming. In my years as an executive I was occasionally complimented on my regulatory gaming skills. I took this badly. The principles I have described above are not gaming. They are just good management. Gaming is not unknown among regulators, but no one is going to punish them for it. For regulated companies, it is a normally a waste of time. Attempts to outflank the regulator—or worse, the customer—are fully expected and rarely go unnoticed. They normally succeed in damaging the reputation of the business. The key to success is in good planning, strong evidence and realism.

Mike Toms

[1] This represents the amount of annual revenues allowed in the regulatory determinations currently in force in the energy, water, aviation, rail and telecommunications (BT Openreach) sectors. Source: regulatory determinations.

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

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