

Agenda

Advancing economics in business

The role of government in GB network regulation: is independence under threat?

The role of government in the regulation of GB network utilities is changing. What are the drivers of this change, and what form is it taking in different sectors? Finally, what are the possible implications for the future of network regulation?

Greater prominence is being afforded to government policy in Great Britain in the utilities sectors to address a wide range of issues which may not be adequately tackled within the current framework—eg, security of supply, carbon emissions and affordability for vulnerable consumer groups. The 2009 Budget also announced a review of the powers and duties of Ofcom, the communications regulator, to 'ensure that it can strike the right balance between delivering competition and promoting investment'.¹

These changes are occurring because of fundamental reviews of economic regulation in particular sectors (such as Ofgem's 'RPI – X@20' review in the case of energy markets and the Department for Transport's (DfT) review of the regulation of airports²), as well as through broader developments that are reshaping the interaction between regulator and government. The ultimate outcomes of these changes will be driven by the evolution of the role of government, as well as by the continuing and emerging interaction between competition and regulation.

This article looks at the types of change in government involvement that are being considered or are likely to occur, the provenance of these changes, and the possible implications for network regulation. It begins by discussing some of the main changes that are taking place in regulated sectors.

The changing role of government

An example of the changing role of government in regulation is the DfT's proposals for the duties of the Civil Aviation Authority (CAA), which will require, if enacted, the airports regulator:

to take account of guidance issued by the Secretary of State, and to assist in delivery of airport infrastructure consistent with the National Policy Statement on Airports unless there are compelling reasons not to do so.³

The requirement to take account of guidance from the Secretary of State is a duty to which other UK sectoral regulators are typically already subject, but this is a new duty for the airports sector, as is the duty to assist in the delivery of infrastructure to support government policy (through the national policy statements⁴).

In the energy sector, Ofgem's RPI – X@20 project is considering whether an expanded role for the government in the regulation of these networks may be appropriate; the possibility of a 'guiding mind' defining the future of energy network outputs is likely to be one of the options considered as part of Ofgem's ongoing evaluation of different regulatory models.⁵ One version of such a guiding mind could be a model of energy regulation, involving an active role for government in prescribing network development that expands the scope of regulation to which these networks would be subject, and the agreement on a rolling basis of network capital expenditure between government, the regulator and the network companies themselves.⁶

The Energy Act 2008 increased the emphasis of Ofgem's statutory duties on 'sustainable development' (Section 83), and made more explicit the duty to future consumers. The interests of future consumers may be best protected by government since this group of consumers has, for obvious reasons, limited opportunity for self-representation. Other notable developments in the energy sector that indicate a change in the role of government in regulation include the practice of certain projects being undertaken jointly by Ofgem and government departments—a recent example being the Transmission Access Review (Ofgem alongside the Department of Energy and Climate Change, and previously with the Department for Business, Enterprise and Regulatory Reform (BERR)).

The 2008 'Hooper review' of postal services reaffirmed the importance of the universal service obligation

(USO), while at the same time recommending that part of Royal Mail secure a strategic minority partnership with a privately owned postal operator, and that the government take over responsibility for reducing Royal Mail's pension deficit.⁷ Furthermore, the government has accepted the review's recommendation of transferring regulatory power from Postcomm to Ofcom, partly as a reflection of the challenges faced by Postcomm in discharging its duty under the Postal Services Act 2000.

Two recent inquiries into different aspects of the water industry in England and Wales suggest a changed role for government in that sector. The failure of competition to develop, as reflected in the low rates of customer switching, was one of the motivating factors in the Department for Environment, Food and Rural Affairs' 'Cave review', which has recommended changes to legislative and regulatory frameworks to deliver the benefits of competition, contestability and innovation throughout the water and sewerage supply chain.⁸

The Environment Agency's recent publication of its water resources strategy for England and Wales also points to long-term changes in the structure of the industry, including the means by which water resources are allocated, in order to promote greater resilience within the industry to the pressures of climate change and growth in the demand for water.⁹ Different options for licensing and allocating water resources are under consideration, which could involve attaching different priorities to different water needs.

These water sector inquiries do not in themselves necessarily indicate a change in relationship between government and regulator in the fashion implied by the DfT review of airports and elements of Ofgem's RPI – X@20 review. However, they do confirm the important role played by government in the water sector, while the Environment Agency's strategy could plausibly lead to a greater ongoing role for government in network regulation in order to secure better coordination and resource allocation in light of the future challenges identified. Similarly, the prospects for continued government intervention in the postal sector, and the concomitant implications for regulation, appear to have been strengthened following the report of the Hooper review and the Postal Services Bill.

The changes reflecting the evolving policy agenda differ across sectors, and may be characterised as follows. In some sectors, such as airports, there is an explicit mandate and reform agenda that will reconfigure the structure of the entire industry on its completion. These changes appear to have been driven by concerns over the failure to deliver new capacity. In the energy sector the prospect of more renewables capacity and security of supply, and the need to change generation mix, may be seen as core drivers. In other sectors, such as water, security of

supply and carbon issues have also become important, although the changes in the short-to-medium term are more likely to be incremental in nature and to focus on bringing more competition into various parts of the value chain.¹⁰

Having reviewed some of the main changes that are occurring, or that may occur, what are some of the drivers for these changes in the fundamental rationale for the existence of independent regulators?

Governments and regulatory authorities

Government influences every sector of the economy. In most cases it is understood that this influence is not intended to be the defining feature of the sector concerned: instead, the role of government is to develop and maintain the institutions that support the operation of the market economy. In these sectors, it is accepted that the interests of producers and consumers are largely aligned and the operation of competition can be expected to increase welfare overall.

However, in the utility sector, extensive government involvement is the norm. It is a well-understood and accepted proposition that the economic characteristics of network monopolies—particularly monopoly power—require government intervention in order to correct the market failures that would otherwise arise. Since the privatisations of the 1980s and 1990s, independent regulatory authorities have been created to oversee those parts of the market that, for one reason or another, cannot be exposed to competition, while liberalising other parts where competition can function.

If privatisation was intended to address the problems of inefficiencies through the imposition of commercial incentives, it left unresolved the precise way in which government ought to prescribe how an 'independent' regulator, the creation of which was necessitated by the act of privatisation, should address the market failure of monopoly power.¹¹ The delegation of authority to a stand-alone regulator is a complex exercise in contract design, requiring an understanding of how the principal-agent relationship between the government and regulator can best be sustained in the face of potentially conflicting objectives and the inevitability of incomplete contracts in a world of imperfect enforceability. This has been an ongoing debate since privatisation. A 2007 House of Lords report on UK economic regulators considered how this exercise might be undertaken, and concluded that:

Independent regulators' statutory remits should be comprised of limited, clearly set out duties and that the statutes should give a clear steer to the regulators on how those duties should be prioritised.¹²

While this is clear and reasonable in theory, the reality may be different, reflecting in part the different motivations of governments to delegate responsibility to independent regulatory authorities, and the type of complexities that are inherent in any principal–agent approach, including the following.

- Resolution of commitment problems: independent regulators may enhance the credibility of decision-making in a way that is less easy to secure when decisions are made under the intrusive aegis of a government department. Commitment can also protect against short-term political decisions.
- Independent regulators can develop technical expertise both in terms of the details of the industries they oversee, and in governance and regulation.
- Rule-making and efficiency may be enhanced under delegation to a dedicated, independent regulator, with the government (as the principal in the relationship) setting and defining the general terms of policy.
- Independent regulators allow governments to avoid taking (all of) the blame for unpopular policies.¹³

Nevertheless, governments generally retain a measure of control over independent regulators, so that in practice ‘independence’ is a matter of degree. This is the case in a number of EU countries where governments share a degree of responsibility with independent regulators. In the UK the statutory provisions governing the behaviour and responsibilities of sectoral regulators typically allow the Secretary of State significant powers of intervention. This joint responsibility may be rationalised in part by theories that suggest that having more than one ‘regulator’ (in practice, if not in name) can help guard against regulatory capture.¹⁴

The discussion above shows the inherent complexity of the internal organisation of government; nevertheless, it is in this complexity that the drivers of change in the government’s approach to independent regulation must be identified.

Drivers of change

What explains the changes in governmental involvement in regulation, and more particularly, the apparent reversion to an environment of greater direct involvement that had largely been abandoned following privatisation in the industries concerned? The contributing factors include the following.

Inadequacy of existing mechanisms

One motivation for a changed role for government may be that, in one sense or another, the existing mechanisms that define the operation of independent regulators are not fit for purpose. A criticism levied

against the system of guidance provided by BERR to Ofgem was that the intended spirit of guidance itself could, in practice, be ignored by the regulator despite the requirement of the regulator to take account of this guidance under the Utilities Act 2000. For example, the guidance that existed prior to the Energy Act 2008 (which dated from 2004) assumed no conflict between repressing retail energy prices and supporting the development of renewable electricity, rendering as questionable its practical usefulness.

In the airports sector, there is a regulatory ‘gap’ with respect to government policy, leading to the situation in which the independent competition authority (the Competition Commission) concluded that the government’s own aviation policy (including its support for runway development at Heathrow and Stansted as set out in the 2003 Aviation White Paper¹⁵) was a factor that distorted competition in the market for airports.¹⁶ The lack of obligation on the airports regulator to deliver the government’s aviation policy was reflected in its lack of support for the development of runways at these airports, leading to inadequate capacity in the south-east that appears to have been, at least in part, an implicit motivation for the government’s review of the economic regulation of airports. The policy response has been a proposed duty on the airports regulator ‘to assist’ in the delivery of government policy.

There may of course be many specific reasons, beyond conflicting views of what capacity ‘should’ be delivered, which can influence investment in new capacity. These may include factors such as commercial risks (eg, if a private owner bears stranding or volume risk as a result of changes in the market environment or future changes in government policy); the limitations of the current regulatory structure, typically characterised by five-year price controls and limits to what regulators can credibly commit to in terms of future recovery of investment; and uncertainties or delays due to the planning process.

The manner in which regulators interpret their statutory duties has also been an issue in the water sector, and was one of the motivations for the Cave review of competition.

Complexity of objectives

The mandate faced by most regulators in the wake of privatisation was relatively straightforward, with a clear emphasis on efficiency and cost reduction, to be achieved, in most cases, by the pursuit of competition. As industries have matured and regulated charges have been driven down to average cost, new and more complex concerns have emerged, which have often been in conflict with the pursuit of competition.

The need to protect the universal service in postal services, while still supporting the development of

competition, is a prominent example. The need to address concerns such as fuel poverty and security of supply in the energy sector provides a further set of examples of the requirement to reconcile competition with new policy concerns.

More generally, wider policy concerns have emerged. For example, the increasing complexity of energy policy was noted by the government, which has suggested that future energy policy would not necessarily be based on a ‘markets-only approach’, but would instead be based on ‘strategic government and dynamic markets’.¹⁷

Emerging competition, technological change and other market developments

The nature of markets subject to ex ante price regulation has changed since privatisation. Levels of competition (bolstered by the introduction of an explicit use of competition law) and technological developments have changed the economic case for such intervention, at least in some markets (particularly telecommunications).

Technological developments should be accommodated by the regulatory regime where there is a case for these developments to support the interests of consumers. Innovations such as smart metering could, in principle, exert a fundamental influence on energy and water networks over the long term. These types of innovation may require changes to the overall structure of regulation that could not have been foreseen at the time of the original regulatory framework.

The emergence of competition itself has been an important theme in many sectors, including airports and postal services, leading to changes in the market power of airports that are designated for price regulation under the Airports Act 1986, and market pressures on Royal Mail’s ability to fulfil its USO.

The politics of blame

Casual empiricism suggests that governments cannot completely insulate themselves from the attribution of blame that is generated by public dissatisfaction with the standard or cost of services provided by regulated industries. As one of the motivations for delegating authority to an independent regulator, this lack of protection from public grievances may incentivise governments to intervene directly in order to secure outcomes consistent with a populist agenda— notwithstanding the long list of ‘wins’ that have been secured by network regulation since privatisation, including reductions in operating costs on the part of the networks themselves, and a history of reliability in supply and improving quality of service in most cases.

Implications for network utility regulation

The box below identifies some possible advantages and disadvantages accruing to the public interest of greater government involvement in network regulation.

The extent to which the balance between these advantages and disadvantages is determined remains to be seen—however, greater government involvement, and, in particular, prescription of the outputs that ought to be produced by networks, will change the nature of regulated businesses. Such prescription could conceivably change the nature of the network businesses concerned, so that they would primarily act as passive responders to central government diktat.

This would have implications for the returns that could be secured from investing in these networks, as well as the extent to which network companies can innovate and use discretion to respond to their changing circumstances.

Possible advantages and disadvantages of government involvement in regulation¹

Advantages

- Reduced regulatory risk to network utilities because of a clearer mandate from government than under the status quo, reducing the risk that regulators will subsequently appropriate sunk investment.
- Refinement of guidance mechanisms and greater clarity for regulator as to how to interpret the substance of government policy.
- Clearer understanding on the part of network companies and their users as to the outputs that are to be delivered by regulatory settlements.

Disadvantages

- Increased risk of ‘government failure’ alongside ‘market failure’, with interventions having unintended consequences and negative implications for regulated networks and their users.
- Long-term undermining of independent action, with political interference and short-term intervention becoming common.
- Moral hazard problems as government is expected in some capacity to ‘bail out’ network utilities.
- ‘Chilling effect’ of intervention on regulatory innovation and efficient risk-taking on the part of regulated companies.
- Greater risk of internal conflicts between responsibilities of different agencies.

Note: ¹ Subject to the type of involvement.
Source: Oxera.

Conclusions

This article has explored how and why government involvement in network regulation is changing. The ultimate implications of this changing involvement will differ between sectors, and will depend on the type of interventions proposed as well as the policy problems and economic characteristics of the sectors concerned.

One possible perception from recent developments is that 'independence' is all very well, provided that it delivers the outcomes that governments—and their

electorates—desire. A less instrumentalist conclusion may be that governments, like network companies themselves, are doing as much as they can to respond to new political and economic agendas, technological development and the need to respond to a complex and occasionally conflicting set of objectives. More generally, greater activism at the European level in enforcing competition law, and trends towards tighter regulation in certain sectors, may be part of a broader movement towards closer government scrutiny and involvement in the business of 'independent' regulators.

¹ HM Treasury (2009), 'Budget 2009: Building Britain's Future', April 22nd, para 4.41.

² Ofgem (2009), 'Regulating Energy Networks for the Future: RPI – X@20: Principles, Process and Issues', February, p. 39; and Department for Transport (2009), 'Reforming the Framework for the Economic Regulation of Airports', March.

³ Department for Transport (2009), op. cit., p. 63, para 6.8 (iv).

⁴ The government proposes to introduce a system of national policy statements, which would establish the case for infrastructure development, and set a policy framework for planning commission decisions. See <http://www.communities.gov.uk/documents/planningandbuilding/pdf/320282.pdf>.

⁵ Ofgem (2009), op. cit.

⁶ Helm, D. (2008), *Credible Energy Policy: Meeting the Challenges of Security of Supply and Climate Change*, Policy Exchange: London, pp. 41–45.

⁷ Department for Business, Enterprise and Regulatory Reform (2008), 'Policies to Maintain the Universal Postal Service in the United Kingdom: An Independent Review of the UK Postal Services Sector'.

⁸ Cave, M. (2009). 'Independent Review of Competition and Innovation in Water Markets: Final Report', April.

⁹ Environment Agency (2009), 'Water for People and the Environment: Water Resources Strategy for England and Wales', March.

¹⁰ This is not to mention the change in government intervention contained in the July 2004 White Paper, 'The Future of Rail', in which the government announced that it would take charge of setting strategy and policy for railways, including the outputs that public expenditure for railways would buy. This was put into force by the 2005 Railways Act.

¹¹ Notwithstanding the fact that privatisation per se does not necessarily imply independent regulators.

¹² House of Lords Select Committee on Regulators, (2007), 'UK Economic Regulators', Select Committee on Regulators, 1st Report of Session 2006–07.

¹³ See Thatcher, M. and Stone Sweet, A. (2002), 'Theory and Practice of Delegation to Non-majoritarian Institutions', *West European Politics*, 25:1, pp. 1–22.

¹⁴ See Laffont, J.-J. and Martimort, D. (1999), 'Separation of Regulators against Collusive Behaviour', *RAND Journal of Economics*, 30:2, Summer, pp. 232–62.

¹⁵ Department for Transport, (2003), 'The Future of Air Transport', December.

¹⁶ Competition Commission (2009), 'BAA Airports Market Investigation', March.

¹⁷ 'The Rise and Fall and Rise Again of a Department for Energy', lecture by Ed Miliband, Secretary of State for Energy and Climate Change, Imperial College, London, December 9th 2008.

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

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