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Best practice for price-controlled companies: business plans and bidding

In 2010, Oxera Non-executive Director, Mike Toms, wrote a series of Agenda articles setting out principles for best practice for regulated companies in price reviews, based on his long experience and observations as a regulation executive. Since then, he believes that companies have become better organised and regulators more sophisticated. New issues have arisen, and excellent examples of best practice have emerged—but also new mistakes. He now asks: how should these guiding principles be revised and expanded?

My original ten principles for best practice in price control regulation were as follows.

1. Make sure the whole company understands **the importance of regulation**—it is probably the biggest driver of profit, and a good outcome depends on all the management pulling together.
2. **Planning** is everything—start preparing for the next review a fortnight after the previous determination is issued. (Why a fortnight? Everyone needs a holiday after a review!)
3. **Integrate** business strategy with regulation—understand that your business and commercial objectives and decisions will have big consequences for your regulatory prospects, and vice versa.
4. **Technical mastery** is essential—use and display the fact that you know more about your business than your regulator. The objective is not to deceive, but to impress with your focus and tight control, and make the regulator trust your competence and fear the result of gainsaying you.
5. Go easy on the **soundbites**—regulation is complicated, and it is not helped by reliance on simple aphorisms. As an example, the line that any price increase would be 'good for customers' just looks facile unless the more specific reasons are compelling.
6. Get onto **the regulator's agenda**—try to make what you want fit into what they want, preferably in their language.
7. It is **not a negotiation**—the regulator has all the power. This is discussed further below.
8. **Life's not fair**—and regulators will not normally feel any obligation to be considerate to you.
9. Don't rely on **appealing** the regulator's decision—you might have to do this, but it is hugely expensive and time-consuming, and frequently backfires.
10. **Don't cheat**—you will probably be found out and, if you are, the damage will be massive.

Nothing I have seen in the last four years would make me want to scrap any of these principles, but watching companies prepare their regulatory business plans has made me want to add a few more.

The business plan submission is probably the most important single piece of work that a company will undertake in a review. Although regulators hate the expression, and despite the move in UK regulation towards getting customers to 'sign off' key elements of the plan, the business plan undoubtedly represents the company's bid for the price settlement. A company that gets this right has already staked out safe ground and effectively closed off the worst outcomes; a company that gets it wrong may well have lost its credibility and leverage over the process at the very start.

This brings me to the first rule: the process is about **persuasion, not negotiation**. I have found myself in the boardrooms of companies where the CEO has instructed that the business plan should ask for the highest possible settlement, on the basis that this will somehow frame a zone

of negotiation within which the regulator has to work. It is rarely like this. The regulator is under no obligation to have the outcome limited by a company's tactics. If the business plan is too obviously a highball bid, the most likely result is that the regulator will simply disregard the company's views from the outset, and make it more difficult to make any later submissions stick, even where they are better founded. This problem is not fanciful—there are some very good, or indeed bad, examples of it around.

This is not to say that a submission should not show some ambition—after all, the regulator is almost certainly going to take something out of it—just that it needs to be credibly within the zone of possible outcomes, not off the top end of it. The challenge is then to make the numbers persuasive.

An associated rule is **realism in the details**. There is no point proposing something that can be underpinned by a wall of obscure technical advice if it flies in the face of established thinking. Just for the sake of illustration, if the prevailing wisdom at the time of the submission is that regulated utilities' cost of capital is around 5%, arguing that your company needs 8% is likely to be ineffective and credibility-destroying unless you have a simple, clear and killer argument about why your risk is so much greater than everyone else's. It might be better to argue for something less ambitious, with a more solidly and broadly based case.

One of the regulation team's biggest problems in assembling the business plan is **internal bidding**. Where business plans are compiled from the plans of individual departments, the results can be inconsistent. (I have seen two departments submit business plans to the same management using widely different assumptions about volume and staff pay.) Departmental managers often have an incentive to bid up their staff needs, CAPEX requirements, etc. in the hope that the company's board will sign off something that is easy for them to outperform. To avoid this, the top executives and the regulation team must give departmental heads clear and consistent instructions about the assumptions to be used and the tenor of their projections, and the regulation team needs to be empowered to challenge the bids it receives.

It is now generally accepted that one of the preconditions of a good outcome is that the company can prove that it has involved its **customers** in the business plan. There have been some great examples of this, notably in the water sector. Unfortunately, on other occasions it has sometimes looked more like box-ticking than true engagement. The best companies have shown their commitment to customers by building customer research and engagement into their normal business processes, rather than by waiting for a price review. These companies have also shown that they ask customers not only about their wish lists, but also about the price–service trade-off, and that they respond to the views they receive when they create their plan.

Companies often think that a business plan built up from fine detail will be difficult for a regulator to dispute. In practice, regulators will not let themselves be forced into second-guessing a myriad of operational projections. They will probably focus on the detail in a few sensitive areas, but their main activity will be to subject the plan to high-level benchmarking, often using consultants. A smart company anticipates this by **testing the plan** with these tools before it is submitted. How does efficiency compare with other companies, and is the rate of improvement consistent with history? If this work throws up discrepancies, the company can strengthen its position, by either adjusting its forecasts or preparing a compelling explanation of the differences. Then, when the regulator's challenge comes, it will be ready to respond.

This brings me to the point that a price review may be **a voyage of discovery** in the legal sense of the word. Most regulators have wide-ranging powers to seek, or 'discover', the internal documents of regulated companies. Concealing such documents is often a criminal offence. It is therefore important that, if and when such a request arrives at the office, there is nothing in the files that would suggest that the figures have been manipulated in any way, or that the company has another, more bullish, plan in the Finance Director's drawer. This should not really need saying, but it does happen, and when it does, the fallout is considerable. It is not just confined to the numbers: I have witnessed a company being put on the rack for an ironic comment about a thoroughly undeserving customer pencilled in the margin of an internal memo.

In the end, the point of the business plan is to **justify a proposed level of prices**. In many cases, at the first iteration the plan is likely to show the need for an increase in prices. At this stage the company needs to step back and ask itself a layman's question about how likely it is that a regulator will contemplate increases on the scale proposed.

In general, regulators are not rewarded for increasing prices, so the company needs to ask itself at a high level whether an outcome close to the bid is a real prospect. In doing so, it will want to consider not just the regulator's disposition, but also some contextual factors. Does the company have good standing? Are its prices already controversial? Is it cheap by the standards of its industry? Are there special factors such as major essential investment? If these considerations are helpful, they may need to be spelled out. If they are not, the company may want to revisit its plan, possibly by cutting softer elements of CAPEX or OPEX.

It is probably better to do this internally than have the regulator do it for you. There is a contrary argument that this kind of cutting can take place at a later stage, when the regulator's position is clearer. But the later it is left, the more difficult it will be to cut, and the cuts may not come in the areas that the company would choose. When a company responds to a low regulatory proposal by threatening CAPEX cuts (for instance), there is a real danger of a spiral of downward bidding, where the regulator responds with either a further cut in the price proposals or licence conditions to enforce spending. Either way, there is likely to be relationship damage.

Adopting these principles should improve the company's chances of achieving a bearable outcome in a price review. However, it does not guarantee a result. Even with a finely honed and robust business plan, well communicated by a management passionate about its customers, a regulator sometimes produces a price proposal that is frankly hostile. Regulators are human, with the full range of human frailties. Then, of course, there are the politicians, somewhere in the shadows. So the final principle has to be that **managements should not always blame themselves!**

Mike Toms

This article follows on from Toms, M. (2010), 'Living with price regulation: how do the best companies do it?', *Agenda*, January, and Toms, M. (2010), 'Best-practice principles in regulation: part 2—the regulators', *Agenda*, May. The views expressed in this article are those of the author alone.