

# Agenda

## Advancing economics in business

### New rules for good regulation

**How has regulation changed in the last six years? Oxera Director, Mike Toms, looks back at recent regulatory developments, and considers how his advice to company executives might now have a different focus in terms of markets, customers and regulators**

In 2010 I used the pages of *Agenda* to propose some points of guidance for the executives of recently privatised companies in getting the best out of regulation. These were provoked by my own experience as a regulation director, and then as the chair of a substantial utility, as well as the advice I had provided to regulated companies in the UK and elsewhere.

Looking back on this now, I like to think that most of it was sensible and enduring; but of course the world has changed. At that time, price control—RPI - X—was the almost universal focus of regulation, and the big gains for companies were to be had in achieving a good settlement of the value of X. And all was still to be played for in the calculations. Methodologies were still evolving and the weight of precedent had not yet narrowed down the range of outcomes.<sup>1</sup>

Now, six years later, the emphasis has changed sharply, and the priorities of companies and their regulatory directors have shifted. With this in mind, I would like to add some new priorities for those trying to navigate the regulatory minefield. I apologise at the outset to those experienced practitioners who will probably regard these as self-evident, but there are still managements and boards that have not fully grasped the opportunities that might be there to be taken.

#### It's all about markets...

The first, and most important, of these is to really know your market, not just intuitively but also analytically. Why? The biggest gains for companies over the last five years have been won not through good price settlements, but by using market analysis to argue successfully for the scope of price control to be narrowed, and the form of control to be loosened. Airports, postal services and telecoms have all seen significant reductions in the coverage of price control, but there are more areas where the potential still exists. For those that have been liberated, there is the need for continued alertness to the danger of creeping re-regulation.

One key is to be able to demonstrate that the company's products can be unbundled so that parts of the offer can be sold in a market where competition with other providers will naturally constrain prices while delivering adequate levels of service. Another is to be able to demonstrate that recent and current company behaviour has been constrained by competition, even where price control exists.

In many cases, companies will be knocking on an open door. Regulators have a self-deprecating view that their own decisions will be inferior to those of the market, even where it is imperfect. They have an understandable predisposition to prefer competition to control, and will welcome a well-made case. But the case still has to be made; assertion will not be enough. To do this, companies need to deconstruct their total product offer, and gather robust data on present and future levels of competition for each segment. Realistically, analysis may demonstrate that competitive forces are strong, but fall short of the full force of perfect competition that would allow a regulator to step back and rely solely on the market. Some regulators may be prepared to take the risk of suboptimal outcomes on the basis that they will be less suboptimal than regulation, but others may insist on the inclusion of additional behavioural controls in the regulatory package to protect consumers.

This requires another level of market understanding and analysis, and an ability for companies to design and propose controls that satisfy regulators, rather than sitting back and relying on measures designed by the regulator. An upfront offer of, say, improved transparency, governance or ring-fencing may produce a more palatable outcome than a series of checks and balances designed by the regulator. The danger of not being prepared is that the company can end up with behavioural controls that are, in effect, as onerous as direct regulation. The best companies will have proposals of this kind ready to table when they first launch their bids for freedom from the chains of price control.

## ...customers...

Of course the key to markets is customers, and it is the interests of customers that should lie at the heart of good regulation. Companies have the choice of a compliance-based approach to customer service, based on doing what regulators tell them must be done, or a proactive approach. The smartest companies don't wait for regulatory instruction, but actively pursue better understanding of the customer's preferences so that they can approach any regulatory investigation able to show that they have already effectively self-regulated. Investment in this area can buy a disproportionate amount of regulatory goodwill. The England and Wales water industry is a case in point.<sup>2</sup> Looking back over the last three regulatory reviews, I hazard the opinion that those who designed and built high levels of customer awareness into their strategies voluntarily outside and in advance of the regulatory process have been rewarded with intangible but valuable regulatory goodwill.

There are two important caveats to this point. It's not about PR and having a great strapline. And it's not about promising very high levels of investment and customer service at the expense of very high costs. It's about showing that the trade-off between cost and service has been made at the point that best reconciles differing consumer preferences. Again, it is not about assertion, but about genuine engagement with customers supported by rigorous analysis.

For a number of years there has been an anomaly in relation to those industries where the regulated company is selling its service to intermediate customers, rather than to individuals. Airports and air traffic controllers selling to airlines rather than passengers; electricity generators selling to suppliers rather than households; and UK infrastructure manager, Network Rail, selling to train operating companies rather than rail travellers are cases in point. Regulators have had a tendency to judge the effectiveness of the market in terms of whether the regulated company has engaged effectively with its direct commercial customers, rather than validating the ultimate effect on retail customers. I sense a growing awareness from regulators that this kind of 'constructive engagement' between the big commercial players cannot always be relied on to deliver for the public. UK air traffic control services provider, NATS, has recently been required to collect better data on the effects of air traffic delays not just on airlines but also on passengers,<sup>3</sup> and in Great Britain the electricity industry code panels comprising generators and suppliers are now being required to assess the impact of code changes on consumers.<sup>4</sup> The best companies will have anticipated this change and will be ahead of the game.

## ...and regulators...

Executives sometimes confuse regulators with judges. They assume that the regulator will come to the issue with no preconceived views and determine each issue solely from the careful weighing of the evidence put to them. This is not so. Regulators typically come into post with strongly formed views on economic issues, which will frame the way they approach the job. Indeed, they may have been appointed precisely for that purpose. An early telecoms regulator took up their post with a clear view on accounting issues; a water regulator made it clear from the start that their tenure would be focused on increasing competition. In neither case did regulated companies that challenged this view benefit from their opposition. This simply demonstrates the point that it pays for companies to understand the regulator's priorities and shape their proposition in the regulator's terms and language.

Other executives confuse regulators with arbitrators. They think that it's the function of regulation to find a reasonable point between customers and suppliers that shares rewards 'fairly' between the parties. In reality, regulators can be expected to seek the outcome that gives the company no more than is necessary to ensure that it stays in business over the long term, and delivers the required levels of service and investment. Executives, boards and shareholders need to understand this point if they are not to be disappointed.

Allied to this misconception is another confusion often felt by chief executives brought in from the commercial sector. They see the regulatory process as a negotiation. It isn't. Although there may be an element of compromise, particularly at the final stages, the process is essentially one in which the company is subject to whatever determination the regulator decides to impose. The smartest managements understand that the challenge is to put the case for the right determination.

## And finally...

It goes without saying that these strategic considerations will be of little value unless the company deals with the mechanics of regulation efficiently and sensitively, combining compelling evidence and consistent messaging. A perfect strategy may be heaven, but the devil will be in the detail.

**Mike Toms**

<sup>1</sup> The author's original *Agenda* article from 2010 was reprinted with commentary as Toms, M. (2015), 'Living with price regulation: how do the best companies do it?' (reprint), *Agenda*, April, <http://www.oxera.com/Latest-Thinking/Agenda/2015/Living-with-price-regulation-how-do-the-best-compa.aspx>.

<sup>2</sup> Further information on the regulatory approach to customer engagement can be found in Ofwat (2013), 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans', July, [http://webarchive.nationalarchives.gov.uk/20150624091829/http://ofwat.gov.uk/pricereview/pr14/pap\\_pos201307finalapproach.pdf](http://webarchive.nationalarchives.gov.uk/20150624091829/http://ofwat.gov.uk/pricereview/pr14/pap_pos201307finalapproach.pdf).

<sup>3</sup> Walmsley, R., Anderson, T., Brendish, C., McDermid, J., Rolfe, M., Sultana, J., Swan, M. and Toms, M. (2015), 'NATS System Failure 12 December 2014 – Final Report, Independent Enquiry', 13 May, <https://www.caa.co.uk/WorkArea/DownloadAsset.aspx?id=4294974241>, Recommendation 29.

<sup>4</sup> Ofgem (2016), 'Code Governance Review (Phase 3): Final Proposals', 31 March, [https://www.ofgem.gov.uk/system/files/docs/2016/03/code\\_governance\\_review\\_phase\\_3\\_final\\_proposals\\_2.pdf](https://www.ofgem.gov.uk/system/files/docs/2016/03/code_governance_review_phase_3_final_proposals_2.pdf), paras 4.82 and 4.83.