Agenda

Advancing economics in business

Regulation 2018: 'back to basics'

The UK is experiencing a backlash against the liberal orthodoxy of utility regulation of ten years ago, which was based on privatisation, competition and deregulation. A recent *Agenda* article on the legitimacy of sectoral regulation in the UK asked 'Is it policy, ownership, industry structure, governance, financing or regulation that is driving the problem?' Martin Cave, Visiting Professor, London School of Economics, provides his perspective

This article is based on a talk given at the European Policy Forum on 2 May 2018. The views are those of the author.

Other European countries have not faced quite the backlash that has characterised the utility sector in the UK (see Oxera's *Agenda* article from March this year),[1] although this is largely because many did not ever fully introduce market-based regulatory reforms in practice. The problems with privatisation have tended to be restricted to the Anglosphere economies, and the criticisms extend to all regulation, whether it be competition- or sector-specific.

The USA is experiencing a rather different debate with regard to competition policy—via a phenomenon called 'Hipster Anti-Trust'. Crudely put, this asserts that: (i) big is bad; (ii) competition policy should be used to achieve a variety of policy objectives; and (iii) it is quite right in competition law to raise distributional issues.

This last issue, in application to vulnerable customers, is very topical in the UK. Thus the Competition and Markets Authority's (CMA) work plan for the current year includes the following sentence: 'In how we choose, and then how we go about, our work, we will take a particular interest in the needs of, and harm suffered by, vulnerable consumers.'[2]

Another take on distributional questions can be seen in the UK Department of Energy and Climate Change's Regulatory Impact Assessment of a scheme intended to redistribute energy expenditure among energy customers (the Warm Home Discount Scheme[3]). How should such a redistribution be assessed? The report revives an old idea, authorised in HM Treasury's Green Book, of assigning different welfare weights to members of the community, for example split by income decile. Welfare weights can be calculated by applying an assumption concerning the rate at which utility declines with income in the marginal sense. In the UK, the top decile has a welfare weight that is about one-ninth that of the lowest decile.

This demonstrates that there are ways in which these distributional questions can be taken into account. And the current zeitgeist is increasingly in favour of paying much greater attention to these issues than in the past.

At a stretch, this trend might be described as the emergence of a populist approach to regulation and competition policy. It is therefore interesting to explore the extent to which it might be based on some kind of underpinning in what has been happening in the real economy. The eminent US economist, Carl Shapiro, in a paper called 'Antitrust in a time of populism', looks at whether there are features of the US economy which might explain why people are 'mad as hell', and want change.[4]

Shapiro and others find that there is almost a perfect storm that is encouraging populism in the USA. There has been a very substantial increase in inequality; economic sectors have become more concentrated; companies are making higher profits. It is not surprising that middle-income households that have endured this since the beginning of the century are now frustrated.

Tommaso Valletti, Chief Competition Economist at the European Commission, has helpfully compiled similar data for the UK and other EU member states.[5] This shows that inequality in the UK has diminished, and that there has been a decrease in the concentration of economic sectors; nonetheless, according to the Institute for Fiscal Studies, the UK workforce will not regain its average real wage of 2007 until 2022.

Another factor more specific to the utilities sector is the decline in productivity growth. In the UK water sector, according to a 2017 study on behalf of Water UK, there has been virtually no increase in productivity since 2008 despite substantial increases in the late 1980s and 90s.[6] The perpetuation of upstream monopoly in water may have created circumstances in which the water regulator is boxed in by limits on competitive pressure for cost reduction and a duty to allow the recovery of static levels of 'efficient' costs.

Ministers from the UK Department for Business, Energy & Industrial Strategy have heavily criticised the 'Big Six' energy companies over their price rises, but the most trenchant criticism of utility companies can be found in a remarkable speech delivered by the Environment Secretary, Michael Gove, at the Water UK Conference on 1 March this year.[7] He begins by saying: 'The way we as a nation organise our water supply inspires strong feelings,' and it soon becomes apparent that he has formed a fairly strong view that the England and Wales water industry has been characterised by financial rapacity since privatisation. He repeats the statistic that, over the ten-year period to 2016, the largest water companies earned £18.8bn in profits and distributed £18.1bn in dividends. Although these figures may require careful unpicking, their symmetry is very striking.

One consequence of these concerns is a renewed focus on retail price caps. The first new or renewed price cap that I mention was imposed on payday lenders following an Act passed by Parliament which instructed the regulator—the Financial Conduct Authority (FCA)—to impose it. It was not particularly controversial, and was unobtrusively renewed at the end of 2017.[8] The question of a cap on the cost of unarranged overdrafts is still before the FCA.

A restored price cap was recently mooted when Ofcom became concerned that voice-only telecommunications customers (who tended to be older members of the community) faced rapidly increasing monthly rentals. The regulator proposed a price control, but it was not imposed because first the chief provider of the service and then another provider introduced voluntary measures that had a similar effect.[9]

Most recently, the House of Commons has given a third reading to a Bill to impose price caps on default household retail tariffs in the GB energy sector. The fundamental problem addressed by this measure is a lack of engagement by more than half of households.

This last illustration raises the question of whether such protection should be afforded to all household customers, which might be seen as being excessively paternalistic, or whether it should be confined to vulnerable customers, supposing they can all be identified—as is unlikely.

More fundamentally, it also raises the question of whether a better response if customers are overpaying for a service is to help them make better purchasing decisions—in other words, if the problem is on the demand side, why not take pro-engagement demand-side measures?

We are greatly helped in answering this question by a comprehensive analysis by Professor Amelia Fletcher of the Centre for Competition Policy, University of East Anglia, of major UK cases over the past 10 or 15 years in which a competition authority or regulator has tried to encourage particular customer behaviours, including search and switching.[10] Professor Fletcher's paper does not provide much by way of commentary on her findings, but I think it is reasonable to conclude from it that only some schemes have been successful, and it is difficult to predict in advance which those will be.

A new trend is to test such schemes via randomised control trials. In one recent case, Ofgem, the energy regulator for Great Britain, monitored the behaviour of 137,000 energy customers, of which:

- a third received no letter pointing out to them the existence of a cheaper alternative tariff;
- another third received a letter from Ofgem indicating how much they could save, given their particular consumption levels, if they switched to another company;
- a final third received the same letter but from a supplier.

In the trial, the control group (which received no letter) had a 1% switching rate; among those who received a letter from Ofgem, the rate was 2.4%; and of those households which received a supplier letter, 3.4% switched.[11] It looks as if it might take quite a long time for this particular measure to make much of a dent in the disengaged figures if this rate is maintained.

A second question for regulators to address is whether price caps deter switching. If this were the case, there would appear to be a binary choice between demand-side measures and price caps. If it were not, the two could run in tandem, with price control as a short-term fix that is no longer needed as the demand-side measures take effect.

There is fragmentary evidence that a household's propensity to switch supplier does depend to some degree on the savings it could make, but only as one of a number of factors. On this view, a cap which brought prices down might discourage engagement.

On the other hand, there have been cases of retail markets in many countries, particularly in energy and telecommunications, in which competition even with a price cap has progressed far enough for the regulator to remove the cap. On this footing, almost every supporter of temporary retail price caps also fully supports demand-side measures.

Turning from retail to network markets, I note that several UK utility regulators have recognised that, in the last five or more years, companies have earned greater profits from their networks than now seems appropriate. The regulators may have made decisions consistent with their then expectations, but other factors turned out differently to what was expected. In one case the regulator has asked for, and received, a degree of voluntary repayment.[12]

Ofgem has published a careful examination by CEPA (a consultancy firm) of what happened in the first half of RIIO-1.[13] It concluded that, to some extent, the expected risk-free rate used to calculate the weighted average cost of capital was not justified by events. When this was combined with the operation of ex post performance incentives, observed rates of profits were higher than expected.

I have thus described sources of dissatisfaction with outcomes in both retail and network markets, which have led to some criticism of both companies and their regulators. It would be nice to think that we had novel ready-made solutions for these problems, of the order of Professor Stephen Littlechild's innovation of incentive regulation, or the unbundling strategies of the 1990s, or even the 'invention' of the regulatory asset base (RAB).

Here I do not address renationalisation proposals, but it is my impression that many of the regulatory ideas currently being discussed within the current ownership structure as a response to the problems identified above are not novel. Essentially they involve upward or downward arithmetical adjustments to key variables in the price control formulae. By adjusting the components of the weighted average cost of capital, imposing tougher efficiency targets, and recalibrating outperformance measures, the likelihood of excess profits can be reduced. Thus the apparent remedy of choice (and the title of this article) is going 'back to basics'.

In practice, I do not think this condition of stasis will exist for long. This is because the utility sector is at, or in some cases well past, the threshold of a process of digital transformation which will fundamentally upset the regulatory apple cart with respect to both network inputs and the consumer experience. One very promising development is 'software unbundling', including the use of application program interfaces (APIs), which can allow both the sharing of customer data and the decentralised control of networks.

But rather than straying further into this medium-term territory, I would like to end by describing a more timeless but relatively novel regulatory approach which operates more at a meta level. It involves applying to regulators as agents some of the same ideas used by behavioural economists to elucidate cognitive difficulties or biases demonstrated by households and (to a lesser extent) by firms.

A useful early contribution to this discussion was made by Paul Joskow in the 1970s, in his discussion of regulatory objectives.[14] As discussed above, it may be a reasonable approximation to assume that investor-owned utilities are maximising profits or dividends, but what are the regulators trying to do? One crudely reductionist answer produced by the 'economic theory of regulation' is that they simply sell the benefit of the exercise of their powers to the highest bidder. But Joskow makes the quite different argument that, given the large amount of flexibility that regulatory agencies have to take their own decisions, 'they seek to limit the conflict and criticism appearing as "signals" in the economic and social environment in which they operate.'

This approach was taken up by Clare Leaver in a later and much more detailed empirical paper, in which she described how 'a desire to avoid criticism prompts otherwise public-spirited regulators to behave inefficiently. Decisions are taken to keep interest groups quiet, to keep mistakes out of the public eye.' Inventively, she calls this the 'minimal squawk' hypothesis.[15]

A more explicitly 'behavioural' approach is taken by William Kovacic (a former chair of the Federal Trade Commission and a CMA board member) and a colleague, James Cooper.[16] It is based in part on the thinking of psychologist Daniel Kahneman, a winner of the Nobel Prize in economics. The authors note that regulators regard themselves as experts in performing Kahneman-style slow thinking—for example, they take up to four years to produce a price control. This does not relieve them of certain characteristic biases, known in the jargon as: availability, representativeness, optimism and salience; myopia; status quo and confirmation bias; and herd-like behaviour (which might be illustrated by the manner in which regulators endlessly compare themselves with one another—in setting the cost of capital, for example).

What implications might flow from this? In choosing regulatory officials, there could be better and more diverse selection mechanisms; each regulatory body should install and regularly refresh its internal challenge procedures—to preclude routinisation of this vital check; and there should be conditional long tenure for regulatory decision-takers, so that they are held accountable not for regulatory outputs (the glossy documents which emerge from agencies full of promises), but for regulatory outcomes—i.e. what actually happens or fails to happen in the marketplaces they regulate. Finally, I believe that wherever possible it can be very helpful to introduce sunset clauses, because adopting a different and wider 'choice architecture' within which to address regulatory questions may take matters in a different direction to the one they would otherwise have taken.

This sounds a bit vague but, based on my own experience as a regulatory decision-taker, a greater degree of individual and collective self-reflexiveness by regulators might yield benefits.

Professor Martin Cave

Contact: Dr Luis Correia de Silva

[1] Oxera (2018), ‘Legitimacy and renationalisation: where next for utility regulation?’, *Agenda*, March, http://bit.ly/2qOvbSy.

[2] Competition and Markets Authority (2018), ‘Competition and Markets Authority Annual Plan 2018 to 19’, CMA75, 29 March, http://bit.ly/2L8WteF, p. 5, para. 1.11.

[3] DECC (2016), ‘Warm Home Discount Scheme, Impact Assessment, 2016-18’, http://bit.ly/2Jf1oh3.

[4] Shapiro, C. (2017), ‘Antitrust in a Time of Populism’, 24 October, http://bit.ly/2J2x9ux.

[5] Valletti, T. (2017), ‘Concentration trends in Europe’, http://bit.ly/2sksvNJ.

[6] Frontier (2017), ‘Frontier report assesses productivity changes in the English water sector’, 29 November, http://bit.ly/2J5HLEC.

[7] Gove, M. (2018), ‘A water industry that works for everyone’, speech, 11 March, http://bit.ly/2sgJy3t.

[8] See Financial Conduct Authority (2018), ‘FS17/2: High-cost credit and review of the high-cost short-term credit price cap’, 31 January, http://bit.ly/2J0katc.

[9] See Ofcom (2018), ‘Pricing trends for communications services in the UK’, http://bit.ly/2srwHvx, 17 May, pp. 10–11.

[10] Fletcher, A. (2016), ‘The Role of Demand-Side Remedies in Driving Effective Competition: A Review for Which?’, 7 November, http://bit.ly/2J0jSTa.

[11] See Ofgem (2017), ‘Cheaper Market Offers Letter Trial’, http://bit.ly/2La50ht.

[12] See Nolan, D. (2018), ‘Tighter power network regulation will pay off for UK consumers’, opinion, 7 March, https://on.ft.com/2JhfbDQ.

[13] Cambridge Economic Policy Associates (2018), ‘Review of the RIIO framework and RIIO-1 performance’, final report, March, http://bit.ly/2slSvsb.

[14] Joskow, P.L. (1974), ‘Inflation and Environmental Concern: Structural Change in the Process of Public Utility Price Regulation’, *Journal of Law and Economics*, University of Chicago Press, **17**:2, pp. 291–322.

[15] Leaver, C. (2009), ‘Bureaucratic Minimal Squawk Behavior: Theory and Evidence from Regulatory Agencies’, *American Economic Review*, **99**:3, pp. 572–607, http://bit.ly/2IZL18P.

[16] Cooper, J.C. and Kovacic, W.E. (2012), ‘Behavioral Economics: Implications for Regulatory Behavior’, *Journal of Regulatory Economics*, **41**:1, pp. 41–58, http://bit.ly/2J2NoU1.