CIPFA Conference

Regulation Past, Present and Future

A speech given by Sir Ian Byatt in Edinburgh

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Ladies & Gentlemen,

In talking about regulation past, present and still to come, I will adopt a historical approach to the development of late CXXth and early CXXIst regulation. I believe that in the UK we have created – and are still creating - a new model, eminently suitable for today's conditions.

I find it convenient to distinguish between three situations, namely:

- regulation of revenue yielding utilities;
- regulation of financial services; and
- regulation of health, safety, environment etc.

These are three different kinds of environment, involving three different types of job. Utilities have customers, who pay bills for familiar understood products – bills that generally (should) cover costs. Markets in financial services are innovatory and face instability. Health & safety, etc. involves making sure that a myriad of regulations, deriving from statute are being followed.

Each requires its own styles. Yet perceptions of regulation can confuse important differences – and regulators may not always be sure what game they are playing. I propose to stick to the utilities, where there are paying customers, not just users or consumers of a service. These customers have their own objectives which go much wider than complying with governmental rules.

I begin with in the early days of privatisation and the Conservative supply side agenda, of the 1980s. I move on to the developments of the late nineties when Labour returned to power. I then look at the developments of regulation for publicly owned bodies in the CXXI, concentrating, as I am in Edinburgh, on developments in the Scottish water industry.

I characterise these three phases as i) the response to the privatisation of utilities where they were statutory monopolies, ii) the quasi-nationalisation of regulators as a means of implementing government policy and iii) the emerging regulatory framework for regulating utilities remaining in the public sector.

Privatisation

Privatisation was an important element in the supply side agenda of the 1980s. Politically it meant choice for users –customers rather than consumers. Economically it meant the enterprise and business skills of the private sector. For entities in competitive markets, such as British Airways, and the National Coal Board, this meant leaving enterprises to prosper or decline, according to market forces.

For the utilities, the incoming government had no blueprint for privatisation. It started to privatise the utilities as a consequence of its macro economic, not its micro economic policies. The prime interest initially was the finance of investment – initially for British Telecom – while pursuing a policy of de-escalating the growth of the money supply in order to beat the inflationary pressures that had built up in the 1970s.

There was an attempt to float Buzby bonds to provide the finance for the electronic exchange programme of BT. But it could not be squared with the role of the PSBR as a counterpart of £M3. Eventually the Gordian knot was cut by the radical move of privatising a utility that had started life as a government department.

Such services had been managed differently in the US, as private companies subject to regulation at the State level. So it was natural for DTI officials to consider US style rate of return regulation for BT. But Alan Walters, the PM's economic adviser, was well aware of the problems arising from rate of return regulation. Stephen Littlechild was appointed urgently to write his famous report. He conceived RPI-X. He and Michael Beesley had been advocating a more competitive, less state-planning approach to utilities, and, as we all know, RPI-X was initially designed as a transition to competition.

So BT was floated with an X of 3 – the modest number that arose from 6 months Whitehall negotiation with BT. Bryan Carsberg was appointed the first regulator of a licenced utility.

More followed when Nigel Lawson became energy Secretary. British Gas was privatised, but under Peter Walker as an entity. In true British style a similar, but not identical regulatory regime was created and James McKinnon appointed regulator. Electricity took things further. Nuclear was initially kept in the public sector and the rest of the Central Electricity Generation Board (CEGB) split into the Grid, National Power and Powergen. There were advocates for greater diversity in generation, but there were limits to what could be achieved after Walter Marshall had done so much in the miner's strike.

Water raised a different issue. Water authorities were largely self-regulating bodies. Nicholas Ridley wisely decided to split off their regulatory functions into a National Rivers Authority. So a quality regulator was created to ensure that collective objectives for the rivers were delivered, as well as creating an economic regulator to protect customers.

For railways, privatisation proceeded on the basis of an elaborate dis-aggregation of functions.

Regulation in the early days

Regulators were set up under statute, to ensure compliance with licence conditions. They had no guidance on process, nor how they might best pursue their duties to promote competition and protect customers.

They developed RPI-X so that it became a sophisticated tool allowing for specific developments, such as meeting European Union (EU) obligations while providing incentives for efficient operation. As a result, utility costs fell dramatically.

Statutory monopolies tend to be riddled with cross-subsidy. This is inimical to soundly based customer choice and regulators have rightly sought to ease them out.

Regulators had considerable scope to promote competition. The gas market became competitive through the vertical dis-integration of British Gas. This we owe to James McKinnon & Clare Spottiswoode at Ofgas and to Michael Beesley and others at the Monopolies and Mergers Commission (MMC). Electricity generation became competitive as Stephen Littlechild was able to increase the number of competitive generators. In both gas and electricity retail competition was introduced – something that would have been barely imaginable a generation ago.

Progress was slower in telecoms, but customers were empowered by the emergence of a mobile network. While Bryan Carsberg had acted quickly and decisively to establish interconnection between entrants and BT – as well as getting BT to repair phone boxes in the street – the competition agenda in Oftel seemed to flag, although Ofcom is now back on the street.

In water, market competition proved difficult. But very extensive use has been made of comparative competition to the benefit of customers.

In railways, competition and market forces, where they have been allowed to work, have proved beneficial. There is now a wide range of fares giving customers extensive choice and leading to a substantial increase in rail travel.

The exposure to capital markets was crucial. Utilities are now tradeable on capital markets. Regulators have worked with markets to ensure ring-fencing and to develop incentives to efficient behaviour. For example, regulators and bankers have done much more to improve investment decisions than authors of successive editions of the Treasury Green Book could ever have hoped to achieve.

I also believe that regulators have helped to protect customers from stealth taxes. This was especially significant in water, although I think that there are parallels – not yet fully thought through - in railways and now in energy.

Privatisation provided the opportunity to use the capital markets to finance the investment necessary to meet water and environmental quality objectives. But it also provides the opportunity for ministers to spend other people's money - eg Chris Patten's advancement of the EU waste water directive at the cost of customers in Devon and Cornwall.

Ofwat put this into context by emphasising the cost of quality and by following it up by a process for establishing water and environmental quality objectives – at least as far as UK ministers are concerned - that forces them to cost their objectives and be transparent about the costs that they are imposing on customers.

In these, and maybe other, ways there were significant developments of the arrangements for regulating utilities, stemming not from government ministers but from the regulators themselves.

The "quasi-nationalisation" of regulation

The New Labour government of 1997 neither wanted, nor could afford, to renationalise the utilities. But it wanted to regain greater control of what it traditionally regarded as public bodies.

At the overall level there was a windfall tax and a review of the system. The latter focussed primarily on whether to retain RPI-X or switch to a profit sharing regime. It also delved into less critical issues, such as the position of customer representative bodies and whether to have individual regulators or boards of regulators.

After a considerable internal struggle RPI-X survived "if the regulators thought it best". That was the most important decision.

Ministers also wanted to pursue their objectives at the sector level.

I will not attempt to go into the rail story. In water, ministers wanted to control leakage because of its political resonance, although such control would have struck at the heart of using business skills to get results for customers.

This ministerial agenda has lengthened in recent years. Ministers have found that they can specify objectives at little or no cost to the public finances, achieving their aims through the use of customers' money. This presents regulators with a dilemma – should they act as agents of ministers, or should they have a role in protecting customers against policies that are cost ineffective?

This issue has been handled in water by insisting on a transparent process. There is open correspondence between regulators and ministers in an attempt not to quarrel with ministerial objectives but to seek to ensure both that customers know what they are paying for and that these objectives are being achieved in an effective and efficient way. In this way regulators are seeking to improve the policy-making process.

This is not confined to water. There is – or should be – a well informed debate on government policies in relation to energy saving. Energy saving policies should be fully articulated across all the utilities and, indeed, much more widely. As the debate on climate change rages, it is increasingly important to set out a coherent framework. It is to be hoped that the report from Sir Nick Stern, due later this year will provide an important stage in this process.

Regulation of publicly owned utilities

The other side of the post 1997 coin is a flexible form of devolution, the appointment of regulators for publicly owned utilities, such as the Post Office and water in Scotland.

Ministers have baulked at full privatisation, although there is the partial privatisation of the London Underground and Air Traffic Control. Yet they have given up pricing powers and seem to want to see competition developing in parts of what has been traditionally seen as a statutory monopoly serving a public interest. They have retained their role as bankers, but for how long?

The case of Scottish Water

As I am involved in the regulation of Scottish Water, I would like to turn to how the Water Commissioner, Alan Sutherland –the beginning of the modern age - from 1999, and since last July, the Water Commission for Scotland has – and is planning – to apply competition and incentive regulation to water and sewerage services north of the border.

First, competition.

The Competition Act 1998 strengthened the legal presumption favouring competition across the board, including areas where competition seemed difficult, for example in water. Rather than leave matters to regulators, ministers subsequently legislated in England and Wales (2003) in Scotland (2005) to manage – effectively to restrict -competition.

Household customers are excluded, both north and south of the border. In England and Wales only water supply is covered, and customers taking less than 50Ml/year are excluded.

In Scotland, common carriage is banned but there is no restriction on the size of business customer and access applies to waste water services as well as to the supply of water. This permits retail access to more than 100,000 business customers ranging from corner shops to paper mills.

By April 2008, the retail business market will be open to all who obtain licences from the Commission, that is all those who can show competence and sound finances.

The job of the regulator is to ensure that there is a level playing field, and one that is seen to be level, between Scottish Water's retail entity and any entrants.

Separation between Scottish Water wholesale and Scottish Water retail is crucial to success. This separation must involve separate management, separate governance and separation of the activities and assets of the two businesses.

The Commission will continue to ensure, by setting price limits for it, that the wholesale business remains financially viable, provided that it is efficiently run. It has a legal duty to ensure that the opening up of the retail market does not prejudice the core functions of Scottish Water.

Turning to incentives, the strategic review of charges for 2006 to 2010 announced last November involved five key elements.

First, the use of a comparative model to determine the costs of an efficient supplier. These are the costs that Scottish Water could be incurring, if it was performing as well as other companies in England and Wales, allowing for the special circumstances of Scotland.

In this way, public supply in Scotland is benchmarked by the results of pressures and incentives south of the border, giving Scottish Water a challenge to meet, or better, a challenge to beat.

Secondly, price limits allow Scottish Water to make a return on its capital that will cover interest charges, and risks that are within the responsibility of management.

Thirdly, in a utility, with specific service obligations, management cannot be expected to manage all risks. Where events, such as a new quality obligation, are outside the control of management, the Commission will be ready to change price limits within the four-year period, or formally to recognise that such events will be fully dealt with at the next strategic review.

Fourthly, as an innovation in the 2005 strategic review, the Commission and the Scottish Executive have agreed a £50 million quasi- equity buffer to allow for events outside management control that may not be large enough to qualify either for an interim adjustment of prices or for logging up for the next review.

A further innovation was to create the potential for a fund, to be invested in gilt-edged securities, in which out-performance on capital or operating costs can be held. In the Scottish public sector model out-performance will not leave the industry in the form of dividends.

Fifthly, should Scottish Water spend the financial resources available without achieving the required ministerial objectives and improving customer service, the Scottish Executive will meet the costs of remedying this.

Customers will not be expected to pay twice.

These arrangements readily create a set of incentives by establishing minimum acceptable outcomes that must be met.

Out-performance remains in the system to be used – at the next strategic review - for lower prices, better water and environmental quality and better customer service - or some combination of all three.

At a wider level, greater efficiency in the water industry can release funds to deliver other public services to the Scottish people – and vice versa where efficiency falls short of expectations.

The Scottish Executive -as the owner - has recognised that this creates a framework for bonuses that links rewards for managers and workers with the benefits to customers and the environment. Those who create the wealth and improve customer service can share in the benefits.

The future

A new model has been created, where ministers set collective objectives, where regulators look after the diverse interests of customers and where suppliers use their business skills to deliver what ministers and customers want.

The crucial issue is whether ministers can confine themselves to specifying collective outcomes and keep out of trying to influence operations, including pricing, employment, pay and working practices.

Herbert Morrison wanted arms-length arrangements where nationalised industries set objectives and ministers were concerned with finance. We can now see why this did not work.

If ministers are not involved in finance nor in prices, nor in structure, arms-length arrangements are viable. This position has been reached in energy and telecom, but ministers are deeply involved with railway finance and in the case of posts, with progress on competition.

There seems to be no easy resting place in the interplay of collective and private objectives. The balance of the two shifts in a political world. But these

shifts can be transparent and so accountable. I like to think that in water, the regulators have taken the lead in creating a framework that can make the issues manageable.

Let me finish on a key point of achievement. Regulation has involved greater transparency and wider access to information. Regulators have an educational responsibility. Better information does not just involve more numbers, nor more pages on the website. But good information, well disseminated, can create a whole new approach to making decisions. The smoke-filled rooms long beloved of our rulers can go.

Thank you, Ladies & Gentlemen, for listening to me. I am ready to take any questions that you may have.

Ian Byatt
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