

The Design of Regulatory Institutions & Consumer Empowerment in the UK

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Ladies & Gentlemen, it is a great pleasure to be here to share our experience with you and to learn from approaches in other jurisdictions and other countries.

The power of the consumer depends on his or her position in the economic system, on the strength of competitive forces, the power of economic incentives and the openness of the national economy, as well as on particular institutional structures. I begin with the macro position and go on to what has been happening in utility industries.

The economic climate

I grew up in the world of post-war reconstruction – a world that in Britain meant widespread nationalisation & top-down economic planning, a world-view where, “the gentleman in Whitehall really does know better what is good for the people than the people know themselves”.¹

By the 1960s and 1970s, the shortcomings of this collectivist culture became very apparent. By the 1980s and 1990s, the British economic landscape had changed - with privatisation of state industries, the growing reliance on competition to protect customers and the rapid growth of international trade, within the European Union and beyond.

More recently, in the 1990s and subsequently, we have seen an increase in contracting out of investment in public services, notably health and education in the form of the Private Finance Initiative, where new buildings were first financed and then maintained and managed by the private sector. The jury is still out on these developments.

Institutionally, regulation was substituted for direct government action, and consumer bodies, such as the National Consumer Council & its successors, and pro-competitive government bodies, such as the Competition Commission, were strengthened.

¹ Douglas Jay, *The Socialist Case*, 1939

Parallel with these changes in government structures, the IT revolution and the internet has become a key instrument of consumer empowerment in the new century.

The “market” is now empowering customers: producers have to follow their signals. Confidence in the “market” may have been damaged by the financial crisis, but I do not believe that recent event have shown that trade, economic pricing and competition have become any less important in meeting the wishes and priorities of the consumer.

Ownership, Entry & Competition

The UK saw the privatisation of nationalised industries, both in competitive markets and in the utilities, where monopoly was based on statute. This has reduced the scope for state aid. Where a monopoly activity was privatised, it involved the creation of a new regulatory body, with its own statutory duties, including duties to promote efficiency and competition. It has also involved strengthening direct consumer representation, sometimes by establishing representative customer bodies within the office of the regulator - and sometimes as independent bodies.

Coincident with the move away from statutory monopoly, there has been fruitful work to separate the natural monopoly component of a utility, primarily the network, from the parts of the business that can be made competitive, or at least, contestable. This has led to the introduction of competition to industries, such as gas, electricity, posts, railways and even water - in ways that would have been unimaginable 30 years ago. Their structures are becoming horizontal rather than vertical; monopolies have been broken up and new suppliers have entered the market.

This did not usually happen at privatisation, but has developed progressively – often as the result of regulatory leadership.

In energy, there are now five large generators and one gas supplier, separate from the now merged gas and electricity grids and from the local electricity distribution networks. British Telecom has now divided its trunk/transmission business from its supply/retailing business. Exceptionally, the railway system was dis-aggregated at privatisation; train operating companies work in a competitive market, while the track is regulated.

There is upstream competition for bulk collection and bulk transport for letters, although the “last mile” – the postman’s walk - remains a monopoly for the publicly owned Royal Mail. Competition is increasing in the airports market where the privatised British Airports Authority is being required to sell some of its

airports. Water remains a vertically integrated regional monopoly in England & Wales, but in Scotland, where Scottish Water is still publicly owned, customer-facing retail activities have been separated from the wholesale business of providing water and removing wastewater, and four entrants have been licenced to provide retail services to all business and all public service customers.

Dis-aggregation has involved legal separation. Sometimes this has happened within the structure of common ownership, by a clear ring-fencing of activities. More often, and more satisfactorily, it has involved separate ownership, a better way of avoiding the conflicts of interest that so easily arise.

The Entry of the Regulators

The establishment of independent regulators has been a key component of utility privatisation in the UK and has spread to the regulation, or supervision, of other public activities, such as such as health and education.²

These regulators (or supervisors) operate independently from Ministers. They have specific statutory duties, both to customers and suppliers; they operate under protected terms of office: and they are securely financed, from the regulated companies, and not directly from the government.

They are not, of course, completely detached from government; they carry out a governmental, but not a political, role. Their remit covers the prices of basic services to the public – services that can never be ignored politically. While they cannot work effectively without taking due account of elected governments, they work best when they establish, and explain, their own strategies for their sectors and use the discretion available to them to pursue policies in ways that are particularly supportive of consumers.

In the early days in the UK, there were complaints about the discretion given to utility regulators. There are now complaints about the growing burden of information required and the box-ticking mentality that goes with it. In a changing and only partially understood world, regulators must exercise their discretion provided they do not stray into political areas. In doing so, they must, however, be transparent, both about their processes and their decisions, explaining them in ways that are comprehensible to the layman, setting out the essentials and leaving the details for the experts.³

² See Frank Vibert, *The Rise of the Unelected; Democracy and the New Separation of Powers*, Cambridge University Press 2007

³ Regulators in the UK have developed systematic process, notably in relation to medium-term reviews of tariffs. In water there is, in England & Wales, a 5 year Periodic Review of obligations, asset management plans & price limits for the privately-owned companies and in Scotland a 4 year Strategic Review of Charges levied by the publicly-owned Scottish Water. The regulator in Scotland, the Water Industry Commission for Scotland, acting independently from Scottish Ministers, publishes papers on its process & methodology, leading up to papers that set out and

Regulators have worked hard, often against strong opposition from incumbents, to develop opportunities for competition or contestability. They have also sought to build regulation around incentives, both for regulated industries and their customers by ensuring, to the extent possible, that the costs of activities are translated into prices that cover the continuing cost of the activity, including economic depreciation and a reasonable return on capital.

Stephen Littlechild saw RPI - X regulation as a makeshift until full competition could be achieved. RPI - X has, however, flowered into a system of incentive regulation, whereby the gains in efficiency achieved in one price review period can first reward shareholders and, after the next price review, be transferred to customers.

Because of the political importance of the provision of utility services, there is always a risk of capture of regulators by Ministers. In Britain we saw that the return of a Labour government in 1997 led to attempts to exert greater control over regulation – in railways, in water, and more recently in energy. I see no harm in the ministerial specification of environmental and social policies – indeed such specification is integral to democratic politics. But clarity and transparency are essential and regulatory mechanisms need to ensure them.

Because of the scale of environmental objectives in the water business, I found it essential to have guidance from Ministers on the scale of new environmental objectives.⁴ In seeking such advice I found it essential to inform Ministers of the regulator's assessment of the cost of potential obligations. Such costs should, moreover, be expressed in a comprehensible political currency, for example the effect on average household bills.

This issue is of growing importance with respect to carbon emissions – particularly in the energy utilities, but also in water and transport. Decisions about these matters require clear political decisions. Governments do not find this easy. It should be the job of regulators to make these issues sufficiently exact and sufficiently transparent for customers to understand the nature and scale of the costs that may be involved.

explain its draft & final determinations for the charges that Scottish Water can levy on household and non-household customers for the next 4 years. The Commission also publishes three annual reports on the performance of Scottish Water – its Customer Service, its Progress on Investments & on Costs & Performance, In 2009, It also published an assessment (to be repeated annually) of progress on retail competition. All this material is available on the Commission website:- www.watercommission.co.uk

⁴ See "The Cost of Quality; a Strategic assessment of the Prospects for future Water Bills. Ofwat 1992. Guidance from Ministers has become a regular feature of medium-term price reviews in England & Wales. There is a similar process in Scotland where Scottish Ministers issue statutory Directives relating to water and environmental quality objectives for the 4 year period covered in charges limits. This may also include principles of charging, such as averaging of national (Scotland) tariffs for a class of customers or the general speed of unwinding particular cross-subsidies, for example, between household & non-household customers.

In capital intensive utilities, the cost of capital and, therefore the appropriate regulatory return in the monopoly businesses is a crucial element in the prices paid by customers. As a result of privatisation and developments in financial markets, regulators have worked to ensure that, while this is sufficient to attract capital for investment, it is no higher than necessary for this purpose.

These changes have been of benefit to consumers, in the form of better products, more choice, and better prices. There has been a significant increase in efficiency – both from the switch from government ownership and from the greater scope for competition. Prices have fallen and new services have been offered. For example in water in Scotland, new billing systems and new tariff structures have been offered that will help users to reduce bills by using water services more wisely.

Strengthening Consumer Representation

The UK has experimented with two models, first, the incorporation of customer committees within the regulators office and, secondly with free standing bodies. In the first model, customer representatives can draw on the expertise of the regulator's office and the regulator has in-house access to their expertise.⁵ There is, however, always some conflict of objectives arising because the regulator has obligations to companies as well as to customers.

In the second model the customer representatives have freedom of action, but lack of expertise; they seem either to be doomed to take a simple price reduction policy or to get snarled-up in complications.⁶

The role of customer representatives is currently being examined in a debate on the scope the development of "constructive engagement"⁷ – a set of

⁵ In the case of water services, the Regulator (the Director-General of Water Services), under the 1989 legislation, appointed ten geographic Customer Service Committees, each covering the area of a water & sewerage company. The Chairman of these Committees met regularly with the regulator in what was originally the Chairman's Group and which became the Ofwat National Customer Council. Similar arrangements existed for Telecom, Electricity & Gas, but the model was most powerful in practice in Water Services, where market competition has proved more difficult to achieve.

⁶ The incoming Labour Government in 1997 was committed to the creation of Consumer Councils, independent from the regulator, and appointed by Ministers. Separate bodies were appointed for Energy, Telecom, Posts, Railways and Water. Several of them have been subsequently merged into an overarching body, Consumer Focus. Postwatch will be incorporated within Ofcom, which will take over the work of the current Postal regulator Postcom. The fate of the still separate water body in England & Wales, the Consumer Council for Water is not yet clear. In Scotland, an independent consumer body, Waterwatch, was appointed, but is unlikely to survive.

⁷ Stephen Littlechild *A New Approach to Water Regulation* Utility Week, 23-10-08. London. For the moment, "constructive engagement" remains a proposal in the UK, although there are some

arrangements that envisage direct negotiations between customer representatives and utilities – with the regulator standing aside or acting as a backstop.⁸

Such developments may be particularly valuable where customers have strong champions, for example airlines, in relation to airport regulation - or where competition is developing and where a light regulatory touch is appropriate. But there are many questions to be answered before the mass of small customers could be effective in such a situation.

Information

Individual customers need information to enable them effectively to respond to the market signals arising out of incentive regulation and increased competition.. This is key to customer empowerment.

Research has shown that customers are looking for an authoritative independent source of information.⁹ Comparison websites are a useful tool, but some action appears to be needed to increase consumer's confidence in the independence of this information. This would go a long way to making customers more confident and more active in these emerging markets.

If customer representative bodies are to be properly engaged, they require high level information from both companies and regulators. Such information should be clearly specified, probably with the regulator playing the role of a constructive arbiter. It will also require some regulatory involvement in ensuring that the company information is properly audited.

The IT revolution has seen a vast explosion of information in the form of data and our ability to process and disseminate it. But this does not automatically lead to a better grasp of its significance and to public understanding of the key issues. Regulators, and others, now publish vast amounts of material in sometimes overwhelming detail. Expert analysis should in no way be discouraged, but much more effort is required in putting it into accessible form for those whose lives it should and will affect.

In the UK, regulators have developed systematic measures of performance for customers. An example is the Overall Performance Assessment, (OPA)

elements of it present in airport regulation, i.e. the role of airlines as proxies for final customer (travellers). In suggesting this approach, Stephen Littlechild drew on examples from Argentina & Florida.

⁸ See Stephen Littlechild "Regulation, Overregulation and Deregulation Occasional Lecture 22 Centre for the Study of Regulated Industries University of Bath, 2009

⁹ The results of two pieces of research are reported in *Consumers Command Power*. Newsletter # 15 Centre for Competition Policy, University of East Anglia, Norwich UK November 2008. www.ccp.uea.ac.uk

developed by Ofwat for the delivery of water services. It not only shows what customers get, but allows for valuable comparisons to be made between different providers.¹⁰

Such information is now increasingly being provided for other public services, such as health and education.

But we must always remember that quantitative information is only part of the story. It is, for example, of little value to have the telephone answered quickly to be put in a long queue or to be given an unhelpful answer. There is great scope for consumer representative bodies to delve into quality issues and to assess the service provided more comprehensively that could be done by quantitative indicators alone.

Conclusions, concerns & sustainability

Huge steps have been taken to empower customers. The re-orientation of government has opened up a more competitive world – at both the macro level of greater reliance on markets and at the micro level of regulation focussed on consumers rather than producers.

This has involved political support for a competitive and open economy. It is essential to preserve this, despite the pressures for greater control and for protectionism in the world economy. Within the utility (and public service) sectors, it is important to continue to work at distinguishing between elements of natural monopoly and areas where activities can be made competitive or contestable.

It is also important to maintain the distinction between the role of Ministers and the role of regulators. . Two elements are crucial, i) statutory independence for regulators and ii) transparency, in process and in outcome.

In terms of process, Ministers must specify *outcomes*, that is the political, social, environmental and economic end-states that they wish to see achieved. There is then a critical role for regulators to identify the *outputs* that will deliver these outcomes; to cost these outputs and ensure that they can be, and are, delivered. The *inputs* required to deliver these outputs then become a business matter for the suppliers, be they in the private or public sectors.

Customer representative bodies have a crucial role to play in these developments:-

¹⁰ The Water Commission in Scotland has been careful to ensure that customer service in Scotland can be compared with that in England & Wales. This has been an important technique for pushing up the low level of customer service that was delivered in Scotland to a place within the England & Wales pack.

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First, they need to keep their agendas sufficiently wide, working co-operatively with regulators. They should aim at constructive engagement with suppliers, but will need to assemble the information they need for this.

Secondly, they need to ensure that customers get the information that will enable them to exploit the opportunities arising from incentive regulation and from competition in utility markets

Thirdly, they need to be tough in managing conflicts, taking a wide and long term view on behalf of customers where monopoly makes this necessary, while helping regulators to develop competitive markets.

In all these three areas they can speed the process of empowering customers.

Thank you for listening to me - and over to you for action.

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