A better deal for consumers and an attractive environment for investors: How the UK's economic regulators are developing the use of regulatory and competition powers

Price, Richard and Ross, Cathryn

UK Negulators' Network, Office of Water Services, UK

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Richard Price and Cathryn Ross[1]

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Introduction

There are great expectations in the UK for infrastructure and its role in delivering for customers and society, promoting efficiency and economic growth. These expectations are matched by an ambitious forward programme of investments in renewal and expansion of network capacity and quality across sectors, in some cases backed by the government and in others by private investors. Economic regulation and competition have a big role to play in aligning the interests of investors with the interests of customers and society. Specifically, in relation to investors, economic regulation and competition help to ensure investment is efficient, with the right investment taking place the right place, at the right time and at efficient cost. In this context, regulatory coherence and stability has rarely been so important.

[1] Richard Price is Chief Executive of the Office of Rail Regulation (ORR) and Chair of the UK Regulators' Network; and Cathryn Ross is Chief Executive of the Office of Water Services (Ofwat).

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In this paper we discuss

- the relationship between competition and regulation, and the way regulators use their powers;
- the importance of independent regulation in helping to ensure the delivery of what customers and society need, want and can afford from regulated sectors, particularly against a background of major investments in UK infrastructure;
- how economic regulation needs to learn and evolve if it is to continue to help ensure delivery of what customers and society expect, given that regulated sectors and the environment in which they operate change over time; and
- how the regulators are working together to maximise the benefits from coordination or read across between sectors.

What has been the impact of economic regulation?

First, it's worth remembering that economic regulation has achieved a lot over the period since privatisation. Across regulated sectors, the UK's approach to independent economic regulation has spurred efficiencies and helped to deliver a step-change in the consumer experience and, linked to this. Linked to this, independent regulators have facilitated massive investment programmes at relatively low costs of capital, reflecting the stability, predictability and long term view they provide. We have seen substantial gains for consumers in all regulated markets – whether substantially liberalised or still price-cap regulated.

- Since privatisation in 1989, the water sector has attracted £116 billion of investment, delivering greatly improved infrastructure and services to customers at no cost to taxpayers. Bills are around one-third lower as a result of Ofwat's efficiency challenge, and have been constant since 2009. [2]

- Regulation of the communications sector has driven strong competition, innovation and investment, which have transformed the economy and our daily lives. Mobile and broadband services are now ubiquitous and constantly improving in terms of speed, capability and the range of services available to consumers - yet the average family in the UK is spending less now on these services than it did a decade ago and is paying less than families in other leading developed economies.

- In the first 15 years after energy privatisation, regulation led to a halving in the cost of network charges for delivering energy to consumers, and over the next 8 years will enable a 50 per cent increase in investment at a lower cost of capital. Ofgem's retail market reforms will intensify competition, and the recently announced referral of energy markets by Ofgem to the CMA will consider whether

[2] See chart 1, at end.

further remedies are needed to remove barriers to competition. Britain's energy system is more secure, sustainable and reliable and, at a time of rising energy costs, prices remain below the average faced by consumers across Europe.

- Economic regulation has supported transformation in the airport sector. It has created enormous choice and value for passengers by supporting the development of competition and the expansion of regional airports. It has underpinned £11bn of investment in world class facilities during the last decade that have transformed the global reputation and perception of Heathrow.

- In rail, regulation has driven down the day-to-day cost of rail infrastructure by 40 per cent over the last decade, with a further 19 per cent to come over the next five years, freeing up resources for investment in a better network.[3] It has set stretching targets for punctuality which have underpinned sustained growth in demand – with a doubling of passenger kilometres and a 25 per cent growth in freight volumes since privatisation in 1997; record levels of customer satisfaction; and a recent safety record among the best in Europe.

It is fair to say that more and better ex-post evaluation would help us to establish how these benefits were achieved, what represents best practice, and whether even more could have been achieved with different judgements or levers. We believe that this is an area in which both regulators and the research community could do more.

The UK model is held in high regard and copied in other countries and is recognised as a positive model for reconciling the interests of consumers with those of investors while preserving dynamic incentives to efficiency.

We are also seeing the extension of parts of the economic regulation toolkit and consumer empowerment to some public services, without privatisation – notably health services and –under legislation currently proposed – England's strategic road network.

[3] See chart 2, at end.

Whatever happened to the 'withering on the vine' of economic regulation as competition law and 'normal markets' took over?

A lot has been delivered since privatisation. But one major expectation has not happened. Regulation has not withered on the vine in all sectors.[4]

- In water there have been challenges in extending competition – for example, , while the new appointments regime allows for 'competition for the market' it still replaces one monopoly at the retail level with another, and the Water Supply Licensing regime introduced in the Water Act 2003 only allows the very largest business customers to switch supplier and few have done so;
- in energy markets there has been dissatisfaction with the results of market liberalisation and especially about the benefits delivered for consumers: Ofgem recently referred the whole energy market to the CMA; [5]
- in rail, the structural and financing responses to the post-Hatfield crisis have weakened incentives on the incumbent infrastructure monopolist to perform for its customers; and like the market for passenger rail services, it is prone to intervention by civil servants;
- in health – we are only starting to see the impact of a form of regulation compelling the commissioners of NHS-funded services to think hard about consumer benefits first. But Monitor – and beyond Monitor the competition regime – is starting to focus minds;
- meanwhile there have been more successful, structural interventions and deregulatory moves in airports; while in communications liberalisation and technological change have transformed the market and people's everyday experiences.

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[4] As illustrated in chart 4.

[5] Ofgem referred the energy market to the CMA for a full competition investigation on 26 June 2014, expecting that the CMA would examine among other things the relationship between the supply businesses and generation arms of the six largest suppliers barriers to entry and expansion for suppliers; the profitability of the six largest suppliers; whether or not there is sufficient competition between the large energy suppliers; the trend of suppliers consistently setting higher prices for consumers who have not switched; and low consumer engagement that contributes to weak competitive pressure in the market.

See Ofgem announcement: https://www.ofgem.gov.uk/press-releases/ofgem-refers-energy-market-full-competition-investigation

Why have we seen so many regulated sectors remaining with relatively little competition being introduced? There are several possible explanations.

Even recognising that there are good reasons why competition has taken hold more fully across regulated sectors, regulators have recently been challenged - by government and commentators – on why we have not made more use of our powers under competition law. There are a number of possible explanations.

First, we don't see "lazy old regulators" simply not doing the work on competition and structural issues because it's too difficult, or likely to be tough to explain and a battle to achieve. On the contrary we see regulators trying to confront difficult issues in different sectors –where progress often requires interventions and conversations over time. All regulators spend time considering whether we have the right balance across the levers that we use. We think a lot about the balance between on the one hand the use of ex-ante regulatory levers - which can be complex and intrusive but often yield rapid and visible improvements for consumers; and on the other, the use of competition powers and structural reforms which might lead to market solutions in the longer term, and significantly reduce the scope and intrusiveness of regulation.

We don't see much evidence of capture or cosiness either - though of course, when parts of your workforce as a regulator are embroiled in the day-to-day interactions with regulated companies, this is always something the needs to be guarded against.

Beyond this, in the grind of day-to-day regulation, such as monitoring and holding to account, you need to make sure that you give enough focus and attention to the big issues for customers, society and the economy, now and over the long term. You have to challenge yourself constantly about whether you are really putting most effort where it will deliver most value.

That can be hard – and it is harder when regulators face multiple objectives or take on functions which are not central to their task, or which risk compromising their independence of government. Some see this as paralleling what we ask regulatees to do – we are 'playing to our USP' and 'growing the business'. But another way of looking at this is what the Institute for Government calls the 'Christmas tree quango' - taking on incremental function by incremental function. We need to remember that we are not 'growing businesses'. We are independent statutory bodies with duties, among other things, to improve the lot of consumers and business users. When considering our functions we need to keep clearly in mind the need to sustain and improve the integrity, focus and expertise which allows us to act firmly in consumers' interests now and in the long term.

We not only have statutory duties but statutory powers, and we consider carefully when, where and how to use the different levers available to us. In particular, we challenge ourselves as to whether we have the right balance between our use of competition powers and those powers available to us under the sectoral regulatory framework. Regulators have generally taken fewer cases under the 1998 Competition Act (CA98) than the competition authorities – though there have been several. If on the other hand you look at the crude numbers of market studies over the last decade[6] since 2005, the numbers initiated by sectoral regulator are around one-quarter of the numbers undertaken by the Office of Fair Trading, across all markets and the entire economy. This is proportionately not far out of line. So it is not clear that regulators have shied away from the use of competition powers compared with other sectors.

The use of regulatory measures is not always wrong-headed from the perspective of consumer outcomes: far from it. Regulatory and ex-ante levers can often get surer, quicker benefits for consumers – indeed the OFT's use of commitments and the Competition Commission's use of behavioural remedies shows that the use of ex ante solutions is not limited to regulated sectors.[7] Further, ex ante powers – used pro-competitively – can also be the best way of introducing and embedding competition in markets that have historically been monopolistic. And as we are all under pressure to demonstrate value for money and improve efficiency, our choices will also be affected by the resource implications associated with different levers. We are constantly looking for the most efficient and effective tools to solve the given problem, while recognising that using some levers – such as those available under competition law – also bring wider benefits for the regime as a whole.

It is fair to say, and perhaps obvious, that just as the stance of regulators varies across sectors in respect of the use of their competition powers, so too the role and approach of government varies enormously across sectors. That variation reflects in part the different structural circumstances of each sector; in part it reflects intertwining goals of promoting economic growth, the interests of consumers, and other policy objectives. It can reflect the financial exposure of government departments, and the amounts of public money at stake in sectors such as transport and health. And sometimes it reflects different departments' stances on structural issues - from pro-competition to less so. There are very significant variations in approach between departments.

So there are significant differences between sectors – in approach, in underlying economics, in market structure, in conduct and in technology, as well as in the legislative and policy framework. These help to explain the variation in the balance of

[6] Since 2005. Source: Competition and Markets Authority: 'Baseline' annual report on concurrency (April 2014), and archived websites of the Office for Fair Trading and the Competition Commission.

[7] See Amelia Fletcher: Privatisation, economic regulation and competition in the utilities: Have we got the balance right?; Beesley Lecture Series, 14 November 2013; pp 9-10. http://competitionpolicy.ac.uk/publications/presentations-and-lectures

competition and regulators levers used by sectoral regulators and the competition authorities.

Regulation and new investment

We highlighted above some of the notable successes of economic regulation in the past decade. We sometimes forget, or take for granted, how the system of independent economic regulation has improved efficiency, quality and choice, for consumers, in part through the provision of a stable and predictable environment for investors in which risks are understood, commitments are credible, and the cost of finance commensurately lower. This is all the more difficult where other pressures – often beyond the regulated market itself – have led to upward pressure on prices. It is a difficult message, but even where prices have risen – perhaps as a result of the need for massive investment to improve service, or to deliver environmental benefits – they are still lower than they would otherwise have been without independent economic regulation. There is a danger that we fail to learn from the way regulation has played out over the last decade, and miss an opportunity to apply the techniques and lessons to new circumstances.

This is all the more important at a time when plans for renewal and expansion of UK infrastructure are becoming more ambitious. This is in part a response by the Government to concerns that underinvestment in infrastructure may constrain future economic growth.

The World Economic Forum's 2013 global rankings for the quality of infrastructure suggest that the UK has slipped from 6th to 8th position.[8] The Treasury's National Infrastructure Plan points to evidence that this may have constrained GDP growth over the last decade.[9]

On the positive side the UK remains a world-leader in attracting private sector investment in infrastructure. A recent study ranked the UK as the No.1 place in the world for infrastructure investment.[10] Independent economic regulation, has contributed to developing a stable, attractive environment for investors. It is a framework which global investors are familiar with and understand. It provides a long term view and insulation from political risk, which they value and which benefits consumers through lower financing costs.

[8] World Economic Forum: Global Competitiveness Report 2013-2014
[9] HM Treasury: National Infrastructure Plan 2013; December 2013, chapter 2.
[10] Nabarro LLP: Nabarro Infrastructure Index - Attracting Investment

The UK Government's National Infrastructure Plan points to an infrastructure project pipeline over the next decades totalling investment of £377 billion at 2012-23 prices.[11] Around £220 bn of this is in the energy sector, and £120 bn in transport, including aviation, roads and rail (see chart 5). But there are significant programmes in other sectors too. It includes some of the biggest engineering projects of our age – such as the Thames Tideway Tunnel, High Speed 2, and major investments in low-carbon energy generation and transmission; as well as increasing airport capacity – though the findings of Sir Howard Davies' Airports Commission are of course not yet factored in. There are also major investments beyond the regulated networks – in the strategic roads network and in flood risk management.

The regulators are of course engaging with government and businesses in the process of considering how projects can best be scoped to deliver efficiently benefits for consumers and the wider economy; and how they can be funded in a way which protects the interests of consumers both today and into the future.

It is fair to say that a variety of instruments is developing to attract investment to the infrastructure pipeline. Sometimes they make good use of the existing regulatory regimes – as in the case of the Thames Tideway Tunnel, enhancing existing rail infrastructure, and airport capacity. Economic regulation will not be the answer to all problems in all circumstances. But, going forward, the economic regulatory tool kit may have more to offer, for example in providing an alternative to long-term contracts and guarantees and one that provides ongoing, dynamic incentives to deliver services and improve efficiency in the best interests of consumers. These are the very the problems where independent regulation has a strong track record - with its toolkit of efficiency reviews and credible incentives, and scope to evolve to meet new challenges.

We are not attempting to answer this question here. But with a massive programme of investment in the pipeline for the UK, and with increasing concern about efficiency and the cumulative cost to consumers, it is in everyone's interests that we improve the understanding of what independent regulation can contribute; where it works best; and how it can evolve to get better results for the future.

[11] HM Treasury: National Infrastructure Plan 2013; December 2013

Change is good: learning and evolution to drive better outcomes

If policy-makers need to (re)learn about the benefits of economic regulation and where it can best add value in our economy and society, regulators need to learn too.

As is apparent from the current policy debate, the continued existence of independent economic regulation is not an incontrovertible truth. The legitimacy of economic regulation – and the ability therefore of regulators to do their jobs – rests on its ability to deliver. In particular, regulation needs to continue to play, and be seen to play, an important role in customers and society getting what they need, want and can afford from regulated sectors. This is an important learning point in itself for regulators. It also has a number of important implications.

The first is that regulators need to improve their understanding of what really drives the delivery of the outcomes that customers and society experience. This is increasingly important as, decades from privatisation, the low hanging fruit has been picked from the former state-owned monopolies and the obvious routes to market opening and efficiency improvements have been taken. For the most part, regulators' activities these days are concentrated on more complex and less tractable issues. To maximise our effectiveness and efficiency, and guard against perverse outcomes, we must understand the complex matrix of interactions within and between sectors which together result in the outcomes experienced by customers and society. We must understand the transmission mechanisms by which the regulatory tool kit influences those outcomes, and how this is affected by the wider set of influences on company behaviour. Regulators need to be prepared to work with and through others whose influence can complement theirs. And overall, there is a greater premium on understanding what works and what doesn't and why.

The second implication is that regulators must recognise that relationships matter. In part this is because of their role in delivering outcomes, as noted above. But it is increasingly clear that strong, effective relationships – particularly those between service providers and customers – have a value in themselves, especially in the provision of public services. Customers could be getting an objectively good product, with a good level of service at a reasonable price, but if they aren't kept informed, don't trust that they are getting what they paid for, or don't know what to do when services don't work as they should, then there is something wrong.

The third implication is that regulation must evolve, or it will decay. The complex systems that ultimately determine the experience of customers and society in regulated sectors are constantly changing. And the expectations of customers and society are changing too. If regulators are to use our tools to maximum effect in helping to deliver what customers and society expect, then it is clear that the tools we use and the way we use them must evolve to be successful.

On one level, this seems self-evident. But change in regulated sectors is often controversial. Indeed, we have noted above that one of the successes of independent economic regulation has been its creation of a framework that has enabled private financing of massive investment in UK infrastructure at low cost, in part because of the stability and predictability it provides. So change needs to be managed carefully, and regulators need to devote time and effort to doing it. There are three key elements to this. The first is that there needs to be a clear and compelling case for the change; if change is unsettling, then change for change's sake is scary. The second is that it must be clear what is not changing. In the case of economic regulation, this is about sticking to a clear and consistent articulation of the goals and principles, which sit above the use of individual tools. The third is that there must be ongoing two-way communication before, during and after the change. In this way the regulator can build and maintain the trust of those affected, and also maximise the effectiveness of the change itself by working with and through others, and building on learning through the process.

So the continued legitimacy of independent economic regulation and its ability to provide precisely that stability and predictability that has been a cornerstone of its success, requires that it must change.

Learning across sectors: the UK Competition Network and the UK Regulators' Network

We have already talked about the increasing importance of understanding what works and what doesn't and why, the scope to work more collaboratively, and the need to ensure we are constantly evolving best practice and applying regulatory and competition levers to the advantage of customers and society. This applies as much – if not more – across sectors as within them. Our feeling as regulators is that we need to do more together, to pool and share experience and expertise; and to undertake specific work on shared problems.

In promoting competition, the advent of the UK Competition Network (UKCN) and of the CMA, with additional resource from next year for deployment in sectors where regulators have concurrent powers – makes a difference to what we can do. Individually most regulators have limited numbers of CA98 cases and market studies, and consequently limited specialist capacity. We're already seeing joint work across the UKCN between the CMA and regulators – with the reviews of energy markets and retail banking being the most high-profile examples.

In parallel we have launched the UK Regulators' Network (UKRN) to work on areas of common interest. The Network consists of the UK's nine economic regulators. It mirrors the UK Competition Network, but without the CMA, to avoid potential conflicts with their regulatory appeals role. The CMA has observer status at our discussions.

The UKRN is a vehicle for co-operation that supports the separate independent regulatory frameworks of the individual regulators. It will allow regulators to work closer together on issues of cross-sectoral significance and to learn lessons across industries which help to improve regulation and the promotion of competition in order to secure better outcomes for consumers.

The three main objectives of the UKRN are to improve the consistency of economic regulation across sectors, deliver efficiency of regulation, and to improve understanding of how independent economic regulation works in the interests of consumers, society and the economy, identifying scope to do better.

The members of UKRN are committed to working together to achieve these objectives. This commitment includes a programme of joint work on issues of cross-sectoral significance and applying lessons learned across sectors to improve the system of economic regulation.

The first areas of focus for the UKRN will include understanding what works in promoting customer engagement and switching in regulated markets; assessing cross-sector resilience and cyber-security and developing a clear understanding of the overall affordability of regulated services for consumers. We will also look at our skills and labour market across the regulators to see if we can make more of our scarce expert resource.

An important focus for UKRN now is in ensuring that the existence of multiple regulatory regimes does not impede investment. A specific project aims to address this, and will produce a handbook for investors, giving a clear explanation of the way the UK system works, the roles of the regulators and the significance of regulatory independence, recognising that some new investors are less familiar than others with the UK framework for reducing political and regulatory risk. And for the first-time investors with cross-sectoral interests will be able to pick up the phone and talk to a central point person who can make sure issues are addressed collectively where appropriate.

Correspondingly, and building on the government's 'Principles for Economic Regulation', we will be able to do more to draw lessons across sectors on how government can most effectively work with independent regulators – something which in our view has been neglected for too long. [12]

UKRN builds on the previous arrangements for collaboration between regulators, which was the Joint Regulators' Group. But it is different in three important ways. First, it will be led by the Chief Executives of all the member regulators, who will provide direction, who will commit resource and who will be accountable for the delivery of its expected benefits. Second, there is dedicated resource for UKRN. We have a small office to coordinate and drive progress, staffed by people from the regulators. We also have committed funding from the members, and a further commitment to contribute staff for projects as necessary. Third, there will also be a small expert panel to support and challenge our thinking, and our work and the challenge will be transparent so people can see what we are up to.

This is not a world takeover or an attempt to create a "super-regulador", in the style of Spain, Estonia or the Netherlands.[13] UKRN does not have any decision-making powers or functions in respect of any of the regulated sectors. UKRN does not compromise regulatory independence or the ability of each regulator to make the best judgements for its sector. Regulators' functions and duties remain as now, with each Chief Executive on UKRN accountable separately to his or her own Board. Beyond the Chief Executives, there is no collective oversight, we are separately accountable, as now.

UKRNs work will be very focussed on maximising the benefits from coordination or read across between sectors. We will not do anything which we, as Chief Executives, are not willing to take to our Boards and consider acting on. We will focus on work we think is better done together or where we have things to learn from each other, and only where we are clear it will have practical impact.

Conclusion

Independent economic regulation has delivered a great deal for UK customers and society in the decades since privatisation. It has helped to deliver better service, step changes in efficiency, and massive investment in infrastructure. The economic regulator's tool kit – powers under general competition law and under consumer protection law, sectoral regulation of monopoly and sectoral regulation to promote competition – is a powerful one. It has an important role to play in years to come, especially taking account the scale of the investment pipeline needed if the

[12] Department for Business, Innovation and Skills: 'Principles for economic regulation', April 2011.

[13] Global Competition Review: 'The painful birth of el super regulador', 17 December 2013.

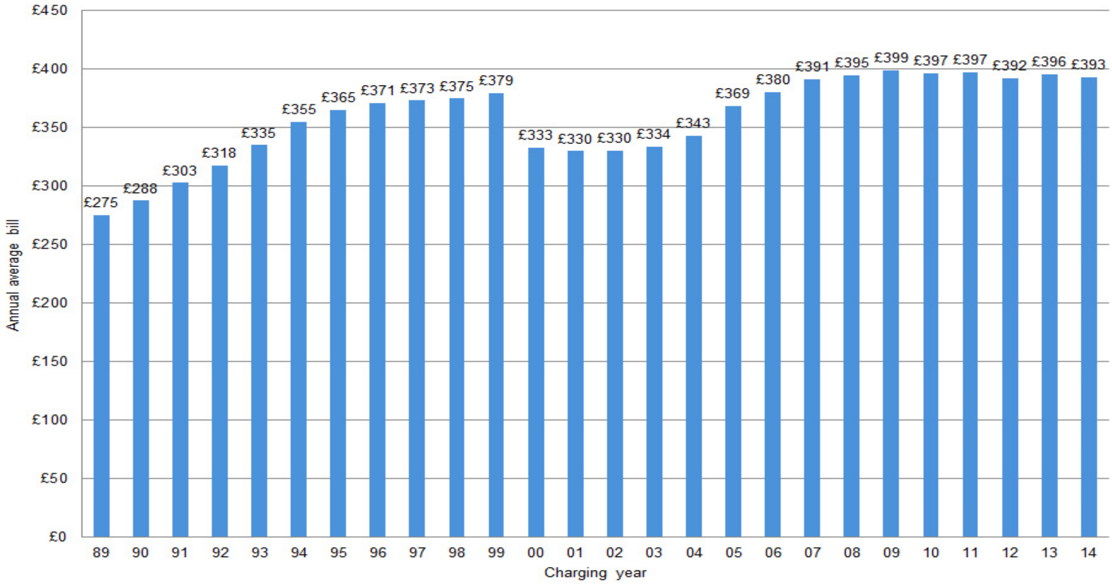
expectations of UK customers and society are to be met and the UK economy is to grow.

But we cannot take independent economic regulation for granted. Regulation needs to maintain its legitimacy by helping to deliver what customers and society expect from regulated sectors – and being able to demonstrate the value it adds. While the goals and principles of economic regulation remain constant, the way in which regulators use their tools will need to evolve. Regulators need to manage such change carefully, building relationships and trust. And any change must be informed by learning – within and across sectors.

The UKRN provides a great platform to facilitate and promote this learning. Under this umbrella, we are keen to hear from researchers, consumer groups, businesses and others to help us all to get a better understanding of the effectiveness of different regulatory and competition policy levers; to evaluate regulatory practice; and to assess the potential gains from market reform. We are committed to maximising the benefits that economic regulation can bring for the UK economy and society, enabling us to assess how economic regulation can best meet future challenges.

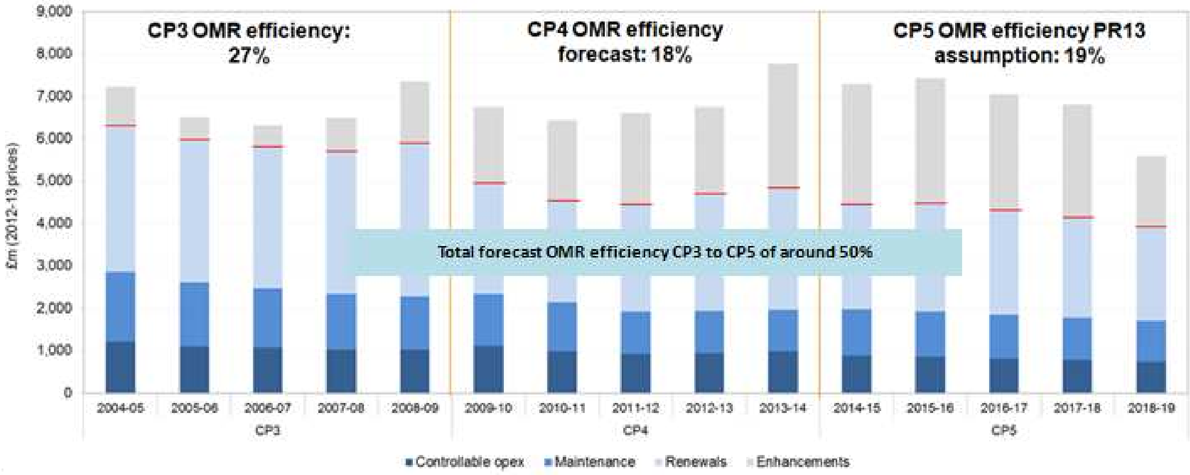
Annex: charts

Chart 1: Annual average domestic water bills, England and Wales, 1989-2014: average bills have risen but are around one-third, or £130, lower because of Ofwat's efficiency challenge. Bills have remained flat at around £1 a day since 2009.



Source: Ofwat. November 2013 prices.

Chart 2: Network Rail operating, maintenance and renewals costs; and enhancement spending, 2004-05 to 2018-19: under the regulatory regime, improved efficiency has freed up funding for network growth and improvement



Source: Office of Rail Regulation. 2012-13 prices.

Chart 3: Privatisation: the expected story

- Privatisation: Was to change managerial incentives to focus on profit-maximisation.
- Regulation: Was to ensure, in the absence of competition, that those profit-maximising incentives drove benefits for productivity and consumers.
- Competition: Was to be the beautiful butterfly that could thereafter be left to work its magic for productivity and consumers alike.

Source: Amelia Fletcher: Privatisation, economic regulation and competition in the utilities: Have we got the balance right?; Beesley Lecture Series, 14 November 2013

Chart 4: Regulation: a changing focus

Most water and sewerage services	Energy transmission and distribution	Financial services
2nd class stamps	BT infrastructure	Telecoms retail
Heathrow and Gatwick airports	Water/sewerage wholesale	Energy wholesale
Regulated rail fares	Network Rail	Energy retail (so far!)
	'Last mile' postal services	Water/sewerage services for large use customers
	(Payment systems)	Other postal services
		Other UK airports
		Other rail fares

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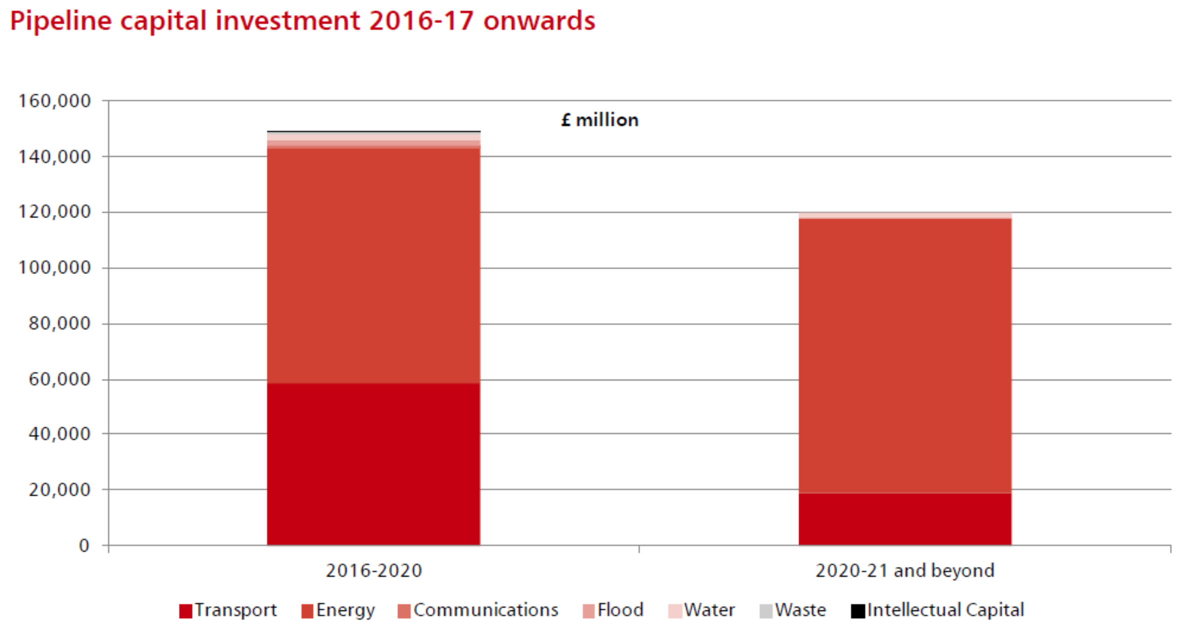
Source: Amelia Fletcher: Privatisation, economic regulation and competition in the utilities: Have we got the balance right?; Beesley Lecture Series, 14 November 2013

Chart 5: Projected infrastructure investment, by sector, 2012-13 prices



Source: HM Treasury: National Infrastructure Plan 2013; December 2013

Chart 6: UK Regulation Network – organisation

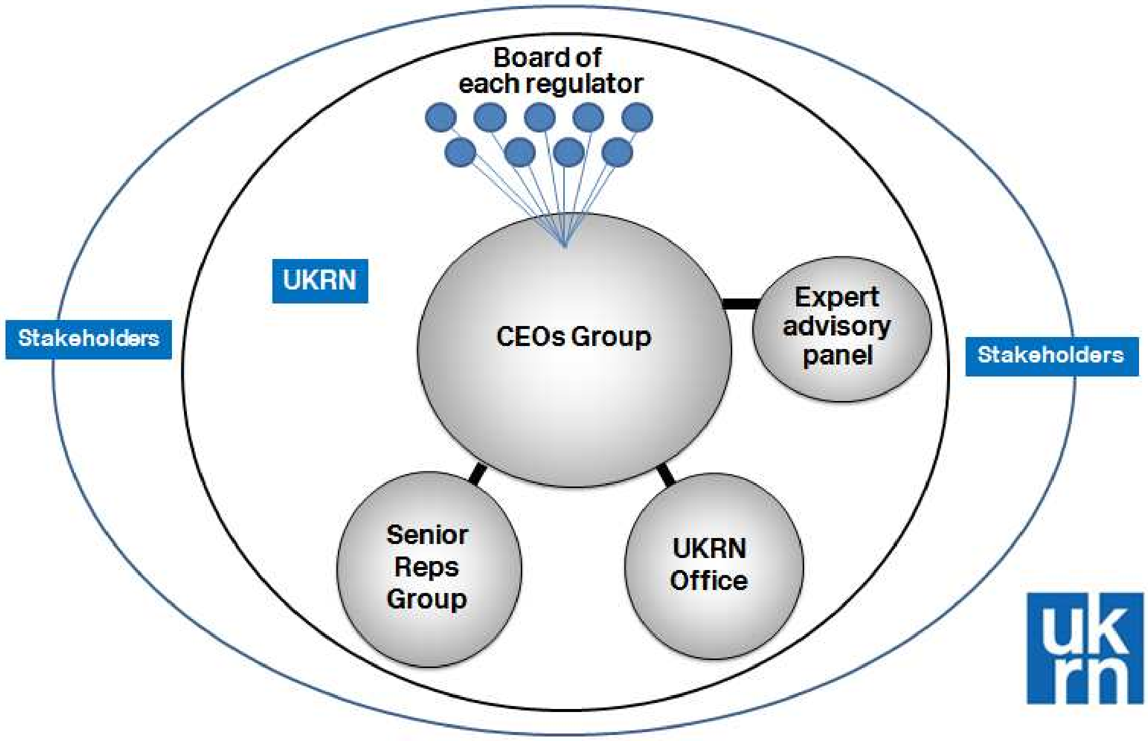


Chart 7: UK Regulators' Network: Project governance and delivery