Substitutes & complements for traditional economic regulation of monopoly infrastructure
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Outline

• Does utility regulation need reform?
• Ofgem's RPI-X@20 review
• Argentina: the public contest method
• US and Canada: negotiated settlements
• UK airport regulation: constructive engagement
• Australia and NZ: monitoring & light-handed regulation
• A way forward?

Does utility regulation need reform?

• Privatisation, competition and regulation have often been controversial in the UK
• But generally quite successful in delivering greater efficiency and value for customers
• In particular, RPI-X network regulation is impressive, thorough and effective, But …
• Increasingly complex & burdensome
  • Cf Prod Comm AER to reduce cost & complexity
Some concerns

- Does it lead to efficient investment?
- Customers give views, not take decisions
  - So regulators have to try to justify their decisions instead of customers deciding for themselves
  - Adverse effect on industry relationships
  - Puts premium on media and political pressure
- Tendency to regulatory uniformity
  - Less tailoring to local needs
  - Less innovation
  - Less comparison
  - Less learning from experience

Ofgem’s RPI-X@20 review

- Ofgem is also examining regulatory approach
  - For example, in electricity distribution
- Prices down
  - Distribution charges halved since 1990
  - Opex reduced 7.7% per annum 1992-2003
- Quality up
  - 11% fewer power cuts 1990-2005
- Interruptions 30% shorter
- Investment up (figures per 5 year period)
  - £3.8 bn 1986-1990 pre-privatisation
  - £5.2 bn 1990-2004 post-privatisation (average early periods)
  - £7.4 bn 2004-2009 current period
Ofgem’s evaluation (continued)

- Cost of capital down (partially less risky)
  - ~ 8.5% pretax WACC 1990
  - ~ 6% pretax WACC 2005
- Has accommodated changes in demand and supply on networks
  - 30 GW gas CCCTs replacing 24 GW coal & nuclear
- Ofgem supportive descriptions of RPI-X
  - “A trusty servant … hugely successful”
  - “A faithful and sturdy workhorse in delivering efficiency and investment”

Then why review RPI-X?

- RPI-X has delivered well but now time to review
  - Complexity, financial issues and 20 year routine check-up
  - Suggestions by companies and academics
- Most important - the world is changing
  - Renewables, carbon reduction, nuclear, distributed energy, smart meters & grids
  - Networks efficient but risk-averse, reactive, not innovative
- Two main questions
  - How to get innovation & efficient networks against backdrop of hugely uncertain future?
  - How to engage consumers & users, improve company focus & improve legitimacy of process?

Some other approaches

- What other approaches more involve users?
- Argentina Public Contest method
- US negotiated settlements at FERC
- And as applied in Florida
- And at National Energy Board, Canada
- Constructive engagement as applied by CAA to UK airports
- Ofgem: apply to UK energy networks?
Public Contest method

- Argentina electricity privatisation 1992 – govt sceptical of companies and regulator
- Existing transmission grid RPI-X price cap
- New investment proposals had to be proposed, voted for and paid for by users
- Construction, operation, maintenance put out to competitive tender to determine cost

Experience

- Initial problem but generally worked well
- Bidding competitive
  - Generally won by new independent cos
  - Introduced innovative technologies
- Cost reductions over time
  - cost/km about halved
- Users did in fact work together
- PC method resisted political pressure
  - More economic outcomes than regulation

US energy regulation: FERC

- US federal energy regulators encouraged parties to settle
  - Initially to cope with backlog at Federal Power Commission
- 1994-2000: 41 gas pipeline cases, 34 settled in full, 5 in part, only 2 litigated
  - (Wang 2004)
- Different approach: look at situation as a whole
- This process led to innovative rate freezes and better efficiency incentives than regulation could
  - FERC could accept but not legally impose these
Consumer advocate in Florida

- Public Service Commission is regulator
- But consumer advocate (Public Counsel) has negotiated settlements with utilities
- Customers got rate reductions worth $3bn
- Utilities got greater accounting flexibility
- And revenue-sharing price freezes (pro-efficiency) instead of rate of return control

FPSC base rate cases

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FPSC rate cases and OPC stipulations

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Toll hearing days one quarter of previous level
What caused this change?

Pipelines in Canada

- Before: National Energy Board long hearings
- Since 1997 almost all rate cases settled
  - Especially multi-year incentive systems
  - Also provision of info, quality of service provisions
  - Better info and customer relationships in industry
- National Energy Board policy
  - Encouraged settlements
  - Refrained from cherry-picking and giving directions
  - Set generic cost of capital to aid negotiation
- Policy: if process sound, accept outcome
  - Don’t substitute own view of public interest
Emerging principles?

• Regulatory responsibility does not mean that the regulator has to take all the decisions
• Role of regulation is to facilitate market discovery process not replace it
• If regulator removes monopoly power, market participants can determine outcome
  • But regulatory responsibility to any parties not at table
• Parties are in fact willing & able to participate
  • Transactions cost not a problem in practice

Constructive engagement

• Civil Aviation Authority (CAA) had concerns about previous price control process
• Asked airlines & airports to try to agree
  • Quality of performance standards, traffic forecasts and investment programme
  • CAA retained responsibility for opex, cost of capital, financing and final price control
• Largely achieved at Heathrow & Gatwick
  • Plus improved relationships and understanding
  • Initially unsuccessful at Stansted

Constructive engagement cont’d

• Competition Commission critical of some aspects
  • Limited availability of information by BAA, capex growth during & after process, CAA should be arbiter
• But supported principle of constructive engagement
• Faced with Stansted, CC restarted constructive engagement process – capex agreement reached
  • With strict rules, & recognising delay to second terminal & runway
  • "airline customers generally in much better position than regulator to suggest needed development"
  • future airlines & passengers’ interests don’t deviate from present
  • Made recommendations to improve process (more information by BAA, and CAA to appoint facilitator) – now implemented
Lessons from NZ?

- History of regulation has been problematic
- 1984-1999 Light-handed regulation
  - Ineffective at protecting customers
- 1999-2008 First attempts at regulation
  - More credible threat (thresholds) but often arbitrary
- 2009 The new model
  - Input methodologies systematic - but inflexible?
  - Negotiate/arbitrate – only for few users?
  - Default price quality paths – no role for customers
- Too soon to use as model for elsewhere

Lessons from Australia?

- Monitoring of airports in lieu of control
  - 2002 Productivity Commission recommendations
- 2006 Productivity Commission review
  - Benefits re investment, not excessive prices, but
    - market constraints not strong & lack of regulatory clarity
- 2007 policy continued & valuation principles set
  - Commercial negotiations encouraged
  - But Forsyth: light-handed cost-plus regln hence inefficiency?
- Will follow experience – will monitoring principles allow longer term contract market to develop?

Which approach best to explore?

- Will depend on circumstances
- Public contest method would require changes in UK law, & added complexity of voting
- NZ and Australian experience as yet limited
- Constructive engagement is consistent with UK law & develops existing regulatory practice
- CE offers benefits of negotiated settlements if
  - It reflects wishes of participants re scope for engagement
  - Parties consider total price of package
  - Doesn't unduly constrain form & discourage innovation
CE still has role for regulator

- Eg set timetable and process
- Enforce rules on information disclosure
- Specify constraints eg government policy
- Continue aspects of existing approach
  - opex assessment and comparative benchmarking?
  - set cost of capital?
- Satisfy itself on who represents customers
- Fallback process in event failure to agree

Who would take part?

- How to identify consumer groups?
  - Large users, public bodies, poverty lobby groups
- Are they interested and able to participate?
  - Some precedent in UK 1995 - Consumer committee supported company on capex, not Offer
- Consumer groups might need support?
  - Regulator could require networks to provide info
  - Consultancy advice charged to customers?
  - Or to companies via price control (eg Alberta, US)
- How to use consumer research evidence?
  - Which is increasingly used in present approach

Advantages of this process

- Regulation more responsive to users
  - More legitimacy – customers themselves decide
  - Better tailored to local conditions
  - Better local monitoring of ‘capex contract’
  - Better relationship customers & companies
- Better resolution of future uncertainty
- More flexibility on price control settlements
- More innovation, more lessons learned
Conclusions

- RPI-X regulation generally successful in UK
- But concerns at limited role of customers
  - And Ofgem concern about meeting future uncertainty
- Other approaches involve customers more
- Constructive engagement seems worth exploring & extending in UK (energy, water)
- Benefits in terms of customer preferences, legitimacy, innovation & meeting uncertainty