ACCC/AER Regulatory Conference 2016
The future of economic regulation: Does the conventional wisdom still apply?
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Thank you very much for inviting me to speak. It has been a long journey from a number of perspectives for me to be here – but I am very grateful to the AER and the ACCC for the opportunity.

As I have recently joined the commercial world, I need to be clear upfront that the views that I am expressing today are very much my personal views and have been formed from my experience as a regulator across utilities and in healthcare. Views on payment services – and the regulation or not of this important sector will need to wait for another occasion.

When I first looked at the title for the event today I was puzzled by what people would understand conventional wisdom of economic regulation was.

As I had the great privilege early in my career of working in an organisation led by Stephen Littlechild and spending time with Michael Beesley, I thought I would go back to, to understand what it was supposed to be:

1. RPI-X (or price cap) provides greater scope for firms to keep gains above the productivity bargain;
2. Competition should be promoted where ever possible; and
3. Price regulation is likely to be more effective where technology is changing slowly whereas the promotion of competition is more effective where technology is changing rapidly

My question is more around what it has become in the circa 30 years since privatisation began in the UK.

Anyone who has worked with me will tell you that I definitely do not have a reputation for being conventional, and have often been frustrated by the tendency within economic regulation to be bound by our own increasingly complex rules and principles. At times I think that this makes it difficult to take a step back and look at whether we are driving the best outcomes for customers.

So, today I am going to cover 3 areas with you.

1. Politics - & its relationship with regulators
2. Regulators - & the risk of unintended consequences
3. Customers - & how they might just be <u>the</u> (or at least part of the solution) in establishing a new kind of conventional wisdom.

Politics

I thought after working for 9 years in energy policy that I understood politics. That was until I spent 4 years in the heart of UK government working to reform the National Health Service.

The era of 24-hour news cycles meant that policy responses were developed in minutes and out to the media within the same hour. Prime Minister's Questions in the House of Commons became the opportunity to attempt to gain control of the political narrative – although equally it could become the most challenging day of the week as the opposition often tried to demonstrate their social credentials to the media (and ultimately the electorate).

What became very evident, week by week, and year by year was that it was challenging if not impossible for health care providers to take investment or even medium term operational decisions.

Priorities that were established – for example to focus on stroke care – were rapidly refocused on to emergency care. Decisions to make providers autonomous and responsible for their own care provision were equally wound back if the politicians felt that they did not have a good answer to the delivery of poor quality care by one provider. And finally there was musical chairs in the roles and responsibilities for the system, as the political wind changed from a centralist agenda to more localism, and community ownership for healthcare and back again.

Please don't get me wrong – I could not do the job of a Politician– but for me what is important that we take from this experience is that politicians are always going to be influenced by relatively short term agendas – even when dealing with seemingly long term issues like providing the best health care for a community, or an energy policy for the UK. And that is a convention which is unlikely to change.

My time in energy was something of a golden era. The political environment – especially from the period from 1998-2004 was relatively straight forward. Politicians wanted us to use markets and increasing competition to ensure bills were as low as possible (and to keep the lights on – which given the legacy of the past was relatively straight forward).

By the time the new trading arrangements were introduced in 2001 the Government had managed to get itself out of the business of picking winners in the form of particular technologies to support in the generation mix. Lobby groups kept up the pressure but there were clear and consistent messages about technology needing to find its own place in the market.

This clarity began to fade as climate change moved up the politically agenda. And once a department of government is established with a secretary of state who feels responsible and accountable for the delivery, perhaps understandably, it is rare that the choice is made to rely on markets alone.

We saw the energy trilemma formally established from 2003. With government interventions seeking to reduce carbon, securing supplies and trying to keep bills as low as possible. One of the most significant issues was that it was quickly realised that there were trade-offs and it was very hard to achieve all three objectives simultaneously. The consequence of this was the Government focused on different issues driven by short term political imperatives.

Sadly the energy market that I left in 2007 which was beginning to work as anticipated now resembles something more akin to healthcare, and is again characterized by short term interventions – with consequential impacts on investment and other more medium term decision making.

In many respects this was puzzling because the conventional wisdom of economic regulation was in part that regulators were put in place to protect investor interests against short term political decisions. However what is interesting is that when you look at the relationship between the regulator and government in this period, the statutory responsibilities of the regulator were amended and guidance offered to ensure that the political will was delivered.

The UK Competition and Markets Authority (CMA) in its recent report into the energy market has made some very far reaching comments on the relationship between government and the regulator, which the government has already committed to accept. For me it is interesting that these perhaps have not achieved as many column inches as some of the other findings – again because they potentially are longer term in their impact.

The CMA found that a combination of features in the wholesale and retail gas and electricity markets give rise to an AEC through an overarching feature of a lack of robustness and transparency in regulatory decision making which, in turn' increases the risk of poor policy decisions which have an adverse impact on competition. These features were:

• The regulator's statutory objectives and duties which, in certain circumstances, may constrain its ability to promote effective competition;
• The absence of a formal mechanism through which disagreements between government and regulator over policy decision-making and implementation can be addressed transparently; and
• The lack of effective communication on the forecast and actual impact of government and regulatory policies over energy prices and bills

To address these deficiencies the CMA proposed a number of remedies:

Which the government has agreed to initiate a legislative programme with a view to:
• Reverting to a focus on promoting competition
• Setting up a clear process to allow the regulator to publically comment on all draft legislative and policy proposals which are relevant to its statutory objectives and likely to have an impact on the GB energy market.
• For government and the regulator to publish detailed joint statements concerning governments proposed policy objectives that are likely to necessitate parallel or

consequential Ofgem interventions setting out (1) an action plan for the regulatory interventions needed and an action plan for these (2) an estimated timetable, and (3) where appropriate, a list of relevant considerations in designing the policy.

So what next?

The Government is currently firmly invested in the energy market. This investment comes through the various contracts and support mechanisms that it has put in place. The vast contribution of policy costs on customers' bills which is already significant is only set to rise over the coming years. And it looks likely to continue for a very long time to come (10 to 35+ years) if the UK Government proceeds with its nuclear programme.

The implementation of the CMA's remedies offer an opportunity to both get the regulator refocused on what it was originally set up to do. And an opportunity for the regulator to be a thorn in the side of the politicians through explaining the costs of interventions in markets.

However vesting the accountability and control in a regulator comes with its own note of caution on the basis of experience in UK energy markets.

Regulators and the risk of unintended consequences

As a regulator you spend a lot of your time focused on questions that arise due to a firm's market power or monopoly position. I have spent many years pondering whether customers are better served through having a franchise for system operation for example, rather than 'gifting' this to the incumbent company. Equally I have challenged hard the premise that all extensions to the networks need to be delivered by the incumbent and with some success changed the conventional thinking on this.

However I probably spent less time than I should have focused on the only certainty on these questions – which is that as a regulator you have the ultimate statutory monopoly – and severe care needs to be exercised to use those powers well and responsibly.

In my experience no one in regulatory offices sets out to have an adverse impact – in fact the opposite is true that people generally strongly identify with the objective of the organisation and want to 'do the right thing'.

I want to share with you a couple of examples where good intentions may have had some far reaching and unintended consequences.

Example 1: Winter outlook report

The winter outlook report was introduced in the UK to address a growing amount of noise and concern around whether markets would deliver security of supply. Our intention was to simply provide the market with information – and the idea was that the roles and responsibilities would remain unaltered.

In the absence of resource – and of any other party willing to do this – it was decided to ask National Grid as system operator to undertake the activity.

The report was initially very well received. However over time it has become the focus of political attention with headlines in tabloid newspapers around National Grid predicting that the lights would go out. This fed a political concern that 'something needed to be done' to stop this from happening.

It was also a mistake to put National Grid in the role of producing the report – not least because this blurred accountability and responsibilities. And again as soon as you make someone feel accountable and responsible they understandably want to have levers and tools to address the issues.

Since this time we have witnessed the reintroduction of a capacity mechanism and seen National Grid greatly expand its role in contracting power in the market. Estimates of these costs to customers are as high as £1.5bn and rising.

Of course we can't put this all down to the well intentioned release of information – and we will never know the counterfactual – however I regret deeply the well intentioned and pragmatic decision we made to ask National Grid to produce this report.

The second example relates to delivering social outcomes through markets.

Until the mid 00's the mandate was clear. To lower the cost of energy and to use markets to deliver this. There was no clearer statement of this intent than when Ofgem removed all remaining supply price controls in 2002 from the energy market.

As time went by there was a growing unease about the difference between the 'haves' and the 'have nots in terms of switching. Switchers tended to be relatively well educated and from relatively affluent backgrounds. The fact that the poorest people in society were paying disproportionally more for their energy costs became increasingly difficult to accept socially and politically. It is important to note that this was particularly the case because of the mounting policy costs that were being added to customers' bills which are regressive by their nature as utilities see them mostly as fixed costs.

Eventually by 2008 Ofgem gave in to increasing political pressure and undertook a review of the retail markets. This review was far reaching but found that the customers that were not sufficiently engaged in energy markets and confused by the complexity of supply company offerings. This has been the dominating theme of energy retail since and has seen several regulatory interventions in the market.

In particular in 2016 the CMA found that the remedies that Ofgem had put in place to address these issues – which centred around banning complex tariffs, limiting the number of tariffs that a company could offer to 4 and the simplification of cash discounts, actually had caused an adverse impact on competition. To address this the CMA is proposing to effectively wipe the slate clean and remove all the restrictions on competition.

However, the CMA seems to potentially be falling into a similar trap with regards to some of the remedies that it is proposing to address the outcomes of the competitive process and its dissatisfaction with customer engagement.

The following chart is used by the CMA to explain the problem in the energy market. And you can see that it depicts a socially worrying picture that switchers still tend to be relatively well off.

To address this the CMA is proposing a number of measures including allowing Ofgem to create a data base of all customers that have been with their supplier for more than 3 years so that companies can choose to market to these customers to attempt to get them to switch. Of course we are restricting how marketing can happen – to postal contact – despite knowing that postal marketing is the least effective means of customer switching.

Perhaps more worryingly is the introduction of the price cap on pre-payment metered customers. I attended an event recently and what struck me is that we are trying to solve a problem through the energy market that actually has much more to do with financial inclusion.

There are without doubt significant policy questions that need to be addressed around how to ensure that people living on low incomes are not disaffected particularly by policy costs – however – my fear is that any solution through energy policy will always risk unintended consequences.

So, this morning you have heard me worry about the short term nature of politics and the risk of unintended consequences through regulators trying to do the right thing but delivering risks and costs, so I thought by this point I needed to offer something of an answer.

Customer engagement

Whilst the water reviews in the UK will be remembered by investors for the lowest to date return on regulated equity across the sectors, it was the process of customer engagement and how powerful it could be to the customers (& actually the company & its investors) that I believe could deliver long run and sustainable benefits.

It may be a harsh characterisation but historically the regulation of the water companies in England and Wales has been a black box. Companies submitted plans to the regulator. Behind closed doors the economic regulator challenged these plans. Quadripartite meetings were held between government, the environmental regulator, the water quality regulator and the economic regulator – which often added investments back into the plans. And at the end of this process a settlement was reached.

The last reset of prices (PR14) fundamentally changed this. Out went the process of having companies fill in proformas from the regulator. Instead they generated their own plans based on conversations with their customers. They had the freedom (with sufficient evidence) to move away from the outputs that the regulator considered important and instead to replace these with the outcomes that mattered for their customers.

At times this challenged the regulators conventional wisdom that we knew what was best for customers. A great example of this relates to leakage where customers explained that visible leaks discouraged them from taking actions to conserve water consumption. This insight across a number of companies led to increased investment in leakage management beyond the conventional wisdom of the economic level of leakage.

Old style quadripartite meetings were replaced. Customer challenge groups were used to negotiate a settlement between affordability and drinking water quality and environmental obligations. Companies were challenged to find more affordable solutions to meet their statutory environmental obligations which often involved innovating and accepting different risks.

The role of the regulator fundamentally changed to challenge the company to listen harder to their customers and to be focused on the areas where asymmetries of information still existed – largely around cost assessment and financing costs.

The good news is that if the regulator is smart it can and should overcome these remaining information asymmetries next time around and reveal information to the customers that allows them to ask searching questions of their companies around why they are relatively inefficient or face extremely high financing costs during the formation of their plans.

This changed approach was not without cost or risk. Customer engagement is expensive and without doubt more costly than having regulated companies just engage with the regulator.

Of course in a competitive market companies need to understand their customers' preferences or ultimately put at risk their own survival. Through regulation we have historically closeted network companies from needing to do this - probably resulting in a notably slower update in technology amongst other factors in these areas of the economy compared to e-commerce more generally.

As well as coming with an increased price tag there are different risks associated with customer engagement. The distinct advantage of having oversight of 18 different companies is that you were able to see great examples – but also to be frank there were some ugly examples as well. Companies deliberately trying to frame questions and information to gain a particular outcome on significant investment or offering only choices that involved tariff increases then citing overwhelming customer support for the least expensive of the increases.

To be honest I think that customers do not compare or base their expectations on a water company – they just know overall what they consider good customer service looks like – and equally understand the bad.

The future lies in exposing more information – in clever ways – to customers themselves so they can take decisions. And it is important to keep in mind that no one is more invested in the long term than communities themselves.

Conclusion

So in conclusion, I often wonder whether we would have established a conventional wisdom in economic regulation if we had been able to access the technology that we can today to both protect customers' interests and ensure that investment can be delivered at as low as possible a cost of capital to these vital sectors.

My hypothesis is that just as we now have the world's largest accommodation provider that owns no properties – Airbnb – and the world's largest taxi company – Uber- that owns no vehicles – if we are brave and do not seek to protect the status quo through regulation, we will see rapid transformation at scale in the delivery of utilities for customers.

I suspect that there will always be a role for government and indeed regulators. I just suspect it can be much more limited to what we have today in the UK.

All of which probably would be extremely controversial in the UK – as I expect that they might be here. But I hope that they at least challenge those of you who thought you understood what the conventional wisdom was for economic regulation to think again.