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REGULATION

The CMA and Ofwat: Another nail in the coffin?

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Stephen Littlechild

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Arguing over price controls is now almost a full-time activity, laments professor and former electricity regulator Stephen Littlechild. Writing for Utility Week, he suggests that the CMA appeals in water may represent an opportunity to overhaul the price control process and move towards a more productive and less confrontational approach.

We are now two months on from the Competition & Markets Authority's (CMA) interim findings on the PR19 appeals by four water companies.

Ofwat has since accused the CMA of "fundamental errors of approach" in its redeterminations, which allowed higher returns the regulator did.

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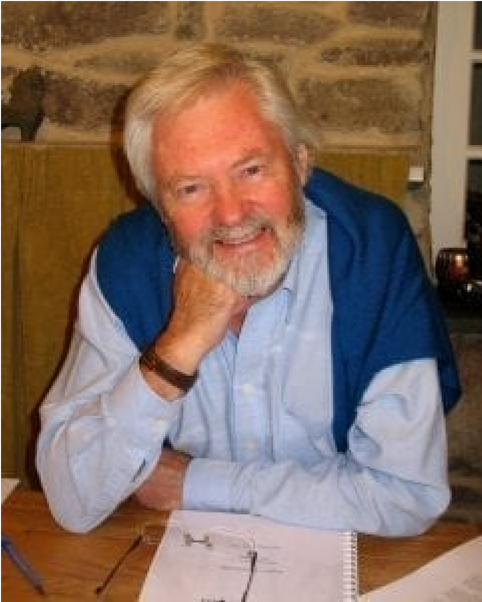

How is it that the UK water regulator and the UK competition authority cannot agree on how to set a price control? Does one or other of them have to learn how to do it properly? Or does it suggest that the question they have been setting themselves is not conducive to an easy answer – and that it would be more productive to change the question and the approach?

I argue here that the various forms of the UK price controls have value but a more constructive and less confrontational approach to setting the controls is needed – and indeed, is available. This need not be an activity monopolised by regulators. It can be a cooperative yet competitive process – a rivalrous discovery process taking place over time, involving negotiation between companies, customers and other interest groups. The regulator would act as facilitator rather than as the sole source of wisdom and decision.

In the beginning

In 1983, the government decided to privatise British Telecommunications (BT), hitherto a nationalised monopoly. It originally envisaged a maximum rate of return control, along conventional US lines. Professor Alan Walters objected and suggested an output-related profits levy. I was asked to advise.

I agreed about the disadvantages of rate of return regulation – "cost-plus" as we saw it, and conducive to excessive investment – when [the] priority was to increase efficiency and innovation in the hitherto

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inefficient nationalised industries. But I was not convinced by the profits levy.

I recommended instead a transitional tariff cap known as RPI-X. This sought to better achieve the efficiency aims while being seen to protect customers in the new and unknown world of private ownership and impending competition.

But additional reasons for recommending RPI-X were practical and tactical ones. As an unknown academic, I was now intending to reject the price controls proposed by the government and the prime minister's economic adviser and to propose something novel based on economic theory. Scary.

However … that RPI-X formula had already been proposed by BT's financial advisers (Andrew Smithers and Michael Valentine at Warburgs) as a means of reassuring the government during an earlier proposal to enable the nationalised BT to borrow from the financial markets.

A form of control that had been developed and advocated by the privatised company itself surely meant that it was workable and would have "buy in" from the company. If one is looking for a practicable, sensible and mutually acceptable way forward, it's important to make full use of the knowledge and suggestions that the parties themselves can bring to the table and to try to get all the parties on board, rather than simply to recommend or dictate from above what should be done.

Three decades of progress

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After some three decades of regulators setting tariff caps in the UK, particularly in telecoms, water, energy and airports, what are the main results?

Various studies have generally suggested higher productivity, greater efficiency and innovation, greater investment in desired areas, higher quality of service, and in some cases lower prices than would otherwise have occurred under nationalisation.

These achievements are attributable to several factors: the skill and dedication of the staff in all these companies, the stimulus of comparative competition between the companies, and the conscientious design and implementation of the tariff caps by successive regulators. Important here has been regulatory learning and innovation, including the willingness to explore new incentive mechanisms, different controls for different parts of the business, and the possibility of contracting out certain major investments.

The relatively recent emphasis on customer engagement has required companies to engage with consumer groups to understand better what they want, how best to deliver that and how to make the various tradeoffs between quality and cost of service. These valuable insights have been incorporated into company business plans (to varying extents). Also, the process enables customer groups to understand better the practicalities of company business plans, and what they can and cannot deliver in what timescales and at what costs.

So, what's not to like?

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Unfortunately, the popular perception is that the gains of the process have been unfairly distributed between companies and customers. Companies are said to have made excess profits and the regulators unable or unwilling to rein them in. And now, a regulator and the competition authority have fallen out over precisely this issue.

In my view, regulators have not been unwilling to rein in companies making excess profits. Rather, the problem is how to do so.

In the US, a regulator can step in at any time if a company seems to be making excess profits. Because that can dampen the incentive to efficiency, the UK approach has been to commit to a tariff cap for, say, five years. So, a lot hangs on getting the initial tariff cap "right", so that companies earn sufficient but not excessive profits by the end of the period.

This is easier said than done. The National Infrastructure Commission (NIC) recently concluded that UK regulators have rather systematically under-estimated the cost reductions that companies can achieve and over-estimated their cost of capital. Hence the considerable criticism by customer groups and some media and politicians.

The NIC also suggested that regulators should make their best estimates of various price control parameters then explicitly "aim off" to reflect systematic past errors. Indeed, one of the points of dispute between Ofwat and the CMA is the extent to which the new price control does or should "aim off" in various respects.

Meanwhile, **Ofgem has asked the CMA** to make clear that nothing has to say about the water companies has any relevance for ener

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sector regulation. Oh dear.

An alternative approach?

Arguing over price controls has become a nearly full-time activity, costly in terms of time and money. Ultimately, that means costly to customers.

The repeated and increasingly adversarial process of setting price controls has become damaging to the reputations of the companies and regulatory bodies in the water and energy sectors, and now of the competition authority too. Rather than continue to debate the theory and practice of estimating costs and "aiming off", would it not be more fruitful to look for an alternative approach?

Various forms of "negotiated settlement" have been used successfully elsewhere in the world – and, indeed, by regulator WICS to set charges for Scottish Water and by the CAA to set UK airport charges (via "constructive engagement").

Put simply, all interested parties, especially customer groups, are invited to negotiate with companies, possibly subject to some regulatory guidance, and on the understanding that, if they can reach agreement on a price control that meets statutory and regulatory conditions, the regulator is minded to accept it. If they can't agree, the regulator determines the control. In the UK, appeal to the CMA against a regulatory determination would still be available.

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Two possibilities

To discuss the various ramifications of this approach is beyond the present article, but let us just focus on two possibilities.

First, there are surely many issues that are not central to the "excess profits" issue. These could be handed over to the company and customer groups to resolve, rather than simply ask those groups to provide information to the regulator that it might or might not heed.

In water, these issues might include the scope of the various controls, regional differences, quality of service, resilience aims, and so on. This would not solve the excess profit problem, but it would enable all parties to work together and to determine outcomes, to give a sense of ownership of the way forward.

Second, on the level of the control, it is possible that the parties might be able to resolve the present type of impasse by, for example, the company offering assurances on matters that were of particular significance to the other parties. But are we sure that the present form and duration of control are the most appropriate for all companies?

- **What about allowing the parties to reduce the duration of the control, thereby reducing the scope for extended excess profits?**
- **What about a profit-sharing arrangement? Or a reopener under certain conditions?**
- **What about allowing parties to renegotiate a five-year control after three years, to reflect new information, achievements and priorities?**

Perhaps these variants might reduce some efficiency incentives. But inefficiency is less serious now than it was when the incentive price cap was first proposed nearly 40 years ago. "Fairness" of the con[...] has become a more sensitive issue. Working together and the abi[...]

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respond quickly and flexibly will likely be more important to meet future challenges such as net zero.

For a regulator to impose any particular price control modification on all companies would take years of agonising argument. But, if a particular company and the interested parties found and agreed on a better way to resolve their differences, why stop them? We need to discover what can (and can't) be agreed, and to learn from the experience of different companies and customer groups trying different things.

Is it a problem for regulation if different companies adopt different kinds or durations of price control? The same cost and productivity statistics can be calculated for comparative purposes. It might be less neat and tidy for the regulator, but more important considerations are the ability of companies and their customers and other interested parties to work in harmony together, and the learning from experience that this provides.

Regulatory inconvenience is a price worth paying for that. Indeed, the regulatory burden of a negotiated settlement approach, while not trivial, would be less than under the present "command and try to control" approach.

Of course, not all these innovations can be expected immediately. It will take time to develop the experience and mutual trust required. But there are important challenges facing the regulated sectors.

The most important thing now is to move to a more consensual a
less adversarial position, to discover from innovation and experie

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what kinds of arrangements are most conducive to companies, customers, other interest groups and regulators working constructively together. Regulators trying to estimate what costs will be five years in the future, adjusted by the optimal degree of "aiming off", will not achieve that.

So, UK regulatory price control processes are not dead. But they need a new lease of life, by encouraging negotiated settlements. Only the regulators themselves can do that. But the present CMA panel, now with some actual experience under its belt, could provide a steer.

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