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THE REGULATION OF PUBLICLY-OWNED UTILITIES

Utility regulation developed as the counterpart of privatisation in the UK, and was developed elsewhere to manage the grant of long-term concessions to private companies. Now governments are exploring the contribution regulation can make to the performance of utilities that remain publicly owned and operated. Using a regulatory model similar to those devised for regulating privatised assets and concessions, Frontier has worked for several governments to help raise standards with respect to the four Cs - customers, comparisons, contestability and clarity. This bulletin discusses some of the challenges involved in creating disciplines similar to those provided by the market.

The state monopolies established for utility services in post-war Britain were structured as public corporations - operating under financial constraints, but outside the day-to-day activities of government. This model had clear advantages, compared with direct operation by a government department or a municipality. Operational decisions could →

be separated from politics. Social objectives, such as the extension of supply, could be pursued without external subsidy. Government could concentrate on over-arching public objectives and on specifying the financial framework governing the use of public money.

That, at least, was the theory, and the model had early success in the UK. It generated considerable investment in the energy sector. Criteria were developed for the setting of financial targets, and to ensure that public investment was preceded by good investment appraisal. But it developed serious faults. Ministers became involved in operational decisions, especially on pay. Prices were constrained to meet macroeconomic objectives. Operating efficiency lagged behind best practice. Capital efficiency was low and returns inadequate. Cross-subsidy became endemic. Quality of service was determined by what the corporation considered appropriate rather than by evidence of customer preferences.

SELL AND SCRUTINISE

Privatisation showed how these defects could be remedied.

- It changed the incentives facing utility managers. They no longer monitored their own outputs; satisfying customers became crucial, especially where there was some prospect of competition. When social and environmental objectives were set by ministers and monitored by regulators, managers could concentrate on the efficient use of resources. The discipline of the share price exposed them to capital market scrutiny, and the need to raise capital directly meant that investment appraisal became a real financial discipline.
- It increased the information available to all concerned. Regulators who act transparently and give reasons for their decisions need to publish much of the information that they collect. Systematic data on customer service showed what improvements could be achieved by focussing on specific tasks. Different managements, all seeking to reduce costs to increase profits, revealed levels of efficiency well beyond what commentators had expected. Direct access to capital markets led to better understanding of the cost of capital and to more efficient capital expenditure.
- The establishment of regulators, accountable to Parliament and to the public, led to a helpful division of labour. Ministers remained responsible for high-level outcomes, such as a well-structured regulatory regime, and for the achievement of national objectives – for example, EU water quality obligations. Regulators provided the analytical basis for establishing clear outputs and for measuring the costs of providing services to customers.
- Regulators, acting under the general competition law and under legislation specific to their sectors, have acted to increase competition and contestability. For example, they increased the scale of competitive supplies in electricity generation and stimulated unbundling in gas supply. They developed a contestable market for large water customers.

GOOD HOUSEKEEPING

However, many of the functions developed in the regulation of private utility companies can be carried out even when both assets and operations are retained in the public sector.

- Regulators can ensure that customers, and the public generally, understand the regulatory regime; that processes are in place for canvassing stakeholders' opinions; and that robust complaints procedures are established providing effective redress and compensation.

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- Benchmarking studies, making due allowance for differences in operating environments, can be used as the basis for setting performance aims and efficiency targets. This involves ensuring that public sector suppliers have proper regulatory accounts, duly audited, that reveal economic costs, including capital costs, in ways that are comparable across companies in different locations.
- Regulators can promote competition by setting prices that will give private suppliers access on fair terms to public sector networks. For example, the methodology Postcomm (the postal regulator) has adopted for setting access prices to Royal Mail's delivery network has been used as the basis for the negotiations between Royal Mail and access seekers.
- Suitably qualified assessors can challenge suppliers to establish good systems for gathering information – including market research – in order to improve the quality and transparency of that information, particularly with respect to customer priorities.

CLARIFYING ROLES

When assets are privatised, regulators have a duty to set limits on the tariffs that can be charged. They also have powers to approve a structure of tariffs that avoids undue preference or discrimination for or against groups of customers. There has, however, been some hesitation in giving these powers to those regulating publicly-owned utilities. The overall level of tariffs is a politically sensitive matter and the structure of tariffs can have a disproportionate effect on vulnerable groups; governments are reluctant to let go of control with respect to organisations clearly in the public sector.

In the UK the pattern varies. Postcomm sets tariff levels for the Post Office. The Civil Aviation Authority sets limits on charges at the state-owned Manchester airport – as well as at airports owned by the public company BAA plc. In Scotland, a commissioner was originally appointed to advise Scottish ministers on the level of tariffs and to approve Scottish Water's charging scheme. The Scottish Executive will now establish a commission to set water tariffs subject to appeal, not to ministers, but to the Competition Commission. However, the Government retains firm control over the BBC's licence fee, although it does set this for several years at a time.

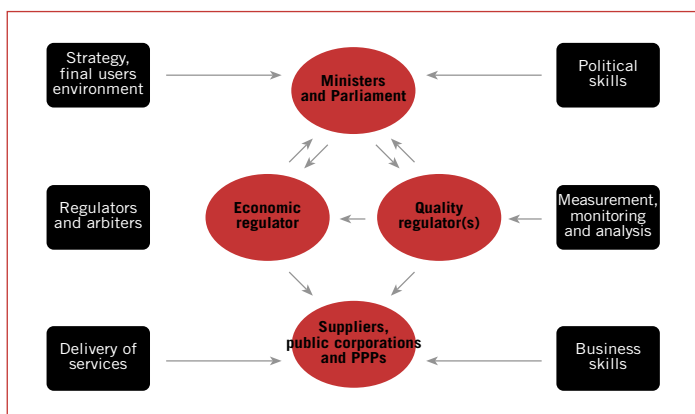


Figure 1: A new structure of supervision

WHERE'S THE LIMIT?

Privatisation has shown the importance of a hard budget constraint, giving suppliers incentives to control costs rather than use political skills to ease their resource positions, either by charging more or doing less investment. Publicly-owned utilities can scarcely be expected to increase efficiency to the same extent as their privately-owned counterparts unless their managements face the same incentives and penalties.

The absence of shareholders, however, restricts the scope for dealing with failure. Any fines imposed on equity-based companies will – provided that they are reasonable and consistent with the assumptions made by the regulator when setting prices – tend to

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come out of shareholders' pockets. In the case of a private not-for-profit company, the company's bankers will have to foot the bill. However, fines imposed on publicly-owned utilities are likely to end up as a charge on taxpayers or customers, which are hardly the right targets.

Should a private company fail financially, it could be sold to another owner. Arrangements for special administration in the UK allow for continued supply to customers while a buyer is found and, moreover, for a special review by the regulator to set appropriate price limits. Such arrangements need to be adapted for a publicly-owned utility. To ensure a hard budget constraint and to avoid the risks being left with customers or taxpayers, a financial cushion must be provided.

Not all aspects of the new regime developed for the regulation of privatised utilities carry over into options for the regulation of publicly-owned utilities. Where utilities are privately-owned, ministers can concentrate on establishing the outcomes they desire. They can leave it to competition to deliver results or, where competition is not possible, establish regulators to design transparent systems for ensuring compliance and delivery. Where companies are publicly-owned, ministers also have interests as owners and employers. These may clash with their interests as the guardian of customers.

They must, therefore, be careful not to act in a way that would loosen budget constraints on suppliers. This would damage efficiency and divert managerial effort to political activity. To maintain the correct incentives, ministers should make it clear that their priorities are the efficient delivery of services to customers and, where relevant, clearly specified social and environmental obligations – and to ensure that decisions always reflect priorities.

CONCLUSIONS

Privatisation of utilities with monopoly power has led to the development of a new model of utility regulation. When this model is working well, ministers decide outcomes, including social and environmental objectives. Regulators promote the delivery of these outcomes, by specifying the outputs needed and by using competition to ensure that they are delivered efficiently and effectively. Competition for customers is to be preferred, but yardstick, or comparative, competition can yield beneficial results where market competition is difficult to achieve. Suppliers are incentivised to use their business skills to deliver these outputs efficiently and in line with customer preferences.

Many elements in this model can be applied to publicly-owned utilities. Its application involves a shift from reliance on traditional direction of a monopoly public corporation to regulatory supervision of a government-owned company at arm's length from ministers. Supply should be contestable, with a duty on the regulator to promote or facilitate competition.

In this model, effective and efficient operation depends on specifying clear accountabilities. These require access, particularly by customers, to good information, i.e. transparent regulation and open government. This model also requires clear objectives and hard financial constraints. UK experience shows that such arrangements can, if they meet these tests, deliver many of the advantages of the contestability and greater accountability that have come from privatisation, while retaining assets and operations in the public sector.

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