



RESEARCH PAPER 98/19
2 FEBRUARY 1998

Regulating Energy Utilities

The increasing liberalisation which has characterised the gas and electricity industries since privatisation is culminating with the introduction of competition for domestic customers. A government review is nearing completion, the purpose of which is to establish whether changes to the regulatory system are needed for the utility industries. This paper includes a compilation of some of the contents and conclusions of six reports which have informed the review, focusing on the energy utilities.

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Summary

On 30 June 1997, the President of the Board of Trade announced an inter-departmental review of the regulation of the utility industries, focusing on gas, electricity, telecommunications and water. The terms of reference of the review are to consider whether changes are needed to the regulatory system in order to ensure open, predictable and fair regulation, which also provides sufficient incentives to managers, and promotes government environmental policy. A ministerial committee began considering these matters following the 5 September deadline for additional representations.

This paper will deal with the gas and electricity industries in the UK. After introducing the Government's review, the development of both industries since privatisation will be charted. An overview of the industries' structure will be given in the context of ongoing moves towards the introduction of greater competition. This year, nation-wide competition in the supply of electricity and gas should be in place, even for domestic consumers. The regulatory systems under which each industry operates are discussed in the context of the roles of their respective regulators whose responsibilities include setting price caps.

The second part of the paper compiles some of the contents and conclusions of six of the reports which have informed the present review: those by the Public Accounts Committee, the Trade and Industry Committee, the Environment Committee, the UK Round Table on Sustainable Development, the Hansard Society and the CBI

I Gas and Electricity Industries

A. The Government's Review

On 30 June, the President of the Board of Trade (Margaret Beckett) announced a review of utility regulation in a written answer¹:

I am announcing today an inter-departmental review of the regulation of the utility industries. My aim is for the review to report to Ministers by the end of the year.

The Government's objective for the review is to set a long term stable framework for utility regulation which is seen as fair by all the interest groups involved, particularly by consumers. Without fairness, there can be no long term stability. We want the regulatory framework to deliver value, quality and choice to consumers while providing incentives to managers to innovate and improve efficiency. The guiding principles must be transparency, consistency and predictability of regulation.

The terms of reference for the review are to consider whether changes are required to the system of regulation of the utility industries in order to ensure open and predictable regulation, fair to all consumers and to shareholders, and which promotes the Government's objectives for the environment and sustainable development, whilst providing sufficient incentives to managers to innovate, raise standards and improve efficiency.

The review has concentrated on gas, electricity, telecommunications and water, while taking into account regulatory experience garnered from other industries. Some constraints on the review included a decision to retain the "arms length independence" of the industry regulators, and the general principle of price capping. The latter is in contrast to economic regulation in the USA which is based on allowing companies a given rate of return on their investment, whether productive or not.

If, as a result of the review, ministers contemplate changes then a full consultation exercise will be launched. On the day Mrs Beckett announced the review, she addressed a conference in London on the future reform of UK utility regulation². A passage in her published speech identified some of the input to the review:³

The review will in no sense start with a blank sheet of paper or without an understanding of the variety of views already on record. It will - naturally - take all such reports into account including the conclusions and recommendations recently made by the Public Accounts Committee, the Trade and Industry Committee, the Environment Committee, the UK Round Table on Sustainable Development, the Hansard Society and the CBI. The list is a long one.

¹ HC Deb 30 June 1997 cc20-1W

² *Utilities 2000: The Agenda* — conference sponsored by the Public Utility Reform Group and the Institute of Public Policy Research (Church House Conference Centre, Westminster 30 June 1997)

³ HC 307 1997/98 and <http://www.dti.gov.uk/Minspeech/speechf.html>

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Extracts from the six reports identified above will form a substantial part of this paper. Additional representations concerning the review were invited, a response by the National Consumer Council⁴ being among these. Remarks therein concerning "too much profit from domestic customers" echo widespread sentiments which doubtless enhanced the political acceptability of the windfall tax (the first instalment of which fell due on 1 December). Among the privatised utilities affected were British Gas (now BG plc and Centrica), National Power, PowerGen, Scottish Power, Hydro-Electric, and the regional electricity companies. Each company's tax bill is calculated according to the difference between its value at the time of flotation and a valuation calculated from average annual profits over a period of up to four years following privatisation⁵. Further details and background on the windfall tax appear in a library standard note⁶.

In her speech last June, the President of the Board of Trade asserted that the utilities review and the windfall tax were completely distinct issues (though one might argue that the latter was an acknowledgement of a need for the former). Another matter being taken forward distinct from the review is the Government's *Competition Bill* (HL Bill 46 1997/98), though this will modify the framework within which regulators operate. That Bill⁷ will incorporate provisions based closely on Articles 85 and 86 of the Treaty of Rome. These prohibit anti-competitive agreements and the abuse of dominant market positions. As such, the anticipated changes to competition law, including a facility for imposing fines, should extend the powers of the utility regulators to promote competition⁸. Their decisions will be open to review by a new Competition Commission replacing the Monopolies and Mergers Commission⁹.

B. Gas

1. Industry structure

The privatisation of the gas industry was underpinned by the *Gas Act 1986*. British Gas was privatised intact, retaining its monopoly in a regulated tariff (small customer) market¹⁰. New entrants were to be allowed to compete for the custom of users demanding more than 25,000 therms annually¹¹. In practice, however, supply competition in the industrial market did not get underway until 1990, and that was linked largely to the "dash" for gas-fired power stations, coupled with the gas release scheme instituted by the then Director General of Gas Supply (Sir

⁴ *Regulating the Public Utilities: Response to the DTI review of utility regulation* National Consumer Council October 1997

⁵ "Gordon Brown's Budget" *Utility Finance* July 1997 p21

⁶ Business & Transport Section, House of Commons Library (reference: windfall.as)

⁷ <http://www.dti.gov.uk/competition/bill/>

⁸ "Competition Policy and Regulation" *Utility Finance* September 1997 p3

⁹ "The New Competition Bill" *Energy Utilities* September 1997 p6

¹⁰ *Gas in the UK*, Oxera Press 1995

¹¹ *The Energy Report: shaping change* volume 1 (DTI, 1997)

James McKinnon). Barriers to competition in this non-tariff industrial market had been identified by a 1988 Monopolies and Mergers Commission report, prepared as a result of the referral of British Gas by the Office of Fair Trading.

A 1991 report by the OFT presaged a reduction of British Gas' industrial market share, and an extension of the competitive sector by reducing the tariff threshold, using the powers in the *Competition and Services (Utilities) Act 1992*, from 25,000 to 2,500 therms¹². While acknowledging the importance of the OFT's intervention, two MMC reports, published in August 1993, argued that competition could only be secured in the long term if British Gas divested its supply business from more natural monopolies like storage and transportation. On 21 December 1993 the then President of the Board of Trade (Mr Michael Heseltine) rejected divestment, settling instead for a complete separation of the transportation and trading businesses within continued British Gas ownership¹³. At the same time he announced that British Gas' tariff monopoly would end in April 1996, with competition being phased in over a two year period to April 1998; this was a faster reduction in the gas monopoly than the MMC had suggested.

On 17 February 1997 British Gas demerged, creating two separate companies, Centrica plc and BG plc. Centrica, which trades as British Gas in the UK, incorporates gas sales, services, and retail, together with the gas production business of the North and South Morecambe gas fields. BG includes international activities and the operations of Transco, the gas transportation and storage business. This was the most profitable part of the former British Gas and is also less susceptible to the competitive pressures which are accompanying gas liberalisation¹⁴.

The demerger completed a process of separation in line with the *Gas Act 1995*. This included provisions forbidding a holder of a public gas transporter's licence (BG) from holding a licence for supply or shipping (Centrica). Transco transports and stores gas for its customers, the 40 or so companies (known as shippers) through a UK-wide gas pipeline network¹⁵.

Exercising the powers conferred upon him by section 8(2) of the *Gas Act 1995*, the then Secretary of State published, in February 1996, a *Determination of the Standard Conditions of Public Gas Transporters' Licences*. These comprise 28 general conditions, which can be modified by the Director General of Gas Supply when a licence is granted. As an example, condition 7 includes a requirement on a public gas transporter to prepare a document called the "network code". This sets out the terms and arrangements for providing an economic and efficient transportation system and for securing effective competition between relevant shippers and suppliers. The network code incorporates a market-based mechanism for balancing demand

¹² "The British Gas market 10 years after privatisation: a model or a warning for the rest of Europe?" *Energy Policy* March 1997 p387

¹³ "Heseltine announces decision on MMC report on gas industry" *DTI press notice P/93/759*, 21 December 1993

¹⁴ *Energy Utilities* June 1996

¹⁵ <http://www.transco-bgplc.com/info/role.htm>

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and supply, in other words ensuring that inputs of gas into the system are equal to the offtakes. Arrangements have been drawn up to charge shippers for deviations between the actual gas input and the promised or "nominated" quantity¹⁶.

2. Regulation

The 1986 Gas Act created the Office of Gas Supply (Ofgas), headed by the Director General of Gas Supply (currently Clare Spottiswoode). The duties of the DGGS were set out in the 1986 Act and modified by the *Competition and Services (Utilities) Act 1992* and the *Gas Act 1995*. The changes introduced by the two later Acts were partly concerned with securing greater competition between different gas suppliers. Both the Secretary of State and the DGGS have general duties (section 1 of the *Gas Act 1995*) to secure that all reasonable demands for gas are met, to secure effective competition in the gas industry, and to protect consumers both in terms of prices and quality of services. Section 2 of the *Gas Act 1995* places duties on both the DGGS and Secretary of State with respect to safety.

The DGGS fulfils some of her responsibilities, enhanced by the 1995 Act, by issuing or modifying licences related to the transportation, supply and shipping of gas. Of particular significance are the price controls which the DGGS imposes on the monopoly areas of the gas industry, namely supply to small consumers (where currently competition is being phased in) as well as on Transco. In cases of dispute with the gas industry, she has powers to make references to the Monopolies and Mergers Commission. A recent example related to the pricing formula for Transco, after the company rejected proposals by Ofgas in October 1996. The MMC report was published in June 1997, recommending price cuts broadly in agreement with the Ofgas proposals¹⁷. Their subsequent implementation has been described by Transco¹⁸.

Following the telecommunications industry model, the price caps drawn up by Ofgas are based on the RPI – X approach¹⁹. This means that revenue is allowed to increase by the rate of inflation, minus a factor which takes into account efficiency improvements. The actual price cap formula, though of the above general form, has also contained correction terms other than those connected with efficiency. For example, the price cap which operated from 1992 to 1997 allowed British Gas to pass on to customers costs incurred in purchasing bulk supplies of gas from producers and in part-funding the Energy Saving Trust²⁰. These additional factors were called, respectively, the gas cost index²¹ and the E-factor.

¹⁶ "Gas Regulation 1995/96" in *Regulatory Review 1996* (Centre for the Study of Regulated Industries, October 1996)

¹⁷ "Ofgas accepts MMC report on BG plc" *Ofgas press information 10/97*, 18 June 1997

¹⁸ *Gas Transportation Charges from 1st October 1997*, Transco

¹⁹ *Gas in the UK*, OXERA press 1995

²⁰ *Regulated Industries: The UK Gas Industry* (Regulatory Brief 10, Centre for the study of Regulated Industries, December 1996)

²¹ *The Office of Gas Supply: The Regulation of Gas Tariffs (The Gas Cost Index)* Committee of Public Accounts HC 37 1996/97

The present DGGs has been much less keen than her predecessor (Sir James McKinnon) to use the E-factor to finance energy efficiency measures such as efficient boilers and schemes for rating the energy consumption of houses²². One argument is that the DGGs, an unelected official, should not add a substantial E-factor to the price control formula if this does not benefit consumers in general. In its submission to the Government's review of utility regulation, Ofgas argued against an extension of its discretionary powers to finance environmental and social objectives²³. In evidence to the Commons Trade and Industry Select Committee, Ms Spottiswoode reiterated her position that regulators should not be in the business of taxation²⁴. In certain cases, gas companies may have a commercial incentive to reduce consumer demand by investing in energy efficiency measures rather than more expensive improvements to pipeline infrastructure.

Customer interests are directly addressed by the Gas Consumers Council, established under the 1986 Act as an independent body. It is funded through grant-in-aid from the DTI though most of this cost is recouped via the licence fee paid to Ofgas by the gas companies²⁵. One role of the Prime Minister's social exclusion unit is to investigate discrimination by utilities against poorer customers²⁶.

3. Liberalisation

Domestic competition in gas supply was introduced in Cornwall, Devon and Somerset in April 1996. This was extended in February 1997 to Avon and Dorset and in March to Kent and Sussex. Some 2 million domestic customers in these areas can choose their gas supplier, and over half a million have switched to a new supplier²⁷. The final phase-in of competition began on 1 November with over 400,000 customers in Scotland and North East England opting for new gas suppliers²⁸. Full competition in gas supply is expected to be in place by June of this year. British Gas now has fourteen²⁹ competitors for domestic custom, eleven of which are Regional Electricity Companies or their affiliates. These suppliers are free to set their own charges, though British Gas is (for the time being) subject to price controls imposed by Ofgas. All gas suppliers must nonetheless have a licence, the conditions of which compel them to provide, on request, gas to anyone connected to the mains in the licence area. In addition, they must offer a variety of ways for customers to pay their bills³⁰. In their recent report on the *Progress in the Liberalisation of the Gas Market* (HC 338 1997/98, 14 January 1998) the Trade and Industry Committee expressed concern over "the widening differential between the prices offered to prepayment customers and to those who pay by other means."

²² *Energy Efficiency: The Role of Ofgas* Environment Committee HC 328-iii 1993/94

²³ Ofgas press information, 11 November 1997

²⁴ "MPs in attack on gas watchdog" *Guardian* 13 November 1997

²⁵ "Increased Funding for Gas Consumers' Council" *DTI press notice* 29 September 1997

²⁶ "Utilities probed for discrimination against the poor" *Observer* 28 September 1997

²⁷ Ofgas information, 13 November 1997

²⁸ Ofgas information 30 October 1997

²⁹ *The Energy Report: Shaping Change* vol 1 1997 (DTI)

³⁰ *All you need to know about gas competition* (Ofgas, 1997)

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One current area of concern relates to the fact that RECs are in a position to offer customers dual fuel (gas and electricity) supplies, at reduced cost due to single billing systems, before gas suppliers may do so. This is because public electricity suppliers presently have a monopoly over electricity meter reading, and this is not due to end until 31 March 2000. Gas meter reading has, in contrast, been open to competition since October 1996. Furthermore, the domestic gas market is being opened to competition faster than that for electricity. Offer and Ofgas issued a joint consultation paper on dual fuel offers in the electricity and gas markets, responses for which were invited by 19 December 1997³¹. A joint decision document was published last month³². This called for restrictions on public electricity suppliers from offering both gas and electricity until they have opened to competition in their areas. More modest constraints (keeping gas and electricity pricing separate) were finally agreed³³ in a compromise involving the Energy Minister Mr Battle, the regulators and the electricity companies (to the reported³⁴ “annoyance” of Centrica).

The formation of Transco, separate from British Gas’s supply activities, has been essential to providing a level playing field for competing gas suppliers wishing to gain access to the network of pipes. This increasing competition has been underpinned by a separate price cap on Transco, and the development of the Network Code governing the contracts between Transco and the shippers (wholesale gas suppliers)³⁵. The code was implemented on 1 April 1996.

The introduction of competition into the domestic gas sector is clearly significant, given that sales account for some 43% of the total UK gas market (1995 figures)³⁶. For regulatory purposes, commercial and industrial customers are those demanding 2,500 therms or more per annum. Competition in these sectors developed significantly from 1992, coinciding with the *Gas (Modification of Therm Limits) Order* which removed British Gas’s monopoly for customers demanding between 2,500 and 25,000 therms annually. Some 70 suppliers, including major oil and gas producers, now compete with Centrica in the industrial and commercial market, accounting for 70% of sales³⁷.

³¹ “OFFER and Ofgas issue a joint consultation paper on dual fuel offers in the electricity and gas markets” OFFER press notice R53/97, 20 November 1997

³² *Dual Fuel Offers in the Gas and Electricity Markets* (Offer/Ofgas, January 1998)

³³ “Tough warning on gas market” *Financial Times* 30 January 1998 p8

³⁴ “Ofgas drops plan for tough curbs on recs” *Financial Times* 28 January 1998 p22

³⁵ *Regulated Industries: The UK Gas Industry* (Centre for the Study of Regulated Industries, December 1996)

³⁶ *ibid.*

³⁷ *The Energy Report: Shaping Change* vol 1 1997 (DTI) p37

C. Electricity

1. Industry structure

The Trade and Industry Committee's 1995 report³⁸ on *Aspects of the Electricity Supply Industry* outlined four features of the industry in England and Wales resulting from the 1990 privatisation:

- Separation of the assets and activities of the Central Electricity Generating Board between three generators (National Power, PowerGen, and Nuclear Electric) and National Grid Company (which operates the national transmission network and co-ordinates the operation of individual power stations). The 12 regional electricity companies operate the local distribution networks and supply customers. As intended, these distinctions have become blurred: many RECs are now involved in generation (usually through involvement in 'independent power producers' (IPPs)), and the generators now supply many of the larger electricity consumers directly.
- Competition was introduced in generation and is gradually being introduced in supply, but transmission and distribution will remain monopolies. NGC and the RECs conduct both competitive and monopolistic activities. From 1998, when supply is due to be fully opened to competition, about two-thirds of the total cost of electricity will be subject to competition.
- There is an electricity Pool — a half-hourly spot market in electricity, intended to maintain the benefits of an integrated network in a competitive market open to new entrants. The Pool is a set of contractual agreements rather than a physical entity, but virtually all electricity is deemed to flow through it. It is designed to cope with the fact that electricity cannot be stored in large quantities and that supply and demand must always be in balance. Its two main purposes are to determine which generating stations run (based on prices bid) and to determine the cost and price of electricity traded. In practice most trading is covered by contracts, which typically adjust the Pool price to a fixed sum, but contract prices and average Pool prices are closely related over time.
- There is a Director General of Electricity Supply, currently Professor Littlechild, who heads the Office of Electricity Regulation (OFFER).

In March 1995, the Government's special shares in the regional electricity companies were redeemed. This set the stage for a sequence of take-overs and mergers involving the RECs and other utility businesses. For example, Norweb and North West Water merged to form United Utilities³⁹.

The Scottish electricity industry remains vertically-integrated, with Scottish Power and Scottish Hydro-Electric generating, transmitting and supplying electricity to final consumers. These two companies purchase electricity from Scottish Nuclear, now part of British Energy.

³⁸ HC 481 1994/95 (19 July 1995)

³⁹ "Merger in the English electricity industry" *Energy Policy* March 1997 p393

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In Northern Ireland, the privatised electricity industry comprises Northern Ireland Electricity plc which is responsible for transmitting, distributing and supplying electricity. This it purchases from generating companies in private ownership. The Office for the Regulation of Electricity and Gas (OFREG) has regulatory responsibilities. Both Offer⁴⁰ and Ofgas⁴¹ recognise the strengthening case for a combined energy regulator in Britain, given the ever closer interaction between gas and electricity companies.

The Trade and Industry Committee's 1995 inquiry focused on five aspects of the industry in England and Wales:

- The intended liberalisation of electricity supply in 1998;
- The adequacy of competition in generation, and the main generator's undertakings concerning disposal of generating stations;
- Whether the Pool price mechanism is working effectively;
- The future structure of the electricity supply industry in the light of recent takeover activity;
- The effectiveness of regulation.

2. Regulation

Among the Committee's recommendations in relation to regulation were that alternative ways of regulating prices be looked at. The Committee questioned the effectiveness of setting RPI-X price control⁴² reviews for five year intervals, and whether these reviews had been sufficiently rigorous. Improvements in the consultation process were suggested as a way of ensuring greater transparency in decision-making. Furthermore the Committee recommended that the Government consider the case for a single regulatory authority for the gas and electricity industries. The possibility of a regulatory panel, as an alternative to an individual regulator, was also aired.

The general duties of the Director General of Electricity Supply derive from section 3(1) of the *Electricity Act 1989*:

(1) The Secretary of State and the Director shall each have a duty to exercise the functions assigned or transferred to him by this Part in the manner which he considers is best calculated—

- (a) to secure that all reasonable demands for electricity are satisfied;
- (b) to secure that licence holders are able to finance the carrying on of the activities which they are authorised by their licences to carry on; and
- (c) subject to subsection (2) below, to promote competition in the generation and supply of electricity.

⁴⁰ *Review of Utility Regulation: Submission by the Director General of Electricity Supply* (OFFER, October 1997)

⁴¹ <http://www.ofgas.gov.uk/public/ptopfr.htm>

⁴² *Guide to Economic Regulation of the Electricity Industry* Oxera Press, September 1995

Subsection (2), referred to above, is designed to prevent price discrimination against different tariff customers within a given area of Scotland. The rest of section 3 imposes secondary duties on the Director General and Secretary of State, most particularly the protection of consumer interests. Offer is responsible for handling consumer complaints, aided by regional consumers' committees appointed by the DGES, and by the National Consumer Consultative Group which Professor Littlechild chairs. This contrasts with the independent consumer body for gas: the Gas Consumers Council.

3. Liberalisation

Last year, the Trade and Industry Committee further examined progress towards the 1998 liberalisation target, established when the industry was privatised. The terms of reference of their inquiry were:⁴³

to examine developments in respect of electricity liberalisation since the Committee's Report in July 1995, with particular reference to the practicality of liberalisation in 1998 and the allocation of responsibility.

The report also addressed the costs and benefits of liberalisation, and recommended that an independent assessment be made for different types of consumer, especially those on low incomes, in different regions.

Volume 1 of the DTI's *Energy Report*, published on 16 September 1997, includes a progress report on competition in the electricity industry. It refers to the ongoing programme of work involving new systems, commercial and trading arrangements, and licences. The public electricity suppliers are individually responsible for providing a customer registration system in their own areas and, collectively, they have been working on new commercial, trading and settlement arrangements (involving data transfer systems). Assisted by PA Consulting, the Director General of Electricity Supply (Professor Stephen Littlechild) is co-ordinating all of this work. Final drafts of public electricity supply licences have been issued.

In May 1997, the new Minister for Science, Energy and Industry (Mr John Battle) commissioned a report from the DGES on the current status of this programme to introduce competition into domestic supply by 1998. Reports by the DGES and PA Consulting were published on 29 May. In September an *Update on the 1998 Programme* was published by PA Consulting, the overall programme manager. Their assessment was that four public electricity suppliers could be ready for market launch in April, a further seven in May, with the remaining three ready between June and September. More recent suggestions have been

⁴³ *Liberalisation of the Electricity Market* Trade and Industry Committee HC 279 1996/97, 17 March 1997

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that some consumers may have to wait until around the end of this year before being able to switch to a new supplier⁴⁴, and that the planned April start date could be put back⁴⁵. Indeed, PA Consulting went on to stress that their timetable was “tight”, its achievement being heavily dependent on the accuracy of forecast delivery dates and the outcome of the ongoing system tests. These difficulties have recently been confirmed in another report by PA Consulting⁴⁶, which advised the DGES that initial market opening was realistically likely to begin in September. All electricity franchise areas should be open for initial competition by the end of this year, with the market fully open by mid 1999, “following a period of controlled market start up.”

The completion of the competitive electricity supply market will end a process begun at privatisation. A speech⁴⁷ given last summer by Professor Littlechild charted the development of competition not only in supply but also generation. In 1990/91, the first year after vesting, just over 40% of sales to large users (more than 1 megawatt power demand) in England and Wales went to so-called second-tier suppliers. These are suppliers other than the local regional electricity company. In 1997/98, this figure had risen to 70%. Competition was introduced later in the 100 kilowatt⁴⁸ to 1 megawatt market, but now 50% of sales go to second-tier suppliers. In Scotland, supply competition is markedly less advanced, the market being dominated by ScottishPower and Hydro-Electric.

Competition in electricity generation has also increased notably since privatisation, at least in England and Wales. In 1989/90, National Power and PowerGen enjoyed a 78% share of the market, a figure which had fallen to 46% by 1996/97. Speaking in July, Professor Littlechild identified developments underlying this changing picture. The increased capacity factors achieved by the interconnectors linking the grid in England to Scotland and France have provided wider market access for generators. Nuclear power’s increasing share has been notable, the result of Sizewell B’s completion and improved plant efficiency, doubtless motivated in part by the 1996 privatisation of the newer stations. New entrants in the generation market, building gas-fired power stations (often in partnership with RECs), accounted for 12% of market share in 1996/97. Finally, following guidance from the DGES, National Power and PowerGen sold 6,000 megawatts of coal-fired plant to Eastern Group, now part of the Energy Group. Competition between generators is likely to increase as more companies enter the supply market, with implications for electricity bills. Generation costs currently account for about half of a typical bill⁴⁹.

⁴⁴ Offer press notice R53/97, 20 November 1997

⁴⁵ “Electricity competition problems still unsolved” *Independent* 9 January 1998

⁴⁶ *Review of the 1998 Programme: Report to the Director General of Electricity Supply* (PA Consulting Group, January 1998)

⁴⁷ “Development of Competition in the Electricity Industry” speech by Professor S Littlechild at the Energy Utilities Group Quarterly Meeting, Oxford Economic Research Associates Limited (24 July 1997)

⁴⁸ 1000 kilowatts equal one megawatt

⁴⁹ “Power regulator wants tougher curbs” *Independent* 8 October 1997 p24

II Reports on Utility Regulation

A. Public Accounts Committee

Following a National Audit Office survey⁵⁰, the Public Accounts Committee published a report⁵¹ last year on *The Work of the Directors General of Telecommunications, Gas Supply, Water Services and Electricity Supply*. Though the Committee compared the work of all four Directors General, this paper will highlight aspects of their report of particular relevance to electricity and gas. Inevitably, a key concern was the role of the Directors General in promoting competition, and its benefits.

The Director General of Gas Supply told us that competition was much more effective than a regulator could ever be in giving companies an incentive to discover what they might be able to do to control costs better. She also commented that in the South West, where there was now competition for everyone, domestic customers were seeing discounts of 15 per cent to more than 20 per cent below British Gas's charges, and that competition was the reason why prices for business customers had fallen by between 45 per cent and 54 per cent since privatisation, while those for domestic customers had fallen by 24 per cent.

The Committee also inquired about the impact the new competitive markets would have on low income households. Their conclusions on regulation and competition included the following:

17. We note the work being carried out by OFGAS and OFFER to extend competition in gas and electricity supply to all customers between now and 1998, and the practical challenges that need to be overcome to achieve this deadline. We look to the Directors General of Gas Supply and of Electricity Supply to ensure that all action necessary is taken to complete this work on time, and for them to be alert to opportunities to accelerate the process where this can prudently be done.

18. We also note the monitoring being carried out by OFGAS to protect the interests of customers on low incomes in the new competitive market. We recommend that all of the Directors General carry out similar monitoring as competition develops in their respective industries.

Electricity and gas prices are controlled by the DGES and DGGs, the precise inputs to the formulas depending on a variety of data made available to them.

⁵⁰ *The Work of the Directors General of Telecommunications, Gas Supply, Water Services and Electricity Supply* HC 645 1995/96, 24 July 1996

⁵¹ HC 89 1996/97, 5 March 1997

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23. The Director General of Gas Supply referred to the publication of information about the regulated company. She was concerned to secure transparency as regards the costs of the companies she regulated. In this respect British Gas's competitors gave her well informed criticisms of the information that she received from British Gas. She was concerned to put as much of such information as possible into the public domain. But she told us that under her existing powers she could only publish information if she could prove that it was not commercially confidential. There could be justifiable reasons why information should not be published, for example if it made British Gas's negotiations with their suppliers more difficult, but she thought that the benefits of having information made public outweighed the problems it would cause the company concerned.

25. The Director General of Electricity Supply told us that, in reviewing the level of the price cap, he carried out studies, which were as detailed as possible, to assess the main components, including a consideration of operating costs, capital expenditure, and what sort of return on capital would be needed to attract new capital. He took consultancy advice, formed a view as to what would be an appropriate level, and took the views of the companies and of others. And in his view, the controls he was now proposing had got it just right.

In determining the level of price caps, the Directors General take the capital value of the regulated company, and allow a percentage rate of return to cover loan interest and reasonable profits. Much of the controversy surrounding price reviews relates to different methods of estimating capital value as well as what constitutes a reasonable cost of capital (i.e. the rate of return). For a given rate of return, a regulated company will benefit most from a price cap assigning it a large capital value.

29. First, as regards the capital values of the regulated companies, the Director General of Electricity Supply told us that he had considered whether to look at the book value of assets. He had suggested that replacement value was not the most appropriate basis for calculating the revenue which should be earned in respect of existing assets, if a lower revenue could yield an adequate return to shareholders' investment. He had therefore decided that it was more appropriate to look at what investors had paid to purchase the company. He said that subsequent experience and regulatory practice had reinforced this view. He had valued the companies at £7.7 billion (at 1990 prices), made up of equity of £5.9 billion, based on the share price at the close of the first day's trading, plus £1.8 billion in the net debt. And he had valued the distribution part of their businesses at £5.3 billion (also at 1990 prices) and their holdings in the National Grid Company at £2.4 billion.

30. By contrast, when we examined the Department of Trade and Industry about the conduct of the sales, we were told that the asset value of the regional electricity companies was £16.1 billion (at 1990-91 prices). The net proceeds of the sale were £7.7 billion.

31. The Director General of Electricity Supply told us that it was not possible to give figures precisely comparable to the valuation of £16.1 billion because some of the companies no longer produced current cost accounts at the group level. He added, however, that the current cost value of the net assets of the regulated businesses of the regional electricity companies and of the National Grid Company (which at the time of privatisation was wholly owned by the regional electricity companies) increased from £16.4 billion at 31 March 1991 to £20.5 billion at 31 March 1996.

32. The Director General of Electricity Supply said that he was not privy to the setting of the price control established at the time of privatisation and could not say on what basis the Government had set the control. He was not aware, therefore, of any assumptions the Government might have made about the values of the assets of the companies, or about an appropriate return on those assets. He told us that during the period of the first price control the financial returns of the regional electricity companies had been influenced by several factors, but that they were not influenced by changes in the current cost accounting values of net assets after privatisation.

The decision of the DGES to base capital values used for price regulation on what shareholders had actually paid was welcomed by the Committee. Capital cost, that is the percentage rate of return on capital, has depended on the need of various utilities to attract investment, with riskier investments implying a higher cost. One way in which companies can make larger rates of return is if their efficiency improvements are greater than anticipated in the price cap.

43. The price controls put in place by the Government at the time of privatisation, and continued by the Directors General in their subsequent reviews of price controls, regulate prices rather than profits or costs. As a result, if a regulated company manages its business much more efficiently than was allowed for when the price control was set, it can earn a rate of return very much in excess of what the regulator has judged to be the company's cost of capital. If this happens, two issues arise for the regulator in his or her next review of the company's price control: first, what approach to adopt towards past profits earned by the company in the prior period; and second, what approach to adopt if the regulator expects the future price control period to begin with the company receiving a rate of return above the level the regulator considers appropriate.

44. The Director General of Electricity Supply told us that the returns achieved by the regional companies in the first five years after privatisation appeared higher than he would envisage shareholders would need in relation to these kinds of businesses. The first price control had been set by the Government and the subsequent controls that he had set had been considerably tighter.

45. The Director General told us that he had taken the view that, in setting his control, he should ask what the companies needed so as to be able to operate in future; in his view it was considerably less than in the past. He had also considered whether he should make an adjustment based on the profits of the companies in the first price control period.

46. He had concluded that such profits should not clawed back because the original prices controls had been set by the Government and were on prices rather than on profits so as to provide greater certainty for customers and greater incentives towards efficiency.

47. The Director General had concluded that for a regulator to claw back profits retrospectively would constitute a breach of faith with investors. It would increase perceptions of regulatory risk and might raise the cost of capital. It would weaken incentives towards efficiency, and be contrary to customers' long-term interest.

The Public Accounts Committee asked the Directors General about the balance between consumer interests and the ability of the utilities to finance their activities.

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64. We also asked the Director General of Electricity Supply whether the size of the profits of the regional electricity companies, compared with the proceeds of their sale, indicated that regulation had gone wrong. These profits had totalled £8.7 billion over the five years following privatisation. He said that it reflected two things: the way in which the initial price controls were set at flotation; and the way in which the industry was perceived by investors at the time. He told us that the Government had taken the view that the price control they did impose was needed in order to float the companies and that it was in the national interest that they should set that price control. His view, when he came to re-set the price control, was that prices at that level were not justified for the future, and over the course of two years he reduced those prices by about 25 per cent.

The Committee acknowledged that the Directors General were not responsible for the terms on which the utilities were privatised, or on the initial regulatory regime they inherited. Noting the magnitude of the profits made by the water companies and RECs, they concluded:

To avoid the risk that profits might again rise above a reasonable level we recommend that the Directors General set price controls which will ensure that profits should be no more than is sufficient to provide the return required to attract the necessary funds for investment in future periods.

In welcoming the real price reductions which had occurred since privatisation in the electricity, gas, as well as telecommunications industries, the Committee's conclusions nonetheless expressed concern about directors' salaries:

We recommend, therefore, that the Directors General impress on companies the risk they face, in terms of loss of public confidence and trust, if they pay excessive emoluments to top executives; and that they seek ways of influencing companies to avoid unjustified levels of pay.

On the overall balance of interests between consumers and companies, they concluded (para 78):

We note the evidence of the Directors General that, in seeking to strike a balance between the interests of customers and those of shareholders in the companies they regulate, the Directors General have regard to the long-term interest of customers that the companies should be able to undertake necessary capital investment. And we note also that in the gas industry in particular the rate of return has been set at a level intended to attract investment.

A major part of the Committee's inquiry dealt with the developing role of the individual regulators, for example the desirability or otherwise of having single regulators rather than boards. The DGGs made the point that the *Gas Act 1995* saw no need to change the general structure of regulation in the gas industry. On this point, the Committee concluded:

102. We note that the role of the Directors General as single regulators has been established by legislation, and their view that these arrangements work well. The statutory arrangement does, however, confer greater power on single individuals so we consider it to be essential that the Directors General ensure and demonstrate that they exercise such power responsibly.

103. We also note how, within their existing powers, the Directors General have developed the use of advisory panels of experts to assist them in reaching their decisions. We believe that the use of expert panels of high standing helps to instil public confidence in the regulatory process and should also help the Directors General to reach sound regulatory decisions. In the absence of any legislative change to their position as single regulators, we recommend that the Directors General should seek to make increased use of high level advisory panels.

Checks on the regulators' powers include consultations on their proposals, appeals by the companies to the MMC, and judicial review.

105. We note that customers or competitors of companies in regulated industries have no appeal to the Monopolies and Mergers Commission against regulatory decisions. Although judicial review might provide a form of appeal for customers or competitors, it was little used. We recognise that there might be difficulties in devising a mechanism which allowed for appeals by all customers and competitors while at the same time including safeguards against frivolous applications. In the absence of such an appeal mechanism, however, we consider that that Directors General need to strive to ensure that the quality of decisions is as good as it can be and that the reasons for decisions are clear to those affected by them.

106. We therefore welcome the emphasis given by the Directors General to consultation. We recommend that the Directors General ensure that when they consider significant decisions, they do all that they can to consult in advance on the issues that they must consider, to explain the reasons for the decisions they have made, and to publish, so far as they are able, the financial and other information that they consider justifies the particular conclusions that they have reached.

Mergers between utilities have raised the question as to whether regulatory offices should mirror this. Recent reports⁵² continue to suggest that the Green Paper emerging from the review will support a merger between Offer and Ofgas. The Directors General already meet about every three months, along with the water, telecommunications and rail industry counterparts. The Public Accounts Committee's report noted:

101. The Director General of Gas Supply told us that there had been a lot of talk about amalgamating OFGAS and OFFER. She said that each had a very tough task in getting competition into their respective industries, but that the gas and electricity industries were getting much closer together. Gas was now a very important fuel in generating electricity and all the regional electricity companies had subsidiaries that sold gas. And at some point after 1998, it might be appropriate to amalgamate the two offices.

⁵² "Electricity and gas watchdogs to be merged in regulatory overhaul" *Independent* 5 November 1997 p.24

B. Trade and Industry Committee

Last March, the Trade and Industry Committee published a report entitled *Energy Regulation*⁵³. Against the backdrop of converging gas and electricity industries, the Committee had set itself the following terms of reference:

To examine the regulatory regime for the electricity and gas industries, with particular reference to:

The statutory duties of the regulators, including the weight given by the statutes to different considerations and the extent to which the regulators have freedom of action;

The accountability of the electricity and gas regulators, their consultation procedures and the transparency of their decision-making;

The regulatory implications of the creation of companies combining electricity, gas and water interests;

The division of responsibilities and co-operation between the electricity and gas regulators;

The relationship between regulation in Scotland and in England and Wales;

The resources and expertise available to the regulators;

The methods used by the electricity and gas regulators, including RPI-X price caps, and whether there are better alternatives;

Whether regulatory panels would be more satisfactory than individuals;

The effectiveness of the electricity and gas regulators in achieving the objectives set for them.

The report opened with a summary of the regulatory regime and its rationale, with which the Committee broadly approved:

11. The system of arm's length economic regulation by Directors General independent of the Government was intended, the Department of Trade and Industry (DTI) told us, to leave the management of the privatised companies free, without Government interference, "to promote ... a competitive market and to protect the interests of consumers in those areas where competition has not yet developed, or where monopoly is likely to remain", without Government interference. They added "a regulatory regime was ... necessary ... to secure increased efficiency, lower prices, and better quality by promoting competition and protecting consumers' interests in markets which were dominated by powerful incumbents, and in which there remained elements of monopoly".

⁵³ HC 50-I 1996/97

13. As a means to fulfilling their duties, each regulator sets the maximum prices which may be charged by regulated companies. The first price controls after privatisation, in gas and electricity, were set by the Government, with subsequent ones being set by the regulators, typically for 4 or 5 years but varying from industry to industry and company to company. The formula chosen by the Government was broadly that price increases should be no more than the increase in the retail price index (RPI) over the period, plus or (more usually) minus a certain percentage colloquially known as 'X' (see para 35). The regulators have maintained that system.

In a discussion of the general duties and functions of the gas and electricity regulators, the Committee noted that they may, in principle if not in practice, be issued with general directions by the Secretary of State. The Energy Intensive Users Group had complained to the Committee that the relationship between regulator and Secretary of State was clouded.

22. While the Secretary of State and the regulators have similar statutory duties in respect of energy regulation, the DTI were not in doubt about the division of responsibility. "The broad distinction is that the Government is responsible for preparing the legislation and other instruments which establish the regulatory framework and for appointing the regulator, while the regulator is responsible for carrying on the business of regulation within that framework". The regulators were equally clear.

1. Price controls

A large part of the report came under the heading of "regulatory objectives". Security of supply, that is ensuring all reasonable demands for energy are met, is a primary duty of each regulator. Some coal industry sources complained that the encouragement of gas-fired power stations could compromise long term security of energy supplies, leaving them vulnerable to political upheavals in Russia and the Middle East. It can readily be argued that securing energy supplies, as well as the other key objective of promoting competition, are entirely compatible with the protection of consumer interests. Indeed, both the DGGs and DGES considered competition, where feasible, to guarantee these more effectively than regulation. Where competition is absent, or still developing, regulation is needed to protect consumers in terms of prices:

... To achieve this, the Government chose to impose price controls, rather than methods such as an annual rate of return requirement which would control profits, and adopted a formula based on the RPI-X principle. Although not obliged by law to continue with this form of regulation, all utility regulators in the UK have so far decided to do so. The two energy regulators told us that they believe that it protects consumers from the abuse of monopoly power and benefits consumers through greater efficiencies, while encouraging companies further to increase efficiency.

Price caps appear to have contributed significantly (at least for domestic customers) to the decline in gas and electricity prices since privatisation. However, it is difficult to separate from these caps, contributions due to falling fuel prices and efficiency improvements. The

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latter are often at the expense of job losses which impose a burden on the taxpayer, not to mention the workforce⁵⁴. The pros and cons of price capping, and its alternatives were also considered:

40. Several witnesses contrasted the RPI-X form of incentive regulation with the 'rate of return' method adopted in the US, which is based on controlling the profits of regulated companies. A particular advantage of the rate of return system is that it reduces the possible extremes of profit or loss. However, a system which permits the firms to earn no more than the specified rate of return each year does not give the company strong incentives to reduce costs because the company will receive no benefits from efficiency improvements. In fact, as we found when we visited the United States, there is an incentive to undertake excessive capital expenditure in order to expand the asset base on which the rate of return is to be earned (a process known as 'gold-plating'). This is regarded as the major drawback of the rate of return system.

42. Criticisms of RPI-X regulation have centred around the implementation and operation of the formula, the main ones being:

- the RPI-X caps "have not been tough enough"; that the high levels of profits and returns achieved by the companies have not been consistent with a fair distribution of benefits between the shareholders and customers;
- the disadvantage that the regulator faces in obtaining accurate information about the company's efficient level of forward-looking costs gives the scope to obscure the picture leading to a built-in tendency to set price caps which are too lax;
- any mistakes made in the setting of prices carry a risk of being magnified by the length of time for which the price control is set.

The energy regulators both argued that the high profit levels enjoyed by the utility companies had arisen from the initial price controls set by the Government. In this context it is noteworthy that Scottish Power and Scottish Hydro-Electric had lower internal rates of return⁵⁵ than their counterparts in England and Wales. The Scottish companies attributed this to their later privatisation, "at a time when the Government had learned more about the valuation of electricity companies and the regulators about the RPI-X system"⁵⁶. One suggestion has been that companies could give their customers annual rebates based on profits. A modification to this is sliding scale regulation whereby lower price levels are set in return for a lower rate of profit sharing.

49. The main advantages of a profit-sharing mechanism are that it ensures that prices do not get significantly out of line with costs, it creates an automatic correction over any lax price formula and, most importantly, it results in an earlier, more equitable distribution of efficiency benefits between shareholders and consumers. Several disadvantages were also put forward:

⁵⁴ paras 189, 194

⁵⁵ internal rate of return is a profitability measure, based on the value discount rates (real interest rates) would have to take for a company's costs to equal its prices.

⁵⁶ para 187

- any sanctions on profits would have detrimental effects on incentives to reduce costs compared with the existing RPI-X control;
- although customers might receive a larger share of the profits in the short term, this is likely to be more than offset by the higher cost base which they would ultimately have to bear;
- there is a risk that it would give companies incentives to manipulate levels so as to minimise or eliminate any requirement to reduce prices to customers;
- above all, profit-sharing would make regulation more detailed, complex and uncertain as it would involve defining 'normal' and 'excess' profits, and annual discussions between the regulator and the company.

50. After consulting on the issue of profit-sharing, the regulators have, on the whole, rejected the idea in favour of the existing system chiefly on the grounds that extensive annual profit-sharing arrangements are likely to reduce incentives to increase efficiency...

The Committee recommended the continuation of RPI-X incentive regulation. As for the specifics of the price cap calculations, the Committee noted:

66. The price cap the regulators set must allow the regulated company to cover its forecast costs from sales revenue. The calculation of price caps is based on of the company's operating costs, capital expenditure, the annual depreciation charge and the cost of capital (new and existing). This information is also used to arrive at X, the appropriate factor for productivity improvements through the review period...

Changes, from one review to the next, in the basis for calculating X have attracted industry criticism on the grounds that the resulting uncertainty made their businesses less attractive to potential investors. Some witnesses thought that the undesirable differences in methodology between regulators had been exaggerated. On this, the Committee wrote⁵⁷:

While we accept that industries have different characteristics, and inconsistencies between industries may arise, **we recommend that individual regulators should seek to improve their calculations by taking account of regulatory practices in other industries with the aim of achieving greater consistency. This is especially important for energy regulators whose different methodologies could distort the choice of energy source.**

⁵⁷ para 73

2. Developing Competition

Paragraphs 77-80 of the Committee's report summarised the development of competition in both gas and electricity. However, there remain activities widely regarded as being natural monopolies. In the context of electricity these are transmission and distribution.

82. One area of concern noted by witnesses was the operation of the Pool. The Pool is a half-hourly spot market in electricity, intended to maintain the benefits of an integrated network in a competitive market open to new entrants. The Pool is not a physical entity, being rather a set of contractual agreements, but virtually all electricity in England and Wales is deemed to flow through it. It is designed to cope with the fact that no significant volume of electricity can be stored and that supply and demand must always be in balance. Its two main purposes are to determine which generating stations run, based on prices bid by the generators, and to determine the cost and price of electricity traded. In practice, a substantial proportion of trading is covered by contracts, but contract prices and average Pool prices are closely related over time.

Responding to concerns that the pricing mechanisms and governance of the electricity Pool⁵⁸ could be inhibiting competition, particularly in the wholesale market, the Committee recommended⁵⁹:

... that the Government conduct a thorough review of the relationship between OFFER and the Pool, to establish whether the DGEN needs more extensive powers to ensure that consumers receive the maximum potential benefits of competition and that the Pool operates efficiently, transparently and in consumers' interests.

In October 1997, the Minister for Science, Energy and Technology (Mr Battle) invited Professor Littlechild to draw up the terms of reference for such a review⁶⁰. These were published on 28 January⁶¹, attracting Mr Battle's approval⁶², and cover electricity trading arrangements, including the Pool. Offer expects to submit its conclusions and recommendations to the Minister in July. In the gas industry, the Network Code performs functions analogous to those of the Pool, though the DGEN has more powers to influence the rules of operation.

As competition has been introduced in the industrial gas and electricity markets, so the role of the respective regulators has declined. At the same time, regulators are needed to ensure the delivery of financially unattractive services which satisfy social and environmental

⁵⁸ A good guide to the workings of the electricity Pool has appeared in *MagTech* (Magna Electric, April 1997)

⁵⁹ para 84

⁶⁰ OFFER press release R50/97, 5 November 1997

⁶¹ *Review of Electricity Trading Arrangements: Advice on Terms of Reference* (Offer, January 1998)

⁶² DTI press notice P/98/049, 28 January 1998

objectives⁶³. Furthermore, it is important to prevent cross-subsidisation and inappropriate information exchange between the competitive and monopolistic arms of a company. The supply and distribution functions of the regional electricity companies provide an example⁶⁴.

In the context of improving transparency in the regulatory process, the Committee recommended⁶⁵:

... that the Government introduce legislation at the earliest opportunity to create a system whereby information relating to natural monopolies is assumed to be non-confidential unless it can be shown to be otherwise and that the Government gives both energy regulators the authority to publish information relating to natural monopolies as they see fit, unless the company concerned can prove that publication would be commercially damaging.

In the context of the above recommendation, the Committee took care to acknowledge that some information possessed by a monopoly might be market-sensitive.

3. Environmental Protection

The gas and electricity industries contribute significantly to emissions of the greenhouse gas carbon dioxide, as well as having a range of other impacts on the environment. Here, the Environment Agency (or the Scottish Environment Protection Agency) has overall regulatory responsibility. The Committee did not accept that there was a need for “extending or strengthening the environment role of the energy regulators”. Existing powers requiring them to address environmental concerns should now be used⁶⁶.

Nevertheless, it important that the respective roles of OFFER, OFGAS, the Environment Agency and other bodies are clearly and widely understood. To that end, **we recommend that Government annually publish and disseminate a clear statement defining the environmental regulatory responsibilities of each Government department and each agency involved and include in such statements a report on progress towards meeting its internationally agreed obligations. These statements should be subject to appropriate regular parliamentary scrutiny.**

Improvements in energy efficiency are among the most obvious and cost effective ways of reducing the environmental costs of gas and electricity use. The energy regulators share with the Secretary of State a statutory duty to promote the efficient use of energy. Ofgas acknowledges the “regulatory distortion” created by simple RPI-X price controls which provide an incentive for Centrica to sell as many therms of gas as possible. Incorporation of

⁶³ para 93

⁶⁴ paras 96-8

⁶⁵ para 102

⁶⁶ para 110

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the E-factor in the price control is designed to counter this, and raise funds for energy efficiency schemes. These are managed by the Energy Saving Trust. The Committee broadly agreed with the stance of the present DGS that only commercially viable schemes should be funded through the E-factor, it being the responsibility of Government to raise funds in support of its environmental policies.

Analogous recommendations were made in respect of the electricity industry where the Standards of Performance levy (£1 per annum per tariff customer) is used for energy efficiency programmes.

The Committee recommended that “the regulators do their utmost, within their respective remits, to promote energy efficiency”. Price controls where revenue was linked less closely to volume of sales were one direction in which the regulators had already been moving. However, the Committee reported concerns that competition would focus, at least initially, on the price of energy supplies — a disincentive for energy conservation. Against this were the commercial advantages afforded by diversification into selling energy services like insulation or low energy lamps.

126. If the development of energy services is to compensate for the negative impact on energy conservation that lower prices is likely to have, it is important that such services develop quickly. The Association for the Conservation of Energy told us “the free market alone is not likely, in the short to medium term at least, to result in an energy sector which meets society's needs in an optimal way”. The World Wildlife Fund estimated energy services will not emerge for several years. The UK Round Table on Sustainable Development, in their Report on *The Domestic Energy Market: 1998 and Beyond*, expressed similar concerns. **We support the recommendation of the UK Round Table on Sustainable Development that the government “should consider promoting the development of energy services if these do not emerge quickly on their own accord”.**

Further details of the UK Round Table’s report are given in section D below.

4. Social issues

The energy regulators set standards of performance for licence holders. In gas, these cover several activities including the restoration of supply interruptions, meter reading, responding to customers within certain time limits and so on. Failure to meet standards could, in principle, trigger a reconsideration of price controls. Public electricity suppliers are required to pay compensation if they fail to meet those standards deemed to be guaranteed. Their performance levels are published in Offer’s annual *Report on Customer Services*. Both regulators have duties towards older or disabled customers (and Ofgas to the chronically sick).

131. Under section 14(3) of the 1986 Gas Act, British Gas is prohibited from undue preference or undue discrimination to any persons or classes of persons in the setting of its tariffs. It is for the DGGs to ensure compliance, as she did when British Gas introduced its DirectPay and OptionPay tariffs in 1995. These tariffs introduced discounts for customers paying by monthly or quarterly direct debit, monthly standing order or quarterly credit. In both cases, after investigation, the DGGs found that there was no preference or discrimination on a scale to contravene section 14(3) of the 1986 Gas Act.

132. Despite such measures to protect consumer interests in the gas industry, complaints made by consumers about British Gas and other gas suppliers have risen substantially since privatisation...

Paragraph 135 continues:

...The NCC point to the increasingly large volume of complaints, together with a decline in the standards of service from British Gas, and the dubious marketing practices employed by some gas suppliers in the gas trials in the South West, as evidence that OFGAS has not done enough to protect interests.

However, the fall in gas prices since privatisation may be considered a social benefit. The Committee noted that prices to domestic electricity consumers had also fallen⁶⁷, as had customer complaints to Offer⁶⁸, since vesting. Furthermore⁶⁹,

There has been a significant fall in the number of domestic customers disconnected for debt from 65,000 in 1990-91 to 1,083 in 1994-95. (We note, however, that these figures not include self-disconnections, ie. those prepayment customers who stop consuming because they cannot afford to make the payments)...

41. We recognise that the introduction of competition into energy markets is likely to lead to unbundling and more cost-reflective pricing. These developments, if unfettered, are likely to lead to wider differentials between tariffs, with those on pre-payment meters, usually low income consumers, suffering most or, at best, gaining least. The extent to which tariff differentials should be tolerated, or those on low-incomes compensated, is a matter of social policy and therefore for the Government, and not the regulator, to determine. Nevertheless, we would not want to preclude the use of the regulatory system as a tool for implementing Government policy, as it may be the most efficient delivery system. Nor would we wish to see economic regulatory policy conflicting with either Government policy or consumer interests. Thus, we have concluded that the current legislative balance between economic and social issues is broadly correct.

Notwithstanding the above, the Committee recommended⁷⁰ that “the Government introduce legislation amending the 1989 Electricity Act to impose a duty on the Director General of Electricity Supply to take into account in the exercise of his primary duties the needs of those

⁶⁷ paras 136, 184

⁶⁸ para 137

⁶⁹ para 136

⁷⁰ para 142

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who are chronically sick”. This would bring electricity into line with gas. The National Consumer Council was concerned that liberalisation of the energy markets would not provide a fair share of benefits to low-income customers.

144. Both regulators have already taken action in an attempt to ameliorate the potential adverse effects of competition on vulnerable consumers. Nevertheless, there will be an ongoing need to monitor the impact of liberalisation on these consumers and action may be necessary to address the concerns of the NCC and other consumer groups. **We recommend that both regulators undertake detailed monitoring of the effects of liberalisation on vulnerable consumers and publish their findings, and take swift remedial action where necessary. We further recommend that they continue to seek ways in which the interests of such consumers can be best protected and implement such provisions where it is consistent with their other duties.**

The Committee further recommended that⁷¹:

the Government introduce legislation to impose duties on the Directors General of Electricity Supply and Gas Supply to take into account in the exercise of their primary duties the needs of those who are on low incomes.

5. Accountability

Some evidence received by the Committee suggested that single regulators should be replaced by several regulators sharing responsibility for a given industry. The main arguments in favour of such panels was that they might reduce the personalisation of controversial issues. Against this, decision-making could be slowed down, and accountability blurred⁷². On this the Committee resolved the following⁷³:

We reiterate our earlier recommendation that, when competition in supply is fully established in the gas and electricity industries, the Government reconsider whether the offices the DGGS and DGES should be merged and whether the regulator should be individual or collegiate.

The report recorded the regulators’ views on their accountability:

⁷¹ para 145

⁷² paras 189-90

⁷³ para 191

152. Both OFFER and OFGAS set out the ways in which they believe themselves to be accountable: to the Secretary of State, who appoints and may dismiss them and who must submit their annual reports to Parliament; to Parliament through the Secretary of State and through its Committees (including, since their activities are subject to scrutiny by the Comptroller and Auditor General and Parliamentary Commissioner for Administration, the Public Accounts Committee and the Select Committee on the Parliamentary Commissioner for Administration), and to the courts, mainly through judicial review. They also suggest a more general accountability to those who may be affected by their decisions.

A suggestion by the former Energy Minister, Mr Tim Eggar, that a Select Committee on Regulated Industries be established, did not convince the Committee:

We recommend that the current system of monitoring by parliamentary select committees should remain unchanged.

The powers of the regulators are checked in various ways, including consultation exercises, formal or otherwise. Section 13 of the Gas Act 1995 states that “It shall be the duty of the Director General of Gas Supply, where either he [or she] considers it expedient or he is requested by the Secretary of State to do so, to give information, advice and assistance to the Secretary of State with respect to any matter in respect of which any function of the Secretary of State under this Act is exercisable”. The Committee reiterated the recommendation of its Eleventh Report of 1994-95 that the Government impose a duty on the Director General of Electricity Supply to give reasons for his decisions.

168. There are various methods by which certain interested parties can appeal against decisions made by the energy regulators. Where a licensee does not agree with licence modifications proposed by the Director General, and the Director General wishes to proceed with the modifications, the matter is referred to the MMC. If a licensee objects to an enforcement order (an order requiring compliance with licence conditions) issued by the Director General, the licensee may use a special legal appeals procedure. Furthermore, any decision taken by the Director General (except those in relation to enforcement orders) is subject to judicial review.

Commenting on the absence of a mechanism whereby a company can appeal against a regulator’s decision not to modify licence conditions, the Committee recommended

that the Government, in consultation with the regulators and licensees, consider the need to enable licensees to appeal against decisions not to amend licence conditions and ways in which such appeals could be conducted.

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Allowing consumers more scope (beyond judicial review) to force reviews of regulatory decisions found little favour with the Committee. This was for practical reasons as well as the attendant danger of greater uncertainty for the utilities, increasing the cost of capital and raising prices in the long term.

One further factor impinges on the accountability issue: the clarity of the roles and interaction between regulatory offices:

175. There is inevitably an interaction between energy regulation and general competition law. The energy regulators can act concurrently with the Director General of Fair Trading (DGFT) in some functions under the Fair Trading Act 1973 and the Competition Act 1980. The Minister told us that "the reason for the concurrency is to make sure that there is no gap which falls between them". However, Mr Eggar told us that there was a lack of clarity and the potential for conflict inherent in the duties of the regulators and those of the OFT. In practice both the energy regulators have signed concordats with the DGFT which set out how each will act in matters where they have overlapping duties. The concordats provide that, where the principal effect of action is on competition in the electricity or gas markets, the relevant regulator will act, with the DGFT acting in all other cases. Nevertheless, as the DGES told us, there is always liaison between regulatory offices in such matters. While there have been few problems with this system to date, we recognise that there is potential for conflict given the differences in statutory duties between those of the energy regulators and those of the DGFT.

The Government's review of utility regulation is a response⁷⁴ to the Trade and Industry Committee's report. In the following sections, the contents of four more reports are summarised. These, together with direct submissions to the review⁷⁵, have also informed the Government's deliberations.

C. Environment Committee

A large part of the Environment Committee's report on *Water Conservation and Supply* (HC 42-I 1996/97) focused on issues unique to water, rather than to the general regulatory process. As the title suggests, primary concerns included trends in water usage and availability. These in turn are influenced by charges levied on users, the impact of drought, climate change as well as leakages in the supply infrastructure. Long term water supplies are more vulnerable to the vagaries of nature, and to the polluting effects of industry, than are electricity and gas. One reason for this is the existence of national and transnational cables and pipelines, not to mention a diversity of options for electricity generation. But parallels may be drawn between water and energy from several standpoints: regulation, conservation, and social imperatives to name but three. The fact that the electricity generation industry is a major user of water drives home the interrelationships among utilities, as does the emergence of multi-utility companies.

⁷⁴ *Government Observations on the First Report from the Trade and Industry Committee (Session 1996-97) on Energy Regulation* HC 307 1997/98, 4 November 1997

The encouragement of energy efficiency by price controls has an echo in the water industry. In the latter case a central issue is the whether water meters ought to be installed at all. Managing demand by installing meters “remains highly controversial, largely on social grounds...”,⁷⁶ an observation which contributed to the following recommendation:

164. Whilst a case may exist for metering water on conservation grounds, there are clearly other issues to be considered and it is far from proven that it is either a cost-effective or an equitable way to reduce demand. A combination of other measures, if pursued imaginatively and energetically, will suffice to reduce demand to levels which, with good management and proper regulation, water companies should be able to meet in the foreseeable future.

Some other measures mentioned by the Committee included the setting of mandatory leakage targets for water companies⁷⁷, and the factoring in of environmental costs when assessing economic leakage levels⁷⁸.

One of the seven broad terms of reference adopted for the inquiry looked at the “roles, achievements and policies of Ofwat, the Environment Agency and the Department of the Environment in relation to water conservation and supply”. The Office of Water Services (Ofwat) has a primary responsibility for the economic regulation of the water industry in England and Wales.

268. The evidence of the Department of the Environment sets out the duties of the various individuals and bodies involved in water management and policy both succinctly and clearly. We can do no better than quote their explanation: “Under the arrangements established following privatisation of the water and sewerage companies in 1989, the task of regulating the industry was transferred to independent regulatory bodies, save that the Drinking Water Inspectorate remained part of the Department of the Environment. The Office of Water Services became responsible for price regulation of the industry and for protecting the interests of consumers, whilst ensuring that the industry, operating prudently and efficiently, could finance its functions. The National Rivers Authority became responsible for environmental regulation of the industry and for water resources management including conserving, re-distributing or augmenting water resources in England and Wales and securing the proper use of those resources. These latter functions were transferred to the Environment Agency on 1 April 1996 The Secretary of State retained responsibility for: legislation, including subordinate legislation; appointment of companies as water undertakers; appointment of the Director-General of Water Services; appointment of members of the Environment Agency; the making of ordinary and emergency drought orders; and various aspects of enforcement where these have not been delegated by means of general authorisations”. The Director-General’s duties include looking after the interests of the consumer at national level. In addition, there is a series of Ofwat Customer Service Committees.

Some witnesses, such as North Yorkshire County Council, did not feel that the respective responsibilities of Ofwat, the Environment Agency and the Department of the Environment were sufficiently clear⁷⁹. Specific criticisms of Ofwat were also recorded:

⁷⁵ some of the submissions to the review are listed in the further reading section at the end of this paper.

⁷⁶ para 126

⁷⁷ para 102

⁷⁸ paras 88-9

⁷⁹ para 269

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271. Of all the witnesses, perhaps the Mid Yorkshire Chamber of Commerce was the most fiercely critical of Ofwat, especially for failures to protect the public during the drought of summer 1995. They accused the Director-General of being “largely silent throughout the crisis”, not making a submission to the public inquiry “preferring instead to hold an inquiry behind closed doors”, and only sending an observer to the public inquiry for the last three days. It concluded with a round condemnation: “As a result ... we are in the situation where the one privatised utility which is a true monopoly by its very nature has the weakest regulator”.

The Mid Yorkshire Chamber of Commerce added that it should be a primary duty of the Director-General of Water Services to ensure water supplies⁸⁰ (analogous duties already apply to the energy regulators). At the same time, they judged that the Department of the Environment had failed “to provide direction and stimulus to Ofwat”. For its part, the Department did have reservations about interfering with the work of an independent regulator⁸¹. The Environment Agency’s position was to request expanded powers for themselves, including the power to require water companies to draw up and submit drought contingency plans, to charge for drought permits and drought orders, and to require information⁸². These suggestions met with the broad approval of the DGWS.

The Committee called for a national strategy for water, spearheaded by the Environment Agency⁸³. It might be tempting to extend the analogy with energy further in this context, particularly in view of the ongoing government reviews in the energy policy field.

292. Given the confusion, and all that has so far surrounded all matters pertaining to this inquiry, it seems to us that this planning process must be open and accountable to all parties. **Each water company should undertake, with the regulators (the Environment Agency and Ofwat), a transparent and accountable water resource planning process which considers all the options to meet demands for water in the long-term including their financial implications. It should include contingency planning for droughts and consideration of how much extra capacity must be provided, what levels of leakage will be achieved, how far demand for water might be increased, and how far demand side management will lead to better use of water. The whole process must be subject to a strategic environmental assessment. Such a plan should also be deposited with the regional office of the Environment Agency for public display and public debate. The plan should be revised at regular intervals.**

293. The Director-General of Ofwat told us that, as a result of the new duty in the Environment Act 1995 for the water companies to promote the efficient use of water, he had required water companies to submit to him by 1st October 1996 their plans concerning demand side management, having consulted with the Environment Agency and local Customer Service Committees. We hope that these plans will go some way to meet our call for openness and accountability.

The Committee strongly endorsed the idea of a Water Saving Trust to⁸⁴ “campaign, through education and through the provision of grants or other incentives, for the sustainable and efficient use of water in the home and and in industry.” This would be analogous to the Energy

⁸⁰ para 286

⁸¹ para 272

⁸² para 279

⁸³ para 290

⁸⁴ para 301

Saving Trust, and raises similar funding questions. In his response⁸⁵ to this recommendation, the DGWS did not consider that customers should be asked to fund such an initiative through higher prices. He also observed, as did the Conservative Government⁸⁶, that water companies already had a duty to promote the efficient use of water. However, neither Ofwat nor the former Government explicitly opposed the concept of the Trust.

D. UK Round Table on Sustainable Development

During her speech on 30 June 1997, and in a written answer announcing the utilities review⁸⁷, Mrs Beckett alluded to a report by the UK Round Table on Sustainable Development, *The domestic energy market: 1998 and beyond* (January 1996). The Round Table was established in early 1995 with a remit to encourage discussion of major sustainable development issues. Members and participants are drawn from central and local Government, business, environmental organisations and other sections of the community. The Round Table takes care to point out that this does not imply Government endorsement of its recommendations. Its 1996 report began by addressing the goals of competitive energy markets.

4. The Department of Trade and Industry (DTI) envisages that a competitive market will bring the following benefits:
 - immediate reductions in prices to consumers;
 - the development of alternative forms of service including energy efficiency services, for example through energy management companies;
 - the development of "smart" meters to enable customers to manage their consumption and to shop around; the possibility of a more informed consumer culture;
 - greater production and conversion efficiency;
 - for electricity, more decentralised production and better matching of generation and consumer demand;
 - innovation leading to more efficient and less environmentally intrusive methods of generation; and
 - tariff structures which better reflect marginal costs and make more efficient the handling of peaks in demand.
5. The Round Table agrees that competition is likely to lead to improvements in efficiency of production and supply, and benefits generally to customers. However, there are concerns that the results of competition will not necessarily be wholly consistent with environmental or social objectives.

The Round Table's first three recommendations related to the maintenance of a competitive market for energy and energy products:

⁸⁵ *Ofwat's response to the Environment Committee's First report on "Water conservation and supply"* 18 February 1997

⁸⁶ *Government Response to the Conclusions and Recommendations of the Environment Committee: First Report on Water Conservation and Supply* Cm 3562, February 1997

⁸⁷ HC Deb 30 June 1997 cc20-1W

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Recommendation 1. The regulators and the competition authorities must ensure that the restructuring of the energy supply industries introduces genuine competition.

Recommendation 2. The remaining core monopolies (the pipes and wires) will need to be regulated. Prices should be set to simulate competitive pressure and to avoid distortions to other areas of the market.

Recommendation 3. In the interests of ensuring effective competition, the regulators should assess the way in which information on tariffs is likely to be provided and consider whether further measures may be necessary or desirable to assist customers and consumer organisations to understand and to compare data between suppliers.

Meeting the needs of consumers, and allowing derogations from the requirement to supply openly to all customers were considered next. The latter could be desirable if a utility company was established specifically to target social housing estates.

12. Competition should increase the efficiency of the gas and electricity supply industries. However, to the extent that consumers' needs are for heating and lighting rather than for gas or electricity as such, neither the current arrangements nor the 1998 changes necessarily mean that those needs will be met in the most efficient way in the home.

13. Evidence from the opening up of the non-domestic market suggests that early competition in the domestic market will focus on price, with competition on the basis of energy services emerging only slowly

Recommendation 4. The Government and the regulators should provide a framework which encourages companies to develop energy services.

Recommendation 5. The government and industry should consider promoting the development of energy services if these do not emerge quickly of their own accord...

Recommendation 6. The regulators should be flexible in the way in which specific licences are drawn up to allow innovative supply arrangements to be adopted.

Energy efficiency was seen as a key environmental objective, and the Round Table saw scope for competitive pressures to encourage the deployment of more efficient power stations, most particularly if demand peaks could be managed more effectively. Such demand peaks often have to be met by older power stations which are less economic (and efficient). For a given fossil fuel (coal, oil, gas) less efficient power stations emit more carbon dioxide (a greenhouse gas) per unit volume of electricity supplied.

Recommendation 7. As long as price formulae continue, and particularly in terms of the remaining core monopolies, the regulators must ensure that the price formulae contain no incentives which will tend to increase the volume of energy supplied.

Recommendation 8. The Government should initiate further work on the scope to use economic instruments to contribute to environmental objectives.

The Round Table suggested a range of financial and other measures to promote energy efficiency, not least to counter a negative consequence of competition: the effect of lower prices on consumer demand. The DTI has estimated that a 10% price reduction in electricity could stimulate the total demand for all energy sources by 0.1%, the comparable figure for gas being 1.7%. Though such an increase in demand was undesirable, liberalisation by itself was “unlikely to have a significant effect on the consumption of energy resources”⁸⁸.

Recommendation 12. The Government should establish a specific energy conservation levy to fund energy efficiency schemes. This could be an expansion of the existing E factor in gas price control and the special allowance in electricity supply price control, or some other form of finance.

The energy efficiency needs of lower income households were addressed, as well as more general social objectives.

27. Both OFFER and OFGAS are required to protect the interests of customers and specifically to take into account the interest of those who are disabled or of pensionable age (but not those on low incomes). They have published proposals for the post-1998 market covering the maintenance of standards of performance and standards of service, including continuation of the obligation to supply. Maintaining minimum standards of performance and standards of service is essential to protect all customers, especially vulnerable customers (including those on low incomes).
28. There is a possibility that vulnerable customers - for example those with prepayment meters - may not be so attractive to new suppliers and may not therefore benefit as much as other customers from deregulation. Competition is also likely to lead to the removal of cross-subsidies, both geographical and between consumers, which may adversely affect certain customers, including those on lower incomes.

Recommendation 14. The impact of competition on particular groups of customers should be monitored and remedial action taken if necessary.

The importance of maintaining a more general watching brief over the development of liberalisation was the subject of the Round Table’s final recommendation:

33. The Round Table accepts that it is not possible to predict the outcome of liberalisation. Nevertheless, it is important to establish in advance objectives against which the changes can be monitored and limits which will trigger intervention by the Government or the regulators.

Recommendation 16. If sustainable development is to be achieved in the energy sector, clear objectives for the economic, environmental and social consequences of liberalisation must be established and closely monitored by Government and the regulators so that corrective action can be taken if the limits are exceeded.

⁸⁸ para 35

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The latest Round Table study, entitled *Economic Regulation*, was published last week (29 January). This provides further commentary on the roles of the electricity, gas, water, and rail regulators. It reiterates the need for monitoring the progress and impact of market liberalisation, and calls for the economic regulators to be given a duty to promote sustainable development. To this end, Government “should issue statutory guidance to regulators on the principles, objectives and targets for sustainable development relevant to their work”.

E. Hansard Society and the European Policy Forum

The Hansard Society for Parliamentary Government and the European Policy Forum are all-party foundations, with a “clear and pro-active interest in participating in the discussion about the quality and public accountability of the new system of regulation, and about the role of Parliament in these matters”. To this end they established a joint commission with the following remit: “to review the present regulatory regimes for the privatised utilities, and to recommend changes in the light of experience and the evolving structures of the industries”. Their study spanned the telecommunications, electricity, gas and water sectors in the UK, in a wide context which included the development of European and British competition law. The Commission’s recommendations, which the two sponsoring all-party foundations do not necessarily endorse, appear in *The Report of the Commission on the Regulation of Privatised Utilities* (Hansard Society and the European Policy Forum, December 1996).

In addition to being a useful resource of information about the powers and duties of the regulators, and their interaction with other players, the report contains several recommendations. Some of these are prescriptive to a degree which might almost guide the hand of a parliamentary draftsman. One example is the recommended four-stage procedure for modifying the licences of utility companies. The commission not only endorses the common proposal that Offer and Ofgas should be amalgamated, but also suggests a name for the new body: Ofres (Office for the Regulation of Energy Supplies). A majority felt this should be headed by a three-person executive board, rather than a single Director-General. Many of the recommendations formalise existing “best practice” by the regulators. The Hansard Society and the EPF have published the following summary of the report’s findings:

1. **There is widespread feeling that the British system of utility regulation is in need of reform.** The current system of utility regulation has been widely criticised and there have been calls for fundamental reform. Some causes of dissatisfaction arise from difficulties intrinsic in establishing a regulatory regime. Others relate to the progressive elimination of distortions that existed under the previous nationalised monopolies. Still others concern defects in the privatisation settlement - including alleged underpricing of shares - which have contributed to the perception of unfairness.

2. **The framework within which the regulators operate has also been criticised.** Another set of sources of dissatisfaction centres on the 'Regulatory regime' - the institutional, procedural and 'constitutional' aspects of regulation. The regime has been criticised for its lack of transparency and the complexity of its decision-making procedures. The extent to which all interested parties are properly represented in the regulatory process has also been questioned. The new independent industry regulatory bodies established at privatisation have been accused of enjoying inappropriate powers, of lacking accountability for the use of their powers and of 'interfering' in matters beyond their legitimate remit. Others accuse regulators of failing to protect the interests of consumers - especially small and disadvantaged users - while tolerating manifest corporate excess. From various view-points the system is seen as unfair, unstable and in need of far-reaching reform.
3. **An effective and legitimate regulatory regime is indispensable for the socially acceptable operation of the utilities.** An effective and legitimate regulatory regime is indispensable for successful regulation. It is a means of managing the conflicts that are inescapable in the regulation of the utilities. It should be stable and long-lasting, outliving transient disputes and withstanding inevitable disagreements over particular decisions. Our remit was to examine the regulatory regime, addressing the second set of criticisms, rather than controversies over substantive questions of pricing or the terms of privatisation.
4. **The principle of independent economic regulation is sound.** The principle of independent economic regulation - ie., regulation focused on economic objectives and free from day-to-day political intervention - is central to the current British system. On the whole it has worked well and should not be compromised in the process of reforms designed to improve accountability and transparency in its operation. Nevertheless we believe that it is necessary to address the concerns, problems and lacunae that have developed or become apparent over the last decade by adapting the current regulatory regime.
5. **Social and distributional concerns should be explicitly addressed.** Treatment of social and distributional concerns, and of the tax/subsidy questions that underlie them, is less satisfactory. These should be clear responsibilities of government and parliament, and not part of the job of unelected regulators. In accordance with this principle we propose that accountable ministers should prescribe the framework and limits within which, for example, the regulators may implement cross-subsidisation of vulnerable groups through the issue of a Social Policy Framework Document approved by Parliament.
6. **There are arguments for replacing individual directors general by regulatory commissions.** There are good arguments both for and against replacing individual regulators with panels of, say, three executive commissioners or supplementing them with advisory boards of non-executive directors whose advice should be published. Depersonalisation of regulation favours panels, but they might blunt effective decision-making unless streamlined procedures were in place. We recommend the immediate establishment of advisory boards, with an eventual move to executive boards especially as and when some regulatory bodies are amalgamated.
7. **Regulatory bodies could be restructured.** Having a separate regulatory body for each industry - albeit overarched by the Monopolies and Mergers Commission - has had the great advantage of allowing learning from varied experience. But the case for some regulatory amalgamation is strengthening in the light of technological and market developments. Thus there are grounds for merging Offer and Ofgas into an energy regulator after full liberalisation of supply in 1998. And, as the scope of its traditional activities begins to diminish, Oftel might be broadened into an Office of Communications concerning itself with all relevant infrastructure but not with content (any more than does Oftel).

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8. **Transparency and accountability should be further strengthened.** The transparency of the regulatory process has increased over time. We propose a series of measures to consolidate and extend these improvements, including the clarification of duties, requirements on information disclosure, the publication of regulatory principles and reasoning in the form of an Application of Principles Document, and mechanisms for consultation (especially with those whose voices are less easily co-ordinated). Third parties with a direct commercial interest should be able to appeal to a body to be established for the utilities (if not more generally), concerned in resolving disputes about licence amendments and the enforcement of licence conditions and competition rulings.
9. **Consumer representation should be on a standardised statutory basis.** Existing arrangements for consumer representation vary from industry to industry. Some are statutory some are independent, some are appointed by the Secretary of State, others by the Director General. We recommend standardisation on the model of the Gas Consumers Council, with statutory independence, access to independent funding, appointment by the Secretary of State (in consultation with the Director General) assuring diversity of experience and requiring particular consideration of the interests of small users.
10. **Competition law for the utilities should be recast.** Perhaps the largest gap in current regulatory arrangements concerns competition law, which is increasingly important as liberalisation extends, and in which the DGs should retain responsibility. We propose that competition law for the regulated industries - if not for the economy as a whole - should be reformed along the lines of Articles 85 and 86 of the EC Treaty of Rome so that significant anti-competitive behaviour by dominant firms is prohibited, and with scope for interim measures, fines, third party rights, and appeals against competition rulings. We also propose limitations on ministerial powers to veto utility merger references to the MMC.

F. CBI

The CBI's discussion paper, *Regulating the Regulators* was published in October 1996. While its hostility to the windfall tax has been overtaken by events, the paper contains much to stimulate current discussion not only on utility regulation, but on competition law in general.

4. The CBI, whose members include regulated industries, their customers, suppliers and advisers, fully supported privatisation. Those regulated industries are vital for the rest of business. Their performance is therefore a critical element in achieving national goals of growth and competitiveness for the UK in the global economy. They need to be efficient and innovative, investing effectively to meet business customers' future needs. These goals can best be met by introducing elective competition, in a balanced manner, wherever feasible. But, where this is not possible, specific regulation will be required and should, so far as is possible, create those outcomes on price, service and investment that come closest to the competitive model.

5. Although opinions about the regulators vary across industry, the following areas of common concern exist:
- lack of openness of the decision-making process;
 - lack of a simple appeals mechanism;
 - lack of accountability;
 - the debate about the effectiveness of the price control mechanism; and
 - proposals for a windfall profits tax.
- 6 The CBI has concluded that, whilst radical reform of regulation is not required, there are a number of improvements which could be made in order to address these concerns.

The main conclusions are, in brief, that:

- privatised industries should be regulated by general competition law (reformed along the lines suggested by the CBI earlier this year), but sector-specific regulation remains necessary in some areas;
 - improvements are required to increase accountability and transparency of decision-making by regulators. Proposals include:
 - the removal of the concentration of discretionary power in the hands of a single individual;
 - the use of open hearings, where possible, on major decisions;
 - the publication of fully reasoned decisions;
 - the use of Codes of Conduct or Guidelines setting out procedures, enunciating Government policy and clarifying interpretation and approach to common issues encountered by each regulator;
 - greater Parliamentary scrutiny.
 - a simple short-form appeals process is required for minor disputes between the regulator and the regulated company concerned, in order to avoid the delay and costs of full MMC inquiries, and the difficulties associated with judicial review;
 - each regulatory office should establish formal independent consumer representation.
7. In addition to these improvements, the current investigation has reinforced the CBI's view that:
- regulation of each privatised industry should, at present, continue under separate regulatory offices;
 - where full competition is not feasible, the current RPI-X price control mechanism provides a strong incentive to efficiency for privatised companies and benefits to consumers; no compelling case has yet been made for a change; and
 - proposals for a windfall profits tax should be opposed.

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Throughout the document, the CBI details its conclusions (preceded in each case by a brief rationale). On the social and environmental obligations of the regulators, the CBI concludes:

- Each regulatory office should establish independent consumer representation in a form in which the business as well as the domestic consumer view is effectively represented. The regulatory offices should liaise with consumer bodies to explain areas of particular concern to consumers in consultative documents and give guidance on issues upon which consumers' views are particularly requested.
- Many social issues are essentially political and therefore should be decided by Parliament and not by individual regulators.
- As far as possible, Parliament should spell out social obligations in legislation, after making thorough cost compliance assessments of their impact, so that regulators and regulated can make informed judgements of their impact on regulation.
- As competition is introduced, clear policy is required in relation to the terms of entry for new entrants in respect of social obligations, such as universal supply and the impact of change on the duties of the incumbents.
- The remit of the regulators' duties with respect to the environment and the way they balance these duties with their other duties needs to be clear.
- The impact of overall Government policy on the environment on the regulators' own agendas should be clear.

After considering alternatives to RPI-X price controls, such as rate of return regulation, dividend sliding scale regulation and profit sharing, the CBI concluded:

- Where full competition is not feasible, the current RPI-X price control mechanism provides a strong incentive to efficiency for privatised companies and benefits to consumers; no compelling case has yet been made for a change.
- A stable regulatory regime is important - frequent intervention by the regulator can undermine incentives for efficiency and cost control.
- It is vital that regulators are provided with adequate and accurate information upon which to base their reviews.

Formal checks and balances on the powers currently vested in individual regulators were recommended, perhaps involving a reformed MMC and the replacement of individual regulators with small boards. More formal consultation procedures prior to major regulatory decisions were also considered desirable. An improved method of launching appeals was considered necessary:

It should be possible for "short form" appeals to be heard within the framework of the CBI's proposed Competition Commission.

Short-form appeals would be available in cases where either no reference is presently possible (and judicial review is the only mechanism of appeal) or in the case of minor licence amendments, to avoid the cost and delay of present MMC inquiries...

Decisions of the Competition Commission should be binding upon the regulators.

III Further Reading

Progress in the Liberalisation of the Gas Market Trade and Industry Committee, HC 338 1997/98 (14 January 1998)

Economic Regulation UK Round Table on Sustainable Development (29 January 1998)

The Work of the Directors General of Telecommunications, Gas Supply, Water Services and Electricity Supply (National Audit Office, HC 645 1995/96)

<http://www.ofgas.gov.uk/> — the Ofgas web site.

Regulating the Public Utilities: Response to the DTI review of utility regulation (National Consumer Council, October 1997)

Review of Utility Regulation: Submission by the Director General of Electricity Supply (Office of Electricity Regulation, October 1997)

Privatisation and Regulation: Some Comments on the UK Experience (Centre for the study of Regulated Industries, June 1997)

Whither Regulation? Current Developments in Regulated Industries 1997 (Centre for the study of Regulated Industries, July 1997)

Windfall Tax (House of Commons Library, Business and Transport Section standard note, 15 July 1997)