Introduction
Colin Robinson

In his Introduction to the published version of the 1998 Lectures in Regulation, the late Michael Beesley argued that the UK system of regulation had become the government’s ‘primary choice for influencing company conduct in the utilities’. Sadly, the 1999 Lectures had to proceed without Michael, who died just before the series began. Nevertheless, the papers reproduced in this volume – the first produced by Edward Elgar in association with the Institute of Economic Affairs and the London Business School – provide an opportunity to assess whether or not the government is still permitting the regulators to supervise the privatized utilities without the extensive intervention which used to occur under nationalization. Avoiding the politicization of decision making which characterized the nationalized corporations was one of the principal aims of Michael and others who helped formulate the principles on which privatization was based.

The first paper in the 1999 renamed ‘Beesley Lectures’ was given by Professor Colin Mayer of the Said Business School, University of Oxford who, in the context of the 1999 price review in the water and sewerage industries, produced an ingenious scheme to reformulate the RPI-x price cap devised by Michael Beesley and Stephen Littlechild. Colin argues that, though the water periodic review has been a ‘model of process and consultation’, it has been complex and has left a significant probability that some of the heroic assumptions made will turn out to be false. The regulator may therefore again intervene between periodic reviews, further undermining the ‘credibility of price-cap regulation’ and risking a trend towards rate of return regulation. To avoid this unfortunate outcome, Colin proposes to move to ‘relative price regulation’ (RPR). Under this, at the end of each year the regulatory asset base would be adjusted by the difference between the average rate of return in the industry and the cost of capital. Thus, Colin Mayer argues, RPR ‘credibly re-establishes and enhances the incentive properties of price cap regulation’.

The second paper is by Professor David Llewellyn, University of Loughborough, who spoke in a session chaired by Howard Davies, chairman of the Financial Services Authority. David provides an extensive review of the costs and benefits of financial regulation in which he makes some important distinctions and introduces some relevant concepts – notably the ‘regulatory
Regulating utilities

regime’ and ‘regulatory strategy’ – the components of which are discussed in
detail. Throughout the paper, he emphasizes the ‘central importance of
incentive structures and the potential for regulation to affect them’. Incentive
structures should be aligned to reduce, as far as possible, conflict between the
objectives of the firm and those of the regulator. Regulation, though important,
is in David’s view only one component of the regulatory regime. In the end, it
is the responsibility of shareholders, managers and markets to supervise
financial firms: managers should not be allowed to ‘hide behind the cloak of
regulation’.

In his chairman’s comment, Howard Davies explains some of the innova-
tive features of the legislation which will establish the Financial Services
Authority (FSA) – in particular, its definition of the FSA’s statutory
objectives. The tasks he sees ahead for the FSA are to explain how its objec-
tives will be implemented and to establish criteria for ‘success’ or ‘failure’ in
relation to the regulatory regime. He sees David’s paper as offering practical
help in carrying out these tasks.

Professor George Yarrow, Queen Mary and Westfield College, University
of London, examines the shift of emphasis in the new Competition Act
towards examination of the effects of competition. He argues that this shift
acknowledges the ‘significance of decentralized information, discovery and
innovation in the market place’. What is now most important, in economic
assessments under the Act, is to examine whether certain types of conduct
hamper market innovations and restrict economic progress. Short-term market
failures are best remedied by market innovations: only ‘persistent monopoly’
presents problems which are best overcome by public policy. George cautions
that poor rules and an inflexible ‘rule-making process’ can themselves
hinder economic progress: the competition authorities should recognize the
importance of adaptation and innovation in conducting their own activities’.

John Bridgeman, Director-General of Fair Trading when the paper was
given, agrees about the need to adapt policy to avoid constraints on economic
progress and to concentrate policy on persistent abuse. He expects his new
powers under the Act (for example, to levy substantial penalties on companies
which breach the prohibitions) to act as a powerful deterrent. The new Act will
be a clear ‘change for the better’.

In a paper on the New Electricity Trading Arrangements (NETA) and
transmission, Professor Ralph Turvey, London School of Economics,
describes how the interim new arrangements will deal with transmission losses
and transmission capacity costs. He then discusses possible ways of
introducing better locational incentives. He bases his conclusions on the view
that use of system charges which do not reflect marginal costs should be
minimized (subject to recovery by NGC of its allowed revenue), difficult
though that will be under NETA. Ralph considers such thorny issues as how
transmission problems can be dealt with in ways consistent with the ‘NETA approach’, how to determine long-run marginal costs and how to establish transmission zones.

Dr Eileen Marshall, Deputy Director-General of Ofgem, in her chairman’s comments, finds Ralph’s paper ‘timely and thought-provoking’. She stresses the importance of governance reform under NETA so that in future changes become easier than they have been in the past. In the cases of both transmission losses and transmission constraints, she points out that some of Ralph’s suggestions are close to Ofgem’s ideas. In her view, it might be possible to develop a system for dealing with transmission constraints in electricity similar to the new entry capacity regime in gas.

European communications regulation is discussed in a paper by Martin Cave, Brunel University and Luigi Prosperetti, University of Milan: the lecture was given by Martin. The paper is principally concerned with the European Commission’s November 1999 Communications Review. The authors argue that, though the review promises some ‘welcome adjustments to the existing framework’, it does not place as much reliance on competition law as it should. Martin and Luigi are concerned that it does not provide a coherent access policy and that it fails to give incentives for the construction of new broadband networks. Some of the remedies proposed in the review rely too much on ‘a regulatory framework which has clearly shown various shortcomings’ and too little on ‘full deployment of [the Commission’s] powers under competition law’.

David Edmonds, Director-General of Telecommunications, in his chairman’s comments argues that there is an underemphasis on the consumer as the ‘proper object of regulation’. Competition, not regulation, is the best way of protecting consumers, he says. Hence Oftel will be moving to ‘the heaviest possible reliance on competition law’ and away from sectoral regulation and the use of licence conditions.

The role of on-rail competition in public policy towards the railways is, as Ian Jones of National Economic Research Associates argues, an ‘important area of unfinished business’. Ian believes that franchise renegotiation could result in a further reduction in already limited on-rail competition. The Strategic Rail Authority (SRA) should, in his view, look sceptically at proposals to reduce on-rail competition through mergers and at demands for ‘exclusivity in return for investment’. There is some evidence that competition on a given rail route has had beneficial effects. Moreover, experience in other transport markets which have been liberalized (such as European air transport) shows that competition stimulates service innovation. The limited extension of open access proposed by the previous rail regulator should therefore proceed.

Tom Winsor, the Rail Regulator, agrees with the case Ian Jones makes for more rail competition. He wants to avoid undue protection for franchise
Regulating utilities

holders. But he is concerned that franchisees may not invest if they are subject to competition from open-access operators. He sees ‘little appetite for additional competitive services’ at present. He points out also that there is a ‘new regulatory agenda’ of ‘more proactive regulation’.

In a paper on airport regulation, Dr David Starkie, Economics Plus Ltd, continues with a theme emphasized by Michael Beesley in his lecture in the 1998 Regulation Lecture Series: that, in terms of regulation, airports are different. David explains the present regulatory regime for airports and some of its effects, such as the distortions which arise from operation of the ‘single-till’ principle. In his view, there would be advantages in doing away with the single till. Abolition of price-cap regulation should also be considered seriously now that the Competition Act will give the CAA power to monitor and, if necessary, punish abuse of a monopoly position. Pricing undertakings under general competition law could replace formal price caps.

Sir Malcolm Field, Chairman of the Civil Aviation Authority, comments on David’s paper that it makes important contributions in several ‘key areas’. He agrees with David’s reservations about the applicability of RPI-x to airports. However, he points out that the single till has resulted in reducing real prices to airlines and he questions whether airlines have sufficient market power to counter the market power of airports.

The ‘original model of economic regulation’ is not well suited to delivering social objectives, argues Professor Catherine Waddams Price, University of Warwick, in her paper on regulatory response to social needs, particularly in the gas industry. But views are changing, she argues, as evidenced by the government’s proposals to issue statutory guidance to regulators, inter alia, about social measures with significant financial implications. Catherine assesses the plans developed by Ofgem which has, she says, ‘embraced the need to address social needs as part of the regulatory process’, including asking supply companies to report on their social programmes. She questions how far utility markets should be used to ‘deliver social objectives which can be much more effectively addressed through the tax and benefits system’.

In his chairman’s response, Callum McCarthy, Director-General of Gas and Electricity Markets, agrees with Catherine that it is difficult to identify those in ‘social need’. A central concern of Ofgem, he says, has been to establish a balance between competition promotion and establishing a safety net for sectors where competition is not yet effective. In those sectors where price control remains, it is intended to be a ‘complement to competition’ rather than to ‘bite’.

The final paper, by Professor Dan Goyder of King’s College, University of London, examines prospects for the Competition Commission, including the new Appeal Tribunal, which replaced the Monopolies and Mergers Commission in April 1999. He is generally optimistic, but he sees several problems.
He is uncertain whether the new ‘open approach’, involving public hearings in some cases, will be an improvement; he sees dangers in reducing the use of scale monopoly references; he wonders whether the Appeal Tribunal will have sufficient resources; and he foresees difficulties in the two parts of the Commission working closely together. Professor Goyder also notes the dependence of the Commission on the work of other bodies (especially the Office of Fair Trading and the Department of Trade and Industry).

Dr Derek Morris, Chairman of the Competition Commission, accepts that there is considerable uncertainty about how the new Competition Act will operate. How the Appeal Tribunal will deal with decisions by the Office of Fair Trading, for example, raises difficult issues. Despite the different types of processes represented by the two parts of the Commission, he sees logic in combining them. He thinks the Commission will ‘deliver a sound, coherent and transparent approach as competition policy evolves in the future’.

It is clear from the papers in this volume that utility regulation continues to evolve, as it has done since its beginnings in the early 1980s. The regulators and the competition authorities have done much to liberalize markets following privatization schemes which, in many cases, left incumbents with substantial market power. Some of the changes have been remarkable. For example, small consumers now have choice of gas and electricity supplier and those two products are now traded in markets similar to those for other commodities. The flourishing of services in telecommunications is another example of a development which could not have been foreseen at the time of privatization.

But liberalization may no longer be foremost on the agenda. Though the government evidently accepts the benefits of improving efficiency, it also sees a need to pursue social and environmental objectives. It is not clear how the tensions between these different objectives can be reconciled. Similarly, there are signs that ministers are not always comfortable with leaving regulation to the regulators – for example, on the railways, in water and in energy (where coal policy has had consequences for electricity and gas). The roles of the regulators may therefore be changing in ways which, at present, can only be foreseen dimly. It is such changes which will provide ample material for future papers in the Beesley Lectures series.