Introduction

Colin Robinson

The fifteenth series of the annual Beesley Lectures, organised by Leonard Waverman of the London Business School and Colin Robinson on behalf of the Institute of Economic Affairs, took place in the autumn of 2005. The chapters in this book are revised versions of the papers given in the series and the comments made by the chairmen. Books based on the series, of which this is the latest, provide a unique insight into the development of utility regulation since its early days.

When the late Professor Michael Beesley founded the series in 1991, the British utilities had only recently been privatised, privatisation was beginning to spread around the world and utility regulators were trying to discover how best to supervise the industries for which they were responsible. Michael saw the series as a forum for discussing the many issues that arise from privatisation and regulation. In particular, he was aware of the dangers of over-regulation and inefficiency in the regulated industries. He was keen to see utility markets liberalised, with ‘light touch’ regulation confined to cases where there was no alternative. Fifteen years on, we can see that the results of privatisation and regulation have been mixed. In Britain, some utility markets have been liberalised but others are still virtually untouched by competitive forces, being governed instead by comprehensive regulation; a degree of politicisation has returned as, for example, social and environmental obligations have been imposed by government and industry ‘policies’ have reappeared; regulatory offices have grown in terms of staff and budgets; boards have replaced individual regulators; and regulators and regulated companies have learned how to play the regulatory game. But the underlying issues with which Michael was concerned – how to introduce competition, how to limit the scope of regulation and how to avoid the inefficiencies of traditional regulation – remain the same.

The chapters in this book discuss some specific topics in the context of particular utilities – energy, telecoms, broadcasting, the railways and postal services – and two more general topics – the proper scope of regulation and the cost of capital. They deal with regulatory issues in the United Kingdom, the European Union (EU) and the United States.

Chapter 1 is by Professor Stephen Littlechild who considers recent changes in the British system of utility regulation and also ways of going beyond conventional regulation. He concentrates on electricity markets, though he argues that there are wider lessons. He begins by pointing out the increasing influence of government in the UK electricity market, as demonstrated by the various requirements of the Utilities Act 2000 (including the replacement of individual regulators by commissions) and, particularly, by the government's energy and environmental policy measures. Littlechild then discusses the costs and benefits of electricity liberalisation in different countries, considering both wholesale and retail markets. In general, he argues that the introduction of competition has been a success. In several retail markets, customers are 'now determining for themselves the nature and duration of their contracts for electricity supply'. He concludes the chapter by examining some alternatives to traditional regulation for natural monopolies, such as merchant transmission lines in Australia, user-pays transmission in Argentina and negotiated settlements in North America.

Commenting on Littlechild's chapter, Professor Colin Robinson agrees that there are disadvantages in some of the recent changes to the UK regulatory regime, such as the introduction of authorities in place of individual regulators. He agrees also that government is becoming more intrusive, giving the example of the government's attempts to 'pick winners' in the energy sector, whether renewables, nuclear power or other energy sources, thereby encroaching on the energy regulator's territory. As regards overseas experience of innovative regulatory schemes for networks, Robinson argues that regulation is such an unsatisfactory business, risking arbitrary decision making, that every effort should be made to minimise it. It is therefore well worthwhile to examine ways of avoiding traditional regulation.

In Chapter 2, Professor Thomas Hazlett contends that Ronald Coase, in a 1959 article that preceded his famous paper on social cost and at a time when 'information age' technologies were unknown, discovered a 'simple model of human action' that deals with the spectrum allocation question. Governments should auction licences to the highest bidders, with well-defined rights, thereafter allowing market forces to work. 'Without any knowledge of the innovative advances to come, Coase got the public policy right.' It is time, says Hazlett, to rediscover 'the Coasean vision of property rights to spectrum question'. The state needs to be only a 'judicial back stop', defining rules and acting as referee: the actions of market participants will solve what appear to be intricate coordination problems. Moreover, empirical evidence shows that Coase was correct: bureaucratic allocation of spectrum has led to coordination failures whereas liberalisation has led to Coasean-type efficiencies.

Professor Leonard Waverman comments that Hazlett makes essentially two points. The first is that private property rights in spectrum are a long way from being established. The second is that there is confusion between the ownership of the property and the revenue-generating applications, the access regime: comments about ‘commons’ are frequently not about what the regime should be but about what the price should be. Scarcity of spectrum may often be a consequence of regulation, as in the case of cell phones in the United States. Suggestions that all voice calls will one day be free are a result of the ownership/access confusion pointed out by Hazlett: revenues have to recoup costs in a competitive market.

For many years, there have been attempts to liberalise energy markets in the EU. In Chapter 3, Jorge Vasconcelos examines to what extent the latest attempts to liberalise have succeeded and analyses the obstacles to progress. Vasconcelos says that EU liberalisation was initially inspired by experience of electricity liberalisation in the United Kingdom but went on to develop its own solutions, most recently under the ‘Lisbon Agenda’, followed by energy directives approved in 2003. The EU competition authorities have now stepped in to clarify the application of competition law to the energy sector. Proper implementation of the EU legal framework for energy is now urgent: some member states have only recently introduced the necessary amendments to their legislation and in some cases ‘transposition of EU directives seems not to be in line at least with the spirit of these directives’.

Philip Lowe, commenting on the paper by Vasconcelos, argues that there are still barriers to entry which prevent there being a single market in energy. He sees many problems in moving to that single market. For example, increased interconnection capacity is required to make markets more competitive and to enhance security of supply. Market concentration is a key issue, especially in gas where the scope for competition is very small: the four major sources of gas imports are ‘not competing in any serious sense’. Transparency about access to networks is a ‘huge problem’. Moreover, the ‘notorious links between gas and oil prices’ do not create the right signals for investment and, in electricity, where wholesale markets are marginal, there is little confidence in pricing. The Commission’s energy sector enquiry is expected to produce conclusions and remedies that will provide a ‘political impetus for change’.

Chapter 4, by Professor Paul Joskow, is a comprehensive discussion of security of supply issues in liberalised electricity and gas markets, taking examples both from the United States and the United Kingdom. The UK’s regulatory framework for liberalised electricity and gas networks in his view sets the ‘international gold standard’. Joskow sees no inherent conflict between liberalisation and security where liberalisation has followed the right path. However, he sees challenges ahead for the UK’s energy regulator

in dealing with only partly liberalised European gas markets at a time when expansion of import capability has to be facilitated. He argues also that 'the jury is still out' on the question of whether UK electricity generation capacity will continue to be adequate now that the conditions that led to a big expansion of capacity in the 1990s no longer exist. In the US, the main challenge is to find a speedier and cheaper process for expanding liquefied natural gas (LNG) import capacity.

Commenting on Joskow's chapter, Sir John Mogg agrees that there is no inherent conflict between having liberalised markets and secure supplies, provided there are appropriate market rules, industry structure and regulatory institutions. Political intervention is to be distrusted but in a European context it is difficult to believe that governments will not be involved in electricity generation. Sir John sees some problems in energy trading between the UK and non-liberalised EU markets and fears flows of natural gas through the interconnector might in some circumstances be restricted. He is concerned also about uncertainties caused by the UK planning system.

In Chapter 5, Dermot Glynn and David Stubbs argue that reform in the European postal sector has lagged behind other network industries and that there should now be a move to end these delays. They describe the history of postal regulation in Europe, leading up to the 2002 EU Amended Postal Directive which sets out a timetable for full accomplishment of the internal market in postal services by end 2009. Some member states have been reluctant to introduce reforms and, unusually, reform has been 'primarily driven at European level'. After reviewing the development of European postal markets and some key trends, Glynn and Stubbs examine the case for the 'postal exception', based in the past on the need to maintain a universal postal service. They find the case wanting since the exception is costly in terms of its poor efficiency and innovation incentives and the market distortions it creates. In the UK, Postcomm should reduce the present degree of regulation, which is disproportionate to its objectives, relying on regulation of third-party access prices as the main instrument of price control.

Nigel Stapleton begins by pointing out that postal services regulation varies considerably across the EU. In particular, in the UK Postcomm is independent of government but, in some other EU countries, postal services are regulated by government departments. Stapleton challenges the argument of Glynn and Stubbs that the universal service obligation (USO) in the UK is financed by cross-subsidies. That is only partially true, he says: economies of scale also help to finance the USO and it is important to ensure that they are fully exploited. Stapleton also argues, contrary to Glynn and Stubbs, that the USO is still necessary for people to keep in touch. Retail price control may continue to be required so as to challenge the Royal Mail to improve its efficiency.

Chapter 6, by Chris Bolt, assesses the future of rail regulation, following the rail review and the 2005 Railways Act which, *inter alia*, abolished the Strategic Rail Authority and expanded the responsibilities of the Office of Rail Regulation (ORR). Bolt supports the government's view that there have been real benefits to rail consumers from the partnership between public and private sectors, and that maintaining that partnership is crucial to future success: the government provides strategic direction, the single regulator ensures safety and protects investors and the private sector supplies innovation and customer focus. Bolt sees a key role for ORR in making sure that the government's strategic objectives are achieved. ORR has some short-term challenges – such as integrating economic and safety regulation and monitoring Network Rail's performance – but it also needs to provide a regulatory framework in which rail investment decisions are taken using a long time horizon.

Professor Chris Nash says that the division of responsibilities under the new arrangements is rather puzzling. He would like to see the government declare objectives and set the appraisal framework, leaving specialist agencies to turn this framework into services. However, the Department for Transport (DfT) is going into considerable detail about individual routes and its new responsibility for franchising will also involve it in the detail of what services are to be run. Network Rail's lead responsibility for timetabling also looks odd, given its lack of any direct relationship with passengers or any contractual relationship with the DfT. Another area where Nash foresees problems is in the responsibility given to ORR, if there is a funding shortfall, to determine which services give poor value and where money should be saved.

Professor Julian Franks discusses, in Chapter 7, some issues in estimating the cost of capital. First, he asks whether regulators should worry about leverage. High leverage increases the probability of default, but the risk of default *per se* should not concern a regulator who should worry only if the costs of default are significant. High leverage, combined with a large investment programme, can produce a 'debt overhang problem' which makes raising new equity difficult. Regulators should, *inter alia*, promote low-cost means of transferring licences in the event of failures. Second, Franks questions whether it is wise to rely solely on the capital asset pricing model (CAPM) when estimating the cost of capital: most finance scholars would want to use another method, at least as a cross-check. Third, Franks sets out the case for using different costs of capital for different parts of a company's business. Finally, he makes a proposal for approaching a consensus on cost of capital estimation by forming a committee of economists that would review the evidence and produce regular estimates.

Philip Fletcher agrees that regulators should not rely on the CAPM, or any single approach, to estimating the cost of capital. Faced with the need to finance a large water investment programme, Fletcher says that Ofwat used a pragmatic approach, providing the companies with a 'financeability element', based on a basket of financial ratios, in addition to the estimated costs of capital. Ofwat's aim was to avoid a deterioration in balance sheets. The financeability element may become unnecessary in future as confidence grows in the companies' performance and the regulator's approach. Also, if the current pattern of low-cost debt becomes firmly established, that too will help to hold down the cost of capital. Fletcher points out also that provision exists for dealing with company failures.

The final chapter, by Ed Richards, is about Ofcom's strategic approach to regulation, covering a wide range of its economic regulatory activities. Richards begins with Ofcom's general approach to regulation in a fast-changing industry where it is important to weigh the prospective benefits of regulation against the options of doing nothing or doing less. In fixed link telecommunications, where there is a vertically integrated incumbent, Ofcom is attempting to establish equality of access for competitors, *inter alia*, by a new ring-fenced division of BT which controls the bottleneck asset. In broadcasting, Richards argues that there is still a case for public service broadcasting though it rests more on 'broader citizenship benefits' than on traditional market failures. As regards spectrum, Ofcom will be putting market-based measures at the centre of the allocation process. Richards summarises Ofcom's approach in all these areas as making markets more competitive, reducing barriers to entry and focusing regulation on the 'root causes' of bottleneck power.

In his comments, Richard Feasey says that Ofcom has high-quality management and that there is now a welcome degree of distance between regulator and regulatees. He is uncertain, however, about whether Ofcom's approach to regulating BT's copper assets is correct and he raises the question of whether sufficient prominence is given to the role that cable companies could play in competitive broadband. Ofcom, he suggests, has to consider to what extent it should act to promote entry and to what extent market concentration is necessary to permit infrastructure investments to be made. Ofcom should do more to make its thoughts known internationally and it should also be concerned with making the consumer's voice heard.