The purposes and functions of economic regulation
RPI Annual Westminster Conference
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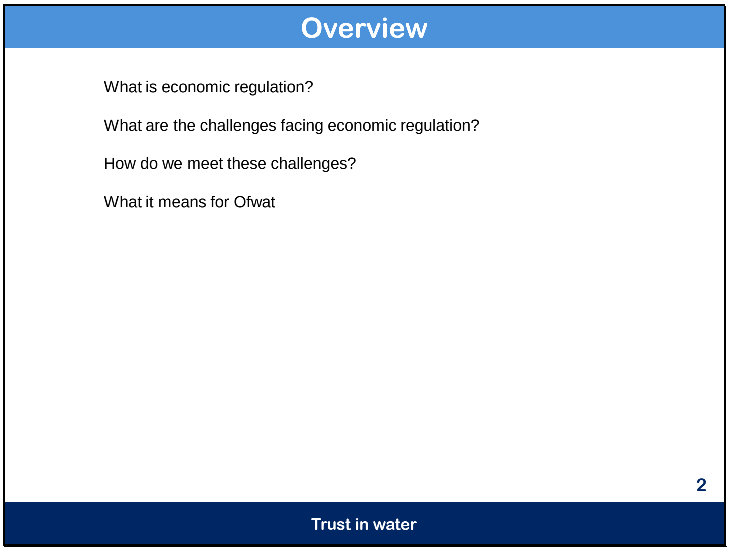


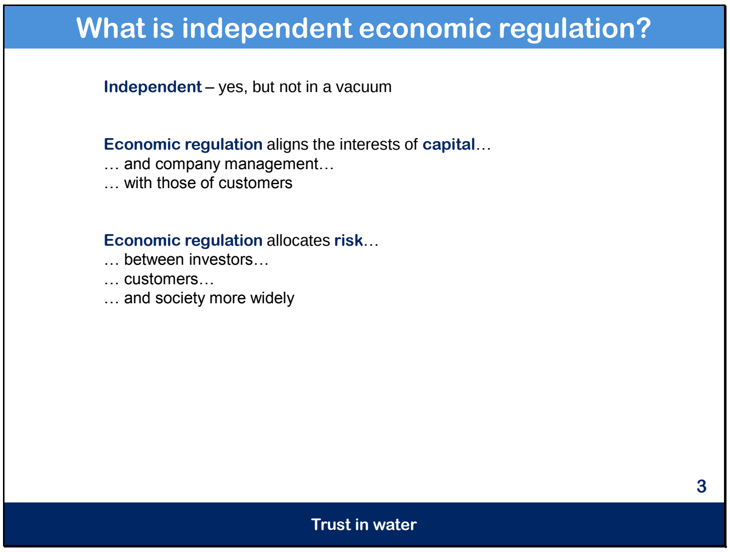
Richard has asked each of us to be very clear what we mean by independent economic regulation… so I will say a few things at the start about that…

I then want to highlight a really important – I'd say existential – challenge we're facing as regulators,

I'll then talk about some of the choices we have in how we respond to that challenge …

… the choice we've made at Ofwat …

… and why I think that choice – even though it's not easy – is the right one



Independence first.

I've said elsewhere (Oxera Agenda Nov 2013) that I think there is an inherent paradox in independent economic regulation. Regulators exist because the sectors they regulate matter – not only to their customers, but also to our economy and society more widely. In short, regulated sectors are politically salient. But independence from government has been key for delivery of the government's policy objectives at the time of privatisation – opening up markets and facilitating investment takes a long term view, predictability and stability. For example, the stability and predictability that Ofwat's regulation has brought in water enabled the delivery of over £100bn of investment at a cost of capital very much lower than it would have been had the sector been exposed to political risk.

So … independence has been key for regulators' success. But the political salience of the sectors we regulate mean it shouldn't be surprising when politicians take a keen interest.

And indeed there are and have always been appropriate ways for them to do this. They can change legislative frameworks and institutions, they can issue guidance, and they can influence the public debate. If their interest remains at the strategic level (rather than in micro-specification) and manifests itself through the appropriate channels and is transparent – no problem.

Now let's turn to economic regulation. I want to make two points about this.

First, at its essence, economic regulation is about aligning the interests of capital, and company management (not the same thing) with the interests of customers.

Let's pause for a moment on this. Because it is important. You often hear economic regulation or regulators referred to as 'balancing the interests of investors/companies with those of customers' or, more crudely still, 'limiting the profits of monopoly firms'. I think this is quite dangerous – it risks positioning the regulator as an all seeing all knowing arbitrator between regulated firms and customers. It also risks creating a narrative in which a pound for the customer is a pound from the investor and vice versa.

For me, the essence of economic regulation is all about achieving that alignment – where companies and investors profit by doing what their customers want. [Of course, that's what well-functioning markets do and expanding the extent to which there are well-functioning markets in regulated sectors is an important part of what regulators do – but even where that isn't possible and we use regulation to mimic their effects, we should be looking to do that through the creation of frameworks that achieve that alignment of interest.]

Second, the economic regulation is the use of a tool kit that is all about allocating risk – some of that risk is inherent in the sector (eg risk of operational failure), some is created by the regulator (eg risk that outturns differ from assumptions underpinning the regulatory settlement, or the money at risk – downside and upside – within specific incentive schemes). It is through the allocation of risk that we create incentives, and through incentives that we align interest.

But beyond this essence, economic regulation can and does take different forms. Which is where I think many of us as regulators are facing real choices – I'll come back to this.

The challenge facing economic regulation

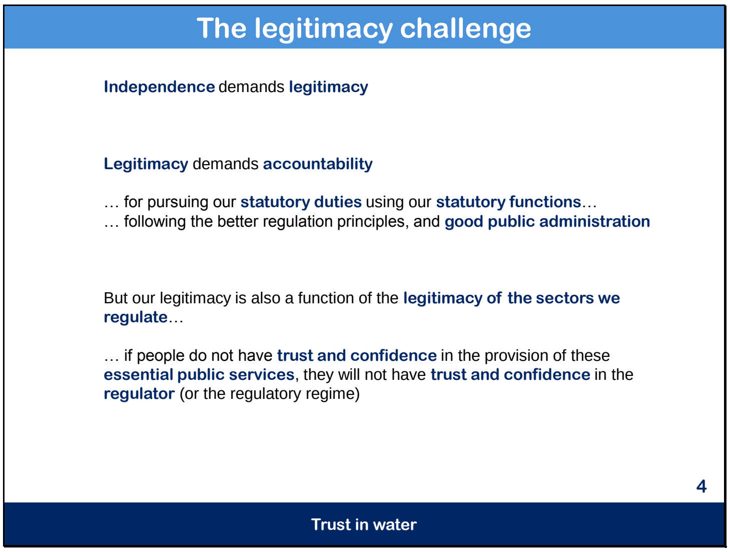
Before I talk about challenges , it is important to remember the successes that independent economic regulation has delivered.

I've just taken over from Richard Price as chair of UKRN. And it is great to do so and be able to talk about the successes of the UK economic regulatory regime. I have just come back from the Infrastructure Investor conference in Berlin, at which it was great to hear people talking about the UK model as the gold standard and citing it as a principal reason why they want to continue to provide capital to our infrastructure sectors.

It is also great to be able to point to the savings delivered for customers (in water bills are a third lower than they would have been without our efficiency challenge). And to the innovation that regulators – principally by opening up markets – have delivered, for example in sectors like telecoms where Local Loop Unbundling triggering a wave of consumer and welfare benefits in terms of lower prices and better service via competition, still sustained as the technology and market structure and consumer expectations rapidly evolve.

But … we are facing a serious challenge and it is important that we both understand it and meet it. I also think it is important how we meet it…

That challenge is one of legitimacy.



The legitimacy challenge

To be clear – regulators should take their legitimacy very seriously.

Our legitimacy underpins our independence – as I've said we may be independent but we do not operate in a vacuum and we need to be and be seen to be legitimate if we are to maintain that independence.

And as I've also said, that independence is very important for our ability to do our job. Enabling us to use our technical expertise to take a long term view in the best interests of customers.

I think our legitimacy is closely linked to our accountability. And I see that as, inevitably, a broad accountability. We are of course accountable to parliament, but in reality we are held to account by a wide range of stakeholders – customers (perhaps more their representatives), investors, NGOs, and to an extent the companies we regulate…

The key question is: what are we held accountable for? Where does that legitimacy challenge come from?

Partly it is about how we do our job. Are we working in line with the framework set out for us by parliament – our statutory duties and functions, the better regulation principles, sound public administration? These are hygiene factors.

Beyond this, we are – whether we like it or not – held accountable by stakeholders for the experience that customers and society have of the sectors we regulate. What customers get in terms of products and service and the price they pay for that. How externalities, such as environmental impacts, are dealt with. More broadly, whether customers feel they are treated fairly. By companies who take their responsibilities seriously.

It is a fact that if the public do not have trust and confidence in provision of the essential public services we regulate, we – and the independent economic regulatory regimes we operate – will not be seen as legitimate.

There are obvious examples of sectors where that trust and confidence seems lacking. We've all been following the debate in energy and in financial services. But even in other sectors we can't afford to be complacent, in the face of rising public expectations and demands for investment that could easily bring pressure on prices.

Meeting the challenge – we have choices.

As regulators, we all face this challenge. And we have choices in how we respond.

I want to draw out some of the key choices we face – choices that will certainly define the forms that economic regulation takes over the next few years.

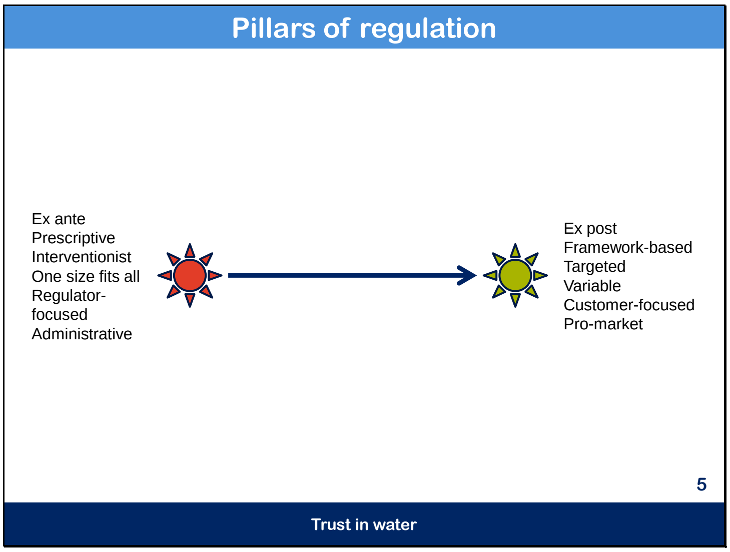
A broad view of your role, focussed on customer outcomes vs a narrow view of your role focussed on regulatory process. You could look at the sector you regulate from the point of view of the customer (or indeed society more widely) and ask what you can do to help move the sector to deliver more of what customers and society want (for a better price – which is part of what they want). Or you could look at what you've traditionally done, within your traditional remit, and decide to 'stick to the knitting'… which takes me to my next set of choices…

A broad view of the regulatory tool-kit, which includes softer elements, including our ability to provoke and challenge by setting an agenda or informing the debate, vs a narrow, formal, view of the regulatory tool-kit (which would be focussed around licence enforcement and determinations)

A pro-market regulation vs regulation that replaces market mechanisms with administrative interventions. By pro-market I don't mean pro-competition – I'm using the term more broadly. I'm talking about the choice we all have between regulation that tries to create markets – places for buyers to meet sellers – where they are missing, and try to reduce transactions costs by improving information and parties' ability to respond to it, and creates incentives to respond efficiently, and regulation that replaces those markets with administrative interventions.

To many in this room, this may sound like an obvious choice. But you should not under-estimate the pressure we all face – by those who hold us to account, especially where sectors are seen not to be delivering for customers – to tell companies what customers want, what they have to deliver and to beat them up publicly if they don't do it. I'm not saying that is always the wrong answer – but some people would like to see it as the dominant model.

And the pro-market route is tricky… especially in some sectors where there are big issues on the demand side, with customer behaviour – not something the traditional regulatory tool-kit is well equipped to deal with. FCA is doing a lot of interesting work on this.



So where's Ofwat in all this?

Those who have been following what we've done through our work on Future Price Limits post PR09, through the implementation of PR14 won't be surprised by what I'm going to say here.

We are outcome-focussed – our new strategy hangs off a vision for the sector of trust and confidence in the provision of water and waste water services, because ultimately that's what customers and society want. The question for us as a regulator is how best to use our tool kit to move the sector in that direction.

We see our regulatory tool-kit as a broad one. One in which those softer tools can be highly effective, especially in the context of the culture change we want to see in our sector – as we move from a sector focussed on its regulator to one focussed on its customers.

On the spectrum I've put on the slide we see ourselves as moving from the left hand side – as far as we can, managing that transition carefully, over time – towards that right hand side. We aren't delusional – we will not, cannot, get to a position where every stage of the water value chain has effectively competitive markets. But we can create more scope for transactions to take place –revealing information and creating value. We can improve information and reduce transactions costs, even where markets are regulated, and regulated heavily for example through ex ante price controls.

This isn't just talk – it is what we have done in PR14:

Outcomes, based on customer engagement

A better balance of risk and reward, more focussed on delivering real operational efficiencies and more of what customers and society want

More flexibility for companies through totex and financeability levers

And it very much informs the work we are doing looking towards our 2019 review and building on the reforms in the 2014 Water Act:

Looking at how we can get inform, enable and encourage efficient water trading.... Those transactions will create value (if they wouldn't they wouldn't happen)…but the information they reveal will also inform other decisions, such as those in relation to new capacity… and they will support resilience by increasing diversity in the public water supply.

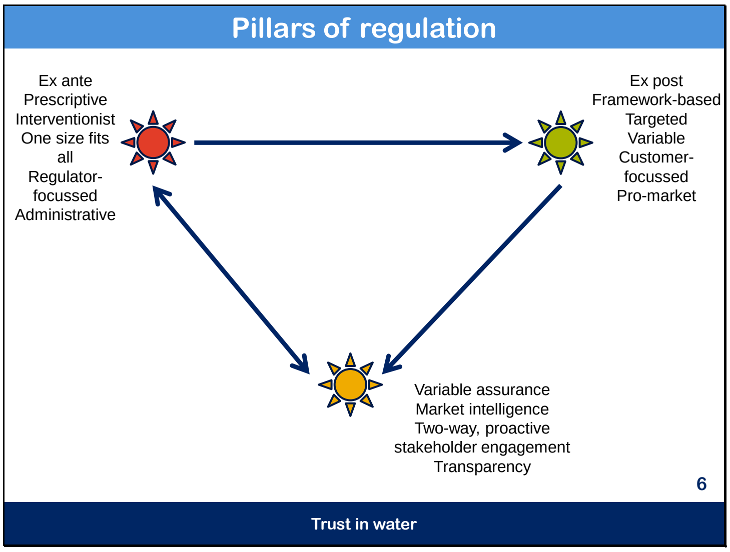
Looking – partly linked to this- at the system operator role in the water and waste water sectors. Looking at what that role is in respect of geography (local-national), time (short term, system balancing through to long term capacity planning), and depth of function (from thin – just putting information out there through to fat, where the SO contracts for provision). This, incidentally, builds on a firm commitment we made in the PR14 methodology statement – to have in place a network management incentive in some form by 2017-18

We also know that we need to pay more attention to our casework and consumer law enforcement functions - so we get the right policy framework, pick the right cases, and communicate our decisions effectively.

So… our outcomes-focus is a bit different, but in terms of the way we want to use our regulatory tool kit, moving from left to right (as far as we can) on the spectrum – probably feels quite familiar. A lot of regulators have been there.

But – perhaps because of experiences in other sectors - I have to tell you that it feels brave. It relies on companies, and other market participants, stepping up, making good use of the information, ability and incentives our framework provides for to act in ways that not only make money for investors but also deliver for customers and society. There's a lot resting on that – the legitimacy of the sector, and the regulatory regime…

… which is why there is an important third pillar to our regulatory model …



How do we know it is working?

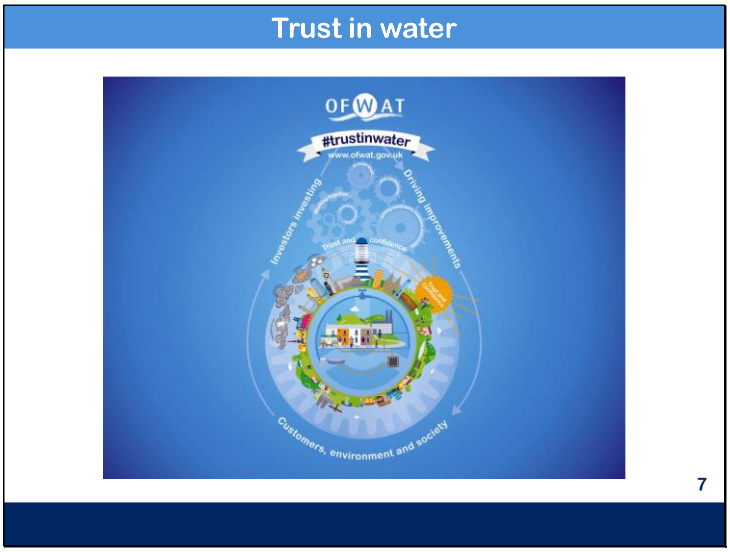
We have a responsibility as a regulator not only to set up a framework that we think will generate the right behaviour, but to be challenging and provocative about what good behaviour looks like… and to put in place a system for looking at the information available to us – through market intelligence and regulatory reporting – and interrogating that information so we know whether we are doing is working … or not.

There are a three important points on this.

First, it is important that we identify leading indicators of risk. So that if things aren't working – in our case if the sector is not building trust and confidence – we may need to step in. Possibly with our traditional regulatory tool kit – a licence enforcement case or a determination. Possibly using part of our broader tool kit – maybe, from time to time, not too often, throwing the odd boulder in the pond…

Second, its important that we don't just take that information at face value, especially where it is reported to us by companies – we need to think carefully about the assurance we need to be confident in it. And where we are less confident… we may need stronger assurance…

Third, it is also important that the information we collect- or encourage others to put out there – is not only for our use. We want information out there that encourages others – customer groups, NGOs, investors - to challenge the sector and hold it to account.   Which presents us with a further tool we can use - we need to think about where when and how we might accredit that information.



To conclude:

What we're doing still feels brave. If you look at the experience of some other sectors, it could be easier to retreat to that regulator-dominated conversation – with the regulator setting targets and standards, the regulator challenging all companies at a very micro-level about what activity they should and shouldn't be doing, collecting and assessing lots of information, and beating up on companies that aren't doing what we told them to. When things go wrong – as they will – I could tell a great story in the press or at the select committee.

But it would be the wrong thing to do – there may be superficial attractions, but if you think about what I said economic regulation was, when it is most powerful – it is all about alignment of investor and company interests with those of customers. Choosing that superficially attractive path would actually undermine the value of economic regulation. And ultimately, because it would be less effective, because it wouldn't deliver a robust, sustainable system – and all those things customers and society want depend on systems – it would fail the legitimacy challenge. Potentially undermining the basis for continuation of independent economic regulatory model...