THE REGULATORY STATE:
LABOUR AND THE UTILITIES 1997-2002

Dan Corry

30-32 Southampton Street, London WC2E 7RA
Tel: 020 7470 6100 Fax: 020 7470 6111
info@ippr.org.uk
www.ippr.org
Registered charity 800065

The Institute for Public Policy Research (ippr), established in 1988, is Britain's leading independent think tank on the centre left. The values that drive our work include delivering social justice, deepening democracy, increasing environmental sustainability and enhancing human rights. Through our well-researched and clearly argued policy analysis, our publications, our media events, our strong networks in government, academia and the corporate and voluntary sector, we play a vital role in maintaining the momentum of progressive thought.

ippr's aim is to bridge the political divide between the social democratic and liberal traditions, the intellectual divide between the academics and the policy makers and the cultural divide between the policy-making establishment and the citizen. As an independent institute, we have the freedom to determine our research agenda. ippr has charitable status and is funded by a mixture of corporate, charitable, trade union and individual donations.

Research is ongoing, and new projects being developed, in a wide range of policy areas including sustainability, health and social care, social policy, citizenship and governance, education, economics, democracy and community, media and digital society and public private partnerships. We will shortly embark on major new projects in the fields of social justice, overseas development and democratic renewal. In 2003 we aim to grow into a permanent centre for contemporary progressive thought, recognised both at home and globally.

For further information you can contact ippr's external affairs department on info@ippr.org, you can view our website at www.ippr.org and you can buy our books from Central Books on 0845 458 9910 or email ippr@centralbooks.com.

Trustees

Production & design by **EMPHASIS**
ISBN 1 86030 220 3

Contents

Preface

We are delighted to publish this pamphlet by Dan Corry, IPPR's former Senior Economist. Drawing on his experience as a special advisor in the DTI and DTLR between 1997 and 2002, it analyses developments in how the state regulates the public utilities. While stressing that Labour has continued to put competition and the consumer first, Dan argues it has significantly improved many of the details of the regulatory process. Above all the Labour Government has clarified that regulation remains at heart a political process that demands the state sets a clear policy framework for balancing a range of policy objectives within which the regulators can function. Regulation is not a 'technical' issue and neither is it likely to 'wither away'. Many people will be particularly interested in how Dan applies this analysis to discuss future policy in difficult areas such as the railways, the energy sector and the Post Office.

IPPR has a long history of work in this area of public policy, not least thanks to Dan, and his pamphlet will provide the raw material for further work in this area.

Peter Robinson
Senior Economist

Acknowledgements

Many thanks to all I have worked with and discussed these issues with over the years in academia, government, industry, consumer bodies, trade unions and think tanks. I particularly learned lots from discussions with Dieter Helm, Peter Lehman, Geoffrey Norris, Catherine Bell, Ruth McKenzie, Stephen Glaister, Gerry Holtham, Catherine Waddams, George Yarrow, Shriti Vadera, Nick Eyre, Linda Leonard, Tony Cooper, Stephen Tindale as well as all the regulators and regulated that I have been lucky enough to work with. Extra thanks for detailed comments on this paper from Phil Burns, Alan Bland, David Leam, Jon Stern, John Roberts, and Patrick Law.

IPPR are grateful for the support of the funders of this publication, Thames Water and United Utilities. The views in this pamphlet are the author's own, and do not necessarily reflect those of the funders or IPPR.

About the author

Dan Corry is now Executive Director of the New Local Government Network. He worked as a Special Adviser in the Department of Trade and Industry and the Department of Transport, Local Government and the Regions between 1997 and 2002. He was Senior Economist at IPPR, 1992-1997, following periods working for the Labour Party and as a Treasury economist.

Introduction

At one time, centre-left thinking on the great utilities and other essential services was largely limited to issues relating to their *ownership*. Broadly speaking the centre-right was trying to bring in the discipline of the market, particularly the capital market, through the privatisation of sectors like electricity, gas, water, telecoms and even rail. Meanwhile, the centre-left was trying to protect public ownership and seek some intellectual justification for so doing.

However, forced by events, some ideas and proposals on the centre-left began to emerge about the regulation of the privatised utilities. At IPPR from 1992 to 1997, I attempted to provide a forum for some of this thought as well as developing my own thinking. Areas covered in discussions at this time included how to reform the regulatory system, whether and how to introduce competition and what to do where there were potentially conflicting policy objectives. The aim was in one sense to help the centre-left 'modernise' and think about how to achieve its objectives in a market economy. However, just as important at the time was to help generate some ideas as to what an incoming Labour government should actually do in this area.

Between 1997 and 2001, as special adviser at the Department of Trade and Industry, I was able to get an inside view of many of the issues surrounding regulation, not least during the process that led to the Utilities Act 2000. I then spent a year at the Department for Transport, Local Government and the Regions (DTLR) working on related sectors like rail, the tube and public private partnerships (PPPs) in local government and elsewhere.

The aim of this paper is to give a selective account of how centre-left thinking before 1997 was (or was not) taken forward and how it worked out in practice. It is a personal view that therefore reflects my position at the centre rather than the way it felt to those on the receiving end! As ever in the real world, policy developments were shaped by a complex amalgam of theory, events and politics. Most importantly, this paper attempts to reflect on the experiences of Labour's first five years in government to give a clearer idea of what has worked and what has not and how regulation should develop from here.

Broadly the issues addressed cluster around three key areas:

- the institutional form of regulation;
- the balancing of economic and non-economic objectives; and
- the interaction of regulation with government and policy more generally.

Overall, what I want to look at is what our experiences tell us about whether, and in what circumstances, a regulated PLC model can work reasonably well and how it might be improved further. An important side-benefit of such an analysis is to help reveal for policy makers (implicitly at least) the areas where the model works badly and where other models – including non-equity companies, not-for-profit trusts and mutuals – could be considered as possible alternatives.

The sectors I have had some involvement in include energy (gas and electricity); telecoms (and the OFCOM debate about creating a converged regulator for the communications sector); water; rail; the tube; National Air Traffic Services (NATS); the Post Office and BNFL. This paper focuses on the regulated PLC model and tries not to stray too much into the debates on the PFI and PPPs more generally. However, experiences with the tube PPP as well as a number of others (like the doomed Horizon project for a Post Office benefit card and local authority PPPs) informs some of the thinking.

1. Regulation in context: the regulatory state

If policy makers on the centre-left once tended to see a sharp divide between what the state should do and what the market and private sector should do, that distinction has become blurred over recent years, certainly in relation to the utilities.

On the face of it, the stark delineation of political position has now evaporated. To an old Labour cynic, there is now no difference between left and right for not only has 'New' Labour not tried to reverse any of the Conservative privatisations, they have if anything intensified the process in various ways.

There were of course powerful arguments that led over much of the post-war period to the belief that the utilities should remain in the public sector. There was an economic case relating to natural monopoly and the network properties of many utilities. There were powerful social and industrial arguments to do with the way utilities underpin so much of our economic and social activity. There was a pressing need for long-term investment and decision making. There was also a need to include the utilities in the public sector portfolio in the days when industrial planning was still in vogue.

Less convincing but nevertheless resonant arguments came from a producerist philosophy and revolved around job protection as well as the need for a 'public service ethos' in the delivery of key services. Similar arguments can still be heard today with regard to other key public services, such as health and education for example.

However, many on the centre-left came to see some of the weaknesses in these arguments, both in theory and in practice. They also began to doubt whether state ownership really solved many of these problems and whether it did not create too many problems of its own. Consequently the key issue for public policy became the management of the *interface* between state and the market, that is the role of regulation.

Regulation is carried out in a number of overlapping ways. At one level regulation sets the rules within which market activity takes place. In this category comes competition and employment law, company law and rules covering health and safety, the environment and so on. At another level regulation can be used to help hit policy objectives set by the elected government.

In utility regulation there is an ongoing debate about how much of each of these levels of regulation is appropriate for the sector. There is also disagreement about how far regulators are, or should be simply a surrogate for a competitive market in industries that have unavoidable elements of monopoly, or whether they have a wider 'social' role.

The introduction of wide-scale sectoral regulation resulted in the creation of a new arm of government: the utility regulators.[1] Over time this raised profound issues of accountability and it was in the area of utility regulation that the Labour Government first grappled with them. The degree to which it was successful here has implications for the sustainability of the regulated PLC model more generally and also its potential applicability to other public services.

Although one of the original driving forces behind privatisation was the de-politicisation of the running of the utilities, in the end I believe strongly that regulation has to be political, at least with a small 'p' (Young 2001).[2] Regulation is certainly about efficiency, but it is also about values, about democracy and about the purposes of public policy.

In this sense our experience with the utilities connects closely with the increased use of the private sector to deliver public services. Contracts written under the PFI and strategic partnerships in local government are also dealing with this interface between public and private, and so confront similar issues of accountability, fears about the erosion of a public service ethos, doubts about what happens when things go wrong and who ultimately bears risk.

Generic issues that haunt this agenda have been explored in different dimensions in the utilities. For instance, as soon as we have a third party delivering a 'public' service, we have what economists call a principal–agent situation. One of the consequences of this is severe asymmetric information problems in that the provider knows more about what they are up to than the purchaser or regulator. This in turn leads to 'gaming' in the price review and is echoed by the problems in writing a sensible contract with the private sector (see Corry, Le Grand and Radcliffe 1997 and IPPR 2001 for general discussion of these issues).

As the Government pushes PPPs further into health and education, it has proved reluctant to trust traditional forms of private sector involvement and has sought to mediate it in some instances through public interest companies, mutuals and other 'not-for-profit' forms.

Again this is territory already covered in the utilities sector and so the right lessons need to be learned.

Overall, it seems appropriate to state that Britain in 2003 is worthy of the epithet 'the regulatory state'. It is probably fair to say that whilst the focus of the centre-left is on exploring how to make this regulatory state work, the more free market centre-right criticise all of this as state control and interference through other means and therefore want to try and get rid of it.

These differences reflect different views about how market economies work, what externalities exist and what responsibility the state has to try and do something about them. They also reflect different views on the efficacy of public policy, and of course different values, and the weight to be given to concepts like equality, social cohesion and sustainable development.

That is why politics cannot in the end be taken out of regulation. Utility regulation depends crucially on the policy framework within which regulation operates which can only be given – and changed – by governments. It also depends on a myriad of interactions between government, regulator, the regulated and other stakeholders. The promise of a neutral, value-free approach given by the once powerful ideas of New Public Management theory is simply an illusion.

At its core then, utility regulation is one of the most advanced and worked-out set of relationships between state and market that we have so far and it helps us to think clearly about the proper role of government in making such relationships work.

2. Changes to the form, structure and technical sides of regulation

Those who were emotionally opposed to privatisation took rather a long time to get to grips with regulation. Perhaps this was not surprising as to start to grapple with the issues surrounding regulation was in effect to accept that some 'public' services could best be delivered by private sector bodies. As a consequence anyone on the centre-left who tried to talk about these issues was regarded with a degree of suspicion. Thinking from the centre-left perspective was therefore very limited for a long period.

Meanwhile on the centre-right, privatisation was the big goal and regulation very much an afterthought.[3] With no political party to drive forward a regulatory philosophy, regulators developed and evolved policy largely on their own between 1984 and 1994, until Labour started to take regulation seriously.

Labour's shift was of course also motivated by political imperatives, in this case through a mixture of pragmatism and positioning. Once privatised, the utilities became difficult in practice to take back into public ownership, not least because of the perceived costs involved. New Labour also wanted to show that they were different and were not ideologically opposed to using markets.

As this process began, there was still a lack of clarity as to whether the debate should be about regulation as a technocratic exercise that one could improve and add some 'left' values to, or whether appropriate regulation could substitute for some of the desirable features of public ownership itself. This caused some confusion. For instance, an early IPPR piece (by David Souter, then Head of Research at the National Communications Union) intended to say that the issue the left needed to face was not how to renationalise, but how to do regulation – quite a radical statement at that time, not least from someone with his background. However, his comments were widely interpreted as trying to introduce backdoor renationalisation because they talked of 'stakeholder' regulation (that there should be a regulatory board containing people with certain types of pre-defined background experiences).

In the end though, the general direction of thinking among centre-left contributors to this debate centred around making sure regulation

could deliver decent and fair economic outcomes, but without threatening the basic model of a privatised PLC delivering what were ostensibly public services. The issues that followed from this were how to get the incentives right, how to develop sensible accountability and so on.

The most common approach to reforming regulation, therefore, was to say that there was nothing wrong with the regulated private PLC model in theory, but in practice the way it was being carried out was inefficient or incorporated the wrong incentives. From this perspective, all that was needed was to amend some of the regulatory structures, instruments and tools to make the existing system work better.

Of course some of the ideas following this approach were more profound in their potential effects (and philosophical underpinnings) than others. Indeed, some people came to realise that regulation really was immensely more important than issues of ownership. Within the same regulated PLC model, regulation could be tough and prescriptive or loose and very light touch. It could bring in non-economic factors or exclude them entirely.

Analysis by various thinkers in the years running up to the 1997 election had produced a suite of proposals for institutional and technical changes. Among the key ones that were actually taken forward by the Government were:

- depersonalisation of regulation by using regulatory boards instead of single individuals.
- greater independence and powers for consumer councils.
- greater openness and transparency of the process, including making regulators give more reasons for their decisions.

In some ways these proposals were simply technical changes designed to reduce uncertainty and so reduce the cost of capital for companies. They also had the virtue of helping amend perceptions (some of them based on reality) of a bias in the system towards the regulated firms and their 'fat-cat' bosses. However, they also had a wider purpose or meaning. One should also note that while these reforms look relatively minor and common-sensical from today's perspective, they were very hotly contested at the time.

Depersonalisation

The original Conservative privatisations had not really thought that much about regulatory structures and techniques (see Helm 2003 for a full analysis). In the absence of strong governmental views, the essence of the regulatory policy had been to put a 'good chap' in charge with lots of discretion and let them run things. If this regulator had the 'right' views and instincts and was of sufficient quality then things should go fine.

Such a policy could work well when there was little conflict. However, it could create havoc if the individual got into battles with the regulated firms that became based more on personalities than on policies. Difficulties could also arise if the individual started to pursue their own agenda or if they were weak either intellectually or in the way they regulated, as some would argue the first rail regulator was.

None of this is to argue that there were not good regulators in the early years, nor that some of the big battles that took on a personal tone were not legitimate areas of struggle that had to happen. Indeed the biggest one, of more or less ongoing warfare between OFGAS and British Gas between 1987 and 1997, was in some ways 'regulated' through various aspects of the involvement of the OFT, the MMC, and several Trade and Industry Select Committee inquiries.

In addition to the potential 'day-to-day' problems of personalisation, such a system also set up significant regulatory uncertainty when a change of regulator occurred or seemed to be upon the horizon. This included the run up to the 1997 election when many thought Labour would almost overnight replace all the regulators with their own placemen and -women.

Perhaps even more than this, giving so much power to a single individual offended against notions of fairness and accountability. Given that the trend to having appointed, non–elected bodies in powerful, virtually independent positions, is one that has continued or even strengthened since 1997, taking extreme power away from a single individual brings a bit more accountability and less arbitrariness to such decision making. A panel or commission is more likely to ensure that decisions are sound and follow best regulatory practice as well as creating a wider spread of expertise upon which to make decisions.

Moves to open up the process by providing more information on decisions and processes can also be seen in these terms – an attempt to avoid regulation by 'whim' of a personality rather than via a thought out, defended and accountable process.

Consumer representation

The proposals for strengthening consumer input into regulation came from a slightly different pedigree, although again one of the aims was to open up the whole regulatory process by getting consumers to shine a bright light into it. The argument here was that the regulator would always end up having its closest relationship with the regulated companies and that a counterbalance was needed if the focus was to be on the ultimate user of the service. Thus the ideas that emerged were for more powerful consumer bodies, de-coupled from the regulator and with their own powers to influence debate and avert the threat of regulatory capture.

In addition, whilst the regulator is likely to be most keen on economic arguments, for instance being happy (along with most companies) if they can find a way to unwind cross-subsidies, a consumer body may want to put the case for a different balance of interests.

It was also hoped that the setting up of such councils would help change the dynamics of the regulatory process away from an inward looking technical debate based on a theory of what consumers might want, and bring the wider interests of real consumers to the debating table. The creation or strengthening of such bodies would also be a very physical and concrete way of illustrating that we wanted regulation to be primarily about serving consumers.

These proposals were largely brought into practice after 1997 with powerful consumer bodies being created for energy, via the Utilities Act, as well as for Post, while the necessary steps are at last being taken in water and a degree of strengthening has occurred in rail. The major exception has been in the proposals for OFCOM where consumer representation has been embedded within the regulator itself. Although the proposed consumer panel and Content Board will have some degree of independence, I fear this is not enough and that the agenda is likely to be captured by a combination of business, professionals and even 'luvvies'.

Broadly speaking I think the consumer bodies have done what we wanted and expected them to do. They have made sure that the consumer voice is heard in all the relevant debates and they play this role in a less 'economic' and more practical and down to earth way than the regulators.

This, however, remains keenly contested terrain. In fact there has been a lot of opposition from regulators and some regulatory thinkers (see for example Vass 2002) to the creation of such powerful independent consumer bodies, not least once we had shifted the objectives of regulation to be more squarely about delivering for the consumer.

RPI-X

Much of the technical thinking on the left before 1997 surrounded the RPI-X system that generally consisted of setting a cap on price increases every 5 years following a review. This price cap form of regulation undoubtedly played an important role in sharply reducing the costs of what turned out to have been pretty inefficient public sector bodies. However, as it matured it always looked likely that problems would arise.

On the face of it asymmetric information problems made it unlikely that RPI-X would work that well in the medium term or that it could provide a distribution of any cost savings amongst shareholders and consumers that was and was perceived to be fair. The significant profits made by the utilities in the earlier periods of privatisation (that gave rise to the windfall tax in Labour's first Budget) helped to bring the whole concept of privatisation with regulation into disrepute. Therefore it was natural that much thought went into the question of whether RPI-X was the right way to regulate prices and profits or whether there was not a case for moving towards some element of error correction, sliding scale or profit sharing (See Waterson 1994 and Burns *et al* 1995 for more detail of these arguments).

These ideas in their full splendour were resisted after prolonged discussion and consultation within government (although one should note that the price formula is a licence condition and is not in statute so the regulators are not bound to use straight RPI-X if they do not want to). As ever, resistance was partly political, partly driven by external events and partly based on the technical arguments.

I think that the Achilles heel of the argument for change was that at the time some feared that it would look too much like the windfall tax mark 2, and give the impression that Labour was somehow against profits. In addition almost all companies were strongly against it, as were the regulators, while even consumer groups were divided, with some of them fearing it would be too soft on firms. However, in any case the object of all this thinking was disappearing into the gloom as the concept of an RPI-X regime being applied in a rigid way began to dissolve. As commentators have pointed out, what has been called the 'RPI-X' regime has been applied very differently and has had completely different economic characteristics, both over time and across sectors (see for example Frontier Economics 2002). So the way regulation has been carried out in practice over the last five years – if not before – has seriously diluted the pureness of RPI-X even if it ever really existed in its strict textbook form (Helm 2003). In that sense, one could argue that this particular debate is now over.

However, the debate about moving away from RPI-X, which began as a potential solution to the problems of asymmetric information, gaming and the consequent 'excess' profits that seemed to be obtained by firms, has in more recent times come back onto the agenda. This is for rather different reasons and ones that were not widely discussed on the centre-left (or right) pre-1997 (although some academics had predicted these issues emerging, see Armstrong *et al* 1994 p 362). The new concern was that although RPI-X turned out to be an excellent regulatory tool for 'sweating the assets' – in other words forcing firms to find efficiencies and so allow regulators to further bring down prices – it is not a good tool for giving incentives to firms to invest.

Now that most of the (easy) cost savings have been realised, the bigger public policy issue is how to get the incentives right to secure investment in the core networks (the pipes and the grid in energy; the wires in telecoms and so on.) RPI-X gives confused incentives here and can make firms reluctant to invest (NAO 2002). On the other hand, alternatives, like rate of return, are likely to give companies an incentive to 'gold-plate' infrastructure since they are guaranteed a return on investment. Other methods have the regulators getting too involved in operational decisions on the scale of necessary investments and the way they should be carried out or even financed.

This debate in various forms has yet to be resolved. Disappointingly, the 2003 Energy White Paper fails to grapple with the best way forward: perhaps the water review will be bolder. Some suggest what are potentially radical amendments to the way RPI-X is currently done or price reviews carried out, for instance to give a bigger effective weight to investment done early in the period rather than later (see, for example, Currie 2001). There have also been attempts in other countries – like the Netherlands, Austria and parts of Scandinavia – to develop innovative incentive-based schemes that do provide the right incentives for quality provision and investment behaviour. As these countries have learnt some of the lessons from the UK experience, their subsequent policy development may provide some signposts for policymakers in the UK.

Either way it is hard to disagree that we probably need to think differently about

- 'compulsory' investment mandated by some outside body (such as Europe on environmental issues in water; and possibly in the future, the Government on networks able to handle increased distributed energy) where the game is simply to get firms to do it efficiently
- and 'discretionary' investment that we would like firms to do if it cost-effectively improves quality, reliability and the service in the longer term.

Given asset lives are so long in most of these industries, there is a premium on getting all this right.

Other issues and 'dogs that did not bark'

A number of other pre-1997 proposals on the technical side were not taken forward for one reason or another. Attempts to make the regulators work together so that they had common methodologies on things like the cost of capital were fiercely resisted by the regulators at the time. In the end they had to be given up when the Utilities Bill was shrunk to a Bill for the energy sector only (largely due to pressures of Parliamentary time).

An aspect of regulation that particularly concerns the centre-left is the need to maintain decent services for all, even in a more market

orientated situation. This has two aspects. In the first place is a concern that the poor do not end up paying more for their service than the rich. Poorer customers are generally more expensive to serve and less attractive to private profit-making firms. Therefore the drive for efficiency that privatisation brought in, as well as the introduction of competition, meant that any cross-subsidies between richer and poorer customers were under threat and that cost-reflective pricing was likely to become dominant.

Concerns in this area led to the Utilities Act 2000 controversially, and despite misgivings in some parts of Whitehall, including backstop measures for a potential power to levy networks so as to create a fund dedicated to stopping those on pre-payment meters from getting a raw deal.

This power has not been invoked (at least so far) primarily because the cross-subsidy issue proved less important in practice than one might have thought – and no doubt the threat of intervention if things got too out of hand acted as a useful discipline!

A second aspect of regulation of great concern to the centre-left, is the more general Universal Service Obligation (USO) issue. In particular, with services delivered on a commercial basis in the private sector, how would we ensure that what many would regard as basic rights were secured, for example the right for everyone to have access to a telephone, and for there to be a supplier of last resort so that all firms could not refuse to serve a customer. Again various features of the regulatory structure Labour has constructed give more prominence to these issues than a free market regime would have.

On one big issue where people worry a lot about the USO – the Post Office – we made sure that the prime duty of the regulator was to maintain the USO (uniform service at a uniform price throughout the UK).[4] Competition can and should be introduced but must not threaten this. This balancing act will be very difficult for PostComm. It is probably an impossible task to heap full delivery of the USO on the Post Office as it faces increased competition from all sides. Although provision was not ultimately made in the Post Office Act, there may eventually be a need to have the potential power to levy all major players to create a USO 'fund' if this commitment is to be maintained.

Another thing very much on Ministers' minds in 1997 was the potential problems (alongside the benefits) that the coming of multi-

utilities might bring. One company producing every key utility a household might want could make competition more difficult, as well as potentially leading to situations where people got their gas cut off for failing to pay their water bill. This was discussed in the Utilities Green Paper (DTI 1998, paras 7.37-7.40) and the regulators were asked to look at the issue seriously and carefully and to produce joint reports on it. However, we were not sure what else to do. This is another dog that has not – as yet – much barked. But if it does it will be a complex one to sort out and it would be very interesting indeed to see how the 'usual' tool kit – ring-fencing, separate listing, and so on, as well as the sectorally based regulatory structure – would deal with it.

3. Competition and other objectives

In theory, one can have few or many objectives for a regulatory system for the utilities. At one end of the spectrum there is simple economic efficiency. At the other end are a potential plethora of desired objectives ranging from environmental concerns to issues of fairness and social justice.

Thinking on the centre-left before 1997 was very strong on having efficiency and competition at the heart of regulation. However, the motivation was pragmatic rather than ideological. So where pure free market thinking put competition on a pedestal as an *aim* of policy, most centre-left thinkers saw it rather as, in most cases, the best way of achieving a large number of objectives. Hence in addition to the stress on competition there was concern to somehow take into account in regulation issues like fuel poverty and the problems for those using pre-payment meters (see Markou and Waddams Price 1997). There was also a desire to think innovatively about how to use regulation to help achieve environmental objectives (Eyre 1996; Corry, Hewitt and Tindale 1996).

A key underpinning of the intellectual case for this approach was that in practice regulation could not only be about economic efficiency. It always had wider ramifications and so government had at least to give a steer to regulators as to how to take these other things into account when making their decisions.[5]

It is worth pausing to note the contrast between the view that there are constant trade-offs between different objectives in the utilities so that giving the regulator a complete free hand in making them is unsatisfactory, with the thinking surrounding central bank independence. Here, economic theory suggests there is no *long-run* trade off between inflation and employment but that politicians, given the chance, will constantly want to exploit the *short-run* trade off, eventually giving us sub-optimal outcomes. In such a case an independent body can be given a single objective with nothing else to worry about or have to balance. In contrast, given the inevitable trade-offs in utility regulation, and the power of the regulator to therefore affect the achievement of other desirable objectives, one should at least get them to bear these things in mind.

There was another line of thought in this area, again upsetting some of the free market purists. This was that although in principle other

policy instruments could be used to tackle 'non-economic' issues (redistributive taxes and benefits in the case of fuel poverty or those without phones; energy levies in the case of the environment), this was not a good enough reason to mean the regulator should pay no attention to them in their own deliberations and decisions. This is not least because there are other practical and political problems in delivering these objectives through other tools which may in any case cause their own distortions and inefficiencies.

Arguably Labour after 1997 actually downplayed these trade-off issues a bit more than the pre-1997 work would have suggested. This was a consequence of the free-er market feel of the official Treasury machine at the time (still enjoying the talents of the soon to be ennobled Steve Robson); some misleading analogies with the very successful granting of independence and a single target to the Monetary Policy Committee; the unhappiness of the regulators (who used to have pre-meetings to agree common lines before coming to see Ministers on these issues); and the desire of Number 10 not to antagonise business too much in a period when lots of employment regulation (and some perceived business tax increases) were being brought in.

It also reflected the perhaps surprising conclusion that a combination of firms competing on reputation, sensible pressure from regulators and government (via guidance, duties and informal pressure) and decent flanking policies in other areas (in terms of things like social benefits and energy efficiency incentives), meant that competition did not seem to cause as many problems for non-economic outcomes as might have been expected – at least on social issues. In particular, and as noted earlier, the unwinding of cross-subsidy appeared to cause fewer problems than anticipated. In fact the bigger problems seemed to be on competition and the environment especially in the energy field, not least because the flanking policies were absent.

In general then, my contention is that the Labour Government more or less continued with the thrust of a policy based on economic efficiency. Despite what some predicted (or feared, or hoped for!) given Labour's political base, issues like jobs, poverty and environmental externalities never got near trumping the focus on economic efficiency.

Furthermore, the latter was pursued via a significant *strengthening* of the commitment to competition, as the anti trust, pro-consumer wing of

leftist ideology came to the fore with New Labour. IPPR's Commission on Public Policy and British Business (1996) gave a strong hint of the change in thinking towards competition on the left.

This was given concrete substance in the Competition Act 1998, which rates only just behind the giving of independence to the Bank of England, as the most important change to the economic and business climate that Labour brought in. In addition, the significantly increased powers the OFT was given by that Act, to root out anti-competitive practices, was given – in the case of the regulated sectors – to the regulators, significantly increasing their powers to deal with anti-competitive actions. The focus on competition was also evident in merger policy being firmly driven by competition and, ultimately leading to Ministers being taken out of such decisions completely. In the utilities themselves, competition was pursued rigorously, with the roll-out of domestic competition for gas and electricity and the introduction of the New Electricity Trading Arrangements, being some of the boldest examples.[6]

However, elements of the 'multiple objectives' school did survive. This could be seen in the setting of the duties of regulators, where a stronger focus was given to certain types of disadvantaged consumer. More particularly, it was seen in one of Labour's other innovations in regulation – the addition of 'guidance' to regulators on non-economic issues, particularly social (or poverty) issues and environmental ones.

As many have pointed out, the net result of having competition as the main objective with 'guidance' on other issues to be taken into account, does feel somewhat messy. The guidance that emerged (after a prolonged consultation and even longer periods of silence) is vague and gives no hard and fast rules. It is also only guidance and cannot supersede the regulators' other objectives. Arguably this gives the regulator greater discretion as they can choose the weights to give to different objectives themselves.

For some this massively confuses the whole system, puts a step change (upwards) in regulatory risk with subsequent cost of capital consequences and is a real downside from deviating from the purer economic regulation that should prevail.

However, this critique suffers from a general failure to prove any of it, as well as ignoring the fact that the regulators had vast and arguably more discretion on these issues in the pre-guidance days.

The guidance has if anything been rather toothless so far, although it has been helpful in clearly marking out where the Government stands on these things. Rightly, judgements on non-economic issues that implied big costs for consumers or companies were reserved for government, to avoid the problems that an earlier regulator (Claire Spottiswoode) had pointed to, namely that she could use her powers to impose large 'taxes' on consumers, something that should be reserved for governments (Spottiswoode 1995). Indeed the fact that most people in and out of industry want the guidance strengthened, not abolished, shows that it is on the right not the wrong lines (Roberts 2002). And the recently published Energy White Paper makes clear that they intend to make the guidance more specific to reflect – *inter alia* – the increased policy emphasis on the environment (DTI 2003, para 9.15)

More profoundly, I would argue that the criticism of the guidance misses a key point. Because a regulatory system is inherently political, it only works if people consider it to be fair and to be dealing with the issues that they care about. A regulatory system that paid no attention to social cohesion issues at all (say on pre-payment meter issues, access to phones for the blind, or to global warming) would be one that lost public credibility and support and would come under increased political pressure for change, so raising the risk premium. Thus in some ways, the guidance gave added legitimacy to the system, increasing its stability, while allowing the focus on competition and economic factors to remain the key factor in regulation.

Finally, it is worth noting that the focus on efficient, competitive markets wherever possible – both in the product market and in the market for the control of companies (meaning take-overs) – was very rarely challenged by any concern for the health of British companies. 'National champions' were hardly given a look in, except perhaps in the case of BT. In energy, for instance, while at the beginning of the period the major electricity generators, and most of the Regional Electricity Companies were still UK owned, by the end only a handful were (Electricity Association 2002). In rail many Train Operating Companies became foreign owned while in water and gas, the same phenomenon has occurred.

There are perhaps arguments here that the desire to break the monopoly power of incumbents almost led to excessive entry. That is

what appears to have happened in electricity generation. Certainly we have seen many US companies dip their toe in the UK energy scene before heading off fast (including Enron and Vivendi among others) while consolidation of the sector has been quite intense since the early days. It is arguable whether anyone except shareholders lost in all this, and some of this activity is what one expects as a market matures. Nevertheless, to the extent that regulation encouraged some of this entry it may add up to a waste of economic resources.

4. Relations between regulator and government

A key issue for the utilities is the connection between the regulator and the elected government. For some, the central aim of utility privatisation was the desire to take political interference completely out of their operation.[7] Therefore not only should the operation of the business move entirely outside the public sector to the private, but the regulator should be totally separate from the government whose role should end almost as soon as it has set up the structure.

Many on the centre-left would certainly subscribe to the benefits of stopping day to day interference in decisions of management, or slashing investment in water or telecoms simply to reduce the macro budget deficit, or preventing necessary price rises for energy because of macroeconomic concerns over inflation. However, there then remains the issue of how separate regulation itself should be.

It is certainly true that arms length separation between the government (which sets policy) and the regulator (who carries it out on a day-to-day basis) makes a lot of sense. The regulatory framework should enhance transparency, predictability and make clear where accountability lies, although it does in itself raise the issue of who – if anyone – regulates the regulators.

Thinking on the centre-left before 1997 clearly accepted the need for separation and independence, but there is no doubt that companies and other observers were very suspicious as to whether a Labour government in office would actually keep to it.

However, one striking thing about Labour's first term in office is how strongly it pursued a model of independence for economic regulation – ranging from the Bank of England, significantly increased independence of powers for the OFT and Competition Commission and of course a continuation of independence of the utility regulators. I certainly did not get the impression – from officials, companies or commentators – that we as a Government were in contact with the regulators any more than our predecessors had been. Indeed, especially in the early days, we were so afraid of being accused of such a thing that we probably left them too much alone!

Yet this relationship is always difficult, first and foremost because Ministers know that the public will blame them if the lights go out,

water is cut off or mobile phone calls seem too expensive, but more profoundly because Ministers really are *and should be* in charge of policy.

Herein lies one of the most vexed and confused elements of regulation. My belief was always that regulation could only take place in the context of decided and stated government policy (see, for example, Corry 1995a).[8] Indeed as one commentator has put it, the Utilities Green Paper was an attempt to delineate these roles more clearly (Lawrence 2002).[9] This clearly means that the regulator is not simply acting as a surrogate for competition.

However, many were confused on this point, including Whitehall officials. Not surprisingly, they tended to see the creation of arms-length independent regulators as somehow ending their responsibility for policy-making. Strangely they also doubted that the regulator was just a market referee believing that it was she/he who actually set policy. Some regulators also saw it that way (for example Don Cruickshank and his advocacy of infrastructure competition in telecoms to the exclusion of doing much about access to infrastructure).

In fact regulation does need elected politicians to make policy. This is not only because that is how democracy works, but because the private sector, making huge investments, needs to know the direction of government policy on different issues. Is the Government ultimately going to put environment above security of supply in energy? Is it going to frown on 100 per cent debt financed water companies? Is it going to push for its broadband targets at the expense of other issues? Is it going to put more or less funding into rail? The reality is that elected governments will have views that affect the activity of regulated companies, and of course the behaviour of the regulator, and they need to make them clear. This set of issues has only recently begun to be properly confronted.

Even if one accepts this of course, the reality is that the setting of policy itself can not clearly be done by one side or the other. In theory Ministers should set policy and leave independent regulators to carry it through on their own. However, in fact there is, and must be, a constant interaction between policy thinking and formulation and the regulators. The regulators have much of the expertise to judge what the impact of a potential policy decision might be; their criticism of a policy decision can cause chaos for the Government

(and most are no slouches in making their views known); and they have been handed many of the tools needed to deliver policy and can frustrate policy implementation if they want, not least by appealing to their statutory duties in a rigid way. In truth it has to be a bit of a messy relationship: it needs intelligence and understanding on both sides.

Sometimes regulators prefer it that way. So it is Ministers who in several areas were asked to give green lights to major structural changes. The decision to go-ahead with NETA, for instance, was a joint OFGEM/DTI exercise in the end, but with the Government taking the final decision. It was one of the most difficult I have ever been involved in due to its complexity and the strong disagreement amongst experts on its likely impact. In other cases regulators feel that policy is somehow getting in the way of their duties: Labour's 1997 manifesto commitment on BT being a case in point (the promise to let BT broadcast over their wires in return for helping roll out the information superhighway). At times OFGEM have given the impression that they could do without the ten per cent renewables target (and obligation) set by government. It will be interesting to see how they resopnd to the even heavier shift towards renewables and the environment indicated in the Energy White Paper.

Some have argued that Labour put in regulators that were more 'political' and so more likely to listen to what we were saying (see in particular Helm 2003). This would have been harder to do since 1997 as an exhaustive 'Nolan' process had to be used for recruitment as opposed to the 'picking your mate' possibility easily available in earlier times. In any case in my experience this was not what happened, either in intention nor I think in practice. The personalities were different and that may have given a false impression, but the likes of Callum McCarthy and David Edmonds strongly guarded their independence and were no 'easier' to deal with than most of their predecessors. Certainly the new regulators listened to what the elected government had to say, as is surely right. However, they did nobody's bidding. In addition, the appointment of very powerful independent and well-respected economists to the top competition jobs (John Vickers at the OFT and Derek Morris at the Competition Commission) was a profound change to the usual lawyer-led approach. (They have now been joined by David Currie at OFCOM.)

In my experience too, the private sector, after being a little unsure to start with, quickly realised that there was not much of a back door to regulators via Ministers. My impression was that there was more of this in the earlier years, especially when the Heseltine approach to industrial policy held sway.

This does leave the problem of how one can regulate the regulators. Of course this is a rather loaded way of putting things. It is usually a question posed by the regulated companies when they dislike the way a decision is going. It is also connected to the debate about over-regulation.

5. Do we have over-regulation?

It is an easy and frequently made accusation against Labour that it is zealous about regulating and brings in regulation with hardly a nod to the consequences in terms of the dynamism of the market. It is also a generally false accusation. However, there is no doubt that in all the thinking before 1997 nobody on the centre-left really believed that we would see utility regulation severely diminish in the near future if at all and we were not that bothered by the thought that regulation would continue. If anything we overdid that, failing to see how quickly we would be able to bring competition into certain areas allowing regulation (in theory at least) to be scaled back.

For some, even the continued existence of regulation is an affront and proves we have over regulation. There are those who famously believed that post-privatisation, regulation would quickly wither away. They therefore like to blame the Labour government for this failure. However, commentators always doubted that this would be the case. Vickers and his colleagues wrote way back in 1994 that: 'Regulation that was intended to be "with a light rein" has had to be supplemented and tightened repeatedly' (Armstrong, Cowan and Vickers 1994, p 355).

Coming back to the real world, there nevertheless are criticisms that under Labour there has been more regulation than was strictly needed and that this has added unnecessary bureaucracy as well as uncertainty to the system and stifled innovation and market forces from working where they could safely have been allowed to. An increasing noise has been made – especially from the academic wing of the debate – that one way or another we are ending up with excessive regulation. The argument goes that the rhetoric of light touch regulation has been overwhelmed by a desire by regulators (and implicitly, government) to interfere.

There is something in this argument. At one level regulators are loath to get rid of regulations they have made for a particular contingency even when it no longer seems needed, but they are very fast to try and introduce new ones. This applies particularly to letting go once competition has begun to be established in a sector. At another level, regulators (as do Ministers) like security blankets. It is always useful to have something in the back pocket for when things go wrong.

The great debate over the 'good behaviour' clause in electricity that began in 1999 (where the regulator was looking for a very general

power to punish players who manipulated prices in the pool, or who tried to under NETA) was an example where Ministers (and the Competition Commission) proved less risk averse than the regulators.

Much of the focus of this debate in recent times has been about the regulation of mobile phones. Here the desire of OFTEL to continue regulating in what looks like a highly competitive market is seen by some as strange, unnecessary and bad for competition – and hence innovation and prices (see for example Cubbin and Currie 2001).

In this case, the final decision on call termination has been taken by the Competition Commission, and is supportive of OFTEL rather than the mobile companies. However, more generally I am sure that there is something in the critique of 'regulatory creep'. There must be an inherent tendency to gold plate one's armour, especially as the day-to-day business of a regulatory body is dealing with companies whose aim in life appears to be to put one over on them and find a chink in the regulatory armour. Therefore we do need mechanisms that force regulators to get rid of regulations that are no longer necessary, especially as competition in a sector progresses.

However, as authors have noted, one of the reasons that some regulators have been able to do away with certain regulations has been that fuller competition has arrived earlier in some sectors than in others, often as a result of very intrusive and major regulatory interventions, like NETA (see Stern 2002). In the case of OFGEM ending retail price controls, this is largely because the introduction of energy supply competition (the '1998' programme) plus the separation of distribution from supply and the disposal of generation that Labour encouraged has made this possible. For various reasons structural solutions have not been applied to telecoms, which makes the situation more difficult for regulators as there are inevitably always suspicions that BT is not offering fair terms to its competitors in terms of access to its local loop. Whether one should blame the regulator or government for this or just accept different sectors are different is a moot point.

A debate also goes on about whether the use of *ex ante* sectoral regulation is a an *unnecessary* burden tand would be better replaced by more familiar *ex post* style competition policy. In some versions of this argument it would be best to either combine all the regulators into one, or better still, put them within the OFT.[10]

With a much-toughened competition policy where extremely heavy

fines are now available, there is certainly more in this argument than there once was. The deterrent effect should be much stronger. Nevertheless, a shift away from *ex ante* sectoral regulation would surely most benefit monopolistic incumbents, not least in areas like telecoms. Potential new entrants would find life even more difficult if the punishment to the incumbent only happened after they had gone bust.

In any case there is a bias in the argument about over-regulation. It tends to come from economists somewhat besotted with markets and the prevalence of 'government failure' or from (incumbent) companies who always want less regulation for themselves. The public is rarely asked for their opinion. If in fact the public is risk-averse, over regulation may either not matter that much or indeed in some sense not exist. This would apply in particular to regulation that is in place as a backstop to deal with systemic failure that could lead to catastrophic results.

I recall many of my arguments in favour of government introducing measures to be used if a company failed being treated with a certain disdain in Whitehall when first made. The ideas were dismissed as bureaucratic, undermining the regulators, distorting incentives and raising the cost of capital. However, as the lights went off on Friday 20 February 1998 in Auckland and more recently in California, many realised that the number one aim for policy in these areas is making sure the system can continue to operate and that severe shocks (including on prices) are avoided. Of course such an outcome should be secured by ensuring that all aspects of regulation and policy – competition policy, economic regulation, energy and environmental policy – are joined up (as they failed to be in California where they did not build a power station for 12 years). However, slightly higher prices – through 'extra' regulation leading to a higher cost of capital – for real insurance may well be optimal from the citizen and consumer viewpoint.[11]

Similar arguments apply to the margins of safety that require 'excess' investment and manpower in areas like gas and rail. Some authors are alarmed at the very limited degree to which any slack has been left and believe we will see more problems arise as a result (Kay 2002). Certainly the Government's aggressive response to the slowness of electricity companies to mend fallen wires and pylons after heavy storms in 2002 suggests that they are unlikely to sit by and let this develop.

One conclusion might be that the real cost of over regulation is not

so much the bureaucracy it brings or the gold plating it may engender, but that it may stop true market signals being sent and received. A good example revolves around electricity where price spikes and troughs may – where they reflect market fundamentals and not market abuse – be a good way of letting the market know where next to invest. Indeed, NETA, which abolished capacity charges, more or less 'requires' price spikes in periods of shortage. The trouble is first that regulators may find it hard to tell which signals are 'legitimate' and which result from manipulation and second that there will be many screams when such spikes appear which may be politically impossible to tolerate.

One related issue is whether our system of regulation and monitoring is any good at identifying when things are going wrong before we have a crisis. The companies in such circumstances have every incentive to hide the truth until too late (because of the effects on share price, amongst other things) and the regulator has little ability to get hold of this sort of information. Luckily, there have been very few failures in the UK. Independent Energy went under in September 2000 but was quickly bought up and its customers' supply was not interrupted. Some discussions within government apparently took place within government on what to do if a major telecom company collapses (*Financial Times* 23.8.02). Interesting issues surround the problems of British Energy of course. Certainly nobody at the time in California actually realised how bad things could get so fast: are we sure we are any better off here?

6. What happens when government is 100% shareholder?

The 'privatise and regulate' PLC model ought to fit a wide range of different circumstances. However, if for one reason or another the privatisation option is not considered a runner, and nor are alternatives like competition for the franchise, then the enterprise remains in public ownership.

There was some thinking done on alternatives to full privatisation before 1997. At IPPR a tradition grew up of looking at mutual forms of ownership (Holtham 1996) and also at how to work with bodies that remained within the public sector (see Radcliffe 1998 and Turner 1998). However, it was far from fully thought through.

In government there were some attempts to modernise the way these relationships worked. I was involved in at least two cases where the company had been turned into a PLC but remained in pubic ownership (in other words, all shares were owned by the public sector). In the case of BNFL, we inherited such a situation – although we did then try to see if we could pull off a PPP for BNFL, which failed largely due to external factors – such as the discovery of record falsification on certain nuclear pellets, as well as financial problems. In the case of the Post Office, a decision was taken – in line with manifesto commitments – not to privatise the Post Office, but to give it more commercial freedom within the public sector. The result was to set it up in a corporate form that was familiar to the markets, transparent, liable to usual company law and so on: that is, a PLC. But here all shares were owned by the Government.

This model in theory has quite a few things going for it when full private ownership is not wanted. However, there are enormous conflicts created by the need to regulate such a monopoly body. The largest of these conflicts is that the Government (as defender of taxpayers' interests) wants to maximise the value of its shares. But it is also pursuing other policies that may well reduce that value. In the case of BNFL the biggest of these tensions was regulation by the nuclear and environmental inspectorates. Others included policy on energy prices (lower ones clobber the nuclear industry) as well as security of supply.

In the case of the Post Office, there is bound to be some conflict between maximising the revenue and profits of the PLC and producing a postal service that is good for UK competitiveness overall. But in fact

we went much further and arguable introduced additional tensions. As the Post Office White Paper of 1999 made clear, the Government also decided to bring much tougher competition into then market and set up a strong independent regulator (PostComm) to do so. This it did, and although many of the problems of the Post Office pre-date these decisions and reflect severe internal inefficiencies, greater global competition and new technological substitutes (e-mail), the very anticipation of liberalisation had large and potentially devastating consequences for the Post Office. This led, according to newspaper reports, to some pressure from the DTI on PostComm during 2002 for them to go a little slower! So the Government is caught here between its desire for more competition to improve postal services and its desire to look after its shareholding in the Post Office itself.

The other problem is that following the theoretically desirable policy of leaving the public PLC Board of the company to make all the operational decisions, with government just setting overall policy and strategy, is extremely difficult in practice. One problem was that sometimes there were divergent objectives: put crudely, the network of post offices mattered more to Ministers than it did to the Post Office management. A more profound problem is that of asymmetric information: they have all the information and you can only get it via them. This puts the board and management constantly in the driving seat and can make the government shareholder side very suspicious. At times, I recall that getting timely, accurate information out of BNFL (especially under the BNFL leadership we inherited) was like getting blood from a stone.

Added to this is the lack of external and diverse shareholders who have a financial interest in being involved in continuous accountability and monitoring, digging out information from different angles and providing contested viewpoints of the company's true position. Competition and the regulator will help here, but cannot entirely reproduce that situation. Private shareholders may have lots going against them, but from my experience they are much better at asking the right questions and knowing what is going on than are public sector shareholders.

Government also found it difficult to give the Board full powers to carry out its strategy with real discretion – not least for public expenditure reasons. In the Post Office White Paper (and Act) a

compromise was hammered out between the DTI (which wanted to give lots of freedom to the Post Office) and the Treasury (who were worried that any mistakes made would come back to haunt them). This allowed the Post Office to make purchases of up to £75 million without approval from the Departments.[12] This sounds a lot but in a world where acquisitions were proceeding quickly as the European and US postal systems consolidated, this was a tremendous brake on the Post Office's ability to act, as getting government clearance invariably took months.

Unsurprisingly, management of both BNFL and the Post Office often felt at the receiving end of a desire by departmental officials to micro-manage them (although they would also play this card if they did not like the legitimate instructions they were being given) and things could get tense.

7. What happens when there is government subsidy?

Most centre-left thinking on regulation had not really confronted the issue of what to do where the regulated private sector company also received significant sums of taxpayers' money. There had been a little playing around with ideas of equity stakes in rail that had been mooted prior to rail privatisation, but this had been dropped by the time of the 1997 Labour Manifesto.

This is an area where regulation is likely to be problematic and cause all sorts of problems. There is always going to be a fear that government subsidy is just feeding straight through to the shareholders. Of course in many contracted out services and other PPPs, *all* the money comes from the public sector and in that sense the shareholders' return is partly a function of the generosity (or naivety) of the public sector client. However, in that case there is a clear contract to be delivered and prices that have been agreed. In contrast, in a situation where we have a regulated PLC that receives substantial government money, that clarity is absent.

Of course, we saw this most strongly in Railtrack where a great deal of the company's value came directly from the exchequer. Further, the company was in a position to keep coming to government for more money, putting the Government in a very difficult position if it wanted the service delivered. Again asymmetric information problems, and the natural incentives given by the PLC structure (do whatever you can within your contract or regulatory situation to maximise shareholder returns) added to the Government's dilemmas.

Rail was in fact even more confused than this. The amount of money to be given to the company was in practice determined by an independent regulator (the Office of the Rail Regulator by the end of the period, but still a single individual) who has no statutory duty to take into account the Government's budget constraints. So government spending was being decided by an independent, un-elected regulator. While from one angle this seems quite daft, from another it was of course essential to make the private regulated PLC model work. If the Government could unilaterally determine how much subsidy to give, this would have worried potential investors with subsequent increased risk premiums and so on being necessary.

Another problem with this situation became clear as the Railtrack saga reached its finale. Despite very clear warning statements from the Government[13], it is apparent that the markets thought that government would in the final analysis always pick up the tab for Railtrack and therefore they marked the shares (and debt) as extremely safe, despite earning a good return. Apart from the fact that this was not true – and could never be – the existence of what was thought to be an implicit guarantee must surely have resulted in an odd set of incentives to efficiency and behaviour for Railtrack's management.

So the question becomes whether, in a vital public service, government can avoid giving an implicit guarantee. If there really is no guarantee then the cost of raising private finance rises a great deal. If there is then the advantages to private sector ownership and shareholder pressure become much less.[14] As is well known, this Gordian knot was cut in the case of rail by a decision to reject further funding and to turn the company into a non-equity private company.

8. Reflections

Is the technical reform of regulation largely complete?

The Government acted fairly decisively on what I have called the technical areas of regulation, making its intentions clear in the Utility Green Paper, even if being rather slower to follow up. However, it did largely deliver on depersonalisation of regulation, giving the consumer primacy, introducing tougher consumer representation and ensuring it was the Government that has to take key decisions on non-economic objectives with big financial implications. Do these changes show that the inherent problems of regulation – asymmetric information, producer capture or indeed institutional conflict between regulator and regulated – can and have been addressed? Broadly over the last few years, I think that they have worked in one key sense.

The fact is that despite tough price caps (leading to ferocious lobbying by companies and sometimes by proxy through their trade unions) regulation of the utilities has not been a political hot potato in recent years. I feel that at least part of this is due to the greater openness of the process, and the fact that a board, not just an individual makes many of the decisions. The theory of 'regulatory capture' predicted that regulators would be captured by the companies they regulate. In the UK, regulators have been more captured by public opinion: they were truly burnt by the media and politicians for the 'fat cat' period between1992-1997; and regulators wanted to be populist and get tough with the companies. Since then, the windfall tax, tough distribution price controls and large price cuts in a number of sectors have taken a lot of the heat out of the issue. More sensible use of RPI-X has also helped. In this narrow sense at least Labour's reforms have worked.

There do, however, remain barriers that cannot be overcome. Game-playing can and will never end (one reason for regulators to get out of price controls (via competition) if they can). Game-playing is particularly prevalent on capital expenditure issues. Here the consequences of downside mistakes by the regulator (by being too tough) will only become apparent with time and will by then be hard to reverse. Knowing this, companies are always likely to try things on in this area. And in turn, knowing this, regulators will always tend to assume they

are being told an excessively sorry story and so will react by discounting much of what they are told. This habit in turn gives companies a logical incentive to shade the truth thus justifying the regulators assumption that they would.

One of the abiding lessons of the whole period for me is just how important it is to get the incentives as right as possible in designing regulation. I think that we generally failed to realise just how strong 'market' (or rather profit) incentives are. That means that if one gets regulation wrong, the PLCs respond to the 'wrong' signals very fast. They may then be criticised and lambasted but it is not that they are 'bad', just that equity-based firms will respond to profit opportunities from wherever they come. Appealing to their better nature or trying to inject elements of Corporate Social Responsibility into them is useful but will have limited success. So across the whole set of policy objectives (economic and social) it is important to be precise and thorough in designing the incentives to achieve those policy objectives – simple platitudes will not be enough.

This is one of the more powerful reasons for looking for potential alternative rules or even structures that are less sensitive to game playing and to the precise incentives set by some regulatory body. Mutuals and 'not-for-profits' may be one answer and in some limited areas need to be looked at very seriously. There is certainly no harm in having a diversity of models as long as one does not go overboard and pursue diversity for its own sake.

A more consistent set of incentives across quality regimes, operating and capital expenditure targets will be needed in any case. Most of the incentive signals over the past 20 years have inevitably been a bit rough and ready and game playing was endemic. But this mattered less because if regulators did see it going on (which is questionable) there was plenty of fat and excess returns for price cuts. As this runs out, regulators are having to think hard about the appropriate incentives to get continuous, though more modest, productivity growth. Eliminating the incentives for game playing is a big part of that.

RPI-X in its 'pure' form now seems like a historic or transitional mechanism. For some areas it is now redundant as a result of the introduction of competition. For others, it seems hardly relevant to the current problems, which are more to do with encouraging optimal investment than bearing down on operating expenditure. Sharper, more

focused incentive arrangements are rendering the meaning of RPI-X more and more obscure and obsolete. Arguments for more intelligent use of the time period of regulatory reviews and the keeping of efficiency gains, better use of comparative and yardstick competition, and so on, are also strong (Frontier Economics 2002).[15]

In addition there are a number of more general but still useful ideas for improving regulation, summarised well in the Better Regulation Task Force (BRTF) report of 2001. These focus mainly on how to do regulation more openly and systematically, including the use of more 'impact assessments'. The idea of 'forcing' the regulators to review areas systematically where price controls are in operation would help even up the bias towards over-regulating. I remain dubious, however, that regulation would work if every single decision proposed had to pass a full cost-benefit analysis clearly, as the BRTF and some commentators suggest. Sometimes, especially in the early days, there has to be a bit of a leap of faith, especially when bringing in competition where the short-term costs are much easier to quantify than the longer-term benefits.

Keeping regulation independent but not separate

Depersonalisation has achieved a lot for regulation. However, that is not to deny that the personality and views of the 'chair' of the Board does not matter a great deal. In reality under the Board system the chair has a lot of power over their Board members. This is both because the executive members are (usually) their appointments and because it is very difficult for government to reject the chair's suggestions and vetoes for non-executives. I think this gives these individuals too much ability to shape the Board. At minimum we should certainly split the chair and CEO jobs in all cases. I would go further and say that the non-executives should be clearly appointed independently by the Government in the way that it seems to work for the Bank of England. To avoid suspicion that Board members start to cosy up to government of the Chair of the Board near their reappointment time, I would tend to favour longish fixed, non–renewable terms for all of them.

Meanwhile, while there may be insurmountable problems, it would be interesting to assess whether some version of the minutes of the Regulatory Board could not be published – with a lag – to let everyone

understand better what had gone on (Stern and Trillas 2001). Again, this builds on the successful experience of the Bank of England and the MPC.

Putting these arguments to one side, I think that Labour's experience in government shows that independent regulation – allied to the necessary role of elected Ministers in setting policy – can work. However, as noted above, independence must not be confused with government washing it hands of any responsibilities. There is a need in my view for a strengthening of policy and technical ability and expertise in the Departments, even if that duplicates the regulators a little. Ministers want to know what *their* officials think, not just what the regulator thinks. All too often we quite frankly – and sometimes rather embarrassingly obviously – did not have the capacity to do our own thinking and analysis.[16]

More fundamentally, the experience of the last five years shows that government must set out its policy clearly in many of these areas and not abdicate responsibility. In truth, we did a bit, especially where the policy decision was very tough and there were no obvious 'political' benefits from doing it. But without a strong steer from government, the private players in these largely network- and investment-heavy industries will be struggling to understand the world in which they themselves have to make major financial decisions.[17] As Dieter Helm (2002) has put it,

> The importance of policy frameworks is in providing a clearer investment context, and in helping to bind regulators to the publicly defined objectives… Sectoral regulatory bodies not only create cohesion and more integrated approaches but they can help to limit economic regulation to its technical role, and thereby reduce the regulatory uncertainty which has characterised the exercise of policy through RPI-X price caps.

Slowly this sort of approach has emerged. The joint DTI and DCMS Communications White Paper, now being fully debated as the Communications Bill goes through Parliament, set out a very clear vision for policy in the converged age, which will firmly guide OFCOM once it emerges from its shadow status (DTI/DCMS 2002). In energy policy, 'non-economic' elements crept in, like the hard

fought-for renewables target and the climate change programme. However, the PIU Energy Review was the first stab at realising a joined-up energy policy – something we had rather deliberately avoided for too long – and the 2003 Energy White Paper has taken this on a bit, although being rtaher thin on precise delivery mechanisms. In water, the Environment Agency, along with the European Commission, helps give shape and direction in policy. In air, the CAA has an important role, while work on the Airports White Paper is an attempt to grasp the difficult nettles left un-grasped for decades. Meanwhile in rail, the ten-year plan with all its faults, started to set out a vision of where we wanted the industry to go. Since then, with changes in its senior personnel and in the guidance given to it by government, the Strategic Rail Authority has developed into a body setting policy and aims for the network within which private operators can function, as the hope that the market could in some way determine this has been exploded by experience.

Helm (2002) believes that this is a very important shift, building on what the Utilities Act only half started, which is making sure that the system is more investment focused:

> This is a very marked shift from the Conservative model of the commoditisation of utilities. These initiatives all implicitly or explicitly acknowledge the role of government in setting the context within which markets operate. Markets and competition are harnessed to the goal of the policy framework but they do not define it. It is now widely recognised that privatisation did not lead to a withdrawal of the role of the state; rather, it changed its form.

There is another aspect of regulatory independence that matters and this involves the 'overseeing' of the regulators themselves. For it is important that scrutiny is applied to what the regulators are up to in a complex world where the decisions have big implications. Although the bodies that have looked at these issues (such as the NAO and BRTF) have come up with some useful conclusions and insights on institutional and procedural change, they simply do not have the ability or arguably the remit to get to the bottom of some of the key issues.

At present Select Committee oversight is by the committee relevant to the subject area (as well as the Public Accounts Committee). It has often been mooted that it would be better to have a specialist Select Committee that really got to understand these issues and could make comparisons across regulators. There are many problems with this, including a potential loss of focus, but in the absence of any better ideas it might be worth experimenting with such a committee as an addition to, rather than a replacement for, the current structure.

In addition one should be aware that as various constitutional changes take place within the UK, these may, in time, have implications for the lines of accountability and scrutiny of both firms and regulators. Already the Welsh Assembly and Scottish Parliament are taking an interest in these issues, with important implications in the case of Wales and Glas Cymru. Elected regional assemblies may in future play a role as well, as will elected mayors, particularly in significant cities like London (Graham 2002).

More prosaically, the structure of appeal mechanisms available to different parties to protest a decision by the regulator are important not only for natural justice reasons, but also as a check and balance upon the regulator. Under pressure both from human rights legislation and the EU, we have moved over the last few years beyond having only judicial review as an appeal. So now in telecoms and aspects of Ofcom's broadcasting work, there are appeals available on the facts of the case, not just the way it was handled. And in some cases the merits of the case can be re-argued. In addition the Competition Commission Appeals Tribunal can be appealed to where a regulator is using their Competition Act powers and there remains of course the ability to appeal to the Competition Commission itself over most regulatory decisions.

A wide range of appeal options are now therefore available. The concern in this area must always be to avoid the appeal body becoming the de facto regulator if appealing is too easy and painless. So far we have avoided this while making the system fairer and less arbitrary and unchallengeable. I doubt there is a case for adding any more appeal options at this stage.

Is regulation now adequately transparent?

> Just as asymmetric information about industry conditions hampers the effective regulation of firms, asymmetric information about the process of regulation is also undesirable. Better information would enhance clarity and predictability, would lead to better public debate and scrutiny and would minimise the danger of regulatory capture. (Armstrong, Cowan and Vickers 1994, p361)

As this quotation makes clear, there are a whole complex web of issues and relationships running through regulation. There is massive interest and pressure from regulated firms, from the City and from other financial institutions. The regulators pump out buckets of complex consultation documents. A number of consultancies and academics have concentrated on these areas and advise both regulator and regulated.

However, one of the problems in such a system is that it is still pretty opaque to most people (the 99 per cent who are utility users but fit into none of the above categories).

The relevant trade unions try and participate in the debate, but are unsurprisingly stretched to have the capacity to deal with the volume and complexity of the issues. The general consumer organisations, the Consumers Association and the National Consumer Council, touch on the area now and then, as do the Citizens Advice Bureaux. But it is rightly not their bread and butter.

What one needs is for the regulators to embrace pro-active consumer oriented approaches. Thousands of pages of technical consultation documents on a website does not count as genuine participation. Although it is difficult to see how to really take such consultation to the 'masses', the efforts made by some regulators to do regional public meetings must be worthwhile.

A number of the changes made by Labour did actually bring more openness to the proceedings, including legislative requirements on OFGEM to give reasons for most of its significant decisions. It also seems that the general thrust of the Utilities Green Paper, in terms of encouraging more use of open consultation and explaining decisions did spread widely throughout the regulatory bodies, even if a number of

the measures were not actually carried through into legislation. Quite possibly the threat of legislation helped in this process (see for example Lawrence 2002 p23).

One important way through this dilemma that was proposed in the Green Paper was to radically strengthen the consumer voice through stronger and more independent Consumer Councils. They were to be given increased power to get hold of information, to publish and to make their views known. Over times this has more or less occurred.

Of course, there remains a problem as to which consumers they represent. Some feel for instance that the consumer body for postal services, PostWatch, represents those who want cheaper post more than those who want a substantial network of Post Offices. Earlier versions of the Electricity Consumer body seemed to have little interest in poorer consumers. However, some of the sanest perspectives I have come across do come from the consumer groups, like the Rail Passenger Council and Energy Watch. And I suspect that in the end even most regulators value the extra pressure and insight that such bodies bring. I know that we in government did!

It does seem to be the case though that they get sidelined. As noted above, regulators feel that their fundamental job is to look after the consumer, so they struggle to see the need for consumer councils. Admittedly consumer councils can at times become rather shrill demanders, adding little to debate. However, the job should be to strive to make them more effective and representative of public opinion,[18] even think of giving them limited rights to challenge regulatory decisions or make 'super-complaints'. This, along with more transparency, sensible appeal mechanisms and more Parliamentary scrutiny seem the best ways of letting more daylight into the process.

Is more regulation and more complexity inevitable?

A major issue raised earlier is whether the changes Labour introduced made the system more complex and if so, is this inevitable? If one thought it was, then the case for going for another model that avoided so much confrontational and complex regulation would be strong. Not only does complexity lead to a world which only a few experts understand – always a dangerous outcome in a democracy – but it leaves far too much room for game playing and confusion.

From one angle we overdid the idea that regulation is always needed, underestimating the extent to which competition is possible. We are seeing important steps in this area already. OFGEM, for example, have scrapped supply price regulation and want to become less intrusive at price controls more generally. But we also 'under-did' the role of regulation with too much easy rhetoric about light touch regulation, easing the burdens, and so on. In fact regulation in some areas may actually need to get tougher and/or more intrusive and complex – at least for a period – to get markets working better.[19]

My view is that while these issues will always be contested, regulation has not got over complex and in general has got simpler as Labour has pushed competition and so been able to let regulators withdraw from some elements of scrutiny and interference. It is where this cannot ever be the case that there may be some inevitability towards over-complex regulation which therefore raises the question as to whether a regulated private PLC model remains most appropriate in those areas.

Has the emphasis on competition become too strong?

Given my description of the basic thrust of regulatory policy under Labour, the question is whether the general approach of pushing competition and treading relatively softly on the other objectives proved successful?

On the whole I think it has worked. As noted above, some pine for a more purist version of regulation where economic efficiency alone reigns supreme while other objectives are the duty of other arms of government (if they matter at all). On the other hand, some would and did argue for a system that gave much more weight to non-economic aspects, for instance berating the Government for going ahead with NETA because of its impact on some renewable technologies. We came somewhere in the middle of that debate, which seems the right place to be.

We have to be clear that competition is a means of improving consumer welfare rather than an end in itself. The fact that competition should be used unless there is a good reason why not (a thought embodied in legislation in different ways in most sectors) does not alter that basic observation.

More generally, however, it is clear to me that a narrow focus on competition in the regulatory regime does not really solve that many policy questions and dilemmas, it simply shifts responsibility for them. After many bruising years, the centre-left became sceptical (over sceptical in my view) about the ability of public action to succeed. This is one of the reasons why we shifted very hard to a pro-competition stance. But although regulation does throw up lots of problems, the lesson is you do not avoid them by going for this simple, one-objective policy, you just shift them. And unless you can deal with the problems better in the place you have shifted policy responsibility too, you may not have achieved as much as you think.

There are some who speculate that the high water mark of Labour's infatuation with competition has come to an end, pointing for instance to the 'victory' in water for the anti-competition forces at DEFRA over the DTI and Treasury. Having been involved on the pro-competition side of this argument, I prefer to see the outcome as a sensible weighing up of the options – at this point at least.

Certainly as the need for investment has become more and more important, one needs to think carefully about pushing competition into yet new areas. Is excessive reliance on gas auctions really helpful in trying to secure an optimal scale of investment – even if they may be useful in guiding some allocation decisions?[20] Do we need to allow longer contracts or even elements of oligopoly if security of supply matters above all in energy? Certainly on-line competition in rail proved a chimera and the experience of Railtrack – with its tendency to under investment in infrastructure revealed by the Hatfield accident – has worried many people and led to a taking back of power via the SRA.

So far, as well, the nationality of ownership issue does not seem a great problem. The referral of the first energy merger that Labour faced – Pacificorp/ Energy Group – was done to allow the MMC (as was) to see if they agreed with the regulators that with a few steps (such as accounting separation) regulation was still fully possible when the ultimate owner was based in another country. Having been reassured on that point, Labour has been quite right to be ownership neutral.[21]

One big complaint that British owned utilities made to us many times was that our tough competition policy meant that it was easier for foreigners to buy our companies than for UK firms to merge. However, that is simply a consequence of believing in competition and applies to

all sectors not just the regulated ones. Some of these concerns should be minimised as a European Single Market gradually becomes more of a reality.

This benign approach comes with just one small caveat. My experience in dealing with a whole host of regulated and non-regulated companies, especially at the DTI, is that – at the margin and only at the margin – the country where the Board comes from or the boss lives does matter. That is not to say that regulators behave differently in their dealings with companies that are foreign owned but that inevitably what one might call 'informal' regulation is bound to be slightly different in these situations.

Who are the real power players in regulated industries?

One thing that only became clearly apparent to me when working closely on these issues was the power of players, other than the regulated company, in the regulatory game particularly at moments of change or crisis. These others included the banks, major shareholder groups and – especially when bonds come into the picture (as on the tube PPP or where debt finance becomes very important) – the credit rating agencies.

Far less than the actual companies themselves, these players often only vaguely understand the context in which decisions are being made. They are the ones who mistake a one-off intervention for a desire to continually interfere. They often do not follow the complexities of a price review but just look for the bottom line.

This is interesting for a number of reasons. First, there is even more room for regulatory game playing, as the regulated companies can play their financiers off against the regulator as an extra constraint on their actions. Everyone in the chain has incentives to cheat. Second, government itself (and regulators) has much less understanding of the way these groups operate, think and play the game than of the companies themselves. Sometimes, I certainly wondered if government or its agents really knew what it was doing when it came to dealing with and understanding these players. The Departments that I worked in leant heavily on the Treasury at times like this, as the key interface with the financial world. Hired (and very expensive) private guns can also help a bit. However, the Government

needed more expertise, as did the regulators. Given that external financiers are an inevitable consequence of the regulated private PLC model, not to mention of the increased use of PPPs, much more attention needs to be paid to this.

What future is there for models that have government as shareholder or that give big public subsidies?

The conclusion I draw from the examples of BNFL and the Post Office, and possibly also from NATS where HMG is a 49 per cent shareholder, is that the public PLC route as a solution where private PLCs are felt to be inappropriate for whatever reason, has enormous problems in it.

Maybe government can become a better shareholder. It would help if the job was taken far more seriously in Whitehall and top people were put on the case. Ideas that have been played around with, of creating a separate ownership grouping within government for all publicly owned bodies, look like they are now coming to fruition with the creation of a Shareholder Executive in the Cabinet Office (Pre-Budget Report 2002 para 3.112). Not only would this concentrate expertise, it would separate ownership from policy so that for instance DTI could remain concerned with postal markets and policy towards them while elsewhere in government someone else worried about the value of HMG's shares in the Post Office. Interesting things have been tried successfully along these lines in Sweden for instance (see Detter 2000). Certainly it is worth trying alternative ways of making this relationship work, not least where privatisation, for whatever reason, is not an option.

In principle, regulation can work in the presence of major subsidy, but first there must be clarity and consistency in the treatment of the two sources of revenue, prices set by the regulator and subsidies set by the government. Once subsidies are set, there must be credibility. There must be a hard, rather than soft budget constraint that will not be relaxed. This time-consistency issue is one that has bedevilled rail and similar regulated industries. Finally, there must be a guarantee that the vital public service will continue, but that is not the same as providing a guarantee that the current service provider will always continue to provide it. That means having the statutory powers to take over (or allow the take-over of) a company if the owner goes bust, which is also

a useful signal to the companies that the regulatory constraint is binding.

However, in practice, this is all immensely difficult. The Railtrack story illustrates that almost all of these conditions are hard to meet. This includes the problems caused when there is 'failure'. Privatisation has set up a group of people with legitimate ownership rights and expectations (the shareholders). This makes it hard to replace the company (while successfully keeping the service operating) in a way that is legally sound with respect to the shareholders, while being sensible with taxpayers money.

The British Energy story, where government support is more about the need to keep an essentially non-economic body going than about direct subsidy, also illustrates the problems. It raises the issue of whether the limits of privatisation in these sorts of services have been reached and maybe gone beyond. As Jackson (2002) has commented, 'the British Energy debacle may not weaken the case for privatisation in general but it provides a powerful example of its limits' while Elliot has noted that the companies causing the problems are the ones taken to the market last (Elliott 2002).

Various solutions are proposed to these problems and some may be worth trying. What I do not see working are ideas that say that everything would work if government simply set the outputs it wanted and let the regulators determine how much subsidy is needed to achieve that (Vass 2002). Fine in theory: madness in the real world.

Mutuals and other not-for-profits

I do not intend to dwell on the implications of what occurs if the regulated private PLC model fails, but a few comments may be useful.

In general I see the best case for rejecting the model as being where substantial subsidy is needed. In this case one may well do better with a contractual model (if one wants to use private PLCs), an approach that the post-Railtrack/stronger SRA model is probably leading us closer to. The use of non-equity arrangements can be useful here because it changes the incentives away from seeing government as a supplier of funds for shareholders.[22]

However, there are many well-rehearsed problems with non-equity models, although they vary depending on whether we are talking about

Companies Limited by Guarantee (CLG), mutuals or other varieties of not-for-profits. There are particular concerns over incentives to efficiency, inability to act decisively in difficult times and forms and effectiveness of accountability. I am far more relaxed about such models in essentially competitive markets since the sanctions for bad service and inefficiency are clear: customers go elsewhere. So organising local government services like leisure services in this way makes more sense than in some other areas that are quasi or actual monopolies. Ironically, however, many supporters appear to be attracted to not-for-profit models in monopoly areas.[23]

The accountability issue also needs to be carefully thought through. Clearly we need some accountability to ensure efficiency and to watch over the Board. However, others want stakeholder boards to actually decide what, for example, Network Rail or Foundation Hospitals do on almost a day-to-day basis and devise varying degrees of unwieldy democratic structures to achieve this.

Now while there may be something behind such thinking, it mostly seems to me to democratise the wrong processes. In general it should be the purchaser or local or national policy setters that should be democratised rather than the provider. So it should be the health purchasers (the PCTs) or the SRA that get democratised. The danger with a rush to 'democratise' 'provider' organisations is that we may end up merely weakening incentives to efficiency with few offsetting benefits.[20]

Adopting a CLG route represents a shift from a private equity firm to a private non-equity one, as we did with Railtrack. Of course the private sector has pursued this course itself in some areas, like water, and some want to see more of it. It has also been argued that these models require less messy regulation and certainly not of the RPI-X variety and so we should be encouraging them.

Here I would have to agree with the many commentators (Currie 2001; Stones 2002) who doubt that this is a sensible route to take. Glas Cymru may have worked well, taking advantage of particular circumstances and having a strong initial management team (although we will see how it copes in a crisis), but the flight from equity is only likely to end up in problems for consumers (and hence government) in future years. We should probably welcome the fact that we do not have a monopoly of models, but government would be unwise to encourage

companies to go down this path at present unless the combination of circumstances make it clearly fit the needs.

Did it all work?

A reasonable question to pose is whether the blend of privatisation and regulation produced better outcomes in terms of prices, productivity, and so on than alternative models may have.

I have always been a little sceptical about the big stories told on all this (Corry 1996), believing that technology and competition explain more than their fair share of the benefits, while being unsure that such things would in fact have been allowed to let rip so much if the bodies were still in the public sector.[25]

Most of the evidence does, however, suggest a shift towards a true customer focus, which despite the warts and all that come with it (like doorstep mis-selling of energy), are an improvement on what went before. And the lack of political inference at a macro level (for example, keeping down prices to stop inflation) has been a great force for stability that all have benefited from. In addition, and whatever intellectual qualms one has about it, it is almost certainly true that more investment has taken place because it now counts outside the Government's budget deficit.

In a sense the privatise and regulate model had an easy ride when there were easy and obvious cost savings to be made to satisfy all stakeholders. The real test of the model will lie in the future when we need more investment and markets are less keen to fund it.

9. The agenda in some key sectors

It is not the prime aim here to set up an agenda for the future, rather to try and reflect on the lessons of the past and learn what they tell us about how to approach the future. Nevertheless it may be worth commenting on a few of the live issues in key sectors as we go forward.

Energy

The aims set for the energy sector by the Government in its early phase, were laudable: sustainable, secure supplies at competitive prices. However, they now look over-simplistic. Security of supply has so far been achieved, but at the cost of creating the over supply required to break-up the duopoly set up at privatisation. Prices have been brought down very effectively. However, this is now causing disquiet among many given its impact on various technologies.

The overwhelming focus now is going to be upon how to incorporate environmental policy within the economic framework to ensure that those objectives are realised. How in short do we marry environmental aims with competition in energy markets? Here the Government will need to give a strong lead, for instance putting the requirement to encourage a market for energy service companies (whose aim is not to maximise energy use but to keep a house warm through a combination of energy use and energy efficiency measures like insulation) above the potential anti-competitive impact of the longer contracts needed to make it worthwhile to get consumers to sign up to such an offer.[26] And all this has to be done at a time when security of supply is leaping up the agenda as policy makers look over the edge nervously at a world where Britain might become 80 per cent dependent on imported gas.

The 2003 Energy White Paper attempts to set the policy framework within which regulators and the industry can now act, making clear that it is going to pursue ambitious renewable targets and – if a little tentatively – call a halt to the great nuclear experiment. It is courageous in explicitly accepting that the 'price' of following a 'greener' policy will be price rises of as much as 15 per cent for households by 2020 (para 7.6). And perhaps most pleasing of all is its explicit acceptance that government cannot avoid playing its role in the sector:

> it is Government's responsibility to set the overall goals for UK energy policy and to ensure that our energy markets and other policies deliver those goals. Energy producers, investors, business and consumers need a clear, settled, long-term framework within which they can plan and make decisions with confidence. (DTI 2003, para 1.4)

Communications

In many ways this sector is well placed with the new regulator (OFCOM) coming in with a clear policy framework that has been much debated in Parliament and beyond. Of course the sector has been going through a difficult time, particularly in telecoms where investment has crashed. This is something the operators still try to blame on the Government for 'forcing' them to bid too high in the 3G spectrum auction. Recent Competition Commission decisions on mobile phones will only add to their unhappiness. Meanwhile the commercial broadcasters are all having problems coping with the advertising downturn, which has impacted on revenues at the same time that a resurgent BBC has benefited from a generous licence fee settlement. The transition to digital, moreover, still appears some way off. These difficulties will provide some early challenges for the new regulator but the overall policy framework now appears appropriate to addressing them.

There are, however, two areas that are still in need of action to make the regulatory system work better. The first relates to telecoms, the second to broadcasting.

The great mistake we made in telecoms was not to break up BT. Having not done this, both the government and the regulator became caught in a world where complex and intrusive regulation was needed but even then could be frustrated by the incumbent, or at least feel that way to new entrants. Some argue that the 'voluntary' 'splitting' of BT has done the job and that competition concerns are now history. I doubt this. In any case, the best way forward here would be for OFCOM to try and settle the issue once and for all by referring it to the Competition Commission.

It is also clear that the BBC really does need to come under OFCOM on content issues with the regulator having backstop powers (only). To

avoid this is in nobody's interest. Irrespective of the sensitivities of the Governors, and arguments about the independence of the BBC from 'political' control, to have the BBC regulated differently and by itself would be like saying that PostComm should let the Post Office regulate itself in certain aspects of its behaviour. The latter is clearly a nonsense so why is the former not as well?

Post

The Governments' policy with respect to postal services is to move – reasonably slowly – to break up the Post Office monopoly. While this is certainly the right policy, the interface with other objectives, particularly the USO, will cause ongoing tensions. As noted earlier, I think PostComm would be in a much stronger position here if the Postal Act had contained the once mooted idea of a power to put a levy on all providers to pay for the USO. Even if never needed (perhaps because the USO turned out to be quite cheap to provide and of commercial value to the Post Office in any case, as PostComm has argued) it would have meant the regulator could have been bolder as they moved forward. Of course the road ahead will be difficult, partly because it is clear the Post Office is going to have to shed many jobs, which is difficult not least because it is still publicly owned.

The question still remains as to whether 100 per cent public ownership is the equivalent of a trip to never-never land. Is it fair to have competition soon to be rampaging through postal services and not let the Post Office move fast to make the investment decisions and deals that it will need to survive in this world without government (and especially the Treasury) having to approve almost its every move? This area needs another look. Labour at least needs to get itself off the manifesto hook this time and avoid having a policy saying that it cannot put the Post Office into the private sector even if that were best for the workforce and the Post Office itself. It at least needs to be free to choose.

Rail

In retrospect the privatisation of rail was so flawed it is perhaps surprising that the model survived as long as it did. Even some of the great Tory advocates of privatisation were unhappy with what was done

here (see for example Michael Beesley quoted in Currie 2001). There are also arguments that there was inadequate regulation as well as a botched privatisation as the first regulators let Railtrack have too easy a time.

The recent dramatic change to the structure of Railtrack illustrated how difficult it is to deal with a crisis when one has created a private plc and how difficult it is to undo a privatisation.[27] That is a lesson whose implications need to be learned across government.

Looking forward, those changes and others have now led us to a situation where the SRA, as the 'strategic' arm of government, is now taking control of strategy and investment in a sensible way under the framework of policy decided by the Government. The big lurking question now comes back (rightly) to the one that privatisation sought to avoid: namely how much should the government be paying to have a decent rail system that is really only used by a small minority of the population?

Water

Perhaps the heaviest investment of all has been in water. Here, so far, there look to be few opportunities for much serious competition and even innovation is likely to be limited. It is crucial therefore that the stability of the regulatory framework be underpinned. There is therefore a strong case that price reviews should be for longer than five years, provided they remained vigorous.

Two other issues remain alive. Firstly, it is strongly argued by the industry that the failure to allow capital market pressures to work, through allowing water mergers, is a mistake. They ask with some merit, why it is reasonable for electricity distribution companies to merge but not water ones? The answer here should not be to allow a free for all but to end the practice of having a mandatory reference for water mergers. It would be better to let the relevant authorities – the regulator, the OFT and the Competition Commission – sort out the trade-offs between the need for comparators and capital market competition.

The second big debate concerns the flight from equity issue: how much does that matter and what are the regulatory implications? As discussed earlier, I do not think we need to outlaw 100 per cent debt-financed water companies but nor should the regulator or government

let the industry think that it welcomes them. A ministerial statement saying that the circumstances need to be exceptional to allow any more, because government basically believes in the current model it has for water, would help a great deal.

10. Conclusions

This paper is more about reflections than conclusions. However, the major conclusions overall appear to be:

- The role of regulation and regulators is not unchanging and cannot be fixed irrespective of the challenges that arise. If, as John Roberts (2002) has put it, 'economic regulation should be seen as part of a wider co-ordinated policy making and delivery mechanism for each sector', then regulation must respond to changing policy needs, be that the shift away from the problems of over-capacity and gold-plating to the lack of investment in the energy sector, or from how to build new infrastructure to how to share it in telecoms.
- The UK's model of regulation has worked pretty well and most of the changes we have made since 1997 have been right and have made it work better. The investment problem must, however, be tackled soon – and some regulators have already begun (such as OFGEM). Ironically, just as a need for investment drove the original privatisation of BT, so it will drive the search for better ways of regulating now, which will lead us away from the original versions of regulation experienced in this country.
- Competition must remain clearly as a means not an end. The Government's sound-bites may sometimes have given an impression that we were deviating from that but I do not think we really have gone too far down an 'only competition matters' road. Many of the important issues now around require a more subtle balance between different tools, although the presumption should always be in favour of a solution via competition. Arguably that does mean more emphasis on the need to robustly argue the case for big new injections of 'competition' via, for example, gas auctions or water competition – while certainly not excluding them.
- This same rule of thumb applies to the use of non-PLC models. Where there are very big important balances between different objectives to be made, then we should first look at ways that a PLC model can achieve them. Only then should we look at non-

PLC models. The same applies to gaming: it will always exist and we can and should get better at identifying what is real and what is not. However, only where it is very severe should we move to other types of model.

- We need more transparency and openness in regulation, to make it accessible not just to experts but also to the public (not least as one way to foresee a crisis a bit earlier). The consumer bodies are useful but have not quite worked the way we hoped. It may be worth establishing a new overarching Select Committee to help open up the process and drive best practice across different sectors. Pro-active outreach by regulators (and consumer bodies) must be undertaken.
- Government cannot abdicate policy-making to the sectoral regulator. If it wants some distance, then a policy making arm of government should be used – as is happening to a broad extent in various areas – with the Government only giving the broad parameters of policy.
- Where there is major government subsidy involved it is unlikely that a regulated private PLC model will work in the longer term. This may also be true where the service is essentially one the Government feels it must keep running (for example British Energy as a means of keeping the nuclear option alive).
- Alternative solutions – be they public ownership or some form of 'not-for-profit' – have to show how they overcome the problems identified above as well as keeping incentives for efficiency. There is no harm – and indeed benefit – in having some diversity of type of supplier, but extreme care is needed in this area as the lure of the not-for-profit idea grips many in the wake of Network Rail and the supposed success of mutuals and public interest companies elsewhere.

Endnotes

1. The regulators are 'part of the pattern of networks which influence public policy decisions. Part of the infinite series of pressures and counter-pressures…firmly connected to the political system, though not quite of it, the regulators are in a constitutional no mans land' (Young 2001).
2. As she puts it 'Most of the published literature...concentrates almost exclusively on the economics of regulation… But this is a field which is irrevocably political.' (Young 2001).
3. Free market guru Irwin Stelzer told me back in 1994 'What you did is willy-nilly created a new branch of government. That is you created a group of regulators with power to set prices...and effect investment decisions in about 20 per cent of your GDP without really thinking through questions of accountability, whether or not there should be a democratic or bureaucratic procedures and so on. And I think ...everybody started to realise that there are profound issues of government here as well as profound issues of economics and equality' (Corry 1994).
4. It is worth noting however that we were not explicit on what the USO in post actually was – for instance did it means deliveries twice a day, or on Sundays or even every day? The regulator was left with the decision on this, in a contradiction of the theory that government should set policy.
5. Ian Byatt has been very frank on this: 'Oh there's definitely a balance to be drawn. When I announced the new price limits in July I said I had to strike a balance between the customers who want the bills to be kept down, those who want to se improvements in the environment and the companies who have to deliver the improvements'. Meanwhile academic Paul Seabright put it as follows: 'people who say it's a purely technical matter are either prone to believe that there is no question of balancing interests, that its entirely a matter of getting the answer out of text books or else they're people really covering up for a view that by keeping troublesome people out of the process, then you can get an outcome that's more to your liking' (both from Corry 1994).
6. Some have argued that Labour went soft on competition when it allowed vertical integration to occur, especially in electricity. But one should note that this really only accelerated after a fair degree of competition had been introduced in both generation and supply (separated from distribution) and that the decision to let these

mergers go ahead were almost all made on the advice of the regulatory authorities.

7. One of the architects of the Tory privatisation's, Colin Robinson, recently said 'Avoiding the politicisation of decision making…was one of the principal aims of Michael [Beesley] and others who helped formulate the principles on which privatisation was based' (Robinson 2001).
8. 'It is clear that regulation is no substitute for policy. The answer to "what do you want to do with the energy sector" cannot be simply to "regulate it"' (Corry 1995a)
9. She says 'The Green Paper represented an attempt to provide a rationale for regulation and to try and define what a Labour government felt that the role of the regulators should be. The government was committed to retaining the role of the utilities regulators but stated that these regulators should operate within a defined framework and have clear objectives…[it also] stated the government's view that the regulators had a wider brief than to merely enforce competition' (Lawrence 2002 p5).
10. Cosmo Graham (2002) makes good arguments against all of this.
11. The 2003 Energy White Paper emphasises strongly the importance of the 'reliability' of the system, although its tools for making OFGEM focus on this – OFGEM to report on how its regulatory activities impact on energy security, plus various join OFGEM/DTI working groups – are quite tame (DTI 2003, para 6.6).
12. McIntyre (1999) gives a good account of the tensions all this raised (pp417-420).
13. 'The government stands behind the rail system but not individual rail companies and their shareholders who need to be fully aware of the projected liabilities of the companies in which they invest and the performance risks they face' April 2001.
14. John Kay believes that the end of the Railtrack situation at least brought into the open these risk transfer issues: 'there's been a fudge that the government has said it was transferring risk to the private sector while the private sector thought that that wasn't really happening. You know that fudge is over now and if that makes the private sector be rather more wary of a lot of these transactions because they know that, or if they're no longer sure that if they go wrong the government will bail them out, then I think that will be all to the good' (Walker 2001).

15. While the basic case for using more external ways of getting at a firms potential efficiencies through comparators of different sorts (so that the firm cannot play games by choosing not to reveal its possibilities) there are other views that say excessive sue of the technique can dampen incentives and destroy the point of incentive regulation especially if they use the 'best' in class rather than the average of other players (NERA 2000).
16. One interesting thought is that it is easier for government to get capacity into the regulatory offices because the industry pays for most of it, whereas running costs are always being squeezed in mainstream departments!
17. There is a related set of arguments about whether where there is another regulator or that covers another aspect of 'policy, it is helpful (for example with a water and environment agency) or whether it is better to integrate them (OFCOM). Some see these as adding policy inputs in different ways. But neither excludes the need for government to set policy.
18. Gordon Brown (2003) raises this point in his lecture on public services.
19. Martin Cave (2002) a very strong 'light touch' regulation advocate, concludes in a recent paper 'continuing complex regulatory interventions' for OFCOM. He also proposes two extensions to OFCOM's work.
20. See Stern and Turvey (2002) for discussion of these issues. The conclude 'it is difficult to see how auctions for private investment in networks would ever over-estimate the amount of new capacity required and forthcoming, but there are many reasons why they might under-estimate it...[therefore] our view is that...auctions can have some role in providing long-term as well as short term information on capacity requirements for network companies and regulators but that this role is limited' (p18).
21. It is interesting to see that regulators clearly remain a little nervous in this area. OFGEM recently changed the license condition to ring-fence cash flows from Midland Electricity to its US owner which is in financial trouble – clearly not confident that it was safe enough with what they had already done (*Financial Times*, January 2003).
22. David Currie (2001) brings out this point forcibly with respect to Railtrack: 'Stephen Byers was right to accuse Railtrack of becoming an effective machine for seeking those handouts, for that must surely have been the case if the directors of Railtrack were fulfilling their

fiduciary obligations to maximise shareholder vale. But that illustrates the problems of the equity model in an industry dominated by subsidy' (p3).

23. Some put a lot of weight on the success of the Canadian air traffic control company, NAV Canada which is rather like a mutual. Among the reasons this seems to work is that the users are highly concentrated, powerful and clear; that there are simple and narrow objectives with few trade offs for NAV Can; and that these factors mean there has been a move away from price control regulation given it really does have internal efficiency mechanisms (McCallum 2002).
24. My scepticism in this area does not mean that there are not big roles for these sort of institutional structures in places, not least where getting the 'user' to understand their part in helping improve services is crucial (so-called 'co-production'). This might apply for instance in community regeneration schemes or possibly in some aspects of health and education.
25. John Kay suggests that the system was in desperate need of a major shock which privatisation provided – suggesting that much of these gains could have been realised by other forms of shock (Kay 2002). Corry *et al* (1997) note that public services need a shake up every now and then and if nothing else PPPs provide that.
26. The Energy White Paper's promise merely to set up a 'working party' on the issue looks very weak given the ambitious CO_2 targets it embraces (DTI 2003, para 3.35)
27. Kay (2002) notes that with Railtrack 'The administrators obligations to creditors and the holding companies' duties to shareholders have worked against the overriding public interest in the speedy injection of new management and refinancing'.

References

Armstrong M, Cowan S and Vickers J (1994) *Regulatory Reform: Economic analysis and the British Experience* MIT Press

Better Regulation Task Force (2001) *Economic Regulators* Cabinet Office

Burns P, Turvey R and Weyman-Jones T (1995) *Sliding scale regulation of monopoly enterprises* Centre for Regulated Industries, Discussion Paper 11

Corry D (1996) 'The issues raised by the experience of utility privatisation in the UK' *Annals of Public and Co-operative Economics* 67.3

Corry D (1995a) 'Why should we regulate – and why is it so hard?' in Corry D (ed) 1995b

Corry D (ed) (1995b) *Regulating in the public interest: looking to the future* IPPR

Corry D (ed) (1995c) *Profiting from the utilities: new thinking on regulatory reform* IPPR

Corry D, Hewett C and Tindale S (eds) (1996) *Energy '98: competing for power* IPPR

Corry D, Le Grand J and Radcliffe R (1997) *Public private partnerships: a marriage of convenience or a permanent commitment?* IPPR

Corry D, Souter D and Waterson M (1994) *Regulating our utilities* IPPR

Currie D (2001) 'Mutualisation and Debt only vehicles' *The Beesley Lectures* IEA/LBS November

Cubbin J and Currie D (2002) 'Regulatory creep and regulatory withdrawal: Why regulatory withdrawal is feasible and necessary' *mimeo* City University Business School, May

Detter D (2000) *Managing commercial assets under state ownership* Swedish Government Presentation at OECD meeting, 19 September 19 (available at www.naring.regeringen.se/inenglish/areas_of/state_owned/reading.htm)

DTI (2003) *Our Energy Future: creating a low carbon economy* (Energy White Paper) Cm 5761

DTI (1999) *Post Office Reform: a world class service for the 21st century* (Post Office White Paper) Cm 4340

DTI (1998) *A Fair Deal for Consumers: modernising the framework for utilities regulation* (Utilities Green Paper) Cm 3898

DTI/DCMS (2002) *A new future for communications* (Communications White Paper) Cm 5010

Electricity Association (2002) *Who owns whom in the UK electricity industry?*

Elliott L (2002) 'Wheels come off the privatisation express' *Guardian* 9 September

Eyre N (1996) 'Meeting environmental objectives in liberalised energy markets' in Corry, Hewett and Tindale (1996)

Frontier Economics (2002) 'Incentives' Appendix 5 to NAO report *Pipes and Wires*

Graham C (2002) 'Independent Regulation – a "constitutional approach"' in Vass (2002b)

Helm D (2003) *Energy, the State and the Market: British energy policy since 1979* OUP

Helm D (2002) 'The Political and Economic Case for Regulatory Reform' *mimeo* New College, Oxford

HM Treasury (2002) *Pre-Budget Report*

Holtham G (1996) 'Water – our mutual friend?' *New Economy 3.4*

Holtham G (ed) (1998) *Freedom with Responsibility: can we unshackle public enterprise?*

IPPR (YEAR) *Promoting Prosperity* Commission on Public Policy and British Business IPPR

IPPR (2001) *Building Better Partnerships* The final report of the Commission on public private partnerships IPPR

Jackson T (2002) 'A Privatisation too Far' *Financial Times* 7-8 September

Kay J (2002) 'The Balance Sheet' *Prospect* July

Lawrence G (2002) 'Who regulates the regulators?' *CRI Occasional Paper 16* University of Bath Management School

Leam D (2002) 'Introductory Essay' in *Stones* (2002)

Markou E and Waddams Price C (1997) *Effects of UK Utility Reform* IPPR working paper

National Audit Office (NAO) (2002) *Pipes and Wires* HC 723

Radcliffe R (1998) 'Public vs Private Enterprise: is there a third way?' in Holtham (ed)

Roberts J (2002) *Multi-utility perspective: the governance contract* in Vass (2002b)

Souter D (1994) 'A Stakeholder Approach to Regulation' in Corry, Souter and Waterson (1994)

Spottiswoode (1995) 'The Regulator's Perspective' in Corry (1995c)

Stern J (2002) 'Regulatory Forbearance: why does OFTEL find it so hard?' *mimeo* Regulation Initiative, LBS, March

Stern J and Trillas F (2001) 'Telecom Regulation: lessons from independent central banks' *Business Strategy Review 12.4* LBS

Stones C (2002) *Changes in the pipeline? Economic and public policy implications of water industry restructuring* Social Market Foundation

Turner A (1998) 'Commercial freedom and the PSBR' in Holtham (ed) (1998)

Vass P (2002a) 'Principles of better regulation' in Vass (2002b)

Vass P (ed) (2002b) 'Regulated Industries – the governance contract' *Proceedings 30* Centre for Regulated Industries, University of Bath Management School

Waterson M (1994) 'The future for utility regulation: economic aspects' in Corry, Souter and Waterson (1994)

Young A (2001) *The Politics of Regulation: privatised utilities in Britain* Palgrave