

Where next for utility regulation?

George Yarrow

Regulatory Policy Institute

Beesley Lecture, 16 September 2010

Some issues and themes

- Adaptive work

“... the regulator must be careful to maintain ... legitimacy when dealing with adaptive work, which in contrast to technical work is the work of learning about changed circumstances and making changes in values, traditions, attitudes, and behaviors that people hold dear. The need for adaptive work arises when fundamental changes in a group’s (or an individual’s) environment call for a rethinking of basic goals and strategies to thrive or even just survive.”
Jamison, 2008

- Learning from experience

“...the information the experiment promises to yield will be relevant in many contexts, not least in the context of environmental regulation itself.” Vickers and Yarrow 1991.

- Politicisation

- Innovation

Areas for discussion: fault lines in public policy

- Regulatory cultures
- Independent regulation and separation of powers
- Climate change regulation
- Cross-subsidisation and consumerism.
- Monopoly and the discovery/innovation problem

Theses

- Independent, 'de-politicised' regulation works.
- Nevertheless, re-politicisation has occurred.
- The single biggest driver is highly politicised climate change regulation.
- Unless climate change regulation is significantly de-politicised, it will undermine the effectiveness of sectoral regulation.
- The single, biggest defect in the policy system is the absence of an independent climate change/environmental regulator.
- Bureaucracy and associated 'executive' regulatory cultures have been an exacerbating factor.
- Ditto in relation to 'consumerism'.

Regulatory cultures

- The original contexts of today's sectoral regulators.
- 'Hard headed intellectualism'.
- Some change was inevitable and desirable: freer markets need more rules.
- But ... Two short stories.
- On Bullshit.
- ?A principal objective of regulators today – *to convey a good impression of themselves?*
- The entanglement of powers, exacerbated by expanding bureaucracy:
“The dilemma faced by Congress in establishing regulatory agencies is that a dual purpose is envisioned. Regulatory agencies must be accountable to the Congress or the Executive and represent an exercise of congressional or executive power. However, it is desired that the regulatory issues proceed fairly, that they accord individuals the due process of law, and that their decisions are consistent with judicial review. Unfortunately, achieving these two purposes within a single agency may be inconsistent or problematic at best.” Spulber

Independent regulation

- Independence is necessarily relative.
- Principal protection required is against unstable/volatile political preferences and opportunistic interventions.
- Failures of individual regulators to resist instability.
- Failures of boards; tendencies to consumerism.
- Institutional arrangements appear to have been less durable than US equivalents.
- A rational government will want to maintain the general approach, particularly in a period of fiscal entrenchment.
- But ... unintended consequences and other pressures.

‘Consumerism’

- Take a step back into the economic history of utilities.
- Textbook theory: the natural monopoly problem.
- Historical realities: political preferences for cross-subsidisation.
“The pervasive tendency of state intervention has been to suppress these differences, usually by creating monopoly rents which are partially dissipated either in cross-subsidies or via explicit subsidies to the high-cost customers.” Peltzman
- Extensions to the banking sector.
- Political preferences for cross-subsidisation have never gone away.
- The competition policy objectives of sectoral regulation are subject to subversion by such influences.

Climate change issues

- Increasing influence of climate change policy on the utilities.
- Climate change policy highly politicised.
- Conventional wisdom: market failure on the grand scale.
- Leads toward highly centralised policy responses to issues, when the better approach is to develop markets (note to economists: associating the word 'failure' with features of the likely paths to solutions is not a very clever idea).
- History lesson: 'The tragedy of the commons' and land enclosures.
- De-politicised climate change regulation is missing from the UK framework.
- This blights large parts of sectoral regulation.
- Electricity already a near basket case.
- Reform is challenging, but a step by step approach is feasible.

Persistent monopoly and innovation

- Comparative advantage of competition over monopoly greater where the scope for learning and innovation is greater.
- Climate change implies great scope for learning and innovation, including in networks. Lesson: competitive solutions, where feasible, are likely to be far superior.
- Incentives for innovation under price controls generally very weak. Ripe for reform.
- Ofgem is not well placed, but this is a natural duty for an independent climate change regulator.
- In the relevant context, prize systems have considerable merits.

Where next?

- Unbundling of network regulation, competition policy, consumer protection, and climate change policy.
- Separation of executive, rule-making and quasi-judicial powers. More Australian?
- Shift balance of regulation toward rule-making (legislative) and adjudication functions.
- Regulation best done by small platoons.
- Above all, de-politicise aspects of climate change regulation via the creation of a independent regulator.
- Business as usual on this point will lead us toward a car crash.

And finally ...

- Politicians have failed, regulators have failed, boards have failed, but utilities have failed too.
- “Industries get the regulators they deserve” is not quite true, but it encompasses the truth that producer interests can have a strong influence on the evolution of regulation.
- The regulatory framework is a collective good, and all have responsibilities.
- If companies use politicians to undermine regulators, regulation will be that much more politicised, and there will be no use bleating about uncertainty and the cost of capital.
- Ditto if companies fail to challenge decisions when regulators themselves open the door to political opportunism.

... the last words, on civic virtue, to another Adam

“If forms of proceeding, written statutes, or other constituents of law, ceased to be enforced by the very spirit from which they arose; they serve only to cover, not to restrain, the iniquities of power: they are possibly respected even by the corrupt magistrate, when they favour his purpose; but they are contemned or evaded, when they stand in his way: And the influence of laws, where they have any real effect in the preservation of liberty, is not any magic power descending from shelves that are loaded with books, but is, in reality, the influence of men resolved to be free; of men, who, having adjusted in writing the terms on which they are to live with the state, and with their fellow-subjects, are determined by their vigilance and spirit, to make these terms be observed.”

Adam Ferguson, *An Essay on the History of Civil Society*, 1767.