Electricity sector governance in the UK

George Yarrow
Regulatory Policy Institute, Oxford, UK
www.rpieurope.org

Toronto, 4 June 2010

Pre-privatization (up to 1990)

- Public ownership in the form of public corporations.
- Intention: strategic direction from government, operational matters devolved to the corporations.
- In electricity, three systems:
  - England and Wales: one generation + transmission corporation plus twelve, regional, distribution + supply companies, each a monopoly in its own area.
  - Scotland: two companies, regionally based (highlands, lowlands), fully integrated (generation + transmission + distribution + supply).
  - Northern Ireland: one vertically integrated corporation.
- Regular re-evaluations of governance and performance in consequence of perceived weaknesses, but little action.

The major problems

- In general, weak incentives and poor performance, confirming A.Smith – *"monopoly is a great enemy of good management".*
- Investment performance was particularly poor:
  - Relative to continental Europe, coal-fired stations took a lot longer, and cost a lot more, to build, often due to ongoing design changes.
  - Ditto for nuclear stations, where non-standard designs were favoured.
- In relation to governance:
  - Political supervision went far beyond strategic matters (such as use of the sector to protect the UK coal industry) to much more specific interventions in relation to pricing, investment, etc.
  - Political objectives were unstable (i.e. constantly changing) as political priorities shifted from one year to the next.

The privatization settlement (1990 -)

- Privatization started in 1990. Broadly: separation of generation from transmission in E&W, but not in Scotland or Northern Ireland. Transition first to competitive generation (wholesale) market and then supply (retail) market.
- ‘Independent’ regulator for GB – Director General, supported by an Office of Electricity Regulation (Offer) – established by statute.
- Director General (DG) appointed by Minister, accountable to Parliament. Checks and balances relatively limited (due to traditional, British establishment aversion to judicial supervision?).
- Later, following amalgamation of electricity and gas regulation, the DG was replaced by an ‘authority’ – the Gas and Electricity Markets Authority (GEMA) with a Chairman and CEO.
- Majority of non-executives on the GEMA board, but technical nature of work raises problems for supervision.

UK innovations ... and failures to innovate

- UK policy sought actively to avoid US-style rate of return regulation of monopoly.
- Major innovations included:
  - Price cap regulation (RPI-X), incentive regulation more generally.
  - More fundamentally, regulatory duties to promote or facilitate competition where feasible (i.e. principally generation and supply) were introduced, alongside more traditional regulatory duties in relation to consumer interests, efficiency, etc.
- Little consideration of what might happen when government had rather different strategic objectives (this was the late Thatcher period, when energy policy was generally non-interventionist).
- In particular, no real consideration of environmental issues.

Early warnings, not heeded

- Vickers and Yarrow, *The British Electricity Experiment*, <u>Eonomic Policy,</u>1991, final paragraph:
  - ... *Environmental regulation can be expected to be <u>the</u> major issue facing the electricity industry, worldwide, in the 1990s. Since the new regulatory framework in Britain was not developed with environmental problems in mind, there is a danger that, at the international level, it will come to be treated as a mere sideshow to the main (environmental) event. If so, that would be a pity; for, as we hope we have shown, the information the experiment promises to yield will be relevant in many contexts, not least in the context of environmental regulation itself. The reforms may not be widely copied, but they do merit close scrutiny.*
- In the opening summary: *Many issues remain to be resolved , however, not least in the field of environmental regulation ....*

Lessons well learned ...

House of Lords Report on Regulators, 2007:

1.1. We conclude that:

- *Independent regulators' statutory remits should be comprised of limited, clearly set out duties and that the statutes should give a clear steer to the regulators on how those duties should be prioritised.*
- *Government should be careful not to offload political policy issues onto unelected regulators.*

3.11 … the later increase in the importance within the regulators' roles of other duties (particularly social and environmental duties) means that there is now a less clear distinction between what policy issues should be dealt with by government and which by regulators. Such an expansion of duties, along with a lack of clarity about the respective roles of government and regulators, can arguably reduce the effectiveness of the regulator, create regulatory uncertainty and risk compromising the independence of the regulator.

… in theory but not in practice

- Regulatory agencies are conveniently available to governments for offloading ‘actions’ when new policy priorities have arisen.
- In telecoms, for example, Oftel became Ofcom (the Office of Communications) with a much expanded remit that included broadcasting as well as telecoms (on the US FCC model).
- In energy, social and environmental policies have driven a major expansion in duties. Also, the Energy Act 2010 gave government reserve powers to ‘adjust’ market prices in the name of ‘fairness’.
- Today, there is no stable prioritisation among a growing list of devolved responsibilities.
- On what basis does an unelected regulator balance off consumer prices (‘affordability’) against security of supply against carbon reduction objectives?

The internalisation of the political

- UK energy regulation has been re-politicised.
- It appears to have happened partly as a result of old-style political direction/intervention, but also partly by regulators 'internalising' the political influences: *"if we don't do this, the Minister will, and he will do it in a more damaging way than if we do it."*
- Example: Ofgem restrictions on price discrimination in retail energy markets whose effects can be expected to be anti-competitive, motivated by 'micro-consumerism' (i.e. providing benefits to certain groups of consumers, even when the consequences for consumers as a whole are adverse).
- Project Discovery, concerned with security of supply, proposed possible re-monopolisation of the wholesale market, and went well beyond what even a government increasingly inclined toward micro-management was contemplating.

The Financial Times on Project Discovery (4 Feb 2010)

- ***Ofgem off-target***

  Ofgem may be right that the UK electricity market requires reform. But the regulator's views would carry more weight if it were consistent in its diagnosis of the industry's problems. Unfortunately, its chief executive, Alastair Buchanan, often contrives to give a fair impression of a cork bobbing in a storm. A couple of months ago, he complained that the generators' margins were rising too far. Now he says that those same companies are not making enough money to build the capacity needed to keep the lights on.
- An arbitrary priority switch: affordability -> supply security.

The future?

- New coalition government in its early days, so development of strategic policy directions still to be clarified.
- There is general recognition of the governance problem that has re-emerged (i.e. agencies should not be asked to address broad policy trade-offs on a delegated/devolved basis, but political preferences tend to be unstable).
- Thinking on how now to establish greater stability in policy priorities is, however, still very primitive.
- Progress will require a new policy architecture, likely featuring ‘independent’ environmental regulation; new structures within government for ‘meta-rulemaking’ in relation to the allocation of powers, duties and relationships among the various agencies; and less haphazard checks and balances (tighter judicial supervision).