Where next for utility regulation?

Points arising in the post-lecture discussion

Is de-politicisation of environmental policy feasible?

This was perhaps the most important question arising in the discussion. If such de-politicisation is not feasible, it is clearly not worth wasting time trying.

In that case (non feasibility), the implications of the central argument are that independent regulation is dead in electricity, and seriously compromised in gas and water; and that we should be working to develop different ways of regulating those sectors, and of obtaining private sector finance for infrastructure.

My view is that de-politicisation, in the sense in which that term was defined in the lecture, is feasible, but it will necessarily be a step-by-step process, and the first steps may be small ones. The process could begin with the identification of what may be a few small areas of existing policy that are less 'sensitive' in terms of short-term political preoccupations, or areas of policy which are not yet worked out or developed, and, because of that, are still 'below the radar'. In the lecture, I suggested a technological prize system to encourage innovation in the mitigation of climate change as just such an area of policy.

In water, there is a potentially major agenda of defining and re-defining property rights in water abstractions, and of creating conditions conducive to trading in such rights; and this is another candidate area for delegation. (In a sense, the matters are already delegated, and fall within the conglomeration of activities that, in England and Wales, is the Environment Agency; but the EA does not have the kinds of objectives, skills and powers that are appropriate to the challenges ahead). Early establishment of an independent, focused, climate change regulator might, in this area (water abstractions), actually pre-empt the political volatility and opportunism that could occur if the relevant matters are handled poorly, as a result of a poorly adapted institutional structure.

One of the main arguments in the lecture was that we should learn from past experience in utility regulation when thinking about environmental regulation. A particular aspect of that experience that is particularly helpful is the regulation of British Gas (and the history of telecoms regulation is broadly similar, though less stark). At the time of the privatization of British Gas (1986), a number of economists, me included, were concerned about the imbalance of power between British Gas, which operated as an integrated, monopolist-cum-monopsonist with a rather autocratic managerial style, and Ofgas, which was initially a rather small establishment with limited powers.

What I think we didn't appreciate at the time, and came only later to understand, was that the establishment of Ofgas in effect kick-started a whole new policy process and policy dynamic. In the event, the subsequent twenty years or so have been marked by a string of successes that have turned the Cinderella of the energy sector into the real poster child.

Two points might be noted in this regard.

- Ofgas was not alone. The removal of early log-jams in the way of liberalisation was greatly assisted by work done by the OFT and the MMC. The history is a good illustration of how different institutions can work together for the good of the system (here consumers and suppliers in the gas market), rather than tussling like proverbial ferrets in a sack (which is what can happen when there is competition for jurisdiction).

- The process is partly governed by what I will call the 'first law of regulation': supply creates its own demand.[1] Establish a regulatory office with responsibilities and power, hang a sign outside the door, and pretty soon there will be plenty of interest groups knocking on that door trying to convince the inhabitants to do this or that about something or other. Once an agency is established, politicians can also find it to be a convenient substitute for some of the awkward decisions that might have to be taken (e.g. those that will lose votes whichever way the decision is made). More generally, one of the lessons of utility regulation to date is that duties and responsibilities tend to grow over time.

Putting these points together, I think there is a reasonable prospect of a gradual de-politicisation, through delegation, of a widening area of climate change policy. And, even though the process would not likely be rapid, the private sector decisions of most concern are to do with investments in assets with potentially long asset lives. That is, time horizons for investment appraisal are relatively long, and decisions can be affected in benign ways once it becomes clear that the policy super-tanker is being turned (albeit slowly) on to a more sensible long term course.

Adjudication

Another big point raised concerned the mechanics, including detailed practicalities, of unbundling some of the different tasks that are currently undertaken by sectoral regulators.

This can be done to some extent within the boundaries of a single organisation, but there is always an element of spitting against the wind in this, since the cultural DNA of

[1] Students of macro-economics will notice the obvious similarity to Say's Law, which came under withering attack from Keynes in *The General Theory*, on account of its implication that there could be no general, persistent deficiency of aggregate demand in the economy. The difference is that Say's Law has little explanatory power as a proposition (Keynes was right), whereas the 'first law of regulation' has significant explanatory power.

organisations points them toward seeking to co-ordinate the various parts, even as the parts themselves often exhibit the aforementioned ferrets-in-a-sack tendencies. The bureaucracies of executive government seem to me, all too frequently, to exist in a state of suppressed internal warfare.

The 'separation of powers' argument has many aspects to it, but one that is relevant is that it can be an example of the 'strong fences make good neighbours' point. It economises on unproductive squabbling.

If there is not to be coordination of different parts of the policy system by 'internalisation' (i.e. conglomeration of the type criticised), then other institutional adaptations are, of course, required. Where separation exists in the existing arrangements, there has been little sense of consummate cooperation between bodies in the interest of the wider good (although there have been exceptional periods and examples that show what could be achieved). In some cases, organisations have avoided each other as if the other had a communicable disease. Without other checks and balances, organisations revert to type; each retreating to its own silo.

A better initial design for the institutional frameworks of sectoral and environmental regulatory policy would help greatly, but there is a need for a space, within government, for monitoring and evaluative discussion on *how the system as a whole is working.* This is a less technical task than detailed scrutiny of individual regulatory decisions, and, following a suggestion in the discussion, it may be an exercise in which Parliament could effectively take the lead – although that should not necessarily preclude BIS or DECC initiatives in this area.

The main point about more judicial approaches, however, is the institutionalisation of an element of competition into economic assessment processes. In a court, different parties present different cases before the judge: there is competition to provide facts, and competition in the interpretation of facts and the development of narratives.

There is nothing comparable in investigative approaches led by a single organisation. All too often, a dominant narrative establishes itself at an early stage of an assessment process, and it becomes exceedingly difficult to dislodge, irrespective of what facts subsequently emerge. Time and again I have seen or heard of accounts of cases where minds were largely made up very early in the process, in some cases 'on day one'. Organisational tricks, like employment of a devil's advocate, usually at a late stage of the process, offer no sound defence against this early 'monopolisation of the narrative'.

In contrast, judges face conflicting arguments right at the outset of their consideration of the relevant matters, and that is a huge advantage of this type of evaluative system (at least if the ultimate interest lies in something other than the production of bullshit). My own reading of the evidence on the quality of decision making is that it more than compensates,

by some margin, for any lack of technical expertise in the relevant area on the part of the adjudicator.

At one stage, proponents of the better regulation agenda sought to encourage the agencies of government to take a more critical approach to regulatory impact assessment right at the outset of each individual assessment. The NAO put heavy emphasis on this point, for example. The suggestions were well motivated, but the effects have been negligible. The relevant point is similar to that made in the lecture notes regarding the impact of the 1967 White Paper on Nationalised Industries: the exhortation in each case was contrary to the fundamental nature of the organisations that it was seeking to change. Organisations have strong tendencies to prevent, restrict or distort intellectual competition; and where they can't, they try to 'manage it'. I am therefore always puzzled to hear advocates of competition arguing for greater centralisation and consolidation in their own institutions. The relevant policy advice is of ancient vintage: *physicians, heal thyselves*!

As the regulatory history books now tell us, 'hard headed intellectualism' is hard to sustain in bureaucratic institutions; which, of course, was why Len Waverman was surprised to find it at Ofgem. I am, however, persuaded that it can be sustained in institutional arrangements that ensure that, the first time a decision maker meets an issue, she/he immediately, or almost immediately, meets competing accounts, theories, and narratives.

The civic responsibilities of commercial interests

Two slides were added to the lecture notes, and were covered in the lecture itself, dealing with the responsibilities of all involved in regulatory processes to seek to maintain the shared rules/institutions, which are a collective 'good', in a shape that will work well for society as a whole. I noted those results of decades of study of regulation which pointed to the major influences that supply-side interests have had on regulatory outcomes; not in every case, of course, but on average, and across a wide range of different circumstances.

There was some pushback on this, but I think the accumulated evidence speaks for itself. Perhaps the most informative area at the moment is electricity regulation. There is a strong argument to the effect that, if supply-side interests had had a greater influence on environmental policy, we would not now be in quite the state we are in, and that the state that we are in indicates that, at least in this case, companies had little or no influence on policy development. I would, however, only go along with that argument up to a certain point.

Companies might not have willed the re-politicisation that has occurred, but neither have they been slow to enter the subsidies game. This is entirely understandable, given their own goals; but in doing so they have often expressed greater enthusiasm for, and hence have given greater credence to claims made for, the relevant subsidisation policies than is

consistent with their own, enlightened, long-term interests; which is not commendable. Like regulators, they have not shown that spirit and vigilance, in ensuring that the terms of previous bargains with the state be kept and observed, which Adam Ferguson (in his *Essay on the History of Civil Society*) advocated as a key aspect of the civic virtue that is necessary to sustain common institutions.

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