

Negotiated settlements: a role for American practice in UK policy?

Stephen Littlechild

Hertford Seminar in Regulation

23 February 2007

Outline

- Evolution of UK utility regulation
 - From light-handed to heavy-handed?
- Is there scope to reduce regulation?
 - by greater involvement of market participants
- Practice and experience in America:
 - Argentina, Florida and Canada
- And in UK: London Underground and CAA
- Possible scope in network price controls

UK utility regulation

- ‘Regulation with a light rein’ (Patrick Jenkin, Sec of State, BT privatisation 1983)
- There are examples of removing/reducing regulation in competitive markets
- RPI-X initially simpler than US regulation
- But seems to have become more heavy-handed in monopoly/network sectors
- Is this inevitable? Is it a problem?

Costs of regulation

- Better Regulation Task Force: extent of regulation is rising despite more competition
- Growth and cost of regulation
 - Offer/Ofgas/Ofgem fivefold increase £16m to £87m 2001, now £30m+ but still double previous level
 - NAO: Costs of 2000 DPCR: companies range under £0.5m to over £1m each, Ofgem's cost £2.5m

Information issues

- Protection of customers takes resources
 - Data cleaning for consistency & comparisons
 - To make large price cuts need supporting evidence
 - Especially consultancy studies of opex and capex
- NAO survey of electricity companies: How much requested information is necessary?
 - 1 company said 51-75%
 - 5 companies said 26-50%
 - 4 companies said under 25%

Intrinsic problems of regulation

- How can regulator know & decide for users?
 - eg on investment, quality of supply and security
 - public interest or consumer sovereignty?
- Concern that agreed investments not made
 - Regulator unable/unwilling to monitor and enforce
 - Tending to continual monitoring process (eg water)?
- Central regulation means uniformity
 - limits variety of solutions and innovation
 - eg RPI-X or sharing? Duration 5 yrs - or 3 or 10 yrs?
 - What incentives re quality? What cost pass-through?
- Alternatives from overseas experience?

Argentina

Evidence on alternative regulatory
arrangements for transmission
expansion

Argentina background

- Argentina electricity reform 1992
 - Per UK: restructuring, privatisation, competition, incentive regulation of existing T and D networks
- Mistrust of regulation
 - Decided that transco & regulator should not be responsible for new transmission investment
- Public Contest method
 - Users to propose, vote & pay for major expansions
 - Construction O&M (COM) out to competitive tender

Received view of experience

- Argentine electricity reform worked well
 - lower costs & prices, better service, more investment
- But major caveat: method of regulating transmission expansion did not work well
 - Claimed externalities, free riders, transactions costs
- But only one illustration of this:
 - Several years delay to much needed Fourth Line from Comahue (major generation source) to Buenos Aires (major demand centre)

Fourth Line

- Congestion increasing on this corridor
- Sept 1994 3 generators proposed 4th Line
 - With COM fee about \$58m p.a. over 15 years
- Feb 1995 Public hearing 50% vote against
 - Surprise and concern, including by regulator
- May 1996 revised proposal - accepted
 - Proposed max fee \$55m p.a.
 - Nov 1997 winning bid \$35.5m p.a.

Examination of 4th line

- On closer examination, benefits about \$10m p.a. compared to cost of \$58m or \$35.5m p.a.
- Conclusion: 4th Line was not economic
 - Cheaper to locate generation near demand instead
 - Delay was socially beneficial, not costly
 - Final decision reflected subsidy arrangements
- None of alleged problems of Public Contest method actually materialised here
- Elsewhere, Public Contest method worked well

Competition in construction

- Bidding competitive: 2-3 bids in 5 cases
- All these won by new independent cos
- 4th Line: 4 bidders 13 bids (alternatives)
 - introduced innovative technologies
- Cost reductions over time
 - pre-reform at least \$230k/km
 - 1st & 2nd tenders (Govt) \$267k/km, \$170k/km
 - 4th Line \$130k/km - so cost/km about halved
- Bidding to construct was very successful

Assessment of Argentine policy

- Public Contest method in fact worked well
 - Made better use of existing lines
 - Competitive tendering lowered costs
- 4th line: delay not a failure of PC method
- Regulation would have yielded to political pressures to build many uneconomic lines
- PC method resisted political pressure
 - Led to more economic outcomes than regulation
 - Preferable if aim is efficient allocation of resources

Negotiated settlements

US origins and early perceptions

Origin of negotiated settlements

- Large backlog of rate cases at Federal Power Commission (FPC) in 1960s
 - 1960: over 2900 applications, 10 dealt with
 - 1960: 3200 requests, with triple staff would take 82 yrs
- FPC encouraged settlement
 - 1960-70: some or all of 56% cases
 - saved time and money, reduced uncertainty
 - some concerns about non-consenting parties (slow down process?) & non-participants (overlooked?)
- Assumed settlement easier way to same end

Settlements at FERC

- Successor FERC continued FPC policy
 - Federal Energy Regulatory Commission
 - 1980: 70% of gas pipeline rate cases settled
- Wang (2004): 41 cases 1994-2000
 - 34 settled in full, 5 settled in part, 2 litigated
 - savings in cost & reductions in uncertainty minimal
- Settlement: different process & outcomes
 - looked at situation as whole, not item by item
 - more innovative outcomes not available to FERC
 - especially rate moratoria 21 of 39 settlements

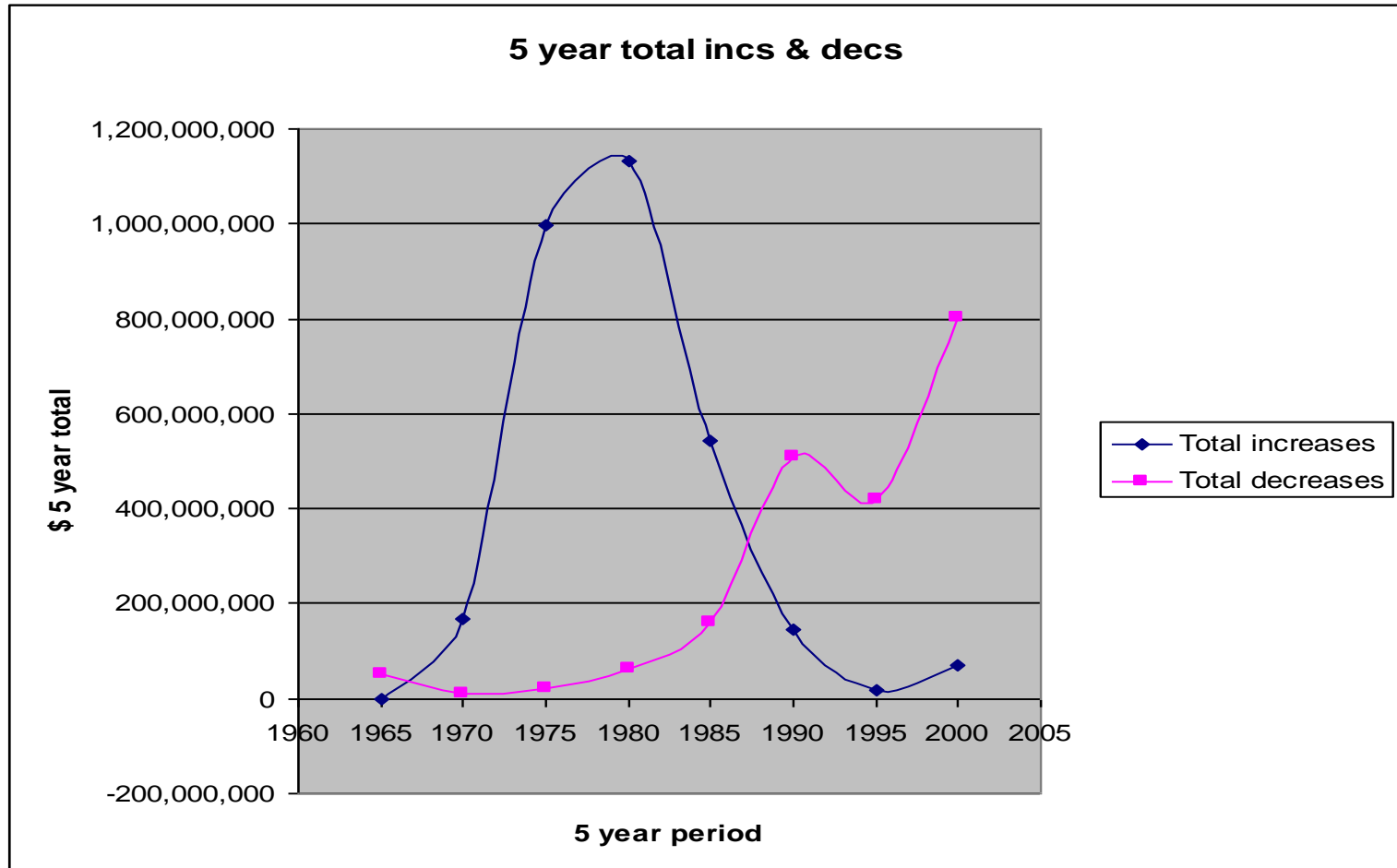
Florida

Evidence on nature of stipulations
and settlements with a consumer
advocate

Regulation in Florida

- Public Service Commission FPSC 1897
 - 386 staff, budget \$27m
- Office of Public Counsel OPC 1974
 - duty “to represent the general public of Florida”
 - staff 15, budget \$2.5m plus consultants
 - single incumbent Public Counsel 25 years
- Scepticism about US consumer advocates
 - limited effect? tend to favour larger users?
 - Is this true in Florida?

FPSC base rate cases



Stipulated settlements in Florida

- Public Counsel represents customers
 - by challenging utility in regulatory hearings
 - also by negotiating stipulated settlements with utility, then inviting FPSC to approve
- FPSC staff not involved in negotiations
- All stipulations accepted in total
 - no cherry-picking (unlike California)

Types of case where OPC signed stipulations, 1976-2002

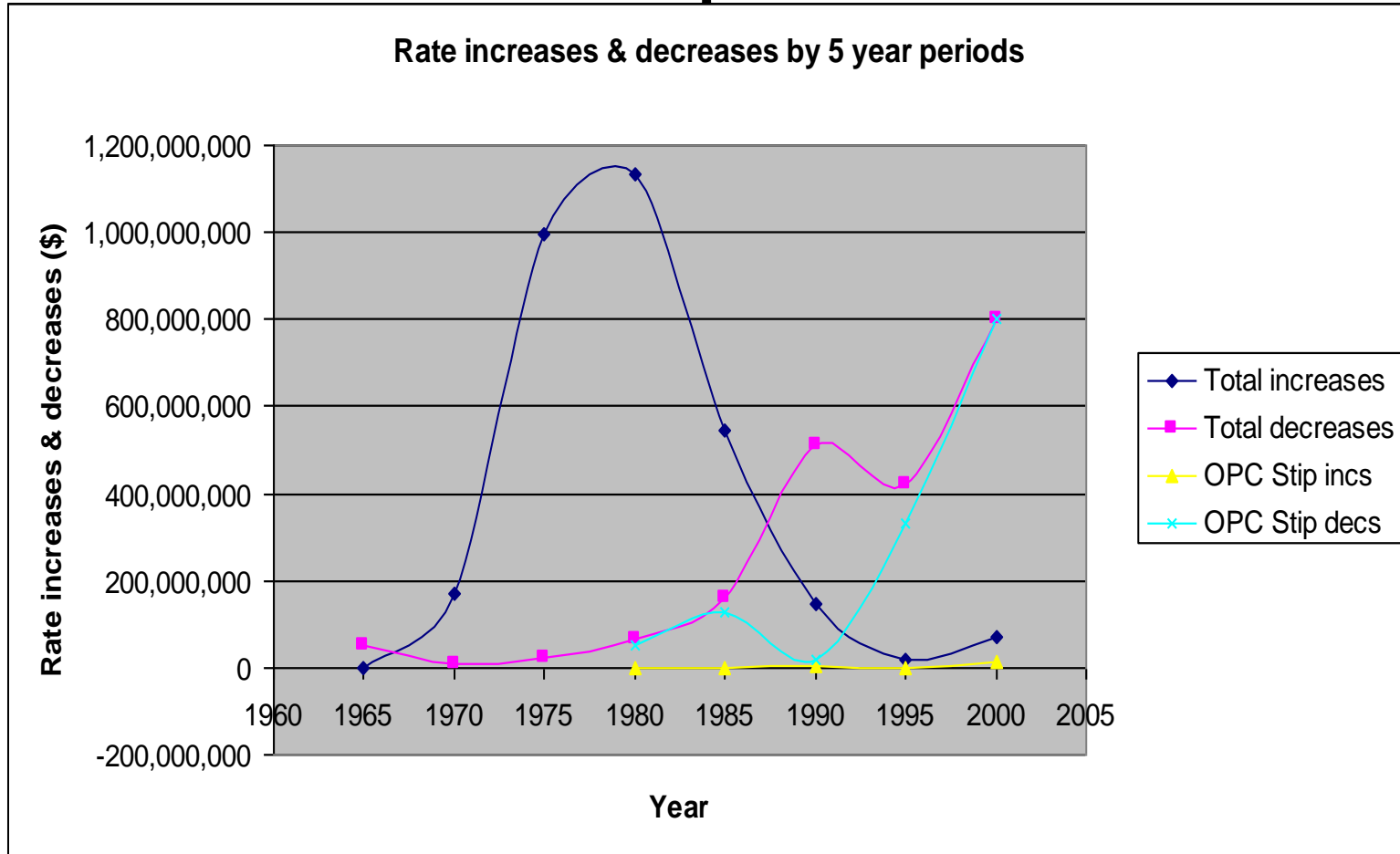
Type of case	Total	OPC stipulations	
	No.	No.	%
Predicted high participation by OPC: -Earnings review	93	29	31%
Predicted low participation by OPC: -Requested rate increase	82	6	7.3%
-Minor cases (tax, ROE, MMFRs)	58	1	1.7%

Florida PSC earnings review cases 1976-2002

	Number of cases of earnings reviews	Aggregate value of reduction \$m	% of total revenue reduction	Average value of reduction \$m
With OPC stipulation	29	1437.7	77.0*	49.6
Without OPC stipulation	64	429.4	23.0	6.7
Total	93	1867.1	100	20.1

*91.2% excluding Southern Bell 1988

FPSC rate cases and OPC stipulations



Who benefits?

- Cost savings relatively small (<1% value)
- Customers: bigger and earlier rate reductions
 - Confirm larger users benefit more in some ways
- Utilities: less uncertainty & embarrassment?
- Utilities get what FPSC could/would not give
 - Removal of objections by others (e.g. to merger or in court)
 - Flexibility on accounting provisions (depreciation)
 - Price caps (up to 4-years) and revenue sharing (instead of profit caps or earnings sharing)
 - often despite initial objections of regulatory staff

Conclusions on Florida

- Stipulations are significant in Florida
 - 77% of base rate reductions since 1976
- Stipulations have benefitted customers
 - greater & earlier rate reductions
 - reformulation especially favoured large electricity users
 - but residential customers still benefit overall
- And have led to changes in regulatory policy
 - More flexibility on depreciation etc than staff/FPSC
 - More innovative forms of incentive regulation
 - Have almost superceded electricity hearings since 1995

Canada

Experience of National Energy Board
with negotiated settlements

Settlements at NEB

- NEB regulates oil and gas pipelines
- since about 1995 almost all regulatory issues here have been covered by settlements between pipelines and users (producers, shippers and consumers)
- this has halved number of hearings and halved average time per hearing, so total hearing time down by three quarters

Nature of settlements

- Scope of settlements has been very varied
 - tariffs, opex, ROE, service quality, capex programs
- multi-year incentive programs
- transition to light-handed regulation
 - with individual settlements
 - price discovery regime to facilitate new entry
 - complaint-handling & complaint-based regulation
- improvements in productivity, service design, communications & industry relations

Reasons for success

- Parties could negotiate mutually beneficial outcomes (not just cost-saving)
- NEB policy to encourage settlements
 - Initial cherry-picking discouraged interest
 - Now normally accept unopposed settlements
 - Not judge whether each element reasonable, but whether process reasonable (open, informed, agreed)
 - Generic Cost of Capital decision to fix benchmark, removing market power and leaving scope to agree premium for better service and innovative products

UK

London Underground Limited (LUL)
contracting out its electricity network
CAA constructive engagement at airports
Scope in network price controls?

Contracting out electricity network

- LUL largest non-utility electricity network in UK, about 5% size of small REC network
- 1998 30 year contract worth £1.5 billions
- to operate, maintain, finance and renew the network, and take most risks
- awarded to lowest bidder (Seeboard SPL) subject to meeting engineering, safety & human resources requirements

Nature of contract

- Detailed quality and risk specifications
 - including specified investment program & outputs
 - plus liquidated damages
- Provisions for risks and uncertainty
 - Bid price RPI-indexed, which reflects many costs
 - Risk of demand uncertainty taken by LUL, any additional investment costed on terms in contract
- Provisions for monitoring and enforcement
 - LUL kept 30 monitoring staff, specified accounting standards, required reserves & parent co guarantees

Summary of LUL experience

- Knowledgeable buyer able to deal with electricity supplier, no monopoly problems
- Contract well designed & discussed
 - outputs and quality well-defined, kept staff to monitor, provision to transfer assets & staff at end
- Has worked well
 - planned capex spent, improved maintenance, better system performance

CAA Constructive engagement

- 2003 CAA concerns
 - airport/airline relationships & communications
 - extent of CAA involvement in decisions e.g. traffic volume forecasts, service quality levels, capex plans
- Proposed constructive engagement
 - to agree key inputs for next price control review
 - otherwise if CAA took decisions the outcome uncertain and might not satisfy any parties

Outcome so far

- Heathrow & Gatwick
 - Towards agreement on traffic forecasts, shared vision of the future of the airports, service quality regime, construction costs of capex projects
 - capex program at Gatwick but not yet Heathrow (commercial tensions on investment priorities)
- Stansted
 - as yet unproductive - different views & using media
- Manchester
 - material progress, airport to provide more financial info, could remove price cap (noting competition)

Conclusions on CE

- Constructive engagement has been helpful
- working well at LHR, LGW & Manchester
- helped by agreement with airports to pay costs of consultants for airlines on capex efficiency
- CE well reflects views of existing airlines, need to ensure that interests of future entrants and passengers are considered (BAA point)
- Has exceeded expectations, basis for future
 - More information, continued & productive dialogue

Scope for settlements in UK?

- Evidence that users and companies jointly determine policies for approval by regulator
 - Argentina, Florida, Canada, LUL, CAA
- Could these ideas be further applied in UK?
- Network price control reviews provide an opportunity to explore more extensively
 - Sort of precedent SHE v Offer at MMC 1995
 - consumer cttee supported SHE capex, MMC agreed

Possible price control review

- Need to identify consumer groups in each area
 - to negotiate price controls with companies
 - they may or may not agree on opex, but
 - they could focus on investment programs
 - and other aspects overlooked by regulator?
- Consumer groups would need support
 - they would need information, perhaps via regulator
 - and consultancy advice, charged to customers
- Regulation would be a backstop if necessary
 - e.g. users & companies determine items on menu & cost & choose, regulator determines mark-up (WACC)

Advantages of this process

- Less regulation, more responsive to users
- More flexibility on price control settlements
- Better relationship customers & companies
- Better tailored to local conditions
- Would allow more innovation in price control
- Shifts focus from opex to capex
- Better local monitoring of ‘capex contract’
- Lessons from comparing different experiences

Conclusions

- UK improved on US regulatory model
- but heavy on regulation and has limitations
 - local knowledge, enforcement, uniformity
- Overseas evidence that users and utilities can play a bigger role with less regulation
 - outcomes different and better than regulation
- Some encouraging signs in UK
- Could consider adopting more widely here