Roger Barnard says Ofgem should be wary of some of the easy answers being bandied about as it explores alternatives to RPI-X regulation

Model behaviour

Transmission: security of supply considerations have changed the regulatory equation

There are markets in ideas, just as there are markets in soya beans and shares. Price controls on the RPI-X incentive model were first implemented during the utility privatisations of the 1980s. They were seen as the best alternative to the direct regulation of dividends and profits. The policy objectives were to improve the efficiency and productivity of regulated companies, and to keep prices low to the consumer.

This model has since been evolved by regulators into a much more complex scheme of control over the activities and outputs of the network-based utilities that provide the basic infrastructure of modern life. But all markets overshoot, and even the best ideas can be pushed to their logical conclusion – and beyond. A big unanswered question for the utility industries, therefore, is whether RPI-X remains a stock worth holding.

Ofgem, the gas and electricity regulator, thinks this question is so important that it has set up a two-year project – the "RPI minus X at 20" review – to investigate the workings of the current approach. The review will report back with recommendations to Ofgem's governing body, the Gas and Electricity Markets Authority, in summer 2010. Its aim is to ascertain if the RPI-X model is still fit for purpose or whether, after two decades of incremental development, the regulatory framework needs more fundamental change.

Actually, Ofgem ought to have called its project the "RPI minus X at 25" review, since it is now a quarter of a century since Stephen Littlechild produced his hugely influential report for the former Department of Industry on how to regulate British Telecom's pricing after privatisation. Littlechild advocated a pseudo-competitive mechanism, in which the regulated company would be both incentivised to outperform the cost assumptions of the price control and allowed to retain the benefit of the resulting efficiency gains. This laid the foundation for the RPI-X regimes that are now in force for almost all of the monopoly industries in the utilities sector.

However, the admiration we all must have for Littlechild's great contribution to the practice of utility price regulation should not sway Ofgem from moving on. Regulatory agencies rarely question the fundamental basis of what they are doing. Inertia inside the structures of regulation, as in all fields of public administration, means that officials prefer to soldier on until a crisis erupts, at which point the available solutions are likely to be sub-optimal. So Ofgem is to be commended for conducting a review of potentially great significance, not just for the energy industry but for the utilities sector as a whole.

Two recent public workshops sponsored by Ofgem were quick to identify the key issue for the review. It is whether the RPI-X model of fixed-term price caps can continue to deliver an equitable settlement between customers and owners, while enabling gas and electricity networks to invest to meet the new security of supply and carbon reduction objectives at the heart of current energy policy. This is a debate of great national importance, and the issues with which the review will need to engage are both numerous and difficult. Here are four candidates for Ofgem's urgent attention.

First, the fashionable idea that some of the complexity of price controls can be replaced by a simpler process, in which customer groups negotiate directly with companies on the key parameters of a settlement, should be treated with caution. The recent ruling by the Competition Commission that BAA acted against the public interest in failing to "engage constructively" with airline companies about its investment plans for a second Stansted runway is clearly significant. But merely to mention this case is to highlight the fact that, in energy, there is no obvious counterparty for network operators to agree settlements with. Suppliers cannot fulfil that role because network operators have statutory duties and they do not. That is why the proxy for the customer is the regulator – Ofgem.

The parallels that are being drawn with the use of negotiated settlements overseas are also unhelpful. While it is true that negotiated price caps are possible under some state jurisdictions in America and Canada, these are an adjunct to the normal method of regulation and are made possible only through a well-defined legal framework.

This is the reverse of the situation in Britain, where the rules and standards of regulatory process are poorly defined and decision-making is often subjective and always unpredictable from one price control period to the next. In this context, negotiated settlements, far from simplifying regulation, are likely to bring even further complexity into the picture, and to result in a patchwork system of second-best outcomes.

An issue that may need greater visibility in the review is the industry's operational and financial resilience. Looking back with the benefit of hindsight, it can be seen that the evolution of the price control methodology over two decades has reflected a particularly narrow view of efficiency held by economic regulators. The real-world consequences of this have been networks that are more capacity constrained and generally older than they should be, and investment decisions that tend to be dominated by fear of regulatory disallowance. A just-in-time approach to asset renewal and enhancement leads to lower levels of industry resilience and, over time, may ultimately put whole systems at risk of catastrophic failure.

The same may also be true of the potential for external cost shocks, or other adverse economic events, to produce financial distress for network operators, especially those in group structures that are highly debt-leveraged. Gas and electricity networks are primary public goods. The scale of collateral social damage in the event of any systemic failure of an energy infrastructure provider is almost incalculable.

Luckily, as a recent position paper from Ofgem points out, the financial ring-fencing and special administration regimes for regulated energy assets have never had to be tested to destruction. But we should note that, in the implosion of banking systems over the past 18 months, regulators were at all times behind the curve, not ahead of it, and every important regulatory safeguard, both structural and behavioural, failed.

Running on empty: how much inefficiency is there left to be squeezed out of gas networks?

With tighter credit markets, regulated companies could have more difficulty in future in attracting capital for network investment needs. A sharper focus on *ex ante* measures to avoid the risk of operational or financial failure may result in a more prescriptive regulatory approach to output delivery and companies' capital structures. The greater the degree of prescription, the more important it will be for the price control process to provide adequate checks and balances for licensees. So a third issue for early attention, as you might expect from a lawyer trespassing on economists' territory, is that Ofgem should include legislative change within the scope of its review.

This issue is of general concern for utility industries. There are generic statutory provisions in place across the sector, which enable the Competition Commission to act in effect as an appeals body against price control determinations for regulated companies. The fact that there has been no reference of a disputed price control proposal for the energy industry for more than ten years strongly suggests that companies feel deterred from making use of the appeals process in the way that Parliament intended.

This is hardly surprising because, under the current system of appeal, the Competition Commission re-examines all of the issues in order to reach a fresh determination, and the company has little or no control over the terms of reference (which can be significant). A better system would be for a company to have to specify the items of difference between itself and the regulator, with the commission being required to decide in favour of one side or the other on each such item, rather like pendulum arbitration in industrial disputes. This approach – which would require new legislation – would strengthen the incentive on the regulator to ensure that its decision on each component of the methodology was correct.

A final concern is the leisurely pace of this review. Originally announced in March last year, its conclusions – which could be radical – will not be available until late in 2010, and the earliest that any major changes of approach could take effect in a price control would be the electricity transmission settlement scheduled for spring 2012. This generous timeframe, covering four years from inception to implementation, seems dangerously inconsistent with the urgency of the new national policy demands on the energy networks industry.

It is right to remind ourselves that models of regulation should not be changed without good reason, not least because of the importance of regulatory stability. Of course there must be consultation, and of course it must be detailed and extensive. But as we rightly celebrate its 25th anniversary, let us not forget that Stephen Littlechild's ground-breaking report on economic regulation was produced and submitted to the government of the day in just six weeks – and that included the Christmas holiday. ■

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Distribution: local networks will need significant investment to be able to handle renewables growth