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Utility Regulation in a Smaller System

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May 2013

Research Paper No. 12/2013

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¹ Credentials and caveats:

Iain Osborne is currently responsible for economic regulation of UK airports and air traffic control, as well as fulfilling a number of other roles as a board member of the UK Civil Aviation Authority. He has previously had overall responsibility for regulatory regimes in electricity, gas and water, and also worked at a senior level in telecommunications regulation. He has worked at European, UK and devolved levels, including as CEO of Northern Ireland's energy and water regulator. From 2009-10 he was Convenor of the Next Generation Utilities Forum and during 2012 he was Chair of the UK Joint Regulators Group.

On the principle of not marking one's own homework, nothing in this paper should be taken as directly applicable to regulation in civil aviation.

This paper is a reflection on the author's experience. It is not grounded in extensive research, but is offered in the hope that it might enrich research by others with more expertise and time.

Foreword

It has been a long haul, but worthy of all the effort. These latest research papers mark the final stage in our series of four ‘conversations’ on issues related to possible constitutional change in Scotland. We are most grateful to the ESRC for providing support for this venture; and to Professor Charlie Jeffery and colleagues at the Department for Government at the University of Edinburgh for being our partners in the venture. Along the way we have had a great deal of support from many people, including a number of DHI Trustees. Their input is much appreciated; and I must also acknowledge the major assistance provided by Catriona Laing and Joan Orr in the DHI office. Catriona has nobly worked with me on organising all the round tables and seminars and Joan has had responsibility for all the publications. The operation would not have been feasible without them.

To remind you all, each ‘conversation’ has followed a similar format. We have sought draft papers from a number of key and informed parties, to be discussed at a private round table. Then the papers have been re-visited and discussed at a full DHI seminar, with a main speaker and contributions to an extended Q&A/discussion session from all authors. Both round table and seminars were held, as is usual for our events, at the Royal Society of Edinburgh in George Street. The papers have been published on our web site just in advance of our seminars. Generally there has also been significant media interest.

The first ‘conversation’ covered issues related to macro-economic policies and financial regulation. Then we moved on to welfare and social security matters before tackling the energy sector – in co-operation with the Scottish Council for Development and Industry. Our final topic, for which we have worked closely with the Scottish Government, has been competition policy and regulation. The papers for this last conversation are now being published.

For conversation 4 the round table was held at the RSE on 8th April, ably chaired by DHI Trustee Kyla Brand – who also happens to run the Office for Fair Trading office in Edinburgh but was operating in a personal capacity. (I should also note that for over 8 years I have been a member of the Competition Commission, but my involvement was as DHI Director.) Papers were prepared by Martin Cave and Jon Stern – on the over-arching background and key issues; David Simpson (ex DHI Trustee and ex WICS board member) on the positive experience in the water sector; Iain Osborne based upon his experience as a senior regulator across five different sectors and at the EU, UK and devolved levels; Luis Correia da Silva of OXERA – providing an informed outsider’s view; the Netherlands Authority for Consumers & Markets; and David Saunders the Chief Executive of the Competition Commission specifically on competition matters. We owe a huge debt to them all.

It is my firm view that this set of papers, and the various discussions which have taken place, will be of major assistance to the Scottish Government as it considers the best way forward for competition policy and regulation in the event of a yes vote at the referendum next year; and also in the event of a no vote when there might well be scope for beneficial change and possibly further devolution of responsibilities. The whole series has been a great success and this last venture in particular should be seen as making a major positive and constructive contribution to informed decision-making and policy formation.

Nevertheless it is my eternal duty, while Director, to note that while the DHI welcomes the contribution made to debates of this nature, we have no view and as a charity can have no view on the policies considered. It is now for others to make best use of the fruit of our labours.

Jeremy A Peat
Director
David Hume Institute

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Key Points

- i. Efficiency and investment in utilities² are vital for any developed society. These fundamental industries generate a significant proportion of GDP, and are enablers for the rest; they make up a large element of household bills; they enable a comfortable life, social inclusion, learning, cultural exchange – in short, civilisation. It is therefore of vital importance for Scotland that they are subject to effective institutional frameworks. It cannot be left to chance, to make sure that they respond to society’s needs; that they are run for the benefit of the public, not that of shareholders or employees; and that instability should not needlessly raise costs.
- ii. Sound institutions are particularly important in a smaller system, and one which does not have a long-standing reputation. A sound framework will make explicit the political choices which are baked-in to any regulatory framework; and enable these choices to evolve in a controlled fashion. Pressures for change need to be allowed-for, and channelled in ways that ensure change is evolutionary, and prevent disruptive pressures building up. To enable stability, this framework must be sketched on a large enough canvas to include all the issues that make a difference – issues such as ownership and funding, environmental and social issues – not just limited to control of market power.
- iii. The conduct of regulation may be different in a smaller system. The risks of “capture” are particularly acute. It can be harder to be effective when fewer resources are available. Options to mitigate these risks are discussed.
- iv. The essay ends on an optimistic note: concluding that sound future development depends primarily on independence and stability, which in principle should be achievable also in a smaller system. (It does not depend on maintaining large teams to run highly complex regulatory processes.)

Evolution and stability

1. The utilities are part of society; because society changes, the utilities will change. Society’s priorities (e.g., regarding environmental or social protection) alter. As society gets richer, new demands emerge, as they do from shifting patterns of spatial development or new industries. Technology enables old problems to be solved in new ways.

² This term is fuzzy but useful. It relates to a clutch of economic activities that share characteristics such as: being important enablers for the rest of the economy, and having significant positive or negative externalities; being prone to market failures (natural monopoly, investment strikes); capital intensiveness; shared or common costs being important in the cost-base. It obviously includes core industries like energy and water/sewerage networks, while it shades off when one starts looking at communications and transport networks. We need not worry too much about the grey areas, so long as we recognise that they exist. The term is particularly useful in describing economic regulatory structures since these share a strong family resemblance across the utility sectors.

2. Stability is essential for the utilities. If they seek to attract private capital, the cost of that capital will be lowest if investors believe the rules of the game are known and reliable. Capital investment (across a large and complex asset base) is most efficient if planned on a programme basis, which requires confidence about funding levels across a number of years. Asset stewardship is most effective when planned over a time-frame that is a significant portion of total asset life – which, in the utilities, means decades.
3. Both the preceding statements are true, and they must be reconciled.
4. To create an independent regulator is inherently a “stability play”.
5. It is often stated that the statutes underpinning such bodies are a main pillar of this stability. This has some truth, insofar as the statute (combined with judicial oversight) hinders policy drift and a change of policy through Ministerial fiat. However, statute can be altered. The pressure on Parliamentary time and the fact that legislation makes the change highly visible and subject to scrutiny, mean governments will only take this route where a real political priority is at stake.
6. The institutional existence of a regulator also creates a strong pressure for stability. Political change often happens because it becomes convenient to all the power-players only to focus on one side of an argument. If an independent regulator exists (and its leaders are doing their job), proposals for change will be reviewed in the round. The metabolic rate of politics is much faster than that of the regulated industries, and political proposals can be hasty, while the institutional forms of regulation (including judicial scrutiny) tends to favour deliberation. Independent regulators should also be uncomfortable with arguments conducted in secret, and will tend to bring debates into the public domain where evidence can be properly scrutinised. These factors should also apply in cases where party politics are less of a consideration: regulators that are working well will not be captured by intellectual fashions but will weigh arguments for change carefully.
7. The previous paragraphs read very much as if written by a regulator! It would be self-serving to suggest that political pressure is always or only hasty or half-baked. Regulators can also sometimes become captured by a particular view of priority or way of analysing the market. This can lead them to give insufficient weight to other perspectives or pressures. There have been cases of regulators failing to give much weight to newer issues rising to prominence in society – sometimes arguing that their statutory basis does not give grounds to consider new factors, but without showing much inclination to test the proposition before the courts. Regulators have also sometimes changed approach in a way that has been seen as linked to changes of leadership. To the extent that this can clear away obstacles to progress, this can be seen as a good thing; but where it involves significant change of regulatory approach, then the link to personalities might be seen as inimical to regulatory certainty.
8. So a balanced view on stability and change would see the need for regulators to be held accountable, among other things for keeping up with events. A regulatory framework should evolve as the regulated sector evolves, which would include a capacity to place new emphasis on emerging issues, and to reflect deeper changes in social attitudes.
9. However, the pace of change that can be accommodated needs to reflect the metabolic rate of the regulated sectors – which generally have the heart-beat of a whale, not of a shrew.

For the asset-intensive industries, the minimum period over which a modest innovation can be planned and implemented might be five years; while a major change of approach can best be digested over two or three regulatory cycles (10 to 15 years).

10. For policy-makers that live by a 24-hour news cycle, and indeed for Ministers who can only expect to stay in the job for a few years (at most), this pace of change can be a source of major frustration. Making credible commitments to a policy course that is going to take several Parliaments to deliver is also a significant challenge in terms of institutional design.

Policy and institutions in Scotland

11. Utilities policy in Scotland will require some hard questions to be faced about what matters most. We can all agree that the environment must be protected, and so must the poor, and bills must be kept down, and investors given confidence. The hard choices are about what matters most; for instance:
 - a. Renewable energy technologies are not mature, and there is a respectable case for supporting them as they enter the market; but this raises bills;
 - b. Energy security and penetration of intermittent generation technologies can be reconciled, but the price of this (in terms of paying for back-up or for long-distance interconnection) may be high;
 - c. Utilities infrastructure proposals often raise green-on-green conflicts. Do we want wind-farms in beautiful, wild places, and do we want the pylons to connect them to the grid? Energy-from-waste is a key response to waste-disposal challenges as well as to energy security, but is often opposed on ecological (as well as health) grounds. Choice between environmental goods is one of the fundamental dilemmas of the water and waste-water sector, which has developed energy-intensive techniques so as to meet demanding ecological standards for river basins;
 - d. Fuel poverty is an affront to a civilised society, with implications for morbidity, social inclusion, education and other aspects of well-being. Is the average citizen prepared to pay more so as to help the poorest, and should such help be delivered through energy bills or through social security?
 - e. It is easy to drive down bills in the short-run by reducing the returns on capital. In the long run, this will mean private capital is not available. How to strike a fair balance between investors and consumers – particularly when times are hard?
12. Institutional design to some extent “bakes in” a response to set of responses to these dilemmas. For instance:
 - a. Most economic regulators (particularly in sectors that deploy private capital, and that grapple with natural monopoly so that “hold up” is a potential problem) have duties to ensure that an efficiently run company can finance itself. Thus, many of the possible answers to perceived short-run investor vs. consumer tensions are ruled out from the start;

- b. The trade-offs between economic development and the environment may be handled quite differently if the responsibility for making the trade-off is given to one organisation, or shared between several. A single body can decide the balance it considers appropriate – even if this is seen by some stakeholders as quite extreme. However, if responsibilities for consumer welfare on the one hand, and environmental protection on the other, are given to different bodies (e.g. as in the water sector), it is much more likely that the outcome will be a middle-ground compromise, mediated through public processes and very possibly through the courts;
 - c. The interests of a person as a consumer of utility services may be for a minimalist approach to externalities (so as to keep the bills down); whereas that person as a citizen might favour much more weight being placed on externalities and on the future (e.g., if she is a young person expecting still to be around when the chickens come home to roost, or a parent or grand-parent, or because of an ethical standpoint). Where these trade-offs are acute, it matters a lot to whom the regulator owes a primary duty;
 - d. It also matters considerably to the fuel poverty argument (and to issues of social inclusion more widely) whether the regulator has a duty to vulnerable people alongside its duty to the general population, and whether the former is subordinate to the latter.
13. For the reasons described earlier, once institutional frameworks are set up that embody these policy choices, they are likely to prove quite resilient. It is important that the frameworks include mechanisms for enabling evolutionary change on these points, at the right pace.
14. Over-rigid frameworks that do not allow the changing aspirations of Scottish society to be expressed are likely simply to break. It is hard to imagine a worse outcome, from the point of view of building credibility with investors and other stakeholders, than to set up a brand new regulatory system and then to tear it up in five or ten years and start again.
15. What is the right trade-off on these inherent dilemmas is a question beyond the scope of this short essay³. Some thoughts are set out, however, on how to enable evolution at the right pace.

Legislation

16. The most important way that regulators' priorities have been adjusted over the last couple of decades has been through changes to statute. A number of economic regulators were set up under Conservative administrations prior to 1997, and after that date the new Labour government tweaked their statutory duties.
17. These statutory changes were not fundamental, and their effect was not to produce a sudden change in the way the regulators operated. In fact, avoiding a perception of radical change that undermined investment confidence was one of the legislators' objectives. The changes to regulatory statute have tended more to focus on:

³ And one which the author, as an Englishman, hesitates to enter uninvited!

- a. De-politicisation. For instance, the Ministerial role in regulatory appeals has now largely disappeared, in the same way as the political role in competition matters; and
 - b. Signalling. For instance, duties on regulators to contribute to sustainable development would fall into this category. Regulators did not quickly move when given this new duty to act in a way that would clearly have been *ultra vires* without such a duty; but we have seen a progressive evolution in this direction. Regulators see themselves and rely on being seen by other stakeholders as “creatures of statute”. It is much easier for them to modify their approach when given a signal by a statutory tweak, than to do the same thing for instance in response to a Ministerial speech or White Paper.
18. However, there are significant drawbacks to this process of sending signals by modest accretions to a regulator’s statutory duties. In the short term, it often disappoints stakeholder expectations: they fight a major lobbying battle, win what they see as a Parliamentary victory... and then nothing changes very fast. In the long-run, the result can be a set of regulatory duties that are highly complex, broad, and potentially self-contradictory. In practice, a broad envelope of duties gives the regulator wide discretion to manoeuvre within – which arguably is the opposite of the original intention. Such a broad discretion may also tend to undermine regulatory certainty⁴.

Ministerial guidance

19. In the last years there has been a growing sense that the interface between regulators’ duties and big-scale policy has not operated well. One possible response could have been to see regulators’ duties “stripped back” to core economic issues; although it is not obvious, in such a case, how the inherent trade-offs mentioned above are to be managed. (Some who propose such a course would argue strongly that in any case the social factors should be seen as the function of social security, not the utilities. There is sometimes a sense that the authors of such proposals would quite like the environmental factors simply to be disregarded.)
20. Another approach focuses on the mechanisms by which Ministerial policy impinges on economic regulation. This stream of thought influenced the Principles for Economic Regulation, published by the UK Department for Business in April 2011, which are one of this administration’s most important statements on how policy should interact with regulation. The Principles deal mostly not with advice for regulators, but with how Government should act. They stress stability and independence, but also the need for accountability and for regulation to evolve as the regulated sector changes. While re-affirming the commitment to independent regulation within statutory limits, the Principles also describe a practical system for setting a balance. The most relevant sections of the Principles are as follow:

⁴ It is extremely difficult to assess regulatory certainty empirically. For what it is worth, a number of investors have told the author they see the UK regime as less clear, coherent and predictable than it was around the turn of the century.

“Government has a legitimate role to play, defining a strategic vision of the likely needs and priorities over the long term and providing a policy context for regulatory decisions in the medium and short term.”⁵

“In order to maximise the benefits from a stable regulatory system Government should offer a credible commitment to restrain itself, as strategic visions should not be changed too frequently and should be updated according to a pre-announced calendar.”⁶

“The Government therefore commits to put in place, for each regulated sector, strategy and policy statements for the individual regulators to provide context and guidance about priorities and desired outcomes. When it sets out the policy context, the Government will use that opportunity to reaffirm the fitness for purpose of the regulators’ responsibilities, pursue changes where they are required to keep the system effective and clarify the respective roles and responsibilities of regulator and Government. The Government expects to do this no more frequently than once a Parliament.”⁷

“The Government will ensure that regulators’ objectives are clear and appropriately prioritised (including through broader guidance) to reflect the issues that the regulators should take into account in their decisions. The Government will take opportunities to simplify and clarify regulators’ objectives where appropriate as and when the frameworks are reviewed. The Government will not seek to add objectives, responsibilities or duties to regulators’ remits without detailed consideration of the impact of the addition on the overall framework, and consideration of cross-sector impacts and even then only when it is clear that the addition is the optimal way to achieve the outcome sought.”⁸

21. The approach described, if followed through coherently and rigorously, offers an opportunity to manage evolutionary change in a way that does not imperil overall regime stability. The most important elements of this approach would be:
- a. A statutory role for Ministerial guidance. There must be confidence that the guidance will actually be followed by the regulator. There has been much debate over whether the duty to have regard to the guidance should be subordinate to the primary duty to consumers, equal to it or above it;
 - b. Government must in fact have a clear policy. If Government does not have a long-term vision (perhaps because it is unwilling to tackle the trade-offs and prioritisation involved in setting out such a vision), it is clearly impossible to incorporate one into Guidance. The temptation, in such a case, would be for Ministers to seek to micro-manage and address short-term issues;
 - c. The Guidance must focus on desirable outcomes (for society), not tell the regulator how to conduct its business or define the outcomes sought from individual regulatory processes;

⁵ <http://www.bis.gov.uk/assets/biscore/better-regulation/docs/p/11-795-principles-for-economic-regulation.pdf>, para 27.

⁶ *Ibid.*, para 28

⁷ *Ibid.* Commitment 3.

⁸ *Ibid.*, Commitment 5.

- d. Ministers should observe the self-denying ordinance only to give such Guidance once per Parliament, at most.
22. The first fruit of this approach is the Guidance to Ofwat on which Defra has recently consulted⁹. In many ways, this document is a positive contribution to the framework surrounding the England and Wales water industry. That sector has seen intense policy debate over a number of years and the recent White Paper, along with the Guidance, are helpful in laying down some clear lines for future development. Much of the content of the Guidance addresses issues that most would see as important strategic questions (e.g., affordability and support for the vulnerable; long-term vs., short-term investment; ecosystem services; managing water resources effectively, etc.).
23. However, the framing of the document is not as clear as it could be, and it notably fails to offer a ringing endorsement of the principle of regulatory independence. The effect of silence on this issue is magnified by some odd phraseology:
- “The principle underpinning this guidance is that high-level decisions involving political judgement are taken by the Government; whilst day-to-day regulatory decisions are undertaken independently by Ofwat.”¹⁰ This principle seems to be novel, and is absent from the relevant statute;
- “Ofwat’s duty to contribute to sustainable development (covered in further detail in section four below) requires them to act in accordance with the Government’s vision for the long term interests of our economy”¹¹ This is a highly innovative interpretation of the notion of sustainable development;
- “Ofwat must ensure that changes to the regulatory framework are consistent with Government policy and do not anticipate or pre-empt decisions regarding future reform of the sector”¹² Given the wide range of possible future decisions, and the many ways Ofwat could cut across them, taken at face value this would produce a regulator that did not seek to change much at all.
24. There is an opportunity to clarify the drafting when the guidance is finalised. It may be wise, if such guidance is to be a feature of each regulatory regime, to adopt a less discursive style in future.
25. A special case of Ministerial guidance arises where a regulated company is state-funded. In such a case, effective co-operation between the Ministerial department and the regulator is essential. Without a clear framework for co-operation, the regulator can require the department to write blank cheques; while the department (by destabilising the regulated entity, providing stop-start funding, altering desired outcomes) can effectively prevent the regulator from driving efficiency and quality. Various mechanisms have been found to address these issues:

⁹ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/82656/consult-sps-seg-doc-20121112.pdf.

¹⁰ *Ibid.*, Executive Summary paragraph iv, page 3.

¹¹ *Ibid.*, paragraph 2.12.

¹² *Ibid.*, Priority IX, page 24.

- a. In the cases of water in Scotland and rail in England and Wales¹³, legal provision exists for Ministers to set out in advance how much money is available, and the kind of outcomes that are desired. The regulator then has the task of determining how much progress should be delivered towards Ministerial goals, and holding the company to account to deliver such progress;
 - b. In the Northern Ireland water industry, a similar provision is in place underpinned by an MoU¹⁴.
26. Similar issues arise in the case of the England's¹⁵ roads network, and proposals have been made to underpin the Highways Agency with similar legal structures¹⁶. However, it is now unclear on what timescale we may see this agenda move forwards, and attention is now turning to how the worst impacts of funding instability can be mitigated.¹⁷

Personnel

27. As noted above, regulated companies sometimes see changes in approach as being linked to changes of leadership in the regulator.
28. This effect was undoubtedly present when UK regulators were first formed, and were led by single individuals as Directors-General. It is arguable that when regulators were first staking out the ground - breaking up vertically integrated monopolies, restructuring markets, and so forth - the concentration of power in individuals served a purpose. However, effectively all regulators have now switched to “plc-like” governance frameworks, with power distributed between a board, a Chair and a CEO. This switch has mitigated substantially the risk to stability from a change of personnel, although some risk persists, particularly where the Chair and the CEO change simultaneously.
29. There are some signs of a trend emerging recently for Ministers to spend more time on such appointments, including interviewing themselves quite a long list of recommended candidates. Given the short tenure many Ministers have in role, appointments to a regulatory board can often be one of the main opportunities a Minister has to influence events, and it is hard to criticise Ministers for investing time in these appointments. It may well be thought legitimate for a Minister to be particularly keen to bring onto the board certain kinds of experience, or to make sure that due weight is given by appointees to better regulation principles or to openness and engagement with stakeholders.

¹³ The Scottish water process runs under the Water Industry (Scotland) Act 2002, as amended by the Water Services etc. (Scotland) Act 2005, and these contain the powers under which Ministers commission price reviews. The England and Wales rail regulator was created by the Railways Act 1993, which

¹⁴ http://www.uregni.gov.uk/uploads/publications/MoU_UR_and_DRD_-_Nov10.pdf.

¹⁵ Check – am I right this does not include Scotland?

¹⁶ See Alan Cook’s interesting report:

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/4378/strategic-road-network.pdf.

¹⁷ This section would be stronger with a more detailed discussion and references.

However, the more Ministers engage on the detail of such appointments, the higher the bar is raised in terms of Ministers needing to demonstrate that they are not seeking to influence the regulator's approach on individual decisions.

Conducting regulation in a smaller system

30. The second half of this essay attempts to consider some issues about the practice of regulation in a smaller system. Some of the topics covered below may apply whatever the size of jurisdiction, but the author's experience¹⁸ is that they are of particular salience when the total market addressed is smaller.
31. The main differences addressed in this essay are:
 - a. A more goal-driven approach to economic development;
 - b. The greater prominence of utility companies in the local business community, and the consequent political focus on their issues;
 - c. The need to carry out regulation with fewer staff.

Goal-driven approach

32. It is self-evidently untrue that large states are always better run or thrive better than smaller ones, nor *vice versa*. However, it is generally true that the way smaller states fail or thrive is likely to be different. Smaller states need not and perhaps cannot succeed by having a wide range of reasonably successful industries, which is how large states generally earn their living. In a smaller jurisdiction, there are likely to be pressures to concentrate on a small number of world-beating industries.
33. This would not, of course, be an uncontested process – we can expect continued pressures to maintain good conditions for a wider range of industries to thrive – and there would naturally be strong competition to be one of the priority sectors. (Indeed, whether the prioritisation strategy actually succeeds depends partly on whether the political system is capable of generating consensus and resisting pressures to make everything a priority.) Nevertheless, we do see a more goal-driven approach to economic development in many smaller jurisdictions – and, indeed, see signs of this in the Scottish government's approach to energy and to the water sector. (With both sectors being identified not only as underpinning domestic economic development, but as drivers of exports and high-skill jobs.)
34. Such an approach would have particular implications for the utility infrastructure sectors. In a larger state, where the goal is broad-based development, policy priority tends to be given to enablers. That is to say, to creating the conditions in which a wide range of industries can thrive (good-value energy, good connectivity, broad skills development). If the aim is to deliver a few highly successful sectors, smaller states would need to be able to concentrate effort, aligning inputs from multiple domains (e.g., infrastructure, skills, tax...) to support the chosen sectors.

¹⁸ As noted above, this experience has been in leading regulatory regimes covering the UK as a whole (pop. 60m), and in Northern Ireland, with a population of around 1.8m. Scotland obviously falls between. This essay also draws on experience working with national regulators for telecommunications and energy, including in smaller member states around Europe, when the author worked for pan-European companies (in telecoms) and for DG Competition (in energy).

Given the risks associated with concentration on a few sectors, a smaller jurisdiction following this pattern would need to be nimble (gifted with strong analytical resources and institutions capable of adapting rapidly).

35. If such is the strategy adopted by Scotland's leaders, it will be evident that certain tensions are likely to emerge *vis-à-vis* regulatory institutions:
 - a. Focus and nimbleness can sometimes be achieved by getting leaders round a table and hammering out a deal. How does this relate to the transparent public policy processes that are the daily diet of regulators?
 - b. Regulatory statutes tend to emphasise fairness. How well does this sit with focusing support on particular sectors?
 - c. Existing approaches to regulation place primacy on the interests of users, explicitly giving these priorities over those of producers. This approach clearly prevents the consumer-base being used as a cash-cow to fund international ventures, or to soak up risk without receiving the economic reward for providing this service.

Utilities as the "jewel in the crown"

36. The pressures on regulators are likely to be particularly intense, to the extent that utility companies play a particularly important role in the local economy.
37. In many smaller jurisdictions, there are few head-offices and more branch-plants; attracting high-skilled jobs is a constant challenge; gaining real industry support for government initiatives is difficult as local management has limited flexibility. Of course, these challenges are not only or even mainly a function of being smaller – they can also relate to peripherality and perhaps a lack of competitiveness.
38. Where such conditions do apply, the importance of local utility companies to the economy and social fabric can be highly salient. They may be one of the main employers, particularly for higher-value, technical jobs. They may be one of the few local companies with flexibility and budget to support apprenticeships, sponsor voluntary or social initiatives, and to offer practical help with implementation of government policy.
39. In such conditions, these companies inevitably acquire significant political influence. Even where they do not exercise such influence, there may be a feeling that it is risky to take forceful action to create extra competition or to drive efficiency – on grounds that such action might damage a key local company. Such a perception is fallacious: the importance of the company is merely an expression of the underlying importance of utility services to the local economy, and the benefits from superior execution in these vital enabling activities are likely to outweigh by far the advantages of a strong "home team". However, taking this kind of long view implies a wide perspective, on which it can be difficult to achieve consensus.
40. These pressures can be all the greater where the state is also a shareholder in the regulated company. It is a key test of political maturity, whether a Minister can preside over a system that runs in the best interests of the community as whole, despite the fact that this can create pressures on the Minister's own budget.

41. The reader can judge to what extent these factors apply in Scotland.
42. No immediate answers are offered to these questions. Rather, the objective of this essay is to highlight them and to stress that they need to be considered in developing an institutional design which suits Scottish conditions:
 - a. It would be desirable for Scotland's leaders to consider these points, and recognise that the approaches that might seem most natural (for instance in light of lobbying by local companies) could nevertheless not be in Scotland's long-term interests;
 - b. There is little point following legacy institutional models on grounds of stability, if these do not in fact respond to the aspirations of Scotland's leaders. That would in fact be likely to produce frequent, *ad hoc*, institutional re-design, the opposite of stability.

Efficient regulation

43. One key challenge for a regulator in a smaller system is that the charge-base cannot support as many staff.
44. If the activities of a regulator were wholly scalable, this would not be a problem. However, this is not the case. Broadly, the activities of regulation can be categorised as follow:
 - a. Policy formation. This involves generating options, exploring costs and impacts, talking to stakeholders, drafting consultations, etc.. In general, these tasks are at least as demanding in smaller systems as larger ones. Where real efficiencies are feasible is when certain parts of the question can be taken as read ("we looked at this last year"; "it seems to work elsewhere so we'll do it here"). Whether this is in fact feasible is partly a question of the level and nature of appeal and/or judicial scrutiny;
 - b. Creating market structures. This typically involves implementation of complex IT systems and governance frameworks (e.g., multi-lateral contracts). Scotland's experience of water competition (and Northern Ireland's of creating a new wholesale energy market) suggests that these things can be done more cheaply in smaller systems, but it is not obvious that scale *per se* is the main driver. The costs might be lower partly because there are fewer players (particularly regarding IT systems, where every player needs to adapt its own system). However, the costs to the regulator of supervising change are probably not very different. Again, simplicity of approach is a way of reducing the overall cost both to industry players and specifically to the regulator.
 - c. Creating regulatory tools, such as price controls. There is a clear scale effect here, but it relates not to the size of the market but to the number of players in it. Setting a price control for a small water company is not much cheaper than setting one for a large one. However, setting price controls for 14 water companies at once involves more resources than doing the same for one energy transmission company. That said, the cost difference is likely to be less than 14.

Much of the detailed work (on cost of capital, technical challenges) can be done just once for a whole industry, but the task of tailoring this overall learning has to be done for each individual company.

- d. Enforcement. Such work tends to be on a case-by-case basis, so the costs relate to the number of cases. Many factors might influence this, with number of regulated companies probably not one of the main ones.
45. Overall, then, economic regulation is an activity whose costs shrink somewhat in smaller systems, but not proportionately. Funding them within a smaller system is therefore more challenging, in terms of cost-per-consumer.
 46. One response to this challenge is to foresee regulatory agencies that look after multiple sectors, an approach championed by the Scottish government. There is clear scope for savings here, if only in saving on establishment costs. In addition, there is some scope for reducing the actual costs of regulation on the grounds that tasks of regulation are similar across sectors, and can be done once for all, not multiple times.
 47. To what extent, though, is that actually true? Getting a clear perspective on this question is challenging since most people approach it through the lens of a particular industry, and each industry sees itself as unique and special. The author has seen two attempts in the UK in recent years to address this question:
 - a. The Northern Ireland Authority for Utility Regulation published a study on how it regulated networks across both energy and water. The study considered whether to adopt a range of proposals from other jurisdictions, and also identified where practice within the Utility Regulator in one sector could learn from the others. For instance, energy regulation has learned from water to be more explicit in specification of outcomes; and has introduced a Reporter role, following the energy tradition;¹⁹
 - b. The UK Joint Regulators' Group conducted a series of studies (collectively called Project Splice) to compare the approaches of its members to issues like cost-of-capital, benchmarking, and approving charges²⁰. These studies demonstrated that some differences arise from genuine differences in the sectors in question; some from differences in statutory framework, while there was no evident rationale for some differences which appear to relate to legacy.
 - c. The Scottish government has looked at international examples of converged regulators, but has not so far published much on the how regulation is conducted in practice within such institutions. This may be a fruitful area for future research.
 48. One of the strong impressions created by reviewing the Joint Regulators Group work on this theme is of the complexity of regulatory regimes. These have evolved over many years. To some extent differences have evolved because of differences in the sectors. However, it must be admitted that there is little strong countervailing influence towards either coherence or simplicity.

¹⁹ http://www.uregni.gov.uk/uploads/publications/Proposals_for_a_cross_utility_approach_to_network_price_controls.pdf.

²⁰ JRG does not have its own web-presence, but its work can in principle be found on the web pages of each of its member organisations – for instance, see <http://www.caa.co.uk/default.aspx?catid=2552>.

No regulator has a statutory duty to co-operate, either on grounds of efficiency or coherence. To master the range of approaches between JRG members on a few topics, and to compare them, required a very substantial professional effort. It must be open to doubt whether such an effort is within the reach of any of the main stakeholders, and whether the consequent near-impossibility of grasping the UK framework as a whole is good for industry, investors or communities.

Conclusions

49. To conclude, the themes of this essay are drawn together:

- a. Institutional design must be built on a realistic view of Scotland's underlying policy aims. Ducking that debate before institutions are created will set up decades of instability;
- b. Mechanisms exist to ensure that, at any given time, the goals and priorities of the system are clear. This is partly a question of statutory drafting, but also a role is foreseen for Ministers - who must play this part in a way that leaves clear space within which independent regulation can operate. Utility policy needs to evolve at the pace of the utility sectors, not at the pace that suits politics;
- c. Regulatory institutions will face resource challenges. Creating multi-sectoral regulators seems a sensible response to this challenge. However, a main way to keep the resource-load manageable is to deliver policy aims through simple and aligned regulatory approaches.

50. Simplicity is in fact a common theme:

- a. No stakeholder should welcome a framework where political factors were subterranean: so that alongside the explicit rules, there was another set of real rules; as well as the statutory decision-maker, other people were pulling the strings. That would be a paradise for lobbyists, but a waste of time for everyone else, and likely to produce fragmented and contradictory policy.
- b. Ministerial policy will ring true, and create clear space for regulation, where it has clean lines and a strong logic. It is an indicator of failure when Ministers feel the need to address every controversy of today, when setting out their goals for the coming decade or two.
- c. Simple regulatory rules - derived from a coherent and empirical analysis of the market and of the consumer interest, and applied robustly - are what deliver most of the benefit of regulation. Complex analytical models have their place, but they are the icing not the cake.

51. A fresh approach to Scotland's regulatory institutions is a great opportunity. With rigour of thought and open-mindedness, a framework can be designed that answers these questions with, if anything, greater clarity than before. Scotland does not need to reproduce the complexity of the UK's approach to these issues, but rather to produce clear and simple answers – ones that can be explained to any sixth-former – to the classic questions:

In whose interests is the sector's evolution being steered?

Who is in charge, and how are they held accountable?

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