

Regulatory Policy Institute Westminster Conference
Too busy to think? Entropic processes in regulatory policies
One Great George Street, 3 May 2017

Programme notes

The working title for this year's RPI Westminster Conference is somewhat cryptic. The original thought comes from Richard Rumelt's book, *Good Strategy Bad Strategy: The Difference and Why it Matters*. The citations that follow are drawn from this book.

Rumelt was concerned chiefly with business strategy, but the introduction to the book opens with reference to the Battle of Trafalgar and quickly follows that up with comments on public monetary and financial policy strategy in 2008. It's therefore safe to conclude that the author believed that the central concepts of his work had wider applicability, and regulatory and competition policy strategies are obvious candidate areas for such applications.

Rumelt introduced the notion of a strategy 'kernel' – roughly the bare bones skeleton on which all else hangs – comprising three elements:

- A diagnosis that defines/explains the nature of the challenge(s).
- A guiding policy for dealing with the challenge(s) and for overcoming obstacles/barriers lying in the way.
- A set of coherent actions that are designed to carry out the guiding policy.

The kernel is therefore a mixture of thought and action. The question *Too Busy to Think?* is a way of asking whether enough thought (cognitive effort) is systematically applied to these three elements lying at the centre of a policy strategy.

Arguably, what is observed in practice is mostly bad strategy:

“Strategy is scarcity's child and to have a strategy, rather than vague aspirations, is to choose one path and eschew others.”

“The creeping spread of bad strategy affects us all. Heavy with goals and slogans, the national government has become less and less able to solve problems rich with targets and standards, but poor in comprehending and countering the sources of underperformance.”

The potentially good news here is that the near ubiquitous presence of bad policy strategy serves to greatly leverage the payoffs from good policy strategy. (Whether those responsible for such leverage are afforded credit for their achievements is another matter entirely.)

The working themes of the May Conference derive from Chapter 14 of Rumelt's book, “Inertia and Entropy”.

“In business, inertia is an organization's unwillingness or inability to adapt to changing circumstances. Even with change programs running at full throttle, it can take many years to alter a large company's basic functioning.”

This observation gives rise to an immediate question. Other things equal, we might expect the degree of inertia to be positively correlated with organizational size. Yet much

contemporary discourse in regulation and competition policy is focused on perceived problems of consumer/household inertia. Since households are rather small-scale social structures, is there perhaps a ‘beams and motes’ cognitive bias at work here?

Given the existence of inertia, some of the implications of disruption in an economic environment are obvious: a policy strategy can become unfit for purpose over time. In conferences past the term ‘stranded regulation’ has been applied to such a development, and this can happen much more quickly if the environmental change is itself rapid. ‘Stranded regulation’ can also become dysfunctional: a stranded asset may have little or no value, but a stranded policy can very easily become a barrier to economic progress, i.e. be of negative economic value.

In regulatory contexts, the normal effects of organisational inertia are often reinforced by arguments based on requirements for regulatory certainty. There are clearly trade-offs to consider in this area, but it is not immediately obvious that a regulatory strategy that is out-of-sync with changing commercial realities will afford greater certainty for investors than one that is more adaptive.

Rumelt, however, focuses on a different aspect of a disorderly (entropic) policy strategy:

“Were organizational inertia the whole story, a well-adapted corporation would remain healthy and efficient as long as the outside world remained unchanged ... [but] weakly managed organizations tend to become less organized and focused. Entropy makes it necessary for leaders to constantly work on maintaining an organization’s purpose, form and methods even if there are not changes in strategy or competition.”

There is an echo of George Orwell here – “to see what is in front of one’s nose needs a constant struggle”, i.e. the work to be done encompasses constant application of cognitive effort, even in more static economic contexts.

The fairness focus in the conference programme reflects this second point. Fairness issues have been with us for centuries – see the notion of the ‘just price’ price in medieval scholasticism and the ‘fair and reasonable’ prices of later utility regulation – and they are likely to be with us for as far into the future as we can realistically hope to see.

The sort of problems that can develop even in the absence of any requirement for major adaptation in regulatory strategy is signalled in a recent letter to the Daily Telegraph by five former GB energy regulators, attached below with permission of that newspaper.

In effect, in 2008/9 Ofgem/GEMA introduced a novel concept of fairness into its regulatory strategy for retail markets and thereby initiated a protracted entropic process. That process may have exhibited a further step jump in the general direction of disorder by the time of the conference on 3 May 2017. We wait to see.

The regulators’ letter focuses on the subsequent effects of the shift from good strategy to bad strategy, but the significance of the interpretation of the notion of “fairness” in giving rise to the process was also fully recognised at the time (see the attached extract from a paper circulated by George Yarrow when the relevant matters were in contemplation).

28 March 2017

Attachments

We must resist the temptation to intervene on energy prices

The Government is preparing to “step in” because the energy market is “manifestly not working” for customers. As former British energy regulators, we want this market to be properly understood, and lessons to be learnt from past experience.

We have been here before. The chief executive of EnergyWatch expressed the same concern in 2008. Retail competition had been successfully introduced in the late 1990s but from 2004 prices rose rapidly. These were driven by rising global gas prices and by increasing social and environmental obligations on suppliers. But there was pressure to Do Something.

Ofgem’s 2008 probe found “unfair price differentials” totalling £500m. Ofgem introduced a non-discrimination condition. The price differentials disappeared – but by increases in the lower prices, not reductions in the higher ones.

Suppliers competed by introducing new tariffs. Ofgem argued that these baffled customers. In 2012 Ofgem introduced a “simple tariffs” policy that limited the number and variety of tariffs. This did not assuage public concern, or restore the previous customer switching rate.

In 2014 Ofgem asked the Competition and Markets Authority (CMA) to investigate the energy market. In 2016 the CMA reported that Ofgem’s “simple tariffs” policy had had an adverse effect on competition. It limited tariff variety, innovation and price competition. The CMA required Ofgem to end this policy.

There remains a major and understandable public concern that retail energy profits are too high, and most large suppliers have recently increased prices. But two of the six large suppliers have consistently made retail losses over the last eight years.

The CMA’s investigation did find that there were customer detriments of £1bn to £2bn per year. But these were not conventional estimates of excess prices or profits. They were estimates of how much lower prices could be if the large suppliers were more efficient, as the CMA thought they should be.

The CMA acknowledged this, and identified a consequent problem with price control. “A large part of the detriment we have observed in the form of high prices is likely due to inefficiency rather than excess profits, such that if we were to eliminate the entirety of the detriment we have observed through a price cap it would create substantial losses for the sector as a whole.”

Another public concern is that price differentials are unfair. Loyal customers on standard variable tariffs are charged more than customers who shop around and choose short-period fixed-price tariffs.

But differential prices, and discounts and cheaper products to keep the most active customers and attract new customers, are standard practice in many industries with overhead costs to cover. The undiscounted prices, too, are subject to competition, not least from over 50 new

entrants, most of whom are still exempt from significant social and environmental costs imposed on larger suppliers. Retail energy profits are not excessive, loyal customers are not being ripped off, and there is no need to pressure consumers to be more active.

There is concern that poorer customers are less engaged and on the worst deals. Until 2008, switching rates were similar across the socio-economic range. Ofgem's crackdown on doorstep selling led suppliers to move to online channels that excluded some poorer customers. But many new entrants are once again reaching these customers, using iPads to comply better with Ofgem's direct marketing rules and prevent mis-selling.

Many local authorities, customer organisations and switching sites are also reaching out to poorer or less engaged customers, to enable them to benefit fully from the competitive market. Energy prices have indeed gone up, which is a legitimate worry to customers, politicians and government. But the main determinants of energy prices are fuel costs, regulated distribution and transmission network costs, and the costs of environmental and social obligations.

Retail suppliers must recover these costs as well as their own costs: it is no use shooting the messenger. Competition is increasingly forcing all suppliers to be more efficient and to pass these benefits to customers.

The CMA majority concluded that a wide price cap would – even during a transitional period – “undermine the competitive process, potentially resulting in worse outcomes for customers in the long run. This risk might occur through a combination of reducing the incentives of customers to engage, reducing the incentives of suppliers to compete, and an increase in regulatory risk.”

The temptation to intervene further should therefore be resisted. The evidence is clear: regulatory interventions have been counterproductive. Retail energy price controls would have an adverse effect on a market that is working better than is generally realised – and would have ominous implications for other markets.

Stephen Littlechild, Sir Callum McCarthy, Eileen Marshall CBE, Stephen Smith, Clare Spottiswoode CBE

Letter to the Daily Telegraph, 22 March 2017

11. *Another notable, differentiating feature of this policy exercise is the persistent use of the word “unfair”, a word with notoriously elastic meaning and with a dark side to its history (e.g. the role of the alleged “unfairness” of foreign imports in promoting protectionist measures that contributed so much to the Great Depression; the role of the perceived “unfairness” of the Treaty of Versailles and of the effects of the Great Depression in the rise of National Socialism; etc.). The January consultation document is awash with references to “unfair price differentials” (about forty times in the text of this short document, plus as a header on every page, making seventy-eight references in all), and to a lesser extent with references to “undue price*

discrimination”. Indeed, the constant repetition of the “unfairness” of it all comes to feel like a form of psychological harassment, or maybe an inducement to feelings of victimhood. Yet nowhere is anything approximating a workable definition of “unfairness” offered, such as might lead to an administrable regulation. We should, I think, all feel very uncomfortable about this apparent step, however small it is, away from reason and evidence and toward propaganda.

12. *The notion of “unfair pricing” has, in fact, been given meaning by the European Court of Justice, and in the domestic courts there is good discussion of some of the (difficult) issues involved in the Attheraces v. British Horseracing Board case. The consultation document makes it plain however that the current proposal in relation to undue price discrimination wants nothing to do with these competition-based meanings of “unfairness”. Ofgem apparently does not want its powers to be circumscribed by such law.*
13. *The proposals have other ideas in mind, but what those ideas are we are, for the most part, left to guess, based only on promises of clear guidance later. Economists and lawyers at the European Commission (and many academics) have struggled for years to develop clearer guidance on price discrimination in the enforcement of Treaty Law to dominant firms, but have largely failed. The Authority can therefore have no reasonable basis for an expectation that promises on guidance could be met in a satisfactory way, and to my mind the making of such promises would amount to a false regulatory prospectus.*
14. *It is possible, though by no means certain (since meanings appear to be constantly shifting) that the proposal on undue price discrimination is seeking to interpret “unfairness” as equivalent to ‘significant deviations of price ratios from attributable cost relativities’. If so, that would be an extremely odd approach. Discrimination very frequently takes the form of pricing according to willingness to pay, and in many market contexts willingness to pay is positively correlated with ability to pay (again a point that has been made by Professor Waddams – see the above comments on pre-payment prices). The result is that market processes frequently deliver what might be classified as “discriminatory but progressive” pricing structures (those less able to pay pay less – see senior citizen and student discounts, ‘value items’ on supermarket shelves, etc, etc, etc.); and it would be unusual to hear these discriminatory structures being described as “unfair”.*

Extract from an informal paper circulated to GEMA colleagues by George Yarrow in the context of assessment of proposed measures to prohibit undue price discrimination (2008/9).

Further details of the conference are available on the RPI website rpieurope.org