

# Some reflections on the evolution of network price determination processes

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Regulatory Policy 25<sup>th</sup> Anniversary Conference,  
Merton College, Oxford 13 September 2016

# Setting REC price controls

- 1983 proposed RPI-X, how to determine X?
  - How hard can it be?
  - Not precise, reassurance to investors & customers
- 1990s electricity price controls - ask BC
- Duty to promote interests of customers
  - Take to limit of what BT would accept
- Need more explanation for 12/14 RECs
- Confrontational: how far appropriate given role to balance interests of customers & investors?
- But what was the alternative?

# Option 1 Beesley approach

- Aim: forward-looking approach, not based on cost-plus or rate of return on existing capital
- Projected efficient opex & capex
- What is maximum X that will enable company to meet demand at specified quality of service standards & finance necessary new investment?
- This meant judgements on dividend coverage, dividend policy, stock market value
- One step too far for a regulator?

# Option 2 Horton approach

- Allowed revenue should cover projected efficient opex & allow return on efficient capex
  - & return of existing capital (to avoid “depreciation”)
- Rate of return model – but mostly forward-looking
- Endorsed by MMC, later widely accepted as building block model (esp Australia), GH deserves credit
  - Query: other industries eg telecoms, water etc?
- Enabled innovative initial Po price cut
  - Price path reflects costs in period, not cost at end
  - Reduced prices quicker than X alone – important in elec

# Application to REC controls

- Initial company proposals very undemanding
- SCL response opposite: toughest assumptions
- Letter leaked: share prices fell
- Review proceeded & proposals drawn up
  - Assumptions on opex, capex, cost of capital
- What value of vesting assets
  - CCA? Too high. HCA? Not available.
  - What investors paid? Adjust up for rise in stock market

# Price control proposals 1994

- Original price controls for 12 RECs
  - range RPI – 0% to RPI+2.5%
- Aug 1994 proposals
  - Po cuts range 11-17%, then RPI-2% for all
  - Most significant price cuts for regulated industry?
  - Should be good for customers?
- Share price increases
  - + 6% on the day, +9% first week, +19% end Aug

# Defending the initial proposals

- $X = 2$  too low? But with  $P_0$ , equivalent to range RPI- 5.5% to RPI-7.5%
  - Worth £2.5bn to customers (relative to end-period prices)
- Nov 1994 Explanation of share price rises
  - Leaked letter implied  $P_0$  20% then RPI-4%
  - Not plausible, so share prices at false level
  - This explained half (9% of 19%) share price increase
  - Increased regulatory certainty explained rest
  - Important not to claw back past profits

# Northern Electric takeover bid

- Dec 1994 Trafalgar House bid for Northern Electric – share price increases
- Feb 1995 NE defence document
  - promises to increase borrowing, repay £5/share, & keep shares - more share price increases
- Widespread view – regulator got it wrong
- What to do: resign, hold out or reopen review? All had serious disadvantages



# Reopening the price control review

- Reopen – undermine principle of RPI-X regulation? No, still in consultation, recall Oftel, new information
- “Good well-understood data missing”? No
  - UK regulation not about actual “data”.
  - Updated info confirmed judgements about opex & capex. Cost of capital OK too
- Seemed too generous, unacceptable. So need to tighten
- MMC/SHE – don’t allow severance payments in opex
  - So could increase X from 2% to 3%
- MMC/SHE – don’t adjust up value vesting assets
  - So could increase Po cut by further 10% to 13%
- Revised proposal, net effect 30% price fall 5 yrs
  - Could that have been achieved initial proposal? Doubtful

# Reflections

- Setting X price caps not straightforward - very hard
- Arduous time-consuming process – sensible?
  - 1 year out of 5 reasonable, but not 3, 4, 5 yrs?
- Confidentiality won't hold for 12 cos – open discussion
- Stock market response can be helpful
  - Condition market expectations
- Is there “right” price control based on “data”? No
- Need a price control that is “acceptable”
- Is there a better process to achieve that?
  - negotiated settlements N America (Florida, NEB Canada, FERC), also CAA constructive engagement
  - role of regulator to facilitate acceptable outcome

# Recent UK approaches

- Ofgem, Ofwat, WICS customer engagement
- Regulators' have been cautious: Will customers get it right? Surely regulator's job to make decisions?
- Price control process as rivalrous discovery process?
  - Information/guidelines from regulator
  - Let companies & customers innovate, negotiate, compare proposals & responses of others
  - including stock market investors
  - Learning process over time, for all parties
- “Acceptability” important as well as efficiency