Beesley Regulation Lectures 2010

Regulating a state owned company: can we create the right incentives?

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Introduction

- A prediction from 1994:
  - “Even without politically driven changes, however, I think it is interesting to speculate whether 10 years or so hence the Beesley Lectures, as I am sure these splendid occasions will come to be called, will actually need a slot for a railway regulator.” (Ian Jones)
- I will range widely, and not be constrained by the title!

What are ‘the right incentives’?

- Delivering the ‘public interest’
  - protecting the interests of consumers
  - sustainability etc
- Specifically
  - meeting reasonable requirements
  - doing this efficiently
  - ability to finance

A hypothesis

- Effective regulation of state owned companies depends on:
  - a distinction between the Government's role in setting sector strategy and its role as shareholder
  - clear objectives and a hard budget constraint; and
  - an appropriate regulatory framework which includes realistic sanctions for poor performance.
- And, if these conditions are met, the outcome is likely to be better for customers and taxpayers than if the company is in the private sector but, for whatever reason, ineffectively regulated.

1: The two roles of the state must be clearly distinguished

- Strategy and ownership
- The NAO view of the challenge this creates
  - “Balancing public policy and shareholder value objectives ... is difficult. As a customer, the Government can sometimes benefit from the delivery of policy objectives at a price below the real cost to the business. “
- Clarity of Government strategy and expectations?
- Dieter Helm’s view:
  - In infrastructure sectors “there are multiple market failures, which together are sufficient to conclude that the private sector, left to its own devices, will produce a seriously sub-optimal level of provision. Put simply, there will be inadequate energy, transport, communications and water networks, to the detriment of consumers and industry.”

The role of IUK and the National Infrastructure Plan

- James Sassoon's assessment:
  - "For several decades, the UK's approach to infrastructure investment has in general been timid, uncoordinated, incremental, wasteful in its procurement and insufficiently targeted to supporting balanced and sustainable growth in the economy, both economically and environmentally. The result is that our infrastructure is ageing, plans are unclear and costs are too high."
- The need for, and limitations of, a NIP
- Sector-specific examples
- Clarity, transparency and commitment are key

An example: Guernsey electricity

- Debate over appropriate regulatory value (and impact on electricity prices)
- Independent expert panel: Byatt, Newbery and Bolt
- Two key recommendations on governance:
  - "It would be more appropriate to distinguish the roles of Treasury and Resources Department as shareholder and Commerce and Employment Department as responsible for energy policy and for regulation"; and
  - "We consider that a distinction should be made between the shareholder's policies in respect of financing and the protection of customer interest, and the basis on which price limits are set to promote efficient operation by GEL and energy use by consumers."

2: The company must have a hard budget constraint

- Distinguishing between taxpayers and consumers?
- How far can risk be transferred to the private sector:
  - “we ask [regulators] to review not just procedure but also strategy in the companies over which they exercise prudential supervision. All this in a context in which they are accountable to ministers and parliament for their behaviour and their failures. We expect the taxpayer to take financial responsibility for these failures. There is a name for that policy. It is nationalisation.” (John Kay)
- Ineffectiveness of sanctions: incentives depend on effect on management pay and on reputation

Some examples

- Network Rail
- The London Underground PPP:
  - “The failure of the London Underground Metronet PPP gave private finance projects in general a bad name. Yet this project was exceptional because huge debt guarantees together with a typically narrow equity base limited risk transfer. We recommend that the state should not guarantee large amounts, and a high proportion, of debt as a means to make highly geared PPPs happen.” (HoL EA Committee)
- Scottish Water
  - “We in Scotland have achieved ministerial acceptance of the policy that ‘customers should not pay twice’. This gives a powerful incentive to the owner, the Scottish Executive.” (Ian Byatt)

3: The form of regulation is key

- Contracts v licences
  - effects on flexibility and effectiveness of processes?
- Key issue is powers of regulator to take action
  - Arbiter could prepare for references, but only give guidance or direction when asked
  - problem reinforced by ambiguous position of Mayor

4: The lessons of the past must not be forgotten

- "Those who cannot remember the past are condemned to repeat it” (George Santayana)
- Herbert Morrison’s vision:
  - “Transport is or ought to be a very lively and adaptable industry. It has intimate contact with the public. It is important that it should be quick to respond wherever possible to public wishes and desires. Transport is a vital instrument of trade and commerce. It is desirable it should be able with speed and decision to adapt itself to the changing needs of the modern world”

The nationalised industry reality

- Stewart Joy:
  - "The British Transport Commission assumed that virtually all the existing railway services would be provided for an indefinite period, and that if users would not pay their full cost, taxpayers would be forced to"
- Christopher Foster:
  - "The chairmen and boards of nationalised industries had a great practical independence [which] they used to pursue what they believed to be the interests of their public corporation. For them that, not the interests of the public, as Herbert Morrison or changeable Ministers conceived them, or the improvement of economic efficiency, was the public interest."

The Shareholder Executive

- Formed in 2003 to act as a professional 'institutional investor'
- The NAO assessment:
  - "The Executive can hold management to account for the performance of businesses by using several 'shareholder levers', which include: selecting the Chair and Board members; approving transparent business objectives that respect policy constraints; and agreeing finance for investment."
- Limitations:
  - new funding requires HMT approval
  - political pressures eg executive pay
  - inability to sell

Conclusions

- Conditions for the effectiveness of regulation of state owned companies
- These will also be relevant if the RAB model is extended as discussed in the NIP
  - real issue is regulation of ‘state owned risk’
- But don’t think privatisation solves all the problems:
  - “The programme of privatising major utilities was driven primarily by political and bureaucratic self-interest and heavily influenced by producer pressure groups.” (Colin Robinson, 1992)