The future of independent economic regulation

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Thank you. I want to start by saying thank you to Martin Lodge and to the esteemed Centre for the Analysis of Risk and Regulation here at LSE for hosting me here this evening. The Centre makes a great contribution to learning across regulators, and I'd class it is a 'critical friend' in the true spirit.

My topic for this lecture is the future of independent economic regulation. And if you are reading into that title that I think independent economic regulation *has* a future – you would be right. Although I do think its future will be very different to its past.

My starting point is that it makes no sense to think about the future of independent economic regulation in isolation – it is (and always was) part of a wider system of governance around a set of essential public services that are provided by the private sector (which I will refer to in short hand form as 'public utilities' though I think that brushes over some of the complexity of what they do). So, in thinking about the future of independent economic regulation it makes sense to think about how that whole system is evolving and then to think about what this means for economic regulation.

I will start with a very brief recap on the context in which independent economic regulators were set up in the UK and a (fairly broad brush) overview of the governance system that was put in place alongside them.

I then want to talk about some of the key changes to that system – changes in what it is there for, changes in the roles of some of the key players within in and finally changes in the nature of the system itself.

And I will then sum up by discussing the implications of these changes for independent economic regulation and the challenges and opportunities that brings.

Some ground clearing

Before I get into any of that – a little bit of ground clearing.

I know any good essay about independent economic regulation would start by defining that key term. But I'm not going to do that. Because as you will see I think the very essence of what independent economic regulation is is changing, so to define it upfront would be self-defeating.

But what I should make clear is that I am talking here exclusively about the UK.

And I am talking primarily about independent economic regulation as it applies to public utilities (remember I'm using that as a short hand!). I know the bounds economic regulation these days are set higher and wider, and I'm sure a lot of the points that I will make will be relevant for those new frontiers in economic regulation, but in developing my thinking it has been the more traditional applications I have been thinking of.

I should make clear is that this is very much a practitioner's perspective. If you are expecting an erudite academic treatise, now is the time to leave. But I do hope that what I have to say will be no less useful for that. Indeed, I'm often reminded of one my favourite quotes from David Newbery who said back in 1997 that in regulation 'practice, which is evolving rapidly, continues to outstrip theory, providing challenges to the [economics] profession in modelling, testing and proposing superior and workable alternatives.'[1] Maybe one or two challenges will come from the perspective I'm offering tonight?

The final piece of ground clearing I ought to do is to make clear that this is not intended to be any grand state of the nation piece. I have modest aims. I merely want to observe some of the changes I see as happening in and around independent economic regulation, try to distil some themes from that and share some thoughts about what it all might mean.

Independent economic regulation UK-style – the original model

To understand where regulation is going we need to pause for a moment on where it came from. Independent economic regulation was the solution to a very particular problem at a very particular time and in public policy terms the thinking was inextricably bound up with privatisation and competition.

[1] Newbery, 1997 'Rate of return regulation versus price regulation for public utilities', Dept of Applied Economics, University of Cambridge

The failings of state owned industries especially through the 1970s were widely recognised at the time as linked to their ownership structures. In contrast, shareholders would respond to the incentives they faced to create value in their companies, company boards would respond to shareholders by creating incentives on management and instilling private-sector management disciplines, and the result would be greater efficiency and better service with no recourse to the public purse.

And the introduction of a new governance model within public utility companies was complemented by new governance around those companies. In which independent economic regulators were to play a key role.

In some of those sectors and in some parts of the value chain it was envisaged that competition would serve to align the interests of shareholders and customers. And regulators here would promote competition.

In other sectors (such as water, where competition was not originally envisaged). In other 'natural monopoly' parts of the value chain (commonly 'pipes and wires'), and where competition had not yet taken hold, the regulatory framework would act more directly to align the interests of shareholders with those of customers. Regulators would set price controls that included an efficiency challenge but would leave scope for companies to profit by outperformance and reveal new efficiency frontiers that would benefit customers at the next review. Regulators would set standards and enforce obligations such that firms not complying would feel the force of financial penalties.

Government was not absent from this governance model. But it operated at one step removed.

The policy framework of privatisation, competition and regulation was owned by government. Government proposed the legislative framework, enacted by parliament, that enabled the privatisations to happen, that created economic regulators and gave them their statutory duties – principally the promotion of competition and the protection of consumers.

But government understood that if privatisation were to succeed the incentives and private sector management disciplines it relied on needed to be given space to play out. And that day to day government intervention would be unhelpful. It also understood that it needed a credible pre-commitment strategy to avoid investors and company management simply factoring in what they would see as the likelihood of government intervention – which would at best hamper those private managers from really delivering better service and efficiency and worst would undermine the viability of these new companies as investment propositions. And so economic regulators were created as independent of government.

Independent never meant unaccountable. Reflecting the importance of public utilities for the whole of our society and economy, regulators were created accountable to parliament - crucially rather than government. This quite reasonably gave our democratically elected representatives a mechanism to convey their views about what regulators were doing and what they were delivering, while avoiding undermining that the benefits of independence from government. And the regulators' decisions were subject to both judicial review and in some cases, such as price controls, specialist appeals more on the merits.

Crudely characterised, then, in their original conception, regulators were charged with promoting competition and protecting consumers. And they could broadly rely on the power of financial incentives acting on shareholders, who would align their interests with company management to make stuff happen. And they were largely left to get on with that job by government.

So, if that was the past, where is the future taking us? I want to take about three drivers for change here that stem from changes that are taking place in that whole system of governance, but which have profound implications for the role of independent economic regulators within in.

I want to talk first about what I see as a shift in the public policy purpose of that system of governance. Then I want to talk about the shift in roles and responsibilities of various other actors within that system and what implications this has for regulators. And then I want to talk about the changing nature of the dynamic across the whole system.

A changing purpose

So let's start by talking about that shift in the public policy purpose of the whole system of governance around public utilities. Because that is probably the most profound shift and it drives many other things. And I want to be clear before I get into it that I am not talking here about changes in regulators' statutory duties – they have changed, some more than others – but rather about what the public is looking for from these critical sectors and how it expects to see that delivered.

You can read better informed and more eloquent commentators on the referendum result and indeed the recent election result than I. But of the things I think we are seeing in many parts of political and economic life right now is people asking some very fundamental questions about the sort of society and the sort of economy we want to be. I'm referring to them together, by the way, because I just don't think they make any sense apart - the idea that 'economic policy' (which should be left to expert economists) can somehow be considered distinct from 'social policy' (which more rightly has a political dimension) is just bunk.

At some point we may have a government that wants to revisit the whole question of private provision of public utilities. We got rather closer to that in the last election than many thought we would. But even absent that, this shift in the public debate has given some regulators – us included – pause for thought. At Ofwat it has prompted us to go back to first principles, look back beyond our statutory duties and into the wider public policy context in which we operate and ask ourselves the big question, which is 'what are we for?'. Which, we concluded, is ultimately to ensure that the public have trust and confidence in (privately-provided) water and waste water services. That is our vision for the sector and it is why our strategy is called 'trust in water'.

Yes, enabling and incentivising efficiency is a big part of that. And so is holding companies to account for complying with the law and delivering against their promises to customers.

But even in respect of what customers and society get from their service providers, it is about much more than that. Because now more than ever people's expectations are rising – the products and services they expect are changing, becoming more personalised, more targetted and more reflective of their needs. We don't live today in a society where a regulator can hope to do enough by doing some customer research and writing some service standards and introducing a licence obligation to deliver against them. Regulation needs to inform, enable and incentivise genuine innovation.

And we need to look beyond this too. Because it isn't just the 'what' that matters for trust and confidence, it is the 'how'. The relationships that services providers have with their customers matter enormously - the extent to which they are part of the communities they serve, the extent to which customers and wider society feel their service providers are accountable. And if people look at the governance structures within these companies and look at what they are reporting and don't feel confident they are operating in the public interest, they worry. That trust and confidence – such a fragile thing – gets chipped away.

If you replace 'consumer surplus' or even 'total welfare' as the regulator's maximand with 'trust and confidence' you get a very different regulatory model. Value for money and holding to account against obligations remain a critical part of it – that trust and confidence needs to be grounded in reality not a PR exercise. And there are some drivers of trust and confidence, especially where they are linked to question of distributional 'fairness' that I think regulators should be wary of and leave to others, such as government. But there is no doubt that taking trust and confidence as our purpose does suggest a broader remit and a wider tool kit. And crucially it takes us beyond any idea that in order to make regulation more effective all we need is more, better quality data, and a bigger spreadsheet to put it in…

A changing system

As I said before, if the public policy purpose of that whole system of governance around public utilities is shifting, it has implications for the role of others in that system too. Let's talk about that now.

Government

A lot of the debate in regulatory circles has focussed on the more activist role being taken by government. And it can sound sometimes as though the regulatory community feels rather threatened by it. You hear discussion sometimes about how those in government circles – not only the politicians but the officials too - have 'forgotten' about why we have independent economic regulation, and about how we need to a better job in reminding them of all of its achievements and strengths.

There may be an element of truth to that. But it misses the big point. If as a country we are asking ourselves what sort of society and economy we want to be, it is hardly surprising that we are seeing government taking a keener interest and involvement in questions both of what gets delivered and how it gets delivered.

And when it comes to questions of nationally strategic infrastructure investment, when it comes to questions of distributional impacts, there are questions that involve major externalities both as between different parts of our economy and society and between generations, so there is a space here that government needs to fill.

Frankly it seems odd to me that government was as absent as it was for so long. With public utilities delivering substantial improvements in service and investment, with no pull on the public purse, and with relatively benign economic conditions, you can see why government through the 1990s perhaps didn't see a need to intervene. And I can see why they might have been concerned not to do any injury to the independent economic regulatory goose that was laying the golden egg. But these are politically salient sectors, and there are issues here that seem entirely appropriate for our democratically elected representatives to have a view on and quite possibly a say in.

But there is no doubt that government today is playing a more active role. And there is a different interface now between government and regulators. We need to get used to it, and we need to work with government to figure out our respective roles.

The legislative framework exists for most of the economic regulators now to get a 'Strategic Policy Statement' from government. We were the first regulator to get one back in 2012. And they set out what government sees as the principal high level priorities for regulation of the sector.

The National Infrastructure Commission – an executive agency of HM Treasury – takes a national strategic view on infrastructure need and regulators are required to have regard to this in their work.

These are very significant changes. But ultimately, for me, welcome ones, because they acknowledge the role that Government rightly has in these sectors and provide transparency around the interface with independent regulators.

And of course there is more government now than there was at the time of the privatisations. We have devolved administrations in Scotland and Wales, with increasing powers and their own policy identities, distinct from the UK government in Westminster. We see this in water, for example, where the Scottish Government (with a publicly owned incumbent water company and a separate regulator) introduced retail competition for business customers 9 years ago. The UK government brought forward legislation to do this in England in 2014 and we opened the market this year. The Welsh Government has said it is unconvinced of the benefits of competition. That is the most obvious example I can think of, but there are subtle differences in policy context too that the devolved administration expect to be able to hold us to account for reflecting in our work.

And we are barely at the foothills as far as the potential for greater regional government and localism goes in England. We have had a Mayor in London for some time now, but we now have mayors across city regions. And it remains to be seen how they will expect to influence what people and businesses in their areas experience from the sectors we regulate. And how they will expect us to demonstrate how we have taken their views into account.

Companies

For all the time we spend – and I am as guilty as anyone here – discussing the changing role of government, I'm not sure it is the most significant change in the system of governance for utility sectors. There are a couple more I want to unpack.

One of these is the changing role of companies.

It is true that the requirements on company directors these days have widened. Boards – and I'm referring here to corporate law and the UK Corporate Governance Code – are explicitly charged with responsibility for the 'long term success of the company' and directors are required now to have regard to wider stakeholder matters beyond the narrower interests of their investors.

But there is further to go on this. And I think investors are key. Investors have a key role through boards in ensuring companies have the right leadership, and similarly they play a key role, through boards in motivating those leaders, through remuneration and wider opportunities. And investors need to realise that in these public service sectors the long term sustainability of their investment rests on the – demonstrable – legitimacy of the company. In short we need to see more 'enlightened self-interest'.

I do think there is movement on this. We have seen investors in the water sector, for example, increasingly recognising the legitimacy point. Though it may be tempting to observe that it took the regulator – in particular with the arrival of our current Chairman Jonson Cox – to take that conversation to them… And there is still more to do get beyond payment of lip service, into a position where investors and company boards genuinely see the alignment of their own interests with the public interest, and where we see that flow through the governance and reward structures of the companies.

For those of you who are familiar with the thinking on 'ethical regulation' (and I'm a fan) I think this is a critical factor for its success. Maybe someone will pick that up in the discussion later?

Customers and citizens

The final group within the governance system I have been talking about is that of customers and indeed citizens more widely. I think the role of these two groups has changed enormously in recent years.

Let me talk about customers first.

The changes here have been somewhat paradoxical when you think about it through the lens of what was expected in many of these sectors at privatisation.

Competition was intended to empower customers. Competitive markets would make companies directly accountable to them, giving the ultimate sanction – to vote with their feet – if they didn't like the price or service they were offered. We now know a bit more about how utility markets work…. While there are some products that really get customers excited and engaged – consumer goods for example – there are many others that are less exciting. And public utilities tend to fall into the latter group. Especially where the complexity of products and tariffs – possibly coupled with some bad experiences - just causes people to switch off.

There is evidence to suggest that customers *overall* are better off as a result of competition. But – unsurprisingly – those who don't engage don't get as good a deal as those who do. And there is no doubt that the difference in the experience between those who engage and get the best deal, and those who don't, is increasingly seen as unacceptable. Especially if those who get the best deals are being subsidised by those who get the worst. It is a situation that just doesn't deliver on that redefined public policy goal for the whole system – trust and confidence.

So where we have competition in utility markets, maybe regulators should expect a little less from customers, and be more prepared to stay involved? Certainly regulators need to pay close attention to the need to build customer trust in competitive markets and build their confidence to engage. Another different relationship there.

But going back to my paradox - in those sectors and parts of the value chain where there is persistent monopoly, customers are taking a bigger role as regulators encourage companies to deploy more customer engagement, to improve allocative efficiency (using their scarce resources do more of what customers and society want), increase accountability and build trust. At Ofwat we have also said we would like to go beyond this and see greater 'customer participation' – with customers involved in co-creating visions of the future with the companies and involved in co-delivering them.

I talked at the start of this section about customers *and citizens* and it is clearly very important to involve not only bill payers in this sort of engagement and participation. How water and waste water companies provide services to customers has a huge impact on the environment, for example, and engagement on that is important. And some aspects of what companies do – in respect of the environment but also major infrastructure investment – have a big impact on future generations too.

There are clearly limits to this – not all customers and citizens will want to be engaged, let alone participate. Indeed I think we are already seeing an increasingly competitive market for customer and citizen bandwidth!

And not all aspects of regulation are suitable for this approach – the challenge we bring on the basis of the information and expertise we have is always going to be important and it wouldn't be a great idea to crowdsource the weighted average cost of capital.

But customer engagement and customer participation in price reviews is a huge improvement in legitimacy terms over where we were a few years ago.

A more porous system

OK – I have talked about what I see as the shifts in the public policy purpose of the governance system around public utilities, and about some of the shifting roles of the different actors in that system. I now want to say something about the changing nature of the dynamic within the system.

I could characterise the original system of governance, as in the immediate post-privatisation period – admittedly crudely – as rather a rather linear 'top down' transmission mechanism.

Government set the policy framework that enabled private investors to come in and own public utilities and enabled regulators to set the policy framework, which alongside the incentives investors placed on management, determined what the company did, which determined what customers got.

What we have now is much less linear, more multi-dimensional and more multi-directional.

Yes, government sets the policy framework, but it may also have things to say about what gets built, and possibly about the prices that customers pay.

And yes investors do determine the incentives placed on management, but those incentives are open to much more scrutiny by regulators, and by customers and civil society groups.

Yes, regulators do still set incentive frameworks, but they encourage processes that involve customers. Yes, we still hold companies to account for price and service, but pay attention to culture and governance within the company to so we can focus our attention where it is really needed, and we encourage transparency so that others have a role in holding companies to account too. And we increasingly see customers and NGOs for example doing just that.

Yes, customers and citizens still receive services from regulated service providers. But they are more involved in shaping those services, in designing and delivering the future and holding service providers to account.

It is a very much more dynamic and porous system, and much more dynamic and porous environment for economic regulators to work.

So what future for independent economic regulation?

So, what does all this mean for the future of independent economic regulation?

The good news – at least if you are a regulator – is that I think independent economic regulation has a very bright future.

The core purpose of independent economic regulation – that core purpose that has remained constant – this being to drive efficiency and better service in privately provided public services remains.

We have a tool kit that – notwithstanding perennial scope for improvement – at its heart works very effectively at doing some things that really matter in respect of this core purpose – enabling investment, driving value for money.

And even acknowledging the wider public policy purpose of the whole system of governance – the importance of trust and confidence in these critically important sectors and the services they provide, I think independent economic regulation offers some solutions, especially if regulators are unafraid to use their wider tool kit and focus not only on 'what' customers get bit but on the relationships between service providers, customers and society and pay proper attention to the long term dynamics within sectors.

In short I see big opportunities for independent economic regulation to help build trust and confidence in public utilities. And also to help others, who are also feeling their way in this evolving system of governance, play their part effectively too.

We do face some challenges, of course. From where I sit, there are four that seem most significant.

The first is successfully redefining our relationship with government.

That starts with being seen by government as part of the solution rather than the problem, which I think we are. But we need to establish perhaps a more mature relationship than we had in the past. A relationship which sees us acknowledge that the sectors we regulate are politically salient, that government will have things to say and quite properly will have interventions to make. Which sees us help government to do what it is trying to do in these sectors transparently, and with the benefit of our expertise, but which gives us permission to be critical friend (rather than a cheerleader). Because let's face it economic history is littered with examples of, quite possibly well-intentioned, government interventions in markets that were not an unalloyed success…And I think regulators should have permission to challenge and question in this space.

Crucially, we need a relationship that maintains our ability to set out and operate our regulatory frameworks on the basis of statute, so that investors and management can bring their expertise to our sectors to the benefit of customers. And which sees us really doing our job effectively – and being seen to do our job effectively - so that government doesn't feel the need to intervene on a 'remedial' basis.

The second is redefining our role with respect to customers.

In competitive markets we need to stay more involved than we might once have thought. We need to keep an eye on whether competition is really effective and on how we can improve it. But more than that we need to keep an eye on whether those markets are delivering for customers – not just on average but across different groups of customer. And if they aren't we will need – quite possibly working with government – to figure out whether that needs intervention. And in respect of monopolistic markets, we need to stay focussed on customer engagement and participation. But also challenge companies to keep up with increasingly fast paced changes in customer expectations about products and services, about how they access these and about communications more generally.

The third challenge in about redefining our role in respect of companies.

I think economic regulators need to be much more demanding of companies, in terms of expectations – not only on service and the customer experience more broadly but also on things like corporate governance and transparency – but demanding in a different way. We need to be clearer at the macro level about the immense responsibilities that companies, and indeed investors, in these public service sector have, especially where they have the privilege of monopoly. And much less willing to step in at the micro-level and tell them exactly what to do and how to do it. Because I have seen in water that micro-level intervention across a sector – while it might have been appropriate in the early years following privatisation – over time just infantilises the sector. Rather than provoking and challenging and holding to account, the regulator ends up providing a safety net for companies and that isn't what we should be doing at all.

Finally, I think we have a big challenge in challenging ourselves.

Part of this is about staying connected with those we serve – not losing sight of what matters to customers and to citizens, not losing sight of the realities of life for people.

To be clear I'm not talking about going backwards to regulators doing giant customer surveys and telling companies what to do. I'm just talking about the fact that we are experts. That's a good thing – a big part of our tool kit is pretty technical and we need our expertise to do use it as effectively as we can for. But we need to stay grounded.

And – another part of this challenge – we need not to be defensive. Part of this is about challenging our ourselves on policies and approaches – to learn from what had worked and also from what has not.

And it also includes perhaps not being defensive of the institutional structure we all work in. I'm not generally a big fan of structural change. Too often it seems to meet cosmetic demands for 'something' to be done, while achieving little beyond cost and distraction. But as I talk about the need to redefine our relationship with customers and with companies, it strikes me that we do need to reflect on the world as customers and those who provide services to them increasingly see it. And it is a world of multi-utility bundles, of 'connected home' services and a more holistic view of the customer as a human being living a multi-dimensional life, rather than as a water bill payer, or a telecoms bill payer or an energy bill payer. At the very least we are going to need to work much more closely together to ensure that customers are properly protected and service providers don't face undue barriers in competing across sectors. I'm not saying structural change is the only way to do that, but I think we should be open minded about it.

On structures, policies and approaches, we need to stay open and curious, and seek out the maverick voices, so we don't drown in self-congratulatory groupthink.

But from what I can see regulators are pretty conscious of these challenges and are working hard on them.

And we do have a genuinely really valuable mutual support network through UKRN – which helps us think through the challenges and opportunities we face together, learning from each other.

So it is with a genuine feeling of optimism that I look forward to seeing what independent economic regulation – as part of this ever evolving system of public utility governance will deliver for society and our economy over the next 30 years!

Maybe Martin will invite me back for a retirement gig….?