

## Central Control and Competition in the British Electricity Industry – There and Back Again

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In 1990, the UK government launched a new model for the British electricity industry based on an open market. The intention of the model, as set out in the 1988 White Paper, was to let competition between privately owned companies drive investment decisions. Experts and officials who worked on the reforms travelled around the world carrying the message that competition works for utilities. The British example changed attitudes in many other countries. The UK acquired a reputation for favouring competition over central control, especially in the electricity industry. However, experience from the last ten years suggests this reputation is no longer deserved.

The UK government currently plays a central role in deciding what generation capacity is built for Britain's electricity market, and also how a large share of it will operate. (The British electricity market covers England, Scotland and Wales. It began in England and Wales, but was extended into Scotland in 2005. The electricity market of Northern Ireland, the other part of the United Kingdom, operates within the Single Electricity Market for Ireland.) The provision of 'state aid' is so important and so controversial, that the Austrian government has filed a lawsuit in European courts over the UK government's financial support for an expensive new nuclear power station.

As shown below, nuclear power is not the only area of state intervention in the British electricity market. For many years after the initial restructuring, British politicians wanted to intervene, but were kept in check by institutional or competitive constraints. In the last ten years, however, successive UK governments have steadily increased their influence over investment in generation. Indeed, virtually no new projects are feasible without some form of government support operating alongside the electricity market (either a special scheme or a supplementary capacity market).

By 2015, the policies of successive UK governments have replaced free competition in the electricity industry with a system described as 'cumbersome, complicated, riddled with judgements by politicians, civil servants and regulators and an ongoing lobby-fest for technologies seeking support' (Porter, 2014, p. 326). This is not how it was meant to be.

So how did this reversal of policy take place? What forces led the UK government first to introduce competition and then to turn its back on it? And, more importantly for other countries, what does this experience mean for the design of energy sector policies and institutions?

Below, recent history is divided into four parts, to explain the economic factors behind the liberalisation and restructuring of 1990 and the reasons why UK governments have not let competition flourish since then.

### History Part 1: Replacing Politics with Competition

The recent history of the British electricity industry begins with its privatisation in 1990-91. (Different parts of the industry were privatised at different times.) The privatisation has been extensively documented elsewhere; only the highlights are summarised below, as context for the discussion of later interventions.

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*Privatisation was intended to reduce the role of government*

The UK government of the late 1980s believed that utilities would operate better under private ownership than under state ownership, but the decision to privatise was driven by practical as well as ideological concerns. Ministers knew that future investment needs would place the public finances under enormous strain. At the time, the electricity industry was proposing to invest in a suite of new nuclear power stations, a choice ensuring that any government decisions on investment would be controversial. The government hoped that privatisation would provide access to new sources of finance and would also take decisions out of the hands of politicians. Any increase in efficiency from decentralising investment was a bonus.

The UK government's White Paper of 1988, 'Privatising Electricity', set out these aims in paragraph 19, titled 'Government Intervention'. It describes the government's 'wide ranging powers to interfere in the running of the industry' as a 'weakness in the present structure'. It notes that governments had to approve the industry's capital expenditure plans and total borrowing limit, and laments the lack of freedom granted to industry management. It predicts that 'In the private sector, the industry will be free of Government intervention in its day to day management, protected from fluctuating political pressures, and released from the constraints on financing which public ownership imposes.' (Secretary of State for Energy, 1988, paragraph 19)

These concerns about (1) government intervention in investment, and (2) the link to public finance, permeate the rest of the White Paper. It proposed a new, more competitive industry structure, in which investment decisions would be driven by the needs of consumers, and lists the following benefits of privatisation (among others):

**'Decisions about investment in power stations** will be driven by the distribution companies and so will reflect the needs of consumers';

**'Greater competition** will create downward pressures on costs and prices, and ensure that the customer, not the producer or distributor, comes first'; and

**'Investment plans will be subject to commercial tests**, and the industry will have access to **private sector finance**.' (Secretary of State for Energy, 1988, paragraph 66, emphasis added)

These three tenets – decentralising decisions, promoting competition and private sector finance – formed the core of the liberalising ideology that experts and officials took around the world. In practice, the desire to gain access to private sector finance has survived longer than the principles of decentralisation and competition.

*The industry operated through a competitive wholesale market*

At the heart of the new system lay the Electricity Pool, a compulsory day-ahead market for all output from generators above a minimum size threshold. The Pool was not mentioned in the White Paper but emerged from two of the three 'principal conditions for a secure supply of electricity' (Secretary of State for Energy, 1988, paragraph 44):

- 'Proper control of the generating and transmission systems' and
- 'Sufficient generating capacity to meet demand'.

The Pool set prices for day-ahead electricity sales based on the 'System Marginal Price' (the cost of production) adjusted for the 'Value of Lost Load' (value to consumers when load is lost) and a day-ahead 'Loss of Load Probability'. A major effort went into ensuring that this pricing rule gave a competitive market signal for efficient, decentralised investment that ensured security of supply. Unfortunately, the competitive aspect of pricing was weakened by the presence of large generator companies, as explained below.

*The structure of the generating sector was highly concentrated from the start*

The third of the three 'principal conditions for a secure supply of electricity' in the White Paper was 'Protection against interruptions in fuel supply'. (Secretary of State for Energy, 1988, paragraph 44) Strikes at British coal mines during the 1970s and 1980s had severely weakened confidence in the reliability of a coal-based system. The White Paper recognised a role for fossil fuels and renewable energy, but identified 'a vital strategic need' for nuclear power. Pre-privatisation plans spoke of building one new nuclear generator per year and construction of one PWR had already begun. The privatisation needed a financially robust home for nuclear power, in the form of a 'Big G' generator company that owned all the existing nuclear generators and some of the fossil fuel generators. That left room for only one other generator company, known as 'Little G', to emerge from the old nationalised industry.

In the end, the plan to privatise nuclear generators foundered on their poor financial prospects, so they were held back from the privatisation of 1990-91. A state-owned company, Nuclear Electric Ltd, was carved out of Big G and awarded ownership of all nuclear generators in England and Wales. Given the late hour of this decision, the government chose not to change the remaining structure. The remnants of Big G and Little G were privatised intact as two large fossil fuel generator companies, under the names National Power and Powergen. Nuclear Electric Ltd operated as a base-load generator supported by a special levy on retail sales of electricity. It had little influence over market prices, which were set by the two fossil fuel generator companies. (Nuclear generators were eventually privatised in 1996, as British Energy. This company ran into financial trouble in 2004 and required state assistance to survive. In 2009, British Energy was bought by a joint venture of two large energy companies, EDF Energy and Centrica.)

*The new structure made further intervention necessary*

This sequence of decisions had unfortunate consequences. The new industry started life with an uncompetitive structure for reasons that were no longer valid, because 'Big G' (National Power) no longer had to support nuclear power. Britain's electricity industry quickly acquired a reputation for uncompetitive behaviour. The privatisation of 1990-91 therefore set up the new electricity industry with an uncompetitive structure that invited continued intervention by government.

## **History Part 2: The Urge to Intervene Proves Irresistible**

Hopes for real competition lay in new entrants displacing incumbents. However, 'promoting competition' soon turned into 'promoting competitors', with adverse consequences for efficiency and the competitive market.

*Cost pass-through put 'greased skids' under new entrants*

The privatisation allowed new entrants into generation to receive financial support from 'distribution companies' – integrated 'retail suppliers' and 'distribution network operators'. These companies retained a partial monopoly over final consumers in their historical franchise areas, and were allowed to pass through the costs of their contracts with generators. The regulatory arrangements were complex, but effectively allowed new gas-fired plants to enter the market on 'greased skids' – that is, even if their total cost was more than

the avoidable cost of running existing coal-fired generation or of buying electricity at the market price.

So successful was this artificial support of investment that it soon brought the Government into conflict with the liberalised market. The 'dash-for-gas' – a boom in gas-fired generation – would have forced the closure of British coal mines faster than even a Conservative government could bear. Ministers stepped in to impose a more politically acceptable outcome.

*Government 'twists arms' to force the extension of coal contracts*

British coal mines received a degree of protection between 1990 and 1993, in the form of contracts to supply coal to the two big generator companies. These coal contracts were backed by electricity contracts between the generators and the twelve retail suppliers in England and Wales, who used their retail monopoly to recover the associated costs from final consumers. By 1993 it was clear that competition from gas-fired generation would sharply reduce demand for British coal, once these contracts expired. To reduce the harm to coal mining communities (and to their electoral prospects), ministers co-ordinated an extension of the coal contracts and of the associated arrangements for cost pass-through. Their methods were somewhat opaque – there was talk at the time of the government 'twisting arms' – but they were ultimately successful. The new arrangements ran from 1993 to 1998. By 1998, both the coal and electricity industries had changed so much that further extension of these arrangements was unnecessary.

Thus, soon after privatisation, the government was already intervening on behalf of coal mines, to offset the effect of its favourable policy on investment in gas-fired generation.

*The regulator regulates prices, and starts to break up the generators*

As the 1990s wore on, it became apparent that entry into base-load generation was not reducing the influence over market prices wielded by National Power and Powergen. The Office of Electricity Regulation (Offer) eventually decided to limit this influence by imposing a price cap – although ironically the two generator companies could only comply with this price cap if they exploited all the influence over prices for which they had been criticised.

Between 1 April 1994 and 31 March 1996, Offer obliged National Power and Powergen to offer their plant into the Pool at prices calculated to achieve certain average annual Pool prices – £24.00/MWh on a base-load ('time-weighted') basis, and £25.50/MWh



on average over all consumption ('demand-weighted'), all in October 1993 terms (Porter, 2014, p. 131). This rule explicitly acknowledged that the big generators would influence prices, which undermined confidence in the market and reduced liquidity in contract markets for several years.

The price cap was only intended to be temporary. The generator companies were also obliged to sell off a total of 6 GW of generating capacity. (Total generating capacity in England and Wales was about 60 GW at the time.) In the end, Eastern Electricity, one of the 'distribution companies' described above, bought 4 GW from National Power and 2 GW from Powergen. Eastern (later TXU Europe) became the third company with a major role in setting electricity market prices. However, its entry into the market did little to increase confidence in the state of competition, not least because average prices changed relatively little (Bower, 2002, pp. 16-17).

#### *The government finishes the job it began in 1990*

The non-competitive structure of the generation sector was only resolved by further ministerial intervention. In 1998, both National Power and Powergen applied to take over a retail supplier (and, in the latter case, a distribution network as well). The relevant minister still had a role in competition policy at that time and used it to demand another major divestment of generation in return for approving the takeovers. This time, capacity was bought by several different companies. From 1999, for the first time since privatisation, a number of generators competed to set electricity market prices.

The precise effect of these divestments is hard to isolate. In 2001 the government replaced the Electricity Pool with the New Electricity Trading Arrangements or 'NETA' (later the British Electricity Trading and Transmission Arrangements or 'BETTA'). Some claimed that this reform, rather than the divestment of generation capacity, caused electricity prices to fall from 1999 onwards, but such claims do not fit with NETA only starting operation in 2001. (See Bower, 2002, for a discussion of this controversy.)

By the end of the 1990s, the generation sector finally had a company structure that allowed competition to flourish. The UK's international reputation for favouring competitive markets had also been flourishing for the past decade. Events over the next decade were about to make this reputation increasingly undeserved.

### **History Part 3: A New Dawn For The Electricity Market**

In 1997, the electorate voted out the Conservative government and its ideological affection for markets, decentralisation and competition. Later governments showed no reluctance to intervene.

#### *The 21st century opens with an attempt to promote competitive markets*

The new era did begin with reforms intended to promote competition and markets. In 2001, the New Electricity Trading Arrangements replaced the Electricity Pool. Many features of NETA improved the potential for competition, for instance by creating an active demand side (instead of demand forecasts). The design of NETA emphasised the use of electricity contracts, because the regulator placed great weight on the views of (actual and potential) energy traders, and wanted to promote liquid contract markets. Unfortunately, the designers of NETA devoted less attention to the needs of the industry and its consumers, and to the all-important question of investment signals.

Under the Pool, as under any electricity market, electricity companies had written (long-term) contracts priced against expected (short-term) Pool prices. Pool prices – more generally, 'imbalance prices' – perform the vital role of defining the value of uncontracted generation and consumption, and hence of all electricity. The Pool price rules emerged from extensive discussion of the need to promote efficient operation and investment, leading eventually to a market-based formula. NETA danced to a different tune – with long-lived adverse consequences.

Under the influence of energy traders, the new imbalance prices were designed as penalties intended to encourage contract trading – with low prices for uncontracted surpluses and high prices for uncontracted deficits. Perversely, this 'dual pricing' of imbalances encouraged vertical integration of generation and retail supply, not contract trading. Electricity companies preferred to manage imbalance risks internally, rather than face unpredictable penalties. Trade in electricity contracts remained stunted, so companies that were not vertically integrated found it difficult to buy and sell electricity and to manage risks.

#### *The choice of 'non-market' imbalance prices persisted for two decades*

At first, NETA set imbalance prices equal to the average price of balancing actions, excluding actions to manage constraints. Subsequent decisions reduced the scope of this average but did not

abandon the principle of averaging. Pricing at average cost is an odd rule for a market. Efficient, competitive markets set prices equal to marginal cost (that is, the cost of the most expensive unit required to meet demand), but the regulator felt that such rules made it easy for large companies to manipulate prices. Instead, Ofgem (the regulator for electricity and gas markets from 1999) instructed designers to adopt non-marginal pricing rules, based on average prices accepted in the balancing market (Ofgem/DTI, 1999, p. 7). The outcomes, predictably, were not market outcomes.

Distorted price signals caused some inefficient operational decisions, such as companies preferring to use their own generation rather than trading at short term. Mostly, this inefficiency had a minor impact on total costs. However, at times of capacity shortage, the average pricing rule ‘dampened’ imbalance prices, that is, it held them below marginal costs (Ofgem, 2011, paragraph 2.4). These depressed incentives hindered efficient operation and investment and threatened security of supply.

The system operator signed contracts with some reserve generation, but doing so undermined transparency and liquidity. Market participants tinkered repeatedly with the rules to bring imbalance prices closer to marginal costs, but they were reluctant to overturn the reliance on penalties and contract trading. Ofgem eventually reviewed imbalance prices and in 2014 instructed market participants to adopt a single imbalance price based on marginal cost (Ofgem, 2014b). Even then, Ofgem delayed full implementation until 2018-19.

This experience shows the danger of designing markets to force the creation of liquidity. Liquidity is the product of traders’ confidence in a competitive market, so it cannot flourish without efficient market pricing. Having adopted non-market pricing rules in 2001, the British system will take nearly two decades to remedy this design error.

#### *The regulator shows its desire to intervene more*

Although the market was becoming more competitive, Ofgem defined a novel form of competition policy prohibiting market abuses based on the possession and use of ‘significant market power’ – a new and not very well defined concept. Several generator companies accepted a new ‘market abuse licence condition’, but two appealed to the Competition Commission (as it was then called).

The Competition Commission was the UK’s general competition authority and was uncomfortable with Ofgem’s attempt to redefine competition policy. The Competition Commission rejected the licence condition outright in January 2001 (Competition

Commission, 2001) and later concluded its decision was borne out by subsequent events (Competition Commission, 2008). However, since then, UK politicians have argued with increasing frequency and fervour in favour of granting themselves or the regulator stronger powers to intervene in energy markets.

#### *A new government looks for things to do*

The new Labour government that came to power in 1997 began with a ‘one-off’ windfall tax on the so-called ‘excess returns’ of the privatised utilities. That decision may have been popular, but was not based on a detailed understanding of markets or profits.

Some of the ‘excess’ returns represented a reward for bearing regulatory risk in the early days after privatisation.

The new government also imposed a ‘moratorium’ on investment in new gas-fired generation plant. The policy was driven in large part by a residual desire to support the coal industry. Once a power base of the Labour Party, coal mining had shrunk considerably in output and influence by 1997. Supporting it conflicted with environmental policies, so the moratorium still allowed investment in gas-fired CHP. This was the first of many such conflicts within government policy.

For a while, the new government adopted ‘fuel poverty’ as the reason to intervene in energy markets. However, this concept proved more or less synonymous with simple poverty. The UK government currently ‘considers a household to be in fuel poverty if: they have required fuel costs that are above average (the national median level); [and] were they to spend that amount they would be left with a residual income below the official poverty line’ (HM Government, 2015a). This policy has evolved into consumer protection and debt collection procedures for retail energy markets, rather than any major interventions in wholesale energy markets.

Nevertheless the new government’s overt wish to intervene gave a taste of things to come.

#### **History Part 4: Governments Re-Establish Central Control**

Since about 2005, successive UK governments have shown greater willingness to intervene in energy markets. The main motivating factors have been (1) concerns about competition (or rather about rising prices) and (2) climate change policy.

#### *Europe provides a market context for climate change policy*

The focus on climate change is curious, given the market-based policy launched at European level

around this time, namely the EU Emissions Trading Scheme (EU ETS). Since 2005, the EU ETS has capped the total CO<sub>2</sub> emissions of major industries in Europe – including electricity generation – whilst allowing participants to buy and sell scheme ‘allowances’ that permit them to emit CO<sub>2</sub>. (For a description of the scheme’s 2013-2020 ‘phase’, see EC, 2015a and 2015b.) The market price of CO<sub>2</sub> emissions allowances is included in electricity prices, as a marginal cost of production.

In principle, the EU ETS solves the problem of CO<sub>2</sub> emissions by ‘internalising the externality’, that is, by making polluters pay for their pollution. However, national politicians throughout Europe seem to see it differently. They act repeatedly as if further intervention to reduce CO<sub>2</sub> emissions in the electricity industry were (a) necessary and (b) effective.

If further reductions in CO<sub>2</sub> emissions were necessary, EU governments could have lowered the cap within the EU ETS. If they thought intervention necessary to stop the price of allowances rising too high, they could have adopted a fixed tax on CO<sub>2</sub> emissions, instead of a cap on volumes. In practice, national governments have often complained about the *low* price of CO<sub>2</sub> emissions allowances (see below).

Moreover, cutting CO<sub>2</sub> emissions in Europe’s *electricity industries* does not reduce CO<sub>2</sub> emissions in Europe *as a whole*. Such action shifts emissions within the cap, reducing emissions in the electricity industry and allowing higher emissions in other industries. Total emissions at the end of each ‘phase’, which provide the baseline for future reductions, remain unchanged by investment in renewable generation. Many government interventions in the electricity industry therefore have no effect on Europe’s total emissions of CO<sub>2</sub> in either the short run or the long run.

Hence, the EU ETS renders ineffective most national climate-change policies for the electricity industry, but national governments still act as if they had a role to play.

### *The environment acquires a central role in energy policy and regulation*

Competition may once have been a tool for promoting efficiency, but the period 2003 to 2008 saw it transformed into a tool for fulfilling government energy policy.

The government issued a White Paper on energy policy in 2003, an update in 2006 and another White Paper in 2007 (Secretary of State for Trade and Industry, 2003, 2006 and 2007). The 2003 White

Paper pinned its hopes on renewable energy. The 2006 and 2007 documents reintroduced nuclear power as a major plank of climate change policy. All three documents added environmental goals to the normal regulatory objectives of low prices and high security of supply.

This new emphasis on environmental goals was captured in legislation. The Electricity Act 1989 gave the regulator a set of statutory duties that were primarily production-oriented (meeting reasonable demands and letting licensees finance their activities). The Utilities Act 2000 placed over those duties a ‘principal objective’ of protecting consumer interests. The Energy Act 2004 gave the regulator a new statutory duty to take account of the environment and the Energy Act 2008 raised it to the same level as the production-oriented duties. The Energy Act 2013 obliged the regulator to ‘have regard’ to the government’s strategic priorities for energy policy, subject to its principal duty to consumers.

Since 2004, therefore, the environment – as represented largely by government policy on climate change – has played a major role in all regulatory decisions.

This expansion of the regulator’s statutory duties created a three-way trade-off between security of supply, low prices and the environment. The outcome of that trade-off depends on the weight governments place on each objective. Vacillations over this trade-off expose the electricity industry to political risk. The resultant damage to incentives makes yet more interventions necessary.

### *Boom and bust both infected energy policy and regulation*

The economic boom of 2007-08 and the subsequent crash of 2008-09 showed how changing economic conditions affect government policy, and investment incentives in the electricity industry.

The boom gave many European governments strong (but misplaced) confidence in their ability to direct investment into combatting climate change. This confidence manifested itself at EU level through the Renewable Energy Directive 2009, and in the UK through the Climate Change Act 2008, among other measures.

Both the Directive and the Act commit the UK government to ambitious – and expensive – targets for investment in renewable energy sources. The economic underpinning for this duty is unclear, as the EU ETS removes the economic rationale for subsidies to renewable energy (see above). Nonetheless, national governments in Europe apparently felt compelled to take decisive action on



renewable energy – for both domestic and foreign policy reasons. In Europe, national governments retain jurisdiction over wholesale electricity markets (unlike state governments in the US or Australia), and the self-imposed duty to promote renewable energy gave another reason to override electricity markets.

After 2009, the financial crisis spawned strong political criticism of free markets, which gave the UK government another source of support for intervening. The mantra heard frequently in and around government circles became ‘markets don’t work’.<sup>1</sup> Under this school of thought, energy markets ‘don’t work’ because investors are not building enough renewable energy plants to meet government targets. This so-called ‘failure’ really highlights the high cost and low reliability of renewable energy sources, but UK governments have responded by strengthening their support for investment in renewable energy, passing higher costs and more risk onto consumers.

## **The Current Era: Widespread Intervention, Tightening Constraints**

*The current government is applying broadly the same policies as before*

The 2010 election brought into power a coalition of Conservatives and Liberal Democrats, in which the senior energy minister was a Liberal Democrat. The coalition set up an Energy Market Review (EMR) in 2010. It was still running in May 2015, when the next election brought in a purely Conservative government. The 2015 Conservative Party manifesto supported competition, whilst remaining committed to intervention. However, financial constraints are beginning to limit government ambitions.

The EMR proposed four major reforms (DECC, 2015). First, feed-in tariffs offering fixed prices for ‘low carbon’ generation (that is, renewables and nuclear power) are replacing tradeable green certificates for renewable energy. (This policy was inspired by the success of German feed-in tariffs, although curiously the German government was moving at this time towards a more UK-style, market-driven policy.) Second, the government has put a floor under the price that electricity generators pay for emitting CO<sub>2</sub>, to stop it from falling ‘too low’. (This policy undermines the commonly stated view that subsidised investment in renewable energy is needed

to prevent this price rising ‘too high’.) Third, emissions standards will be tightened, effectively ruling out investment in new coal-fired plant. Fourth, to offset the increased political risk of investing in fossil-fuelled generation plant, the government will add a capacity mechanism to the existing wholesale electricity market.

In pursuit of its policy on nuclear power, the UK government signed a high-priced contract with EDF Energy and its Chinese partners for the output of a future nuclear generator. The same type of nuclear generator is being constructed in France and Finland and the French government recently announced the discovery of a serious flaw in its design (Sage, 2015). That is not its only problem, however. In 2014, the European Commission approved the ‘state aid’ to this project, but the Austrian government is mounting a legal challenge against this decision (Barker et al., 2014, Pickard et al., 2015, Oreanda, 2015 and Reuters, 2015). The UK government will therefore have to defend in court its financial support to an investment by state-controlled French and Chinese companies (Stothard, 2015).

Recent events show the current government to be less tolerant than previous ones of the rising cost of renewable energy. Even before the election, the Chancellor of the Exchequer had stopped planned increases in the CO<sub>2</sub> price floor (Reuters 2014). Since the election, he has announced the early termination of subsidies to onshore wind farms and commercially sized solar power projects, reduced subsidies for energy efficiency projects, ended tax exemptions for ‘clean’ cars and for consuming renewable energy, and abolished rules on zero carbon housing (BBC, 2014). Budgetary constraints will require future interventions to be more tightly focused, but they remain important nonetheless.

*EMR puts government decisions where markets once reigned supreme*

For instance, once EMR is implemented, competitive electricity markets will no longer select the most efficient way to meet demand and CO<sub>2</sub> emissions limits. Instead, the government will: (1) dictate the timing, level and type of investment in renewable energy sources and nuclear power; (2) discourage coal-fired generation; (3) set the price of CO<sub>2</sub> emissions, if only within the British electricity industry; and (4) allocate new rewards for investment in fossil-fired generation, to offset increasing political risk.

The UK government once regarded its powers to ‘interfere in the running of the industry’ and to approve ‘[a]ll capital expenditure plans’ as a ‘weakness’. Today’s governments regard those same powers as the hallmark of strong leadership.

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<sup>1</sup> Frequent questioning by the author as to the meaning of this phrase never produced any fundamental criticism of market economics, but rather the complaint that ‘markets don’t do what governments want’. This complaint is nothing new. It used to be a criticism of ‘unrealistic’ government policies. Now it is a criticism of ‘uncooperative’ markets.

## Retail Markets: Under Attack from All Sides

Retail electricity and gas markets have increasingly become the focus of government interventions.

In the UK energy sector, retail monopolies were abolished and retail tariffs liberalised around the turn of the century. At first, energy prices and retail tariffs remained low and the regulator expressed satisfaction with the state of competition. However, prices began to rise from 2004-05 and the regulator found it ever more difficult to maintain that position, amid trenchant criticism of energy companies in the press and the political arena.

Talk of a second ('one-off') windfall tax around 2008 eventually led the major retail suppliers to adopt energy efficiency programmes targeted at the homes of poor consumers (Porter, 2014, pp. 230ff). Such programmes continue to the present day, and their costs formed an increasing part of retail energy prices. In 2014 the government relaxed the targets to mitigate their impact on consumers (DECC, 2014, and HM Government, 2015b).

### *Ofgem intervenes in retail energy markets*

Press criticism of retail suppliers continued, as energy prices rose and stayed high. The regulator remained circumspect about the state of competition, but grew concerned that consumers were put off switching supplier by the time and effort required to compare multiple tariffs. In an effort to 'simplify' retail markets, Ofgem (re-)inserted a non-discrimination clause into supplier licences from 2009 to 2012, to discourage market segmentation. In 2013, Ofgem also restricted the structure and number of tariffs that each supplier could offer (Ofgem, 2013). In 2014, Ofgem obliged the largest generators to publish offers and bids for contracts, to give independent generators and suppliers better access to electricity and to risk management tools (Ofgem, 2012 and 2014a).

Ofgem intended these measures to enhance competition. However, making it easier to compare tariffs may have hampered competition between suppliers instead (see below).

### *Politicians lose patience; omens not good*

Faced by high prices, some politicians seemed to lose patience with the slow and careful analysis required by regulatory processes.

In September 2013, the then leader of the opposition stated that, if elected in 2015, he would 'freeze' retail energy tariffs for 20 months. His timing was curious, since tariffs were then reaching their highest levels, and freezing tariffs was impractical anyway. The subsequent fall in wholesale prices would have

required a cut in tariffs to limit supplier profits; any rise in wholesale prices would have required an increase in tariffs to fund the government's own policies. The proposed freeze might also have faced legal obstacles. Parliament's ability to set energy tariffs is limited by an EU Directive of 2009 instructing Member States (among other things) to *guarantee* the independence of the national regulatory authority for energy.<sup>2</sup>

Despite these failings, the proposed tariff freeze received a relatively benign response in political circles and in the press. The policy will not now be implemented, but potential investors might be worried by the lack of rigour in policy-making shown by this episode.

### *Ofgem instigates an investigation of competition in energy markets*

Public criticism of energy companies continued unabated so Ofgem referred electricity and gas markets to the Competition and Markets Authority (CMA) in June 2014 (Ofgem, 2014c).

The CMA's provisional findings (CMA, 2015) provide little evidence of anti-competitive behaviour. The CMA suggested some technical improvements to the rules of the wholesale electricity market, but found no evidence that generators had unilateral market power or earned excessive profits in wholesale markets (CMA, 2015, paragraph 38). The CMA also found nothing to suggest that vertical integration had adversely affected competition (CMA, 2015, paragraph 79).

The CMA investigated supplier behaviour in retail markets, but its provisional findings do not match the tone of the political debate. The CMA found that customer response to price differences had been weak, giving suppliers some unilateral market power over their 'inactive customer base' (CMA, 2015, paragraph 128). The CMA noted that suppliers could charge higher tariffs in this segment of the market (CMA, 2015, paragraph 135). However, the CMA concluded that Ofgem's own efforts to 'simplify' consumers' choices by limiting the number of tariffs had contributed to suppliers' pricing policy, by

<sup>2</sup> 'Member States shall guarantee the independence of the regulatory authority and shall ensure that it exercises its powers impartially and transparently.' The regulatory authority must ensure its staff and personnel 'act independently from any market interest; and do not seek or take direct instructions from any government or other public or private entity when carrying out the regulatory tasks.' Member States must also ensure that the regulatory authority 'can take autonomous decisions independently of any political body'. EU Directive 2009/72/EC, clauses 35.4 and 35.5.



reducing the scope for innovation and ‘softening’ competition (CMA, 2015, paragraphs 146-150).

The CMA also made some pointed remarks about the reform of Ofgem’s statutory objectives weakening its commitment to competition (CMA, 2015, paragraph 200) and about the potential for government to undermine Ofgem’s independence (CMA, 2015, paragraph 201). The CMA concluded that the ‘lack of robustness and transparency in regulatory decision-making’ had an adverse effect on competition (CMA, 2015, paragraph 205).

Ultimately therefore, the CMA’s remedies may focus on regulatory interventions that harm competition, rather than on supplier behaviour.

## Lessons

The Conservative government elected in 2015 is different from those of the 1980s and 1990s. It is following the recent trend of intervening in electricity markets on environmental grounds, albeit within ever tighter financial constraints. Few politicians in the UK now promote the principles that liberalised the electricity industry in 1990. Instead, they (and politicians in many other EU Member States) frequently express a wish to exercise more control over national energy markets. Sometimes it seems like today’s politicians abhor competitive, efficient electricity markets like nature abhors a vacuum: as an empty space that needs to be filled. The growing tendency to intervene does not promote the interests of economic efficiency (or of electricity consumers). Current EU Directives obstruct some interventions, but European rules are often amended or re-interpreted to accommodate national aims.

The over-arching lesson to draw from UK experience is the need to protect the independence of regulatory institutions from political pressure (whilst allowing regulatory decisions to be challenged in the courts). The CMA has highlighted how Ofgem’s independence from government was compromised in recent years. The 2009 ‘third package’ of EU Directives provides for regulatory independence, but it has yet to be tested and could be reversed. Jurisdictions outside the EU have to rely on other institutions, either at state level or at federal level (if available), but every system must find ways to protect regulatory decision-making from political pressure.

As for market design, three key lessons emerge from this survey of UK history:

First, well-designed markets are important for supporting the reliance on competition, since poorly designed markets create a need for intervention. Imbalance prices (the prices attributed to inadvertent flows outside any bilateral contracts) underpin all

other electricity prices. The rules for setting such prices must give priority to providing market-based signals for efficient investment in new plant and efficient operation of existing plant (especially during peak periods). Contract trading and liquidity arise from efficient, competitive markets. They cannot be adopted as design objectives, however desirable they are.

Second, UK experience shows the danger of trying to impose a ‘competitive outcome’ on an uncompetitive structure, by capping prices or by ‘promoting competitors’. Such interventions have adverse effects and are unlikely to create competitive conditions. Action to make (or to keep) the industry structure competitive provides a better basis for efficient competition and a stable energy policy.

Third, environmental policy does not justify government action to override the outcome of competitive electricity markets; competitive markets can easily accommodate environmental goals. Self-imposed obligations to increase output from renewable energy sources (rather than to reduce CO2 emissions) have undermined competition in electricity markets, leading to ever more interventions. In Europe, such obligations were not necessary and are not even effective in reducing CO2 emissions.

In summary, badly designed electricity markets contain the seeds of their own destruction. Reacting with government intervention is counter-productive. UK experience shows that political solutions rarely serve consumers’ interests as well as efficient, competitive electricity markets.

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## Critical Issues in Regulation – From the Journals

**Market Failures and Public Policy**, Jean Tirole, *American Economic Review*, 105, 6, 2015, pp. 1665-1682.

This article is a revised draft of the lecture Jean Tirole delivered in Stockholm, Sweden, on 8 December 2014, when he received the Bank of Sweden Prize in Economic Sciences in memory of Alfred Nobel (aka the 'Nobel Prize in Economics'). Jean Tirole notes that, while economists have long extolled the virtues of markets, competition is rarely perfect. He further notes that markets fail and market power (the firms' ability to raise price substantially above cost or to offer low quality) must be kept in check. In this article, he considers this issue from both a regulation and an anti-trust perspective, reflecting the breadth and depth of his research leading to the award of the Nobel Prize. The key terms included in this article are: market failure; public policy; foreclosure; upstream bottleneck; essential facility; vertical integration; information asymmetry; high-powered incentives; ratchet effect; Ramsey-Boiteux pricing; two-sided markets; shotgun regulatory approach; and network externalities. There are 36 references to the professional literature, including references to Marcel Boiteux, Augustin Cournot, Jules Dupuit, Jean-Jacques Laffont, David Sappington and Carl Shapiro.

While Tirole takes a broad approach, he pays particular attention to an industrial organisation (IO) perspective. In his view, the theory of IO has proved a very useful tool to think about one of the major challenges of our economies, and has 'fashioned' both antitrust and regulation. By recognising that industries are different from each other, the IO approach has recognised that 'one size does not fit all'. It has patiently built a body of knowledge that has helped regulators better to understand market power and the effects of policy interventions, and for regulated businesses to formulate their strategies. Tirole (p. 1666) summarises the practical contribution of the new approach in the following terms:

On the policy front, there was widespread recognition that old-style public utility regulation, which by and large insured public utilities against poor cost performance, led to inflated cost and poor customer satisfaction, and so reforms were called for. To crown it all, institutional change favored the use of economic reasoning. Where disputes were settled and regulations designed opaquely in the minister's office, transparent processes run by independent agencies were put in place. For instance, competition authorities and regulatory agencies sprung up in Europe,

which used economic reasoning. This most fortunate conjunction of circumstances led to a [rich and complex] new paradigm.

The Nobel lecture version of this article is available [here](#) and the published version is available by subscription to the *American Economic Review*.

**PC Productivity Update 2015**, Productivity Commission (PC), Commonwealth of Australia, 20 July 2015.

This edition of the **PC Productivity Update 2015** begins by providing an overview of key nation-wide and industry-specific trends from the most recent release of the ABS productivity statistics. In 2013-14, labour productivity growth in both the Australian economy and the twelve-industry market sector (which accounts for 65 per cent of the economy) was close to the trend of the last two and half decades. But growth of multifactor productivity remains below the longer-term average. This overview is followed by a closer look at recent changes in measured productivity for four sectoral areas – agriculture, forestry and fishing; mining; electricity, gas, water and waste services; and information, media and telecommunications. This appraisal highlights some of the main contemporary factors influencing those changes. Chapter 2 reports on per capita national income growth in Australia and the contribution of productivity growth to that income growth. It highlights that, as the terms-of-trade effects associated with the mining boom recede, it will be crucial to achieve higher productivity in order to maintain and increase per capita income. Investment in new capital has consistently played a key role in lifting Australia's labour productivity and supporting the introduction of new technologies and ways of working. Chapter 3 outlines recent work by the PC aimed at improving the efficiency of public infrastructure investment through more transparent and rigorous project selection processes. In its recent report on *Public infrastructure*, the PC assessed that there is considerable scope to improve the quality and efficiency of government investment in public infrastructure investment in Australia. In its report, the PC presented a wide range of issues and made recommendations to improve the processes for selecting projects, financing initial capital commitments, and funding ongoing operations. It also included recommendations to overhaul institutional governance to inject greater rigour into project evaluation and decision making, including more transparent and accountable processes and a more efficient regulatory environment. Finally,



chapter 4 outlines recent work undertaken by the PC to identify the specific productivity performance within both the mining and financial and insurance services industries. The mining report traces the transition of mining industries through the investment phase of the mining boom to the production phase and towards positive multi-factor productivity (MFP) growth. The financial and insurance services report indicates that it is productivity growth in the insurance, superannuation and auxiliary services industry that has driven recent changes in the multifactor productivity for the financial and insurance services sector as a whole.

**Tariff Regulation with Energy Efficiency Goals**, Laura Abrardi and Carlo Cambini, *Energy Economics*, 49, 2015, pp. 122-131.

This paper is about the optimal tariff structure that could induce a regulated utility to promote energy efficiency (EE) by its customers given that it is privately informed about the effectiveness of its effort on demand reduction. The key result is that the regulator should optimally offer a menu of incentive compatible two-part tariffs. There are six headings in the article: introduction; the model; perfect information benchmark; asymmetric information; extension the consumer's effort; and conclusion. An appendix contains the proofs of the propositions and there are 28 references.

EE activities may have a variable impact on demand. For example, the simple promotion of a more responsible, energy-saving behaviour may be less effective – in terms of demand reduction – than the actual installation of energy-saving devices at the consumer's premises. Where the business's EE activities have a high impact on demand reduction, the consumer should pay a high fixed fee but a low per-unit price, approximating the tariff structure to a decoupling policy, which strengthens the business's incentives to pursue energy conservation. On the other hand, if the business's effort to adopt EE actions is largely ineffective, the tariff is characterised by a low fixed fee but a high price per unit of energy consumed, thus shifting the incentives for energy conservation on to consumers. Where the consumer can also adopt EE measures, the optimal tariff structure also depends on the cost of the consumer's effort and on the degree of substitutability between the consumer's efforts and those of the business.

When the business is privately informed about the effectiveness of the EE activities, the regulator has an additional problem – that is to extract the business's information, given that a business in the high-effectiveness environment always has an incentive to underperform in effort and explain the resulting high consumption by a scarcely responsive

demand. This hidden information problem can be solved by offering the business a menu of contracts, designed in such a way that the business correctly self-selects on the basis of its information.

Finally, the authors note that a comprehensive model should also incorporate all the externalities of EE activities and should consider a more general setting where more than one policy tool might be available.

This article can be accessed by subscription to *Energy Economics*.

**An Econometric Assessment of Electricity Demand in the United States Using Panel Data and the Impact of Retail Competition on Prices**, Agustin J Ros, NERA Insights in Economics, 9 June 2015.

**This paper** is about the econometric estimation of electricity demand in the United States and the econometric estimation of the impact of retail competition on retail prices. The author, Agustin J Ros, observes that there have been major developments in the electricity market including significant technological changes in generation services and the development of wholesale and retail competition. In this paper he uses panel data covering 72 electricity distribution businesses during the period from 1972–2009 to estimate econometrically structural demand equations separately for residential, commercial, and industrial customers and to examine the impact that retail competition has had on electricity prices. The paper includes a literature review (six references in the list of publications) and contains a detailed description of the data, analytical method and results.

As for the demand estimation, the author finds the own-price elasticity of demand for residential, commercial, and industrial consumers that are generally consistent with the published economics literature, ranging between  $-0.382$  and  $-0.613$  for residential demand,  $-0.747$  for commercial demand, and ranging between  $-0.522$  and  $-0.868$  for industrial demand.

Regarding retail electricity competition, the author examines econometrically the impact of the restructuring of the retail electricity sector in the US from the mid-1990s. Since this period and up to 2009, a total of 21 states permitted retail customers (some states permitting only large industrial customers and some states also permitting smaller commercial and residential customers) to select their electricity generation supplier (retail competition) from a business other than the incumbent electricity distributor. As of 2009, 17 and 15 states still permitted retail competition for large and smaller

customers, respectively. The paper reports the estimation of reduced-form static and dynamic price equations controlling for demand and supply factors, and include a binary variable for those states and time periods where retail competition was permitted. The author tests the null hypothesis that retail competition had no statistically significant impact on real electricity prices, and finds that retail electricity competition is associated with lower electricity prices for each customer class with the magnitude of the impact being greater for the larger customer classes.

**Modelling Household Energy Consumption using ABS Survey Data**, Kay Cao, Rosalynn Mathews and Summer Wang, *Economic Papers*, 34, June 2015, pp. 36-47.

This paper reports on the modelling of household energy consumption using data from the Australian Bureau of Statistics 2012 *Household Energy Consumption Survey*, covering approximately 12,000 households across Australia. The authors use a reduced-form equation approach explained on page 38 of the article. Household energy consumption is found to be influenced by: household income (small positive coefficients ranging from 0.05 to 0.07); energy price (own-price elasticities ranging from  $-0.77$  to  $-0.96$ ); geographic location by state or territory (higher in New South Wales than in Queensland and Western Australia; high in the Australian Capital Territory and the Northern Territory); household size (more members means more consumption); dwelling characteristics (for example, more bedrooms and more hot-water systems mean more consumption); and the presence of a solar system (significant negative). With respect to the solar system, the consumption explained by the authors' model is energy from the grid only – that is, exclusive of the household's photo-voltaic own-production. Therefore, there is no conclusion relating to total energy consumption and the possibility of a 'rebound effect' from the use of small-scale household solar systems. The reference list contains twenty items.

This article can be accessed by subscription to *Economic Papers*.

**Prices Based on Current Cost or Historical Cost: How Different are They?**, Timothy Tardiff, *Journal of Regulatory Economics*, 47, 2015, pp. 201-217.

This paper is about the alternatives of pricing utility services with either historic costs or with current costs, and how different they are. While rates based on current costs have differed in the expected way from the corresponding rates based on historical costs, this paper seeks to demonstrate that (1) the

large differences expected by conventional wisdom are the result of faulty application of the current cost methodology; and (2) proper application substantially narrows the difference between the rates produced by the respective approaches. The reference list contains twenty items, including to thirteen articles published in academic journals.

In 1996, The Federal Communications Commission (FCC) prescribed total element long-run incremental cost (TELRIC) to determine the rates that incumbent local exchange carriers (ILECs) can charge for most mandated wholesale services. TELRIC, which bases prices on a hypothetical incumbent that serves current volumes with completely new equipment, was a major departure from the predominant use of historical (or original) costs for regulated prices. The FCC made two exceptions where rates are based on original cost calculations: total-service resale of local exchange services; and rental of space by cable television providers and competitive local-exchange carriers on poles and conduit owned by electric utilities and ILECs. The FCC's use of both current cost and historical cost methodologies recalls what Timothy Tardiff describes as 'the fierce debates' over whether regulated rates should be based on replacement (current) costs or original (historical costs) that preceded the US Supreme Court's 1944 *FPC v Hope* decision. Parties advocating low rates favoured replacement costs when equipment costs were expected to decrease, but original costs when such asset prices would be expected to increase. The *Hope* decision upheld the Federal Power Commission's use of original costs, which subsequently were widely used by federal and state regulators.

The published version of this article can be purchased on-line or by subscription to *Journal of Regulatory Economics*.

**The Value of Network Neutrality to European Consumers**, Rene Arnold and seven others, A study commissioned by the Body of European Regulators for Electronic Communications (BEREC) and prepared by WIK, YouGov and Deloitte, April 2015.

The Body of European Regulators for Electronic Communications (BEREC) recognised network neutrality as a key policy priority in 2010, and this recognition led to various related activities, for instance fact-finding on traffic-management practices and an assessment of Internet Protocol (IP) interconnection. While these activities have given European regulators a solid basis for understanding issues around network neutrality, this enhancement has been much more in relation to the supply side of Internet Access Service (IAS) than the demand side.

These key questions arose: How do consumers understand and conceptualise network neutrality? Do consumers value aspects of network neutrality in their purchase choice for IAS offers?

BEREC commissioned an extensive **study** to answer these questions. The authors of this study note that network neutrality has been a part of policy and public debate in Europe for some time now. While various previous studies have investigated numerous aspects of the net-neutrality issue from regulatory, legal and other perspectives; according to this study, consumers have largely been neglected. In light of this lack of focus, the present study sets out to discover the value of network neutrality to European consumers from various perspectives. The research was conducted in four selected test areas across Europe: Croatia, the Czech Republic, Greece and Sweden. The authors use a mixed-methods approach, including both qualitative (focus-group discussions) and quantitative research methods (online survey including a conjoint analysis).

**Benchmarking and Effects of Reforms in the Fixed Telecommunications Industry: A DDF Approach**, Clementina Bruno and Alessandro Manello, *Telecommunications Policy*, 39, March 2015, pp. 127-139.

This paper is about the efficiency evaluation of European fixed-line telecommunications operators using the Directional Distance Function (DDF) approach. Section headings are: introduction; motivation, theoretical background and model; data; results and discussion; and conclusions. There is also an appendix. There are 59 items in the reference list, mainly articles in professional academic journals.

The authors use the DDF approach which is an extension of the Data Envelopment Analysis (DEA) technique, involving a 'more flexible concept of distance'. Details of the DDF approach are explained on pages 130-133 of the article, with references to the key publications. Inputs and outputs are characterised into those that are either less desirable or more desirable. The dataset contains financial and operational information for 13 incumbent operators in fixed-line telecommunications within the European Union. The authors use a second-stage multiple regression analysis to investigate the impact of the following variables representing: the competitive environment; the ownership structure; and the extent of vertical integration. Results include that: a more developed competitive environment 'worsens incumbents' performance'; ownership 'is not likely to affect ... performance'; vertical separation provides 'an effective incentive towards more virtuous efficiency performance'; and vertical economies of

scope are 'not so relevant' in fixed-line telecommunications. The authors argue that the choice of benchmarking framework is of 'crucial importance when non-parametric frontier methods are employed for regulatory purposes' (p. 137).

The article can be purchased on-line or by subscription to *Telecommunications Policy*.



## Regulatory Decisions in Australia and New Zealand

### Australian Competition and Consumer Commission (ACCC)

#### Wheat Terminals – Exemptions Granted

The ACCC has granted exemptions from parts of the Wheat Code to wheat terminals at: (two) the Port of Brisbane (24 September 2015); Bunbury (24 September 2015); and (two) the Port of Newcastle (30 July 2015).

#### Australia Post Price Notification – Issues Paper

On 7 September 2015 the ACCC announced that it had received a draft proposal by Australia Post to increase the prices of its ordinary letter service. Australia Post is proposing to increase the basic postage rate to \$1 for letters delivered at a new timetable, which allows an extra two business days for delivery to occur. The ACCC released an **Issues Paper** seeking stakeholder views.

#### Regulated Transmission Services (DTCS) – Draft Report on Access Pricing

On 4 September 2015 the ACCC **released** its draft final access determination (FAD) for the declared domestic transmission capacity service (DTCS).

#### NBN-Optus Agreement Authorised

On 28 August 2015 the ACCC authorised the revised agreement between NBN and Optus. **MR Here**.

#### Mobile Voice and SMS Terminating Access Service – Final Decision

On 24 August 2015 the ACCC released its **final** decision on the price that mobile network operators should charge each other and fixed-line network operators for receiving calls on their mobile network. For the first time, the ACCC has also decided on a price for mobile network operators to charge to terminate SMS messages.

#### Acquisition of iiNet by TPG Not Opposed

On 20 August 2015 the ACCC **announced** that it will not oppose TPG Telecom Limited's proposed acquisition of iiNet Limited. TPG and iiNet are two of the five largest suppliers of fixed-line broadband in Australia.

#### Viterra's Long Term Agreements – Draft Decision Not to Accept

On 16 July 2015 the ACCC released a draft decision not to accept Viterra's long-term agreements. **Find the MR here**.

#### NBN Co Proposed Information Disclosure Requirements

On 30 June 2015 the ACCC released a **report** recommending that NBN Co make available more information about the deployment of the national broadband network.

### Australian Competition Tribunal (ACT)

#### Applications for Review of AER Determinations and Decision

The ACT is hearing applications under s 71B of the National Electricity Law for a review of distribution determinations made by the Australian Energy Regulator in relation to Ausgrid, Endeavour Energy, Essential Energy, ActewAGL under rule 6.11.1 of the National Electricity Rules and in the matter of an application under s 245 of the National Gas Law for a review of a full access arrangement decision made by the Australian Energy Regulator to Jemena Gas under rule 64 of the National Gas Rules.

### Australian Energy Regulator (AER)

#### Cost Thresholds Associated with the Regulatory Investment Tests – Review Initiated

On 2 September 2015 the AER **published** its Draft Determination and called for submissions on the cost thresholds for the RIT-T and RIT-D are cost-benefit tests that network businesses must apply to identify the most efficient option to address a need on its network. The test applies for only transmission and distribution investments above certain cost thresholds set out in the National Electricity Rules.

#### Quarterly Compliance Report on National Electricity and Gas Laws Published

On 17 August 2015 the AER published its latest Quarterly Compliance Report: National Electricity and Gas Laws. The report summarises the AER's compliance monitoring and enforcement activities in the wholesale electricity and gas markets during the April-June 2015 period. **Access report here**.

## Amadeus Gas Pipeline – Gas Access Arrangement Proposal from APT Pipelines (NT) Pty Ltd

On 5 August 2015 the AER **announced** it had received a gas access arrangement proposal from APT Pipelines (NT) Pty Ltd for the Amadeus Gas Pipeline. The AER is required under the National Gas Rules (NGR) to determine the revenue allowance for this pipeline. The proposal covers the access arrangement period 1 July 2016 to 30 June 2021.

## Australian Energy Market Commission (AEMC)

### Pipeline Regulation and Capacity Trading Discussion Paper – Call for Submissions

On 18 September 2015 the AEMC called for submissions on a gas Pipeline Regulation and Capacity Trading **Discussion Paper** which is part of the East Coast Wholesale Gas Market and Pipeline Frameworks Review.

### AEMC's Strategic Priorities

See 'Notes on Interesting Decisions'.

### Demand Management Incentive Scheme – New Rule

On 20 August 2015 the AEMC **made a final rule** in line with proposals from the Total Environment Centre and COAG Energy Council, to encourage electricity distribution networks to make efficient decisions in relation to network expenditure, including investment in demand management. The rule amends the existing demand management incentive scheme arrangements to provide greater clarity to the Australian Energy Regulator and stakeholders in respect of how a demand management incentive scheme and a demand management innovation allowance should be designed and applied.

### East Coast Wholesale Gas Market and Pipeline Frameworks Review – Discussion Paper

On 6 August 2015 the AEMC released a wholesale gas markets **discussion paper** for consultation as part of the East Coast Wholesale Gas Market and Pipeline Frameworks Review. In addition, as part of its consultation, the AEMC will hold a public forum on this review on 30 September 2015.

### TasNetworks – Replacement Framework and Approach

On 9 July 2015 the AER **released** its final decision to replace the Framework and Approach for Tasmania's

electricity distributor TasNetworks Distribution, which is to apply for the 2017-2019 regulatory control period.

## National Competition Council (NCC)

### Declaration of the Shipping Channel at the Port of Newcastle – Draft Recommendation

On 30 July 2015 the NCC released its draft recommendation (**available here**) on the application for declaration of the shipping channel service at the Port of Newcastle. The draft recommendation is that the service not be declared. The NCC also reached the view that the designated Minister for this matter is the Commonwealth Minister. On 18 September 2015 the nine submissions that were received on the draft recommendation were placed on the website.

## Australian Capital Territory

## Independent Competition and Regulatory Commission (ICRC)

### ACT Electricity Feed-in Scheme Summary Report – June 2015 Quarter

On 31 July 2015 the ICRC **published** its final summary report on the Electricity Feed-in Scheme for feed-in from renewable energy generators to the electricity network, for the period 1 March 2009 to 30 June 2015. The minister responsible for the scheme has asked the ICRC no longer to provide the report. This work is now managed by the department responsible for the Electricity Feed-in Scheme policy.

## New South Wales

## Independent Pricing and Regulatory Tribunal (IPART)

### WAMC Price Review – DPI Water's Submission Received

On 14 September 2015 the IPART announced that it had received the Department of Primary Industries - Water (DPI Water)'s **submission** to its issues paper on the review of prices to be charged by the Water Administration Ministerial Corporation (WAMC) from 1 July 2016. WAMC is the legal entity responsible for water management in NSW, and WAMC's water management activities are largely delivered by DPI Water.

### Sydney Water, Hunter Water and WaterNSW Price Reviews – Issues Papers Released

On 7 September 2015 the IPART **released** Issues Papers for its reviews of prices charged by Sydney

Water, Hunter Water and WaterNSW (for its Greater Sydney customers) for their monopoly water and (where applicable) sewerage services. This follows the receipt of the utilities' pricing proposals on 30 June 2015. The Issues Papers provide relevant background information and identify key issues. The reviews will occur over a period of twelve months, with new prices to apply from 1 July 2016.

### **Solar Feed-in Tariffs – Draft Determination**

On 31 August 2015, the IPART released a Draft Report and Draft Determination for its review of solar feed-in tariffs in 2015-16. Its draft determinations are that the retailer contribution will be 4.9 cents per kilowatt hour from 15 November 2015, and the benchmark range will be 4.4 to 5.8 cents per kilowatt hour until June 2016. **MR Here.**

### **Retail Electricity Monitoring – Draft Report**

On 20 July 2015 the IPART released a **draft report** on the performance and competitiveness of the retail electricity market in NSW for residential and small business customers for the period 1 July 2014 to 30 June 2015.

## **Queensland**

### **Queensland Competition Authority (QCA)**

#### **Dalrymple Bay Coal Terminal (DBCT) DAAU – Refusal to Approve**

On 25 August 2015 the **QCA released** its Final Decision on DBCT Management's Differential Pricing DAAU, which refuses to approve the DAAU, and indicates the manner in which DBCT Management would need to amend the DAAU so that it could be approved.

## **Northern Territory**

### **Utilities Commission**

#### **Compliance Framework and Reporting Guidelines – Draft Issued**

On 15 July 2015 the Utilities Commission issued **draft Compliance Framework and Reporting Guidelines** to supplement its Statement of Approach on Compliance. The Guidelines include, among other things: a requirement for annual compliance reporting; additional information on the reporting of material compliance breaches and an annual declaration from the Board of Directors of each business as a 'vehicle for elevating the importance of compliance'.

## **South Australia**

### **Essential Services Commission of South Australia (ESCOSA)**

#### **Access Regime for Intrastate Rail – Final Recommendation**

On 7 September 2015 the **ESCOSA** announced that it had finalised its Inquiry into the Access Regime that applies to the major intrastate railways in South Australia; marking the completion of the SA Rail Access Regime Review. The final recommendation of this review is that the current regime that provides for third-party access to South Australian railway infrastructure services should continue from 31 October 2015 for a further five-year period.

#### **SA Water Regulatory Determination 2016**

On 2 September 2015 the ESCOSA **announced** that SA Water has provided it with its Regulatory Business Proposal 2016, signalling the start of the ESCOSA's review of the regulatory arrangement between SA Water and its customers for the four-year period commencing 1 July 2016. The ESCOSA's review will seek to ensure that SA Water is planning to deliver water and sewerage retail services in an efficient and prudent manner.

#### **Tarcoola-Darwin Railway Ten Year Review of Revenues – Final Decision**

On 29 August 2015 the ESCOSA completed its **Final Report** on the Tarcoola-Darwin Railway – Ten-year Review of Revenues. The ESCOSA found that access revenues have not been excessive in respect of non-competitive infrastructure services provided on the Tarcoola-Darwin Railway for the period from 15 January 2004 to 30 June 2013.

#### **Strategic Directions Consultation Paper**

See 'Notes on Interesting Decisions'.

## **Tasmania**

### **Office of the Tasmanian Economic Regulator (OTTER)**

#### **Investigations into Standing Offer Prices and Regulated Feed-in Tariffs**

In July 2015 the OTTER announced its intention to conduct investigations into **Standing Offer Prices** and into **Regulated Feed-in Tariffs**.

#### **OTTER Restructured**

In July 2015, following the enactment of the **Economic Regulator Amendment Act 2015**, the Tasmanian Economic Regulator was restructured



from a three-person panel to a single person with the capacity to appoint an Assistant Regulator for specific functions, if required. The amended Economic Regulator Act also provides for the appointment of an Acting Regulator, to act as the Regulator, during any period that the Regulator is absent.

## Victoria

### Essential Services Commission (ESC)

#### True Value of Distributed Generation to Victorian Consumers – Terms of Reference Released

On 11 September 2015 the ESC released the **terms of reference** it had received from the Victorian Minister for Finance for an inquiry into the true value of distributed generation to Victorian consumers.

#### Energy Hardship Review – Draft Report Released

On 1 September 2015 the ESC released its **draft report** on the Energy Hardship Review covering: the design of the current regulatory framework; current industry policies, practices and procedures; leading and best practices in other jurisdictions and industries; and a proposed new framework that aims to deliver better outcomes for customers experiencing payment difficulties.

#### Minimum Feed-in Electricity Tariff

On 25 August 2015 the ESC released its **Final Decision** on the Minimum Feed-in Tariff to apply from 1 January 2016.

#### Review of Water Pricing Approach

On 31 July 2015 the ESC released a **series of papers** on generating ideas on the pricing approach for Victoria's water sector.

## Western Australia

### Economic Regulation Authority (ERA)

#### Review of the Railways (Access) Code 2000 – Draft Report

On 23 September 2015 the ERA **released** its draft report on the review of the Railways (Access) Code 2000 and invited submissions from interested parties.

#### Railways (Access) Code 2000 – 2015 WACC Announced

On 18 September 2015 the ERA **announced** that it had calculated the Weighted Average Cost of Capital

(WACC) for the Public Transport Authority, Brookfield Rail and The Pilbara Infrastructure, as at 30 June 2015, as required by the Railways (Access) Code 2000.

#### Wholesale Electricity Report to the Minister Published

On 9 September 2015 the ERA published the 2014 Wholesale Electricity Market Report to the Minister for Energy **which is available here**.

## New Zealand

### New Zealand Commerce Commission (CCNZ)

#### Customised Price Paths – Draft Amendments Published

On 7 September 2015 the CCNZ **published** draft amendments that would provide more flexibility for gas and electricity distributors when applying for a customised price-quality path.

#### North Island Grid Update – Increased Recovery

On 6 August 2015 the CCNZ released its **final decision increasing** the amount Transpower can recover for the North Island Grid Upgrade (NIGU) Project by \$52.3 million.

#### Christchurch Airport's Pricing Information – Final Decision

On 9 July 2015 the CCNZ published its **final report** on Christchurch International Airport Limited's disclosure of revised pricing information.

#### Input Methodologies Review – Earlier Consideration of Airport Land Valuation Rules

On 3 July 2015 the CCNZ **announced** it had decided to fast track the consideration of airport land valuation rules as part of the input methodologies (IM) review announced on 10 June 2015.

#### Copper Lines and Broadband – Further Draft Decisions

On 2 July 2015 the CCNZ released **further draft decisions** for consultation setting proposed prices that Chorus can charge for use of its local copper lines and broadband service over the next five years.

#### Wellington International Airport's Pricing Information – Final Decision

On 30 June 2015 the CCNZ released its **final report** confirming Wellington International Airport Limited (WIAL) is targeting returns for the period from 1 June

2014 to 31 March 2019 that fall within the estimated range of acceptable returns.

## **Electricity Authority**

### **Demand Response Initiatives – Discussion Paper Released**

On 11 August 2015 the Electricity Authority published an **information paper** that sets out the principles that, in the view of the Authority, should apply to demand-response initiatives.

## Notes on Interesting Decisions

### AEMC's Strategic Priorities

On 10 September 2015, the Australian Energy Market Commission (AEMC) released a **Strategic Priorities Discussion Paper** as part of its third strategic priorities review to determine how the existing priorities may need to evolve given advances in the COAG Energy Council's policy priorities and changes both within the energy markets but also in a range of external factors that influence the way those markets operate. The AEMC has already had early engagement with the COAG Energy Council's Senior Committee of Officials (SCO), a range of consumer groups, industry participants, the Australian Energy Regulator (AER) and Australian Energy Market Operator (AEMO). The development of the AEMC's strategic priorities is guided by the national electricity objective, the national gas objective, and the national energy retail objective. Each objective incorporates the achievement of economic efficiency in the long-term interests of consumers as the basis for the advice the AEMC provides to the COAG Energy Council (the Energy Council) and when it makes decisions about rule-change requests. The Discussion Paper is 32 pages in length and has chapters on: introduction; context for the strategic priorities; consumer priority; gas priority; and markets and network priority.

In relation to environmental policies (section 2.2), the AEMC states these 'are unambiguously the role of governments' and its role 'is in the mechanism for achieving the objective and ensuring this is done in a way that supports energy market efficiency and the long term interests of consumers'. Specifically with respect to the Renewable Energy Target (RET), the AEMC states that the 'the integration of that policy with the National Electricity Market was potentially not well understood':

The RET set a fixed target for growth in renewable generation without regard to supply and demand conditions and wholesale prices in the market. Risks around whether the new investment would be profitable or efficient were effectively transferred to consumers through higher retail prices, as well as the equity owners of existing generators in the form of lower wholesale prices. Unlike the new capacity supported by the RET, existing generators are not shielded from lower wholesale prices through certificate payments funded by consumers.

With respect to distributed generation, the AEMC recalled its Power of Choice and the rule changes

that followed. The Power of Choice review noted that most consumers (with or without distributed generation) were not paying prices that reflect the underlying costs and benefits of supply. This was due to current network tariffs and retail offers and the limited availability of real-time metering data. In response, the AEMC made a rule establishing a new pricing objective and new pricing principles for distribution businesses that will require that network prices reflect the efficient costs of providing network services. Network prices based on the new pricing objective and pricing principles will be gradually phased in from 2017, and these 'will go some way' to removing cross-subsidies between different network users, including those with and without solar PV.

The final chapter, covering the broad area of 'markets and networks priority', contains observations on how markets and networks are evolving. The chapter invites consideration of the market and regulatory arrangements that contribute to the right environment for business model evolution, while still promoting the consumer outcomes that are the objective of regulation.

### ESCOSA's Strategic Direction

The Essential Services Commission of South Australia (ESCOSA) is considering its overall regulatory approach and key focus areas for the period from 2016 to 2019. On 13 August 2015 it released a **Strategic Directions Consultation Paper** seeking public comment. Further, to assist stakeholders in providing comment, the ESCOSA will hold public forums across South Australia.

The Essential Services Commission Act and various industry Acts together provide the ESCOSA with regulatory and advisory powers and functions. In performing its functions, the ESCOSA has the objective of protecting the long term interests of consumers with respect to the price, quality and reliability of essential services. The Act also aims to: promote competitive and fair market conduct; prevent misuse of monopoly or market power; facilitate entry into relevant markets; promote economic efficiency; ensure consumers benefit from competition and efficiency; facilitate maintenance of the financial viability of regulated industries and the incentive for long term investment; an independent; consultative; ethical; professional; accountable; and transparent.

The ESCOSA performs a range of functions across the different industries it regulates, including pricing, licensing, performance monitoring and reporting, compliance and scheme administration. For each industry, the relevant industry regulation Act specifies the scope of its role. These are tabulated on page five of the consultation paper. The ESCOSA has two broad advisory functions: The first is to provide



advice to the Treasurer, on request, in relation to any matter. In that capacity the ESCOSA acts as a consultant to the Government, providing independent advice on economic and regulatory matters. The second is to conduct public Inquiries (Part 7 of the Essential Services Commission Act) which can be initiated by the ESCOSA; by the Treasurer (into any matter); or by an industry Minister (into any matter concerning a regulated industry). The ESCOSA's main industry-based functions relate to: water (SA Water, 37 intermediate suppliers and 26 minor suppliers); energy (mainly licensing and solar PV feed-in price regulation); access regulation of the Tarcoola-Darwin railway and for specified intrastate rail lines; and sea ports (the pricing and third-party access regulator for specified types of ports services at proclaimed ports in South Australia).

## Regulatory News

### 2015 ACCC/AER Regulatory Conference – Presentations

The presentations from the 2015 ACCC/AER Regulatory Conference are available here on the **ACCC website**.

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