

# Electricity Privatisation and Restructuring in Ontario and Abroad: *Lessons from the UK and elsewhere*

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# Why Privatise?

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- ▶ 1980s Thatcher Gov' t privatisation agenda: Why?
    - ▶ Controversial – Selling family silver? Just for proceeds?
  - ▶ There Is No Alternative – economic survival
    - ▶ British Telecoms – customer service & innovation
    - ▶ Water sector – funding for massive investments (quality stds)
    - ▶ Coal & steel – stem losses, reduce costs for rest of UK industry
    - ▶ Electricity – seemed well run, not loss-making, so why?
  - ▶ 1988 White Paper on Electricity privatisation
    - ▶ “Decisions should be driven by needs of customers” Hmm
    - ▶ Restructuring monopoly to enable competition – more efficient
    - ▶ Regulation: to promote competition and protect customers
  - ▶ *Lesson 1: Efficiency central reason to privatise*
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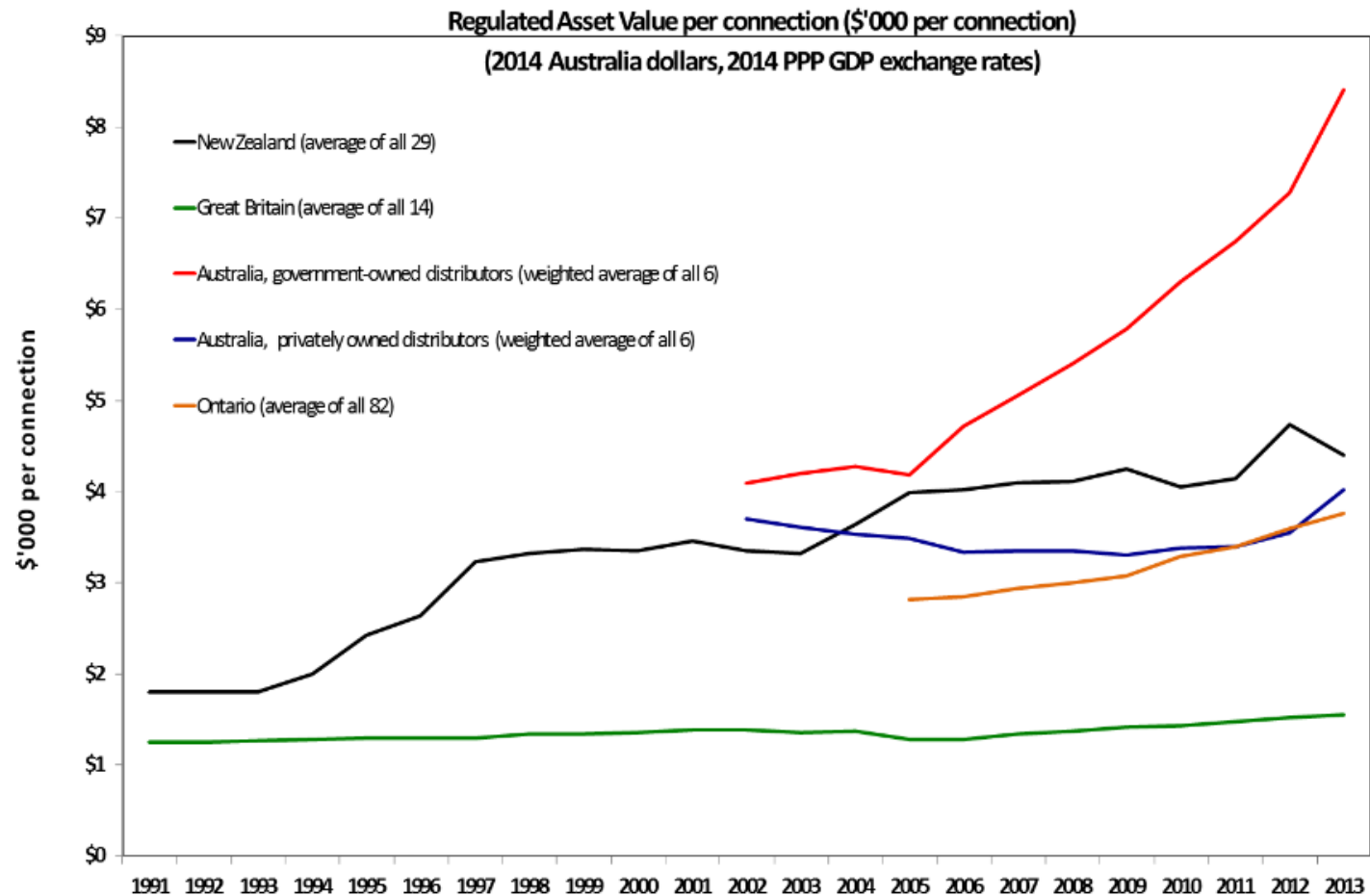
# Does Ownership Matter?

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- ▶ Yes, for competition (in generation & later retail)
- ▶ Ownership affects incentives (efficient monopoly)
  - ▶ Incentive regulation only works if co's respond
  - ▶ Example 1 Contrast energy & water networks v Royal Mail
- ▶ Gov't ownership compromises regulation
  - ▶ Ex 2 Guernsey, N Ireland – lack of due process, appeal to Gov
- ▶ Private cos more innovative & flexible
  - ▶ Example 3 National Grid Co (later)
- ▶ Do majority/minority holdings ever work?
  - ▶ Best of both worlds? Or worst of both?
  - ▶ Partial ownership seen as risk – only temporary in UK
- ▶ *Lesson 2: Regulation of govt co's is less effective*



# Ownership & Regulation: Examples



Source: Bruce Mountain

# Regulation

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- ▶ Key Q: How to reassure customers & investors?
  - ▶ 1983 Privatisation British Telecom: RPI-X
    - ▶ This means tangible benefits for customers & investors
    - ▶ But what about the future? Is asset expropriation a risk?
  - ▶ Regulation independent of government
    - ▶ Duty to promote competition & protect customers
  - ▶ Company obligations (eg price control) in licence and licence changes only by agreement with Co
    - ▶ Regulator can refer to Competition Commission – fresh review
  - ▶ This has worked – privatisation forced a regulatory system that protects both customers & investors
    - ▶ Too cosy regulation? Too few appeals? Some recent changes
  - ▶ *Lesson 3: Privatisation has forced form of regulation to protect both customers & investors*
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# Creating Competition

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- ▶ Privatisation is an opportunity to restructure
- ▶ UK initial plan duopoly Big G 70%, Little G 30%
  - ▶ Distorted – aim to hide nuclear (15%) in Big G flotation
  - ▶ At last minute nuclear pulled, so 55%, 30%, 15% shares
- ▶ New entry (Dash for Gas) but still market power
  - ▶ Increasing regulatory & public concern about ‘duopoly’
- ▶ Forcing private co’s to divest plant is not easy
  - ▶ Mixture of carrots and sticks eg allow vertical integration
- ▶ Better to restructure at privatisation
  - ▶ Eg Argentina, Victoria (Australia)
- ▶ *Lesson 4: Restructure while you have the chance*



# Is Transmission Boring?

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- ▶ National Grid Company (NGC)
  - ▶ Initially owned by 12 dist co's, later floated as separate company
- ▶ NGC then bought national gas trans & dist networks
  - ▶ NGC more efficient? But concern about single owner Elec & Gas
  - ▶ Required to sell off some regional gas distribution networks
  - ▶ Enabled comparative regulation - NGC now selling those it kept
- ▶ Plan: New trans invs (>£100m) put out to tender
- ▶ NGC has invested in US & interconnectors to UK
- ▶ Conflict: separate trans operator & system operator?
- ▶ *Lesson 5: Trans co's too can be major players in fast changing world, but need flexibility & control (private)*



# Distribution & Retail Companies

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- ▶ What to do with 12+2 local dist/retail companies?
  - ▶ Merge to 1 strong rival? No, keep many decision-makers
- ▶ Separate distribution & retail supply businesses
  - ▶ Specialisation: engineering (distribution) v markets (retail)
  - ▶ Importance of a capital market with going price
- ▶ Incentive regulation uses comparative competition
- ▶ Led to numerous takeovers & mergers
  - ▶ Ownership evolved, as in other markets. Scale econs? Some. Now 4 Distcos (with 3-4 networks each) & Big 6 Retail suppliers
- ▶ Same in successful markets Victoria, NZ, Texas
- ▶ *Lesson 6: Let market determine industry structure*





# Overall Impact of Privatisation

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- ▶ Distco's: National Audit Office Pipes & Wires 2002
  - ▶ Price cap regulation of networks has delivered substantial benefits – strong incentives to increase efficiency
  - ▶ Opex cuts 25% 1994/5-1997/8, Transco 50% (controllable) 1990+
  - ▶ Other benefits including improved reliability
- ▶ Generation/transmission: Cost-Benefit Analyses
  - ▶ 1997 study: £4 - £10 bn NPV, all to investors
  - ▶ 2004 study (later, with alternative counterfactual): £23bn NPV, half to customers
- ▶ Evidence of manpower reductions across sector
- ▶ *Lesson 7: privatisation can be good for customers & investors*



# UK Energy Price Control Reviews

(RPI-X@20: Energy Regulator's Review of Network Regulation 2008)

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## ▶ Achievements

- ▶ Efficiency, 30% lower network prices, 30% greater reliability, more investment, rewards shareholders

## ▶ Weaknesses

- ▶ Reviews are time-consuming, costly, complex
- ▶ Innovation good but narrow (opex efficiency, finance)
- ▶ Not good in network design, operation & pricing – latter will be more important in future (low carbon techs)
- ▶ No incentive for good business plans: same process
- ▶ Companies focus on regulator instead of customers

## ▶ *Lesson 8: Regulation may need refreshing*



# New Regulatory Approach

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- ▶ Need innovative, flexible networks to work with & respond to customers
- ▶ More incentives, more innovation
  - ▶ Eg Funding competitions for innovations
- ▶ Focus on Outputs not Inputs
  - ▶ Eg capacity & reliability not expenses & investment
  - ▶ Focus on Totex not on Opex & Capex separately
- ▶ Fast-track price control review for well-evidenced business plans with good customer engagement:
  - ▶ Complete in 6 mos instead of 18 mos
- ▶ *Lesson 9: Regulation can evolve significantly. And there are precedents for this in North America*



# Negotiated Settlements in North America

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## ▶ US Negotiated Settlements

- ▶ To reduce time, cost, risk, parties agree proposal to regulator
- ▶ Florida 1990s: Public Counsel & el cos agreed \$4bn cuts
- ▶ FERC 2000s leads discussions, parties often settle in 6 mos

## ▶ National Energy Board (NEB) Canada

- ▶ NEB set cost of capital formula to avoid long hearings
- ▶ Since 1997 almost all rate cases settled
- ▶ Introduced multi-year incentive systems
- ▶ Also provision of info, quality of service provisions
- ▶ Better information & customer relationships in industry

## ▶ NEB Policy: If process sound, accept outcome

- ▶ Don't substitute own view of public interest

## ▶ Ontario, Australia & Germany: Used settlements

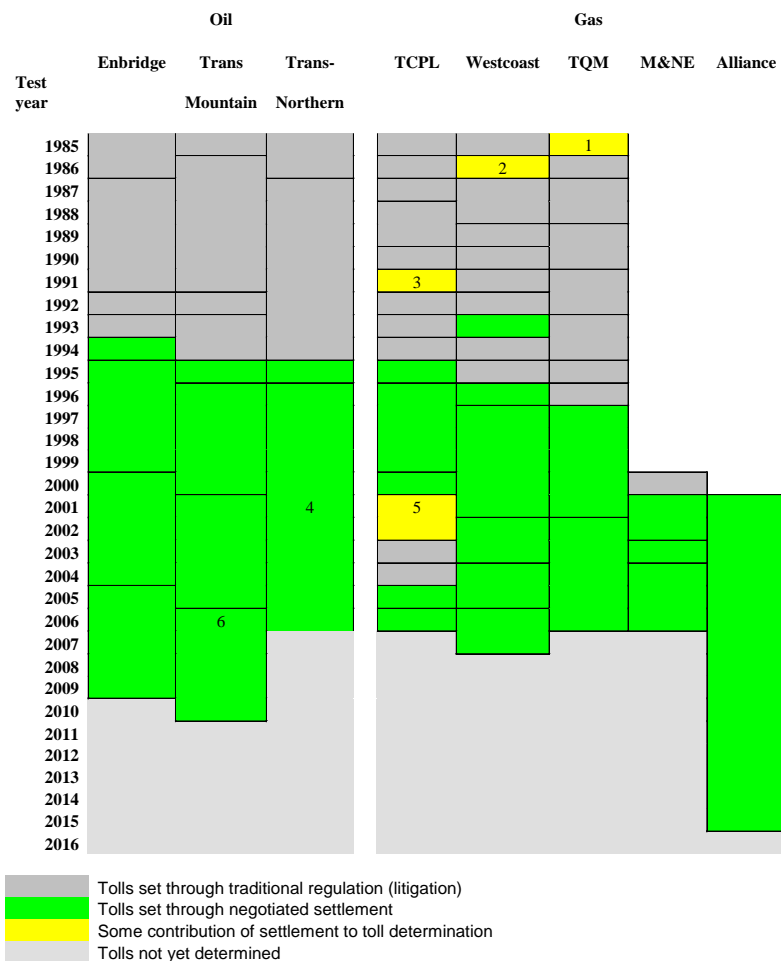
## ▶ *Lesson 10: Regulation can work by “holding the ring” and allowing parties to negotiate*

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# NEB Canada Settlement Activity Since 1985

(as of 2006)



Source: NEB toll decisions

# First UK “Constructive Engagement”

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- ▶ UK price control reviews more complex than NAm
    - ▶ Not test year actual costs – assess 5 yr opex & capex plans
  - ▶ 2005 CAA (airport regulator) changed approach
    - ▶ 2003 review confrontational – CAA had to take all decisions
    - ▶ Airport & its airlines to try to agree traffic forecasts, quality of performance standards and future investment programme
    - ▶ CAA set opex, cost of capital, financing and final price control
  - ▶ By 2007 aims largely achieved (at 2 airports)
    - ▶ Plus improved relationships and understanding
    - ▶ 2009 onwards, continued use, with CAA giving more structure to negotiating process, learning how best to facilitate
  - ▶ *Lesson 11: Regulation can be adjusted to enable informed customers to play a greater role*
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# Latest UK Customer Engagement

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- ▶ Can process work with 2m residential customers?
- ▶ Energy & water regulators offered fast-track reviews
  - ▶ Co's & customer representatives keen, engaged strongly, business plans much revised & customers supported them
- ▶ But regulators fast-tracked only 1 co each sector
  - ▶ Other companies offered insufficient cost reductions – Failure?
- ▶ Contrast Customer Forum in Scotland
  - ▶ Created by Scottish water regulator, WaterCo & Customer Body
  - ▶ Invited to negotiate business plan subject to regulatory guidance – achieved – formed basis of price control – Success
- ▶ *Lesson 12: Again, regulators may achieve more by guidance rather than taking all decisions*



# UK Government & Regulation

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- ▶ 1989 Privatisation: Gov' t energy policy = No policy
    - ▶ Gov' t & regulator duty: promote competition & protect customers
  - ▶ 1997-2008 Gov' t slightly modified regulatory duties
    - ▶ Promote competition “wherever appropriate”
    - ▶ Gov' t can issue guidance on social/environmental policies
    - ▶ Duty to contribute to achieving sustainable development
  - ▶ 2008 – 2010 Govt further modified duties
    - ▶ Interests of customers include lower greenhouse gas emissions
    - ▶ Before promoting competition, consider other ways of regulation
    - ▶ Supported Ofgem intervention in retail market (re “unfair prices”)
  - ▶ 2013 Gov' t Strategy & Policy statement
    - ▶ New Ofgem duty to further delivery of this Gov' t policy
    - ▶ Explain how, whether succeeded & if fail how remedy
  - ▶ *Lesson 13: Govt's will find ways to use regulation, but regulation probably not main means of action*
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# UK Government Energy Policy

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- ▶ 2008 Complete rewrite of Gov' t energy policy
  - ▶ “important decisions cannot be left to the market”
- ▶ 2010 Energy Market Reform policy
  - ▶ Targets for renewable energy
  - ▶ Contracts for low-carbon energy
  - ▶ Contract for nuclear generation (at twice market price)
  - ▶ Capacity mechanism
- ▶ 2015 What is present energy policy?
  - ▶ Cuts to some subsidies but support nuclear & offshore wind
- ▶ Increased risk, is unsubsidised investment viable?
- ▶ *Lesson 14: Gov' t cannot be controlled & will change policy. But privatisation means it has to act explicitly, so Parliament can hold it to account.*



# Lessons for Other Jurisdictions

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- ▶ Privatisation has many potential efficiency benefits – important beginning, but not the end of the story
- ▶ Chance to restructure for competition & comparison
- ▶ Competition is possible in generation & retail supply
- ▶ Also need to find efficient transmission & distribution
  - ▶ So allow market to continue to evolve with takeovers
- ▶ Initially aim at payoff from improving efficiency but increasingly focus on finding what customers want
- ▶ Design regulatory role to protect customers & investors – but also flexible, innovative, responsive
- ▶ Accept that political concerns will have an impact
- ▶ But intervention worse in absence of privatisation

