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Don't Look Back in Anger

CC REJECTS RETROSPECTIVE REGULATION IN PHOENIX GAS CASE

In February 2012 Phoenix Natural Gas Limited (PNGL) rejected the price control proposed by the Northern Ireland energy regulator (UR). UR subsequently referred the price control to the Competition Commission (CC) to investigate whether the price control conditions operated against the public interest. The CC's decision will have implications for all UK regulators, since it bolsters the credibility of regulatory commitments by underlining the costs of retrospective regulatory interventions.*

The "PNGL12" price control was referred to the CC in March 2012. The review was unusual: PNGL and UR did not disagree substantially on the proposals for future cost allowances. Instead the dispute was focussed on UR's proposal to write off approximately 25% of PNGL's regulated asset base (RAB).

PNGL considered this proposal to be unexpected, unjustified, and contrary to the principles of incentive regulation, since it retrospectively altered the previously agreed value of PNGL's asset base. UR argued that it was acting in line with regulatory practice, and protecting the interests of customers, by removing "unspent allowances" from the asset base after 5 years. Ultimately, the nature of the 'contract' between regulator and regulated company was at stake.

REGULATING THE NATURAL GAS INDUSTRY IN NORTHERN IRELAND

From a regulatory perspective, PNGL was an unusual project, since it was a "greenfield" investment which began from a zero customer base. This necessitated a regulatory model with uncommon features:

- PNGL's allowed weighted average cost of capital (WACC) was fixed at 8.5% (pre-tax, real) for the duration of the original contract (20 years);
- the licence included a mandatory requirement for PNGL's network to reach a fixed percentage of properties within a given timeframe;
- since there was no historic investment, there was no RAB to start from – a "cashflow model" was used instead;
- PNGL was given a stronger incentive to outperform on capex than is typical in Great Britain (see box below); and
- recovery of the up-front investment (and of PNGL's reward for any cost outperformance) was deferred towards the end of the 20-year period (the "revenue deferral model") when volumes were expected to be higher.

Jointly, these features ensured that PNGL had the right incentives to roll-out the network widely and efficiently, and to expand the customer base. They also ensured that the project was attractive to investors, who required long-term regulatory commitments given the level of uncertainty associated with a start-up business that required large upfront capital investment to make returns that would only accrue in the long term.

Why reward networks for outperformance?

Standard network incentive regulation sets cost targets for opex and capex over a price control period, and allows networks to keep a share of any outperformance against those targets as profit. This encourages the network to reduce costs, and also helps to overcome the information asymmetry between regulator and network: at subsequent price reviews, the regulator can use outturn cost performance to inform the level of efficient cost allowances for the next period.

In Great Britain, the "sharing factor" (i.e. the share of any outperformance that the network retains as profit) has historically differed for opex and capex. Opex savings have often been retained in full by the company. For capex, it has been common for companies to earn depreciation and return on any cost reduction for a defined period of years. However, PNGL's original licence allowed it to retain outperformance in full for both capex and opex. This provided strong incentives to find efficiencies in a new-build network, which could be passed on to customers through lower cost allowances in future.

In 2006, PNGL and UR agreed a number of significant changes to this framework, including formally introducing a RAB (calculated at c.£312m). Around a quarter of this related to cost outperformance which had accrued to PNGL through the incentive mechanisms in place in its licence between 1996 and 2006 ("historic outperformance"). Due to the revenue deferral model, PNGL had yet to recover this outperformance, so it was included in the RAB to be recovered in future. Other changes included reducing the allowed WACC to 7.5% and agreeing the sale of PNGL's transmission business. At the time, UR described the package of changes as a "win-win" for PNGL and its customers.

IN THE LAND OF INCENTIVE REGULATION, CREDIBILITY IS KING

UR's PNGL12 proposal was simple on the surface. By 2012 PNGL had earned five years of depreciation and return on the historic outperformance that was included in the RAB in 2006. To pass on the benefits of outperformance to customers, UR proposed that the remaining outperformance be removed from the RAB, in line with a "standard" GB model. UR claimed that this had been its intention when it agreed the RAB in 2006. The sums of money at stake were significant: UR proposed a c.£80m write-down, roughly a quarter of the RAB. UR considered that transferring this value to customers was in the public interest.

PNGL disagreed. It had expected the outperformance included in the RAB to be recovered in full, in line with the incentive mechanism in place when it made the cost efficiency savings between 1996 and 2006 (see box); and with its expectations when it agreed the changes to its licence in 2006. PNGL argued that UR's PNGL12 proposal amounted to a retrospective change to the regulatory contract which would cause significant long-term detriment to customers.

The CC found that UR's proposal was not adequately signalled in 2006, and that the rationale for it was not sufficiently well communicated or understood. Changes to the regulatory framework that were enacted in this way *"would lead to a perception of regulatory uncertainty, as investors may assume that UR's future actions could be unpredictable….Investors may anticipate that in addition to normal commercial risks there could be greater uncertainty in the future about the regulatory environment, and thus increased risks that returns on investment will not be realized in the way or to the extent that is expected. This is likely adversely to affect investment decisions in the future."*[1] The extent to which, and means by which, regulatory instability can have a detrimental impact on customers was a key issue of debate, and the CC's considerations on this issue have significant precedent value for UK regulators.

The CC identified two ways in which customers could be harmed by retrospective interventions in the long-run. First, increased regulatory uncertainty is likely to affect the cost of attracting capital. Investors in network infrastructure place high importance on the credibility of the regime when deciding where to invest. This is because investments in network industries often involve sinking substantial upfront investments. The only guarantee that the investment will be remunerated is the credibility of the regulator's commitment: the less credible the commitment, the riskier the investment and the higher the cost of capital.

This is illustrated by the fact that the "regulatory risk" facing an entity is a key factor considered by ratings agencies when determining credit ratings. The CC

[1] Competition Commission Final Determination, paragraph 8.89.

placed a strong emphasis on the fact that ratings agencies reacted negatively to UR's PNGL12 proposals: Fitch went as far as placing PNGL on Ratings Watch Negative, pending the outcome of the CC's review. The cost of this - a higher WACC than would otherwise have been the case - would ultimately have been borne by customers.

A second impact of such interventions is the likely blunting of efficiency and innovation incentives: *"In general, a regulatory regime should provide incentives to reduce costs and to innovate and, in PNGL's case, also to develop the gas industry in Northern Ireland…If it is perceived that adjustments might be made after, for example, efficiencies have been achieved which then impact on investors' prior expectations, there is the possibility, if not more, that such incentives will be blunted in future."*[2] In the long run, these effects will be to the detriment of customers, as regulated firms will foresee the actions of the regulator, and reduce their efforts to seek efficiencies, the benefits of which are shared with customers.

The CC recognised that while it was *"clear that prices to existing customers would reduce* [if outperformance were removed from the RAB as per UR's proposals]*, we also note that there is a substantial risk that the consequences of such measures would be to reduce the willingness of investors to invest in future development of the gas network (and possibly other regulated sectors in Northern Ireland) and could increase the cost of capital applying. Therefore we consider that this could impede future gas network development which could otherwise create substantial future benefits for future customers, and could increase costs for current and future gas consumers."*[3] In other words, the CC came to a view that balanced the short-term consumer interest arising from a reduction in the RAB with the long-term consumer interest given the associated *"opportunity cost"* of such an intervention.

Regulator and regulated network play a repeated interaction game, coming together periodically to agree new cost allowances and incentive mechanisms that will apply for the next period. But the more scope a regulator gives itself to revisit parameters (such as the RAB or the sharing factor) and "change the rules of the game" after the event, the more clouded the network's effort/reward trade-off becomes, and the more uncertain investors are of their expected return. The CC's conclusion demonstrates that the regulator's credibility is therefore key: without a credible commitment that the regulator will stick to its word, the cost of capital is likely to increase, and incentive regulation is undermined.

THE PUBLIC INTEREST: PAST, PRECEDENT, AND FUTURE

The CC's task was to consider whether the existing price control would be expected to operate against the public interest and, if so, whether it could be remedied by licence modification. Ultimately it proposed only a £13.6m reduction to the RAB.

In doing so, the CC established a precedent which rules out retrospective interventions in all but the most exceptional circumstances: *"Because regulators make their decisions anew at each periodic review, there will be no expectation that all elements*

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2 *Ibid*, paragraph 9.114

3 *Ibid*, summary paragraph 37.

of the regulatory framework will remain unchanged from review period to period. In line with normal regulatory practice, our view is that any revision of previous regulatory determinations should be: well reasoned, properly signalled, subject to fair and effective consultation, clear and understood, and, normally, forward-looking. We consider that some changes are more serious than others, and that to reduce ex post and without clear signalling the opening value of a RAB is a step that should not normally be taken without very good justification, and only then after an appropriate period of consultation on the proposals. The RAB is an important aspect of the credibility of a regulatory regime in that it provides investors with a qualified assurance that they will be able to earn an assured return."[4] Given the need to avoid retrospective changes as far as possible, it is clear that regulators under the CC's jurisdiction must seek to get the framework right from the outset.

But the CC has left some wriggle room for regulators. *"Having said that, our own decision in the reference indicates that RABs can and should be changed where justified in the public interest. Regulators are free to depart from previous decisions where appropriate in pursuit of their statutory objectives, but they should consider carefully whether their actions may be considered to lead to regulatory instability that will add to uncertainty in the industry."*[5] In particular, "technical errors", where identified, could meet the CC's high threshold for warranting retrospective adjustments. The CC defines a technical error as *"for example, the input of incorrect data or an erroneous mathematical calculation, which are clearly wrong"* but stresses that it *"does not refer to differences of opinion on judgement and discretion"*[6]. The concept of a technical error includes instances of "calculation error", particularly where that error may have led to some form of "double counting" of allowances (such double counting accounts for £5m of the CC's proposed RAB adjustment).

It remains to be seen whether the concept of a technical error will feature in future regulatory reviews. In any case, the CC has signalled strongly that any short-term gains for customers arising from regulators revisiting their past decisions must be weighed against the long-run implications of doing so for regulatory predictability and stability. It is clear that the CC considers such decisions could have significant, long-run impacts on the cost of capital and on incentives to invest. And in the specific context of large, sunk upfront, "greenfield" investments, the CC has established that credibility of the regulatory contract is particularly important, and that the public interest is best served by stable long-run arrangements where regulators honour their commitments.

** Frontier Economics advised PNGL during the CC's review.*

4 *Ibid*, paragraph 9.112

5 *Ibid*, paragraph 9.112

6 *Ibid*, paragraph 5.89, footnote 59.

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