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Utility regulation – Changes afoot

Patching up a tainted model

By Nigel Hawkins

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Executive summary

- While the gas supply crisis – and its price implications – have dominated the UK price regulated sectors in recent months, other issues have arisen that have seriously tainted the price regulation system itself. Indeed, it is fair to ask whether it is "fit for purpose".

- Back in 1984, price regulation, via an unsophisticated RPI-x formula, was introduced to prevent the privatised British Telecom (BT) from abusing its market power. A similar price regulatory formula applied to British Gas, which was privatised in 1986. In the latter's case, a full "cost pass through" (CPT) mechanism was permitted so that end users directly bore the cost of higher gas input prices.

- More than 35 years later, we have turned full circle, with a new energy price cap being set at £1,971 for households on a default tariff – some 22m consumers. By October 2022, that figure is expected to exceed a shocking £3,200. Admittedly, for a regulatory regime to absorb such a massive turnaround in input costs, is unprecedented; in time, the cap should fall back.

- Ofgem has just announced a review of the existing electricity market arrangements, in which gas prices play a pivotal price-setting role, especially at the margins. The electricity distribution review is also under way for the 14 Distribution Network Operators (DNOs). It will be applied between April 2023 and March 2028. With most of the DNOs now part of larger companies, the financial impact of the distribution review will be far less wide-ranging than was the case in the mid-1990s.

- Although the intervention of the Competition and Markets Authority (CMA), as the appeal body, in adjusting Ofwat's Weighted Average Cost of Capital (WACC) for the 2019/20 periodic review was widely – and rightly – criticised, not least by Ofwat itself, the latter is already undertaking preparatory work for the 2024/25 periodic review. A 25-year capex span is planned, with storm overflow issues assuming higher priority than previously. Leakage levels will also be to the fore.

- On the telecoms front, rolling out broadband is crucial, as the COVID-19 experiences highlighted, especially for enhancing work-from-home (WFH) opportunities. However, BT's RPI+3.9% pricing formula seems very generous, all the more so with current inflation being close to 10%. Hence, broadband bills will rise sharply. In time, Ofcom may have to intervene and curb such increases, especially if high inflation persists.

- Heathrow Airport has become a new regulatory battleground – memories of the long-running Battle of Transco in the 1990s between Ofgas and the then British Gas abide. As today's ringmaster, the Civil Aviation Authority (CAA) is trying to adjudicate between the highly geared Heathrow Airport, which is seeking to ramp up landing charges, and the airlines, which are seeking far more modest increases. The gap between the protagonists remains very wide.

Background

The famous RPI-x for BT in 1984

UK utility regulation goes right back to the privatisation of BT in 1984, when just over 50% of its shares were sold, many to retail investors. Given the market power that BT possessed – and mobile telephony was in its infancy at the time – it was hardly surprising that some form of price regulation was necessary to prevent BT abusing its dominant market position. As such, an RPI-x formula was applied against BT's revenues, although much of the methodology to determine the impact of this figure was either unpublished or non-existent.

In 1986, the privatisation of British Gas, as a monopoly, raised similar issues. A complex supply formula was drawn up, which effectively gave British Gas a right to "pass through" its full gas supply costs: the Weighted Average Cost of Gas (WACOG) became a Key Performance Indicator (KPI). In principle, the "cost pass through" mechanism endures to this day, as the unprecedented surge in current wholesale gas prices feeds through to the end user.

OFFER's 1995 fiasco

Between 1989 and 1992, the 10 largest English and Welsh water companies and most of the electricity supply industry were privatised on the back of a defined regulatory regime. However, the latter was severely damaged by the 1995 periodic review for the electricity distribution companies, which, embarrassingly, had to be re-run after major shortcomings on the financial analysis undertaken by Ofgem's predecessor, OFFER.

The battle of Transco

Subsequently, price reviews have come and gone, with the infamous battle between Transco, then part of British Gas, and the then Ofgas over the rate of return to be allowed on its gas transportation and distribution network. The dispute was finally settled when British Gas was effectively split in the late 1990s.

In recent years, price reviews have become far more complex, with some regulatory documents running into many hundreds of pages. Moreover, the process has become very extended.

CMA's quixotic water judgment

Most recently, attention has focused on the CMA, which – to general disbelief – overturned elements of the WACC assumption that lay at the heart of Ofwat's painstaking and complex 2019/20 periodic review of the water sector.

In recent months, various other developments have taken place in different areas of utility regulation.

£1,971 default price cap

Inevitably, the gas pricing issue has been accorded the highest profile, given the recent surge in gas prices, which drove the price cap to £1,971 per year from April 2022, for the average household; this figure is expected to rise to ca.£3,200 by October this year. Moreover, the impact of this development also flows through to the electricity generation sector, given the major contribution that Combined Cycle Gas Turbine (CCGT) plants have made – and continue to make – to the UK's electricity generation output.

On the water front, aside from the CMA issue, Ofwat has already published some initial thoughts on the next periodic review, which will set consumer prices as from April 2025.

Broadband bills to rise sharply

The rise in inflation to ca.10% is also driving up the cost of broadband, which – as its highest priority – BT is installing nationwide.

Airport regulation, especially landing charges at Heathrow, has also been to the fore as part of the ongoing issues relating to the aviation sector, which have dominated travel news in recent months.

These, and related issues that have arisen in recent months, are addressed in this article. In some cases, where it is simply not "fit for purpose", fundamental reform of the regulatory structure may be needed.

Energy

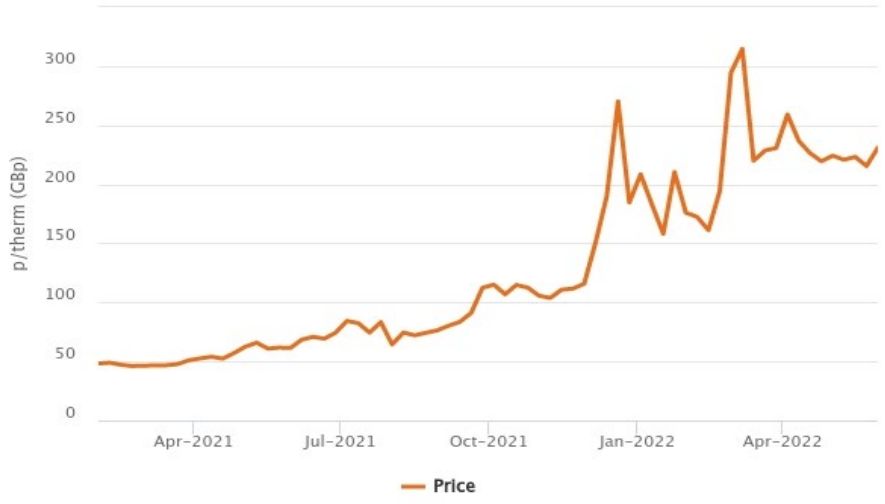
Cost pass through principle is key

Central to the regulatory principles dating right back to the flotation of British Gas in 1996 is the ability of the gas supplier to "pass through" wholesale price increases to the end-user. This scenario reduces the risk element for the gas supplier, although – as has been the case in the UK energy supply market of late – surging cost inputs can devastate a business model, as the swathe of bankruptcies among new energy suppliers has demonstrated.

Unprecedented gas price surge – dwarfing OPEC in the 1970s

The gas price increases over the past year have been unprecedented, especially in terms of the highly volatile spot market. The graph below, published by Ofgem, shows how much gas prices per therm have risen of late: the data is based on forward delivery contracts.

Ofgem gas prices: forward delivery contracts – weekly average (GBp)



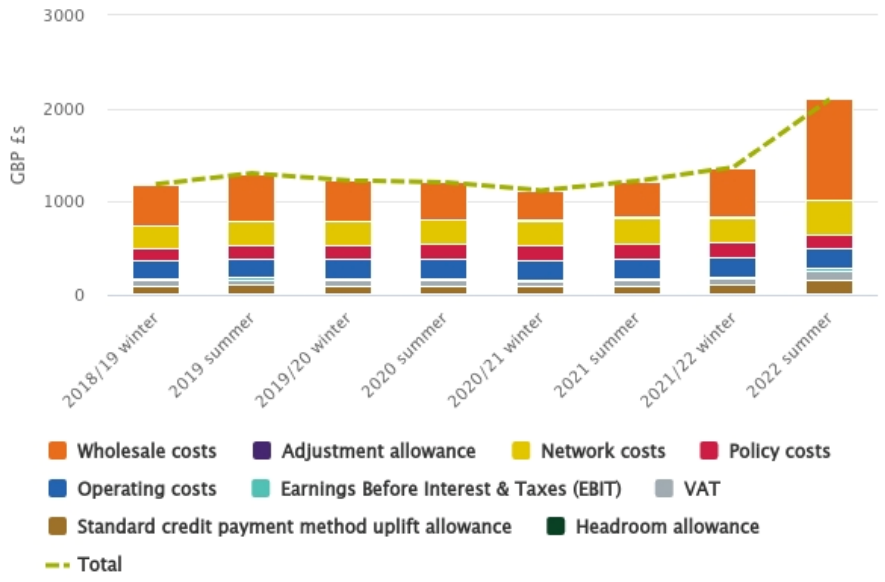
Note: Information correct as of July 2022
Source: Ofgem

Default price cap now at £1,971 – and set to exceed £3,000 by October

Inevitably, over the past year, the impact of surging gas prices, by far the largest component of Combined Cycle Gas Turbine (CCGT) operating costs, has had a profound impact on domestic energy bills: some 22m consumers are now subject to the default tariff price cap. Previously, the price cap was £1,277 per year for gas and electricity use by the average household. In April 2022, the figure was raised to £1,971, an increase of 54% in a single year. Those using the prepayment mechanism pay an additional £36. Moreover, consumer pain will worsen when the default price cap is reviewed in October – the expectation is that the energy price cap will, in all probability, exceed £3,000.

Ofgem has published a chart of the default price cap's level; it shows how steeply it has taken off over the past year.

Ofgem breakdown of the default tariff price cap (£, standard credit)



Note: Information correct as of 1 April 20222
Source: Ofgem

While Ofgem is attempting to tackle the impact of the surge in gas prices, along with the numerous bankruptcies in the energy supply market, it is also undertaking the periodic distribution review of the 14 DNOs. The determinations will apply as from April 2023 and will last until March 2028. It is still early days, with final determinations some months away, but National Grid, the owner of Western Power Distribution, has already responded, in very general terms, to various initial proposals that will see markedly higher investment.

Review of electricity market arrangements – the gas price marginal driver

Ofgem has also announced a review of the electricity market arrangements. Currently, the gas price often sets the marginal generation price – hardly an ideal arrangement when gas prices, as at present, are soaring.

Trying to kick start new nuclear-build

Although it will not contribute – for at least a decade – to solving the current gas crisis, either in terms of price or availability, the government seems wedded to the belief that further investment in new nuclear-build is necessary.

Hinkley Point C overruns

Since the Advance Gas-cooled Reactor (AGR) programme in the 1980s, only one new nuclear plant, Sizewell B, has come on stream – in the mid-1990s. To be sure, the construction of Hinkley Point C is well under way. Despite many delays and costs that are way above budget, the plant is likely to be commissioned by 2027 at the earliest – around a decade behind the original target date.

Sizewell C secures planning approval, but is it fundable?

Looking forward, the government has just given planning approval, against the recommendations of its own Planning Inspectorate, for the construction of the 3,200MW Sizewell C plant, with an estimated £20bn cost. There are well-founded concerns about water supply, among many other issues.

Funding the proposed new plant will be extremely challenging. The soon-to-be-fully nationalised EdF will be central to the project, with Chinese investment now far less likely.

RAB model to fund new nuclear-build

To make new nuclear-build more financially attractive, the government has indicated that its Regulated Asset Base (RAB) model, used for the Thames Tideway Tunnel sewerage project in London, is likely to be implemented. It will enable investors to receive financial returns while the plant is being built rather than having to wait for its commissioning, which – as nuclear new-build has so often shown – may well be seriously delayed.

Offshore wind at £37.35p per MWh

In the shorter term, the ramping-up of offshore wind investment seems set to continue. The latest auction saw a Contract for Difference (CfD) awarded at just £37.35p per MW – some years ago, the comparable figure was well in excess of £100 per MWh. The latest strike price also compares very favourably with the £92.50p (2012 prices) per MWh strike price granted for Hinkley Point C, which is due to be commissioned within the next five years.

National Grid pushes the boat out

Significantly, too, National Grid has just announced a massive £54bn investment programme, a substantial part of which is earmarked for improving connections between offshore wind plants and the Grid's transmission backbone.

Water

Methodology details in December 2022

While Ofwat retains robust views about the CMA's unwanted intervention in its WACC assumptions for the 2019/20 periodic review, it is already undertaking preparations for the 2024/25 periodic review. A methodology paper is due to be published in December 2022.

In framing its periodic review, Ofwat has confirmed it will be "building on PR19". However, it will take a decidedly long-term view by projecting water demand and supply levels for the next 25 years. The issue of new reservoirs seems certain to arise.

Storm overflows is a sensitive issue

Ofwat will aim to minimise any price increases. However, capex levels will remain high – Ofwat has specifically identified the tackling of the controversial issue of storm overflows. Leakage policy – and leakage levels – are likely to figure prominently.

The WACC figure is crucial

These, and many other issues, will be addressed by the water companies in their detailed business plans. Also, of course, there will be renewed debates about Ofwat's assumed WACC, which – given increased interest rates since 2019 – will presumably be higher than in 2019/20.

Telecoms

FTTP rollout to 25m by 2026 – a colossal undertaking

Clearly, the massive Fibre-to-the-Premises (FTTP) investment undertaken by BT, which is due to cover 25m premises by 2026, needs remuneration.

After all, COVID-19 and the WFH ethos demonstrated the importance of enhanced broadband connections. The political drive to deliver this priority is considerable, with BT, via its Openreach subsidiary, far better placed than others to do so.

RPI+3.9% in an inflationary environment looks very generous

Then again, the RPI+3.9% figure agreed with its regulatory body, Ofcom, looks very generous when it is boosted by near double-figure inflation numbers, as is the case currently.

Nonetheless, if inflation does not subside over the next few years, monthly broadband bills, at least in nominal terms, will increase markedly. Regulatory intervention may follow.

Heathrow Airport

While accusations fly between the government, the airport operators and the airlines regarding the responsibility for cancelling a vast number of flights of late, often at very short notice, the issue of the level of landing charges at Heathrow Airport persists.

The saga has rumbled on for years, not helped by the contentious debate about the third runway at Heathrow Airport and, if it were eventually built, how it would be financed.

Battle royal – but the gap is large

In short, Heathrow Airport's owners, the Ferrovial-led private equity group, which acquired control in 2006, is at odds – with a very large gap between them – with the airlines, most notably British Airways (BA), now part of the International Airlines Group (IAG).

Gold plating incentive

For regulatory purposes, Heathrow Airport has a Regulatory Asset Base (RAB) of £17.8bn, on which it is allowed to make a rate of return that is calculated by the Civil Aviation Authority (CAA). This methodology inevitably encourages gold plating, whereby investment is made in some assets, the value of which is – at best – very marginal; this represents a regulatory failure.

The numbers are certainly complex. Pre COVID-19, the average charge per person was under £20. Recently, Heathrow Airport sought over £40 per person – more than doubling the figure. On the back of ferocious pressure from the airlines, anxious to keep fare increases as low as possible, the CAA ruled that just over £26 per person was a reasonable figure. Inevitably, Heathrow Airport's owners disagreed.

Destined for the courts?

While a final determination from the CAA remains outstanding, the issue may eventually end up in the courts. In the long term, airport regulation may need a thorough overhaul – the CAA's ring-master role, especially during times of difficulty, is simply not working.

Conclusion

Energy issues are still attracting considerable national interest, especially with respect to the surge in domestic gas and electricity prices. It seems unlikely this situation will go away for some time.

The other regulation-orientated issues – discussed above – are especially relevant to individual sectors. For decades, there has been relatively little consistency across the regulated sectors, especially in terms of the WACC assumptions – something that may need to change.

Regulatory reform on the agenda?

Over the next two years, it is likely that some regulatory reforms will emerge to address the anomalies that have arisen in recent years.

About the author

Nigel Hawkins is the Infrastructure and Renewables Specialist at Hardman & Co.

Nigel specialises in the energy sector, with a particular focus on the expanding renewable generation market, in both the UK and overseas, about which he has written several reports assessing the sector's finances. He has been involved in analysing the utilities sector since the 1980s. He covered the privatisation of the water and electricity companies for Hoare Govett between 1989 and 1995. Subsequently, he researched the UK and EU telecoms sector for Williams de Broe. He has also written many feature articles for Utility Week magazine since the mid-1990s.

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