

**PUBLIC UTILITIES**

**ANNUAL REPORT 2010 UNITED KINGDOM**

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**INDEX**

- 1. INTRODUCTION**
- 2. ENERGY**
- 3. ELECTRONIC COMMUNICATIONS**
- 4. WATER**
- 5. RAIL**
- 6. POSTAL SERVICES**
- 7. AIRPORTS**
- 8. CONCLUSION**
- 9. WEBSITES**

**1. INTRODUCTION**

The public utilities in the UK are different from those in many other countries. They had been publicly owned, but under the Thatcher and Major Governments from 1979-1997 were privatised; now the only substantial enterprises in public ownership are the Royal Mail and Scottish Water, and the former is now being prepared for privatisation. Government has not retained any shareholdings in the privatised enterprises, and regulation takes place through the independent regulatory authorities, each of which will be discussed

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below.<sup>1</sup> Government has continued to play an important role in the regulatory environment, however, and there have been a number of changes in the regulatory arrangements in recent years. This report will look selectively at some of the main issues which have arisen in 2010 and early 2011, covering both the last period of the Labour Government and the first year of the Coalition Conservative/Liberal Democrat Government.

A number of important pieces of legislation were passed right at the end of the previous Government in 2010, notably the Energy Act 2010 and the Digital Economy Act 2010, which will be discussed below. The May 2010 election produced a new Coalition Government committed to radically different policies on a number of issues, especially the reduction of public spending. However, this has not so far produced major changes in the regulation of the public utilities, although, as we shall see below, a number of reviews of areas of regulatory policy have been initiated. The regulators have survived relatively unscathed the new Government's cull of 'quangos', through which many public bodies operating at 'arm's length' from government face abolition. However, the official consumer representation body 'Consumer Focus', which has had an important role in monitoring the effectiveness of consumer protection by regulators, faces abolition, as does the Administrative Justice and Tribunals Council which has some supervisory functions over them. There may be changes later; for example the Prime Minister stated before the general election that the functions of Ofcom, the communications regulator, would be changed to remove its policy making role, and a further review is being undertaken of the competition authorities, which may affect the regulators. The regulators themselves, whilst expected to increase their own efficiency, have largely escaped the effects of the major Spending Review process, being largely financed by levies from the industries. I shall now discuss in more detail some selected developments in each of the regulated sectors.

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<sup>1</sup> For further information on the regulation of the public utilities, see Tony Prosser, *Law and the Regulators* (Oxford: Clarendon Press, 1997) and *The Regulatory Enterprise: Government, Regulation and Legitimacy* (Oxford: Oxford University Press, 2010), ch. 9.

## 2. ENERGY

The role of the Office of Gas and Electricity Markets (Ofgem) has been reviewed by the Government, which has decided to retain it as an independent regulator but to set it new strategic goals.<sup>2</sup> Two major themes have been evident here. The first is the continuing efforts by Ofgem to make the liberalised energy markets work effectively for consumers. Thus in 2009 Ofgem undertook major investigation into energy supply markets after the industry had imposed substantial price increases.<sup>3</sup> The measures to be adopted included clearer information on bills, better information on tariffs, making it easier to switch suppliers where customers had outstanding debts, and stronger rules on sales and marketing (almost half the consumers who switched due to doorstep selling did not achieve a price reduction). Ofgem also decided to adopt new licence requirements that charges for different payment methods should be cost reflective and to prohibit undue discrimination in terms and conditions offered to customers, which it considered would substantially help the most vulnerable customers. These changes were mainly implemented by changes in the licences of the regulated companies, but the Energy Act made further provision for reform, notably by giving the Secretary of State power to introduce a new licence condition prohibiting some forms of abuse of market power *ex ante*; this power has not yet been brought into effect. The Act also empowered the Secretary of State to establish schemes for the reduction of fuel poverty and to adjust charges to assist disadvantaged groups of customers.<sup>4</sup>

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<sup>2</sup> Secretary of State for Energy and Climate Change, Written Ministerial Statement, 19 May 2011, 528 HC Debs col 26WS.

<sup>3</sup> Ofgem, *Energy Supply Probe – Initial Findings Report*, (2008); *Addressing Undue Discrimination – Final Proposals*, (2009) and *Energy Supply Probe – Proposed Retail Market Remedies*, (2009).

<sup>4</sup> Ss. 9-15, 18-23, 26-9.

Ofgem undertook a further retail market review in 2010-11. It found that further action was needed to protect consumers and to deal with structural weakness in the industry. It proposed measures to improve tariff comparability, to enhance liquidity through facilitating market entry by requiring dominant firms to auction generating capacity, to strengthen the remedies introduced after the earlier review and to improve reporting transparency.<sup>5</sup> Ofcom also introduced a rule requiring suppliers to give 30 days notice of price increases. The problems of consumer protection and of competition in the industry are likely to continue to be a major issue for Ofcom in future years.

The second major issue has been that of sustainability, and related questions of security of supply and of the encouragement of renewables. The Energy Act 2010 changed the statutory duties of Ofgem to make it clear that the interests of consumers, which must be protected by Ofgem, include their interests in the reduction of emissions of greenhouse gases and their interests in security of supply.<sup>6</sup> Though competition will remain the primary means of protecting consumers, the regulator must now also consider whether other means would better protect their interests.<sup>7</sup> In order to achieve the goals of decarbonisation, energy security and affordability, the Government consulted on Electricity Market Reform and on Carbon Price Support, and proposed major reforms including the use of feed-in tariffs to support low-carbon generation, a carbon price support mechanism, new emissions standards and a new capacity mechanism to ensure energy security.<sup>8</sup> The role of the electricity market in this has been examined by the Energy and Climate Change Committee of the House of Commons, which considered that ‘the big omission from the

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<sup>5</sup> Ofgem, *The Retail Market Review – Findings and Initial Proposals* (2011).

<sup>6</sup> Ss 16-17.

<sup>7</sup> Ss 16(3), 17(3).

<sup>8</sup> Department of Energy and Climate Change, *Consultation on Electricity Market Reform*, Cm 7983 (2010); HM Treasury, *Carbon Price Floor: Support and Certainty for Low-carbon Investment* (2010).

Government's proposals is a plan for reform of the wholesale electricity market.' This would need to break the dominance of the current 'big six' energy companies to permit new entrants to invest in low carbon generation.<sup>9</sup> A Government White Paper is awaited on these issues; it is clear that reform of the energy market will be a major future concern, involving both government and the regulator.

### **3. ELECTRONIC COMMUNICATIONS**

The Office of Communications (Ofcom) was established by the Communications Act 2003 as a unified regulator of all forms of electronic communications, including telecommunications and broadcasting and much of the 'new media'. Its work has been largely praised as a successful merging of different regulatory bodies, and it survived review by the National Audit Office and the House of Commons Public Accounts Committee in 2010-11 subject to only minor criticism.<sup>10</sup> However, as mentioned above, the Prime Minister promised to end its (largely advisory) role in the making of policy, and a review of its future is currently taking place.

The most notable work of Ofcom recently has been in the broadcasting field, notably in its review of the Pay-TV market and its advice to Government in relation to the proposed full purchase of Sky-TV by News Corporation.<sup>11</sup> However, a couple of other areas are of interest. The first is that of auctioning wireless spectrum for use for new-generation mobile

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<sup>9</sup> 'Electricity Market Reform', HC 742, 2010-12.

<sup>10</sup> NAO, 'Ofcom: The Effectiveness of Converged Regulation', HC 490, 2010-11; Committee of Public Accounts, 'Ofcom: The Effectiveness of Converged Regulation', HC688, 2010-11.

<sup>11</sup> Ofcom, '*PayTV Phase 3 Document: Remedies*' (2010); *Report on the Public Interest Test on the Proposed Acquisition of British Sky Broadcasting Group by News Corporation* (2010).

phone and related purposes; this is seen as essential for extending broadband coverage. After several small auctions, a major auction was announced in 2008; however, it was delayed by litigation on the part of some mobile operators who were strongly opposed to the details of the arrangements. The Government commissioned a review by an Independent Spectrum Broker; this resulted in a direction under the Wireless Telegraphy Act 2006 to Ofcom from the Government to carry out the auction.<sup>12</sup> Ofcom has now consulted on the arrangements for such an auction.

Litigation also figured in a highly controversial new role for Ofcom in the policing of alleged infringement of copyright online under the Digital Economy Act 2010. The Act provides that internet service providers must notify subscribers if their internet addresses are reported by copyright owners as being used to infringe copyright, must keep track of the number of reports about each subscriber and must compile on an anonymous basis a list of those reported on. After obtaining a court order to obtain personal details, copyright owners will be able to take action against those on the list. Implementation of these provisions is through the drafting of a Code by Ofcom.<sup>13</sup> A challenge was brought to these provisions by two internet service providers, with no less than 12 other parties taking part, including organisations concerned with copyright protection and with freedom of speech. The challenge was based on alleged breach of a number of provisions of EU law, including the Technical Standards Directive, the e-Commerce Directive, and the Data Protection and Privacy and Electronic Communications Directive. The challenge was unsuccessful, except on one minor ground relating to the requirement for copyright owners to reimburse part of the enforcement costs, and the provisions were held not to breach EU law.<sup>14</sup>

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<sup>12</sup> The Wireless Telegraphy Act 2006 (Directions to OFCOM) Order 2010, SI 2010/3024.

<sup>13</sup> Digital Economy Act 2010, ss 3-18.

<sup>14</sup> *R (on the Application of British Telecommunications plc and TalkTalk Telecom Group plc) v The Secretary of State for Business, Innovation and Skills* [2011] EWHC 1021 (Admin).

These two examples underline both the complexity of Ofcom's various tasks and the highly litigious nature of the electronic communications industry. Reflecting the latter point, the former Government had consulted on a proposal that the current full right of appeal on the merits to the Competition Appeal Tribunal from Ofcom decisions on electronic communications (not broadcasting) matters be restricted to grounds similar to the more limited ones for judicial review, having decided that this would be compatible with EU requirements.<sup>15</sup> It remains to be seen whether Ofcom's role will be fundamentally changed in the future; clearly it will survive in some form as a regulator, if only to comply with EU law on electronic communications regulation.

#### **4. WATER AND SEWERAGE**

There is currently considerable uncertainty about a number of elements in the regulatory regime for water, administered by the Water Services Regulation Authority (Ofwat) for England and Wales and by the Water Industry Commission for Scotland. The last periodic review, in which it sets the price caps for water and sewerage providers, was completed in 2009 with the next due for completion by 2015. However, two major issues remain unresolved. The first is that of developing greater competition in the industry. The current structure in England and Wales is that of regional monopolies with very little provision for competition or new entry. Ofwat's lack of progress in developing greater competition was heavily criticised by Parliamentary committees, and a major review of how this could take place was commissioned by the previous Government (the Cave Review).<sup>16</sup> It reported in

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<sup>15</sup> Department for Innovation, Business and Skills, *Implementing the Revised EU Electronic Communications Framework: Overall Approach and Consultation on Specific Issues* (2010).

<sup>16</sup> Professor Martin Cave, *Independent Review of Competition and Innovation in Water Markets: Final Report* (2009).

2009, recommending that, whilst competition for supply to household users was not feasible, various steps should be taken to develop greater competition to supply large business and public sector users with water. These included separation of the suppliers' household and business retain operations, reform to the water supply licensing regime giving Ofwat the power to determine the criteria for setting charges, reform of the merger regime for water, and reform of the 'inset regime' enabling a supplier to replace another outside its own area in certain circumstances. The last Government accepted these conclusions, though it did not include provisions to implement them in legislation passed just before the election. The Coalition Government is considering the issue and proposals to increase competition will be included in a White Paper on water to be issued in Summer 2011. By contrast, in Scotland under the Water Services (Scotland) Act 2005 there is a framework for competition with no location or size restrictions in the supply of the non-household market,

The other matter of controversy is that of water charging. Currently, charging is on the basis of a mixture of charges set on the basis of the notional rateable value of the property and by metering. A number of problems had arisen; thus schemes to protect vulnerable customers had been ineffective and, since the banning of water disconnection for failure to pay bills by household consumers, there had been an increase in bad debt owed to water companies. The former Government established an independent review of water charging (the Walker Review).<sup>17</sup> It recommended a number of changes to the charging system, including the further use of metering in some areas, revised tariff principles and better targeted support for low-income families. Limited provision for social tariffs was included in the Flood and Water Management Act 2010.<sup>18</sup> However, the whole question of charging

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<sup>17</sup> Department for Environment, Food and Rural Affairs, *The Independent Review of Charging for Household Water and Sewerage Services – Final Report* (2009).

<sup>18</sup> S. 44.

falls within the review being undertaken by the Coalition Government and will be addressed in the forthcoming White Paper.

## **5. RAIL**

The rail industry is in a similar position to that of water; it has faced major criticism in recent years and now awaiting the outcome of a far-reaching review, in this case particularly focussing on the explosion of costs since privatisation in the early 1980s; public support is running at around five times its level before privatisation (in real terms). Regulation is mainly carried out by the Office of Rail Regulation (ORR) which completed in 2008 its last periodic review of charges which Network Rail, the infrastructure operator, can levy on rail operating companies. The next such review will be in 2013, and work has already commenced on international benchmarking studies, which have shown that Network Rail has considerably higher costs than comparable enterprises overseas. Other work carried out by the regulator has included working with Network Rail to implement improvements and efficiency savings required by the periodic review, improving passenger information during disruption of services, and resilience of the network in bad weather. The major continuing issue is to ensure that Network Rail delivers efficiency improvements and controls its costs and those of its contractors; a report by the National Audit Office has found that, whilst the regulator has significantly developed the range and quality of its analysis, and has required substantial efficiency savings from Network Rail, weaknesses remain in its information on costs and on the gap between Network Rail and more efficient performers.<sup>19</sup>

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<sup>19</sup> 'Regulating Network Rail's Efficiency, HC 828, 2010-11.

Almost all passenger services are provided by operators on the basis of franchises awarded for groups of routes. These have given rise to a number of problems, which have included the operator of the East Coast Main Line handing back its franchise after serious financial difficulties; the franchise is now temporarily delivered by a publicly-owned company. More generally, there have been serious problems of micro-management by the Department for Transport which issues the franchises, and which has specified in very considerable detail the services to be provided, thereby limiting initiative and flexibility. The Coalition Government issued a consultation document on reforming franchising in July 2010.<sup>20</sup> This proposed that franchises should be set for a longer period in the future, 12-15 years rather than the current 7-10 years, revised arrangements for the allocation of risk between the operator and government. A base level of service would be specified but this would be fleshed out by bidders for the franchise with greater operating flexibility. Implementation has been postponed, however, to await the McNulty review of value for money in the rail industry. This reported in May 2011 and made a large number of proposals for increased efficiency without reducing the extent of the network or imposing a wholesale increase in fares, and was broadly supportive of the proposals for franchise reform.<sup>21</sup> It will be followed by a White Paper setting out new rail policy in Autumn 2011.

## **6. POSTAL SERVICES**

It is postal services which face the most far-reaching changes in the near future. The Royal Mail has suffered serious financial problems and has been plagued by poor industrial relations. It is currently wholly state owned, and regulated by the Postal Services

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<sup>20</sup> *Reforming Rail Franchising* (2010).

<sup>21</sup> Department for Transport, *Realising the Potential of GB Rail; Report of the Rail Value for Money Study* (2011) (the McNulty Review).

Commission (Postcomm). In 2008 the Hooper report recommended that the Royal Mail should enter into a strategic partnership with one or more private sector companies with expertise in transforming a major network business. Its huge pension deficit should be assumed by government, and regulation should be transferred to Ofcom to reflect its presence in the broader communications market.<sup>22</sup> The Labour Government introduced a Postal Services Bill to implement these measures but it was withdrawn after facing political opposition in Parliament to private sector involvement in the Royal Mail. The Coalition Government commissioned an updating of the Hooper review, which came to similar conclusions, in particular that private capital should be introduced.<sup>23</sup> The Government then announced plans for a full privatisation of the Royal Mail, although the Post Office Ltd, which provides actual post offices, would remain in the public sector. This is to be implemented by the Postal Services Bill, introduced to Parliament in October 2010 and which completed its progress through Parliament in June 2011. When it has received the Royal Assent and becomes law, the Bill will restructure the Royal Mail group of companies and makes provision for unrestricted sale of share in it. Historic pension liabilities are to be transferred to the Government, and the Bill gives Ofcom the new function of regulating the postal services sector; it also makes provision for the maintenance of the universal postal service. Finally, the Bill makes provision for a special administration regime should a provider of the universal service face insolvency. State aid approval will be needed for the changes from the European Commission, and the organisation of the sale is likely to prove complex. Nevertheless, unlike the previous Government, the Coalition has succeeded in obtaining the necessary legislative basis for privatisation.

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<sup>22</sup> Hooper Review, *Modernise or Decline: Policies to Maintain the Universal Postal Service in the United Kingdom*, Cm 7529 (2008).

<sup>23</sup> Hooper Review, *Saving the Royal Mail's Universal Postal Service in the Digital Age*, Cm 7937 (2010).

## 7. AIRPORTS

The major airports are regulated by the Civil Aviation Authority (CAA), which also regulates civil aviation. Though the basic legal procedures are similar to those applying to other regulators of public utilities, there are some differences in its powers and procedures, and reform of these has been promised for over ten years. Legislation to bring its procedure for setting price caps into line with that of other regulators was announced in the Queen's Speech at the beginning of the 2010-11 Parliamentary session, though introduction of the Bill has now been postponed to the following year.

In the meantime, a major problem was the closure of London Heathrow, the UK's busiest airport, from 18-20 December 2010 due to snowfall. Reports commissioned by the British Airports Authority (BAA), Heathrow's owner, and by the House of Commons Transport Committee, were highly critical both of the lack of preparation for such an eventuality and the absence of proper passenger information and concern for passenger welfare. This was attributed to a lack of proper economic and regulatory incentives for the airports operator to provide proper elements of resilience in their operations and to invest adequately in this. Extraordinarily, the major disruption did not figure in Heathrow's performance measures, which recorded an unexceptional month, suggesting the need for major reform in the scope and nature of the relevant performance measures.<sup>24</sup>

Another major issue involved the general competition authorities. BAA (owned by the Spanish company, Ferrovial), is the dominant operator, owning seven UK airports, and in particular the three main London airports, Heathrow, Gatwick and Stansted. In 2009 the Competition Commission, after a detailed inquiry, required BAA to sell both Gatwick and

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<sup>24</sup> British Airports Authority, *Report of the Heathrow Winter Resilience Enquiry* (the Begg Report), 2011; Transport Committee, 'Keeping the UK Moving: The Impact on Transport of the Winter Weather in December 2010', HC 794 (2010-11).

Stansted as well as either Edinburgh or Glasgow on the grounds that the absence of competition between airports caused serious consumer detriments to both passengers and airlines.<sup>25</sup> This decision was successfully challenged in the Competition Appeal Tribunal on the ground of apparent bias because a member of the Commission's panel was also an adviser to a pension fund which was a possible purchaser of divested airports.<sup>26</sup> The Tribunal's decision was successfully challenged in the Court of Appeal, which decided in October 2010 that the interest of the panel member was too distant to be of real concern to a fair-minded and informed observer, and so the CAA's decision was re-instated.<sup>27</sup> Leave was not given for further appeal, and the Competition Commission is now requiring the divestment to go ahead.

## 8. CONCLUSION

2010 has not seen any major new development of general importance for the UK public utilities. Unsurprisingly with the election of a new Government, a number of reviews are taking place and are likely to result in greater changes in the next few years. However, it seems likely that the current arrangements for regulation of the utilities will be retained in something resembling their present form, the most important difference of substance being the transfer of responsibility for regulation of postal services from Postcomm to Ofcom.

If any more general themes can be drawn from the events described here, the most apparent concern the role of markets and the role of government. As the experience in energy shows

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<sup>25</sup> Competition Commission, *BAA Airports Market Investigation* (2009).

<sup>26</sup> *BAA Ltd v Competition Commission* [2009] CAT 35.

<sup>27</sup> *BAA Ltd v Competition Commission* [2010] EWCA Civ 1097.

clearly, where public utility markets have been liberalised they need constant regulatory policing both to protect consumers and to facilitate public interest goals such as sustainability. This policing will involve both sectoral regulators and, as in the case of airports, general competition authorities. Indeed, it is now a truism that in these markets liberalisation creates the need for more regulation, not less. The same is true in the rail sector, which has not been fully opened up to competition but where the fragmented nature of the industry has created the need for extensive oversight.

The second theme which is apparent is that the regulators, though independent in their day-to-day decision making, actually have to operate in conjunction with other bodies. These include not just the competition authorities but also government itself. Once more this is apparent in energy, with the interventions of the government department on sustainability grounds needing to be supplemented by market surveillance by the regulator, and in rail where the responsibilities of the regulator sit alongside the regulatory aspects of the franchising process carried out by the Department for Transport.<sup>28</sup> As markets evolve, regulation of the public utilities has become more complicated, and is likely to develop in new ways as the concept of sustainability becomes a more central regulatory objective alongside that of protecting consumers. Transparency in the relations between different actors involved in regulation is likely to become a major area of interest for future public lawyers.

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<sup>28</sup> For further discussion of the relationship between regulators and government see Tony Prosser, *The Regulatory Enterprise*, pp. 6-8, 223-30.

## 9. WEBSITES

[www.ofgem.gov.uk](http://www.ofgem.gov.uk): Ofgem

[www.ofcom.org.uk](http://www.ofcom.org.uk): Ofcom

[www.ofwat.gov.uk](http://www.ofwat.gov.uk): Ofwat

[www.rail-reg.gov.uk](http://www.rail-reg.gov.uk): Office of the Rail Regulator

[www.psc.gov.uk](http://www.psc.gov.uk): Postcom

[www.caa.co.uk](http://www.caa.co.uk): Civil Aviation Authority