

UR-151 Correcting for Unforeseen Outcomes: Regulatory Precedent

1. Introduction

In our experience, companies and their investors understand that regulatory rules can sometimes have unforeseen consequences and that a regulator has a right to step in and correct matters if the interests of customers are materially prejudiced to the benefit of shareholders (or vice versa).

This paper highlights previous instances in which a regulator has felt that it is necessary to step in and correct for the unforeseen consequences of previously established regulatory rules.

We consider that there is value for the Commission to consider these cases when finalising its determination.

2. MMC/Competition Commission Precedent

2.1 NIE inquiry, 1997: double-funding of capex

Synopsis: NIE under-spent its RP1 capex allowance by approximately one third (£97m). The regulator and company disagreed over whether money should be clawed back from NIE in respect of under-spend that was the result of deferral rather than efficiency. The MMC determined that it was in the public interest to claw back one third of the financial benefit that NIE obtained from its under-spending.

The starting point in this dispute was summarised by the MMC in its inquiry report as follows:¹

2.108 The DG said that the underspend was not solely due to efficiencies achieved by NIE. He pointed out that NIE itself had explained, in reply to the DG's questionnaire, that the underspend in 1992/93 and 1993/94 had been due partly to the time needed for the company to review the policies and organizational structure which it had inherited from the days of public ownership. The DG said that some of the capital expenditure which had not been undertaken in the first price control period, but for which revenues had been allowed, would have to be undertaken in future and it would not be reasonable for customers to pay again for the financing of such expenditure. He therefore proposed to reduce the allowance for capital expenditure in the next period to avoid such 'refinancing'. After taking account of representations from NIE he set the reduction at half the underspend in 1993/94 and 1994/95 on the grounds that some of the underspend could be attributed to efficiency gains, the benefit of which NIE should retain.

NIE's position was as follows:

2.109 ... [NIE] regarded the DG's proposal as a form of clawback, which it said was contrary to the principles of incentive regulation. Such clawback would introduce an asymmetric risk in that NIE would be subject to penalties for underspending but would not be granted additional funds if it overspent. There had been no reference to such a risk when NIE had been privatized. If the principle of clawback became established, regulated companies would have an incentive to 'gold-plate' investment projects and to carry out work before it was needed in order to spend their allowance. The right course was for the DG—and now the MMC—to scrutinize closely NIE's capital programme for the forthcoming price control period.

¹ MMC (1997), Northern Ireland Electricity plc, paragraphs 2.106 to 2.118. Available from: http://webarchive.nationalarchives.gov.uk/20111202195250/http://competition-commission.org.uk/rep_pub/reports/1997/fulltext/397c2.pdf

The MMC made the following determination:

2.113 In the present case the scale of the underspend in the first period is difficult to ignore, and we note that NIE itself has acknowledged that not all of it has been due to efficiencies. Several projects which were included in the capital programme for the past five years, particularly in transmission, appear to have been included again in the programme for the forthcoming period. This applies, notably, to most of the transmission projects listed in Appendix 7.1. Customers have already been paying for the assumed financing and depreciation of these investments and it is arguably unreasonable that they should be asked to pay again through the price levels to be set for the next five years.

...

2.116 We are not persuaded that some adjustment for past capital expenditure underspend is inconsistent with incentive regulation, as NIE argued. With regard to capital expenditure which is postponed from one period to the next, if there is no adjustment for underspend then consumers pay for the depreciation and return on the capital expenditure when it occurs, as they should, and they pay for it in the previous period when the expenditure did not occur. The only offset is that consumers benefit from not having to pay for the depreciation and the return from the end of the first period until the capital expenditure is actually carried out. There is a trade-off therefore between any disincentive effects of such an adjustment and passing any substantial benefit on to consumers. If the capital expenditure is never incurred then, without an adjustment, the gains from higher expected financing and depreciation costs go to the company in the quinquennium and never reach the consumer. In these circumstances it is not obvious that weight should only be given to the incentive effects. We do not believe it is inconsistent with incentive regulation to take account of the trade-offs involved.

...

2.118 ... Bearing in mind the incentives aspect, and in view of the fact that the present situation is less than ideal because of the absence of established output measures, we consider that the adjustment should be based on one-third of the value of the total underspend in the three middle years of the first period, a level of £25 million. We believe that an adjustment of this level would not significantly reduce the incentive on NIE to look for ways of reducing expenditure, nor do we consider that it would affect NIE's ability to finance the carrying on of its licensed activities, including a capital expenditure budget of the size we judge appropriate.

2.2 British Gas Transco inquiry, 1997: a change to depreciation rules

Synopsis: There was also a dispute in 1997 over an attempt by Ofgas to change the way in which the depreciation component of Transco's price control was calculated. A 1993 MMC inquiry had determined that Transco would be allowed to collect depreciation on the book value of its assets. Ofgas wanted to implement a new approach in which this depreciation charge was to be written down by 40%, to reflect the difference between the book value of the network and the price that investors paid for the company at privatisation. Transco objected to this proposition. The MMC in its 1997 inquiry report found in favour the regulator.

The original 1993 determination was summarised by the 1997 inquiry group in the following terms:²

² MMC (1997), A report under the Gas Act 1986 on the restrictions of prices for gas transportation and storage services. Available at:

Approach of the 1993 MMC report

2.106. There was substantial discussion in the 1993 MMC report of the appropriate basis on which the return to shareholders should be calculated. At the date of privatization the ratio of BG's [British Gas's] market value to the CCA [Current Cost Accounting] book value of its assets (the MAR) was some 40 per cent, reflecting the level of discount to CCA book values at which BG was privatized ... The 60 per cent MAR was applied to the cost of capital for new investment of between 6.5 to 7.5 per cent, giving a range of returns on replacement cost of pre-1992 assets of 4 to 4.5 per cent.

...

2.108 In the 1993 MMC report, the MMC accepted that full depreciation of existing assets should be allowed in revenue. The allowance for full depreciation in revenue can be regarded as consistent with the 'operating capability maintenance' (OCM) approach of CCA.

The Director General of Gas Supply, Clare Spottiswoode, in price control proposals published prior to the reference to the MMC had proposed to change this framework:

The Director General's approach

2.109 Although the Director General considered that alternative approaches had merit, she generally accepted the MMC's figures in the 1993 MMC report of a 60 per cent MAR in December 1991 ...

2.110 ... For the purpose of her review, as noted below, the Director General calculated shareholders' past investment by rolling forward the initial market value from December 1991, to give a value (in her August 1996 proposals) of £11.7 billion at April 1997. The Director General said that, to be fair to BG's shareholders, they should be allowed this capital sum, maintained in real terms (and hence revalued after 1997 by the RPI rather than by reference to replacement costs), through the revenue Transco was allowed to recover in charges to customers over the remaining life of the assets. Depreciation was therefore to be based on this value of shareholders' investment, and this would ensure that shareholders were adequately repaid for their past investment. ...

2.111 The Director General's approach to depreciation and asset value after April 1997 was therefore to abate the full depreciation charge by the application of the MAR to pre-1992 assets, and to index investment by the RPI to maintain its real value.

The company objected to this proposal.

BG's approach

2.119. As described in more detail in Chapter 13, BG supported continuation of the approach in the 1993 MMC report ... An abandonment of the previous approach would itself lead rational investors to expect similar regulatory shocks in future, and require a higher rate of return to compensate for the reduction in the value of their investment.

...

13.45. In BG's view, the appropriate treatment of depreciation was to continue to calculate it on the basis of 100 per cent of the CCA value of all Transco's assets, both existing and new. It said that this was consistent with:

- (a) the way in which BG was privatized. It was set out in the prospectus and clearly understood that investors could expect a cash flow which included full CCA depreciation on all assets;
- (b) its subsequent regulation, which had maintained the treatment of BG's existing assets in a manner consistent with the way it was privatized. This included the 1988 MMC report, the 1992 tariff formula, the 1993 MMC report and the Director General's previous price control;
- (c) its legal obligations. BG was obliged under the Gas Act to develop and maintain the gas transportation system. Full depreciation allowed BG to meet this statutory requirement without either offering a windfall gain to shareholders or departing from the expectations created in 1986;
- (d) its own accounting approach, which had been approved by the Director General and was consistent with Standard Condition 2 (as amended) of the licence; and
- (e) the principles of economic pricing. Inclusion of full CCA depreciation created the correct price signals, with all users paying for actual consumption of the assets.

13.46. BG submitted that the Director General proposed to rewrite the conclusions of the 1993 MMC report and to reverse her own adoption of that approach in 1994.

...

13.51. The Director General's rewriting of the MMC's conclusions undermined regulatory stability. BG further argued that this would lead rational investors to expect similar regulatory shocks in the future. They would therefore demand an even higher rate of return to compensate them for the prospect that the value of their investments might be reduced. This, in turn, would lead to increased costs in the future.

The MMC sided with the regulator in its determination.

Assessment

(c) Depreciation to be included in allowable revenues

2.131. The Director General's approach to depreciation (see paragraphs 2.109 to 2.112), namely to include in allowed revenues only MAR-adjusted depreciation of pre-1992 assets, represents a major change in the basis of regulation from that used following the 1993 MMC report. The 1993 MMC report was produced at a relatively early stage in the development of utility regulatory thinking in the UK. The report was prior to the extensive price reviews of the water industry and regional electricity companies carried out by the Directors General of Water Supply and of Electricity Supply, which resulted in references to the MMC. Our current approach takes into account a broad range of views that have developed and been expressed to us on depreciation and asset values since the 1993 MMC report, and in particular during the course of this inquiry.

2.133. Depreciation can be regarded either as a means of financing replacement of assets or as a return of capital. By allowing for a full depreciation charge, the 1993 MMC report effectively allowed in charges for customers for the full cost of replacing the assets owned by BG in December 1991. The Director General is, however, in our view correct in arguing that, by allowing full depreciation on these assets, the full replacement value of the assets would be returned to the company over time, providing shareholders with a significant gain over the investment they made in relation to these assets. We believe that the 1993 MMC approach

would therefore have the effect of producing prices higher than is necessary to enable BG to finance its activities over the period under review.

2.134. BG argued that the effect of the Director General's approach to depreciation would impact severely on cash flows, and its ability to raise finance for future investment. We accept that a corollary of the Director General's approach could be that Transco would have to raise additional finance for the replacement of assets as well as for new investment (see paragraph 2.132). However, the Director General's approach would ensure that, under effective management, this new finance would be able to earn an adequate return. BG would thus be able to finance its functions. Whether this new finance is raised through debt, retained earnings or new equity is a matter for the company.

2.137. In summary, we agree with the Director General's approach for the period under review of including in revenues only MAR-adjusted depreciation on pre-1992 assets, and full depreciation of post-1991 assets. For the purpose of rolling forward assets after 1997, depreciation should also be calculated on this basis. This approach provides a reasonable return on regulatory value and hence on shareholders' existing investment, and on future investment by the company.

In response to BG's arguments about the cost of capital, the MMC made the following statements.

2.102. BG was concerned that the change in the approach to regulation of BG proposed by the Director General, particularly in the treatment of depreciation which we discuss (and endorse) below, could lead to uncertainty as to how returns on new investment, as well as on existing assets, would be treated by future regulators. BG also believed that the Director General's proposals to increase monitoring of capital investment could lead to her disallowing particular investments in the future capital base. While it is open to regulators to use their discretion (subject to their legal duties), the earning of a full rate of return on new investment has not been called into question, and we believe that continuation of the current disapplication provisions, with reference to the MMC in the event of any dispute about future charging conditions, represents a significant safeguard of BG's position in this respect.

2.103. We do not, therefore, believe there are such uncertainties facing BG as would imply a significant increase in Transco's cost of capital.

2.3 BAA inquiry, 2002: double-funding of pensions costs

Synopsis: Shortly after the CAA set BAA's 1997-2002 price controls, BAA unexpectedly took a pension contribution holiday on account of a large surplus that had built up in its pension fund. This surplus had largely disappeared by the time of the 2002 review, mainly due to the dotcom stock market bust, and BAA was forced to restart contributions at a much higher level than it paid pre-1997. The Competition Commission decided that BAA should not be funded again in the 2002-07 price control for pension contributions that it chose not to make in the 1997-2002 period.

The background to this issue was summarised by the CC as follows:³

2.361 ... during Q3, BAA was able to take a pension holiday due to general increases in share prices; before that, the cost of pensions was about 14 per cent of pensionable pay, and had been assumed to remain at that level in Q3. The evidence we saw in the current inquiry showed that a surplus on past service had increased significantly, from 118 per cent of liabilities in 1992 to 142 per cent in September 1995 (the valuation for 1995 being available in

³ Competition Commission (2002), BAA plc. Available from: <http://www.caa.co.uk/default.aspx?catid=5&pagetype=90&pageid=1322>

1996) and 150 per cent of liabilities in 1996 ... A pension holiday was declared from 1 April 1997, the start of Q3, with a view to eliminate the surplus by 2014.

2.362 ... With recent movements in share prices, however, the estimated value of the surplus was very low by the end of our inquiry—an asset value of 103 per cent of liabilities in 2002 estimated on a spot basis (although the full valuation would be on a three-year moving average basis). Between 1997/98 and 2000/01, BAA included a charge in the airport accounts for pensions of about 3 per cent of salary cost but this rose to 18 per cent in 2001/02 although no actual contributions to the main scheme were made.

2.363. BAA's forecasts (prepared before the recent preliminary valuation) included a pension cost to each airport of 9 per cent—the amount it judged necessary on the basis of the previous valuation of the surplus, but which it said could well increase given recent falls in share prices. However, there was a further centralized cost projected of 13 per cent, giving 22 per cent of pensionable pay overall, the amount it believed would be required if there were no surplus. On the basis of its 2002 estimates of the value of its remaining surplus, a contribution of 19.3 per cent would be needed. ...

The CC expressed concern about this situation:

2.364. We noted, however, that the funding level of the scheme was at its highest—150 per cent—at the time of the previous review (although the formal valuation was not carried out until the autumn of 1996). Despite the surplus (which on the basis of information supplied to us we believe was evident to BAA during that review) BAA, ourselves and the CAA assumed contributions would continue—it is a matter of serious concern to us that this situation should have arisen. The current projection of a required contribution of 19 per cent partly results from that pension holiday, without which a contribution of only about 15.4 per cent would be needed. Hence, charges in Q3 allowed for payments that were not paid ...

When the CC floated the idea that the 2002-07 pension allowance should be reduced due to BAA's past behaviour, BAA objected:

2.363 ... As noted in Chapter 14, it argued that to reduce projected pension costs for the amount of the surplus would be expropriating the gains of it outperforming other schemes, and lead it to change the basis of its pensions policy.

14.113 ... BAA did not, however, believe that the surplus should be expropriated to give to airlines. This was a one-off gain, due to outperformance over a defined period of time (unlike permanent staff savings which BAA would expect to be reflected subsequently in charges). To reduce airport charges as a result of the surplus would effectively confiscate the gains that resulted from the schemes' managers outperforming the market ...

The CC was unmoved by these arguments:

2.364. ... to have higher charges than would otherwise be necessary in Q4 because of contributions allowed for in charges but not made in Q3, would represent in effect a double charging of airlines for that element of pension cost. If that element of pension costs is excluded, then the appropriate level to be included in the financial projections is 15.4 per cent, which we have taken into account in our modelling below.

The CC returned to the same issue in its 2007 inquiry. BAA again protested.⁴

⁴ Competition Commission (2007), BAA Ltd.
Available at: http://www.caa.co.uk/docs/5/ergdocs/ccreport_apph.pdf

43. The under-payment in Q3 pension contributions is still a factor that needs to be addressed in this price review. BAA argued that revisiting past decisions in this way undermined any incentive for airports to strive for efficiency and out-performance.

The CC was once again very clear that a correction was required. This time it put forward a slightly different solution:

44. ... We currently believe that, in order to deal with this Q3 under-payment issue once and for all, a proportionate share of the shortfall in pension fund assets should be deducted from the RAB of Heathrow and Gatwick.

The amount of the RAB adjustment was £135m.

3. CAA Precedent

3.1 NATS price control review, 2005: unjustified rewards from 5-year rolling opex incentives

Synopsis: A five-year 'rolling' opex incentive mechanism was inserted into NATS' licence in 2002. The CAA's formula produced a £50m reward for NATS at the end of its first control period. However, the CAA spotted that NATS' costs had been reduced for temporary reasons and that the opex allowance for the 2006-10 control period did not pass any efficiency gains on to customers. It therefore decided to cancel the payout that NATS was to receive.

The CAA's final determination explains the CAA's decision in greater detail:⁵

15. A mechanistic application of the roll-over calculation would have provided NERL with an upward adjustment to the UKATS RAB of approximately £50m, but would not have recognised the degree of bounce back in opex in 2005/06 that the CAA is including in its calculation of NERL's CP2 opex allowances. Because this bounce back reverses a large proportion of the savings that NERL made in years 2 and 3 of CP1, it is not the case that the resetting of charges at this review takes away from NERL the benefits of efficiency improvement prematurely. In these circumstances, it would not be appropriate for the CAA to provide NERL with continuing reward for the savings made in these years.

16. This is a one-off situation reflecting the unique nature of many of the savings that NATS made during the financial difficulties affecting the business in 2002/03 and 2003/04. For the next control period, the CAA confirms that it sees the efficiency roll-over mechanism as an integral part of NERL's incentive framework and that it would expect to reward NERL for out-performance although the CAA has concluded that it is appropriate to make small refinements to the current mechanism.

In contrast to the other companies profiled in this paper, NATS did not dispute the CAA's logic and did not force a claim for money that it was strictly speaking entitled to under the terms of a previous CAA decision.

4. ORR Precedent

4.1 Network Rail price control review, 2008: double-funding of tax payments

Synopsis: ORR's price control for 2004-09 included a pre-tax WACC, in which the cost of equity was grossed up by the prevailing statutory corporation tax rate of 30%. In practice, Network Rail did not pay any corporation tax in this period due to the tax losses it inherited from Railtrack.

⁵ CAA (2005), NATS price control review 2006-10: CAA's firm proposals. Available at: http://www.caa.co.uk/docs/5/ergdocs/erg_ercp_natsfirmproposals.pdf

ORR decided in its 2008 that it would consider the 2004-09 tax allowance pre-funding for the tax payments that Network Rail would eventually make when it moves back into a tax-paying position.

The ORR's proposal was first put to Network Rail in a letter:⁶

Allowing for corporation tax through a tax wedge approach does not necessarily align the corporation tax allowance with corporation tax payments in any one year or in any one control period ... In Network Rail's case, it had large brought forward corporation tax losses at the start of CP3 and is forecasting to pay a very small amount of corporation tax in CP3. In effect, in CP3 Network Rail has probably been funded for corporation tax liabilities in future control periods and has used this money to pay down debt or invest in the network. By moving to an approach whereby Network Rail is paid for its expected corporation tax liabilities, it could be argued that the company will have been paid twice for some of its future corporation tax liabilities.

ORR considered different ways of avoiding this double count and eventually settled on an approach in which the CP3 funding would be held 'on account' and treated as pre-funding for Network Rail's future tax bills. Network Rail objected to this stance:⁷

We believe this is flawed because we were never expecting to pay any tax in CP3 and this amounts to an arbitrary reduction in the RAB

ORR's proposed reduction of future specific tax allowances for "double counting" retrospectively reopens the CP3 price control.

We are concerned that this could appear opportunistic.

ORR stuck to its policy in its final determination:⁸

We maintain our view that Network Rail was allowed a tax wedge in the cost of capital in CP3 (there is a statement in the ACR03 final conclusions that Network Rail was provided with a pre-tax cost of capital) and that by not making an adjustment to reflect the change in approach to allow for future corporation tax liabilities would amount to the company being paid twice. We will therefore be making an adjustment.

The value of the adjustment was £1,300m.

⁶ Available at: <http://www.rail-reg.gov.uk/upload/pdf/pr08-financial-issues-let-060907.pdf>

⁷ Available at: <http://www.rail-reg.gov.uk/upload/pdf/DDresp-nr-040908.pdf>

⁸ ORR (2008), Periodic review 2008: Determination of Network Rail's outputs and funding for 2009-14. Available at: <http://www.rail-reg.gov.uk/upload/pdf/383.pdf>