

# Sustainable development duties: New roles for UK economic regulators

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## Abstract

When the utility regulators were established in the UK their primary duties and roles were focused on economic regulation – setting price controls for monopolies and promoting competition where possible. The increasing emphasis in government policy on sustainable development has led to pressures on the regulators to pay greater attention to social and environmental concerns alongside economic ones. Ofwat and Ofgem now have duties to contribute to the achievement of sustainable development. Why and how did this change come about, what impact will it have on how the regulators deal with sustainable development and on the nature of regulation?

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## 1. Introduction

When the utility regulators were established in the 1980s their primary purpose was to develop competition where possible and to act as a surrogate for competition (by setting limits to the prices that could be charged) where it was not feasible (such as in cases of natural monopoly) (Baldwin and Cave, 1999). Alongside this was the duty to ensure that companies could finance their functions thus placing some limits on how far regulators could bear down on prices. In the debate about what constitutes “good regulation” (Baldwin and Cave, 1999) some have stressed the need for regulators to stick to their original mandate of economic questions to retain their independence, remain accountable and help preserve stability and certainty – they should not concern themselves with issue of distribution, or environmental damage, for example (e.g. Foster, 1992). Others, however (e.g. Prosser, 1997) note that the UK regulators were not given solely economic objectives when they were first established and that a mixed set of goals is an inevitable part of the framework. For example, the

regulation establishing the water and energy regulators gave them duties to take into account the interests of specific groups of consumers, such as the elderly and disabled and those who live in rural areas; plus duties requiring them to take into account the effects on the environment of the activities of the utilities that they regulate. Nevertheless, it was always clear, until the change of government in 1997 that the primary duties were economic and that other social and environmental duties were subordinate. However, the Labour Government, elected in 1997, signaled its intention to review utility regulation and in early 1998 began to consult on proposals for change (Cm 3898, 1998), that have eventually culminated in the specific duties relating to sustainable development that are the subject discussed here.

This article examines the evolution of environmental concerns during the 1990s in energy and water regulation and the process by which the regulators were given sustainable development duties. Some of the questions that are considered include: the boundaries between regulation and politics; whether these new duties signal real or merely symbolic change; how trade-offs between competing objectives are made; what this UK experience teaches us about how sustainable development considerations may be internalised into utility regulation. The article will focus mainly on the

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environmental issues, although the sustainable development debate also includes concerns about social issues (e.g. Ernst, 1994; Dubash, 2003; Haselip et al., 2005; Owen, 2004), such as protection of the interests of low income and disadvantaged consumers.

## 2. The 1990s – environmental issues emerge

### 2.1. Setting the context

The term “regulation” can be defined in a number of ways, but the central concept is that of the state setting rules to control the behaviour of businesses and individuals to achieve public policy (socially desirable) goals (e.g. Majone, 1996; Baldwin and Cave, 1999). When the UK decided in the 1980s to privatise the utilities that had been nationalised in the 1940s, it might have opted for the long established system of utility regulation in the US where private sector monopolies had existed for many years. However, the UK rejected much of the US model, opting for the RPI-X regime as an alternative to US style rate of return regulation and rejecting the US model of regulatory commissions, which were seen as too legalistic and cumbersome. UK regulation is therefore much more discretion based than that in the US and Europe (Wilks and Wright, 1987; Moran, 2003) – and this links back to the British system of “club government” (Marquand, 1988; Moran, 2003) which was distinguished from Europe “in the extent to which law was marginalised... the degree to which regulation was a matter of co-operation between insiders rather than of open adversarial conflict” (Moran, 2003, p. 34).

Although Stephen Littlechild (the architect of the RPI-X formula whilst an academic and later the first electricity regulator) tried to create a narrow formulaic task (Moran, 2003, p. 105), right from the beginning the regulators were given discretion to exercise judgement over a range of duties. Some social and environmental obligations were included in the original privatisation legislation, inserted in the face of government resistance largely due to lobbying by non-governmental organizations working with sympathetic MPs and Lords to secure amendments. Furthermore, universal service obligations and restrictions on disconnection go back as far as 1899 (Prosser, 1997, p. 305).

Regulators in the UK have thus had some social and environmental duties since they were established, but there were two specific episodes during the 1990s that focused debate on the role that the regulators should play in delivering the Government’s environmental objectives. The first was in the energy field and the second in water and these are dealt with in the early part of this section. In the latter part of the section a more recent example from energy is examined.

### 2.2. The gas and electricity regulators and the Government’s climate change policy

The Acts that established Ofgas and Offer included duties to promote the efficient use of gas and electricity. Initially this was interpreted as setting standards on information for

customers. At that time prices to end consumers were controlled by the RPI-X formula, but gas or electricity purchase costs could be passed through 100%. Energy conservation advocates said this created a disincentive to investment in energy efficiency. The Association for the Conservation of Energy (ACE) (an energy conservation industry funded lobbying organization) argued for a system similar to that used by the Regulatory Commissions in the US, where utilities were required to compare the costs of supplying more units of energy with the costs of saving units. In 1990 Ofgas commissioned ACE to produce a report which concluded that the price formula was “an active disincentive operating on British Gas to undertake gas conservation and efficiency investments which could provide the least cost gas services to consumers” (Brown, 1990, p. 33). The House of Commons Energy Select Committee, in its March 1991 report, also concluded that “any aspects of the tariff systems which bias utilities against energy efficiency measures should be rectified” (HC 91-I, 1991, p. xxv).

In 1991 Sir James McKinnon, the then Director General of Ofgas, introduced the “E” factor to allow the costs of approved energy efficiency projects to be passed through to gas customers and make it profitable for British Gas to invest in schemes that might result in less gas being used. McKinnon envisaged that around £50 million a year might be spent on these projects (though he set no specific limit). The Government saw this as a potential means of helping it to meet new environmental targets envisaged since the publication of the White Paper on the Environment (Cm 1200, 1990). The Conservative Manifesto to the 1992 general election contained the pledge: “Together with British Gas and some of the Regional Electricity Companies, we will establish an independent Energy Savings Trust to promote energy efficiency” (Conservative Party, 1992, p. 11).

In the Second Year Report on the Environment White Paper, the Government set out the role for incentives like the E factor. “...it is unlikely that information programmes by themselves will realise the full scope for savings... financial incentives to consumers to improve their energy efficiency provide the way forward” (Cm 2068, 1992, p. 53). However, public expenditure constraints meant that the money would not come from the taxpayer. Instead, the Government viewed the energy utilities as “well placed to deliver such incentives” (Cm 2068, 1992, p. 53).

The Trust was established in November 1992. In evidence to the Environment Select Committee, in May 1993, the Government indicated that the Trust could contribute savings of 2–3.5 MtC (one quarter of the Government’s target agreed at the Rio Convention on Climate Change) (HC 328, 1994). By this time, OFFER too had indicated that it would allow the costs of approved energy efficiency projects as part of the revised supply price formula – up to £100 million over four years under the Energy Efficiency Standards of Performance Scheme (EESOP). The Trust calculated that, to achieve the climate change target, it would need to spend £1.5 billion by 2000.

In the meantime, however, Clare Spottiswoode, the new gas regulator had been appointed and had begun to raise some concerns about the E factor. On 25 January 1994 she made

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