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WHAT THE LITTLECHILD REPORT ACTUALLY SAID

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[1] A volume with the full set of papers (including a reprint of the 1983 Littlechild Report) can be purchased from the CRI via their website: www.bath.ac.uk/cri

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1. Introduction

"The" Littlechild Report is the 1983 report to the Secretary of State for Industry entitled 'Regulation of British Telecommunications' Profitability' and published in February 1983. There is, however, the "other" Littlechild Report, a 1986 report, entitled 'Economic Regulation of Privatised Water Authorities'. In this paper, I will primarily concentrate on the more famous 1983 report except where the 1986 report provides interesting commentary or contrasts.

The 1983 Littlechild Report must be one of the most famous but least read economic papers. It was written in under ten weeks in November 1982 to January 1983 and published in February 1983. The reason for its fame is its adoption and advocacy of price cap regulation and the RPI-X model as opposed to rate of return regulation for privately financed utilities. The reason for it being so little read is that its original print-run was very small (a few hundred) and it has long been out of print. Surprisingly, it has not been widely reprinted and is not available in electronic form. We can only hope that the twentieth anniversary of its publication will see it become available again and read as well as cited.

In this paper, I will discuss the 1983 Littlechild report, its origins, its message and its influence and compare some key issues with what was said in the 1986 Littlechild report. I am explicitly looking back with hindsight, with the intention of being able to identify trends that are likely to affect the future as well as discussing concerns of the 1980s.[2]

[2] Companion papers in this volume by Chris Bolt and Martin Cave discuss in more detail developments since 1983 and the future outlook both with RPI-X and in telecoms. A volume with the full set of papers (including a reprint of the 1983 Littlechild Report) can be purchased from the CRI via their website: www.bath.ac.uk/cri

2. The 1983 Littlechild Report – Myths and Truths

2.1 The Single Person Regulator

Until recently, the UK model of utility regulation was known for having regulatory offices headed by a single person, the Director General. This is sometimes associated with the 1983 Littlechild report.

This association is false. The original government intention was to give the responsibility for regulating the (partially) privatised British Telecommunications (BT) to the Office of Fair Trading (OFT). However, Sir Gordon Borrie who was Director General of the OFT at that time argued strongly that this was too big a task for OFT and the government decided to establish an Office of Telecommunications (OFTEL), to be headed – like the OFT – by a Director General. The 1983 Littlechild report was written against the background of the 1982 Telecommunications Bill, which provided for OFTEL and a Director General. The report was commissioned to advise on how OFTEL should regulate BT's profits.

(Note that Littlechild (1983) consistently refers to OFTEL – acronym form. The organisation has long been known as Oftel – logo form. We will use the latter.)

2.2 Inventing Price Cap Regulation via the RPI-X Formula

It seems to be widely believed that the Littlechild Report *invented* the RPI-X formula. This is partially rather than wholly the case. Para 13.5 of the 1983 report states that the original idea emerged earlier in the discussion of the 'Buzby Bond'. As we shall see, this is something of an over-simplification. Nevertheless, the key point about the 1983 Littlechild report was that it recognised how the idea could be used for regulating the prices (and hence the profits) of BT's monopoly services while preserving its incentives for improving efficiency.

The Buzby Bond was an attempt by BT while state owned to issue a bond on the London corporate bond market. The proceeds of the bond would be used to fund BT's investment programme, particularly in the new System X digitalised exchanges. The government (and more specifically, the Treasury) rejected the notion of the Buzby Bond on the grounds that there would be no genuine transfer of risk away from the public sector. However, the rejection of the Buzby Bond was a major step on the road to the privatisation of BT[3].

The Littlechild Report states that it was suggested that "the bond prospectus would include a clause stating that BT's prices should not increase by more than RPI-X, where

[3] For further discussion of the Buzby Bond and BT privatisation, see Samuel Brittan, "Public Private Partnerships – a temporary landmark for the third way", November 2001.

X was a specified number"[4]. However, Stephen Littlechild now finds from his notes of the time that the Buzby Bond discussions always used a fixed RPI-2 rather than anything more general – at least in public. Hence, he realised that the Buzby Bond's RPI-2 could be generalised into a RPI-X and that this concept had wider applicability. He therefore seized on it as an alternative to US-style rate of return regulation. Apparently, this realisation took place in the week before the report was submitted[5]!

The key sentences from para 13.5 of Littlechild 1983 are as follows:

"This idea [an RPI-X price cap] could be adapted to present circumstances, by incorporating a condition in BT's licence requiring it not to increase tariffs on monopoly services by more than RPI-X per cent, i.e. to reduce these tariffs by X per cent in real terms. There are several details to be settled: to which services should tariff reduction apply? Should the guarantee apply to each service separately or to a basket of services? At what level should X be set?"

2.3 Price Cap Regulation as a Temporary Necessity

The 1983 Littlechild Report is frequently cited as arguing that utility regulation need only be temporary. This is absolutely true.

The whole thrust of the report is that sufficient competition would emerge in telecoms within five years or so to allow abolition of the price cap at that point. Indeed, it is very noticeable there is no discussion at all in the report about how X might be reset. This is in contrast to the 1986 report on price cap regulation of the water industry where Littlechild was obliged to confront the issues of probable *permanent* price cap regulation. We will discuss this contrast in a later section.

As an interesting footnote to the temporary/permanent regulation issue, it is worth noting that Littlechild 1983 quotes the projected costs of Oftel at £1.5 million per year (£0.5 million on regulatory arrangements) and staff requirements of around 50. Oftel's last annual report quotes reported expenditure in 2001-2 of £17 million and the employment of 230 staff. Given the explosion in telecom output over the last twenty years, this is still under 0.5% of UK telecom industry turnover. However, it is a substantial real increase and clearly much more than would have been anticipated or desired in 1983. And now Oftel is to be merged with the Independent Television Commission, the Radiocommunications Agency, the Broadcasting Standards Commission and the Radio Authority to form OFCOM ….

3. The Littlechild 1983 Report and its Background

4 See Littlechild (1983), para 13.5, p.34.

5 Reported by Stephen Littlechild at the 9 April 2003 conference. See Littlechild paper in this volume for a fascinating discussion of this episode and for the involvement of others in the late emergence of RPI-X.

3.1 Background

In the early 1980s, when BT was privatised, the telecom industry was massively different from what it now is. The business of the industry was confined to fixed line voice telephony. Mobile, electronic data transmission and cable telephony were still some years away with internet use a decade away. However, the industry was rapidly entering a digital world with the arrival of digital exchanges and the major investments associated with them.

In spite of the example of the break-up of AT&T in the US, it was decided not to split up BT before privatisation. This would have greatly delayed the privatisation which was largely driven by the need to get BT's investment programme off the PSBR (Public Sector Borrowing Requirement). Mercury was the only licensed competitor to BT and a relatively small player. Hence, the issue of how to handle BT's dominant position was crucial and economic regulation was seen as the way of stopping BT abusing its dominant position and preventing the development of competition. Economic regulation with clear criteria was also demanded by investment banks and others involved in the flotation to ensure potential investors so that they would participate in the share issue.

As the BT privatisation was the first, it was done cautiously. Only 51% of the company was sold in the 1984 privatisation. In addition, Ministers (the Secretary of State for Industry) retained the power to issue licences, in consultation with Oftel, rather than giving the powers to the regulator. They also retained the right to issue directions to Oftel. However, these were essentially "fail-safe" powers which were little used.

The immediate background to the Littlechild Report was that, during 1982, an Inter-Departmental Working Group chaired by the DTI (Department for Trade and Industry had proposed a form of maximum rate of return (MRR) scheme for BT. This MRR proposal was similar to US-style rate of return regulation, but, as we shall discuss below, with some interesting incentive additions.

The MRR proposal was strongly opposed by Alan Walters who was the economic adviser to Margaret Thatcher, the then Prime Minister. He was a staunch opponent of US-style rate of return regulation and claimed that the MRR proposal "had many of the characteristics of a 100% marginal tax rate"[6]. Instead, he argued for an output related profit levy (ORPL) which was intended to remove the incentive on BT to behave in a monopolistic way by restricting output and raising prices.

Alan Walters' proposal in turn attracted considerable criticism and Stephen Littlechild was commissioned in October 1982 to

- work up a more detailed version of the ORPL;
- evaluate both schemes;
- consider variants; and
- make recommendations.

6 See Littlechild (1983), para 2.2, p. 3.

The final report was to be prepared by mid-January 1983 and was published in February 1983.

3.2 The Regulatory Options Considered and the Evaluation Criteria

Initially, Littlechild had two options to choose between: the Inter-Departmental Working Group's MRR and an outline version of the Walters' ORPL scheme. Very importantly, all the Littlechild comparisons were made against *a **base case** of no ex ante regulation of profits or prices* ie just leaving BT and telecoms to ex post competition policy oversight.

The evaluation criteria used in the Littlechild report were:

(i) Protection against monopoly (and BT's abuse of its dominant position)

(ii) Encouraging efficiency and innovation (static and dynamic)

(iii) Minimising the burden of regulation

(iv) The promotion of competition

(v) Maximising the flotation proceeds.

Interestingly, criterion (iii), the promotion of competition, was <u>not</u> in the list of objectives for the report as given to Stephen Littlechild in the terms of reference. In fact, this issue became the main focus of the report. Evaluation criteria (i), (ii) and (v) were included as objectives, as was "facilitating the operation of BT plc as a commercial organisation after privatisation" but this last was not explicitly included as an evaluation criterion. Criterion (iv), minimising the burden of regulation, was also not explicitly included in the terms of reference[7].

In all cases, the five options were ranked against one another on a comparative basis derived from a qualititative appraisal. Hence, the final summary rankings, with five options, reported scores of 1-5 for each option on each criterion.

In carrying out his evaluation, Stephen Littlechild argued that protection against monopoly abuse was the critical requirement which had to be satisfied – this followed its listing as the first objective in the terms of reference. Failing to deal with this issue was the key problem with the "no regulation" base case and with the ORPL (which also had other difficulties). Maximising the flotation proceeds was in the terms of reference but was not a critical criterion for the report.

In the initial evaluation, the MRR was rejected because it was scored badly on all the criteria except protection against monopoly (very badly on the burden of regulation and the promotion of competition). The ORPL was also scored badly on these criteria (and

[7] For the full terms of reference, see Littlechild (1983), p. v.

very badly on flotation proceeds). Comparing the ORPL and the MRR, Littlechild concluded that "… the choice would be between a scheme that is largely unknown and a variant of one that is known to be unsatisfactory. Neither can be recommended[8]." The base case of no ex ante regulation was far superior on all the criteria – except for the critical one of protection against monopoly. Hence the need for variants.

The first variant option considered was a (high) profits ceiling. This got fairly short shrift. Stephen Littlechild argued that, if the ceiling were set high (eg at around twice the expected cost of capital), it would provide little protection against monopoly abuse. But, more importantly, he argued that there were strong political economy reasons why the ceiling would be pushed towards the expected cost of capital – in which case it becomes a crude rate of return method of regulation with even more problems than traditional, standard US-style rate of return regulation.

The second variant considered was the 'local tariff reduction scheme' or RPI-X price cap as we now know it. As we have seen, this was the proposal that Littlechild came up with in the last week of his work. This he scored highly on all the criteria – particularly on efficiency and innovation, financial proceeds and (most importantly) on protection against monopoly. It was this last that gave it the edge over the base case of no ex ante regulation. But, it is clear from the report that the abolition of ex ante regulation was regarded by Stephen Littlechild as the goal for regulatory policy and the OFT.

3.3 Proposed RPI-X Coverage

It is not often realised but the 1983 Littlechild report recommendation for RPI-X was for a very restricted set of services and <u>not</u> for all BT services or even all BT national services. The Littlechild proposal was for confining price cap regulation to a tariff basket covering BT's business and residential rentals and local call charges only. Littlechild was clear that non-local (trunk) calls and international calls should be excluded from price cap regulation to help foster competition[9].

In contrast, the Interdepartmental Working Group MRR scheme covered all these BT services with proposed different maximum rates of return for local, trunk and international calls[10]. In the event, RPI-X was adopted but covering a wide basket of BT services and not just the limited set of services recommended in the Littlechild report.

4. Competition, Regulation and RPI-X

4.1 The Potential Speed of Development of Competition in UK Telecommunications

8 See Littlechild (1983), para 11.32, p. 31.
9 See Littlechild (1983), para 13.7 and 13.8, p. 34-35.
10 See Littlechild (1983), paras 7.3 to 7.6, p 14-15.

The 1983 Littlechild Report is rightly associated with a strong advocacy of competition. In addition, it is clear that the development of competition was seen as the way in which the economic regulation of BT would be made temporary. There are a number of statements that can be quoted from the report on these lines. The following, from para 4.11, is perhaps the most forthright:

"Competition is indisputably the most effective – perhaps the *only* effective means – of protecting consumers against monopoly power. Regulation is essentially the means of preventing the worst excesses of monopoly; it is not a substitute for competition. It is a means of 'holding the fort until competition comes."

Curiously, the report does not discuss what kind of competition was expected to develop in telephony. The implication is that it was facilities based competition although the report made a strong plea to allow the unrestricted resale of BT's (and Mercury's) circuits which presages the development of competition based on other companies retailing BT wholesale services. Given the major problems that there have been in developing facilities based competition (at least in the residential and small business markets), it must be questionable how realistic it was to expect effective competition to develop rapidly. Only cable has provided such competition on any scale so far at the local level for other than large businesses and that has been a largely urban (and heavily loss-making) activity which only got going in the 1990s.

In his contribution to this volume, Stephen Littlechild points out the Thatcher Governement decision to maintain a BT-Mercury duopoly as a major reason why competition was slow to develop. It is correct to point to the importance of the duopoly policy and Stephen Littlechild may well be correct in his conjecture that the duopoly policy was a major impediment, but it is not absolutely obvious. In particular, it is at least debatable whether, how much and how rapidly telecom competition would have developed in the absence of the duopoly policy.[11] Facilities based competition to the incumbent main telecom companies has been slow to develop in the US and many other countries besides the UK; indeed, it has been in retreat over the last few years – and certainly since the stock market downturn of 2000. The local loop unbundling saga is even less encouraging.

The result of these difficulties has been that competition for small customers in the UK has developed increasingly via the resale of BT *wholesale* services viz internet, broadband and the planned retailing of BT line rental service from autumn 2003. In consequence, for clear competition policy reasons, Oftel has been clearly (if somewhat reluctantly) pushed into substantive regulation of many of BT's wholesale services – in large part because of pressures from competitors complaining against margin squeezes and other claimed examples of anti-competitive behaviour by BT.

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[11] The costs and benefits of this probably unsuccessful policy is a topic that might well be worth analysis in the light of what we have learnt since about encouraging competition in telecoms. A thesis topic for someone?

It may be that creating effective competition in telecom services (other than from fixed v mobile voice telephony) is intrinsically harder than developing effective competition in electricity generation and supply or in natural gas. This could arise because of the much stronger synergies between network and services in telecoms which makes it intrinsically less attractive – and harder – to separate natural monopoly and service elements from other output elements than in electricity and gas.[12]

One note of interest is that Littlechild in his 1983 report was very strong in its advocacy of:

(i) tough non-discrimination clauses in BT's licence to prevent predatory behaviour against competitors (para 13.15); and
(ii) a requirement that BT should be required to publish its tariffs (para 13.16).

As noted, these are requirements that would not be desirable on competition policy grounds in "standard" markets but were advocated here (and again by Stephen Littlechild in his 2002 discussion of mobile call termination rates). The failure to impose such requirements was a major reason why nineteenth century UK railway regulation was such a failure.[13]

4.2 The Record on Competition in UK Telecommunications and the Duration of Price Cap Regulation

No reader of the 1983 report could come away with any other view than that price cap regulation of BT was expected to be a temporary phenomenon that could be dropped after about five years or so. At that point, Littlechild 1983 expects that competition could (and would) have developed sufficiently to return to standard competition policy oversight, at least for profits and prices - and presumably also for quality where licence conditions for BT were deemed necessary at least while price cap regulation was in place.

In fact, the explicit statement in the 1983 report discussing this issue is very judiciously worded. Much of the rest of the report is very direct if not positively outspoken for an official Government published report. But, in this case, the relevant paragraph (para 13.14) is carefully drafted so as not to commit hostages to fortune. It is worth quoting in full:

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12 See "Regulatory Forbearance: Why Does Oftel Find It So Hard?", Jon Stern, Regulation Initiative Public Policy Notes No 1, March 2002 for a fuller discussion of this issue and particularly Annex 1.

13 See "Regulators, Competition and Transitional Price Controls: A Critique of Price Restraints in Electricity Supply and Mobile Telephones", Stephen Littlechild, IEA, 2002 and "Regulation and Contracts: Complements or Substitutes? Lessons from UK Historical Experience", Jon Stern, LBS Regulation Initiative Working Paper No 54, 2003.

“In any event, an automatic reference to the MMC [Monopolies and Mergers Commmission] after, say, five years seems appropriate. By that time the extent and strength of competition should be apparent, and it may be appropriate to extend or restrict the scope of the ‘monopoly basket’; to change the value of X or to rebase the calculation; to abolish the tariff reduction scheme altogether or to impose additional constraints.”

However, as we have noted above, there is no discussion at all about resetting the formula and para 13.20 (in defence of RPI-X as implying a low burden of regulation) states that:

“The DGT does not have to make any judgements with respect to capital allocation of costs, and demand, desirable performance, etc.”

But, this is only correct if the RPI-X price cap is a one-shot temporary scheme. Hence, the logic of the 1983 report is that RPI-X could only have been abolished if sufficient competition were to have developed in UK telecoms within the first five years after the privatisation of BT. The report seem clear that this was certainly possible but other observers at the time were far less optimistic and extensive facilities based competition was far from the outcome. The slow development of competition in key areas and at key bottleneck points is presumably why BT still faces residual price cap regulation for retail services to small consumers and substantive regulation for some wholesale services and network access price elements.

4.3 Price Cap and Rate of Return Regulation where X is Regularly Reset: Are They Opposite Sides of the Same Coin?

My view (which I think is the conventional view) is that price cap regulation and rate of return are opposite sides of the same coin – *at least for utilities (or elements of utility service) which face regular periodic reviews eg every 3 or 5 years*. Since price/profits regulation has not withered away even for telecoms, that, in practice, means for all UK privatised utility service industries with major network elements.

There are, though, some clear differences between price cap and rate of return regulation. I would argue that price cap regulation is inherently more forward looking and more focussed on incentives. Conversely, rate of return regulation is inherently more backward looking and needs specific mechanisms incorporated to encourage efficiency (as have increasingly been developed in the US since around 1980).

At the limit, (eg with annual reviews) *both* price cap and rate of return collapse to being simple cost-plus pricing. In this context, it is worth noting that the DTI MRR rate of return scheme discussed in the 1983 Littlechild report provided for an annual review of whether or not BT had made excess profits with rebates to overcharged customers on a sliding scale from 52.5-75%.

Of course, Littlechild 1983 is famous for advocating price cap regulation as a *superior substitute* to rate of return regulation and quite different from it. Littlechild 1986 seems to take a different view. The later report discusses RPI-X in the context of the permanent regulation of a localised natural monopoly water industry. The key passage is in para 10.20 which reads as follows:

"In deciding how far to revise X … the economic regulator needs to examine the company's production methods and investment programme. He must ascertain the scope for cost and price reductions through increased productivity and efficiency and the need for capital expenditure. He needs to predict the consequences of X on what the company will do, how it will do it, how consumers will be affected and how others will react…. So permanent regulation is more complex than temporary regulation."

Similarly, the first sentence of para 10.21 reads "It should now be evident that rate of return considerations are necessary implicit in setting and resetting X." Stephen Littlechild has pointed out that this sentence and the rest of para 10.21 were written to make it clear that the chosen level of X must allow investors in utilities an expected, risk adjusted rate of return comparable to what they could expect from other investments. But, this seems to me to recognise that the incentive effects of RPI-X *only* arise for repeated reviews if companies are given a strong expectation of what they can expect regarding the (risk-adjusted) rate of return. In consequence, many of the information requirements and debates at regulatory review are common to both methods (eg on cost of capital and regulatory asset base definition and measurement).

The 1989 Rand Journal article by Beesley and Littlechild goes further in admitting that RPI-X and rate of return can converge for repeated regulation of monopoly facilities eg of electricity transmission networks or other natural monopoly facilities. Moreover, Stephen Littlechild's contribution to this volume seems, however reluctantly, to recognise this outcome as well as to explain why it has happened.

That, though, is not the end of the story. Characteristically, Stephen Littlechild concludes his contribution with how he is exploring other means by which we may be able to do away with the need for price regulation by a regulatory agency of even the most natural monopoly-like element of utility services. I, and other readers, may or may not be convinced by these arguments but it is important that they continue to be made by him and others since, clearly, economic regulation should be relaxed and terminated unless the benefits from it continue to exceed the likely costs – dynamic as well as static.

5. UK Price Cap Regulation Following the 1983 Littlechild Report

5.1 UK Telecommunications Price Regulation Following the 1983 Littlechild Report

Of course, RPI-X regulation was introduced for BT following its privatisation in 1984. However, its coverage was much broader than Littlechild recommended. Indeed, the eventual form chosen seems to have introduced some major elements of the Inter-Departmental Working Group MRR scheme into the Littlechild proposals.

The key difference was that price regulation was imposed on national and many international calls as well as on local calls and line rentals. This followed the Inter-Departmental Working Group's recommendation for the MRR coverage. Littlechild had recommended confining RPI-X to local calls and line rentals only.

Similarly, the Inter-Departmental Working Group had recommended differential rates of return for the different businesses, which, as Littlechild pointed out, implied a continuation of the cross-subsidies eg from international and trunk calls to local calls. The outcome was a single RPI-X "tariff basket" formula for all services but one in which rebalancing between services (and between domestic call charges and line rentals) was heavily constrained. This continued for a long period whereas Littlechild seems to have envisaged rather more substantial and earlier rebalancing, particularly from competitive entry into the national and international call business.

It was also the Inter-Departmental Working Group that recommended an Oftel review of BT's performance and licence at regular five year intervals[14]. This recommendation (including review and revision of the price caps) was introduced for BT and has since been followed for all the other privatised and regulated utilities. As we have seen, Littlechild had recommended a review by the MMC after five years, essentially to establish whether sufficient competition had developed to allow the RPI-X cap to be eased, modified or abolished.

Since 1984, price cap regulation has gradually been withdrawn for BT retail services, particularly international and then national calls, but most of the change has been relatively recent. Since 2002, there is only a residual "fail-safe" price cap on household retail call charges. Similarly, price regulation has – at least in recent years – been withdrawn from most network access price elements, with the exception of access termination charges. Following the 2001-2 Oftel review and the subsequent Competition Commission referral decision, mobile termination charges are still regulated, as are many of BT's wholesale service products. This is far from what was intended or expected in the 1983 Littlechild report but arises from the slow and relatively limited development of facilities-based competition, particularly until the development of cable (and to a lesser extent of mobile) from the mid-1990s[15].

5.2 General UK Developments on RPI-X Regulation

We all now know that the UK Government not only introduced RPI-X regulation for BT, but successive governments, Labour as well as Conservative, have used it for regulated elements of all subsequent privatised utilities (gas, electricity, water, railways, airports);

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14 See Littlechild 1983, para 7.2, p.14

15 Littlechild opposed regulation of mobile termination charges in his 2002 IEA paper "Regulators, Competition and Transitional Price Controls: A Critique of Price Restraints in Electricity Supply and Mobile Telephones". For further details and for a more detailed exposition of developments in UK telecom regulation, see the paper by Martin Cave in this volume.

for partially privatised utility services (air traffic control); and state owned entities (the Post Office).

There are, however, some fascinating difficulties concerning conflicts of interest and incentives in extending the regulator with price cap model to industries where the government has a significant ownership stake in the regulated company and is heavily involved in the appointment of the company board and management as well as appointing the regulatory decision makers – as has occurred with the Post Office. Similar problems arise where the industry is heavily long-term dependent on public subsidy – as occurred with Railtrack. This regulatory model with price caps has survived a major shock over air traffic control services (NATS) post 9/11. However, it failed over Railtrack and its experience during the two and a half years that it has so far been in place in postal services has been more than somewhat fraught.

It is very noticeable, though, that the way that RPI-X has evolved for the other industries as well as for telecoms is very different from the original conception - and very contrary to the nice, simple formula in Littlechild 1983. Price cap formulae have become a lot more complex, starting with the RPI-X+K formula for the water industries. Current price cap formulae now tend to be multi-parameter, have intercept adjustments, glide paths, etc. In addition, there are typically several price caps per industry – including in telecoms.

This was not what Littlechild 1983 or Littlechild 1986 intended or hoped for. Indeed, for the water and sewage privatisation, Littlechild 1986 advocated:

a) a *single X* (in a simple RPI-X price cap) for all water supply *and* sewerage services per company (para 11.7); and
b) a *single uniform X* for all 10 water authorities (para 12.1-12.6)

The latter was recommended subject to a number of conditions set out in paras 12.12-12.17 but was the clear recommendation eg in the Executive Summary. Neither of these was implemented. Indeed, the development of separate price caps for water supply and sewerage plus different Xs for each regulated company based on yardstick competition was the start of the growth in the complexity of price cap formulae.

6. The 1983 Littlechild Report and its Influence

6.1 Retrospective Surprises

With the benefit of hindsight, there are a number of surprises in the 1983 report – some positive and some negative.

The major *positive surprise* is the recognition in para 14.8 of the potential for competition from cable, radio (mobile radio and cellular), satellite etc[16].

To a 21st century reader, the main *negative* surprises relate to the absence of any discussion of:

(i) The distinction between BT's network services and products (calls etc);
(ii) The BT ownership, management and business structure and unbundling; and
(iii) Network access and interconnection terms and prices and the basis on which they should be set or regulated.

In his contribution to this volume, Littlechild explains that the absence of discussion of these issues relates primarily to the decisions that had already been taken to privatise BT as a single entity and to maintain a BT-Mercury duopoly for some years after privatisation. The role and importance of access charges to BT's network clearly grew during the 1980s - and particularly the 1990s - as competition developed. Littlechild was far from alone in the early 1980s in not anticipating how important pricing of access to incumbent network operators would be for the development of competition in telecoms.

6.2 The Influence and Importance of the Littlechild 1983 Report

The Littlechild report is primarily remembered for two things:

(i) The invention and promotion of RPI-X price cap regulation; and

(ii) The suggestion that price cap regulation need only be temporary because sufficient competition would develop so that it could be removed relatively quickly.

On (i), as we have seen, RPI-X was 75-80% rather than 100% *invented* by Littlechild, but it was his foresight and understanding that led to it becoming so important a <u>general</u> concept for utility regulation. It was not, as he had hoped, a way of banishing rate of return issues from utility regulation but it was crucial in leading economic regulation to be much more forward looking and to pay a lot more attention to competition and incentives.

On (ii), Littlechild's optimism was not borne out by events. How far that was due to prior and subsequent policy decisions, to regulatory decisions, etc can be debated. However, it remains the case that economic regulation for telecoms has not been withdraw in the UK or anywhere else in the world. Given the more difficult position of potential entrants following the 2001 and after collapse of the share prices of telecom companies (and particularly the glamorous new entrants of the 1990s), it seems to me more likely than not that some price/profits regulation of telecoms will be here 40 years after the 1983 Littlechild report and not just 20 years after. My judgement is that it will

[16] Littlechild's paper in this volume suggests that these and other proposals on para 14.18 were largely due to Bruce Laidlaw and Jonathan Solomon.

take major cost reducing technological advances permitting substantial new entry to lead to the potential abolition of such regulation over the next 20 years.

Nevetheless, the importance of the 1983 Littlechild Report is very considerable. The Littlechild Report was and remains a crucial, landmark document. After its publication, the world of utility regulation economics and policy-making would never be the same again. It can be described as like " a brick in the pond" in the sense that it was a major shock that created lots of waves.

Until the Littlechild Report was published in 1983, the world of regulatory economics and policy seems to have been a relatively small group, clustered around discussion of the US regulatory system and rate of return regulation. Since 1983, that closed world has been opened up and any country – developed, developing, transition or whatever - now considering introduction or reform of its utilities now routinely discusses a much wider array of options for economic regulation. Such discussions include, not just the traditional US model or the UK RPI-X model, but combinations, variants and new possibilities. It is because of this opening-up of the discussion of regulation and relating it to competition, competition policy and incentives that the 1983 Littlechild Report has been so important.

How much Stephen Littlechild is personally responsible for these developments cannot be reliably estimated but his 1983 report certainly caught the direction of the times and spurred many creative responses. That is why it was and will remain an important historical document.

Jon Stern

May 2003