REGULATED INDUSTRIES -
THE ‘GOVERNANCE CONTRACT’

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THE ‘GOVERNANCE CONTRACT’

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PREFACE

The CRI is pleased to publish the papers from its conference on Regulated Industries - the ‘governance contract’ as its 30th set of Proceedings. The papers have been ordered differently from their delivery on the 16th April in order to best bring together, in the light of the authors’ presentations, the related chapters. The headings used are as follows, and the individual chapters within them are set out in the contents list:

• The regulatory framework: governance perspectives
• Independent economic regulation: policy and practice
• Stakeholder perspectives
• Measuring corporate governance

We hope that this set of Proceedings will help continue the CRI’s contribution to the debate on good governance – by both the regulators and the regulated – and whether reforms are required. In that respect, we are indebted to the authors and presenters at the conference for their contributions. In particular, the CRI is indebted to RSM Robson Rhodes for their generous support and sponsorship of the conference.

The CRI would welcome comments on these Proceedings and further analytical work in the area. The CRI publishes work on regulation by a wide variety of authors, covering a range of regulatory topics and disciplines, in its International, Occasional and Technical Paper series. The purpose is to promote debate and better understanding about the regulatory framework and the processes of decision making and accountability. The views of authors are their own, and do not necessarily represent those of the CRI. Comments, enquiries or manuscripts to be considered for publication should be addressed to: Peter Vass, Director-CRI, School of Management, University of Bath, Bath, BA2 7AY.

Peter Vass
Director, CRI
September 2002
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1 MULTI-UTILITY PERSPECTIVE – THE GOVERNANCE CONTRACT

John Roberts

Introduction

Privatised utility companies supply public services that are every bit as important as those supplied by the public sector – arguably more so – being clean water, energy to warm and power our lives, and the communications that support our wealth and prosperity. But in recent years the supply of essential utility services has moved out of the public eye, at a time when the clamour for investment in schools, hospitals and transport reaches new highs. Except at times of water shortage, and in the financial pages, utility companies are largely invisible to the national media.

That is quite an achievement - one we can be proud of and for which we can take some credit. Like the referee in a football match, we know we’re having a good game when no one talks about us. However, I believe that energy, and to a lesser extent, water issues, are set to re-emerge on the national agenda, as the government wrestles with environmental and climate change targets, and the question of how best to ensure security of energy supply.

Ultimately, achievement of these government objectives will depend on investment – as do the aspirations for transport, education and health. But while taxpayers cannot choose whether to pay, the capital markets can and will. For example, significant investment will be needed to:

- develop new renewable energy technologies and deploy them;
- transform gas and electricity distribution networks to facilitate a sustainable and secure energy system;
• provide effective drainage to cope with warmer and wetter winters;
• deliver higher environmental quality targets in pursuance of the EU’s water framework directive.

To pave the way, government must set the right conditions to raise investor confidence and provide appropriate incentives to allow a decent rate of return – crucial issues as we gear up for the price reviews in 2004. The city needs to see that government has learned the lessons of its handling of Railtrack, that unpredictable policy changes have downstream consequences for the availability and cost of capital.

There needs to be greater consistency between ministers and regulators – greater consistency between broad social and environmental goals and economic regulation, and greater certainty on policy direction over a longer planning period. That will require regulatory reform.

Regulatory reform

During the decade following privatisation of the water and electricity industries, regulation was relatively clearly understood. It was essentially economic in nature. The tasks were to:

• improve efficiency;
• attract investment in water;
• introduce competition in energy.

Regulators understood that their objective was to set prices as low as possible, consistent with financing of the companies’ functions. To the extent that there were policy trade-offs to be made, they largely turned on an assessment of the balance between lower prices and higher profits. To take the example of the electricity industry, during the 1990s it was possible to have the ‘holy trinity’ of:
• lower costs;
• enhanced security of supply;
• greater diversity.

Today’s trade-offs are more varied and complex:

• lower costs might not be compatible with environmental interests;
• market mechanisms may not deliver security and diversity of supply.

The Performance and Innovation Unit Energy Review commented that:

“Trends in energy markets have been comparatively benign over the past 10-15 years, … but that ... the future context for energy policy will be different ... new challenges require new policies … where energy policy decisions involve trade-offs between environmental and other objectives, then environmental objectives will tend to take preference”.

Trade-offs are not so new to the water industry. Throughout the 1990s there was a tension between improved water quality and environmental performance and rising prices. Nevertheless, there is a growing recognition that the one-off, step-change improvement in efficiency was just that, a one-off. For one thing, the increase in debt that funded so much of the improvement cannot be repeated. For another, quality improvements were, to some extent, bought at the cost of routine maintenance, which cannot be postponed indefinitely.

On this analysis, regulators can no longer be seen as largely independent economic actors. Rather, they are vitally important players in determining the future of the UK’s infrastructure industries.

The key components

So what are the key components in the reform of regulation?
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First, economic regulation should be seen as part of a wider co-ordinated policy-making and delivery mechanism for each sector. In water there is a history of sharing responsibility between environmental impact, water quality, and independent economic regulation. But this history has not always been a happy one, and co-ordination has to replace the type of in-fighting that has characterised relations between regulators in the past.

In the short term, ministers could be more explicit in guiding regulators to take broader public policy issues into account. We welcome the announcement earlier this year from the Department for Environment, Food and Rural Affairs (DEFRA) that the forthcoming Water Bill will place a duty on the director general to act in a way best calculated to contribute to the achievement of sustainable development.

There are also opportunities, longer term, for reform of the regulatory institutions. Ofwat and Ofgem are economic regulators, while, for example, the Civil Aviation Authority (CAA) has broader duties, including economic regulation but with safety as its top priority. The CAA organisation is also much broader, with directors of safety, consumer protection and airspace policy sitting alongside the director of economic regulation. This has helped the CAA to take a more balanced view on the desirability of price-cuts against the desirability of investment. It provides a potential template for reform.

The second key component is to place the five-year regulatory cycle within a longer-term framework. This needs to encompass the broader changes to which companies might be subject, and an understanding of how these changes then impact upon companies’ costs and financing. Five yearly reviews will still be necessary but they should be seen as staging posts on a journey already mapped out.

Third, regulators need to attend to the realities of company financing, and the balance between debt and equity. There has been no deliberate plan, but we now have three competing models of water industry financing:
• the not-for-profit, contracted out Glas Cymru model (company limited by guarantee), whose finances are provided by bondholders and customers;

• stock-market listed companies, such as United Utilities, embodying unified management control of their operations;

• the thin equity model adopted by Mid-Kent.

Future financing

Philip Fletcher (Director General, Ofwat) has been openly supportive of the role of equity in the water sector and Callum McCarthy (Director General, Ofgem) has been openly hostile towards equity leaving the energy sector. From this I take it that neither wants to see companies pushed toward near total debt financing, and there are some good reasons why the substantial removal of equity should be resisted:

• some of the risks currently borne by shareholders would be transferred to customers and/or tax payers;

• debt investors are much more risk averse than shareholders, which would reduce incentives on companies to be efficient and innovative;

• funding flexibility would be reduced, since equity would no longer be a source of funds for investment.

Moreover, removal of equity would almost certainly be irreversible. There is consequently a need to make investment in utilities sufficiently attractive to retain existing shareholders and attract new equity, for example to fund network transformation to facilitate connection of new renewable generation projects.

If regulators accept that equity is an important component of the financing of companies, then a real challenge is to establish the
continued presence of equity finance, and, in some cases perhaps, even the raising of new equity after 2005. It is essential, therefore, that regulators maintain a dialogue with the capital markets.

Energy policy

Energy policy – and particularly renewable energy – provides an example of how broader government aims and objectives may be scuppered without proper incentives and more enlightened regulation.

The prime minister’s cross departmental think-tank, the Performance and Innovation Unit (PIU), recently published its review of Energy Policy, a valiant attempt to map out energy policy to 2050 in a little over four months. The review provides a pretty good analysis of the issues, but is lighter on answers and recommendations – we’ll have to wait for the government’s white paper.

Of course, mapping out policy on virtually anything for the next 50 years is a vain task. A little like Neville Chamberlain asking for a policy on internet development. But the report does reach some conclusions. The report stresses the need for flexibility, and avoids backing particular generating technologies. At the same time, it recommends steps to make rapid progress towards a lower carbon economy, with targets for increased energy efficiency and greater deployment of renewable generation, raising the target to a fifth of the UK electricity market by 2020.

It is accepted that such a rapid expansion in renewables from such a low base will be challenging, particularly in the face of technical, regulatory and investment barriers. Unfortunately, the PIU’s call for NETA to be sorted out by 2003 is not matched by similar urgency to deal with network transformation and planning issues, in particular:

- while the renewables obligation will stimulate new generating capacity, it does nothing to incentivise operators of distribution networks to invest in transforming networks to connect it;
while planning authorities continue to take a local, and largely hostile, view of renewable energy schemes – particularly wind and biomass – developers will continue to waste time and money preparing schemes which have little or no chance of success.

There must remain some doubt, therefore, whether the 10% target for 2010 will be reached, let alone the 20% target for 2020.

It was concern over fragmentation and inconsistency of public policy and funding arrangements that led to the initiative we are taking to support renewable energy in the north west of England, the home of our licensed business operations. We are working with the Northwest Development Agency and other regional partners to establish ‘Renewables Northwest Ltd’, a not-for-profit company bringing together private and public sector interests. We want Renewables Northwest to work strategically, gaining political and public approval to pave the way for deployment of the new technologies. We launched this approach at a regional conference at the end of March.

United Utilities is an international company, but the north west of England remains our home, which means:

- as owners and operators of the electricity distribution network we have a close interest in incentives to facilitate new generation connections;

- as owners and operators of the region’s licensed water business, we have a significant asset base for hydro, sewage gas and, potentially, wind and biomass developments;

- as the operator of some 10% of non-fossil fuel renewable energy electricity schemes in England and Wales, we have significant technical knowledge and capability, and aspirations to develop a further 200 MW of generation in the next five years.

We want to use this strong base to give regional leadership. We want to try out some new approaches to tackling issues strategically – whether on transformation of our distribution network, acceptable location for new projects in the region, or simply closer working
between business and the public sector. We want to help the region capitalise on its significant natural resources, and manufacturing and R&D skills, to develop the UK’s leading renewable energy cluster.

We are not doing this because we have to, but because we can see the longer term commercial benefits of giving renewables a kick start. However, the incentives are not yet right for us to invest in large-scale transformation of the network, nor to go out of our way to connect new generators (the PIU proposes these issues be handled in the 2004 price review). But we anticipate that the approach we are taking will help move the agenda on so that those incentives are ultimately available.

**Water industry investment**

The water industry has seen unprecedented levels of investment since privatisation and much has been achieved. In the north west we now have the highest ever levels of drinking water quality and customers are receiving high levels of service. Bathing waters in the region have all passed EU quality requirements for the first time, and we are proud of the contribution we have made to that. However, earlier expectations of reduced investment needs going forward are not being realised.

The backlog in asset maintenance which arose as a result of the need to focus investment on environmental obligations in previous years cannot be postponed indefinitely without unacceptable risk of failure. It must therefore be addressed in the next five years. On the environmental front, the welcome holistic approach to water management embodied in the water framework directive will require sustained investment. Customers are also demanding, rightly in my view, that problems of homes at risk of sewer flooding, or affected by odour from treatment plants, should be afforded higher priority.

We believe now, therefore, that investment will need to remain at its current high level if environmental objectives and customer aspirations are to be met.
Conclusions

The utility companies’ progress since privatisation – in lowering prices while delivering investment – has been remarkable. The last decade has seen real reductions in gas and electricity network charges of 45%, with Ofgem commenting that “since 1991, companies have demonstrated a steady improvement in their performance against the overall standards”. Water infrastructure has benefited from a massive investment programme, but prices were nevertheless reduced by 12% on average in 2000. Ofwat wrote last year that “since 1991, industry performance has shown a steady improvement across the range of levels of service indicators”.

We now need to move on from asset-sweating and price cuts to investment and price stability. We need to increase investment in gas and electricity infrastructure, to provide network security and pave the way for increased diversity, including renewables. In addition, we need to maintain high levels of investment in water infrastructure to meet environmental and water quality targets, and eat into the maintenance backlog.

If we can get the regulatory framework right, so that investors have confidence to provide the funding needed, these challenges represent tremendous opportunities:

• to improve the performance of our economy, both at a local level and nationally;

• to address environmental change in a responsible and cost-effective way;

• to maintain the UK’s leadership position internationally in managing energy and water services.

Independent, economic regulation has worked well in the past in improving services and efficiency. But it may not be the best tool for delivering the government’s objectives in the future. We are seeking an approach:
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• which better balances the interests of our customers as consumers, and as citizens;

• which provides strategic leadership and incentives – for example, on CO₂ reduction – while leaving market forces to deliver;

• which looks to long-term sustainability, rather than short term price reductions, and gives investors confidence.

Government has a golden opportunity, in the light of the energy review, and in the run up to price reviews in 2004, to set out the policies to deliver this approach, and secure the investment needed. It is an opportunity that should not be missed.
Introduction

The object of this chapter is to do two things: first, to put the general arrangements for the creation of independent economic regulators into their constitutional context and, secondly, to go on from there to consider what changes could, or should, be made to the institutions that have been created. The reason for this ordering is because the issue of how to design a regulatory system cannot be separated from the wider constitutional issues, since it is a smaller version of the larger problem.

In order to structure the argument, I thought that it would be useful to subject the regulatory arrangements as a whole to the principles of good regulation as espoused by the Better Regulation Task Force. It is fairly common to subject the activities of individual regulators, or indeed a class of regulators, to such scrutiny, but less common to subject the system as a whole to such scrutiny. Although the Task Force has done its own overview, my approach in this discussion will be different. So, after some introductory remarks about the constitutional context, this chapter looks at the principles and then their application in this area, before finishing with a brief look at proposals for reform.

My starting point is the contention that the so-called regulatory contract, and problems with it, are a sub-set of wider constitutional

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issues and that, ultimately, a satisfactory solution to the regulatory contract issue depends on solving the constitutional ones – or perhaps at least posing them in the right way. There are two major themes that are important to highlight, and two minor ones. The first major theme is that of the creation of agencies and the delegation of public services. At the last count, over 70% of all civil servants worked in executive or next steps agencies or their equivalents. What we have seen is a transformation in the way government is organised, away from departments providing services with a politically accountable head towards a system where there is meant to be a separation of policy and management issues, with political accountability applying only to the former. This has required some attempt to specify the division of powers between ministers and the agencies. Independent regulators can usefully be seen as another part of this movement, albeit in a legally more secure position than executive agencies as they have their own legal personality, and relationships with government are enshrined in a statute. At the same time we have seen a re-working of the convention of ministerial responsibility and a decline in the status and prestige of parliament. So ministers are taking responsibility for less and the public is taking less notice anyway.

The second major theme is legalisation. In relation to agencies, there seems to be a growing interest and awareness in using the courts to attack decisions that you do not like. This is still relatively rare but the threat may often be there, and that causes regulatory agencies to look at their procedures very carefully. This comes about partly because we have given people, both individuals and companies, new rights under the Human Rights Act, of which the most important is Article 6 – a right to a fair trial in front of an independent tribunal. Additional rights appear via European Community law and, certainly in competition law, assumptions are made about what are acceptable procedures, based on European Community procedures.

The first minor issue is the devolution of powers to Scotland, Northern Ireland, Wales and, rhetorically at least, London. As far as

utilities are concerned, water in Scotland and water and energy in Northern Ireland are subject to their own individual arrangements. In addition, the regional legislatures are also beginning to develop an interest in regulatory matters. So, for example, the Welsh Assembly has supported the development of an alternative ownership structure for Glas Cymru and the Welsh Committee of the House of Commons is looking at broadband cabling in Wales. Indeed, the mayor of Greater London is currently developing a draft energy strategy, which has been put out for consultation.³

The second minor issue is the question of reform of the House of Lords, which will be returned to at the end of the paper. The point here is that these two minor issues, plus the Human Rights Act, are part of a constitutional reform programme, which in some sense moves us away from our traditional understandings, both about how public services and policies are delivered and how those who execute them are held accountable for their actions.

The Better Regulation Task Force’s five principles of good regulation are: transparency, accountability, proportionality, consistency and targeting and are set out in Table 1.

Table 1: Better Regulation Task Force’s five principles of better regulation

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I am going to focus on transparency, accountability and consistency, because these suit my concern with institutional design, whereas proportionality and targeting are directed more towards the substantive results of regulation.

Transparency

The Better Regulation Task Force explains that transparency means that “the case for a regulation should be clearly made and the purpose clearly communicated”. Historically, as regards all the agencies created for the regulation of privatised companies, the case for, and the purpose of, regulation was never articulated clearly. In the case of telecommunications a brief white paper emerged, but this simply repeated a ministerial statement about the future of the industry with less than a paragraph on the proposed regulatory arrangements. As regards gas, no white paper or considered consultative document was published. The white paper on electricity privatisation dealt with the issue of regulation in five paragraphs. The Energy Select Committee criticised this as a “theoretical statement of intent” and “a misty outline” rather than a fully worked out scheme.\(^4\) There was slightly more discussion in relation to the regulation of the water industry, but this was largely due to the complexities of dividing economic and quality regulation between two bodies. The only substantial official discussion that has been published is Professor Littlechild’s report on the regulation of British Telecom’s profitability (complemented by his subsequent report on water regulation).\(^5\) This envisaged that regulation was only a temporary condition, a means of ‘holding the fort’ until competition arrived. In the year 2002, the fort is still standing and there is no sign of regulation disappearing. Furthermore, what was enacted under the Telecommunications Act 1984 was, arguably, not what Professor Littlechild envisaged.

Although individual regulators have tried very hard to explain their role there has never been a clearly articulated view of the purposes of regulation from the government – no matter what political colour. The one attempt at an overall vision since 1997 was provided by the Labour government in its original proposals for the Utilities Act 2000, which covered all four industries, but which collapsed with the removal of telecommunications and water from the framework.

\(^4\) HC 307 1987-8 at paras. 60, 176.
\(^5\) Littlechild S (1984), Regulation of British Telecommunications Profitability London, HMSO; Economic Regulation of Privatised Water Authorities (1986), London HMSO.
You cannot answer the question by just examining the duties in the legislation because, to quote the CRI:

“There is also inherent conflict between some of the duties of the regulators. … some of the duties are of so general a nature, and are so far removed from the regulator’s powers, that it is difficult to see how they can actually influence the activities followed and decisions made by the regulator”.  

There has been, since 1997, a gradual change in regulators’ roles, away from an almost exclusive emphasis on economic regulation, towards greater emphasis on the social and environmental side of regulation. This can be partly seen in the new duties imposed on Ofgem under the Utilities Act, which is perhaps reflected in the creation of the social action plan and the environmental action plan. The plans for the office of communications’ regulation envisage a regulator with dual responsibility: economic and content regulation. The regulators have also become rule-makers, through the ability to produce standard licence conditions, something that has not really been acknowledged and, in addition, now have powers to impose financial penalties on companies, either through concurrent powers held under the Competition Act or, in certain cases, through industry specific powers to impose financial penalties for breach of licence conditions. 

In summary, two separate stages can be identified. Originally, the role of the regulatory system was seen as being to provide a protection against monopoly power through the regulators acting as a surrogate for market forces, through price controls and by encouraging competition, thus protecting consumers. With the coming of competition in most of the industries, although to a lesser extent in water, the setting of price controls has become relatively less

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6 Lawrence G (2002), Who Regulates the Regulators? p12, Centre for the study of Regulated Industries (CRI), University of Bath. A similar comment is made by the Better Regulation Task Force in Economic Regulators at p14.  
7 Strictly speaking, the Gas and Electricity Markets Authority.  
8 For example, Electricity Act 1989 section 11A.
important, whereas policing the competitive process has become relatively more important. In addition, the powers of the regulators have expanded, and the current government has insisted that issues such as social obligations or content regulation have a more central place in the regulatory process, even though they are less susceptible to technical expertise. This change in the regulators’ role has not, however, been accompanied by any real debate over the objectives of regulation; an issue exacerbated by a lack of clarity about the government’s role in the regulatory process.

Accountability

Although the focus is usually on the regulators when it comes to accountability, this is somewhat misleading, as government has always had a role in making decisions about the regulated industries, although it is not something that it has enjoyed talking about. Historically, it was government which granted the original licences and decided on the degree of competition that would be present in an industry from the outset. A good example of shyness relates to the guidelines on social and environmental obligations envisaged in the Utilities Act 2000. There have been two rounds of consultation on these, the last ending in August 2001, yet they have not been laid before parliament or officially produced. Why not? In theory, this is a way of attributing responsibility and clarifying the division of powers.

We should remember that government has important reserve powers in all the industries, for example, the levy powers introduced by the Utilities Act 2000. These may never be used but there are other powers, for example, in relation to licence alterations, which, if not used, give the government an informal means of influence. There is some evidence in the literature that there are plenty of informal contacts between government departments and regulators. Perhaps, even more importantly, governments have the power to change the rules or the conditions of regulation. For example, it needed legislation to abolish disconnection in water or there was Stephen Byers’ intervention with Railtrack, not only to put it into
administration but also, according to the rail regulator, to threaten emergency legislation to prevent the rail regulator conducting an interim review of Railtrack’s finances.\footnote{See select committee on Transport, Local Government and the Regions Passenger Rail Franchising and the Future of Railway Infrastructure, Minutes of Evidence, 7 November 2001 Qs 759, 761, 765 and compare Minutes of Evidence 14 November 2001 Qs 865 and 867.} Finally, there are various examples of the division of power between public agencies. For example, in water there is the quadripartite process, which is used to take into account environmental costs when water price controls are set, which seems to have worked well in terms of flushing out the issues, if you will excuse the phrase. On the other hand there is the division of safety responsibilities in relation to rail between the HSE, Railtrack and the regulator, which does not seem to have worked well. We might also mention the concurrent application of competition law. There is a broader question as to responsibility for social obligations in say energy and water, which seems to be migrating from government, via the regulators, to the companies.

Also, I cannot leave this area without mentioning freedom of information on which there are two points: full implementation of the legislation has been delayed until 2005, and the real issue is not access to information of the regulator, but access to company information on which decisions are based.\footnote{For more detail see Fitch M and Graham C (1999), Utilities and the Freedom of Information Bill, Consumer Policy Review, 9, No. 2, 57-63.}

In terms of accountability, the regulators’ record is generally good. They have all put large amounts of information into the public domain, they conduct a variety of consultation exercises before making decisions, some of which have instituted genuinely innovative procedures in a British context, and they have regularly appeared before parliamentary select committees, as well as being subject to investigation by the National Audit Office. They are also subject to judicial review, and cannot impose a change in licence conditions without the agreement of the companies concerned unless they are prepared to argue their case before the Competition Commission. By contrast, although ministers have to appear before select committees,
and are subject to judicial review, accountability is only that demanded by parliament, which is relatively much less demanding.

Consistency

Is there consistency here? No, is a short answer. An obvious starting point is that at present we have director generals of telecommunications and water services, (although the post of director general of water services is now to be discontinued under the latest Water Bill), whereas by contrast we have a Postal Services Commission and a Gas and Electricity Markets Authority (although still commonly referred to as Ofgem). The director general of Telecommunications will be subsumed within the planned office of communications, and the government has recently announced that the rail regulator will also be replaced by a board. So there will be consistency in this area in the future!

The Enterprise Bill envisages that if you do not like what the Competition Commission decides on a merger or market inquiry you go to the competition appeal tribunal, which will apply judicial review principles.\footnote{Enterprise Bill Clauses 114 and 169.} If you are subject to a fine or enforcement order by Ofgem, by contrast, you bring a case before the ordinary courts.

Finally, I should just mention the currently very differing methods for consumer representation, ranging from the energywatch and Postwatch model to the Ofwat National Customer Council for water (recently re-named WaterVoice\footnote{Which is to be replaced by a new independent customers’ council under the Water Bill.}) to the advisory committees, which currently exist in telecommunications that are planned to be replaced by a consumers’ panel for the Office of Communications. Leaving aside the question as to which of these is the best arrangements, or indeed whether any such arrangements are needed at all, it is not obvious that there are good reasons for such differences. There may also be important substantive differences in relation to the treatment

\footnote{Enterprise Bill Clauses 114 and 169.}
of consumers. Why are disconnection and pre-payment meters prohibited in relation to water, but not in the energy sphere?

When dealing with a regulatory system that encompasses a number of different industries, it is inevitable and desirable that there will be some differences between the industries. The problem with the arrangements for regulation that have been created is that the differences between the arrangements are not simply justifiable on demonstrable grounds.

Proposals for reform

There are, or have been, a number of proposals for the reform of the regulatory system which are best avoided. Top of this list is the idea that regulators should be directly elected, as happens in some American states. This is a very bad idea because regulators need to make decisions that are correct, rather than ones that are popular. The second idea is to reduce the discretion of regulators. This is really just chasing a chimera. If one of the problems at present is how to adapt the regulatory framework to a changing environment, then hedging the regulators around with rules is not the answer. The third set of arguments involves the creation of super-regulators, for example, a generic utilities’ regulator. My experience in the United States has indicated that such general commissions tend to split themselves into specialised parts in any event. Also, there is a danger that you have less transparency when you create one large body. There is something to be said for having separate bodies which, to some extent, conduct their arguments out in the open, as is the case with the quadripartite arrangements in the water industry. Finally, there is the argument that we should move away from sectoral regulation towards only competition law. In response to this, there are some issues which will not go away, such as regulation of networks and social issues, and, in addition, the argument that such an

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13 For a more detailed discussion see Graham C (1996), Is There a Crisis in Regulatory Accountability?, Discussion Paper No. 13, Centre for the study of Regulated Industries, University of Bath.
A ‘CONSTITUTIONAL’ APPROACH

approach will only distort competition law by broadening it, and thus its particular focus will be lost.

The major problem, I feel, lies not at the level of the regulators, but at the level of government and ministers and their relationship with the regulators. The answer is not to move back towards ministers being in charge, or to having elected regulators. The answer is to get more accountability for the actions of government ministers, which is the constitutional issue, as well as a clear statement of the relationships between the two parties. The guidelines on social and environmental obligations mentioned above are an example of a start here. I still think that there would be value in consistent parliamentary oversight, rather than the issue-based work that happens at the moment. Given that this is a highly technical area, one thought would be that this is the sort of committee that could usefully find a home in a reformed House of Lords – depending on what we think the Lords will end up doing. Finally, although I am aware of the various ways in which regulators have tried to make their procedures more open, the legalisation drive will encourage even more formal procedures from regulators.

14 See the statement by the Leader of the House, Robin Cook on 13 May 2002 385 HC Debs starting col. 516.
3 THE PRINCIPLES OF ‘BETTER REGULATION’ – SEPARATING ROLES AND RESPONSIBILITY

Peter Vass

Introduction

It is common to hear calls for reform of the regulatory system – as it has been since the first ‘network’ industry (BT) was privatised in 1984. The tone and focus may change – and currently the debate is about whether RPI-X has run its course as an incentive mechanism because companies are close to the frontier of efficiency – but we still have to distinguish special pleading from disinterested policy analysis. Special pleading can, of course, be dressed up in superficially attractive argument, and can take advantage of modern political and decision-making contexts which focus on mantras such as ‘change for a changing world’. Change is then justified for its own sake, and if the consequent reform proves sadly lacking, the response is simply, ‘no problem, another round of reform is available’.

To decide whether reform is necessary, therefore, we need to be clear about the objectives of the regulatory system, the rationale for the instruments that we have chosen to achieve those objectives, and the consequences of those chosen instruments for the various parties involved. Taken together, these represent the ‘framework’ of regulatory policy, within which we should expect to find rational evaluation criteria for judging policy actions and proposed reforms, and by which the accountability of both the regulator and the regulated can be judged.

It is my contention that such a well-founded regulatory framework exists, and that the evolution of our regulatory system has been consistent with that framework, in that it is generic, and hence equally applicable to all sectors of network industry regulation. Too often it
has been implicitly stated, rather than explicit, but that is being progressively remedied by the new management disciplines now being imposed on the machinery of government to ensure that the principles and practice of good governance are achieved. The consequence, therefore, is not a need for reform, but for a sense of ‘renewal of’ (or re-acquaintance with) the regulatory framework which has served us well to date, and which can continue to do so. The dangers are otherwise clear, because the current evidence of reform initiatives is too often of fragmentation and incoherence, rather than well-founded development in the light of experience.

The principles of ‘better regulation’

An important catalyst for improvement in policy analysis and regulatory governance was the publication of the ‘Principles of Good Regulation’ by the government’s Better Regulation Task Force (BRTF) in 1998.\(^1\) Part of the on-going search for improved government, their great advantage was their simplicity and intuitive appeal as a rational basis for decision-making. At the same time they effectively encompassed both principles and practice; a high level regard for the objectives of regulatory policy, complemented by process disciplines to help ensure that good policies are achieved in practice. A notable example is the development of the Regulatory Impact Assessment (RIA) which now has to accompany regulatory proposals, a subject on which the National Audit Office has reported.\(^2\) An example of its application is given by the Office of Water Services (Ofwat) guidance on its use of regulatory impact assessments.\(^3\) The OECD has equally been promoting such principles, most notably in a

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2. National Audit Office (2001), Better Regulation: making good use of regulatory impact assessments, report by the Comptroller and Auditor General, HC 329, HMSO.
3. Ofwat (2002), How we use regulatory impact assessments, (July), www.ofwat.gov.uk/
series of studies on regulatory reform since 1997.\textsuperscript{4} It has also published best practice examples (the RIA process having been progressively adopted around the world following its formal introduction in the United States during the 1970s).\textsuperscript{5} The European Union has taken a number of recent initiatives too. First, the Commission’s white paper on governance published in 2001.\textsuperscript{6} Secondly, a ‘better regulation package’, a series of communications issued in 2002, evolving out of the Mandelkern report.\textsuperscript{7}

The principles state that regulation and its enforcement should be:

- transparent;
- accountable;
- targeted;
- consistent;
- proportionate.

A few observations on these principles! Transparent means that the policy objective is clearly stated, but a corollary flows from this. Clear expectations and understanding should be cultivated in the minds of the public and the customers on whose behalf the regulation is done. For example, in an incentive-based regulatory system driven by profit, then it makes sense for the government generally to explain that profit has a purpose – and to distinguish legitimate profit from efficiency improvement from illegitimate profit derived from the abuse of monopoly power. Too often the public’s pejorative sense of profit has been used by politicians and commentators (particularly with regard to utilities and network industries) to undermine confidence in the regulatory system and call for inappropriate reforms, whether through ignorance or for self-interested reasons.

\textsuperscript{4} OECD (1997), Report on regulatory reforms, vol 1, sectoral studies, vol 2, thematic studies, \url{www.oecd.org}
\textsuperscript{5} OECD (1997), Regulatory impact analysis: best practices in OECD countries, PUMA, Paris, \url{www.oecd.org}
\textsuperscript{6} European Commission (2001), White Paper on European Governance (Com/2001/0428 final), Brussels.
\textsuperscript{7} European Commission (2001), Mandelkern group on better regulation, final report, 13 November 2001, Brussels.
Accountable encompasses not only the due process of consultation, but a meaningful process in which a response to consultees’ submissions is published by the regulator, and a clear line of supportable argument pursued as to the reason(s) for the final decision. Such accountable evidence is a necessary element in improving the safeguard of judicial review, and should help define a little more closely the idea of ‘reasonable’ decisions by regulators. Accountable decisions are likely to be proportionate in the sense of being balanced and taking all interests into account.

Proportionate, however, links in many respects more directly to the principle of being targeted on the problem. Most importantly, regulators should be concerned with outputs (or outcomes) and not lose sight of those by focusing on the more controllable, or measurable, inputs; substituting means for ends. The RIA process also helps to ensure that all effects are included, so that, for example, the risk of more road accidents is taken into account if travellers would be diverted from rail or air by a proposed regulatory policy specifically targeted on the safety of those modes of travel. The regulatory link between inputs and outputs can usefully be captured in the words, cost-effective, and the cost-benefit test is an essential part of regulatory practice, whether for a regulator in deciding to collect more information from the regulated companies (the regulatory burden versus the public benefit) or in deciding on the appropriate level for the security of supply (once again the RIA process is helpful, in the first case by helping to constrain the regulator’s natural inclination to impose more information requirements than is optimal because the regulator might otherwise only take into account the cost to their own office). The concept of proportionality in this sense of targeted is well-enshrined in the European Union’s legislation, and particularly so in relation to competition policy, the single market and the constraints on member states to be able to make exceptions for industries which are judged to provide ‘services of general economic interest’.

Finally, consistent, and this principle too has an important corollary. Fairness and consistency with other regulations and precedents is an important quality but we must recognise that consistency is not rigidity, or slavish adherence to past precedents. Consistency must
allow for flexibility and adaptability in order to continue to meet the objectives of regulation, and with the benefit of experience and new information. We should, therefore, be consistent within the objectives of regulation. Otherwise we might find ourselves consistently ‘wrong’, which could destabilise the system and undermine support, thereby increasing political risk, and hence regulatory risk. The result must be to allow for regulatory discretion; to allow the evolution of the system and the changing of the rules in an ordered and defensible way, and ‘compensating’ if necessary disadvantaged parties where they have had legitimate expectations of continued practice. Where there is no reason for change, consistency delivers both stability and predictability, qualities which are important to public and investor confidence. But where change is necessary, consistency as described brings with it a sense of predictability because it is contingent on the objectives of regulation. The arbitrary use of discretion must, of course, be constrained, since that increases regulatory risk, and hence the cost of capital.

The gas industry has provided good examples of how economic regulation has had to evolve, perhaps the most notable being the decision of the Monopolies and Mergers Commission (now the Competition Commission) to change its approach between 1993 and 1997 to evaluating the impact of the discount at privatisation and the application of the market to asset ratio (MAR) abatement. Its former approach was methodologically flawed and could be shown to reward shareholders with windfall gains.\(^8\) Quite rightly, it corrected this in its next inquiry, but had to face a robust campaign from British Gas that it should stick to past precedent.\(^9\) Inevitably, such a campaign should – and did – fail, because the regulator’s first duty is to apply remedies which meet the objectives of regulation. With hindsight, the experience of this particularly ‘adversarial’ phase of regulation (between BG and Ofgas) has had benefits for all of the regulated sectors in creating a better understanding of the roles and

\(^8\) Monopolies and Mergers Commission (1993), Gas and British Gas Plc, reports under the gas and fair trading acts, vols 1-3, Cm 2314, 2315, 2316 and 2317, HMSO.

\(^9\) Monopolies and Mergers Commission (1997), BG plc, a report under the Gas Act 1996 on the restriction of prices for gas transportation and storage services, HMSO.
relationships, expectations and constraints on the various parties, and for each to see more clearly their part in the regulatory system as a whole. It is to this ‘jigsaw’ which we turn now.

Who does what and why?

Implementing the principles of better regulation naturally focuses attention on who (or which institutions) should do what, and why. We can discern in British regulatory practice a framework for regulation which identifies four separate (albeit) interrelated aspects, as follows:

- **the problem(s) to be addressed**
  (ie, market or ‘conduct’ failures)

- **the hierarchy of regulation**
  (powers, duties, institutions and accountabilities, including parliament, government ministers, ‘independent’ regulators and self-regulation and co-regulation)

- **the efficiency and effectiveness of regulation**
  (eg, the market or command and control instruments used, the incentives - rewards, penalties and remedies - and contextual activities, such as consumer education)

- **the processes and procedures of regulation**
  (eg, issuing licences, consultation, reporting and due process, monitoring and enforcement).

The key message is that regulation (like government generally) is there for a purpose, not for its own sake, the objective being to ‘correct’ for market (or conduct) failures, consistent with applying the principles of ‘better regulation’. Dividing market failures into three broad categories, as follows, can help us to see why different people and institutions should be responsible for remedying them, and to understand the type of regulation adopted.
Types of market failure

1. Abuse of monopoly power
   - anti-competitive practice (eg, cartels)
   - abuse of dominant position (eg, through control of an essential, or natural monopoly, facility)

2. Public goods and externalities
   - external effects not captured in private costs and benefits
   - information asymmetry between producers and their customers and investors
   - resulting in under-provision due to the ‘free-rider’ problem, too low quality and health and safety standards, environmental pollution, and inadequate financial and product information made available by producers to consumers, shareholders and other stakeholders

3. Unacceptable ‘distributional’ outcomes
   - affordable access to ‘essential services’
   - social exclusion, inequity and discrimination

The first two market failures are often treated (in economics textbooks at least) separately from the third, based on the argument that the first two are about economic efficiency (technical and allocative), whilst the third is fundamentally a ‘political’ decision. In regulatory terms, however, the three stand equally in the sense of correcting for ‘market failures’, since the third type arises where the ‘uncorrected’ distribution of income and access to essential services is deemed politically unacceptable, and hence is a form of market failure to be corrected by regulatory action.

The three regulatory domains

Each type of market failure brings its own particular issues, technical problems, appropriate instruments and accountabilities, and this has led, quite naturally, in Britain to separate institutional responsibilities, thereby allowing each regulator to focus on their particular area, knowing that their role is carried out within an integrated regulatory
system. The corollary of this, of course, is that each regulator knows the constraints on, and responsibilities of, their role in relation to the other parts of the regulatory system, given its interdependence.

The long term effectiveness of the ‘unbundled’ regulatory system is therefore dependent on each regulator playing their role effectively, and as part of a ‘balanced’ regulatory system as a whole. Trying to change those relationships unilaterally, or in unwarranted ways, can destabilise the system and its long term benefits. The development of the more accountable RIA process is an additional safeguard for the long term integrity of the regulatory system, and in maintaining the balance between long run regulatory objectives (to which governments subscribe) and short run political imperatives!

Institutional form and market failures have therefore, in general, been aligned for regulatory purposes into three different ‘domains’ of responsibility as follows:

- **economic regulation**;
- **environmental and public goods regulation**;
- **regulation of social disadvantage**.

The ‘economic regulators’ are well known, with their common style of acronyms, such as Ofwat, Oftel (soon to become Ofcom) and Ofgem (from the merger of Offer and Ofgas), although there are exceptions, such as ORR, SRA and the CAA. The CAA is also an exception because the Competition Commission is directly involved in the periodic review process of setting price controls for airports (and there is no appeal to the Commission against the CAA’s final decision). Particularly important is the recognition that economic regulation can be the province of appointed ‘independent’ regulators (albeit that their independence is constrained by the law and the principles of better regulation).

But why independence? Consistency of economic regulation, and consistency of incentives for innovation and efficiency by the regulated companies, are endangered by undue political interference (which was the experience of the nationalised industries, unable to operate at ‘arms length’ from ministers on a day to day basis because they became instruments of macro-economic policies, such as
counter-inflation policy, and social policy). Government recognises this and accepts that ministerial discretion should be constrained. **In short**, we need ‘bounded’ regulatory discretion to ensure consistency with the objectives of regulation, and independence of economic regulation to constrain ministerial discretion in this area where that is unrelated to long run changes in the government’s regulatory policy, with its attendant processes of debate, and parliamentary and electoral approval. This approach promotes public confidence in the regulatory system and minimises regulatory risk, hence reducing the cost of capital – a cost which consumers have to bear!

The other two regulatory domains are properly the responsibility of government ministers (accountable to parliament). This is because decisions in these two areas involve decisions on ‘taxation’ or the setting of product and service standards common to all consumers, and over which the consumers have no effective individual choice. The legitimacy of these decisions is underpinned by the democratic mandate afforded to ministers, and hence ministers should be directly accountable for them. This is illustrated by the Communications Bill, which will require the secretary of state (rather than Oftel or Ofcom) to determine the extent of the universal service obligation (but which must at least meet the requirements of the European Commission’s directive on the USO for telecommunications). Ofcom will determine how the obligations specified are to be met and which operators are required to provide universal service. We should note, however, that in practice some public service standards, such as reliability and security of supply, are made by the economic regulators, or where the standards are best depoliticised as far as possible (such as content standards in broadcasting).

**The cost-benefit test**

It is in the latter areas too that the impact of the better regulation principles, and the requirement for the cost-benefit test has, and will continue to have, a notable effect. For environmental standards and other common public service and product standards (eg, security of supply and the quality of drinking water), there should be an explicit cost-benefit test to ensure that the standards set are, in principle, at a level where the incremental (or marginal) cost is equal to the
incremental (or marginal) benefit. Ofwat’s initiative, headed by the Director General Sir Ian Byatt, to promote a ‘cost of quality’ debate in the period 1992-1994 made a major contribution to embedding this cost-benefit principle in government decision-making, and led to its incorporation in the Environment Act 1995 (and the European Commission’s better regulation package will now enshrine such tests in the development of their own directives). Of course, in these areas, the costs may be easier to quantify than the benefits, and ministerial decisions may have to be made based on judgement. The point then is ‘informed’ judgement, and the cost-benefit test provides a ‘process’ by which that informed judgement is found, and provides the documentation on the evidence, methodology and line of argument used, by which the minister can be held accountable for that informed judgement. Likewise, government ministers specify the means by which a politically acceptable, distributional outcome can be achieved, but it too should be subject to the economic test that the means used should minimise the economic and financial distortions (so, for example, targeted income support would be compared with the effects of requiring institutionalised cross-subsidies).

In practice, therefore, ministers appoint ‘independent’ economic regulators (or ‘boards’ of economic regulators – such as the Gas and Electricity Markets Authority – a government policy which has been endorsed by the BRTF in its report on the economic regulators), supported by their office (a non-ministerial public body, such as Ofgem), and are themselves supported by specialist non-departmental public bodies in regulating public goods and social disadvantage.\(^\text{10}\) These bodies, such as the Environment Agency, or the Drinking Water Inspectorate, administer consents, monitor implementation and conformity with the standards, and may take enforcement action. They have a considerable influence on the standards set by ministers because they typically act as the expert advisory body to ministers, and have some discretion in translating the standards into practice. Such bodies may also expect (and be expected by the public) to play an ‘advocate’s role’ for higher standards, and it can be to the advantage of a minister heading a spending department (such as the Department of the Environment, Food and Rural Affairs – DEFRA)

for them to do so. The meaning of independence, and distinctions about its degree for different regulators, is therefore a moot point; often a difference of degree rather than kind.

Economic regulation

Nevertheless, the concept of ‘independent’ economic regulation has been well-developed because it is seen as a technocratic function (controlling the abuse of monopoly power), a function for which ministers are ill-equipped.\footnote{NAO (2002), Pipes and Wires, Report by the Comptroller and Auditor General, HC 723, Session 2001-2002.} It does this first by encouraging competition (where it is appropriate) and where it is inappropriate (provision of natural monopoly services), or competition is not yet effective, by a regulatory ‘surrogate’ for the incentives of competition. In practice this has meant ‘incentive’ regulation by way of periodic maximum price controls on the regulated businesses (the well known RPI-X system), rather than annual profit control (ie, rate of return regulation). The corollary of this competition-based approach is that tariffs should be cost-reflective and that there will be a role for sectoral economic regulators as a competition authority (although this could be given to the national competition authority). We should also note that competitive disciplines can be applied to even the natural monopoly service providers, including competition for procurement, competition for the market (franchises and concessions), or competition for corporate control, the last of which is particularly important where there is strong information asymmetry in the hands of the company directors (leading, potentially, to directors serving their own, rather than their shareholders’ interests). Comparative competition based on yardstick comparators is another important source of information for regulators.

The substance of an economic regulator’s role can therefore be summarised as a primary duty of consumer protection, but subject to constraints, which contrasts with, but is not inconsistent with, the traditional statutory approach of specifying primary and secondary
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duties. This is set out in Figure 1, which helps to explain misconceptions about the regulatory system.

Figure 1: The purpose of economic regulation

**Primary objective: Consumer protection**

by, **first**, promoting competition (where appropriate) and, **second**, by ‘incentive’ regulation with a focus on achieving the lowest possible prices (for a specified standard of service) using price control rather than profit control (or rate of return regulation)

**Subject to constraints, such as:**
- ensuring the regulated business can finance itself (minimum required return for an efficient company)
- specified environmental and service standards
- non-discriminatory tariffs based on cost
- specified public and universal service obligations
- specified duties to special interest groups (eg, the disadvantaged)
- specified duties for sustainable development

It is important to note that the constraints are ‘overriding’ in that the instruments chosen by the economic regulator to combat the abuse of monopoly power have to be consistent with satisfying the constraints. Hence, for example, if there is a universal service obligation to deliver letters anywhere in the country for a single price (as in the UK with the price for either a first or second class stamp), then introducing competition could undermine that because new entrants would ‘cherry-pick’ the low cost business areas (such as urban deliveries) and erode the ability of the incumbent to fund the USO from cross-subsidies. Either competition has to be introduced with mechanisms to compensate the incumbent for the lost contribution which previously cross-subsidised high cost deliveries in rural areas (by means of a USO fund or by differential access prices using an ‘efficient component pricing rule’ methodology), or the incumbent retains exclusive rights and the incumbent is incentivised to improve efficiency by incentive-based periodic price controls.
The **first** misconception arose because the legislation at privatisation focused the primary duties of the regulators on ensuring that all reasonable demands for the service were met, and that the regulated businesses could finance themselves. Hardly surprising, given the government was both trying to sell the shares and wished to retain public confidence in the transition from what had previously been a government provided, essential service. However, the absence of a primary duty of consumer care was interpreted by some as, at best, legislative obfuscation and, at worst, regulatory capture. Whilst it is best if legislation clearly signals its objective (which is consumer protection in this case), we can take comfort in the fact that in practice the regulators’ actions have been directed towards that objective (whether they did it well is another question!). The Utilities Act 2000 has started the process of recasting the duties, but since figure 1 has been the template for regulatory action in practice, it wasn’t needed substantively (for example, Oftel’s annual report under Don Cruickshank always begun with a ringing declaration that Oftel’s activities were all directed towards the consumer benefit).

**Second**, its rational focus demonstrates that economic regulation is not flawed because of its absence of a social agenda. Sir Brian Carsberg has been reported as saying in the early years of Oftel that ‘we are not agents of social justice’; a quite understandable statement when the role of Oftel is placed in the context of the regulatory system as a whole, with different bodies addressing different market failures. Hence a comment less hard-hearted than it appears, more of a job description!

**Third**, the assertion that a duty to ensure a regulated business can finance itself is contrary to the consumer interest. All regulators have made it clear that the duty means setting price controls that allow the *minimum* required return (given the risk of the business) based on the costs of an efficient business. To set prices any lower would clearly not be in the consumers’ interest if they want the services to continue to be provided, and at the required quality.

**Finally**, the view that environmental and quality standards (and improvements to them) are incompatible with the role of economic regulation. Specifying obligations (or, less onerously, duties to have
regard to …) as constraints in figure 1 shows how, once set by ministers, they become the baseline from which the economic regulation proceeds. The environmental regulators, once having set standards in conformity with the principles of better regulation, and the associated cost-benefit tests, are then assured that the output requirements can be met because the ‘reasonable’ costs of achieving them are passed through in the price controls (and accepted by the operator when agreeing to the periodic review settlement). The process of determining the ‘optimal’ standards will involve iteration, in that, for example, the highest standards first chosen might not prove to be affordable or cost-effective, and so the interested parties involved will consider other combinations until the ‘best balance’ is found and agreed upon.

The regulatory framework

We can now bring together the various elements of the regulatory framework and illustrate the interrelationships in a diagram (Figure 2). It shows, horizontally, the three types of market failure to be addressed by regulation and, vertically, the separation of roles, highlighting in the central spine the relationship of government, regulatory bodies and the regulated companies. For this reason it can be viewed as a ‘two-way, tri-partite model’ of the regulatory framework. The diagram reflects the following key elements:

- government is responsible for regulatory policy and setting the output requirements (in general or specific terms as required). The government must ensure that the regulatory framework as a whole is consistent and effective, that is, each regulatory element properly plays its part in the context of the whole. Inconsistent practice or conflicting requirements should therefore be identified and

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12 This requires that formal arrangements and procedures are in place to facilitate inter-regulatory debate and agreements, for example, between the Environment Agency and Ofwat in agreeing the environmental programme to be incorporated in each periodic review of price controls for the water companies, and between the sectoral economic regulators in order to harmonise methodology and consistency of approach.
remedied as part of the on-going ‘guardianship’ of the regulatory framework. The government’s regulatory framework will have to have regard to the ‘institutional endowment’ and constitutional context of the country;

- regulators are responsible for the executive implementation of that policy, with the appropriate degree of ‘independence’ and discretion;

- companies focus on customers, but with the protection of an appeal process to the Competition Commission, or the courts (judicial review), where regulators’ actions are considered unreasonable or arbitrary. Following the MMC’s review of Ofreg’s 1997 proposals for revised price controls on Northern Ireland’s transmission and distribution businesses (some recommendations of which the Northern Ireland regulator decided not to accept), the Commission’s role has been strengthened to ensure that, in effect, the sectoral regulators apply the remedies set out by the Commission;

- customers look to the companies to provide good service and to address, where necessary, complaints. However, customers are protected by consumer committees which can represent them, and have powers to take up unresolved complaints on their behalf (or to remit them to regulators for enforcement). A distinction should be made where necessary between consumer representation and consumer ‘advocacy’, where the latter might involve pro-active lobbying on behalf of particular interest groups;

- feedback is an important element in the evolution of an effective regulatory system.

13 The suitability and effectiveness of the appeal remedies currently available are much debated, it being suggested that there is insufficient protection against arbitrary regulatory decisions. In any event, rights of appeal may in due course be affected by the recent incorporation of the Convention on Human Rights, and the government has decided to set up a competition appeal tribunal (CAT) which is to be separate from the Competition Commission, proposals which are incorporated in the Enterprise Bill 2002.
* delivery of consumer policy involves (and will be influenced by) bodies such as the National Consumer Council (a public body), the Consumers’ Association (CA) and the National Association of Citizens Advice Bureaux (NACAB), and sectoral bodies such as energywatch and WaterVoice. Internationally, for example, there is the European Consumers’ Organisation (BEUC).

** sectoral regulators, such as Ofwat, Oftel(Ofcom), Ofgem(GEMA), CAA, ORR and SRA; national competition authorities, such as the Office of Fair Trading (OFT) and the Competition Commission.

*** in the UK, now the Department of Work and Pensions.

(a) reflecting the devolution of responsibility for setting certain public good standards, such as reliability and security of supply, to the ‘economic regulators’ (accompanied where relevant by ministerial ‘guidance’).

(b) reflecting inter-regulatory dialogue and the impact of the better regulation principles and the requirements of the cost-benefit test when setting standards.

(e) reflecting the impact of ‘social action’ plans required of economic regulators by government by way of ministerial ‘guidance’.
Some policy questions and clarifications

Setting regulatory policy questions into the broader regulatory framework helps interpretation and provides a template to guide policy development. In particular, it shows that each regulatory activity should not be viewed in isolation (for example, we can answer the question as to why, in general, economic regulators should not be concerned specifically with issues of social equity). More generally, it draws attention to the fact that the regulatory system has complementary elements of partnership and adversity between the various parties to the regulatory system. Too often, in a world characterised by ‘independent’ regulation, the government is assumed to be excluded or disinterested. Completely wrong. The government is responsible for setting the policy and for defining outputs, which, in effect, the regulated companies are ‘contracted’ to provide. The economic regulators, however, as surrogates for competition, have a necessarily adversarial role in relation to the regulated companies.

To summarise, there is, therefore, a generic framework of regulation applicable to the privatised water, energy, transport and communications sectors, the key features of which are:

- government, either ministers directly or, where appropriate, their regulatory agencies, set the output requirements and standards (quality, safety, capacity and security of supply) within a long run perspective: the corollary of which is that regulation is designed to ensure that an efficient regulated business can fund itself;

- the regulated ‘public service’ companies, being ‘appointed service undertakers’, are, in effect, agents of the government in providing the outputs (through the licence ‘contract’), but have discretion over the inputs required (noting that the discretion is secondary to the obligation to provide the outputs, so that reputation as a public service company and compliance with required service standards comes first, not cost-cutting which imperils those standards simply to make short-term, and hence unsustainable, profits for their shareholders. Discretionary economic profits, which are a real
incentive, should be derived from good management, innovation and efficiency, whilst delivering all of the required outputs);

- ‘independent’ regulators monitor and enforce the required outputs, and provide the incentive models (whether by competition or price control) to promote efficient and innovative delivery of the outputs (with suitable rights of appeal by the companies to the Competition Commission);

- ‘periodic reviews’ (a partitioning mechanism) integrate the short term with the longer run efficient delivery of outputs by balancing incentives to efficiency with the equitable transfer of out-performance to customers, and by allowing the up-dating of forecasts.

Government policy and regulation is subject to the principles of better regulation (transparency, accountability, targeting, consistency and proportionality), one corollary of which is a clear allocation of responsibility for risk-bearing, and a consistent methodology for rolling forward the regulatory book value across successive periodic reviews. Major innovations or extensions of regulatory policy, such as the introduction of domestic supply competition in electricity and gas, or the reform of the electricity trading arrangements (NETA), would be expected to be accompanied by an RIA and associated cost-benefit analysis (noting that the RIA might, due to the proliferation of acronyms applied in this area, be referred to by another name).14 Attention to these principles, and the generic model of regulation, inspires confidence (including city confidence, which reduces the cost of capital) and should be a useful guide to government policy making. A duty on regulators to have regard to the principles of good regulation might be a discipline worth introducing into the statutory framework!

14 Terms in use include impact assessments which are strategic (SIA), stakeholder (SIA), consumer (CIA), environmental (EIA), and policy (PIA), each depending on the ambit of the assessment and the intentions of the preparer. Perhaps impact assessment (IA) will become the generic term.
In this context, two regulatory reforms in recent years can be questioned, being consumer representation and rail regulation.

‘Independent’ consumer representation

Economic regulators, in practice, have a primary duty of consumer protection, and the government is now recognising this in amending legislation (Utilities Act 2000 and subsequent planned legislation, such as for water and telecoms). Consumer representation was embedded within the institutional structure of economic regulation for water, electricity, rail and telecommunications, although gas was a notable exception, with the Gas Consumers Council separate from Ofgas. New Labour’s review of regulation, following coming to power in 1997, led to a policy of independent consumer representation; independent of the economic regulator and designed to ‘challenge’ the regulator. Energywatch, for example, has now taken over the role of both the Electricity Consumer Committees and the Gas Consumers’ Council.

A question arises, however. The government (the DTI) is appointing its representatives to Ofgem (ie, the GEMA board) and energywatch, both of which have a primary duty of consumer protection. If the economic regulator has a primary duty of consumer protection, then it is surely necessary for the regulator to have in place arrangements to hear the customer’s voice. So, the divided arrangements are at best bureaucratic (which is evidenced by process agreements being necessary, known as memorandums of understanding), and at worst adversarial in a way which could undermine public confidence in regulation (for which there has been some evidence provided by the public disagreement between energywatch and Ofgem – ie, Ann Robinson and Callum McCarthy – over whether sufficient competition exists in the retail gas market for price controls to be lifted).

The inference to be drawn from analysis of the overall regulatory framework is that ‘independent’ consumer representation in this form is unnecessary, and hence unlikely to prosper. Nevertheless, the government continues at present to plan on the basis of this model (having established Postwatch and plans to empower WaterVoice
through the current Water Bill). The explanation for this may be in the pre-election political dialogue, in which new labour presented a platform of radical reform of regulation when the public was particularly angry about excess profits and executive pay in the network industries. Although much of the proposed radical reform has been discarded in favour of continuity, given the evident efficacy of the existing regulatory system, some reforms had to be delivered!

**Rail regulation – a mismatch of theory and practice?**

It is also interesting to consider the implications of the ‘idealised’ regulatory framework in the context of rail and its current problems, with the government having put Railtrack into ‘administration’ and restructuring the rail industry based around an enhanced role for the SRA and with a debt-funded company limited by guarantee structure (CLG) for bringing Railtrack out of administration (Network Rail). The generic model focuses on three primary activities; government policy on the size, safety, frequency and reliability of the rail system; ‘public service’ provision by a private provider (whether CLG or equity-owned), and independent regulation (such as by HSE for safety and ORR for control of monopoly power). Yet we observe a duplication of organisations in rail, necessitating such artificial mechanisms as ‘concordats’ between the ORR and the SRA. The present proposed structure, with ministers involved in issuing both instructions and ‘guidance’, is illustrated in Figure 3.

A logical structure, however, could be:

- **government ministers** - with the Department of Transport and HSE - specifying outputs and standards;

- **network rail** as the infrastructure company, but incorporating the franchising function of the SRA (which had incorporated Opraf);

- **rail regulation** (perhaps the SRR would be a suitable acronym?) controlling the economic costs of infrastructure services, monitoring and arbitrating as necessary the franchise agreements between network rail and the train operating companies, supervising SPVs promoted by network rail for major projects,
acting as a competition authority, and incorporating the arrangements for consumer representation of rail passengers and users – given the rail regulator’s primary duty would be consumer protection.

**Figure 3: Current rail policy on structure**

The wheel to rail interface co-ordination problem would thereby be addressed (noting that we do not need an office of water service franchising or gas supply contracting for access to Transco’s network). The duplication of functions would be eliminated by the SRA functions being absorbed by network rail, ORR and the Department of Transport, as appropriate. The experience of the model of *economic regulation* set by Ofwat, with its reporting engineers, logging up systems and the use of renewals accounting has clearly been drawn upon in the development of ORR’s functions to date.

One concern might be that rail is different because it is subsidised by government to keep open routes and services which would otherwise
not be commercially viable (in effect, buying a ticket on behalf of the passengers or users) or to keep prices below cost in order to encourage diversion from road traffic for environmental reasons. But why? Given the outputs specified by the government, the control of subsidy would be achieved by, first, the regulation of the economic costs of the infrastructure by ORR and, secondly, by the competitive bidding process for the franchises let by network rail. The franchise competition would be based on the competitive question, ‘what is the maximum contribution that I am willing to make to network rail (or minimum receipt to receive from network rail) to have the rights to the franchise, after allowing for any price-capped fares and for the direct costs of operating the franchise?’ The minimum aggregate subsidy would then be directed through network rail, where the total revenue from franchises was less than that required to meet the infrastructure costs.

If the government wished to control the absolute level of the subsidy, rather than specify the outputs, then the competitive franchising question would have to be turned around, that is, ‘what is the maximum service that the franchisee is willing to run for the given subsidy?’. Subsidy minimisation could be further incentivised (if thought to be necessary) by benchmarking the subsidy and profit-sharing.

In due course, once confidence has been restored, the CLG (ie, Network Rail) could be restructured to an equity owned plc, thereby improving the alignment of incentives.

How it evolves, of course, we shall see.
4 INDEPENDENT ECONOMIC REGULATORS – DEFINING THE ROLE IN PRACTICE

David Edmonds

Introduction

This chapter focuses on answering the following questions, based on the UK’s experience in telecoms:

- why does independence matter in telecoms regulation?
- what form does independence take?
- how does independent regulation work in telecoms?
- what are the implications for Ofcom?

Why does independence matter in telecoms?

Creating telecoms networks, whether fixed line or wireless, involves substantial investment which is likely to be recouped over a long time-scale. This investment enables competition between networks, which brings benefits to consumers in terms of improved value for money and greater choice of services.

If investors are to commit substantial resources over long time periods to investing in networks, then they need a stable regulatory regime where they understand how it makes its decisions. They need assurance that it will not be subject to changes in approach that could undermine the rationale and basis for their investment. Regulation that is ‘independent’ of such day to day political pressures will provide this assurance.
What form does independence take?

In considering the practicalities of this question, the statutory position is set out below, followed by a brief description of the relationship with ministers and parliament.

Oftel is a non-ministerial government department established by the 1984 Telecoms Act. Independent economic regulation needs to work within widely understood parameters and constraints if it is to be effective. Telecoms regulation in the UK has had a system whereby:

- the regulator is appointed for a fixed term by the secretary of state;

- the regulator works within a legislative framework set by statute (principally the Telecoms Act 1984, the Competition Act 1998 and EU Directives covering telecoms and electronic communications);

- the overall policy framework is set by government (ie, promoting competition in telecoms) but the detailed implementation is carried out by the regulator;

- the regulator’s decisions can be challenged through use of specific mechanisms (eg, judicial review, Competition Commission referrals);

- so policy is set by ministers but director general actions are accountable to parliament not ministers.

The regulator does share some duties with the secretary of state, and they do work together. Also, the regulator liaises with ministers on key areas of policy. The regulator has a statutory duty to advise the secretary of state but all key decisions made are the director general alone, and not subject to a ministerial override.
How does independent regulation work in telecoms?

Having established the form of independence, it is up to the regulator to make it work in the circumstances of the telecoms market and its various stakeholders – consumers, consumer groups, telecoms network operators and service providers, and others with an interest in telecoms, for example, in government departments, agencies and voluntary sectors.

Key elements among the approach that Oftel has pursued are:

- transparency of the process of decision-making, so that it is accessible to stakeholders and enables their participation;
- being accountable for its decisions to its stakeholders;
- a focus on the outcome of its work being of benefit to the end user (consumer);
- maintaining an arms length relationship with its stakeholders, that is, not acting in a sponsorship role for particular players or sectors of the industry.

To bring its approach into focus both for stakeholders and its own work, Oftel has set out its strategy for how it is pursuing its overall goal of the ‘best deal for consumers’. This ‘competition plus’ strategy gives a framework for its decision-making. It recognises competition as the key mechanism for delivering benefits to consumers but acknowledges that sectoral regulation can involve additional action (the ‘plus’ element) to protect consumers, either where competition is not effective or where there are special features of telecoms networks that mean additional regulation is required.

This approach is given effect in Oftel’s annual management plan – which is consulted on. Given the rapidly changing nature of telecoms markets, this framework needs to be flexible to adapt to new services.
and new circumstances, and implies a technologically neutral stance that is proportionate to the opportunities available.

This competition plus strategy should be achieved through ‘appropriate regulation’ that brings the best deal for consumers, avoiding the risks of over-regulation that discourages investment, as well as the risks of under-regulation that could allow players with market power to exclude potential competitors from entering the market.

For example, in promoting competition Oftel is taking decisions that are carefully assessed in relation to the extent of competition in the relevant market and the prospects for competition developing. In mature markets, where the prospect of competition is someway off, Oftel has required BT, as a network operator with market power, to provide access to other operators on the basis of ‘cost plus’ prices. In other markets which are new, with higher levels of risk, Oftel has required access on the basis of ‘retail minus’ prices to ensure incentives to invest are not undermined.

Implications for Ofcom

The Office of Communications (Ofcom) proposal is for a statutory corporation, rather than a non-ministerial government department. This means an increased range of responsibility for one organisation and greater independence from government, as it would not be a government department. The case for, and practice of, independent regulation is well illustrated by Oftel’s experience. The implications for the new converged communications sector regulator (Ofcom) are a need for continuing independent regulation that:

- promotes competition to benefit consumers;
- makes economically efficient use of the radio spectrum;
- enables a clarity of analysis between networks and content issues;
- pursues transparent, accessible and inclusive processes for policy development, implementation and monitoring.
5 EFFECTIVE GOVERNANCE AND THE PRINCIPAL-AGENT PROBLEM – LESSONS FROM AVIATION REGULATION

Doug Andrew

Introduction

In this chapter we examine the pre-requisites to effective governance and how effective governance addresses the principal–agent problem by looking at the relationship between incentives and ownership structures. We illustrate this with examples from the aviation market and the impact of aviation regulation on achieving effective governance.

In the UK, along with an increasing number of other countries, the provision of previously state provided services by large, centralised government departments and entities has been gradually replaced by a more commercial public management approach to service provisioning. This has resulted in the creation of independent operating agencies, and more explicit regulatory regimes, within which they, and their competitors, operate. The main objective has been to enhance efficiency and effectiveness in these markets by devolving power to autonomous agencies that are able to operate with, and within, higher-powered incentives, and with more effective accountabilities.

Empirical evidence has been mounting that this approach is offering strong net gains. Perhaps this should not be surprising, given gains from clarifying objectives and reducing public sector restrictions (eg, funding constraints) result in better service delivery from the
customer perspective and less wasteful use of resources. Capital markets demand strong accountability and high quality management teams, with hostile takeovers being the ultimate sanction to address poor performance.  

The principal-agent problem

The principal-agent problem arises when the owner of a firm (the principal) employs someone else (the agent) as manager to do something in a setting where ‘effort’ cannot be perfectly monitored. This will be the case when the manager of the firm and the owner of the firm do not share the same interests (ie, their interests are not aligned). As a result, the agent may not act in the principal’s best interests (eg, the agent is ‘shirking’, not exerting the effort they would exert if they were pursuing their private interests). Opportunities for shirking give rise to a risk to the principal, characterised as a moral hazard problem because (part of) the actions of the agent are difficult to observe.

Moral hazard might be reduced through improved monitoring of the agent’s actions and/or creating an incentive structure that aligns the agent’s and principal’s objectives. If the principal can monitor the actions and outcomes of the agent’s actions as specified in the contract, then the agent’s performance can be controlled. However, in practice, due to imperfect information the transaction costs of doing so are potentially very high. As a result, a shift has taken place from the use of control mechanisms (eg, detailed rules) towards the use of incentive structures.

Corporate governance, in substance, aims at providing the best achievable incentive structures, by aligning the interests of the agent with the interests of the principal, thus reducing monitoring costs as the contract will become more self-enforcing or incentive compatible. Pre-requisites to good corporate governance are therefore a clear

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specification of the respective roles of the principal and the agent and well-defined property rights. In the private sector this does not usually pose a problem, but in the public sector this often does pose problems. Public governance issues often arise, as it is more difficult to monitor the performance of public sector managers. This in part is due to the environment in which managers operate (more limited management autonomy) as well as particular characteristics of public sector goods and services, such as:

- outputs are often not well-defined, and related to this;
- outputs are difficult to measure;
- the relationship between inputs and outputs is difficult to specify;
- monopoly provision, and related to this;
- markets are not contestable.

Incentive structures tend to be less high powered compared to the private sector. Private sector managers usually have clearer objectives eg, shareholder value maximisation, which through the use of hard incentives aligns their interests with that of the firm’s owners. As a result of the institutional structure in which they operate, public sector managers may have different interests from the government and different objectives. The objectives of the organisations they manage are often less clearly specified and more subject to change depending on political imperatives.

Nevertheless, the shift from public service delivery within the government bureaucracy to the creation of autonomous agencies with more narrowly defined objectives should at least potentially reduce public governance problems. More autonomous agencies allow greater independence from day-to-day political control than characterises departments, thus allowing a longer-term focus. How far governance is effective tends to remain open to debate. From the government’s perspective the reform process is creating greater distance between it and the agents who will actually provide the desired services (the government is usually regarded as the principal while itself an agent for the citizens who are the ultimate principals). Clearly, effective governance in these agencies requires that the management of these agencies have the autonomy to act and can be held accountable independently from the government, whilst being
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accountable to the government, through the establishment of clear contracts.

To address governance issues in the public sector, the focus should therefore, first and foremost, be on the institutional framework (ie, specification of clear property rights, respective roles of the government, the service provider and the regulator) in which the service provider (and the regulator) operate, because the effectiveness of governance hinges for a great part on the clear allocation of responsibilities and the effectiveness of incentives.

Policy framework

The institutional framework will depend on how the government defines its role, the implementation of this definition and its perceived sustainability. The relations between the regulator and the government should be transparent and set out in statute, ensuring the regulator’s independence whilst also ensuring that the regulator can be held accountable. The government appoints the regulators and determines how much discretion the regulators have (by statute and/or other means). Regulatory governance can be regarded as the degree of the regulator’s discretion, and, therefore, the extent the regulator can be held accountable. Best practice in the UK is evolving, with the Monetary Policy Committee perhaps leading the way in implementation, while Ofcom represents current policy thinking eg, separation of the chair from the chief executive officer.

How far the regulator is able to impose an effective incentive structure on the regulatee on behalf of society overall will depend to a great extent on the institutional framework, including market structure, in which both operate. In order to design and implement a regulatory framework based on high-powered incentives, regulatory credibility is essential. However, regulatory credibility will, to a large extent, depend on how far the regulator can pre-commit, and this will depend on the institutional framework and the approach to regulation from the government and regulator alike (ie, how far is the ultimate aim the phasing out of economic regulation?). Empirical evidence has
shown that regulatory independence is crucial for regulation to be effective.  

Clearly, regulation will always be a second-best solution, the first best solution would be the introduction of competition and reliance on competition law. Monopolies, even those subject to the best possible regulation, will by definition never be subject to the same levels of market discipline, resulting in costs to society where more competitive structures are achievable. The key to market contestability is to remove government-imposed entry/exit barriers wherever possible by redefining the role of the government and by greater reliance on market mechanisms and commercial firms, even where sunk costs are high.

The benefits of competition have become increasingly clear in a variety of industries, such as gas, electricity and telecoms: consumers face a choice of suppliers and lower prices, given quality of service levels. Evidence shows that firms operating in competitive markets not only operate in a more efficient manner, but also deliver the appropriate levels of service quality, and deliver timely investment compared to available alternatives.

As Crandall shows, the unnecessary and inappropriate regulation of the US cable market in the 1990s, resulted in an overall loss of consumer surplus due to reduction in service quality of approximately $5 billion per year.  

Therefore, in the case of the US cable market, he argued that an unregulated monopoly would be preferred above a regulated monopoly. Hence, the costs and benefits from market failure versus regulatory failure should explicitly be taken into account.

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A change to more de-centralised market-based provisioning of services, based on pricing, commercial provision and competition, requires a different way of thinking about the role of the government (and the ‘need’ for regulation), compared with command-and-control approaches. In the case of service provisioning, one of the main approaches to introducing more effective governance is by introducing more commercial management where outputs are commercial in nature, whilst also introducing competition where possible. This also enables a move towards more light-handed regulation, thus reducing regulatory distortions.

Lessons from the aviation industry

_Airlines_

Airline liberalisation is a good example of the significant benefits resulting from a redefined role of the government, combined with a changed approach to ownership structure outside of the US, where airlines had traditionally been privately owned.

Liberalisation has given rise to flights to destinations which are most valued by the consumer, whilst catering for different preferences by offering different service levels at different price levels. Fears that, due to entry (sunk) costs, airlines would compete each other out of business have proved to be misplaced. Although the airline structure is still constrained by international regulation and remaining state ownership, the emergence of low-frills carriers shows that innovative approaches to doing business only result in more effective competition, with substantial net benefits to the travelling public and to society as a whole. The competitive process, unconstrained by government-imposed entry barriers, allows existing business models to be challenged by new models offering superior service packages, including service quality.
As summarised by Crandall, deregulation of the US airline market has resulted in a 33% reduction in real fares. A World Bank study by Galal, Jones, Tandon and Vogelsang compared the actual post-privatisation performance of 12 large firms (mostly airlines and regulated utilities) in the UK, Chile, Malaysia and Mexico with the predicted performance if the firms had remained in government ownership. They found net welfare gains in 11 of the 12 cases. Ehrlich, Gallais-Hamonno, Liu and Lutter examined the link between ownership and firm-specific rates of productivity growth for 23 international airlines during 1973-1983 and found that in the long-run private ownership leads to higher productivity growth and lower costs but that these benefits are based on complete privatisation of the firm in question.

There remain serious constraints in that aviation markets are highly regulated outside of the EU and the US. Entry to markets is limited: only two UK and two US airlines can service the Heathrow-US market. Ownership and control of airlines is nationality based, severely restricting efficient cost-effective governance appropriate to an international industry. The EC’s proposed Trans-Atlantic Common Aviation Area, effectively combining de-regulated US and European air markets, would address this, generating significant net benefits to the UK economy as well as the EU and US economies. On the other hand, there is also continuous pressure for re-regulation of airlines, potentially constraining opposition (e.g., by imposing regulations that fix uniform denied boarding compensation). Such rules should be subject to rigorous cost-benefit analysis and ‘sunset’ clauses, if implemented.

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4 Ibid.
6 Ibid.
Aviation infrastructure

With the rapid growth of the UK aviation market, aviation infrastructure in the south east of England has become the problem. Compared to other regulated utilities, there is substantial unsatisfied demand in the south east for runway access and terminals are under pressure at Heathrow. Due to the planning system, and probably existing ownership structures, considerable entry barriers are in place.

Most UK airports are privately owned and subject to competitive pressures. However, BAA, which serves 90% of the south east market, although privately owned (albeit with a government golden share) and subject to economic regulation, still sees itself as the government’s airport builder. Mike Hodginson, BAA’s Chief Executive was quoted in the Guardian, 30 April 2002 as saying

“We are a builder of airports on behalf of the government (…) It is the government’s responsibility to decide how airports develop and where airports develop”.

Fundamentally, a firm with a high market share will under-provide output as the corollary of pricing above competitive levels. This arguably applies to investment decisions also, although strategic considerations will be a major factor. Economic regulation aims to counter-veil this risk. However, the current regulatory regime, the traditional cost-based ‘single till’, whilst ensuring low prices, has provided weak investment incentives compared to a situation where prices reflect the much higher short or long run social marginal costs that are actually likely to prevail.

CAA airport price cap proposals: a move to increase incentive regulation

In February the CAA recommended to the Competition Commission a set of regulatory policies that under current projections would result in real price increase at BAA’s London airports, while prices would
be maintained in real terms at Manchester over the five years commencing 1 April 2003.\(^7\) Two noteworthy aspects of the proposals are the move away from the traditional ‘single till’ basis of price setting and the introduction of a long term ‘price path commitment’ which, inter alia, will remunerate the proposed fifth terminal at Heathrow on an incremental output/incremental cost basis. The single till operates to offset the costs of monopoly airport services by the projected net profits on retail activities. It does not address excessive retail pricing.

The CAA sets the maximum airport charges at these airports. It does so following a recommendation from the Competition Commission: an unorthodox process including the fact that the CAA decision cannot be appealed to the Commission. The Act requires the CAA to set the price cap most likely to further reasonable user interests, promote efficient and profitable airport operation, encourage timely investment and impose minimum restrictions.

Since the last review there has been increased scrutiny over the role of economic regulation. The Better Regulation Task Force has reflected a general view that ex ante economic regulation should be removed from competitive areas. This, the developments in market conditions, together with the Competition Act 1998, are all significant changes since the last review. The CAA has considered and evaluated a range of regulatory policy options in the knowledge that it has only one policy instrument: a price cap. These options range from the continuation of the traditional single till, cost-based model, modifications of it to reduce regulatory coverage, to incremental costs through to market prices. It has judged the policy alternatives where there are trade-offs between statutory objectives in terms of maximising total benefits to users and airports in aggregate, including minimising regulatory costs. It has weighed transfers on a ‘pound is a pound’ basis, noting that transfers involved here are generally between airports and airlines, not travellers or cargo shippers.

The CAA has recommended the following key policies for the four airports:

\(^7\) Documents available at www.caaerg.org.uk
LESSONS FROM AVIATION REGULATION

• separate price caps for each BAA designated airport based on the individual airport’s costs;
• revising the regulatory cost base for charge setting, focusing on the costs of airport monopoly services, and removing commercial costs and revenues;
• greater information disclosure to inform consultation between airports and airlines;

Gatwick specific proposals

• a service quality term as part of the price cap, including aerodrome delays;

Heathrow specific proposals

• As for Gatwick plus a revenue allowance per additional passenger in excess of 60m p.a. once Terminal 5 opens (2008) and per additional peak-period runway movement reflecting incremental costs and values respectively.

The proposals for Stansted and Manchester will give airlines and passengers the assurance that airport charges will not be excessive in relation to airport monopoly costs, including a reasonable return on the assets invested. But we recommend an end to the single till at all regulated airports. This reduces the regulatory domain to the monopoly outputs and the resulting adverse effects on commercial and airport development, consistent with the thrust of the BRTF report. This incentive structure, together with enhanced information disclosure, will facilitate more contracting and reduced need for regulation.

The application of (historic) single till, cost-based price caps at the congested Heathrow and Gatwick airports has been increasingly problematic, forcing prices down and seriously out of line with the value of that capacity and the costs of new capacity. However, setting caps to allow market-clearing prices, while permitting better use of scarce capacity, would provide weak incentives for development by
the dominant BAA. The resulting rent transfers would have been substantial, raising questions about the sustainability of such a policy.

The CAA’s proposed policy is a compromise, maintaining (modified) cost-based pricing for existing outputs while introducing more powerful incremental cost incentives for the delivery of new capacity. This will allow real prices to rise at the congested airports, reflecting the economic fundamentals and the long-term user interest. While the CAA is conscious of the regulatory risk involved, the proposals give strong incentives to BAA to deliver on improved service quality in the 2003-8 period and to deliver an implementable long term business plan aimed at addressing the capacity-demand imbalance, developed in consultation with airlines.

The recommended long-term real price path for these airports will improve the incentives to operate efficiently and invest effectively. This will provide a simple and transparent foundation for the major investment programme planned, minimise regulatory risk, and will bridge the gap between investment projects with long lead times and pay back periods and the price caps that are fixed for only five years.

This is a radical proposal, and regulatory credibility is important. While a regulator cannot commit his or her successors, the CAA considers that laying out a clear long term policy framework will give clear guidance at future reviews, if endorsed by the Commission in its unusual advisory, rather than appellate, role. A further benefit of the framework is the flexibility it provides for addressing future capacity enhancements beyond Terminal 5. The government plans to publish a white paper on future airport capacity later this year. If this were to lead to new capacity additions, under the framework the CAA would identify the outputs the enhancement was expected to produce, and link a new revenue allowance to those outputs. There would not be a need to change the elements of the price path specified now.

Figure 1 illustrates the price path options and the recommended price path for Heathrow. As the CAA recommended policy would translate into lower real prices than those from existing (single till) policies, the CAA has, for reasons of maintaining regulatory commitment, set the price path at no lower than single till levels for the 2003-08 period.
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This also reduces the price ‘spike’ when T-5 opens, consistent with the policy of gradualism.

Figure 1: Breakdown of contributions to the overall price cap

Improved economic regulation as proposed by the CAA, by moving from the single till to a long-term price path commitment in cases where new capacity is proposed, most notably London Heathrow, will provide better investment incentives. Nevertheless, although real prices would be allowed to rise under the CAA proposals, even under the new regulatory regime, prices will remain below (marginal) costs/values. It is unlikely that even the best possible regulation will be able to provide incentives as powerful as those provided by competition. New and existing competitors to BAA would carefully evaluate BAA’s likely response before promoting major aviation infrastructure projects as their profitability could be serious reduced by BAA action.

Although for different reasons, the same applies to Manchester Airport. Manchester Airport is owned by local governments in the area. Its ownership structure results in what might be characterised as
a regional public interest objective, instead of a commercial objective. It is often seen to be insufficiently responsive to its users, it seems to be high cost, and investments may be made too early, contributing to the high cost structure. Regulation, even the best possible regulation, will not be able to solve the resulting governance problems. A more commercial approach to the management of Manchester Airport would provide a more appropriate incentive structure to its management to improve efficiency and allow the north of England airport market to develop on a more level playing field basis. We note that Manchester is currently introducing several significant efficiency enhancing measures.

The slot mechanism set by EU rules is one of the other obstacles to a more efficient aviation infrastructure. The current mechanism is inadequate, due to the absence of adequately defined property rights and hence pricing of slots, resulting in the likely failure of the best use test. Clear property rights in relation to existing as well as newly created slots need to be established to address this problem. Allowing secondary trading would be a start to encourage a more efficient use of scarce capacity.

The main remedy to regulatory governance problems in the case of airport infrastructure is therefore not more regulation, but a shift to more light-handed regulation and, whenever possible, deregulation, combined with a redefined role of the government, clear property rights in relation to slots and maximum use of competitive pressures. The potential gains are substantial. While not strictly comparable, but illustrative nonetheless, in the case of the US, Morrison and Winston estimate that better infrastructure pricing combined with improved investment decisions could increase economic welfare by $16 billion per year (current dollars).\(^8\)

The government’s main role should be to provide the right framework for competitive firms to operate in. In the case of the UK, this requires extensive changes to the planning system, with the focus being on

addressing externalities, rather than the ‘need’ for a project. Developers are better placed to assess the commercial viability of developments. The government needs to focus on setting the framework to decide on the environmental cost to be ‘paid’ by the development if it is to proceed. The government is currently reviewing the operation of the planning system.

Air traffic control

National Air Traffic Services (NATS) is another infrastructure service provider that is struggling to meet demand at desired levels of service quality in the busy south east: delays are higher than desired by customers imposing net costs. The government has responded to this performance problem by moving NATS onto a more commercial footing. NATS, the provider of air traffic control services in the UK, has been set up as a statutory monopoly (30 year licence) with the government owning a 49% stake, with major UK airlines holding a 46%.

The combination of it being a statutory monopoly (and thus lacking market discipline) combined with the large government stake and high gearing level (currently 110% of regulatory asset base), has produced an unusual governance situation. Corporate finance models suggest that a mix of debt and equity is most beneficial from a governance point of view, with lenders limiting exposure. Due to its high gearing level, NATS has strong incentives to focus on cost reduction: NATS is high cost by international standards. The existing price cap being higher than incremental costs, and having normal regulatory asset base under-pinnings, should give NATS appropriate incentives to invest to close the capacity-demand gap, but it is unclear whether the financial structure may compromise clear leadership/management of NATS. With the government retaining 49% the government will have to be able to satisfactorily separate its ownership role from its over-arching role of setting the policy and

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regulatory environment, including appointing regulators. Future public policy will need to bear in mind the evidence produced by Boardman and Vining that as well as state-owned, mixed (state and private) ownership enterprises are also significantly less profitable and productive than privately owned firms.\textsuperscript{10}

The CAA is currently considering NATS’s application for a price increase. ATC pricing, while being distance and weight related, has some way to go before being fully cost and output-related. It will be interesting to see how much progress the PPP makes on this important issue, given the European and international constraints. Equally the on-going role of the major UK airlines as the strategic partner raises interesting regulatory governance issues in the sense of NATS potentially evolving as a (partial) user club. The EC’s Single Skies proposal for improving ATM in Europe provides a basis for more sensible airspace and ATM rationalisation, noting that there are nearly 60 air traffic control centres in Europe compared 20 in the US, even though traffic is only half of the US level.

Conclusion

Effective regulatory governance requires a clear definition of the role of the government and transparent property rights for the commercial entities now providing the services. The main role of the government is to create the right framework for service providers (and regulators) to operate in, particularly by minimising government-imposed economic entry/exit barriers. A change to more de-centralised market-based provisioning of services, based on pricing and competition, requires the government to be clear about its role, particularly when it retains ownership interests (and the ‘need’ for regulation). Addressing environmental externalities and improving the planning system so that it focuses on these is a priority for government.

The last decades have shown that increased commercial provision of what were traditionally publicly provided services has contributed to

\textsuperscript{10} Ibid.
growth in GNP via greatly improved economic efficiency. As the case of airlines has shown, deregulation, liberalisation and competition have resulted in large efficiency gains. Application of the same policy to infrastructure is also showing sound gains. Regulatory governance can be made more effective by moving to more high-powered incentives structures, with the CAA’s proposed long-term price path commitment being an example.
6 CONSUMER PERSPECTIVES

Allan Asher

Introduction

From a consumer perspective, the very best form of consumer protection would be no regulations whatsoever. Of course, we would require vigorous competition in fair and informed markets. If we do not have that, we need economic regulation, environmental regulation and consumer protection regulation.

In this chapter I discuss some of the principles of regulation, some of the problems that we experience in understanding and working in the framework, and then pass on to some prospects for the future of regulation as well. In the United Kingdom, where regulation came as something of an afterthought, regulatory reform in the UK has been about fixing some of the underlying market problems (whether they were problems of electricity transmission, market power or rail) through super-imposing contestability on the system, thereby making new entry and access possible.

The recent report of the National Audit Office (on pipes and wires regulation) is substantially correct. There have been improvements in aspects of consumer welfare as a result of the work of the regulators, but I hasten to add that it has been slow and patchy.

Consumer rights

So what do consumers want from regulations? They are formulated in a set of consumer rights, the first of which is the right to the satisfaction of basic needs. The second right is one that the consumer movement has campaigned on, more or less, since it was invented in its current form at the end of the 19th century, that is, the right to
safety, to be free from harm from products that they use (that is to say, unusual or unexpected harm, and that remains a legitimate goal of a regulatory framework).

The third one concerns more the economic interests of consumers, and another is at the heart of the work of the Consumers’ Association. The right to choice, that consumers’ welfare, on the whole, is going to be increased or enhanced if they are able to use their buying power to choose between competing goods or services in the marketplace. Of course, that has got some way to go too, partly because of sectors where there is market power or, perhaps, in some franchise area where that choice has been taken away. Consumers are far too often passive and fail to use the tool of choice, and fail to use the information that is available to them.

The right to representation is another right that consumers have asserted, and there have been huge strides made in finding people to represent the interests of consumers, to give them adequate means of reporting back, and in trying to be genuinely in touch with the various groups from within society. It is not a straightforward issue and not cheap. The reality is that, even though fees are sometimes paid, and train fares or bus fares are provided, consumer groups find it difficult to find people who can take the time off from their work to be engaged in all of the representative opportunities that exist. So while the progress is welcome, and, indeed, it is a consumer right, it is one that it is not a straightforward thing to make the best use of.

The right to education is another, and by that I mean to be made a critically-aware consumer, so that consumers have a proper understanding of the consequence of their consumption and what the alternatives are. The final right that I will touch on is one that, within the consumer movement, is not controversial, but outside the normal remit, which is the right to a healthy environment. In a way, that addresses the issue that often consumers are also passive consumers of the things that they don’t want: pollution and noise for example.
Other players

Of course, consumers are not the only participants in the marketplace. What do asset owners and investors want from regulation? They want to get a return on their investments, to keep their shareholders happy, and also they want encouragement, if there is any incentive regulation, that they will get a slice of the upside. The goal of incentive regulation is to try and provide ways of encouraging more efficiency, lower cost or further innovation so that costs can be saved. Too often in the regulatory equation all of the upsides are given to asset owners or investors and none to consumers. On some occasions we have seen all of the upside being taken away from the investors, not given to consumers but dissipated in the transaction costs of the process. Hence, the strong claims by energywatch over the last couple of days about where the £400m a year savings in electricity costs have gone.

It seems to me that one of the reasons for the seminar, and a number of the points made at it, relate to another phenomenon. It is not a UK phenomenon; it is a global one, and that is the retreat of governments that we see around the world – governments retreating from active intervention in the marketplace. Now, there are two reasons for that, one is actually a good reason and the other one is a very bad one.

The good one is that, increasingly, governments are recognising that markets can and do work, that they do not need to be as involved in regulation of supply and distribution, and even consumption, as they used to be. Left to themselves, markets can work quite effectively. Hence, competition policy has become, globally, the dominant economic tool of governments, and it is one with which consumer groups have no great difficulty.

But there is a second reason, a bad one, that governments simply cannot, or will not, put money in where they need to, and hence we have, at one end, a withdrawal from some parts of the market, but it is somewhat indiscriminate. Governments also withdraw from parts of the market when they should not. It is also a challenge, especially to economic regulators, where there is always a tendency, which can be
demonstrated empirically, I believe, for their missions to creep somewhat, and their willingness and their ability to encourage more competitive opportunities is often under-developed.

Key issues

Regulation of quality, safety and performance are still serious issues. In the Financial Times (16th April), there was a letter from the National Energy Action Group in Newcastle. It related to a rather self-congratulatory editorial in the Financial Times about the National Audit Office report, and one paragraph reads:

“but the UK also wins the dubious distinction of having the highest rate of fuel poverty of any country in Europe and, although the problem existed before privatisation, the issues are closely linked”.

Later on it says that energy competition and deregulation have favoured some consumers more than others. As usual, low-income households are disadvantaged. Consumers in debt are commonly prevented from switching energy suppliers, and that creates additional problems for the poor, which is a serious concern for the Consumers’ Association.

We believe that our mandate is to represent all consumers, not just those who subscribe to our magazine, and we are particularly concerned about those who are marginalised, so I raise here the issue of the universal service obligation.

Similar debates have been held in other countries, and they cover areas such as financial services, transport and water. My point is that while one ought to have a genuine concern for the marginalised and for the poor, and those with limited access, that simply does not happen by disputing every claim from the owner of a regulated asset, or saying that there is scope for using contestability to get the price down to the lowest that is feasible. Let me say a little bit about financial services. This is not the focus of this conference but it
seems to me to be one of the greatest areas of regulatory failure in the UK, and it is consistent with some of the other failures that have occurred. Successive regulatory regimes have simply done little or nothing to prevent massive mis-selling to the tune of many billions of pounds. We now have a new regulatory system, that started on 1\textsuperscript{st} December last year, which seems to have many elements in it which may also sow the seeds of their own failure.

A couple of other quick points that I think I could emphasise. One, the issue of monopoly or market power. In earlier deregulatory phases, it was assumed that network industries were not much different to other industries, and that some of the expectations for local loop unbundling or, access to broadband telecommunications, pipes, rail or airports, were things that would happen without too much intervention. After nearly twenty years of struggle in telecommunications, and if you look at the issues of BA and landing slots at Heathrow, and some of the fights that have gone on there, you see that some of these are intractable issues. Largely this is because too many of the property rights were settled and granted at too early a stage, and the regulatory system was not able to deal with some of the underlying structures that gave rise to market power in the first place. From a consumer perspective, and perhaps it is a classic economic perspective too, the much better approach is to avoid having to have behavioural regulation, and that where structure can be adjusted to provide for more competitive operation in the first place, then that is going to lead to much better outcomes.

Consumers lose because innovation is retarded and competitive delivery is reduced. But quality, safety and performance are all at the heart of some consumer expectations. It is a great frustration for many economic regulators because quite often they are told not to get involved in those things, and I understand why that is. If you impose on a regulator too many apparently conflicting goals, then they are going to end up in failing to achieve much at all.

There are examples where quality, safety and performance can be blended in as part of the incentive regulation package so that companies out-performing agreed targets can be rewarded, and consumers benefit as well. Some issues for marginalised consumers
CONSUMER PERSPECTIVES

include aspects of disconnection policy and the problems of switching where there are metering restrictions in electricity, even the ability to get access to gas in areas that are newly connected. These ought to be part of the criteria for effective regulation.

I want to say a little bit about global impact because, especially for the UK, so much of the regulatory policy that applies is policy that is being formed elsewhere. Not just in Europe but through the OECD, through the World Trade Organisation and through many other global rule-making forums – the International Telecommunications Union and the International Standards Organisation.

Remedies

My opening theme was that it would be better if consumers were able to look after their own interests but we recognise that, because of market power and various other reasons, there are problems with the markets. One thing that could, and should, be done is that consumers be given far more effective access directly to remedies where there are problems. The Enterprise Bill, which is before parliament now, provides an extension of powers, including giving power to consumer groups to bring actions for compensation directly to the Competition Commission where there are breaches of competition laws.

In addition, there are new injunctive powers that are going to be provided to certain groups to stop certain forms of conduct. There is sometimes an over-reliance on regulators to take action on behalf of affected businesses or consumers, and that moving more swiftly to give private rights of action, and standing to bring proceedings, would be another deregulatory measure, and also one which would put within the hands of those most affected the ability to do something about it.

Of course, that is not going to be of much use to those at the bottom of the pile, but that would then allow the regulators to concentrate more on those areas. It would allow Ofgem to do something about the pricing systems in Scotland, for example, and it would allow them
to concentrate on some of those other problems of energy poverty that I have referred to.

Similarly, under the Enterprise Bill, there are some issues of merger control that come up. This has been the bane of much reform, not just in the UK but in Australia, in New Zealand and in Europe, as vertically separated or horizontally disaggregated networks can reaggregate through mergers and re-acquisition. The reality is that action for abuse of market power and monopolisation is almost impossible to apply in network industries, and is usually ineffective.

A few concluding points. There is an opportunity now for a review of some of the regulatory goals. The regulators are, generally speaking, doing the jobs that they were set up to do, with some exceptions, and some of those exceptions are not their fault but the fault of the enabling legislation, or the way in which they go about their work.

User representation is important and there has been a lot of progress, but there is still a long way to go. What is the point of it all? The point is to enhance the welfare of consumers. A commitment that I make on behalf of the Consumers’ Association is that we are ready, willing and able to work with any regulator, any industry association or any business that wants to enhance the welfare of consumers. I would also say that we are ready, willing and able to work against anybody who doesn’t.
In reviewing the UK privatisation experience, it is important to remember that there were a wide range of formats. The English and Welsh water companies were privatised as monopolies, whilst the regional electricity companies were part monopoly and part competitive businesses. The generating companies operated entirely in a theoretically competitive market. Moreover, a few of the privatised stocks were growth businesses, especially BT. Most were, though, traditional utilities. In the case of the water companies, their heavy pre-flotation debts were almost entirely extinguished, so as to give them substantial financial headroom in order to undertake the very pronounced capex uplift.

The issue of debt versus equity remains a crucial factor with respect to the financing of utility operations. In particular, most utilities are currently trading at a notable discount to their regulatory asset valuation (RAV).

Since 1989, when the water companies were floated, major economic changes have taken place. Currently, interest rates are historically very low and, hence, the use of higher debt levels seems appropriate. Ofwat recognises this factor and has not generally opposed the various refinancing initiatives being undertaken. The monopoly water business of the former Hyder, Dwr Cymru, is now entirely debt financed following the serious financial difficulties faced by its predecessor. In fact, the shift to high debt financing amongst UK utilities goes back to 1995 when Northern Electric announced its defence strategy to gear up to 225%, in order to see off a take-over bid by Trafalgar House.

However, heavy debt levels for utilities are far from risk free - an issue fully recognised by leading bondholders. The Railtrack collapse
EQUITY AND DEBT HOLDERS

is a case in point. Indeed, in reviewing that scenario, I would argue that the shambles of the West Coast mainline upgrade was the key factor. From an expected cost of around £2.5bn, the capex bill seems to have soared to over £7bn and perhaps to as high as £9bn. To what extent the Railtrack collapse will bring about collateral damage for other major financing requirements, especially those with Government involvement, remains to be seen. I do not believe that the adverse impact will be entirely limited to the financing of the railway industry.

Going forward, various utility refinancing issues are on the agenda. Scottish Power’s effective transfer of Southern Water to Vivendi, via intermediaries, has been widely discussed in recent months, along with Awg’s proposals to operate on the basis of a ‘thin equity’ structure, partly to finance its Morrison business. Indeed, Awg has had to offer certain bondholders additional incentives in order to allow this deal to proceed.

For a growth orientated company, the traditional equity profile still has many attractions. In BT’s case, a modest debt figure of below £1bn at March 1999 was converted into a staggering £28bn by March 2001 - with the inevitable plunge in the share price. A record £6bn rights issue and some notable disposals have now restored its finances. Increasingly, investment bankers are studying the feasibility of separating the growth orientated parts of a company - a suitable vehicle for equity financing - from the utility components, where low cost debt finance is preferable.

Implementation of such a strategy has been carried out by the former British Gas, which has now produced three offspring - BG, Centrica and Lattice. In the telecoms sector, Cable & Wireless’ massive investment in its global operations has produced desperately poor results, whilst the secure earnings from the regional business, mainly telecoms in the Caribbean, have provided much needed profitability. In the future, a separation of the two businesses, whose recent fortunes have been so very different, is quite possible.

In reaching any conclusions about the various financing options, a sector specific analysis is necessary. It is very much ‘chacun a son
gout’ - on the basis of what is best for each individual company within its own sector. The more assured the revenue base - typically very high for a monopoly utility - the stronger is the case for a disproportionate level of debt funding. The greater the risk, the stronger the argument for more equity.

Across the utilities and telecoms sectors, we are seeing a range of models, from bond financing of Dwr Cymru to ‘thin equity’ for Awg and ‘fat equity’ for many others, such as Centrica. Irrespective of the financing mechanism, cash generation is increasingly seen as being the key criterion for the discerning investor. A rather dry analysis perhaps - and a long way from some of the ‘gung ho’ elements that accompanied the drive to privatisation.
Why measure corporate governance?

Awareness of corporate governance and its role in the global economy has grown steadily in recent years. In developed markets, particularly where there exists an active market for corporate control, governance concerns are increasingly articulated by shareholder value activists, and companies’ governance practices are regularly scrutinised in the public domain. In the emerging markets, the financial crises in Russia and East Asia in the late 1990s also revealed great gaps in corporate governance practices that many economists attribute to helping to bring about these crises. More recently, the Enron debacle and less dramatic governance related issues in companies such as Marconi, Global Crossing and ABB show that corporate governance risks are also relevant in more developed markets, such as the US and the UK.

Stock exchanges and regulators around the world are increasingly looking to set standards or codes of best practice for corporate governance. Moreover, investors are beginning to review more systematically a company’s corporate governance practices as part of the investment decision-making process. Increasingly, the debate on corporate governance extends beyond a company’s own shareholders to include other stakeholders, such as creditors, employees, customers, the environment and the local community.
In the context of this growing interest in corporate governance, there have yet to emerge any established global benchmarks to help a company’s shareholders, managers, directors or other stakeholders objectively assess and compare corporate governance practices from one firm to another and from one country to another. The concept of corporate governance rating or scoring is a way to address this gap, and several firms around the world have either launched governance scoring activities or are actively exploring entry into this area.

The methodology that is presented below is used by Standard & Poor’s, a leading global provider of independent financial analysis, information and advisory services. Standard & Poor’s began to develop this methodology in early 1998. Following a pilot project to test this methodology, Standard & Poor’s built a dedicated unit and launched a corporate governance scoring service in 2000.

This chapter introduces the concept of corporate governance scoring at the individual company level. While there are potentially many approaches to assessing corporate governance, this approach takes a financial perspective, namely the perspective of financial stakeholders - both shareholders and creditors. On that basis, and for purposes of this discussion, corporate governance can be defined as the way in which a company organises and manages itself to ensure that all financial stakeholders receive their fair share of a company’s earnings and assets.

Even with this financial focus, the practice of corporate governance scoring is a challenging endeavour, and must be approached with care. Unlike other forms of financial analysis where quantitative measures can provide some ‘hard’ benchmarks to guide more qualitative aspects of analysis, the assessment of corporate governance is largely a qualitative exercise. This chapter will address how the practice of corporate governance at the company level, and how corporate governance is influenced at the country level, can be broken down into sub-components for detailed analysis and benchmarking.

The great challenge of establishing a single global benchmark that can legislate meaningfully for the differing cultures of corporate
governance around the world must not be underestimated. As this chapter will discuss, overarching principles of fairness, transparency, accountability and responsibility must guide the interpretation of different governance structures and systems at the corporate level. As with many forms of analysis, a global perspective must mesh with local understanding.

While other non-financial stakeholders may find value in this approach to corporate governance benchmarking, this methodology does not directly address broader stakeholder issues unless they in some way affect the economic performance, the market value, or the financial strength of the company. The main beneficiaries of this approach to corporate governance benchmarking are as follows:

- shareholders (minority and majority);
- creditors;
- management;
- directors;
- regulators/exchanges;
- policymakers;
- financial intermediaries and advisors;
- analysts;
- academics.

For these constituencies, corporate governance scores can serve as a new tool with varying potential applications, including investment screening, highlighting areas for individual firm improvement, guiding regulation and policy, and helping to price and place issues of new capital.

**Independence**

To be credible, a corporate governance score should represent an independent opinion, based upon transparent criteria and a standardised analytical process. It should not be regarded as an audit, nor as a credit rating, nor as equity analysis. By itself it should not be intended to serve as financial advice, nor as a recommendation for a specific course of action. Its simple purpose is to provide an objective
benchmarking of a company’s corporate governance standards in a global context.

The independence of the corporate governance evaluator is a key issue. As with credit ratings, independence can only be assured if the institution providing the corporate governance analysis has no market exposures which might consciously or subconsciously bias the nature of the governance assessment. Many brokerages and consultancies, for example, have strong analytical capabilities regarding corporate governance assessment. Yet their own balance sheet interests and/or client relationships suggest that formal corporate governance scoring for public consumption is best left to firms without these potentially conflicting financial and advisory relationships.

Even firms which promote shareholder activism need to be assessed with regard to independence. The governance debate is comprised of many actors, including financial stakeholders (majority and minority shareholders and creditors), managers, and board directors. If the governance assessor assumes the perspective of one of these constituencies to the exclusion of others, then there is scope for the objectivity of the analysis to be influenced by the perspective of the analyser. In this sense it is arguably the case that the greatest independence derives from individuals or firms that are independent of any of the individual constituencies.

Corporate governance, the economy, and financial markets

Effective corporate governance is at the core of an efficient market economy. Shareholders and other financial stakeholders must have access to information and have the ability to influence and control management, through both internal governance procedures and external legal and regulatory mechanisms, in order to ensure that a company’s assets are being utilised in the interests of all financial stakeholders. This is important in both developed and developing economies.
At the macro - or country - level, increasing emphasis is being placed on the building of a strong legal and regulatory environment, including the effectiveness and the enforceability of existing laws, as well as the level of transparency and disclosure required by the market. This reflects the premise that countries with higher standards of investor protection are, relatively speaking, better insulated against market turmoil than those countries where investor protection laws are weak. Relating this to financial markets, poor corporate governance is often cited as one of the main reasons why investors are reluctant, or unwilling, to invest in companies in certain markets. It can also explain why, in some economies, the shares of many companies trade at a significant discount to their true value. Even better governed companies are ‘tarred with the same brush’ - almost a case of guilt by association.

If investors are unable to evaluate governance risk, they are likely to be reluctant to invest or will require a significant premium to mitigate uncertainty. In many cases where the investor is unable to evaluate the risks associated with governance practices, equities may be incorrectly priced. This disadvantages the company and raises the cost of capital. For example, the market capitalisation of one major natural resources company suspected of shareholder abuses is 90% less than that of its western equivalent although its reserves are six times greater.

In developed markets, large institutional investors pay considerable attention to corporate governance practices. Some US pension funds, such as CalPERS and TIAA/CREFF, actively pursue corporate reform through their positions as major shareholders. Every year, for example, CalPERS publishes a list of the best and worst US corporate boards in an attempt to promote change. As institutional investors own more than 50% of the equity of US companies, companies are becoming much more sensitive to the desires of these shareholders.

The market rewards those companies that do change. Some studies have shown that efforts by a company to improve the quality of its board have a significant and positive effect on share price. Similarly, companies that continue to engage in activities that place the interests
of management over those of shareholders tend to trade at a discount relative to other companies in their sector.

In emerging economies, the quality of corporate governance can vary enormously. Indeed, poor governance or corrupt governance (‘crony capitalism’) negatively affects the returns on investment in many countries and also contributes to larger, systemic problems at national and regional levels. The scarcity and poor quality of publicly available information, as well as limited legal and regulatory recourse, frequently complicate efforts by financial stakeholders to ensure that management is acting in their interests. The (sometimes legal) expropriation of outside investors is a major problem of corporate governance. Although expropriation is not exclusive to emerging economies, it is certainly much more prevalent there. Examples of expropriation include cashflow diversion (transfer pricing), dilution of minority shareholders, asset stripping and delay, or non-payment of dividends.

In countries where poor governance practices are suspected, a company’s share price will often trade well below what should be the real economic value of the enterprise. A June 2000 survey of 200 global institutional investors by the management consulting firm, McKinsey, found that they would be willing to pay a significant premium for the shares of companies that they knew to be well governed. In fact, some investors stated that good governance practice was a key determinant of whether they would invest in a particular company or not. Not surprisingly, the average premium differs from country to country. Companies domiciled in countries with high governance standards could expect to pay significantly less than companies in countries where the reverse is true. This 2000 survey was also repeated by McKinsey in 2001, with similar results. McKinsey’s findings are consistent with good risk management practices, where logic suggests that investors will pay a premium to reduce risk (in this case, risks associated with poor governance practices). Conversely, these investors will expect to receive a discount for assuming greater risk.

The linkage between corporate governance and company financial performance and share valuation is a subject of considerable research
interest. In addition to the McKinsey study, research projects by academics and practitioners continue to attempt to more rigorously define this linkage. While evidence is beginning to mount to establish a clearer correlation of corporate governance and financial performance, research to date has been inhibited by the lack of global benchmarks that allow for meaningful comparative research on corporate governance. It is hoped that institutionalisation of corporate governance scoring can help to promote further research on this important theme.

Measuring corporate governance practices

Overview

There is no one model of corporate governance that works in all countries and all companies. Indeed, there exist many different codes of ‘best practices’ that take into account differing legislation, board structures and business practices in individual countries. However, there are standards that can apply across a broad range of legal, political and economic environments. With this in mind, the Business Sector Advisory Group on corporate governance to the OECD has articulated a set of core principles of corporate governance practices that are relevant across a range of jurisdictions. These are:

- fairness;
- transparency;
- accountability;
- responsibility.

These same principles can be used as cornerstones in a corporate governance scoring methodology for individual companies. To the extent that these core principles transcend individual country jurisdictions, the process of corporate governance scoring therefore entails the assessment of individual corporate and country practices and structures against these broad principles. This methodology presents an approach to analysing corporate governance both at a
country and at a company level. These two dimensions can be assessed jointly or separately.

**The concept of corporate governance scores**

- **Definitions**

A company ‘corporate governance score’ (CGS) expresses an opinion about the extent to which a company adopts and conforms to codes and guidelines of good corporate governance practices that clearly serve the interests of its financial stakeholders. For purposes of the CGS, corporate governance encompasses the interactions between a company’s management, its board of directors, shareholders and other financial stakeholders. The extent to which a company adopts and conforms to codes and guidelines of good corporate governance practices can be reflected by the award of a CGS on a scale that can be numeric, letter-based or alphanumeric. Standard & Poor’s, for example, employs a numeric scale for its corporate governance scores on a 1 to 10 basis (with 10 being the best possible score). In these definitions, ‘financial stakeholders’ include both a company’s shareholders and creditors. This reflects the premise that the quality of a company’s governance process can affect its ability both to honour contractual financial obligations to creditors and to maximise the value of a company’s equity and distributions for its shareholders.

Different models of corporate governance around the world reflect the nature of local legal and regulatory systems, as well as differing approaches to economic management. The Anglo-Saxon system focuses primarily on the shareholder, while others, such as the German or Japanese systems, are often perceived as advocating a greater balance of interests between shareholders and other external stakeholders (including creditors, employees, the community and the environment). By addressing the interests of both creditors and shareholders, this scoring methodology recognises the importance of stakeholders’ rights beyond the rights of the shareholder. Hence, this system can be applied generally in many countries around the world, operating with differing general approaches to corporate governance.
- Relationship to credit ratings

The term ‘corporate governance score’ is used to distinguish corporate governance scoring results from credit ratings. A credit rating is generally an opinion of the financial ability of an entity to meet its debt obligations in accordance with their terms. A CGS and the accompanying analysis is a composite assessment of various company practices. Its scope is to benchmark the recent and current standards of corporate governance, rather than opine on specific financial or commercial performance. While corporate governance can affect a company’s creditworthiness and equity attractiveness, the score does not itself express an opinion about a company’s credit quality or share valuation.

Company corporate governance score

Introduction

The company corporate governance score (CGS) provides an assessment of how a company’s governance process serves the interests of financial stakeholders. Individual company governance standards can reflect a company’s degree of adherence to externally imposed governance standards. In countries where the external environment is weak, it can also reflect the extent to which internal company governance disciplines may or may not offset the weaker external infrastructure. The CGS is intended to be relevant to different national approaches to corporate governance. In the methodology outlined below, over 100 prompts can be derived to guide analysts through sets of interrelated observations. These prompts have been designed to reveal the quality of corporate governance arrangements and minimise jurisdictional influences to the extent possible.

The company scoring methodology focuses on four main components, and their sub-categories, to evaluate the corporate governance standards of individual companies. These four components, and the sub-categories, are as follows in Table 1:
CORPORATE GOVERNANCE PRACTICES

Table 1: Company scoring methodology

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<thead>
<tr>
<th>Component 1 - Ownership structure</th>
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<tbody>
<tr>
<td>Sub-categories:</td>
</tr>
<tr>
<td>• Transparency of ownership structure</td>
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<tr>
<td>• Concentration and influence of ownership</td>
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<table>
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<tr>
<th>Component 2 - Financial stakeholder relations</th>
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<tbody>
<tr>
<td>Sub-categories:</td>
</tr>
<tr>
<td>• Regularity of, access to, and information on shareholder meetings</td>
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<tr>
<td>• Voting and shareholder meeting procedures</td>
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<tr>
<td>• Ownership rights</td>
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<tr>
<th>Component 3 - Financial transparency and information disclosure</th>
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<tbody>
<tr>
<td>Sub-categories:</td>
</tr>
<tr>
<td>• Quality and content of public disclosure</td>
</tr>
<tr>
<td>• Timing of, and access to, public disclosure</td>
</tr>
<tr>
<td>• Independence and standing of the company’s auditor</td>
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<tr>
<th>Component 4 - Board structure &amp; process</th>
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<tbody>
<tr>
<td>Sub-categories:</td>
</tr>
<tr>
<td>• Board structure and composition</td>
</tr>
<tr>
<td>• Role and effectiveness of board</td>
</tr>
<tr>
<td>• Role and independence of outside directors</td>
</tr>
<tr>
<td>• Directors and executives compensation, evaluation and succession policies</td>
</tr>
</tbody>
</table>

Each of these components contributes to the overall score. However, in the case of extremely poor financial transparency and information disclosure, a meaningful assessment of other governance factors may not be possible. So poor transparency by itself can either result in a low overall governance score or it can mean that a governance score is not possible.

Weighting of variables in the governance scoring process is not addressed in this methodology. Several approaches are possible in this regard, ranging from the equal weighting of all inputs to the
development of differing weightings for specific categories. While analysts or institutions may have varying views regarding the question of weightings, the key for a robust scoring system is consistency of approach from one company to another. Even if the scoring system may be initially applied with no weightings, empirical results may subsequently lead to the introduction of different systems of weighting individual analytical inputs.

**Components and their scoring guidelines**

- **Ownership structure**

Understanding the ownership structure of the company is essential, especially when there is a known majority holder or when *de facto* majority holdings may exist on the basis of collusive shareholding arrangements. Similarly, the existence of a large number of nominee shareholders will make any analysis of the concentration of share ownership difficult.

Whilst the presence of a large, or majority blockholder, is not necessarily a negative governance issue, it is necessary to examine the relationship of any blockholder with the company in order to assess the extent to which that blockholder acts in the interests all shareholders. This is particularly important in economies where ownership is clustered in the hands of the state, financial-industrial groups or families.

An understanding of whether the company has interactions with other companies that may involve transfer pricing on non-market terms, or whether intercompany linkages give rise to intercompany advances, arrears or subsidies is important. This is particularly true to the extent that management may engage in transactions that may have a detrimental effect on the specific company or corporate structure in which minority shareholders and creditors have a stake. However it is beyond the scope of this methodology to employ techniques of forensic accounting to establish evidence of non-market transfer pricing.
(a) **Transparency of Ownership criteria:**

- There should be adequate public information on the company’s ownership structure, including, where relevant, information on beneficial ownership behind corporate nominee holdings.
- The company’s actual ownership structure should be transparent, and should not be obscured by cross-holdings, management controlled corporate holdings, nominee holdings, etc.

**key analytical issues:**
- breakdown of shareholdings;
- identification of substantial/majority holders (including indirect ownership and voting control);
- director shareholdings;
- evidence of indirect shareholdings;
- management shareholdings.

(b) **Concentration and Influence of Ownership criteria:**

- If large blockholders exist, these should not exert influence that is detrimental to the interests of other stakeholders. Minority shareholders should be protected against loss of value or dilution of their interests (e.g., through capital increases, from which some shareholders are excluded, or through transfer pricing with connected companies).
- Concentration of economic interests and influence of controlling shareholders of the parent/holding company on independent board/management action should not occur through block holdings of key operating subsidiaries and through effective control of key customers and suppliers.
- Shareholders should not be disadvantaged by management and insider shareholders who are shielded from accountability.

**key analytical issues:**
- affiliations amongst shareholders;
- commercial arrangements or related party transactions between the company and affiliates, or individual managers and directors;
- corporate structure, shareholding and management of key affiliates;
- terms of key contracts and licences;
- internal financial and operational control system;
- management shareholding/voting control;
- charter provisions regarding change of control;
- contracts with directors/management.

- **Financial stakeholder relations**

Financial stakeholder relations reflect a company’s treatment of, and relationship with, its financial stakeholders. In a country with weak regulations and laws, a CGS analyses the extent to which a company adopts or exceeds codes and guidelines of good corporate governance practices generally. In a country with stronger regulations and laws, a CGS analyses the extent to which a company meets or exceeds these laws and regulations. In both cases, a CGS reflects what a company does rather than what is the minimum requirement of law, regulation or custom.

(a) **Regularity of, ease of access to, and information on shareholder meetings.**

**criteria:**
- The processes and procedures used for advising shareholders of general meetings should provide for equal access of all shareholders and should ensure that shareholders are furnished with sufficient and timely information.

**key analytical issues:**
- Shareholder meeting procedures:
  - Notices of meeting
  - Documents sent to shareholders
  - Information for shareholder attendance

(b) **Voting and Shareholder Meeting Procedures**

**criteria:**
- Shareholders representing at least 10% of the voting rights should be able to call a special meeting and shareholders should have opportunities to ask questions of the board during the meeting and to place items on the agenda beforehand.
- A shareholders’ assembly should be able to control decisions through processes that ensure participation by all shareholders.

**key analytical issues:**
- charter provisions on calling meeting
- arrangements for shareholders’ participation in meetings
CORPORATE GOVERNANCE PRACTICES

- previous meeting minutes
- shareholder information on voting procedures
- any deposit agreement for overseas listing
- proxy arrangements
- charter provisions on voting thresholds

(c) Ownership Rights

criteria:
- There should be secure methods of ownership of shares and full transferability of shares.
- A company’s share structure should be clear and control rights attached to shares of the same class should be uniform and easily understood.
- Voting/control rights should be in proportion to the shareholder’s economic stake in the firm.
- A shareholders’ assembly should be able to exercise decision rights in key areas, ensuring that minority shareholders are protected against dilution or other loss of value (eg, through related party transactions on non-commercial terms).
- All shareholders should receive equal financial treatment including the receipt of an equitable share of profits.

key analytical issues:
- charter provisions
- arrangements with registrar
- share structure – classes and rights of common and preferred shares
- charter provisions – shareholder and board authorities
- shareholders agreement
- dividend history
- examples of share repurchases and swaps

- Financial transparency and information disclosure

Transparency involves the timely disclosure of adequate information concerning a company’s operating and financial performance and its corporate governance practices. For a well-governed company, standards of timely disclosure and transparency are high. This enables shareholders, creditors and directors to effectively monitor the actions of management and the operating and financial performance of the company. Good transparency means that the financial reporting
facilitates a clear understanding of a company’s true underlying financial condition. In part, this means that contingent liabilities and non-arm’s length relationships with other related companies are disclosed. In certain countries where accounting standards are limited, a commitment to transparency may mean that the company adopts internationally recognised accounting principles in addition to local accounting standards.

Transparency also dictates openness regarding non-financial performance - particularly relating to a company’s business operations and competitive position. Public disclosure of corporate charter, by-laws, and a clearly articulated corporate mission also help to promote high standards of transparency. From a board perspective, it is important to have clear disclosure of who the company directors are, the basis of their remuneration and the extent to which they are independent or insiders.

(a) Quality and content of Public Disclosure criteria:
- Financial reporting and disclosure should be clearly articulated and completed to a high standard.

key analytical issues:
- Financial statements and reports (including data on key affiliates) disclosed to shareholders and investment community
- Corporate records available at company’s headquarters

(b) Timing of and Access to Public Disclosure criteria:
- All publicly disclosable information should be promptly available and freely accessible to the investment community and shareholders. Public disclosure is a function of internal transparency and effective internal control policies.
- The company’s by-laws, statutes and/or articles should be clearly articulated and readily accessible to all shareholders.
- The company should maintain a website and make company reports, summary reports and/or other investor relevant information available in both local language and English.

key analytical issues:
- financial statements filed with regulatory bodies
CORPORATE GOVERNANCE PRACTICES

- procedures for disclosure of market sensitive information
- briefing materials for investment community presentations
- records available to all shareholders at the company’s headquarters
- reports to shareholders
- website and web-based reporting.

(c) Independence & Standing of Auditor criteria:
- Auditors should be independent of the board and management and the company’s performance, and objectives. They should also be reputable.

key analytical issues:
- audit contract
- level of audit fees versus consulting fees from the auditor’s company
- finance and control systems, and audit committee process
- charter provisions
- audit reports

- Board structure and process

Board structure and process addresses the role of the corporate board and its ability to provide independent oversight of management performance and hold management accountable to shareholders and other relevant stakeholders.

Separation of authority at the board level is important. Boards with high accountability include a strong base of independent outside directors, looking after the interests of all shareholders - both majority and minority holders. Conversely, companies with a strong majority shareholder - or dominated by a few shareholders - may have boards with limited accountability to all shareholders. This is particularly the case when the company’s management is heavily represented on the corporate board. Boards often have key subcommittees, and the composition of these committees - particularly the balance between independent and non-independent directors - can be significant. In particular as the methodology is used to differentiate companies whose governance is at a high level, it is anticipated that further calibration will be possible with a greater understanding of how
corporate boards actively and effectively employ ‘risk management tools’ in their stewardship of the company.

Another significant board governance factor is how management is remunerated and what other benefits managers may enjoy. With regard to the selection of management and board members and other voting matters, a cumulative voting structure can allow for board representation for minority shareholders. The board selection process is best when non-staggered to ensure the possibility of change. The process by which outside directors are nominated and elected to the board, and the methods by which they are compensated for their board duties, are important considerations relevant to an assessment of the board’s accountability and practice.

(a) Board Structure and Composition
criteria:
- A board should be structured in such a way as to ensure that the interests of all the shareholders may be represented fairly and objectively.

key analytical issues:
- board size and composition
- board leadership and committees
- representation of constituencies

(b) Role and effectiveness of the Board
criteria:
- The board should bear overall accountability for the performance of the company.

key analytical issues:
- definitions of board role
- board and committee meeting’s agenda and papers
- management compensation process
- internal controls to properly monitor business, market and operational risks

(c) Role and Independence of Non-employed Directors
criteria:
- A significant proportion of the non-employed directors should be truly independent and act as such. Independent or outside directors
CORPORATE GOVERNANCE PRACTICES

- should ensure that the long-term interests of all shareholders are represented by including that the interests of other stakeholders are duly taken into account.
- Directors should be elected under a transparent system in which they are not able to participate.

**key analytical issues:**
- relationships between outside board members and senior management
- history of involvement of outside directors with company
- terms of outside director engagement
- control committee independence and activity
- articulation of the specific role of outside directors
- director election procedures

**(d) Board and Executive Compensation, Evaluation and Succession Policies**

**criteria:**
- Directors and executives should be fairly remunerated and motivated to ensure the success of the company.
- There should be clearly articulated performance evaluation and succession policies/plans for employed directors of the company.

**key analytical issues:**
- amount of compensation
- form of compensation
- performance evaluation criteria
- compensation setting process
- succession planning

Applications of corporate governance scores and benchmarks

With corporate governance scoring still in a relative infancy, the practical uses of this tool remain to be determined. However, it is possible to isolate different user groups to explore potential applications of this tool. While it is to be expected that the primary use of this tool will be for investors, these investors can run a broad range to include majority shareholders, minority shareholders and
creditors. But there are also meaningful applications for other groups, including board directors, managers, regulators, policymakers, financial intermediaries, analysts and academics. Potential applications of governance scores reflecting the specific interests of these groups are outlined below.

**Shareholders (majority and minority)**
- To understand how management is promoting the interests of the shareholders;
- To understand the relative degree of transparency at a firm;
- To guide existing and new investments: both strategic and portfolio investment.

**Minority shareholders specifically**
- To appreciate how management treats minority shareholders vis-à-vis majority shareholders or other significant blockholders.

**Creditors (lenders, investors, counterparties)**
- To use as a guide or as conditionality for lending decisions;
- To understand how management promotes the interests of financial stakeholders;
- To guide rollover or new lending decisions.

**Board directors**
- To understand the relative standing of existing governance practices;
- To use as benchmarks for improvement;
- To reduce directors’ liability insurance premia;

**Managers**
- To understand the relative standing of existing governance practices;
- To use as benchmarks for improvement;
- To communicate governance standards as an investor relations tool (annual reports, websites, advertising, etc).

**Regulators/exchanges**
- To assist in market regulation (shares and fixed income);
CORPORATE GOVERNANCE PRACTICES

- To promote governance and high transparency standards;
- To include in exchange listing requirements.

Stakeholders (eg, community, employees, customers)
- To understand better how the company balances the interests of its shareholders with and other constituencies that are affected by the company’s governance practices.

Policymakers
- To identify key gaps in governance standards at the country and private sector level to guide policy formation and new legislation.

Financial intermediaries and advisors
- To facilitate pricing and placement of new debt and equity issues: IPOs, secondary offerings, syndicated loans, bond issues, fairness opinions for M&A transactions.

Credit rating/equity analysis
- To include as part of broader management assessment.

Academics
- To use as units of measurement in research linking corporate governance to company performance.

Relevance to regulated industries in the UK

The growing concern about corporate governance in global financial markets is not limited to the emerging markets. The visibility of Enron’s situation reveals that a breakdown in corporate governance was one of the root causes of its demise. Enron’s case shows that investors are vulnerable to corporate governance risks, notwithstanding the developed legal system, accounting standards and regulatory framework in the US. Moreover, investor research, notably that of McKinsey, suggests that a corporate governance premium for well governed companies exists even in developed economies. Companies in markets such as the US or the UK that are
judged as well governed stand to benefit from more favourable financial market recognition.

UK regulated industries can benefit from corporate governance scores by using them as an investor relations tool, particularly during capital raising exercises. Moreover an independent corporate governance score can serve as a handy reference for companies to share with investors that are increasingly trying to learn more about corporate governance practices of UK companies. For regulated industries, an independent governance assessment might also provide greater transparency about how the company balances the issues of its relationships with its shareholders, regulator and other financial stakeholders. The complicated balancing act that regulated companies must manage vis-à-vis its varying constituencies is well suited to the analytical framework that comes with assessing these companies’ corporate governance standards.

Methodology development and references

This methodology has been under development since early 1998, and its drafting has drawn from a wide range of sources. This includes literature from multilateral banks, academics, law firms, brokerages, regulators and exchanges. In particular, many codes of best practice were reviewed, reflecting a variety of country and individual company perspectives from around the world. In the development stage, this methodology was shared for feedback with various specialists in corporate governance, including lawyers, economists, bankers and investors. Further refinement came through a pilot project in which this methodology was tested on a range of companies, from large listed companies to closely held small and medium sized enterprises.

The spirit of the methodology is to synthesise the key elements of corporate governance on a global basis, and not to impose the standards of any particular country or jurisdiction. As mentioned earlier, the approach is to understand individual governance practices and structures through the lens of overarching principles, such as
CORPORATE GOVERNANCE PRACTICES

those emphasised in the OECD corporate governance guidelines. The key is to ensure sufficient flexibility to accommodate different governance structures in the scoring process without compromising the assessment of the ultimate substance of a company’s governance standards as reflected in the broader principles of fairness, transparency, accountability and responsibility.

This methodology provides a way to objectify the process of corporate governance scoring. Its application in individual companies inevitably combines objective benchmarks with subjective assessments on the part of the analyst. Hence, the process of governance scoring is as much of an art as a science. This is not a foolproof process, particularly in that it cannot legislate for fraud. Moreover, it also cannot purport to the same level of insider knowledge that would come through active participation in the governance process as a manager or director. That notwithstanding, the methodology that is presented here provides a robust basis for assessing corporate governance at the firm and country levels. Inevitably the methodology will evolve over time to reflect improvements in both process and in thinking about corporate governance.
9 CORPORATE SOCIAL RESPONSIBILITY AND CORPORATE GOVERNANCE

Anthony Carey

Introduction

RSM Robson Rhodes has undertaken a survey of the annual reports and websites of the leading listed companies which control regulated companies in the telecommunications, utilities and transport sectors in the United Kingdom. The objective has been to create a discussion paper to be used as a catalyst by boards, government, regulators and stakeholders when considering governance, social and environmental issues. The survey looks at governance issues for companies required to comply with the combined code (ie, UK-incorporated companies listed on the London Stock Exchange) and social and environmental reporting for all of the sample. We seek to identify trends where appropriate and to highlight examples of good practice.

Regulated industries in the UK are of key importance to the economy, the investment community and consumers for a number of reasons:

- they make up 10% of annual gross domestic product; 3
- they represent at least 12% of the market capitalisation of the UK stock market; 4
- they provide employment for 4% of the labour force; 5

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1 See appendices for methodology.
2 Water supply and sewerage, electricity and gas companies.
3 Table 2.3 UK National Accounts, The Blue Book 2001.
4 Based on UK listed companies only in the sample, versus the FTSE All Share excluding investment trusts, 4th March 2002.
5 Table 5, Employment, Workforce jobs by industry, National Statistics Office, September 2001.
• they provide essential services to every member of the UK population and to the European Community in one form or another.

Due to their vital contribution to the economic infrastructure of the country and their significant impact on nearly every citizen’s life, we believe the companies in the regulated industries should strive to be at the forefront of best practice in the areas of reporting, governance and social and environmental performance. Support from within their communities is critical to their long-term success. We also believe it is important for government and regulators to be encourage leading-edge performance by companies in the regulated industries in the areas identified. Looking ahead, it is not in the public interest for the regulatory focus and that of government to be very largely on economic and competition issues; a broader perspective is needed.

The structure of the regulated industries is now very different as a result of mergers, takeovers and diversification to that when their constituent companies were originally privatised in the 1980s and 1990s. At the time of privatisation the new UK listed companies which emerged, with the exception of the large number of train operating companies formed from the break up of the British Railways Board, were either regional or national monopolies, with the regulated business tending to account for the lion’s share of the listed company’s turnover. As Table 1 illustrates the regulated industries now have much more complex structures, with some companies forming part of multi-utilities (eg, Scottish Power and United Utilities), a number having been acquired by foreign companies, and some representing a small part of the total business of their ultimate parent company. South Staffordshire Group Plc, for example, successfully transferred from the FTSE water sector into the FTSE support services sector because the majority of its profits came from non-regulated business.

Some listed parents of smaller ‘water only’ regulated companies are not covered in the survey. In designing an improved governance and reporting framework for the regulated industries it is suggested that a number of issues arising from the more complex structures of the industries, together with the implications of changes in reporting and
Table 1: Ownership and size of companies in the RSM Robson Rhodes survey sample

<table>
<thead>
<tr>
<th>Company</th>
<th>Industry</th>
<th>FTSE 100(^1)</th>
<th>FTSE 250(^2)</th>
<th>Other UK listing/ quotation(^2)</th>
<th>Location of principal/reg’d off if overseas</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>TELECOMS</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BT Group</td>
<td>Telecoms</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vodafone Group</td>
<td>Telecoms</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>TRANSPORT</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BAA</td>
<td>Transport</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Arriva</td>
<td>Transport</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FirstGroup</td>
<td>Transport</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Go-Ahead Group</td>
<td>Transport</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>National Express Group</td>
<td>Transport</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stagecoach Group</td>
<td>Transport</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>John Laing</td>
<td>Transport</td>
<td></td>
<td>FTSE Small Cap</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GB Railways Group</td>
<td>Transport</td>
<td></td>
<td></td>
<td>AIM</td>
<td></td>
</tr>
<tr>
<td>Railtrack Group</td>
<td>Transport</td>
<td></td>
<td></td>
<td>SUSPENDED</td>
<td></td>
</tr>
<tr>
<td>Sea Containers Ltd</td>
<td>Transport</td>
<td>✓</td>
<td></td>
<td></td>
<td>Bermuda</td>
</tr>
<tr>
<td>Vivendi Environnement SA(^3)</td>
<td>Transport</td>
<td></td>
<td></td>
<td></td>
<td>France</td>
</tr>
<tr>
<td><strong>ENERGY</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Centrica</td>
<td>Energy</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Innogy Holdings</td>
<td>Energy</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Powergen</td>
<td>Energy</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ScottishPower</td>
<td>Energy</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Scottish &amp; Southern Energy</td>
<td>Energy</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amerada Hess Corp</td>
<td>Energy</td>
<td></td>
<td></td>
<td>USA</td>
<td></td>
</tr>
<tr>
<td>American Electric Power Co Inc</td>
<td>Energy</td>
<td></td>
<td></td>
<td>USA</td>
<td></td>
</tr>
<tr>
<td>Mirant Corp (formerly Southern Energy Inc)</td>
<td>Energy</td>
<td></td>
<td></td>
<td>USA</td>
<td></td>
</tr>
<tr>
<td><strong>WATER</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Severn Trent</td>
<td>Water</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United Utilities</td>
<td>Water</td>
<td>✓</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>AWG</td>
<td>Water</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kelda Group</td>
<td>Water</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pennon Group</td>
<td>Water</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>South Staffordshire Group(^4)</td>
<td>Water</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bristol Water Holdings</td>
<td>Water</td>
<td></td>
<td>FTSE Small Cap</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bouygues SA</td>
<td>Water</td>
<td></td>
<td></td>
<td>France</td>
<td></td>
</tr>
<tr>
<td>Enron Corp(^5)</td>
<td>Water</td>
<td></td>
<td></td>
<td>USA</td>
<td></td>
</tr>
<tr>
<td>RWE AG</td>
<td>Water</td>
<td></td>
<td></td>
<td>Germany</td>
<td></td>
</tr>
<tr>
<td>Suez SA</td>
<td>Water</td>
<td></td>
<td></td>
<td>France</td>
<td></td>
</tr>
</tbody>
</table>

\(^1\) Where companies are involved in more than one sector, they have been classified according to FTSE sector (exceptions included below).

\(^2\) Listing information is as at 28/2/2002.

\(^3\) Vivendi Environnement has been classified as ‘Transport’ on the basis of UK turnover.

\(^4\) South Staffordshire Group’s FTSE sector was reclassified from Water into Support Services in December 2001

\(^5\) Following Enron Corp being placed into Chapter 11 reorganisation, its common stock is no longer traded on the New York Stock Exchange, but is currently traded as an over-the-counter equity security.
corporate governance impacting on listed companies generally, have yet to be fully explored. These include:

- what amendments or interpretations are required to the general governance and reporting requirements for listed companies if they are to be successfully applied to regulated businesses. For example, should the regulated businesses be expected to comply with the combined code requirements relating to the composition of boards? What requirements should there be about ‘ring-fencing’ the assets of regulated business?

- what information should be required to be provided by the regulated entity;

- what information should be made publicly available by the regulators and by the regulated entities/their parents, and in what form;

- what linkages should there be between the various sources of information and what reconciliation should be provided from regulated entity information to that related to the parent company.

**Compliance with the combined code and the Turnbull report on risk management**

*Extent of full compliance*

Of the 32 companies analysed as part of this study, 22 are required to disclose adherence to the combined code as they are UK-incorporated companies with a listing on the London Stock Exchange. As Table 2 illustrates, 10 of the 22 companies (45%) appeared to indicate full compliance with all aspects of the combined code on corporate governance. There was a significant difference between FTSE 100 and FTSE 250 companies in terms of the proportion of companies in each grouping in full compliance with the code. Among FTSE 100 companies, 6 out of 9 appear to be in full compliance as compared to
4 out of 10 of those in the FTSE 250 group. It is also noticeable that 3 of the 5 companies in the water industry in the FTSE 250 seemed to be in full compliance, compared with only 1 of the 5 transport holding companies which operate a number of train franchises.

**Table 2: Summary table of compliance with the combined code**

<table>
<thead>
<tr>
<th>Full compliance with the combined code</th>
<th>FTSE 100</th>
<th>FTSE 250</th>
<th>FSTE Smallcap</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>BAA (Transport)</td>
<td>AWG (Water)</td>
<td>Bristol Water Holdings (Water)</td>
</tr>
<tr>
<td></td>
<td>BT Group (Telecoms)</td>
<td>Arriva (Transport)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Centrica (Energy)</td>
<td>Kelda Group (Water)</td>
<td></td>
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<tr>
<td></td>
<td>Scottish Power (Energy)</td>
<td>Pennon Group (Water)</td>
<td></td>
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<tr>
<td></td>
<td>Scottish &amp; Southern Energy (Energy)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>United Utilities (Water)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Not in full compliance with the combined code</th>
<th>FTSE 100</th>
<th>FTSE 250</th>
<th>FSTE Smallcap</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Innogy Holdings (Energy)</td>
<td>First Group (Transport)</td>
<td>Bristol Water Holdings (Water)</td>
</tr>
<tr>
<td></td>
<td>Powergen (Energy)</td>
<td>Go-Ahead Group (Transport)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Vodafone Group (Telecoms)</td>
<td>National Express Group (Transport)</td>
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<td></td>
<td></td>
<td>Severn Trent (Water)</td>
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<td></td>
<td></td>
<td>South Staffordshire Group (Water)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Stagecoach Group (Transport)</td>
<td></td>
</tr>
</tbody>
</table>

|                                               | | | |
|                                               | | | |

An alternative way of analysing the situation would be to note a far higher degree of compliance with the combined code among companies formed out of nationalised industries/public sector bodies and a far lower one in the trains section of the transport sector where existing companies acquired franchises as train operating companies.

**Main reasons for non-compliance**

Details of the reasons for non-compliance are set out in Table 3. They range from the relatively minor issue of Vodafone not having a training programme for directors to Railtrack not having satisfied the requirements of the Turnbull report on risk management and internal controls, which it partly attributed to matters arising from the Hatfield train disaster.
In a few cases, non-compliance was a temporary or transitional issue. Powergen, in the energy sector, and National Express Group, a train operator, remedied their areas of non-compliance following the year-end, whilst Bristol Water Holdings Plc has indicated the notice periods of two directors with contracts terminable at 2 years notice will be reduced to the recommended 12 months notice period by April 2003.

Table 3: Compliance with the combined code  
(as given in the statement of compliance in the annual report as at the date shown)

<table>
<thead>
<tr>
<th>Company</th>
<th>Compliant</th>
<th>Issues of Non-Compliance</th>
<th>Reasons Given</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>TRANSPORT</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BAA</td>
<td>Y (31-Mar-01)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Arriva</td>
<td>Y (31-Dec-00)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FirstGroup</td>
<td>N (31-Mar-01)</td>
<td>• remuneration committee did not contain only independent non-executive directors</td>
<td>• consider the inclusion of the employee director to be positive contribution</td>
</tr>
</tbody>
</table>
| Go-Ahead Group           | N (30-Jun-01) | • no senior independent non-executive director  
• no nominations committee  
• two executive directors have contracts terminable with two year’s notice | • the group’s size does not justify the appointment of a senior non-executive director  
• due to the group’s size the whole board is responsible for appointments |
| National Express Group   | N (31-Dec-00) | • no appointment of a senior independent director | • due to resignation during the year; however post year end a senior independent director was appointed |
| Stagecoach Group         | N (30-Apr-01) | • one director has a service contract terminable with two year’s notice |                                                        |
| John Laing               | N (31-Dec-00) | • non-executive directors comprise less than 1/3 of the board  
• nominations committee did not contain a majority of non-executive directors throughout the year |                                                        |
| GB Railways Group        | na (31-Mar-01) |                          |                                                        |
| Railtrack Group          | N (31-Mar-01) | • no appointment of a senior independent director  
• implementation of Turnbull incomplete | • post-year end a senior non-executive director appointed |
<p>| Sea Containers Ltd       | na (31-Dec-00) |                          |                                                        |
| Vivendi Environnement SA | na (31-Dec-00) |                          |                                                        |</p>
<table>
<thead>
<tr>
<th>Company</th>
<th>Compliant (year end)</th>
<th>Issues of Non-Compliance</th>
<th>Reasons Given</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>TELECOMS</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BT Group</td>
<td>Y (31-Mar-01)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vodafone Group</td>
<td>N (31-Mar-01)</td>
<td>• no formal training programme for directors</td>
<td>• consider the information and assistance provided to all directors on appointment to be sufficient</td>
</tr>
<tr>
<td><strong>ENERGY</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Centrica</td>
<td>Y (31-Dec-00)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Innogy Holdings</td>
<td>N (31-Mar-01)</td>
<td>• Chairman and CEO combined • not all internal controls in place by year end</td>
<td>• Board believes that it is balanced with strong independent element • due to demerger process, although by early 2001 processes were fully embedded</td>
</tr>
<tr>
<td>Powergen</td>
<td>N (31-Dec-00)</td>
<td>• roles of chairman and CEO combined</td>
<td>• roles now separate and kept under review</td>
</tr>
<tr>
<td>ScottishPower</td>
<td>Y (31-Mar-01)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Scottish &amp; Southern Energy</td>
<td>Y (31-Mar-01)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amerada Hess Corp</td>
<td>na (31-Dec-00)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>American Electric Power Co Inc</td>
<td>na (31-Dec-00)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mirant Corp (formerly Southern Energy Inc)</td>
<td>na (31-Dec-00)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>WATER</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Severn Trent</td>
<td>N (31-Mar-01)</td>
<td>• one director has a two year contract</td>
<td></td>
</tr>
<tr>
<td>United Utilities</td>
<td>Y (31-Mar-01)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>AWG</td>
<td>Y (31-Mar-01)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kelda Group</td>
<td>Y (31-Mar-01)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pennon Group</td>
<td>Y (31-Mar-01)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>South Staffordshire Group</td>
<td>N (31-Mar-01)</td>
<td>• no senior independent non-executive director • notice period of AGM less than combined code recommends</td>
<td>• an experienced independent non-executive chairman is in place • the notice period for the AGM is compliant with the Companies Act</td>
</tr>
<tr>
<td>Bristol Water Holdings</td>
<td>N (31-Mar-01)</td>
<td>• two directors have contracts terminable with two year’s notice</td>
<td>• these notice periods will be reduced to twelve months from April 2003</td>
</tr>
<tr>
<td>Bouygues SA</td>
<td>na (31-Dec-00)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enron Corp</td>
<td>na (31-Dec-00)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>RWE AG</td>
<td>na (30-Jun-01)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Suez SA</td>
<td>na (31-Dec-00)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1 Issues included under issues of non-compliance are those included by companies within their statement of non-compliance with the combined code.

2 Where companies are involved in more than one sector, they have been classified according to FTSE sector; subject to the exceptions listed below.

3 Vivendi Environnement has been classified as ‘Transport’ on the basis of UK turnover.

4 South Staffordshire Group’s FTSE sector was reclassified from Water into Support Services in December 2001.
CSR AND CORPORATE GOVERNANCE

Risk

Apart from Railtrack, as discussed, and Innogy, where issues arose due to their recent demerger, all companies indicated compliance with the Turnbull report on risk management and internal control. Under the Turnbull requirements, companies are not called on to disclose their actual risks and few do so but an interesting example of good disclosure in this area came from BT, which in their combined annual report and 20F disclosure discussed ‘some of the significant risks that could affect us’. Among the fairly broad range of those highlighted were:

- Credit rating downgrades – in February 2001 Standard & Poor’s placed BT on ‘Credit watch with negative implications’ and BT observed that about one-third of their debt was subject to covenants which would increase the interest rate if there were further downgrades.
- The ability to pay dividends in the future was dependent on the success of the new companies created by their restructuring programme. It was noted that in many respects the success of restructuring will depend on factors beyond the company’s control.
- Investment in third generation mobile licenses and networks may not generate an economic return.
- If BT were subject to significant price controls, it may lose market share, competitive advantage and future profitability may be affected.
- Health concerns from mobile phone handsets and masks may reduce customer demand and affect profitability.

The board and its committees

Introduction

The combined code states that every listed company should be headed by an effective board which should lead and control the company. Effective boardroom leadership is central to corporate performance and accountability. In this chapter we explore a number of issues
relating to boardroom composition including compliance with the combined code in this area.

**Number of directors**

The average board of companies in the sample is composed of 10 directors, in line with FTSE 100 companies, which on average have 9 board directors.¹ For 19 of the 22 companies in the sample, the size of the board is between 8 and 12 directors. Not surprisingly, PIRC sees a correlation between board size and company size and this certainly carries through to the sample companies, with telecommunications and energy companies in general having the highest number of directors and turnover.

**Combining the roles of chairman and chief executive**

The combined code states that there should be a clear division of responsibilities at the head of the company to ensure a balance of power and authority so that no one person has unhindered control. Our analysis indicates that three companies in the sample of regulated companies combined the posts of chairman and chief executive officer (CEO).

Innogy Holdings Plc points out in its annual report that the combined code does not require separation of the post of chairman and chief executive officer, rather only that a decision to combine the posts be justified. It goes on to say that the board believes that given its demerger it was in the best interests of the group and shareholders to combine the role at the start of the group’s life as a listed company. It also points out that there is a clearly defined schedule of roles and responsibilities for both the chairman and chief operating officer.

Powergen in its annual report had regard to the broad spirit of the wording of the combined code provision relating to the combination of the roles of chairman and CEO and indicated that the roles had been combined during the year as a consequence of which the

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¹ Corporate Governance 2001: PIRC Annual Review of trends and structures in the FTSE All Share Index.
company had not complied with Principle A2 of the combined code. Subsequent to the year-end the roles were split with a new CEO being appointed.

Kelda Group Plc said that in April 2000 John Napier agreed to accept an interim appointment as executive chairman, combining the roles of chairman and chief executive. The interim appointment is kept under review and the directors believe it is in the best interests of the company to maintain it. In addition, John Laing Plc do not appear to have identified a CEO. Sir Martin Laing is shown as chairman and together with Robert Wood, deputy chairman, makes up the membership of the group executive. Almost three quarters of chairmen held non-executive appointments.

Independent and non-executive directors

All boards with the exception of John Laing Plc comply with the code provision that indicates non-executives should constitute a third of the board and all fulfil the element of the provision calling for a majority of non-executive directors to be independent of management and free from any business or other relationships which could materially interfere with the exercise of their judgement (see Table 4). Interestingly, the majority of companies appear to regard their chairman as an independent director. It is arguable that in view of his leadership role, albeit of the board rather than with regard to line management, that it is difficult for the chairman to be fully independent.

There has been a move in recent years to increasing the proportion of total board membership made up of non-executive directors and it could be regarded as leading-edge practice for a majority of the board to be made up of independent directors.
Table 4: Composition of the board at the company’s year-end

<table>
<thead>
<tr>
<th>Company</th>
<th>ExecutiveDirs</th>
<th>Non–executiveDirs (NEDs)</th>
<th>NEDs &gt;=1/3 board?</th>
<th>Ind. NEDs to total board</th>
<th>Ind. chairman?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BT Group</td>
<td>3</td>
<td>0</td>
<td>9</td>
<td>✓</td>
<td>75%</td>
</tr>
<tr>
<td>Vodafone Group</td>
<td>5</td>
<td>1</td>
<td>9</td>
<td>✓</td>
<td>60%</td>
</tr>
<tr>
<td>Railtrack Group</td>
<td>6</td>
<td>1</td>
<td>5</td>
<td>✓</td>
<td>42%</td>
</tr>
<tr>
<td>Arriva</td>
<td>6</td>
<td>0</td>
<td>3</td>
<td>✓</td>
<td>33%</td>
</tr>
<tr>
<td>National Express Group</td>
<td>4</td>
<td>0</td>
<td>4</td>
<td>✓</td>
<td>50%</td>
</tr>
<tr>
<td>John Laing</td>
<td>7</td>
<td>0</td>
<td>3</td>
<td>No</td>
<td>30%</td>
</tr>
<tr>
<td>FirstGroup</td>
<td>5</td>
<td>1</td>
<td>3</td>
<td>✓</td>
<td>33%</td>
</tr>
<tr>
<td>Stagecoach Group</td>
<td>6</td>
<td>1</td>
<td>5</td>
<td>✓</td>
<td>42%</td>
</tr>
<tr>
<td>Go-Ahead Group</td>
<td>3</td>
<td>0</td>
<td>3</td>
<td>✓</td>
<td>50%</td>
</tr>
<tr>
<td>BAA</td>
<td>6</td>
<td>0</td>
<td>6</td>
<td>✓</td>
<td>50%</td>
</tr>
<tr>
<td>Innogy Holdings</td>
<td>5</td>
<td>0</td>
<td>4</td>
<td>✓</td>
<td>44%</td>
</tr>
<tr>
<td>Powergen</td>
<td>4</td>
<td>0</td>
<td>6</td>
<td>✓</td>
<td>60%</td>
</tr>
<tr>
<td>Scottish &amp; Southern Energy</td>
<td>5</td>
<td>0</td>
<td>6</td>
<td>✓</td>
<td>55%</td>
</tr>
<tr>
<td>Centrica</td>
<td>5</td>
<td>0</td>
<td>5</td>
<td>✓</td>
<td>50%</td>
</tr>
<tr>
<td>Severn Trent</td>
<td>5</td>
<td>0</td>
<td>7</td>
<td>✓</td>
<td>58%</td>
</tr>
<tr>
<td>United Utilities</td>
<td>4</td>
<td>0</td>
<td>5</td>
<td>✓</td>
<td>56%</td>
</tr>
<tr>
<td>Kelda Group</td>
<td>4</td>
<td>0</td>
<td>4</td>
<td>✓</td>
<td>50%</td>
</tr>
<tr>
<td>AWG</td>
<td>4</td>
<td>0</td>
<td>6</td>
<td>✓</td>
<td>60%</td>
</tr>
<tr>
<td>Scottish Power</td>
<td>6</td>
<td>1</td>
<td>9</td>
<td>✓</td>
<td>56%</td>
</tr>
<tr>
<td>Pennon Group</td>
<td>3</td>
<td>0</td>
<td>4</td>
<td>✓</td>
<td>57%</td>
</tr>
<tr>
<td>South Staffordshire Group</td>
<td>3</td>
<td>1</td>
<td>5</td>
<td>✓</td>
<td>56%</td>
</tr>
<tr>
<td>Bristol Water Holdings</td>
<td>3</td>
<td>0</td>
<td>5</td>
<td>✓</td>
<td>63%</td>
</tr>
</tbody>
</table>

As Table 5 (by company) highlights, a significant majority of the listed companies in regulated industries (73% of total) now have 50% or more of the board made up of independent directors. It is noticeable that of the six who do not have a majority of independent directors all but Innogy are in the rail industry: Railtrack Group Plc and four holding companies owning train operating companies franchises.

Table 5: Independent directors as % of total board

<table>
<thead>
<tr>
<th>No of Companies</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 50%</td>
<td>6</td>
</tr>
<tr>
<td>50%</td>
<td>5</td>
</tr>
<tr>
<td>More than 50%</td>
<td>11</td>
</tr>
</tbody>
</table>

| Total           | 22 | 100 |
Appointment of senior independent director

The combined code indicates that there should be a strong non-executive element on the board, with a recognised senior member other than the chairman. About three quarters of the companies analysed had satisfied this provision of the combined code. Those who did not included Go-Ahead Group Plc, National Express Group, Railtrack Group Plc (which appointed one following the year end) and South Staffordshire Group Plc which stated that there was already an experienced independent non-executive chairman and this action could prove ‘unnecessarily divisive’. There has been resistance amongst some listed companies to the appointment of a senior non-executive director, a provision which was not in the original Cadbury code, but this role does have merit as it provides an important channel that facilitates non-executives discussing matters collectively when necessary and for the shareholders and others to know to whom they should express concerns about the direction or leadership of the company if these are a major cause for concern.

Drawing directors from a wider pool

There would be merit in listed companies with regulated businesses, in common with other listed companies, reviewing the pool from which they draw their directors, executive and non-executive, to ensure that there are no glass ceilings related, for example, to the recruitment of female directors or those from ethnic minorities. Less than half the companies had a female director on the board and only a couple had two female directors; none had more. Most non-executives naturally had a business background with a minority including a director, normally only one, who had held a senior university appointment, generally at vice-chancellor level, or who had been a senior civil servant or member of the diplomatic community. At the executive level, it was also noticeable how few HR directors were on the main board – Arriva Plc was a rare exception - and the very small number of main board appointments linked to environmental or social issues, though Railtrack Group Plc had appointed a director of safety and environment after the Hatfield crash.
Among non-executives, FirstGroup had made an innovative appointment of an employee director to the board and BAA’s non-executive directors (NEDs) included Dr Chris Fay, previously with Shell and with a strong background on the environment, and Val Gooding, chief executive of BUPA. In Derek Osborn, Severn Trent also had a non-executive director who was a leading figure in the environmental world while Innogy Holdings had appointed Yvonne Constance, a former chairman of The Electricity Consumers Council as an NED. Table 6 shows the summary of fees paid to non-executive directors.

Table 6: Summary of fees and benefits in kind paid to non-executive directors

<table>
<thead>
<tr>
<th>Company</th>
<th>Range of fees paid to non-executive directors excluding audit committee chairman &amp; non-executive chairman (£’000)</th>
<th>Range of benefits in kind paid to non-executive directors excluding audit committee chairman &amp; non-executive chairman (£’000)</th>
<th>Fees and benefits paid to audit committee chairman (£’000)</th>
<th>Fees and benefits paid to non-executive chairman (£’000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>BT Group</td>
<td>22 – 75</td>
<td>0</td>
<td>25</td>
<td>n/a</td>
</tr>
<tr>
<td>Vodafone Group</td>
<td>57 – 81</td>
<td>0</td>
<td>89</td>
<td>414</td>
</tr>
<tr>
<td>Railtrack Group</td>
<td>27 – 39</td>
<td>0</td>
<td>28</td>
<td>200</td>
</tr>
<tr>
<td>Arriva</td>
<td>28</td>
<td>0</td>
<td>28</td>
<td>70</td>
</tr>
<tr>
<td>National Express Group</td>
<td>28 – 49</td>
<td>0</td>
<td>100(^1)</td>
<td>100(^1)</td>
</tr>
<tr>
<td>John Laing</td>
<td>30</td>
<td>0</td>
<td>32</td>
<td>n/a</td>
</tr>
<tr>
<td>FirstGroup</td>
<td>11 – 23</td>
<td>0</td>
<td>30</td>
<td>60</td>
</tr>
<tr>
<td>Stagecoach Group</td>
<td>1 – 43</td>
<td>0</td>
<td>21</td>
<td>n/a</td>
</tr>
<tr>
<td>Go-Ahead Group</td>
<td>28</td>
<td>0</td>
<td>50(^1)</td>
<td>50(^1)</td>
</tr>
<tr>
<td>BAA</td>
<td>30 – 39</td>
<td>0</td>
<td>41</td>
<td>156</td>
</tr>
<tr>
<td>Innogy Holdings</td>
<td>10 – 26</td>
<td>0</td>
<td>36</td>
<td>n/a</td>
</tr>
<tr>
<td>Powergen</td>
<td>25 – 55</td>
<td>0 – 1</td>
<td>30</td>
<td>n/a</td>
</tr>
<tr>
<td>Scottish &amp; Southern Energy</td>
<td>27 – 35</td>
<td>0</td>
<td>30</td>
<td>100</td>
</tr>
<tr>
<td>Centrica</td>
<td>28 – 48</td>
<td>0</td>
<td>28</td>
<td>169</td>
</tr>
<tr>
<td>Severn Trent</td>
<td>14 – 32</td>
<td>0 – 1</td>
<td>31</td>
<td>115</td>
</tr>
<tr>
<td>United Utilities</td>
<td>35 – 150</td>
<td>0</td>
<td>35</td>
<td>68</td>
</tr>
<tr>
<td>Kelda Group</td>
<td>11 – 44</td>
<td>0 – 5</td>
<td>26</td>
<td>n/a</td>
</tr>
<tr>
<td>AWG</td>
<td>24 – 29</td>
<td>0</td>
<td>33</td>
<td>143</td>
</tr>
<tr>
<td>Scottish Power</td>
<td>7 – 64</td>
<td>0 – 21</td>
<td>43</td>
<td>240</td>
</tr>
<tr>
<td>Pennon Group</td>
<td>22 – 40</td>
<td>0</td>
<td>30</td>
<td>134</td>
</tr>
<tr>
<td>South Staffordshire Group</td>
<td>17</td>
<td>0</td>
<td>17</td>
<td>37</td>
</tr>
<tr>
<td>Bristol Water Holdings</td>
<td>17 – 22</td>
<td>0</td>
<td>19</td>
<td>33</td>
</tr>
</tbody>
</table>

\(^1\) The chairman of the board is also the chairman of the audit committee.

Note. Directors included above are those in office at the year-end date. The figures above include directors appointed part way through the year. Directors may have been appointed as chairman or chairman of the audit committee part way through the year.
Where companies have a standard fee for their non-executive directors it generally seems to be in the range of £20,000-£30,000 a year. The remuneration paid to non-executive chairmen, however, seems to vary substantially between companies.

**Nomination and remuneration committees**

Turning to the membership of committees, all but John Laing Plc comply with the provision that companies except those with small boards should establish a nomination committee, a majority of the members of which should be non-executive directors (see Table 7). Go-Ahead Group Plc has taken advantage of the derogation for those with small boards.

**Table 7: Composition of the nomination committee in terms of its members at the company’s year-end**

<table>
<thead>
<tr>
<th>Company</th>
<th>Compliant with combined code: majority of members non-executive directors?</th>
<th>All non-executive directors?</th>
<th>All independent directors?</th>
</tr>
</thead>
<tbody>
<tr>
<td>BT Group</td>
<td>✓</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Vodafone Group</td>
<td>✓</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Railtrack Group</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Arriva</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>National Express Group</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>John Laing</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>FirstGroup</td>
<td>✓</td>
<td>✓</td>
<td>No</td>
</tr>
<tr>
<td>Stagecoach Group</td>
<td>✓</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Go-Ahead Group</td>
<td>No committee</td>
<td>No committee</td>
<td>No committee</td>
</tr>
<tr>
<td>BAA</td>
<td>✓</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Innogy Holdings</td>
<td>✓</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Powergen</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Scottish &amp; Southern Energy</td>
<td>✓</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Centrica</td>
<td>✓</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Severn Trent</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>United Utilities</td>
<td>✓</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Kelda Group</td>
<td>✓</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>AWG</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Scottish Power</td>
<td>✓</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Pennon Group</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>South Staffordshire Group</td>
<td>✓</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Bristol Water Holdings</td>
<td>✓</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>
It could be argued that to ensure independence of management, at least for the selection of independent directors, a case can be made for the nomination committee to be made up wholly of independent directors. About one third of companies would satisfy this more rigorous proposal (see Table 7). First Group Plc was the only company to indicate its remuneration committee was not made up solely of independent non-executive directors and that was due to the fact that its non-executive employee director served on the committee, a decision which it not unreasonably viewed positively.

**Audit committees**

Reassuringly, all the companies in the sample had an audit committee whose membership complied with the relevant provisions of the combined code, ie it comprised a minimum of three non-executive directors a majority of whom were independent (see Table 8). It was also encouraging to observe that the audit committee of all companies except First Group Plc and Scottish Power Plc were made up wholly of independent non-executive directors which could reasonably be thought to be best practice. The reason First Group did not have all independent directors was that its employee director was a member of the audit committee and in the case of Scottish Power its chairman, Charles Miller Smith was a member.

**Other committees**

About half of the companies in our sample have established committees to focus on one or more of environment, social and community and health and safety issues (see Table 9). BAA has probably the most comprehensive range of committees in this area with three separate ones covering ethics; charitable donations; and health, safety, security and environment. Most of the committees in the rail industry in addition to the normal ones of nomination, remuneration and audit are safety committees. In water by contrast, most of the additional committees focus on environmental and sustainability issues.
Table 8: Composition of the audit committee

<table>
<thead>
<tr>
<th>Company</th>
<th>Combined code requirement: all non-executive directors?</th>
<th>All independent non-executive directors?</th>
</tr>
</thead>
<tbody>
<tr>
<td>BT Group</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>Vodafone Group</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>Railtrack Group</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>Arriva</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>National Express Group</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>John Laing</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>FirstGroup</td>
<td>√</td>
<td>No</td>
</tr>
<tr>
<td>Stagecoach Group</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>Go-Ahead Group</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>BAA</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>Innogy Holdings</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>Powergen</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>Scottish &amp; Southern Energy</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>Centrica</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>Severn Trent</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>United Utilities</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>Kelda Group</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>AWG</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>Scottish Power</td>
<td>√</td>
<td>No</td>
</tr>
<tr>
<td>Pennon Group</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>South Staffordshire Group</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>Bristol Water Holdings</td>
<td>√</td>
<td>√</td>
</tr>
</tbody>
</table>

Whilst having specific committees to cover an issue does not necessarily mean it receives higher priority at board level than if the matter is dealt with by the whole board, it provides a powerful signal that the issue is of importance to the company. A separate committee can also devote more time to the matter in question.

Table 9: Committees related to environmental and social issues

<table>
<thead>
<tr>
<th>Telecons</th>
<th>Pensions, Community Support</th>
</tr>
</thead>
<tbody>
<tr>
<td>BAA</td>
<td>Charitable Donations, Ethics, Health, Safety &amp; Security and Environment</td>
</tr>
<tr>
<td>Arriva</td>
<td>Health &amp; Safety</td>
</tr>
<tr>
<td>FirstGroup</td>
<td>Safety</td>
</tr>
<tr>
<td>National Express Group</td>
<td>Safety</td>
</tr>
<tr>
<td>Energy</td>
<td>Customer Service</td>
</tr>
<tr>
<td>Innogy Holdings</td>
<td>Health &amp; Safety Review, Corporate Social Responsibility</td>
</tr>
<tr>
<td>Water</td>
<td>Charitable Contributions, Environment Advisory</td>
</tr>
<tr>
<td>AWG</td>
<td>Sustainable Development</td>
</tr>
<tr>
<td>Kelda Group</td>
<td>Environment &amp; Community</td>
</tr>
<tr>
<td>Pennon Group</td>
<td>Environment</td>
</tr>
</tbody>
</table>
Social and environmental performance

Introduction

For their long-term prosperity it is important that regulated companies possess a moral licence for running their businesses from their customers as well as the necessary formal grant of authority from the regulator. By investing in social and environment programmes the companies can show that they care about their customers and the communities in which they operate. Due to the unique position that these companies have in society, their stakeholders expect high standards of ethics, transparency, sensitivity and responsiveness.

Moreover, these days the stakeholders of these companies are able to monitor their actions more easily due to development in technology and growing media coverage of sustainability issues. Hence, leading-edge performance on social and environmental issues is an important business issue as well as valuable in itself.

Business in the Environment (BiE) survey

A survey of analysts, fund managers, journalists and investor relations managers, commissioned by Business in the Environment, found that a company that pays attention to its environmental and social performance is seen as attractive to investors. Good management of environmental issues was viewed as contributing to the overall quality of management within a company. Investors’ interest in environmental issues has increased for a number of reasons but particularly because:

- recent legislation has required that UK pension fund trustees include in their statement of investment principles the extent to which social, environmental and ethical considerations are taken into account in their investment strategies;

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• the global community, including investors, other stakeholders and the public at large, have begun to develop guidelines for the ethical behaviour of large companies; ⁸

• as investment products have diversified, a raft of ethical products have been developed, approximately £1.4 trillion in assets were invested in ethical investment funds in the US in 1999.

Business in the Environment undertake an annual survey to identify the best performers on environmental issues. Interestingly, approximately one third of the companies in its top 20 are the listed parents of regulated businesses analysed in this report.

One important conclusion that one can draw from this survey is that those entities that have scored highly are the ones that have moved from the public sector into the private as a result of privatisation. Unlike these companies, most of the transport companies that own the train operating companies and have always been in the private sector are outside the top 100 of the BiE index. Additionally, the top five scoring sectors in the report are water, automobiles, gas distribution, electricity and mining, with the biggest improvement having been seen in telecommunications. Clearly, firms in these sectors are becoming only too aware of the necessity of ensuring that they are seen as having strong reputations in the corporate social responsibility arena.

The DTI considers that corporate social responsibility has:

“a wide-ranging agenda and involves businesses looking at how to improve their social, environmental and local economic impact, their influence on society, social cohesion and human rights, fair trade and on the ways in which that fairness can be corrupted”. ⁹

Among other developments FTSE4Good was launched last year, an index of approximately seven hundred companies, the majority of which are relatively small quoted companies with good records of

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⁸ For example, Global Reporting Initiative: Draft Sustainability Reporting Guidelines, April 2001.
social responsibility. Additionally, the prime minister last year challenged the UK’s top three hundred and fifty companies to produce environmental reports by the end of the year. At this stage, most of the initiatives are voluntary, but the pressure for the development of a formal framework for social and environmental reporting is set to increase, not only in the UK but also on a global basis. The Global Reporting Initiative, the Global Compact and the Dow Jones Sustainability Indices are but three of the projects being undertaken.

As noted in the introduction, the ownership structure of a number of utilities companies has changed significantly since privatisation. From being primarily regional businesses in many instances, a number are now part of much larger, more complex and diversified concerns and there is a risk that such changes must potentially increase the likelihood that social and environmental issues, at least with regard to particular regions, are likely to feature less highly on the corporate agenda of the companies concerned. In the electricity industry, for example, the supply side is now less regionally focussed though many businesses will still have a large concentration of customers in their original areas.

Social, health and safety issues

Some coverage of community affairs is evident in the annual reports of almost seventy percent of the sample, often in a separate section or paragraph. Those which do not seem to contain coverage include some overseas owned companies, but also some of the other smaller listed entities such as South Staffordshire Group Plc, Go-Ahead Group Plc and First Group Plc as well as AIM-Listed GB Railways Group Plc. BT commits a minimum of 0.5% of its UK pre-tax profits to direct activities in the support of society. The company also caters for customers with special needs with, for example, a free priority fault repair service for housebound people. AWG has set itself clearly defined targets for health and safety at work, for example by stating that it wants to achieve an accident frequency rate of 0.2 accidents for every 100,000 hours worked during 2007, with an interim goal of 0.45 by the end of 2003.
There are quantifiable measures of community involvement included in just under 45% of companies. A good example would be that of United Utilities Plc, which is particularly clear in its social and environmental review, and was voted company of the year by Business in the Community, “in recognition of its integrated approach to corporate social responsibility across the group’s operations”. It indicates its ranking in the Business in the Environment 2001 survey and also its ranking globally by the UN’s Environment Programme. It also lists the group’s commitments to the environment and the community and publishes a separate social and environmental impact report.

About a third of companies, principally in the transport sector, made statements regarding negative impact in social, health or safety (non-employee) areas. Less than twenty percent of these companies, however, quantified these impacts. An example of a company that did was Railtrack Group Plc’s in its annual report which faces the issue of the Hatfield derailment on page one in the chairman’s statement. The company also appointed a director of safety and environment to the main board and has established Railway Safety as a not-for-profit, wholly owned subsidiary dedicated to “helping the whole railway industry to focus on improved safety management”.

In terms of charitable donations, BT made donations totalling £1.2 million. Foreign owned companies did not generally disclose this information as there is no requirement for them to do so. The law in the UK regarding corporate political donations was changed with the passage of the Political Parties, Elections and Referendums Act (PPERA) which came into force on 16 February 2001 and requires companies to obtain prior shareholder approval for any donation to a ‘political organisation’ within the EU of over £5,000 in any twelve month period. No UK companies in our sample appeared to have made any political contributions and overseas-owned utilities do not make any such disclosures.

**Environment**

Almost all companies gave coverage to environmental matters and about half of those who did included quantifiable measures of
environmental performance, particularly in the water and transport sectors. Scottish Power Plc, which came first equal (2\textsuperscript{nd}, 2000) in the BiE 2001 Index of Corporate Environmental Engagement (Table 10), listed a number of achievements:

- it came second in the Business in the Environment survey of 350 FTSE companies;
- the technology it developed to reduce coal-fired power station emissions won a Queen’s Award for Enterprise in the sustainable development category;
- it launched a £1 million Rural Care Grant Scheme in October 2000 to encourage and support the creation of new native woodlands;
- in the 2000 bathing season, only two out of seventy nine beaches failed compliance tests;
- its structures and controls were commended with a Utility Week award for environmental management;
- all group businesses are required to implement an environmental system equivalent to ISO14001;
- it ranked as top utility in the Business in the Environment corporate engagement survey of the FTSE350;
- it was rated AAA by the Safety and Environmental Agency;
- its Pacificorp plants have emission rates seventy percent below the national SO2 average and eighteen percent below the national NO\textsubscript{x} average;
- it states that throughout its operations, it will meet or better, relevant legislation and regulatory environmental requirements.

One of the key features that makes the Scottish Power environmental report easy to use is the clear cross-referencing in the overview section of this report. Another feature that was very positive about the report was that it not only highlighted the performance measures where it had done well but also those where the performance had deteriorated. It is also easy to both pick out improvement as well as under-performance against a baseline represented by a tick and a cross respectively. BAA uses the guidelines produced by GRI in the compilation of information presented in its annual report. It has also worked with an independent sustainability verification company to define issues, set targets and audit progress. Scottish Power has also
employed on independent third party to review its environmental governance arrangements. AWG and Severn Trent have been named as leading water company and utility company respectively in the Dow Jones Global Sustainability Index. The index, which tracks the performance of top 2,500 companies on the Dow Jones Global Index, rates a company’s social and environmental activity alongside its economic performance. Severn Trent says that it has increased the amount of renewable electricity that it generates from 20% last year to 35% of the total needs this year though it does not indicate what targets it was trying to achieve. Wessex Water has included a set of ‘green accounts’ reflecting their aim to move closer towards being a sustainable company.

**Table 10: BiE 2001 Index of corporate environmental engagement**

<table>
<thead>
<tr>
<th>Company</th>
<th>Average Score</th>
<th>Ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td>IBM</td>
<td>91 – 100%</td>
<td>81 – 90%</td>
</tr>
<tr>
<td>Lattice Group (demerged from BG Group)</td>
<td>91 – 100%</td>
<td>-</td>
</tr>
<tr>
<td>Scottish Power</td>
<td>91 – 100%</td>
<td>91 – 100%</td>
</tr>
<tr>
<td>Shields Environmental</td>
<td>91 – 100%</td>
<td>81 – 90%</td>
</tr>
<tr>
<td>Unilever</td>
<td>91 – 100%</td>
<td>81 – 90%</td>
</tr>
<tr>
<td>Blue Circle Industries UK</td>
<td>91 – 100%</td>
<td>-</td>
</tr>
<tr>
<td>AWG</td>
<td>91 – 100%</td>
<td>81 – 90%</td>
</tr>
<tr>
<td>BAA</td>
<td>91 – 100%</td>
<td>81 – 90%</td>
</tr>
<tr>
<td>J Sainsbury</td>
<td>91 – 100%</td>
<td>91 – 100%</td>
</tr>
<tr>
<td>Jaguar</td>
<td>91 – 100%</td>
<td>-</td>
</tr>
<tr>
<td>Co-operative Bank</td>
<td>91 – 100%</td>
<td>81 – 90%</td>
</tr>
<tr>
<td>BP</td>
<td>91 – 100%</td>
<td>81 – 90%</td>
</tr>
<tr>
<td>Scottish &amp; Southern Energy</td>
<td>91 – 100%</td>
<td>81 – 90%</td>
</tr>
<tr>
<td>British Airways</td>
<td>91 – 100%</td>
<td>91 – 100%</td>
</tr>
<tr>
<td>Shell International</td>
<td>91 – 100%</td>
<td>91 – 100%</td>
</tr>
<tr>
<td>Severn Trent</td>
<td>91 – 100%</td>
<td>91 – 100%</td>
</tr>
<tr>
<td>United Utilities</td>
<td>91 – 100%</td>
<td>91 – 100%</td>
</tr>
<tr>
<td>Proctor &amp; Gamble</td>
<td>91 – 100%</td>
<td>81 – 90%</td>
</tr>
<tr>
<td>ABB</td>
<td>91 – 100%</td>
<td>81 – 90%</td>
</tr>
<tr>
<td>Marks &amp; Spencer</td>
<td>91 – 100%</td>
<td>41 – 60%</td>
</tr>
<tr>
<td>Cable &amp; Wireless</td>
<td>91 – 100%</td>
<td>81 – 90%</td>
</tr>
<tr>
<td>Rio Tinto</td>
<td>91 – 100%</td>
<td>91 – 100%</td>
</tr>
<tr>
<td>Waste Recycling Group</td>
<td>91 – 100%</td>
<td>81 – 90%</td>
</tr>
<tr>
<td>Innogy Holdings</td>
<td>91 – 100%</td>
<td>-</td>
</tr>
<tr>
<td>ST Microelectronics</td>
<td>91 – 100%</td>
<td>81 – 90%</td>
</tr>
<tr>
<td>BT</td>
<td>91 – 100%</td>
<td>91 – 100%</td>
</tr>
</tbody>
</table>
Employees

There is a defined benefit (final salary) pension scheme in all UK-owned companies, although it is not stated in most companies’ reports whether or not this scheme is open to new employees; we would expect it unlikely to be so. The normal employer’s contribution averages at about seven percent of salary and it is estimated that roughly seventy-seven percent of employees belong to these schemes. This is certainly a large future liability for these companies should they choose to continue with the defined benefit pension scheme.

About sixty percent of companies have a defined contribution pension scheme, and again, an average employer’s contribution is about seven percent. A third of companies have quantifiable measures in respect of human capital issues. Examples would be that of United Utilities Plc, which has one hundred home workers, and First Group Plc, which has safety training workshops for all staff and an employee communications programme. The latter, as discussed, also unusually had an employee director on the main board. During last accounting year AWG set up training and development workshops throughout the business to spread knowledge and expertise and to develop the interpersonal skills of its employees whilst Stagecoach Group Plc has a section in its annual report entitled ‘Employment Policies’ setting out its goals in relation to its employees, the benefits offered and its involvement with trade unions.

Customer satisfaction

About a third of utilities companies analysed include a statement of performance in terms of measured customer satisfaction, and just over fifty percent provide a statement of performance in terms of other objective performance measures. Examples include:

- BT Group Plc’s customer survey of business and residential customers indicated that ninety seven percent of orders were completed by the agreed date;
- Railtrack Group Plc attributed the number minutes of delays due to them;
in Leeds and Ipswich, Firstgroup’s guided busways reduced journey times by one third and in Leeds, increased passengers by more than seventy five percent;
• Powergen answered calls in an average of 17.3 seconds in UK call centres;
• Wessex Water has improved its customer guarantee scheme by offering to go above and beyond the statutory minimum required by Ofwat.

Few companies, however, included a balanced range of measures of customer satisfaction such as those they are required to report on to the regulator and with details of benchmark performance or performance against targets. About 15% of the companies analysed did contain some information on benchmarking of performance measures relative to competitors in their annual reports although, not surprisingly, this tended to be when they were at or close to the top of the league table being quoted. John Laing Plc said that twice during 2000, Chiltern Rail was ranked first for customer satisfaction in the national passenger study for the London and South East region and Kelda Group Plc said it was one of the best performers in the industry when assessed against Ofwat results on assessed service scores.

Corporate websites

Introduction

The use of corporate websites as a means of communicating with analysts, investors and stakeholders has grown rapidly in recent years, and all companies analysed had sites. In 2000, the Investor Relations Society (IRS) developed a set of non-prescriptive guidelines for online investor relations, with the suggestion that companies use them based on their own communications strategies, budgets and legal advice. 10 There are a variety of benefits associated with the use of corporate websites, the main ones being:

- timeliness of communication with investors, analysts and stakeholders;
- potential for the creation and retention of investor and analyst interest;
- ability to cover current issues, including takeover threats, in a timely manner;
- the opportunity to link the site with other sites of interest or relevance;
- price – it can be cheaper to maintain a large website than post out thousands of annual reports on request each year.

The IRS suggested that listed company websites have dedicated investor relations sections; all analysed companies did except for Bristol Water Holdings Plc. IRS also had suggestions in relation to timeliness, disclosure and content. Company press releases are available on all websites analysed. Companies’ websites are available in English in all cases, except for Vivendi Environnement SA, which has sections in English. The IRS suggested that registered users be sent email notification of press releases; this is available in about sixty percent of cases; one would have expected BT Group Plc and Vodafone Group Plc to have had this technology on their site, but surprisingly, they do not appear to do so.

Investors and analyst presentations are available on the site to all users in eighty percent of companies in our sample. The transport sector tended not to have these on their sites. Go-Ahead Group Plc, FirstGroup Plc, John Laing Plc and GB Railways Group Plc may, for example, wish to consider this issue. There is a real-time or delayed share price facility, in some cases with graphing capabilities, in over eighty percent of the sample. Considering that one can purchase this sort of information easily it is disappointing that some companies have not done so. Just over twenty percent of the companies in our sample had a website link to the regulator’s website though none of the foreign owned companies did so. About fifty percent of the companies had a link to their regulated subsidiary companies’ websites but only American Electric Power Company Inc and Railtrack Group Plc appeared to have regulatory accounts on their sites. However, regulatory accounts are available instead on the regulated subsidiaries’ websites for Powergen Plc and Severn Trent
Plc. BT Group Plc had a note on their website in relation to regulatory accounts.

There is a separate section on the environment in seventy-five percent of companies analysed and there is a community programme/affairs/social issues section or report on the website in about fifty percent of companies. The only foreign-owned companies doing so were Suez SA and Mirant Corporation Inc. Less than twenty percent of companies had an employee issues report or section on their websites. It may be that these companies make use of intranets where issues are covered in-house but Severn Trent Plc, Centrica Plc, Vodafone Group Plc, BT Group Plc and Railtrack Group Plc are to be commended for their inclusion. Sites worthy of commendation include:

- BT Group Plc has a particularly good website in terms of social responsibility issues, covering a wide range of areas including vision and values, employees, customers, suppliers, environment, community, human rights and sustainability issues;
- Vodafone Group Plc also has a section with reports on corporate social responsibility and links to FTSE4Good (of which it is part) and the Dow Jones World Sustainability Index;
- Railtrack Group Plc has a section containing its report on corporate social responsibility along with a number of health and safety issues;
- BAA Plc and National Express Group Plc have webcasts from their sites;
- BAA Plc has a clear, user-friendly site, with a number of initiatives including a sustainability report and links to the Global Reporting Initiative.

Overall, regulated industries appear to have responded well to the challenge of creating and maintaining sites for investors, analysts and stakeholders, providing information not only in relation to financial aspects of the company but environmental and community issues as well.
Regulated entities’ websites

In the water and the rail industries, for example, most of the regulated entities also have their own websites, separate from those of their parent companies, but these generally focus on marketing or accounts billing information though there are some exceptions worthy of commendation:

- trains

- GNER’s website contains a section on delivering a better railway with information on issues such as reliability, capacity, comfort and facilities, security and competition;
- First Great Western provides a graph charting the performance of their trains against all train operating companies and against a couple of individual companies;
- Thames Trains includes punctuality and reliability measures, with performance against target, for the last year.

- water

- Welsh Water has a whole section of their website devoted to performance and provides a comprehensive summary of the company’s performance on key measures compared with the monitoring plan;
- Wessex Water highlights key achievements in the year to March 2001, including customers’ bills reduced by on average 10% and an efficiency reduction of 3% in operating costs;
- Yorkshire summarised the findings of consultations with customers, undertaken as part of the periodic review by Owat, of their priorities for service and environmental improvements and the price they would be willing to pay for them.

- regulators’ websites

The regulators’ websites tend to be information rich but are not generally strong on visual appeal though the SRA website is among the better designed. Relevant information on regulated entities tends
to be in different places on different regulators’ websites and customer performance information is not generally easily able to be accessed. Moreover, the regulatory accounting information on the websites is generally very limited. ORR helpfully provides links both to the individual train operating companies’ websites and to the listed parents’ websites and Ofgem provides a useful analysis by region of the proportion of electricity and gas customers who have switched suppliers.

Regulatory accounts and governance issues

Accounting framework

In their final proposals paper on ‘The role of regulatory accounts in regulated industries’ the regulators noted that the government’s green paper on utility regulation ‘A Fair Deal for Consumers’ had suggested there would be benefits if companies were to produce more standardised accounts. The final proposals paper indicated that regulators have agreed to adopt a set of common accounting principles (see relevant extracts in Table 11 and 12). These generally deserve support and would be an improvement on the present diverse range of different requirements relating to regulatory accounts (see Table 13) but are expressed in fairly broad terms with a number of references to ‘where appropriate’ or ‘where relevant’. Important issues with reference to the common regulatory accounting framework include the following:

- Even if it is not possible to prepare a SORP under the ASB’s umbrella that is directly used by all regulated entities due to some areas of non-compliance with UK GAAP, the regulators should prepare an equivalent document for direct application by these entities. Where necessary, but hopefully only in a small number of areas, each regulator can provide additional guidance on how accounts are to be prepared in their industry. A case in point would be detailed guidance on determining the carrying amount of assets within the common principle that they should be included at the value determined by the regulator for use in the regulatory final
determination, ie carrying amounts should include discounts at privatization. The regulatory asset value or equivalent should be included in the carrying amount rather than just stated by way of note (as seems to be allowed in the final proposals paper).

- The common guidelines should consider how issues such as pensions and deferred taxation should be dealt with in the regulatory accounts in the light of the new accounting standards in these areas.

- Now that the ownership structure of many regulated industries has changed, and the regulated businesses in some instances are a relatively small part of their listed parent, the regulatory accounts are the primary means to obtain information on the regulated business. Therefore, whilst welcoming the broad direction of the proposal that the published regulatory accounts will include, ‘where relevant and, where appropriate, the additional information normally only required as part of a listed company’s statutory accounts’, we believe the common framework should establish clear guidance covering:
  - the content of the OFR (including information on performance against targets and details of future plans);
  - customer performance reporting (with target and benchmark information);
  - social and environmental performance reporting;
  - governance and risk management.

- The regulators should review the action taken to date to implement the proposals as some regulators appear to have made greater progress than others in implementing their commonly agreed framework. Change to the current requirement is required because regulatory accounts are at present regarded by many stakeholders as of very limited use in decision-making.

- With regards to publication of regulatory accounts, they should be available for each industry on the regulator’s website, with appropriate archive information, and should also be on the regulated entity’s website. The (listed) parent company should at
least provide a cross-reference to them in their annual report and on their website.

Table 11: Agreement by regulators relating to regulatory accounts

- regulatory accounts will be prepared and audited using the common regulatory accounting framework. Where there are any conflicts between Regulatory Accounting Guidelines (RAGs) and UK Generally Accepted Accounting Practice (UK GAAP), then the RAGs will take precedence;
- where practicable there will be consistency between the formats of the regulatory accounts used in the industries regulated by the members of the working group;
- where appropriate, actual performance will be compared to the assumptions underlying price controls;
- the requirements for the audit of the regulatory accounts will become more clearly defined and regulators will have the reserve powers described in chapter 5 (of the final proposal paper);
- regulatory accounts will be published no later than four months after the regulatory accounting year end; and
- where appropriate, the regulatory accounts will include additional information that will enhance understanding of the regulated companies’ performance.

In addition:

- it is not considered appropriate to develop a Statement of Recommended Practice (SORP) for regulatory accounts;
- there will be no requirement for interim regulatory accounts;
- there is further scope to identify and spread best practice between regulatory offices; and
- it is envisaged that the working group will continue to meet in order to discuss matters of common interest and identify issues where collective action would be appropriate.

Source: The role of regulatory accounts in regulated industries. A final proposals paper by [the various regulators], April 2001.
Table 12: Regulators’ proposals on regulatory accounts: publication issues

2.9 The main common areas with respect to publication include:
- where practicable there will be consistency between the formats of the regulatory accounts used in each of the industries regulated by the members of the working group;
- each regulator will decide how the regulatory accounts in its industry should be published;
- the availability of the published regulatory accounts will be properly publicized;
- the companies concerned will make the regulatory accounts available on the Internet;
- the regulatory accounts will be published as soon as possible after the regulatory accounting year-end, with the publication date being no later than four months after the regulatory accounting year-end. However, the deadline may be delayed in a particular year, where a regulator consents to a request from the regulated company for additional time; and
- the published regulatory accounts will include the information identified in paragraph 2.10 below.

2.10 In addition to the primary accounting statements, the associated notes, the directors' report and the auditors' report, the published regulatory accounts will include, where relevant:
- a commentary discussing the results (where appropriate this commentary should be structured to take account of the ASB’s statement on operating and financial review);
- where appropriate, a comparison of actual results to the assumptions made in setting price controls;
- an explanation of the variances between the actual results, the results of the previous year and where appropriate the assumptions made in setting price controls;
- where appropriate, a discussion of the results against plan and an outline of the forward plans for key business drivers such as principal capital expenditure projects, financing arrangements, organisational shape, operational performance and so on;
- a formal statement from the directors of the licensee that the licensee has complied with license obligations such as charges being cost-orientated or that the licensee has not unfairly cross-subsidised or unduly discriminated;
- detailed disclosure of the basis of preparation of the regulatory accounts;
- a note in the regulatory accounts or in supporting documentation as appropriate setting out the regulated company’s estimate of its RAV, how the RAV was determined, the return on the RAV, where appropriate the return on the price control basis and other performance indicators;
- a detailed statement of cost attributions, cost allocations and inter-business recharges;
- where appropriate, the additional information normally only required as part of a listed company’s statutory accounts;
- a reconciliation between the information in the regulatory accounts and other relevant information, such as the statutory accounts, the RAV or data on capital expenditure; and
- any other information that the regulator deems relevant such as references to license conditions or RAGs.
### Table 13: Current regulatory accounting requirements

<table>
<thead>
<tr>
<th>Sector</th>
<th>Licence condition/Accounts Condition[^1]</th>
<th>Regulatory accounting guidelines</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rail network</td>
<td>Condition 12 (4) - to maintain accounting records with such accounting policies as the Regulator may reasonably require.</td>
<td>In the process of being developed. These were scheduled to be published last autumn but were postponed due to Railtrack administration</td>
</tr>
</tbody>
</table>
| Airports        | Condition 1 – 12 transactions that must be reported  
Condition 2 – to describe broad principles which have been followed by the airport operator  
Condition 3 – to describe broad principles that have been followed in allocating costs between airport charges activities and other operational activities  
Condition 4 – accounts must show total revenue and total expenditure associated with operational activities  
Condition 5 – auditor’s report to confirm that the airport operator has compiled with the 1st 4 conditions | No such guidelines publicly available |
| Water           | Condition F – financial affairs of the Appointed Business to be reported as if it was a separately UK listed company.  
The Regulator requires regular accounting information to enable him to compare the financial position and the performance of the Appointed Business | RAG 1 – Current Cost and RCV  
RAG 2 – Classification of expenditure  
RAG 3 – Contents of regulatory accounts  
RAG 4 - Analysis of operating costs and assets |
| Electricity     | Condition 3 – “keep or cause to be kept for the period referred to in Section 222(5)(b) of the Companies Act 1985 and in the manner referred to in that Section such accounting records in respect of each Separate Business as would by Section 221 of the Companies Act 1985 be required to be kept in respect of each such business if it were carried on by a separate company so that the revenues and costs, assets, liabilities, reserves and provisions of, or reasonably attributable to, each Separate Business are separately identifiable in the books of licensee” | Allocation of overheads  
Internal recharges  
Capitalisation policies |
| Gas             | Condition 52 – “keep or cause to be kept for the period referred to in Section 222(5)(b) of the Companies Act 1985 and in the manner referred to in that Section such accounting records in respect of each Separate Business as would by Section 221 of the Companies Act 1985 be required to be kept in respect of each such business if it were carried on by a separate company so that the revenues and costs, assets, liabilities, reserves and provisions of, or reasonably attributable to, each Separate Business are separately identifiable in the books of Licensee”  
Accounting statements and information to have the same content and format (in relation to the supply business and each separate business) as the statutory accounts of the licensee prepared under section 226 and, where appropriate, section 227 of the Companies Act 1985  
Unless the accounting information prepared is on the current cost basis as provided by the alternative accounting rules, the licensee shall, unless otherwise agreed by the Authority, prepare current cost accounting statements for each separate business | No such guidelines available |

[^1]: There are 5 accounts condition that Civil Aviation Authority has added to certain airport’s permission.
Governance issues

The area of governance, risk management and ring-fencing of assets in regulated businesses appears to be one deserving further consideration. Our initial thoughts would be that the regulated businesses should be required to:

- be established as separate legal entities in accordance with the Companies Act;
- fully comply with the principles and provisions of the combined code for the regulated entity (ie, including those relating to having independent directors and nomination, remuneration and audit committees);
- implement the Turnbull Report on risk management at the regulated business level and report accordingly.

We consider that these proposals for ring-fencing the regulated businesses are likely to be in their owners’ interests in the longer term as the risk associated with loaning them debt capital, and hence its cost would be reduced, especially given the extra transparency that would result from implementing the regulatory accounting and governance proposals contained in this paper.

Conclusions

In view of their importance to the economy and to society in general, regulated companies should strive to be at the forefront of best practice in governance and reporting issues, including those related to social and environmental performance. Their long-term success is likely to be significantly influenced by their reputation in the communities they serve.

A regulatory environment that focuses very strongly on competition and financial issues and does not have appropriate regard to broader stakeholder issues is unlikely to serve the long-term public interest.
There has been a major change in the structure of regulated industries since privatisation and the last decade has also seen substantial developments in the fields of corporate reporting and corporate governance. Consideration needs to be given to whether these have yet been fully taken into account in the regulatory system for transport, telecoms and utility companies.

Companies in the regulated industries should be encouraged to fully comply with the combined code. Consideration needs to be given to any amendments that would be necessary to enable the principles of the code to be applied in respect of the regulated businesses.

A number of the listed parent companies of regulated businesses are in full compliance with the combined code. In terms of industries, however, there seems to be a stronger culture of compliance, for example, in the water than the rail sector.

Companies should review their board structure and membership to see that they are giving appropriate weight to social and environmental issues. There currently seem to be few executive directors at main board level with special responsibilities in these areas. There would also seem to be opportunities to draw non-executives from a wider pool, in particular from among those with strong experience of social, environmental or consumer issues.

The companies in the regulated industries which are at the leading-edge of developments in social and environmental issues are among the leading players at national and, in some instances, international levels in these fields. There is, however, significant scope for many of the other companies in the regulated industries to raise their level of performance to more closely approach that of the leaders. Again, in terms of industries, water companies tend to have been ahead of rail companies on environmental and community reporting. Special issues arise in the energy sector where a number of companies have, as a result of the introduction of competition, broadened their geographical area of operation though many still do have a strong presence in given regions.
Regulators’ websites are often relatively information rich but tend to lack visual appeal. Often it is also not easy to access comparative customer performance information for companies in a given regulated sector. There should be easily accessible links in the case of all regulators from the regulator’s website to the websites of regulated entities and their listed parents. A corporate section on each regulators’ websites to which analysts and other users could easily refer would be helpful. The regulated entities’ websites should contain full regulatory accounting and related information, along with relevant data on customer performance and future plans and targets. Websites are also a very suitable medium for publishing social and environmental information. Regulatory accounts should be publicly available online and should form the basis, with as few adjustments as possible, of the information used by the regulator for the purposes of determining the regulatory settlement.

The proposals relating to regulatory accounts set out in their paper, ‘The role of regulatory accounts in regulated industries’, are generally welcome and we would urge all regulators to implement them as a matter of priority. The proposals indicate that development of a SORP under the ASB’s umbrella to apply across the regulated industries is not a practical possibility. Even if this is the case, the regulators should develop a common framework on governance and reporting matters – embracing social, environmental and consumer issues – which should be directly applicable to all regulated entities. Where necessary, individual regulators can provide supplementary guidance on how parts of the framework are to be applied in the circumstances of their particular industry, eg, with regard to the determination of regulatory asset values or their equivalent.
Appendix

Population of companies from which the survey sample is drawn

WATER

<table>
<thead>
<tr>
<th>Licence holder</th>
<th>Ultimate parent</th>
<th>Structure of ultimate parent</th>
<th>Is ultimate parent UK or overseas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anglian Water Services Ltd</td>
<td>awg</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>Dwr Cymru Cyfyngedig (Welsh Water)</td>
<td>Glas Cymru</td>
<td>Debt listed</td>
<td>UK</td>
</tr>
<tr>
<td>Northumbrian Water Ltd</td>
<td>Suez SA</td>
<td>Equity Listed</td>
<td>Overseas</td>
</tr>
<tr>
<td>Severn Trent Water Ltd</td>
<td>Severn Trent</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>South West Water Ltd</td>
<td>Pennon Group</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>Southern Water Services Ltd*</td>
<td>ScottishPower</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>Thames Water Utilities Ltd</td>
<td>RWE AG</td>
<td>Equity Listed</td>
<td>Overseas</td>
</tr>
<tr>
<td>United Utilities Water</td>
<td>United Utilities</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>Wessex Water Services Ltd*</td>
<td>Enron Corp</td>
<td>Shares Suspended</td>
<td>Overseas</td>
</tr>
<tr>
<td>Yorkshire Water Services Ltd</td>
<td>Kelda Group</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
</tbody>
</table>

*Southern Water is now owned by a consortium of Citigroup Inc’s Coll, TBH Investments Ltd, Marquis Ltd, Tavistock Capital Investments Inc, Morgan Ventures Ltd and a private equity investor. The companies purchased the shares in Southern Water from Scottish Power through a jointly controlled special purpose vehicle First Aqua Holdings Ltd.

*Wessex Water is now owned by YTL Power International Bhd and its parent YTL Corp of Malaysia.

Water only companies

<table>
<thead>
<tr>
<th>Licence holder</th>
<th>Ultimate parent</th>
<th>Structure of ultimate parent</th>
<th>Is ultimate parent UK or overseas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bournemouth and West Hampshire Water</td>
<td>Bi-Water &amp; Nuon BV</td>
<td>Privately owned</td>
<td>UK</td>
</tr>
<tr>
<td>Bristol Water</td>
<td>Bristol Water Holdings</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>Cambridge Water Company</td>
<td>Union Fenosa</td>
<td>Equity Listed</td>
<td>Overseas</td>
</tr>
<tr>
<td>Cholderton and District Water Company Ltd</td>
<td>Cholderton &amp; District Water Company Ltd</td>
<td>Privately owned</td>
<td>UK</td>
</tr>
<tr>
<td>Dee Valley Water</td>
<td>Dee Valley Group</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>Folkestone and Dover Water Services Ltd</td>
<td>Vivendi Environnement SA</td>
<td>Equity Listed</td>
<td>Overseas</td>
</tr>
<tr>
<td>Mid Kent Water</td>
<td>Swan Capital Investments</td>
<td>Privately owned</td>
<td>UK</td>
</tr>
<tr>
<td>Portsmouth Water</td>
<td>Brockhampton Holdings</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>South East Water</td>
<td>Bouygues SA</td>
<td>Equity Listed</td>
<td>Overseas</td>
</tr>
<tr>
<td>South Staffordshire Water</td>
<td>South Staffordshire Group</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>Sutton and East Surrey Water</td>
<td>East Surrey Holdings</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>Tendring Hundred Water Services Ltd</td>
<td>Vivendi Environnement SA</td>
<td>Equity Listed</td>
<td>Overseas</td>
</tr>
<tr>
<td>Three Valleys Water Services</td>
<td>Vivendi Environment SA</td>
<td>Equity Listed</td>
<td>Overseas</td>
</tr>
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</table>
### Other regulated water companies

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<tr>
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<th>Structure of ultimate parent</th>
<th>Is ultimate parent UK or overseas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albion Water Ltd</td>
<td>Pennon Group</td>
<td>Equity Listed</td>
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</table>

### TRANSPORT

#### Airports

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<th>Airport</th>
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<th>Is ultimate parent UK or overseas</th>
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<tr>
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<td>BAA</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>London Gatwick Airport</td>
<td>BAA</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>London Stansted Airport</td>
<td>BAA</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>Manchester Airport</td>
<td>Consortium of Manchester Councils</td>
<td>State owned</td>
<td>UK</td>
</tr>
</tbody>
</table>

The airports listed are those where the CAA regulates the charges paid by airlines.

### Rail Infrastructure

<table>
<thead>
<tr>
<th>Licence holder</th>
<th>Ultimate parent</th>
<th>Structure of ultimate parent</th>
<th>Is ultimate parent UK or overseas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Railtrack</td>
<td>Railtrack Group</td>
<td>Shares Suspended</td>
<td>UK</td>
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### Train Operating Companies

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<th>Franchise</th>
<th>Franchise operator</th>
<th>Ultimate parent</th>
<th>Structure of ultimate parent</th>
<th>Is ultimate parent UK or overseas</th>
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<tbody>
<tr>
<td>Anglia</td>
<td>Anglia Railways Train Services Ltd</td>
<td>GB Railways Group</td>
<td>Equity Listed</td>
<td>UK</td>
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<tr>
<td>Arriva Trains Merseyside</td>
<td>Arriva Trains Merseyside</td>
<td>Arriva</td>
<td>Equity Listed</td>
<td>UK</td>
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<tr>
<td>Arriva Trains Northern</td>
<td>Arriva Trains Northern</td>
<td>Arriva</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>c2c</td>
<td>c2c Rail Ltd</td>
<td>National Express Group</td>
<td>Equity Listed</td>
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</tr>
<tr>
<td>Central Trains</td>
<td>Central Trains Ltd</td>
<td>National Express Group</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>Chiltern</td>
<td>Chiltern Railways Co Ltd</td>
<td>John Laing</td>
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<tr>
<td>Connex South Eastern</td>
<td>Connex South Eastern Ltd</td>
<td>Vivendi Environnement SA</td>
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<td>Gatwick Express</td>
<td>Gatwick Express Railway Co Ltd</td>
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</tr>
<tr>
<td>First Great Eastern</td>
<td>Great Eastern Railway Ltd</td>
<td>FirstGroup</td>
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</tr>
<tr>
<td>Great North Eastern Railways</td>
<td>Great North Eastern Railway Ltd</td>
<td>Sea Containers Limited</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>First Great Western</td>
<td>Great Western Trains Co Ltd</td>
<td>FirstGroup</td>
<td>Equity Listed</td>
<td>UK</td>
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<tr>
<td>Island Line</td>
<td>Island Line Ltd</td>
<td>Stagecoach Group</td>
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</tr>
<tr>
<td>Midland Mainline</td>
<td>Midland Mainline Ltd</td>
<td>National Express Group</td>
<td>Equity Listed</td>
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</table>
**CSR AND CORPORATE GOVERNANCE**

<table>
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<th>First North Western Trains</th>
<th>North Western Trains Ltd</th>
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<td>Scotrail Railways Ltd</td>
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<tr>
<td>Silverlink</td>
<td>Silverlink Train Services Ltd</td>
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<tr>
<td>South Central</td>
<td>South Central</td>
<td>Go-Ahead Group</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>South West Trains</td>
<td>South West Trains Ltd</td>
<td>Stagecoach Group</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>ThamesLink</td>
<td>Thameslink Rail Ltd</td>
<td>Go-Ahead Group</td>
<td>Equity Listed</td>
<td>UK</td>
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<td>Thames Trains</td>
<td>Thames Trains Ltd</td>
<td>Go-Ahead Group</td>
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<tr>
<td>Virgin Trains</td>
<td>Virgin Trains Ltd*</td>
<td>Stagecoach Group</td>
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<td>Wales and Borders</td>
<td>Wales and Borders Trains</td>
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<td>Wessex Trains</td>
<td>National Express Group</td>
<td>Equity Listed</td>
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</tr>
</tbody>
</table>

* covers CrossCountry Trains Ltd, and West Coast Trains Ltd

**ENERGY**

**Domestic electricity suppliers**

<table>
<thead>
<tr>
<th>Licence holder</th>
<th>Ultimate parent</th>
<th>Structure of ultimate parent</th>
<th>Is ultimate parent UK or overseas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amerada.co.uk*</td>
<td>Amerada Hess Corporation</td>
<td>Equity Listed</td>
<td>Overseas</td>
</tr>
<tr>
<td>Amerada*</td>
<td>Amerada Hess Corporation</td>
<td>Equity Listed</td>
<td>Overseas</td>
</tr>
<tr>
<td>British Gas Trading T/A British Gas</td>
<td>Centrica</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>British Gas Trading T/A Scottish Gas</td>
<td>Centrica</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>Enron Direct Limited</td>
<td>Centrica</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>London Electricity Group</td>
<td>Centrica</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>Scottish Power Energy Retail Ltd</td>
<td>ScottishPower</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>Midlands Gas Ltd T/A Amerada</td>
<td>Amerada Hess Corporation</td>
<td>Equity Listed</td>
<td>Overseas</td>
</tr>
<tr>
<td>Northern Electric &amp; Gas Ltd</td>
<td>Innogy Holdings</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>Npower Yorkshire Ltd</td>
<td>Innogy Holdings</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
<tr>
<td>Powergen Retail Ltd</td>
<td>Powergen</td>
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<td>UK</td>
</tr>
<tr>
<td>Scottish Hydro Electric</td>
<td>Scottish &amp; Southern Energy</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
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<td>ScottishPower</td>
<td>ScottishPower</td>
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<td>AEP Inc</td>
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<td>Overseas</td>
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<tr>
<td>Severn Trent Energy</td>
<td>Severn Trent</td>
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<td>UK</td>
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<td>Scottish &amp; Southern Energy</td>
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<tr>
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<td>Amerada Hess Corporation</td>
<td>Equity Listed</td>
<td>Overseas</td>
</tr>
<tr>
<td>Yorkshire Electricity</td>
<td>Innogy Holdings</td>
<td>Equity Listed</td>
<td>UK</td>
</tr>
</tbody>
</table>

*Amerada’s trading operations have been sold to TXU Energi.*
The list of suppliers is taken from the Ofgem website. Ofgem notes that a supplier's inclusion on these lists is voluntary. Some licensees may choose not to publish their details. Ofgem states on its website that price restraints on final bills are applied to dominant suppliers (such as regional electricity companies in their own areas).

Note. From 1 April 2002, regulation of gas and electricity supply via price controls will be replaced with the use of powers of investigation and enforcement under competition law.

### Domestic Gas Suppliers

<table>
<thead>
<tr>
<th>Licence holder</th>
<th>Ultimate parent</th>
<th>Structure of ultimate parent</th>
<th>Is ultimate parent UK or overseas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amerada.co.uk*</td>
<td>Amerada Hess Corporation</td>
<td>Equity Listed</td>
<td>Overseas</td>
</tr>
<tr>
<td>Amerada*</td>
<td>Amerada Hess Corporation</td>
<td>Equity Listed</td>
<td>Overseas</td>
</tr>
<tr>
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<td>Dee Valley Group</td>
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*Amerada’s trading operations have been sold to TXU Energi.

The list of suppliers is taken from the Ofgem website. Ofgem notes that a supplier's inclusion on these lists is voluntary. Some licensees may choose not to publish their details. Ofgem states that it imposes some price controls on British Gas Trading – a cap on the differentials between tariff types.

Note. From 1 April 2002, regulation of gas and electricity supply via price controls will be replaced with the use of powers of investigation and enforcement under competition law.
TELECOMS

<table>
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<tr>
<th>Licence holder</th>
<th>Ultimate parent</th>
<th>Structure of ultimate parent</th>
<th>Is ultimate parent UK or overseas</th>
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*BT Cellnet has demerged from BT Group plc, and is now separately listed as mmO2.

The licence holders listed are those subject to price controls as at 28 February 2002.
BT’s existing price controls are due to expire on 1 August 2002.
The price controls relating to interconnection charges for other operators terminating calls to the BT Cellnet and Vodafone mobile networks were due to expire on 31 March 2002.
Following its recent review of the mobile markets, Oftel has proposed charge caps on future termination rates of RPI – 12% over four years.
The four mobile operators (Vodafone, BT Cellnet, Orange and One 2 One) publicly objected to the proposed charge controls. Oftel has referred the matter to the Competition Commission for a decision on whether regulatory action such as charge controls is in the public interest.
The existing controls on Vodafone’s and BT Cellnet’s termination charges are therefore being maintained, pending the outcome of the Competition Commission investigation.