REGULATORY ACCOUNTING AND REPORTING IN UTILITIES AND NETWORK INDUSTRIES
~ OBJECTIVES AND THE STATE OF THE ART

Michael Bromwich
David Brown
Ian Carruthers
Martin Crouch
Kieran Duffy
Elizabeth Dymond

Nick Fincham
David Parker
Jean Shaoul
John Thomas
Mike Toms

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REGULATORY ACCOUNTING AND REPORTING IN UTILITIES AND NETWORK INDUSTRIES

~ OBJECTIVES AND THE STATE OF THE ART ~

Proceedings of a CRI Conference held in association with the Chartered Institute of Public Finance and Accountancy on 9th May 2007 at The National Liberal Club, London Chaired by Peter Vass

Edited by Peter Vass

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Centre for the study of Regulated Industries (CRI)

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Further information about the work of the CRI can be obtained from:-
Peter Vass, Director-CRI, School of Management, University of Bath, Bath, BA2 7AY
or
CRI Administrator, Jan Marchant, Tel: 01225 383197, Fax: 01225 383221, e-mail: mnsjsm@management.bath.ac.uk
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PREFACE

We are pleased to publish the proceedings of the CRI conference on *Regulatory Accounting and Reporting in Utilities and Network Industries ~ Objectives and the State of the Art*, held on 9th May 2007. We wish to thank all of the contributors to this set of proceedings for their papers, but also those who spoke at the conference and participated in the debate, and who are not represented by papers in these proceedings. In particular, we thank CIPFA for their financial support towards the conference.

Effective regulatory accounting and reporting has been shown to be of key importance, with a number of developments in recent years. First, effective accountability is accepted as the basis for effective regulation and regulatory governance, particularly since the House of Lords Select Committee on the Constitution produced its report ‘The Regulatory State - Ensuring its Accountability’ in 2004. Second, the progressive development of the ‘better regulation’ agenda, with its emphasis on consistency and coherence of methodology. Thirdly, the problem of climate change, which means that utilities and network industries are at the forefront of the debate and potential solutions. Their reporting needs to lead the way in integrating environmental, social and financial aspects. This conference has been an opportunity therefore to take stock of current theory and practice, and identify developments for the future.

The CRI publishes a wide range of occasional and technical papers, research reports and regulatory briefs, and encourages those working in the field – whether as academics or in other types of organisation – to submit suitable material for consideration for publication. Enquiries and manuscripts should be addressed to: CRI, School of Management, University of Bath, Bath BA2 7AY.

Peter Vass
Director
CRI
August 2007
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## CONTENTS

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preface</td>
<td>iii</td>
</tr>
<tr>
<td>A policy perspective on corporate regulatory and Government reports</td>
<td>1</td>
</tr>
<tr>
<td><strong>Michael Bromwich</strong></td>
<td></td>
</tr>
<tr>
<td>Information and other issues in competition inquiries</td>
<td>13</td>
</tr>
<tr>
<td><strong>Elizabeth Dymond</strong></td>
<td></td>
</tr>
<tr>
<td>Opportunities for self and co-regulation - a personal view</td>
<td>27</td>
</tr>
<tr>
<td><strong>David Brown</strong></td>
<td></td>
</tr>
<tr>
<td>Reporting subsidies, costs and investment in the privatised railways</td>
<td>35</td>
</tr>
<tr>
<td><strong>Jean Shaoul</strong></td>
<td></td>
</tr>
<tr>
<td>Ofgem’s regulatory reporting framework</td>
<td>51</td>
</tr>
<tr>
<td><strong>Martin Crouch</strong></td>
<td></td>
</tr>
<tr>
<td>Ofwat’s regulatory reporting framework</td>
<td>59</td>
</tr>
<tr>
<td><strong>Kieran Duffy</strong></td>
<td></td>
</tr>
<tr>
<td>ORR’s regulatory reporting framework</td>
<td>73</td>
</tr>
<tr>
<td><strong>John Thomas</strong></td>
<td></td>
</tr>
<tr>
<td>The CAA’s regulatory reporting framework</td>
<td>81</td>
</tr>
<tr>
<td><strong>Nick Fincham</strong></td>
<td></td>
</tr>
<tr>
<td>Respondent - Competition</td>
<td>93</td>
</tr>
<tr>
<td><strong>David Parker</strong></td>
<td></td>
</tr>
<tr>
<td>Respondent - Transport</td>
<td>97</td>
</tr>
<tr>
<td><strong>Mike Toms</strong></td>
<td></td>
</tr>
<tr>
<td>Respondent - Public sector accounting</td>
<td>99</td>
</tr>
<tr>
<td><strong>Ian Carruthers</strong></td>
<td></td>
</tr>
</tbody>
</table>
A POLICY PERSPECTIVE ON CORPORATE, REGULATORY AND GOVERNMENT REPORTS

Michael Bromwich

Introduction

I am pleased to open this important conference on regulatory accounting and reporting by giving my own personal policy perspective in this area. I do so as an observer of the scene, rather than a practicing regulator, though I have for a number of years advised the Office of Fair Trading (OFT) on accounting and finance matters and have written on cost structures in telecoms. Here, I have time to touch briefly on only a number of points. I will first address some general issues as I see them, emphasising competition rather than regulatory issues. Second, I will look at some accounting issues, adopting both a regulation and competition perspective.

The current regulatory scene

To an outsider a number of things are striking about the current competition and regulatory scene. Looking, widely, there seem to be a very large number of regulators with quite diverse objectives, methodologies and characteristics; the existence of many of which is often not generally recognised. Many of these are outside the area of utilities and network industries. Two, perhaps fairly contrasting, examples are the Financial Services...
Authority (FSA) and the Housing Corporation. The first seeks to protect investors by ensuring the quality of the staff in the financial markets and by enforcing behavioural rules. The second seeks to ensure the financial viability of social housing assets and to achieve value for money and efficiency in providing social housing and tenant satisfaction. It also provides funding for social housing. One question that arises is: does this large number of regulators have much in common, and could they learn from each other in events like this conference? I would venture to suggest that a large number of these regulators are concerned with both reducing the effects of market failures on the ultimate consumers, and trying to protect them by requiring published information that aids the customers in understanding the activities of service providers in order to improve the accountability of the service providers.

A general and pervading current belief in society seems to be that providing transparent information to consumers, especially investors, is a significant way to help overcome many problems in poorly functioning markets. As an accountant cum economist, I do not see increased information as a general panacea. The utility of increased information depends on the market in which it is being used. An informationally transparent monopolist is still a monopolist. Providing more or different information can only go so far in dealing with externalities not taken into account in the market. Even where the market problem is information asymmetry, information provided to overcome this problem may be difficult for lay consumers to understand or act upon. Moreover, the information required to improve consumer welfare in the face of market failure may be substantially different to that required to enforce public accountability.

There seems to be a very strong desire by the authorities, including governments and the EC, for deregulation. Here regulation should be understood as detailed and comprehensive control of conduct, not just concerning pricing but often including investment and service quality. Of course, the ability to deregulate varies between industries with, perhaps, telecoms
leading the way. The success of deregulation may depend on the length of time the regulator has had to encourage competition, given the success of deregulation depends on the ability to encourage well-behaved markets in the place of regulation. Deregulation needs care as better markets do not mean that all consumers will necessarily be better off than they were under regulation.

In my view, where regulators are permitted to undertake anti-competitive or market studies, more and more of them are beginning to focus either on the correction of non-competitive aspects of the relevant markets, or ameliorating market failures through trying to stop non-competitive practices. I suspect that seeking to inhibit anti-competitive activities is in some ways more difficult than regulation as the case against such practices has to be compelling in itself, and also in law, whereas regulation may allow the participants to look at the overall outcome for them and see it to a degree as the result of a bargaining exercise where gains in some areas allow losses in other areas to be tolerated. In contrast, anti-competitive cases stand on their own, and depend on the reasonableness of the cost allocations and business plans available which have to be, perforce, provided by firms which seek to show that their behaviour is only a reasonable response to competition.

Moreover, my feeling is that this increase in the desire by regulators to undertake more market studies may be compounded by an increase in the demand for these studies by both competitors and consumers. Both groups are becoming more aware of this opportunity. It is relatively cost free for the complainants and cheaper than resort to litigation, which seems to be used much more in the USA. Following from this, there may be more pressure for more rapid responses by regulators. A possible problem with more competition complaints is that regulators will have to find some logic for selecting those cases to be given priority with only limited resources.
A possible problem with dealing with alleged instances of anticompetitive behaviour is that solving problems in one area may cause difficulties to appear in other areas. For example, reducing penalty fees on credit cards because they do not seem to be cost based may provoke significant responses from banks - the threat of the loss of free banking (I should say I had nothing to do with the OFT study in this area). Part of this problem is the usual unintended consequences of all types of regulation. This makes it essential to monitor the consequences of regulatory intervention. It is not clear to me that this always done routinely.

My impression is that the law has become very important in regulation and in anti-competitive studies. Certainly the standard of proof required of the OFT in competition studies seems very high. I do wonder whether the influence of the law may make some regulators rather risk averse. In my view, any such characteristic could be compounded by the existence of the Competition Appeal Tribunal, which is the appeal body for competition cases for OFT, the Competition Commission and utility regulators. As I understand, this tribunal can look at the competition issues from scratch and often examines in detail the regulator’s methodology, thereby increasing the uncertainty borne by regulators. I am not a lawyer but I feel this may impose a major burden on the relevant regulators and may make them further risk averse in the face of appeal uncertainty. I do not know the history but I do wonder why the usual notions that you can appeal only on the facts, and on the law as found by the subordinate court, was not followed, at least in the competition area.

I am not clear that over time the asymmetry of information between firms and regulators has eased much. Basically, and not surprisingly, the balance is weighted heavily against regulators because of, amongst other things, knowledge of the industry and the different amounts of resources available to the regulators and to firms.
From some experience, I am not sure that regulatory accounts are always very helpful to regulators, if only because generally they involve allocations between regulated and unregulated services, which may be far removed from the area of interest, within highly complex and intertwined organisation structures. Thus, such accounts have to be very carefully designed to be helpful.

Solutions to the information asymmetry problem are not obvious. Often independent expert advisers are not available. One possibility is to use the historical business plans used by the firm which can be shown to have been acted on by boards, rather than plans designed to answer the regulator’s questions. Few regulators have sufficient resources and knowledge to build their own models of the firms involved. Appropriate bench marking is clearly useful in helping to overcome this problem.

Alternative approaches to competition regulation

I get the impression that with competition enquiries that some commentators feel that regulators should take a more US style approach - look for suspicious market behaviour and try to prove intent. Search out the incriminating email. This is, perhaps, a much more exciting ‘007’ approach to investigating competition than looking for excess profits. This ‘police’ type approach is very popular in the United States.

It would involve moving away from the UK tradition of, in the early and later rounds of possible and actual investigations using amended accounting figures in both searching for excess profits and determining the cost of efficient firms. I believe that with this approach, the possible drivers for such profits should be discovered and clearly identified, prior to looking for excess profits.
One problem with the accounting approach to regulation is that value to the ultimate consumer does not figure strongly. Though I believe that this can be incorporated into ROI regulation, I do agree with commentators that estimates of the effects on consumer surplus have not figured strongly in the UK regulatory literature.

Some accounting issues

There are many reasons to believe that current financial reports are not very helpful in regulation. A few examples are given below.

Financial reports are basically backward looking. They report the historical cost of past transactions, though there is a fair amount of the future in even conventional financial reports. Depreciation gives an indication of the length of asset lives and, similarly, bad debts provisions provide an estimate of future debtors. Impairment also tells us about the future. This is where the carrying value of an asset on the balance sheet is written down if it is greater than the highest present value in use by the firm, that is, the present value of its future cash flows, and its market sale price. Revaluations of assets indicate the market’s view of the asset’s future cash flows as seen at a given time by participants then transacting in the market. Such revaluations may not be actioned regularly over time. Many intangible assets are not recorded as assets in conventional accounting and, more generally, conventional financial reports are conservative, that is, understate current income and understate asset values in the balance sheet.

Thus, with conventional financial reporting information, the regulator has to seek to segregate anti-competitive excess profits from both normal operating profits and those obtained legitimately from permitted market dominance. This requires that the regulator seeks to define some ‘normal’ return with which to ‘benchmark’ actual and planned profits. Many
commentators believe this to be an impossible task and doubt whether the conventional corporate cost of capital, in any of its many guises, can serve this role.

Generally, regulators seek to overcome the understatement of the asset base by historical cost valuation by using instead the current cost of replacing the services provided by assets. This practice can be defended using analytical economic and accounting models. Such a valuation equates with what a new entrant would have to pay to enter the industry on the same scale as the incumbent or incumbents. Elsewhere in accounting, current cost accounting is less fashionable. This use of current cost is an example of the need for regulators to sometimes depart from generally accepted accounting principles (GAAP), where necessary for their purposes. They are often constrained in this by the, at least, claimed weaknesses in the management accounts of firms.

Often this need to deviate from GAAP means that regulators are seeking to deal with accounting problems that do not yet have generally accepted solutions and may, perforce, have to be leaders in solving such problems. For example, regulators in network industries are leaders, usually with the industry’s cooperation, in determining long run marginal costs and dealing with joint costs.

Another example of taking the lead in dealing with accounting problems arises when deciding whether to include some or all of claimed corporate intangibles in the asset base. Without their inclusion, the asset base may make little sense in industries where intangibles are important but the wholesale acceptance of claimed intangible assets may overstate the asset base. There is a need for a theoretical foundation here. My own view, which is not dissimilar to those of the Competition Commission and OFT, is that depending on the character of the regulatory exercise being conducted, qualifying intangibles should be permitted. The qualifications or constraints I would impose include:
A POLICY PERSPECTIVE

• claimed intangibles should not be part of what has been called the firm’s internally generated goodwill, or the fruits of organisational efficiency, which include the net present values of individual projects expected to earn more than the going rate of return and the net present value of synergies between sectors of the firm. Such benefits accrue to the firm as a whole and cannot be allocated to individual projects. More importantly for regulators, internally generated goodwill would include any expected benefits of market exploitation and of anti-competitive behaviour, the extent of which regulators are seeking to determine;

• they should be not part of usual operating costs;

• they should be separable in their cash flows from other assets;

• their cash flow contribution should be able to be clearly ascertained, that is, the benefits they yield to the individual consumer should be clear and, ideally;

• each intangible should, at least, be able to be conceived as saleable as a single unit.

The underlying theory here is that intangibles would be valued at the estimated price a new entrant would pay for them as separable assets.

Accounting reports are not sufficiently segmented for regulation, where the concern is often with sections of the organisation not used in published segmental reporting. Segmental reporting in financial reports may become more useful where, as will be required by International Accounting Standards, reports have to follow the same structure as segmental reporting within the firm and as reported to the Board. This would at least give a base with which to reconcile the firm’s answers to the questions about the organisational sector of regulatory interest.
However, many commentators feel that what is missing for the regulator and investors in general are published narrative reports of business objectives, business strategies for achieving these objectives, product successes, amounts invested in research and development and intangibles and the expected returns from assets. None of these items are required to be shown in published financial reports. This led to demands for the ill-fated Operating and Financial Review (OFR) in the UK, a narrative report to accompany the financial reports which included these items as part of a strategic forward review, but also included detailed corporate social responsibility information with major key performance indicators. It was ill-fated as, after many years of discussion in the business community, the requirement for it was placed in the Company Law Reform Bill (2005), only for the Chancellor of the Exchequer to announce its withdrawal in November 2005, ostensibly as a way to reduce red tape.

Companies now have to provide only a business review which is required by the EU. Although the business review covers much the same ground, the OFR was much more strategic and forward looking and required explicitly items like those listed above. These statements no longer need to be provided. Of course, this is information regulators require and which they can demand of companies involved in inquiries. However, there is much to be said for regulators being able to use information in the public domain, and to be able to reconcile the corporate information provided to them with published information that carries with it a positive audit opinion, together with a statement that they have not discovered matters inconsistent with the OFR as was required with the OFR. Thus, the existence of the OFR may have helped regulators.

Finally, I deal very briefly with some changes in the concepts behind International Accounting Standards and in published financial reports and ask whether such changes will help or hinder regulators.
A POLICY PERSPECTIVE

Changes in conceptual framework of the International Accounting Standards Board

Currently the standard setting emphasis is away from the age old principle of matching costs and revenues over time, and therefore away from giving priority to periodic income. Standard setters now wish to include in balance sheets only those accounting items which meet their definitions of assets and liabilities. Costs which do not meet these tests will be written off in the income statement. With this approach, income is seen as the difference between net assets at the end of the period and those at the beginning. This should give a better and generally understood capital base, though one less comprehensive than in the past. This, however, is at the expense of income having little meaning, at least, as a guide to the on-going operating profits, as profits will incorporate all gains and losses in assets values. This approach will make it much more difficult to use accounting numbers to forecast future periodic profitability and profits from operations. The achieved better capital base will, by no means, be perfect as it will not include intangibles but will include some revaluations made at the discretion of firms.

A far greater possible change in financial reporting by standard setters is to require that all assets and liabilities be valued at fair value where fair value is defined as a market price obtained in good markets with actors that have no unfair advantages relative to each other. Perhaps this is where the term fair value comes from. Such market prices may not necessarily be based on actual transactions but rather on hypothesised market prices. Moreover, there is a strong move by standard setters to base fair values on exit prices: what a firm could get if sold individually and one by one its assets, and settled separately each of its liabilities.

So far the application of fair value accounting in accounting standards has been only to some financial assets and some liabilities, to business combinations and to asset impairments.
There is some disagreement with the claimed identity between fair values and exit prices with some commentators, such as the UK Accounting Standards Board, arguing that in some circumstances fair value should be defined as the current cost of replacing non-financial assets. The general view of the business community is that the US standard setter and the International Accounting Standards Board will in due course seek to extend fair value to all non-financial assets.

It is far too early to suggest what a full-scale adoption of fair value would mean to regulators. It would seem to give a better understanding of what is in the asset bases of firms. Ideally, the profits from a firm, determined under fair value in a well-organised market, are equal to earning a normal return on the opening asset base of the period, thus, providing a possible benchmark for regulators. But, at first glance, I am not convinced that this will provide a very useful benchmark.

First, because the asset base is determined by what could be realised by the incumbent if the incumbent were to leave the industry. In contrast, the wish of regulators is to estimate the asset and liabilities required by a firm trying to enter the industry. Secondly, the asset base would be that assumed to result from a well organised market in assets and liabilities, free of market power. Not necessarily the type of markets often encountered by regulators. Thirdly, asset values would be based on the selling prices of assets and liabilities.

Such valuations do not capture the value to the firm of all assets and liabilities including those held for the long term, those assets specific to the firm, and the value of any synergies between assets where, for example, assets are used in interdependent bundles, a usual characteristic of ‘hi tech’ firms. Also, asset valuations will include only items that are seen by standard setters as assets. Current examples of non-assets include research expenditure and many in-house generated intangibles.
A POLICY PERSPECTIVE

There may also be difficulties with the income numbers generated. For example, income here does not provide a good basis for estimating on-going profits, including the effects of market distortions. Part of income would arise from increases or decreases in asset valuations in the market which have not yet been realised in sales by the firm. Making sense of realised profits relative to this income comparator would be difficult. Realised profits would include the results of all the items left out of the asset balance and the periodic gain from market dominance and the periodic fruits of anti-competitive behaviour.

In sum, there are many opportunities and challenges emerging for regulators, especially in dealing with non-competitive practices.
INFORMATION AND OTHER ISSUES IN COMPETITION INQUIRIES

Elizabeth Dymond

First, I should say, as was clear from Peter Freeman’s speech to the CRI last September, that the Competition Commission (CC) has not in fact done much work on regulated industries in the last five years.\(^1\) Therefore, in that context, how relevant to this conference is what I might have to say?

However, the situation appears to be changing. Whilst one could have said last year that we had done nothing in the regulated sectors since looking at a water merger in 2003 and no regulatory inquiries since 2002, we are now more active in the regulated sector.\(^2\) \(^3\) \(^4\) I will come back and set out what these references relate to.

As two of these recent references are market investigation references, I thought that I could talk about the framework for market investigations, what has happened in such investigations in other sectors and about some of the issues that we’ve faced in

\(^1\) Freeman P (2006), Regulation and Competition: Chalk and Cheese? The Role of the Competition Commission, CRI/ECPR Conference, Frontiers of Regulation: Assessing Scholarly Debates and Policy Challenges, 7-9 Sept 2006. Peter Freeman’s speech is available on CRI and Competition Commission websites.

\(^2\) Vivendi Water UK plc & First Aqua (JVCo) Ltd, full details can be found at www.competition-commission.org.uk/

\(^3\) The categories of regulatory inquiries that the CC can conduct are set out in Peter Freeman’s speech, cited above.

\(^4\) Manchester Airport PLC (20/12/02), BAA PLC (29/11/02) and Mobile Phone charges (6/1/03) available on Competition Commission website.
conducting these inquiries.\textsuperscript{5} This would be based on a belief that such issues might become increasingly relevant to regulated companies.

**Update**

First of all, I will update you on recent references or appeals in regulated sectors. These have all happened since Peter Freeman’s speech to the CRI conference in September 2006.

**South East Water/ Mid Kent Water merger**

This was a mandatory water merger reference made to us last November and concerned the purchase by Hastings of, in effect, South East Water when it was already the owner of Mid Kent Water.\textsuperscript{6} The question that the CC had to answer in this merger reference was not the general merger test of whether the merger had resulted, or was likely to result, in a substantial lessening of competition, but rather whether the merger had prejudiced or may be expected to prejudice the ability of the Water Services Regulation Authority (otherwise know as Ofwat) in carrying out its functions to make a comparison between water companies. In our final report, published on the 1 May, the CC concluded that this merger could be expected to prejudice Ofwat’s ability to make comparisons but that the extent of the prejudice was limited.\textsuperscript{7} The CC, nevertheless noted that certain consumer benefits would be generated by the merger and its remedy, which was a price reduction to customers of the merged companies, totalling £4m, took these benefits into consideration. In particular, the CC concluded that the merger was expected to result in cost savings that would be passed on to customers

\textsuperscript{5} Many of the points made, for example, with regard to choice of cases, importance of the timetable and difficulties in making markets more competitive have been made in speeches by other senior members of the Competition Commission over the last year.

\textsuperscript{6} www.competition-commission.org.uk/inquiries/

\textsuperscript{7} www.competition-commission.org.uk/press_rel/
through future regulatory price reviews. The merger may also result in improved water resource sharing and planning across what were previously company boundaries. The CC’s choice of a price reduction remedy allowed these benefits to be retained.

**Heathrow and Gatwick quinquennial review**

This was the compulsory reference to us by the Civil Aviation Authority under the Airports Act 1986, requiring us to report back to CAA on the question of the maximum amount that Heathrow and Gatwick should be allowed to charge by way of airport charges. This reference only relates to Heathrow and Gatwick as there is a possibility that Stansted Airport may be de-designated, and so no price control may be required for that airport. The references also requires us to consider the conduct of Heathrow and Gatwick airport over the last five years and whether they have pursued any course of conduct that has, or might be expected to operate, against the public interest. These reviews must be completed by the CC within a six month period from the 30 March.

**BAA airports market investigation**

The Office of Fair Trading (OFT) also announced on the same day as the CAA’s announcement that it had decided to make a reference to us for an investigation into the supply of airport services by BAA within the UK. The OFT stated that it had concluded that it had reasonable grounds to suspect that the following factors combined to prevent, restrict or distort competition:

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9 Department for Transport consultation on de-designation (February 2007) at www.dft.gov.uk/consultations.
COMPETITION COMMISSION INQUIRIES

- BAA’s high regional market share in the south east of England and lowland Scotland;
- the system of economic regulation of airports;
- capacity constraints.

In addition, The OFT also stated in its press release that it considered there was evidence of poor quality of service at BAA airports, particularly those in the south east of England.\(^\text{11}\) They noted that this low quality appeared to go hand in hand with relatively high user charges. The OFT considered that, together, these factors raised a valid question as to the benefits to consumers of the current situation. The OFT stated that, in its view, the lack of competition between BAA’s airports in both the south east of England and lowland Scotland might lead to higher charges and higher yields and, ultimately, higher costs than would be the case if these airports were owned by separate firms. These are all preliminary conclusions and it is over to us now to report on this market, for which we have the statutory two years.

Rolling stock market investigation

On the 26 April the Office of Rail Regulation (ORR) announced its decision to refer the leasing of rolling stock for franchised passenger services to us for further investigation.\(^\text{12}\) This decision followed a public consultation by the ORR following which it remained of the view that certain market features limited competition and had the potential to lead to train operating companies paying higher prices and receiving poorer quality of service than would otherwise be the case in a more competitive environment. The ORR noted that rolling stock leasing is a significant part of train operating costs, around £1bn a year.

\(^\text{12}\) Office of Rail Regulation Press Release (2/5/07).
**Code modification appeal relating to gas offtake arrangements**

This relates to an Ofgem decision of 5 April that was appealed to the CC on 30 April. Dealing with code modification appeals is a new responsibility of the CC. Although we have had a previous appeal that was subsequently abandoned, this may be the first to run its course.

**Potential work - mobile phone termination charges appeal**

On the 27 March, Ofcom announced new charge controls limiting the amount that mobile network operators are able to charge other telephone companies for connecting calls on their networks.13 These controls apply to Hutchinson and other providers of 3G services, as well as 2G network operators who were previously subject to regulation. Any appeal against this decision would go in the first instance to the Competition Appeal Tribunal but we would be involved in any part relating to the price control (Communications Act 2003)

**Market regime**

Two of these recent references involving regulated sectors are market inquiries. So I now turn to the basis of the market investigation regime and the CC’s experience of it to date.

**The CC and the UK Market Investigation Regime**

The market investigation regime (MIR) gives the CC the power, on reference from the OFT or one of the concurrent regulators, to investigate markets, to assess restrictions of competition and to impose remedies (if needed). These regulators may choose

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13 Ofcom press release (27/3/07) at www.ofcom.org.uk/media/news.
whether a market investigation or some other further measures are appropriate in any given situation.\textsuperscript{14} \textsuperscript{15} Whether to make a reference to the CC is, unlike the case for mergers, a discretion rather than a duty.\textsuperscript{16} The hurdle for exercising this discretion is not high.

Market investigations enable the CC to take an in-depth look at markets where competition is not thought to be working well, but where the problem does not at first sight appear to emanate from single-firm dominance or hard-core cartels.\textsuperscript{17} They are meant to be detailed and thorough, and to apply a cure rather than a punishment. The CC has a statutory maximum of two years within which to complete a market investigation, although we aim to do them somewhat faster.

\textit{Adverse effects on competition}

The MIR relies on a flexible legal framework based on adverse effects on competition (AEC). An AEC arises where “\textit{any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of goods or services in the United Kingdom}”

\textsuperscript{14} ORR’s power to make a market investigation reference to the CC derives from section 67(2A) and (2B) of the Railways Act 1993; GEMA’s in relation to gas derives from section 36A(2A) and (2B) of the Gas Act 1986 and, in relation to electricity, from the Electricity Act 1989, section 43(2A) and (2B); Ofwat’s derives from section 31(2A) and (4) and section 36 of the Water Industry Act 1991; Ofcom’s derives from section 370(1) to (3) of the Communications Act 2003; and the CAA’s derive from section 86(2) and (4) of the Transport Act 2000.

\textsuperscript{15} Such market studies by the OFT or regulators can also result in the following outcomes: (i) the market is given a clean bill of health; (ii) information is published to help consumers; (iii) firms are encouraged to take voluntary action; (iv) a consumer code of practice is recommended; (v) recommendations are made to regulators or to the government.

\textsuperscript{16} Section 131(1) of the Enterprise Act states that the OFT (or a sector regulator) “\textit{may}” make a reference if it has “\textit{reasonable grounds for suspecting}” that an AEC exists.

\textsuperscript{17} A good summary of this is given in the Explanatory Notes to section 370 of the 2003 Communications Act.

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or a part of the United Kingdom”. The AEC test has a considerably wider scope than Articles 81/82 EC (or chapters I/II Competition Act 1998) and can arise from one or more of the following features of the market:

(1) the market structure;
(2) the conduct of suppliers or acquirers of goods or services;
(3) the conduct of customers.

Conduct includes any failure to act, whether intentional or not, and any other unintentional conduct.

**Undertakings ‘in lieu’ of a reference**

It is open to the OFT or the sectoral regulators to accept undertakings from the parties to avoid the need for a CC reference. This power has not been much used so far. Undertakings were, however, accepted by Ofcom in the BT case in September 2005.

**CC decisions and remedies determinative**

A CC decision is final and effective, subject only to review by the CAT, as to the existence or otherwise of an AEC. If the CC finds an AEC, it has a duty to remedy it in as comprehensive a way as possible, taking account of any consumer benefits that might thereby be put at risk. Section 168 of the Enterprise Act 2002 (EA02) requires the CC to have regard to regulator’s statutory functions when determining what remedial action would be reasonable and practicable. Remedies may include

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18 Enterprise Act 2002, section 134(1).
19 Enterprise Act 2002, section 131(2).
21 Undertakings given by British Telecommunications Group plc to Ofcom on 22 September 2005. Undertakings were also given to OFT in relation to Postal Franking Machines.
recommendations for action by others (including deregulatory measures), in particular to change existing legislation.\textsuperscript{22}

\textbf{Decisions}

Since the market investigations came into force in June 2003, nine investigations have been initiated. Of the six initiated prior to 2007, the CC has published final decisions on four and the fifth will be published May 2007. Looking at the four decisions offers a varied pattern:

- \textbf{In Store Cards}, the CC found competition problems in the downstream market and adopted essentially informational remedies – particularly a requirement to draw customers’ attention to interest rates exceeding 25\% (which, as you may have heard, came into effect this month) as well as requiring certain insurance products to be unbundled from the store card provision.\textsuperscript{23}

- \textbf{In Bulk Domestic Liquid Petroleum Gas (LPG)} the CC found that customers could not easily switch suppliers and decided on measures to make the transfer of LPG tanks between suppliers much easier.\textsuperscript{24}

- \textbf{In Home Credit}, a market where the CC found very little competition but a rather fragile industry, it opted for market opening measures through improved data sharing; better information for borrowers on what obligations they are taking on; and an adjustment to the early settlement rebate régime to remove an existing inequity.\textsuperscript{25}

\textsuperscript{22} The CC got quite close to doing this in relation to the safety régime for Domestic LPG.
\textsuperscript{23} Store Cards Final Report (7/3/06).
\textsuperscript{24} Liquid Petroleum Gas Final Report (29/6/06).
\textsuperscript{25} Home Credit Final Report (30/11/06).
• In Classified Directories Advertising Services, price controls on Yell, publisher of Yellow Pages in the UK, will continue, although in a modified form.  

In the fifth, the CC found provisionally, last autumn, an opaque and rather sclerotic situation in Northern Irish Personal Banking and its published remedies working papers set out a series of potential informational remedies. The final report with remedies will be published May 2007. In Groceries, the sixth market investigation, we have recently published several working papers and our Provisional Findings Report will be published in September. Of the three market references made this year Payment Protection Insurance (PPI), BAA Airports and Rolling Stock Companies, it is too early to say what our findings will be, let alone what any possible remedies, if necessary, may be.

So having explained how the regime operates and some of the actions we have taken to date, I turn to some of the issues arising from the regime and for us at the CC.

**Choice of cases**

First, market investigations are not to be undertaken without careful consideration. The intensity of the process and the resources consumed by authorities and parties are such that the use of this instrument must be applied only to the most needy cases. This places great importance on the OFT and other sectoral regulators considering carefully, on the basis of all the information that comes available to it, which cases are appropriate for detailed investigation. The current market inquiries into Groceries, the Airports market and Payment Protection Insurance certainly give us some significant areas to investigate.

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26 Classified Directories Advertising Services Final Report (21/12/06).
27 Northern Irish Personal Banking Final Report (15/5/07).
28 PPI Term of Reference (5/2/07).
29 BAA Airports Term of Reference (29/3/07).
30 Rolling Stock Companies Term of Reference (26/4/07).
In terms of choice of cases, it is also important to consider the interaction of the MIR with other CC roles. The CC now has parallel competition and regulatory references in relation to the airport sector as it did in relation to British Gas in 1992.\(^{31}\) The CC is therefore faced with considering the same (or an overlapping) factual situation from both the competition and regulatory standpoints. Although this presents some problems, it is probably good that these issues can be considered by the same institution.

**Significance of AEC**

Market investigations should be neither arbitrary nor disproportionate in their operation. It is true that most markets can probably be said to be not ‘working well’ in some or other respect. And assessing what a competitive market would be, when confronted with a possibly uncompetitive one, is not a precise science. But here the CC’s accumulated experience of judgment comes into play. An AEC will not be found on the basis of transitory conditions – adverse effects will be considered from the point of view of durability and sustainability. Interventions will be kept to an appropriate level. This was essentially why no formal test of ‘appreciability’ or *de minimis* was included in the legislation.

**Transparency and timing**

Market investigations are genuinely difficult to do fully and fairly in a manageable time frame. The statutory maximum is two years and cannot be extended. The CC accordingly aims to conduct the substantive part of its investigations within approximately the first year (this will not always be possible), leaving the remaining time to cover the all important aspects of remedy formulation (tasks which pre-Enterprise Act often took much longer than this). To achieve this, the CC has to keep

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\(^{31}\) There were four British Gas references in 1992: two under the Gas Act and two under the Fair Trading Act 1973.
ELIZABETH DYMOND

control of its timetable and the principal parties must play their part in the process.

**Dilemma of the ‘last word’**

It was said that when the Enterprise Act was in gestation that competition authorities’ understandable wish to run a transparent process was doomed to be self-defeating; that they would be condemned to an endless cycle of argument and counter-argument and it would always be open to parties under investigation to argue that the authority had failed to consider their last argument. Sir Derek Morris, when he gave evidence to the House of Lords in 2003, called it the ‘vicious circle’ problem pointing to the growing habit of parties demanding to know whether their arguments had been accepted and, if not, demanding to know why, so that those reasons could, in turn, be rebutted with the threat, actual or implied, of judicial review at each stage.

Peter Freeman, our chairman, has called this the problem of ‘the last word’. In an argument that must, by law, arrive at a decision, who has the last word? The statute says us, obviously, but deciding when enough has been said, against what may look like a barrage of demands for further iterations, can be problematic.

This issue arose recently and significantly in the Home Credit case where the focus of that part of the argument was on profitability, and what methodology we should employ. However, the essential point is of general application. It is this – we are not required to ‘agree’ our conclusion with the parties under investigation.

On technical matters, and competition cases are often highly technical, we will continue to engage within the constraints of our published procedures in what can loosely be called a ‘dialogue’ with the parties affected. This is to understand the evidence and arguments they are presenting. To enable this dialogue to be useful, we are normally prepared to disclose the
COMPETITION COMMISSION INQUIRIES

essence of our analytical approach and methodology, the evidence we are relying on and, to a degree, the direction this is pointing us in. We will also try and indicate which part of a party’s case we accept and which we do not, together with an indication of why. We will consider carefully arguments made in response. What we will not do is table our proposed conclusions for discussion and continue the dialogue until the parties accept what we are saying or vice versa. At the point where we feel justified in saying ‘you’ understand the position we are taking and ‘we’ understand your objections, we will then bring the discussion to a close and resolve the case.

This seems the only solution to the dilemma of ‘the last word’. And it involves a stringent approach to timetables, particularly as a case nears its close. Provided these have been made clear in an investigation (and timetable and end-dates are normally very clearly signalled), it will be difficult for us to give weight to argumentation put in late, and deadlines for comment and correction will shorten. We are not obliged to take the maximum permitted time for our inquiries (although this is not uncontroversial – we received a letter on a recent market investigation querying our intention of meeting ‘its non-binding, unilaterally imposed timetable’ which was only a couple of weeks short of the two year limit). We see it as a valid objective, which meets the occasional criticism that our process is too heavy a burden on business, to conclude a case as soon as reasonably possible on the basis of a published and properly enforced administrative timetable.

Conclusion

*Pragmatic balance to produce coherent result in two-year timeframe*

It is clear (and was indeed clear from the CC and the Monopolies and Mergers Commission’s past history of monopoly
investigations) that the scale of the task of investigating markets is potentially very great, and that a pragmatic balance has to be struck between thoroughness and duration to produce a coherent result. The statutory minimum period of two years is long enough to get to the bottom of the issues but not so long as to lead to data obsolescence. It should also be noted that in comparison to many other competition investigations, two years is a short duration, and the statutory time limit cannot be extended.

**Pragmatic use of far-reaching remedies powers**

The cases so far suggest that the CC is showing an appropriate degree of caution in the way that it applies the far reaching powers at its disposal. In each of the four cases so far concluded, it has been firm in its findings but measured and pragmatic in its remedies, in particular resisting calls for price controls in Store Cards and Home Credit.

The CC has in this respect operated entirely predictably and professionally, preferring to be, as our chairman says, “rigorously wise rather than spectacularly foolish”.

**Inherent difficulty in making a market ‘more competitive’**

These first cases, whilst possibly not in themselves of enormous individual significance, have served to highlight one of the challenges for the régime. This is the inherent difficulty in making a market ‘more competitive’. In the cases so far, possibly with the exception of CDAS, the CC has placed emphasis on the perceived low level of customers switching suppliers and have interpreted that partly as a reflection of information asymmetry and poor customer understanding, particularly, of financial products. The remedies have thus concentrated in part on requirements to provide better information and on the nature and structure of prices in
COMPETITION COMMISSION INQUIRIES

particular. But that assumes that better informed customers will put pressure on suppliers to compete.

These direct interventions in the competitive activity of providers have been relatively modest – certainly proportionate – in the situations that have so far arisen. So the question arises, whether the CC will make more drastic use of its powers, in particular to order division or divestment of suppliers found to have abused the position of market power that they enjoy? The answer has to be that the CC will certainly do this in an appropriate case where such a remedy can seen to be acceptable and justified.

Whether such a case will arise in a regulated sector, we will have to wait and see.
OPPORTUNITIES FOR SELF AND CO-REGULATION – A PERSONAL VIEW

David Brown

Introduction

This paper offers a personal view, covering: the industries the Office of Communications (Ofcom) regulates; how it approaches regulation; the contribution industry can make to effective regulation; and how the role played by industry has informed Ofcom’s recent assessment of BT’s regulatory financial reporting requirements.

What does Ofcom do?

- a statutory corporation established by the Communications Act 2002;
- the regulator for the UK communications industries;
- responsibilities across television, radio, telecommunications and wireless communications services;
- covers both content and infrastructure in the communications sector.

How does it do it?

Ofcom’s approach takes account of a number of key principles. It is described by some as ‘light touch’ regulation. Three key
points can be drawn from Ofcom’s list of principles to give some context to this term:

- bias against intervention – but will intervene firmly and quickly if required;
- seeking the least intrusive mechanism;
- remaining at forefront of technological understanding.

These three points hint at why industry can contribute to effective regulation. Perceived benefits of industry involvement include:

- expertise;
- (relative) flexibility and speed;
- lower regulatory burden for industry;
- lower cost to regulator (less relevant industry important for regulator).

How can industry help?

Self-regulation is a live issue for Ofcom. Its 2007/08 annual plan sets out strategy for three years and policy priorities for 2007/2008. Policy priorities include reducing regulation and administrative burden, including considering the extent to which self-regulation (administered and enforced by industry) and co-regulation (involving both industry and regulator) offer an alternative to formal regulation. Content regulation and the scope for individuals to play a wider role have been identified as areas for particular focus. Therefore it is helpful to consider criteria for promoting effective self-regulation identified by industry and Ofcom. Issues identified during the 2004 consultation with industry included the following:

- beneficial to consumers;
- clear division of responsibility between co-regulatory body and Ofcom;
- accessible to members of the public;
• independence from interference by interested parties;
• adequate funding and staff;
• achieve and maintain near universal participation;
• adequate funding and staff;
• effective and credible sanctions;
• auditing and review by Ofcom (including key performance indicators);
• transparency and accountability;
• consistent, proportionate and targeted regulation;
• appropriate appeals mechanism;
• ability to diverge from the above criteria where appropriate.

In my opinion, it is likely to work best when:

• industry, rather than regulator instigates; and
• incentives are aligned (industry and customer/within industry). ABTA is good example of aligned incentives and ‘cost’ of not belonging,

Where does industry already have a role?

Industry and regulator involvement in regulation can be considered across a spectrum between statutory and self-regulation, passing through varying degrees of co-regulation.

Figure 1 illustrates this by identifying a number of regulatory bodies and indicating where they might sit on this spectrum. Those on the left were instigated by industry and those on the right by the regulator.
Figure 1: Co-regulatory bodies

The Independent Committee for the Supervision of Standards of the Telephone Information Services (ICTSTIS) and the Advertising Standards Authority (ASA) (re: the Broadcast Committee of Advertising Practice (BCAP) and Committee of Advertising Practice (CAP)) are funded by industry. The role of ATVOD (Association of TV on Demand) illustrates some of the challenges facing Ofcom and its ability to regulate content. IWF (Internet Watch Foundation) illustrates the potential role of the consumer in not only self-regulating but contributing to regulation.

An informed industry may also contribute in other ways

A well-informed industry can contribute to an effective regulatory environment. This is a key factor in our current review of BT’s regulatory financial reporting regulations. Ofcom requires regulatory financial information to monitor and enforce various obligations that are placed on BT in markets where they are found to have significant market power. The regulatory financial reporting regime also provides confidence to the
industry that certain ex-ante obligations are being effectively monitored and enforced.

The financial reporting regime includes published information plus information provided only to Ofcom. Published information provides evidence of first order tests of compliance with obligations. Over time the publication requirements have evolved and have increased in size and detail. Last year’s report was over 200 pages long. Against a background of changes in the commercial and regulatory environment – notably the creation of Openreach – it made sense to revisit these obligations. BT and Ofcom both provided their interpretation of the obligations. BT’s proposed a 37 page report. Ofcom’s proposals were for a 100 page report. The underlying obligations were the same – so why the difference in report size?

A key difference between BT’s and Ofcom’s proposals is the perceived role of industry. BT considers that it is for Ofcom alone to monitor BT’s compliance with its obligations. Ofcom considers that a key question is whether it is sufficient for industry to be informed that BT has demonstrated compliance with its obligations or whether there is a role to be played by industry in reviewing, challenging and potentially using this information to stimulate effective regulation, competition and innovation. Informed by examples provided by industry of how the published information has been used in the past, I believe that an informed industry contributes to a more effective regulatory environment. Disputes and investigations will be resolved more quickly, efficiently and on the basis of more reliable information.

Specifically, relying solely on the regulator’s assessment of whether compliance has been demonstrated carries the risk that either:

- important issues that may have been identified by stakeholders will remain unnoticed; or
• Ofcom’s allocation of scarce resources to important issues will be reduced as it is obliged to consider an increased number of speculative complaints raised by less well informed stakeholders.

Further, the publication of cost and volume data has provided a foundation for significant regulatory and competitive developments. For example, the early development of flat rate internet access call origination was enabled in significant part by the existence of published costing information that allowed Internet Service Providers to calculate the underlying costs of new interconnection services that they had requested in advance of BT’s voluntary provision of such information. This triggered faster development and take-up of internet access services than otherwise would have been the case.

The economic benefits of the disclosure were therefore considered to be greater than the costs of publishing the information.

Challenges ahead

Robustness of cost data: Changes in network infrastructure mean a higher proportion of costs will be fixed, with implications for interpretation of cost orientation. Publication of cost data – eg, long run incremental cost (LRIC) data - becomes less informative to industry.

Significance of cost data: In some markets – the Openreach markets for example – we are seeing a trend towards quality of service rather than price as the key concern of industry. Quality of service already subject to some co-regulation via the Office of the Telecom Adjudicator. However, against the background described above of moving towards self-regulation where possible, this is an area where greater – not less – regulatory intervention may be required. Ofcom is therefore considering
whether it is appropriate to formalise the regulation of quality of service.

Conclusion – a personal view

Industry and individuals have a role to play as part of effective regulation and Ofcom has a duty to promote self-regulation and is actively looking to do so. In some areas this may take the form of regulatory bodies, in others this may simply be the contribution made by an informed industry (or consumer). However, Ofcom must not forget its principal duty to protect the interests of citizens and consumers and this may mean that more formal solutions remain necessary.
OFCOM’s REPORTING FRAMEWORK
REPORTING SUBSIDIES, COSTS AND INVESTMENT IN THE PRIVATISED RAILWAYS

Jean Shaoul

Introduction

My purpose today is to examine the reporting and disclosure by both the regulatory authorities and the private sector of public subsidies, the cost structure of the different elements of the industry, and the cost of operating passenger services. By way of contrast, while other speakers have dwelt on the need of the regulatory authorities for such information for decision making purposes, my aim is to focus on information to the public for accountability purposes. This is important because public subsidies are funded by taxation, a compulsory levy that citizens must pay, and granted not to a state owned enterprise as in the past, but to the private sector, which has very different objectives.

The concept of accountability in the context of public expenditure on essential public services implies that, first citizens or at least their political representatives, the media, trade unions, academics, etc, can see how society's resources are being used, and, secondly, that no members of that society are seen to have an explicitly sanctioned unfair advantage over others in relation to how those resources are used. In the context of the privatised railways, accountability also includes the issue of regulatory accountability: that the regulators are seen to be doing their job properly.

But first, it is necessary to place Britain’s privatised railways in their broader context. When the Conservative government
announced in 1993 that the nationalised railways were to be broken up and sold off, it claimed that the private sector would find the finance for the much needed investment programme, make the railways more efficient and deliver a better service to the public. But these promises ignored the basic realities of the industry. As a highly capital intensive industry, railway networks – as opposed to individual lines or services – the world over are unable to recover the full cost of running the industry, including the cost of enhancing the infrastructure and extending the network and rolling stock, from the fare box. Nevertheless, the railways’ broader economic, social and environmental benefits justify public investment. In Britain, the nationalised railways already had the highest labour productivity in Europe, making it difficult to reduce costs further without affecting service and quality, and the lowest subsidies.¹

Furthermore, while as with the public utilities, rail privatisation was accompanied by regulation, ostensibly to protect the consumer, in reality the duty of the regulator was to ensure that the infrastructure company, Railtrack, could continue to finance its activities, as the rail regulator argued when the government put Railtrack into administration, albeit without Railtrack pursuing that course of action to its ultimate conclusion. This necessarily includes the cost of private debt, which is higher than public debt, and equity returns. In other words, costs would increase. There was therefore no financial headroom for any transformation of the industry.

As everyone now knows, the outcomes of privatisation have shown that the new owners were indeed unable to overcome the constraints of the industry and transform it in the way that the government had claimed. More importantly, the industry now has one of the highest fare structures in the world and is increasingly dependent upon a system of public subsidies and capital grants to the train operators and the infrastructure.

company – far more so than under public ownership. Subsidies have risen to nearly £6bn a year by 2006-07, including £1.2bn for the Channel Tunnel Rail Link.²

The reporting of subsidies

Train operating companies

The Conservative government asked the bidders to state the level of subsidies required and awarded the passenger franchises on the basis of the lowest level of subsidy needed for running the existing services and enhancing or providing extra services, such as new trains that were to be leased from the rolling stock companies (ROSCOs) and refurbished stations.

In total, the level of franchise support commitments from all sources was £1.8bn in 1998, £1.5bn in 1999, and £1.3bn in 2000, the first three years of full privatisation, more than double that given to British Rail (BR) in the late 1980s, before the restructuring of the industry for privatisation. While the government claimed that the level of subsidies paid to the train operating companies (TOCs) would fall and ultimately the franchises would pay premia to the government, these estimates proved hopelessly optimistic.³ Subsidies to the TOCs were never less than £1bn a year (in 2002) and since then have risen to about £1.5bn in 2006-07 (Secretary of State for Transport, 2005).

But it is difficult to get detailed, consistent and accurate data on subsidies and support from the TOCs’ regulator, variously the Office of Passenger Rail Franchising, the Strategic Rail Authority (SRA) and now the Office of Rail Regulation (ORR) and the Department for Transport (DfT). While the SRA

² Secretary of State for Transport (2005), Statement to the House of Commons, February 10/2005.
published information on subsidies in its annual National Rail Trends Yearbook 2004, this is far from clear. For example:

- The Yearbook shows the proceeds of privatisation as negative amounts, which are then subtracted from all the other forms of government support in the relevant year to reach a ‘net’ figure. This results in apparently low levels of support for the years ending March 1996 and 1997.
- The SRA’s different publications produce per company data that do not always reconcile to the aggregate annual total, data that vary in format from year to year and data that are not explained in the footnotes.
- The SRA reports completely different subsidies for two of the early years in its Annual Report and Accounts 2003-04 from those listed in its National Trends Yearbook 2003-04. In subsequent years, the amounts differed by up to £200m.
- Such is the complexity of the system that the SRA had to publish an erratum for the 2003-04 subsidies in its Annual Report and Accounts 2003-04.
- While the SRA reports the net level of subsidies in aggregate and the amount paid to each of the TOCS annually, it does not explain the purpose or itemise the different elements to the subsidies that include a complex system of penalties and incentives that affects the net amount of grants paid to the TOCs.
- It does not explain how and why the amount paid differs from the level expected earlier.
- While the penalties are reported on a per company basis in the SRA’s annual National Rail Trends, no historical series is shown, so it is necessary to have recourse to different sources to chart the trend.
- It is impossible to identify from the SRA’s sources which TOCS received ‘compensation’ for failures by the infrastructure company, Railtrack/Network Rail, or how much, although some information does become available in a

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4 Strategic Rail Authority (2004), National Rail Trends Yearbook 2003-04, Strategic Rail Authority.
piecemeal fashion. For example, in the three years to 2002-03, the train companies netted between £150m and £200m in compensation from Network Rail.\(^5\)

But while such disclosures are not made to the public, they are made to the London Stock Exchange (LSE). For example, Stagecoach, one of the owners of Virgin Trains which operates the West Coast franchise, announced in June 2003 that it was to receive a £282m subsidy as compensation for the problems on the West Coast Main Line which prevented the company operating its new trains. Stagecoach had to make this announcement to the stock market, because LSE rules require such disclosure. It appears that the government inserted ‘gagging clauses’ in the TOCs’ contracts restricting their right to give in depth interviews to journalists. But again, since the SRA does not identify and publish such information in a clear and consistent way on an annual basis, it is unclear how this is reflected in its data relating to subsidies.

Some of the problems have undoubtedly arisen because of the complexity of the system and the failure of both the TOCs and the government’s advisors to vet the TOCs’ original bids carefully enough. The level of subsidies has risen \textit{ex post facto} for various reasons. Firstly, the TOCs were reimbursed for the increased charges to access the network as the infrastructure company’s costs rose. However, nowhere is it set out how the track access charges have impacted on subsidies. Secondly, when many of the TOCs faced insolvency, the SRA was obliged to step in to ‘ensure continuity of train services’, increase the subsidies and/or amend the franchise agreements. Again, the amounts, the companies involved, and the reasons for this are not identified. The press reported claims from the industry that the government was imposing ‘gagging clauses’ to prevent the TOCs disclosing information about their bailouts. Thirdly, over one third of the franchises were converted into management only contracts with payment to the TOCs on a ‘cost plus’ basis and a

higher subsidy for less risk, prior to re-tendering the franchises.\textsuperscript{6} While the SRA admitted that these contracts were more expensive, the impact on subsidies was not explicitly disclosed (SRA, 2003).

There is also a growing absence of financial transparency in franchising. The award of the Inter City East Coast franchise in 2005 was published without the profile of the premia to be paid to the government, presumably because the public would be able to see the adverse impact this would have on fares and/or the financial viability of such a scheme, which in this case, it clearly was not.\textsuperscript{7} The contractual obligations and the companies’ financial models are not published for reasons of commercial confidentiality, as the Office of Rail Regulation’s web site explains. Yet when the companies are unable to meet their obligations, they simply hand back the keys, leaving the tax payers to pick up the tab.

It should also be noted that while the TOCs report the total subsidies received in their annual report and accounts, this is not itemised. Furthermore, these do not always reconcile with the SRA figures, in part due to accrual and timing differences. While apparently the government requires the TOCs to provide regulatory accounts which presumably prescribe the format and detailed content of such accounts, these are not made available to the public.

\textit{The rolling stock companies}

The government also provides support for the industry in other ways about which it is impossible to get information. Firstly, the SRA has used s54 of the 1993 Railways Act to ‘give comfort’ to the rolling stock companies (ROSCOs) that a successor franchise will be obliged to take over rolling stock for a defined period even though the residual risk remains with the ROSCOs and is

\textsuperscript{6} Strategic Rail Authority (2003), Strategic Plan 2003: Platform for Progress, Strategic Rail Authority.

\textsuperscript{7} Ford R (2005), Modern Railways, pp21-22.
priced into the contract. Secondly, the government has provided ‘letters of comfort’ to their financiers. However, there is no clear statement of any of the contingent liabilities connected with these forms of support in either the SRA’s strategic plan or its annual report and accounts.

The infrastructure company

After Railtrack’s collapse, the SRA paid capital grants directly to Network Rail, Railtrack’s successor, for work on the infrastructure. Again, however, the amounts reported in Network Rail’s accounts do not match the grants set out by the SRA. Various government statements indicate that these mounts have risen and while some publications and statements include the capital grants for the Channel Tunnel Rail Link (CTRL), others do not. Grants to Network Rail, excluding CTRL, were due to reach £2.86bn in 2006-07 (Secretary of State for Transport, 2005).

The SRA does not systematically publish information about the penalties exacted for poor performance and delays caused to passenger services that are supposedly part of the TOCs’ contracts with Railtrack/Network Rail, even though this is substantial, running into hundreds of millions of pounds. Presumably, grants to Network Rail have had to rise to meet the cost of the compensation paid to the train operators.

In other words, it is difficult to get a clear, systematic and detailed account of the level of subsidies and to whom they have been paid from the SRA and other public agencies’ publications. It is a matter of some concern that the reporting of billions of pounds of tax payers’ money and potential liabilities and future commitments is so opaque. It raises questions as to the regulatory authorities’ control and competence over and accountability for such large sums of public money.
REPORTING RAIL SUBSIDIES

The reporting of the railways’ costs and investment

The train operating companies

With no standardised reporting format in the TOCs’ annual report and accounts, it is impossible to obtain detailed information about their income and costs. While the regulators collect the information, it is not put in the public domain for reasons of commercial confidentiality, as the Office of Rail Regulation’s web site explains. The combined revenues of the 25 train operating companies rose from £4.6bn in 1997 to £5.8bn in 2003, which was more than double BR’s total revenues in the last year (1993-94) of public ownership due to increases in fares and passenger numbers, ‘revenue protection’ measures, and subsidies, which were considerably higher than in the 1980s and early 1990s, and accounted for £2.1bn or 71% of total income in 1996, declining to £1.45bn or 26% in 2004.8

Most of the TOCs’ revenues (75%) went on external purchases, mainly track access charges, train leasing and maintenance, with most of what remained going on wage costs.9 Thus the rolling stock companies and the network operator are also beneficiaries of the subsidy regime. But the increase in revenues notwithstanding, the companies are totally dependent upon subsidies to recover their costs and deliver a profit. Without subsidies, the companies made a loss every single year and there is no expectation that the losses will be eliminated in the foreseeable future, or at least while the present financial regime is in place. Indeed, had the ‘market’ and the franchise agreements operated as intended, many of the TOCs would have gone out of business, had not the SRA intervened with extra subsidies and/or franchise amendments, as explained earlier.

Their operating profit before interest and tax were typically about 3-5% of total revenues, including subsidies, despite revenues and subsidies more than double BR’s. While their profit margins as a percent of total income were low, their post tax returns on shareholders’ funds were at least 140% after 1997. The TOCs paid out £160m in dividends to their parent companies in 2003 and £1bn since privatisation, due to the extensive system of public subsidies not superior performance.

Should the economy move into recession and passenger numbers decline, then many of the TOCs could find themselves in financial difficulties, generating a need for further subsidies to bail them out, as most of their costs are fixed, and higher subsidies for future franchising rounds. In other words, this is by no means a stable situation. Furthermore, since most of the TOCs’ income went on charges for track access, rolling stock, and maintenance, it was their suppliers, Railtrack/Network Rail, the three rolling stock companies and the engineering companies that also benefited from the subsidies.

The rolling stock companies

Again there is no prescribed format for their accounts other than that required under the Companies Acts and the Accounting Standards Board, or at least not in the public domain. The three rolling stock companies’ annual revenue was about £860m in 2004, entirely derived from leasing charges to the TOCs.10 There is no breakdown of their costs in their annual report and accounts that enables the cost of maintenance to be ascertained with any certainty. As a leasing operation with low running costs, the ROSCOs averaged a 45% operating profit margin, a post tax return on shareholders returns of 27% in 1998 declining to 8% in 2004, and paid dividends to their parent companies totalling £1.4bn since privatisation. Yet despite being the most profitable part of the railway industry, they have remained largely invisible and are not subject to direct regulation. There is no publicly

available information about the leasing charges for old trains that were fully paid for by BR via public debt that the government retained after privatisation, the leasing charges for new trains, or the leasing regime post-2001 and 2004 when the old agreements expired.

Under the terms of their franchises, many of the TOCS were required to commission new trains from the leasing companies and received subsidies to do so. It is difficult to reconcile the ROSCOs’ investment in new trains with the SRA’s data. There is no detailed breakdown produced by any of the regulatory authorities, including the NAO’s report, of the cost of the trains.11 Many of the trains were delivered late, were unreliable and in some cases had to be mothballed because they were incompatible with the infrastructure, thereby generating further costs to other parts of the system, as well as additional subsidies, without impacting on the ROSCOs (NAO, 2004). For example:

- the SRA paid or is committed to paying additional subsidies of some £760m to four TOCs to offset the additional costs associated with the new trains;

- under the terms of the contracts, further subsidies to the TOCs are necessary to pay for the cost of mothballing trains awaiting improvements to the infrastructure before entering service, as well as the cost of leasing replacement trains;

- the estimated £1.2bn cost of the necessary improvements to the infrastructure to accommodate the new trains will ultimately be borne by higher track access charges and thus subsidies and fares;

- although the leasing charges will have paid for the new trains, which have a life of at least thirty years, within about seven years, the TOCS will continue to need subsidies to help cover the leasing costs for the remaining 23 years.

The infrastructure company

Since Railtrack’s collapse, Network Rail’s income has risen to £3bn in 2003, £2.6bn in 2004 and £3.8bn in 2005. Two points should be noted. Firstly, income now includes grants from the SRA of £996m in 2003, £452m in 2004 and £2,058m in 2005 and £2.8bn in 2006. That is, it now receives a direct subsidy as well as indirect subsidies via the train operators’ track access charges. This was conceived as a way of paying part of the existing and agreed future track access charges to compensate for the fall in income due to speed restrictions and the increased cost of maintenance and renewals following Hatfield.12 Secondly, income is shown after deducting penalties payable to the train operators of £442m in 2003 and £396m in 2004. But it is unclear how either sum relates to the data published by the SRA.

Nevertheless, despite bringing back maintenance in house, an annual saving estimated variously at £170-250m and £300m, and the additional grants from the SRA, losses rose to £688m in 2004, reflecting a change in when the SRA’s grant was paid and the increase in post-Hatfield costs inherited from Railtrack, before falling back to £96m in 2005 (Transport Select Committee, 2004). Investment grew to record levels, £3.8bn in 2004 and £3.5bn in 2005. Long term debt soared to £9bn in 2004 and £16.85bn in September 2005, and is expected to rise to £23.5bn between 2009-2014.13

In 2003, the ORR set the track access charges at a total of £19bn for 2004-2009, a 50% increase on the determination in 2000, creating in turn the need for some combination of increased rail fares and subsidies to the train operators, and reduced services. Consequently, in 2003 the SRA scaled back the TOCs’

investment plans and dropped long-delayed schemes, in order to ensure that the TOCs could pay the track access charges (SRA 2003). The SRA admitted that cost-cutting, fare increases and line closures were under consideration: for while branch lines account for 17% of the 11,000mile network, they take 64% of the operating subsidy. Only a year later, the ORR set the revenue requirement for the five year period at £22.7bn (ORR, 2005).

A parliamentary minute (September 15/2005) stated that the government would make Network Rail’s debt guarantees more explicit and wider ranging to reduce the cost of borrowing by £250m per year. It would issue a long term indemnity to back all Network Rail’s borrowing. Thus, irrespective of Network Rail’s claim that it is getting costs back under control after the dark days of Railtrack, there is no disguising the fact that it is reliant on ever larger explicit and implicit government support.

While Network Rail’s debt and loan guarantees are shown on the whole of government accounts, its debt is scored as private sector debt on the National Income accounts. This is because the government has no formal control over the company and its loans. This piece of creative accounting enables the Chancellor to claim that government debt is lower than it really is and thus satisfy his own rules on government borrowing. But this only means that the government’s implicit debt is mounting. In other words, the infrastructure company’s ever mounting costs consequent upon privatisation and the break up of the industry has not only led to increased costs but also greater risks to the taxpayer.

How has all this impacted on the cost of running Britain’s railways? In 1993-94, the last year of operation under nationalisation, BR’s total income from passengers, freight, parcels, subsidies and grants was, according to its accounts, £3.6bn. While there is some discrepancy between the amount of subsidies/grants recorded as being received by BR and that disbursed by the Department for Transport, much of it is accounted for by grants in relation to the Channel Tunnel Rail
Link (CTRL), which are excluded from this analysis. Given that BR did not on average make a sufficient surplus to cover all its costs, then BR’s total income of £3.6bn broadly equates with the cost of running the railways.

In contrast, in 2003 the comparable figure for the industry had risen by £3.8bn to a staggering £7.4bn, the sum of the total income – including subsidies – of the train and freight operators that filter down to the ROSCOs, Network Rail and their suppliers, plus the direct grants to Network Rail. That is, the railways’ income had more than doubled. While £1.7bn of this came from the increase in subsidies since 1994, £1.9bn was the result of increased receipts from passenger (due to an increase in both fares and patronage). That is, the public has funded this increase via both taxes and fares. Since 2003, this has risen even further.

Given that BR’s income served as a proxy for its costs, this in turn means that the annual cost of running the railways has more than doubled. In 2003, the identifiable interface costs (cost of private finance and returns to equity for the TOCs, ROSCOs, Network Rail and all the subcontractors), were about £1,000m, of which a small part will return to the exchequer as corporation tax. In other words, even after Network Rail was established on a ‘not for profit basis’, nearly half of the £2.2bn subsidies in 2003 went to the providers of finance, a cost that would not have been incurred under public ownership. Furthermore, it also suggests that the transaction costs and loss of skills and expertise resulting from the fragmented industry have led to a considerable part of the £3.8bn in increase in costs in 2003 compared with 1994. While it is indisputable that some of the increased cost is the result of the greater capital expenditure since privatisation, the cost would not have been as high due to the lower cost of public borrowing and the lower cost and greater efficiency of operating in an integrated industry. But this in turn means that the public as tax payers and passengers have funded the increased and more costly investment, not the private sector as successive governments and the industry have claimed.
Conclusion

From the perspective of the axioms of accountability stated in the introduction, which are of course intimately related, several conclusions flow from this analysis.

First, it is far from easy to understand the subsidies, costs and investment of the railways, because there is little disclosure of the most basic information by all the parties concerned to the public. It is deeply concerning that the government and the regulatory authorities have not seen fit to ensure that detailed, consistent and accurate information is put in the public domain.

Second, a privatised railway system is a very expensive way of providing public transport and must, without bringing the railways back into public ownership, lead to cuts in public services elsewhere and/or tax rises, that is, a cut in the social wage. The chief beneficiaries have been the providers of finance, rather than the passengers, taxpayers and citizens as a whole, leading to a redistribution not from the rich to the poor but from the mass of the population to the financial elite.

Thirdly, to the extent that the regulators’ role is to protect the consumers and the kinds of information and analysis detailed in this paper are not in the public domain, then the regulatory authorities and the government provide little accountability.

In short, the reporting of the railways’ finances does not pass the accountability test, as set out in the introduction. These issues are not unrelated. This in turn raises the possibility that the government obscures what it does not wish to reveal and for which it has no democratic mandate.
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REPORTING RAIL SUBSIDIES

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OFGEM’s REGULATORY REPORTING FRAMEWORK

Martin Crouch

Introduction

Incentive regulation of natural monopolies, as applied in the Great Britain energy sector, relies on information provided by the regulated companies. It is vital to the integrity of, and confidence in, the regulatory framework that the data used is reliable. The Office of Gas and Electricity Markets (Ofgem) has made significant progress in the last few years in improving the framework it uses for collection and assessment of regulatory data – but we continue to seek further improvements.

Background

In common with other sectors, Ofgem’s predecessors in the 1990s collected data through regulatory accounts, price control compliance returns and business plans developed specifically for price control reviews. In the electricity distribution sector, the price review in 1999 identified weaknesses in the framework for reporting outputs, which led to an Information and Incentives Project. This involved redefinition and assessment of data relating to power supply interruptions and a new process of technical audit of that data.

The use of data in companies’ 1999 business plans was criticised in the National Audit Office (NAO) report ‘Pipes and Wires’, which recommended improvements to the regulatory accounts.\(^1\) Despite substantial effort in this regard, no breakthrough was

\(^1\) National Audit Office (2002), Pipes and Wires HC723, HMSO.

Martin Crouch, Director, Electricity Distribution, Ofgem
achieved and we still required a major normalisation exercise in 2003-04 for the next price review. Following that review (DPCR4), Ofgem and the distribution companies developed a new regulatory reporting pack for cost data. Alongside this we developed a new model for price control compliance. These are discussed further below.

**Principles**

In developing our regulatory reporting framework, we are seeking to improve the reliability of critical data and to comply with the principles of better regulation. In many ways these will be complementary rather than requiring trade-offs. We participated in work with the NAO in 2005/06 which drew out the key principles set out in Figure 1.²

**Figure 1: Principles for managing regulatory information**

<table>
<thead>
<tr>
<th>Co-operative</th>
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<tbody>
<tr>
<td>• Regulator and companies establish an open, dialogue-based relationship.</td>
</tr>
<tr>
<td>• Regulator and companies adopt a transparent and consultative approach to identifying information needs.</td>
</tr>
<tr>
<td>• Regulator and companies establish arrangements to provide feedback on the process of providing information.</td>
</tr>
</tbody>
</table>

![Diagram showing the relationship between Co-operative, Outcome-focused, Efficient, Robust, and Adaptable principles]

Source: NAO (2006)

² National Audit Office (2006), Managing Regulatory Information, unpublished work by the NAO. Ofgem contributed to this work along with Ofwat, Water UK and ENA.
The over-arching principle is of co-operation between the regulator and the companies to establish information provision based on understanding what is required and how best to achieve it. This contributes to the other elements:

- Outcome-focused: whereby planned analysis is linked to project aims; information requirements are directly and causally linked to the planned analysis, and reflect the evolving market context and regulatory role;

- Efficient: where information requirements are based on an understanding of the key economic drivers combined with a risk assessment; in a process that minimises the burden on companies having discussed the optimal method of providing information, and with clarity throughout the data request and collection stages;

- Robust: the information collected is used in the project and can be traced to output; the regulator understands the quality of data provided and takes this into account; the processes stand up to internal and external review, and reflect the tensions inherent in the regulatory system;

- Adaptable: the regulator regularly reviews information requirements to ensure they are necessary and sufficient, explains and justifies proposed changes in a timely manner, and considers and justifies any differential treatment of companies; and companies accept the need to provide information in a consistent format.

Scope of reporting

While attention tends to focus on financial returns, such as the regulatory accounts, the system of regulatory reporting in the GB electricity distribution sector also includes a wide range of other requirements. In addition to the areas noted above, this includes:
OFGEM’s REPORTING FRAMEWORK

• reports on separation of monopoly from competitive businesses, such as a business separation compliance officer’s report and returns relating to the financial ring-fence;

• reports published for the benefit of network users, such as charging statements and long term development reports;

• in 2006, and potentially in future, responses to a letter from Gas and Electricity Markets Authority’s (GEMA) chairman seeking confirmation of the quality assurance of regulatory reporting.

Example of process for cost reporting

As an example, this section outlines the new process we have developed for cost reporting. The process began in the latter stages of the last price review with the development of a reporting spreadsheet and a set of instructions and definitions. These were developed very much in co-operation with licensees. The current version is published on our website. We have set out the objectives of the process. They are to:

• calculate the regulatory asset value (RAV) in accordance with the DPCR4 final proposals;
• improve the robustness and consistency of the cost data;
• reduce the reporting burden during price control review;
• avoid varying interpretations between companies of definitions and reporting requirements.

The process we adopted for 2005/06 data is summarised in Table 1 below.
Table 1: The process for cost reporting

<table>
<thead>
<tr>
<th>Date</th>
<th>Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>End July 2006</td>
<td>Data submitted by companies</td>
</tr>
<tr>
<td>August</td>
<td>Ofgem identified first pass issues</td>
</tr>
<tr>
<td>8 September</td>
<td>Data re-submitted by companies</td>
</tr>
<tr>
<td>Mid-September</td>
<td>Ofgem issued discussion points pre-visit</td>
</tr>
<tr>
<td>Sept-November</td>
<td>Company visits (3 days per group, team of 4-5)</td>
</tr>
<tr>
<td>End November</td>
<td>Final re-submission taking account of actions from visits</td>
</tr>
<tr>
<td>Dec-January 2007</td>
<td>Discuss outstanding issues (especially RAV calculation)</td>
</tr>
<tr>
<td>January 2007</td>
<td>Cost report published</td>
</tr>
<tr>
<td>January 2007</td>
<td>Informal consultation on revisions to instructions</td>
</tr>
<tr>
<td>8 February</td>
<td>All company meeting to discuss changes</td>
</tr>
<tr>
<td>Feb-March</td>
<td>Formal consultation on amendments</td>
</tr>
</tbody>
</table>

We have published the cost report each year including annual RAV additions which provides more transparency to investors. The process of review has increased confidence in the most important items of data, although there is further to go in that regard. We are using our improved understanding to focus on key data and reduce unnecessary requests.

The process does involve significant resource. Based on discussions with the companies, we understand that each of the seven management groups running the licensees has required of the order of 2 person-years to complete the pack each year. As far as Ofgem’s resources are concerned, this task comprises the majority of the workload of a finance and reporting team that has an overall budget approaching £400,000 a year.

In terms of benefit, we do expect this process to streamline the process during a price control review, but probably not to the extent of offsetting five years of annual review costs. A significant part of the benefit lies in better quality of information

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3 The annual reports and instructions can be found at www.ofgem.gov.uk
and understanding, and more accurate recording of the RAV where adjustments have amounted to tens of millions of pounds in aggregate so far. Some of the RAV adjustments have been agreed with the companies concerned; others remain in dispute (which will be resolved through acceptance or rejection of the next price control proposals).

Auditing

We have adopted a range of approaches in terms of audit of information – seeking the most appropriate form for each type of information. For regulatory accounts, we have a view from external accounting auditors on whether they fairly present the financial position of the licensee. For price control revenue returns, we have set out agreed upon procedures against which the same auditors report their findings. This enables us to be clear what tests have been conducted and their results, but is obviously only as good as the tests specified.

The returns in relation to interruptions performance can give rise to significant rewards or penalties – sample data from these returns is subject to a technical audit, now performed by a joint team of consultants and Ofgem staff each year. The cost reporting returns are not audited directly, but are reconciled to the total costs figures in the regulatory accounts and assessed by Ofgem in-house and through the annual visit.

We have found that a key issue for us is the consistency of the data with the basis of price control and across companies. We are generally not as interested, if at all, in compliance with accounting standards. This suggests that our own staff are often better placed to assess the returns than staff from audit firms.

We also have mixed experience of the value of external audit. For example, in a recent case, a set of regulatory accounts had to be resubmitted because the basis of preparation set out on the face of the accounts was wrong and a £10m allocation error was
uncovered in asset additions between the two licensees in the group. Neither error was identified by audit – one was spotted by Ofgem and the other by the company in additional cross-checks prompted by the cost reporting pack.

Compliance

As noted above, it is vital for the integrity of and confidence in the regulatory framework that the critical information that underpins the system is reliable. There have been some issues identified with data in the electricity distribution sector – there is certainly no scope for complacency. We have worked to improve our assessment of returns, for example by implementing various cross-checks. We consider that it is important to understand the extent of risk and how far these have been assessed (for example, moving to use of agreed upon procedures rather than audit opinions in some cases).

One area where we can help facilitate compliance is through the documentation of reporting requirements. It is important that users of reporting instructions understand what is required of them and that the scope for varying interpretation is minimised. This can be assisted by a sense of shared ownership of reporting instructions – based on iterative improvements, particularly in the early years of introducing a new system (as with cost reporting in our case now). We have tried to build direct discussion, for example through company visits, between those drafting the instructions and those using them to complete returns.

We have also sought to ensure that companies actively seek to comply. One of the principles of our enforcement of reporting requirements is that it should be in the interests of licensees to check their own submissions and to inform us of discrepancies – we will take a tougher line where we uncover problems that have not been checked or reported by the company concerned.
Conclusions and way ahead

We are approaching the third year for electricity distribution cost reporting and the process is beginning to stabilise. We are confident that it will enable a smoother process for price control review (for example, allowing us to avoid a general request for historic data and providing a better understanding of past performance going into the review). We are now rolling out cost reporting to the other network sectors we regulate: transmission and gas distribution. There are some similarities in terms of our requirements but also important differences which we will reflect in our approach.

We are committed to working within the better regulation framework. We need to continue to focus on reducing unnecessary data collection and to concentrate on key issues. Where we have made most progress, this may enable us to remove other requirements. For example, in electricity distribution, progress on cost reporting may allow us to remove the requirement for regulatory accounts, subject to finding an alternative way to provide the transparency and cross-check on total costs that the accounts currently provide.

Overall, we consider that we have made significant progress in moving beyond data collection to understanding the information content of the data so that we can use it intelligently. More importantly, we are continuing to build on the foundations we have developed to date.
OFWAT’s REGULATORY REPORTING FRAMEWORK

Kieran Duffy

Introduction

The title of the conference today is Regulatory Accounting and Reporting in Utilities and Network Industries ~ Objectives and the State of the Art. In this paper, I will consider Ofwat’s use of regulatory accounting to perform its duties. I will consider this in the context of wider regulatory reporting, using the following themes:

- philosophy;
- objectives;
- history;
- key aspects;
- integration of financial, environmental and social reporting;
- current developments.

To conclude, I will illustrate that the regulatory reporting regime used by Ofwat is key to delivering transparency, accountability and promoting the public interest for a regionalised, monopoly business.

Background

Ofwat was created as the Office of Water Services (Ofwat) in 1989. Ofwat supported the work of the Director General of Water Services as the economic regulator of the privatised water and sewerage industry in England and Wales. The office of the Director General of Water Services was replaced by a corporate
structure, the Water Services Regulation Authority, in April 2006. Both entities are referred to as Ofwat in this paper as the key functions of both entities and their impact on the regulatory reporting framework are largely consistent.

At the time of privatisation in 1989, there were 10 water and sewerage companies in England and Wales and 29 water only companies; a total of 39 companies. The companies were granted a monopoly licence for a designated geographical area. The companies were all vertically integrated regional monopolies. The water and sewerage companies replaced the regional water authorities. These were government bodies which had been created by consolidation of the industry around geographical river basin management structures by the Water Act 1973. The number of companies has reduced to 23 as at May 2007 due to a series of consolidations and mergers within the industry.

**Regulatory regime**

In common with other economic regulators, Ofwat implemented a system of incentive-based price cap regulation, commonly known as RPI-X. It monitored both the companies’ performance in delivering the service to customers and the significant capital investment required to meet new environmental and water quality standards.

A key difference in the privatisation approach employed in the water industry compared to the energy and transport sectors was the embodiment of a system of comparative competition or benchmarking within the statutory framework, namely the Water Act 1989, as consolidated in the Water Industry Act 1991, as amended. To give effect to the comparative competition regime, Ofwat needed to capture information from all of the water and sewerage and water only companies in a consistent manner. This enabled Ofwat to make comparisons between the operational and financial performance of the companies and devise an incentive-based regime to encourage the best performers to continue to
improve, and to encourage the other companies to improve performance, such that they closed the gap in performance with the leading, or benchmark, companies. The needs of the comparative competition regime determined the philosophy and objectives to Ofwat’s approach to devising its regulatory reporting framework.

**Philosophy**

Ofwat’s regulatory reporting regime seeks to ensure that the information captured is relevant, necessary and appropriate to enable Ofwat to perform its statutory duties. Ofwat’s primary duties, as set down in S.2(A) Water Industry Act 1991 are as follows:

- to further the consumer objective;
- to secure that the functions of a water undertaker and of a sewerage undertaker are properly carried out as respects every area of England and Wales;¹
- to secure that companies holding appointments…. as relevant undertakers are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions.

A further set of secondary duties include the following:

- to promote economy and efficiency on the part of companies holding an appointment…. in the carrying out of the functions of a relevant undertaker;
- to secure that no undue preference is shown, and that there is no undue discrimination in ……. water and drainage charges;

¹ A similar duty exists in relation to the functions of water supply licensees, created under the water supply licensing arrangements. This is not considered further in this paper as it has little impact on the established regulatory reporting regime.
OFWAT’s REPORTING FRAMEWORK

- to ensure that consumers are also protected as respects any activities …… which are not attributable to the exercise of functions of a relevant undertaker…… and in particular by ensuring that
  - the transactions are carried out at arm’s length
  - the company… maintains accounts in a suitable form and manner.

Objectives

In addition to performing the statutory duties, Ofwat seeks to ensure that the interests of consumers are protected when they receive water and sewerage services from vertically integrated regional monopolies and to ensure that the system of comparative competition can work effectively. Ofwat seeks to ensure that the regulated companies publish accounting statements consistent with the economic framework within which they are regulated. The structure and format of Ofwat’s regulatory accounts provide a comparable measure of the real costs of supply, including the cost of capital across companies. They also provide a realistic measure of asset values and the trends in returns earned on these assets.

The regulatory accounts help promote transparency of regulation. For example, by promoting transparency of costs and publishing the regulatory capital value (RCV) for each regulated company. At price setting, Ofwat provides for a return on the RCV (or RAB) value within price limits. The RCV is now widely used by the investment community as a proxy for the market value of the regulated business.

History

Ofwat issued five regulatory accounting guidelines (RAGs) between May 1992 and May 1993. The guidelines, which have
been consulted on and revised several times since then, are as follows:

RAG 1: Accounting for current costs and regulatory capital value
RAG 2: Guideline for classification of expenditure
RAG 3: Guideline for the contents of regulatory accounts
RAG 4: Guideline for the analysis of operating costs and assets
RAG 5: Transfer pricing in the water industry

RAG 1 provides the theoretical background to the regime implemented by Ofwat. RAGs 2-4 provide guidance on the structure and content of the regulatory accounts and how to classify costs. RAG 5 provides guidance to the companies on how to demonstrate that they are trading at arm’s length with associate companies. This is critical in ensuring that Ofwat’s comparative analysis is not distorted by intra-group trading and non-regulated aspects of the businesses. The RAGs form part of the wider regulatory reporting regime utilised by Ofwat.

**Annual regulatory reporting submissions**

Ofwat receives a comprehensive information submission from each of the regulated companies annually – the June return. This return provides the data needed to enable Ofwat to perform its comparative analysis on all aspects of the regulated companies’ performance in each financial year. Ofwat uses comparisons of companies’ performance to judge the best performing companies and to raise standards across the industry. We identify the best performers across all areas of company activity and use them as a stimulus for the rest to out-perform the targets set.

The June return covers the operational, financial, service delivery and capital investment performance and enables Ofwat to compare how the companies are performing relative to each other both now and over time. This is an established monitoring regime that is based on high quality data that has been subject to
OFWAT’s REPORTING FRAMEWORK

scrutiny. The annual analysis is a key support to the periodic review analysis and setting future efficiency targets.

- **Principal statement:** the annual submission from the companies to demonstrate that the annual customer charging scheme meets licence duties on undue discrimination and that price limits are accurately reflected in realising revenue from the customer base.

*Periodic review submissions*

Draft and final business plans covering the five year period are submitted by the companies. These plans focus on the financial needs for new capital investment, capital maintenance, operating costs and depreciation charges.

*Transparency, accountability and the public interest*

I acknowledge that the level of information sought by Ofwat is not insignificant. The challenge remains on Ofwat to show that all the information sought is relevant, useful and necessary in discharging our duties and protecting consumers. Given the emphasis on comparative analysis in the water industry, it remains important for the economic regulator to collect all of this information. The information gathered by Ofwat is necessary to:

- assist Ofwat in delivering its statutory duties;
- protect the interests of consumers;
- facilitate comparative competition;
- improve transparency of the costs of water and sewerage services;
- enable Ofwat to publish information on company performance on a consistent and comparable basis.
Key aspects

**Accounting basis**

It may be helpful to consider the structure and format of the regulatory accounts in more detail. Ofwat uses current cost accounting (CCA) principles for the regulatory accounts. The principal reason for this is that there are well-documented limitations to historic cost accounting (HCA) principles in the context of capital intensive industries with long asset lives. The issues that can materialise are:

- understated asset values;
- overstated profit measure;
- overstated returns on capital and distorted measures.

The water industry had adopted infrastructure renewals accounting prior to privatisation to address these limitations in part. Infrastructure renewals accounting is typically used for long-life assets. It regards the whole quantum of individual assets as a single infrastructure asset to be maintained such that serviceability is maintained over a reasonably long period. Using CCA in conjunction with infrastructure renewals accounting helps to overcome more of the deficiencies identified above. CCA also provides Ofwat with measures of total real costs and trends in rates of return that are suitable for comparative purposes.

**Type of current cost accounting**

Ofwat uses the real financial capital maintenance (FCM) version of CCA. This focuses on maintaining the real financial capital of a company and its ability to continue financing its functions. Under FCM, profit is measured after provision has been made to maintain the purchasing power of opening financial capital, by using an index such as the retail price index (RPI). Profit is defined as the increase in the purchasing power of shareholders’
funds, allowing for the introduction and withdrawal of capital, including dividends. This addresses shareholders’ interests and concerns that their investment is effectively maintained and earns appropriate returns.

There is a clear read across to consumers’ interests in that the secure provision of water and sewerage services depends on the companies remaining financially viable. This is important in the context that the water companies continue to be cash negative – that is, the amount spent by the companies on investment, maintenance and operations each year exceeds the amount of revenue raised from their customer base.

**Comparison of RAGs with UK GAAP**

Presentations earlier today highlighted the importance of seeking consistency in accounting information, except where there are valid reasons for deviation. In this regard, the RAGs seek to follow UK GAAP in all regards, with the following key exceptions.

- infrastructure renewals accounting is specifically excluded from UK GAAP and therefore cannot be used for statutory accounting purposes. This means that it is necessary to produce a reconciliation of the regulatory accounts to the statutory accounts annually.

- as a consequence, ‘FRS 12 Provisions, contingent liabilities and contingent assets’ and ‘FRS 15 Tangible fixed assets’ are disapplied for the regulatory accounts.

- disclosures normally required by ‘FRS 17 Retirement benefits’ and ‘FRS 19 Deferred Tax’ are not required for the regulatory accounts if they are already provided in the statutory accounts and these are found in one document with the regulatory accounts.
additional information not normally required by UK GAAP must be provided as notes to the regulatory accounts, eg, details of the regulatory capital value and disaggregated cost information.

Contents of the regulatory accounts

<table>
<thead>
<tr>
<th>Historic cost</th>
<th>Profit and loss account</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Balance sheet</td>
</tr>
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<td>Reconciliation to statutory accounts</td>
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</tbody>
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<table>
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<tr>
<th>Current cost</th>
<th>Profit and loss account</th>
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<tr>
<td></td>
<td>Balance sheet</td>
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<td></td>
<td>Cashflow statement</td>
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Analysis of turnover and operating income;
Analysis of fixed assets by type;
Working capital;
Movement on current cost reserve;
Reconciliation of current cost net operating profit to net cashflow from operating activities;
Analysis of net debt;
Regulatory capital value;
Activity cost table.

Integration of financial, environmental and social reporting

One of the themes we are considering today is the integration of the various strands of reporting. The comprehensive nature of the June return submission encompasses all of these strands. For example, it incorporates:

- focus on outputs achieved for consumers and the environment;
- progress on delivering five year investment programme against output expectations of the company, regulators and consumers;
OFWAT’s REPORTING FRAMEWORK

- financial performance;
- costs – both capital and operating;
- efficiency – capital and operating;
- balancing supply of, and demand for, water and sewerage services;
- competition issues – initiatives in companies’ area and the impact on supply and demand balance.

Operating and financial review

We heard views in earlier presentations on the benefits of some of the reporting envisaged under the Operating and Financial Review guidance. Ofwat agrees that there are positive benefits to be gained by encouraging the water companies to provide information in line with ‘Reporting Standard 1 – Operating and Financial Review’ for its stakeholders. In particular, this provides an opportunity for the companies to set out their strategy for the business and customer priorities and plans for their stewardship of the regulated assets.

Independent audit and certification of regulatory information

Ensuring that data received from companies is reliable, accurate and complete is a key aspect of the regulatory regime. Ofwat utilises the expertise of the companies’ auditors and independent certifiers, or ‘reporters’, to assist it in this task.

We require the auditors to follow general audit principles in auditing the regulatory accounts. The auditors provide a modified audit opinion as the regulatory accounts do not fully reflect UK GAAP for the reasons noted above. The auditors also provide a long form report on transfer pricing and Ofwat takes forward matters of concern and decisions on compliance with RAG 5 with the individual companies. We use the ‘reporters’, who are certifying engineering consultants, to review and report on company performance and aspects of company service. We aim
to balance the complementary skills of the auditors and ‘reporters’ and seek to plan the independent reviews to avoid duplication of effort and conduct them in a cost-effective manner.

Ofwat is currently undertaking regulatory investigations at three companies that cover data quality and misreporting issues and the impact on customer service standards. These investigations have highlighted some areas for improvement in the review and scrutiny of some of the ‘softer’ aspects of company performance at the companies concerned.

I do want to point out that this presently appears to be confined to the companies concerned and there is no evidence to suggest that this is a systemic problem within the industry. The issues have contributed to a negative perception of the industry and all companies are suffering as result, despite the fact that the majority clearly take concerted efforts to meet the standards expected. We expect to report shortly on the outcome of these investigations. There will be lessons for both the companies concerned and Ofwat and we will be keen to ensure that similar issues do not emerge in future.

Current developments

*Review of cost structure within water companies*

Ofwat is planning to undertake a detailed review and analysis of the cost structure of the vertically integrated regional monopoly companies. We consider that this will help identify which stages in the water supply and sewerage disposal processes impose highest costs. This has the potential to assist the development of competition in the water industry by enabling potential new entrants to identify where the possibility of innovation could allow new entrants to earn a margin on their work. There are parallels with the Competition Appeal Tribunal’s (CAT) findings in the ‘Shotton’ case. This is a specific case dealing with a
discrete distribution system with only two large users. The CAT emphasised an issue of regional average pricing versus local costs associated with discrete non-potable water networks in its 2006 judgements.

A key point to note, however, is that any development of competition could potentially significantly unwind the social cross-subsidies that were embedded in the privatised model used for water. Two examples are: i) the regional-averaging of prices which means that rural customers may typically pay less than the true cost of serving them and ii) the inherent cross-subsidies embodied within the unmeasured charging system whereby larger families in low rateable value properties pay less for the larger volume of water consumed than smaller families in higher rateable value properties.

It is the tension between the need to promote competition and the desire to retain the current inherent socially desirable cross-subsidies that best illustrates the current dilemma with the development of competition within the water industry.

**Cost-benefit analysis**

Ofwat and the Environment Agency are working with water companies to assist in creating a robust and generally accepted method of assessing the costs and benefits of future investment driven by environmental legislation. A key consideration in this area is the Water Framework Directive and the requirement for the UK to achieve ‘good status’ for all inland and coastal water by 2015. The industry will have invested some £67bn in the period 1989-2010. It is likely that substantial further investment will be required to achieve the outcome sought by the Water Framework Directive. Given that this will arise in addition to the ongoing cost of paying for investment already made, consumers will need to understand that all appropriate steps have been taken to ensure that additional investment sought will represent best value for the outcomes sought.
Applying better regulation principles

There is a continuing challenge on Ofwat to demonstrate that the significant volume of data it collects remains necessary and is used by Ofwat. Water companies have estimated that the annual, additional cost to the industry is £5m to provide the data that Ofwat requires. Ofwat must always seek to take account of the impact of market forces where these can assist in reducing the activities regulated or the extent of that regulation. Alongside that, Ofwat must continue to deliver on its duties to protect the interests of consumers.

In addressing these principles Ofwat undertakes an annual review of data requested. We remove any data points that are no longer used. We also seek to ensure that the principles of better regulation (proportionate, targeted, consistent, accountable and transparent) are applied in all areas of our work.

Conclusion

I have explained how the structure of the water industry and the privatisation model implemented has steered Ofwat down a certain route in relation to regulating regional monopolies by using a method of comparative analysis. This was necessary to deliver on transparency, accountability and protecting the public interest.

We have sought to ensure that the regulatory accounts devised for the water companies provide meaningful information in a comparable manner that can support Ofwat’s work and improve transparency. We do collect a significant amount of information annually but all of this is necessary to:

- enable Ofwat to fulfil its statutory functions;
- ensure consumer protection;
OFWAT’s REPORTING FRAMEWORK

- create a vehicle for collecting information to place in public domain and improve transparency;
- support the comparative competition analysis and challenge undertaken by Ofwat;
- provide meaningful information to stakeholders and the investment community.

The regulatory regime has worked well for consumers and delivered a significant level of investment to improve the reliability and quality of service received by consumers. The industry’s level of efficiency has improved significantly since privatisation. We recognise and address the constant challenge to seek to reduce the burden and level of information gathered. There are several initiatives in motion at present but we do not underestimate the challenges posed.
ORR’s REGULATORY REPORTING FRAMEWORK

John Thomas

Introduction

This chapter describes the extent and purpose of the Office of Rail Regulation (ORR)’s regulatory reporting framework, largely in the context of our economic regulation functions. It covers the type of data and information that we currently receive from Network Rail and explains what we do with it. Although utility regulators aim to ensure consistent practices wherever possible, I explain that ORR’s relatively detailed and frequent monitoring and reporting of Network Rail’s performance is mainly due to the company’s unique features compared with other utilities. I also describe proposed future developments consistent with our aim to become an ever more focused and effective regulator.

Why do we monitor Network Rail?

There are two key purposes underpinning our regulatory reporting framework:

• to measure Network Rail’s performance against its licence obligations, including the delivery of outputs (such as performance and capacity improvements) for which Network Rail has been funded. This enables us to determine whether action needs to be taken to address any underperformance by Network Rail. We have developed a ‘regulatory escalator’ with the aim of identifying problems early and giving Network Rail the opportunity to resolve them before they have an adverse impact on passengers and freight customers;
ORR’s REPORTING FRAMEWORK

- to enhance reputational incentives through transparent and extensive public reporting of Network Rail’s performance, including a quarterly media briefing.

We believe the emphasis on the latter to be of particular importance because the typical corporate financial incentives faced by most utilities are significantly weakened for Network Rail, where investors are protected by the existence of a Government guarantee. Investors are therefore much less likely to scrutinise and be concerned about Network Rail’s operational and financial performance as they would be if their capital were at risk.

Regulatory reporting principles

The main principles that guide our data and information requirements are as follows:

- to fulfil our monitoring and reporting objectives as outlined above whilst imposing the minimum burden on Network Rail in achieving those objectives. We aim to:

  a. be clear about the data and information on which Network Rail should report;

  b. be timely in specifying our requirements;

  c. explain the purpose of the reporting requirements and how data and information will be used;

  d. ensure, where possible, that our reporting requirements can be met using data and information that is already collected for Network Rail’s own business purposes;

- to focus on the reporting of final outputs or outcomes wherever possible, for example financial performance, operational performance (in terms of delays caused to train services), and delivery of schemes which increase the capacity and capability of the network. However, it is also necessary to
monitor what might be termed ‘intermediate outputs’ such as asset condition because these can be important leading indicators of the long-term sustainability of final outputs.

What do we require from Network Rail?

Described below are the annual reporting requirements of Network Rail. The licence requirements for the company to produce annual regulatory accounts and an annual return are fairly common across utility regulators. We also require monthly reporting of income and expenditure, asset condition and train performance. This is used to compile our Network Rail Monitor which is published quarterly.

**Regulatory accounts**

In common with other utility regulators, the purpose of the regulatory accounts is to enable us to:

- monitor Network Rail’s financial performance against the assumptions underlying periodic review determinations;

- inform future periodic reviews and other regulatory decisions that require financial information, by ensuring that we have consistent time-series financial information. We also ensure that the historic data presented in the regulatory accounts is consistent with forecast data contained in periodic review submissions;

- monitor ongoing capital investment (particularly investment which enhances the capacity or capability of the network).

The accounts are prepared and independently audited in accordance with guidance and instructions contained in our regulatory accounting guidelines. The accounts are published with a directors’ statement confirming that the company has
adequate resources to fulfil its obligations for a period of 18 months. They contain information on:

- capital expenditure (renewals and enhancements) and movements in the regulatory asset base (RAB);
- operating and maintenance costs;
- sources of income;
- a comparison of, and commentary on, regulatory financial performance.

The regulatory accounts were rationalised in 2005 in order to focus on information required for comparisons of actual performance with periodic review determinations and with the company’s submissions for future control periods. More recent changes have been made to include disaggregate data on operating and maintenance costs and to provide separate information for Scotland, and England and Wales.

**Annual return**

Network Rail’s licence requires the company to submit an annual return to us by 31 July each year, in accordance with the form and content that we specify by 31 December in the preceding year. The annual return contains information on:

- operational performance – delays caused to train services, including information on the percentage of trains arriving on time; customer and supplier satisfaction;
- network capability – maximum speeds, gauge, axle loads, etc;
- asset condition – number of broken rails, asset failures, track quality, station condition, etc;
- volume of work undertaken – rail, sleepers, ballast, signalling, etc;
- safety and environment related expenditure;
- expenditure by asset category and route – a comparison of actual expenditure against what Network Rail had budgeted for at the beginning of the year; and
- unit costs and efficiency analysis.
The data and information contained in the annual return is audited for accuracy by one of the independent reporters.

**Business plan**

Network Rail is required to produce a business plan by 31 March each year. It includes the work the company is planning to undertake, by route and asset type, in order to accommodate the forecast traffic volumes and deliver required outputs (in terms of performance, journey times, etc.).

We propose to revise the requirement for Network Rail to produce an annual business plan from the beginning of the next control period (April 2009). Instead, we will ask the company to produce a five year plan consistent with the periodic review determination, which we will then use to monitor the company’s performance. Flexibility to make annual adjustments will be allowed in response to changing circumstances, for example market conditions (volume of traffic), new asset condition data, and changes in best practice (new technology).

**What do we do with the information?**

**Annual assessment**

The purpose of the annual assessment is to provide Network Rail’s train operator customers, funders and members, as well as railway users and other stakeholders, with a comprehensive independent assessment of Network Rail’s performance. It compares actual performance to periodic review targets, business plan targets and licence requirements.
ORR’s REPORTING FRAMEWORK

Quarterly Network Rail monitor and national rail review

The quarterly Network Rail monitor provides a ‘balanced scorecard’ of high-level key performance indicators covering safety, train performance/delay, asset condition and reliability, financial health, expenditure and efficiency, satisfaction of Network Rail’s customers and suppliers, and progress on major projects. We provide a commentary on the key issues. The national rail review provides comments on issues and trends in the wider national rail industry. Recent issues have covered crowding, value for money, level crossings safety policy and train service performance (which includes how train operators are performing).

The principal target audiences of both these publications are key stakeholders in the industry and the general and technical railway press. The publications are accompanied by a media briefing. Network Rail also sends the publications to its members. As indicated above, we believe that high profile public reporting of Network Rail’s performance (good and bad) helps to strengthen manager’s incentives to continue to strive for improvements in performance because of the reputational impact such reporting can have.

Other uses

We use the information provided to us to monitor whether Network Rail is complying with its licence obligations and we take action in accordance with our regulatory escalator if we discover that things are going wrong. The reporting requirements described above can provide an early warning mechanism that might lead us to be concerned about an issue. We can then, if necessary, seek more detailed information from Network Rail to confirm this or otherwise.

We also address directly Network Rail’s members once a year to set out our assessment of Network Rail’s performance. We also
provide to Network Rail’s remuneration committee our independent assessment of the company’s efficiency relative to the periodic review determination.

Future developments

We are reviewing the regulatory reporting framework as part of the 2008 periodic review. We are aiming to develop a better, more complete, definition of outputs for Network Rail to deliver in control period 4, against which we can monitor the company’s performance. We are also aiming to develop a robust measure of outperformance of the regulatory determination for reporting purposes.

We will continue to improve the alignment of incentives between Network Rail and train operators with the aim of promoting stronger, more effective partnerships which will deliver what passengers and freight customers want – better and more consistent levels of performance at an affordable cost. As this happens, we will continue to review our regulatory reporting framework to ensure that the objectives and outcomes remain appropriate and to ensure that it is properly targeted with the minimum burdens being imposed on Network Rail.
ORR’s REPORTING FRAMEWORK
THE CAA’s REGULATORY REPORTING FRAMEWORK

Nick Fincham

Introduction

The world of airports regulation is currently undergoing considerable change:

- the Competition Commission is currently engaged in an inquiry into the price controls that should apply to Heathrow and Gatwick airports;

- the government is looking at whether price controls should continue to apply at Stansted and Manchester airports;

- the Competition Commission has also embarked on a market investigation into BA’s airports in the South East of England and lowland Scotland.

In this context, I had looked forward to spending some time in the much calmer waters of regulatory reporting frameworks. At least, that is what I thought until I heard Professor Shaoul’s presentation! I want to begin my presentation with a brief outline of the objectives of regulatory reporting, and some – principally personal – thoughts on some of the desirable features of regulatory reports. I will then go on to consider regulatory reporting frameworks in the two sectors which the Civil Aviation Authority (CAA) economically regulates: airports and air traffic control. In each case, I will briefly outline the context in which regulatory reports are produced, showing how the features of the industry (in terms of market circumstances and statutory framework) condition the reporting that takes place. I will
concentrate principally on regulatory accounts and I will conclude with a word or two about some of the live issues facing the CAA.

Objectives of regulatory reporting

Following the government Green Paper, ‘A Fair Deal for Consumers’, a joint regulatory group was formed in 2000 to consider whether there would be benefits if regulated companies produced more consistent regulatory accounts. This group published a report which identified that the main purpose of regulatory accounts was to provide financial information about regulated businesses for use by a wide range of stakeholders including: regulator, industry, investors, consumers and other stakeholders, and noted a number of applications.¹

Out of all of these potential audiences, I would argue that the most important is the user/consumer community. This is because there are already mechanisms by which investors can collect information (eg, through statutory accounts) and also means by which regulators can collect information (eg, through the use of the relevant statutory powers). Moreover, in terms of the content of regulatory accounts, the information should permit assessment of both regulatory performance and, the performance of the regulated company. This way, regulatory accounts can be used as a means by which regulators can ensure that they are accountable for their decisions, with ‘accountability’ being one of the five principles of better regulation. In addition, regulatory accounts can provide annual updates on the performance of regulated companies against price caps and/or service quality or investment requirements. I have summarised these as follows (Table 1):

¹ The Role of Regulatory Accounts in Regulated Industries - A Final Proposals Paper by the: Chief Executive of Ofgem; Director General of Telecommunications; Director General of Water Services; Director General of Electricity and Gas Supply (Northern Ireland); Rail Regulator; Civil Aviation Authority; and Postal Services Commission, April 2001.
Table 1: Objectives

<table>
<thead>
<tr>
<th>Objectives</th>
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<tr>
<td>• Joint regulators’ consultation identified main purpose of regulatory accounts to be to provide financial information about regulated businesses for use by the regulator, industry, investors, consumers and other stakeholders</td>
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<tr>
<td>• It noted that practical applications could include:</td>
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<tr>
<td>• monitoring performance against the price control;</td>
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<tr>
<td>• informing future price control reviews;</td>
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<tr>
<td>• assisting detection of anti-competitive behaviour;</td>
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<tr>
<td>• assisting comparative competition;</td>
</tr>
<tr>
<td>• monitoring financial health; and</td>
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<tr>
<td>• increasing transparency</td>
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<tr>
<td>• CAA considers that regulatory accounts should be focused on the needs of users, informing them on:</td>
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<tr>
<td>• regulator performance – has the regulator set an appropriate price cap?</td>
</tr>
<tr>
<td>• regulated company performance – is the company producing the desired outputs?</td>
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Regulatory reporting frameworks

Stepping back from previous work on regulatory accounts, Table 2 identifies some of the desirable features of regulatory reports.

Table 2: Some desirable features of regulatory reports

<table>
<thead>
<tr>
<th>Proportionality</th>
<th>Market circumstances</th>
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<tbody>
<tr>
<td>Scope</td>
<td>Statutory framework</td>
</tr>
<tr>
<td></td>
<td>Focus on objective eg, performance against the ‘regulatory contract’</td>
</tr>
<tr>
<td>User accessibility</td>
<td>Clarity(for ease of interpretation)</td>
</tr>
<tr>
<td></td>
<td>adequate publicity</td>
</tr>
<tr>
<td>Production efficiency</td>
<td>Capable of being produced at reasonable cost</td>
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I would argue that regulatory reports should be:
proporionate – the nature, level and scope of the reporting requirements should be tailored to fit the market circumstances of the relevant industry (e.g., the degree of competition in the industry) and the statutory framework (e.g., the particular requirements that might be placed on the regulator and regulated companies through primary legislation);

focused – the scope of the report should be tightly focused on the objective that the report. For example, there is little point requiring regulatory accounts to report depreciation using International Accounting Standards, if the price control against which performance is being compared deducts projected depreciation from the RAB, regardless of differences between actual and outturn depreciation;

accessible – the reports should be clear and understandable, and given sufficient publicity;

efficient – the reports should be capable of being produced at reasonable cost, where what is reasonable should be judged against the benefits that their production and dissemination can be expected to yield.

Before considering the reporting requirements on price-controlled airports, it is important to understand the market and statutory context in which regulatory accounts are prepared. The key points are set out in Table 3.

**Table 3: Airports - Key industry features**

<table>
<thead>
<tr>
<th>Market circumstances</th>
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<tr>
<td>• Airports do not necessarily share cost characteristics of ‘natural’ network monopolies</td>
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<tr>
<td>• Four UK airports are currently designated for price control regulation (by the Secretary of State), but designation of Stansted and Manchester currently under review</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Statutory framework</th>
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<tr>
<td>• CAA operates in 20 year old statutory framework, with limited flexibility</td>
</tr>
<tr>
<td>• CAA has very few statutory powers, i.e. main function is to set price caps</td>
</tr>
<tr>
<td>• CAA’s statutory duties include a duty to impose the minimum restrictions necessary</td>
</tr>
</tbody>
</table>
In terms of the market context, it is important to recognise that the airport industry does not share the cost characteristics of a ‘natural monopoly’. A natural monopoly generally enjoys falling costs with scale, undermining the ability of rival firms to mount and/or sustain a credible competitive challenge, whereas the incremental costs of airports – especially those operating in congested, growing markets – can rise with scale. That airports can operate effectively in an unregulated environment is also borne out by the successful development of regional airports, whose growth in recent years has outstripped the regulated London airports. It is also worth remembering that out of the 50 plus UK airports with annual turnovers exceeding £1m, only four are currently price-controlled. Moreover, the continued application of price controls at two of those airports (Stansted and Manchester) is expected to be reviewed later this year.

In terms of the statutory framework for the economic regulation of airports, the CAA operates in a 20-year-old statutory framework, which gives the CAA very limited flexibility. The CAA has few statutory powers, and also a duty to impose the minimum restrictions necessary. All of these factors influence the kind of regulatory reporting that takes place.

The statute requires that designated (ie, price controlled) airports include certain specified information on subsidies, income and expenditure, in the accounts they deliver to Companies House. Whilst it is still possible today to understand the motivation for some of the specified statutory requirements, taken together they are not very well geared to the clear and transparent reporting of performance against a RAB-based price control. As a result, the CAA has sought to agree with both BAA (the owner of the 3 price controlled London airports) and Manchester Airport Group (the owner of Manchester airport) arrangements for effective and efficient reporting against the price controls, with negotiations taking place against the backdrop of the CAA’s broader statutory power to collect (and disseminate) information that it reasonably requires to perform its functions. These arrangements were last considered a few years ago, and are set out, at a high level, in
CAA’s REPORTING FRAMEWORK

correspondence between the regulator and the regulated companies.

This is summarised in Table 4 below:

<table>
<thead>
<tr>
<th><strong>Features of regulatory accounting framework</strong></th>
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<tr>
<td>• Designated airports must produce annual accounts containing certain minimum information</td>
</tr>
<tr>
<td>• Delivered to Companies House (or disseminated as the CAA considers appropriate)</td>
</tr>
<tr>
<td>• CAA has the power to require any information necessary to support its price setting functions</td>
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</table>

<table>
<thead>
<tr>
<th><strong>Regulatory accounting in practice</strong></th>
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<tr>
<td>• Designated airports produce regulatory accounts which go further than minimum statutory requirement (with format of regulatory accounts established through discussion and correspondence with the airport operators)</td>
</tr>
<tr>
<td>• Accounts are made available to users, eg, on BAA’s ‘extranet’</td>
</tr>
<tr>
<td>• Accounts provide a comparison of outturn performance against regulatory determinations, and track the on-going value of the RAB (though the opening value of the RAB for each control period is only validated in the review process itself)</td>
</tr>
</tbody>
</table>

Against this background, it is fair to say that the regulatory accounts produced by the airports provide a reasonable starting point a user wishing to compare outturn income and expenditure against that projected at the time the price controls were set. However, the reported regulated asset bases (RABs) at each airport are not approved annually by the regulator; regulatory endorsement of RABs – in line with the CAA’s duty to impose the minimum restrictions necessary – is instead reserved for consideration at each five yearly periodic review.

A further observation to make regarding the airport reporting arises in respect of coverage. Airport regulatory accounts do not cover financing. In other words, there is no balance sheet, and no indication of the capital structure of the airports. There is a good reason for this. It is because the CAA’s approach to setting
price controls on airports is to do so based on reasonable – but notional – assumptions about how airports can be financed, and without regard to the specific financial arrangements that an airport puts in place.

The rationale behind this approach – including the importance that the CAA places on its continuing public promulgation – goes beyond the scope of this presentation. Suffice to say that this policy is consistent with:

- the fundamentals of the UK airport industry, including the fact that the consequences of operational interruption of airports are less severe than in other network industries (such as gas distribution networks) and that there are strong economic incentives on any airport owner to keep facilities open (by virtue of the dual income streams from aeronautical and commercial activities);

- the fact that effective incentive-based economic regulation can provide a reasonable defence against the transfer of inappropriate risks to users, ie, it is perfectly credible for the CAA not to countenance the re-opening of price caps and/or to recoup returns on investment that has been deferred or cancelled for financial reasons, in circumstances where the CAA has made clear, in advance, that it is prepared to do so;

- the structure of the Airports Act 1986 which, in general terms, does not envisage regulatory intervention in matters of finance and does not, for example, place an obligation on airports to supply, or grant the CAA the power to prevent the disposals of regulated assets;

- the maintenance of clear division between the role of the regulator and the role of the company.

The market circumstances in which air traffic control services are provided is rather different. National Air Traffic Services (NATS) is the sole provider of en route air traffic control
services and – while it is part-owned by a consortium of its airline users, ie, part-owned by its customers – when the CAA last reviewed the NATS price control, in 2005, it came to the conclusion that the ownership structure did not permit withdrawal from standard price control regulation.

The key industry features are set out in Table 5 below:

<table>
<thead>
<tr>
<th>Table 5: NATS - key industry features</th>
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<tbody>
<tr>
<td><strong>Market circumstances</strong></td>
</tr>
<tr>
<td>• Sole provider of en-route air traffic control services in the UK</td>
</tr>
<tr>
<td>• Degree of competitive threat to airport air traffic control business, but NATS is virtual monopoly in provision of en route (or network) services</td>
</tr>
<tr>
<td>• NATS owned by a combination of the Airline Group (42%), NATS staff (5%) and BAA (4%) with the Government holding the remaining 49%</td>
</tr>
<tr>
<td><strong>Statutory framework</strong></td>
</tr>
<tr>
<td>• The NATS PPP was completed in July 2001</td>
</tr>
<tr>
<td>• NATS (En Route) Ltd regulated by licence issued under the terms of the Transport Act 2000 – regime comparable to standard utility regulation model</td>
</tr>
<tr>
<td>• ‘Composite solution’ took place following September 11, requiring shareholder and exceptional user contributions, and subsequently more intrusive monitoring of NATS’ financial position</td>
</tr>
</tbody>
</table>

The statutory framework for air traffic services has much more in common with the economic regulation found in energy and water markets than with airports. NATS is licensed, and the regulator can introduce, remove or modify conditions as it sees fit in order to best meet a set of statutory duties, subject to an appeal to the Competition Commission. The circumstances in which the CAA regulates NATS differ from those in which it regulates airports in another important respect.

In 2003, the CAA oversaw what became known as the ‘composite solution’, whereby investor and user contributions were made in order to address the unsustainable level of debt that had been placed on NATS at the time of the Public Private
Partnership (PPP). The justification for this regulatory intervention lay partly in the benefits associated with continued privatisation, and partly in the fact that the CAA had not – prior to the composite solution – had the opportunity to spell out clearly and publicly where the risks of high leverage lay between users and shareholders under regulation. In that sense, the circumstances can be clearly distinguished from those which apply today in the regulation of airports. But, whatever the justification for the intervention, a consequence of that intervention was for the CAA to take a greater role in the financing of NATS, and, the corollary, a much greater interest in the effective regulatory reporting of changes to the financial position. Table 6 summarises the position:

<table>
<thead>
<tr>
<th><strong>Table 6: NATS reporting framework</strong></th>
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<tbody>
<tr>
<td><strong>Features of regulatory accounting framework</strong></td>
</tr>
<tr>
<td>• NATS is required under licence to produce annual regulatory accounts, a business plan report and a statement of adequacy of resources</td>
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<tr>
<td>• Purpose of regulatory accounts set out in condition 6 to:</td>
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<tr>
<td>• enable the CAA and the public to assess the financial position of the regulated businesses</td>
</tr>
<tr>
<td>• assist the CAA to assess the Licensee’s compliance with the Licence</td>
</tr>
<tr>
<td>• assist the CAA and the public to assess performance against the assumptions underling the current price control</td>
</tr>
<tr>
<td>• inform future price control reviews</td>
</tr>
<tr>
<td>• Subject to regulatory accounting guidelines (RAGs) drawn up in consultation between licensee &amp; CAA and approved by CAA</td>
</tr>
<tr>
<td><strong>Features of financial reporting framework</strong></td>
</tr>
<tr>
<td>• In addition, following the Composite Solution, it was required to provide to the CAA a number of documents relating to its financial position, including:</td>
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<tr>
<td>• quarterly management reports</td>
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<tr>
<td>• interim financial statements</td>
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<tr>
<td>• semi-annual business review by independent technical adviser</td>
</tr>
<tr>
<td>• Following 2006 review of reporting requirements, CAA relaxed a number of post Composite Solution reporting needs in April 2007.</td>
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CAA’s REPORTING FRAMEWORK

In terms of the reporting framework, the CAA requires NATS to produce regulatory accounts, a business plan and a statement of adequacy of resources. The purpose of the regulatory accounts is laid out clearly in the licence, and NATS and the CAA agree regulatory accounting guidelines (RAGs) that fulfil that purpose.

In view of the history of NATS financing, the CAA takes a continuing interest in the financial position of the company. Accordingly, NATS is required to provide a number of documents relating to its financial position. However, following a recent review, the CAA has sought to minimise the burden of the reporting requirements associated with the Composite Solution. For example, the CAA has removed obligations to provide information routinely, replacing them with an obligation to furnish the regulator with information where there is a material change.

Conclusion

Looking forward, there are a number of areas for potential development in respect of airports:

- the taking of BAA plc private last year raises questions about whether the access to information on BAA’s regulated airports will continue to be as accessible in future as it has been in the past;

- to defend against the transfer of inappropriate risk to users may require a strengthening of reporting of investment performance;

- the continuing emphasis on the ‘passenger experience’ raises the question as to whether the service offered by airports (and airlines) to passengers is adequately recorded and publicised;

- the need to check that investment plans (and – in this context – reporting against those investment plans) is fit-for-purpose.
As regards NATS, in the immediate future, the relevant RAGs will need to be further aligned with the requirements of the regulatory contract. Looking further ahead, the next NATS price control review (known as the CP3 review covering the period 2011 to 2015) offers the CAA, users and NATS the opportunity to move to a much lighter touch approach to the regulation of NATS’ finances: one which firmly establishes financing, and the associated risks, as NATS’ responsibility.

The issues are summarised below in Table 7.

### Table 7: Some live issues…….

<table>
<thead>
<tr>
<th>Airports</th>
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<tbody>
<tr>
<td>• Implications of private ownership – a transparency issue?</td>
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<tr>
<td>• Strengthening reporting of outputs in line with focus on incentive based regulation</td>
</tr>
<tr>
<td>• delivery of investment</td>
</tr>
<tr>
<td>• passenger experience at airports</td>
</tr>
<tr>
<td>• Ensuring that airport-user consultation fit-for-purpose &amp; effective</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>NATS</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Using the Regulatory Accounting Guidelines to secure like-for-like comparisons in performance reporting</td>
</tr>
<tr>
<td>• The forthcoming CP3 review – an opportunity to clarify roles and responsibilities for financing?</td>
</tr>
</tbody>
</table>
I will keep my comments brief. The papers by Elizabeth Dymond and David Brown provide very interesting insights into elements of policy in the Competition Commission and Ofcom. I compliment both speakers on their presentations. I will take Elizabeth Dymond’s paper first because, as I was a member of the Competition Commission for eight years until this March, I have much more knowledge of its operations than those of Ofcom, which I have only been able to study from a distance.

Elizabeth made reference to the Commission’s recent report on the merger of South East Water and Mid Kent Water and the possibility of permitting the merger in return for price reductions to customers. The water industry is unique, as far as I am aware, in being the only privatised utility where the retention of the capability to undertake benchmarking exercises by the regulator is effectively written into the legislation.

Other regulators have chosen to use some benchmarking when re-setting price caps or making judgements about service quality, although it does not seem that these regulators have placed anything like as much emphasis on comparative performance as the water regulator, Ofwat. Indeed in the other utilities, price cap setting has arguably been more a ‘bottom up’ exercise than a ‘top down’ one, despite the intention of people like Professor Stephen Littlechild at the time of the privatisations.

The emphasis on benchmarking in water poses a dilemma for the competition regulator in so far as there needs to be a minimum number of independent comparator firms operating in the water sector in England and Wales to permit a meaningful statistical exercise. Hence, Ofwat opposes mergers in the industry. Even so, at privatisation in 1989 there were 39 water suppliers in England.
and Wales and, today I believe, there are 22. The capacity for Ofwat to benchmark usefully has therefore receded and continues to recede when further mergers occur. Price reductions for customers when mergers occur do not address this fundamental dilemma for regulatory policy in this industry.

That water is different to the other utilities in stipulating performance benchmarking is an accident of history. It arose out of deliberations within government during the planning of the water privatisation. This brings me to an important lesson that I feel we should not lose sight of, that is, the regulatory system we have today in the UK was not rigorously planned as a coherent whole; rather it evolved and in a somewhat haphazard way.

Let me take airports as another example. During the planning of the privatisation of the British Airport Authority in the mid-1980s, one reason why the airports were not split up to compete with one another under separate ownership, or why the London airports were not placed under one ownership and the Scottish airports under another (both possibilities were explored), was the future of Prestwick airport in Scotland. Prestwick was losing money and there was a threat of closure if cross-subsidies, especially from Heathrow and Gatwick, did not continue (there was a similar problem with Stansted airport which was new and needed further funding). Therefore, the regulatory issues relating to airports today (with the Competition Commission now undertaking a parallel market inquiry into airports and a review of the price cap, as Elizabeth Dymond has mentioned) is because of a decision made in the mid-1980s about the structure of the privatised entity. Another accident of history.

Turning to David Brown’s discussion of Ofcom, I am impressed with the way Ofcom has reviewed its regulatory processes since coming into operation. In particular, amongst the regulatory offices, Ofcom has pioneered the expansion of self-regulation and co-regulation. Self-regulation and co-regulation are now very fashionable and numerous supportive papers have been published. However, it is important to recognise that self-
regulation has been used in some sectors before, such as financial services, and been found wanting in some respects. I conclude that the jury is still out on self and co-regulation. It may not prove to be the efficient and effective alternative some expect it to be to existing regulation.

Meanwhile, may I just make the further observation that after twenty-three years BT is still regulated. Will this always be so? And why are telecoms regulated but grocery sales not (although Tesco seems to have almost a permanent presence at the Competition Commission these days!) The fact that we have an Ofcom but not an Ofgros (the Office of Grocery Services) is another accident of history – groceries were never state-owned.

Let me make a few final comments. As a student of regulation in the UK over many years I cannot but be aware of the dangers of ‘regulatory creep’. In her presentation Elizabeth Dymond commented that “most markets are not working well”. I am quoting her out of context and apologise for this, but I do believe that regulators can adopt a mental model of the world in which more regulation is necessary and fully justified. I do not conclude that “most markets are not working well”. Markets rarely if ever work ‘perfectly’ in the economic sense, but most markets work well – delivering cost-effective goods and services to customers, ‘24/7’. It is markets not regulators which deliver! In this context I would like to see an expansion in the serious use of regulatory impact assessment (RIA) techniques to check the growth of regulatory creep. Offices like Ofcom do undertake RIA exercises, but how effective are they?

Finally, at this conference today there is no discussion of the role of regulation in strategic management and how regulation can be a competitive tool. Coming from the Cranfield School of Management this fascinates me. But perhaps this a theme for a future CRI conference?
The presentations by the Office of Rail Regulation and the Civil Aviation Authority (CAA) provided an interesting contrast in regulators’ approaches to financial and performance reporting.

ORR had developed systematic, detailed and regular reporting processes (acknowledging the cost of compliance). These were designed to ensure that it was always up to date on the condition and performance of Network Rail. The CAA had by contrast established no formal regular reporting requirements or accounting guidelines on airports, preferring to leave them to run their businesses between reviews and starting data gathering anew at each review.

The difference can be explained in part by the different history and situation of the two sets of regulated businesses. The rail network had been through deep crises, and was still a large consumer of public funds. There had been a high level of confrontation between the players in the industry. By contrast, from 1987 to 2002 airports had been self financing and high investing. They had worked in a constructive partnership with government and had not needed heavy handed monitoring or control. Since 2003 the regulatory environment for airports has become much more demanding, but it is not clear that reporting requirements have evolved in parallel.

In 2003 the CAA affirmed its policy of regulating each airport on a standalone basis, but it put in place no measures to ensure proper allocation of shared costs, or to monitor the balance sheet and cash situation of each airport. During the Airport Developments Incorporated takeover, the CAA demanded information on financing plans for the British Airports Authority group, but not for its regulated subsidiaries. It had subsequently
declared itself uninvolved in financing structures, either at the group or airport level.

The decision of the Office of Fair Trading to ask the Competition Commission to consider whether the BAA airports should be split into separate ownership gives real relevance to this situation. The absence of any system for reporting on the financial condition and prospects of the individual airports could prove a significant constraint on the ability of regulators to make well informed decisions on the relationship between ownership, prices and investment for truly stand-alone airports.
RESPONDENT - PUBLIC SECTOR ACCOUNTING

Ian Carruthers

HM Treasury - Whole of Government Accounts (WGA) and other work

- Convergence of accounting policies across UK public sector
- Current values approach
  - Full cost of services (market and non-market)
  - National Accounts compatibility
- Better data to underpin operation of fiscal rules and resource allocation

Local Authority Transport Infrastructure Assets
- Objectives of the CIPFA review

- The best way to use asset management plans (AMP) based information to:
- Support good financial management locally;
- Provide good information to support policy development and resource allocations;
- Provide financial accounts complying with relevant International Financial Reporting Standards (IFRS) requirements;
  - Deliver consistent high quality information for WGA and National Accounts purposes.
  - Lessons for other local authority (LA) assets.
Why look at changing accounting?

- WGA
- Consolidation should be based on consistent accounting policies. Local roads are the big area significantly out of line with rest of public sector.
- Statement of recommended Practice (SORP) – historic cost; depreciated over the useful economic life; renewals approach allowed but not much used.
- WGA – current values; renewals accounting.

Why look at changing accounting?

And, importantly, existing LA infrastructure accounting information is:

- Of no use for resource allocation and policy purposes;
- Does not reflect true value of asset or what is happening to it;
- Does not support effective management of assets;
- Does not support National Accounts.

Why an AMP based approach?

- Resource accounting and budgeting (RAB) for national roads established to serve WGA requirements. Not AMP based. Satisfies some objectives:
  - Current cost valuation consistent with other public sector assets;
  - Of some use for National Accounts;
  - Renewals accounting provides some useful info about depreciation and impact of expenditure on asset values from year to year.
Benefits of an AMP based approach for LA transport infrastructure

- Set defined levels of service and measure performance against them.
- Understand and track over time condition and performance of assets and cost of holding them.
- Ability to predict consequences of particular funding levels and strategies.
- Whole life cost based resource prioritisation – a ‘stitch in time’ instead of ‘worst first’.

Benefits of an AMP based approach

- Potential to deliver substantial cost savings and efficiency gains.
- Provide robust consistent data for national policy and resource allocation purposes.
- Demonstrate stewardship of the assets and explain local resource allocation and policy decisions to users and taxpayers – get away from present crude performance measures.

Project timetable

- Draft report to be published beginning of July; three months consultation to be supported by events, stakeholder meetings etc.
- Report to be revised in the light of consultation responses. Final report to be published in November.
- Will be for others to take decisions.
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