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PREFACE

The CRI is pleased to publish its *Regulatory Review 2004/2005*. It follows the same format as previous years, with reviews of each regulated sector (focusing particularly on developments in the last two years), followed by thematic reviews of either general regulatory issues or current topics of debate. The thematic reviews provide a comparative focus to the sectoral reviews. The reviews take account of developments to the beginning of 2005.

Each chapter is written by a specialist, either an academic or someone who is closely associated with the practice of regulation, whether in a regulated company, a consultancy or a regulatory office. It is this blend of authors and perspectives which we believe is a strength of the CRI Regulatory Review, particularly when the successive annual regulatory reviews are taken as a set, and the evolution of regulatory thinking can be further examined, both in the UK and abroad.

The CRI is very grateful to this year’s authors for their contributions, which we hope will promote both understanding and debate. Each author’s views are, of course, their own, and do not necessarily represent those of the CRI.

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
June 2005
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1 AIRPORTS REGULATION

David Starkie

Introduction

In the 2002/3 Regulatory Review, Ralph Turvey had the very challenging task of reviewing the final year of a long process leading up to the setting of the current price-caps for both Manchester and BAA’s London airports. The process had started in July 2000, when the Civil Aviation Authority (CAA) decided to undertake a fundamental review of the regulatory approach. This was followed in early 2002 by a referral, required under the 1987 Airports Act, to the Competition Commission. The Commission then made recommendations to the CAA prior to the latter’s final proposals and subsequent decisions in February and March 2003; these took effect from April 2003.

Ralph Turvey was able to set the scene right up to the CAA’s final proposals, but he was not quite able to close the chapter with the final decisions on Manchester and BAA, both of which were made after the last Regulatory Review had gone to press. In the event, the CAA’s two decisions differed from its proposals only in some minor ways. And, as Turvey pointed out, the CAA’s Proposals generally accepted the Competition Commission’s recommendations; the only difference of real significance being the future treatment of each London airport on a stand-alone basis rather than treating them as a single airport system. This means that it will no longer be possible for BAA to leverage its market power at Heathrow to support further development at Stansted.¹

The final airport price-caps allow Heathrow to increase its charges in real terms by 6.5% per annum, thus reflecting the

¹For the significance of this change in policy, see Starkie D (2004), Testing the Regulatory Model, Fiscal Studies, December.

David Starkie, Director, Economics Plus
considerable capital spend on Terminal 5 during the 2003/8 period. Two new elements were introduced into the Heathrow cap: first, a ‘trigger’, which reduces the maximum allowable charge when the airport has not achieved particular capital project milestones on time and, second, an incentive for BAA to increase peak period runway capacity. At Gatwick (also subject to a trigger) and at Stansted, the price-cap was set at zero. (This cap was expected to be marginally binding at Gatwick but non-binding at Stansted in view of the latter’s lack of pricing power). At Manchester charges are to fall in real terms by 5% per annum.

The regulatory framework

The path to the decisions had been a long and, some would say, winding one. A very large quantity of the material had been produced by all sides and yet the basic regulatory approach (save for the setting aside of the systems approach in the case of the London airports) had changed little; radical features proposed initially by the CAA (such as the dual-till approach and proposals for a long-term price path) did not find favour with most airlines nor a rather conservative Competition Commission and the two bodies were often at loggerheads; the final convergence of view was rather more apparent than real.

Inevitably this led, subsequently, to criticism of the overall process. BAA has been particularly acerbic, commenting that:

“… they [CAA and the Competition Commission] took contrasting policy positions on virtually all the issues of principle, and the process led to no meeting of minds… on key issues…. A more regrettable aspect of the dual review process, which goes to the question on excessive regulation, was the failure of the two
regulators to manage and co-ordinate on the bread and butter analytical work”.\(^2\)

And: “Where two regulators can differ as much as the CAA and Competition Commission appear to, the credibility of regulation itself is open to question”.\(^3\)

Of course, as Ralph Turvey reminded readers last year, the regulatory structure for airports is unusual. It differs from the other regulated industries because the Competition Commission has been given a mandatory role as adviser to the CAA. In other industries, the Commission becomes involved only when a regulated utility refuses to accept the regulator’s decision. In 1998, the government sought views through a formal consultation as to whether the CAA should become the single regulator for airports, with a mechanism for referral to the Competition Commission only in the event that there was a disagreement between the regulator and regulated companies.\(^4\)

Following the consultation, the government confirmed its intention to implement this and other changes but it did not include them subsequently in the Utilities Act. In the light of developments outlined, this was perhaps unfortunate.

**CAA consultation on airport regulation processes**

Since the conclusion of the 2003/8 price-cap reviews, the singular event of some importance has been the CAA’s launch of a consultation that looks at lessons to be learnt from last time round and sets out in some detail how it believes that airport

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\(^3\) Toms M (2004), UK Regulation from the Perspective of BAA plc, in Forsyth P et al, The Economic Regulation of Airports, Ashgate, Aldershot.

AIRPORTS REGULATION

regulation should develop in the run up to the next reviews.\(^5\) Notwithstanding the fundamental review at the time of the last price-cap reviews, the consultation document includes itself some radical proposals, but their focus is essentially on the ‘processes’ involved in a price-cap review, rather than on methodological issues.

The document acknowledges that the last airport reviews were ambitious in scope and covered a significant number of weighty issues. This, in turn, created a degree of uncertainty during the review process, and meant that the process itself was resource intensive for all concerned. It also acknowledged that a number of policy issues were highly contentious. For the future, the CAA has stated its intention of adopting a more evolutionary approach so that fundamental regulatory choices are not revisited every five years. But, its key proposal is that in future the CAA should act more as a facilitator to enable the regulated companies to engage with the airlines and other users in a more structured and hopefully constructive dialogue. It is felt that airport companies and airlines are better placed than the CAA to understand user needs and are, therefore, in a better position to reduce regulatory risk by taking more control of the regulatory agenda through embedding it in their own commercial processes.

Specifically, the CAA is suggesting that the business plans for each designated airport should be drawn up following detailed consultation with the airlines and that this process should precede, for the purposes of the price-cap review, submission of the plans to the CAA. It is intended that the airports and airlines will agree the key variables of capital expenditure (capex), operating expenditure (opex) and service quality that feed into the submission. The CAA will continue to take the lead on issues such as the cost of capital, where it considers it has a comparative advantage. In the absence of agreement the CAA will, as now, provide a regulatory determination: but recourse to

\(^5\) CAA (2004a), Airport Regulation, Looking to the Future - Learning from the Past, May.
the regulatory decision-making process is to be seen as a last resort.

In principle, this proposal by the CAA is appealing; it holds out the prospect for a lighter regulatory touch in general, for less regulatory risk, and a lower cost of capital. But there are some major hurdles to overcome if the new approach is to be successful.

First, it is arguable whether too much is expected from airlines in particular. At one time they were considered the apogee of a contestable industry with very little sunk costs (‘capital on wings’ was the coined phrase). Although a less sanguine view is now taken of whether the airline industry is fully contestable, there remains a sharp contrast between it and the airport industry with the focus of the latter on capital with generally a long economic life, irretrievably committed to a specific purpose in a specific location. Consequently, the planning horizons of the two industries differ substantially; added to which is an imbalance of resources and expertise; some airlines have no staff versed in airport or general utility regulation, whilst others have only limited resources devoted to such issues. It is a problem that potentially could be eased by the airlines in time developing their in-house expertise or, alternatively, by using airline trade associations to pool resources. But, importantly, different airlines have different agendas; the expectations and requirements of low-cost carriers such as Ryanair or EasyJet are rather different from those of the full service carriers like BA, and the requirements of the two groups are sometimes mutually exclusive.

A second difficulty concerns the role of the Competition Commission in the overall process and the CAA’s proposal that, in future, the Commission should not undertake a full regulatory review but focus only on those areas of continuing dispute. Until now, the Competition Commission has not shown a willingness to disengage; it has tended to cover more and more issues in increasing detail at each regulatory review. It has done this most
probably to avoid the risk of a legal challenge to its recommendations and it is difficult to foresee this situation changing, especially so if the airlines seek to influence the Commission in the event of disagreement with the regulated airports on various issues. In anticipation of such differences the CAA is signalling that it will reach a view on the merits of the case and not split the difference between entrenched positions so that the parties need to consider - in addition to the perceived upsides - the potential downsides of leaving decisions to the regulator. But there is no requirement for the Competition Commission to follow suit and it remains to be seen how in the future the CAA will handle disagreements between the two regulators; although the CAA has the final say, last time it appeared to be the one to concede most ground perhaps mindful itself of a legal challenge.

Following consultations on its May 2004 document, in December the CAA announced that it proposed to publish a further consultation document in March 2005, setting out in more detail a framework to enable discussions to take place between airports and airlines.⁶ In doing so, it signalled its intention to press ahead with its earlier proposal but, it noted: “[T]here are undoubtedly some significant issues to be resolved on which there is not – nor would we expect there to be – universal agreement”. Amongst these issues, the degree of information to be provided by the airports to the airlines in a timely manner and the need for both parties to engage at a senior level were highlighted (the latter echoes the disparities in expertise noted above). Finally, the CAA commented that, having observed recently the interplay between airports and airlines at a number of the designated airports, “…the nature and depth of… disagreements appear to be very substantial”. It added that, unless this was a passing phase, it would call into question whether the proposed approach based on increased airport/airline engagement should be applied

at all the designated airports or whether at some a more traditional regulator-led review would be more appropriate.

De-regulation?

The CAA’s proposed approach is in the spirit of trying to reduce the extent of regulation, which during the last price-cap review was widely acknowledged as a burden to all concerned. But, regulatory creep is a powerful force and, as Toms has pointed out:

“The first review [of BAA], in 1991 took 12 months. The second review in 1996 took 21 months, the .2002 review [took] 32 months. The first formula was a simple value of ‘x’. The current proposed formula is a value of x, with six trigger points, and a service quality scheme covering a dozen parameters. In addition, the BAA operates under a web of agreements and undertakings, which have grown at each review” (Toms, 2004).

Perhaps the time has come, therefore, to place on the agenda once more the question: is it still appropriate to subject all four airports designated in 1987 to a continuing regulatory review.

Manchester has always been in an anomalous position in so far as it is wholly within the public sector and, as Turvey remarked in the 2002/3 Regulatory Review, the need for economic regulation of a local authority airport is far from obvious. Nor is it obvious that, if economic regulation is needed, standard price-cap regulation is the appropriate form to apply.\(^7\) Price-cap regulation is designed to incentivise a profit-maximising firm,

\(^7\) Starkie suggests that more stress is placed on the structure of prices rather than the level of average prices. See Starkie D, Peak Pricing and Airports, in Helm D and Holt D (2003), Air Transport, The Challenges Ahead.
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but Manchester admits to pursuing a wider agenda and is not seeking to maximise profits *per se*.

The broad purpose of economic regulation is to remedy an insufficiently competitive marketplace but Manchester, today, faces more effective competition from other airports than it did when it was first designated nearly twenty years ago. In 2005, the competitive environment Manchester faces will increase with the opening of commercial flights from a former RAF base near Doncaster. Consent for this development was given in 2003 (in spite of objections from Manchester). It poses a major threat to Manchester because of its long runway, located within a region from which Manchester has previously drawn much traffic.

Stansted is another anomaly as a designated airport. It was first designated when it had a tiny annual throughput of 0.5mn passengers. In spite of its rapid growth in recent years (it is now larger than Manchester), it is viewed as having relatively little market power and it has struggled over the years to price up to the notional price-cap set for it. In the past, de-designation would have been difficult because of the integration of Stansted’s regulatory asset base with that of Heathrow and Gatwick as part of the system approach to the regulation of BAA’s London airports. However, with the change of CAA policy following the last review, with each airport now assessed on a stand-alone basis, this constraint on de-designation no longer applies.

De-designation of Manchester and Stansted would leave just Heathrow and Gatwick to be subject to the existing regulatory framework. This narrower focus would reduce the regulatory burden on the airport industry and on airlines, particularly those using more than one designated airport. The opportunity might also be taken to de-couple the price-cap review of Heathrow and Gatwick, so that they are sequenced a year apart. Moreover, all this can be accomplished without the need for primary

\[8\] As part of its new proposals, the CAA is also considering sequencing the review of Manchester vis BAA, thus returning to the *status quo ante* that preceded the 2002/3 Review.
legislation; the 1986 Airports Act provides for designation, and thus de-designation, by the secretary of state using secondary legislation and Section 20 of the Statute also allows for the deferment of a review by up to one year.

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(bold numbers refer to the footnote in which first cited)

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2 ELECTRICITY REGULATION

Ralph Turvey

Introduction

Besides Ofgem, the main regulators of the electricity industry include the Department for Trade and Industry (DTI), the Department for Environment, Food and Rural Affairs (DEFRA) and the local planning authorities. Ofgem now comes under the Gas and Electricity Markets Authority (GEMA), chaired by Sir John Mogg. Its chief executive Alistair Buchanan and the five divisional heads (of markets, networks, corporate affairs, corporate strategy and operations) are the full-time members of the authority, and there are several non-executive members whose terms of appointment suggested that their membership would involve a couple of days work per month.

Ofgem is quite large; in 2003-4 its income was £52.1m. However a major part of its work involves the administration of a number of schemes for the government. Thus during that year, Ofgem issued 10m renewable levy exemption certificates, 7m renewable obligation certificates and 15m combined heat and power levy exemption certificates. It also assessed and approved 120 energy efficiency commitment schemes.

The following survey of developments in the industry and the major activities of its regulators divides them into four groups:

- trading arrangements;
- supply competition;
- network price controls;
- environmental regulation and renewables.
ELECTRICITY REGULATION

Trading arrangements

**BETTA**

The British Electricity Trading and Transmission Arrangement (BETTA) is to be introduced in April 2005. According to the Department of Trade and Industry’s regulatory impact assessment its purpose:

“is to facilitate the creation of a single, integrated and competitive wholesale electricity market covering the whole of Great Britain (GB). This will involve:

- a single GB system operator;
- common rules and charging arrangements for connecting to and using the transmission system;
- common set of balancing and settlement arrangements”.

It was explained that:

“These benefits are expected to be felt primarily in Scotland, where the degree of change to existing arrangements will be more dramatic. The benefits for consumers in England & Wales are likely to be small in view of the fact that the trading arrangements will not change substantially”.

If the National Grid Company had taken over Scottish transmission at its regulatory asset value, becoming sole transmission operator as well as sole system operator, the introduction of the new arrangements would have proved less complicated than it has in fact been with Scottish transmission remaining in the hands of the Scottish companies. As it is, Ofgem has published no fewer than forty documents to provide the legal framework for creating the single GB wide wholesale electricity market.
Market developments

Turnover on the two power exchanges, APX and UKPX has not been sufficiently high to provide a really liquid market. However the situation is improving: turnover has been growing and the Dutch owned APX has now taken over UKPX so that a full range of solutions for market participants, including forwards and futures will be available. Calculation of a more meaningful half-hourly reference price has now become possible. The dual-price cash out system has the disadvantage of not providing such a price but it now actually requires one. Modification P78 to the balancing and settlement code implemented in February 2003 has made the ‘reverse price’ (the price paid to participants who are long when the system is short or paid by participants who are short when the system is long) equal to the reference price derived from power exchange pre-gate closure prices.

According to the National Grid Company, the resulting reduction in the difference between system buy and sell prices has resulted in a reduction in the incentives on market participants to over-contract. Consequently, the net imbalance volume has significantly reduced (see Figure 1).

Figure 1: System buy price - system sell price spread
A proposed move towards basing system buy prices and system sell prices on marginal bids and offers rather than on their volume-weighted average values has also been discussed and rejected by Ofgem in favour of a wider review of cash out arrangements currently in train. It mainly concentrates on short-term issues. The topics which are under examination include, in particular, the basis for the calculation of dual cash out prices and methodologies for determining them in emergency circumstances; whether the tagging mechanism used to remove system balancing actions from electricity cash out prices is appropriate and whether the current arrangements for returning/collecting the residual imbalance cash flows to/from market participants are appropriate. Issues which will not be examined include single versus dual cash out prices; pay-as-bid versus cleared price; whether gate closure should be changed; or the split between system and energy balancing actions when calculating cash out prices.

Security – short term

During recent summers there has been some concern about whether the plant margin would be adequate during the coming winter. In July 2001, the Joint Energy Security of Supply working group (JESS) was set up to assess risks to Britain’s future gas and electricity supplies. Following the publication of the energy white paper in February 2003, Ofgem undertook to report every six months on the performance of the electricity and gas industries in delivering security of supply. Then in July 2004 the Energy Act required the secretary of state to report jointly with Ofgem to parliament annually on security of supply. National Grid Transco (NGT) has recently produced its 2004/05 winter outlook report, presenting a view of the outlook for gas and electricity supply and demand and their inter-relations for the coming winter. As the latest JESS report tactfully indicates there is a need to eliminate duplication of effort and resources.
Some dramatic power system failures reinforced anxieties, but in fact they were unrelated to any shortage of generating or transmission capacity.

- In August 2003 some 50 million consumers in the Northeast USA and Canada were deprived of supplies, in some cases for up to two days. Three separate transmission outages in Ohio due to contact with trees initiated a cascade of outages which might have been avoided with better contingency planning and communication between the four system operators and reliability coordinators.

- In the same month there was a London system power failure, with loss of supply to the underground. Supplies, except to the underground were restored in 46 minutes. The cause turned out to be that the wrong protection relay had been fitted in a substation, triggering a circuit trip although the circuit was carrying much less than its capacity.

- Then, in September, a power failure in Scandinavia deprived five million consumers of supplies. It was due to two unrelated outages, one of which was a double outage, which happened within five minutes of each other, an extreme contingency of a sort which it would be impossibly expensive to allow for in system planning.

- A few days later there was a loss of power throughout Italy and full power was not restored everywhere for twenty hours. Again a transmission trip due to contact with trees was involved, but dilatory action by Swiss and Italian system operators, and the Italian grid’s inability to recover from isolation from the rest of Europe in an unstable situation, were the main reasons for the failure.

There turned out to be no significant difficulties in meeting demand in the winter 2003/4, though the National Grid Company had warned that capacity might be short under some cold weather conditions. A rising forward spark spread induced a return to
service of some mothballed plants, raising the plant margin to 21.6% by the year’s end. The forward spark spread has again risen for the next two years, both gas and electricity forward prices being, like spot prices, very considerably higher than a year ago. NGT has recently forecast the plant margin for the coming winter at 20%, and an additional 1.2 GW of mothballed plant could return within this winter period if required, raising the margin to over 22%.

The National Grid Company has taken various initiatives to increase peak availability:

- contracting for more MW of standing reserve;
- introducing a new maximum generation service providing emergency non-firm access to generation not offered all the time;
- introducing charging for short term transmission entry capacity to facilitate the return of mothballed plant within the year;
- renewing the previously experimental demand turndown scheme for the provision of reserve from large demand users or aggregators of smaller demand sites and/or smaller generation.

The National Grid has also proposed that when there is insufficient generation to meet demand and demand control is initiated, calculating system buy price should be set at the price of the most expensive accepted offer, ie, as a marginal cost. This was not accepted, but, as mentioned above, Ofgem is considering possible changes to cash out price determination.

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1 Gas forward prices are converted to a £/MWh of electricity equivalent, using an efficiency factor of 52%, and subtracted from electricity forward prices to give the spark spread. A contributor to the IEE seminar on security of supply, 6th July 2004, David Alcock, suggested that the spark spread “must be ~£12/MWh to cover losses + BSUoS (£1/MWh) and cover capital + operating expenses of £90-95/kW at 95-98% availability. [52% HHV efficiency]”.

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Security – long term

There has been a good deal of discussion about whether the way the market functions under NETA will give sufficient incentive for investment in adequate generation capacity. Expected load growth, the advent of emissions trading schemes, the large combustion plant directive, and the planned decommissioning of older nuclear units, justify the construction of new generating capacity. There is a market in forward trades only up through 2006 and the volume of such trades is miniscule in comparison with trades for the more immediate future. Thus decisions to undertake new capacity investment must depend upon expectations rather than on contracts, expectations extending over many years into the future and relating to electricity prices in relation to gas prices.

Prices agreed in contracts for a forthcoming season or year, through arbitrage, reflect expectations about the behaviour of pre-gate closure bilaterally negotiated or exchange prices over such a contract period, and these in turn reflect expectations of cash out prices. The expectation of price spikes which may last only for a few hours will raise the average price expected over a longer period encompassing those few hours, and it is expectations of these average prices which are relevant to investment decisions. However, there is a fear that the occurrence of extreme price spikes will be treated as a result of market manipulation and/or be deemed politically unacceptable, resulting in the imposition of some form of price cap, so reducing the average price over longer contract periods and attenuating the incentive to invest.

Thinking along these lines has given rise to the idea that a market system which ensured moderately high spot prices over longer periods known fairly certainly well in advance would be preferable to the present system which makes it likely that there

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2 A more extensive discussion is provided in Turvey R (2003a), Ensuring Adequate Generation Capacity, Utilities Policy, 11, pp95-102.
will be extremely high spot prices over shorter periods with very uncertain timing, even if the long-term average was the same in either case. Hence the idea of imposing some capacity requirement upon suppliers (such as exists in the New York, New England and PJM systems) has found some favour. Suppliers would, for example, be required to own or contract for available capacity equal to their peak demands plus a reserve margin. This would involve the existence of a capacity market alongside the energy markets, preferably with the penalty imposed for any shortfall below the capacity requirement increasing with the magnitude of that shortfall.

Two paragraphs in the government’s energy white paper rejected the idea as follows:

“6.42 A number of electricity markets elsewhere employ a form of capacity margin instrument (CMI) to seek to secure a fixed level of capacity margin, often to counteract the effect of price caps imposed elsewhere in their electricity markets. We have reviewed the case for such a measure here. [A footnote refers to two NERA studies: Security in Gas and Electricity Markets, October 2002; Electricity Markets and Capacity Obligations, December 2002.]

6.43 We have concluded that the case has not been made for such an instrument in the UK market. The UK market already provides strong financial incentives for suppliers to contract for sufficient power. We also note that experience with CMIs in other countries has been mixed. Some have been subject to material alterations within short time periods, the very sort of regulatory risk that the instrument is supposed to offset. NERA also estimated that a CMI could increase costs to consumers by some £150m per year. CEGB’s security standards”.
Against this it might be argued that £150m/year would be a small price to pay for reduced price volatility and reduced loss-of-load probability and that it would avoid the danger of a backlash against NETA, which some fear might happen under the present arrangements.

Supply competition

In its Domestic Competitive Market Review 2004 published in April 2004 Ofgem reported that about half of domestic customers had now switched supplier. Although ex-PESs retained an average of 59% of the market, the price pattern where incumbents maintained their prices to existing customers whilst offering lower prices to attract new customers, was beginning to break down. An average standard credit customer switching for the first time could save between £20 and £47 by switching electricity supplier, providing they shopped around and switched to the cheapest supplier in their area. But there are many consumers who cannot be bothered, don’t know or get it wrong, and it would therefore be misleading to judge whether suppliers are behaving less competitively than they should, simply on the basis of switching rates.

A statistical analysis showed that there had been a very limited response in the retail prices charged by ex-PESs to changes in the wholesale electricity price (with full pass-through, changes in the retail price would reflect 37% of the change in the wholesale price, as it represents 37% of the average customer bill). Ofgem listed a number of plausible explanations for this low response. The picture is probably similar for small non-half-hourly metered non-domestic customers.

The system of imputing the half-hourly consumption of non-half-hourly metered consumers which is required for half-hourly settlement continues to block any innovation in metering and tariff structure for such consumers. This is partly a chicken and egg problem. It arises because for any new tariff a profile would
be required, and the profile for each existing tariff is estimated, with a considerable delay, on the basis of the recorded half-hourly consumption of a sample of consumers on that tariff. Hence a new profile for a new tariff would require recording the consumption patterns of a sample of consumers who do not yet exist. This problem could be solved if profiles were not estimated \textit{ex post} once a year but, instead, were estimated daily on the basis of daily remote meter readings for sampled consumers. The other part of the problem is that because consumers can change supplier, no supplier acting alone will innovate with a new tariff requiring new metering. A collective decision is required concerning the structure (as distinct from the price charged for each component) of any new tariff and its associated metering system. Unfortunately neither the DTI nor Ofgem is minded to promote or undertake a cost-benefit analysis of candidate possibilities.

Another continuing concern is that the IT system for organising the transfers of customers who switch suppliers is still not entirely functioning satisfactorily. Thus the auditor qualified the balancing and settlement code audit report because there was a sufficient uncertainty about what suppliers owed to each other, and two suppliers were each fined £200,000 after they unfairly stopped some 9,000 domestic consumers from switching to new gas or electricity suppliers.

At the large customer end of the market, many contracts are negotiated annually in October. The suppliers of such customers bear some risk in avoiding imbalances; they are predominantly ex-PES suppliers or vertically integrated businesses.

Suppliers’ appetite for competition appears to have languished of late, since some of the big ones have indicated that they will concentrate on looking after the customers they have rather than seeking new ones.
Network price controls

*Transmission*

Ofgem is to align the timing of the gas and electricity transmission price controls. The current Scottish electricity transmission price controls will be extended by two years, and the National Grid Company’s electricity transmission price control for one year. The new price controls can then begin simultaneously, alongside Transco’s gas transmission price control, in April 2007.

In its price controls, Ofgem distinguishes two roles of the National Grid Company: Transmission Asset Owner and System Operator. In the latter capacity it deals with any transmission constraints (system balancing) and keeps the system in balance in real time (electricity balancing). What Ofgem terms its “external balancing costs” are the costs of balancing services contracts and electricity purchases and sales for balancing purposes, and these have been the subject of a new target and a revised incentive scheme starting in April 2004.

Ofgem quite reasonably wants to incentivise trade-offs between constraint costs and the costs of investment to relieve constraints, with investment responding to market participants’ changing needs, rather than emerging from a planning process based on forecasts. It has, less reasonably, hankered after a system of long term firm tradeable transmission entry and exit rights to secure these aims, apparently ignoring the complexities of power flows in a meshed system (it is a reflection of these complexities that transmission capacity is modelled in terms of boundary capabilities within the network which represent the maximum inter-zonal flows that can be accommodated at peak demand without network reinforcement).

Admitting that its long term aims cannot be implemented immediately, Ofgem’s system operator incentive scheme for
2004/05, resembles its predecessors. In fixing the cost target, Ofgem noted that for the three preceding incentive schemes since NETA began, the National Grid Company’s forecasts had consistently been higher than the final targets agreed, which in turn had significantly exceeded outturn costs. This time it set a £415m target for costs (against the company’s proposal of £439.4m plus an amount in respect of the costs of obtaining short term reserves) with the company bearing 40% of any excess and gaining 40% of any reduction subject to a limit of £40m.

There have been other developments with regard to transmission. From April 2004 transmission assets which are shared, or could be shared, are now charged for via transmission use of system charges rather than connection charges. The way in which these use of system charges are calculated has also been changed, Ofgem having “decided not to direct that the proposed changes may not be made”! They meet most of the criticisms which had been levied against what the National Grid Company called its ‘investment cost related method’. A simplified direct current (DC) load flow model will now be applied to projected peak injections and withdrawals, and the calculations of the cost and incremental costs of the transmission network along existing alignments which would be required to meet them will use forward looking cost estimates which distinguish type of conductor and voltage level. Because of an absence of locational cost patterns for the distribution of sub-stations, their costs will be treated separately. The method models a minimal system which makes no provision for meeting security criteria, but it was stated that the extra costs they impose are more or less proportionate throughout the system, so can be adequately reflected by multiplying all the results by a common factor. However Ofgem has recently stated its preference for a model

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3 Turvey R and Cory B (1997), Inefficiencies in Electricity Pricing in England and Wales, Utilities Policy, Vol 6, no 4, pp283-292. The new method still scales down generation from capacity to match demand rather than applying a merit order to determine the pattern of peak generation, but the National Grid will consider the feasibility of the latter approach which it agrees to be sensible in principle.
that sought to reflect the costs of providing security on a locational basis.⁴

A criticism which remains is that because no asymmetries between incremental and decremental marginal costs emerge from the modelling they are not taken into account. Since the analysis rests upon a scenario selected as most likely, it implicitly assumes that larger and smaller flows are equally likely. Marginal cost estimates should therefore reflect an average of upward and downward marginal costs. This would make no difference only if decrements reduced the amount of expansion investment rather than simply diminishing flows along existing lines. But in some locations, closing an existing generating plant could reduce the present worth of National Grid costs by much less than the establishment of an additional new generating plant would add.

With the coming advent of BETTA, although separate charges will no longer be paid for use of the Scottish interconnector which will now be treated like the rest of the grid, the application of the new charging methodology to Scotland has aroused some disquiet among Scottish generators. Consultations on the charging methodology for Great Britain as a whole are therefore taking place.⁵

Increases in renewable generation will require investment by the three transmission companies that was not allowed for under the 2001-2006 price control review. If the bulk of development took place onshore in Scotland, the total capital cost would be around £1.6bn, but if the most development took place offshore in the three strategic areas off the coast of England, the extra cost would lie between £805m and £1.125bn, depending on the volume of wind found off the Cumbrian coast.

⁴ Ofgem (2004), NGC’s Proposed GB Electricity Transmission Charging Methodologies, the Authority’s Decisions, December.
⁵ National Grid Company’s paper, NGC (2004), GB Transmission Charging, Final Methodologies Consultation, 20 August, proposes the methodologies to be applied following the implementation of BETTA.
In any case, there is a need to create a funding mechanism that is an addition to the existing price controls. An Ofgem paper published in August proposes an appropriate mechanism which will allow recovery of costs where Ofgem’s engineering consultants expect the capital value of the investment to fall below the capital value of the constraint costs that would be expected without the reinforcement.

Finally, there was a transmission development which had been expected but did not happen. Ofgem, quite rightly in the view of economists, had long wished to introduce a locationally variable treatment of transmission losses. They are currently recovered on a uniform basis and divided between generators and suppliers on a 27/73 split. Although the ideal would be to take account of marginal loss factors which vary through time, the zonal transmission losses scheme to which Ofgem gave approval for England and Wales in January 2003 would have applied annual averages and would have scaled the zonal loss factors down so that, on average, they equalled average loss factors. However in June, the Department of Trade and Industry stated that it was “minded not to designate average zonal transmission losses, in the form of P82, as part of the GB balancing and settlement code and in which case it would not form part of the forthcoming BETTA arrangements”.

Despite this, Ofgem stuck to its guns, but legal considerations relating to procedure subsequently forced it to recognise that this proposal could not be implemented. The Department of Trade and Industry justified its line by reference to a cost-benefit analysis commissioned from a consultancy firm which (ignoring the point that transmission use of system (TUOS) charges represent a marginal cost which ought to be taken into account in examining the long run effects upon plant location) showed net benefits to be uncertain and possibly low or negative. The consultancy was not asked to examine a scheme for marginal transmission loss factors differing zonally by differences in marginal losses and varying by time of day and year. The

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6 Balancing and Settlement Code proposed modification P82.
benefits (and the distributional effects) of such an alternative would be much greater.

**Distribution**

For distribution, in contrast with transmission, there has been a recent price review, the fourth electricity distribution price review for the quinquennium 2005-2010. Consultations on it started in July 2003 and the final proposals appeared in November 2004. Ofgem’s direct internal costs for it have been around £3m. The proposals, like their predecessors, rest on many adjustments to past cost data which have been made to secure comparability. Operating and capital expenditures are then forecast, taking account of projected growth and making allowances for a variety of factors which differ between distribution network operators. The efficiency target is made up of two components: a requirement on certain distribution network operators to catch-up with the most efficient (or frontier) distribution network operators in the industry; and a requirement on all of them to improve their efficiency in line with an expected rate at which those frontier companies can improve their performance. Ofgem has set the target for this latter component at 1.5% per year. Calculations set out in tables of 40 lines then explain the allowed revenues and the $P_0$ values (for price changes in April 2005) for each of them. These $P_0$ values average 1.3%, an $X$ of zero being proposed for all but one company, so that on average, distribution charges will be broadly flat in real terms over the quinquennium, with some increases and some reductions.

The need for a considerable increase in investment is recognised. Further improvements in quality of service are expected. There are now to be separate price controls for metering. A set of incentive arrangements forms another part of the proposals.

Ofgem has worked hard to improve its approach, and a number of the criticisms made of the 1999-2004 price controls have now been met. In addition, attention has had to be paid to the
problems posed by the hoped for expansion of distributed generation.\(^7\)

One welcome major improvement is alignment of the ways in which opex savings, capex savings and reductions in losses (now adequately costed) are to be rewarded. In all three cases, a rollover mechanism will allow the first five years’ worth of savings to accrue to the distribution network operators. This removes the previous distortions of incentives between savings made at different times during the quinquennium. Also, at least temporarily, it allows a relaxed attitude to differences between the distribution network operators in their accounting distinctions between opex and capex.

A second major improvement relates to quality of service incentives; they are to be strengthened. The percentage of revenue to be exposed to quality of service performance is to be raised, and the rewards and penalties for surpassing or falling short of the targets will be annual and symmetric. Targets for the number and duration of interruptions and the number of customer minutes lost have been set so as to allow for differences between distribution networks in the make-up of their networks and in the relative importance of planned and unplanned interruptions. Companies whose targets require a reduced number of interruptions or customer minutes lost have been granted interruption cost allowances ‘based on an assessment of the marginal costs of improvement’. These differences in targets and in cost allowances form but one of many cases where regard has been paid to the particular circumstances of particular distribution network operators, sensibly recognising (some?) particularities but hindering inter-company comparisons of the generosity or parsimony of their revenue allowances.

The duration of interruptions, and hence, given their number, customer minutes lost, depends upon restoration times after a fault. The two distribution network operators with the best

\(^7\) Turvey R (2003b), Price Control of Electricity Distribution Networks, CRI Technical Paper 14, University of Bath.
restoration times are to be given an additional 1% of revenue per annum, a reward for current best practice. Since restoration times are unavoidably longer when storms cause many faults, compensation will be payable to customers deprived of supplies because of severe weather only after longer interruptions than those which attract compensation under normal conditions. The companies have been granted annual allowances for such exceptional events which they can use to buy storm insurance cover, to arrange quicker restoration or to reduce the impact of storms. These measures embodied the lessons from the storm of October 2002, when winds gusting up to 100mph hit much of the country. Nearly two million consumers lost their electricity supply due to the resulting damage. Inadequate tree cutting was partly responsible, and the time taken to restore supplies by different distribution network operators varied as a function of their preparedness in response to weather forecasts, the speed with which they mobilised resources and the quality and robustness of their IT systems.

The third major improvement is the recognition that, since privatisation, too little distribution R & D has been undertaken. The need for it has become greater because of the prospective increase in asset replacement and because of the new problems that will arise with extensive distributed generation. If only the first five years of any benefits from R & D can be captured, as happens under the current price control methodology, its net present value will mostly be negative. An Innovation Funding Initiative is therefore to be introduced which will now allow pass through of a large proportion of expenditure on projects which will enhance the technical development of distribution networks to deliver benefits (financial, supply security and quality, environmental, safety) to end consumers. The outcomes are to be openly reported. Then registered power zones will encourage distribution network operators (DNOs) to develop a mechanism to develop and demonstrate new, more cost-effective ways of connecting and operating generation on their systems relating, for example, to voltage control, fault level management and power flow management. The costs and benefits of registered
power zone connection projects will be assessed individually. They will attract a 100% uplift of the £/kW element of the distributed generation incentive scheme (described below) for a five year period, raising the average rate of return for registered power zone projects, calculated on the same basis as for other distributed generation connections, to about 11%.

The case for the distributive generation incentive scheme just referred to arises from the government targets for the amount of energy to be supplied by renewable generation and the capacity of combined heat and power (CHP) to be installed by 2010, most of which will be connected to distribution networks. Some of the costs relate to the physical connection of the generator to the network. From 1 April 2005, distributed generators entering into a connection agreement will no longer face ‘deep’ connection charges to cover upstream reinforcement costs. There will instead be ‘shallower’ charges mainly limited to covering only the costs of assets not shared with any other user. But beyond these, costs can arise for the reinforcements necessary to accommodate distributed generation’s contributions to fault levels, ie, the currents that would need to be interrupted should faults occur which must always be exceeded by the capability of the switchgear. Costs may also arise from rises in local voltage levels and reversals of current flow or higher flows through transformers. In many cases, it is sensible to size the assets modified or introduced to deal with these problems so as to be able to accommodate subsequent new distributed generators, so that the costs need to be shared by those other generators if this happens, while to protect the distribution network operators against loss if it does not, Ofgem is introducing a guaranteed minimum level of return to ensure that they are able to at least earn a return equal to the cost of debt.

The incentive scheme aims to facilitate and encourage efficient and economical connections of distributed generation, allowing the network operators on average to earn a return above their allowed cost of capital for other investments. The scheme, whose details are complicated, has two parts:
(i) 80% of the costs in excess of connection charges that are incurred to provide network access to new distributed generators will be recovered from all of them over a 15 year period through their use of system charges;

(ii) there will be a further supplementary £/KW revenue driver (or incentive rate) to incentivise these connections. The rate will reflect the average of (widely varying) connection costs reported by the companies and, when added to the 80% pass-through will yield a rate of return some 1% above the allowed cost of capital for other investments for a connection with a typical cost per KW.

There will be interim arrangements for connection charges and for distribution use of system charges for generators, and considerable further developmental work is planned.

Another incentive scheme, a novel one, has been proposed in respect of capital expenditure. Large increases in 2005-2010 compared with 1999-2004 are deemed necessary for all distribution network operators, but some of them have forecast increases much in excess of those viewed as appropriate by PB Power, Ofgem’s consultants. The ratios of distribution network operators’ forecasts to PB Power’s view of appropriate capital expenditure varied widely. Ofgem proposes a sliding scale of capital expenditure allowances which rise with these percentages, but less than proportionately, and marginal rewards and penalties for divergences from the sliding scale allowances which range from 40% of the divergence when the ratio is 100% to only 20% when the ratio is 140%. The result will be to reward savings below forecast capital expenditures more strongly for companies whose forecasts are close to the PB Power view than for companies whose forecasts are well above it, but to penalise excesses by the high forecast companies over the PB Power view relatively lightly up to a ratio of some 120%. All companies will be given a higher capex allowance and return than if allowances were simply set equal to the PB Power view.
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It is not clear whether the company forecasts already made and discussed with PB Power and Ofgem may be revised. If they are, either now or five years hence in the next round, a company which is risk averse and uncertain about its forecasts may choose to play safe and go for a forecast which is on the high side so that neither the incentive to economy nor the penalty for excess would be very strong.

Environmental regulation and renewables

In January 2000 the government announced its aim that renewables that are eligible for the renewables obligation (described below) should supply 10% of UK electricity in 2010, “subject to the costs being acceptable to the consumer”. It aspires to double this share by 2020, and one of the four goals of the white paper on energy policy issued early in 2003 was to cut the UK’s carbon dioxide emissions - the main contributor to global warming - by some 60% by about 2050, as recommended by the Royal Commission on Environmental Pollution. To achieve these aims, the white paper named a wide range of hopes, committees and measures, but stated that the government did “not propose to set targets for the share of total energy or electricity supply to be met from different fuels”. Nonetheless, the government considered it “right to concentrate our efforts on energy efficiency and renewables. We do not, therefore, propose to support new nuclear build now. But we will keep the option open.”

The share of electricity supplied to customers from energy sources eligible for the renewables obligation rose from 1.7% in 2002 to 2.0% in 2003; 2.9% for all renewables as against the 5% government target proposed in 1999!

The main contributor to such further growth of renewables generating capacity as takes place will undoubtedly be wind power, mostly offshore. Wind power’s capacity factor in Britain is regarded as 30% or more. Rough arithmetic shows that to meet
the 10% target, even with help from other renewable sources, on average 2MW of turbines will have to be installed at a rate of something like one a day until 2010. The recent admirable report from the House of Lords Science and Technology Committee, Renewable Energy: Practicalities summed up the possibilities as follows:

“Onshore, we have little doubt that it is technically and physically possible to manufacture and install sufficient numbers of wind turbines to meet the government’s targets. The constraints on onshore development are not primarily technical, but environmental.

The white paper describes offshore wind power as “about to take off”. In spite of the Danish experience, we are less sanguine. Offshore development is still largely a step into the unknown, and potential investors face serious technological and commercial risks”.

Later in their report they note the difficulty of forecasting generation costs:

“One of the difficulties in assessing the practicality of developing renewable energy is the lack of an authoritative assessment of the costs of the various generating technologies…..It is still harder to estimate future cost trends”.

The costs of the grid extensions required to support the expansion of wind energy are perhaps less uncertain, and the intermittency problem is at least initially less serious than has sometimes been suggested. Two excerpts from Dennis Anderson’s review of the written evidence summarise the

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8 House of Lords Science and Technology Committee (2004), Renewable Energy, Practicalities, July.
position (estimates provided by Lewis Dale of NGT with regard to a system postulated for 2020 with 20% wind energy):

“Total additional cost relative to a grid based on conventional plant with no wind: approximately £1.2bn per year (approximately 1.5 p/kWh). This includes:
- investment in network reinforcement of £3.7bn in total;
- balancing costs (hot standby etc) of 0.285 p/kWh;
- an assumed investment in wind turbines of £14bn.
The overall effect is to increase electricity supply costs at the grid by approximately 10%.

For up to 10% penetration of wind energy on the system there should be no technical problems in managing intermittency and ensuring reliable supplies. Some investment in back up capacity will be needed, but at this level of penetration it would be quite small, and recourse could be had to standby plant already on the system.

At 15% penetration the required back up capacity increases significantly” (House of Lords, 2004, Appendix 13).

The renewables obligation

About 3% of the UK’s electricity currently comes from renewables and the target for 2010/2011 is 10.4%. Electricity suppliers are now being obliged either to ensure that a specified percentage of their sales, rising through time, comes from renewables or to pay Ofgem, which administers the scheme, a ‘buy-out-price’. This started at £30/MWh, and has subsequently been adjusted by the RPI to £31.39/MWh for 2004-05. The

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9 Solar power, geothermal power, co-firing of biomass with fossil fuel (until 2016), biomass, sewage gas, some small hydro facilities, landfill gas (which accounted for almost half in the first year) and wind (which will provide most of the future increase). Coal mine methane is excluded.
evidence that electricity comes from renewable sources is provided by renewable obligations certificates (ROCs) issued for generation from renewables. They can be and are traded. The total buy-out payments made on account of the excess of the aggregate obligation over actual generation from renewables are redistributed to those suppliers who have correctly produced ROCs in proportion to the number each produces. If the obligation is O while actual renewable generation is only R, falling short of O, the marginal value of a ROC = \( \frac{O}{R} \times £31.9 \), currently some £47. This marginal value of a MWh from renewables, coming on top of the selling price per MWh obtained by renewable generators, powerfully favours their output. If continued, it would be sufficient to make onshore wind generation highly profitable. But its future values are highly uncertain, since they will depend upon the future ratios of eligible generating capacity to the obligation level.

The total cost to suppliers of this arrangement, almost certainly passed on by suppliers to consumers, equals the excess of the receipts of renewable generation over what would have been the receipts of all generators for the same amount of generation had the obligation not existed. According to the House of Lords committee cited above, taking 2004-05 as a basis, the obligation of 4.9% of energy will cost consumers just over £500m in this year alone. This cost will rise annually in line with the size of the obligation, and the government estimates the cost of their renewable energy strategy to the consumer for the 30 years 1990-2020 at an average of £1bn per annum.

Trouble has been caused by the demise of some suppliers which failed to pay their buyout charges, but measures will be taken to secure the buy-out fund in the event of a shortfall occurring. A more significant issue arises from the fact that a decision whether to invest in renewable generation must take a view of the future level of the buyout charge and the future value of ROCs over a period reflecting the expected lifetime of renewable generation installations. But suppliers are unlikely to be willing to sign long-term contracts with renewable generators because they may
lose customers and because of uncertainties about the future value of ROCs. For example, a faster growth in co-firing than anticipated, or admission of energy from waste, might increase the supply of ROCs and lower their value. Indeed their value would fall to zero if ever renewable generation provided more than the specified percentage of total generation. Hence an extension beyond 2010-2011 to 2015-16, with the percentage increasing in stages from 10.4% to 15.4% was widely welcomed by actual and potential renewable generators. It remains true, however, that, if the target is ever met, ROCs will cease to be worth anything.

Subsidisation of energy from renewables is not limited to the system of ROCs. Government is making capital grants to help get offshore wind schemes off the ground and for energy crops/biomass demonstration projects. In addition it has proposed a cross subsidy within transmission pricing, taking powers in the Energy Act to allow dispensation on transmission charges for renewable generators in a specified area with otherwise high renewable energy potential, the Highlands and Islands of Scotland. Ofgem’s Chairman, Sir John Mogg, in a splendid manifestation of regulatory independence expressed his regret over this, regarding it as “unnecessary and misguided”.

**Combined heat and power**

A combined heat and power (cogeneration) plant provides both usable heat and electricity obtaining very considerably higher overall efficiency of fuel utilisation than conventional electricity generation. Such a plant is a substitute for the heat only boiler that could meet the heat requirement plus purchase of electricity, so the efficiency gain and the carbon savings it provides depend upon the carbon savings stemming from the reduction in purchased electricity and upon the fuel it uses and would have used in a heat-only boiler. A fall in the price of electricity, reducing the savings in electricity purchase or the revenue from sales of its electricity output, makes it less attractive, as will a rise in the price of its fuel input, usually gas.
These facts explain why estimates of the carbon savings it provides depend upon gas and electricity prices as well as upon purely technical considerations. There is the additional complication that generators of less than 20MW are not directly affected by the renewables obligation. The result has been that some existing combined heat and power schemes were mothballed, new construction was discouraged and the government’s target for carbon savings from combined heat and power 2010 has been revised downwards. Yet it is thought that the subsidy required to make combined heat and power schemes profitable would be very much smaller than the subsidy provided by the system of ROCS.

**Emission allowances**

A British scheme for reducing CO\(_2\) emissions, under which the Department for Environment, Food and Rural Affairs agreed to pay participants £215m over five years, in return for commitments to cut their greenhouse gas emissions, is to be succeeded by a European-wide scheme for emission allowances which aims to meet Kyoto targets. This will have two phases, an initial one starting in 2005 and a second one with wider coverage for 2008-2012, the first commitment period of the Kyoto Protocol.

Emission allowances are being allocated in a national allocation plan. The sectors covered from the start include electricity generation. Each participant will be required to surrender a quantity of allowances each year equal to its emissions in the preceding calendar year or face a penalty of €40 per excess tonne of CO\(_2\) in 2005-2007, and €100 per tonne from 2008. However, these allowances are to be tradeable internationally so that participants with high abatement costs will be able to cover their emissions by purchasing additional allowances, while those with low abatement costs will be able to reduce emissions and sell their surplus allowances for a profit. Thus the cost of the emission reductions for the European Union as a whole will be minimised.
Allocations to each generating station will be issued in three equal annual instalments. Allowances will be made available to new entrants in the first phase free of charge from a new entrant reserve of 7.7% of total allowances, with some priority being given to CHP reserve. Auctioning will be used only for the distribution of any un-issued allowances in the new entrant reserve.

These arrangements will add to each plant’s marginal fuel cost of generation since, at the margin, by reducing output it could sell allowances and would have to buy allowances to increase output. The carbon content in relation to the energy content of natural gas is 52.5 gC/kWh; for oil 66.9 gC/kWh; for coal 86.7 gC/kWh. In 2002, the gross efficiency in converting heat from combustion into electricity of combined cycle gas turbine stations (which use natural gas or oil as fuel) was 47%; for coal fired stations 36%. Hence actual carbon emissions resulting from electricity generation were about 100 gC/kWh for gas, and 250 gC/kWh for coal (House of Lords, 2004, p127). The increase in marginal fuel cost with an allowance price of, say £6.66 per tonne (=0.000666 pence per gramme) would therefore be 0.0666 pence per kWh for gas and 0.1665 pence per kWh for coal.

Such a rise in the marginal cost of coal-fired generation relative to that of gas-fired generation will alter the merit order. This will change the pattern of generation, though the extent to which this will occur depends not only upon the future market price of emission allowances, but also upon the feedback to gas and coal prices and any effect of the higher electricity prices upon electricity consumption. Nonetheless it is clear that gas-fired generation will replace some coal-fired generation so reducing CO₂ emissions, that wholesale electricity prices will rise and that, in the aggregate, generator profits will rise - they have acquired valuable emission rights without having had to pay for them. Some coal-fired plants will lose however, the effect of the reduction in their outputs exceeding the effect of the higher prices. There is no fear that any UK generators will have exploitable market power in the market for allowances, since the
market is a broad one, encompassing other industries and other countries. Thus the price of the allowances, ie, the marginal cost per tonne of CO$_2$ emissions will be a competitive one which may be expected to be much higher in the second phase than in the first.

These effects may be fairly limited in the first phase, since the volume of permits allocated in European countries’ national allocation plans is not very restrictive, so that the price of a permit is likely to be low until the commencement of the second phase.

The Large Combustion Plants Directive

Another factor diminishing the future contribution of coal-fired generation is the European Commission’s Large Combustion Plants Directive due for implementation in 2008, which applies to combustion plants with a thermal output of greater than 50 MW. Its purpose is to reduce acidification, ground level ozone and particles by controlling emissions of sulphur dioxide, nitrogen oxides and dust (particulate matter) from large combustion plants. These include not only plants in power stations but also petroleum refineries, steelworks and other industrial fuel burning processes.

New combustion plant must meet certain prescribed emission limit values. Existing plants may be regulated in either of two ways: (i) by use of a plant specific cap, the emissions limit value approach (which limits the rate of coal burn but does not cap the total burn), or (ii) by fixing a national maximum amount of emissions, known as the national emissions reduction plan (which caps the total amount of emissions but does not set an emissions target for individual plant). The latter would set an annual national level of emissions calculated by applying the ELV approach to existing plants, on the basis of those plants' average actual operating hours, fuel used and thermal input, over the 5 years to 2000. Environment secretary Margaret Beckett has confirmed that the UK will ask Brussels if it can combine
two available options under the directive. However a derogation allows an operator to choose the alternative of not operating the plant for more than 20,000 operational hours starting from 1 January 2008 and ending no later than 31 December 2015. This option will not be selected by generators with flue gas desulphurisation equipment. Others will have to choose between installing such equipment to reduce their emissions or move towards early closure. For example, Scottish and Southern Energy which recently acquired Ferrybridge and Fiddler’s Ferry, two coal plants, expects them to operate at a load factor of around 40% until 2008 and then for a total of 20,000 hours between 2008 and 2015, after which they are due to be decommissioned.

**Planning constraints**

A large fraction of schemes for onshore wind power are held up by planning problems. Some of these arise from local objections to wind turbines, there being no incentives to local communities to accept them. Others arise from concerns of the Ministry of Defence that high turbines would adversely affect aircraft and radar systems. It has been asserted that it takes nearly twelve months for a decision to be taken on the average wind farm planning application in England. Such delay, together with refusals, and reference to public enquiries exert a strong disincentive to developers to incur the initial costs of preparing a scheme, including making wind surveys, which have to precede planning applications. Thus although the number of schemes is large, the number under construction is still limited. In August 2004 a revised national planning policy statement for renewable energy was set out, requiring local plans to contain policies designed to promote and encourage the development of renewable energy with regional targets and providing criteria against which planning applications for renewable energy projects will be judged.
Final remarks

Regulation grows no simpler. The industry and Ofgem have both been learning by experience and, not surprisingly, greater complexity is the result. Much of the effort involved in new environmental regulation results from the adoption of a plurality of measures, governments being unwilling to adopt a single strong method for limiting carbon emissions. Renewable energy is treated as intrinsically desirable rather than just becoming economic because emissions are penalised. But at least the travails of extending the single market system to include Scotland should come to an end before long.
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3 GAS REGULATION

Graham Shuttleworth and David Hough

Introduction

During the last two years, the whole outlook for the gas industry in the United Kingdom has changed in several important respects, especially, in our view, the importance of long term investments and hence long term contracts. These long term investments will have the most dramatic effects on gas sector regulation and network tariffs in the future.

In this chapter we discuss two key themes that summarise the main changes to gas sector regulation in the UK in 2003 and, more particularly, 2004. The first theme is restructuring the UK gas pipeline business, brought about through the sale of four regional distribution networks (RDNs) by National Grid Transco.¹ The sale will affect not only the distribution sector, but also the interface between the transmission and distribution sectors, and potentially the relationship between gas supply companies and shippers. The second key theme is the continuing trend towards greater reliance on gas imports. A number of regulatory developments derive from the development of infrastructure to import gas into the UK, such as moves to exempt new interconnectors and LNG import terminals from the licensing regime, and at the same time to introduce licensing for existing interconnectors.

¹ The sale of the RDNs is still subject to the final consent of Ofgem to the sale of these assets. This is expected sometime in 2005.

Acknowledgement
The authors would like to acknowledge the invaluable assistance they received from their NERA colleague, Essie Linton.

Graham Shuttleworth, Director and David Hough, Director, NERA
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In addition to these themes we discuss the state of the gas market, focusing on physical supply, current rises in gas prices, and the outlook for future gas prices. We also consider the state of competition in the gas market, and the effect of regulatory developments on competition.

Context

Sources of gas in the coming years

Gas remains the single most important primary energy source for the UK and the main source of energy for power generation. However, the sources of gas consumed in the UK have changed significantly. Since the first quarter of 2000 gas imports to the UK have increased over five times. The Joint Energy Security of Supply working group estimated in May 2004 that the UK will become a net gas importer by 2006, confirming estimates published by Transco in its Ten Year Statement for 2003, which asserts that by 2011 the UK will be dependent on imported gas for 50% of total consumption, rising to 60-80% by 2020.

Table 1 shows the gas balance in the UK over the period from Q3 2002 until Q1 2004 (the latest figures at the time of writing).

Comparing equivalent quarters shows that indigenous production is faltering. Final consumption, on the other hand, shows no sign of declining. Imports are rising whilst exports are falling, so between winter 2002/03 and winter 2003/04, the UK switched from being a net exporter to being a net importer, a trend that is expected to continue.

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2 Department of Trade and Industry (DTI) (2004a), Energy Trends, Supply and Consumption, Natural Gas, Quarterly Tables, 30 September 2004.
4 Transco (2003), Ten Year Statement, p27.
Table 1: UK gas balance

<table>
<thead>
<tr>
<th></th>
<th>Q3 2002</th>
<th>Q4 2002</th>
<th>Q1 2003</th>
<th>Q2 2003</th>
<th>Q3 2003</th>
<th>Q4 2003</th>
<th>Q1 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supply</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indigenous Production</td>
<td>235,677</td>
<td>339,969</td>
<td>350,861</td>
<td>282,956</td>
<td>244,158</td>
<td>318,142</td>
<td>316,757</td>
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<tr>
<td>Imports</td>
<td>7,882</td>
<td>20,862</td>
<td>23,847</td>
<td>13,812</td>
<td>11,329</td>
<td>37,310</td>
<td>47,720</td>
</tr>
<tr>
<td>Exports</td>
<td>35,430</td>
<td>39,260</td>
<td>38,071</td>
<td>63,871</td>
<td>51,558</td>
<td>23,539</td>
<td>14,877</td>
</tr>
<tr>
<td>Stock change</td>
<td>-14,640</td>
<td>1,623</td>
<td>28,266</td>
<td>-7,481</td>
<td>-18,363</td>
<td>1,070</td>
<td>22,956</td>
</tr>
<tr>
<td>Transfers</td>
<td>-37</td>
<td>-25</td>
<td>-36</td>
<td>-10</td>
<td>-34</td>
<td>-18</td>
<td></td>
</tr>
<tr>
<td>Total supply</td>
<td>193,452</td>
<td>323,169</td>
<td>364,867</td>
<td>225,406</td>
<td>185,559</td>
<td>332,949</td>
<td>372,538</td>
</tr>
<tr>
<td>Statistical difference</td>
<td>-2,092</td>
<td>+3,963</td>
<td>-1,486</td>
<td>+2,990</td>
<td>+740</td>
<td>-2,369</td>
<td>-1,040</td>
</tr>
<tr>
<td>Total demand</td>
<td>195,544</td>
<td>319,207</td>
<td>366,353</td>
<td>222,418</td>
<td>184,820</td>
<td>335,318</td>
<td>373,578</td>
</tr>
<tr>
<td>Transformation</td>
<td>87,085</td>
<td>87,351</td>
<td>86,134</td>
<td>80,403</td>
<td>85,321</td>
<td>92,265</td>
<td>91,680</td>
</tr>
<tr>
<td>Energy industry use</td>
<td>19,381</td>
<td>24,691</td>
<td>24,767</td>
<td>21,670</td>
<td>19,109</td>
<td>22,877</td>
<td>23,447</td>
</tr>
<tr>
<td>Losses</td>
<td>1,813</td>
<td>2,619</td>
<td>2,106</td>
<td>557</td>
<td>1,279</td>
<td>1,866</td>
<td>2,306</td>
</tr>
<tr>
<td>Final consumption</td>
<td>87,265</td>
<td>204,546</td>
<td>253,346</td>
<td>119,788</td>
<td>79,111</td>
<td>218,310</td>
<td>256,145</td>
</tr>
</tbody>
</table>

Source: Department of Trade and Industry, Energy Trends, Supply and Consumption, Natural Gas, Quarterly Tables.

The expected growth in gas imports has prompted a number of developments in the infrastructure needed for gas imports and storage. In addition to existing interconnectors between the UK and Belgium and the UK and Norway, new pipelines are planned between the UK, Norway, and the Netherlands. The development of LNG import terminals in the UK is also accelerating. Construction of an LNG import terminal is underway on the Isle of Grain on the Thames Estuary and two separate consortiums plan to build LNG terminals at Milford Haven.

The sustained rise in UK gas prices

Another important element of the UK gas market is the rise in the level of gas prices in late 2003 and 2004. In October 2003, following a period of (till then) exceptionally high gas prices, Ofgem received complaints from a number of customers and companies, on the grounds that there were no obvious reasons for the increase in prices. In November 2003, therefore, Ofgem launched a probe into the causes of the price increase. Ofgem’s investigation found that the main driver of higher prices in the UK was the rise in continental gas prices, which now affect UK prices through trade over the interconnector. Ofgem commented also that continental gas prices demonstrate a link with oil prices,
which Ofgem suggested might be a sign that competition in the gas sector is inadequate. However, Ofgem also found a number of other factors were important:

- declining UK gas supplies;
- lack of release of European gas to the UK market;
- contracts in the UK that may have restricted supply.\(^5\)

In October 2004 prices were again exceptionally high and market sentiment implies that high prices are here to stay for a while. Figure 1 shows gas forward prices for the period to Q1 2007.

Figure 1: Gas forward prices as at 14 October 2004

![Graph showing gas forward prices from November 2004 to Q1 2007](attachment:gas_forward_prices_14_october_2004.png)

Source: Heren Report Forward Price Data: Price Assessments for Gas Traded at the NBP, quoted on 14 Oct 04

In recent years, the forward price curve for gas (as for oil) has shown sufficient ‘contango’ (rising trends) or ‘backwardation’ (falling trends) to bring price back to a ‘normal’ level within about two years. Unusually, the forward price curve quoted on 14 October 2004 does not revert to ‘normal’ price levels at any time within the next two years. This pattern mimics the position in oil markets, where current forward prices stand at $50.80 per...

\(^5\) Ofgem (2004a), Ofgem’s Probe into Wholesale Gas Prices, Conclusions and Next Steps, October, pp60-61.
barrel for November 2004 and are not expected to fall below $40 per barrel before 2007.\(^6\)

The expectation of continuing high prices in the oil market and, hence, in the continental gas market has little to do with conditions in the UK gas sector. However, the realisation that UK demand for gas will rely increasingly on imports means that these factors now play a crucial role in determining how UK gas will be used and what investment in infrastructure is required to maintain the security of supply. The industry and the regulatory authorities are both having to adapt to the requirements of this new situation.

**Competition in the gas market**

The British gas market has been fully open to retail competition since 1998, and Ofgem removed all retail price controls in 2002. However, the market is still dominated by the incumbent firm, Centrica plc (trading as British Gas), which retained over 60% of the gas supply market in 2003.

**Continuing changes in retail market shares**

Table 2 shows the market shares of the five largest gas supply companies. Competitors to Centrica have achieved some growth in market share, but they remain significantly smaller than the incumbent. Organic growth in the customer base is proceeding quite slowly and major changes in market share reflect consolidation through mergers and takeovers. PowerGen increased its market share markedly following its acquisition of TXU Energi in October 2002. LE Group also increased its market share through acquisition, by acquiring Seeboard in 2002. (the group now trades as EDF Energy.) Other firms such as SSE

\(^6\) International Petroleum Exchange, Forward Price Data (quoted for delivery within one month of forward period date), 14 October.
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(Scottish and Southern Energy) have maintained their market share by buying the customer base of independent suppliers.\(^7\)

**Table 2: Market shares in gas supply**

<table>
<thead>
<tr>
<th>Market share in gas supply</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Centrica (trading as British Gas)</td>
<td>63%</td>
</tr>
<tr>
<td>PowerGen</td>
<td>12%</td>
</tr>
<tr>
<td>Npower</td>
<td>9%</td>
</tr>
<tr>
<td>SSE</td>
<td>6%</td>
</tr>
<tr>
<td>LE Group</td>
<td>5%</td>
</tr>
</tbody>
</table>

Source: Ofgem (2003a)

Ofgem states that prices paid by non-switchers have fallen on average by 8% in real terms since 1998, which Ofgem attributes to the effect of competition (this statement precedes the considerable increase in gas prices in 2004). Despite these signs that competition is continuing to develop, Ofgem remains concerned about the market share of the incumbent, the focus of price competition on customers who switch, and supplier profitability. Ofgem has therefore decided it must continue to monitor the supply market.

**Competition in related services**

Ofgem is also pursuing competition in a number of the services related to the provision of gas, such as metering. Ofgem first highlighted the development of competition in metering services as a priority when it published its metering strategy in March 2001.\(^8\) In the following year, 2002, United Utilities became the first energy supplier to tender successfully for the provision of metering services, winning contracts with Centrica (British Gas Trading) for the provision of metering services in North Wales,

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\(^7\) Ofgem (2003a), Domestic Gas and Electricity Supply Competition: Recent Developments, p40.

\(^8\) Ofgem (2001), Ofgem’s Strategy for Metering, a Consultation Paper, March.
the North West and North East England, thereby displacing the incumbent, Transco. In 2003, British Gas awarded further contracts to Utility Metering Services (subsequently renamed OnStream), a subsidiary of National Grid Transco (NGT) and Siemens.

Despite these developments, Ofgem is continuing to act to increase competition in the metering business. In 2004, Ofgem issued a final decision on a series of amendments to the transmission licence imposing the formal separation of Transco’s own metering businesses from its other activities.\(^9\)

The development of competition is also an issue in gas storage. Following Dynegy’s acquisition of BG Storage in 2001, the Office of Fair Trading (OFT) referred Centrica’s subsequent acquisition of Dynegy to the Competition Commission in 2002. The Competition Commission’s report voiced a number of concerns and recommended that twelve behavioural remedies be applied to Centrica.\(^10\) Chief among these remedies is an undertaking to supply capacity to firms on non-discriminatory terms, but Centrica also had to undertake not to participate in the primary sales process, and to apply legal, financial and physical separation between its storage business and other businesses. However, the Commission noted that divestment of the Rough facility may be required should Centrica fail to comply with the behavioural remedies. This remedy was also supported by Ofgem, but has not so far been implemented.\(^11\)

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\(^9\) Ofgem (2003b), Competition in Gas Metering Services, Proposed Licence Amendments, December.
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Sale of the regional distribution networks

The sale of the regional distribution networks (RDNs) was, in our view, the single most important event in the restructuring of the gas industry since the demerger of Centrica plc from British Gas in 1997 and it will have a major impact on regulation of the UK gas sector. Although the gas supply market in the UK remains dominated by Centrica, the sale marks the end of the monopoly held by National Grid Transco (NGT) over gas distribution and thus a major diversification of ownership within the sector.

The sale disposed of four regional gas distribution networks:

- the North of England RDN: sold for £1.4bn, to a consortium led by Cheung Kong Infrastructure Holdings Limited and including United Utilities PLC;

- Wales & the West RDN: sold for £1.2bn, to a consortium led by the Macquarie European Infrastructure Fund;

- Scotland RDN and the South of England RDN: sold for £3.2bn, to a consortium comprising Scottish and Southern Energy plc, Borealis Infrastructure Management Inc and Ontario Teachers Pension Plan.

Following the asset sales, NGT will retain gas distribution networks in the West Midlands, London, the East of England, and the North West.

Implications for gas retail markets

The creation of individually owned RDNs will affect the operation of both the transmission and distribution systems. One key impact will be the mechanisms put in place to ensure the smooth functioning of the market. Previously, Transco determined the provision of exit capacity and other services on
the transmission and distribution networks. Following the divestment, the different network operators must find a way to co-ordinate their decisions. To facilitate this co-ordination Ofgem is proposing the establishment of an agency that will carry out, on behalf of the network companies, many of the functions that NGT currently carries out under the banner of supply point administration.

Other initiatives have been progressed by Ofgem during the period to improve retail governance. In particular, the introduction of a licence obligation for domestic gas suppliers to comply with the supply point administration agreement (SPAA) was introduced in April 2004. The SPAA, drafted by the gas industry governance group (GIGG), was intended to establish governance rules for gas retail market processes, in particular, the transfer of customers between gas suppliers.\footnote{Ofgem (2004b), Gas Retail Governance, Decision Document, April.}

**Implications for licences**

Transco’s current licence reflects the previously integrated nature of its business and the sale of the RDNs will require changes to Transco’s licence, as well as new licences for the new RDNs. Ofgem’s initial view is that one standard form of licence will in future apply to both the transmission and distribution companies. However, certain conditions will be ‘switched off’ in each licence, as appropriate to define the roles of transmission and distribution network operators.

Each of the six new gas transporters’ licences will require a separate price control. Initially, Ofgem will set these price controls in line with the price control currently in place for Transco. Transco’s current price control works by setting five-yearly RPI-X price caps for the transmission business and for each of the eight regional distribution zones.\footnote{Only metering and meter reading services are excluded from the RPI-X price control due to the development of competition in these services, they are subject to a tariff cap and a non-discrimination condition.} The price controls

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\footnotetext[12]{Ofgem (2004b), Gas Retail Governance, Decision Document, April.}
\footnotetext[13]{Only metering and meter reading services are excluded from the RPI-X price control due to the development of competition in these services, they are subject to a tariff cap and a non-discrimination condition.}
define a revenue which is 65% fixed and 35% dependent on deliveries of gas at different pressures, plus a number of incentive payments. The main incentive scheme is a reward for replacing old pipelines, as required by the Health and Safety Executive. This scheme gives Transco receives a fixed price per km of pipe replaced, where price depends on the diameter of the pipe, and allows Transco to share any variation in unit costs.

Following the creation of the independent RDNs, Ofgem does not propose to reopen Transco’s price controls and may even extend them for an additional year until 2008.\textsuperscript{14} Ofgem does however propose to apply a new incentive scheme to distribution networks owners to encourage efficient investment. These incentive arrangements will supplement the current price control arrangements. Their form is to be decided in a forthcoming consultation.\textsuperscript{15}

The creation of separate RDNs will affect Ofgem’s ability to compare the costs of each business at the next price control review, although it remains to be seen whether such comparisons provide any truly valuable information.

\textit{Implications for relations between transmission and distribution}

The sale of the RDNs created a need for new contractual agreements to govern the relationship between NGT and the RDNs, including those owned by NGT. Ofgem’s preferred approach is to make each RDN responsible for RDN system operation and for planning on its own network. Each RDN would have its own set of system operator (SO) incentives and, potentially, its own investment and planning obligations.

\textsuperscript{14} Ofgem (2004c), Open Letter on Gas Distribution Price Controls, 16 March.
However, these decisions will affect Transco’s planning of the transmission network. The relationship between the NTS and each RDN will be governed by a uniform network code, which has yet to be finalised, and the creation of regional distribution networks owned by new investors will have several important longer term consequences (Ofgem, 2004d).

For example, the need to co-ordinate investment decisions in transmission and distribution networks will give the RDNs a voice that they have not been able to wield independently of Transco in the past. RDNs may therefore come to play a much larger role in deciding where Transco invests in its network. Depending upon who pays Transco’s costs, shippers or the new RDNs may seek to influence the terms and duration of contracts for exit capacity. RDNs may disagree with Transco’s investment plans, and shippers or RDNs may object to paying the costs of Transco’s investments without securing some long term security in return. Putting these pressures together, we may find that the system moves closer to a ‘contract carriage’ system than many people imagine. If this is the case, then this could change the way the whole gas industry works.

Special administration

Although not strictly related to the sale of the RDNs, Ofgem’s new powers to appoint a special administrator, in the event of insolvency of network companies, also change the ‘rules of the game’. The role of the special administrator will be to keep networks running, should a monopoly network business become insolvent. The need for a special administrator arises in part because monopoly network operators are operating under various different ownership structures in association with increasingly diversified and, perhaps, risky businesses. Ofgem is therefore concerned to ensure that problems in these other businesses do not infect the regulated network and prevent it from operating efficiently. The ability to appoint a special administrator provides a safety net.
The new powers bring the energy network companies into line with similar powers over the railways and the water companies. However, the effects of the change are not universally on the benefit side. The power to impose a special administrator will reduce Ofgem’s concerns over bankruptcy, which currently acts as a constraint on the behaviour of the regulator. Removing this constraint will increase regulatory risk, in that Ofgem will be more able to take actions that drive a company into insolvency; Ofgem’s statutory obligation to allow licensees to finance their licensed activities may therefore come under closer scrutiny.

**Changing relations within the sector**

The need to change industry documentation to cope with the sale of the RDNs is well recognised and proceeding rapidly. What is less widely recognised is the way in which the restructuring will change business relations within the sector. Transco will no longer be able to plan the whole system and will have to coordinate closely with independent RDNs. Given that RDNs will probably want to minimise their own costs, and have no interest in letting Transco’s costs rise, the RDNs can be expected to dispute some of Transco’s decisions about investment in exit capacity and the allocation of costs. The process of resolving such disputes (or even overcoming discomfort about Transco’s methods) could lead to radical changes in the tariff and contracts applying to exit capacity, just as we have seen changes in the way of allocating and pricing entry capacity. Putting the two trends together could leave a very different role for Transco in the long term.

**Gas import reliance and gas market regulation**

The period under review saw some notable developments in the regulation of the UK gas market. Many of these regulatory developments relate to the increasing reliance on imported gas
and the concurrent requirement to develop the necessary gas import infrastructure, including both cross-border interconnectors and facilities for the importation of LNG.

The 2003 Energy White Paper addresses both the reliance on imported gas and the importance of gas relative to alternative fuels by encouraging investment in more diverse sources of gas supply and, more generally, diverse energy sources. However, increasing the diversity of gas supply will depend on the UK’s ability to increase both foreign sources of supply and entry points into the UK.

Publication of proposals by the Department of Trade and Industry (DTI) to introduce a licensing regime for interconnectors and LNG import terminals will affect the development of such facilities and therefore the development of entry points into the UK. These proposals are consistent with the procedures set out in the 2003 EU Gas Directive and the Energy Act 2004, which requires a system of regulated third party access be applied to interconnectors. Licensing will impose requirements to offer third party access and a transparent charging methodology for third party access to a licensee’s interconnector. Licensed interconnectors also face a requirement to offer terms for access to the licensee’s interconnector and for dispute resolution. Investors might be wary of such provisions, when large investments are at stake.

However, the licensing regime also allows for certain provisions to be ‘switched off’, providing an exemption from the general obligations. The DTI has already proposed to grant licence exemptions for specific facilities. These exemptions are aimed at encouraging the development of new entry points for gas

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imports into the UK. The exemption criteria listed by the DTI are:

- that the investment in the licensee’s interconnector enhances competition in gas supply and, enhances security of supply;
- that the level of risk attached to the investment is such that the investment would not take place unless the exemption is granted;
- that the interconnector is not owned by the relevant system operator;
- that charges are levied on the users of the interconnector;
- that the exemption is not detrimental to competition or the effective functioning of the internal or gas market, or the efficient functioning of the regulated system to which the interconnector is connected.

The exemption of some facilities from certain parts of the regulatory regime (ie, third party access and regulated tariffs for the duration of the contract for capacity) is intended to have the effect of encouraging investment in interconnectors, which would be beneficial to security of gas supply in the UK, and increase competition in the sector. As the DTI puts it in its recent consultation on proposals to exempt LNG import facilities from the need to hold a gas transporter’s licence, the stated objective of the exemption is “to minimise the regulatory burdens on operators of these import facilities at a time when the UK is becoming increasingly import dependent”. So far, Ofgem has agreed provisionally to offer exemptions from the requirement to allow third party access and charge regulated transportation charges to:

- the planned pipeline from the Netherlands to the UK (the ‘BBL pipeline’ connecting Bacton and Balgzand);

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18 DTI (2004c), Consultation on a Possible Exemption from the Requirement for a Gas Transporter Licence in Respect of Liquefied Natural Gas Import facilities, 3 September, p3.
• LNG terminals at the Isle of Grain on the Thames Estuary; South Hook and Dragon at Milford Haven.

An important effect of licence exemptions is to allow investors to secure the necessary funding for investment through long term contracts for capacity, rather than the short term (eg, monthly, annual or even 5-yearly) arrangements found on the existing network(s). The willingness to offer these exemptions means that in future the gas network access regime might consist of short term tariffs for existing networks, plus long term contracts on new investment in interconnectors and LNG terminals with a significant role in security of supply.\(^\text{19}\) However, the use of long term contracts to finance investment does not rule out the creation of a short term access regime.

By way of example, the BBL pipeline will be covered by long term contracts that offer tradable capacity and a short term ‘use-it-or-lose-it’ provision. Thus, when shippers do not wish to use contracted capacity for a certain period, they will have an incentive to ‘sub-let’ some or all of their capacity to another shipper. GTS is considering whether to make available a bulletin board for the BBL, where shippers can post offers of capacity to facilitate secondary trading. Moreover, if shippers fail to nominate capacity by some deadline, the pipeline operator will make it available on an interruptible basis to other shippers.\(^\text{20}\)

These characteristics are similar to the ‘contract carriage’ access regime found in the United States. If applied to all significant new investments, it would result in a very different regime from the short term third party access tariffs envisaged in the directive.

\(^{19}\) This will only apply until they have to invest in new capacity, at which point longer-term arrangements will become necessary, as in the case of Transco in Britain.

\(^{20}\) Gastransport Services (2003), Draft Application for an Exemption for the Balgzand Bacton Pipeline Project (BBL), Ofgem website, September, p4.
Looking ahead

In our view, two key factors will decide the outlook for the industry: high and enduring gas prices, and an increasing reliance on gas imports.

High gas prices look likely to stay for a while. Current forward curves do not show any reversion to past price levels in the next two years, which mimics the position in oil markets. This trend will primarily affect consumers, as gas supply companies seek to pass through increases in wholesale prices.

In addition to high prices, the UK will become increasingly reliant on gas imports, which will not only change the nature of the risks facing British consumers (eg, reliance on gas policies in other jurisdictions), but will also increase reliance on investment in new delivery facilities (interconnectors and LNG). The reliance on new investment may diminish the industry’s appetite for experimenting with short term network tariffs, a feature of the British system since the mid-1990s, and increase reliance on TPA-exemptions for long term contracts, in order to secure finance for long term investment.

The long run effect of the move to long term financing and long term contracts may be a standardisation of this system. In other words, to facilitate efficient competition, these long term contracts may have to offer standard terms for the definition of available capacity and charges, with standard provisions for allocating and reallocating capacity. Such standardisation would lead to a more formal system of contract carriage, rather than a mix of short term ‘entry-exit’ tariffs and a set of ad hoc exemptions. That would be a truly exciting development in the EU regulatory framework.
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4 POSTAL SERVICES REGULATION

Paul Dudley

Introduction

The Postal Services Act established a regulator (Postcomm) for the postal sector with four objectives, which were placed in an order of priority.¹ The act set the regulator’s first objective as that of ensuring the provision of the universal service;² the second as that of promoting effective competition to further the interest of postal services and having regard to specific groups;³ the third, as the promotion of efficiency and economy; and the fourth, as that of having regard to the need to ensure the financial viability of the licence holders. Under the act, the regulator issued Royal Mail Group a licence to undertake the provision of the universal service, a requirement of the state under the EU Postal Services Directive.⁴

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² “a universal service is provided if (a) except in such geographic conditions or other circumstances as the Commission considers to be exceptional – (i) at least one delivery of relevant postal packets is made every working day to the home or premises of every individual or other person in the United Kingdom or to such identifiable points for the delivery of relevant postal packets as the Commission may approve, and (ii) at least one collection of relevant postal packets is made every working day from each access point.” HM Government (2000), The Postal Services Act, Part 1, paragraph 4. See also footnote 6.
³ Individuals who are disabled or chronically sick, pensionable age, low income, and reside in rural areas.
The Royal Mail Group comprises Royal Mail Letters, Parcelforce and Post Office Limited. In recent years, Post Office Limited has embarked on significant changes to the post office network; Parcelforce has rationalised its operations to focus on its parcel and express customers; Royal Mail Letters business has undertaken a significant rationalisation of its network (which is referred to as the renewal plan).

This chapter focuses on the Royal Mail Letters business, which undertakes, amongst other requirements, the universal service obligation for the UK under a licence from the UK regulator.\(^5\) The market in which this business operates is being progressively opened up to competition both in terms of end-to-end services and downstream access services. In addition, the regulator has commenced a review to set the next control of prices and quality of service when the current control ends.

### Universal service

The mail service involves the collection, outward sortation, transportation, inward sortation and delivery of mail items. Public tariff services are available to all customers and include domestic first class (next day delivery); second class (three day delivery) mail and general parcels that are sent and delivered within a region/country; and international mail that is sent by airmail and surface from the UK. In addition, there are registered next day services at premium rates and discounts on the standard domestic and international mail prices for bulk mail.\(^6\)

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\(^6\) Bulk mail relates requires a minimum mailing. There are a range of discounts relating to the costs avoided from, for example, the class (prescribed duration between collection and delivery), machineability of the mail, level to which the mail is sorted, and extend to which mailings exceed the minimum.
The directive defines an obligation on each member state to provide a universal service and describes it in terms of the collection and delivery each working day of domestic and international postal items at an affordable price within a geographic region. The directive also allows individual member states to apply a geographically uniform price throughout their national territory within this universal service obligation, which for the UK is introduced through the act. Consequently, neither the directive nor the act prescribes products offered by Royal Mail to be within the universal service.

The universal service obligation could be met through Royal Mail’s public tariffs of the second class domestic mail, general parcels and surface mail (excluding domestic first class next day delivery and international airmail) since these services fulfil the obligation of daily collection and delivery. They are also affordable in the sense that they are cheaper than the domestic first class and international airmail services.

The definition of the universal service could be narrowed further by reference to the methods of payment. The most universally available and known is that of the postal stamp. However, franking machines and pre-paid postage impressions on account are also used. The directive and act make no reference to all three payment methods necessarily being within the universal service and, as such, the definition could be narrowed to include only mail paid through stamps as the universally available payment method.

While such narrow definitions of the universal service appear consistent with the directive and act, the UK regulator has set out

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7 A universal service is provided in the UK if “(b) a service of conveying relevant postal packets from one place to another by post and the incidental services of receiving, collecting, sorting and delivery such packets are provided at affordable prices determined in accordance with a public tariff which is uniform throughout the UK and (c) a registered post service is provided at such prices.” HM Government (2000), The Postal Services Act, Part 1, paragraph 4. See also footnote 2.
proposals define the universal service in broader terms to include not only the public tariffs but also some bulk mail services used by some businesses with large mailings. Reasons for this broader definition could include a belief that the first class public tariff and airmail services are engrained in the UK public’s psychology as being, in some way, universal, or a belief that broadening the universal service obligation on Royal Mail will facilitate the promotion of effective competition by constraining Royal Mail from implementing more cost-reflective, geographic pricing. Both of these explanations would be consistent with the current definition of the scope of the universal service being temporary and part of the transition period to a competitive market.

Finally, in addition to leaving the definition of the universal service open, neither the directive nor the act defines affordability. To date the price control has set maximum price increases in individual prices at the RPI inflation rate for the first price control and the RPI inflation plus 1.5% in the current and second price control. However, this is not based on any assessment of affordability. Indeed, at no point in the past have postal prices been defined or considered to be unaffordable and postal prices have progressively fallen in real terms under a single supplier in the presence of mail volume growth, greater efficiency and economies of scale. On any reasonable assessment of affordability, there would be scope to increase significantly individual postal prices. In addition, the directive requires that prices should be “more geared to cost” or more cost-reflective. Consequently, the directive appears to envisage significant rebalancing and restructuring of prices, with some guidance on the direction of the price changes.

In summary, there remains some scope for the definition of the universal service in the UK to be narrowed and still meet the requirements set out in the directive and act. A narrowing of the definition would increase the flexibility for Royal Mail to

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introduce geographic pricing, but could require a significant change in opinion as to what constitutes a universal service in the UK. Meanwhile, the existing broader definition of the universal service remains a very significant issue for Royal Mail, and particularly so as the market is opened up to competitors who have no universal service obligation.

Competition in end-to-end services

Since the 1980s the standard UK approach in the utility industries has been to open the market to competition in services where entry is economic and welfare enhancing. Regulation was considered necessary in the transition period for the development of the competitive market and in the provision of services where entry was neither economic nor welfare enhancing. To facilitate this, the single process undertaken by the utility has, in several instances, been split into separate activities. For example, in electricity, the supply and generation functions were separated and opened to competition, while the distribution and transmission functions remained regulated under licences that prohibited duplication and protected the monopoly status within a prescribed geographic area for each respective business.

For Royal Mail, there are significant assets in the property and machinery (primarily in mail centres, regional distribution centres and delivery offices) to undertake the functions of collection, outward sortation, transportation, inward sortation and delivery of mail items throughout the UK, as required by the universal service obligation. These fixed costs mean that there are significant economies of scale within the end-to-end services, which are most pronounced in the delivery function.\(^9\) However,

whereas the licences for transmission and distribution in electricity restrict the duplication of the network, there is no similar restriction on competitors using property to undertake any part of the mails function in any part of the country. Instead, the directive refers to a reserved area in which competition is restricted. The reserved area is defined by the weight and price of a mail item.

The directive has set out how the reserved area is to be reduced in time:

- under 350g items or 5 times the public tariff for an item of correspondence in the first weight step of the fastest standard category in 2000;
- under 100g items or 3 times the public tariff for an item of correspondence in the first weight step of the fastest standard category in 2003;
- under 50g items or 2.5 times the public tariff for an item of correspondence in the first weight step of the fastest standard category in 2006;
- and then a further review will lead to a significant further step, possibly full liberalisation, in 2009.

This is akin to the regional electricity supply businesses’ reserved areas with no competition for under 1MW (in 1990) then under 100kW (in 1993) and no limit (in 1998). However, there are two significant differences between the market opening in electricity and that envisaged by the directive. First, the network distribution businesses of the regional electricity companies were protected from competition through the rights to distribution within the licence, whereas Royal Mail’s licence does not offer such protection. Secondly, while it was envisaged that the whole electricity supply market would be opened up to competition from the outset, the directive does not prescribe full marketing opening from the outset; the directive recognised the need to ensure the provision of the universal service and the potential need to retain a reserved area for up to 50g items to secure the universal service.
While the directive envisaged a gradual opening up of the mails market to competitors, it provided the scope for individual member states to move more rapidly towards the removal of the reserved area. In May 2002, the UK regulator issued a decision to increase the pace of market opening in addition to and beyond that of the directive by licensing operators of predefined services within the reserved area. In the period to March 2005, this related to operators wishing to (a) provide mailing with at least 4000 items in the same format (bulk mailings), (b) consolidate mail from a number of users, and (c) provide specific and specialised services.\(^{10}\) In the subsequent period to March 2007, this related to a further reduction in the requirements for bulk mailings.\(^{11}\) Finally, from March 2007 onwards, all service restrictions were to be lifted. In September 2004, the regulator proposed to bring the March 2007 date forward to January 2006, three months ahead of the end of the current price control.\(^{12}\)

With no reserved area to ensure the universal service it becomes less clear as to what is in place to meet the regulator’s primary duty of ensuring the long term future provision of the universal service. While the level of competition to date is relatively small and primarily focused on niche markets, entrants are developing their strategic plans and entry is expected to increase significantly over a transition period. There are several additional levers that could facilitate the provision of the universal service during such a transition period:

- Royal Mail could become a more efficient universal service operator. Ahead of the last price control review the Royal Mail identified the scope for a step change in efficiency through what it called the renewal plan. There may be further efficiencies to be obtained, but these efficiencies may take

\(^{10}\) Or an average mailing of 4,000 items if under multiple mailing contract.\(^{11}\) Either through a reduction in the minimum number of items and/or the restrictions on the definition eg, the requirement for the mailing to be posted from a single site in the same format.\(^{12}\) See Postcomm (2004b), Revised Market Opening Timetable, September.
some time to extract given the significant labour input in the mails business, and will become exhausted over time as in other regulated businesses.

- Royal Mail could have the flexibility to rebalance and restructure its prices to be more cost-reflective. As examples, the second price control facilitated some price rebalancing between products that were much needed from historic prices that were not well aligned to cost and Royal Mail has applied to restructure its prices to be based on size rather than just weight to better reflect the costs in its processing of mail.\(^\text{13}\) A further example is a narrowing of the universal service definition to facilitate geographic pricing (see above). Even with greater flexibility there remains a question as to whether some prices can continually increase to recover the fixed costs of the provision of the universal service as traffic is lost to competitors or moves to other mediums of communications. This is referred to in the literature as the ‘graveyard spiral’ and is primarily an issue of future demand functions and demand elasticities that are inherently uncertain.\(^\text{14}\) While it may be hoped that the future demand functions will ensure the long-term provision of the universal service, there is a significant risk that they will not.

- Royal Mail could benefit from any remaining obstacles to entry beyond that of the reserved area. In this context, whether a real or illusionary obstacle, the regulator has referred to the need for competitors to charge VAT while Royal Mail remains

\(^{13}\) For example, in Sweden there has been a significant rebalancing of prices, reducing bulk mail prices and increasing public tariff prices.

VAT exempt as a barrier to entry.\textsuperscript{15} However, many business customers can reclaim input tax, significantly reducing the average impact of any such change and causing variation in the impact between businesses. In addition, the regulator’s petitions to remove the VAT exemption status of Royal Mail to promote effective competition needs to be seen in the light of its actions and plans to ensure the long-term provision of universal service (its primary duty). Ultimately the decision on VAT lies with the government rather than the regulator.

It is difficult to see any actions or plans by the UK regulator that are specifically in place or being sought to ensure the long-term provision of the UK-wide Royal Mail network and universal service. Without such action, the long-term future of the universal service and Royal Mail is at significant risk. At the end of the potential transition period, the only means of securing the universal service is through some form of funding through external taxes, be they on competitors or from central funds.\textsuperscript{16} \textsuperscript{17}

In summary, the UK mails market is being opened much like the electricity supply market, but without a reserved area to ensure the protection of the Royal Mail network. A transition period is likely in which various levers would be pulled to try to ensure the provision of the universal service. However, there remains a significant risk that at the end of the potential transition period there would be no further means of ensuring the provision of the universal service other than to resort to external funding.

\textsuperscript{15} See Postcomm (2004c), A Review of Royal Mail’s Special Privileges, Consultation Document, January.
\textsuperscript{16} As already introduced in Finland.
\textsuperscript{17} See De Donder P, Cremer H and Rodriguez F (2002), Funding the Universal Service Obligation under Liberalisation, in Postal and Delivery Services: Delivering on Competition Crew MA and Kleindorfer PR (eds), Boston, Kluwer Academic Publishers.
**POSTAL SERVICES REGULATION**

*Competition through downstream access*

Under its licence Royal Mail is required to offer terms for access to its postal facilities on reasonable and non-discriminatory terms. In 2001, a competitor to Royal Mail, UK Mail, entered negotiation with Royal Mail for access to its delivery network and subsequently sought a determination from the regulator over the terms of access to Royal Mail’s postal facilities. In 2003 agreement was reached between UK Mail and Royal Mail over the terms of access, which commenced in April 2004.\(^{18}\) These terms are available to all on a non-discriminatory basis, including not only other mail operators, such as UK Mail, but also customers.\(^{19}\) Several operators have since signed access agreements with Royal Mail and further take up is expected in the period ahead.

While access is not new to utility industries, particular features make the issue complex for Royal Mail:

- There are inherent cross subsidies within the mails business pricing arising from historic pricing and the universal service obligation. Royal Mail’s pricing policy and original offer of access was based on the end to end tariff less the costs avoided by it (‘tariff minus’), a principle set out in the directive. The regulator was interested in an approach of setting the access price based on a cost plus margin (‘cost plus’).\(^{20}\) Royal Mail considered the low access prices derived by the ‘cost plus’ methodology to threaten its finances and in particular the recovery of the contribution necessary to ensure the provision of the universal service.

- Third party access was sought to the delivery offices, prior to final delivery by Royal Mail. This not only involved the

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\(^{18}\) See Postcomm (2003b), Postcomm Welcomes Access Head of Terms, December.

\(^{19}\) Of which the primary interest would be amongst large customers.

\(^{20}\) See Postcomm (2003c), Access by UK Mail, Notice of Proposed Determination, Reasons etc, May.
potential of third parties to access delivery offices that were not designed for such a function, but also the need for further sortation at the delivery offices of returning mail to the mail centre up the process line for sortation before returning to the delivery offices. Significant additional costs were involved and led to a resolution for terms of access to mail centres.

- The delivery cost per letter increased significantly with reduced delivery point density. The access service was a new service that did not come under the definition of a universal service and, as such, was not subject to the condition of uniform geographic pricing (and affordability). Consequently, the initial access prices were set on the basis of a national profile of mail, with deviations from this incurring different costs and price variants (for example, in the case of a geographically differentiated access price).

The fundamental issue, though, was whether an access price could be set that was sufficiently low to encourage entry into access services and sufficiently high to retain interest in end-to-end entry and not undermine the provision of the universal service. It would have been difficult for the regulator to judge such a balance appropriately, particularly given its emphasis on the promotion of effective competition as seen through its decisions on market opening for end-to-end services (see above) and more recent publications.\(^2\) The business offering the service is likely to be the best at judging such a balance and Royal Mail’s licence facilitates this by placing the onus on a negotiated settlement.

If the access terms lead to competitors using the access facility rather than develop their own network, then they provide a means of securing the recovery of some the fixed costs involved in the provision of the universal service. In the United States, the access to the universal service provider is mandatory for this purpose. However, as discussed above, the UK market has been

opened up and it remains possible for competitors to develop their own delivery networks and bypass the Royal Mail delivery network.\textsuperscript{22}

In summary, the risk to the universal service remains with the introduction of downstream access but may be reduced if the access terms are appropriately balanced. This is perhaps an area where the market should be allowed to develop without the intervention of the regulator.

Control of prices and quality of service

In April 2003, the UK regulator introduced a new price and quality of service arrangement for Royal Mail that was expected to be in place for 3 years but could be extended. Prior to that date the price control set a limit on individual prices such that prices in the reserved area were price controlled and capped at their nominal values, while those in the non-reserved area and price controlled could increase by no more than the rate of inflation.\textsuperscript{23} The new price control restricts the prices for over 20 billion items with a turnover of over £5bn. It set a limit on the average price increase of a single basket of prices at RPI inflation less 1\% per annum with the scope to rebalance prices and set a


\textsuperscript{23} The latter also included a few prices within the reserved area.
maximum of 1.5% above RPI inflation per annum. In addition, the price control made special provision for price changes to the basic weight step of first and second-class mail which, in itself, accounts for a significant portion of Royal Mail’s overall traffic and revenue.

In March 2004, the UK regulator commenced its review for the next price control. This price control will cover a transition period towards the development of a competitive market and is expected to be of 3 or 5 years duration. The setting of the price control will need to reflect the balance, as set out in the act, of the regulator’s duties to first, ensure the provision of the universal service, second, promote effective competition, third, to promote efficiency and economy and, finally, to have regard to the finances of the licensee.

Most of the key issues in the development of the mail market have been raised in this chapter and are summarised in the context of the price control review as follows:

*Ensuring the provision of the universal service (and financial viability)* involves:

- the levels for the allowed profit, pensions deficit, expenditure and savings;\(^2^5\)
- the flexibility in Royal Mail’s prices (though rebalancing, restructuring or adjustments to the level for allowed revenue) to help recover the contribution for the provision of the universal service lost from competitive entry;

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\(^{24}\) Set on a cumulative basis so that price increases could exceed the 1.5% above inflation in any year and catch up if there was slack from a previous year.

• the development of access terms which, as this paper states, is best undertaken by Royal Mail in negotiation with its competitors.

Promoting effective competition involves:

• the level of Royal Mail’s prices, the extent to which they reflect costs and the headroom for entrants to offer lower prices;
• the timing of market opening and the treatment of the reserved area;
• the treatment of other potential obstacles to entry, whether real or imaginary;
• the restrictions and limits placed on Royal Mail’s freedom to compete.

Promoting efficiency and economy involves:

• the levels for the allowed profit, pensions deficit, expenditure and savings;
• the flexibility for Royal Mail’s prices to become more cost reflective and promote efficient entry;
• the incentive for Royal Mail to best utilise its economies of scale and increase its mails volume.

Finally, the quality of service targets are set out in Royal Mail’s licence and audited by Postwatch. Both compensation payments to customers and reductions to the allowed revenue (and thereby prices) arise from failures to meet the quality of service targets. Royal Mail has struggled to attain the high targets expected for service quality, and particularly so in 2003/04 as significant operational changes were introduced as part of its Renewal Plan. The quality of service is a critical

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26 The customer body for the UK mails industry.
27 See Postcomm (2003d), Review of Royal Mail Group plc’s Price and Service Quality Regulation, February.
factor in improving customer satisfaction and placing Royal Mail in the best position to retain its customer base going forward.

In summary, the next price control will be key to managing the development of the mails market through a period of significant transition. Through its incentives and restrictions the price control will have a fundamental influence on the market position of Royal Mail during and at the end of the period, and the extent to which it is able to undertake the universal service obligation into the future without external funding.
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5 RAIL REGULATION

Hugh Aldous

Introduction

In truth, dear public, ‘You’ve never had it so good’. New track, new rolling stock, gentle fare increases (so far!), more trains, few strikes and even less leaves on the line. Slight problems with punctuality. Rail travel has rarely been better. All at huge cost – but not directly to our wallets. Soothing oleaginous words in a calming white paper. Worries are a distant concern. Except if you have been in the Treasury and watched public expenditure support for railways increase to around £4bn per annum and renewals spending (which of course you guarantee) rising like a balloon.

To which can be added something like another £3.5bn per annum currently of ‘private investment’ - ie, expenditure not from the public purse, although the entire structure is effectively financed and guaranteed from there. Shortly there will be something of the order of £22bn (give or take) of government backed borrowing.

You could probably refurbish the entire schools system for that and have an intellectual asset for our society and our economy. From which would one get the better return?

How did that happen?

‘Hatfield’? Years of under-investment by Railtrack/Tories/anybody? Failing to ask for an interim review in the summer of 2001? Excessive emphasis on safety and new engineering standards? Or did Stephen Byers release the floodgates by removing the critical commercial constraint that stopped massive demands by infrastructure managers, and those demands were
RAIL REGULATION

subsequently met with regulatory approval? Economic historians have a case study to unravel: how did the signal box that pulled the levers of regulation, network directions, public representation and cash management open the line to express cash consumption – and for what value and against what other calls on the public purse?

Before the Treasury Select Committee re-forms and blames the regulator and Mr Winsor returns from the City to remind us of our facts and of the law, some key events are worth recalling for those unfamiliar with them (and those who do know these events will know that there is a huge history of other matters not set out here). October 2000 saw an access charges review (the process which determined the income that Railtrack needed to obtain, through charges to franchised passenger services and in addition to grants and other sources, to operate, maintain and renew the existing infrastructure at set levels of performance). That established that Railtrack was entitled to £14.9bn for the period 2001 – 2006. This was followed shortly afterwards by (in my view) the unnecessary Administration of Railtrack. There were then a couple of small interim reviews of no great consequence, but December 2003 saw the conclusion of another access charges review and the regulator decided that Network Rail would receive £22.2bn through access charges for the operation, maintenance and renewal of the network over the five years starting 1 April 2004. The regulator’s determinations were coupled with expectations and requirements of Network Rail which were always extensive, setting baseline outputs and requiring efficiency savings. Enthusiasts can read all that and more in the reviews themselves.

As a consequence Network Rail has all the cash it needs and Railtrack could have made its case for that.

Most businesses agonise over cash, margins and sustainable returns. How can they generate the best return they can out of what sustainable business? They worry about whether the market thinks that the business is adding value by its actions or
not. Remove those market dynamics and an alternative framework is essential. This is even more vital for the railway as a whole, because much of the railway is inherently cash consuming and commercially value destructive. Its social attributes have to be supported by the state, hopefully as value for public need.

Regulatory governance

How do we now govern something that is ‘not re-nationalised’ but whose drivers are only commercial if you can value and interpret the public benefit? Something where change still takes years and the implications of change are not clear for some time either. How does one govern a business in which the consequences of change happen on a far longer timescale than political or commercial franchise decisions?

How do you govern a monopoly that is intended to operate commercially whilst cushioned by the state from its market? Even the NHS has some private comparators. Inherently cash consuming, the capital ‘assets’ of the railway soon become liabilities unless, quite unusually, public willingness to pay generates a real return from a so-called enhancement (examples please on one side of one piece of paper).

In the past governance of the railway was not too difficult: an ‘under-secretary job’, by and large. A secretary of state appointed a chairman. The secretary of state took advice from a group of able officials who in turn had a slightly wary relationship with their opposite numbers in the Treasury. Nothing was formally written down. No one took 10 year transport plans seriously – or the French (who did). Things evolved. Over time the country got the railway that was the product of constructive tension between Treasury, department and chairmen, monitored with amateurish intensity. The outcome worked. It was cheap. The net modern equivalent was never foreseen, but it was dictated by cashflow. British Rail
sandwiches may have been the butt of jokes but both chairmen and secretaries of state had staff skilful at answering letters from the public. The formality of governance of the railway was identifiable: a courtly correspondence between the secretary of state (whose officials carefully placed responsibility on the chairman) and the chairman and board of BR, who accepted it - in return for the chairman’s knighthood.

What’s the point of that reminiscence today? None specifically! History is never as simple as retrospect suggests, and the clock cannot be turned back, but there is this point: that was a forum of governance, now there is no focus for governance; and even if there was, there is no way to apply it. As the previous regulator put it in July of 2004, “the emerging picture as the 15 month review proceeded...showed by how much the revenues of Network Rail would have to rise to maintain the existing pattern of services...[The SRA, Department for Transport and Treasury] failed to take the necessary avoiding action which could have led to much lower levels of access charges and compensating grants”. In other words, the regulator did his job, but they (the departments and the SRA) did not do theirs for the outcome they might have wanted. But how could a secretary of state announce, before a review had concluded, that he had directed that there be less services, or less high speed, for example? Government has never previously got into the business of specifying the outputs it requires. That former regulator might well have been legalistically right (he usually took care that he was) but the system of governance was frankly dysfunctional.

Governance is normally a process by which people of appropriately skilled minds try to achieve agreed objectives through a strategy that is evident, monitored and has in-built checks and balances. Minds in quoted companies are concentrated by a stock market that dumps the shares of the inept. Often the people charged with governance in the private sector meet as a board (or two, if you are Shell) and feel fairly acutely responsible for economic activity on the one hand and have shareholders to whom they are accountable on the other.
The structures set up during and after privatisation were inappropriate for public governance, or for competition or overall control in the public interest, and putting Railtrack into administration demonstrated that even a struggling board controls cash better than pulling the whole edifice firmly into the lap of government.

Railways are exercises in logistics and utilisation organised in the interest of the consumer (though you might not think so in a freezing cold carriage with an inaudible announcement). Speed, frequency and efficiency are expensive. But the consumer’s wishes are disconnected from market economics. First there isn’t seriously much choice. Second no one really pays what the thing costs. The decision to avoid cold and windy stations and late trains is very different from deserting M&S for BHS. Consumers are not directly faced with the real costs of rail travel and railways are maintained at a high cost. The consumer doesn’t think of that. He is interested in performance, a seat, probably a modern carriage, predictability, risks (at a fair cost) and, possibly, a passably pleasant station in the winter. The secretary of state has to assess that against the allocation of national resource. In doing so he attempts to reflect the wishes of the consumer and becomes, now, the major determinator of use and reach. The problem is that it is difficult for a secretary of state to represent, arbitrate and decide without seemingly ending up running the railways. It would be nice to think that he and his officials genuinely worked out best value for the public. In practice that is unlikely. Value for the public was always best left to the public. Particularly if limited investment and limited subsidy led to limited supply.

The future of rail - who does what?

‘The Future of Rail’ catalogues a history of failures in risk management, cost controls, project management, internal reporting and estimating costs and benefits that would precipitate the removal of entire boards in private sector businesses and
invoke action under the Sarbanes-Oxley Act for irresponsible statements. Governance is all about getting a grip: objectives – strategies – leadership and implementation – monitoring. But whose objectives? Ministers? They come and go, leaving some initiatives (but probably more coffee spoons). Treasury? Certainly not – that’s not a department to be caught having other departmental objectives. Network Rail? They are the sort of chief operating officer for the rump of the business.

The white paper of July described changes designed to “enable the government to keep clear control of public expenditure on the railways” and “outputs that could ….. be expected to be delivered from that expenditure”. There is to be a system in which “decisions on the totality of the rail budget are properly integrated” and that means that the government will decide the level of public funding and will consider, “in consultation with the ORR”, the outputs in an iterative process (enter, if the names mean anything to anyone, the spirits of Lazarus, Palmer, Monck and Reid\(^1\)). A secretary of state setting national-level strategic outputs is novel. I suspect that ‘setting’ means ‘choosing’ and that someone else has to offer the choices.

The white paper tells us that the new Office of Rail Regulation (ORR) will assess the cost of the outputs specified by the secretary of state and determine the size of Network Rail’s income by “discussing....options of what the railways might deliver”. From that would develop a “statement of reasonable requirements” for Network Rail’s licence, enforced by ORR. The ORR will “help” ensure value-for-money, enforce health and safety and licence the operators, amongst other things. That is said to be a “complex and challenging task”, with the objective of participating in restoring what is delightfully called the “long-term efficiency and affordability of rail” through the principle of public and private partnership.

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\(^1\) Peter Lazarus, Perm Sec, Dept. Transport; John Palmer, Dep Sec, Dept. of Transport; Nick Monck, became a Perm Sec, HM Treasury; Sir Robert Reid (the first), Chairman of BR, all of whom ‘foxed’ their way through to what is now seen as a period of stability and progress for BR in the 1980s.
What does any of that mean?

Well it might mean that ORR becomes the arbitrator of claims for outputs, of cash requirement and of Network Rail’s bid for acceptable performance. In the process, ORR might call for, probe for, longer-term measures of sustainability and network integrity and in doing so help keep all parties to the debate more ‘honest’. Between them, the Department for Transport (DfT) and ORR might ensure that Network Rail delivers as best it can within a framework that is acceptable, eventually, to competing parties. But deliver what? The pattern has recently been set that even after considerable efficiency gains the very large increase in spending on operating, maintenance and repairs crowds out major enhancements (see Figure 1).

**Figure 1: Comparison of renewals spending proposed in Network Rail’s June 2003 business plan with historic expenditure levels (£m 2003 prices)**

The next review process surely invites debate. What are we trying to maintain here? For what comparative value? Who says whether travelling rapidly up the west coast is worth the sacrifice of the equivalent expenditure on hospitals, suburban services, Crossrail or whatever? It might be, but who says? Who decides...
whether a new fast route to Scotland is a vital artery to the UK? Would the public prefer to accept the consequences of such expenditure and fund more schools and hospitals privately and pay more for healthcare, whilst travelling rapidly, etc, etc? Or does better transport so stimulate economic growth that both can be afforded? Is the answer to that something that officials, economists, the government, ‘know’? Where is the cockpit of inquiry and debate which leads to an arbitral view which at least can be examined, and reviewed afresh at each succeeding round?

Up until now I think it has been assumed that ORR costs the outputs and seeks to ensure efficient delivery principally by Network Rail. Could it now be that ORR takes a wide view and evaluates different options for the entire future railway? Could it be that ORR will offer different choices to the secretary of state and, the secretary of state having chosen, could it be that ORR will become more of a supervisory board for the railways listening to its ‘shareholder representative’ (the secretary of state) and to its bankers (the Treasury) as much as rating agencies and bond holders? Such an ORR would be looking at whole life costs of the railway in assessing what sort, and extent, of railway is sustainable. It would be assessing the trade off between revenue spend and enhancement, and whether ‘enhancement’ is truly FRS 15 ‘capital’ and ever anything other than an expense to be expensed. It might even look at how the whole railway operation could focus better on the passenger. That then begs the question as to whether ORR could inquire and debate openly. It has produced consultative papers in the past, but why not open up its thinking on issues, options and ‘remedies’? Could it explain the issues it is assessing, its alternative views, and its optional remedies to the public? Could its consultation papers lead to the distillation of discussion and debate before presentation of alternatives to the government and parliament?
Communicating the ‘vision’

How might ORR inform the political debate: is there a scorecard of costs, sustainability and outputs. Since no one knows what the vision of the railways really looks like, such an approach would develop vision as a consequence of influences. The modern equivalent railway will emerge as one that costs no more than X within a developing efficient culture.

This rather assumes that ORR’s team can generate, and publish, inquiry work in a way that begins to identify the change in cost drivers in railways and that it can bring pressure to bear by being able to put a value and cost on outputs and by measuring supply chain efficiency. Such a picture assumes a willingness to try to control risks as well as a willingness to debate a future ‘steady state’ acceptable railway. A regulator working by process, as well as deliberate inquiry, would throw constant fresh light on the industry and facilitate a change programme which would anticipate probable outcomes over the next few years and stimulate the interaction of Treasury, Department for Transport, Network Rail and operators.

What would be a good outcome? There may always be a strong spring pulling outcomes towards half of the current level of the Treasury cash outlay; but will that be a maintained/sustainable modern equivalent railway? Although this is an industry steeped in history, it is neither an industry with established long term measures of network integrity nor one with an obvious market satisfaction measure. Users of the railway can leave rail and take to the roads, but to do that is actually not a comparable decision. Someone will have to cut through the mass of detail and argument that surrounds any discussion of the railways, and do so with a shrewd eye for future financial crises, in order to project and present to the public and the politicians the choices that they face that lead to acceptable ‘satisfaction’.

If this view is right then ORR is going to become part of a really interesting public governance of our ‘private’ railway. The ORR
will become the facilitator, the go-between, the mediator with its own strength of inquiry and ability to challenge, the provoker of alternative long term views of the railway. Such an ORR could be more thoughtful, more openly provocative in a constructive way (look, for example, at the probing by the Competition Commission) more influential, more important and of greater value than ever before.

Conclusion

We now have an Office of Rail Regulation with a far more subtle role. The new ORR will have to model and work all the options so as to offer choices: choices about railways that you, the public, could have at different costs to the public and private purse at different outcomes. Praise will go to the secretaries of state who make wise choices – whatever they may be – through an iterative process between department and regulator and the award of wisdom will only be visible in history.
6 COMMUNICATIONS REGULATION

Peter Strickland

Introduction

This chapter covers a period of fundamental change in the regulation of communications in the UK. A new set of European Union (EU) directives came into force. There was new primary legislation in the UK, reshaping the regulatory institutions. There were also several major regulatory cases that raised questions about the objectives and conduct of regulation.

The backdrop was a dismal business environment. There was little growth in the market. Investors shunned the sector. Shareholders saw their holdings continue to fall in value. Some operators had already embarked on a painful course of asset disposal, seeking economies and refocusing on more modest business objectives. Others would shortly be driven down the same route. A significant number of operators ended the period with different names and under different ownership.

It was also a time of innovation. Broadband started to move from a relatively expensive niche service available only in major conurbations to nationwide availability and much more extensive take up. A consequence was that broadband issues came to occupy a significant amount of regulatory attention.

This chapter attempts to cover developments in the regulation of UK communications from late 2002 to mid 2004. Faced with such a task it was necessary to impose some boundaries. I have adopted the assumption of control by Ofcom, in December 2003, as the terminal point, moving beyond only to complete particular themes. The focus reflects my telecommunications background
and I have not strayed into areas where I have no expertise, such as broadcasting and radio spectrum management.

I have not attempted to produce a comprehensive account of all the major issues that agitated the regulatory community during this period, but have selected several episodes that raised important questions about policy, or may provide pointers to the future. The chapter starts with a review of the legal and institutional changes and then proceeds to the issues and events.

The new European Union regime

European Union (EU) legislation has a notoriously protracted gestation period and the new communications directives were no exception. Their origins lay in a review that commenced in 1999, they were formally adopted in February 2002, came into force on 25 July 2003 and, at the time of writing, have still to be implemented in several member states.

There are four principal directives:

- Framework;
- Access and Interconnection;
- Universal Service and User Rights;
- Authorisations.\(^1\)

One of their functions was consolidation of what had become an unwieldy set of interrelated and much amended measures into a more manageable package, but they were also intended lead to significant policy changes. This section summarises the content of the four directives and reviews their implementation in member states.

\(^1\) European Commission, Framework Directive 2002/21/EC; Access and Interconnection, 2002/19/EC; Universal Service and User Rights, 2002/22/EC; Authorisations, 2002/20/EC.
The content of the directives

- the Framework Directive

The directive defines the roles and responsibilities of the National Regulatory Authorities (NRAs) and the procedures they must follow. Specific measures include:

- special regulatory obligations may only be imposed on specific undertakings if significant market power (SMP) has been detected following a market analysis;
- the definition of SMP is aligned with dominance in competition law;
- the broad markets formerly analysed for SMP are replaced with narrower sectors, listed by the Commission in a recommendation;
- the Commission has veto powers over NRA market definitions, and findings of SMP;
- there must be an independent appeal body empowered to consider the merits of the case, not simply procedural issues.

- the Access and Interconnection Directive

The Access and Interconnection Directive deals with access to and interconnection of electronic communications networks and associated facilities. It gives operators of public communications networks rights to obtain, and obligations to provide, interconnection.

Where operators have been found to exercise SMP special conditions (‘remedies’) listed by the Commission, may be applied. The full set of remedies need not be imposed in all cases – but a selection proportionate to any problems caused by the presence of SMP. The remedies listed include:

- transparency, non-discrimination, and accounting separation;
- access to specific network facilities – where denial of access would obstruct competition;
- price control and cost accounting, where an operator might sustain high prices or apply a price squeeze.
COMMUNICATIONS REGULATION

- the Universal Service and User Rights Directive

The Universal Service and User Rights Directive deals with the rights of users and consumers and the corresponding obligations of undertakings. The key points are:

- universal service now includes functional internet access. In time this may draw broadband services into the USO;
- operators responsible for providing universal service may be funded provided the net cost has been calculated and determined to constitute an unfair burden;
- retail price regulation should only be used if the NRA concludes that wholesale (access and interconnect) regulation will not achieve objectives set out in the Framework Objective, such as the promotion of competition.

- the Authorisations Directive

The Authorisations Directive represented a renewed effort to implement the harmonised and deregulatory approach set out in the 1997 Licensing Directive. The 1997 directive allowed member states to use individual licences but made it clear that general authorisations should be the norm. Under the new directive, all electronic communications services and networks will be provided under general authorisation. Undertakings may be required to submit a notification to the NRA but do not need an explicit decision by the NRA before they start business.²

The implementation of the directives

Businesses have frequently complained that the UK implements EU legislation before other member states, and adopts the most rigorous interpretation of the new rules. Despite careful scrutiny, few examples of ‘gold plating’ in the UK implementation of the Communications Directives have emerged, but it is indisputable the UK was an early adopter.

² A notification system has not been established in the UK.
The principal vehicle for the UK implementation was the Communications Act, which received Royal Assent on 17 July 2003, a week before the deadline of 24 July. The UK’s performance was exceptional - only 4 other member states (Denmark, Finland, Ireland, and Sweden) had ‘transposed’ the new framework into their national laws by the due date. In the remaining months of 2003, 2 other countries (Italy and Austria) completed the process, bringing the total up to 7 out of the (then) 15 member states.\(^3\)

This is a dismal performance. One of the objectives of the new directives was to promote harmonisation of communications regulation across the EU. The delays in implementing the package not only perpetuate differing national legal frameworks, but delay the implementation of other measures, such as the market reviews, which are intended to bring the regulatory regimes of member states closer together. The EU faces the ludicrous prospect that the new regime may have been in force for scarcely a year in some member states before the scheduled review of the operation of the directives. The single European communications market is developing at a glacial pace.

The new regime in the UK

*The background*

The need to transpose the new EU directives into UK law was only one of the factors behind the radical changes introduced by the Communications Act 2003. The Telecommunications Act 1984 was showing its age. Its focus was the privatisation of BT rather than the regulation of an industry. It predated both mobile telephony and the internet.

\(^3\) At the time of writing (August 2004) 3 member states have still not implemented the directives.
Some specific features of the act clearly needed modification. In an increasingly fast moving market the cumbersome provisions for the enforcement of licence provisions seemed inadequate. Also, despite the significant economic consequences of regulatory decisions, it was difficult for aggrieved parties to mount a challenge other than on technical, procedural grounds.

The most newsworthy change to be adopted by the government was to merge five institutions dealing with telecommunications, broadcasting and spectrum management into a single regulator. This was partly to overcome overlapping responsibilities between broadcasting regulators, but also a recognition that there were common issues between the broadcasting and telecommunications industries, such as the allocation of radio spectrum, which would benefit from being handled by a single organisation. Allowance must also be made for the optimistic forecasts of the pace of ‘convergence’ between equipment, services and markets during the ‘dot com’ boom, when the basic policy decisions were taken.

The process

The Communications Act 2003 must be one of the most comprehensively debated pieces of legislation ever to reach the statute book. The Department of Trade and Industry (DTI) and Department for Culture, Media and Sport (DCMS) held workshops for industry and consumers in 1999, preceding the green paper. In contrast with many pieces of legislation, there was also ample time to discuss the bill. It was originally envisaged that the legislation would be included in the Queen’s Speech of 2001, becoming law during 2002. It came as a surprise when the government announced that a bill would not be tabled in the 2002-03 parliamentary session. Instead there would be a ‘paving bill’ to establish Ofcom as an organisational entity. Ofcom’s responsibilities and powers would be defined by

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4 Oftel, the Independent Television Commission, the Broadcasting Standards Council, the Radio Authority and the Radiocommunications Agency.
subsequent legislation. A draft bill would be published for consideration by a parliamentary Joint Scrutiny Committee.

The parliamentary Joint Scrutiny Committee, chaired by Lord Puttnam, was only the second to be established. The purpose was to enable a committee, drawn from both Houses of Parliament, to give draft legislation a detailed scrutiny, drawing on the advice of expert advisors, written evidence and public hearings.

The draft Communications Bill was published in May 2002. For participants, the summer was dominated by the committee’s activities. These probed major issues in the legislation, such as Ofcom’s duties and powers, and also considered the development of European Union legislation on communications. Most of the issues considered in the remainder of this section were exhaustively debated. After all this, the bill still had to go through parliament. As expected, it was included in the 2002 Queen’s Speech and the parliamentary passage commenced in the autumn of 2002.

Two aspects of the parliamentary process were noteworthy. The first was that despite all of the earlier discussions and consultations, the bill only just made it onto the statute book before the deadline of 25 July 2003 when the new European Union directives would come into force, automatically abolishing the current UK telecommunications regulatory regime. The exhilarating prospect of regulatory anarchy was removed when Royal Assent was granted on 17 July 2003. The principal reason for the delay was a dispute about the duties of Ofcom, which many felt gave undue weight to economic considerations that were inappropriate for the cultural issues it would be required to address.

The second distinctive feature was Ofcom’s role in the debate. With the passage of the Office of Communications Act early in 2002, Ofcom existed as an organisation, chaired by Lord Currie. Lord Currie intervened several times in the debates, usually to
inject the practical perspective of one who would have to implement the measures under discussion.

Finally the pieces fell into place. The Communications Act became law. The European Union directives came into force. At midnight on 25 July 2003 the regulatory structure created by the Telecommunications Act 1984 passed into history.

The issues

This account concentrates on major matters of concern to telecommunications. The areas covered are:
- Ofcom’s objectives;
- Ofcom’s enforcement powers;
- rights of appeal;
- Ofcom’s structure.

- Ofcom’s objectives

Ofcom’s statutory objectives turned out to be one of the principal subjects of debate. This partly reflected dissatisfaction with the Telecommunications Act 1984. This gave Oftel a small set of high level duties, supplemented by a list of matters to which it should have regard. Important objectives, such as the promotion of competition, fell into the ‘have regard’ category. Critics argued that the act was of little use as a practical guide to what Oftel should be doing and Oftel was effectively free to set its own agenda. The problem was to devise something better.

Discussions about Ofcom’s objectives revolved around what they should be and how they should relate to each other. There was no shortage of potential objectives – all of which had enthusiastic supporters – including the promotion of competition, defence of the interests of consumers, giving reasons for decisions, taking decisions promptly, and reviewing regulation regularly to keep it up to date. All of these, and many more, found their way into the draft bill. The problem was the relationship between objectives that might be contradictory.
Two approaches emerged. The first was that Ofcom’s principal objectives should be given equal weight, and Ofcom required to explain why, in any particular decision, it had favoured one rather than the other. The alternative was for all objectives to be subordinate to an overarching, or ‘meta objective’. The wording of this ‘meta objective’ was, clearly, of considerable importance. Proponents of this approach usually argued that it should be the promotion of competition.

This encapsulated one of the fundamental problems in creating a converged regulator such as Ofcom. Telecommunications tends to be an area where economic considerations are of prime importance. Broadcasting is much more complex. As well as obvious factors such as taste and decency, and news coverage, there are powerful qualitative considerations. The broadcasting camp argued, with strength and logic, that an overriding economic objective would be fatal for the UK’s excellence in broadcast television. It is cheaper to buy American soap operas than make televised versions of Thackeray’s novels – and American soaps might attract more viewers.

The debate was hotly contested. The draft bill proposed seven principal objectives of equal standing. The Joint Scrutiny Committee proposed a unified objective, combining the pursuit of competition with words more sympathetic to broadcasters. The bill laid before parliament compromised by embodying several objectives in a single clause, emphasising consumer interests in telecommunications and ‘citizen’ interests for broadcasting.

The parliamentary debate took an interesting course. Those with a close interest in broadcasting still felt that the bill placed far too much importance on the interests of ‘consumers’, fearing that Ofcom would see ‘economic man’ as its principal customer. They urged that ‘citizen’ interests should be given more weight. ‘Citizen’ interests related to non-economic ideas as impartiality of broadcast news, the protection of minors from undesirable broadcast content, not being subjected to continuous American
soaps, and the desirability of maintaining regional programme production.

The result was a wording that captured the concept of distinctive ‘citizen’ and ‘consumer’ interests but did not link them directly to broadcasting or communications. It acknowledged that both had significance for Ofcom’s entire remit. This was the formulation that entered the statute book when the Communications Act received Royal Assent in July 2003.

- General duties of Ofcom

   It shall be the principal duty of Ofcom, in carrying out their functions; (a) to further the interests of citizens in relation to communications matters and (b) to further the interests of consumers in relevant markets, where appropriate by promoting competition.

Many felt that too much attention had been devoted to Ofcom’s objectives. The result was a general duty open to much interpretation, and – in Ofcom’s reckoning – no fewer than 263 other duties. This, arguably, will invite, perhaps require, Ofcom to set its own priorities.

An alternative perspective is that Ofcom has a reasonable statement of its principal objectives, and a series of clear requirements in other areas, such as promptness standards and reviewing regulation to ensure it remains up to date. These provide a much sounder basis for accountability than the Telecommunications Act.

Surprisingly little attention has been paid to the final status of economic objectives, especially competition. Ofcom’s principal duty makes it clear that while economic (consumer) considerations are important, they are not paramount. They must not be pursued without reference to ‘citizen’ issues. This applies to communications as a whole, not just to broadcasting. Above

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5 Ofcom reflected this by using the term ‘citizen-consumer’.
all, Ofcom has a duty to promote competition only ‘where appropriate’. This is highly significant; many had pressed for the wording ‘wherever possible’. The Communications Act recognises that competition, in some circumstances, may not be an appropriate way to serve the interests of ‘citizen-consumers’.

- Ofcom’s enforcement powers

The Telecommunications Act provided a surprisingly roundabout way for Oftel to enforce its decisions. Oftel was obliged to go to court and show that a licensee had not complied with an order, whereupon the court would insist on compliance. If the party proved recalcitrant, the court could then impose penalties. There was no perceptible dissent from the proposal that Ofcom should have direct enforcement powers, the issue concerned the process involved.

The draft Communications Bill set out a procedure where a provider could be served with a notice stating that it was not in compliance with an obligation and setting a deadline to make representations and, at the same time, remedy the situation. The problem was what a provider should do if it believed that it was compliant. If it simply made a case that no obligation had been breached, it could be fined and be subject to enforcement action if Ofcom disagreed. The decision could, of course, be appealed but this would cost time and money.

A more cautious approach would be for the provider to take the action required by Ofcom while arguing that it had been compliant. This would avoid a fine, but if it turned out that the provider was right it might have ceased providing a service, delayed a product launch or taken other action detrimental to its commercial interests for no good reason. It might, of course, claim compensation from Ofcom, but this would, in itself, cost time and money.

The obvious remedy seemed to be to allow representations to be made about whether or not obligations had been breached before
the commencement of the period of time for taking remedial action. This was resisted by the government on the grounds that it would build delay into the process and impair Ofcom’s ability to take rapid action where necessary.

This subject was discussed in the Joint Scrutiny Committee and during the bill’s passage through the House of Lords. The arrangements were not changed, but, in an interesting intervention, Lord Currie, Ofcom’s chairman, sent a ‘letter of comfort’ to Lord Avebury, who had raised the issue in debate, which was lodged in the library of the House of Lords. The letter gave assurances that Ofcom would respect the right of providers to argue that no breach had taken place. Experience of the practical working of the system will show whether the problem is genuine or hypothetical.

- Rights of appeal

The 1984 Telecommunications Act made no provision for appeal against the decisions of the director general. Successive governments resisted the principle, arguing that judicial review served this purpose. Judicial review clearly enables some abuses of power to be corrected – in cases where a regulator does not have legal authority to take action (vires), or has not followed the correct procedures. It does not, however, really lend itself to arguments that a decision was wrong. Although it is possible to argue in a judicial review that no rational person could have taken the decision (‘unreasonableness’ in the legal sense) the High Court may be reluctant to conclude that, in effect, a director general is insane.

In 1997 the European Union Telecommunications Licensing Directive came into force. This provided for rights of appeal to an independent body against decisions taken by regulators. The government stuck to its line that judicial review fully met the requirements. BT, ironically, judicially reviewed the implementing regulations. Faced with the prospect of a defeat, the government made concessions. The result was the
Telecommunications Appeals Regulations (1999). These effectively extended the scope of judicial review of Oftel’s decisions to include ‘material error as to the facts’ and ‘lack of proportionality’. Nonetheless, they still fell short of a full appeal on the merits of a decision.

The Competition Act 1998 created a farcical situation. If, in the exercise of its concurrent powers under the Competition Act, Oftel took action against an operator, full rights of appeal would be available. If, on the same issue, Oftel decided to proceed under the Telecommunications Act, the operator’s appeal rights would be limited to the ‘enhanced judicial review’ permitted by the Telecommunications Appeals Regulations. This was an indefensible anomaly. Appeal rights were, accordingly, a leading issue in discussions about the Communications Bill.

The principal argument against full rights of appeal was that they might be used by an operator with market power to delay measures to introduce competition. This drew on experience in other countries, notably Germany. The counter argument was that such tactics only worked where regulatory measures were stayed pending the outcome of an appeal. This does not apply in the UK.

The draft bill, fortunately, observed the requirements of the Framework Directive, and duly provided for full appeal rights, and this passed into the Act. This brought a long campaign for protection against potential abuses of regulatory power to a successful conclusion.

**Ofcom – a new model regulator**

Ofcom’s legal status and organisation is significantly different from Oftel’s. Oftel was described as a non-ministerial government department. The majority of its employees were civil servants. The regulator was a single individual, the Director General of Telecommunications (DG). In a sense, Oftel was the
DG’s secretariat – the Telecommunications Act gave duties to and vested powers in the DG, not Oftel.

This concentration of power in a single official had been criticised for some time. Many argued that a board structure would be beneficial for major decisions, ensuring consideration of a wider range of views, and could also promote continuity, leading to gradual change instead of potential sudden changes of direction if an incoming DG differed from their predecessor.

Ofcom is a statutory corporation, similar to the BBC. It is headed by a board, whose chair and members are appointed by the government. The board appoints the chief executive. The Communications Act provided for a content board, specifically addressing media content issues, and a consumer panel. Ofcom’s employees are not civil servants; the organisation sets its own rates of pay and conditions of employment.

For all this, Ofcom’s accountability arrangements are strikingly similar to those of the regulators it replaced. Ofcom’s books are inspected by the National Audit Office, and it is answerable to the Public Accounts Committee for value for money. Its annual report is to be laid before parliament by a secretary of state. The only variation is that as its remit covers both broadcasting and telecommunications, and it faces scrutiny from two, not one, select committees - Culture Media and Sport and Trade and Industry.

Based on experience with Ofcom’s predecessors, this model of Parliamentary accountability is better at occasional intensive investigations of specific issues, than providing sustained, informed scrutiny of a regulator’s performance against its statutory objectives. It is regrettable that nothing emerged from the discussion in both the Parliamentary Joint Scrutiny Committee and other forums that new arrangements ought to be considered to address the scope and significance of Ofcom’s work.
- **Ofcom takes control**

Ofcom assumed its full powers on 29 December 2003. During the interval between the passage of the Communications Act and this event, the old regulatory bodies had continued to operate, administering the new legislation.

Ofcom clearly desired to achieve a smooth transition to the new regime, avoiding sudden, disruptive changes in policy. It made it clear, for example, that it would stand by the conclusions reached by Oftel in its market reviews. Despite Lord Currie’s public scepticism about the use of a price cap for mobile termination charges, there was no reversal of policy after Ofcom’s assumption of power.

Ofcom did announce three major activities – a review of public service broadcasting, the implementation of spectrum trading arrangements and a strategic review of telecommunications. The latter is of particular significance, being the first such review since 1991 and its outcome will be a major factor in deciding whether the new regime really means a new direction – but the task of providing detailed account will fall to the writer of the next review of developments in communications regulation.

**Significant regulatory issues**

As indicated, this is not a comprehensive account of the major regulatory confrontations during the period. I have selected several cases that raise significant issues of regulatory principle or may indicate changes in the policy environment. The issues chosen are mobile call termination rates, the SMP market reviews, the review of the wholesale broadband market, and the saga of 118XXX, the liberalisation of directory enquiries.

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6 Ofcom was required by the Communications Act to undertake the first two activities, but the Strategic Review of Telecommunications was its own initiative.
It should, however, be noted that in August 2002 the new retail price controls came into operation, following Ofcom’s statement in June of that year. There were two principal features of the settlement. The ‘headline’ formula was RPI – RPI. The control would maintain the overall price, in real terms, of a basket of services, principally calls and line rental. The weighting of the components of the basket reflected the expenditure profile of the customers felt to be in most need of protection – the lowest spending 80%.

The controls included a new feature. Oftel wished to promote service competition and included within the retail price control package a requirement for BT to introduce a ‘wholesale line rental’ (WLR) product. This was designed for operators and service providers using carrier pre selection (CPS), a service where customers can have their calls diverted onto the network of another operator for delivery to their destination, and charged accordingly. These customers received a bill from BT for line rental, as well as one for call charges from the CPS operator they had selected. This was felt to be an impediment to the growth of the CPS market.

WLR is a service where an operator or service provider rents a customer line from BT. This enables the end user customer to receive a single bill for calls and line rental from an operator other than BT, even though the line connecting them to the network remains BT’s property. The price control arrangements included a provision that if and when Oftel felt that a satisfactory WLR service was available from BT, the retail price control formula would change to RPI + 0. This would give BT leeway to increase its prices up to the rate of inflation. This was claimed to be an innovation, giving BT an incentive to introduce WLR in order to obtain greater pricing freedom.

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7 Oftel (2002a), Protecting Consumers by Promoting Competition: Conclusions.
Mobile call termination rates

There were further developments in the long and increasingly tangled story of calls to mobile. In February 2003 the Competition Commission published a report on the subject.\(^8\)

The issue concerns the charges levied by mobile operators in exchange for conveying calls to their customers which originate on other networks. A simple example would be a call made by a BT customer to an Orange customer. Orange would charge BT a fee for delivering the call to its destination. This is called a ‘termination charge’. In the mid 1990s Oftel began to be concerned that the termination charges raised by mobile operators were significantly higher than those made by fixed network operators.

This difference arose because termination charges in the fixed network are usually based on a reciprocity principle – interconnecting operators agree a single termination charge which each applies to the other’s calls. As practically all operators interconnect with BT, this means fixed network interconnection charges tend to be based on BT’s regulated, cost related prices. The mobile operators began with no such regulatory constraints and the fact that they were operating a different type of network provided an apparent justification for the price difference.\(^9\)

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\(^8\) Competition Commission (2003), Vodafone, O2, Orange and T-Mobile: Reports on References under Section 13 of the Telecommunications Act 1984 on the Charges made by Vodafone, O2, Orange and T-Mobile for Terminating Calls from Fixed and Mobile Networks. The report was largely the work of its predecessor the Monopolies and Mergers Commission, whose first report on the subject had appeared in 1997.

\(^9\) There is no reason, in principle, why each operator, whether fixed or mobile, should not charge a different rate, related to its own costs and commercial interests. The development of more sophisticated billing systems has removed the practical difficulties in passing on such charges to the relevant customer. In Belgium one operator has applied a higher termination charge which is passed on to the customers of other operators who call its numbers. This has been most unpopular with consumers.
Oftel was concerned that the higher mobile call termination charges were not governed by competitive pressures. Mobile customers were not affected by the higher charges – they did not have to pay them. The people who did pay them were customers of other networks – but by an indirect route. As the charges were not passed on to the customers who dialled the number triggering the higher charge, it became a general burden on all customers of those networks. The price difference was, therefore, invisible to both the originating and receiving customer. Oftel’s conclusion was that mobile operators could use their termination charges to make money and that something should be done.

Oftel tried negotiation to no avail. It proposed a new licence condition capping the termination charges of Cellnet (as it was then known) and Vodafone – Orange and One to One (as it was then known) were exempted as newcomers to the market. There was clearly little prospect of agreement, so Oftel referred the case to the MMC, which reported in 1998, backing Oftel. The termination charges of Cellnet and Vodafone were capped.

These price caps expired in 2002. Oftel investigated the market and found that the problem had not gone away. It now proposed to apply a price cap to all four mobile operators. The proposal was rejected, so Oftel once again called in the MMC, now the Competition Commission.

The inquiry generated the usual library of legal and economic papers, but the underlying arguments were straightforward. Oftel argued that its proposed licence amendments were in the public interest because each mobile operator exercised a monopoly in connecting calls from other networks to its customers. The prices charged were significantly above cost, and effectively unrestrained by market forces. Regulation was necessary to

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10 The idea that an operator exercises a monopoly in access to its customers may turn out to have significant implications. Would any restriction on access by other operators, for example to provide value added services, be an abuse of a monopoly position? Such provisions are not unusual in the industry.
prevent over charging at the expense of all fixed network customers.

The mobile operators argued that in comparison with other EU member states, their overall charges were low. Competition in the industry was intense, leading to falling prices. There was a high level of customer satisfaction. The industry was also investing heavily – particularly in 3G licences. The termination charges had to be seen in this context. They were, in fact, supportive of competition, as they enabled the price of handsets to be reduced, fuelling competition between operators for new customers, and enabling more people to afford mobile telephony. In other words, prices were low, customers happy, and competition intense. Was there any need for regulatory action? The Competition Commission backed Oftel. Mobile termination charges remained capped.

The episode is full of issues for regulatory policy. Both Oftel and the mobile operators had valid arguments. Oftel had identified a clear case of overcharging. The mobile operators could show that the market as a whole was highly competitive, and that their customers were satisfied. This raises the question whether a regulator should only intervene if there are significant problems, with a perceptible impact on consumers, or whenever there is any imperfection in the market. Should the regulator’s goal be tantamount to perfect competition, or a level of competition sufficiently effective to keep suppliers on their toes and ensure consumers get a good deal?

There is also a question about equitable treatment of companies in different sectors of the economy. No market is free of imperfections. The mobile market is significantly more competitive than many that have been allowed to go about their business without regulatory intervention for years. The mobile companies were unlucky because, as a result of the historical accident of BT’s privatisation, they came within the jurisdiction of a sectoral regulator accustomed to intervention at a highly detailed level. It is safe to say that in any other part of the UK
market they would have been left alone. This does not seem to be an equitable approach to economic regulation.

There were alternatives to Oftel’s approach. It was open to Oftel to exercise its concurrent powers under the Competition Act to address the problem. This would have avoided entangling the mobile operators in sectoral regulation. It may be that one of most significant effects of the case will be the lessons learned by Ofcom.\textsuperscript{11}

\textit{The SMP market reviews}

If the significance of regulatory activity is related to the quantity of paper generated – or, in today’s world, the amount of bandwidth occupied – the SMP market reviews were among the most crucial events of this period. Both Oftel’s consultative documents and the responses to them set new standards in length, level of detail and intricacy of analysis. As the process drew to a conclusion, however, it was difficult to identify much in the way of significant change attributable to it. As well as being a cause of great disappointment to several parties, this reflected important differences about the purpose of the reviews and the future of regulation in the EU.

\textbf{- What was the purpose of the reviews?}

From the perspective of the Commission, a key aim of the new directives was to move closer to a single European communications market by harmonising the regulatory regimes in different member states. Part of this was high level activity in areas such as the authorisations system. The market reviews had the key task of promoting a common approach to market power. Accordingly, NRAs were required to undertake market reviews as soon as possible.

\footnote{One of the most remarkable aspects of the case was that Ofcom’s Chair, Lord Currie, then a ‘regulator in waiting’, made it known that he felt a price cap was not the right way of addressing the problem.}
There were, however, some features in the directives which were more severe than their predecessors. The principle of ‘leveraged dominance’ was included. This addressed the ways in which an operator might use strength in one market to its advantage in another – through linked sales, discount schemes and similar tactics.

The Commission’s aspirations gave rise to great expectations among UK operators. Those seeking to develop business elsewhere in the EU felt frustrated that features taken for granted in the UK, such as a full range of wholesale services at regulated prices, did not exist in some other member states. There was a widespread belief that regulators in other member states protected the former monopoly operators. The process set out in the directives, and the ability of the Commission to veto decisions on market definition and findings of SMP, should ensure that these regimes became more favourable to new entrants.

BT felt that it was far too severely regulated, especially in comparison with its counterparts in other Member States. The market reviews provided an opportunity to redress the balance. It expected to have SMP removed in several markets and to face fewer ‘remedies’ where findings of SMP were made. BT felt particularly strongly that the result of the reviews should be a reduction in the regulation of its broadband services – a theme we will cover later.

For many operators the market reviews became the principal regulatory activity for 2003, rivalled only by the Communications Act. Teams were established and consultants engaged. Everything was in place for a major regulatory encounter.

- The UK

The market reviews set difficult problems of timing and administration for the UK. The new directives were to come into
force in July and Ofcom was to take over in December. There was no completely satisfactory timescale.

Delaying commencement of the reviews until July or even December would mean a later completion than the Commission clearly desired. There were also practical arguments against Oftel starting the reviews and handing them over to Ofcom for completion. Faced with these dilemmas, Oftel decided to start the reviews as soon as possible, without waiting for the directives to come into force, and attempt to complete them before Ofcom took over.

The first problem Oftel encountered was a delay in the publication of the Commission’s guidelines on relevant markets. Oftel boldly launched the process on the basis of draft Guidelines, hoping that there would be no significant changes. The timescale was, however, compressed as a result. This made some interested parties anxious that they would not have time to prepare their submissions, and Oftel would not have sufficient time to read them.

It was also becoming clear that Oftel was leading the field. Many member states did not intend to start the reviews until national legislation implementing the new directives had been enacted – in 2004. Many came to feel that Oftel was proceeding with excessive haste for no good reason; the UK seemed to be the only member state to take the Commission’s timescales seriously. Oftel agreed to moderate its pace. Most of the reviews were, in fact, concluded before Ofcom took over in December. The principal exceptions were the reviews of leased lines and wholesale broadband access – the latter was arguably the most significant of the reviews and is covered in a separate section.

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12 Finally published as Commission Recommendation of 11 February 2003, ref. 203/311/EC.
13 At the time of writing (August 2004) only 2 other member states have substantially completed the market review process.
The general result of the reviews (see Table 1) was to reaffirm Oftel’s approach. There were few changes. BT was found not to exercise SMP in the provision of wholesale international direct dial services (international calls) on routes accounting for 95% of the market. Vodafone, O2, Orange and T Mobile were found to have SMP in the call termination market. It fell far short of radical change.

Table 1: Markets reviewed by Oftel

<table>
<thead>
<tr>
<th>Narrowband markets</th>
<th>Broadband markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed narrowband retail,</td>
<td>Leased lines</td>
</tr>
<tr>
<td>Fixed narrowband wholesale</td>
<td>Wholesale broadband access</td>
</tr>
<tr>
<td>Fixed geographic call termination</td>
<td></td>
</tr>
<tr>
<td>Wholesale international services</td>
<td></td>
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<tr>
<td>Wholesale unmetered narrowband</td>
<td></td>
</tr>
<tr>
<td>Internet termination</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Other markets</td>
<td>Reviews not yet commenced</td>
</tr>
<tr>
<td>Mobile access and origination</td>
<td>Unbundled local loops</td>
</tr>
<tr>
<td>Mobile voice termination</td>
<td>Apparatus(^\text{14})</td>
</tr>
<tr>
<td>Broadcasting transmission services</td>
<td></td>
</tr>
</tbody>
</table>

Oftel clearly saw the reviews as a process for reformatting UK regulation into the new EU pattern and that no change of substance was necessary. Oftel showed no interest in bringing the UK regime more closely into alignment with that of other member states. It could, reasonably, argue that the real problem was excessively lax regulation in certain other countries. The

\(^{14}\) This is a UK eccentricity. For many years Oftel claimed that the removal of regulation from the apparatus supply market was a triumph of liberalisation and proof of its deregulatory intent. There was, therefore, surprise and bewilderment when provision was made in the Communications Act for Ofcom to make SMP designations in apparatus markets. This is outside the terms of the directives. Needless to say, no other member state has shown the slightest interest in the idea.
area where Oftel did want to see change was the broadband market where, as we shall see, a further difference in perspectives arose.

*The review of the wholesale broadband market*

- **The position before the market review**

Throughout its existence Oftel was concerned that BT would use its strength in existing markets to enable it to acquire a similar position in new areas. Its policy towards broadband services was, arguably, more designed to ensure the market was competitive than successful in terms of attracting customers – this had resulted in some tension with a government embarrassed by the UK’s low ranking in the international broadband league tables.

As a result, alone among member states, wholesale broadband services were available in the UK from the outset. BT launched IPStream at the same time as its own retail broadband service. By then unbundled local loops (LLU) were also becoming available. In 2002 Oftel extended the range of available wholesale services through its ATM Direction.\(^{15}\) This required BT to provide a new service, DataStream, tailored to the needs of larger operators.\(^{16}\) There were, therefore, three wholesale broadband products, IPStream, DataStream and LLU.

BT soon found itself faced with requests from other operators for customised versions of DataStream. The customisation usually revolved around the precise point at which the traffic was handed

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\(^{15}\) Oftel (2002b), Direction to Resolve a Dispute Between BT, Energis and Thus Concerning xDSL Interconnection at the ATM switch.

\(^{16}\) IPStream provides connection to the end user, transport to the wholesale customer’s location, and conversion of the signals into internet protocol (IP) format. It meets all the needs of internet service providers. DataStream has less functionality – it does not provide the IP conversion – and is cheaper. This makes it attractive to larger enterprises who believe they can provide the IP conversion themselves at less cost.
over from BT’s network. Providing these variants was not cost free, and BT felt that it was being asked to do too much for its competitors. Competitors felt that BT was being obstructive. The result was a series of disputes.

As well as the problem of product proliferation, the issue of margin squeeze rose to become one of the most contentious areas of regulation. The concept of margin squeeze is simple. If, for example, the price of IPStream was reduced while the price of DataStream remained unchanged, operators using IPStream could cut their retail prices. If operators using DataStream responded they would become less profitable. A price change to one of the wholesale broadband services had commercial implications for anyone using any of the others.

Oftel responded to this by performing margin squeeze tests on actual or proposed changes to broadband wholesale prices. This generated further difficulties. The first was time – the process was not simple and this was a fast moving market. The second was more fundamental. Margin squeeze is simple to understand but extremely difficult to calculate. Any model must include assumptions about such contentious subjects as the cost to an efficient operator of performing the relevant activities, profitability, and revenue effects.

BT took the view that the solution was to reduce the number of wholesale broadband services it was obliged to provide – or at the very least freeze it. Any problems should be addressed through the Competition Act. Oftel committed itself to the idea that prices should be set, and services available, so that an efficient operator could prosper whatever the point at which it connected with BT. This was the background to the market review.

- The arguments in the wholesale broadband market review

BT’s case in the market review started by emphasising the passages in the directives that recommended special treatment for
new markets. It went on to argue that there was significant competition. Broadband services were part of a continuum from narrowband, via ISDN, followed by a series of higher levels of capacity. Substitution took place between adjacent layers. There was direct competition from the cable companies, who provided broadband services over their own networks and no shortage of high capacity networks covering the main cities in the UK.

Oftel saw the market in a completely different way. It claimed that broadband services were in a category of their own. Nobody accustomed to using broadband would willingly revert to narrowband speeds, so the scope for substitution was limited. Oftel also observed that while cable networks covered the majority of the UK population, over much of the UK’s surface area BT was the only supplier. Competition was dependent on access to BT’s network.

Oftel, accordingly, found that BT exercised SMP in wholesale broadband markets.\textsuperscript{17} BT was required to meet all reasonable needs for access – paving the way for a further proliferation of the wholesale portfolio. Prices were to be cost-based. Margin squeeze tests were to be used to ensure there were no anti-competitive consequences from price changes.

It is worth noting that this review was published after Ofcom had taken over. Ofcom took pains to make clear that it stood by the contents.

- Differing perspectives

The most interesting feature of this episode was the way in which it highlighted different approaches to regulation. Oftel could reasonably argue that BT tended to focus on hypothetical rather than actual sources of competition, and to overlook the fact that most competitors were dependent at some point on its services.

\textsuperscript{17} Ofcom (2003), Review of the Wholesale Broadband Access Markets.
Oftel’s approach to remedies was more open to criticism. It envisaged a major extension of regulation – in precisely the kind of new market where the directives had recommended a minimal level of controls. Not only would BT have to provide an even greater number of variants of wholesale services, but this proliferation would increase exponentially the number of necessary margin squeeze tests for each price change.

The remedies proposed by Oftel, which Ofcom will have to implement, involve a very high level of involvement by the regulator in setting prices and deciding which services should be provided. The proportionality of this approach is questionable. The UK broadband market is easily the most competitive in the EU. At the time of writing wholesale broadband is still not available in several member states, including Germany.

Again, it is questionable whether making available all the wholesale services the market requires is sensible. It may discourage investment both by the provider and by buyers, confident that the services will be made available on regulated terms. It may support inefficient market entry. Time will tell whether Oftel’s broadband legacy to Ofcom will nourish or stifle a competitive market.

**Directory enquiries: 118 XXX**

One of the most entertaining regulatory events of the period was the broadening of competition in directory enquiries (DQ). Oftel had long been committed to the idea – a consultation was held in 1995 setting out the benefits of such a course of action. During 2000 events were set in motion to give the policy substance.

Most telephone users make very little use of DQ and it is hardly a major component of household telecommunications budgets. The BT (192) service was, accordingly, allowed to continue as usual, while other sectors were opened to competition. The

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trigger for change lay in the obscure realm of numbering. European harmonisation measures proposed to set aside the number range beginning 118 for DQ services. European harmonisation measures proposed to set aside the number range beginning 118 for DQ services.\textsuperscript{19} 118 XXX entered the telecommunications vocabulary. Oftel decided the time had come to make DQ competitive.

Oftel believed that BT had significant advantages. It already operated a service that was generally acknowledged to be affordable and efficient. Ensuring that competition took root would be a challenge, but Oftel by now had extensive experience of opening up markets. The first step was to ensure that everybody had a chance to obtain the numbers they wanted. Some numbers are more memorable than others – 118811, 118118, 118000, are obvious examples. Oftel decided to deal with allocation by auctioning available numbers, an impeccable, and profitable, free market solution.

It was appreciated that the critical moment would be the discontinuation of the 192 number. Allowing all 192 calls to be diverted to the BT service would merely perpetuate the status quo. Sterner measures were needed. Oftel hit on the idea of a ‘carousel’. Customers dialling 192 would be diverted to a recording listing the available alternatives. To prevent the operator at the top of the list having an unfair advantage, the point at which the recording started was randomised.

It was clear from the outset that success would go to competitors whose number was remembered by the largest number of potential customers. There would be a limited window of opportunity to attract a customer base and establish a revenue stream sufficient to sustain a viable business. After a few months it would be clear whether sufficient revenues had been established – if not, departure from the market would be the result.

\textsuperscript{19} There was, typically, discord on the total number of digits, some countries opting for five, others, including the UK, six.
The day appointed for the cessation of the 192 service was 24 August 2003. In the months leading up to this date the public was subjected to a crescendo of advertising. Irritating advertising jingles incorporating 118XXX numbers clamoured for attention from television and radio. In an effort to be distinctive, one company based its advertising on two runners with 1970s style long hair and droopy moustaches. Veteran athletes objected, ensuring the public remembered the campaign. Roadside hoardings were dominated by 118XXX numbers and promises of wonderful service at low prices.

Oftel, naturally, kept a close watch on BT’s promotional activities. They objected to an edition of the telephone directory with the number of BT’s service (118500) on the cover. The company prudently decided to pulp all undistributed copies.

Oftel claimed that 118 XXX had been a triumphant success. By the autumn new entrants had built up customer numbers and BT was not the biggest operator. Competition was delivering the goods. The problem was that the public did not seem to see it that way. Fewer people were using DQ services – either they could not remember the number(s), thought the service had been abolished, or were afraid they would be charged too much.

There were also repeated complaints that some of the new services were not very efficient. Newspapers developed a genre of articles based on ringing 118XXX operators to see if they provided the right numbers. In one celebrated case, an operator failed to provide the telephone number of the Times newspaper. Charging was another subject of complaint - especially where operators enthusiastically persuaded customers to be connected straightaway to the number they had found - without making clear that there was a charge for this additional service.

The press became highly critical. Oftel’s policies had created confusion, leading to fewer people using DQ and believing, rightly or wrongly, that they were paying too much. As new operators failed to achieve critical mass and withdrew from the
market, their departure was noted with *schadenfreude*. The question was even asked what had been wrong with the old 192 service. Oftel’s insistence that these were mere teething troubles did not seem to convince.

This was unprecedented. Oftel’s argument that any short term pains associated with the introduction of competition would be offset many times by the long term benefits had always been believed. This time there was open, public scepticism. For the first time, Oftel had lost the battle for public opinion.

The 118 saga may turn out to have been a minor episode of little consequence. It may, however, mark a turning point. Ofcom’s duty is to promote competition ‘where appropriate’. The reaction to competition in DQ services indicates that citizen-consumers feel that it is not always appropriate.

**Conclusion**

The period from late 2002 to early 2004 was unquestionably of major importance for the structure of communications regulation. New legislation at both the EU and UK level, accompanied by the creation of Ofcom changed the arena in which regulatory issues are contested and resolved. What is less clear is whether it will inspire a serious reconsideration of regulatory policy. This chapter has argued that fundamental issues were raised including the reasonableness of attempting to secure a higher standard of competition in communications than other sectors of the economy. Ofcom’s strategic review of telecommunications will show whether the practice of regulation as well as its institutional structure will change.
References
(bold numbers refer to the footnote in which first cited)


Competition Commission (2003), Vodafone, O2, Orange and T-Mobile: Reports on References under Section 13 of the Telecommunications Act 1984 on the Charges made by Vodafone, O2, Orange and T-Mobile for Terminating Calls from Fixed and Mobile Networks. (8)

Ofcom (2003), Review of the Wholesale Broadband Access Markets. (17)

Oftel (1995), Use of Directory Information. (18)

Oftel (2002a), Protecting Consumers by Promoting Competition: Conclusions. (7)

Oftel (2002b), Direction to Resolve a Dispute Between BT, Energis and Thus Concerning xDSL Interconnection at the ATM Switch. (15)
Introduction

The close of 2004 is an apt time to review the regulation of the water industry over the past two years. We announced our final price limit determinations for the period 2005-10 on 2 December. This marked the culmination of over two years intensive work by Ofwat, the companies and other key stakeholders. The true success of the outcome is for others to judge, but at this stage I believe that it is a job well done and a fair conclusion for all.

Although the price review has dominated our work, particularly through the last few months, other developments have also affected the way we have regulated the industry, and I will touch on these too. In particular, the Water Act 2003 extends opportunities for price competition with the main provisions taking effect in autumn 2005 and in 2006 the new Water Services Regulation Authority is expected to assume my statutory functions.

Periodic review 2004

We first published our aim for the periodic review in November 2001 in the ‘Ofwat Forward Programme 2002-03 to 2004-05: Draft for consultation’:

“We aim to set price limits that provide best value to customers now and in the future. We intend to:

- enable well managed companies to finance the delivery of services in line with relevant standards and requirements;
• provide incentives for companies to improve efficiency and service delivery.

We will adopt an efficient and transparent process to carry out the review”.

In considering our approach to price setting we sought to reflect the Better Regulation Task Force’s principles of good regulation (transparency, accountability, proportionality, consistency and targeting). We also looked to the learning points from the 1999 price review, the Competition Commission references in 2000, the various parliamentary committee reports on the 1999 price review and the Public Accounts Committee’s report on the National Audit Office’s (NAO) ‘Pipes and Wires’ study.¹ ² ³

We adopted an open process throughout the review. We consulted on our approach and explained our thinking before reaching decisions. This has been an important part of ensuring reasonable regulatory certainty. So although the outcome was dependent on a number of factors not always within companies’ control we wanted all stakeholders to be clear how we were going to deal with issues. We held a number of very useful workshops with the industry on key issues before and during the review. We formally began the review with a consultation on our approach in October 2002.⁴ We published a summary of responses and confirmed the approach we would take in March 2003.⁵

² Water Prices and the Environment, Select Committee report.
³ National Audit Office (2002), Pipes and Wires, 10 April.
We are accountable under statute for achieving certain objectives through the price limits. The Environment, Food and Rural Affairs and Environmental Audit Parliamentary select committees between them evaluated the process three times during the review, the last report appearing the day before final price limits were published. Other bodies may review our approach and the outcome further now that we have made our final determinations. We have established a steering group under the chairmanship of John Baker, one of our non-executive advisory directors, with an independent membership to review the periodic review process and outcome, and it will publish its findings. We will be looking to this group and the outcome of any Competition Commission referrals for learning points for the next price review in 2009. During 2005-06 we will also consult on the appropriate period to cover at the next price review. We did consider extending the 2004 price review beyond five years but stakeholder views were mixed, so we promised to reconsider this for the 2009 review.

For this review, I believe our determinations were proportionate to our aims in terms of the burden placed on companies and other stakeholders. We reviewed the need for information and made use of all of the information we requested.

Our determinations are a package with price limits impacting on the revenue stream a company will receive and the outcomes it is expected to deliver. If such outcomes are not delivered then we take action. As a minimum this action will reflect the consequences in the company’s regulatory capital value at the next price review. Our decisions are focused on price setting, giving each company the flexibility to decide how best it delivers the outputs required within price limits, and mechanisms for change where necessary.

We made judgements about the likely resources each company needed to finance and carry out its functions properly, assuming that it improved its efficiency year-by-year. We have taken account of the interests of customers and of the wider
WATER REGULATION

environment. Although the price limits run only to 2010, we have reflected in them the need for each company to continue to provide services for the foreseeable future.

We took as our starting point each company’s final business plan, submitted in April 2004. In general terms we were content with the strategies proposed by the companies. However, following scrutiny and challenge we considered that the companies in general tended to overestimate the costs of their strategies and underestimate the scope for further improvements in efficiency. This challenge explains why we were able to determine price limits that were only around two-thirds of the increase that companies sought. Table 1 sets out a summary of the key figures for the price limits.

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</thead>
<tbody>
<tr>
<td>Ofwat’s final determinations</td>
<td>3.4</td>
<td>9.6</td>
<td>3.9</td>
<td>3.2</td>
<td>2.5</td>
<td>2.0</td>
<td>4.2</td>
</tr>
<tr>
<td>Companies’ business plans</td>
<td>3.4</td>
<td>13.4</td>
<td>7.1</td>
<td>4.6</td>
<td>3.4</td>
<td>2.9</td>
<td>6.2</td>
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### Customers’ bills

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<tr>
<td>Average annual household bill</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Water (£)</td>
<td>117</td>
<td>130</td>
<td>134</td>
<td>137</td>
<td>139</td>
<td>140</td>
</tr>
<tr>
<td>Sewerage (£)</td>
<td>132</td>
<td>140</td>
<td>144</td>
<td>148</td>
<td>152</td>
<td>155</td>
</tr>
<tr>
<td>Total (£)</td>
<td>249</td>
<td>270</td>
<td>278</td>
<td>285</td>
<td>291</td>
<td>295</td>
</tr>
</tbody>
</table>

We judged that an increase in bills is essential to maintain the progress in service quality and performance, which has already been achieved, and to make further advances where these are required. The price limits are as high as they need to be to enable each company to provide these services. But price limits are no higher than they had to be for customers, who in general have no choice about their supplier. Our determinations were prepared on a consistent basis but take account of each company’s circumstances, and accordingly vary considerably from one company to another.
Changes for the 2004 price review

The outcome of the price review in 1999 was a 12% reduction in average bills in year one and reasonably stable bills thereafter. During the period 2000-04 we made eleven changes to price limits following interim determinations. Factors driving these included increased costs arising from bad debt and debt management costs, the rate of uptake of meters, changes to the environmental and drinking water quality programme, and increasing construction prices. We recognised that, although not all companies sought revisions to price limits (nor would they have qualified), there were pressures on bills towards the end of the period which affected most companies. As for other industries these included rising pension and energy costs. Companies also spent more on maintaining their systems than we anticipated they would when setting price limits in 1999. By 2003 it became clear that there was likely to be another significant programme of enhancements from 2005. So from a very early stage in this review we were looking at bill increases rather than decreases. The issue was how to balance the revenues the companies needed with the need to control the scale of any increases for customers of monopoly businesses.

One of the most significant and successful changes for the 2004 review was the introduction of draft business plans. We asked each company to lead the debate on the right option for its future and to explain its proposals to its customers and others. Each company prepared its own preferred strategy and one, or, for the water and sewerage companies, two, reference plans. These reference plans were based on sets of common assumptions provided by us to facilitate comparison between companies. This information informed a public debate in the autumn of 2003. It was the basis for our published advice to ministers and subsequently their principal guidance to me focussing on quality enhancements to be expected from the industry.

The involvement of the public in this price review has been achieved in a much more co-operative manner by the key
stakeholders than in the past. The economic and environmental regulators, government departments, companies, customer representatives and environmental representatives all joined together for two surveys of customers’ views, the first in late 2002 and the second in 2003. These used actual company data from the draft business plans to ask customers what changes they wanted to see, and to gauge their willingness to pay. The outcome showed that customer satisfaction with current services was high. Customers wanted services maintained rather than reduced. Most customers supported the companies’ plans. Most support was given to:

- ensuring the safety of tap water;
- managing the taste, appearance and smell of tap water;
- ensuring a reliable and continuous supply.

This was followed by maintaining water and sewerage systems, reducing sewer flooding and improving pressure. Less support was given to environmental and customer service aspects, although their importance was recognised.

Most of the same group, WaterVoice, the companies through Water UK, Defra, the Welsh Assembly Government, the Environment Agency, the Drinking Water Inspectorate, English Nature, the Countryside Council for Wales and Ofwat issued a joint statement setting out the stages of the price review and how customers and other stakeholders could get involved in the process.

We developed a new financial model for the 2004 price review and have shared both the model and our inputs and determination modelling with the companies. We asked the companies to use the model for both their draft and final business plan submissions.

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Having received a full draft business plan from each company we were able to set an ‘early start’ element of the capital programme for the first year of the five-year price limit period. Following each of the previous reviews there was a hiatus in investment while companies waited to see the outcome of the review before committing to an investment programme. This caused problems for the supply industry and was inefficient. This time we asked companies to nominate projects in their draft business plans, which we could confirm by the end of 2003. The early start programme was a little smaller than we had hoped, but it should ease some of the delivery pressures.

We based all of our decisions on the companies’ business plans. We treated all companies fairly and ensured that decisions taken for each company were consistent. We were careful to ensure consistency between companies and that we took account of each company’s particular circumstances. With 23 companies (including Cholderton, a very small water company) this was a mammoth task. We also ensured that our decisions were compatible with requirements placed on companies by the government and other stakeholders.

The timetable for the periodic review was set out clearly at the outset of the process. However, this had to be reviewed early in 2004 when principal guidance from ministers was delayed by 6 weeks, the only significant slip in the timetable. This resulted in companies delivering their final business plans between 7 April (original date) and 30 April (with some late data not arriving until mid-May). As a consequence we put back the dates of draft and final determinations by a week. We announced the revised timetable in an information bulletin on 18 March 2004 and stuck to it.

What is driving the changes in bills?

At each stage of the process we set out the drivers for changes in bills, using the table below (see Table 2). The companies also used this in their public summaries of their business plans.
Table 2: Average household bill in 2004-05

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount (2004-05)</th>
<th>Amount (2009-10)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average household bill in 2004-05</td>
<td>£249</td>
<td>£295</td>
</tr>
<tr>
<td>less (1) past efficiency savings and outperformance</td>
<td>(3)</td>
<td></td>
</tr>
<tr>
<td>(2) scope for reduction through future efficiency</td>
<td>(13)</td>
<td></td>
</tr>
<tr>
<td>plus (3) maintaining base services</td>
<td>18</td>
<td></td>
</tr>
<tr>
<td>of which (a) changes in revenue</td>
<td>(6)</td>
<td></td>
</tr>
<tr>
<td>(b) changes in operating costs</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>(c) changes in capital maintenance</td>
<td>7</td>
<td></td>
</tr>
<tr>
<td>(d) changes in impact of taxation</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>(e) financing</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>(4) maintaining security of supplies to all customers</td>
<td>11</td>
<td></td>
</tr>
<tr>
<td>(5) the impact of improvements in services</td>
<td>33</td>
<td></td>
</tr>
<tr>
<td>of which (a) drinking water quality</td>
<td>9</td>
<td></td>
</tr>
<tr>
<td>(b) environmental improvements</td>
<td>21</td>
<td></td>
</tr>
<tr>
<td>(c) service performance</td>
<td>3</td>
<td></td>
</tr>
</tbody>
</table>

Average household bill in 2009-10 £295

Change from 2004-05 to 2009-10 £46

Inevitably, this table is too simplified for the sake of a clear presentation to customers. Thus all the efficiency assumptions are shown in a single line. In practice the gains will be shared between the various costs of maintaining and improving services.

**Key differences between companies and Ofwat**

The difference between price limits sought in companies’ business plans and our final determinations varied from company to company but overall the company plans were closer to our determinations in 2004 than they were in 1999. The graph below shows the difference in annual average price limits for the two price reviews. In 1999 only six companies proposed price limits within 4% of our final determinations. In 2004 only one company proposed price limits that were more than 4% different (see Figure 1). The depth and rigour of our analysis and
challenge of each company’s plan was similar, if not greater than in 1999, so I conclude that there is clear evidence of better plans from companies for this review.

**Figure 1: Company plans v Ofwat’s decisions 2004 and 1999**

<table>
<thead>
<tr>
<th>Band</th>
<th>Description</th>
</tr>
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<tbody>
<tr>
<td>1</td>
<td>Within 1% each year of Ofwat’s determination</td>
</tr>
<tr>
<td>2</td>
<td>&gt;1% but within 2%</td>
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<tr>
<td>3</td>
<td>&gt;2% but within 3%</td>
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<tr>
<td>4</td>
<td>&gt;3% but within 4%</td>
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<tr>
<td>5</td>
<td>More than 4% away from Ofwat’s determination each year</td>
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</tbody>
</table>

**Key issues**

**Efficiency and incentives**

The water companies have achieved a great deal over the last 15 years. The quality of the services they deliver to their customers is at an all-time high. The pollution impact of the industry on the environment reduces every year. Improving levels of efficiency mean that more has been delivered for less. The industry has embraced new technology, and new approaches to management and service delivery to customers. Our joint drive with the
industry for better quality data both for management and regulation also helped.

- Future efficiency

Our analysis of the relative efficiency of the companies showed that there was still considerable variation in performance, with companies improving at different rates. Stimulating those companies that were not the most efficient to catch up with the current performance of the best companies will deliver further real efficiency improvements by the industry. Additionally, work by our consultants (and others), as well as the considered judgements of some of the leading companies, all support our view that there is still scope for the best performing companies to improve. Our determinations provide for the sharing of the assessed scope for improvements in efficiency between ‘carrots’ and ‘sticks’.

Although they do not directly influence our determination, the improved incentive mechanisms we put in place should stimulate individual companies to strive to outperform our assumptions. We set out our ‘stick’ proposals on the enhanced mechanisms in MD187, PR04 - A Further Consultation on Incentive Mechanisms (June 2003) and published our decisions in MD191, Our Conclusions on Rewarding Outperformance and Handling Under-performance’ (March 2004).\(^7\)\(^8\) These mechanisms will provide additional rewards for future outperformance by the current leading companies.


\(^8\) MD191 (2004), Our Conclusions on Rewarding Outperformance and Handling Under Performance, 25 March.
Maintaining services and the companies’ assets

We have assumed that there will be no deterioration in service to customers or in the level of compliance with environmental consents and licences.

In our determination we took some account of rising pension costs, but not of the full increases that companies proposed. Some companies considered that a proportion of the existing pension scheme deficits would be recovered over time. We assumed recovery of half of any past deficit and all future employers’ contributions.

We also noted that energy costs will rise disproportionately for the water companies as they are high users of power, particularly electricity. We expect energy costs to rise by 40% in the next two years. However, because we expect this to lead to an increase in inflation of around 0.5% a year we reduced the likely increase in costs in our determinations’ assumptions accordingly.

We have continued to keep the cost of bad debts and debt management as a notified item opening up the possibility of an interim determination if these costs rise significantly from current levels.

The industry has developed an improved framework for assessing future capital maintenance needs. We were pleased with the progress made by the companies in this area and we were able to endorse some plans. In others we felt there was still some doubt and adjusted downwards the company’s projection in our determinations. We reviewed each company’s business plan to assess what it needs to maintain the serviceability of its assets.

- Maintaining the balance between supply and demand

Where the current security of supply position is not adequate to meet the needs of new and existing customers we have assumed that the company will make the required improvements either by
reducing leakage to the economic level, enhancing demand management, or commissioning new sources to the timetables set out in our determinations.

**- Quality and environmental improvements**

In total, companies will have invested nearly £25bn between 1990 and 2005 on improving drinking water quality and the environment.

Our determinations assume that the industry will be likely to need to invest around £5.5bn for new quality and environmental improvements (some £1.4bn less than the companies sought). Where companies’ proposals were not fully specified, or were dependent on the outcome of investigations, we included in price limits the costs of investigation only. A few companies’ proposals were very costly for the benefits to be delivered, and we have not included them in our determinations. Required changes to our determinations will use our published change protocol. All of these schemes and the outcome of any investigations will be reappraised during 2005-10.

**- Enhanced service levels**

We have assumed companies will also improve some aspects of their service to customers. Most of this relates to the alleviation of sewer flooding. We expect the sewerage companies to provide permanent solutions to the vast majority of current hydraulic problems they identified in their final business plans and install mitigation measures for the rest.

We expect this to resolve 9,210 or about 90% of the known and emerging high risk internal flooding problems which companies proposed to deal with and 6,030 or 80% of external problems.

We have also allowed for improvements to water pressure, taste and odour or hardness of drinking water for a number of companies.
Cost of capital and financeability

We believe that our approach to setting price limits should create conditions under which the additional investment required could come from debt or equity sources. We believe that the returns allowed should provide shareholders with sufficient incentives to commit additional funds, either in the form of retained earnings or new equity injections where this is appropriate, to enable companies to make new investment. Efficient companies should be able to retain stable credit quality going forward.

Assessing the cost of capital is not a mechanical process. Uncertainties mean that we cannot place too much weight on one tool for assessing the cost of capital. At an early stage in the review, to recognise the fact that the companies have enjoyed a period of historically low interest rates since the last review and indications that this will not persist, we indicated to companies that the evidence pointed to a basic cost of capital no lower than 5.0% post-tax in real terms, compared with 4.75% used at the last review. There is also evidence to suggest that the return required by equity investors may have risen since the last review in 1999.

In our determinations we assumed a cost of capital of 5.1% post-tax in real terms in our determinations. This is equivalent to 7.3% on a fully pre-tax basis (assuming a 30% marginal tax rate). We have also allowed for a small company premium for the water only companies. This ranges from 0.3% to 0.9% depending on the size of the company.

A consequence of requiring companies to undertake large capital programmes is persistent negative cash flow. This can lead to deterioration in credit quality which could restrict companies’ access to capital markets or significantly increase the cost of finance. In aggregate, price limits include around 1.0% for 2007-08 rising to 1.3% by 2009-10 to maintain financeability.

This approach coupled with any outperformance of our assumptions could give rise to higher returns in the later years of
the period. Given the potential capital programme beyond 2010, we expect prudent companies to retain an appropriate proportion of earnings to alleviate the financial strain. If this is not the case, then the argument that large capital programmes increase financial strain could not be sustained at future reviews.

- Uncertainty

For the majority of outputs we can make reasonably confident central estimates of costs and we aim to make the price limits we set sustainable over a five-year period. However, if there are significant changes to specified outputs or if very significant events occur that are outside the control of an efficient company we have mechanisms to allow for changes to price limits (up and down).

This includes the use of our change protocol (a procedure for dealing with changes in outputs between price reviews). The five-year price review process ensures that water companies do not carry risks for more than five years. The resulting relatively low level of risk inherent in the water industry is reflected in the cost of capital and we do not include any general allowance for unforeseen costs.

Beyond testing the final price limits for ‘financeability’ we have not allowed any ‘headroom’ in financial projections as contingency provisions to absorb possible unanticipated cost shocks. To do so would insulate companies from managing risk and would be inconsistent with the cost of capital underpinning these price limits.

A few issues are too uncertain to be included in price limits. We have defined ‘notified items’ so that if the issues do arise and have a material impact on a company’s costs then they can be considered as a reason for resetting that company’s price limits ahead of the next review in 2009. These are in addition to the triggers for interim reviews already in place in each company’s licence.
Water Act 2003

The Water Act 2003 (WA03), which received Royal Assent on 20 November 2003, amends the Water Industry Act 1991 (WIA91) and the Water Resources Act 1991. The WA03 introduces important changes including:

- an independent Consumer Council for Water;
- the Water Services Regulation Authority, in place of the Director General of Water Services;
- financial penalties for water and sewerage undertakers who breach their appointment conditions;
- water industry specific legislation for competition;
- changes to abstraction licensing which the Environment Agency administers.

**Consumer Council for Water**

We are working with Defra and WaterVoice to get this new organisation up and running in October 2005. Although WaterVoice has been resolving policy issues independently of Ofwat for some time this formal separation will result in new challenges for each of us.

**Regulatory Authority**

The Water Services Regulation Authority will assume the powers of the Director General as modified by the Water Act 2003 (WA03). This is currently expected to take effect in April 2006. This timing will allow the current price review process to be completed, including any references to the Competition Commission, before the changes take place. The establishment of the Authority with a formal board structure will build on the current board arrangements including the role of our non-executive advisory directors.
WATER REGULATION

The WA03 requires the Authority to publish a code of practice setting out how it will discharge its functions. Following consultation, we have already issued a code of practice governing the way we discharge our functions. Once the new Authority is set up, we expect it to update this code.

The WA03 will also give the Authority a duty to further the consumer objective, which means protecting the interests of all consumers, wherever appropriate by promoting effective competition. The WA03 includes provisions to increase opportunities for competition in the supply of water services. We have worked with Defra to consider when each section of the WA03 will be implemented.

Financial penalties

The WA03 will allow us to impose fines of up to 10% of annual turnover on companies (water and sewerage undertakers, and water supply licensees). However, we would only expect to impose fines of this scale in a case of extreme failure. With the Secretary of State we have consulted on the criteria we intend to use in deciding whether to impose a fine upon a company, and the factors that should influence decisions on the levels of such fines. The powers are expected to come into effect on 1 April 2005.

Competition – self lay and requisitioning

Extending opportunities for price competition will increase customer choice. This should lead to keener prices, innovation and the provision of new and improved services for customers. The new provisions incorporated in the Water Industry Act 1991 (WIA91) are set within the government’s wider objectives, which are:

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9 RD33/03 (2003), How We Do Our Job – A Code of Practice Governing the Discharge of Ofwat’s Functions, 11 September.
to protect public health, and ensure that the industry continues
to deliver a safe and secure water supply;
to protect and improve the environment;
to meet the government’s social goals including the
affordability of water supplies;
to safeguard services to customers.

The WA03 powers relating to the self-lay of water mains and
requisitioning of water mains and sewers came into force on 28
May 2004. These powers introduce a statutory framework for
self-lay of water mains that increases choice for developers and
clarity for water undertakers, which we expect to lead to
improved efficiency and keener prices. The WA03 also gave us
powers to consider disputes about the terms and conditions of
self-lay and requisitioning agreements.

**Competition – water supply licensing**

The WA03 provides a specific framework for access to the
public water supply systems of statutory water undertakers
within England and Wales. It permits access to a water
undertaker’s supply system by a licensee for the purpose of
supplying a customer’s eligible set of premises.\(^\text{10}\) The new water
supply licensing regime is expected to come into effect in
autumn 2005. Prospective suppliers will be able to apply for:

- a ‘retail’ water supply licence, which entitles the holder to
  purchase a supply of water from a water undertaker and to
  retail it to a customer’s eligible set of premises; or

- a ‘combined’ water supply licence, which is a retail licence
  with a supplementary authorisation that enables the holder to
  introduce water into a water undertaker’s supply system and to
  retail water to a customer’s eligible set of premises.

\(^{10}\) Defined in WA03 as all potable water mains and other pipes
downstream of the undertaker’s treatment works, and any non-potable
networks not connected to any potable system.
There are approximately 2,300 customers at eligible premises, spending in total about £210m on water each year (2002 figures). Eligible premises are defined in the WIA91 as non-households where annual consumption is likely to be not less than the defined eligibility threshold, currently set at 50 megalitres a year. In addition, premises may only be supplied by one licensee at any time.

Along with the Environment Agency and the Drinking Water Inspectorate, Ofwat will undertake a review of the licensing framework, including the 50Ml threshold, within three years of the start of the regime. The review will be co-ordinated by Defra.

**Longer term**

When implemented, the Water Act 2003 will oblige the new Water Services Regulation Authority (WSRA) to carry out its duties in the manner which it considers is best calculated, amongst other things, to contribute to the achievement of sustainable development. We believe that the concepts underlying sustainable development are consistent with our current statutory duties, and that the price limits will contribute in a balanced way to achieving the following four objectives:

- social progress;
- effective environment protection;
- prudent use of natural resources;
- maintenance of high and stable levels of economic growth.

At price reviews we inevitably concentrate on the next five years but set price limits within an evolving longer term perspective. We asked companies to set out proposals that extend to 2014-15, with still longer term projections for asset maintenance requirements, and water resource plans that cover a 25-year period.
Social progress

Since privatisation, customers have benefited from major improvements in the quality and continuity of supply of drinking water, as well as higher levels of customer service. Price increases are never welcome. But for most customers the average increase in water bills, of around 7% in real terms over the decade from 1999 to 2009, is less than the likely growth in household incomes. It is not open to us or the companies to extend cross-subsidies between better off and less well-off customers within a company’s area. We therefore welcome the fact that the government undertook a review of affordability issues and we have taken a full part in providing the information on which it was based.

During the course of the review we have raised questions about value for money issues where projects appeared not to meet our long established criteria. These criteria include a soundly-based needs assessment, clear outputs, wide options appraisals and robust costs and benefits assessments. Well over 95% of the proposals set out in ministerial guidance were included in the price limits we set. However, there remain a small number of proposals that require re-examination and some difficult decisions.

We see the open challenge process as a crucial strength of the regulatory regime. Difficult decisions will always be required but these should follow a constructive and well-informed debate between the relevant parties. We see no reason to expect future periodic reviews not to involve similar challenge, informed debate and difficult decisions.

Effective environmental protection

Overall, the improvement programmes included in price limits will enable water companies to make a further substantial contribution towards delivering national and international environmental obligations, many under European directives. The
2005-10 programmes build on the huge improvements, so far mostly due to water and sewerage companies’ activity, in river and coastal water quality over the last fifteen years. The full benefits of the current programmes will not be evidenced for a number of years.

The companies’ plans, as taken forward through these price limits, should also help ensure a coherent long term approach to environmental protection. We are not in a position to assess how significant the programme of environmental improvements for water companies will be in the period beyond 2010. By 2010, one of the main statutory drivers for work on the water environment is likely to be the Water Framework Directive. Publication of the draft river basin management plans in 2008, will be followed by the establishment of a programme of measures in each river basin district to deliver the environmental objectives in 2009. This should fit with the timetable for the next price review in 2009. However, the focus of the Water Framework Directive is on the overall environmental outcomes and is not specifically directed at the water companies. The expectation is that the polluter should pay.

Prudent use of natural resources

Where justified, resources have been included in our price limits for investigative and developmental work on long term enhancements to supply, and on improving the security of supply. We have continued to encourage water companies to control leakage effectively, with companies expecting to reduce leakage by more than 8% between 2003 and 2010, and to carry out their duty of promoting the efficient use of water by customers. Long term, the most effective and efficient way of encouraging water conservation is to relate the price paid to the amount used. Significant progress in the installation of domestic meters will be made over the coming five years and one company, Folkestone & Dover, plans to apply for ‘water scarce area status’, which would give it greater freedom to install meters.
Economic growth

In relation to the water industry itself, we consider that these price limits provide a demanding but achievable and fair basis for encouraging the industry to further improve its efficiency. This will benefit shareholders as well as customers. In supporting the economy at large, it is essential that the industry should be able to maintain high-quality water and wastewater services. To do so, the complex asset networks developed over 150 years must remain fit for purpose. We have assumed significant increases in spending on maintenance, and noted evidence that asset maintenance may need to be further increased in the period 2010-15.

It is essential that the industry should be able to continue to finance its work. Companies’ revenues are insufficient to pay directly for high levels of capital investment. They therefore need access to the financial markets to service increasing debt levels or to raise new equity. Providers of finance need to be confident that companies can make returns that adequately match the risks of investment.

The size of the capital programme beyond 2010 is not defined but is likely to be substantial and there will be a need to maintain financeability in the longer term. The need for companies to maintain an adequate financial position so that they can continue to raise finance may mean that continuing large capital programmes may have a disproportionate effect on price limits. We have had to allow in the price limits for 2005-10 for higher than average industry returns at the end of the period than at the beginning, due to financing considerations. Such an approach may not be economically sustainable at reasonable cost if companies are required to sustain negative cash flow indefinitely. We shall consider these issues further in preparing for the next price review.
WATER REGULATION

In conclusion

The last two years have been focused on the 2004 price review. We knew by 2 February whether any company was seeking a redetermination of these price limits by the Competition Commission. Meanwhile we have appointed a steering group to evaluate the price review and the lessons learnt. The steering group will consult stakeholders. Its report will help to inform Ofwat’s early thinking on the next price review in 2009.

We will review the length of the period appropriate for the price limits, which will take effect from April 2010.

I have published for consultation our draft forward programme. This is likely to be the last under the current statutory framework.

During the coming year we will prepare for the formation of the Water Services Regulation Authority (WRSA), which will become statutorily responsible for Ofwat’s work from 1 April 2006 on the current government timetable.

A key element of our work is monitoring the performance of the companies across a broad range of indicators, for example leakage from water pipes, and customer telephone call centres. If required we will take action to protect customers. We will put in place the monitoring process for the PR04 final determination.

In June 2005 we will receive the annual information return from the companies covering the final year of the price limits set in 1999. We will publish our performance reports, analysing the outcome of that price review.

We will continue to approach all of this work in an open and transparent way. We shall continue to consider carefully any restructuring or merger proposals from companies. Any proposed mergers between water companies would, by law, be decided on by the Competition Commission.
References
(bold numbers refer to the footnote in which first cited)


MD191 (2004), Our Conclusions on Rewarding Outperformance and Handling Under Performance, 25 March. (8)


National Audit Office (2002), Pipes and Wires, 10 April. (3)


RD33/03 (2003), How We Do Our Job – A Code of Practice Governing the Discharge of Ofwat’s Functions, 11 September. (9)


Water Prices and the Environment, Select Committee report. (2)
8 CAN WE (SHOULD WE) REGULATE ‘CULTURES OF CONSUMPTION’?

Tim Jackson

Introduction

Consumer behaviour is key to the impact that society has on the environment. The actions that people take and the choices we make – to consume certain products and services or to live in certain ways rather than others – all have direct and indirect impacts on the environment, on other people’s lives and on our own personal and collective well-being. But to what extent is it possible, or even desirable, to regulate for changes in consumer behaviour?

Amongst the most firmly held desiderata of modern liberal society is the notion of individual freedom of choice. It seems almost sacrilegious for government to assume influence over the complex mix of personal preference, social expectation and cultural norm which, taken together, constitute ‘consumer choice’. Yet this is precisely what the new environmental and social agenda of ‘sustainable consumption’ appears to demand of us.

To take just one example, the target to reduce carbon emissions by 60% before 2050 is central to the UK government’s climate change policy. But there is an increasing recognition that changes in technology and increases in resource productivity will be insufficient to deliver such targets. Shifts in the scale and pattern of consumption are also likely to be essential. Achieving the latter relies on being able to influence not only the efficiency of industry, the performance of business and the design of...
products, but also the expectations, choices, behaviours and lifestyles of consumers.

Moreover, meeting such ‘deep’ reduction targets will require more than slight shifts in people’s marginal preferences for energy-efficient light-bulbs. Policy will need to influence behaviours and practices in a number of different arenas, including: supply tariff choices, purchases of energy-using appliances, energy-consuming practices in the home (personal hygiene, laundry, food preparation etc), demands for mobility and access (for both work-related and recreational reasons), food consumption behaviours, engagement in recycling and reuse of products, material product choices, home-buying, patterns of use of domestic space, choice of leisure pursuits, demand for public services and so on.

These behaviours and practices depend in their turn on a complex interaction of continually evolving personal values, social norms and cultural narratives. Until very recently, policy-makers in the UK (and elsewhere) have tended to shy away from such complex terrain. The area of lifestyle choice is often regarded as too subjective, too ideological, too value-laden, or simply too intractable to be amenable to policy intervention. Uncertainty over the outcome of attitudinal or behavioural interventions has sometimes deterred government even from piloting change initiatives.

There is evidence that this timidity is beginning to change. In the UK, for example, the government has published a UK Framework on Sustainable Consumption and Production and has recently established a national Round Table on Sustainable Consumption. The Environment Agency is commissioning research on changing personal behaviours, and the Cabinet Office strategy unit has published a key paper on personal
responsibility and behaviour change. The new (2005) UK Sustainable Development Strategy firmly acknowledges the importance of changes in people’s behaviour in delivering sustainability.

At the heart of these initiatives is the idea that behavioural change is not only desirable but essential if key sustainability goals are to be met. Launching the Round Table on 21 April 2004, for example, Margaret Beckett declared: “One of the hardest challenges we confront at home is how we, as a nation, can move to more sustainable lifestyles and reduce the impacts we have on the local and global environment. This is an area where people are rightly suspicious of government intervention. Yet we know that current consumption patterns exact too high a price”.

In short, it appears that in order to accomplish its own declared environmental and social goals, government now finds itself forced to engage in a terrain which, if the rhetoric of the last two or three decades is to be believed, is not the terrain of government at all.

This brief review aims to elucidate the challenge with which policy-makers are now confronted. It examines first of all the existing basis for conventional policy-making on matters of private choice. It then critiques the underlying basis for this model. In the process, it attempts to show more clearly the nature of the apparent impasse with which pro-environmental and pro-social policy-making is faced. This challenge will require a committed effort by policy-makers if key environmental or social goals are not to be abandoned as unattainable.

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‘CULTURES OF CONSUMPTION’

In the final analysis, however, it emerges not so much that government can and should intervene more proactively to regulate cultures of consumption, but that they are already, in some sense, co-creators of the cultures of consumption they now seek to change. The author argues that this is a much more useful and empowering perspective from which to design policy.

‘Correcting market failure’ - the conventional policy response

Conventional responses to issues of consumer policy tend to be based on a particular model of the way that choices are made. This ‘rational choice’ model contends that consumers make decisions by calculating the individual costs and benefits of different courses of action and then choosing the option that maximises their expected net benefits. If it is cheaper for me to travel from A to B by train than by car, I will usually choose to go by train. If it is more costly and time-consuming for me to recycle my household waste than to throw it in the trash, I will tend to do the latter.

There is a familiar and appealing logic to this model. Faced with two clear choices, different in cost but equal in all other respects, it is in my own self-interest to choose the less expensive one. From this perspective, the role of policy appears to be straightforward, namely to ensure that the market allows people to make efficient choices about their own actions.

For the most part, this has been seen as the need to correct for ‘market failures’ (Figure 1). These failures occur, for example, if consumers have insufficient information to make proper choices. Policy should therefore seek to improve access to information. In

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\(^2\) For a more extensive review of the rational choice model, its implications and limitations, see Jackson T (2005), Motivating Sustainable Consumption – A Review of the Literature on Consumer Behaviour and Behavioural Change, SDRN.
addition, private decisions do not always take account of social costs. Policy intervention is therefore needed to ‘internalise’ these external costs and make them more ‘visible’ to private choice.

Figure 1: The ‘market failure’ model of consumer policy

Sadly, the evidence does not support optimism in relation to either of these policy options – at least by themselves. In fact, the history of information and advertising campaigns to promote sustainable behavioural change is littered with failures. In one extreme case, a California utility spent more money on advertising the benefits of home insulation than it would have cost to install the insulation itself in the targeted homes.  

The fiscal approach has also faced limited success in encouraging long term pro-environmental behaviour changes. Although there is evidence to suggest that price differentials (for example) are sometimes successful in persuading people to shift between different fuels, there is much less convincing evidence of the success of economic strategies in improving energy

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Kenzie-Mohr argues that the failure of such campaigns to foster sustainable behaviours is partly the result of a failure to understand the sheer difficulty associated with changing behaviours. As a review of the residential conservation service – an early energy conservation initiative in the US – once concluded, most such efforts tend to overlook “the rich mixture of cultural practices, social interactions, and human feelings that influence the behaviour of individuals, social groups and institutions”.

Beyond ‘market failure’ – consumer policy in the real world

A part of the problem with the existing policy model rests with the underlying rational choice basis. Though it may not yet have filtered down to the level of policy or political rhetoric, the critique of rational choice theory is long-established. Consumer actions are not always so straightforward as the rational choice model suggests. We do not always deliberate carefully over costs and benefits. We do not always act in our own self-interest. Individual choice is continually tempered by social constraints. Sometimes we just don’t deliberate at all, acting through instinct, emotion, moral conviction or habit, rather than reason.


The matter of habit

Habit plays a vital role in our lives. It is also one of the most difficult issues for policy-makers to address. Rational choice models assume that behaviour is based on cognitive deliberation. But many of our everyday actions are carried out with very little conscious thought at all. How often, for example, do we ponder where to throw our waste paper, whether or not to drive to work, or even which brands to buy in the supermarket?

For the most part, we use a variety of mental ‘short-cuts’ – habits, cues, heuristics – to reduce the effort required to make routine choices. It is often only when circumstances disrupt our routines – when someone moves the waste bin in the kitchen, say – that conscious deliberation enters the picture. Now I have to think twice about what I am doing and search consciously for the bin. I may find myself reaching instinctively for the old location, even several weeks later.

This example illustrates both the good and the bad aspects of habitual behaviour. On the one hand, habit makes it possible to function efficiently and frees up the conscious mind for more important tasks – like writing (or reading) reviews on consumer policy. In an increasingly hectic world, this is a useful ability. But the process of habituation makes our everyday behaviours less visible to conscious deliberation, less amenable to policy intervention, and more difficult to change when they are no longer appropriate.

It is important for policy-makers engaging with behavioural change to find ways of addressing the problem of habitual behaviour. This looks challenging. But like many social and psychological processes, habit formation has its own rules and dynamics. For instance, a vital ingredient for changing habits is to ‘unfreeze’ existing behaviour – to raise the behaviour from the level of ‘practical’ to ‘discursive’ consciousness. This process is known to be most effective when it is carried out within a supportive community.
Morals and norms

Our everyday behaviour is guided by two kinds of social norms. Descriptive norms’ teach us how most people around us behave. They allow us moderate our own behaviour without too much cognitive effort. I know what kind of clothes to wear and when to put out my recycling partly by observing continually what others around me do. ‘Injunctive norms’ alert us to what is sanctioned or punished in society. Driving outside the speed limit, polluting the water supply and (perhaps) failing to separate our recyclables from the rubbish are all examples of behaviours which carry varying degrees of moral sanction.

In both cases, there is lot at stake. Our ability to observe social norms influences the way we are perceived in our peer group and is important to our personal success. My ability to find a mate, keep my friends and stay in a good job are all mediated by my success in following social norms. Descriptive and injunctive norms can sometimes point in opposite directions. Most people agree that breaking the speed limit is wrong; but many people do it. The same is true for other unsustainable behaviours.

Pro-environmental behaviours are not always motivated by altruism. Some can be motivated entirely by self-serving interests. But a part of the case for pro-environmental behaviour is a moral one. The environmental impacts of my actions here today are as likely (or perhaps more likely) to fall on other people at some other time and place as they are to fall directly on me. Understanding moral action is therefore crucial.

Expectancy-value theories struggle to elucidate moral behaviours because of underlying assumptions about individuality and self-interest. But useful models do exist. Schwartz’s ‘norm activation’ theory suggests that my intention to behave in pro-social ways is

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higher when, first, I am aware of the consequences of my actions and, secondly, I assume responsibility for them.  If I am aware of the consequences of fuel consumption for the problem of climate change and prepared to accept that I have some responsibility for my own fuel-consuming behaviour, then I am more likely to develop a personal norm to reduce my fuel consumption.

These insights reinforce the idea that awareness plays an important role in pro-environmental behaviour. But they also indicate that awareness is not enough. Mechanisms for promoting responsibility (eg, commitments, quotas, targets) are also vital. At one level, pro-environmental behavioural change can be thought of as a transition in social norms. Better understanding of the evolution of social norms can only enhance environmental policy.

**Sociality and self**

We are fundamentally social creatures. We learn by example and model our behaviours on those we see around us. We learn most effectively from those who are attractive to us or influential for us, or from people are simply ‘like us’. Sometimes we learn by counter-example. And we learn not to trust people who tell us one thing and do another.

Some social theories go further and suggest that our behaviours, our attitudes, and even our concepts of self are (at best) socially constructed and (at worst) helplessly mired in a complex ‘social logic’. 8 Social identity theory, for example, regards key aspects of our behaviour as being motivated by the particular social groups that we belong to. Certain behaviours are more or less

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7 Schwartz S (1977), Normative Influences on Altruism, in Advances in Experimental Social Psychology 10, pp222-279.
ruled in or ruled out for me, simply because I perceive myself as belonging to a particular social group.

The roots of these ‘normal behaviours’ have very little to do with individual choice. Individual change is often not feasible and usually insufficient. Intervention based on the rational choice model simply misses the vital role of the social context within which individual action is embedded.

**The dimensions of consumer action**

A grand unified theory of human behaviour is probably impossible and may not be particularly useful. But a pragmatic synthesis is an essential starting point for policy design. Triandis’ early theory of interpersonal behaviour ([Figure 2](#)) provides a good illustration of such a synthesis. A more complicated social-psychological model along the same lines has been developed by Bagozzi and his colleagues.⁹

In summary, this kind of integrated view suggests that my behaviour in any particular situation is a function partly of my attitudes and intentions, partly of my habitual responses, and partly of the situational constraints and conditions under which I operate. My intentions in their turn are influenced by social, normative and affective factors, as well as by rational deliberations. I am neither fully deliberative nor fully automatic in this view. I am neither fully autonomous nor entirely social. My behaviours are influenced by my moral beliefs, but the impact of these is moderated both by my emotional drives and my cognitive limitations.

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At one level, the lessons from all this are salutary. Looking at consumer behaviour through a social and psychological lens reveals a complex and outwardly hostile landscape that appears to defy conventional policy intervention. Consumer behaviours and motivations are complex and deeply entrenched in conventions and institutions. Social norms and expectations appear to follow their own evolutionary logics, immune to individual control. Social learning is powerful but not particularly malleable. Public service persuasion is confounded both by strong commercial interests and by the sheer information density of modern society.

The rhetoric of consumer sovereignty is inaccurate and unhelpful here because it regards choice as entirely individualistic and because it fails to unravel the social and psychological influences on people’s behaviour. But short of mandating particular behaviours and prohibiting others – an avenue that government has been reluctant to pursue – it is difficult at first sight to see what progress can be made in this intractable terrain.
At the same time the urgency of addressing the task remains undiminished. So how should policy-makers go forward from this point? What options are available to them for addressing these key issues? And what kind of framework should we use to think about policy interventions, beyond the limited perspective of rational choice?

Framing the question - policy options in cultural context

At its broadest level, the problem of motivating sustainable consumption – or of encouraging pro-environmental changes – is a particular manifestation of a perennial social issue. As Gardner and Stern, Ophuls, Daly and Cobb and others have pointed out, it is essentially the problem of ensuring that behaviours which threaten the well-being of the social group are discouraged and that those which promote long term well-being are encouraged.\(^\text{10}\) In one sense, it is quite precisely the problem of societal governance, of coordinating individual behaviour for the common good.

Ophuls suggested that, from time immemorial, there have only ever been a few basic methods – written about by philosophers and employed by societies - for achieving this.\(^\text{11}\) Specifically, the four ‘solution types’ are:

- government laws, regulations and incentives;
- programmes of education to change people’s attitudes;
- small group/community management;
- moral, religious and/or ethical appeals.


\(^{11}\) Ophuls (1973), op cit.
Different societies and different writers at different times have tended to favour specific options or combinations of options. Hobbes, for example, championed the first approach, while Rousseau favoured the third. As we have already noted, conventional policy prescriptions in our society tend to favour the first two options. Or, to be more precise, we tend to favour a specific configuration of the first two solutions, one in which the balance of government intervention is focused on fiscal incentives designed to internalise social and environmental externalities and information is provided to ensure that people make informed or ‘rational’ individual choices.\textsuperscript{12}

Quite why our society should favour this set of options is slightly puzzling at first. Some insights into the ascendancy or otherwise of specific solution types can, however, be gained from the understandings of cultural theory (Figure 3).

Cultural theory suggests four distinct forms of social organisation, with associated ‘cultural types’ and related assumptions about the appropriate form of governance. Modern societies can best be categorised within this framework as low group, low-grid societies, ie, lying in the lower left hand quadrant of Figure 3.\textsuperscript{13} The guiding principles for social organisation in such societies favour the rights of the individual

\textsuperscript{12} A fairly recent addition to the policy menu in modern liberal societies is the concept of self-regulation (see, for example, BRTF (1999), Self-Regulation – Interim Report, Better Regulation Task Force) in which businesses (in particular) are encouraged to protect their own long-term self-interest by developing voluntary ‘codes of conduct’. Largely driven by the threat of future regulation, this option can be classified (at one level) as an incentive-based mechanism. It might also be conceived however as a limited form of community management – although perhaps more obviously management of a regulatory threat than management of a local resource base. A fuller discussion of the basis for this kind of mechanism would be interesting but is beyond the scope of this chapter.

\textsuperscript{13} The ‘grid’ categorisation was coined by anthropologists to distinguish societies according to the degree of ‘insulation’ between different social classes. Low grid societies are characterised by fewer formal class relations and high degrees of social mobility.
over the rights of the group and place a premium on social mobility. Governance is ‘light’ in this cultural worldview. Competition, open access to markets, and equality of opportunity are all prized. Regulation, hierarchy and social insulations are eschewed. This is the entrepreneurial, individualistic society. And its models of governance are precisely those that conform to a particular combination of the first two solution types.

Though cultural theory does not exactly explain how we came to be such a society, it does do two things. First, it highlights that this form of social organisation is only one of a number of possible different forms. Secondly, it suggests that since the world is inhabited by a variety of cultural types, a single overriding form of social organisation is never likely to be entirely successful.

**Figure 3: Cultural theory’s typology of social organisation and cultural type**
From the perspective of this review, we might also offer here another hypothesis. Namely, that the forms of governance familiar to the individualistic/entrepreneurial society are never, by themselves, going to be sufficient to achieve sustainable development. The complexity of human behaviour and the enormity of the challenge of achieving pro-environmental behavioural change mean that we can no longer afford to restrict policy options to the particular combination of solution types conventionally attributed to low-group, low-grid societies. Thinking outside the familiar policy options is going to be vital.

The option that stands out perhaps most obviously as lying outside the conventional policy menu is the third: small group or community management. In organisational terms, according to Gardner and Stern, what makes community management systems work is a combination of participatory decision-making, monitoring, social norms and community sanctions. Interestingly, sanctions are not the most important element in compliance. Rather, the effectiveness of group management comes from the internalisation of the group’s interest by individuals in the group.

This happens for several reasons. In the first place, people have participated in creating them. In the second place, they can see the value of these norms for themselves in preserving and protecting the interests of the local community and themselves as members of that community. In addition, these group norms become a part of the shared meaning of the community, and contribute to the social well-being of the group, not just through the protection of resources, but through the development of trust, collaboration and social cohesion. Sanctions may be necessary to protect the group from those tempted to violate the collective good for individual interests, but the main reason people accept and act on social norms is that doing so cements social relations, signals membership of the group, and contributes to a sense of shared meaning in their lives.
It is clear of course that, as a form of social organisation, local management of communal resources is less common today than it was a hundred, fifty, or even twenty-five years ago. Powerful social and economic forces have intensified trade, eroded community boundaries, distanced cause from effect, and undermined some of the basis for local governance. These trends have been supported by ideological transitions that prioritise social mobility, the globalisation of commerce and culture, and uniformity of political form. From a cultural theory perspective, community management belongs in a completely different quadrant (specifically the lower right – and to some extent the upper right side of Figure 3) from the entrepreneurial, individualistic cultural form that characterises modern society.

In the final analysis, no single solution type, on its own, is likely to be effective in delivering pro-environmental behaviour change. Effective policies for motivating sustainable consumption are going to need to explore the untapped potential for governance within each perspective. But given the critical importance of social processes in consumer behaviour alluded to earlier in this chapter, the scope for exploring the ‘forgotten strategy’ – namely community management – from amongst Gardner and Stern’s solution types deserves renewed consideration.

Policy as a ‘co-creator’ of the culture of consumption

The conclusion to be drawn from this chapter is not that fiscal incentives and information campaigns are irrelevant or inappropriate as policy options to facilitate pro-environmental behaviour change. People are sometimes self-interested. They do make economic decisions. Their choices are swayed by cost. Adjusting prices to incorporate negative or positive externalities is therefore a legitimate avenue through which to promote pro-environmental or pro-social behaviour and to discourage anti-
social or environmentally damaging behaviour. Providing accessible and appropriate information to facilitate pro-environmental choice is also a key avenue for policy.

But the evidence does suggest very strongly that these measures are insufficient on their own to facilitate pro-environmental behaviour change of the kind and scale required to meet existing environmental challenges. And as such, this evidence base provides a critique of the model of governance in which the role of policy is confined mainly to providing information and internalising externalities. In the language of cultural theory, the individualistic/entrepreneurial cultural form is insufficient to deliver sustainable consumption. It simply fails to reflect the complexity and social embeddedness of human behaviours.

But there is also evidence that this model of governance is nothing more than an ‘ideal form’, supported by a set of rather unrealistic assumptions about human behaviour and the role of the state. In a sense, the ‘hands off’ rhetoric of modern governance is nothing more than an ideological discourse. The reality is that policy intervenes continually in people’s behaviour. It intervenes directly – through taxes, incentives and the regulatory framework. More importantly, it intervenes indirectly through its extensive influence over the social and institutional context within which individual behaviours are negotiated.

This view of the state – as a continual mediator and ‘co-creator’ of the social and institutional context – opens out a range of vital avenues for policy intervention in pursuit of behavioural change. The complex terrain of human behaviour, as viewed in a social, psychological and cultural context, is not a place devoid of possibilities for state influence. Rather it is one in which there are numerous possibilities at multiple levels for motivating pro-environmental behaviours and encouraging sustainable consumption. The following paragraphs outline some of these possibilities very briefly.
Facilitating conditions

Time and again, the evidence suggests that external situational factors (also referred to in the literature as facilitating conditions or contextual factors) are a key influence on the uptake of pro-environmental behaviours. Such conditions include the provision of recycling facilities, access to energy efficient lights and appliances, the availability and reliability of public transport services and so on. The adequacy of such facilities and services, equality of access to them, and consistency in their standards of operation are all vital ingredients in encouraging pro-environmental choice. Inadequate or unequal access, insufficient information, incompatibilities between different services: all these factors are known to reduce the effectiveness and uptake of pro-environmental behaviours.

Institutional context

At a broader level, the set of rules, regulations and operating conditions – defining the context within which choice is negotiated – is another key intermediary between policy and public behaviour. For example, the market conditions – established by government – under which energy supplies are generated, distributed and supplied has a profound impact on the kinds of energy generation that are preferred and the extent to which energy efficiency is or is not cost-effective for consumers. These conditions could either foster or sabotage the viability of renewable energy, energy efficiency, energy service companies and so on.

Government also has a vital role in negotiating the institutional context in which business and consumers operate through the setting of legislation, regulations and standards. In particular, it is clear that:
• **Product standards** could make vital differences between durability and obsolescence, between efficiency and waste, between recyclability and landfill;

• **Building standards** could further improve or simply hinder the efficiency of the UK building stock;

• **Trading standards** might either foster or prevent excessive or addictive consumption and play a key role in the success or failure of sustainable consumption patterns;

• **Media standards** play a vital role in influencing the wider social and cultural context of consumer attitudes, motivations and desires;

• **Marketing standards** could either encourage or inhibit unscrupulous or inappropriate selling, advertising and marketing practices.\(^{14}\)

**Social and cultural context**

Government plays a significant role in the social and cultural context within which consumers act. Nor is state influence simply confined to regulation, information and tax setting. These activities are obviously important both as direct and as indirect influences on consumer behaviour. But there is more at stake here. A part of the indirect influence of state policy is symbolic. Evidence from social anthropology suggests that people respond quite explicitly to the symbolic meanings of things.\(^{15}\) Responses to government interventions and public policy messages are no different in this respect.

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\(^{14}\) The importance of marketing and media standards becomes increasingly clear when one considers the vast asymmetry of resources between commercial advertising and public service interests. For a more detailed discussion of this issue see, Jackson T (2004), Consuming Paradise? Unsustainable Consumption in Social-Psychological and Cultural Context, in Hubacek K, Inaba A and Stagl S (eds), Driving Forces of and Barriers to Sustainable Consumption, Proceedings of an International Conference, University of Leeds, 5\(^{th}\)-6\(^{th}\) March 2004; Jackson T (2005, op cit).

\(^{15}\) See Jackson T (2004, 2005) for a fuller discussion of this issue.
Government policies and practices send important signals to consumers about institutional goals and national priorities. They indicate in sometimes subtle but very powerful ways the kinds of behaviours that are rewarded in society, the kinds of attitudes that are valued, the goals and aspirations that are regarded as appropriate, what success means and the worldview under which consumers are expected to act. Policy signals have a major influence on social norms, ethical codes and cultural expectations.

A clear case in point here is the latent schizophrenia that inhabits government discourses on consumption. At one level, initiatives on sustainable consumption have been anxious to point to the role and responsibility of consumers in reducing environmental impacts associated with consumption. Yet at the same time, high-street consumption is seen as the engine of economic growth and consumer confidence as a key indicator of the health of the economy. The importance of consumption to the modern economy is no better illustrated than by George W Bush’s epoch-defining appeal to consumers in the wake of the 9/11 terrorist attacks. “Mrs Bush and I would like to encourage Americans everywhere to go out shopping”, he declared, as fears of the impact on the US economy multiplied. As some sociologists have pointed out, people now find themselves subject almost to a moral duty to consume – a replacement for the now-outmoded Protestant work ethic.

Irrespective of this issue, the consistency or inconsistency of government actions can have a profound effect on the success or viability of pro-environmental messages and interventions. A good deal of ethnographic evidence on consumer behaviour suggests that people mistrust and ignore pro-environmental exhortation if it appears inconsistent with policy messages coming from elsewhere in government, or is seen to be at odds

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with the behaviour of central government, local authorities, private companies and the behaviours of other key social actors.\(^{18}\)

In short, it is not enough to expect that individuals can be exhorted to behave in certain ways. Consumers are social beings, enmeshed in a complex institutional and cultural logic. The architecture of this social logic plays a vital role in facilitating or inhibiting what is socially possible. Government policy must be aware of its own role in this context, and seek to act accordingly.

**Business practices**

Consumers are also employees. As employees, people are immersed daily in a certain set of behaviours, values and logics. In particular, they are exposed to a variety of environmentally significant practices. Does the company behave in an environmentally responsible manner? Do they recycle? Are their procurement practices sustainable? Do they operate a sustainable transport policy? The answers to these questions can have a significant influence on consumers – both as employees and as householders.

In the first place, there is evidence to suggest that behaving in certain ways in one context can have a knock-on effect in another context. If I am encouraged to recycle at work, it is more likely that I will attempt to recycle at home. This spill over is thought to occur in two distinct ways. On the one hand, I gain a familiarisation with the actual practice of recycling. I learn, for example, that wastes can be separated, that quality grading of wastes is important and that appropriate siting receptacles can facilitate sorting. On the other hand, I am encouraged to think of

myself in a particular way and this changed self-concept has an influence on my domestic behaviour.

Sadly, the evidence appears to suggest that sustainable consumption at work often lags behind sustainable consumption in the home. This means not only that business practices are less sustainable than they ought to be, but also that a unique opportunity for influencing and supporting domestic behaviours is lost. There is even a danger that failure to encourage pro-environmental behaviours at work can significantly reduce the incentive for consumers to act responsibly at home. Through its influence on business, government policy can seek to redress this balance.

**Community-based social change**

This chapter has highlighted the social dimensions of consumer behaviour. Time and again, the evidence points to the influence of social norms, expectations and identification processes on human action. These social processes can present significant impediments to pro-environmental consumer behaviour. But they can also be powerful forces for pro-environmental and pro-social change.

The previous section drew attention to the community management of social resources and role of internalised group norms in promoting the common good. The evidence is unequivocal that consumer behaviours are socially negotiated. Changing behaviour cannot be conceived as a process of encouraging change at the individual level; pro-environmental behavioural change has to be a social process.

Government can play a key role in these processes: by recognising the importance of social norms in behaviour change policies; by initiating, promoting and supporting community-led

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19 See for example, KPMG (2004), Recycling at Home More Popular than at Work, Results of a YouGov survey for KPMG, Business Europe.
initiatives for social change; by supporting the community management of social resources; and by designing effective community-based social marketing strategies.

**Leading by example**

Finally, evidence suggests a clear role for government in leading by example. Clear environmental management initiatives and strong sustainable procurement programmes in both the public sector and within public private partnerships can have a robust influence on sustainable consumption in a variety of ways.

There are at least four good reasons for government to practice what it preaches on sustainable consumption. First, public sector consumption constitutes a significant proportion of total consumption. Second, procurement practices can play a key role in stimulating markets for sustainable products and services. Third, the process of changing behaviour across Whitehall (and more widely across public services) would provide invaluable lessons to policy-makers about what is involved. Finally, as mentioned above, government policies and practices send important signals to people about public priorities, and social and cultural preferences. Unfavourable or inconsistent policy signals can undermine the best efforts of government to motivate sustainable consumption.

**Concluding remarks**

Regulating the culture of consumption is difficult. The evidence is unequivocal in that respect. Overcoming problems of consumer lock-in, unfreezing old habits and fostering new ones, understanding the complexity of the social logic in which individual behaviours are embedded: all these are pre-requisites for successful initiatives designed to deliver pro-environmental and pro-social behavioural change.
‘CULTURES OF CONSUMPTION’

But in spite of all appearances this complex terrain is not intractable to policy intervention. The evidence suggests that policy plays a vital role in shaping the social context within which we act. Governments are not just innocent bystanders in the negotiation of consumer choice. They influence and co-create the culture of consumption in a variety of ways. In some cases, this influence proceeds through specific interventions – such as the imposition of regulatory and fiscal structures. In other cases it proceeds through the absence of such regulations and incentives. Most often it proceeds through a combination of the ways in which government intervenes and the ways in which it chooses not to.

As this chapter attempts to demonstrate, a genuine understanding of the social and institutional context of consumer action opens out a much more creative vista for policy innovation than has hitherto been recognised. Expanding on these opportunities is the new challenge for sustainable consumption policy.

One final point is worth making. Social anthropological evidence suggests that consumer goods are implicated in vital ‘social conversations’ about identity, social cohesion and cultural meaning. It is clear from this that behaviour change initiatives are going to encounter considerable resistance unless and until it is possible to substitute for these functions of consumer society in some other ways. In this context, ‘regulating cultures of consumption’ has to be as much about building supportive communities, promoting inclusive societies, providing meaningful work, and encouraging purposeful lives as it is about awareness raising, fiscal incentives and persuasion.
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9 PROMOTING COMPLIANCE IN THE 21ST CENTURY

Jim Gray, Chris Howes and Rosie Clark

Introduction

The Environment Agency is the leading public body protecting and improving the environment in England and Wales. It is a non-departmental public body (NDPB) sponsored by the Department for Environment, Food and Rural Affairs (Defra), which is the government department tasked, among other things, with responsibility for the environment.

Our corporate strategy (‘Making it Happen’) sets out how we will deliver the government’s desired policy outcomes.¹ We set out nine environmental themes, our values and our roles. We also set out key areas where we will focus our work to adapt our organisation and manage our resources to optimise environmental outcomes. ‘Modernising Regulation’ is one of these areas. We believe an environmental regulator should be ‘firm and fair’. Government has a crucial role in delivery of outcome focused regulation within a unified framework or model, allowing regulators flexibility to adopt risk-based regulatory approaches. This will reduce the administrative burden and cost of regulations to both the Agency and those it regulates. It is not all about the approach of regulators. Modern regulation relies on


Jim Gray, Head of Regulatory Development, Chris Howes, Compliance Assessment and Enforcement Policy Manager, and Rosie Clark, Compliance Assessment and Enforcement Policy Advisor, Environment Agency
responsible business taking ownership of the wider costs of their activities. Only this will allow a co-regulatory approach giving business flexibility, reduced costs and recognition. Such an approach needs to be balanced by penalties that promote an effective deterrence to non-compliances.

Principles of modern regulation

Society demands high environmental standards and expects companies and individuals to behave responsibly. Traditional regulatory approaches have achieved much to reduce environmental impacts. However, the nature of regulation has to change to keep pace with changes in the economy and society. The Environment Agency has responded to this challenge through its ‘Modernising Regulation Change Programme’.

The Environment Agency believes modern regulation focuses on outcomes and is risk-based. It encompasses a variety of instruments, including environmental taxes, trading schemes, negotiated agreements and education programmes, and the more traditional direct regulation. Industry expects efficient, practicable regulation, so that administrative costs are kept to a minimum.

Modern regulatory systems should encourage businesses and individuals to improve, rewarding good performers, while remaining tough on those who do not meet acceptable standards. In order to achieve this, modern regulation must be:

- proportionate, allocating resources and implementing systems according to the risks involved;
- transparent, with clear rules and processes for industry and local communities;
- consistent, within and between sectors, and over time;
targeted on the environmental outcome to be achieved, taking into account environmental needs, best practice, sector specific and geographical circumstances;

- cost-effective.

This means that we will concentrate our resources where the risks to the environment are highest, including the highest hazards or the poorest performing operators. We will focus on systems to improve environmental quality. Consistent with this principle, we will adopt a proportionate approach where we see good performance. We have developed a screening method to assess risks to the environment in a quantitative fashion.

Transparency and trust are also vital aspects of our relationship with communities and society as a whole, and we must at all times be seen to maintain a neutral, open and fair stance. Accordingly, we make information on the environmental performance of business and our performance as a regulator widely available.

Tools for modern regulation

Adopting a risk-based approach to regulation, and matching intervention measures to environmental performance, has implications for all involved in the regulatory process.

- legislators need to be smart in devising laws, and use the full range of policy instruments, to allow regulators flexibility in approach;
- businesses and individuals need to take responsibility for their environmental impacts and compliance with regulatory requirements;
- regulators need to use the full range of instruments allowed by the regulatory framework to deliver environmental objectives in an efficient and cost-effective manner.
Direct regulation is the traditional approach to controlling emissions or abstractions, with permits specifying what a business can and cannot do at a particular site. As a modern regulator we are also developing risk-based assessment methods and actively promote voluntary schemes. A number of these approaches are described below.

**Regulation and permits**

The Pollution Prevention and Control (PPC) Regulations in England and Wales implement the EC (European Community) Directive (96/61), which seeks to control the most complex and polluting process industries in a way which integrates emissions to air, land and water, and takes a wide range of issues into account, such as energy use and site conditions. The Environment Agency is currently responsible for more than 850 permits under PPC in process industries in England and Wales, and over the next few years the number of permits will rise to more than 4,000 as additional industries are included within the regulations. In addition, we are responsible for more than 100,000 consents to discharge to inland waterways, 7,500 waste management licences and 49,000 water abstraction licences ranging from those for large scale water companies to individual water supplies. The Environment Agency applies charges to regulated industries under the various licensing regulations. The scale of charges is proportional to the level of regulatory activity required within a sector and within a business.

Direct regulation has proved highly beneficial over many years. The first Alkali Act (establishing the Alkali Inspectorate and regulating factory emissions to air) was passed in 1863. In the 1940s and 1950s London’s notorious smogs were addressed by the Clean Air Acts requiring, amongst other things, smokeless fuel. Continuing direct regulation has resulted, since 1990, in sulphur emissions to air from industrial emissions falling by 72% and emissions
of nitrogen oxides falling by 52%. Environment Agency regulated emissions of particulates (PM$_{10}$s) have also reduced over the same period.

Water quality has benefited from direct regulation, with pollution first controlled in a comprehensive manner by the Rivers Pollution Prevention Act of 1876. Since 1963, most of the significant abstractions from surface water and groundwater have been regulated to ensure requirements for water are met without environmental detriment. Continuing regulation has seen further improvements in water quality. Over the period 1996-2001 water pollution (as measured by biochemical oxygen demand) fell by 65%. The chemical quality of rivers in England and Wales has also improved, from 50% being classified as ‘good’ in 1990 to about two-thirds in 2002 (see Figure 1), with more than 90% being classed as good or fair. Although we know further progress remains to be achieved, particularly because of diffuse pollution sources, such as farming and the urban environment.

**Figure 1: Chemical river quality -
(%) river length classified as ‘good’ quality**

![Graph showing improvement in chemical river quality from 1990 to 2000](image-url)
ENVIRONMENTAL REGULATION

Direct regulation will remain a fundamental part of a modern regulatory framework, using a spectrum of permits, and matching our response to the level of environmental risk and complexity of the targeted activity.²

- Bespoke permits are used for complex or unique processes, or where there are site specific requirements. We aim to standardise permit conditions as much as possible.

- Standard permits are applied where activities across sectors are sufficiently similar that a uniform approach can be taken and environmental improvements delivered by sector wide improvement programmes.

- Registrations lay out the rules and requirements to be adhered to by those registering that they carry out a particular activity. No justification or assessment is needed. However the regulator can take enforcement action where required.

- Direct application of legislation is undertaken where activities are simple and the risks are low. No permit or registration is needed. However the regulator can take enforcement action if problems arise.

Conditions within permits are of two types: operating standards required to protect the environment; and mechanisms to deliver improvements. Conditions are set consistent with what is achievable in terms of best practice (or best available techniques (BAT) in the case of the Pollution Prevention and Control Regulations), which requires the application of the most effective techniques to prevent or minimise environmental harm, whilst recognising the balance to be achieved with the cost of implementation.

² The term permit is applied here to embrace all the mechanisms used for direct regulation including consents, licences and authorisations as well as notices, exemptions and registrations.
Trading schemes

In England and Wales there is a trading scheme for greenhouse gas emissions and there are plans for trading biodegradable municipal waste, nitrogen oxides and sulphur dioxide, and water abstraction rights. The Environment Agency is taking a more prominent role in establishing and enforcing trading schemes, eg, for carbon trading and the forthcoming trading of biodegradable municipal waste.

Trading schemes need to be carefully tailored to meet both national and local environmental objectives. There are different designs but, typically, a scheme might consist of the following elements:

- a binding target or cap on total emissions or resources;
- a clear unit of trade (eg, 1 tonne of NO\textsubscript{x});
- a system for distributing allowances;
- a penalty system for non-compliance;
- a specific compliance period.

At the end of the compliance period participants must hold sufficient allowances to cover their emissions or resources used within the period. Participants covered by the scheme can choose whether to operate within their allowance, buy additional allowances to cover excesses above their allowance, or sell surplus allowances (eg, by reducing emissions below their own allowance).

Environmental management systems

Across Europe, there has been considerable interest in establishing stronger links between environmental regulation and externally validated environmental management systems (EMSs), such as the international EMS.
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standard ISO 14001;\(^3\) and the EU’s Eco-Management and Audit Scheme (EMAS).\(^4\) Since compliance with a permit is the responsibility of the operator, the Environment Agency is encouraging the use of management systems to monitor and report performance in a clear fashion. If it can be demonstrated that possession of an EMS results in improved environmental or regulatory performance, then there is a case for granting ‘regulatory relief’ in the form of, for example, reduced inspection frequencies.\(^5\) In England and Wales, those being regulated pay charges to cover the cost of regulation. If the levels of inspections required are reduced then operators with better controls and performance could be charged less than those who require more of our resources.

However, environmental management systems are voluntary and improved performance cannot be guaranteed. In a recent study of almost 800 sites regulated under the Integrated Pollution Control regime in England and Wales we demonstrated that while having an EMS improves certain procedural aspects of environmental management, it does not appear to reduce the likelihood of breaching permit conditions.\(^6\) The results of this study therefore do not justify rewarding sites that have ISO 14001 or EMAS on the basis of improved regulatory performance. However, we


\(^{4}\) A voluntary scheme specified by Regulation of the European Parliament and Council (Regulation 3658/2000).


believe that an effective EMS can permeate an organisation’s culture so that environmental responsibility becomes built in, rather than a bolt on. There is then a policy case for providing ‘regulatory relief’ where it can be demonstrated that having an externally validated EMS helps companies to go beyond compliance, or if the management of environmental issues that fall beyond the scope of regulation (eg, transport, supply chain influence) is improved. Such a move would not serve any regulatory purpose per se, but would act as a reward for the wider environmental benefits thought to be associated with EMS, and therefore an incentive for their further uptake.

No evidence is currently available on this point. However, Article 10 of the revised EMAS regulation requires that member states should consider EMAS registration “in the implementation and enforcement of environmental legislation in order to avoid unnecessary duplication of effort by both organisations and competent enforcement authorities”. Accordingly, the Environment Agency is now leading a major three year European project, REMAS, which will explore in detail the impacts of EMS on environmental and regulatory performance at specific sites.

**Operator pollution and risk appraisal**

The Environment Agency aims to target its resources on those companies that pose the greatest risks to the environment. Operator and pollution risk appraisal (OPRA) has been developed to assist the Agency in its regulation of the integrated pollution control (IPC) regimes for major process industries and the waste management licensing regime. With the implementation of two new European community directives in England and Wales, elements of the

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8 For more information on the REMAS project see, http://www.remas.info.
waste industry and the large manufacturing sectors are brought under one regulatory regime for the first time.  

In keeping with our aim to introduce common approaches to regulation across a range of regulatory regimes, the new Environmental Protection Operator and Pollution Risk Appraisal (EP OPRA) methodology has been developed as an important step in developing a unified approach to risk assessment across our regulatory regimes. The EP OPRA scheme fits within a recognised national framework for environmental risk assessment and management. It incorporates an element of professional judgement, but the method itself is simple to apply and objective in nature and a public consultation on the scheme was held in 2002. Details of responses are on the Agency’s web site.

EP OPRA will help the Agency target its regulatory effort on those activities that present the greatest risk to the environment. Outputs from this scheme are built into the charging scheme for the PPC regulatory regime. As noted previously, charges for regulation are set to reflect the level of regulatory action required. EP OPRA has four attributes. Three reflect the environmental hazard of the operation and the fourth measures operator performance. In general, the higher the score, the greater the regulatory level of activity required. The attributes used to measure the hazard of the operation are summarised in Table 1.

---

9 Integrated Pollution Prevention and Control (IPPC) and the Landfill Directive (LFD), introduced in England and Wales through regulations made under the Pollution Prevention and Control Act 1999.
11 http://www.environment-agency.gov.uk/yourenv/consultations
Table 1: Summary of EP OPRA attributes

<table>
<thead>
<tr>
<th>Complexity</th>
</tr>
</thead>
<tbody>
<tr>
<td>From an Environment Agency perspective, the more complex an installation</td>
</tr>
<tr>
<td>the more regulatory effort will be needed to understand the processes</td>
</tr>
<tr>
<td>involved, their interactions and pollution potential. A complex site</td>
</tr>
<tr>
<td>generally:</td>
</tr>
<tr>
<td>• has significant releases to one or more media;</td>
</tr>
<tr>
<td>• uses one or several interconnected but distinct processes;</td>
</tr>
<tr>
<td>• has a significant potential for accidental emissions;</td>
</tr>
<tr>
<td>• carries a significant inventory of potentially hazardous materials;</td>
</tr>
<tr>
<td>• is a specified waste activity;</td>
</tr>
<tr>
<td>• is of a significant size relative to the sector and the other criteria</td>
</tr>
<tr>
<td>mentioned here; and</td>
</tr>
<tr>
<td>• is likely to require significant regulatory effort to assess and maintain</td>
</tr>
<tr>
<td>compliance and maintain public confidence.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>The presence or absence of key receptors that could be affected by the</td>
</tr>
<tr>
<td>activity is a further indication of the potential hazard of the</td>
</tr>
<tr>
<td>installation and of the assessment required. In general, we look for:</td>
</tr>
<tr>
<td>• proximity of human habitation (domestic, industrial, office, schools,</td>
</tr>
<tr>
<td>hospitals, nursing homes etc);</td>
</tr>
<tr>
<td>• proximity to sites designated under the Habitats Directive;</td>
</tr>
<tr>
<td>• proximity to a Groundwater Protection Zone;</td>
</tr>
<tr>
<td>• sensitivity of receiving waters;</td>
</tr>
<tr>
<td>• potential for direct release to waters and the presence of control</td>
</tr>
<tr>
<td>measures;</td>
</tr>
<tr>
<td>• potential for flooding and the consequence of uncontrolled emissions</td>
</tr>
<tr>
<td>to the flood waters;</td>
</tr>
<tr>
<td>• inclusion within an Air Quality Management Zone.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Emissions</th>
</tr>
</thead>
<tbody>
<tr>
<td>An emissions index approach is used for emissions to air, water and land.</td>
</tr>
<tr>
<td>The indices are calculated from the annual load of each pollutant that</td>
</tr>
<tr>
<td>would be emitted if the installation operated at the emission limit</td>
</tr>
<tr>
<td>values contained within the permit to operate, and the “Emission</td>
</tr>
<tr>
<td>Thresholds” for that pollutant. The thresholds reflect the potential of</td>
</tr>
<tr>
<td>the substance to cause environmental harm. Chemicals are grouped</td>
</tr>
<tr>
<td>together according to their emission threshold and a simple calculation</td>
</tr>
<tr>
<td>made to obtain an emission index score. When calculated by the Operator</td>
</tr>
<tr>
<td>at the time of applying for a permit, this score is based on the</td>
</tr>
<tr>
<td>projected emissions specified in the application. For land, the indices</td>
</tr>
<tr>
<td>are calculated according to the type of waste disposed of rather than by</td>
</tr>
<tr>
<td>each individual substance. The potential for emissions arising from</td>
</tr>
<tr>
<td>unforeseen events and accidents is covered under the complexity</td>
</tr>
<tr>
<td>attribute.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Operator performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>The overall Operator Performance attribute is calculated on the basis of</td>
</tr>
<tr>
<td>the management systems in place for:</td>
</tr>
<tr>
<td>• operations and maintenance;</td>
</tr>
<tr>
<td>• competence and training;</td>
</tr>
<tr>
<td>• emergency planning;</td>
</tr>
<tr>
<td>• organisation, auditing, monitoring, reporting and evaluation.</td>
</tr>
<tr>
<td>The compliance history of the installation is also taken into account.</td>
</tr>
<tr>
<td>These scores remain for a period of time, guided by current practice</td>
</tr>
<tr>
<td>under the Rehabilitation of Offenders Act.</td>
</tr>
</tbody>
</table>
ENVIRONMENTAL REGULATION

Each attribute has been divided into 5 bands A to E, where A equates to the need for lower regulatory oversight and E the need for more regulatory oversight. For each attribute we have developed either a look-up table or an objective scoring system, so that an operator can calculate the appropriate band to assign to each attribute. These bands are then used to generate an EP OPRA profile.

For complex sites, or sites that deviate from generic norms, a site Compliance Assessment Plan (CAP) is then developed, taking into consideration local and site specific issues, to ensure that within a defined period compliance is checked against all requirements of the permit.

Negotiated agreements

Businesses sometimes agree action or targets without legislation. For example, in England and Wales there is a voluntary agreement on the use of pesticides. Negotiated agreements are most suitable in sectors where a few large companies dominate environmental performance, so that a level playing field can be maintained between competing companies, and they can be particularly effective in achieving commitment from the parties involved. However, such agreements may still require regulatory involvement. The Environment Agency actively promotes such agreements.

How the Environment Agency promotes compliance

Companies need to accept responsibility for their actions and this should be reflected in business culture as well as in their operational targets. The principle of ‘polluter pays’ is now well accepted, whereby businesses should be held to be accountable for their actions. As noted previously, the
Environment Agency’s OPRA system supports the polluter pays principle through a cost-recovery charging framework which can provide a financial incentive to operators to reduce their environmental risks and impacts. By identifying, managing and reducing key risk areas, businesses can reduce their OPRA (risk) profile, which will then be reflected in lower compliance assurance activities and, consequently, charges. In addition, businesses can benefit, in some circumstances, from cost savings in minimisation of resource use and reduced waste, and avoid costs associated with pollution incidents. Promoting corporate responsibility can improve corporate image with an associated positive impact on shareholder value, as well as impacting for example on a company’s credit rating or insurance premium.

**Optimising environmental improvement**

The Environment Agency is developing sector plans and guidance, which address the specific issues associated with particular sectors. Sector plans relate to a coherent, recognisable, target group and define the national and local outcomes and risks that we believe should be addressed for that group. The sector may be a particular industry (such as nuclear or agriculture), or a recreational area (such as angling). This approach allows us to prioritise the regulatory workload between and within sectors. The overall objective is to optimise environmental improvements.

The key to optimising environmental performance is to identify current good practice relevant to the sector, to educate and advise businesses and individuals and to communicate information to the public.
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Identifying good practice

Good practice includes reviewing techniques and experience from within the sector, and across other sectors where similar environmental problems and processes may be encountered. Such reviews are not restricted to England and Wales, and the Environment Agency is keen to learn from the experience of other countries. Good practice also includes the reduction of unnecessary bureaucracy which may inhibit the introduction of innovative solutions to poor environmental performance. In addition, we encourage full life cycle (‘cradle to grave’) analysis of processes to promote good environmental management throughout the whole supply chain.

Education

Businesses and individuals need to be more aware of how their actions impact on the environment and human health. Education and advice can help raise awareness of the issues by providing clear information relevant to specific audiences, demonstrating potential improvements (including cost savings) through case studies, and highlighting national, regional or sector initiatives. We also seek to raise awareness of regulatory requirements, so that businesses and individuals understand fully their responsibilities.

Education campaigns can be more resource effective than traditional regulation in situations of high volume with low environmental risk. For example, the Agency runs targeted educational initiatives such as the ‘national tyres campaign’ to promote recycling and minimise illegal tipping.

Information

We regularly publish environmental performance information for England and Wales, making use of
communication tools such as our ‘Pollution Inventory’, ‘What’s in Your Backyard’ and ‘Spotlight on Business Environmental Performance’ to provide information about environmental performance to a wide audience. These publications are updated annually and are available on our website. ‘Spotlight’ both publicly praises good performers and names and shames poor performers. This we believe helps companies internalise their environmental performance. ‘What’s in Your Backyard’ publishes details of IPC OPRA and Waste OPRA scores for local facilities. An example of banded scores for IPC processes in 2001, 2002 and 2003 is given in Figure 2.

Figure 2: Banded scores for IPC processes in 2001, 2002 and 2003

We also encourage individual businesses to make information on their environmental performance accessible to stakeholders, including local communities and investors, and we know that this information is used to guide investment decisions (see Table 2).

12 http://www.environment-agency.gov.uk
Table 2: Investor use of management profiles

Barclays Bank environmental risk management unit “is using OPRA data in due diligence work”

Innovest (an investment company) uses “data on prosecutions and emissions in its ratings model”

Ethical investor Jupiter Asset Management states that “any external data that gives an insight into a company's site management is important”.

Source: ENDS August 2003

Compliance assessment

The Environment Agency has developed a range of tools which are being progressively implemented to help to assess risks. These include compliance assessment plans (CAPs) and the compliance classification scheme (CCS).

CAPs are used to ensure that compliance against all requirements of permits and other regulatory instruments are checked within a defined period. The CCS assesses the performance of a site against the conditions set in Agency issued permits. It is recognised that some non-compliances will present a greater environmental risk than others. The CCS is used to classify non-compliance with permit conditions according to potential impact on the environment and provides information to support consistent and proportionate responses to non-compliances. This also allows national profiling of sectors and companies. The potential risk categories used within the CCS are ranked from 1 (the highest potential risk arising from a non-compliance) to category 4 (where no immediate risk of harm to the environment is likely). These categories are then used
to inform our enforcement activities, and are linked clearly to our enforcement and prosecution policy.

Stakeholder involvement

Stakeholder involvement can take many forms, and embraces many types of stakeholders. Consultation at the outset of introducing new regulatory tools is perhaps the most obvious form of stakeholder involvement. Typically, we seek to identify affected businesses and local communities and other interested parties (industry or sector representative groups, non-governmental organisations, local liaison bodies, etc) and approach each of these individually. We also publish an invitation to provide comment on our web-site, with provision of a clear route to seek further information. For more broad ranging consultations we publish documents for national distribution.

The use of environmental information to guide investment decisions is also a form of stakeholder involvement and feedback suggests that companies, as well as environmental groups, respond positively to the opportunity to discuss issues with the regulators.

Performance review

Activities which potentially impact on the environment require monitoring so that the risk of adverse effects can be evaluated and appropriate action taken. The development of minimum criteria for environmental inspection is a recommendation from the European parliament which the UK has agreed to implement. This requires environmental inspections to be planned in advance and the Environment
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Agency sees its policy of developing compliance assessment plans as a means of fulfilling this obligation.

The role of the operator is to:

• carry out monitoring and analysis to suitable standards;
• assess and act upon the results within their own EMS;
• make information available.

The role of the regulator is to:

• specify the standards for monitoring and analysis;
• ensure the operator complies with monitoring requirements;
• act upon the results in a proportionate manner;
• publish information on performance and response.

Through internal review, businesses should be encouraged to take responsibility for ensuring that they are not having an adverse impact on the environment, or on people.

Enforcement

Regulatory regimes need to be backed up by penalties or other disincentives to non-compliance. Where businesses do not comply with legislation, the Environment Agency will use its enforcement powers firmly and fairly to prevent pollution or environmental damage, or to require remedial action. The Environment Agency has developed a common incident classification scheme (CICS) to assess and categorise the environmental harm resulting from an incident. As with the compliance classification scheme, CICS provides information to support consistent and proportionate responses to incidents. The two schemes are linked, although CICS is applied to incidents arising from non-regulated activities as well as operations with permits.
Within permitting regimes, the Environment Agency makes sure that it does not set conditions which cannot be achieved and which it is not prepared to enforce. Action includes warning letters, formal cautions, enforcement notices, prohibition notices, suspension or revocation of permissions and modification to permissions. Where required, we will prosecute. Where remedial work is required we will seek to recover the costs of such work from those responsible for the environmental damage (see Table 3).

Table 3: Summary of prosecutions and fines in 2003

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of events leading to prosecution</td>
<td>1,109</td>
</tr>
<tr>
<td>Number of successful charges brought(^{14})</td>
<td>1,466</td>
</tr>
<tr>
<td>Total fines (individuals and companies)</td>
<td>£2.8M</td>
</tr>
<tr>
<td>Number of companies where the fines were more than £10,000</td>
<td>61</td>
</tr>
</tbody>
</table>

Regulatory review

Measuring the performance of the regulator should also be undertaken to ensure, and demonstrate, that actions are focussed on environmental outcomes. The key performance indicators should be based on:

- a better quality of life;
- an enhanced environment for wildlife;
- cleaner air for everyone;
- improved and protected inland and coastal waters;
- restored, protected land with healthier soils;
- a ‘greener’ business world;
- wiser, sustainable use of natural resources;
- limiting and adapting to climate change;
- reducing flood risk.

\(^{14}\) A prosecution may lead to more than one charge.
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The Environment Agency is committed to achieving improved environmental performance in all these areas with a minimum of bureaucracy, demonstrating efficiency, effectiveness, value for money, consistency and timeliness of actions.

Conclusion

The Environment Agency wants to make sure that any new legislation fits the model of modern regulation outlined here. It should be designed so that we can focus on outcomes and risk and provide value for money. When developing new systems, or reassessing how to deliver the desired outcomes from existing regimes, the approaches adopted should use the most cost-effective instrument, or combination of instruments. The required environmental outcomes should be identified, acceptable practices encouraged, actual performance evaluated and compliance enforced. Good environmental performance can lead to reduced costs for the operator and will result in allowing us to redirect our resources to those activities that present the greatest environmental risk.
Glossary

**BAT – Best Available Technique.** The most effective stage in the development of activities and their methods of operation which indicates the practicable suitability of particular techniques for providing the basis for emission limit values designed to prevent, and where that is not practicable, generally to reduce the emissions and the impact on the environment as a whole. BAT takes into account the balance between the environmental damage that can be prevented and the cost for the techniques.

**CAP – Compliance Assessment Plan.** Used to ensure that within a defined period, compliance is checked against all permit requirements. CAPs can be developed at site or sector level and should identify the level of resources to be assigned to the various compliance assessment activities.

**CCS – Compliance Classification Scheme.** The CCS is used to classify non-compliance with permit conditions, according to potential impact on the environment. Non-compliances are categorised from 1 to 4, with category 1 having the potential to cause the most serious impacts.

**CICS – Common Incident Classification Scheme.** Used to classify different types of pollution incidents by actual harm to the environment. Incidents are categorised from 1 to 4, with category 1 causing the most serious impacts.

**Compliance.** Defined as “no evidence of failure to meet the permit (or other) conditions”. An operator is assumed to be compliant unless there is evidence to the contrary.

**Direct regulation.** Regulation by means of a permit issued by a regulator or a requirement written directly in legislation.
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**Enforcement.** Action taken by a regulator to ensure an activity that is non-compliant returns to compliance.

**IPC/PPC – Integrated Pollution Control/Pollution Prevention and Control.** IPC has been the regime employed by the Agency to control the most complex and polluting industrial processes, integrating the control of emissions to air, land and water. PPC is now replacing IPC, and takes a more holistic view of site operations, including energy use and site conditions.

**Monitoring.** The measurement of direct emissions into, or abstractions from, the environment.

**OPRA – Operator and Pollution Risk Appraisal.** A multi-attribute tool to determine the environmental hazards associated with a site and how well they are managed. EP OPRA considers information about the operator’s ability to comply, as well as its past performance. It is linked with charging schemes, with poorer performing sites paying more as they require more of our attention.

**Permit.** Any documented set of criteria issued by a regulator or set down in regulations that require a site or activity to operate in a particular way.

**Pollution Inventory.** Information on 176 substances released to air and water from over 3,000 individual processes is maintained and published annually.

**Sector.** A defined group of activities sufficiently similar for environmental outcomes and targets to be considered on a common basis.
References
(bold numbers refer to the footnote in which first cited)


10 THE PLACE OF APPEALS IN REGULATION – CONTINUITY AND CHANGE

Tony Prosser

Introduction

The UK has a vast range of different procedures for appealing against the decisions of public bodies, in contrast to countries such as France, with its specialist administrative courts to hear such disputes, or Australia, where the Administrative Appeals Tribunal has wide powers over many different types of appeals. Even given this variety, the situation in relation to utility regulation stands out as particularly complex and it is on these appeals that I shall concentrate in this chapter, with some comparative reference to the more consistent arrangements in financial services regulation. My theme will be that the current arrangements for appealing against regulatory decisions are incoherent and inadequate. This can partly be explained by doubts as to the requirements of the European Convention on Human Rights in this context, but they are unsatisfactory given the importance of regulation, not just to regulated industries but to their competitors and to consumers.

The issue is currently a contentious one. The House of Lords Select Committee on the Constitution recommended in 2004 that there should be a move towards allowing appeals on the merits of the case for all who are subject to regulation, subject to protections against unwarranted appeals, and including arrangements for fast track appeals and arbitration arrangements. Where appeals did not lie to the Competition Commission or the Competition Appeal Tribunal, a new Regulatory Appeals
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Tribunal should be created. These recommendations were almost the only ones to be rejected outright by the government, which stressed that appeal provision should be proportionate to type of decision being made. The most financially significant decisions in the form of licence modifications should continue to carry the right for the regulated company to appeal to the Competition Commission, but other decisions of regulators in their arbitration or enforcement roles were of ‘a lower order of magnitude’ and did not justify the further delay and costs of an appeal on the merits. The government would, however, keep the system of appeals under review and strengthen appeal rights where this would be proportionate. It would not be practicable to introduce either fast-track appeals or a single regulatory appeals tribunal.

Before assessing these arguments, I shall first describe the complex existing arrangements for appeal from the decisions of the utility regulators. Two issues are important. First, is there a right of appeal to the courts or to another body, and, secondly, if so, who can use it? Thus some rights of appeal are available only to the regulated company itself, whereas recently there has been a move, especially in general competition law, to permit appeals by others, such as competitors and consumer groups.

The existing maze of appeals

The original legislation establishing the utility regulators made little provision for appeals. Instead, their decisions could only be challenged by the different process of judicial review, which is available as a means of bringing administrative decisions before

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the courts where no appeal right is available. Thus, for example, the Telecommunications Act 1984 provided that if a telecommunications operator was aggrieved by a final or provisional order made by the regulator, he could challenge it in court within 42 days on the grounds that it was not within powers given by the act to make such orders, or that procedural requirements had not been complied with. Other regulatory decisions could also be the subject of judicial review proceedings as no specific statutory provision is needed to make such a review available.

Judicial review is, however, fundamentally different from appeal. It does not permit a re-examination of the merits of the case, in other words, whether the decision was right or wrong. It is concerned instead with its legality; whether it was within the powers granted to the regulator and whether it breached fundamental principles of fair procedure or reasonableness; in the words of a leading case, the courts will assess whether the decision is tainted by illegality, irrationality or procedural impropriety. The concept of illegality has expanded considerably in recent years, as has that of irrationality, especially because of the effect of the Human Rights Act 1998. Moreover, the range of people and bodies who may seek judicial review of a decision has also grown recently, now extending to a well-established pressure group with an interest in the issue, and probably to a business competitor. Nevertheless, judicial review continues to offer much more limited opportunities for a full re-


4 For an early example of judicial review of a decision of the gas regulator relating to disconnection of supply see R v Director General of Gas Supply, ex parte Smith, CRO/1398/88, QBD, 31 July 1989.

5 Council of Civil Service Unions v Minister for the Civil Service [1985] AC 374 (per Lord Diplock).

assessment of a decision than does a right of appeal. It is also subject to procedural disadvantages such as the requirement to obtain advance permission from the court and a short time limit for bringing an action (normally three months). Nor is there an automatic right to a remedy should the application for judicial review succeed, and the most that a court can do is to quash (invalidate) the regulator’s decision rather than substituting its own decision. I shall return later to the question of whether judicial review on its own is sufficient to comply with the UK’s international obligations to provide an independent hearing in relation to the making of some types of administrative decisions.

The one major exception to judicial review as the only means for legal challenge of decisions in the original utility regulation statutes applies in the case of licence modifications by the regulator, including setting the all-important price control formulae. Two procedures were provided for such a modification. If the regulated company agreed to the modification, it could be implemented by the regulator after a brief period of public consultation. If, however, the company disagreed, it could have the dispute referred to the Monopolies and Mergers Commission (now the Competition Commission). The Commission would issue a report after a full investigation lasting six months, and this would form the basis for the modification to be implemented by the regulator.

It has been common for this right to be referred to as an ‘appeal’ to the Competition Commission; indeed, this is the terminology adopted by the government in its reply to the Constitution Committee’s report. It is, however, a curious form of appeal for reasons both of its wide scope and narrow availability. Its scope

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8 Note 2 above, para 67.
is not limited to the specific subject matter of the dispute, but permits the Commission to investigate whether any matters specified in the reference operate against the public interest and to recommend licence modifications to remedy this. This has enabled the Commission to undertake investigations in wide-ranging matters related to the enterprise in question, most notably in the case of British Gas where a report from the Commission (after both a monopoly reference under the Fair Trading Act 1973 and references by the regulator under the procedures currently under discussion) in 1993 recommended the splitting up of the company through divestment of its trading arm and phased liberalisation of the household market.9 As a result, the main role of the procedure has been to give incentives to companies to agree to licence modifications so as to avoid a reference to the Commission and the resulting delay and heavy commitment of management time.

This is reinforced by the limited availability of the ‘appeal’ right, for only the regulated company whose licence is subject to proposed modification can in effect trigger a referral by refusing to agree to the modification. Should the company and the regulator agree, no such right is available to a competitor company or, indeed, a consumer group aggrieved by the outcome. We shall see below that, in other circumstances, rights of appeal to the Competition Appeal Tribunal may be available to third parties, but this is not the case for licence modifications; third parties must have resort to judicial review or to attempting to influence the consultation required after the Commission has reported. On this latter point, a decision of the Northern Ireland Court of Appeal restricted such opportunities by deciding that integral findings of the Commission’s report were binding on the regulator in modifying the company’s licence, thus rendering such consultation almost meaningless.10 In the energy sector, the Utilities Act 2000 has now changed the procedure so that the regulator must consult after the Commission’s report and give

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9 Monopolies and Mergers Commission (1993), British Gas plc.
the latter notice of its preferred modifications, over which the Commission has a right of veto. Similar arrangements have now been introduced for the water regulator.\footnote{Utilities Act 2000 ss. 38-9, 83; Water Industry Act 2003 s. 55.}

There is no doubt that the ability to refer a proposed licence modification has been of enormous value; apart from the threat of such a referral being a useful tool to a regulator, it has enabled the considerable economic expertise of the Commission to be brought to play in issues of price control, and has also been particularly important in enabling the Commission to develop common principles applicable to different regulated sectors, for example in relation to assessing the cost of capital. What it does not do, however, is to offer any comprehensive system of appeal against regulatory decisions, even in relation to licence modifications. I shall assess later whether it is possible to maintain these advantages in the context of a more general system of regulatory appeals.

**Supplementary avenues**

This is the basic structure adopted for challenging regulatory decisions under the original utility legislation. However, supplementary avenues have been added more recently. First, the Competition Act 1998 gave concurrent powers to the utility regulators to enforce the prohibitions on anti-competitive agreements and abuse of a dominant position which are the basis for the new regime under the Act. In other contexts the prohibitions are enforced by the Office of Fair Trading with a full appeal on the merits of the case to the Competition Appeal Tribunal, and, to preserve uniformity, such a full appeal lies also from the utility regulators when exercising these powers.\footnote{Competition Act 1998 ss 46-9, as amended by the Enterprise Act 2002 s. 17.} Importantly, such appeal rights are not only exercisable by the company against whom action is being taken, but by anyone with a sufficient interest. This could include an established consumer group or a business competitor. Indeed, the most important
appeal so far under these provisions against the Office of Fair Trading was brought by such a competitor.\textsuperscript{13} This appeal right against regulatory decisions under the competition legislation has already been important in the utilities sector, most notably in a successful challenge to the former telecommunications regulator for giving inadequate reasons for refusing to proceed with a complaint against BT.\textsuperscript{14}

The regulators also acquired further powers under the Enterprise Act 2002 to undertake market investigations under its provisions. These do not however carry any special appeal rights, unlike the position where the Office of Fair Trading initiates such an investigation.\textsuperscript{15}

The next matter on which special provisions are made for appeals is where a regulator levies financial penalties on regulated companies. Such penalties were not originally available to regulators, but have been introduced in more recent legislation for the rail, energy and postal regulators. In these cases, statutory provision is made for appeal to the High Court against penalties and their amount, but it is not a full appeal on the merits, although the court’s powers include substituting a lesser penalty for that imposed by the regulator. Instead it is limited to grounds similar to those for judicial review; that the imposition of the penalty was not within the power of the regulator, that a procedural requirement had not been complied with, or that it was unreasonable to require the penalty to be paid by a particular day.\textsuperscript{16} The right is only available to the enterprise on whom the penalty has been imposed. As we shall see below, the imposition of a financial penalty raises particularly strong questions of

\textsuperscript{13} \textit{IBA Healthcare Ltd v Office of Fair Trading} [2004] EWCA Civ 142.


\textsuperscript{15} Enterprise Act 2002 s. 179 and Sch. 9 Pt. 2.

\textsuperscript{16} Transport Act 2000 s. 225, Utilities Act 2000 ss. 59 and 95; Postal Services Act 2000 ss. 30-7.
compliance with the European Convention of Human Rights, and this explains the special provision here.

Finally, quite different appeal arrangements now exist in relation to telecommunications regulation and competition-based broadcasting regulation. Here the Communications Act 2003 provides a right of appeal on the merits to the Competition Appeal Tribunal for any person affected by the decision. Special provision is also made for price control matters in appeals to be referred to the Competition Commission for determination, thereby maintaining the advantages of the Commission’s involvement which were referred to above. It is striking that this appeal right is much wider than general arrangements for challenging regulatory decisions, including the right to appeal on the basis of errors of fact and law and against the exercise of a discretion. It is also not restricted to use by regulated enterprises, though general issues of policy are excluded from the right of appeal. The reason for this general provision is simple. Such a right of appeal is required by European Community law liberalising electronic communications.

The final piece in the jigsaw is placed there by the Energy Act 2004. This legislation provides a right of appeal to the Competition Commission (not the Competition Appeal Tribunal) against decisions of the energy regulator relating to designated documents to which references are made in licence conditions. In practice this means modifications to codes relating to the organisation of the competitive gas and electricity markets. The appeal falls somewhere between a full appeal on the merits and review; the Commission may only allow an appeal on specified grounds, but these are wide enough to include an error

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17 Ss. 192, 317.
18 See Sch. 8 to the Act.
20 Ss. 173-7.
of fact or failing to give appropriate weight to the regulator’s statutory objectives.\footnote{S. 175(4).} The right of appeal is available to anyone ‘materially affected by’ the regulatory decision or a body or organisation representing such persons, for example an industry or consumers’ association.\footnote{S. 173(3).} This reflects the fundamental importance of the codes in determining the operation of the competitive energy markets, and follows criticism by the industry of the limits of judicial review as a means of challenging regulatory decisions.

**A ‘mish-mash’**

It is thus very evident that the appeal arrangements for challenging decisions of the utility regulators are a ‘mish-mash’, with major differences in both the scope of appeal rights and their availability depending on the nature of the issue involved. As the government accepts, they leave extensive gaps, even for an enterprise directly affected by a regulatory decision, where judicial review is the only option. Notable examples would be enforcement action taken under powers provided by the utilities statutes other than levying financial penalties, and arbitrating between different parties within an industry. Similarly, even where the enterprise has a form of ‘appeal’ to the Competition Commission in relation to licence modifications, this is not available to competitors or consumer groups.

It is worth contrasting this with the position in financial services regulation, where a much more coherent approach has been taken. This is in part due to the fact that, unlike the utility regulators, the Financial Services Authority may impose penalties for market abuse which are analogous to criminal penalties. The European Convention on Human Rights requires particularly demanding procedures where charges of a criminal nature are involved, and this loomed large in the debates on the design of the procedures under the Financial Services and
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Markets Act 2000.\footnote{See Beazley T (2001), Holding the Balance – Effective Enforcement, Procedural Fairness and Human Rights, in Ferran E and Goodhart C (eds), Regulating Financial Services and Markets in the 21\textsuperscript{st} Century, Hart Publishing.} However, the right of appeal against the Authority’s decisions is a wider one than this, applying for example to disciplinary decisions and refusal to grant authorisations as well as to market abuse. The right of appeal is a full one on the merits (the tribunal ‘must determine what (if any) is the appropriate matter for the Authority to take in relation to the matter referred to it’).\footnote{S. 133(5).} Who can appeal will depend on the context; for example, in the context of authorisation decisions it is an aggrieved applicant or an authorised person aggrieved by the Authority’s exercise of power.\footnote{S. 55.} An appeal does not always involve a full hearing; thus of 59 cases referred to the tribunal since 2002, as of September 2004, nine had been disposed of through a hearing, 27 by other means such as a hearing and 23 were still pending. It should also not be forgotten that a full right of appeal on the merits has been given under the Competition Act 1998 in relation to all decisions of the Office of Fair Trading, and that this goes further than the financial services provisions as it is available also to third parties with a sufficient interest, as we saw above.\footnote{Ss. 46-9.} In comparison to both these regimes, the highly context-specific appeal rights in utility regulation stand out as over-complex and limited in many respects.

The European Convention on Human Rights

It is already evident that much of the recent concern with the adequacy of appeal rights is based on the requirements of the European Convention on Human Rights. Although the UK has been a party to the convention since 1950, only since the Human
Rights Act 1998 (effective from October 2000) has the convention been directly enforceable in UK courts as well as by the European Court of Human Rights in Strasbourg.

The effect of the convention is complex with some important remaining areas of uncertainty, and several distinct issues need to be considered. The first is that an effective remedy before a national authority must be provided in relation to violations of the rights protected under the convention itself. Judicial review will not be adequate to provide such a remedy because of its relatively narrow scope (although this has increased considerably since 2000 where convention rights are involved). The major right at issue in regulation is likely to be that under the First Protocol to the convention, protecting the peaceful enjoyment of possessions, which would cover a regulatory taking of property, for example in the form of levying a financial penalty or limiting the business opportunities of an enterprise through denying a licence or imposing conditions on it. However, the right is highly qualified and such action is likely to be seen as within the discretion of the regulatory authorities where it is proportionate to a legitimate public aim. The right to peaceful enjoyment of possessions explains the special appeal rights where financial penalties are involved. The First Protocol right also forms part of the action for damages brought by the Railtrack Private Shareholders Action Group against the government arising out of the company’s forced administration.

It is also just conceivable that article 8 of the convention, the right to respect for private and family life, could be infringed by a regulatory decision permitting disconnection of utility supplies, though this could only be based on the most extreme circumstances, and it is unlikely that a regulator would ever directly infringe the rights, especially as the role of the regulator

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is normally to set general normative rules relating to disconnection rather than deciding in individual cases. It should be added that rights can only be relied on by a victim of the violation of the convention, and this restriction, which appears both in the convention and the Act, has been interpreted narrowly so as to exclude pressure groups whose members are not themselves victims, and even trade associations, and so is considerably narrower even than the right to seek judicial review.

There is a further important provision in the European Convention which has underlain the provision of appeal rights. This is Article 6, which provides that in “the determination of his civil rights and obligations” or of criminal charges, “everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law”. The meaning of this Article has provoked considerable controversy and much uncertainty remains; particular difficulties have been cause by the meaning of ‘civil rights and obligations’ and by the question of what is needed to satisfy the requirement of an ‘independent and impartial tribunal’.

On the first issue, civil rights and obligations have generally been interpreted narrowly so as to include rights recognised in civil law but not discretionary decisions by public authorities. For example, in one recent case the determination of tax liability was held not to fall within the definition. However, applications for licences, and their revocation where this affects liberty to exercise a profession, will do so. More recently, the court has also examined the financial consequences for the victim of an

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29 Director General of Fair Trading v Proprietary Association of Great Britain [2002] 1 WLR 269.
31 Ferrazzini v Italy (2002) 34 EHRR 45
alleged breach of Article 6. The question has largely been side-stepped in decisions of the domestic courts under the Human Rights Act. Thus, in the leading case of Begum (Runa) v Tower Hamlets LBC, the House of Lords left open the question of whether the provision of housing to a homeless applicant would fall within the concept of a civil right. It is thus impossible to generalise about the applicability of Article 6 to regulatory decisions. Clearly those which directly affect property rights through requiring the payment of penalties (on competition or other grounds), or which restrict land use will be covered, whilst for other decisions relating, for example, to the application of industry codes on markets or disconnections, the position is much less certain, and will depend on their effects in the individual case.

Even if Article 6 does apply, however, there is also some doubt as to what it requires and, in particular, whether the availability of judicial review is sufficient to provide the necessary recourse to an independent and impartial tribunal. The major domestic case on this so far has been the Alconbury decision, which concerned planning appeals, clearly decisions about civil rights and obligations because of their effect on property rights. In this decision the House of Lords held that the availability of judicial review was sufficient to provide the necessary recourse to an independent tribunal. However, the decision was substantially based on the fact the decisions in question were made by ministers and involved matters of policy. To substitute an independent body to determine the merits of the decision rather than the minister responsible to an elected parliament would be ‘profoundly undemocratic’. This argument would not of course apply to regulators who are appointed, not elected, and are not directly responsible to parliament; nor do the decisions in question involve matters of government policy in the same way as those taken by ministers in the planning system.

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33 See Loveland, n. 30, 181.
34 [2003] UKHL 5.
The second major decision on this issue was that of Runa Begum, referred to above. Here an applicant for housing had been offered accommodation which she considered unsuitable; the decision had been reviewed by an officer of the authority itself, clearly not an ‘independent tribunal’. The House of Lords found that there was no breach of Article 6 in view of the right of appeal on points of law (equivalent to judicial review) to the County Court provided to applicants under the legislation. According to Lord Hoffman, the requirements of independence would be less demanding where, rather than deciding on private rights or criminal liability, the body involved was carrying out regulatory functions or administering schemes of social welfare. Once more, however, this can be distinguished from many regulatory decisions in relation to the public utilities, as it was accepted by the House of Lords that no substantive convention rights were brought into play in the Begum case. As we have seen earlier, the right to the peaceful enjoyment of possessions may be affected directly by a decision of a utility regulator.

The position under the European Convention of Human Rights is thus by no means simple. Clearly, whether full appeal rights are required will depend on the nature of the decision in question, notably whether it directly affects the property (interpreted widely so as to include ability to trade) of the enterprise in question. It will also be affected by the identity of the person or body seeking to appeal; the narrow ‘victim’ test under the convention would seem to exclude competitor enterprises or consumer groups from the protection afforded. The current complexity of existing appeal rights in part reflects this, with such rights provided where the convention most clearly requires provision of appeal to an independent tribunal, notably in relation to the levying of financial penalties, both under utility statutes and, perhaps more importantly, under general competition law.
Conclusion

The current position may represent an attempt to reflect the direct impact of the convention, but it is profoundly unsatisfactory in a number of respects. The first is the sheer complexity of the pattern of appeal rights, and the lack of a clear relationship between the importance of the decision and whether there is a right of appeal or not. The government has attempted, in its response to the House of Lords Constitution Committee, to justify this on the grounds of proportionality; it is the decisions which modify licences which have a substantial effect on a firm’s performance, and here the right to force a reference to the Competition Commission is available. However, enforcement decisions may also have a substantial impact on a firm, and here, where the penalty is not financial, no appeal is available.

What is also apparent is that an outdated model of regulatory relations underlies this approach to appeals. Regulation is perceived as a relationship between regulator and the dominant firm which is licensed; a form of bilateral ‘regulatory contract’. Competitors and consumers and their organisations are outside this contract and so should not have procedural protections offered to the licensed firm, such as the ability to seek an independent review of a licence modification decision. However, a broader ‘stakeholder’ approach to regulation has become more important recently, in which the regulator is part of a network of relations with a large number of affected actors, including competitors and consumers. This suggests that each should have procedural rights to challenge regulatory decisions.

We have seen some move towards this model more recently, for example, in the case of the wide rights of appeal available to third parties in competition law, and in the new rights of appeal under the Energy Act, which are available to industry associations and consumer groups, such as Energywatch. The

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time is ripe to review and simplify the current pattern of appeals in the utilities sector, replacing it with, as the Constitution Committee suggested, a general right of appeal on the merits either to the existing Competition Appeal Tribunal or to a new regulatory appeals tribunal. Such a reform would appear to raise two difficulties.

The first is the loss of the expertise of the Competition Commission in determining licence modification references. This is a real concern given the importance of the Commission’s work in developing general principles on some important economic issues, but it could be resolved by adopting the system already implemented by the Communications Act 2003 for telecommunications. Where a price control matter arises in an appeal, it can be referred to the Commission by the appellate body for determination. This would have the advantage of concentrating the Commission’s expertise on price control where it is most valuable.

The second concern, especially if the Competition Act model of providing third party right of appeals is provided, is that of a large number of weak appeals being made, hence wasting resources and slowing down regulatory decision-making. The answer here is to adopt a filter before appeals reach the appellate body. This has been done already in the Energy Act 2004, where the permission of the Competition Commission is required before an appeal is brought and this may be refused only on the grounds that the appeal is brought for reasons which are trivial or vexatious, or that the appeal has no reasonable prospect of success. The new appeal rights could indeed form part of a new Regulatory Reform Act, also addressing common procedures for other aspects of regulation, for example, consultation and the giving of reasons.

37 S. 183 (4-5).
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(bold numbers refer to the footnote in which first cited)


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11 ACCOUNTABILITY IN THE ‘REGULATORY STATE’ REVISITED

Peter Vass

Introduction

The accountability of regulators has improved, is improving and will continue to improve. There are many reasons for this, and its effects, particularly over the last ten years, have been beneficial in both redressing the perceived imbalance between the regulators and the regulated with respect to the disciplines imposed on them to achieve good governance, and in improving regulatory outcomes. Effective accountability is necessary for effective regulation! It exposes regulators, and thereby undermines arbitrary and irrational regulation by providing a discipline on regulators to seek out, and apply, cost-effective regulation. It also helps avoid regulatory capture. This chapter examines the recent report of the Constitution Committee of the House of Lords inquiry into the accountability of regulators, which provides a framework for the current debates and developments.

Context

The privatisation of the utilities and network industries (water, energy, transport and communications) from 1984 onwards was accompanied by independent regulators; a new form of regulator to be at ‘arms-length’ from ministers. Concerns over the democratic mandate for the actions of these technocratic regulators, particularly where they were seen to be trespassing on
policy issues, was the first reason for the development of a renewed debate on the accountability of the regulatory state, and its constituent organisations. Not surprisingly, the regulated were at the forefront of promoting that debate. This debate was given a renewed impetus following the privatisation of the regional water authorities in England and Wales in 1989, and the UK electricity industry from 1990. The profits being made, and directors’ rewards (including salary, bonuses and share options), grew so dramatically that by 1995 customers and the public generally (or at least their vocal representatives - politicians, the press and the National Consumer Council (NCC)), had become outraged. It was seen as a failure of the regulatory system, and the political consequence was that New Labour’s electoral prospectus included a review of utility regulation, with major reforms in prospect, should they win power from the Conservatives in the 1997 election. If regulatory mistakes had been made, then clearly increased accountability was required.

Elected to power in 1997, the review of regulation took place almost immediately. It turned out, in implementation, to be less radical than perhaps had been hoped for by many - some with their desire to reassert direct state and ministerial control over matters that perhaps had seemed to slip from their grasp with the introduction of the concept of ‘public services - privately provided’. This was because, as with any government coming to power, the review gave the opportunity for deeper analysis of the issues than is perhaps available for developing the political rhetoric of a manifesto. New Labour found that the key objectives and mechanisms of incentive regulation (the RPI-x price rather than profit control system), which was policed by independent regulators, were well designed to meet many of the public interest objectives that they espoused. If there had been a

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failure, then it was a failure of the previous government, just prior to privatisation, in setting insufficiently challenging price controls for the water and electricity industries, rather than a set of post-privatisation regulatory failures. From this realisation came the one-off ‘retribution’ of the windfall tax; designed to be one-off to avoid erosion of the very incentives to efficiency that the government had found to be such an important characteristic of the regulatory system bequeathed by the Conservatives.

Given the inherited foundations were found to be ‘fit for purpose’, the Labour Government, having put the past behind it with the imposition of the windfall tax, proceeded to reform the system, in effect, by building on the extant foundations. The results were sometimes surprising - more introduction of competition wherever possible (in part to ‘bypass’ regulation), and more plans for privatisation - and sometimes window-dressing - putting in place reforms which were more political form than regulatory substance (although they were sacred cows for some of the critics of regulation) - the three most notable being:

- regulatory boards to replace individual director generals;
- independent consumer bodies to replace the consumer committees of the regulatory bodies;
- promoting customer protection to the formal statutory status of a ‘primary’ duty on regulators (albeit that regulators had inevitably pursued this objective, it being the primary rationale for their being established in the first place).

Unfortunately, of these three, the first two, as noted below, may prove to have a ‘downside’ of undermining effective regulatory accountability, and hence effective regulation.

A clearer recognition that ministers have to take responsibility for setting social and environmental standards was, however, engendered, particularly as a result of the ‘cost of quality’ debate taken forward by Ian Byatt, the water regulator, in response to rising water bills driven by a succession of environmental
directives form the European Commission. A new documented process was born - formal ‘ministerial guidance’ - which reinforces ministers’ accountability for defining the ‘outputs’ to be met by the licensed or contracted private providers.

**Real progress**

In one respect, however, the results of the review have been a radical development for the regulatory state. These are in the ‘process reforms’ to improve accountability. Corporate scandals and collapses have contributed over the years to a progressive demand for improved accountability and internal control by company boards, culminating in 2003 with the Combined Code of Practice on Corporate Governance (developed first by the Cadbury Committee in 1992). In a similar way, the lack of a demonstrably effective regulatory (and ‘providing’) state led to calls for improved governance, resulting in a wide range of codes of practice.

Under the Conservatives it was presented as a purely ‘deregulatory agenda’, but this was inevitably found wanting because some market and conduct failures inevitably call for the attention of the regulatory state. The review of utility regulation was one mechanism for shifting the balance towards a ‘better regulation’ agenda - regulating where necessary and cost-effectively. It was complemented by a new institutional focus, most notably through the Better Regulation Task Force (BRTF), which published its five ‘principles of good regulation’, and by a recognition that good regulation requires formal processes, most notably articulation of the objectives and reasoning behind specific regulations. Regulatory Impact Assessments (RIAs) were to be the new process tool, and are set to become the

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3 Financial Reporting Council (2003), The Combined Code on Corporate Governance.
4 The Independent Commission on Good Governance in Public Services (2004), The Good Governance Standard for Public Services, Office of Public Management (OPM) and CIPFA.
5 Better Regulation Task Force (2003a), Principles of Good Regulation.
foundation stones for effective accountability of regulators. To promote and co-ordinate this, the government established the Regulatory Impact Unit in the Cabinet Office.

Accountability has, however, to be set in a context: accountability of regulators to whom, and by what mechanisms? Accountability has been a major concern of parliament throughout its history, and the House of Lords Constitution Committee, in the light of recent developments in the regulatory state, decided to hold an inquiry on these matters during its 2003-2004 session. Its report was published in May 2004, entitled ‘The Regulatory State: Ensuring its Accountability’.  

The Constitution Committee’s report

The Committee’s report is substantial; a main report of 98 pages with two further volumes of evidence. It states its line of reasoning succinctly: “Our starting point is that regulation is a means to an end, not an end in itself”, and that “Regulation can only be in the public interest where it serves a clear purpose” (House of Lords, 2004a, p5). The problem is crisply set out too:

“We have to resist the danger of regulatory creep….This regulatory tendency has to be checked, and the best means is effective accountability. Necessary, and cost-effective, regulation can be properly identified; unnecessary regulation can, and should be removed” (House of Lords, 2004a, p5).

The Committee notes in particular the changed context of recent years, identifying, first, the establishment of arms-length independent regulators, and secondly, “the progressive changes to the rights of the regulated in recent years, perhaps most

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clearly exemplified by the incorporation of the European Convention of Human Rights into UK Law” (House of Lords, 2004a, p6). This underpins the idea of appeals against regulatory decisions going beyond the traditional grounds for judicial review, and being allowed on ‘the merits of the case’ (which looks to the principle of ‘reasonable’ decisions by regulators, rather than the traditional view that a regulator’s decision cannot be overturned unless it was so unreasonable that no reasonable person could have made it - in effect, irrational). Given the higher expectations of those exposed to regulatory decisions about their rights, the Committee observes that “we can only expect the progressive consolidation of those rights and expectations into law and judicial review procedures to continue” (House of Lords, 2004a, p6).

The Committee asked ‘who does what and why, and how?’. The why and how questions were brought together in the conclusion that “regulators should be accountable for effective regulation which meets rational, well-defined objectives” (House of Lords, 2004a, p6). Regulators must choose appropriate instruments to tackle regulatory problems; not ‘sledgehammers to crack nuts’. The who does what questions, however, meant that the question of effective co-ordination amongst regulators had to be addressed, since separate agencies might be established to tackle particular issues of concern to the regulatory state. A broad distinction between economic, environmental and social regulation could be discerned, and the former is reflected in the fact that we have economic regulators, such as the Competition Commission, the Office of the Director General of Water Services (Ofwat), the Office of Rail Regulation (ORR) and the Gas and Electricity Markets Authority (GEMA), the latter supported by its office, Ofgem. Whilst environmental effects (externalities on third parties) and social concerns (distributional issues such as inclusion, access and affordability) typically require the close involvement of ministers in approving standards and taking responsibility for the ‘democratically mandated’ judgements involved, there are normally specialist regulatory agencies created, such as the Environment Agency, and social
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security departments, such as the Department of Work and Pensions.

The regulatory state is therefore a complex system which has separate regulators addressing different problems, and set within a process which needs communication between the regulatory bodies over time if balanced and cost-effective outcomes are to be achieved. The Committee therefore identified two consequences: first, that regulators must satisfy a ‘360° view’ of accountability to all interested parties, included those regulated (not just formal accountability ‘upwards’), and secondly, the need for a ‘whole of government view’ of regulation, whereby the government takes responsibility for ensuring an integrated and co-ordinated design for the regulatory state (perhaps best seen as the regulatory framework or ‘blue-print’). The OECD has suggested that a particular department should be charged with this responsibility in order to promote consistency of practice.\(^7\) \(^8\) \(^9\) The Committee’s diagram of its 360° view of accountability is shown in Figure 1 (House of Lords, 2004a, p20).

**Figure 1: 360° view of accountability**

The consequences are clear. Regulated companies are accountable to regulators for the proper performance of their tasks, but equally regulators are accountable to them for the proper performance of their tasks. Nevertheless, the Committee (as the shading in the diagram shows) “drew a distinction between regulators exercising a duty to explain - extending to all the bodies identified in Figure 1 - and being required to respond to demands made by those who gave them their powers or control of the legal application of their powers” (House of Lords, 2004a, p21). Ministers too are directly accountable in this hierarchy, either as direct regulators or as those responsible for operating the regulatory system, including appointing suitable independent regulators.

Parliament does not escape that responsibility either. As the Committee observes “Improving parliamentary scrutiny is essential” but “it is not just a question of the answerability of regulators to parliament, but also one of the duty of parliament to ensure that its scrutiny is effective...“Scrutiny at the moment is dependent on individual (select) committees deciding that inquiry is necessary into a particular regulator or regulatory decision. It is both fragmented and inconsistent. There is no means of establishing a coherent overview of the regulatory regime operating within the United Kingdom. We believe there should be.” (House of Lords, 2004a, p7).

The elements, or steps, by which accountability is given effect therefore required analysis, and the Committee was right to note the insight provided by Sir Derek Morris’s evidence (then chairman of the Competition Commission):

“… I do think that there are three different and equally important levels of accountability. The first, to give it an epithet, would be transparency. People have to know what you are doing and how you have done it, and in trying to explain that and in being forced to explain there is an element of accountability.... The second is more penetrating. It
is not just transparency. It is actually being questioned, if you like grilled, on what you have done and how effective have you been in doing it. The decisions cannot be changed but you can be cross-questioned. There, fairly obviously, the role of the select committees is paramount. The third level is where, of course, the decisions can be changed, and that is in our case through judicial review and to the High Court” (House of Lords, 2004a, p27).

It identifies the three key elements, all of which are required for effective accountability:

- the duty to explain;
- exposure to scrutiny;
- the possibility of independent review.

From this it can be seen why the Committee concluded that “we have not found a conflict between independence and accountability” (House of Lords, 2004a, p6). Accountability, like regulation, is therefore not an end in itself, but is there for the purpose of achieving sustainable, effective regulation. In effect, it is a control system. The duty to explain incorporates the preparation of regulatory impact assessments (RIAs). As the Committee observes “Properly done it reveals whether regulators have subjected their decisions to cost-benefit analysis” (where this should be taken to mean costs and benefits in their broadest sense)….“These RIAs need to be conducted retrospectively as well as prospectively, to ensure that that cost-effectiveness is constantly under review” (House of Lords, 2004a, p7).

The Committee drew together these main principles and practices in a table and diagram and these are reproduced below as Table 1 and Figure 2 respectively (House of Lords, 2004a, p23). They are succinct and self-explanatory.

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Table 1: Effective regulation depends on:

<table>
<thead>
<tr>
<th>Good regulatory design</th>
<th>Control through the processes of accountability</th>
<th>Accountability for outcomes: regulatory performance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Macro (policy)</strong></td>
<td>Duty to explain (provision of information and reasons for decisions)</td>
<td>Accountability to whom:</td>
</tr>
<tr>
<td>The whole of government view:</td>
<td>Exposition to scrutiny (use of information - answerability and challenge)</td>
<td>Citizens</td>
</tr>
<tr>
<td>- encompassed in the regulatory (legal) framework of functions, powers and duties: the division of roles and responsibilities</td>
<td>The possibility of independent review (complaints, appeals and judicial review - particularly in respect of conformance rather than performance)</td>
<td>Parliament</td>
</tr>
<tr>
<td>- whether by regulatory sector, theme or hierarchy eg, arms-length independence versus direct ministerial regulation</td>
<td></td>
<td>Government</td>
</tr>
<tr>
<td><strong>Micro (implementation)</strong></td>
<td>'Competent’ authorities</td>
<td>Ministers</td>
</tr>
<tr>
<td><strong>Citizens</strong></td>
<td></td>
<td>Departments of State</td>
</tr>
<tr>
<td><strong>Parliament</strong></td>
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<td>Regulators</td>
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<td><strong>Government</strong></td>
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<td>Customers</td>
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<td><strong>Ministers</strong></td>
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<td><strong>Departments of State</strong></td>
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<td><strong>Regulators</strong></td>
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<td>Other interested parties.</td>
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<td><strong>Consumers</strong></td>
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<td><strong>Other interested parties.</strong></td>
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</table>

Figure 2 shows clearly how the process of maintaining an effective regulatory state starts and ends with parliament. The time dimension, shown by moving anti-clockwise around Figure 2, not only demonstrates the different, but inter-related, roles which the constituent parts of the regulatory state play at various stages during the regulatory cycle, but also draws attention to the importance of ‘iterative’ arrangements between regulators if balanced outcomes are to be achieved. Hence, for example, ministers propose initial environmental standards, and the implications of these for costs and customers’ bills can then be assessed by the economic regulator, and the implications for affordability taken on board by ministers in making their final judgements. Without this, systemic failure is likely, as exemplified recently by Tom Winsor’s excoriating submission from the then Office of the Rail Regulator to the government’s rail review, and which underlined ministers’ responsibilities for properly defining the required outputs of the rail system.\(^\text{11}\)

\(^{11}\) Winsor T (2004a), DfT Rail Review (2004) - Submission by the Rail Regulator, 6 May, ORR.
The Committee’s recommendations

The consequent recommendations of the Committee bear setting out in full, given that they reflect a synoptic review of the regulatory state, and provide the basis for the subsequent response from the government and on-going debate (see Appendix).

The government’s response

Overall, there were no surprises in the government’s response. They supported those things which one would have expected them to support, and opposed those one would not, given the interests involved and past decisions.12

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On a positive note, the general welcome for the report gives encouragement to those parties involved in trying to ensure the accountability of regulators that their work will be given progressively more attention, and this adds to the authority and effectiveness of scrutiny. Such bodies are encouraged to tackle their work with more confidence, and to demand the attention that it deserves. This helps provide (or redress) the balance between the regulators and the regulated.

**Coherence - the ‘whole of government view’**

The government response is weakest in the area of ‘coherence’ of regulatory policy and process as a whole. Coherence is a principle which informed the Committee’s report and the Committee made reference to it in the context of developing the Better Regulation Task Force’s ‘Principles of Good Regulation’ (see recommendations 10 and 11 in particular). The OECD has placed considerable emphasis in recent years (its ‘regulatory project’) on the need for member states to manage the regulatory state as a whole, and to provide an appropriate institutional structure for doing that. The Committee referred to that work in its report (see recommendation 8).

The government accepted the need for better communication of the ‘whole of government view’ (para 34), which is welcome, but its unwillingness to change the role of the Cabinet Office could be said to be a missed opportunity in the light of the overall thrust of the OECD’s recommendations cited by the Committee. Whilst machinery of government proposals and institutional structures often have pros and cons associated with them, it would be too charitable to suggest that the government’s view was therefore understandable, if rather inert. The government’s response that it should retain the existing ‘dispersed’ arrangements do not, on the arguments presented, provide a reasoned rebuttal to what should otherwise be considered good practice, being based on the ‘one size should not fit all’ style of argument (see paras 6 and 34-37 in particular).
Good examples of the weakness with which the government approaches the ‘institutional’ task of projecting a ‘whole of government view’, are that:

- no one body is given overall responsibility for co-ordinating principles and practice, and being the advocate of efficiency and effectiveness in the regulatory state, unaffected by specific departmental interests (as, for example, the DTI has for certain sectors).

- existing co-ordinating arrangements are not evidently transparent (see, for example, the recently established panel for regulatory accountability set out in the government’s response, para 22).

- the principles of good regulation are not seen as important, generic statutory duties to be applied to regulators.

The arguments in the response seem weak in relation to incorporating the principles of good regulation (para 44), and in particular the second sentence of that paragraph.

“Government does not believe it is necessary to enshrine the principles of good regulation in statute, as a general rule for all sector regulators. Whilst the government is entirely supportive of the 5 principles of good regulation, as noted in response to the BRTF Independent Regulators Report, the principles are not defined in law, so are open to interpretation and potential challenge by judicial review. However, where government departments taking forward amendments to sector legislation consider it appropriate, in particular circumstances, to enshrine the principles within legislation, they will be free to do so” (House of Lords 2004b, para 44).

Is this saying that the objective is to avoid potential challenge by judicial review, when surely the Committee’s recommendation is
to give the regulated avenues to improve the reasonableness test of judicial review because judges can refer to the duty and provide a legal interpretation of what the five principles mean? In any event, the principles of good regulation are being enshrined in statute (see, for example, the Communications Act 2003 and the Energy Act 2004).

It is not surprising that the BRTF should not want to add to its five principles now that they are fairly widely known and used operationally. However, the requirements for coherence, objectivity and rationality are serious ones, and it is to be welcomed, following the government’s discussion with the BRTF, that the BRTF “will seek to incorporate the Committee’s suggestions in the explanation of the 5 principles when the leaflet is next revised” (House of Lords, 2004b, para 33). Hopefully that revision will not be too long in coming.

An interesting indicator of the overall problem of a lack of strategic leadership for the regulatory state is perhaps illustrated by the fact that the government’s response to the Committee came from a DTI minister whose title was Minister for Energy, E-Commerce and Postal Services, which hardly indicates to the wider public a remit for co-ordination and consistency of the regulatory state.

Specific examples of incoherence might best be drawn from the development of policy on consumer representation, comprehensive access by the National Audit Office (NAO) to regulatory offices and appeals on the merits of the case.

**Representing the consumer?**

The government privatised the utilities and network industries with independent regulators. These regulators acted to protect the consumer interest against the potential (or actual) abuse of monopoly power by the industries, and also acted in certain respects to deal with other forms of market and social ‘failure’ as required by the relevant legislation. The key role of consumer
protection was not, however, as explicitly set out in legislation as it might have been (the legislation focusing on such things as the primary duties to ensure that all reasonable demands for supply were met by the industry, and that the companies could finance their regulated businesses). Unfortunately, these ‘primary’ duties, when contrasted with a ‘secondary duty’ of customer protection, led to a sense of a secondary status for customer interests.

The government has sought to redress this perceived weakness since its review of utility regulation in 1998 with the introduction of, first, primary duties of customer protection (see for example the Utilities Act 2000 with respect to Ofgem and GEMA, and subsequent acts such as the Communications and Water Acts 2003), and, secondly, the establishment of ‘independent’ consumer representative bodies, drawing particularly on the model of the pre-existing, independent Gas Consumers Council. The latter policy established specific ‘watchdogs’ in each industry, most noticeably WaterVoice, Energywatch and Postwatch. In the case of WaterVoice and Energywatch, these replaced statutory representative consumer committee arrangements which had been an integral, but quasi-independent, part of each of the regulatory bodies for water and electricity.

Customer protection by regulators, and accountability for that role, is a key feature of the regulatory system, but at the present time the evidence, contrary in some respects to the above, is one of incoherence in regulatory policy. This is illustrated by the following:

- the FSA (from 2000) and Ofcom (from 2003) were established with ‘consumer panels’ integrated within, but quasi-independent of, the regulatory body (contrary as of now to water, energy and posts). This integration is, however, set within a clear primary duty on the regulator (ie, the regulatory board) to protect customers (and hence represent their interests).
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- the Department of Trade and Industry has, during 2004, been developing a new consumer policy.\textsuperscript{13}\textsuperscript{14} Whilst these are consultation documents, the emphasis is on potentially consolidating the independent consumer bodies into a prospective national utilities council (and perhaps the NCC could play a host role in this respect), noting that the provisions of the Water Act which will finally empower WaterVoice are not even being brought into effect until 2005/6. Also, the role of ombudsmen is given a greater prominence (as in the FSA and Ofcom arrangements).

- the rail review, where the proposals for the Rail Passengers Council in the government’s rail white paper were not fully articulated in the context of this evidently on-going policy debate.

It is unclear therefore why we should have had a policy of independent consumer representative bodies if the regulator is given a primary duty for consumer protection, and it seems that the government is implicitly recognising this policy conflict in its current proposals as set out above, with their emphasis on a revised approach based around the new ‘consumer direct’ arrangements and ombudsmen. The question for the debate is not so much which policy is right perhaps, but that whatever policy is chosen, it should be consistently and understandably applied.

\textit{Access by NAO and appeal on the merits}

At present the National Audit Office cannot audit and carry out value for money studies on the Financial Services Authority (FSA) and the Civil Aviation Authority (CAA). The special cases of the FSA and the CAA with respect to access by the

\textsuperscript{13} Department of Trade and Industry (2004a), Consumer Representation in Regulated Industries, A Report by the DTI and HM Treasury, July.
NAO are argued against by the government purely on the basis of *status quo* rather than the outcome of specific reasons which demonstrate that the general presumption of access by the NAO should not be applicable (see recommendation 20 and para 51 of the government’s response in particular).

If independent regulatory arrangements are being established by parliament, then the general principle should apply that decisions made by those regulators, where material, are appealable on the ‘merits of the case’ (ie, a decision for which there is a demonstrable prima-facie case that it could be judged to be other than ‘reasonable’), and to an appeal body specified in the relevant legislation (see recommendation 22 and para 60 of the government’s response in particular).

In these two cases the government’s arguments do not seem to be derived from first principles (comprehensive access and rights of appeal on their merits), other than the acceptable point that there should be a regulatory cost-benefit test of proportionality related to whether there should be extended appeal rights as a subsidiary consideration to the main principle. It is in these two areas that the government’s defensive stance seems least satisfactory, albeit understandable.

My overall sense of the government’s response is of the ‘curate’s egg’ - good in parts. There are points which can be debated and rebutted. The important part of the Committee’s report relating to parliamentary scrutiny is, as the response notes, for the House Authorities to take forward - but with a word of warning about proportionality, which is useful.

**The House of Lords debate**

The debate on the Committee’s report took place on 2 December 2004, and gave the opportunity for the government, once again, to argue why it did not accept the most significant recommendations of the Committee (Hansard col. 609). The
chairman of the Constitution Committee, Lord Norton of Louth, opened the debate, and had prepared the ground for some of his more trenchant remarks.\textsuperscript{15, 16} Lord Triesman, responding to the debate on behalf of the government, referred to ‘generic’ characteristics of the regulatory state by drawing attention to the Committee’s statement that:

“regulators have been established at different times and in different ways, but they share a basic model: a sector-specific regulator charged with a responsibility to operate under a hierarchy of statutory duties to achieve a range of public policy objectives. The statutory nature of each regulator’s duties, coupled with their independence from government, underpins the successful operation of the regulatory framework” (Hansard, col. 610).

However, rather than focusing on the natural conclusion from this of the need for improved co-ordination and a lead department to sustain a consistent regulatory model, he chose, first, to question the breadth of definition of regulation adopted by the Better Regulation Task Force: “so wide as to encompass almost everything” (Hansard col. 612).\textsuperscript{17} He then went on to suggest that as “knowledge and responsibility is vested in the relevant ministers and department.....It is crucial that responsibility and authority should not be diluted and disseminated by adding an additional layer of bureaucracy, with the attendant prospect of loss of coherence and clarity which that could entail” (Hansard col. 612). New ‘layers’ would create the very danger of regulatory creep which the Committee sought to

\textsuperscript{15} Norton, Philip, Professor the Lord Norton of Louth (2004a), Regulating the Regulatory State, Parliamentary Affairs, Vol 57, no 4, pp785-799.
\textsuperscript{16} Norton, Philip, Professor the Lord Norton of Louth (2004b), Who Regulates the Regulators, CRI Occasional Lecture, 8\textsuperscript{th} September, pp1-16, University of Bath.
\textsuperscript{17} “Regulation may widely be defined as any measure or intervention that seeks to change the behaviour of individuals or groups”, BRTF, Principles of Good Regulation, p1, para 1, 2003.
avoid, and so clear allocation of responsibility for cross-cutting work would ensure effective co-ordination (as, for example, “the government believe that the Treasury and the DTI should jointly lead in formulating economic regulation policy and in ensuring that the regulatory framework is fit for purpose” (Hansard col. 613).

The other ‘rebuttals’ were dealt with quite summarily, stating that with regard to access by the NAO to the Financial Services Authority that “it is worth noting that the FSA has no financial relationship with government or parliament, and it is not to be regarded as acting on behalf of the Crown”. Refusing to extend the right of appeal on the merits was driven simply by the view that “the consequences seem to be that almost all decisions, particularly decisions on pricing, are likely to be appealed…. The processes themselves would begin to take so long that price-sensitive decisions of fundamental importance would take too long to get into the marketplace” (Hansard col. 615). Neither of these arguments seem to be persuasive practical grounds for resisting the consistent application of core principles for the design of a regulatory state.

The Hampton Report

The Hampton report ‘Reducing Administrative Burdens: Effective Inspection and Enforcement’ was published by HM Treasury in March 2005. Curiously, it takes forward for the government some of the agenda on improved regulation and accountability of regulators which the Constitution Committee’s report had identified, but which had not been positively embraced by the government at the time. The report identifies the FSA as one of the UK’s largest regulators (p3) and hence should be publicly accountable for its effectiveness - and it focuses on generic frameworks in its recommendations to

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18 HM Treasury (2005), Reducing Administrative Burdens: Effective Inspection and Enforcement, Philip Hampton, March.
consolidate regulators: “regulators should be structured around simple thematic areas” (p9). It puts considerable emphasis on the lead department role when it recommends a Better Regulation Executive (BRE). Indeed it states that “no new regulators (to be) set up without the approval of the Better Regulation Executive” (recommendation 25, p56). Of particular importance in this regard is the recommendation to create a National Regulatory Forum (NRF), to be co-ordinated (and chaired) by the Better Regulation Executive, and that it should include consumer and business representations, the National Audit Office and the Audit Commission.

As the report states (having focused on risk-based assessment): “a regulatory landscape which adopts the approaches to regulatory impact the review suggests, which is consolidated, co-ordinated and prioritised, will still need strategic leadership to improve regulators’ performance and consistency” (para 4.114). Its vision for the BRE clearly accords with the thinking of the Constitution Committee, it too citing the OECD’s work: “The OECD, in its most recent thinking on regulatory matters, recommends that governments develop a strategic centre for thinking and performance management of regulation. The review’s proposed central body (the BRE) could fulfil that role alongside its work in monitoring regulators’ performance....The National Audit Office.....would be the ideal body to carry out this task” (paras 4.117 and 4.118, p76). Finally, the report would welcome the setting up of the joint Parliamentary Committee to scrutinise the regulatory state as recommended by the Constitution Committee (para 4.119).

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Conclusion

During the House of Lords debate, Lord Dahrendorf noted by way of preamble that “Even among House of Lords reports, it stands out for its systematic character, the thoroughness of its arguments and the comprehensiveness of the evidence gathered” (Hansard, col. 596). The job it has done might best be described as having revisited the long standing debates on accountability, and to have ‘codified’ the principles and practices into a set of conducts which can underpin a modern and effective regulatory state. There is strong evidence to suggest that the government is inexorably moving along the path to full implementation of the vision which the Committee’s report has articulated, albeit that ‘inertial’ forces may slow down the arrival point.

Whether the cement for the new foundations will set is dependent, perhaps, on two key developments. First, that parliament takes this opportunity to focus its attention on improved scrutiny of the regulatory framework and the regulatory state as a whole (to which the recommendation of a joint committee of both Houses is addressed). Secondly, that select committees focus their attention on Regulatory Impact Assessments as the primary documentation for framing their scrutiny of regulators (and other interested commentators, including judges as part of an improved judicial review process). In this way RIAs will be forced to be ‘fit for purpose’ by preparers, and the proper balance between the accountability of the regulators and the regulated thereby achieved. This should also focus increased attention on regulatory accounts, too often an underutilised source of information and accountability.

The need to ‘entrench’ such institutional and process requirements should not be underestimated if we are to achieve an overall effectiveness for the regulatory state. Clearly an important start has been made with the BRTF, as evidenced by
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its outputs.\textsuperscript{20} The BRTF is now to become a ‘Commission’, adding to its authority. Equally, the European Commission is addressing these governance matters in relation to managing its own role as a regulatory ‘state’.\textsuperscript{28, 29}

Only then might we be confident not to have a repeat of the rail debacle (and the danger of mixing roles, as with the integration of economic regulation with health and safety regulation, as has just taken place in rail).\textsuperscript{30} The Committee quoted from Tom Winsor’s evidence (the then Rail Regulator) about the problems of maintaining independence from ministers, given his clashes with the transport secretary, Stephen Byers, at the time of Railtrack being force into administration by the government.

“It was an extraordinary episode. I had no expectation that the Minister would ever take the steps that were

\textsuperscript{20} Better Regulation Task Force (2001), Economic Regulators, Cabinet Office.
\textsuperscript{21} Better Regulation Task Force (2003b), Environmental Regulation: Getting the Message Across, Cabinet Office.
\textsuperscript{22} Better Regulation Task Force (2003c), Imaginative Thinking for Better Regulation, Cabinet Office.
\textsuperscript{23} Better Regulation Task Force (2003d), Independent Regulators, Cabinet Office.
\textsuperscript{25} Better Regulation Task Force (2004b), Avoiding Regulatory Creep, Cabinet Office, October.
\textsuperscript{26} Better Regulation Task Force (2004c), Make It Simple - Make It Better, Cabinet Office, December.
\textsuperscript{27} Better Regulation Task Force (2005), Regulation - Less is More: Reducing Burdens, Improving Outcomes, A BRTF report to the Prime Minister, Cabinet Office, March.
\textsuperscript{29} European Commission (2002), Communication from the Commission on Impact Assessment, Com276, Final, Brussels.
\textsuperscript{30} Glaister S (2004), British Rail Privatisation - Competition Destroyed by Politics, CRI Occasional Paper 23, University of Bath.
taken in relation to me. If it was expected that I should be intimidated, I was not….I believe that for an independent regulator to give in to that political pressure, apart from being an irrelevant consideration as a matter of public law, or to resign would have been a very serious and adverse step for the constitutional position of regulators and the relationship between the state and the private sector in areas and in respects going far, far wider than the railway industry…. I think it is notable, and I claim no credit for this, that in the bill which is to be brought before parliament in relation to foundation hospitals, the title of the regulator is ‘the independent regulator’” (House of Lords, 2004a, p41).

Attention to a standard regulatory framework could have both helped avoid the rather unseemly institutional merry-go-round in rail regulation to date - notably the rise and fall of the Strategic Rail Authority - and helped the government seek out the most effective structure to result from its review. This would have pointed to a clearer separation of roles between specifying outputs (ministers), providing services (with Network Rail responsible for infrastructure and franchising out rail services), and regulation of those services by ORR, either of natural monopoly or of the competitive franchising process. The current policy has an unnecessarily complicated interface between the roles of the Department for Transport and Network Rail.

Equally, with entrenched accountability mechanisms, there can be an adequate defence against the possible erosion of accountability which might result from ‘faceless’ regulatory boards and authorities, compared with the ‘identifiable’ director generals, when powers were vested in the individual regulator rather than the board.

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Appendix

Recommendations of the Constitution Committee (House of Lords, 2004, pp8-11)

The overall regulatory framework

(1) Independent consumer bodies should be obliged by statute to engage in open meetings and conduct regular surveys of consumers. This has resource implications which should be met out of public funds. Following a review of the budgetary arrangements for each regulator, an appropriate formula should be agreed for calculating this provision and applied to each of these bodies. We believe that these changes will enhance both the accountability and the independence of the consumer bodies. (para 69)

(2) We are aware that the government is undertaking a review of consumer bodies, supported by the National Audit Office (NAO), and recommend that the review includes an examination of the relationship between regulators and the related consumer bodies in order to introduce greater clarity in the relationship, if necessary through a statutory provision common to the regulatory regime. (para 70)

(3) We welcome the move towards more collective board structures, rather than sole regulators, as one of the principal mechanisms for improving the quality and consistency of regulatory decision-making, and urge that this should be the norm for regulatory regimes. To ensure that there is no loss of accountability we recommend that boards designate one of their number as the public face of the regulator in order not to lose engagement with the public and to perform the role of building confidence and understanding. Normally this should be the Chairman or Chief Executive. Where appropriate open meetings should be held as a means of increasing public understanding and confidence. (para 110)

(4) Government should explicitly accept overall responsibility and accountability for regulatory policy and the regulatory framework, while devolving responsibility under defined circumstances to independent regulators. (para 122)

(5) Ministers should remain responsible for appointing regulators, subject to Nolan rules, to ensure proper responsibility and accountability. (para 126)
(6) Regulatory legislation should normally be drafted in the light of consultation with regulators to achieve clearly defined objectives. The duties imposed on regulators should be consistent with the overall remit of the regulator (for example, economic regulation). They should make clear the underlying purpose of the regulator’s role (such as consumer protection). (para 130)

(7) Responsibility for environmental and social standards should normally remain with Ministers as the authority of a democratic mandate is required for decisions in these areas. (para 138)

(8) The OECD regulatory checklist should be utilised as standard for legislation, regulatory decision-making and in establishing any new regulator. (para 142)

(9) The recommendation of the Better Regulation Task Force (BRTF) that regulators should produce Regulatory Impact Assessments (RIAs) on all new major policies and initiatives has been accepted by the government and should be applied throughout the system. We also endorse the Task Force’s recommendations, among others, aimed at increasing the transparency and accountability of regulators, including open meetings and agreeing a management statement with the sponsor Department. (para 146)

(10) The BRTF should review its principles of good regulation to ensure that the principles of coherence, objectivity and rationality of approach are incorporated and signalled to the wider public. (para 148)

(11) There must be a much stronger communication of the ‘whole of government’ view of regulation. We recommend that the government appoint a lead Department to be responsible for promoting effective regulation in practice, thereby co-ordinating the various roles currently played by a number of Departments, including HM Treasury, DTI, the Cabinet Office and the Office of the Prime Minister. Logically, the Cabinet Office should assume this role, possibly by expanding the remit of its RIA unit. Its responsibilities should mirror those we outline for a parliamentary committee in paragraphs 199 to 203. (para 152)

(12) There should be consistency in applying regulatory models and requirements on a like-for-like basis. (para 153)

(13) The move towards self-regulation should be encouraged and co-regulation should, where appropriate, be used as a preliminary to it. (para 157)
(14) Regulators should have a statutory duty to have regard to the principles of good regulation and effective accountability. These should include self-assessment of their compliance with the same; the design of effective consultation procedures to engage interested parties; ensuring that redress and compensation procedures are clear and accessible; and incorporating the outturn of plans in their annual reports. They should also include the publication of the following:

(a) their mission statements;
(b) codes of practice for the conduct of their regulatory office;
(c) codes of practice for consultation (including the duty to summarise and accept or rebut consultees’ comments, with reasons);
(d) their forward plans;
(e) the explanations of and reasons for their decisions; and
(f) all relevant material necessary for their production before and after RIAs. (para 169)

(15) Regulators should adopt a structured approach to consultation designed to minimise the burdens on those consulted and to facilitate their engagement with either the principles or the detail as appropriate to the interests of those consulted. (para 173)

**Exposure to scrutiny**

(16) A dedicated parliamentary committee should be established to scrutinise the regulatory state. (para 199)

(17) This should preferably be a joint committee of both Houses and should be given the necessary resources to fulfil its task effectively. (para 200)

(18) We recommend that select committees consider expanding their terms of reference to include a requirement routinely to consider and react to regulators’ annual reports, and monitor the use of resources. These activities would be in addition to the ad hoc inquiries they undertake from time to time. (para 202)

(19) In order that parliamentary scrutiny by select committees can be more consistent and co-ordinated, it should be focused around the annual report and the published RIAs, and with specific attention paid to a harmonised whole of government view of regulation. (para 203)
(20) The NAO should have access consistently to all regulatory bodies, including the Financial Services Agency (FSA), with a view to monitoring their cost-effectiveness and budgetary control. (para 212)

(21) We welcome the expansion of the role of the NAO and recommend that the annual review of Regulatory Impact Assessments by the NAO be developed. In order to maintain the strict independence of the NAO and its scrutiny role, we recommend that this should not be undertaken as an agency of the Cabinet Office. These RIAs need to be conducted retrospectively as well as in advance, to ensure that cost-effectiveness is constantly under review. (para 218)

Independent review; improving appeals

(22) Appeals should provide an opportunity for the regulated to have their objections reviewed on the merits of the case, subject only to the condition that the appeal body should have the clear ability and power to identify and penalise appeals designed to frustrate equitable regulation. (para 230)

(23) Simplified systems of fast track appeals against regulatory decisions and arbitration should be developed for the Competition Commission and the Competition Appeal Tribunal, and made available subject to the agreement of each of the parties concerned. (para 231)

(24) We further recommend that a Regulatory Appeals Tribunal should be set up to cover regulatory decisions that do not fall within the jurisdiction of either the Competition Commission or the Competition Appeal Tribunal. (para 232)
12 CORPORATE GOVERNANCE AS SELF-REGULATION: THE COMBINED CODE IN PRACTICE

Tim Rayner

Introduction

Well-run companies can provide their shareholders with sustained returns. By taking good decisions, anticipating and mitigating risks, a company can plot a path that maintains and builds its value. That is why most major companies have committed to high standards of corporate governance. By this we mean adopting governance procedures which allow decisions to be taken in the right place within the company, and ensure that such decisions are open to proper scrutiny.

Much of United Utilities’ corporate governance structure has been in place since the 1990s, when the company grew out of the merger of North West Water and Norweb. Structures have developed over time as we have sought improvement and imported best practice from elsewhere. We largely anticipated the introduction of the combined code on corporate governance, and were well placed for its revision in 2003 following the Turnbull, Smith and Higgs reports.

In this chapter, we describe corporate governance within United Utilities, consider the implications of combined code revisions, and the extent to which adherence to the code can relieve external pressure for more direct regulation of a company’s activities.
The Combined Code

The Combined Code Principles of Good Governance and Code of Best Practice - generally known as the ‘Combined Code’ - forms the basis for our governance structure. All listed companies are required to comply with the provisions of the code, or where they do not, to provide an explanation of why. United Utilities has been compliant with the Combined Code since its introduction in 1998 by the Financial Services Authority.

A revised combined code was published in July 2003 which applies to all listed companies with reporting periods commencing on or after 1 November 2003. The code sets out principles underpinning:

- the make up and appointments to the board;
- arrangements for remuneration;
- audit and financial control;
- communicating with shareholders, the owners of the business.

The revised code is widely seen and accepted as best practice, and we have sought to apply the principles within United Utilities.

The board

The primary responsibility for the running of the company rests with the group board. Underlying the code is the principle that a suitably experienced, informed board which is given proper support will take decisions in the best interests of the company’s shareholders. This is important; shareholders’ interests will often converge with those of the company’s wider group of stakeholders, but not always. We will come back to that later.
United Utilities’ board meets ten times each year with additional meetings called if required. The board has a formal schedule of matters reserved to it, ensuring that it takes all major strategy, policy and investment decisions affecting the group. In addition, it is responsible for business planning and risk management and for the development of group policies, including such areas as health and safety, directors’ and senior managers’ remuneration and for social, environmental and ethical issues. In addition to the Group Board, United Utilities Water plc and United Utilities Electricity plc exist to steer the operation of our licensed, regulated utility interests in the North West of England. They have a role, important to the economic regulators, of ring-fencing the regulated business.

Executive and non-executive directors

The board aims to maintain a balance of executive and non-executive directors. Currently, we have a non-executive chairman, four executive directors and five independent non-executive directors. The directors have a wide and diverse range of business experience and expertise. In addition to the six non-executive directors on the Group Board, two further non-executive directors sit on United Utilities Water plc.

One of Derek Higgs’s key recommendations was the separation of the roles of chairman and chief executive. In United Utilities, separate individuals have been appointed to the positions of chairman and chief executive, and the board has agreed clearly defined responsibilities for their roles, as well as a set of guiding principles to govern the relationship between them. The chairman is primarily responsible for the working of the board. The role of the chief executive is to run the group’s business and implement board strategy and policy.

In line with best practice in the code, the chairman holds meetings with the non-executive directors without the executive directors present. Correspondingly, led by the senior independent
director, the non-executive directors meet without the chairman present at least annually to appraise the chairman’s performance. This gives non-executives the time and space to raise concerns about the operation of the board or the business in the absence of those primarily responsible for day-to-day operations.

Information and support for directors

The quality of the contribution that directors, particularly non-executives, can make is directly dependent on the quality of the information, and support, they can receive. Accordingly, all directors receive comprehensive information on a regular basis. Board papers are normally distributed a week in advance of the relevant meeting to allow sufficient time for directors to be fully briefed. The papers are sufficiently detailed to enable directors to obtain a thorough grasp of the management and financial performance of the company and the operating businesses.

The board has established a governance framework which encourages all directors to bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments and standards of conduct. New directors receive appropriate induction training on joining the board. As part of this, we offer major shareholders the opportunity to meet a new non-executive director.

All directors have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are complied with. The appointment and removal of the company secretary are matters for the board as a whole. The board has adopted policies governing the rights of directors to obtain independent professional advice. The board also has a protocol under which directors have access, through the company secretary, to independent professional advice at the company’s expense where they judge it necessary to discharge their responsibilities as directors.
Delegating and working through committees

Effective as individual members may be, the board cannot do everything. The board has formally delegated specific responsibilities to board committees, and ensures that committees are provided with sufficient resources to undertake their duties. Our main committees are audit, remuneration, nomination, approvals, and treasury.

- The audit committee has primary responsibility for advising the board on internal and external audit of the company’s business. It recommends the appointment of independent, external auditors for approval by shareholders at the general meeting. Its members are the five non-executive directors.

- The remuneration committee makes recommendations to the board on the group’s framework of executive remuneration. It approves, on the board’s behalf, general recruitment terms, remuneration benefits, employment conditions and severance terms for executive management and decides specific employment terms and conditions for executive directors and other senior executives. Its members are the non-executive directors, advised by independent consultants.

- The nomination committee leads the process for board appointments, making recommendations to the board about filling board vacancies and appointing new members. The committee makes recommendations on the board’s composition, balance and membership. The committee’s members are the non-executive directors, including the chairman together with the chief executive.

- The approvals committee considers and approves expenditure and investment proposals within limits delegated by the board. Its members are the executive directors, the group strategic planning director and the company secretary.
The treasury committee considers and approves borrowing, leasing, bonding and other banking facilities within limits set by the board. Its members are the chairman, the chief executive, the group finance director and one of the other executive directors together with, for more significant or complex transactions, one other non-executive director.

Taken together, the committees extend the board’s power and influence in setting the strategic direction for the company and in assessing the company’s overall performance. Minutes of committee meetings are circulated to all board members.

Internal control system – evaluating and managing risk

The board is responsible for the group’s internal control framework and for reviewing its effectiveness, meeting the requirements of the combined code relating to internal control (Internal Control Guidance for Directors on the Combined Code, September 1999). Each year the board reviews all controls, including financial, operational and compliance controls and risk management procedures. The internal control system is designed to manage, rather than to eliminate, the risk of failure to achieve the group’s business objectives and can only provide reasonable, and not absolute, assurance against material mis-statement or loss. The key features of the internal control system are:

- a control environment with clearly defined organisation structures operating within a framework of policies and procedures covering every aspect of the business;

- comprehensive business planning, risk assessment and financial reporting procedures, including the annual preparation of detailed operational budgets for the year ahead and projections for subsequent years;
• a monthly board review of financial and non-financial key performance indicators to assess progress towards objectives;

• monthly meetings prior to each board meeting of the executive leadership team, a forum in which the executive directors, the managing directors of the group’s businesses, the group functional directors and the company secretary exchange information and discuss strategic and operational issues which are of group-wide importance;

• regular monitoring of risks and control systems throughout the year by the operating businesses, supported by the use of risks and issues databases;

• a self-certification process, subject to internal audit, whereby the operating businesses are required to confirm that the system of internal control is operating effectively;

• an internal audit function to provide independent scrutiny of internal control systems and risk management procedures;

• a bi-monthly risk management forum chaired by the group finance director, and comprising the company secretary, the group internal audit manager, the group health and safety manager and senior representatives from each of the operating businesses, to scrutinise key risks in depth;

• a quarterly Corporate Social and Environmental Strategy Group, chaired by the chief executive, and comprising the managing directors of each of the group businesses. The role of the group is to advise on environmental and community policies, and in particular, to identify risks to the environment, recommend targets, and monitor performance against those targets;

• an annual risk assessment exercise involving self-assessment by management of all business risks in terms of impact,
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likelihood and control strength and an objective challenge of that assessment by the internal audit team;

• an annual health and safety performance review carried out by our in-house safety professionals in addition to the normal health and safety risk assessment and management processes carried on within each of the operating businesses;

• centralised treasury operations operating within defined limits and subject to regular reporting requirements and internal audit reviews;

• established procedures, set out in a group internal control manual, for planning, approving and monitoring major capital expenditure, major projects and the development of new business which includes short and long-term budgets, risk evaluation, detailed appraisal and review procedures, defined authority levels and post-investment performance reviews.

Communicating with shareholders

An important part of the board’s role under the Combined Code is in communicating with shareholders. We do this through an ongoing programme of investor meetings and presentations in the UK and overseas, through the annual general meeting, through written reports and new media.

For example, in 2003/2004, the board met or offered to meet with 110 different funds, representing 44% of the company's issued share capital. This, together with regular announcements of significant events affecting the group and frequent updates on current trading, emphasises our commitment to keep our equity and debt investors informed of developments affecting the group. The board regards this programme as important to improving investors’ awareness of the business and for the board to gain an understanding of investors’ priorities.
The board encourages shareholders to exercise their right to vote at the annual general meeting, and in common with most large companies, we are seeing greater shareholder activity at our annual meetings. Presentations are made on the progress and performance of the business prior to the formal business of the meeting. Shareholders are encouraged to participate through a question and answer session and individual directors or, where appropriate, the chairman of the relevant committee, respond to those questions directly. Normally, the chairmen of the audit, nomination and remuneration committees will be available at the annual general meeting to answer questions relevant to the work of those committees. Shareholders have the opportunity to talk informally to the directors before and after the formal proceedings. Voting on all resolutions takes place by means of a poll, ensuring that all shareholders' votes are taken into account, whether lodged in person at the meeting, or by proxy.

The interim report, the annual report, the stakeholder report and summary financial statement remain the primary means the board has of communicating during the year with all of the company’s shareholders. In the coming years, the requirements of the Operating Financial Review will change the style of our reporting, and companies will be required to give more information about the nature of the business and the risks and challenges it faces.

We are also increasingly making use of the internet as a means of communicating widely, quickly and cost-effectively. Financial news releases are made available on the site contemporaneously with release through other news channels and anyone with an email address can register free of charge to receive an email alert upon the posting of each new release.

Corporate governance as self-regulation

Appropriate, balanced and well-informed governance can help a company mitigate risks and grow sustainably in the interests of
its shareholders. In the broad sense, corporate governance is simply the way a company manages, or regulates, its activities.

But can effective corporate governance substitute for more traditional, external regulation? Or in other words, will external regulators, including government, take account of effective corporate governance in future decisions about the scope of regulation?

It is clear that ineffectual corporate governance can lead to intervention by policy makers, and to tightening standards. In the US, the high-profile demise of Enron, Worldcom and Andersens led directly to the Sarbanes-Oxley Act to reform accounting in public companies and protect investors. In Europe, the Commission has put forward new rules for auditors in an attempt to prevent a repetition of the Parmalat scandal. In the UK, there has been no similar rush to legislate. The government recognised that accounting standards were “different and, and is now widely acknowledged, in some respects better” (Patricia Hewitt, July 2002).

Nonetheless, the failures did raise awareness of potential risks, and expectation of action in the UK. This came in the review of the Combined Code, and continues in DTI’s ongoing review of company law. Failures by some companies have led to action affecting many thousands; and in a global economy, few companies will be immune from the new US laws.

Recent history suggests then that governments will, rightly, act to introduce higher standards where there is failure. What is less clear is whether governments and regulators will be prepared to deregulate where companies are developing stronger internal controls.

The prospect is attractive, but currently seems remote. While the Combined Code forms an important part of the way the corporate world governs itself, many more detailed and technical codes and standards exist for the operation of a company’s management
systems. In areas such as health and safety and environmental management, certification is often formally awarded by external bodies. But the evidence seems to be that such certification, while a useful discipline in its own right and for dealings with other companies, weighs little with regulators in their approach to dealing with individual companies. The Environment Agency has, for example, recently been publicly critical of the performance of ISO14001 (Environmental Management).

There is a further dimension with the Combined Code, to which I alluded earlier. The code is a framework for the operation of company boards, whose ultimate duty is to the company’s shareholders. With some licence, this can be extended to current and future shareholders, but it does not explicitly extend to the wider community in which a company operates.

Of course, in taking decisions in the interests of shareholders, boards may frequently find common cause with other stakeholder groups, of customers, interest groups and the wider public, regulators and government, and business partners, all of which have some stake in the continued operation of the company. It would be surprising if this were not the case, since a company’s long term prospects are likely to be limited if it is constantly at odds with its stakeholders. But there can be differences, particularly over shorter time horizons.

For the regulated industries, these differences come to the fore at price reviews, and are resolved not by boards but by ministers and regulators. For example, stakeholders can differ greatly on investment priorities in the water sector. Ultimately, decisions on prices and investment programmes are taken by regulators, taking into account the priorities set by government, in turn informed by advice from interest groups. The role of companies is then to deliver regulatory contracts as efficiently as possible.

In other words, the ability of boards of regulated industries to take strategic decisions embracing a wider set of stakeholder interests is limited, many of the more important choices having
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been taken elsewhere. Their role is in overseeing the organisation and activity of companies to ensure that shareholders secure the best value for their investment over the longer term. Ironically, in so doing, they can tend to be forced into shorter term, tactical decisions which are less beneficial for other stakeholders.

One area where improved corporate governance has changed the mindset of directors has been in the area of boardroom pay, a source of severe criticism in the nineties.

Summary

The combined code has been a useful standard for corporate governance in the UK, and is widely accepted as good practice. Adherence to its principles has largely protected UK companies from the regulatory backlash of high profile company failures overseas.

High standards of corporate governance - and corporate responsibility - are expected of regulated industries, given the essential nature of the services they provide, their history in the state sector and their close links with local stakeholders. Failings in early days of privatisation, particularly on issues of boardroom pay, have largely been corrected, though reputational echoes continue.

The extent to which boards of utility companies can balance the interests of stakeholders is an issue. The combined code focuses on the interests of shareholders. Most strategic business decisions are taken remotely by government and regulators. This both circumscribes the territory in which boards can work and dictates the agenda which boards need to follow. High standards of corporate governance remain important, but are only part of a broader decision making process in which external interests play a prominent role.
13 REFORMING THE RAILWAYS: A RESPONSE TO THE 2004 WHITE PAPER

Sir Christopher Foster and Chris Castles

Introduction

The rail privatisation the Labour government inherited from the Conservatives was flawed in crucial respects. Its design and implementation had been rushed, regulatory roles and relationships were confused, some contractual arrangements were badly designed and incentives misaligned. Nevertheless, until the accident at Hatfield in 2000, rail traffic was growing rapidly, performance was improving and investment was increasing. The new industry arrangements had introduced the vital element of competition within the industry and new incentives to improve performance.

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Chris Castles is a transport economist with over 30 years experience of transport policy, strategy and business planning. He was partner-in-charge of PricewaterhouseCoopers’ transport practice for 15 years where he worked extensively on policy, economics and strategy work for the railways and other transport industries. He now works as an independent consultant.

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Sir Christopher Foster and Chris Castles
The reaction to the Hatfield accident precipitated a sharp fall in performance and reliability to below levels experienced either under British Rail, or since privatisation. It has also led to a loss of control over industry costs, largely driven by concerns over safety and risk averse behaviour by those working in the industry following the political and media reaction to Hatfield, and two previous accidents. As a result, Britain’s railways are now in a mess. Train service performance remains below the level when the government took power in 1997 and, since the Hatfield accident, industry costs have escalated alarmingly so that the government’s strategy of substantial further growth in the use of rail transport by 2010 is now unachievable. Widespread dissatisfaction with the structure of the industry, and how it operates in practice, was also a factor inducing the government to initiate a major review of the industry at the beginning 2004. This should have provided an opportunity to stand back and think carefully about what needs to be done to restore Britain’s railway to a viable future.

The solutions to the industry’s current problems need to be based on an analysis of their underlying causes. As there seems to be no consensus on precisely what has gone wrong and why, it would have been helpful if the 2004 white paper, The Future of Rail, had provided such an analysis, substantiated by evidence. Although a large part of the white paper is devoted to a discussion of the causes of the current situation, the diagnosis avoids discussing some of the fundamental reasons for the loss of control of costs and the decline in performance, probably because they resulted from actions taken by this government since privatisation. Many of the government’s initiatives and exhortations have undermined the incentive structure in the industry, as well the confidence of those who work in it, and have contributed to the current crisis. The creation of Network Rail has returned the risks associated with the provision of infrastructure back to the taxpayer, while the propensity of the Strategic Rail Authority (SRA) to renegotiate, rather than re-bid, failing train operating franchises has had the same effect on the provision of train services, so that now the private sector is
taking few risks but the government continues to pay a risk premium for the financing of the industry.

The white paper does accurately, if belatedly, identify many of the problems that it inherited in the original privatisation. In particular, it highlights weaknesses in the way that policy decisions can be translated through the industry's regulatory and incentive arrangements and some of the flaws in the contractual arrangements put in place at the time of privatisation. But throughout the white paper the government makes general references to a distorted market-based system without identifying the specific causes of these problems or how they can be solved. Instead, it makes rather vague proposals that appear to involve imposing a centralised specification of what the government believes the customers require from the railway, backed up by central control of the timetable by Network Rail, an organisation which also has no direct contact with rail users. These requirements will however, necessarily, have to continue to be delivered through the contractual structure of the industry, which the government has criticised but without saying what it will do to address the issues.

In this paper, we summarise some of the main points that we made in our own submission in March 2004 to the government’s review.\(^2\) We start by identifying our view of the key problems and then outline the proposals we made to government for reform of the industry’s policymaking and regulatory framework and comment on the government’s proposals.

\(^2\) Sir Christopher Foster and Castles C (2004), Creating a Viable Railway for Britain – What Has Gone Wrong and How to Fix It, March 2004. See also for further analysis of the problems of rail privatisation and subsequent government relations with the industry, Foster C D (2005 forthcoming), British Government in Crisis, Hart Publishers.
Escalating railway infrastructure costs

Until it was privatised, Railtrack operated under government cash limits which were based on BR budgets, assuming some productivity gains. When the regulator set the level of Railtrack’s initial access charges in 1994, he expected the costs of maintenance and renewal (M&R) of infrastructure to be below £2bn per year, and he applied substantial reductions to the proposals put forward by the company (based on BR budgets and accounts). In fact, Railtrack spent £2.5bn a year on M & R after it was privatised, which was funded by increased private sector borrowings. Yet it was still heavily criticised by the Labour government and the new regulator for under-spending. As a result, in the next regulatory settlement reached in 2000, Railtrack was to be allowed over £3bn a year for M&R.

In the event, the government put Railtrack into administration as a result of a cash crisis resulting from the emergency expenditure after the accident at Hatfield in October 2000 and the government’s withdrawal from its April 2001 refinancing agreement with Railtrack. This was triggered by the company’s proposal to have its price-cap regulation temporarily suspended. Instead, the government decided that Railtrack’s role should be taken over by a ‘not for dividend’ company – Network Rail – funded by private sector loan finance, guaranteed by the SRA, therefore in effect backed by the government. This has effectively returned infrastructure risks back to the taxpayer and, as the previous regulator observed, made it difficult to develop effective means of incentivising Network Rail's management.

The accident at Hatfield precipitated a loss of control of railway infrastructure costs as railway managers became risk averse (see below). Network Rail submitted a business plan to the regulator proposing a further huge increase in expenditure to an average of £6bn per year for the next 5 years. It claimed this was needed to make up for ‘decades of under-spending on rail infrastructure’- a claim that has not been substantiated and has been challenged by
informed industry observers.\(^3\) What is clear, and is recognised in the white paper, is that unit costs of carrying out maintenance and renewal activity have increased alarmingly, resulting in a major reduction in productivity in the industry for reasons that have not been adequately analysed.

Network Rail’s answer to this issue has been to take back maintenance activity in-house. This is likely to weaken the effectiveness of competition in the supply of maintenance services and the associated labour markets. This decision may help Network Rail to understand its maintenance requirements and its costs better in the short term, but it should not be the long term solution. As pointed out by Stephen Glaister in a recent paper, one of the major causes of the increase in rail industry costs has been the rising level of wages in the industry.\(^4\) Rail workers’ average hourly wages have increased by 50% more than average earnings since privatisation. Experience suggests that eliminating the potential for competition in the supply of maintenance services will only strengthen the position of this group of workers to demand higher wages at the expense of the taxpayer, while not encouraging management efficiency.

There is no reason why railway infrastructure maintenance cannot be successfully outsourced from the asset owners. Other safety critical industries, such as the airlines, have done this efficiently, and indeed railways throughout Europe (including France) have been moving in this direction. It has been shown to be practicable for not-for-profit asset owners to outsource in this way, as evidenced in the water industry by Glas Cymru in Wales, one of the models for Network Rail. What is needed is for it to be done properly in the railways. As soon as Network Rail develops its asset register and populates it with data, it will be better able

\(^3\) Ford R (2003), BR Infrastructure Maintenance Spend Shock, Modern Railways, August.
to manage its assets and outsource maintenance and renewal efficiently without losing control

Between 2001 and 2004, Railtrack in administration and Network Rail increased spending to broadly the level of £6bn which Network Rail was claiming from the regulator while price controls were temporarily suspended and he carried out a further review of infrastructure expenditure requirements post-Hatfield. The regulator concluded that Network Rail should be allowed approximately £5bn per year from 2004, compared to the £3bn he had earlier agreed for Railtrack. Meanwhile, Network Rail’s level of debt has risen alarmingly to over £10bn as the government has chosen to defer the funding of rail infrastructure expenditure from revenue grants or increased access charges (via increased subsidy to train operators). Therefore, instead of subsidy steadily reducing while rail traffic expands, as originally envisaged, the government will have to meet escalating levels of subsidy in the future simply to maintain the current level of traffic on the railway.

At the root of the difficulties Railtrack experienced in managing its maintenance was the failure of the maintenance contractors, once privatised, to realise the productivity improvements, through the better use of labour and the introduction of new technology, which it was predicted would be possible at privatisation. This was compounded by flaws in the contractual arrangements and Railtrack’s subsequent failure to manage its contractors effectively.

The government of the time laid down the policy framework requiring outsourcing of M&R work and the detailed contractual arrangements were designed by BR staff, many of whom were subsequently employed by the newly privatised M&R contractors. The maintenance contracts concerned were fixed price and output-based, with performance regimes that had liabilities capped in order to make the new companies more saleable. This effectively meant that the maintenance companies themselves decided what work needed to be done and they made
proposals on whether renewal rather than maintenance was required. Since renewals were carried out by separate companies they owned, the incentive was for the maintenance companies to do as little as possible for their fixed price work and to seek to shift work onto the renewals companies who were paid on the basis of work done.

Although it was paying for the maintenance and renewals concerned, and it had the legal responsibility for the condition and safety of its infrastructure, Railtrack’s day-to-day role in M&R processes was limited. Since most of BR’s engineering staff and much of the information on the inventory and condition of its assets were handed over to the M&R companies during restructuring, Railtrack did not inherit the information, or the experienced people, to manage its own assets adequately. Neither had it the tools to monitor the work that had been done, or to decide what was needed, or to determine the costs of maintaining and renewing its own infrastructure. It did not have an asset condition register to monitor the state of its assets. Instead it relied on its limited inspection resources and indirect ‘output’ indicators, like the incidence of broken rails, to assess trends in the condition of its assets. Railtrack could not therefore be sure it was receiving value from the increasing amount of money being spent on M&R, or whether some of it was being lost to inefficiency, or excess profits for the M&R companies.

Though these inherited issues were largely not of its original making, Railtrack was slow to address them. Because of agreements entered into when the M&R companies were sold, before Railtrack was privatised, it could not restructure its maintenance contracts until 1998-99. Meanwhile, it did not rebuild its engineering expertise sufficiently to manage its contractors effectively under the inherited contracts. Its contract managers tended to lack railway experience and could not stop the maintenance contractors withholding information and neglecting to keep the asset databases in their charge up-to-date. Although it made some incremental changes in its organisation and in supply contracts, Railtrack did not start developing its
own asset register until it had started to replace the initial contracts with its own versions, which gave it better access to data, in the year or so before it was put into administration.

One consequence of the continuing lack of access to essential information on infrastructure assets was that neither Railtrack, the regulator, the SRA, nor any other interested parties had the means to understand the efficient costs required for maintenance, renewal or investment in the railway infrastructure, and therefore how to manage these costs, or to forecast them reliably. This created a crucial weakness in the system of regulatory controls in place for the 2000 periodic review and the 2003 interim review; a weakness which still persists.

The application of price regulation depends on the ability to make reliable forecasts of efficient expenditure requirements. Thus, although there were two long drawn out regulatory review processes carried out in 1998-2000 and again in 2002-2003 to reach a determination on the costs required, both Railtrack (and subsequently Network Rail) and the regulator were working largely in the dark throughout these processes, with inadequate information. As a result, the regulator continuously changed his view over the level of spending required for rail infrastructure. There remains a high level of uncertainty surrounding the cost requirements of the railway, while the incentives to manage these costs were considerably weakened, first by the process of administration, then by the creation of Network Rail, and finally by amendments to the regulatory regime in 2003, with many more of the associated risks now lying with the government. Yet, in the white paper, the government has decided to place heavy reliance on the ability of the regulator to price accurately the infrastructure outputs that the government will specify.
Other contractual flaws

Although they worked better, there were flaws in other contracts designed during privatisation. Each set of contracts - the franchising agreements between the Train Operating Companies (TOCs) and the SRA, the access agreements with Railtrack, the leasing agreements with the Rolling Stock Leasing Companies (ROSCOs) and the infrastructure M&R contracts - were designed separately by different bodies. They ran for different time periods and their performance regimes and other incentives were not consistent with one another. Consequently, despite the regulator in recent years greatly improving the contractual arrangements at the TOC/Network Rail interface, there remains some inconsistency between the incentives operating on the interdependent operating organisations in the industry, so that they sometimes work against each other. What was urgently required was to build on and implement the work already carried out by the regulator to complete a revised set of contracts between the TOCs, ROSCOs, Network Rail and the infrastructure M&R organisations, which are ‘back-to-back,’ so that each had consistent and self-reinforcing incentives.

Thus, as an example of the problem, the original Railtrack performance regime gave it a strong financial incentive to improve train delay performance. Hence it delivered a 40% improvement in train delays attributable to it in the first two years. But Railtrack was given little automatic incentive to accommodate growth in demand on the network, since most of its access charges were intended to be cost-reflective and accordingly the bulk of its revenues was fixed.

The TOCs, on the other hand, had a strong incentive to grow demand and revenue, but relatively weak train performance incentives. Hence passenger demand and the number of train services grew rapidly but the TOCs’ performance in minimising train delays was disappointing. This growth, however, put further strains on Railtrack’s under-funded infrastructure. Neither the government nor the SRA developed policy leadership to address
the consequential mismatch between supply and demand. Although attempts were made by Railtrack and some TOCs to negotiate increases in access charges to pay for additional capacity, this ad hoc approach failed at the network level because the SRA was unwilling to become involved in agreements which would inevitably result in an increase in subsidy requirements. Similarly, while the regulator placed new automatic, taxpayer-funded, incentives on Railtrack to grow passenger and freight traffic from 2001, in parallel the SRA required TOCs to cut services to improve reliability in the period from 2001, when the regulator’s incentives were intended to operate.

The experience in the post-privatisation period to 1999 nevertheless illustrated the power of financial incentives to drive performance and the positive results that can be achieved (at least when such incentives are operating on private sector companies). This should have pointed the way to improving the incentive framework for the industry to address the weaknesses inherited from the privatisation process. Unfortunately, the present government has pointed the industry in the opposite direction and has failed to address the weaknesses in the incentive regime, while undermining the basis on which the existing incentive structure operates.

The white paper states that access charges no longer reflect the specific costs that train operators impose on Network Rail, thus distorting incentives. It also expresses concern at the way the penalty regime between the train operators and Network Rail now results in large flows of money from Network Rail to the train operators as a consequence of the failure to restore performance to pre-Hatfield levels. In both cases, the answer is to correct the incentives. The regulator introduced infrastructure congestion charges and more cost-reflective access charges from 2001, and re-calibrated the performance regime in 2003 to reflect the current realities of rail performance; but the SRA embarked, in parallel, on a different restructuring of franchise incentives. The white paper makes general criticisms of the industry incentive regime but makes no constructive suggestions to fix it.
Without such incentives, it is not clear how the government propose to operate the contractual structure with the private sector, on which it will have to rely to deliver train services, and rolling stock. The Office of Rail Regulation (ORR) has indicated that substantial detailed work remains at industry level to address these problems.

No strategic leadership and confused regulatory arrangements

The Labour government inherited a rather confused set of regulatory arrangements, which it proceeded to confuse further. A major mistake of the Conservative government was not to clarify the roles and specific responsibilities of the two regulators, a failure that led to endless friction, not helped by the Labour government appointing two unusually adversarial people to the relevant posts.

The role of the franchising authority, Office of Passenger Rail Franchising (Opraf), was to let the train operating franchises against minimum service specifications so as to achieve value for money from the subsidy provided. The original idea had been that the first franchises would run for a limited period of seven years to allow time for the train operating companies, Railtrack and Opraf to determine the affordable investment needed for future development. This investment would then be funded during the next round of franchises. Railtrack was funded to carry out its M&R work but not to expand capacity substantially, since long run trends in rail usage had indicated that there would be limited demand growth. Any additional capacity that might be needed before the next re-franchising round would be agreed by ad hoc negotiations between Railtrack and the TOC concerned, with support from Opraf, if and when justified economically.

In fact, the unexpected growth in demand did put strains on infrastructure capacity, but, as noted above, the process of
negotiating capacity enhancement bilaterally between Railtrack and the TOCs - from which, in the event, Opraf/SRA largely stood back - did not prove workable, partly because any enhancement investment in a loss-making industry was unlikely to be financially viable and would require substantial support from government. Opraf/SRA, as the arbiter of economic value and the primary funder of investment, needed to take a more central role if robust capacity enhancements were to be agreed.

The significant exceptions to this pattern were the West Coast Mainline (WCML) renewal and upgrade project and the Thameslink 2000 project, both of which had been well advanced in the planning stages within BR. In the case of Thameslink 2000, planning delays resulted in the project being repeatedly deferred.

In the case of the WCML project, Railtrack first entered into a fixed price, output-based, access contract with Virgin that had been negotiated between Opraf and Railtrack before the franchise was awarded. Following bilateral commercial negotiations, this was subsequently amended to include further upgrades specified by Virgin, on which its financial franchise commitments to Opraf depended. It was then further altered to include (unfunded) public sector requirements specified during the regulatory approvals process. None of these proposals were subject to any investment appraisal, although ultimately they would largely be funded by the taxpayer. In addition to the extremely onerous commercial terms involved in the resulting deal, Railtrack’s experience in attempting to deliver its commitments for this project exposed its lack of understanding of its existing assets, the proposed new (and untested) signalling technologies, its inability to plan robust timetables for the new service commitments, and its inability to estimate or manage its costs. The estimates for completion escalated from £2.1bn to £13bn at one stage, before the scope of the project was subsequently cut back by the SRA, to enable the current estimates of under £10bn to be derived. This loss of control of its flagship project was a major cause of the subsequent failure of the company.
The Strategic Rail Authority (SRA) was created to replace Oprafto provide strategic leadership in the industry. It was a
recognition of the difficulty being experienced in dealing with
the strategic and policy issues in the industry, such as long term
investment, the appropriate balance between subsidy and fare
box revenue, efficient targeting of subsidy and the management
of the supply/demand balance for rail capacity. Due to delays in
the enabling legislation, the SRA did not come into formal
existence until 2001, after Hatfield, although it spent a
considerable time operating in ‘shadow’ mode.

However, once again the revised role, responsibilities and mode
of operation of the SRA did not appear to have been properly
thought through, or communicated. Instead of developing a
strategic plan to address the policy issues and choices for
government and preparing the investment plan for the industry,
the new chairman decided that the process of developing the
railway should be driven through the train operators, who would
submit their own plans in competitive bids, with investment
commitments, for long term franchises, but without the aid of
guidance, or useful criteria, from the SRA on what it would wish
to buy as the primary funder for most of the investment.

This created considerable difficulties for the bidders in trying to
anticipate what scale and composition of investment would be
attractive and socially worthwhile, given that most investment
could not be profitable and would only be justified on
economic/social criteria. It also created difficulties for the SRA
in trying to compare the relative merits of very different
alternative plans and bids through a competitive procurement
process under public sector rules. The problems were further
compounded by the slow development of revised
economic/social appraisal criteria within the SRA, which were
founded on the New Approach to Transport Appraisal (NATA)
that relied on multi-criteria evaluation, taking into account a
wider range of factors, both quantifiable and unquantifiable, than
had been included in previous cost/benefit appraisals. The SRA
appears to have made little progress in developing a strategy for
the development of the railway and only recently have appraisal criteria for evaluating the economic viability of rail services and investment been applied to strategic planning (eg, in route utilisation strategies).

These uncertainties, together with the inherent difficulties in making reliable estimates of the costs of major investment in the railways, made the whole process extremely risky for bidders. Railtrack, the owner of the infrastructure, was marginalised in this specification process. In consequence, because critical projects such as the connection of the high-speed Channel Tunnel Rail Link to the conventional network, and the east coast upgrade, had to proceed with planning and initial works, Railtrack effectively planned its enhancements in parallel. To meet licence requirements of the regulator, it published a series of Network Management Statements with ever increasing lists of (unfunded) investment proposals that SRA failed to prioritise.

The result of these parallel processes was that Railtrack and the SRA could not agree clear project specifications or firm costings for them. Railtrack’s cost estimates suffered from a systematic tendency to creep up, as had British Rail’s. Coupled with its west coast main line problems, this experience convinced the SRA that Railtrack did not have the management capacity to implement major new investment schemes. Therefore the SRA proposed that ‘special purpose’ vehicles be used to raise the finance for the schemes and that private sector consortia with the relevant skills would manage them. It was unclear how the complex interfaces and interdependencies within the network would be managed by this means. In the event, no such schemes were developed to a successful conclusion before Railtrack was put into administration, and two years and a lot of resources were wasted.

Little work was done to evaluate whether the present levels of infrastructure expenditure to sustain the network in its existing form, recently sanctioned by the regulator in his Interim Review of Network Rail’s expenditure plans, are economically justified.
The SRA’s Network Output Statement – produced as an input to the Interim Review in 2003 - appeared to imply that it viewed different outputs to those proposed by the regulator as being more economic. But as the regulator did not base his conclusions on this Statement, the true position is not clear. Without these essential elements, it is hard to see how the SRA, or a successor body, can give strategic leadership. The lack of a rigorous public sector process for planning, evaluating and prioritising rail investment using economic appraisal criteria left the industry in some confusion and unclear over the long term direction and future development. In the meantime, the pragmatic response was to try to maintain services within the financial resources available, much as had been pursued by British Rail.

The confusion has been compounded by the expansion of the role of the regulator. The independent rail regulator was created to provide comfort to private investors in TOCs that the government, through Opraf, would not set both the quantity of outputs required from TOCs in franchises and also the price and quality of the required inputs in monopoly supply (in access agreements). It also had a role in consumer protection and carried out tasks related to this objective with the support of passengers’ committees. The original prime functions envisaged for the regulator were to establish the level of Railtrack’s access charges, to review and approve the access agreements between Railtrack and each of the TOCs, and to oversee the operation of the contractual arrangements in the industry and resolve any disputes arising.

However, the Labour government’s commitment to ‘tough’ regulation soon led to the introduction by the regulator of additional, and overlapping, direct licence based controls on Railtrack, in addition to its commercial obligations through its TOC contracts. These licence obligations enabled the regulator to require Railtrack to invest and to meet output targets decided by the regulator, not the SRA (or individual train operators), although the SRA would effectively be required to pay for these requirements through government subsidy. These licence based
obligations resulted in responsibility for determining Railtrack’s expenditure and investment obligations being split between the regulator and the SRA with no clear demarcation of responsibilities.

The disastrous failure of the SRA to develop a strategy and an investment plan for the industry left a void which the regulator sought partially to fill, but without having the essential information, tools and expertise. He relied heavily on consultants to carry out the technical work for his reviews, although these advisers often had insufficient reliable information to work from and were not in a position to make the policy judgements implicitly required for their work. It should have been obvious that the idea of one body, the SRA, controlling the specification of train services and funding the costs involved, while another, the Office of Rail Regulation, separately determined the outputs, investment obligations and funding requirements of the infrastructure paid for by the train operators (but ultimately by the government through subsidy), was a nonsense.

Since the government, and not the rail user, is the marginal funder of the rail infrastructure, the effect has been that the regulator’s decisions on the volume, quality and price of infrastructure outputs effectively commits the government to funding the consequences of those decisions, although it was the SRA, as the agent of government, which had the budgetary responsibility for the railway. It is difficult to see what the regulator ‘having regard to the SRA’s budget,’ as he is required to do, can mean in practice if the SRA has not developed a properly evaluated and prioritised plan for the development of the railway and the regulator seeks to impose his own output targets on the infrastructure owner (essentially based on historic outcomes) without the necessary analysis for their justification.

Given the volatility demonstrated in the cost estimates prepared by the infrastructure owner and reflected in the regulator’s decisions in recent years, and the inherent uncertainty in any estimates of these costs under current circumstances, it is
unfortunate that the government seems to have accepted the levels of infrastructure expenditure currently proposed by the regulator without carrying out the work to understand the reasons for the massive cost escalation in the management of the rail infrastructure, or whether the latest levels of funding can be justified economically.

The government’s answer to these issues was to propose to abolish the SRA and to take its functions within government, while relying on the regulator to provide, in the future, more reliable determinations of the costs of supplying Network Rail’s infrastructure than has proved possible so far. However, it is difficult to see how this proposal will address the fundamental issues that have led to the current situation, particularly the breakdown in the control of costs in the industry.

Responding to risk

There is little doubt that one of the major causes of infrastructure cost escalation since 2000 has been the direct and indirect consequences of the heightened level of risk aversion that now permeates the behaviour of managers, staff and regulators operating in the industry. The reason for this can be traced to the reaction of the government and the media to major accidents on the railways since privatisation. But it was also sensitised by the earlier hostility exhibited by the government (and its appointees) to the privatised industry from the outset. This created a climate of blame and recrimination and a corresponding defensiveness in the industry that was not conducive to efficient operations.

Early on John Prescott mounted a campaign of public criticism of the privatised railway for its performance record, despite the evidence of the improvements achieved. This was later reinforced by regular public criticism from the new regulator, focused largely on Railtrack. When the Ladbroke Grove accident occurred in 1999, the reaction of the government was to ‘spin’ the blame onto Railtrack, notwithstanding the fact that the
accident was caused by a driver passing a red light at danger. In fact, the safety record of the privatised railway had been better than under BR, a fact now acknowledged by the government since it has recognised the damage done by its previous stance. Yet politicians and the media at the time created a crisis atmosphere following Ladbroke Grove. The police turned the site of the accident into a crime scene, John Prescott branded the industry a national disgrace and Railtrack was to be ‘stripped’ of its safety responsibilities. Safety would be improved ‘whatever the costs’- a statement that was a considerable hostage to fortune. Railtrack was vilified in the media, the home addresses of Board members were displayed in the press and journalists harassed their families, as well as those of drivers and signalmen.

The safety regulators, and the Cullen inquiry that followed, drew the conclusion that there was a very low public tolerance of rail accidents. Consequently, it was judged that expenditure to improve safety was justified, even though the money would have a much lower impact on safety than if spent elsewhere. According to Professor Andrew Evans, the average cost of saving a life by the installation of train protection and warning system (TPWS) is £11m. Hence, even where railway projects were managed successfully (as in the case of TPWS) there was little economic prioritisation of scarce investment resources. Safety constraints became a major impediment to progressing investment in the railways. The safety regulator operates independently from the other two regulators and the impact of safety expenditure is not subject to consistent economic evaluation to enable policymakers to make the relevant trade-offs. Furthermore, the behaviour of those working in the industry became excessively cautious under the threat of jail sentences for railway staff and managers. This was manifested in defensive driving of trains, inhibiting improvements in train performance, premature and costly asset replacement, and the imposition of cumbersome new procedures slowing work on the railway.

Consequently, when the accident at Hatfield occurred in October 2000, and it was quickly apparent that the cause was the
breakage of a badly deteriorated rail, Railtrack management panicked and imposed hundreds of speed restrictions throughout the network wherever there was any suspicion of the condition of the rail. The damage to rail services was immense and the impacts on costs within the industry are still being felt. Without public support, rail managers were no longer willing to make the sensible judgements about levels of risk that are essential to efficient railway operations.

The accident at Hatfield and the response to it, including the placing of Railtrack into administration, appears to have precipitated a total loss of control of costs and train performance in the industry. Before Hatfield, Pollitt and Smith demonstrated that operating costs in the railways were being managed reasonably tightly, although cost estimates of major projects were escalating and there were doubts over whether maintenance activities were being managed effectively.\(^5\) The enquiry into the rail breakage at Hatfield confirmed those doubts. Since Hatfield, engineers and safety regulators have sanctioned huge expenditure increases, and are proposing much more, simply to restore the levels of performance prior to the accident by the end of the decade. The late Alistair Morton’s characterisation of the industry’s reaction to Hatfield as a ‘nervous breakdown’ was accurate; and it still has not recovered. Andrew Smith in a more recent paper has demonstrated the impact of these cost increases and shown that rail industry costs have increased by 47% since Hatfield, resulting in a sharp fall in productivity that is probably unprecedented in any similar industry.\(^6\) It will be difficult for those in the industry, including safety regulators, to return to rational behaviour unless they are given greater support from politicians and the media. In the meantime, the industry cannot deliver expected performance at a sensible level of costs until

\(^5\) Pollitt M and Smith A, The Restructuring and Privatisation of British Rail: Was it Really That Bad?

confidence is restored to those working in the industry, and a stable framework of effective efficiency incentives has been allowed to operate.

What should have been done

We argued in our submission to government in March 2004 that only a few changes were needed to the present industry arrangements. We believed most structural changes that were being proposed would bring no benefit to passengers. They would inevitably cause disruption, would be costly to implement and delay the actions by the industry on what really matters to restore control of costs and improve the industry's services to passengers. The government seems to have agreed with this diagnosis because the white paper itself offers few industry structure changes beyond abolishing the SRA and taking its functions inside government, and merging the economic and safety regulatory functions within ORR.

However, some important changes are needed to address the confusion of regulatory and policy roles, as the government has recognised in the white paper. More work is also needed to strengthen the incentive framework in the industry to encourage efficiency, but the government seems to have no confidence in incentives and appears to have opted for an uneasy hybrid of central direction and contracts with as yet undetermined incentives. However, since the white paper lacked any detail and was clearly ‘work in progress’, it is difficult to know what the final outcome will be. More work is currently underway to define the government’s proposals in detail and it is to be hoped that the unresolved issues and apparent weaknesses will be addressed in this process.

Our proposal was that the government’s original intention in its 1998 white paper, that the SRA take a central leadership role in the industry, should be implemented properly. This would require the government to provide a clear and consistent policy
framework for the industry and for the SRA then to discharge its leadership role within this framework. Given a more effective SRA, the Office of Rail Regulation would no longer need to fill the policy vacuum and set both the infrastructure outputs and the price of those outputs. Instead there would be a direct, commercial, contractual relationship between Network Rail and SRA that would determine the infrastructure outputs the government wished to buy (rather than the ‘binding arrangement’ funded by government-guaranteed debt, that is now proposed). The price for these outputs would be paid directly to Network Rail by SRA via revenue grants, rather than being arbitrarily split with some paid indirectly through access charges paid by the TOCs (as now). This would ensure that both train services and infrastructure outputs would be planned and delivered on a consistent basis, to consistent timetables, instead of the SRA specifying the train service franchises and the regulator specifying the infrastructure outputs (and, potentially, arbitrating over franchises as floated in the white paper).

The ORR’s role, under our proposals, would be to arbitrate should the SRA and Network Rail fail to reach agreement over the price of the outputs the SRA wished to buy. It would also retain appeal powers over access agreements with private train operators, so that these operators could not be undermined by decisions reached by the SRA and Network Rail.

In this way, the requirement for independent regulation to protect investors would be met. The SRA itself, as the guarantor, on behalf of the government, of Network Rail’s funding would have no interest in driving an unreasonable bargain that threatened Network Rail’s finances, while the role of ORR, as arbiter, would provide an additional defence for investors. The government put in place similar arrangements for the London Underground PPP, against which substantial private sector debt funding was successfully raised, without the type of direct government guarantees now required by Network Rail.
We believe that this arrangement would be more effective in controlling costs and preserving the independence of the regulator than the proposals made by the government in the white paper, since it enables the regulator to step back from a direct role in negotiating and deciding the detailed pricing arrangements for Network Rail. Instead, it would review the outcome of commercial negotiations enabling it to provide an informed challenge to Network Rail’s efficiency, while leaving the prices for outputs to be decided at a detailed level between informed customers (the SRA and the operators) and the monopoly supplier, unless they disagreed. Similar arrangements exist when large electricity users seek to connect to the National Grid. The ORR would only need to reach a judgement when arbitrating over any disputes arising (see later). Under such a structure, the public sector (at national, regional or local level) could still determine on a case-by-case basis when contracting out passenger train service provision to the private sector offered the best value for money – or, as many in the Labour Party have argued, it does not.

The government has now also recognised that it was a mistake for the regulator to take powers to set both the infrastructure outputs and the price that should be paid because this effectively commits the government to expenditure that it cannot control. However, the government now argues that the functions being carried out by the SRA must be carried out directly within government, under the control of ministers. We do not believe that the government needs to, or can be, directly responsible for all the detailed work needed to plan, specify and manage delivery through the contractual relationships with the industry. Indeed we believe its attempt to do this will not improve things and will make it less effective in carrying out its proper role in setting the objectives, direction, policy framework for the industry, including the high level decisions on the resources available. The white paper is silent on whether a new agency (like Opraf) will be needed to manage the details of franchise procurement – but in any event new skills will be needed that are quite different to those required for national policy-making.
The functions of acting as public sector ‘customer’ of rail services for the subsidy provided should be carried out by an organisation that has a degree of independence from government, although it must be answerable to it since it will be managing public resources. These functions involve carrying out detailed work on planning and specifying train service and infrastructure outputs and managing the contractual relationships in delivering these outputs. Whether this work is carried out by the SRA or a successor organisation is not important. What is important is that it is carried out by a commercially competent organisation that is not part of the ‘Whitehall machine’ and is distanced from direct ministerial control. This would preserve the transparency of information and public accountability that has been one of the benefits brought by the SRA. It would also be better able to harness the specialist skills required for the functions needed. And it would be less vulnerable to ministerial interference in response to short term events and expedients. The fact that the SRA has so far failed to perform these functions is due both to management and institutional failures. The confusion caused by the duplication of responsibilities with the regulator for setting infrastructure outputs targets, and the failure of the government to provide consistent policy leadership, inhibited the SRA from providing a strategy for setting a coherent investment and service plan for the industry.

The government clearly recognises some of the limitations of trying to perform the tasks required as a consequence of its decision to abolish the SRA, since it has proposed giving Network Rail and the ORR major new roles. Network Rail is to do the work on planning the maintenance, renewal and investment for the railway, planning the train service timetable and leading the operational co-ordination and control of the industry. The government is to rely on the ORR to provide a source of data and expertise and to ‘price the outputs’ from Network Rail agreed by the government and, presumably to apply the pressure needed on Network Rail to restore control of costs and improve efficiency. In our view, this gives Network Rail, an organisation dedicated to engineering excellence
according to its website, too strong a role in planning expenditure and risks enabling it to ‘write its own cheques,’ without the effective counterweight of an informed customer that would be provided by our proposals.

We also believe that the government’s reliance on ORR participating in an iterative process between Network Rail, the government and ORR, for planning infrastructure expenditure, specifying infrastructure outputs and pricing the results, until the government is satisfied with the outcome, risks prejudicing the independence of the regulator. It will bring the regulator too close to government in trying to balance the requirements of the government, setting realistic efficiency targets for Network Rail and protecting the interests of the lenders to Network Rail and its customers (and through them, passengers). The ORR currently lacks the information to be able to carry out the role of ensuring the accountability of Network Rail and it will, as in the past, be dependant on Network Rail for most of the new information required to price its outputs. The previous regulator was unable to control costs and efficiency levels in railway infrastructure supply due to the absence of adequate information on asset condition, or a basis for estimating the amount of maintenance and renewal needed, or expected levels of efficiency in these processes. Attempts at benchmarking these factors in other railways foundered on problems of non-comparability and data deficiencies. These problems will remain for some time while Network Rail does not have the incentives to address them and few sanctions can be brought to bear.

In the following sections we set out in a little more detail our view of how the contractual arrangements with Network Rail could be determined and outline the respective roles of the government, the SRA (or successor organisation) and ORR.
A contract with Network Rail

The white paper refers to a ‘binding’ relationship between the government and Network Rail to deliver the outputs specified. But it avoids the term ‘contract’ which would appear to be what is needed to make the arrangement binding. In practice, ORR have confirmed that the licence will remain the vehicle for enforcing Network Rail’s commitments, in tandem with the access contracts and its supporting Network Code. This is potentially influenced by the impact that a direct contract would have on the classification of Network Rail’s government-guaranteed debt by the Office of National Statistics.

Our proposal for the SRA to contract directly with Network Rail for the complementary infrastructure capacity supply agreements would however remove the confusion, conflict and duplication of functions between the SRA and the regulator that have blighted the industry for the past seven years. Establishing a direct commercial relationship between the SRA (or its successor) and Network Rail would provide the clarity which is lacking in the present arrangements of overlapping contractual incentives, licence obligations and indirect policy guidance governing Network Rail’s activities. It would enable consistency between the train service specification and the infrastructure outputs provided and the supporting incentive arrangements. It would also enable ORR to preserve its independence by standing back from the process of negotiation with Network Rail, and acting as a reviewer and arbiter in the process, while the SRA provided the initial challenge to Network Rail on its costs and efficiency while negotiating and enforcing the contract.

We believe that the process of negotiating a contract between the SRA and Network Rail and managing it on an ongoing basis would therefore provide a more effective means of regaining control over infrastructure costs than the regulatory review process whereby the regulator periodically makes a judgement on the future required level of Network Rail’s costs, balancing a whole range of interests in the process.
Our proposal envisaged a sharper, commercial basis for this decision in the negotiations between Network Rail and SRA and the incorporation in the contract of incentives to deliver specific outputs, with franchises adjusted to be internally consistent with the infrastructure commitments and funding. It would provide an informed discussion between the provider and the purchaser of infrastructure outputs on the choices and trade-offs to be made at a detailed level, including the flexibility to adjust these by mutual agreement, as required. An ongoing contractual relationship between SRA (or its successor) and Network Rail, combined with transparency of information, backed up by ORR’s regulatory powers of discovery, would provide the means of developing the detailed understanding of the factors driving infrastructure costs and the potential for improving efficiency. This kind of commercial arrangement was not possible under the previous arrangements and is unlikely to be possible under the government’s new proposals.

The implication of this arrangement would be that Network Rail would earn most of its revenue through revenue grants paid directly by the SRA (or its successor) rather than through the access charges paid by the TOCs. To an extent the switch to direct payment by the SRA for infrastructure capacity reflects what has already happened, since the regulator acceded in 2000 to a request that 40% of Network Rail’s income should be paid by grants from the SRA, rather than through access charges and the SRA requested that the proportion increased further following the Interim Review. However, the lump sum grant now in place is not structured to provide any incentives on Network Rail to deliver what the SRA is paying for – indeed the regulator made it clear that such a grant must be indistinguishable from access charge revenue for accounting purposes.

Rather than paying Network Rail through a lump sum grant that the regulator resets periodically as an outcome of access charge reviews, the SRA (or its successor) would under our proposal pay disaggregated fees for individual lines. These fees would be structured to include incentives on Network Rail to deliver
specific outputs for those lines. The fees would pay for the longer
term asset stewardship and outputs that the SRA requires of
Network Rail. There would be a performance regime in the
contract between the SRA (or its successor) and Network Rail
with penalties and rewards based on performance measures
relevant to the delivery of contracted capacity. We would
envisage that this performance regime would be developed in
consultation with the TOCs so that the performance measures
used are relevant to the reliable, long term delivery of
infrastructure capacity.

The TOCs would continue to have their contractual relationship
with Network Rail through access agreements as now. However,
the TOCs would only pay the variable element of access charges
designed to cover Network Rail’s variable costs, as freight
operators already do and in line with emerging European
practice. The contract between the TOCs and Network Rail
would be concerned with day-to-day operational performance,
including the availability of infrastructure, train delays and
customer service requirements. Performance regimes between
the TOCs and Network Rail would therefore continue to
incentivise day-to-day operational performance, with supporting
and consistent shorter term local output commitments under the
network code.

Clearly the two performance regimes between Network Rail and
the SRA (or its successor) and the TOCs must be designed to
ensure that Network Rail faces a consistent set of incentives from
its two customer bases - the SRA/government and the TOCs.
This need for complementary incentives with the public and
private sectors is already embedded in the licence and access
contracts currently in place with Network Rail.

Ultimately, we suggested Network Rail should be returned to the
private sector where it can operate under private sector
disciplines and incentives, and so benefit from the motivation
only financial incentives can provide. However, this is not
practical or desirable until it has established an ability to plan,
forecast and control its cost and performance reliably. Until this is done the risks of infrastructure supply cannot now be passed back to the private sector. Furthermore, until control is re-established and costs are brought down to a sensible level, Network Rail’s performance will remain a major risk to the re-establishment of a viable railway for Britain.

Clearly, it would be possible for the government’s proposed ‘binding arrangements’ with Network Rail to be based on licence obligations which mimicked the provisions of a contract. But it would be difficult to specify, manage and adapt over time the contract in the way we have outlined above, and to incorporate a charging and incentive structure of the kind we envisage to ensure Network Rail is properly accountable, if the government is going to rely on Network Rail to provide the plans on which the outputs would be specified, and on ORR to manage the arrangements. The government would need its own effective organisation, with powers similar to that of the SRA, to be able to implement and manage the kind of contract we believe is required.

The distinct roles of the government and its agent

It is the role of government to make the major policy decisions that will provide the framework for a strategy for the railways. These key policy decisions include the balance of resources devoted to road and rail transport, the financial limits on rail subsidy, the balance of rail funding between subsidy and fare-box revenue, setting criteria for the use rail subsidy and endorsing the consequential decisions on the regulation of fares, the size of the rail network and the scope of rail services supported by subsidy.

We also believe that there is a complementary role required, as an agent to the government, to act as the buyer of rail services
from TOCs and Network Rail. The role would also be to provide expert analysis and advice to government on policy and the planning of the railway and the outputs required, so as to enable the government to understand the impact of its own policy options on the railway and to make informed transport policy decisions. The role would also include managing the government’s relationships with the train service operators and Network Rail. We suggested in our submission to the Rail Review that this role should be carried out by the SRA, as the government had already equipped it with most of the legal framework required and had entrusted it with a strategic leadership role.

However, the government plans to abolish the SRA and do the job itself. We doubt if the Department for Transport can provide the right environment or acquire enough of the right skills to do this. However, the white paper also talks of a new franchising agency, which sounds more promising. The role we envisage could, at some cost in temporary disruption, be taken by a successor organisation with a similar relationship to government as the SRA. The SRA, or its successor, would have the specialists skills needed and would acquire the information and expertise to carry out this role through its ongoing contractual relationships with the TOCs and Network Rail.

The SRA/agent should use its information and experience on rail markets and costs to develop a strategy and investment plan for the railway, based on the framework of policy decisions provided by government outlined above and clear economic appraisal criteria. The strategy and investment plan would enable the SRA/agent to become an informed and rational purchaser of coordinated infrastructure and franchise outputs within the financial resources available to the public sector, something that the regulator is not in a position to achieve. This strategy would be more than simply a shopping list of projects. To summarise, the strategy would need three key elements:
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- The government would work with the SRA/agent to develop policy guidance on the balance of funding between road, rail and other public transport alternatives (e.g., buses, and light rail in urban areas) and the consequential financial limits on rail subsidy. Criteria for determining the allocation of rail subsidy would be developed, together with a consistent policy on the regulation of rail fares to ensure that the appropriate balance of funding from rail users and taxpayers, reflecting the distribution of non-user benefits, is achieved.

- Based on this policy guidance from government, the SRA/agent would review the allocation of subsidy between rail services across the network, and the scope and scale of services supported by subsidy, to ensure that limited taxpayers’ funds were being used in the most effective way possible to achieve the stated goals of subsidy. It would liaise with, and coordinate the inputs of, other public sector funders from Scotland, Wales, the PTEs and London, and regional and local authorities. It would publish the investment criteria it used and the calculations that show its use of them.

- Once a clear policy on pricing, subsidy and the scale and scope of services required was developed, the SRA/agent would then develop a coherent plan for the provision and use of rail capacity, the investment required and the level of funding. Its franchising and Network Rail contractual commitments would reflect this plan.

Neither British Rail, nor Railtrack and the SRA, were ever given this sort of rational policy framework on which to plan rail services and investment. If the railway is going to move towards delivering the government’s policy of long term growth in rail transport usage at affordable costs, the government must give the industry a coherent and forward looking policy framework. If there is a separate agency to deliver rail strategy and procure services efficiently, it must be clear over this policy guidance, which would be published through directions and guidance. Under our proposals, the government would make the key
strategic policy choices and set the policy agenda for the SRA/agent, providing it guidance on the issues it wants addressing. It would be the SRA/agent’s job to address this policy agenda, to carry out the analysis and present the policy choices and their consequences to government. In practice, there is a spectrum of policy choices that must be made, from high-level issues to detailed judgements on operational matters. The government should restrict its guidance to providing the high-level policy framework and delegate decisions on operational matters with policy implications (including withdrawal of individual services) to the SRA/agent, without intervening. Otherwise it would undermine the SRA/agent’s authority and effectiveness.

One of the most important policy issues is to attain the appropriate balance between revenue from customers and subsidy from taxpayers for the funding of the railway. This requires an evaluation of the wider economic and social value of subsidy on individual lines - principally any net environmental benefits of reduced road usage and the benefits of reduced road congestion. It also requires an analysis of the level of passenger fares that would achieve a balance between supply and demand for available capacity.

The growth in rail traffic that has been experienced in recent years has been due, in part, to a fall in the real effective cost to passengers of rail travel relative to road, as roads have become more congested. Marginal rail traffic growth is desirable if it fills under-utilised capacity. But at the point when major investment is needed to cater for further increases in demand, the most economically viable policy is usually to delay the need for investment by increasing charges to restrain demand, until such time as the level of potential revenue and external benefits meets the expected costs of proceeding with the investment, when measured through the relevant appraisal criteria.

There is no case for encouraging additional demand on severely over-crowded services by subsidising fares. If Network Rail’s
underlying efficient costs really are at their current level, it is unlikely that much, if any, expansion in capacity is either affordable, or economically justified. Indeed, at the current level of costs of the rail infrastructure, the scale of the existing network should be reviewed and probably cut back to make it affordable: government-guaranteed borrowing has been financing the existing levels of expenditure. However, the government did not give the SRA any policy guidance to ask it to carry out the required analysis to make rational decisions on either investment or pricing/subsidy policies. Without a coherent policy framework within which to work, the SRA concentrated on tactical measures to achieve a better balance of supply and demand within its financial budget through timetable changes.

Thus the second, and related, policy issue that should be addressed is the size of the network and the extent of rail services. The distribution of subsidy between the various services across the railway network has never been rational. This is largely because the issue of closure or withdrawal of individual rail services, let alone major changes to the timetable, has been deemed to be highly sensitive by politicians and the media, and hence has generally been ducked by those responsible for advising governments on transport policy. Yet this failure has resulted in resources being dispersed ineffectually around the network and has prevented the passenger railway from concentrating on the markets where it can demonstrate a clear economic advantage against road transport, taking account of external costs and benefits (ie, mainly intercity and commuter services in London and other conurbations). It has thereby weakened the railways’ long term position and viability.

Attaining clarity over these critical policy issues - the amount and distribution of subsidy, the size of the network, the extent of rail services and the means to match supply and demand using most effective price/subsidy policy - is essential in order to develop a rational investment strategy for the railway and to specify the train operating franchise requirements and infrastructure outputs the government is prepared to pay for.
Only then will it be possible to evaluate alternative projects and prioritise investment properly. In our view, this work should be led by the SRA/agent which, as an agent of government, is in a position to assess the detailed policy choices involved in planning the railway. Clearly it would need to work closely with Network Rail which, as infrastructure owner, would provide details of the M&R programmes required and analyse options for infrastructure investment in the network and timetable combinations to use existing capacity, which the SRA/agent would need to prioritise and decide. By this means the SRA/agent would present a credible overall investment plan to government setting out the implications of alternative levels of subsidy support and pricing and investment policies.

The government’s proposals, on the other hand, appear to give Network Rail a major role in preparing the infrastructure expenditure and investment plan, and staff from the SRA are to be transferred to Network Rail for this purpose. The ORR is to be given a role in providing a data base for the industry to be used in analysing policy options. It is unclear whether ORR or Network Rail will also be expected to carry out the detailed evaluation work needed, or what role the civil servants within government would perform in order to make informed policy decisions. However, we are doubtful, under these arrangements, of the government’s ability to harness the skills and experience needed to carry out the roles it envisages, which includes specifying the infrastructure and train service outputs required. The white paper states that the government will acquire the necessary skills to carry out these and the other roles of the SRA, presumably by transferring staff from SRA. The ORR will be asked to ‘price’ the infrastructure plan and, through an iterative process choices will be made to fit the resources available.

It seems unlikely to us that this will lead to better policymaking. The iterative process envisaged seems to us cumbersome and unworkable. And, without an arms’ length source of analysis and policy advice, such as could be provided by the SRA, it is likely that the government will continue to fudge difficult decisions and
political expediency will be the main driver of railway policy. We are also doubtful of the efficacy of civil servants, reporting to ministers, managing the commercial franchise contracts and the ‘binding relationship’ with Network Rail. The industry has already had too much experience of ministers ‘spinning’ the blame for all failures onto the operators, and the government’s proposals are therefore unlikely to enhance the confidence of operators and their investors.

Role for the Office of Rail Regulation

Under our proposals ORR would stand outside the relationships between the government and rail industry operators and it would no longer play a primary role in decision taking in the industry. This would enable it to take an independent view of any conflicts arising and to act as a mediating influence through the industry processes. It would also act on behalf of the consumer in addressing any issues arising, either in response to complaints or on the initiative of ORR.

Under our proposals, the ORR would nevertheless be involved during the process of developing all the key contractual agreements in the industry. It would review and, if necessary, comment on these agreements during their development. The ORR would stand ready to mediate if there were disputes arising between industry parties and, in defined circumstances, act as an arbiter for disputes brought by industry parties. However, we proposed that the current requirement in legislation that the regulator approves all access agreements should be removed from the Railways Act, since it could be used by a regulator to intervene directly in the SRA’s negotiations with industry operators. The ORR’s role should be to facilitate agreement by mediation and, in the case of disputes arising, to arbitrate between the parties.

However, the ORR would be bound to act within the constraints of the finances available to the industry and would no longer be
empowered to make decisions requiring an increase in government support. Hence if affordability prevents a proposed solution, ORR would be required to flex outputs, not taxpayers’ cash, to achieve an affordable solution. While this would require a prioritisation of ORR’s existing statutory duties, such prioritisation exists for other independent regulators and would not imply an undermining of ORR’s independence.

In addition, the ORR could provide an additional check on the accountability of the SRA (or its successor) by carrying out periodic reviews of the SRA’s operations, performance and effectiveness. Whilst this is a role normally performed by the National Audit Office, there may be advantages in it being carried out by ORR in the case of the SRA (or its successor), utilising the specialist expertise and knowledge of the complexities of the rail industry available in the ORR.

This new role for ORR would provide a clear separation of regulatory and policymaking roles in the industry. It would provide a proper level of accountability and redress in the operation of the railway institutions and operators, while removing the regulator from direct decision-making and hence removing the source of much conflict and confusion in the current arrangements.

In contrast, under the government’s proposals, ORR is set to have a much more direct role in industry processes. It is expected to build up a data base across the whole industry, implying that it will need access to a wide range of commercially sensitive information from private sector operators, including the drivers of marginal farebox revenues and operator costs, in order to advise government on ‘costed options’. It will be in the centre of the process of the government reaching its ‘binding arrangement’ with Network Rail as it will be responsible for evaluating Network Rail’s levels of efficiency and cost requirements in order to ‘price’ its outputs. The ORR is also likely to take forward the work of the previous regulator in developing the contractual and incentive arrangements for the industry, and will
need to have regard to the parallel redevelopment of the franchise incentives, and the government’s administration of financial support to the freight rail operators. It will therefore be closely involved in agreeing Network Rail’s management incentive plan which is intended to substitute for the loss of shareholder risk incentives resulting from the creation of this ‘not for dividend’ entity. The effectiveness of this management incentive plan depends heavily on where the benchmarks for efficiency are set. Network Rail’s management successfully sought to convince the previous regulator to redefine the level of efficient infrastructure costs at a much higher level than previously accepted, thus diluting these incentives. We believe this combination of responsibilities is a heavy burden for an independent regulator and it risks compromising both its effectiveness and independence.

Conclusions

There is close agreement between the government and our earlier proposals on a number of crucial points.

We agree with the government’s conclusions that the basic operating structure of the industry should remain unchanged. We agree with the emphasis placed in the white paper on reforming the way policy is formulated and translated through the industry arrangements. We agree that the government, and not the regulator, must specify the outputs it requires for the subsidy it provides. There is much to be said for reducing the number of regulators, and ensuring safety regulation is consistent with economic regulation, by combining the roles of Health and Safety Executive and ORR.

However, we do not believe that the government has thought through the implications of abolishing the SRA for how it will manage relationships and performance of the industry operators. While Network Rail is funded through government guaranteed debt, it has few commercial efficiency incentives and must
remain at one step removed from the final customers of the railway. Under this corporate structure, Network Rail has been given too much influence within the industry, while the issues of weak governance arrangements and the lack of efficiency incentives have not been addressed.

The government is also relying too much on ORR to achieve accountability within the industry. We are also concerned by the apparent lack of confidence the government has in economic incentives as a driver of efficiency and performance in industry behaviour, and its apparent tendency instead to rely on central direction, whether from government, ORR or Network Rail.

However we are aware that work is still continuing on developing the details of the government’s proposals and it would still be possible for many these issues to be addressed during this process.
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14 REGULATORY IMPACT ASSESSMENTS - A NEW EUROPEAN GOVERNANCE?

Claudio M Radaelli

Introduction

Both the Organisation for Economic Co-operation and Development (OECD) and the European Union (EU) are investing time, money and institutional determination in programmes and government-wide policy initiatives for ‘better regulation’ and ‘good regulatory governance’. Regulatory impact assessment (RIA) is the cornerstone of these programmes, often in combination with other tools, such as consultation, simplification, codes of conduct on legislative drafting, and initiatives to improve on the access to regulation (e-governance, one-stop-shops for enterprises, etc).

The pivotal position of the RIA stems from the fact that it provides standards for the whole process of policy formulation, by showing how the socio-economic costs and benefits are taken into account in the assessment of regulatory proposals or in the analysis of existing legislation. The RIA can also assist processes of simplification, for example by showing the costs and benefits of different simplification options. Moreover, the RIA includes the systematic consultation of stakeholders – an important element in terms of good regulatory governance. Table 1 presents the main elements of RIA.


Claudio M Radaelli, Professor of Political Science, University of Exeter
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Table 1: Components of regulatory impact assessment

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<td>3. Consultation</td>
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<td>4. Choice of a method to analyse options</td>
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<td>5. Analysis of options</td>
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<td>6. Special tests (small and medium enterprises, competition tests, gender impact tests etc)</td>
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<td>7. Criteria of choice among options</td>
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<td>8. Monitoring and reporting</td>
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The diffusion of RIAs in the European Union

The diffusion of the RIA has been remarkable. Looking at the 15 EU member states (thus excluding the 10 new member states which entered the Union in 2004), RIA diffusion is a recent phenomenon. According to a recent report prepared for the Italian, Dutch, and Irish Presidencies of the EU, before 2001 RIA existed only in a few EU member states. By contrast, in 2004 - the report observes - the RIA was ‘officially recognised’ in the large majority of the EU-15, and even in new member states like Hungary and Poland. In 2003, a study for the Hellenic Presidency of the EU on 13 of the then 15 member states (France and Portugal were not included in the sample) reported on the existence of RIAs in 7 member states, whilst the other 6 member states had at least pilot projects on RIAs. Thus all the countries surveyed by the Hellenic Presidency’s report claim some

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The situation was quite different in 2000, when the OECD did not find evidence of government-wide use of the RIA in Belgium, Greece, Ireland, Portugal, and Spain.

The European Commission’s approach

Turning to the EU level, the new integrated system of impact assessment introduced by the European Commission in 2002 draws on at least a decade of experience in ‘better law-making’. The early stages of impact assessment, characterised by the so-called ‘fiche d’impact’ on proposed directives, created the basis for more sophisticated methodologies and more accurate and systematic approaches. The second half of the 1990s witnessed a proliferation of pilot projects and new methodologies, especially in the areas of compliance cost assessment and better regulatory environment for the business community. Instruments and projects such as business test panels and the business impact assessment pilot project have gained prominence in the process of policy formulation. The commission has also developed experience in the areas of health impact assessment and environmental assessment.

The new integrated system introduced in 2002 is qualitatively different in several respects:

- To begin with, whereas previous initiatives targeted one category of stakeholders, such as the business community, the new approach refers to a broad range of stakeholders.

- Secondly, whereas the previous experiments and pilot projects produced results that were difficult to transfer across different directorates-general (DGs) and different policy areas, the new

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4 France (not included in the sample) adopted RIAs on bills and decrees of the Conseil D’Etat in 1998 (circulaire 26 January 1998). Portugal has a limited form of fiscal analysis.

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approach is based on a single template applicable to all policy proposals.

- Thirdly, although previous experience was essentially, although not always, limited to the commission, the new impact assessment (IA) has potential for integrating the European parliament and the council as users of the assessments of the commission. The potential for streamlined inter-institutional relations in the EU policy process is increased by the adoption of a single template for impact assessment.

- Fourthly, the new emphasis on the analysis of impact is also the result of EU institutions becoming increasingly more focused and more alert on the issues arising out of ‘better regulation’. Political attention has increased throughout the 1990s, with member states, employers’ associations, and EU institutions pushing for more systematic approaches to the empirical analysis of costs and benefits of proposed EU legislation. The diffusion of RIAs at the domestic level has provided an important pre-condition for its adoption at the EU level.  

Following a common practice, the commission’s integrated impact assessment consists of two stages, that is, preliminary assessment and (for major proposals) extended assessment. The preliminary assessment provides a concise analysis of the problem, the alternative policy options (including the option of preserving the status quo), and the sectors affected. It also establishes whether a more extensive analysis of options is needed. On the basis of the preliminary assessment, the commission decides which proposals need an extended impact assessment (European Commission, 2002a:7). The commission announces this decision in its annual policy strategy or, at the latest, in its work programme for the forthcoming year.

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In the past, companies, national research institutes and think tanks complained that the quality of IA varied too much from one DG to another. Another sore point is that the commission need to co-ordinate ‘better regulation tools’ in an overall strategy of regulatory management. The new integrated system addresses these concerns. It replaces (and integrates into a new tool) all previous requirements for business impact analysis, environmental assessment, compliance cost assessment for SMEs, gender assessment, and trade assessment (European Commission, 2002a:3). Of course, the methodologies and scope of the various types of assessment vary according to the substantive policies examined. Proportionality is a guiding principle. It makes sense to invest in deeper analyses only when the importance of the proposals under scrutiny justifies it (European Commission 2002a:8).

The commission has also made some organisational steps to perform impact assessment. The 2002 Communication establishes that impact assessment will be the responsibility of the directorate general in charge, but (as mentioned above) in the context of an organisational network. The latter includes the secretariat general (with major responsibility for the co-ordination of the overall support structure for impact assessment) and the ‘most concerned DGs’ (European Commission, 2002a:8).

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The RIA is an instrument to achieve the major goal set at Lisbon to make Europe “the most competitive knowledge-based economy in the world”. Accordingly, the new system integrates the three dimensions of sustainable development, that is:

- economic assessment;
- social-employment policy assessment;
- environmental assessment.

One delicate issue of incorporating the dimension of sustainable development into the RIA strategy is about possible trade-offs among the three pillars, that is, environmental protection, economic growth, and social policy. Consequently, the RIA becomes a tool to identify and discuss openly the major trade-offs in the formulation of EU policy. This is why the integrated RIA is also about raising the right questions and illustrating the major trade-offs (European Commission, 2002a). The choice of a technique, such as cost-benefit analysis, should not be an implicit political choice, but the broad approach of sustainable development suggests that all techniques (such as cost-benefit analysis) be considered in terms of whether they provide a balanced assessment of economic, social, and environmental policy goals. This is a fundamental point when one examines the legitimacy of impact assessment.

Legitimacy brings in the question of how technical or political is the commission’s approach to the RIA. The latter is an instrument supporting the political role of the commission in the EU policy process. The commitment to perform RIA has been taken up by the commission in the framework of its right of initiative - and the obligation it has to push forward European integration. Finally, the commission’s RIA approach is integrated with the EU’s goals for ‘good governance’. Accordingly, the RIA is situated in the wider regulatory action plan of the
commission and minimum standards for consultation (the standards were finalised in December 2002).\textsuperscript{11} EU impact assessment is also connected to the proposals for the democratisation of expertise and EU reference systems on experts’ advice and the use of science in the policy process (illustrated in the Liberatore report 2001).\textsuperscript{12} As the RIA (especially but not exclusively in the form of risk assessment) makes use of scientific evidence and experts’ advice, one should take into account explicit standards for the use of science and expertise in the EU policy process.

The experience in 2003

The commission used integrated impact assessment in 2003 in an experimental form. Some 21 extended impact assessments (ex IAs, or, simply, final RIAs) were completed in 2003, spawning a lively debate on the quality of RIAs in the EU. In 2003 the commission prepared technical guidelines and launched a training programme and awareness-raising events on the RIA in the EU. One important step in terms of institutional design for the RIA was the inter-institutional agreement for better regulation, signed by the council, the European parliament, and the commission in 2003.\textsuperscript{13} The agreement states that (when the co-decision procedure applies) the council and the parliament “may have impact assessments carried out prior to the adoption of any substantive amendment, either at first reading or at the conciliation stage” (art.30). Further to the agreement, in June 2004 a working party of officers from the three institutions was set up to foster convergence in methodology.

\textsuperscript{11} European Commission (2002b), Communication: Action Plan Simplifying and Improving the Regulatory Environment, 278 Final, 5 June.
\textsuperscript{13} Published in Official Journal of the EU, 31.12.2003, Series C 321/1.
There are at least three studies on the quality of final RIAs produced by the commission in 2003. Samples and methodologies vary, but essentially these studies argue that the results of the new integrated approach to RIA are disappointing. The council has added its own concerns on how the competitiveness dimension is handled in the commission’s RIAs. A sub-group of the Competitiveness Council issued a report in June 2004 suggesting a revision of the technical guidelines of the commission and a specific ‘competitiveness test’.

One has to approach these evaluations and the council’s proposals with caution. To begin with, 2003 was the first experimental year for the commission’s RIAs. The picture is more grey than ‘black and white’: some impact assessments follow international good practice, others leave much to be desired. Rather than rushing into final judgments, it is more important to stress how the commission can learn from the current problems with RIAs – a point convincingly made by Vibert (2004). As for the council’s emphasis on competitiveness, it should be noted that the competitiveness dimension is ‘in-built’ in the RIA. To have a special test on competitiveness on an instrument geared towards competitiveness is somewhat counter-intuitive. Add to this that the scientific literature is quite sceptical.

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about the use of competitiveness when applied to countries rather than firms and sectors.¹⁶

The challenges ahead

Having clarified that the commission has set high standards for its impact assessment process, there are critical areas where improvement can be made. The quality of economic analysis and the explicit consideration of market alternatives to regulation have been rated by most commentators below international standards of best practice. One example is the RIA on gender discrimination and insurance, leading to the proposal to narrow down the gap between insurance premiums for men and women.

It is important that the commission’s RIAs show how alternatives to regulation were assessed, and whether they informed early thinking on policy formulation. As for cost-benefit analysis, the commission does not believe that quantification and monetisation of costs and benefits is always the best option. Given the complexity of the trade-offs that the integrated system of impact assessment has to handle, it would make more sense to ask the commission for more accurate scenario thinking, explicit formulations of probabilities associated to uncertain events, and sensitivity analysis.

Specifically, the 2003 experience with integrated impact assessment highlights the following problems:

- **Selection of proposals.** The commission performed extended RIAs on 21 proposals (see Appendix). It makes sense to be selective, but the problem is that the sample of proposals

³⁶ The notion of competitiveness should not be confused with the competition tests used in countries like the UK. Competition tests are fully appropriate in the context of IA. They check whether regulatory proposals may impact on the market structure, for example by making a market more concentrated or more competitive. This has nothing to do with the current proposals for competitiveness tests aired in the council’s documents.
selected for final or extended RIAs includes all sorts of measures, some of which do not seem the most suitable for impact assessment. To perform an RIA on a broad ‘vision-piece’ like the communication on the ‘future of the European employment strategy’ or on ‘basic orientations for the sustainability of tourism’ is not the same thing as to analyse the impact of specific directives with a regulatory content. The commission has not produced a set of transparent and reasonable criteria to select (on the basis of preliminary assessments) the proposals deserving a final RIA. The credibility and transparency of the RIA process is undermined if these criteria are not publicly discussed and validated.

- **Management capabilities.** It is not clear whether the commission has developed strategic and operational management capabilities for RIAs. The role of the secretariat general in the co-ordination of impact assessment as a process is important, but it cannot be compared to the role of central quality assurance units located in the cabinet office of EU member states. Resources and management capabilities across directorates generals vary markedly. Even the most important DGs in the RIA process, such as DG Enterprise, and the secretariat general itself, have to rely on less than five members of staff dedicated to impact assessment. Finally, it is not clear whether the commission is making the most of inter-service consultation in RIA: when proposals for a directive or regulation reach the stage of inter-service consultation, the preparation of impact assessment is formally completed.\(^{17}\)

- **Quality assurance.** More broadly, the whole issue of quality assurance is still at the stage of debate. The secretariat general has a soft role to play in the diffusion of quality standards, with the assistance of DG Enterprise and DG Market in terms of

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\(^{17}\) The Communication of RIA states that “*The report must be attached to the text of the proposal when it is sent to the interservice consultation*” (European Commission, 2002a:27). The implication is that the RIA process ends before the policy formulation process within the Commission.
specific technical guidance. However, there is no regulatory quality office within the secretariat. Neither is there an external auditor, with quality assurance functions. The European parliament has proposed an external audit, but it is not clear where this audit should be located. The court of auditors (an obvious domicile for this body) has more experience of financial evaluation than performance evaluation. Another problematic issue is the poor linkage between institutional design, process, and methodology. The technical guidelines on the RIA are not closely related to the major steps in the RIA as a process. This may lead to a bifurcation between the RIA as document and the RIA as process.

- **Access and transparency.** The transparency of the RIA is low. Up until spring 2004, it was difficult to find the text of final RIAs on the EU website because the commission had not established a single internet access point to extended impact assessments.¹⁸

- **Multi-level regulatory governance.** There is also the more general problem of the role of governments performing their own impact assessments of EU proposals and how their input should be processed. The commission’s communication and impact assessment and the guidelines are somewhat reluctant in acknowledging the multi-level nature of the exercise. True, the commission performs RIAs in the context of its treaty-based right to initiate legislation, but there is no mechanism through which member states can contribute.

- **Validation of science.** The record in terms of validation of science and replicability of models contained in RIAs is poor (Vibert, 2004). The experience with peer review of RIAs is modest. The commission has not set up a body of scientific advisers to check on the quality of science used in impact assessment.

¹⁸ Now impact assessments are available on http://europa.eu.int/comm/secretariat_general/impact/practice.htm
• **Consultation.** The quality of consultation is variable across the 21 RIAs. Most importantly perhaps, the commission is not consistent in showing how the results of consultation inform the RIA process (for example in terms of choice between alternative options).

• **Sustainable development.** The distinctive element of the commission’s approach is to balance economic, employment, and environmental goals. However, the criteria used to balance these goals are not clear. This has led the council to discuss whether the commission should modify its technical guidance to make the analytical framework used to identify the trade-offs between alternative options and the implicit value judgements more explicit (Council, 2004:12).

**Conclusion**

Overall, the quality of written guidance on the commission’s impact assessment process is high. The aim to assess a broad range of costs and benefits within a single coherent framework is not common throughout Europe, where most governments focus on a narrow range of costs or perform very light RIA exercises.\(^{19}\)

Integrated impact assessment has now hit the road of implementation. Pressure from the council, the parliament, and independent experts on the commission is increasing. This has spawned a debate on the limitations of the 2003 experience and suggestions on what should be improved. The commission has responded by changing the guidelines on the process – the idea being that instead of preliminary and extended impact assessment there should be a single process in which road maps evolve (when necessary) into full assessments.\(^{20}\) The main challenge,

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however, is not to design yet another set of guidelines, but to show that there is enough capacity and commitment (within the institution and across the three main EU institutions) to deliver on an ambitious approach. In terms of quality assurance, it is more important to agree on a set of indicators of RIA quality than to discuss the role of possible audit bodies in abstract.  

Both DG Market and DG Enterprise are developing projects on indicators. For the literature on indicators of regulatory quality see http://www.brad.ac.uk/irq.
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## Appendix

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<th>Lead DG</th>
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15 REGULATORY REFORM IN DEVELOPING COUNTRIES - IS ‘BEST PRACTICE’ TRANSFERABLE?

Martin Minogue

Introduction

This chapter examines the problems involved in analysing and assessing the regulatory reforms that are now on the economic reform agenda in many developing countries. In developed economies, such reforms are generally regarded as belonging to the post-privatisation phase; but in developing economies, privatisation has itself been an incomplete and faltering process, so that associated regulatory reforms are either new, or poorly understood and conceived. Despite the assumption by influential aid donors such as the World Bank that such reforms will have the merit of taking bureaucrats out of business, many factors in developing country political and economic systems demonstrate a propensity for regulation inside government.¹ Since poor governance is regarded by aid donors as a major obstacle to effective economic reforms, a concern with institutionalising regulatory governance is a crucial aspect of the regulatory reform agenda.

The chapter considers problems of definition, scope, and comparison that arise in any attempt to judge what types of regulation exist in developing countries, and the difficulties that


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are presented by notions of ‘best practice’ and ‘independent regulation’. The chapter concludes by recommending a culture-sensitive approach to policy transfer in the field of regulatory reform.

Reforming states and markets

While regulation expressed as a form of rule-making, application and adjudication has a long history, recently it has been seen rather as a by-product of liberalising economic reform strategies expressed largely through privatisation and deregulation programmes. One view of this ‘opposes’ states and markets, on the ground that the market should be left to be self-regulating. While regulation certainly aims to intervene in markets, the benevolent intention is to contribute to the process of ‘constructing’ an efficient market: “markets and regulation are complementary rather than opposed...both are means of delivering public interests’, so that regulation is ‘a process in which economics, politics and law are inextricably intertwined”.

We therefore need analysis of regulation which goes beyond merely economic categories to embrace all the complexity of economic policymaking and management by the contemporary state. This broader approach might be summarised as follows:

- the analysis of regulation goes beyond examination of the formal rules which govern relationships between the public and private sectors, to the broader framework of state-market relations;

- regulation is then seen as part of the whole range of neo-liberal market reforms, which include privatisation and reshaped state-market mechanisms, such as contracting and public-private partnerships;

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• since much regulation is carried out inside government, it is appropriate to consider the effects on regulatory policy and practice of public management reforms that introduce into the state sector the entrepreneurial disciplines of the private sector;

• since regulation can be categorised as a distinctive mode of policymaking it is appropriate to examine its relation to the general public policy process;

• finally, the significant effects on regulatory systems and processes of political ideas, institutions and relationships of power require analysis of governance frameworks and an understanding of such concepts as ‘the regulatory state’, ‘regulatory capture’ and ‘regulatory space’.

How should we tie in regulatory reforms to generic public management changes? First, we can do so by treating regulatory innovations as part and parcel of the generic reform movement labelled as new public management (NPM). The literature on NPM characterises it as a set of principles rooted in public choice theory, and involving a new conception of state-society, public-private relationships. Conceptually, NPM is a response to perceived failures of the ‘command and control’ state, with its Keynesian philosophy of stabilisation and distribution, and strong internal values of public interest and public accountability. NPM rests on the following assumptions:

• the public interest state has led to extensive government failure and inefficiency, and should be replaced, as far as practicable, by superior market mechanisms;

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• a more efficient public sector requires the separation of policy from execution, which would be decentralised;

• an entrepreneurial culture based on managerial incentives will produce better government performance than a public service culture based on public interest principles;

• accountability rooted in a direct relationship between ‘manager’ and ‘customer’ is preferable to legal and political forms of accountability;

• in brief, the key idea is that the state has become too large, too interventionist, and too costly; that many of its activities could be transferred to a willing and capable private sector; and that the disciplines of the market place should be applied to any residual state bureaucracy.

While these are contestable concepts, there can be no dispute about the success of this model in dominating the public management reform agenda in developed economies in the past two decades. With local variations, the design of the NPM model normally included a reduction of the size and scope of the public sector, particularly through privatisation (in social as well as economic spheres); restructuring and reduction of central bureaucracies; the introduction into state agencies of competitive disciplines through contracting of services and internal markets; and the use of performance management and auditing to increase operational efficiency. The aim of such reforms was to produce a slimmer, ‘enabling’ rather than direct provider state, driven by an entrepreneurial, results-oriented, performance driven public management culture.

It is remarkably difficult to arrive at an informed judgement of whether this model has succeeded in practice. Proponents in developed countries claim real improvements in systems, processes, operations, and cultures; but as Pollitt and Bouckaert show, there is an absence of persuasive empirical evidence with
which to measure results on any of these dimensions. There is a genuinely changed discourse of reform, but little to link reforms of structures to processes and outcomes, whether in terms of better policymaking or better delivery of public services. While it is clear that a major structural transformation has taken place, with substantial privatisation across a whole range of public utilities and services, the restructuring and reduction of the central civil service, and the introduction of mixed public-private provision through mechanisms such as contracting out, public-private finance arrangements, and public-private partnerships, the results and impact of these changes are thoroughly contested.

From public management reform to regulatory governance

The relation of public management reforms to changing modes of regulation is also beset by potential contradictions. Lane, for example, characterises public sector reforms as essentially a comprehensive shift from long term contracting (primarily through government bureaucracies and public enterprises) to short term contracting (primarily through contracting out and tendering mechanisms). This move “presupposes massive deregulation, opening up both the public sector and the regulated sector of the private economy to competition”. On the other hand, this extensive reduction of bureaucratic-legal interventions, or what has been called the ‘hollowing out’ of the state, creates a new requirement for regulatory mechanisms to protect public interest concerns, to make good the loss or

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7 For a detailed critique see, Minogue M (2001), Should Flawed Models of Public Management be Exported? Issues and practices, in McCourt W and Minogue M (eds), The Internationalisation of Public Management: Reinventing the Third World State, Cheltenham, Edward Elgar, pp20-43.
weakening of traditional forms of accountability, and to respond to what Moran terms the crisis of the collapse of self-regulation (Moran, 2002).

Moran, summarising a ‘complex political economy of regulation literature’ (Moran, 2002, 2) identifies a pluralist stream which emphasises that the nature of regulation is contingent on the distribution of power among different social groups, and will vary from case to case, and between different national political environments (the obvious contrast in developed country models being that between “a litigious and adversarial regulatory culture in the United States and a British culture which stresses informal resolution of issues and a culture of consensus between regulators and regulated” (Moran, 2002, 2). An alternative construct is a rational actor model in which the strategic pursuit of sectional interests produces benefits not to the public interest but to the powerful actors who dominate the process: politicians, business interests, and bureaucrats. This latter approach is close to, and has roots in, the neo-liberal paradigm which, as we saw earlier, contributed so significantly to generic ideas about the reform of the state-market relationship. In essence these two approaches represent familiar and competing explanatory frameworks for the origins and nature of regulation.

Moran, examining the reasons for the growth of deregulation, identifies a loss of confidence in the regulatory state, partly because of persistent implementation failure, partly because of pessimism occasioned by regulatory capture. But his discussion reminds us that there is more than one version of the regulatory state. Sometimes the literature refers to all aspects of the ‘command and control’ state, and specifically to the expansion from traditional economic regulation to wider social regulation, particularly in respect of welfare, health, and the environment: it has rightly been said that “regulation...is as old as government itself”.9 At other points the focus is much narrower, and refers to the creation of new regulatory institutions in the wake of

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privatisation and deregulation reforms, a phenomenon often termed ‘re-regulation’.

But if we create truly independent regulatory agencies, who will control them, or mediate any conflicts of interest between their actions and broader public interest concerns? This question might also be addressed to proponents of self-regulation as the only viable response to problems of regulatory overload (whether of the traditional or the post-privatisation kind). Ayres and Braithwaite suggest “responsive regulation” as a means of transcending the limits of legal formalism;\(^{10}\) regulation is essential to secure efficiency and to manage risk, but effective regulation “in conditions of great complexity depends on fostering norms among the regulated such that they will voluntarily comply, and depends upon the creation of a constant dialogue between regulators and regulated” (Moran, 2002, 6). Elsewhere, Braithwaite argues that we have moved to “a world where private powers pose many more threats to liberty than public power” and that accordingly we need to escape from traditional forms of political accountability, since these “cause regulated actors to work defensively to avoid blame, instead of creatively to seize responsibility for achieving valued outcomes”\(^{11}\). But this approach appears to beg two questions. First, who decides what the appropriate norms should be, or which values should inform what outcomes? If these norms and values are pre-determined, then they will have to be imposed, which will invite strategies of avoidance; if they depend upon dialogue, they will represent a negotiated bargain, and opportunities for capture. As Moran admits, “non-formal modes of regulation are themselves subject to the same sort of destructive influences as afflict formal modes” and both “are undermined by the creativity of strategic actors searching for advantage” (Moran, 2002, 7).

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\(^{10}\) Ayres I and Braithwaite J (1992), Responsive Regulation: Transcending the Regulation Debate, Oxford, Oxford University Press.

What is missing from most accounts of regulation is an understanding of the cultural elements that are essential to explanations of social behaviour, whether in general, in national systems, in organisations, or in particular groups, and of interactions and transactions between these various entities. This explanatory mode is well understood in social science, but is often neglected by the economists and lawyers who dominate the regulation literature. Recent commentators recommend a cultural analysis of the social relationships underlying regulation. What then emerges as significant is the extent to which this debate must continue to include ‘regulation inside government’ (the title of Hood et al).

The reshaping of the managerial state has brought into existence new regulatory institutions and practices, while at the same time leaving within the boundaries of the state some traditional regulatory responsibilities, in turn reconditioned by innovative regulatory practices (such as audit and performance management). We may add to this the regulatory responsibilities and relationships created by membership of the EU. Regulation therefore takes place inside government, outside government, across national government boundaries, and in institutions which cross the public-private divide. It is the wide-ranging nature of these arrangements that has brought into currency the idea of the ‘regulatory state’ but this too readily implies a replacement of other types of state, such as the ‘traditional’ state, or the ‘welfare state’, or the ‘enabling state’. These are all crude labels, and in reality we are likely to find elements of each, and of the regulatory state, present in any particular national state we choose to examine.

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Perhaps this is why the notion of ‘regulatory space’ has been deployed. Drawn from the prior notion of ‘policy space’ in public policy studies, ‘regulatory space’ offers a canvas onto which we can paint a variety of occupants and their relational configuration; their provenance as state, non-state or hybrid actors matters less than their activities, transactions, motivations, and power or influence; this framework can also accommodate “the variations introduced by differences in markets and issue arenas”.  

In sum, analysis of regulation involves analysis of ideas, institutions, processes, activities, and actors, in all their myriad inter-relationships in economic, social and political spheres. The conceptions of the regulatory state and regulatory space offer us the broadest possible analytical framework, in direct contradiction to the narrow formulations favoured in the standard literature on regulation, and so capably criticised by Black (2002) for its preoccupation with the correction of market failure, when wider issues of the management of a risk society, and the achievement of social justice, should be equally insistent concerns. In this view, we should not think of the targets of regulation only as economic actors and agents.

Policy transfer to developing countries

The NPM model of public management reform, or versions of it, have been widely imitated in developing countries, by the process we label ‘policy transfer’, principally through the mediating channels of the international and bilateral aid agencies. First, regulatory reforms are an integral part of the NPM model, specifically in being closely tied to market-oriented

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institutional changes, such as privatisation and contracting. Consideration of the appropriateness for developing countries of developed country models of managerial and regulatory reform must incorporate a critical evaluation of the weaknesses in, and costs of these models. Second, NPM entails a transformative conception of the state; while it is clear that the state in developing countries is much in need of renewal and reinvigoration, there is very little agreement on what kind of state this should be, or how such a transformation could be achieved. Should we be trying to reduce the scope of that state, or should we be trying to build up its capabilities, powers and resources in order that it may achieve the developmental objectives required by its own citizens?

Finally, the most obvious issue is that of cultural difference. Not only are low and middle economies distinctively different in economic, social and political terms from rich economies, but there is considerable variation between national cultures within these broad categories. Taylor has pointed to the problem that in transferring an NPM model to developing economies, we are making a double transfer, from developed to developing state, then across the public-private boundary.\(^\text{16}\) Both types of transfer are culturally problematic, and Taylor stresses the sociological naivety of those who promote NPM managerial practices that ignore or conflict with the social and political dynamics of public service organisations and systems in developing countries, an argument strongly expressed also by a leading practitioner of NPM in developed economies.\(^\text{17}\)

A related problem arises directly from the condition of underdevelopment itself. It is clear that the economic, social and


political conditions for the range of neo-liberal economic and political reforms favoured by the aid donors are rarely present in low and middle income countries. It has been suggested that the conditions in which the “best practice model of regulation is located include:

- a stable macroeconomic environment, to reduce uncertainty in economic decision-making;
- a redistributive tax base, to fund strong social protection arrangements through a well developed social security system;
- a rules based system supported by an effective legal infrastructure and the rule of law;
- a transparent and accountable public policy process;
- a clear separation of administrative and political roles within a democratic constitutional framework;
- appropriate financial and human resources to ensure that regulatory agencies can work effectively”.

Development agencies are still inclined to proffer models based on conditions and practices, such as those in high income economies, then become frustrated when such models do not seem to work elsewhere, or receive little more than diplomatic lip-service. There is a reality gap here between donor ideas of best practice, and the actual legal, administrative, political, and economic processes that exist in low and middle income countries. A good example is afforded by the principle of ‘independent regulation’.

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What is independent about independent regulation?

‘Independent regulation’ is a phrase much in use but one which appears to produce considerable misunderstanding. Coined in the policy systems of developed economies with apparently well defined separations between economic, legal, administrative and political institutions, it begins to show strain even in this context when subjected to detailed analysis. The developed economy literature on regulation generally conceives regulation to be ‘independent’ where an agency is created with specified powers, and the means to enforce these powers. In many cases such agencies are administratively separated from executive government, as in the USA, or have constitutionally specified powers, as in France. The UK system of ‘separation of powers’ is altogether more ambiguous and productive of a range of agency types. But even in these developed country systems it is possible to argue that the political executive retains fundamental control through the power of appointment, notoriously exercised in the current American administration to neuter the intended operation of regulatory powers by ‘placing’ a politically compliant head of agency.

Less controversially, in the UK the railways regulator was notably independent in word and deed, but was quite unable to influence or prevent regulatory policy changes by the responsible minister, doubtless a primary reason for his decision not to seek reappointment for a future term. In France, constitutional separation is neutralised by the closely integrated bureaucratic culture, rooted in the common recruitment and training ground of the ‘Grandes Ecoles’. It might be argued that in developed countries there is a spectrum of political practice, with interventions in regulatory autonomy likely in more politically

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sensitive areas (eg, UK railways) at one end, and a willingness to forgo such interventions in more technocratic areas at the other.

If we apply this more politically sensitive analysis to developing countries we simply cannot expect the creation of arms-length agencies that can hope to establish any real ‘independence’ of the dominant political and bureaucratic institutions of the central state, especially where political stability itself may depend on the careful exercise of political patronage. In short, where regulators, and even in many cases judges, owe their positions to the political-bureaucratic elite, the possibilities for the exercise of independent judgement and action are considerably reduced, or may be non-existent. Since privatisation and regulatory reforms are largely concentrated in public utilities where there is a strong public interest factor, and therefore political sensitivity to both policy reforms and to regulatory practice, it is difficult to envisage what ‘independent regulation’ could possibly mean, or how it might be somehow insulated from overriding political considerations. This factor lies behind the faltering process of privatisation in developing countries, where the persistence of ‘statist’ values, the resistance of labour unions, and the absence of necessary market conditions means that a clear separation between public and private interests and ownership simply cannot be assumed.

It is clear that national political and bureaucratic cultures themselves can and do hinder the release of economic functions from government control, making independent regulation unworkable. Institutional transfers from public to private control may merely offer new opportunities for clientelist patronage, as in the case of the Malaysian power sector, where financial gains went mainly to members of the ruling political parties. In countries such as Sri Lanka and the Philippines, continued political intervention in supposedly independent regulatory bodies has resulted in an acceptance that mechanisms are not working, and a lack of will from either side to do anything about this. In South Africa, privatisation reforms have stuttered in the
face of labour resistance, and regulators complain about direct political interventions in regulatory activities.

This may at first glance seem a depressing scenario, but these characteristics may be better understood if we accept the complexity of a development agenda in which political leaders are constrained to place the needs of the poor above the requirements of economic efficiency or emerging markets. The choices involved here are political choices, so it is not surprising that governments so often intervene in nominally independent areas of the economy. This points to the crucial role governance systems play in economic regulation and economic development. In the long run, independent regulation may well be a desirable objective both for developed and developing economies alike, but in the meantime, regulators and donors need to work with, and not against the political and administrative systems and cultures actually in place.

This may well mean a recognition that corporatisation of economic activities is likely to be a preferred and more effective variant on outright privatisation; and that regulatory action is more likely to be operated from inside government, rather than in some externalised form. Hood and Scott (2000) see no problem with this, on the grounds that regulators inside government essentially face the same problems as regulators nominally independent of government, i.e., information asymmetries, relational distance, and compliance costs. While they see an element of autonomy as necessary, this is a matter of organisational separation and formalised authority, rather than positioning across a public-private line. On this view, regulatory reform in developing countries might usefully focus on improvement of regulatory relationships and efficiency inside government, and move away from the current preoccupation with independent regulators external to government.

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Accountability

A central element in regulatory governance is the issue of accountability, since improved accountability and transparency are usually posited as the principal objectives of regulatory reform (assuming this to be defined as re-regulation rather than deregulation). The neo-liberal version of accountability with which current regulatory reform is so closely implicated rests on evaluation of performance against pre-set standards or targets, and offers incentives to managers as well as some loosening of the traditional restraints. While financial and procedural accountabilities can be brought within such a framework (and improvements here would undeniably be a gain) it is a framework which sits uneasily with developing country governance (or substantive accountability).\textsuperscript{21} The degree of managerial and institutional autonomy involved, and reliance on a competitive model of public service delivery, assume the existence of market and civil society institutions which in many developing countries are more notable for their absence or deficiencies. Moreover, while the advantages of autonomous regulatory agencies standing at arms length from state political control and intervention are obvious, there are serious disadvantages too, including the reduction of political accountability, and fragmentation at the heart of governments already suffering problems of institutional incoherence.

In the political conditions of developing countries we cannot expect significant public agencies to operate as though politics did not exist, as the practice of privatisation has already demonstrated.\textsuperscript{22} Moreover, giving to the managers of regulated services simultaneously more discretion and more financial responsibility appears to put in place precisely those conditions


which may lead to increased corruption; while giving more autonomy to regulators (by taking them outside government frameworks) is unlikely to reduce regulatory and political capture where constitutional, legal and public interest mechanisms of accountability offer no protection.\textsuperscript{23} As limited experiments with executive agencies in developing countries have shown, where there is a conflict between economic efficiency objectives and the internal dynamics of political governance, the imperatives of politics will usually prevail.\textsuperscript{24}

One conclusion we might draw here is that accountability finally is underwritten less by formal institutions than by relations of trust, the argument that now makes the running in the regulatory literature in developed economies, as discussed earlier (Moran, 2002, Braithwaite, 1999). In this respect, rather than taking the negative, indeed contradictory attitudes adopted by the aid donors to the social and personalistic networks that characterise the governance institutions of many developing countries (contradictory because political networks are ‘bad’ while civil society networks are ‘good’), we could regard these relations of trust as a foundation on which to build effective regulatory governance.

**Conclusion**

The principal thrust of this chapter has been to rehearse the problematic nature of policy transfer from developed to developing countries in the field of post-privatisation regulatory reform. In the first place, the dominant governance reform model is itself a contested conceptual model, and even in developed

\textsuperscript{23} Harriss-White B and White G (1996), Corruption, Liberalisation and Democracy, IDS Bulletin, 27, 2, pp1-5.
economies has produced a contested literature of evaluation and appropriateness. Despite these disputes, reflected in internal debates and power struggles in the major institutions promoting neo-liberal reforms, it is this dominant model which is being ‘transferred’ to developing economies through aid programmes and by imitation. Problems of adaptation to different economic, social, political, legal and administrative cultures will inevitably arise, and must be the focus of a research agenda concerned to assess policy effectiveness in the context of the stubborn and complex realities of underdevelopment. This is a reminder, too, that the developmental state has an essential role; it will remain both the object and the subject of reform, and is likely to retain considerably greater direct regulatory responsibilities than is now customary in developed countries.
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16  COMPETITION POLICY AND PRACTICE UNDER THE ENTERPRISE ACT

Paul Geroski

Introduction

The UK has had a two tiered competition regime in place for the investigation of merger and market inquiries since the Fair Trading Act of 1973. At the first tier – at ‘Phase I’ in other parlance – is the Office of Fair Trading (the OFT hereafter), which (amongst other things) scrutinises mergers and markets, and sends those that it has concerns about to the second tier (for a ‘Phase II’ investigation). The Competition Commission (hereafter the CC) conducts these second tier investigations and its recommendations (to the secretary of state) could not be appealed on the merits, but could be reviewed in the High Court.

Two major pieces of legislation – the Competition Act of 1998 and the Enterprise Act of 2002 – have profoundly transformed the workings of the competition regime in the UK. They have made UK competition law more consistent with European law, given the OFT powers to fine companies that breach the statutes, created a new criminal offence for individuals engaged in cartels, renamed the Monopolies and Mergers Commission as the CC, replaced the old ‘public interest’ test which was used by the CC and the OFT for one that concentrates on a ‘substantial lessening of competition’, abolished monopoly investigations and replaced them with a market inquiry regime based on an explicit competition test, removed ministers from most of the referral and decision making phases for merger and market inquiries and created an independent specialised court – the Competition Appeal Tribunal (or, the CAT for short) – to hear appeals.
against, or reviews of, decisions made by UK competition authorities.

As if this were not enough, further legislation (such as the Energy Act, 2004, the Communications Act, 2003, the Water Act, 2003 and so on) have begun to transform the structure of regulation in the UK, and this too has had knock-on effects for the competition authorities (particularly for the CC which often acts as an appeal body for regulatory decisions). Indeed, this legislation has occurred within a climate of thought that believes that competition policy can, in many circumstances, be a less expensive and, possibly, a more effective substitute for direct regulation. As a consequence, the CC devotes a noticeable proportion of its resources to conducting regulatory inquiries (often in the form of appeals of proposed licence modifications).

The interesting question, of course, is what all of this means in practice. There is a school of thought which argues that most of the effects of particular pieces of legislation lie not so much in what the law says, but in the practices that get built up around its interpretation and implementation. In this view, the right place to look for changes in competition policy is not in the wording of the statutes themselves but rather in the changes in the practices of the competition authorities which have followed changes in the statutes. Following in this spirit, I will focus on what follows on the changes to the CC’s practices and procedures which have occurred in the wake of the Enterprise Act 2002. I will concentrate my remarks under three headings – independence, transparency and expertise – and will show that the new legislation has brought about major changes in the practice of competition policy in the UK.

Independence

Prior to the Enterprise Act, merger and monopoly cases were sent to the CC either directly by the secretary of state (the SoS) or from the OFT via the SoS (cases also did, and can still, come
from the sectoral regulators). The reports written by the CC contained recommendations to the SoS who, within certain limits, had the discretion to act upon them as she saw fit. The Enterprise Act largely removed the SoS from this process, leaving her a decision making role to play only through a small number of so-called ‘public interest gateways’ (relating largely to national security and media mergers). In other words, the CC became determinative. As a consequence, our decisions about adverse effects on competition are final (subject to review but not appeal at the CAT); and, if we reach an adverse finding in a particular case, we have a responsibility to design and implement remedies.

The words of the legislation give little hint of the full impact of this rather revolutionary change.

The most visible manifestation of change brought about by making the CC determinative is in the way that we now undertake cases, whether they are mergers or market inquiries. Prior to the Enterprise Act, the first visible sight of the CC’s thinking on a particular case came with the issuance of our final report (which was only published when the SoS had made her decision, often 6–8 weeks after the inquiry was over). If a particular group reached an adverse decision, it was bound to make recommendations to the SoS on possible remedies that might rectify the problem. Prior to making those recommendations, it had to explore possible remedies with the parties likely to be affected by them. Since no final decision would have been reached on adverse effects when the time came to explore remedies, the CC was obliged to conduct such remedies hearings on a hypothetical basis, in effect asking “if we were to reach an adverse conclusion, what might be an appropriate remedy?”. Unsurprisingly, these were rarely productive, the parties being unwilling to engage in a discussion of remedies for fear that it would encourage the CC to make an adverse finding.
In the wake of the Enterprise Act, we communicate our thinking on adverse effects in the form of a set of ‘provisional findings’ that are issued about two thirds or three quarters of the way through an investigation. These are provisional, and all of the parties to a particular case have 21 days after they are issued to comment. More fundamentally, the issuance of provisional findings (if they are adverse) signals a switch of the investigation into ‘remedies mode’. The provisional findings give parties an opportunity to see clearly just what the CC is thinking, and they remove the fear that just the act of discussing remedies will affect the likelihood of remedies being imposed. In fact, our experience is that parties who find themselves with an adverse finding at the provisional findings stage tend to play an active role in the design of the remedies that are eventually put in place.

There are several rather clear advantages in the design of this process. First, by encouraging the active participation of the parties, the CC benefits from their practical experience of the market and of what remedies might (or might not) be workable. It is, I think, also the case that by participating in the design of remedies, the parties affected by them are less likely to regard them as alien impositions. Second, the fact that the CC is responsible for remedies effectively means that the same group of members and staff that conducted the case and reached the adverse finding also design the remedies. In the old system, the case would be passed on from those in the CC who were familiar with it to staff in the OFT and the DTI who were not. At the very least, this rather cumbersome procedure resulted in the whole remedies process taking much longer. Third, a further and potentially more important effect is the discipline that the design of remedies has on those who are identifying adverse effects: we now have to remedy the adverse effects that we find and this means that we have to be sure about exactly what it is that we have found. In my view, this has led members and staff to work towards making their identification of adverse effects (addressing the questions of what?, who? and how much?) much more precise than hitherto. That is, the responsibility of designing
remedies has sharpened the precision of the analysis of adverse effects.

Independence is, however, more than just removing politicians from the centre of competition policy and making the CC determinative. An organisation that is given the responsibility to act as it sees fit is, in effect, being given a great responsibility and this is bound to have a major impact on its culture. This sense of responsibility has led the CC to make major investments in examining its procedures, think through the whole process of remedy design, and study the effectiveness of different kinds of remedies. The organisation has ceased seeing itself as an extension of the civil service, and, instead, it has begun to benchmark itself against leading competition authorities around the world. With responsibility taken comes self-confidence, and this has made it both easier and very natural for the organisation to design procedures that are much more transparent than they used to be.

Transparency

As part of the process of thinking about how to build a remedies phase into our inquiries, we undertook a thorough revision of our procedures. The Enterprise Act (Section 104) requires the CC to consult parties on a proposed decision along with the reasons behind that decision before it is made final. Consequently, an overriding concern for the CC was to make the way that we worked more open and more transparent.

In this connection, transparency has two dimensions: transparency to the world (particularly towards so-called third parties who have an active interest in the case, or are likely to be affected by its outcome) and transparency to the main parties. The first type of transparency is about inclusiveness and is designed to make it easier for third parties to participate in our process; the second type of transparency is designed to enable the
main parties to see - and comment on - the case and evidence against them.

The first consequence of our move towards greater transparency was a set of published guidelines which set out the procedures that the CC uses in the various types of investigations that it conducts. These guidelines describe the process and time scales of an investigation, identifying critical stages and the tasks that the CC will try to accomplish at each stage. These procedural guidelines are accompanied by a set of economic guidelines which describe how we address the various issues that might arise in an investigation – how we define markets, identify unilateral and co-ordinated effects, assesses competitiveness, interpret profitability data and so on. The object of all of this is to ensure that the parties to any inquiry understand where they are in that inquiry at every stage in the process, what kind of analysis the CC is undertaking and the tools that it is using.

Our revised procedures have, of course, affected the way in which we go about our investigations. The most visible change I have already mentioned, namely the publication of provisional findings. This is designed to enable the parties to understand the problems that the CC believes it has uncovered, and to address the CC’s arguments and concerns before a final decision is reached. In addition, we have a policy of making public as much of the evidence that we receive as we can by posting it on our website (with suitable excisions to protect confidentiality). The evidence that is made public (excisions aside) is the evidence that we will use to form our conclusions, and its publication enables the various parties to an investigation to understand what has been learnt during our investigation.

Our guidelines and the publication of provisional findings are examples of transparency to the world. We also make our thinking transparent to the main parties in several ways. Part of the new working process involves the production of what are called ‘working papers’ which pull together the facts of the case as the group conducting the inquiry understands them. These
working papers also explore the various issues of concern. They are often (but not always) shared with the parties to a case, both for factual checking as well as to give an indication of the CC’s thinking. In much the same spirit, the hearings held with the parties are used not just to collect information, but also to discuss the issues at the heart of the investigation, and we share our thinking on the case during the two or three hearings that we hold with the main parties.

The great problem with transparency is to balance the need to run an open and transparent process against the need to respect confidentiality (of evidence and of some third parties), a trade-off which militates against publishing everything. This said, transparency is important to the CC for two quite different reasons. In the first place, transparency is about fairness, about giving all parties - main parties and third parties alike - every opportunity to understand and address the concerns of the CC in any particular case. Indeed, the length of time taken on particular investigations, and the level of resources devoted to them, are driven in part by the need to ensure that all parties had a fair opportunity to address the CC and influence its thinking. Transparency is important for a second reason, and this has to do with efficiency. It is important for all the parties involved in a case to deploy their resources effectively, and that the investigation is not unnecessarily costly for all parties. For this to happen, everyone needs to know what the key issues are, and be able to focus on them in good time. Submissions that address issues that are not of major concern waste the time of both the parties and the CC.

Expertise

The decision to make the CC determinative carried with it a resourcing commitment. In part, the extension of the CC’s duties required additional resources to cover the additional responsibilities associated with devising and implementing remedies. In part, however, the decision to make the CC
determinative and benchmark it against leading authorities around the world carried with it a commitment to attract highly qualified staff, expert in their relevant fields of competition expertise, and to ensure that the CC made decisions which would be regarded as authoritative. In practice, this has happened in two ways.

The members of the CC are the group of individuals who make the decisions on particular investigations. There are about 50 members in total, and five are typically assigned for each case. In the days prior to the Enterprise Act, the CC was required to examine ‘the public interest’, and, to do this, it required members drawn from a relatively broad spectrum of the population. In the post-Enterprise Act era, the CC is required to examine whether a ‘substantial lessening of competition’ or, in the case of market inquiries, ‘adverse effects on competition’, has or may occur, and this requires a different set of skills in our members. As a consequence, recent appointments to the CC have included a rather higher number of economists, accountants and lawyers than hitherto. Further, independence means that these members must be (and, more importantly, must be seen to be) just that: free of conflicts of interest and not representing any interest groups.

The effect on staff of these changes has been no less profound. The CC nationally advertises virtually all of its staff positions, and operates on pay scales that are market related. This has attracted highly qualified staff members from the private sector – from economics and other consultancies, law firms, and the private sector more generally. In addition, we have invested heavily in training for staff, and several are doing further advanced degrees. All of this has happened in tandem with major investments in our IT infrastructure.

All of this has had a subtle but pervasive impact on the culture of the organisation, and on how well it works. There is a strong ethic of professionalism among staff members, and a considerable focus on our project management skills. The
organisation now actively interacts on a give and take basis with other competition agencies, as well as with a number of private sector bodies. The CC is sharing its expertise at the international level with organisations such as the International Competition Network (ICN). We are, for example, currently working with the Irish Competition Authority on a study of merger remedies within the ICN’s Analytical Framework Group.

The simple fact is that these changes are important because they have made transparency easier to manage, and they have made it easier for the organisation to rise to the challenge of independence. Probably most fundamental of all is the effect that expertise has on the consistency of our decision making. A deep, lively, and commonly shared body of expertise is one of the major ways that we ensure that our decisions across a wide range of different investigations in different sectors are mutually consistent (or at least as mutually consistent as the need for autonomy and independence at group level allows).

And so, what is next?

The pace of change at the CC over the past 2–3 years has been rapid by any standard, and certainly by comparison with that experienced by the organisation over the preceding 2–3 decades. We welcome these changes and have undertaken a significant amount of preparation to ensure that we have the right procedures in place fully to accommodate our increased responsibilities. However, events do not stand still, and the organisation has a number of challenges that it is likely to face in the near future. Let me conclude by identifying a number of these.

One set of challenges is external to the organisation. The modernisation drive emanating from Brussels is designed to decentralise the application of anti-trust policy throughout Europe, placing more responsibility for this on national competition authorities. It is still early days for this process, and
its effects will be felt by all UK competition authorities. More specific to the CC is the CAT. As yet, none of the decisions made by the CC have been reviewed by the CAT, but this state of affairs is unlikely to persist for long. The CAT’s importance lies in ensuring that UK competition authorities are accountable for their decisions. The OFT has experienced appeals being made against its decisions to the CAT and we too must work on the expectation that a challenge will be made on our decisions at some point in the future. Quite what the impact of the review procedure for the CC will be is, as yet, unclear.

Another set of challenges is internal. It is all well and good to raise the level of staff expertise and shift towards appointing more specialised members, but the most important part of these policies occurs after selection. Expertise and collective wisdom only stays alive if it is used, if it is shared and reflected on. Commitments to standards must not slip, and this requires high levels of intellectual engagement both inside and outside of case work. Guidelines must not become rigid or inflexible, and they must be updated on a regular basis to reflect changes in thinking and practice driven by experience. There is a fine line between being imaginative and being thorough, between exploring the issues as we see fit and not setting off in unpredictable ways on unexpected journeys of discovery. In part, what helps to resolve such tensions are guidelines which are clear enough to provide guidance, flexible enough to enable them to be used in the very different types of cases we examine and up to date enough to insure that we make the right decisions for the right reasons.

Finally, we must expect our independence to be challenged in the future. We are confident that we have the independence, transparency in our procedures and expertise to enable us to make well reasoned, robust decisions on high profile and politically sensitive cases. Independence does not mean that we do not listen to different views, but it does mean that the final decision is ours. And it also means that we must be willing to make a decision that we believe is right, even if it is not very popular. Whether we will measure up to this standard remains to be seen.
17 REGULATION OF MUNICIPAL WASTE DISPOSAL

Ralph Turvey

Introduction

Household waste is collected by local authorities or by contractors employed by them and is disposed of by waste disposal authorities, often using contractors. Many of these authorities are constituted by a combination of local authorities. They are set targets and are inspected by central government and they are a focus of attention by the European Commission in the context of environmental protection. The result is that big changes are projected in the way household waste is disposed of.

This chapter takes a look at some of the policy issues involved from an economist’s perspective. It starts by providing some background information on waste disposal, and then describes relevant EU directives which are binding upon our government before examining two recent measures introduced or to be introduced here. In conclusion some critical remarks are made about the approach followed by the Commission and by our government.

Background information

Basic magnitudes

Around 375m tonnes of waste are produced every year in England.

MUNICIPAL WASTE DISPOSAL

- 25m tonnes come from householders (regular household collection, separate collections of bulky wastes, clinical waste, and waste that goes to civic amenity sites);
- 47m tonnes from industry;
- 24m tonnes from commercial businesses;
- 89m tonnes construction and demolition waste

with materials such as agricultural wastes, mining and quarry wastes, sewage sludge and dredged spoils making up the balance.

Household waste makes up some 89% of municipal waste, which also includes street litter, waste sent to council recycling points, municipal parks and garden wastes, council office waste, and some commercial waste from shops and small trading estates where local authority waste collection agreements are in place. Its main components typically include garden waste (20% by weight), paper and board (18%); putrescible waste such as kitchen waste (17%); glass (7%), miscellaneous non-combustible waste (5%), dense plastics (4%); and textiles (3%).

The amount of municipal waste produced in England is growing at around 3-4% per year, faster than the 2-2.5% growth in GDP.

Disposal methods

The following Figure 1 taken from a European Community document shows the main flows in waste collection and disposal.²

² Taken from European Commission, DG Environment (2000), A Study on the Economic Valuation of Environmental Externalities from Landfill Disposal and Incineration of Waste, Final Main Report, Figure 4.1, October.
Recycling: recyclates may be separated by households for separate collection or sorted at collection depots; some can also be separated from treatment residues.

Composting: involves the controlled aerobic degradation of organic material, a process providing stabilisation and sanitation and reducing bulk. The highest-grade compost results from uncontaminated segregated organic waste and can be used on agricultural land. Uses for lower-grade composts, eg, composts arising from mixed municipal waste, include landfill cover material. With active aerobic biodegradation processes the biodegradable portion of municipal solid waste can be stabilised in a significantly shorter time frame than under anaerobic conditions by providing the organic waste fractions with the proper proportions of air and moisture.

Incineration: of waste, sometimes referred to as ‘energy from waste’, reduces the volume of waste by 90%-95%, its solid residues making up 25%-30% of the weight before incineration. Valuable energy is recovered as electricity (entitling the operators to benefit from renewables obligation certificates) and
heat. England makes less use of incineration than other industrialised countries and capacity has been increasing very slowly in recent years.

**Bio-mechanical waste treatment**: is a generic name for a range of processes. In its simplest form it bio-stabilises the mass of residual waste and is followed by landfill. Otherwise some valuable components may be obtained from the residual waste for recycling, anaerobic digestion, composting of the organic fraction and energy recovery.

**Landfill**: when biodegradable waste, such as paper, card and waste food, is disposed of to the oxygen-free (anaerobic) conditions of a landfill, breakdown by bacteria produces gas and soluble chemicals. The soluble chemicals combine with liquids in the waste (eg, rainwater) to form landfill leachate. The gas has a methane content of 36% to 60% and can be used to generate electricity, for the production of hot water or steam (eg, heating of greenhouse, dehydration of live stock feed) or to treat leachates. As good practice requires, all recent sites in the UK now possess a bottom liner and leachate collection system to minimise emissions to water.

England landfills the majority of its municipal waste, almost 80% of municipal waste being handled in this way, compared with 50% of commercial and industrial waste. Through recycling (12%), composting, or energy recovery, some sort of value was obtained from 21% of municipal waste in 2000/01. This is in contrast to the waste management methods of most European countries. For example, Switzerland recycles or composts 45%, incinerates 48% and landfills just 7%.

Note that even if all the waste which could be recycled, composted or incinerated, was treated in one or more of these ways, both waste unsuitable for any other treatment, eg, some construction wastes, and the residues from these other processes, would still have to be landfilled.
Disposal costs

There is a wide range in costs between authorities and regions, both in actual costs and in the approach to reporting costs. Collection, transfer and transport costs, which are significant components of the overall cost, are simply not uniform across different parts of the country; geology and the availability of void space vary. For London, estimates made in 1998 of disposal costs per tonne were:

- landfill - £30, less revenue from energy sales equivalent to less than £1 per tonne, giving a total of the order £29-30;

- incineration - £44 for incineration, £13 for the disposal of residual ash, less £15 from the sale of heat and power, giving a total of £42 per tonne for a new 300,000 tonne plant.\(^3\)

More recent disposal cost estimates for new installations put the cost per tonne of landfill, excluding the landfill tax, at £19 rising to £22 and the cost for mass-burn incineration at £45.\(^4\) Earlier estimates compiled using data from Defra, Biffa and Coopers & Lybrand (1997) had put the gate costs per tonne of landfill at £11 less than for incineration.\(^5\) It certainly appears that, except where sites are difficult to establish, landfill is the cheapest disposal method. The greater use made of it in the UK than elsewhere in Europe reflects British geology and extraction industry history, which have made suitable landfill sites relatively abundant. This explains why the UK spends only 80p per week per capita on municipal waste management against a European average of £1.40.

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\(^4\) Oxera (2004), A Strategic and Economic Overview of Municipal Waste Management, Table 2.4, March 8.
Externalities

Landfill adversely affects the quality of the environment surrounding landfills, in ways including noise, odour and litter problems.

A mixture of carbon dioxide and methane is released from the anaerobic decomposition of organic materials, the amount of carbon dioxide replacing the amount absorbed by them during growth. The global warming potential of methane is a multiple of that of carbon dioxide. Collecting the gas and flaring or combusting it can consume a large fraction of it, though low levels of pollutants not previously present in it, such as dioxins, are formed during combustion. Prediction of the amount and timing of methane generation is very uncertain. The methane capture efficiency of an actively pumped system can be in the region of 70%.

Infiltration of precipitation and surface water into landfills coupled with the biochemical and physical breakdown of waste produces a leachate with a high organic and inorganic content which can cause various adverse impacts. But leachate management, whereby the leachate is collected and treated, produces sludge which can be landfilled and harmless discharges to water courses. There is uncertainty about the emissions from modern/controlled landfills after site closure; landfill liners will not contain waste indefinitely.

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6 Two recent reports survey what is known and what is not known about the extent of some externalities and their health effects, National Society for Clean Air and Environmental Protection (2002), Comparison of Emissions from Waste Management Options, June; Department for Environment, Food and Rural Affairs (2004), Review of Environmental and Health Effects of Waste Management: Municipal Solid Waste and Similar Wastes, May. A report, produced in 2003 by Cambridge Econometrics in association with EFTEC and WRc., applied hedonic regression to examine the effect upon the prices of houses close to landfill which result from odour, dust, litter, noise, vermin and visual intrusion.
Incineration produces emissions to air including carbon dioxide which, insofar as it comes from combustion of organic materials, replaces that absorbed by those materials during growth.

Contaminants in the flue gas are emitted into the atmosphere via the smokestack, although their concentrations can be reduced using flue gas treatment processes. Pollutants removed from the flue gases, necessarily end up either in the wastewater and/or in the residual solid waste which includes bottom ash and the more toxic residues from flue gas treatment, and is typically disposed of at a landfill site.

Road movements of waste collection and transfer vehicles are frequently mentioned as an external diseconomy without recognition that fuel taxes and, in the future, congestion-related road use charges wholly or partly offset this and that, since all vehicles of the same size and speed have similar effects, the right remedy should apply to all of them and not just to waste transport.

The ‘proximity principle’, favoured by the European Commission in an environmental context, is that all waste should be disposed of, or otherwise managed, as near to its place of production as possible. This is one way of dealing with externalities (albeit sometimes a sub-optimal one since it disregards costs). In effect it internalises externalities by making the inhabitants of the area which generate the waste suffer any deleterious effects of its disposal. But nowadays these effects are minimised, Environment Agency inspections ensuring that waste is disposed of in ways which protect the environment and human health.

The difficulties of founding policy measures upon cost benefit analyses are, unfortunately, very considerable in the present context. The European Commission commissioned some extensive studies of the valuation of land fill and incineration externalities, publishing an excellent methodological study in
2000 (European Commission, DG Environment, 2000). This considered external costs related to:

- greenhouse gases causing climate change;
- conventional air pollutants and some airborne toxic substances causing eg, health effects;
- leachate to soil and water;
- disamenity effects of the facilities, eg, visual effects, noise, smell and litter (which have been shown to lower the value of houses within half a mile of a landfill);
- and, as an offset, the cost of the alternative energy replaced by energy recovered from waste.

A ‘robust’ conclusion was that “there is no easy and straightforward answer as to whether incineration or landfill disposal is preferable from the point of view of external effects”. It found that only:

> “the following results can be seen as relatively clear given the current state of knowledge. For incinerators, the most important effects seem to be classical air pollutants whereas disamenity and global warming effects seem to be of a somewhat smaller dimension. For landfills, the major effects seem to be disamenity and global warming. According to current knowledge, leachates play a minor role as regards the overall externalities”.

It considered that, in general, the methodology for valuing externalities from air pollution was fairly well developed and could be applied with a relatively high degree of confidence. Unfortunately, however, for disamenity effects and, in particular, emissions to water and soil, there were relatively few attempts of economic valuation; it considered the existing data and methodologies to be highly uncertain. There was a substantial need for further research, and substantial efforts should be put into establishing data required for more exact analyses.
The great uncertainties are illustrated by an example calculation for landfill showing a possible range of external disposal costs of £4-£16 for a modern containment landfill that fulfils the demand of the recent Landfill Directive, with a leachate collection and treatment system and use of the landfill gas to generate electricity and heat (CHP).

Some of these uncertainties stem from the vagueness of a generic specification; an engineering design for a specific landfill or incineration plant might be able to quantify some of the physical magnitudes more precisely, though the time-path over many years of emissions from landfill is particularly uncertain. Many of them, however, simply result from a lack of knowledge. It is difficult to know whether to be more impressed by the extent of what is now known or by the extent of our present ignorance.

Since the main externality from landfill which cannot be countered by strict design and operational requirements is methane emission to the atmosphere, it might be thought that the way to deal with it would be a tax proportioned to the adverse climatic effect. But though the amount of methane that is flared or used to generate electricity can be measured, the residual amount of methane emitted to the atmosphere cannot. Hence there is a case for recourse to quantitative regulation of the biodegradable landfill which is readily quantifiable.

EU directives

The EU Landfill Directive

The requirements of the directive 99/31/EC include:

- reducing biodegradable municipal waste landfilled down to 75% of that produced in 1995 by 2010 and down to 35% by 2020 (this allows for a four year derogation which the UK has announced it will use);

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7 ibid Table 9.3.
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- banning the disposal of certain types of waste (clinical, liquid, explosive, corrosive, oxidising, flammable, highly flammable waste and tyres);

- treating most wastes before landfilling;

- classifying landfill sites as either hazardous, non-hazardous or inert waste;

- having waste acceptance procedures in place at the landfill;

- prescriptive engineering standards.

If it meets the directive targets Britain will avoid paying infraction fines in the region of £65,000 per day. In addition it could be fined £500,000 per day, up to £180m per year, for not meeting the reduction targets.

The EU Incineration Directive

Directive 2000/76/EC lays down detailed stringent operational conditions, technical requirements and emission limit values concerning the operation of incineration plants. Emission limit values are set for:

- flue gas dust, vaporous organic substances, hydrogen chloride and fluoride, nitrogen oxides, sulphur dioxide, heavy metals and dioxins;

- suspended solids, heavy metals and dioxins in the waste water discharged from the cleaning of exhaust gases

To cite but one example of the detailed level of the requirements imposed, Article 6.1 states that:

“Incineration plants shall be designed, equipped, built and operated in such a way that the gas resulting from the process is raised, after the last injection of
combustion air, in a controlled and homogeneous fashion and even under the most unfavourable conditions, to a temperature of 850°C, as measured near the inner wall or at another representative point of the combustion chamber as authorised by the competent authority, for two seconds. If hazardous wastes with a content of more than 1% of halogenated organic substances, expressed as chlorine, are incinerated, the temperature has to be raised to 1 100°C for at least two seconds”.

**Purpose of the directives**

The preamble of Council Directive 75/442/EEC of 15 July 1975 on waste states quite acceptably that the essential objective of all provisions relating to waste disposal must be the protection of human health and the environment. But its explanation of why this should be the collective business of the EU is less clear. The relevant ‘whereas’ clauses are:

“Whereas any disparity between the provisions on waste disposal already applicable or in preparation in the various member states may create unequal conditions of competition and thus directly affect the functioning of the common market;

Whereas the programme of action of the European Communities on the environment stresses the need for Community action, including the harmonisation of legislation;

Whereas effective and consistent regulations on waste disposal which neither obstruct intra-Community trade nor affect conditions of competition should be applied to movable property which the owner disposes of or is required to dispose of.”
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Two articles of the Incineration Directive state why rules about incineration are considered to be properly a collective responsibility of the EU:

“(5) In accordance with the principles of subsidiarity and proportionality as set out in Article 5 of the Treaty, there is a need to take action at the level of the Community. The precautionary principle provides the basis for further measures. This directive confines itself to minimum requirements for incineration and co-incineration plants.

(10) It is necessary to set strict rules for all plants incinerating or co-incinerating waste in order to avoid transboundary movements to plants operating at lower costs due to less stringent environmental standards”.

These justifications curiously fail to include the main convincing argument in favour of cross-country rules, namely cross-border externalities. Otherwise they are not convincing.

• the precautionary principle can perfectly well be applied at the national level;

• countries with cheaper waste disposal have a competitive advantage; so do countries with cheaper or more skilled labour, cheaper energy or a better climate. It is such comparative advantages that make trade worthwhile;

• the only reference to costs has nothing to do with the weighing up of costs and benefits in determining the appropriate level of protection of the environment and human health.

However, it turns out that the Commission is not completely insensible to the desirability of founding policy upon cost-benefit analysis as it demonstrated by commissioning the research on the valuation of landfill and incineration externalities mentioned
above. But it did not await the results of such analysis before deciding on the directives it has introduced.

**UK measures**

Meeting the Landfill Directive targets for reducing the amount of biodegradable municipal waste that is landfilled is a major aim of UK policy. The landfill tax and/or landfill allowances, which are described below, serve to encourage and/or require this, but the choice between alternative ways of achieving it - reductions in arisings, or diversions from landfill through composting, recycling or incineration with energy recovery - is not to be decided centrally. Waste managers are to choose the best options in the particular circumstances of their areas, taking account of environmental impacts as well as financial costs. Nevertheless, the government has introduced statutory targets, growing through time, for local authorities for the proportion of household waste that is recycled or composted and for the proportion from which value is recovered.

In its Waste Strategy 2000, the Department for Environment, Food and Rural Affairs (Defra), provided estimates of the possible costs of different ways of achieving the targeted reduction in landfill of biodegradable municipal waste.\(^8\) These rested upon modelling four alternative mixes of waste management options for two alternative postulated rates of growth of waste arisings and two alternative percentages of waste segregated by households for recycling, using a whole series of cost and other assumptions. The present worth at 6% of the extra costs over the years 2000-2020 compared with the base case (current levels of recycling, composting, and energy recovery, all other waste going to landfill) varied under sixteen combinations of assumptions between £1.8bn and £7.7bn, proportional increases over the base case cost of between 10% and 33%. The lowest increase was for the case of zero growth,

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with current levels of recycling and composting and all waste diversion required to meet the targets achieved through incineration with energy recovery. However the costs of avoiding any growth in waste volume were not assessed.

Public opinion as well as EU directives has played a role in determining policy in Britain. The Strategy Unit observed that:

“Most householders say they do not want landfill or incinerators (even though in reality 80% of the UK public live within 2km of a landfill, open or closed). People say they do not want landfill but are concerned about the risks from incineration (even though the perception of the risk is massively higher than the reality - about the same likelihood as the risk of death from a lightning strike)” (Strategy Unit, 2002: para 5.22).

The Unit favoured a reduction and recycling option:

“to be achieved through a series of measures including: substantive increases in landfill tax and new incentives on households to reduce waste and increase recycling by local authorities that wish to take this forward”.

The landfill tax

The UK landfill tax dates from 1996. A low rate of £2 per tonne is applied to ‘inactive’ wastes and a standard rate is applied to ‘active’ wastes. The lower rate has remained at £2 per tonne since inception, while the standard rate was increased from £7 per tonne to £10 per tonne in 1999 with an escalator according to which annual increases are being imposed which will take it up to £18 in 2005-06, on the way towards a medium or long-term rate of £35.
An offset to the tax was provided by a 0.2 percentage point cut in employers’ national insurance contributions. At the same time, in 1996, a Landfill Tax Credit Scheme was introduced, allowing landfill operators to allocate up to 20% of their tax liability to approved environmental projects. This has been criticised for not doing enough to fund projects to reduce, re-use or recycle waste and for a lack of transparency and quantifiable outputs. Landfill tax increases are now to be made ‘revenue neutral to business as a whole’ in ways forming the subject of consultations.

Originally the landfill tax rates were based on the estimated value of the environmental externalities of waste disposal at landfill but with the escalator the tax has, in the words of the Strategy Unit:

“become more of a ‘behavioural’ tax, designed to reduce further our reliance on landfill, and encourage a shift towards more sustainable waste disposal practices. It was at too low a rate either to incentivise industry to develop more resource efficient means of production or to encourage local authorities to use alternatives …. Based on SU analysis of the relative prices of waste management options, a landfill tax rate of £35/t would provide a sufficient incentive to change behaviour and reduce reliance on landfill as the major waste management option” (Strategy Unit, 2002; paras 6.45 and 6.54).

A readiness on the part of government to recognise the taxation of externalities as an appropriate tool in some circumstances for dealing with market failures is welcome, but it comes as a shock to find the Strategy Unit proposing a killer tax much exceeding the marginal social cost of the externalities. Their justification can only be a belief that the targets laid down by the Landfill Directive cannot otherwise be met. The Strategy Unit implicitly treats these targets as sacrosanct, presumably not having felt free to examine the question, obvious to an economist, of whether they may be uneconomically excessive.
Part 1 of the Waste and Emissions Trading Act 2003 established a system of landfill allowances for biodegradable municipal waste. The allowances will have to be so set that their aggregate will conform to the requirements of the Landfill Directive. They are to be issued according to criteria that will be the same across the UK, allocation being made, for example, on the basis of the amount sent to landfill in a recent year.

The allowances are to be tradable, in England at least - it is for devolved authorities to decide for each of their territories - so that local authorities able to reduce the volume of such waste most cheaply will be able to transfer part of their allowances to authorities whose costs of reducing landfill are high. This is clearly a sensible idea, since it will reduce the aggregate cost of keeping within the aggregate of allowances.

While the landfill tax is levied on all waste sent to landfill for final disposal, continuing to levy it on biodegradable municipal waste once the allowance system is introduced for such waste would seem inappropriate. If, as is proposed, the allowances are rigorously enforced (with a system of fines) levying a landfill tax on this waste is unnecessary. It is a simple economics proposition that:

- determining quantities and leaving the market to determine prices;
- levying a tax and leaving the market to determine quantities

are alternatives. As a Treasury paper expressed it “a tax or tradable permit scheme will allow negative externalities to be incorporated in prices”.⁹

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This means that since the tradable landfill allowances will force biodegradable municipal waste landfill down to the level required by the Landfill Directive:

- the function of the tax should be limited to controlling the landfilling of commercial and industrial waste;
- there will be no need for continuing (let alone increasing) the landfill tax on biodegradable municipal waste landfill.

The Strategy Unit was far from clear on this point, stating in paragraph 6.52 that:

“It is not envisaged that the operation of the tradable allowances scheme will be adversely affected by increases in the landfill tax. It supplements the effect of the tax by providing an additional incentive to ensure that targets under article 5 of the directive relating to biodegradable municipal waste will be met. However, significant rises in landfill tax rates to those approaching the highest rates in Europe, could remove the incentive for local authorities to trade allowances as the net cost of diverting waste to alternative waste management options falls”.

Policy arguments

The Commission

It is not obviously desirable that the UK should have had the quantitative limits in the Landfill Directive imposed upon it, even with the derogation which permits it to delay implementation longer than most other member countries because of its historically high reliance on landfill. Environmental issues are an appropriate subject for European-wide legislation when they involve cross-border externalities, and the only ones of any
importance in the present context are incinerator emissions and methane emission. Noise, smell, dust and (any) health effects arise in the vicinity of waste disposal sites and are proper concerns for local and national governments. Cross-border externalities, on the other hand, are proper concerns for European wide regulation. As regards the latter, however, Article 6 of the Landfill Directive requires member states to take measures in order that only waste that has been subject to treatment is landfilled. If this comes about and treatment deals effectively with the biodegradable components of waste, the only landfill methane emissions of importance will be those from existing landfills about which little can be done. There will then be no need to limit landfill on account of impact upon global warming.

Instead of sorting out where subsidiarity is and is not appropriate in dealing with waste disposal, the Commission has gone further than is justified by cross-border externalities in its regulatory activity. It has yielded to the temptation to suppose that where there is a problem a community remedy is necessarily the right one. It has based its actions upon principles which apply at the national or even local level as well as at the European or global level. Without mentioning the costs of alternatives, it has proposed that the priorities of different means of dealing with waste be ranked as follows:

“1. Prevention
2. Reuse
3. Recycling
4. Energy recovery
5. Disposal on landfill”.

This kind of approach is widely accepted, though its indifference to cost is a clear weakness. Member states can either generally follow it in deciding on their measures to deal with the environmentally unacceptable effects of waste disposal or, preferably, take the approach of minimising cost subject to constraints upon environmental effects.
The UK government

The query pointed to above as to whether the Strategy Unit’s proposal for a killer tax was justified has been tactfully expressed by the Treasury as follows:

“It is not always clear that targets set by EU environmental legislation are commensurate with the environmental costs imposed by particular sources of pollution within the UK. For example, it could be argued that the Landfill Directive targets will require much greater reductions in the quantity of waste landfilled than might be implied by the initial estimates of the external costs of landfill in the UK. In addition, the quantity of waste sent to landfill in the UK has relatively little consequence for the environment outside the UK. Of course, such assessments are complicated by the uncertainties and the costs and benefits may change over time” (HM Treasury, 2002: para 5.23).

Since landfill remains the cheapest alternative for the disposal of municipal waste in some regions of the country it is fortunate that the government has at least accepted economists’ arguments for the tradability of landfill allowances. But there appears to have been some confusion as to the respective role that these allowances and the landfill tax will play.
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References
(bold numbers refer to the footnote in which first cited)


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