REGULATORY REVIEW
2006/2007
10th Anniversary Edition

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PREFACE

The CRI is pleased to publish its Regulatory Review 2006/2007 ~ 10th Anniversary Edition. We thought we should mark the fact that this is the tenth CRI Regulatory Review, the first being published in 1993. In recent years the Regulatory Review has been published every two years. Another way we have marked this anniversary is by producing a ‘bumper’ edition, running this time to 501 pages and twenty two chapters.

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 Autumn of 2006.

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 has published a wide range of occasional and technical papers, research reports and regulatory briefs. Enquiries and manuscripts should be addressed to the CRI.

Peter Vass
Director, CRI
March 2007
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1 AIRPORTS REGULATION

Michael Toms

Introduction

Over the last year all eyes in the airports industry have been on the takeover of airport operator BAA. The emergence of ADI, a consortium of Grupo Ferrovial (a Spanish construction company), CDPQ (a Canadian pension fund) and GIC (an investment arm of the Singaporean government) as owners and operators of the UK’s major gateways on the world is certainly a significant event. The fact that it follows on from the growth of Australian Infrastructure Funds, managed by Macquarie Bank, into the world’s second biggest airport operator gives added significance to the change. The announcement of the planned sale of Leeds Bradford airport in December leaves Manchester airport group as the only major publicly owned airport operator in the UK.

A system which had previously operated on the basis of a stable, informal, give and take partnership between government, the Civil Aviation Authority (CAA) and airports to deliver capacity has been replaced by something which feels quite different. The system now has to accommodate a world in which airports are tradeable assets and investment decisions are made on strict economic criteria. This change has brought into sharp focus four core regulatory issues:

• the relationship between the government’s airports policy and an independent airport regulator;
AIRPORTS REGULATION

- the degree to which airports and airlines can and should negotiate key outputs, independent of the regulator or passenger interests;

- the relevance or otherwise of financing considerations to the setting of regulated airport charges;

- whether airports serving overlapping geographical markets can and should be structured to compete with each other.

Who sets airport policy?

The basis for BAA’s privatisation and regulation was set out as long ago as 1985 in an airports white paper. This identified the CAA as the industry’s regulator. The subsequent Airports Act 1986 set out the CAA’s duties, including an explicit duty to encourage investment in time to meet anticipated demand from users. The 1985 white paper made it clear that regulation should respect government policy. It said “there must be adequate regulatory arrangements in place to ensure that the policies pursued by the management of the major airports fully support the government’s aviation policies” (ibid, para 10.1). The same white paper set out the government’s airports policy, including the development of Stansted and further development of Heathrow, as the framework for regulation.

Over the following fifteen years the question of ownership of policy lay dormant as there was a broad consensus in the industry as to the type and pace of investment required. The issue has now returned with a vengeance, following the most recent Air Transport white paper in 2003. This document sets out developments the government wishes to see up to 2030, with their sequence and timing. Most notably, it states the

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1 Airport Policy White Paper 1985, Cmnd 9542.
government’s policy that the next runway for London should be developed at Stansted as soon as possible, with a target date for opening of 2012.

The white paper had not been produced lightly. It had resulted from three years of studies of a wide range of sites, and a huge public consultation involving half a million submissions from individuals and organisations. The CAA itself had been a consultee, but its own submission had not advised the government of either its own assessment of demand or its own preferred development strategy.

When the white paper was published, the CAA welcomed its overall thrust of attempting to meet the needs of travellers by additional capacity provision. However, it fell short of endorsing the specific policy of a second runway at Stansted as soon as possible. The CAA’s view appears to be that a runway at Stansted should only be delivered as and when it represents a sound financial investment for the airport. The fact that the soundness of the investment will depend in large part on the CAA’s own decisions on the price control formula at Stansted is captured in paragraph 16 of a CAA paper in December 2005 which says “the challenge for the CAA is to set the incentive framework to encourage BAA to implement....lumpy investments where it is economic to do so”.

Initially, the main difference between the CAA and the government appeared to lie with the timing of construction of the runway. The CAA did not adopt the ‘as soon as possible’ principle, because it did not accept the government’s underlying rationale. The CAA did not adopt the government’s underlying traffic forecasts, or alternatively provide forecasts of its own. The CAA found no framework in its own duties for the government’s proposition that early development of Stansted

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5 Civil Aviation Authority (2005), Airport Review, Policy Issues, CAA, December.
would aid the UK economy generally, or benefit Heathrow and Gatwick passengers, by stimulating competition between airlines. This difference between the CAA and government is broadly based. The CAA has not accepted in principle that as a matter of policy Stansted should have a second runway in the period to 2030. On the face of it, the CAA appears to be neutral to the development. This difference would be interesting, but academic, if the CAA were not in a position, in effect, to override government policy and determine the rate of development by its price control decisions. In this respect the CAA has made its position on the white paper clear. As recently as May 2006 the CAA said “The CAA will take account of the white paper only as far as is compatible with (the CAA’s) functions and duties”.

The CAA’s approach has been carried through in its regulatory activity:

- in February 2003, in setting the 2003-2008 price formulae ten months before the white paper, the CAA announced that it would sanction charges for development at each airport only on the basis that it would not be remunerated from overall London system revenues. This measure was most likely to restrict development at Stansted, which has the smallest base revenues from existing traffic. The decision was taken without modelling of its impact on the timing of capacity and the impact of airport capacity delivery delays on the scope for competition between airlines;

- in September 2003, before the white paper was published, BAA had asked the CAA to clarify its attitude to the recovery of preconstruction costs for whatever runway was chosen for early development. The CAA did not address this request until it had seen the white paper. Immediately after publication of the white paper, BAA set to work on designing the Stansted scheme and acquiring land. It was not until September 2004 that the CAA launched a consultation into whether and how

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6 Civil Aviation Authority (2006a), Airport Review Policy Issues Update, CAA, May.
such mounting costs should be recovered. In January 2005 it published a decision to allow such costs into the regulatory asset base, subject to onerous conditions. It withdrew its decision and recon­sulted. In March 2006 the CAA then abandoned the consul­tation, leaving the issue to be decided by the Competition Commission. By the time BAA knows whether its costs will be allowed, it will have spent over £100m on the scheme;

• from the publication of the white paper onwards, the CAA was careful to qualify its relevance. Its December 2005 policy paper is a good example. Para 12 states “(the white paper) was based on evidence then available and the government’s own analysis of it using different criteria from those in the Airports Act 1986. Importantly, the white paper stopped short of mandating (or even authorising) particular developments or precluding others”. This last sentence is particularly notable the significance it ascribes to a statement, which was no more than a legal recognition that under UK town planning law a white paper cannot amount to a refusal or approval of planning permission for any development.

What this discussion illustrates is a philosophical conflict between the government’s wish for an orderly and planned sequence of developments to meet broad public policy objectives within environmental constraints, and the CAA’s wish for economic forces to decide when and where development takes place. It also illustrates a fault line between the CAA’s desire for economic forces to determine investment, and its own control of those economic forces through its price setting duties. The airport operator has been left in no-man’s land between two of its most important stakeholders.

At the close of 2006 this uncomfortable situation moved significantly. The CAA appears to have found a way to avoid creating any kind of active signal for the timing of Stansted by proposing that the airport, along with Manchester airport is dedesignated for price control and set free to determine its own
AIRPORTS REGULATION

charges and investment.\textsuperscript{7} It has accompanied this by a clear statement that it does not endorse the Stansted generation 2 runway plan (para 4.19), although it had involved itself continuously in the shaping of that plan over the previous three years. Two weeks after this announcement, in its white paper progress report, the government gave considerable ground to the CAA by avoiding an explicit restatement of the ‘Stansted runway as soon as possible’ principle.\textsuperscript{8} It admitted that the CAA’s regulatory decisions could affect the timing of the project (para 5.14) but chose not to exhort the CAA to use its powers to assist in early delivery. The reader might be inclined to ponder whether and when the CAA and the government actually want the scheme to be implemented, and how BAA should manage this uncertainty.

Constructive engagement

When the CAA’s new regulation team took office in 2003, they were immediately concerned about the bitter and angry atmosphere between airports and their airline customers. They concluded that this reflected a failure by both sides to communicate and engage on the issues (an alternative interpretation is that it reflected the airlines’ shock at being confronted with a price formula of RPI + 6.5 at Heathrow to pay for the fifth terminal). It also felt that the previous price review had been unsatisfactory in the degree to which the regulator had been required to determine issues which might better have been settled directly between the parties, notably volume forecasts, required service quality levels and capital expenditure plans.\textsuperscript{9}

\textsuperscript{7} Civil Aviation Authority (2006b), Airports Price Control Review – Initial Proposals for Heathrow, Gatwick and Stansted, CAA December 2006.
\textsuperscript{8} Department for Transport (2006), The Future of Air Transport Progress Report, December.
\textsuperscript{9} Civil Aviation Authority (2004), Airport Regulation, Looking to the Future, Learning from the Past, May.
The CAA’s proposed solution to this very unsatisfactory situation was to put both sides on notice of the requirement to engage with each other constructively, and to agree the key inputs to the succeeding price review in advance. The threatened sanction was that failure to agree would lead to the CAA itself making decisions which would be unlikely to satisfy either side. The CAA’s constructive engagement (CE) proposals were set out in considerable detail, and care was taken to impress on the senior managers of airlines and airports the need to play their part.

BAA supported the general thrust of this proposal, although it had less ambitious expectations of the outcome. A great deal of consultation already took place, but a more structured approach, backed by the CAA, which helped the parties to put the past behind them and focus on the deliverables of discussion, was to be welcomed. Specialist process managers were appointed, databases set up online and workstreams with deadlines agreed. The CAA itself wisely kept off the field of play, to minimise the temptation to play to the gallery. Has it worked? Yes and no.

At Heathrow and Gatwick broad agreement has been reached on traffic forecasts; a shared high level vision of the future of the airports has been created; and progress has been made towards achieving a mutually satisfactory service quality regime. At Gatwick a broad consensus has also been established on the capital programme. Most helpfully, at both airports, there has been agreement on the levels of construction cost to be applied to capital projects. This had been unlocked by an agreement with the airports to pay the costs of airlines to appoint expert consultants.

However, at Heathrow, significant elements of the capital programme remain unresolved, largely because of differences between users on investment priorities. Unsurprisingly, users are less inclined to support investments benefiting other users than those which benefit themselves. The CAA’s response has been to repeat its exhortation to the airport to obtain agreement, although
with clear and rational differences between users and airlines, it is not obvious how a consensus will be reached. Without agreement, the CAA may find itself having to make a decision although it is not clear what criteria they would employ.

At Stansted, the process has been unproductive. There was not the necessary level of trust between the parties at the outset, and the playing out of the issues in the media, not always accurately, has made constructive negotiation very difficult. Notwithstanding this, the CAA has asked the airport to re-engage with users on an agenda defined by the airlines. History suggests that a likely result of such an engagement would be more delay to the second generation scheme.

Although the process is still not finished, a number of overall points are already clear:

- undertaken in the right spirit, CE helps relationship management and takes some heat out of differences between the parties. However, the model is not generic; it will only work if both sides chose to adopt co-operative strategies;

- the model works best where negotiation lies in the hands of line management, not regulatory ‘mud wrestlers’. At the outset, BAA put CE into the hands of its airport managing directors, rather than its regulation team. At Gatwick airlines by and large deployed line operational managers. At Heathrow, airline corporate regulatory advisers were not unseen, and lawyers and the press were ghosts at the table at Stansted;

- the process needs to deal with a natural disparity in resources between the parties. Airports, which have all of their revenues and their capital programmes at stake, will give more attention to CE than airlines for whom airport charges may be around 5% of costs, and shorter term issues may predominate. This puts a burden on airports to support the airlines through the issues (by, for instance, financing airline advisers). It also puts an onus on airlines to use their trade associations to pool their
resources. One of the least satisfactory aspects of the past two years was the failure of airline trade bodies to grasp the nettle of leadership of the issues;

- the process gives natural precedence to the views of existing customer airlines, whereas airport runways and terminals are built with economic lives of fifty years or more. Current airlines cannot be expected to speak for their successors and indeed they might be expected to wish to suppress opportunities for future competition. The history of airports is littered with airports designed for airlines which folded before the facilities even opened – Laker, Pan Am and TWA are all examples. Those who blame BAA for building the wrong airport at the wrong time at Stansted should remember that it was designed for the likes of B Cal and Dan Air, and that today’s two biggest users of the airport did not even exist when the plans were drawn up;

- finally, and most important of all, while the process brought airlines and airports closer, it provides no vehicle for the interests of passengers to be taken into account. Structurally CE invites airlines and airports to come to agreements which share rents, not necessarily to the benefit of consumers. The regulator must have a method for developing a backstop view of whether any deal is in the best interests of the ultimate consumer in, say, seat 13C.

Is financing relevant?

One of the distinguishing features of airport regulation is that the regulator has no duty to secure the financing of the business. Neither does the regulator have a power to impose licence restrictions on airport financing. These issues are addressed only indirectly in the regulator’s duty to set a price formula which encourages investment. The CAA’s 2003 price settlement was alive to this issue. The regulator made it clear that the financing of the business was a matter for the company, not the regulator,
and set a price formula based on a cost of capital which could attract new equity if necessary. Para 4.53 of the 2003 Decision document sets the tone.\(^7\) “Capital structure decisions are best left to the firm”. It then develops the policy.

“The CAA approach in determining the price caps is based on actual gearing rather than notionally ‘optimal’ gearing, due to the lack of a normative model to establish the latter”.

In para 4.58 the CAA spells out the implications of this.

“The CAA has therefore decided to adopt a cost of capital figure consistent with a robust view of the cost of equity…. That allows for the raising of new equity as well as debt where appropriate. ….this should allow BAA a range of options regarding future financial policy”.

The external landscape since 2003 has put this policy under pressure. BAA’s purchase of Budapest Airport in 2005, using the strength of its UK airport balance sheet, caused some anxiety. The emergence of highly geared private equity and infrastructure funds hungry to own utility assets has understandably also encouraged the CAA to shift its ground. The Ferrovial approach to BAA brought this into sharp focus. When Ferrovial’s interest had been announced, but before a bid had been formally tabled, the CAA acted. It issued a short statement, including the following:

“The CAA will set caps on airport charges in accordance with its statutory duties and not in order to accommodate any particular financing arrangements adopted. In this context it is important that in making financing arrangements airport operators recognise the significant near and medium term investment

\(^{10}\) Civil Aviation Authority (2003), Economic Regulation of BAA London Airports, CAA Decision, February.
required to upgrade airport facilities and accommodate a continuing increase in the demand for air travel in the south east of England. This is likely to require the maintenance of credit quality sufficient to ensure the cost-effective financing of future investment”  

This statement introduced a concept new to the CAA’s policies, the need to set a credit quality standard. The practical relevance of this is fairly understandable, though it is not clear in theory why, having set a cost of capital sufficient to attract new equity, the CAA should attempt to influence financial structures. At the time of this statement the market was awaiting a formal offer for the company. The share price had run up from £6.50 to £8.40 and observers had been expecting the bidder to rely on a highly geared financing structure. All other things being equal, one might have expected the market’s response to have been to mark down the share price in anticipation of withdrawal, or a less geared lower offer. In fact, the share price was unmoved.

The bid process unfolded: Ferrovial published a mainly debt financed offer at £8.10, and a Goldman Sachs consortium made an approach at £8.70. Neither appeared preoccupied by the CAA statement. On 16 May, the CAA was moved to make a further statement, in conjunction with a broader policy paper, reminding the market of its concerns about financing. It was explicit that the CAA would not bail out any overleveraged buyer through the price formula, and that it might take away any tax benefit from high leverage. The share price, hovering around £9, was unshaken. Both bidders found more borrowing capacity, and the group eventually changed hands at £9.50.

What had happened: or rather what hadn’t happened? Why had the CAA been so visibly unsuccessful in imposing its view of gearing? There are a number of possible explanations:

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11 Civil Aviation Authority (2006c), Possible Offer for BAA plc: CAA statement, February.
the market knew that, whatever its view, the CAA had no legal power to prevent a highly leveraged structure, before or after the event. Perhaps the most significant element of the CAA’s statement was the absence of any reference to any request to government for it to strengthen the CAA’s powers. The CAA might threaten to punish high gearing through the price settlement, but given the duty to encourage investment, it was not clear how this would work out in practice;

the CAA had not given an indication of the quantum of investment which it envisaged operators should plan for, although it had indicated its doubts about the urgency of delivering the Stansted scheme;

although the CAA made clear its policy concerns, it did not express them in terms of measurable thresholds, targets or standards which had to be met. Neither BAA nor the bidders knew which balance sheet was to be tested (the individual airport, the group of airports or the owning entity), what rating was to be required, or what financial ratios were to be targeted. All parties could persuade themselves that whatever they were doing was acceptable;

the CAA expected all parties to submit their financing proposals for scrutiny, but it made it clear it would not either preclear or reject any of those proposals. Bidders could only interpret the CAA’s state of comfort across the table.

In the heat of a bid battle, any intervention couched in such terms was likely to be of limited impact, and that did indeed turn out to be the case.

Ownership and competition

So far, so good. Up until 25 May 2006 there was only the company’s management, its investors, its creditors, its users, two potential bidders, the national media, an army of advisers and the
CAA involved in the future ownership of the airports. However, at 7am on that morning, just as BAA was launching its key ‘day 39’ defence document, the Office of Fair Trading (OFT) joined the party. It announced that it was considering launching a market study into the structure of the UK airports industry. Its press notice made it absolutely clear that the potential break-up of BAA was on the list of options.\(^\text{12}\)

At the outset it is worth being clear on one point. There is no evidence that this intervention was part of a broader government or regulatory agenda. So far as can be determined, it was an entirely independent act. It did however have some immediate consequences. The BAA share price fell by 70p to below the best price on the table at that time. Had this persisted it is likely that the OFT’s intervention would have accelerated the outcome least desired by the CAA, that is shareholder acceptance of a highly geared bid. In the event, this was postponed. BAA projected the announcement as an opportunity to reopen the consideration of improvements to the regulatory regime, and the share price recovered. And indeed, this is the most interesting structural issue raised by the OFT’s interest. If it is found that London’s airports would compete under separate ownership, price control would arguably need to be lifted, to allow competition to happen.

The OFT’s investigation was launched under the Enterprise Act. This allows for the OFT to conduct a short investigation (typically around three months) and to consult on the outcome. If it concludes that there is a market failure (as appears likely) it can either negotiate a voluntary remedy, or refer the issue to the Competition Commission. The Commission has two years to study the issue, and can direct a divestment at the end.

BAA faces the prospect of the Commission investigating airport charges under a mandatory reference from the CAA next year, with a six month deadline, while the commission is also setting out on a parallel, longer study of the airports market. The

timetables suggest that the CAA will determine the price control formula, taking account of the Commission’s recommendations on prices, about a year before the Commission decides whether the airports should be broken up, possibly with recommendations to government to change the regulatory framework. The price control review for Manchester – if it is still conducted – will take place a year later concluding just before the deadline for completion of any enterprise act studies.

In the last month of 2006 the CAA published its initial price proposals for 2003 to 2008 and the OFT published its draft thinking on the market, flagging real concerns about the system of price regulation. In an ideal world the cart would change places with the horse, and the ownership and regulatory framework would be clarified before prices are set. However, the different statutory obligations, and multiple agencies involved, offers no certainty of such an orderly process, or of an orderly outcome. Meanwhile, airport operators are expected to push ahead, raising money and investing in the growth of the business. It is not surprising that in 2003, the CAA itself noted that regulated companies are not necessarily less risky than their unregulated peers!

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2 COMMUNICATIONS REGULATION

Martin Cave and Matthew Corkery

Introduction

In late 2003, the Office of Communications Regulation (Ofcom) assumed its powers to regulate UK broadcasting, telecommunications and spectrum management, and shortly thereafter it commenced a three stage strategic review of telecommunications regulation. The telecommunications strategy review (TSR) reflected a feeling in the industry, and within Ofcom, that regulation introduced by Ofcom’s predecessor – Oftel – had become increasingly time-consuming to administer and excessively detailed in its oversight of industrial market activities, without either a focus on – or strategy for – deregulation. An infinite future of trench warfare with BT, the main fixed line operator (and the historic monopolist), seemed to beckon. This represented an unappealing prospect for both Ofcom and BT, and also for BT’s competitors, who criticised Oftel for ineffectiveness and delays. The TSR sought to offer a new strategic way forward.

This chapter summarises the conclusions of the review, and describes its early phase of implementation. We focus in particular on one key issue, the utility of separating the incumbent fixed line operator into ‘monopoly’ and ‘competitive’ operations; the better to regulate the former and deregulate the latter. Such separation can take several forms, as are discussed, and it seems that the debate, started by the TSR, has spread to other countries, such as Italy, Ireland and the Netherlands, as well as the Antipodes. The debate is particularly important in the
context of the ‘next generation’ internet protocol (IP)-based networks which operators in Europe are starting to install.

It should be added that the TSR addresses many other issues other than separation – such as fixed-mobile convergence and regulation of the mobile market. But the central issue remains the problem that years of regulation in the UK seem to have been unable effectively to remove the market power of the incumbent. Hence another approach was necessary, which involved separating BT into a potentially unregulated set of activities and a set of monopoly assets requiring regulation on a non-discriminatory basis.

The Telecoms Strategic Review

The context

In April 2004 Ofcom published the first phase of its strategic review of telecommunications (the Telecoms Review or TSR). The review aimed to set out Ofcom’s strategic direction for the telecommunications sector, and to create a new settlement between the regulator, the companies it regulates, and the UK’s citizens and consumers. This review included research and analysis conducted by Ofcom into the existing and future structure and nature of the UK telecoms sector, wherein Ofcom identified key themes in respect of growth, technological change and convergence of the telecoms value chain. A summary of this analysis (which draws directly from the phase 2 document) is set out below.¹

Telecommunications in the UK is a significant and growing sector in the economy:

- in 2002 UK telecommunications revenues were £50bn compared to £18bn in 1984 (at 2002 prices);

¹ http://www.ofcom.org.uk/consult/condocs/telecoms_p2/
• UK telecommunications revenue as a proportion of GDP has grown from 1.7% in 1985 to 2.3% in 2002;

• between 1999 and 2002, net capital expenditure by the UK telecommunications industry was an average of £9bn a year, accounting for 8% of all UK capital expenditure compared with 4% in 1984.

The sector, regulated by the Office of Telecommunications (Oftel) since the privatisation of BT in 1984, and until Ofcom’s inception in 2003, has changed beyond recognition in the last 20 years. There are now approximately 170 public fixed telecommunications providers, five mobile providers, 59 mobile service providers and 700 internet service providers. The telecoms sector is changing rapidly. Unlike broadcasting, where changes can be considered with reference to the central event of digital switchover, the telecoms sector is undergoing significant and concurrent changes, with the only common theme being an evolution from the relative simplicity of the past towards complexity in the future. This is summarised in the Table 1 below.

Table 1: Changes in the telecoms sector

<table>
<thead>
<tr>
<th>Old</th>
<th>New</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uniformity</td>
<td>Difference</td>
</tr>
<tr>
<td>Voice</td>
<td>Many data services</td>
</tr>
<tr>
<td>Narrowband</td>
<td>Broadband</td>
</tr>
<tr>
<td>Monopoly</td>
<td>Competing platforms</td>
</tr>
<tr>
<td>Analogue</td>
<td>Digital</td>
</tr>
<tr>
<td>Utility</td>
<td>Consumer-driven</td>
</tr>
<tr>
<td>Self-contained</td>
<td>Convergence</td>
</tr>
</tbody>
</table>

Source: Ofcom - Strategic Review of Telecoms Phase 2 – Figure 3

There also exist a number of technological changes about which commercial and regulatory decisions are required, and which will fundamentally affect the shape of the telecoms sector. These include:
• **circuit-switched to packet-switched networks:** many network operators are currently designing next generation networks (NGNs).\(^2\) These networks have the potential to simplify regulation (although they also bring with them significant new challenges) as well as the potential to enhance competition;

• **increasing intelligence at the edge of networks:** the increasing processing power of devices connected to telecoms networks offers a greater opportunity for software running on these devices to deliver innovative new services (eg, voice over IP);

• **demand for higher access bandwidth:** new, high bandwidth services such as video-on-demand and IPTV may expose the bandwidth limitations of the existing copper-based local loop. Operators may be forced to invest in ‘next generation’ access (for example fibre to the premises or fibre-to-the-node (FTTN) combined with VDSL-based offerings) and the regulation and competitive environment today are likely to heavily influence such investment.

At the same time that the telecoms sector is experiencing significant technological change, it is also increasingly ‘converging’ in both commercial and technical terms, (ie, in respect of service bundling and multi-service platforms respectively) with the media and the IT sectors. Consequently, the (broader) telecoms sector value chain now involves many activities which would not previously have been thought of as traditionally telecoms-related, as shown in the following Ofcom diagram:

\(^2\) For example, BT has announced that it will invest £10bn in its NGN network over the next 5 years, with the aim of achieving cost savings of £1bn a year by 2008.
Traditionally, controlling the network has been the primary revenue driver for a telecoms business. However, the rise of open network architecture (in particular in the context of the deployment of IP-based networks) may result in the ‘commoditisation’ of simple network access with value shifting both up the value chain into content provision and down the value chain into applications and customer service. This shift in the value chain will require Ofcom to recognise that market power may exist outside the traditional framework of wholesale network access.

**The TSR and Ofcom’s conclusions**

In this context, Ofcom posed five fundamental questions in its phase 1 consultation document:

1. In relation to the interests of citizen-consumers, what are the key attributes of a well-functioning telecoms market?
2. Where can effective and sustainable competition be achieved in the UK telecoms market?
3. Is there scope for a significant reduction in regulation, or is the market power of incumbents too entrenched?
4. How can Ofcom incentivise timely and efficient investment in next generation networks?
5. At varying times since 1984, the case has been made for the structural or operational separation of BT, or the delivery of full functional equivalence. Are these still relevant questions?³

In phase 2 of the strategic review, Ofcom, drawing on its own analysis and the responses to the phase 1 consultation, presented three options for its future relationship with BT:

- **option 1**: full deregulation and reliance on *ex post* competition law;
- **option 2**: referral of BT to the Competition Commission under the Enterprise Act 2002;⁴
- **option 3**: focus regulation on enduring economic bottlenecks, and tackle the problem of inequality of access head-on.⁵

Ofcom also outlined the seven key principles that it would use to guide its actions, stating that it should:

1. promote competition at the deepest levels of infrastructure where it will be effective and sustainable;
2. focus regulation to deliver equality of access beyond those levels;
3. as soon as competitive conditions allow, withdraw from regulation at other levels;
4. promote a favourable climate for efficient and timely investment and stimulate innovation, in particular by ensuring a consistent and transparent regulatory approach;
5. accommodate varying regulatory solutions for different products and, where appropriate, different geographies;
6. create scope for market entry that could, over time, remove economic bottlenecks;
7. unless there are enduring economic bottlenecks, adopt light-touch economic regulation based on competition law and the promotion of interoperability.

Within this context, Ofcom drew a number of conclusions, as set out below.

³ [www.ofcom.org.uk/static/telecoms_review/condoc_phase1.htm](http://www.ofcom.org.uk/static/telecoms_review/condoc_phase1.htm)
⁵ Strategic Review of Telecoms Phase 2 (TSR2) - November 2004
Ofcom concluded that businesses and consumers want more than basic, reliable telecoms services at low prices: they also want choice and rapid innovation and introduction of new services. Ofcom’s assessment was that the most effective way of delivering this is through competition for infrastructure services where competition will be effective and sustainable. Furthermore, competition that had delivered benefits to consumers to date might not be sustainable going forward, so maintaining the status quo in terms of their regulation was not an option.

Though competition may be a means to delivering the kinds of outcomes that consumers want, it cannot be effective unless customers are able to make well-informed choices, and to switch easily between suppliers. Ofcom’s research showed that some groups of consumers had various difficulties in making these choices. Ofcom therefore determined that it would not be appropriate to leave this problem entirely to the market, but also recognised that any intervention should be targeted at the particular groups of consumers who experience problems.

Competition between rival end-to-end infrastructures has proved to be effective and sustainable in the mobile market. However, in fixed telecoms, Ofcom concluded that there were enduring economic bottlenecks, ie, parts of the network where effective and sustainable competition was unlikely in the short to medium term. Ofcom, therefore, adopted the principle that regulation should promote competition between competing infrastructures where competition was likely to be effective and sustainable. However, Ofcom noted that companies that wished to compete on this basis had to rely on BT for access to parts of the network where competition was not sustainable. As a result, in order for competition in fixed telecoms to be effective, BT needed to make such access available on the same terms as it made it available to itself: an approach Ofcom termed ‘equality of access’.

Ofcom proposed to BT that if equality of access was introduced to those parts of the network which constituted a bottleneck, then
it would expect to be able to deregulate elsewhere. Such deregulation could take two forms: either a lessening of significant market power (SMP) conditions where equality of access was applied in upstream markets, or a finding that there is no longer SMP in downstream markets. Ofcom acknowledged that it was particularly important that regulation did not disincentivise efficient investment. In particular, Ofcom recognised that there may be a challenge in incentivising efficient investment in access networks, and therefore proposed to conduct a review of next generation access to assess this issue.

The final fundamental question for the review was whether questions concerning the structural or operational separation of BT remained relevant. Ofcom’s preferred approach of equality of access involves both equivalence at the product level and organisational changes by BT. In June 2005, BT offered Ofcom a set of undertakings in lieu of Ofcom making a reference to the Competition Commission under the Enterprise Act 2002. In the TSR final statement dated 22 September 2005, Ofcom accepted the undertakings from BT, as it felt that these would deliver equality of access.6

**BT’s undertakings**

BT’s undertakings can be summarised as follows:

- **branding and identity**: BT to set up a new, and operationally separate, business unit, subsequently named Openreach, with a distinct brand and identity;

- **product equivalence**: Openreach will be required to support all providers’ retail activities (including those of BT Retail) on a precisely equivalent basis, which Ofcom terms ‘equivalence of input’;

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6 www.ofcom.org.uk/static/telecoms_review/final_statement.htm
• **products and services**: the new business unit will offer a universally available product and service set including: local loop unbundling (LLU), wholesale line rental (WLR), backhaul products (which connect the local exchange and the core network), and IP stream;

• **next generation networks**: the undertakings set out a number of clear principles which BT Group plc should follow in the design, procurement and build of its ‘next generation’ 21st century network (21CN). These principles will help ensure that other providers who will depend upon interconnection with BT’s 21CN do not suffer competitive disadvantage;

• **board and governance**: BT Group plc and Openreach’s compliance with the undertakings will be monitored by a new equality of access board (EAB), which will oversee the delivery of other legacy regulated products not directly delivered by the new business unit.

Following representation from respondents to the consultation, Ofcom agreed to monitor the implementation of the undertakings. Ofcom noted that it was important to measure not only whether the undertakings are being complied with, but also more broadly whether the overall regulatory approach is delivering the kinds of outcomes for businesses and consumers that are intended of it.

Ofcom divided the indicators that could be measured into four groups, shown in the diagram below. The first two categories of indicators will measure whether the undertakings are being complied with, both to the letter and more broadly to the spirit. Intermediate industry outcomes are indicators that measure the rate at which competition is developing in particular markets. Finally, consumer outcomes measure the things that actually make a difference to businesses and consumers: for example, what choice do they have, what price do they pay, how rapidly do new services become available?
Source: Ofcom Strategic Review of Telecoms – final statement - Figure 5

Separation in telecommunications history

The background

The idea of separating incumbent telecommunication firms as a regulatory device to combat dominance and promote competition has a twenty-year history. The break up of the US Bell system in 1984 into local and long distance components was a spectacular inauguration of the process, which was accurately described by a well-known US commentator shortly afterwards as “a reckless gamble – which paid off”. In the 1990s, attention turned in Europe to two alternative forms of separation – some form of horizontal separation between different platforms, and vertical accounting separation of different components in the telecommunication value chain, such as retail, wholesale or access. The 1995 Cable Directive sought to ensure ownership separation between the telecommunications and the cable network in any EU member state. It had mixed success. Deutsche Telekom finally sold off its last cable networks in 2004, but common ownership of cable and telecommunications networks is still observed in Denmark and Portugal, as it is in Australia. Accounting separation of the telecommunications incumbent value chain became, however, a standard and – when accompanied by a rigorous examination of the operator’s cost calculations and allocations – valuable weapon in the armoury of regulators.
Attention has refocused on more radical forms of separation than the accounting option in the current decade. In its early years, several competitors – notably Cable and Wireless in the UK – called for the break up of incumbents into variously specified wholesale and retail components which would fall under separate ownership. This received a mixed response from commentators, the division being neatly illustrated by the Organisation for Economic Co-operation and Development (OECD), two separate committees of which at one time expressed opposing views on the subject. In the absence of any regulatory attempt to achieve ownership separation of this kind (no doubt influenced by the absence in most EU countries of a viable procedure for accomplishing it), attention has swung back to a form of separation intermediate between the accounting option and ownership or structural separation. An ‘operational’ or ‘functional’ separation of this kind (we will use the former term) has been achieved in the United Kingdom, and, in a recent speech, the European commissioner for the information society and broadcasting has clearly ruled it in as a possible element in the review of European regulatory arrangements due to come into effect in 2010. As Commissioner Reding said (using the term structural separation more broadly than we do here to include operational separation):

“I believe that the policy option of structural separation could answer many of [the] competition problems that Europe’s telecoms markets are still facing today. Perhaps we have to be as radical as regulators were in the US in the 1980s to make real progress? Of course, we will have to find our own European solutions, adapted to the needs of our continent. But ‘a European way of structural separation’ is certainly a policy option that needs to be discussed intensively in the forthcoming months”.7

COMMUNICATIONS REGULATION

At the same time, some operators are embracing separation voluntarily. For example, Telecom New Zealand has, in its submissions on the telecommunications amendment bill, proposed a form of operational separation characterised by the following:

- “committing to the principle of non-discrimination in the delivery of targeted access services …;
- making this commitment in permanent legally binding and detailed undertakings on price, products, processes and timing …;
- [their] performance against the undertakings will be monitored by an independent oversight group; there will be audit and reporting of [their] performance against the undertakings;
- separate incentives for [their] staff;
- a high degree of transparency and information sharing with [their] wholesale customers”.  

What does separation seek to achieve?

The answer to this question revolves around discrimination. Consider a vertically integrated incumbent providing a variety of narrowband and broadband services, untroubled by the presence of an alternative wire-based access network, such as cable. Regulation is likely to be applied under the existing European regulatory regime in the form of mandatory access (at either cost-based or ‘reasonable’ prices) to some of the incumbent’s assets, such as the local loop, wholesale broadband access, call origination, termination and transit and, leased lines, and so on. Such ‘pro-competitive’ regulation is seen as an increasingly viable alternative to ‘consumer protection’ regulation in the form of retail price controls. The success of this approach hinges upon the appropriateness of the terms and conditions of access to the assets in question. Discrimination by the incumbent in favour of

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8 http://www.telecom-media.co.nz/resources/
its own retail affiliate will diminish the competitive constraints it faces in downstream markets from access seekers.

Such discrimination can take two forms: price and non-price. Accounting separation is designed to ensure parity between transaction prices paid by competitors for access and accounting prices paid by the separated entity’s downstream affiliate. Excessive prices will show up in excessive returns carried by the access-providing component of the incumbent. A generalised margin squeeze might be illustrated by negative returns for the downstream unit. Of course, such ‘parity’ is not complete in the sense that competitors’ access payments are a genuine marginal cost for them, whereas the marginal cost of the same service to the vertically integrated incumbent is its marginal resource cost (the extra physical cost of producing one extra unit, translated into monetary units). The latter is likely to be much lower than the former, when access prices are based on long run average incremental cost, with mark up, while the production process exhibits economies of scale.

Accounting separation might thus deal with price discrimination. But non-price discrimination is a different matter. Much of the UK case in favour of operational separation rests on the proposition that BT had the means and the motive to practise non-price discrimination in relation to such products as unbundled loops, wholesale line rental, and bitstream, had in fact done so, and was likely to persist in doing so (Ofcom 2005). The incentive arose from:

- BT’s market power in the provision of fixed infrastructure or network services which was constrained by the imposition of cost based access;

- BT’s vertical integration into the downstream markets for which that infrastructure is a critical input.
It is useful to explain this logic further. The Chicago School argues that, when the downstream market is (perfectly) competitive and inputs are used in fixed proportions, a vertically integrated incumbent does not have an incentive to leverage its market power downstream, putting its downstream rivals at a disadvantage, unless they are less efficient. More recent work shows, however, that there are exceptions to this conclusion. Of particular interest here is a form of discrimination that occurs in a regulatory context, and is often described as ‘sabotage’.

In most upstream telecommunications markets incumbents are subject to a number of obligations, including a prohibition to engage in price and non-price discrimination via general *ex ante* non-discrimination obligations. However, enforcement on non-price discrimination is inherently difficult. In the light of this, considerable academic literature has focused on the ability and incentives of a vertically integrated operator to engage in non-price discrimination. By putting downstream rivals at a disadvantage, a vertically integrated operator is able to capture a higher share of the downstream profits. In summary, the incentive to engage in non-price discrimination depends on a number of factors. In particular it increases:

- the tighter is price regulation of the upstream input and the less intense is upstream competition;
- the larger the potential profit opportunity in the downstream market;
- the higher the degree of substitutability of the vertical integrated and competitors’ products;
- the larger the economies of scale in downstream activities.

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9 The next four pages are summarised from Cave M, Correa L and Crocioni P (2006), Regulating for Non-price Discrimination - The Case of UK Fixed Telecoms, Competition and Regulation Network Industries, 1 (3), pp391-411 where full references are given.
In the UK an examination of the development of regulatory obligations since the mid-90s, with a focus on cost based price controls, shows that regulation of fixed telecoms upstream inputs is tightening and expanding to a growing array of inputs. Figure 1 shows that the reductions in the network charge controls (NCC) – ie, the regulated charges for a range of narrowband telecommunications upstream services – between 1998 and 2004 have been substantial in real terms. Similarly BT’s local loop unbundling (LLU) wholesale charges, which are not part of NCC, have also fallen significantly since LLU was mandated.

Figure 1: Average NCC charges from 1998-2004 (real terms, 1998 prices, 1998=100)

Although these are not the only remedies that have an impact on the profitability of BT’s upstream activities, they have the most direct impact. Other obligations could have a significant indirect impact on profitability. For example, accounting separation is designed to reduce the asymmetry of information between the regulator and the regulated company and, insofar as it leads to more accurate regulation, it could potentially limit BT’s profitability. However, these indirect effects are often difficult to assess.
These reductions reflect Ofcom’s estimates of trends in costs, efficiency and the cost of capital over the same period. While incentive regulation allows the firm to keep any additional profits it can achieve from increased efficiency over the charge control period, it would appear that upstream price controls provide a strong and binding constraint on BT’s ability to exploit its upstream market power. The evidence suggests, therefore, that BT’s upstream inputs were subject to strong regulatory constraints and as a consequence will have provided it with an incentive to discriminate with respect to non-price characteristics of the services provided.

The higher the downstream profit opportunity the more likely it is that hampering downstream competitors from obtaining a larger share of a profitable market will increase the vertically integrated incumbent’s overall profits. Only when the downstream market is perfectly competitive would the incumbent be indifferent between discriminating or not. The incentive to hamper rivals may, however, exist even in perfectly competitive downstream markets if it makes upstream entry more difficult.

An analysis of the annual accounts for the period 2002 to 2004 suggests that BT Retail’s profits are not insignificant and represent an increasingly large proportion of BT’s overall profits. There are some indications that returns are also increasing. **Figure 2** below shows the share of operating profit between BT Retail and BT Wholesale. The profit share of BT’s Retail division has been increasing steadily over the years, suggesting that BT’s downstream business profitability increased relative to the regulated upstream activities. This is confirmed by the return on sales (ROS) for BT Retail which increased from just over 6% in 2002 to about 10% in 2003 and 2004.
Figure 2: BT Group’s share of operating profit between wholesale and retail divisions

Source: BT Annual Accounts

**Separation options**

If some form of separation has been chosen as a regulatory measure, then two dimensions of it have to be defined: one structural, the other behavioural. First the separated components (retail, wholesale; monopoly, competitive) have to be defined. Then rules governing relationships between, and transactions over, these boundaries have to be established. The logic of the argument in the previous section is that what has to be policed is the boundary between markets where the incumbent exercises persistent market power (and hence can discriminate with anti-competitive effect) and markets which are competitive. It follows from this that the appropriate division depends upon current and predictable market developments.

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11 See Cave M (2006), Six Degrees of Separation, Communications and Strategies, November, pp89-103.
In discussions of separation, the two principal candidates for making the split are between retail and wholesale and between access and non-access services. Underlying this is a three-way split as shown in Table 1.

Table 1: Ways of separating telecommunications firms

<table>
<thead>
<tr>
<th>Retail</th>
<th>Marketing and selling services to end-users and managing the end-user relationship</th>
</tr>
</thead>
<tbody>
<tr>
<td>Network (non-access)</td>
<td>Core network services, Call origination, termination, transit etc, Trunk segments of leased lines, Some backhaul</td>
</tr>
<tr>
<td>Network (access)</td>
<td>Unbundled local loops, Wholesale line rental, Some backhaul, Tail segments of leased lines</td>
</tr>
</tbody>
</table>

At this very high level of aggregation, it is hard to identify persistent competition problems with retailing or core network services. Other network products may present harder, but not insoluble problems. Where such problems are likely to be found is in access services in areas without cable or effective wireless networks. The intermediate function is backhaul, which will probably be (actually or potentially) competitive in some areas but not in others. This issue acquires particular significance because backhaul is one element (together with the local loop) in wholesale broadband access or bitstream. A national bitstream product will include all backhaul, while a regional product will enable the purchaser to provide its own backhaul, at least from selected regions. On the basis of these arguments, the balance of advantage seems to lie heavily with an access/non-access separation, leaving wholesale broadband access in an uncomfortable half-way house, to be resolved on the basis of individual market conditions.
The second step in establishing a separation regime is to specify the behaviour required between the separated entities. In one sense, the focus should be transactions on the boundary between the separated components, but the objective of achieving non-discrimination here may have to be supported by wider-ranging constraints on the separated entity. Table 2 contains a specification of separation options varying from accounting separation at the bottom of the ‘ladder’ to partial or full ownership separation at the top. Our focus is on the six ‘degrees’ of separation lying between (and excluding) accounting separation and ownership separation. We now describe these options in more detail.

### Table 2: Separation options

<table>
<thead>
<tr>
<th>Ownership Separation (in whole or part)</th>
</tr>
</thead>
<tbody>
<tr>
<td>[6] Legal separation (separate legal entities under the same ownership)</td>
</tr>
<tr>
<td>[5] Business separation with separate governance arrangements</td>
</tr>
<tr>
<td>[4] Business separation with localised incentives</td>
</tr>
<tr>
<td>[3] Business Separation (BS)</td>
</tr>
<tr>
<td>[2] Virtual Separation</td>
</tr>
<tr>
<td>[1] Creation of a wholesale division</td>
</tr>
<tr>
<td>Accounting separation</td>
</tr>
</tbody>
</table>

- **Option 1**

Accounting separation itself entails separate profit and loss statements and balance sheets for the separate entities. This can be accompanied by the creation of a special wholesale (or otherwise named) unit, with a dedicated management ([1] above). This will be responsible at a managerial level for the production and supply of the relevant products, but with no guarantee, at this degree of separation, of non-discrimination between affiliated and competitive access seekers. This is broadly the *modus operandi* of most European telecommunications incumbents at present. Under this regime, the regulator can make attempts to ensure some loose
equivalence between services to affiliated units and to competitors. However, these efforts are hampered by two factors in particular:

- the absence of a clean target level of equivalence – an ambiguity which leads to opportunities for the incumbent to continue to discriminate;

- the fact that the incumbent’s network, IT system and business processes were broadly designed within the context of a fully integrated firm supplying end users directly, but not supplying access services to third parties. Access products were grafted onto this framework, through the adoption of special procedures and technological fixes. This provided for the incumbent a means of introducing discrimination, which was obviously attractive if the commercial motive to discriminate were present.

- option 2

The next variant we consider is [2] – virtual separation. By this we mean the imposition by the regulator of an obligation to achieve full equivalence in the services offered to internal and external customers without any physical separation of networks, signalling systems, business premises, etc. Vertical separation thus requires, in effect, a re-engineering only of the transactions boundary to achieve equivalence, but no change in the underlying production processes. This outcome might be achieved by upgrading services provided to external customers. However, it may also be established – inefficiently – by degrading the quality of services provided to internal customers (for example, the speed with which orders are transmitted and processed). This approach is likely to be much less costly than more comprehensive ‘physical’ separation.

The key issue here is the actual and perceived feasibility of achieving full equivalence in such circumstances. Both are important since a lack of trust in the arrangements will deter
investments by competitors almost as severely as actual discrimination. Still, as this approach has not yet been tried in the context of achieving full equivalence, it is only possible to speculate about how it would work and what it would cost. However, its similarity to previous attempts to outlaw non-discrimination, which in several jurisdictions are regarded as failure, is a handicap.

- option 3

The next step up, [3], involves physical business separation which requires reworking of underlying business practices, and not just changes at the transaction boundary, as with vertical separation. The aim is to segregate particular assets and other inputs within a separate unit, which then trades using identical processes with both internal and external customers in way that can be verified transparently.

However, the separation is not complete; otherwise we would be observing something equivalent to full ownership separation. Instead, the firm’s assets can be separated in different degrees, as shown in Table 3.

There seems no obvious impediment to a high degree of separation of processes, support systems, management information systems, labour forces and brands. Clearly each will have associated costs, which will have to be taken into account in the regulatory impact appraisal.

The separation of major investment decisions in the access network raises more formidable problems. An investment so large has clear commercial and financing implications at the group level, yet it can be used anti-competitively. One non-European incumbent justified an acknowledged loss-making investment in a network for the delivery of broadcast services on the grounds that it was a ‘telephony defence measure’ – it prevented a rival operator proposing to offer telephony and broadcast services on a single network from making headway in
the telephony market. The UK regime for operational separation (described in the text below) deals with this by specifying that the chief executive of the separated access services can authorise annual capital expenditure up to £75m.

Table 3: Candidates for separation

<table>
<thead>
<tr>
<th>Premises</th>
<th>Staff can readily be physically separated in different offices and workplaces</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operational support systems (OSS)</td>
<td>These can be separated, at a cost.</td>
</tr>
<tr>
<td>Labour force</td>
<td>Separate units can have different internal labour market – ie, no movement between them, or they can be integrated</td>
</tr>
<tr>
<td>Brand</td>
<td>The organisations can bear the same or different means, or a compromise – eg, ‘x’ a division of ‘y’ corporation</td>
</tr>
<tr>
<td>Management information systems (MIS)</td>
<td>Their separation will increase trust in prohibitions on illegitimate information transfers across the boundary</td>
</tr>
<tr>
<td>Strategy</td>
<td>Strategy, especially strategic investment decisions, such as construction of a fibre to the node (FTTN) network, is likely to fall to the main board.</td>
</tr>
</tbody>
</table>

The BT undertakings seek to deal with this problem of investment incentives by imposing condition 5.13.2, which states that:

“All investment decisions required in consequence of the product road maps and volume forecast referred to in section 5.13.1 shall be considered solely on their own merits, and shall not take into consideration the potential impact on other product offered by BT’s businesses downstream of AS other than in as much as they affect aggregate demand forecasts”.

12 www.ofcom.org.uk/telecoms/btundertakings/btundertakenings.pdf
This paragraph crystallises an acute problem. The point of operational rather than structural separation is to allow co-ordination of information in the choice of investment projects, and co-ordination of their execution. This requires decision making by a supra-divisional body – the Group – yet the Group’s incentives are by definition group wide – and thus endanger the local incentives arrangements for investments decisions in access. Under the UK arrangements, the equality of access board (EAB) “shall also be responsible for monitoring and reviewing the product roadmaps and volume forecasts – as well as the associated investment decisions as referred to in section 5.13.2, as they relate to AS and SMP products”.

There are two gnomic references to this EAB duty in its updates:

April 26 2006:
“The EAB also noted BT Wholesale’s investment prioritisation process for product enhancements and, in a later presentation from BT’s Director of Investor Relations and Group Controller, the wider BT capital expenditure budget planning process and how the undertakings had been taken into account”.

May 24 2006:
“The EAB satisfied itself that Openreach was not disadvantaged in the allocation of resources”.

What this means in practical terms is not clear: does the EAB examine the case for investments? If so, does it have the resources to do so effectively? If not, how does it check fulfilment of the condition that overspill effects of investments are not being taken into account?

We would conjecture that local incentives for the separated entity should keep investment decisions which fall within its ambit reasonably honest, provided there is not frequent promotion or exchange of managers between from the wholesale unit and the group. If the last condition is not fulfilled, there would be a case
for a properly constituted board with independent directors for the separated entity, as a further line of defence. But there does seem to be an unresolved problem with major investments on a scale which requires main board approval.

- **option 4**

The next level of separation, [4], involves incentives for senior managers in the separated entity, and if externally imposed it involves more detailed regulation not only of the transaction boundary and production processes, but also of the relations of production of the separated services. The simple argument in favour is that, without appropriate incentives, senior managers will maximise group shareholder value rather than divisional profits, as a means of personal advancement and a response to share options. This may lead them to practise discrimination against competitors whose success in downstream market would otherwise jeopardise group profit. To prevent this, managerial remuneration should be tied to divisional performance, and (possibly) restrictions should be imposed on movement of senior staff from the separated unit to the group function.

- **options 5 and 6**

A further escalation of measures in a similar vein [5], would require the creation of a divisional board with non-executive directors independent of the group. This could take the extra form of legal separation [6], a regime in which a separate board is created and separate statutory accounts are filed – all designed to emphasise and support the independence of the separated entity. These options represent the highest degrees of operational separation listed above.

We have attempted to describe above six separation options with their associated internal behavioural rules. Running in parallel are enforcement mechanisms. These can be internal or external. For example, the group can set up an independent complaints body, to investigate the conduct of the separated entity. Or the
regulator can investigate and impose sanctions for breaches of licence conditions or of undertakings. As in other areas, an effective external enforcement system with a high level of deterrence can to some degree secure the achievement of goals which go against the grain of a company’s or a manager’s incentives. Equally, a well-designed incentive mechanism can relieve the pressure on enforcement.

Operational separation and BT

We discuss, against the backdrop of the discussion above, the form of operational separation offered by BT and accepted by Ofcom in September 2005, and describe their provisions and impact to date.

The undertakings offered by BT fell within the framework, not of sector-specific regulation, but of UK competition law in the form of the Enterprise Act 2002. This is a piece of competition legislation peculiar to the UK which allows for Ofcom to refer persistent competition problems to the UK Competition Commission which, in turn, has the power to impose a range of possible remedies including that of structural separation. Breaches of BT’s undertakings lay BT open to fines and to legal action by private parties. In terms of the distinctions made in the section above, the separation chosen is between access (including backhaul) and non-access (core and retail) services and involves ‘business separation’ with local managerial incentives. It is supported by a complaints and enforcement regime described below. It thus represents option 5 above.

In more detail, BT undertakings, expressed in a 55-page document are as follows:

- to establish an operationally separated access services divisions (subsequently named Openreach), located on separate premises;
• to ensure full equivalence for key access products by the following dates:
  IPStream-31 December 2005
  metallic path facility-30 June 2006
  shared metallic path facility-30 June 2006
  backhaul extension service-September 30 2006
  wholesale analogue line rental-30 June 2007
  wholesale ISDN2 line rental-30 September 2007
  wholesale ISDN line rental-December 31 2007;

• to establish an equality of access board (EAB) with a majority of independent members to police BT’s adherence to the undertakings;

• to consult on the development of its next generation networks.\(^{13}\)

To date, an access services division has been established under the name of Openreach; fully equivalent services are available for IPStream and local loops; the EAB has been established; and collaboration on NGNs has progressed via an industry group called NGN UK.

Ofcom has also conducted a survey of BT’s wholesale customers of Openreach and BT Wholesale (which provides wholesale services not provided by Openreach).\(^{14}\) This concluded that not much had changed so far. Openreach management was enthusiastic and approachable, but there were doubts if it would deliver, with these doubts strengthened by teething problems. Respondent saw as priorities:

• increasing staff;
• focusing on resolving hands-on operational and service issues;
• ensuring that focus on equivalence ‘does not result in the lowest common denominator and, consequently, ‘equally poor’ instead of ‘equally good’ services for all concerned’.

\(^{13}\) See fn 11 above.
\(^{14}\) Ofcom (2006a), Survey of BT’s Wholesale Customers, May.
This last point may be related to the considerable growth in access products purchased. In November 2006, the one millionth local loop was unbundled. Of the one million, three fourths had been supplied since the coming into force of the undertakings in September 2005. This enhanced activity is probably responsible for many of Openreach’s problems, and for the delays which all their clients, including BT Retail, have experienced. On the cost side, BT’s Annual Report and Accounts for 2006 record a specific item for operational expenditure of £70m for the estimated incremental and directly attributable cost arising from the obligation to set up Openreach.

Next generation networks

The idea of operational separation as a possible regulatory tool is developing against the backdrop of the prevailing and prospective deployment of so-called next generation networks (NGNs). There is no single, optimal, NGN, since the appropriate development and deployment of new networks will depend on a number of factors specific to each operator and jurisdiction, such as the existing and prospective extent of competition in both access and core networks, the performance and capabilities of their existing network, and the ability and expense in upgrading rather than replacing, the extent to which the addressable market allows for the exploitation of scale and scope economies, the current and expected market demand for services available over an NGN but not able to be served by existing platforms, and the availability of funding to support heavy investment. However, in general terms, there are two forms of IP-based network development for fixed network operators which are represented as NGNs: the ‘core NGN’ and the ‘access NGN’, with the former involving the rationalisation and replacement of existing core network switching and transmission equipment with IP-based routers capable of supporting voice over IP (VoIP), multimedia

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15 News.zdnet.co.uk/communications.
and other packet-based services. The latter typically involves investment in deployment of fibre deeper into the access network (for example Fibre to the Node or FTTN) in order to provide higher speed access to end users.¹⁷

Whilst separation can certainly contribute towards the appropriate regulatory conditions to encourage investment in such networks, and generating the benefits that may accrue therefrom, separation *per se* – in any of the forms discussed above – is not sufficient to secure these benefits. Clearly, the benefits from NGN investment can only be realised if there is NGN investment in the first place which, in turn, requires there to be clearly established and understood incentives for such investment. In this context, regulators face a difficult balancing act in that too little (or too ‘light’) intervention may lead to overinvestment and also foreclosure of new markets (or existing markets using new and more efficient or capable technologies) by incumbent operators, whereas too prescriptive or overly stringent intervention will deter investment to the prospective detriment of end users. Indeed, this challenge in determining the appropriate regulatory framework in the current environment is reflected by the contrasting approaches being adopted by NRAs across Europe. Thus Ofcom established (or adopted), a number of different organisations, groups and oversight bodies to ensure involvement (not only by industry players but also Ofcom itself) and demonstrate compliance in respect of BT’s NGN investment.

Policy makers, in the context of NGN investment, now more than ever face the challenge of establishing a regulatory framework which, whilst encouraging investment and innovation and establishing efficient market entry and exit signals, does not (either by design or by default) serve to ‘shape’ the defining characteristics of the market it is supposed to be overseeing, for example, in terms of the nature of competition (service-or infrastructure-based) and its intensity, rather than policymakers deciding who should provide what to whom, it is clearly better left to the market to establish the appropriate signals for

¹⁷ The node is typically the street cabinet.
investment in new technologies, routes to market and innovative new service offerings.

Therefore, to the extent that separation is used as an effective regulatory tool against the backdrop of NGN investment, it should be seen primarily as a mechanism for establishing the appropriate market-facing incentives, such that competitors and the downstream operations of vertically integrated operators in positions of dominance are treated on an equivalent (and equivalently good) basis, rather than being seen as sufficient, in and of itself, to ensure that the right investments are made for the benefit of end users.

The goal of this process is to give competitors, in their roles as potential customers of NGN services, some influence over the design of such services and their supporting infrastructure. This is achieved via the industry group NGN UK. But Ofcom acknowledges that some operators have doubts about the effectiveness of the consultation process.18

Conclusions and prospects

The UK experience of operational separation is still in its infancy, but regulators close to the process have detected a major change in the way BT’s anti-discrimination obligation now operates. Previously it was fuzzy, responding to the injunction; ‘do not discriminate in a way which has a material effect on competition’. Scores of complaints from competitors were investigated and inquiries by the regulator undertaken, not one of which led to a formal finding adverse to BT.

The new requirement in the undertakings, by contrast, is sharper – the ‘bright line’ of full equivalence of services supplied to internal and external customers – and for that reason much more

easily verifiable and justifiable. It is supported by a complaints body, which is still finding its way, and a senior management incentive scheme only recently completed. It is also combined with a major change in BT’s strategy and rhetoric. The company now denies that it benefits in the UK from the advantages of incumbency. Instead it sees as its key strategic advantage its ability first to succeed in a more symmetrical home market and to take the benefit of that experience abroad in the lucrative market for corporate telecommunications services in Europe and the wider world, where it will face incumbents still enjoying, but about to lose, the fruits of continued discriminatory behaviour. Hence its ceaseless support for regulatory interventions which draw down the benefit of incumbency elsewhere, and create level playing fields everywhere. It is reasonable to suppose that the outcome of operational separation in the UK will be the joint product of regulation and this strategic shift.

This chapter has discussed Ofcom’s diagnosis of the defects in the UK regulatory system, and its decision to impose operational separation. Our evaluation of the diagnosis is positive. The regulatory history which Ofcom compiled of various access products reveals a level of obstructionism consistent with the behaviour for which the analysis of non-price discrimination identifies both motive and means. This is at least partially acknowledged by BT itself.

Whether the problem was capable of resolution by more effective action by the regulator under existing rules is a matter which must be open to speculation. Had the undertakings not been offered by BT and accepted by Ofcom, and had Ofcom instead referred the matter to the Competition Commission under the Enterprise Act 2002, one of the questions to be resolved would have been the adequacy of existing regulation. BT would have had open to it a number of arguments – notably that its conduct did not distort competition, and that it was remediable by more efficient implementation of existing procedures. The lack of a single adverse finding in the previous decade by the sector
regulators – despite numerous complaints and investigations – would have raised serious questions on both the scores.

It is also clear that operational separation in any of its variants is a significant ratcheting up of regulation, and hence one not to be undertaken lightly. It is costly to implement in its more demanding variants, but the greater potential cost is via its effect on investment. The regulated firm’s incentive to invest may be diminished by the imposition of tougher obligations to competitors, while the latter may curb their ambitions to replicate the assets subject to operational separation. In the worst case, the regulator might provide a focal point for a tacitly collusive agreement not to compete on certain segments of network infrastructure.

A proper regulatory impact assessment of separation should take into account both the benefits – the elimination of non-price discrimination, and the cost – a potentially chilling effect on investment and the development of competition in access networks. Ofcom was fully aware of these issues, but both were subject to a high degree of uncertainty. Ofcom chose a fairly advanced version of operational separation, with collateral changes in incentives, governance and enforcement, as well as to the redesign of transaction boundaries and accompanying business processes. The process governing such a choice must be a fairly intuitive one. The rest of the world should, perhaps, be grateful to the UK regulator for embarking on an experiment which would clearly show up any failure of the approach.

One obvious concomitant has been acceleration of the rate at which competitors are acquiring unbundled loops, of which there were 210,000 in December 2005, and one million eleven months later. But this may also be due to the substantial decline in prices which accompanied the announcement of separation. It is not easy to discern in the Ofcom report of April 2006 into competitors’ reactions to the undertakings much of comfort to the view that a major transformation has yet taken place. But it may be too early to expect one.
Then there is the question of next generation networks. Arguably, any long term benefit will be found there. Yet, whilst some form of separation can certainly assist in establishing a regulatory regime which encourages the appropriate incentives for investment and innovation, there still exists a significant challenge for policymakers in establishing a framework in which sound investment decisions can be made with confidence in the underpinning regulatory assumptions. In conclusion, we regard the outcome of the TSR as work in progress, with no big success to date and the looming problem of NGNs unsolved. However, this is unlikely to stop other regulators in Europe and elsewhere, confronted with similar problems, from trying similar approaches.

References
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Cave M (2006), Six Degrees of Separation, Communications and Strategies, November. (11)


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3 EDUCATIONAL QUALIFICATIONS REGULATION

Isabel Nisbet and Alan Greig

Introduction

The Qualifications and Curriculum Authority (QCA) is a statutory body, sponsored by the Department for Education and Skills (DfES). Its functions are set out in the 1997 Education Act, and subsequent amendments. QCA maintains and develops the national curriculum and associated assessments, tests and examinations, and regulates qualifications offered in schools, colleges and workplaces. Its regulatory role covers all qualifications except those awarded by higher education institutions. As QCA states:

“Regulate awarding bodies, qualifications, examinations and national curriculum assessments effectively to ensure that the qualifications market is fit for purpose, that qualifications are fair, standards are secure, public confidence is maintained and that QCA acts as the public champion of the learner”.

(QCA’s ‘Key Results Area’ for its regulatory role)

QCA’s role is restricted to England, although it regulates qualifications jointly with its regulatory partners in Wales and Northern Ireland, and works closely with its counterpart in

Acknowledgment: The authors acknowledge the assistance of Liz Cunningham of QCA in preparing this chapter and are grateful for comments on earlier drafts, notably by Kathleen Tattersall and Sir David Watson.

Isabel Nisbet, Director of Regulation and Standards, and Alan Greig, Head of the Policy and Regulations Team, Qualifications and Curriculum Authority
Scotland. Qualifications are awarded by ‘awarding bodies’, some of which are charitable trusts or linked to professional associations, while others are commercial companies. At the time of writing, QCA recognises 116 awarding bodies, five of which award GCSEs and A levels, while many more offer vocational and other qualifications. In total, there are just over 5,000 accredited qualifications. The existence of a tier of independent organisations (awarding bodies) delivering qualifications is a British tradition which is largely absent overseas.

QCA is much more than a regulator – it is a centre of educational expertise in developing the national curriculum and new qualifications for life and work, and it includes a large executive agency (the National Assessment Agency) which delivers national curriculum tests and has a large modernisation and delivery role for qualifications used in schools and colleges. The regulatory role is largely delivered by QCA’s Regulation and Standards Division, and this chapter is about QCA as the regulator of qualifications, often cited in the press as the ‘exams watchdog’.

The regulation of qualifications is a comparative newcomer to the Centre for the study of Regulated Industry’s (CRI) concerns, as reflected in its publications, which have understandably been dominated by the regulation of public utilities. Apart from one research report in 1998, this is the first time that qualifications regulation has been included. There may be two reasons for this. First, the object of regulation – the ‘qualification’ – is not always obvious to learners or teachers as distinct from the courses of tuition that lead to them. There are exceptions to this observation, including the annual summer ritual of media articles about standards in A levels and GCSEs, but it remains the case that ‘qualifications’ is not an immediately recognisable sector of services. The second reason is, we suggest, that discussion of

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1 ‘GCSE’ stands for ‘General Certificate of Secondary Education’, characteristically taken by young people at age 16 or above, and A levels are awarded under the General Certificate of Education (GCE), characteristically taken at ages 17 or above.
regulation in this country has largely focused on ‘economic regulation’, as described by the Audit Commission, citing Dixon, which involves a national body set up to control a market or quasi-market (such as a privatised utility) and to protect the consumer from excessive prices or service failures.\textsuperscript{2,3} Although we shall argue that the provision of qualifications is indeed a market – or a set of markets – the public does not normally perceive that. Rather they see issues about examinations and tests as matters of quality and standards. As we shall see, QCA and its predecessor organisations have in the past seen their role as monitoring quality. Although we agree with Hood and Scott and others that quality monitoring is indeed part of regulation, that is not so familiar an association as the economic role.\textsuperscript{4}

The fact is that (some) qualifications have been regulated for over 100 years in this country. This chapter will give a brief history of qualifications regulation and describe the current position. It will then consider why qualifications need to be regulated; the operation of a qualifications market, and issues around risk in qualifications.

History

The first qualifications regulator was the Secondary Schools Examination Committee (SSEC), which was set up in the second decade of the 20\textsuperscript{th} century (see below for a summary of key dates). It acted as a committee of the Board of Education and had as its main focus the school leaving certificate. In its latter years it was involved in the establishment of the A level and O level General Certificates of Education (GCE).

\textsuperscript{2} Audit Commission (2006), The Future of Regulation in the Public Sector, March.
\textsuperscript{3} Dixon J (2005), Regulating Health Care: the Way Forward, King’s Fund, London.
\textsuperscript{4} Hood C and Scott C (2000), Regulating Government in a ‘Managerial’ Age: Towards a Cross-National Perspective, LSE Centre for Analysis of Risk and Regulation.
Qualifications regulators – a summary

<table>
<thead>
<tr>
<th>Organisation</th>
<th>Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Secondary Schools Examinations Committee (SSEC)</td>
<td>1911(approx) – 1963</td>
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<tr>
<td>Schools Council</td>
<td>1964 – 1983</td>
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<tr>
<td>Secondary Examinations Council (SEC)</td>
<td>1983 – 1988</td>
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<td>School Curriculum Development Committee</td>
<td>1983 – 1988</td>
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<tr>
<td>School Examination and Assessment Council (SEAC)</td>
<td>1988 – 1993</td>
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<td>National Curriculum Council (NCC)</td>
<td>1988 – 1993</td>
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<tr>
<td>School Curriculum and Assessment Authority</td>
<td>1993 – 1997</td>
</tr>
<tr>
<td>Qualifications and Curriculum Authority (QCA)</td>
<td>1997 – date</td>
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The SSEC was superseded in 1964 by the Schools Council which had a wider curriculum development role as well as overseeing of school examinations. During the time of the Schools Council a model for reviewing examination provision was developed further. This was based on the use of panels of experts to comment on a qualification – principally the question papers and mark schemes. A report was issued to the awarding body. This mechanism (although altered over the years) remains to this day as one of the main ways in which qualifications are regulated.

Next came the Secondary Examinations Council (SEC) in 1983. Another non-statutory body, the SEC had the introduction of the GCSE as its main focus. To do this it introduced criteria that GCSEs offered by the new awarding consortia had to meet. Proposed GCSEs were submitted to the SEC who checked that they met the criteria. The use of criteria for accrediting qualifications is now a key part of the regulatory process. To cover the curriculum development role carried out by the Schools Council another organisation, the School Curriculum Development Committee, was also set up in 1983.

Up to the formation of the SEC, the focus of regulation was on examinations taken in schools. But in 1986 The National Council for Vocational Qualifications (NCVQ) was set up to rationalise vocational qualifications and to introduce a new National Vocational Qualification (NVQ). This signalled the beginning of the regulation of vocational qualifications, albeit one particular type – the NVQ. The rationalisation agenda for
vocational qualifications was not achieved, and remains a matter of contention today, as we shall see.

In the meantime things were beginning to change on the schools front with the introduction of the national curriculum and tests for 7, 11 and 14 year olds. In 1988 two statutory bodies were set up – the National Curriculum Council (NCC) to look after the Curriculum and the School Examinations and Assessment Council (SEAC) to look after the tests. SEAC also had within its remit the requirement to “keep under review all aspects of external qualifications”, and under this cloak it continued SEC’s work to produce criteria for GCSEs and A levels, check qualifications against the criteria and to monitor the examinations.5

The next chapter in the story came about because of the inevitable tension that existed in having separate organisations responsible for the curriculum and its assessment. So another statutory body – the School Curriculum and Assessment Authority (SCAA) – brought together the functions of SEAC and NCC in 1993. The story thus far was of separate school curriculum and assessment bodies at a national level finally coming together.

The logical next step, at a national level, was to bring responsibility for vocational and general qualifications together. This happened with the Qualifications and Curriculum Authority. QCA had an explicit remit to monitor and advise an all ‘external qualifications’, to set requirements for accreditation and to accredit any qualification that met the requirements.6 7 QCA’s

5 This may be the first time that general examinations (such as GCSEs) were referred to as ‘qualifications’ (we are grateful to Kathleen Tattersall for this observation).
6 Defined as “any academic or vocational qualification authenticated or awarded by an outside person, except an academic qualification at first degree level or any comparable or higher level” (Education Act 1997, S 24(6)).
7 Education Act 1997, sections 24(2),26(4), 26A(1).
qualification remit was wider than hitherto and significantly the 1997 Education Act (and subsequent amendments in the Learning and Skills Act 2000 and the Education Act 2002) included the power to limit the number of qualifications in the same subject, to cap qualification fees, to enter premises to obtain documents and to make a ‘direction’ if accreditation conditions were not met. The levers were in place to begin regulating qualifications.

Why regulate qualifications?

It is not self-evident that qualifications should be regulated. Regulation, however ‘light touch’, has a cost. As the Department of Health has argued, there are a number of alternatives to regulation:

- doing nothing;
- advertising and education;
- using the market;
- financial incentives;
- voluntary codes of practice.

Some of those alternatives have their place in the world of qualifications. However, we suggest that there are three main groups of reasons for regulation in other sectors which apply to the regulation of qualifications.

**Consumer protection**

Learners of all ages are the end-users of qualifications. In many cases their future lives may be shaped by the outcomes.

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8 It is difficult to calculate the full on-costs of regulation on those regulated by QCA, although QCA is attempting to do so. The budget of QCA’s Regulation and Standards Division for 2006-07 totalled over £6.5m.

9 Department of Health (2006), Good Doctors, Safer Patients: proposals to strengthen the system to assure and improve the performance of doctors and to protect the safety of patients: A report by the Chief Medical Officer, London, July.
Regulators in other sectors may be needed to protect the physical safety of the public, to protect the interests of consumers who have to take on trust the integrity and standards of the service they are using, and to ensure that the needs of vulnerable groups (such as children or the elderly) are met, and there are echoes of this need in the case of regulating examinations and qualifications obtained by young people. Regulators typically provide an impartial dispute resolution process and can be tasked with assuring service users that the regulated product or service – whether it be the Lottery, betting and gaming or pensions – is run fairly. That does not mean that all consumers have equal success – we do not all win the Lottery or get A grades in our exams - but it could involve, for example, provision to ensure that the rules are applied fairly and consistently, and that the system is not ‘rigged’.

Standards

The second group of criteria is around standards, meaning the standards against which candidates for qualifications are assessed. Learners, their parents, employers, education providers and the public need to know that the standards set for a qualification are appropriate and that the candidate has been properly tested. Without that assurance, the qualification may not command confidence and hence not have much value to the learner. Learners, employers and educational providers need to be reassured that different awarding bodies offering the same qualification are applying the same standards. They also need to have a trustworthy check that awarding bodies competing for custom are not lowering standards to attract more schools and colleges eager to get better results. Anyone who doubts the interest in those questions only needs to open a newspaper at exam results time. And those who think that concerns about the ‘dumbing down’ of standards are new – or linked to performance tables or other current measures applied to schools – may find it salutary to note the following:
Downward competition of awarding bodies

“It must not be imagined for a moment that [one named awarding body’s] examinations .... are really independent exterior tests of a school’s efficiency. These bodies are competing bodies: they exist upon the recognition afforded them by schoolmasters and schoolmistresses..... Examiners are ‘satisfied’ by a rudimentary knowledge of arithmetic, reading aloud and the answering of papers in religious knowledge and English. Such complacency would find in a glass of water and a crust, nectar and ambrosia..... As a result a process of downward competition seems to be settling in”.

(Letter to the Pall Mall Gazette, December 1894)

Public confidence, awareness and understanding

The third group of criteria is around the importance of sustaining public confidence in qualifications. The statutory regulatory functions of the Financial Services Authority include ‘market confidence’ (defined as “maintaining confidence in the financial system”) and ‘public awareness’ (“promoting understanding of the financial system”).

It is clearly in the public interest that where qualifications have the power to determine the paths taken in people’s lives, they should command confidence, and learners, their teachers and their families should be able to understand what qualifications are on offer and what they mean, as should employers and providers of further and higher education. Thus QCA has a statutory role of publishing and disseminating information about qualifications. As can be seen from the quotation at the beginning of this chapter, one of the ‘key results areas’ of the Regulation and Standards Division of QCA is maintaining public confidence.

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10 From UCLES archives. We are indebted to Kathleen Tattersall for this quotation.
11 Financial Services and Markets Act 2000, Ss 2(2), 3(1) and 4(1).
Two observations are apposite here. First, in order to know whether we are succeeding in maintaining public confidence in qualifications, we need to establish a baseline, and QCA has work in hand to do that. QCA commissions regular surveys of perceptions of A levels and GCSEs by teachers, parents and candidates, but it will be important to establish a wider baseline and prepare to measure confidence in new qualifications as they are developed.\textsuperscript{12} Secondly, in our view, the public confidence instilled by a regulator is not simply a matter of the public having good feelings, regardless of whether the good feelings are justified. That could be achieved by the regulator, like the governors of Plato’s Republic, telling “\textit{noble lies}”. Where there are problems with the qualifications system, and where there have been delivery failures, the regulator should publish its findings and say what it is going to do to put matters right. Thus in November 2005, QCA published a report which raised concerns about ensuring that coursework assessed for GCSEs and A levels was the candidate’s own work. One of the problems was lack of clarity by parents and teachers about what kinds of help were allowed. QCA therefore worked with groups of parents and teachers to produce guidance leaflets, and those have been widely distributed.\textsuperscript{13} There is also a role for regulators to inform and educate the public debate, for example around the range of measurement error which is inevitable in any marking system. If it is not technically justified to draw conclusions from small differences in marks, then the regulator must be able to say so.

In summary, we think that regulation – in a form recognisable to those who read and write about regulation in other sectors – is appropriate to the world of qualifications because of the need for consumer protection, maintenance of standards and the sustaining of public confidence. That does not mean that the alternatives to regulation mentioned earlier do not also have a

\textsuperscript{12} http://www.qca.org.uk/downloads/gcse_a-level_mori_research.pdf. The findings are largely favourable, and show increased confidence year by year.

\textsuperscript{13} http://www.qca.org.uk/16188.html.
place. One of those was ‘using the market’, and it is to the qualifications market that we now turn.

The operation of the market

As our brief history indicated, the prime focus (if not the only focus) for regulating qualifications hitherto has been the quality of the qualification. The production of criteria that set out the standards that have to be met, the accreditation of qualifications against these criteria and the consequent monitoring of the operation of the qualification, which in turn leads to improvements in the system, is a conventional quality cycle recognisable in many other contexts. However, as we have noted, in 2002 the QCA was given extended powers (not yet used) to cap the fees charged for accredited qualifications. And there is now considerable debate about the qualifications market – including whether there should be such a market at all – and what role (if any) the regulator should play in regulating it.

In our view, there is no doubt that QCA is a market regulator. Its very existence affects the operation of the market and active recognition of this by QCA and those it regulates is essential if it is to achieve its objectives. However, the picture is complicated by the fact that there are several different markets in operation:

- GCSE and A levels – five awarding bodies (3 in England, one each in Wales and Northern Ireland – oligopoly);
- Other accredited (mainly) vocational qualifications – 116 awarding bodies;
- Non-accredited qualifications – a further 400 or so awarding bodies (derived from QCA, 2005).\(^{14}\)

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\(^{14}\) The estimate of 400 is based on further (unpublished) work done for QCA following the published study by PricewaterhouseCoopers (2005), The Market for Qualifications in the UK, April, www.qca.org.uk/15534.html
National curriculum assessments, taken by pupils in English schools at the ages of 11 and 14, do not operate in a market, but are delivered by a single provider – the National Assessment Agency, itself part of QCA. A single national supplier of tests that must be used by schools is a classic state monopoly. This model can ensure that there are no comparability issues (between tests provided by different suppliers) and it is a fairly secure system (through contract management) for guaranteeing delivery, though there are endemic risks in relying on one organisation and one delivery system to meet the needs of an entire age-cohort in a country as large as England. But once the tender for supplying tests is awarded to one organisation, there is no pressure from contestability for value for money or quality of service. The existence of a monopoly does not, however, preclude a need for regulation. The National Lottery, which is limited by statute to one provider, has a regulator to ensure fairness and “that the interests of every participant in a lottery that forms part of the National Lottery are protected”.15 Within QCA, there are non-statutory arrangements for the Regulation and Standards Division of QCA to oversee the delivery of national curriculum assessments by the National Assessment Agency. This requires establishing some ‘Chinese walls’, but despite those, the practice of one part of QCA regulating another is not altogether comfortable.

The five awarding bodies offering GCSEs and A levels pose other problems for the regulators. The downside of a market in such high-stakes qualifications is that it raises worries that the standards set – and the grades awarded – are not comparable, and hence that the integrity of selection decisions for university and employment is at risk. That has led to an industry of comparability studies across awarding bodies. Concerns about comparability are by no means new as the following Report of the Consultative Committee on Examinations in Secondary Schools (1911) shows. The consultative committee on examination in secondary school was set up to consider “when and in what circumstances examinations are desirable in

15 National Lottery etc Act 1993, S4(1).
secondary schools... Its report was published in 1911. The following abstract is taken from www.bopcris.ac.uk:

“External examinations were the ‘crux of the whole problem’ and the report is mainly confined to them. The problem was complicated by .... the number and variety of bodies, educational and professional, which had ....become actively concerned with the matter.

.... For example, in 20 towns the 4 main examining boards hold independent local examinations, in 26 towns, 3 bodies hold examinations; in 84 towns, 2 of these bodies hold examinations. Professional, commercial and other similar bodies are naturally concerned with distinct purposes, but there is no consultation between them on the common ground of early and preliminary education. One result of this multiplicity of examinations with no adequate system of equivalents is that children try to safeguard themselves by taking several of them. In 2 training colleges in 1910, 124 entrants had taken 2, 9 had taken 3 and 1 had taken 4 examinations. Undue emphasis was placed on them and an undesirable competitive spirit created between schools and schoolmasters. Any development of a wide and modern curriculum can be seriously endangered if a school as a whole or its pupils individually are under pressure to work for individual examinations. Moreover, the isolation of the examining bodies from the schools and from the system of inspection conducted by the Board of Education had in many cases the undesirable effect of fragmenting the higher classes and retarding the work of the schools.

The Committee recommended the establishment of a widely representative Examinations Council which would supervise all external examinations in recognised secondary schools throughout the country.
…Only two external examinations should be taken by ordinary pupils; one at about 16 years - the Secondary School Certificate - to replace the existing variety, the other - the Secondary School Higher Certificate - to be a less uniform test of more specialised education”.

In recent years comparability work has largely concentrated on GCSEs and A levels. In contrast, there is less fevered concern in this country about the comparability of university degrees, or overseas about comparability of qualifications taken by school leavers – for example, in the USA, the lack of comparability of high school grades seems to be accepted as a fact of life, although those grades can influence university entrance.16

Another problem is that the theoretical advantages of a market – competition on price and quality – are not achieved in practice because of market imperfections. The people in schools and colleges (frequently heads of subject departments) who decide which awarding body’s qualification to use are often unaware of the cost, and sometimes have little knowledge of alternatives. The Government has remitted QCA to investigate the reasonableness of fees charged by awarding bodies for GCSEs and A levels. The language of the remit shows that it stems from an explicit desire to encourage a more competitive market:

“We must ensure that the fees charged by awarding bodies to colleges are reasonable. The key is to establish an effective, competitive market and transparency of fees from different awarding bodies on a comparable basis. At present, it is difficult for colleges to compare costs for comparable qualifications across awarding bodies because there is no common format for the presentation of fees. The QCA will lead a review of fees….The review will consider both the level of fees and how, in partnership with the awarding bodies, a common format might be

16 Perhaps because national attention has tended to be focused on the other major source of evidence – aptitude tests (SATs or ACTs).
created... The review will start by considering fees for GCSEs and A levels, and progress to look at other widely used qualifications” (emphasis added).\(^\text{17}\)

The organisations that provide A levels and GCSEs range from a public limited company, to registered charities, to an organisation linked to a major university. All these organisations have become more ‘business-like’ over the last 20 years – thus raising the question of why they should be expected to provide loss-making qualifications (although they do, for a variety of reasons) – the regulator has no power to require awarding bodies to provide specific qualifications. We have also seen greater emphasis by awarding bodies on activities that, while related to their core examining business, are not within the purview of the regulator – for example, marketing, training and other support services.

Finally, turning to accredited vocational qualifications and non-accredited qualifications – there are difficulties at the other end of the spectrum. Our best estimate is that we regulate about one quarter of the qualifications market. The unregulated part of the market includes some high-use international qualifications (such as Microsoft awards), some professional qualifications and some highly specialised ‘niche’ qualifications. Many of these may be of the highest quality. But does the public realise that there is no comeback, no protection, no guarantee for the investment of their time and money? That leads to the question of whether QCA, as regulator, should be seeking to bring the unregulated market into the regulatory fold, by marketing accreditation by the regulator as a badge of quality.

Where regulators are overseeing some sort of market, there may be a tension between the objective of ‘order and coherence’ – making things more regular – and that of ‘encouraging competition’. QCA as a regulator of a qualifications market (or markets) feels that tension acutely. On the one hand, an

uncontrolled qualifications market can be seen as potential chaos – an inefficient system, viewed as a whole, difficult for users to understand (although they may be comfortable with familiar parts) and leaving the customer at risk of frequent change and market failure. On the other hand, competition may be seen as a means of reducing the risk of relying on one firm to deliver qualifications, an incentive to keep prices down and improve standards of service, and a means of ensuring that the qualification meets the needs of the paying customer. This tension is shared with other regulators: for example, the Office of Water Services (Ofwat) and the communications regulator Ofcom have explicit duties to promote competition, but in both cases the wording of this objective is hedged by “where appropriate”.  

Opinions are sharply divided about the extent to which QCA as regulator should aim to rationalise the qualifications market, making it more coherent, and the extent to which we should aim to encourage competition as a means of ensuring that qualifications meet the needs of the customer as the following quotations show:

“We ….want vocational qualifications which prepare adult learners better for employment, because they focus on what employers need and are widely understood. We are therefore committed to improving the value and comprehensibility of these qualifications through developing and implementing a ‘Framework for Achievement’ …. The goal is to put in place a simpler, clearer structure based on sector qualifications strategies …. The qualifications identified in this process as meeting the needs of employers in the sector will be located within the [Framework], regulated by the Qualifications and Curriculum Authority, using common definitions …As a result, the current range of existing vocational

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18 http:/www.ofwat.gov.uk: An introduction to Ofwat; For Ofcom see the Communications Act 2003, S3(1)(b).
Qualifications will be rationalised to those which best meet employers’ needs” (DfES, 2006, paras 3.38 – 3.39).

“A study from the Institute of Directors shows that two thirds of directors were familiar with the range of vocational qualifications in their sector while 70% thought there were the right number or even too few vocational qualifications. “As far as possible, the market should determine the number and popularity of vocational qualifications, not ministers and functionaries”, [said the head of Business Policy at the IoD]. “Employers need to invest in qualifications whilst government reviews and changes to vocational qualifications should be undertaken sparingly and only where there is a clear need” (press release by Federation of Awarding Bodies, and Institute of Directors, March 2006).

Hence, as a market regulator, QCA is faced with different problems in different markets. It needs to secure value for money in national curriculum assessments, balance choice and comparability in GCSEs and A levels, and protect learners’ interests in the vocational market where there is a mix of regulated and unregulated provision, treading a difficult path between the pressures for rationalisation and promoting competition.

Qualifications and risk

QCA has signed up to the government’s five principles of good regulation (proportionality, accountability, consistency, transparency and targeting), and to moving away from detailed checking of processes, and towards monitoring organisations (principally, awarding bodies) and the qualifications system as a
That does not mean the end to detailed checks, however – the guiding maxim, informed by the principles of proportionality and targeting, is that ‘drilling down’ to levels of detail should be determined by risk.

QCA has the problem of operating in an environment of inconsistent risk attitudes towards qualifications. Stakeholders – including government and the media – have little or no tolerance of any mistakes or failures in national curriculum assessments, GCSEs or A levels, while in the world of vocational qualifications, the regulator is urged to apply a light touch and reduce the regulatory burden. In the latter vein, the quinquennial review of QCA in 2002 recommended that “that QCA and the DfES appraise the scope for greater quality assurance of awarding bodies and less involvement in the detail of individual qualifications”.

In considering risk, it is helpful to distinguish between ‘consequential risk’ (harm which would be caused if something goes wrong) and ‘reputational risk’ (harm to the reputation of an organisation or system). It is legitimate for a regulator to consider both kinds of risk, as reputation is closely linked to public confidence. The chief medical officer has commended a risk-based approach to regulation concentrating on consequential risk:

“The concept of risk-based regulation has come to the fore in recent years. The idea is sound. Regulatory attention should be caused on those areas where the chances of something going wrong are high and the consequences of such an event are grave. By doing this, the overall burden of regulation can fall whilst regulatory outcomes are maintained or even improved” (Department of Health, 2006).

A similar philosophy is espoused by the Higher Education Funding Council in the regulation of higher education.

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19 See http://www.brc.gov.uk/publications/principlesentry.asp
20 http://www.qca.org.uk/downloads/quinquennial_review.pdf
Applying this approach to qualifications, the chances of something going wrong with examinations systems increase in line with the number of candidates taking the examination. The complexity of the examination itself is also a factor, but in the main volume is the key driver. This clearly points to the riskier examinations being the ones which focus on age-cohorts – national curriculum tests delivered each year to 600,000 pupils at 7, 11 and 14; and GCSE mathematics and english taken by around some three quarters of a million candidates each year.

The gravity of the harm caused when something goes wrong varies by qualification type. Fortunately, errors in qualification are not life-threatening but errors can affect life-chances, notably when they affect selection for further or higher education, or for employment. In contrast, national curriculum assessment results are used mainly for system measurement and accountability at local and national level. Individual results arguably have little effect on the future of individual students, although the results can affect their self-esteem, and can be used positively to inform teaching.

Results in GCSE english and mathematics clearly do affect life chances. They are crucial ‘gateway’ qualifications, both for progression to further education and employment but also to a general maximisation of life’s opportunities. But for other individual GCSEs, the consequences of an error are much less. First, entry numbers are much lower. Secondly, the value of each individual GCSE to the candidate can be small. The average candidate takes 9 GCSEs – so for them a problem with one GCSE may be of comparatively small importance. If, however, five passes at a certain level are required for progression, then each of the five assumes much greater significance.

It is undeniable that for any individual who has invested time, money and effort into achieving a qualification, only to find that its result cannot be relied on, or there is little public confidence in it, the resulting distress caused can be considerable. The
learner should be able to complain to the regulator and may indeed blame the regulator for failing to ensure that standards were met. But at a system level, qualification regulators, when considering consequential risk, are pushed to target the big volumes and the high-stakes qualifications which affect learners’ lives.

Reputational risk is more fickle. A highly visible failure can affect confidence in the whole system, even if the numbers affected are small. Also, national curriculum assessments are an arena where an entire age cohort of learners and their families meet the national system. If that early interaction goes wrong, the effect on future confidence may be quite damaging. The familiar case-study below shows the complex interaction of consequential and reputational risk, and the intensely political climate in which a spark with consequences for comparatively few people can light a reputational bonfire. We believe that QCA has a continuing role to inform and educate the public debate about risk in qualifications. It is a considerable challenge to do so effectively in an environment which is selectively so risk-averse.

How psychology, history and English brought down the whole house of cards

- Following the publication of A-level examination results in August 2002, one awarding body received 4,000 complaints (compared to the usual 1,500). Most were about grading decisions in psychology, English and history. The complaints centred around candidates receiving lower grades, mostly for coursework, than had been anticipated. Some students complained that coursework seemed to have been marked very aggressively – with students who were getting A grades in exams being failed on their coursework.

- BBC news Sunday 15th September 2002 led with the accusation: “Inquiry into exam fixing claims... the exams watchdog is investigating persistent complaints from head
teachers that this year’s A-level results were ‘fixed’ to stop grades ballooning”.

• An inquiry was carried out by QCA and a separate independent inquiry was commissioned by DfES and undertaken by Mike Tomlinson. The inquiry was completed in December 2002.

• The inquiry led to the review of grades awarded to candidates for one or more units in 31 separate A-level subjects.

• The outcome was that grade boundaries were changed in 18 units (out of a possible 1,200) and 9,800 candidate entries had unit grades improved. Of these 1,945 candidates received higher overall AS and A level grades in at least one subject.

• Sir William Stubbs, the then Chairman of the Qualifications and Curriculum Authority, was dismissed by the Education Secretary Estelle Morris, and she herself subsequently resigned.

• Five candidates had changes to their grades that affected where they went to university.

In conclusion, we have sought to establish that qualifications is a legitimate area for regulation, because of the need for consumer protection, maintenance of standards and the sustaining of public confidence. We have explored some of the regulatory issues around market regulation and risk. We look forward to working with regulatory colleagues in other sectors, and with readers of this volume, in carrying forward the regulatory role of QCA.

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4 ENERGY REGULATION

Maxine Frerk

Introduction

Since privatisation the energy policy framework has sought to combine competitive energy markets and effective independent regulation of networks. Reflecting the statutory duties given to them by Parliament at privatisation, the Office of Electricity Regulation (OFFER) and the Office of Gas Supply (Ofgas) vigorously promoted competitive markets where possible, and regulated to mimic competition elsewhere. This was a highly controversial agenda, which necessitated referrals to the Monopolies and Mergers Commission (now the Competition Commission). Incumbents were forced to make divestments while other structural reforms, for instance to wholesale trading mechanisms, created the conditions in which competition might flourish. The results of all this regulatory activity were striking: competition became well established in supply markets and network businesses achieved substantial cost efficiencies whilst improving their performance. And consumers shared in the benefits. For most of the last twenty years business and domestic customers have enjoyed some of the lowest energy prices in Europe, along with improved service and choice.

In recent years the regulatory framework has changed. Parliament has legislated to give greater prominence to social and environmental issues, and has most recently promoted the twin agendas of sustainable development and better regulation. At the same time the scientific evidence of climate change has become increasingly persuasive and consumer attitudes have shifted. All this has affected the challenges that the Office of Gas and Electricity Markets (Ofgem) faces, and has led Ofgem toward a greater readiness to take into account climate change.
within the parameters of its existing statutory duties. One example of this is the network price controls, where there is now a major emphasis on facilitating the investment necessary to connect the new forms of generation that are being encouraged by government policies to reduce carbon emissions. Bearing down on operating costs remains important, but the relative priorities have changed. Another example is the increasing trend towards self-regulatory policy solutions in the competitive supply markets, as seen in the creation of the Energy Supply Ombudsman.

Conditions ‘on the ground’ have changed too. Rising wholesale and retail prices have threatened to affect industrial competitiveness and undone much of the progress that had been made in reducing fuel poverty. The decline in production of North Sea gas has prompted questions about whether the market invested quickly enough to make new gas import infrastructure available and about how much we can rely on imported gas to provide secure energy supplies. It also prompted discussion about whether enough information was available to allow the market to see this coming. Against the background of price and security of supply concerns in gas, energy is understandably hitting the headlines in a way it never did during the many years of plentiful supplies and falling prices.

A regulator for the 21st century

Sustainable energy supplies

Ofgem is committed to facilitating the development of energy networks that will meet the challenges of the 21st century. Recognising the increasing weight of scientific evidence on climate change, and changing attitudes in society, Ofgem has already done much to take forward the sustainability agenda – even before we were given a duty to carry out our functions in the manner best calculated to contribute to the achievement of sustainable development.
A key area where progress needs to be made is in connecting cleaner forms of generation to the network at the lower voltage distribution level. We have taken a number of steps to facilitate this. As part of the current price control on distribution network operators, we introduced a registered power zones (RPZ) scheme. This gives a financial incentive on distribution businesses to find innovative solutions to connect more renewable generation. Where a distribution company employs an innovative solution to connect a new generator it receives a premium rate of return on the investment. We have allowed up to £500,000 a year during the price control to each distribution business for RPZ projects.

We have also established an innovation funding incentive (IFI). The IFI encourages the distribution businesses to invest in research and development allowing them to invest between £1-2m a year in R&D and pass 80% of this through to their customers. In addition, the distributed generation incentive scheme offers distribution companies an incentive to connect distributed generators to the low-voltage network, and technical issues surrounding distributed generation are being dealt with through a number of industry groups under the Electricity Networks Strategy Group.

In the government’s energy review the government committed itself to a major review of the prospects for, and barriers to, distributed generation. Ofgem is playing its full part in that review. The review will build on initiatives we took at the last electricity distribution price control, and work already underway in our microgeneration forum. In relation to transmission networks, we have allowed major investment of £560m to connect renewable generation, over and above the price control allowances. New transmission price controls, which take effect in April 2007, strengthen the incentives on transmission companies in respect of the environment. For example, we have introduced the IFI concept to transmission, and have put in place
a financial incentive on the companies to reduce the leakage of sulphur hexafluoride, a potent greenhouse gas.¹

-Fuel poverty

Fuel poverty is part of a wider problem of poverty and social exclusion and is caused by high energy prices, low incomes and poor housing conditions. There is an important and continuing role for Ofgem, and the industry, to help ensure that prices are no higher than necessary and to promote energy efficiency. Given the wider social causes of fuel poverty there will be a limit to the role that the industry and regulator can play in tackling it. The focus should be on raising incomes and improving housing – which is a job primarily for government.

We welcome the government’s commitment to explore ways to improve the targeting of help to vulnerable consumers. This commitment is consistent with the ‘find and fix’ approach that Ofgem has advocated and will help facilitate. Energy suppliers have an important role here, for instance through corporate social responsibility programmes. Ofgem’s role has been to bring together suppliers with government and voluntary agencies to ensure that help is targeted where it is most needed. This ‘facilitation’ role may not be a conventional regulatory role but is an important one.

The investment needed to meet Britain’s future energy needs will continue to place upward pressure on costs and hence prices for business and household consumers. Ofgem believes that markets are vital to ensure that costs are truly competitive and lower than they otherwise would be. Ensuring that the market remains competitive will therefore continue to be a central part of our work.

¹ Transmission companies will be encouraged to invest 0.5% of their revenue on research and development programmes targeted on environmental improvement. For details see Ofgem (2006a), Transmission Price Control Review: Final Proposals, 4 December (Ref: 206/06).
- Energy efficiency

We will also continue to take action to help consumers become truly ‘energy smart’. This includes seeking better ways to incentivise and tackle barriers to energy efficiency; developing incentives for smarter metering and improvements in information and accuracy of energy bills. Ofgem is playing an important role in each of these areas. For example, we have invited firms to take part in government funded trials to gather further evidence on how domestic customers change their energy consumption when they have better information on how much energy they use through improved billing or smart metering.

Smart meters could put an end to estimated bills and the need for meter readers to call as well as cutting household energy consumption, which would deliver savings in carbon emissions and on bills. However it is essential that there is robust information on the benefits. We are fully engaged in that debate. In the meantime, Ofgem will seek to remove the regulatory barriers suppliers face in installing smart meters in customers’ homes (such as the obligation to inspect meters every two years, which reduces the cost savings of installing meters that can be remotely read).

In the course of its work in 2005/6 on metering, Ofgem considered the fundamental issue of whether metering services should be a regulated monopoly activity or one in which suppliers can compete as part of their overall offering to customers. Ofgem concluded that competition, rather than a ‘one size fits all’ regulated solution, is the best way to deliver smarter forms of metering. Suppliers are best placed to understand the costs and benefits to different groups of customers of the different technologies available. Relying on the commercial incentives of suppliers is the best means of adequately protecting consumers and ensuring that any new metering investment is cost-effective and meets a real need.  

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2 See in particular, Ofgem (2006b), Domestic Metering Innovation – Next Steps, 30 June (Ref: 107/06).
In November 2006 we published our first report on sustainable development. In the report we set out what sustainable development means to us and how it influences and shapes our work and the way we exercise our powers. We defined a range of indicators that will help us to assess progress towards a more sustainable energy system and set out the contribution that Ofgem has, and hopes to make, to meet that goal, given our present powers and duties. We will also use this report and the indicators to engage in the wider debate and point out where government and other organisations can take action to promote a more sustainable energy system.

**Investment**

Delivering secure, affordable and sustainable energy obviously requires efficient and timely investment in energy infrastructure - the pipes and wires that transport energy to our homes and businesses. As the sources of gas and electricity change, so energy networks must evolve to meet the new patterns of supply and demand. And the market is responding.

In gas, where the shift is from indigenous North Sea supplies to imported sources, the market is investing £10bn in gas import (that is to say, new pipelines, interconnectors and liquid natural gas (LNG) terminals) and storage facilities. If all these facilities secure planning permission – a big if – there will by 2009 be enough gas import capacity to provide 90% of UK demand and by 2010 storage capacity will have doubled. Furthermore, our gas will by then come from a more diverse range of sources than ever before – from Norway, the Netherlands, Qatar, Algeria, Russia, Trinidad and Tobago, Oman and Egypt.

In electricity, local electricity network companies invested £15.5bn between 1991 and 2005 and will invest a further £7.4bn over the next five years. Between 1991 and 2005, £6bn was

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3 Ofgem (2006c), Sustainable Development Report 2006, 2 November (Ref: 192/06).
invested in our national high-voltage transmission network. As noted above, £560m has been provided for upgrading the Scottish high-voltage transmission network to meet the demand for renewable generation. In addition, Ofgem has completed the main five-yearly review of the price controls for electricity and gas transmission. This will provide funding for a further £4.6bn of investment from 2007 to 2012, which is roughly double the amount of investment in the transmission networks allowed in the previous five-year price control periods.

There is inevitably some uncertainty about when projects will be completed and where exactly investment might be needed in future. Ofgem has therefore developed price controls with sufficient flexibility to allow the companies to invest efficiently when necessary, and in a way that best protects customer interests by facilitating investment only when commitments from users demonstrate a genuine need for the infrastructure. The proposals also address the need for companies to replace infrastructure, particularly electricity network equipment, so that current high levels of reliability can be maintained. On average, transmission charges account for a small proportion of customers’ bills (though locational charging means that the actual impact will vary), and increased investment feeds through to charges only slowly, through increases in depreciation and return on the enlarged asset base. However, the sums involved are large and the impact on larger users of the system, such as generators and large industrial and commercial customers, could be much more significant, so it remains vital to ensure that expenditure is both necessary and carried out efficiently.

Network regulation has evolved greatly in recent years, and will continue to evolve. Given the challenges facing network businesses, it will for instance be vital to strengthen the incentives that they have to invest in a timely and efficient manner. For this to happen network businesses first need clear signals of where and when to invest. To that end we have sought to develop longer term contracts for network capacity rights, sometimes using auctions in which system users signal the value
ENERGY REGULATION

of entry and exit capacity at a given point on a network and hence signal to the network operator its priorities for investment. At the same time we have developed financial incentives on network businesses to respond efficiently to those signals, and in a way that ensures that customers’ interests are protected if the investment subsequently proves unnecessary. This ultimately makes network regulation less intrusive and more effective by reducing the need for detailed reviews and debates between regulator and company on how much, where and when to invest.

Competitive energy markets

As highlighted above, Ofgem’s statutory duties are somewhat different to those of its predecessor organisations, reflecting changes in government policy objectives and emerging new challenges such as climate change. But some things have not changed. A constant feature of the regulatory regime since privatisation has been a focus on promoting competition. Since 2000, Ofgem’s principal objective has been to protect the interests of gas and electricity consumers (both present and future), where appropriate, by promoting effective competition. We continue to do this by making markets work for domestic and business energy customers and through the effective regulation of monopoly network businesses.

Ofgem has a range of important secondary duties, including promoting security of supply, having regard to the environment and sustainable development and paying particular attention to the needs of vulnerable energy consumers. We are also committed to better regulation, consistent with our secondary duties, which involves regulating only where necessary, operating transparently, and firmly within our statutory remit for the benefit of consumers and business. Our approach has of course evolved to reflect these changing duties and functions, and we are now much more focused on sustainable development and security of supply when using our powers and taking decisions. But Ofgem’s primary duty, promoting and maintaining
competitive markets, is and will be at the heart of what Ofgem does – unless and until parliament determines otherwise.

**Retail energy markets**

Domestic retail supply markets were first opened up to competition a decade ago. The last remaining retail supply price controls were removed in 2002. Ofgem publishes regular reports on the state of competition in those markets. In the most recent report, published in July 2006, Ofgem concluded that healthy competition between residential energy suppliers was continuing to protect British consumers even as prices rose, even though a number of smaller suppliers had exited the market in previous months.

Ofgem’s research showed that recent price rises had prompted large numbers of customers to take advantage of the competitive market by changing their energy supplier. The figures indicated that the number of people switching was the highest since 2002, and that around 900,000 domestic customers had switched in March 2006 alone. This is unsurprising since there were – and still are – wide differences in the prices charged by different suppliers. Domestic customers that have never switched supplier can save over £100 by doing so. They can also choose from a selection of tariffs, including fixed and capped price contracts. Industrial customers can benefit from cheaper deals if they agree to have their supply interrupted at peak times. There are significant savings on offer for all customers, including those on prepayment meters. So the evidence to date clearly suggests that competition is providing the spur for suppliers to help their customers manage this period of sharply rising prices.4

As new sources of supply begin to come on stream, forward wholesale prices should begin to fall. Reflecting this, retail prices have already fallen for industrial and commercial

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customers. But retail suppliers have suggested that there will need to be a sustained downward trend in wholesale prices before they will cut prices to their domestic customers. Looking further ahead, the cost of measures to reduce carbon emissions, and the global energy outlook, mean that energy prices in Britain are unlikely to return to the low levels of a few years ago. Ofgem’s role will be to ensure that retail prices at all times remain truly competitive and will continue to monitor the markets closely.

**Market solutions to cutting carbon emissions**

Ofgem believes that the environmental agenda is of vital importance, given the strong evidence of the effects of rising emissions on the climate. Beyond the climate change agenda, the gas and electricity industries affect the environment, through other emissions and their impacts on our countryside and communities. We are committed to working with all stakeholders to ensure that we take these wider considerations into account in all of our regulatory decisions. For example, we carry out formal assessments of the environmental impacts of all our important policy proposals. To support this we have sought to establish a value for the cost of carbon to use during the policy development process.

Ofgem strongly supports the government’s commitment to policy measures for tackling greenhouse emissions that are based on, and work with, existing market arrangements. In this respect the introduction of the EU’s emissions trading scheme (EU ETS) from 1 January 2005 was an important step forward. EU ETS has increased the commercial incentives on electricity generators to lower their emissions, and will allow emission reduction targets across the EU to be met at lower costs than alternative arrangements, such as technology, sector or country specific targets. But EU ETS has some significant shortcomings that need to be addressed quickly and effectively if the scheme’s credibility is to be maintained.
One of the shortcomings is that allowances are allocated free to companies and, in particular, to electricity generators. Although the generators receive most of their required allowances for free, they will factor in the full traded allowance price when selling electricity on the wholesale market. This is because some generators will need to buy allowances to cover their emissions and will factor the cost of these allowances into their price. Even generators who hold enough allowances can sell them and will only generate if the electricity price is high enough to compensate them for using and not selling their allowances. The free allocation of allowances therefore increases generators’ profits, potentially by as much as £19bn over phases 1 and 2 of EU ETS. In reality, the effect is unlikely to be this large. Some generators will not be able to raise their prices to include the price of allowances as they sell their output under long term contracts at fixed prices and some suppliers who own generation may not choose to pass through allowance prices immediately to customers. But the overall impact is still likely to be very large.

The government should seek to extend the coverage of the EU ETS to all of the sectors that are major greenhouse gas emitters. It should also try to make future phases of the scheme cover longer periods of fifteen years or more. This will align the schemes with the investment timescales of the industries that participate in the scheme and should lead to lower costs of emission reductions. If a longer term trading scheme could be put in place that covered all of the major greenhouse gas emitting sectors, and over a longer time period, the energy market would respond to the prices and incentives created by the scheme and play its part in helping to meet emission reduction targets. But securing international agreement to such a scheme will obviously take time. In our response to the energy review, we proposed that funded long term carbon contracts could be introduced to work alongside the EU ETS whilst agreement is reached over future phases of the scheme. Such contracts could deliver more sustainable energy supplies and help to resolve some of the

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5 Ofgem (2006e), Our Energy Challenge: Ofgem’s Response, 8 May (Ref: 82/06).
uncertainty that could be stalling potential developers of new power stations. Given that the cost of environmental measures has been a driver of higher energy costs, there is a case to recycle some of the funds raised through these measures to help tackle fuel poverty.

As stated above, Ofgem’s view is that broad market-based measures, such as taxes and emissions-trading, are likely to be the best way for the UK to achieve its climate change goals at lowest cost. But we accept that investments made under the renewables obligation (RO) should continue to receive appropriate support. The nature and level of support should, however, be reviewed from time to time. Other new policies such as the ETS may, over time, remove the need for support from other schemes, such as the RO. It is also important that any support scheme is technologically neutral and provides incentives for all low carbon technologies, not just wind.

The European dimension

Discussion of the EU ETS reminds us that it impossible to consider energy regulation purely from a national perspective. Since the last energy review, energy policy has moved up the policy agenda of the European Commission and the EU. At the start of 2007 the European Commission published a Strategic Energy Review alongside the conclusions to its sector inquiries into the gas and electricity markets.6

Ofgem believes it is vital that the government remains active in influencing and shaping the debate alongside its evolving UK energy policy. As our own energy reserves decline, our markets and prices are increasingly linked to European energy markets. It is crucial to drive the liberalisation agenda forward and to ensure that European energy policy continues to be based around energy markets and effective independent regulation of these markets and associated networks.

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Ofgem is committed to playing an active supporting role with the government to achieve this. We are using our extensive experience of the benefits of greater transparency to achieve a comparable situation in European energy markets. We have supported the Commission in its probe of continental energy companies. Through the European Gas and Electricity Regulators’ Group we can give detailed advice to the Commission on integrating the development and operation of the gas and electricity networks so that they operate effectively as a ‘European grid’. Looking forward, we will continue to support and advise the Commission in its drive to achieve this through new energy legislation and the application of EU competition law. We will also help develop a framework for efficient investment in essential infrastructure, particularly for cross-border investments where there is a ‘regulatory gap’.

Better regulation

As far back as 1997 the Better Regulation Task Force outlined five principles that it believed should underpin regulatory policy making: namely, that regulation should be transparent, consistent, targeted, proportionate, and accountable. These principles became common currency in the policy making arena and have been incorporated into the legislative framework for several regulatory bodies, including Ofgem.

Ofgem starts with an advantage when it comes to understanding and working with the better regulation agenda, as to a certain extent it has been hardwired into our DNA. This is reflected in a strong drive towards self-regulation and a reliance on competition in the markets – which in itself is derived from our principal objective to promote and protect the consumer, where appropriate, through competition. As a result our approach is competition where possible, regulation only where necessary – which is a central plank of better regulation. So when the Energy Act 2004 gave us a duty to have regard to the principles of best
regulatory practice, we were confident of our track record and confident that we could and would do more in the future.

**Supply licence review**

Following the Hampton and Arculus reports of March 2005, the government has upped the tempo, seeking to drive forward a programme of simplifying regulations. We have actively embraced this in our flagship project of reviewing the standard licence conditions for gas and electricity supply. This is we believe an excellent example of a regulator practising as well as preaching better regulation.

The key principles driving the review are that regulation should only exist where there is a clear need for additional protection over and above general consumer protection legislation, given that competition is well established. Given the essential nature of gas and electricity, there will be a continuing need to protect vulnerable customers through a mix of licence conditions and self-regulation. Licence conditions that remain will be clearly drafted and will provide a flexible framework within which the maturing competitive market can evolve. Finally, licence conditions should not prevent suppliers from differentiating themselves in the competitive market.

In December 2006 we published our proposals, which would cut the supply licence from 160 to 80 pages. The proposals would remove unnecessary red tape and ensure that obligations on energy suppliers are targeted and proportionate to the highly competitive market in which they operate. We propose to remove and simplify licence obligations wherever possible, and have identified where self-regulation could replace formal regulation. Of course, we recognise the need to maintain appropriate protection for vulnerable customers, given that

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energy is an essential service, but we believe that the obligations on suppliers towards those customers can often be more clearly expressed. We have taken care to ensure that the obligations that remain neither discourage market entry nor stifle innovation in the range and types of contracts and services on offer.8

**Better network regulation**

The main simplifying activity in the last year has been to consolidate the terms of the electricity network companies’ use of system agreements that govern how users utilise the distribution systems. We have effectively reduced around 400 slightly different bilateral agreements into one. This simple change enables industry to propose and implement changes more effectively and is clearly very cost-effective. Until these changes the only way of making a change was through a series of bilateral negotiations.

The better regulation agenda poses a dilemma for regulators in relation to simplicity and complexity. The current drive to make things as simple as possible is clearly desirable so long as other things are equal. The problem for an energy regulator is that simplicity might well carry an ‘easy win’ for the company - but not the consumer. As an example, after fifteen years of RPI-X price control, at the last distribution price control review, we believed that there were still potentially significant savings to be achieved for the consumer, and we continued to use a detailed comparative assessment of costs to identify these.

We also were aware that we would have to enable a massive increase in capital expenditure. However, estimates of the actual requirement varied substantially between the companies and it was not clear that their forecasts had been developed on a consistent or comparable basis. Our solution was to introduce a ‘sliding scale’ mechanism. This ensured that the companies

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8 Ofgem (2006f), Supply Licence Review - Further Proposals, 18 December (Ref: 217/06).
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could be awarded very large increases in capital expenditure allowances, but would not capture unfair benefits by over forecasting and then under spending. It had the effect of rewarding those companies that could forecast well and deliver to that forecast, and of stopping gaming on an underspend. But it was far from simple. Did we do the right thing by better regulation? If you take account only of simplicity, perhaps not. Did we do the right thing by the consumer? We think so.

Operating efficiently and effectively

Better regulation principles should be applied to regulators’ processes every bit as much to their policies. Here again we have a good story to tell. We are now well into our five year cycle of RPI-3%. We were the first regulatory body to adopt this discipline on ourselves. We have so far beaten our target and as a result have reduced the licence fees payable in 2006/7 by £2.9m, or nearly 10% of our allowed budget. Importantly, the consumer can only benefit from the RPI-X regime because, if Ofgem needs an increase to its budget to carry out its role, we can seek it from the Treasury, but only after we have proved to our audit committee and auditors that we have tried to prioritise our work load. Any such appeal to the Treasury would be transparent to all.

We have also carried out a root and branch review of our paperwork leading to more streamlined, shorter and easier to read published consultation and decision documents. This delivered a 20% cut in the number of documents published in 2005/6 compared with 2004/5 and a much improved format. We are now applying the same principles to our industry code modification and derogation decision letters.

The Sustainable Energy Act 2003 gave Ofgem a duty to undertake impact assessments (IAs), including in particular an assessment of the environmental impact of any important policy proposals that we make. IAs are now a key part of our policy development process. We have developed a rigorous approach to
IAs in line with best practice, while ensuring that our decisions are consistent with our wider statutory duties. We look to identify to the greatest possible extent the environmental effects of our proposals before making policy decisions. Wherever possible, we quantify the environmental costs and benefits of any particular proposal and consider how large the potential environmental impacts are in relation to other costs and benefits of the proposal.

Ofgem considers whether a policy proposal gives rise to any material issues relating to unequal distribution of benefits or costs between groups or within a group, for example between rural and urban customers. We also consider the social impacts of policy proposals in line with guidance issued by the Secretary of State. We are now looking at the structure of our IAs and at whether we can bring together the environmental impacts with the social and distributional impacts to provide a fuller picture of the impact of our proposals on sustainable development.9

Conclusion

Some observers have been asking whether we can continue to rely on a policy based on competitive markets and independent regulation of networks to deliver the government’s energy policy, or whether changes need to be made. Ofgem believes that markets, although not perfect, remain the best way to meet these objectives and deliver secure and reliable supplies to consumers. This reliance on markets, wherever possible, lies at the heart of our approach to better regulation. We hope that the government will harness the power of markets to make our energy supplies more sustainable and meet the carbon challenge. Our view is that the current arrangements will provide secure,

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9 We have published guidance on our approach: Ofgem (2005), Guidance on Impact Assessments - Revised Guidance, 10 June (Ref: 148/05). We will publish revised guidance later in 2007.
diverse and sustainable energy supplies even in a world where we are no longer self-sufficient in gas.

We were delighted that the government took a similar view in its energy review report. Despite political pressures, the government reaffirmed its commitment to markets and effective independent regulation as the cornerstone of Britain’s energy policy. Of course, the energy review and White Paper process provide an excellent opportunity to tackle the concerns that exist and to develop pro-competitive policies that will further strengthen confidence in our energy markets. In a rapidly changing energy world, Ofgem needs to evolve to meet consumers’ needs and to ensure it remains at the forefront of best regulatory practice. We are ready, willing and able to meet this challenge, and are confident we have the necessary powers to do so.
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5 FOOD STANDARDS REGULATION

Dame Deirdre Hutton

Introduction

The current regulatory landscape for food is shifting dramatically. Food safety legislation has undergone a major realignment, food labelling in its entirety is under scrutiny, and food and diet are being influenced by a range of non-legislative activities that, though voluntary, are driving changes in behaviour of both the food industry and consumers. As the UK’s food regulator, the Food Standards Agency (FSA) has been guiding, shaping and contributing to this process for the past six years, in accordance with its core principles of putting the consumer first, being open and accessible, and being an independent voice.

In this chapter I will:

• reflect on how confidence in food regulation has changed since the FSA was established in April 2000;
• discuss how the activities of the FSA have contributed towards those changes;
• consider the future direction for food regulation.

Confidence in food regulation

The Food Standards Agency was created in response to a crisis in public confidence in food and in how food is regulated. Consumers in the late 1980s and early 1990s were exposed to a series of high profile food safety incidents involving pesticide
residues, chemical contaminants and harmful foodborne organisms. Undoubtedly, the most alarming of these concerned BSE. The announcement by the government in 1996, that BSE in cattle and a variant of Creutzfeldt-Jakob Disease (vCJD) in humans were linked, can reasonably be taken as the low point in consumer confidence.

An opinion poll taken at the time by the Consumers’ Association (now known as Which?) reported that 70% of respondents felt that the government had withheld information about the risks associated with BSE, and three-quarters felt that it was difficult to know whether government advice about risks associated with food was independent of political pressures. I am not aware of a direct comparator for those figures. However, several surveys suggest that the situation has improved considerably. Research funded by the European Union has found that consumers in the UK express greater confidence in their food supply than do consumers in five other EU countries. In a review in 2004 of the FSA’s performance to that date, Baroness Dean of Thornton-le-Fylde concluded that there was widespread public confidence in the FSA, and in the FSA’s own surveys tracking changes in consumer attitudes to food since 2000, levels of awareness, trust and confidence in the FSA have been increasing steadily (see Figures 1, 2, and 3).

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1 Consumers’ Association (1997), A National Food Agency.
3 Dean, Baroness Brenda of Thornton-le-Fylde (2005), 2005 Review of the Food Standards Agency. Available at food.gov.uk
4 FSA (2000-2005), Consumer Attitudes to Food Standards. Available at food.gov.uk.
Figure 1: Awareness of Food Standards Agency (including devolved administrations)

Have you ever heard of the Food Standards Agency?
Base: All respondents/All respondents in each country

Figure 2: Rating of Food Standards Agency - level of trust
One statistic that underlines this improving picture is the reduction of 19.2% in the incidence of foodborne illness since 2001 – equivalent to 1.5m fewer people suffering food poisoning over the last five years at a cost saving estimated at £750m (incorporating treatment costs, lost earnings, and pain, grief and suffering).\(^5\) Preliminary evaluation indicates that the FSA’s public awareness food hygiene campaigns have been influential in this reduction, and great credit should also go to the work done by the food industry to reduce Salmonella contamination, particularly in egg production.\(^6\,\,7\)

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\(^6\) FSA (2004a), UK-wide Survey of Salmonella and Campylobacter Contamination of Fresh and Frozen Chicken on Retail Sale. Available at food.gov.uk.

\(^7\) FSA (2004b) Report on the Survey of Salmonella Contamination of UK-Produced Shell Eggs on Retail Sale. Available at food.gov.uk.
Despite this significant progress, concern about food safety issues in general, as reflected in the FSA’s annual surveys, remains stubbornly consistent at around 70% (FSA, 2000-2005). This is a reminder that we need to remain vigilant on food safety to maintain public trust and confidence. At the same time, though, we need to respond to other food risks. In the last few years, awareness of the health risks associated with eating a poor diet has increased substantially. In our most recent survey (2000-2005), the amounts of salt and fat in food were the two biggest specific consumer concerns about food, ahead of food poisoning. Poor diet is a contributory factor to the rise in obesity over the past ten years, and it contributes to well over 100,000 deaths a year in the UK from heart disease, stroke and cancer.8

FSA approach to regulatory decision-making

The statutory objective of the Food Standards Agency, under the Food Standards Act 2000, is to protect the health of the public and the interests of consumers in relation to food and drink. The most efficient and effective way to do that, as the FSA sees it, is through a balanced market in which businesses are responsible for managing the safety of their own products, those in food law enforcement support businesses in taking risk-based, proportionate and timely actions, and where consumers have the information they need, in a form they can use, to make informed choices about what they eat.

The FSA’s role as a regulator is to set the outcomes that food businesses should achieve – in other words, the ‘what’ of consumer protection. When it comes to how to manage food safety, I am firmly of the view that businesses are best placed to decide the steps they need to take, with the help and support of

8 FSA (2005), Strategic Plan 2005-2010 – Putting Consumers First. Available at food.gov.uk.
the Food Standards Agency and our enforcement partners if required, but without overly prescriptive interference.

As the FSA has matured, it has developed a multi-faceted approach to consumer protection that encompasses classic regulatory interventions and non-legislative options. To ensure that others can see how it arrives at its decisions – on whether to take regulatory action, what that action should be, and whether it is appropriate and proportionate – the FSA has published a framework that formalises this approach, along with the key principles that underpin its application by the FSA and its enforcement partners.9

In deciding whether to intervene, the FSA takes into account:

- the evidence, and extent, of harm, or potential harm, to public health or consumer interests;
- the prospects of intervention reducing that harm or mitigating the risks;
- proportionality, taking account of the balance of risks, costs, and benefits to everyone concerned, within its statutory duty to attach the greatest weight to protecting the interests of consumers;
- the risks of inaction – including the risk of loss of consumer confidence in the regulatory system.

The range of options for intervention, having applied these principles, is set out in Table 1.

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9 FSA (2006b), A Framework for Regulatory Decision Making in the Food Standards Agency. Available at food.gov.uk
Table 1: Regulatory tools for intervention

- consciously doing nothing, having first analysed the issue and decided that action is counter-productive or unwarranted.
- assembling and publishing the evidence, to inform public debate.
- providing information to consumers, without advocating a particular course of action, so consumers may make informed choices.
- providing advice to consumers.
- providing and publishing its advice and recommendations to ministers.
- publishing the results of surveys to inform consumers and enable them to make more informed choices.
- encouraging, recognising or rewarding desirable behaviour, and discouraging undesirable behaviour, by the private or voluntary sector by non-statutory means including positive recognition and/or reputational sanctions.
- encouraging self-regulation through voluntary codes of practice.
- co-regulation through statutory or government-backed codes of practice or action plans.
- encouraging compliance through collaborative working with responsible businesses.
- providing practical advice to businesses to help them comply with the law.
- encouraging responsible businesses to blow the whistle on businesses that are irresponsible or fraudulent.
- promoting effective and risk-based interventions by the relevant enforcement bodies, through guidance, training and support, and through standard-setting, performance monitoring and audit.
- encouraging enforcement bodies to take proportionate enforcement action, and to apply or seek appropriate penalties.
- licensing products, people, processes or premises.
- seeking EU-wide or global action to address new or emerging risks.
- negotiating for changes to EU legislation to protect UK consumers, or (where this is legally permissible) advising government to change domestic law to improve consumer protection or make penalties more appropriate.

Although not a formal hierarchy, the interventions become more directive as you read down the table, from voluntary action...
through to changes in legislation, either at the domestic level or in Europe where over 90% of new food legislation originates.

In deciding whether, how and when to intervene, the FSA also aims to follow the principles of better regulation, by delivering the desired outcome through interventions that:

- are evidence based, proportionate and risk-based;
- use the market, where appropriate, to achieve change;
- focus on practical and deliverable solutions;
- minimise regulatory and administrative burdens where this does not compromise outcomes;
- drive improvement and reward good performance, while seeking firm action against those who persistently fail to meet acceptable standards, or negligently expose the consumer to serious risk.

When the FSA does intervene, its preference is for voluntary approaches, using the market to achieve change. It expects businesses to act responsibly, and encourages them to do so. It also looks to work collaboratively with responsible businesses, trade organisations, the enforcement authorities and others to find the most proportionate ways to protect consumers. This is best illustrated by examples, such as the FSA’s initiatives to simplify food safety management and its support for initiatives that use consumer choice to drive up hygiene standards in catering premises.

**Safer food better business**

In January 2006, new food hygiene regulations came into effect, simplifying 17 prescriptive European directives down into three more general, risk-based regulations. One of the new requirements is that food businesses operate documented food
safety management procedures, based on the principles of HACCP (hazard analysis critical control point). Evidence from around the world shows that HACCP offers effective consumer protection, particularly when applied in a highly controlled manufacturing setting. However, the FSA shares the reservations of many, particularly in the catering industry, that the requirements of a formal HACCP system would be disproportionate for small catering premises, difficult for many to understand and comply with, and consequently ineffective in protecting the public.

To overcome this, the FSA has developed an innovative approach to risk-based food safety management, based on HACCP principles, but more proportionate and realistic for small restaurants and take-aways. Safer food, better business (SFBB), as this initiative is known, was developed with catering businesses and local authorities to make sure that it really would be practical and easy to use. Simple fact sheets that the business adopts or adapts combined with a diary to record exceptions have proved effective in raising standards in types of premises where HACCP systems have previously failed. The packs have been extremely successful, with 175,000 distributed by the FSA between September 2005 and October 2006.

SFBB has now been adapted for small retailers and the pack has been welcomed by industry. Dr Kevin Hawkins, the director general of the British Retail Consortium said:

“The British Retail Consortium represents a large number of smaller retailers who will directly benefit from this initiative. I would commend the Food Standards Agency for the way they have responded to the implementation of the EC Food Hygiene Regulation for small retail businesses by developing a pragmatic and proportionate approach to food safety management”. 
The FSA’s work with local authorities has been central to the success of SFBB - they are using it to coach individual businesses and are hosting workshops to help caterers and retailers use the packs. Many local authorities have benefited from grants from the FSA to help them implement SFBB in their areas. The Safer Food Better Business programme is continuing with support for small businesses and adaptations for ethnic cuisines to be available shortly. The programme is a major success, driving up standards in small businesses and improving consumer protection by reducing food poisoning.\(^{10}\)

The FSA’s devolved bodies in Scotland, Wales and Northern Ireland have also been working closely with local authorities and businesses and have produced food safety management packs tailored to their particular needs.

**Scores on the doors**

‘Scores on the doors’ is an initiative being pursued by the FSA to explore how consumer information might be used to drive up hygiene standards in restaurants, cafes, take-aways and other food premises. The theory is that, by providing consumers with ready access to an authoritative hygiene evaluation – either ‘on the door’ of the premises, or perhaps on a website – consumers will be better informed when choosing where to eat, and businesses will be incentivised to achieve good hygiene ratings to attract customers.

There is some evidence from the US for the success of this approach. Since its launch in 1997, a scheme in Los Angeles has increased the number of ‘best performing’ restaurants from 25% to 88%, with those restaurants in that category increasing their revenue by nearly 6% in 1998. The US Vessel Sanitation Programme, a similar scheme applied to cruise ships, is associated with a dramatic decline in the number of disease

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\(^{10}\) See food.gov.uk/sfbb for more information
outbreaks on board ships, even against a background of increased numbers of ships operating and passenger numbers.\textsuperscript{11}

A benchmarking study of hygiene standards in nearly 5,000 food premises in the UK, published by the FSA in July 2006 found that 13\% showed major non-compliance with statutory hygiene obligations and 7.2\% were considered to present a high risk to consumers.\textsuperscript{12} The highest proportion of high risk premises were in the catering sector, and within caterers, take-aways were the group with the highest risk to public health. The results for this survey were garnered from the programmes of routine inspections carried out by local authority environmental health officers, and the FSA’s view – consistent with the Freedom of Information Act and its commitment to openness – is that such information should be made readily available to the public.

A number of local authorities in England and Wales and Scotland have launched, or are planning to launch schemes to make their inspection results public, and the FSA is helping to co-ordinate activity to ensure consistency of inspections and is generating publicity to raise consumer and business awareness. We will also be commissioning research to evaluate the various schemes and the formats in which results are presented and publicised, with a view to recommending, if appropriate, a common approach within the next two years.

The FSA hopes that ‘scores on the doors’ will make a significant contribution to its key strategic target of reducing foodborne disease. The voluntary approach highlighted in the two examples above also applies to our work on diet and health, as is illustrated by the following two initiatives:

\textsuperscript{11} FSA (2006c), PRO 06/09/01 Development of FSA-sponsored ‘Scores on the Doors’ Pilot Schemes. Available at food.gov.uk.
\textsuperscript{12} FSA (2006d), FSA 06/07/03 UK Survey of Hygiene Standards in Food Premises 2005. Available at food.gov.uk.
Salt reduction

The evidence of harm arising from eating too much salt was firmly established in 2003 with the publication of ‘Salt and Health’, a scientific review carried out at the FSA’s request by the Scientific Advisory Committee on Nutrition (SACN). Every day in the UK, 26m people eat more than the recommended maximum 6g of salt, and this excess is a contributory factor in high blood pressure, stroke and heart disease. In response, the FSA developed a strategy for bringing the population average consumption of 9.5g salt a day down to the recommended 6g by 2010. With only about a quarter of salt consumption being discretionary (added by the consumer in cooking or at the table), this strategy has focussed primarily on achieving reductions in the amount of salt consumed in processed foods.

A twin track approach was initiated. One track involves a major publicity campaign, including television advertising, to raise public awareness about the health risks of consuming too much salt. The campaign has been supported by the food industry, health professionals, charities and consumer organisations to amplify the health messages well beyond the reach of the FSA alone. In parallel with this activity, the FSA has been working closely with the food industry, first to identify the processed foods that contribute significant proportions of salt to the diet, and then to agree the reductions in added salt needed across these food groups to allow consumers to achieve the 6g a day maximum figure.

The consumer awareness campaign helps to create the demand for lower salt products to drive industry reformulation of products, while the gradual reductions in added salt over time addresses concerns about product safety and consumer acceptability of lower salt recipes. The proportion of people making a special effort to cut down on salt has increased by 44%

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13 Scientific Advisory Committee on Nutrition (2003), Salt and Health. Available at food.gov.uk/multimedia/pdfs/saltandhealth0503.pdf
since the start of the campaign in 2003. In addition, the second major publicity phase of the campaign in autumn 2005 achieved a ten-fold increase (from 3 to 34%) in consumer awareness of 6g as the recommended daily maximum intake.

In March 2006, the FSA published salt reduction targets for 85 different food groups, and to date 70 food companies and representative bodies have made public commitments to programmes of salt reduction. Achieving the 6g target is going to be a challenge, particularly given that the trend in salt intake was upwards when the last clinical measurements were made in 2003. However, the broad support the FSA has received for the campaign, and the commitment to reductions shown by the majority of the food industry, are cause for considerable optimism.

**Signpost labelling**

Most processed food products in the UK are now labelled on the back of the packet with quite detailed information about nutritional content. Unfortunately, research has shown that many consumers do not understand this information.\(^\text{14}\) With that in mind, and conscious of the very limited time most people have to look at labels while food shopping, the FSA began an extensive programme of research in 2004, seeking to develop recommendations on nutrition labelling that would make it easier for consumers to make informed choices.

Initial proposals for a form of signpost labelling – key nutrition information presented in a simplified form on the front of pack – were gradually refined through a series of qualitative market research surveys and consultations, overseen by an expert group including representation from independent academics, health charities, consumer groups and the food industry.

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\(^{14}\) FSA (2003), Nutrition Label Testing. Available at food.gov.uk.
This culminated in the biggest qualitative survey of its kind, involving more than 2,600 consumers in trials of four shortlisted signposting schemes to see which ones were the most readily understood and the most useful for helping consumers choose between products.

On the basis of this research, the FSA Board in March 2006 agreed to recommend that voluntary front-of-pack signposting systems should be based on the following four core principles:

- provision of information for fat, saturated fat, sugars and salt;

- red, amber or green colour coding to provide at-a-glance information on the level (ie, whether high, medium or low) of those nutrients in a product;

- provision of additional information on the levels of nutrients present in a portion of product;

- use of nutritional criteria developed by the FSA to determine the high, medium or low categorisations.

A set of principles, rather than a definitive scheme, was recommended to allow food businesses the freedom to develop individual schemes tailored to their customers, while maintaining a level of consistency necessary to avoid confusion and make the information meaningful for consumers. Also, the board recommended that signposting should be applied to the sorts of complex, processed foods that can vary greatly in nutritional composition and for which consumers are least likely to have an innate understanding – foods such as breakfast cereals, sandwiches, ready meals and meat and fish products. As well as providing consumers with clear, simple information about key nutrients, signposting also incentivises reformulation of foods to achieve healthier product profiles.
Since the start of this process in 2004, the majority of the UK food industry has voluntarily begun using or developing signposting schemes. While Tesco and a group of major manufacturers have chosen not to use colour-coding as part of their schemes, well over a third of the retail food sector was, by November 2006, using schemes in line with the FSA core principles. This is a remarkable change in market practice, and particularly welcome in light of early indications that signposting can have a considerable impact on consumer purchasing behaviour in favour of foods with healthier profiles. Further research continues, under independent scrutiny, to identify which schemes, over time, prove to be most effective in helping consumers choose healthier options.

Intervening when necessary

As will have become clear, the FSA encourages self regulation by business through voluntary approaches using the market to achieve change. However, the FSA, as a regulator, has the statutory duty to intervene if the market fails or levels of consumer protection are not acceptable. Sometimes this can only be done by regulating. This means that it is doubly important that the regulations it puts in place comply with the principles of good regulation: proportionality, accountability, consistency, transparency and targeted. The FSA also aims to avoid imposing unnecessary administrative burdens on those who have to comply or enforce regulations. The following sections of this chapter set out how the FSA is working to keep its regulations as simple as possible.

Simplification plan

On 11 December 2006 the FSA published its first simplification plan.\textsuperscript{15} This document sets out a number of initiatives that will make the FSA’s regulations more comprehensible and easier to

\textsuperscript{15} FSA (2006e), Simplification Plan 2006/7. Available at food.gov.uk.
enforce, which we believe will lead to an increase in compliance and, most importantly, better protection for consumers. The FSA also anticipates that it will generate more than £190m of savings in the first year. The plan will benefit both the public and private sectors – and, ultimately, consumers.

- **What is simplification?**

Regulatory simplification can be delivered in a number of ways:

- improving enforcement;
- consolidation of regulations;
- taking advantage of European Union law exemptions;
- Information and communications technology (ICT) solutions;
- deregulation;
- reduction of the administrative burden by tackling information obligations.

Let me expand on some of these areas to illustrate the point, for example – ‘taking advantage of EU exemptions’.

Butchers’ licensing was originally introduced across the United Kingdom in 2000 and 2001 following the Pennington report into the fatal outbreak of *E.coli* O157 food poisoning in central Scotland in 1996. These measures were needed at the time to help prevent a recurrence of a similar incident with a tragic outcome. The FSA decided to discontinue butchers’ licensing on the basis that new EU food hygiene legislation introduced on 1 January 2006 provides substantially equivalent levels of public health protection to those available under the licensing scheme. As well as ensuring that consumers continue to receive a high level of protection, butchers themselves benefit from no longer having to pay the £100 licence fee or filling in the paper work to apply for the licence. We estimate that this will save butchers overall nearly £1.4m a year.

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Another example would be ‘improving how the FSA enforces regulations’. In March 2005, Philip Hampton published his report, Reducing Administrative Burdens: Effective Inspection and Enforcement. The FSA welcomed this report, particularly the renewed emphasis on risk-based enforcement and improving business competence. The FSA is taking practical steps to reduce the burden of inspection and enforcement. A key principle of the Hampton report was that regulators should use existing mechanisms to assist enforcement rather than invent new mechanisms. This is why the FSA is proposing that membership of accredited farm assurance schemes, the conditions of which cover the provisions of food hygiene legislations, should be taken into account when calculating how often a farmer or grower is inspected in relation to food hygiene law.

The ‘consolidation of regulations’ is another approach through which the FSA is reducing the regulatory burden. Food legislation – 90% of which originates from Europe – has developed like ‘topsy’ over a number of years. Businesses have to look at a number of source documents to find information, which makes it complex for them to know what they have to do to comply with the law. A good example of this is the bottled water regulations. The original 1999 regulations stem from EU legislation. The requirements of the legislation are extensive and complex. The UK regulations had to be read in conjunction with the EU legislation that it implements. Subsequent amending regulations complicate the matter further by imposing significant amendments to the original legislation. It is quite frankly a mess! From early 2007 the FSA plans that all the legislation will be put into a single Statutory Instrument, with supporting guidance for the bottled water sector and enforcers. Businesses will see a real benefit.

**Enforcement**

In addition to improving and simplifying regulation, the FSA recognises that it has to be smarter about how its regulations are
enforced. Better regulation and better enforcement have to seen as two sides of the same coin.

In this respect, the FSA, in partnership with local authorities, is aiming to develop a new approach to enforcement and what that might mean in the future. The FSA wants to move to a system where it measures and judges outcomes rather than the inputs. It wants compliance with food law to be seen as good business sense, as that will motivate businesses themselves to seek and use the skills and knowledge needed for compliance. If businesses need help, the FSA and their local authority should be there to advise and assist them. This will be driven by a new enforcement strategy.

The enforcement strategy will involve introducing a more flexible menu of interventions for local authorities to use rather than a rigid focus on one particular tool, like, for example, inspections. The FSA firmly believes that it should be possible to strengthen protection for consumers using alternative approaches and in the process lighten the regulatory burdens on those who are achieving compliance.

As a national regulator, the FSA believes in a joined-up approach across government for regulatory services and the way these provide for consumer protection. I recognise how frustrating it must be for businesses to have a series of what may appear to be overlapping, but uncoordinated, visits from various inspectors. But I also recognise that a single visit by an inspector unfamiliar with all aspects he or she is required to cover – say health and safety as well as HACCP – would not be helpful to a business. Improvement will mean working with other regulators, setting out our mutual priorities, discussing how these can be delivered in the context of others’ regulatory strategies, and exploring ways of working together for the future.

In addition to all this, the FSA intends to make better use of the existing evidence and to invest in developing a new evidence base that will help it design different regulatory approaches for
the future. To ensure there is no risk of this extra level of flexibility reducing enforcement activity to the detriment of consumers, the FSA will make the flexibility available in a managed way within a structure that ensures evidence-based approaches.

Conclusion

As the food industry adapts and innovates to meet and shape consumers’ tastes and demands, so the FSA’s role as the regulator has to adapt, evolve and improve. In its first five years, the FSA made a good start in improving food safety, building public confidence and creating a modern culture of openness. That has been acknowledged in the Dean Review (Dean, 2005). But what also came through strongly in that report, was a recognition that even greater challenges lie ahead – partly because expectations are high, but also because the FSA has stepped up its activities on diet and health. This shift presents its own set of regulatory issues in terms of the lines of responsibility, the evidence base for intervention, and the appropriateness of different regulatory tools.

I intend the FSA to be recognised as an intelligent regulator – one that is innovative, efficient and proportionate – in all aspects of its work, and that presents a number of challenges.

The first is to be intellectually clear on what it regulates, why it does it, and how. That will ensure that the FSA delivers regulation that is as simple as possible for industry to comply with so that maximum public health benefits can be realised for the consumer.

The second challenge is to move further towards risk-based regulation, from policymaking through to enforcement. This can be done without jeopardising public confidence and support, as has been shown by the transition in BSE control measures. Despite the understandable dread and fear associated with BSE,
there has been acceptance of more proportionate and cost effective public protection measures. The FSA’s open and transparent approach fostered trust and confidence in our judgement and facilitated a reasoned debate about risk in public. The FSA will remain fiercely protective of the independence that allowed us to operate in this way.

The third challenge is to put the right regulatory tools in the right hands at the right time. That could mean self-regulation for businesses with recognised accreditation or tough penalties for rogues and villains. It could mean education and guidance for well-meaning but poorly informed businesses. Or it could mean improving consumer choice through schemes such as signpost labelling, which I see as better regulation in a nutshell: regulatory action that protects public health and incentivises business at the same time.

These challenges require different things from different people. For those in the food industry, they mean greater responsibility, but potentially greater freedom to operate and innovate. For local authorities, they mean increased recognition of and freedom to apply their enforcement officers’ professional skills and judgement. For consumers, they mean greater confidence in the safety of the food supply, better information on which to base their choices of what to eat, and trust that their interests are being put first.

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6 PENSIONS REGULATION

Tony Hobman

Introduction

What is the pensions community? Exactly who and what does the Pensions Regulator regulate? The first point to make is the diversity of the regulated community. There are around 85,000 regulated work-based pension schemes in the UK.¹ These may be defined benefit or ‘salary-related’ (DB), defined contribution or ‘money purchase’ (DC), or a hybrid of the two; and they range in size from small schemes with a handful of members and a couple of trustees to FTSE 100 schemes with assets of several billion pounds and tens of thousands of members. Our ‘customers’ potentially include trustees, administrators, employers, advisers, providers and members, all with widely varying levels of knowledge, responsibilities and demands.

This diversity in the pensions landscape is matched by a diversity of risks. A large, well run DB scheme with a committed employer may, at first sight, appear to pose a low level of risk; but if it is in deficit, an unforeseen threat to the employer’s financial strength could put the retirement livelihoods of thousands of people at risk. DC scheme members, on the other hand, may suffer if administrative errors result in miscalculation of their benefits; equally, members of the best run DC schemes are at risk, in a sense, if the contributions going into the scheme are simply insufficient to provide the retirement benefits they are hoping for. And some risks, such as fraud, pose a potential threat to schemes of all types.

Added to the mix is a sense of public anxiety around the area of pensions generally, with the phrase ‘pensions crisis’, variously

¹ The Pensions Regulator (2005a), Pension Schemes in the UK, December.
The context

How does the regulator operate in this complex and varied landscape? Consider, first, the circumstances in which we were created. The previous regulator, the Occupational Pensions Regulatory Authority (Opra), set up in 1996 in the wake of the Maxwell crisis, had essentially been a compliance-based organisation tasked with collecting and analysing reports of suspected breaches of the legislation, principally with the aim of detecting possible instances of dishonesty or fraud. It was undoubtedly successful in raising the profile of compliance and, with the limited powers available to it, highlighting the need for good governance. However, the pensions world was already changing, and over the years it became clear that threats to scheme members were much more likely to originate from underfunding than from fraud. Of particular concern were the cases where sponsoring employers became insolvent, leaving an underfunded scheme. In such cases scheme members could be left with a fraction of their promised pension benefits. And a combination of factors, such as increasing longevity, poor investment returns, and failure to maintain realistic levels of funding (with some sponsors taking contribution ‘holidays’, particularly during the 1990s), meant that aggregate deficits had become substantial.2

It was in this context that, in the 2004 Pensions Act, the Pensions Regulator was created, coming into existence in April 2005. The legislation also introduced the Pension Protection Fund, designed to compensate members if their employer did become insolvent leaving an underfunded defined benefit scheme. The 2004 Act ensured that, unlike our predecessor, the Pensions Regulator has

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2 See for example Watson Wyatt Pension Deficit Index at: www.watsonwyatt.com/europe/services/retirement/deficit_index/index.asp
statutory objectives, backed up by powers that are wide-ranging but flexible, enabling us to act effectively and proportionately. These objectives, which underpin everything we do, are clear:

- to protect the benefits of members of work-based pension schemes (including stakeholder and personal pension schemes where access is arranged by the employer);

- to reduce the risk of situations arising which may lead to claims on the Pension Protection Fund;

- to promote high standards of administration.

The approach

Right from the outset, the Pensions Regulator was conceived of as a proactive, risk-based organisation rather than a passive, compliance-based one. Given the range of potential risks to members’ benefits and the numbers of schemes involved, the most effective use of our resources in pursuit of our objectives demands that we work actively to identify and investigate risks, prevent them from developing where we can, and get schemes on the right track where things have gone wrong. The legislation equipped us with a range of powers to facilitate this approach. For the first time, the regulator can now collect detailed information, updated regularly, from all schemes, helping us both to pinpoint particular risks and to build up an accurate picture of the pensions landscape in general. And the duty to report potential problems to the regulator (both problems with schemes and, importantly, problems with the employers who sponsor them) extends to a much wider range of people and situations than before.

There is a broad range of preventive and remedial action we can take in response to potential risks, and later I will consider some specific powers and how we have used them. At this stage there are two points to emphasise. First, the range of powers available
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to us, and way they are framed, gives us great flexibility in taking action, enabling us to respond appropriately and proportionately. We can issue an improvement notice, for example, requiring a particular situation to be addressed within a particular time frame; at the other end of the spectrum, we can impose civil penalties or prosecute offences in the criminal courts.

The second point to make is that, notwithstanding these powers, our emphasis is firmly on prevention. The cliché that prevention is better than cure is particularly true in the world of pensions, where people’s future livelihoods may be at stake. We need to work towards reducing risk in general, through education, guidance and support; and we must be prepared to intervene, in a proportionate manner, in specific situations where we believe that there is a potential threat to the security of members’ benefits. The irony is that having stronger and broader powers at our disposal means that the regulated community is more likely to listen to us, consequently reducing the need for us to use those remedial powers in the first place.

Making it happen

Of course, the risk-focused approach is nothing new in the world of regulation. But how, given the diversity of the UK pensions landscape, does this approach translate into organisational structures, operational strategy and day-to-day activity? And how can we ensure that our finite resources are deployed effectively across the various types and levels of risk that exist within this landscape?

The risk and intervention model

Clearly, if we are to use our resources effectively, we need some way of categorising the schemes we regulate in terms of the risks they pose to members and the types of intervention that will be appropriate and practicable. As illustrated below in Figure 1, the
model that we have developed for this purpose takes into account our assessment both of the level of risk posed by a scheme to its members (and therefore to the regulator’s objectives) and of the potential impact on scheme members should the identified risk materialise.

**Figure 1: The risk and intervention model**

- At any given time, there are likely to be 200-400 schemes in the ‘active intervention’ quadrant. These are schemes with large memberships (1,000 or more) where large amounts of money are involved, and the mitigation of risks to these schemes is therefore our highest priority. All schemes in this category have individual case management, and we are likely to be engaged in direct talks with trustees and employers, as well as working collaboratively with other regulatory and enforcement organisations.

- Large schemes where the severity of risk is lower fall into the ‘proactive monitoring’ quadrant. Over 1,000 schemes occupy this category. Whilst we believe the immediate level of risk to be acceptable, the large number of members potentially affected by adverse circumstances means that it is prudent to monitor corporate activity involving these schemes (such as restructuring or takeover activity) and to actively scan company and scheme information such as accounts and balance sheets. Monitoring the general
environment within which employers operate, as well as specific market sectors, also helps us to identify emerging risks which might make targeted intervention necessary.

It is worth emphasising at this point that the schemes in the above two categories (ie, those with 1,000 members or more), while they are relatively few in number, account for over 85% of scheme members. The remainder of members belong to smaller schemes which are far more numerous (totalling over 80,000) and which therefore demand a different approach. These schemes fall into the other two quadrants of our model:

- Where incoming information about a smaller scheme does not give us immediate cause for concern, the scheme remains in the ‘minimal scheme-specific action’ quadrant. The emphasis with this very large number of schemes is on education and support – for example, through our codes of practice, our educational activities, the provision of advice and our engagement with the wider pensions community through events and roadshows. While reactive, ‘light touch’ regulation is appropriate for these schemes, we will nevertheless contact schemes proactively from time to time, for example to reinforce important messages about trustee responsibilities.

- A scheme will move into the ‘intelligence-based action’ category where our analysis of data (whether direct from schemes or employers, from other bodies such as the police or HM Revenue and Customs (HMRC), or from our scanning and intelligence-gathering activities) leads us to believe that scheme-specific intervention is advisable. Fraud or gross mismanagement are obvious examples, but we might also consider intervention where, for example, we identify a history indicating a generic problem with a particular trustee, adviser or employer. If appropriate, further investigation and direct discussion with those involved will take place to establish the facts before resources are allocated to scheme-specific intervention.

3 See the Pensions Regulator (2006a), Medium Term Strategy, April.
Where does the information come from?

Risk-based regulation clearly relies on the availability of accurate, timely information – and effective analysis and use of this information. The importance of communicating with other bodies, such as the Financial Services Authority (FSA), has already been mentioned. Information in the public domain (for example from Companies House) also has its part to play, and where appropriate we use information from external sources; for example, when determining the strength of employer and its ability to support the pension scheme, we may use data from credit rating agencies.

There are further sources of information specific to the regulator.

- Most work-based pension schemes are now required to submit an annual scheme return to the regulator. This provides us with a far greater range and depth of information than has previously been available about the scheme, its trustees and advisers, its financial circumstances and its sponsoring employer. It also gives us a breakdown of the membership – how many members are still accruing benefits and how many are pensioners, for example, and their average age – which again helps us to determine the scheme’s risk profile.

- Significant breaches of the legislation must be reported to us. Whilst this was the case under the previous regulator, this ‘whistleblowing’ duty now applies to a wider range of reporters. The duty extends not only to trustees, professional advisers, administrators and employers, but also to those engaged to provide advice such as investment consultants and independent financial advisers.

- The 2004 Pensions Act introduced the ‘notifiable events’ framework. Employers must notify us, for example, if they cease trading in the United Kingdom. Trustees must notify us of certain scheme-related events, such as a major transfer of assets into or out of the scheme, or the granting of benefits on
more favourable terms than those set out in the scheme rules without advice from the scheme actuary. The legislation requires such events to be notified to us as a matter of urgency. Notifiable events enable us to identify possible problems with a scheme or employer which could, if not addressed, lead to a call on the Pension Protection Fund.

These requirements to provide information to the regulator are reinforced by our powers to issue a statutory demand for documents or other information and to inspect premises, although these powers will only be used in exceptional circumstances.

**The risk ‘pipeline’**

The customer support function provides the first point of contact between the regulator and the regulated community, and most of the incoming information described above is handled initially by teams in this area. Customer support takes ownership of the large group of smaller, lower-risk schemes occupying the ‘minimal scheme-specific action’ quadrant of our risk model. While there are several teams handling the various forms of contact, correspondence and reporting that take place between us and our customers, this responsibility means that all teams share similar objectives:

- the effective resolution of lower-risk situations (for example, reports of occasional late payments by an employer into their scheme);

- fast, informed decision-making as to whether further analysis is required (for example, when a pattern of administrative problems may be emerging);

- rapid escalation where potentially more serious problems are identified, moving a scheme into a medium or high-intensity category;
• building up a detailed, accurate knowledge base of scheme-related information;

• taking every opportunity in our dealings with customers to promote high standards and provide education and support.

Higher-risk situations are passed on from customer support into the organisation. Dealing with such situations is inevitably more resource-intensive in terms of both investigation and intervention. The model we have developed in order to manage this workflow and identify the appropriate regulatory response is based on a ‘triage’ approach, which sorts situations according to the level of intervention required. This is illustrated in Figure 2.

Figure 2: Delivering regulation: the operating model

High-intensity, high-risk work is channelled, as shown, to the three regulatory practices:

• Scheme Specific Funding, which aims to strengthen scheme funding through the effective implementation of the legislative framework. This practice assesses the risks posed by underfunded schemes which have been brought to its attention, and may intervene, informally or formally, if it considers a scheme’s funding plans to be imprudent or inappropriate.
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- Corporate Risk Management, which also works to improve scheme funding and security, focusing on risks posed by corporate transactions such as takeovers or restructuring which may be detrimental to the interests of the scheme. Like Scheme Specific Funding, the practice will aim, as far as possible, to achieve positive outcomes through negotiation and discussion rather than resorting to formal regulatory powers.

- Pensions Administration and Governance, which tackles risks relating to the running of schemes.

The role of Triage is to manage the flow of work to the practices, ensuring that risks are properly assessed and prioritised, setting up cases, and providing a package of case-related information so that the practices can operate effectively and at an optimum rate. Triage staff capture critical knowledge and, through their analysis of the work coming into the practices, can identify clusters of emerging issues at an early stage. Intelligence staff within Triage have access to a wide range of data sources, including key information gateways with partner organisations, such as HMRC and the FSA.

Intervention

The regulator’s powers under the 2004 Pensions Act to gather information in order to identify and assess risks have already been discussed. Just as these powers are wider than those of the previous regulator, our powers to intervene where schemes are at risk are also considerably stronger. As previously emphasised, we will always try to achieve our objectives through education, advice and negotiation, and we have no wish to increase the regulatory burden on pension schemes. However, our powers are framed in such a way that, even in circumstances where intervention is essential, we can respond in a proportionate manner. For example, the use of improvement notices potentially gives us great flexibility in the nature and scope of the action we can take where there has been a breach of pensions legislation. This enables us to give clear instructions on what action should
be taken to mitigate risks; who should take it; the timescales by which improvements should be implemented; and whether interim progress reports are to be produced. If responsibility lies with someone outside the scheme, such as an auditor or insurer, a third party notice can be issued to similar effect.

Where we conclude that a trustee is not a fit and proper person for the role – for example, due to significant or persistent breaches of pensions or trust law – we can prohibit them from acting as a trustee of a particular scheme or all schemes, and we maintain a public register of prohibited trustees. We may also temporarily suspend trustees; for example, if legal proceedings are being taken against a trustee for dishonesty or deception, we may decide to order that person to cease acting as a trustee in order to mitigate any potential risks to the scheme. We can also appoint trustees to schemes, with exclusive powers if required, and we maintain a register of trustees, also in the public domain, for this purpose. This provides us with a pool of independent trustees with a wide range of experience, enabling us to identify suitable trustees for a particular scheme and its circumstances.

Where it is in the members’ interests to do so, we can direct that a scheme is to be wound up; however, as an alternative to immediate wind-up, we may issue a freezing order, effectively protecting the scheme’s assets whilst providing a breathing space for all concerned, so that further investigation and negotiations can take place before a final decision is made. It may be the case that the trustees and sponsoring employer can agree to secure additional funding for the scheme or modify the accrual of benefits. At the same time it may be necessary to halt further transfers in and out of the scheme, preventing a potential member transferring into a seriously underfunded scheme or an existing member leaving with too great a share of the assets.
Funding

The risks posed by underfunding are clearly recognised in the 2004 Pensions Act, which gives us significant powers to intervene where we consider it necessary, although, as in other areas, intervention will generally be considered only as a last resort. Under the new defined benefit funding framework introduced at the end of 2005, the old minimum funding requirement was replaced by a scheme-specific approach. In essence, the new framework means that schemes must now make a prudent assessment of their liabilities and take action to eliminate their deficits as quickly as is reasonably affordable. Trustees of defined benefit schemes must, in consultation with the scheme actuary, establish the target level of funding that is needed to provide for the benefits promised to members. This figure, based on prudent assumptions and taking into account the particular circumstances of the scheme, must be agreed with the sponsoring employer. Where comparison with the scheme’s current assets reveals a shortfall – as in the majority of cases it probably will – a realistic, concrete recovery plan must be developed setting out exactly how and by when the deficit will be eliminated.

The process of analysing the scheme’s true funding position, and establishing a workable resolution of funding issues, is likely to involve difficult negotiations and tough decisions. It may become clear that modification of the scheme is the only way forward – raising the retirement age, for example, or reducing the future accrual of benefits – and it may well be necessary to involve scheme members in decision-making. It is not the regulator’s role to intervene in such negotiations. Our prime concern is to ensure that funding solutions are robust and workable. If we believe that funding targets may have been set at too low a level, or that recovery plans are unrealistic or too long-term, we will want to look more closely at the details. And if employers and trustees fail to reach agreement, or if the scheme actuary refuses to certify the underlying calculations, we can, if negotiations fail, impose measures such as a schedule of contributions.
With the creation of the Pension Protection Fund in the 2004 Pensions Act came the issue of ‘moral hazard’, related to the risk of underfunding. The creation of the fund raised the possibility that an employer might deliberately avoid their pension liabilities, or fail to provide meaningful support to their schemes, aiming ultimately to abandon their defined benefit pension liabilities to the fund. The Act gives the regulator two principal anti-avoidance powers:

- Where we consider that there has been a deliberate attempt to avoid pension liabilities, the regulator can issue a contribution notice – not only to the employer, but to anyone involved in the attempted avoidance – requiring payment of any amount up to the full buy-out debt.

- If the sponsoring employer is an insufficiently resourced company within a group – for example, following corporate restructuring – we can issue a financial support direction requiring financial arrangements to be put in place to support the employer’s pension liabilities.

Clearly, these are significant powers. While it was necessary to introduce them to the Pensions Bill without consultation, to avoid giving notice to those who might try to avoid their pension liabilities, their introduction was followed by widespread consultation with, among others, the CBI, the British Venture Capital Association and the Society of Turnaround Professionals, on how these powers should be implemented. One result of this consultation process was the introduction of a clearance procedure. This means that those considering transactions involving companies with defined benefit pension liabilities can gain certainty, through a clearance statement from the Pensions Regulator that their intended actions will not be found retrospectively to have fallen foul of the legislation. Whilst the process is optional, a clearance statement provides a valuable degree of certainty to those involved.
Our first year – theory versus practice

Our first year of operation has been characterised by the dual requirement to provide an effective operational capability from day one (which included handling the significant volume of regulatory cases inherited from Opra) while developing and implementing the risk-based approach described in this chapter.

Gathering information

We made good progress with the process of designing and issuing the scheme return in our first year. Returns were dispatched initially to the largest defined benefit schemes, and eventually to all defined benefit schemes with five members or more, with nearly nine out of ten collected by the end of the year. The return is now being rolled out to larger defined contribution schemes followed by smaller schemes. The initial lengthy paper return was replaced with a more streamlined online version which is quicker to complete and which allows possible errors or omissions to be identified immediately rather than picked up at a later stage.

In addition to whistleblowing reports, we have been collecting valuable risk-related information through the new notifiable events framework, with nearly 400 reports in our first year. A new environmental scanning team has started to analyse more general risks across schemes or within specific sectors, gathering data about subjects such as trends in pension provision and the risks facing defined contribution schemes and closed schemes.

A major milestone in 2006 was the publication of the ‘Purple Book’ (the Pensions Universe Risk Profile) jointly with the Pension Protection Fund. This provides, for the first time, a single, credible source of data and analysis of risks in the DB landscape.4

Working to improve scheme funding

We are in the early stages of the new funding regime. Implementation is driven by schemes’ triennial valuations, and it will be some years before all DB schemes have scheme-specific funding plans in place. Our major work in this area has therefore been to communicate the new requirements and to provide support and education. Some schemes have already started to draw up plans to address their deficits, and we have been gathering and analysing information about these. In line with our risk-based approach, we have made direct contact with the largest schemes, and are continuing with this process.

The need to address scheme deficits would exist with or without the presence of the regulator. However, the new requirements mean that this issue must be tackled sooner rather than later. As regulator, we are responsible for the effective implementation of the new framework, and we are under no illusions about the challenges posed to trustees, employers and advisers by the need to establish robust funding plans. It should also be stressed that in funding matters we are very conscious of the balance to be struck, in pursuing our objectives, between the interests of the scheme and the viability of the employer. Our position is that the best means of delivering members’ benefits is, in the great majority of cases, for the scheme to have the continued support of a viable employer. We have consulted widely on our approach to regulating the new requirements. In developing our proposals, we also commissioned extensive analysis from PricewaterhouseCoopers of the impact on employers, the equity market and the economy of reductions in pensions deficits.5

We will use a variety of information sources to identify those funding plans which may place members’ benefits at risk. However, given the many thousands of defined benefit schemes in existence, attempting to analyse all funding decisions in detail

5 The Pensions Regulator (2005b), How the Pensions Regulator will Regulate the Funding of Defined Benefits, Annex B – PwC research on the affordability of the regulator’s proposals, October.
is not a practicable option and would not be an appropriately risk-based response to the issue. We shall therefore be using ‘triggers’ as one means of filtering out schemes that may need closer scrutiny.

The first of these triggers relates to the target funding level the trustees and employers have agreed for the scheme. Initially we compare this figure with a range between two values: the ‘section 179’ valuation (the funding required to secure the level of benefits provided by the Pension Protection Fund in the event of employer insolvency), and the scheme’s liabilities as calculated using the FRS17 accounting standard (or IAS19 where used) as given on the sponsor company’s balance sheet. If the target figure falls below this range, we will want to look more closely at how it has been arrived at. If it lies within the range, whether the scheme triggers our attention or not will depend on our assessment of factors such as the maturity of the membership and the strength of the employer’s covenant.

The second set of triggers relates to the recovery plan. Generally speaking, schemes will trigger if this is longer than ten years or has a significantly higher level of contributions towards the end of the period. And while we recognise that assumptions on likely investment returns may allow a degree of equity outperformance, a further trigger will apply if the recovery plan appears to be based on over-optimistic investment assumptions.

The fact that a scheme triggers our attention does not mean that regulatory action will follow. In all cases, we will carry out a further assessment of the scheme’s circumstances before taking any decision about contacting the scheme or intervening further. Equally, we may decide to investigate a scheme that has not triggered but that has come to our attention through other channels. These triggers, as we have emphasised, are not targets. They are essentially a regulatory tool, and are only one way in which we may identify schemes at risk. Whilst trustees will wish to be aware of how the regulator operates, they must base their
funding strategy on prudent consideration of their scheme’s circumstances, not on the regulatory triggers.

Acting against avoidance

The work of the clearance team in our Corporate Risk Management practice has had a particularly high profile in our first year. We have worked with the trustees of the Turner and Newall pension scheme, for example, to secure a better outcome than had previously been offered; we have given clearance to the restructuring of Heath Lambert which enabled the business to go forward whilst giving the Pension Protection Fund a claim on any future success; and we have worked with trustees of the Marconi pension scheme to provide protection for members when the sponsoring employer became greatly reduced in size.

There have, of course, been many other cases which have not hit the headlines. In fact, we granted clearance for nearly 150 transactions in our first year. The fund value of schemes involved in these cleared transactions was circa £22.9bn, with related FRS17 deficits of £5.6bn based on the most recent valuations at the time of clearance. This represents 4% to 6% of the total market FRS17 deficit estimated during the period. Whilst clearance negotiations did not necessarily result in elimination of a scheme’s deficit, clearance is only granted where trustees and employers have agreed a suitable level of mitigation for the detriment to the scheme resulting from the proposed transaction. In nearly every case this was secured, resulting in considerable reduction in the deficit.

In the two cases where clearance was not granted, the key consideration was that insufficient mitigation was offered despite the fact that the proposals would severely weaken the scheme’s security. We do not have the power to ‘block’ such transactions as is sometimes reported, nor do we ‘approve’ those where clearance is granted. A clearance statement simply means that we will not, on the basis of the facts presented to us, use our anti-avoidance powers in relation to the proposed transaction. Where
clearance is refused, we cannot give such an undertaking, and we may consider it reasonable and appropriate, now or at some point in the future, to use these powers.

Clearance is a new and challenging area for the regulator, and the circumstances in which clearance discussions and applications take place are often sensitive and stressful. However, the experience of our first year has been remarkably positive. The team dealing with clearance matters is multi-disciplinary, including lawyers, business analysts, actuaries and case managers as well as pensions’ specialists. As is the case with many of our teams, there is a mix of regulatory staff and individuals on secondment from (amongst others) legal and accountancy firms, investment banks and insolvency specialists. This gives us a broader perspective, keeps the organisation refreshed with new ideas and experience, and gives us access to up-to-date technical expertise in this complex field. Additionally, we have been encouraging early contact with the regulator where relevant transactions are planned, on an informal or even anonymous basis at the initial stages. Indeed, we deal with a hundred or so such enquiries every month, and while some may need to be taken further, we are often able to confirm that a particular transaction falls outside the scope of our anti-avoidance powers and that a formal application is not necessary.

Clearance provides valuable reassurance and certainty for vendors and purchasers of businesses, lenders, shareholders and other stakeholders. It is optional, as already mentioned; and while it is too early to be sure at this stage, there is some evidence that as shareholder expectations adjust to reflect pension scheme liabilities, and as the regulator’s guidance and decisions get factored into negotiations, transactions are going through in discussion with trustees without necessarily coming to us for clearance. To this extent, we believe we have successfully influenced the market to take proper account of the risks to members’ benefits through what is effectively self-regulation.
Support and education

A major feature of the regulator’s first year has been our work in supporting, informing and educating the regulated community, driven both by the requirements of the new legislation and by our proactive approach to reducing risks. The 2004 Act requires us to produce codes of practice on a range of subjects. The process of consultation, development and obtaining ministerial approval for these has gone on throughout the year, and several of the codes have now been published. Their purpose is to provide practical guidelines to the relevant people – trustees, advisers, administrators, employers and others – on complying with the relevant pensions legislation, setting out in plain English the standards that are expected of them. Topics covered include the reporting of breaches of the law, with guidance for potential reporters on establishing whether a breach is significant enough to warrant regulatory attention; notifiable events, setting out which events must be notified to us, who is responsible for notification, and the timescales involved; and scheme funding, explaining the roles and duties of trustees, actuaries and sponsoring employers in implementing the new funding requirements.

Our codes of practice are not statements of law, and following them is not mandatory. However, they have evidential status; if a code of practice is relevant to the case, a court or tribunal will take the contents of the code into account, and will wish to establish whether it has been followed – and, if not, what alternative procedures are in place.

As well as our codes, we have issued guidance and updates on topics such as clearance and the approval of schemes operating cross-border within the EU. We have also produced general guidance for trustees and information for scheme members on the annuity options available to them when they retire. The
‘codes and guidance’ section is consistently the most visited area of our website, accounting for around one in every eight visits.\(^6\)

In a largely trust-based system of pension provision such as that of the UK, the role of trustee is crucial. Trustees have always been responsible for safeguarding members’ interests, and this essential duty of care has not changed. However, there are undoubtedly new challenges facing trustees – the new funding requirements discussed earlier, for example – and it is important that trustees are equipped to meet these challenges. The legislation recognises this, with the introduction of the trustee knowledge and understanding provisions. Trustees are now required to possess knowledge and understanding, at a level appropriate to their role, of trust and pensions law and the principles of funding and investment. They must also be conversant with their own scheme’s documents such as the trust deed and rules.

Professional and specialist trustees, and those in larger schemes where substantial training is available, are unlikely to fall short of these requirements. However, the fact is that many lay trustees, particularly those in smaller schemes, have in the past had little or no training. Our research has shown that trustees in smaller schemes are generally aware that there are gaps in their knowledge and are keen, in principle, to take advantage of training opportunities. However, the same schemes are likely to have a smaller budget – if any – to spend on proper training.

As well as producing a code of practice on the new trustee knowledge and understanding requirements, we developed a free online training programme (the ‘trustee toolkit’), designed to help all trustees, whatever the size and nature of their scheme, to meet the new requirements.\(^7\) The programme consists of a series of modules, each of which allows users to work through a variety of realistic scenarios in which they join a trustee board and participate in decision-making. Each individual scenario – for

\(^6\) www.thepensionsregulator.gov.uk
\(^7\) www.trustee-toolkit.com
example, resolving a dispute with a scheme member or dealing with a conflict of interest – links to more detailed tutorials covering the learning objectives in greater depth, and is supported by real-life case examples illustrating how the principles under discussion have worked out in practical terms.

Introductory modules on pension schemes and the role of trustee were released early in 2006, followed by modules dealing with pensions law, the asset classes that schemes may hold, and scheme-specific funding. Further modules both for DB and DC scheme trustees are in preparation. We are confident that the programme, when complete, will be sufficient to equip the majority of trustees to meet the legal requirements. The programme is very flexible and users can work at their own pace. The training is not onerous; typically, we would expect a novice user who accesses the toolkit for about an hour a week to be able to complete the entire programme in four or five months. The programme is particularly valuable for the very large number of smaller schemes that may not be able to find affordable training solutions from traditional providers.

It is important to emphasise that no-one expects lay trustees to become financial experts. Trustees have access to expertise through the scheme’s actuaries, auditors and a wide range of other advisers. However, in order to make use of this expertise they must have a sound basic knowledge of the law, a good understanding of the nature and importance of their own role, and the confidence to ask straightforward questions of their advisers so that they can make informed decisions and participate effectively in running their schemes.

Looking forward

The challenges in our first year have been considerable: making the risk-based approach a reality, engaging in urgent negotiations relating to corporate transactions, developing an approach to the issue of underfunding, producing codes of practice, all whilst
pressing on with the day-to-day business of regulation. The regulator’s chairman, David Norgrove, has succinctly summarised our first year’s progress as: ‘so far, so good’. Some of these current challenges will continue into the coming years. In 2006 we published our medium term strategy setting out our key challenges over the next three years and how we intend to respond to them (The Pensions Regulator, 2006a). The three areas on which we shall focus are the strengthening of DB scheme funding, the reduction of risks to DC members and the improvement of scheme governance.

The new scheme funding regime is in its early stages, and over the next few years, as all DB schemes complete their triennial valuations within the new scheme funding framework, we shall be assessing the recovery plans of schemes in deficit and working to ensure that these address the risks to members while taking account of what employers can reasonably afford. The closure of DB schemes and the move to DC provision is likely to remain a feature of the pensions landscape, and if trends continue at current rates, there could be equal numbers of active members of DB and DC schemes by 2012.9

Despite this decline in active members, DB liabilities will remain a major issue for many years to come, particularly as there are very large numbers of deferred members (typically those who have moved to a new employer but who still have benefits in the original employer’s scheme), often with substantial rights.10 Whilst DB provision has inevitably been the focus of our higher-profile work in the first year, we are well aware of the potential risks inherent in DC arrangements. Much of our activity already relates to DC provision (a number of our codes of practice, for example, and parts of our trustee training programme), and many of the reports and other data we collect may relate to either type

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of scheme. Our work to identify and mitigate the risks associated with DC provision will become increasingly important in the medium term. A consultation exercise took place in 2006, as tackling DC risks (particularly those associated with administration, costs, and members’ understanding of their pensions and benefits) will inevitably involve the wider pensions community, including trustees, providers, administrators and employers.\textsuperscript{11}

A related medium-term objective is to achieve an improvement in standards of scheme governance. We have commissioned extensive independent research which has demonstrated that, while trustees are reasonably self-confident in current standards of governance, a significant minority of schemes have shortcomings in certain areas, most notably risk management; over a third of the DB schemes questioned, for example, do not regularly review their employer’s credit rating. Larger schemes, particularly those with high standards of training, are generally better governed than smaller schemes.\textsuperscript{12} Addressing this unevenness in standards and practice will be another important aspect of our work over the coming years.

Finally, it is worth making the point that risk-based regulation is not, in itself, a risk-free business. However, eliminating this risk completely is neither possible nor desirable, as it would involve massively expensive and burdensome regulation of both schemes and employers. Risk-based regulation can only work with the cooperation of the regulated community. The responsibility for ensuring compliance must be shared through constant dialogue with those who manage, advise on and administer schemes; they are on the front line of regulation, and it is information from them that enables us to identify potential problems. Consultation

\textsuperscript{11} The Pensions Regulator (2006d), How the Pensions Regulator will Regulate Defined Contribution Schemes in Relation to Risks to Members, Consultation document, November.

and contact with the pensions community has been a defining feature of our first year of operation, and will no doubt continue to be so as we go about the important task of protecting members’ benefits and improving confidence in work-based pensions.
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7 POSTAL SERVICES REGULATION

Richard Moriarty and Sophie Colman

Introduction

This regulatory review by the CRI is very timely. The last two years have seen a series of changes in the framework of regulation in the postal services market, culminating in January 2006 when Royal Mail’s 350 year monopoly came to an end. Perhaps the biggest change that will affect most people in the short term was Royal Mail’s move from a weight based pricing system to a format based pricing system, altering a way of pricing for mail that had been in place for decades. On top of this, Postcomm and Royal Mail agreed a price control package to help with the challenges of liberalisation, modernisation of an under-invested network, and a huge pension fund deficit. This chapter discusses Postcomm’s approach to these important issues and highlights some of the key regulatory issues that may need to be tackled in the future.

Postal liberalisation is a fairly recent development. Postcomm was established with the passing of the Postal Services Act 2000. The institutional ‘template’ for postal liberalisation and regulation is similar to that in the other sector regulators but there are a number of key differences. First, the vertically integrated incumbent, Royal Mail, is set up as a plc but with all the shares owned by the government. It is not privatised, as are most of the other utilities which are subject to sector specific regulation. Second, the first of Postcomm’s statutory duties is to ensure the continuation of a universal service at an affordable and geographically uniform price. Third, the decision on whether (and how) to introduce competition was a matter given to the regulator.
Competition in post – the end of a 350 year era

Royal Mail had one of the longest standing monopolies in the UK. It was initially granted by Charles I to ensure that he could monitor communications to suppress the risk of treason and sedition rather than for any altruistic public policy objective.

*Why competition?*

Postcomm’s decision to open the whole market to competition in 2006 followed an extensive consultation programme and detailed analysis. Postcomm has always taken the view that customers’ interests are best served, not by the maintenance of monopoly privilege, but through a competitive market delivering a range of innovative, reliable, and efficient postal services, including a universal postal service.

At the time Postcomm decided to start liberalising the market in 2002, Royal Mail’s monopoly was not working well. It was losing money and not providing the range of products and services that customers wanted. Customers, large and small, were calling for a change to allow greater choice. There was also pressure on the company to be innovative, arising from the growing threats and opportunities from alternative media, such as the internet and email. Not many countries have taken the step to liberalise fully their postal markets but those that have (such as Sweden and New Zealand) have experienced significant customer benefits from doing so and have maintained a universal service.

Against this background, the case for liberalisation in the UK was compelling. Postcomm sees economic regulation as transitional: protecting customers until market forces can be relied upon to do the job. It has always been clear that regulation is a poor substitute for the rigours of a competitive market. Whereas the latter tends to encourage a ‘how to stay one step
ahead of the competition’ culture the former can risk developing a culture of ‘how to stay one step ahead of the regulator’. Experience suggests that competition drives rent seeking discovery by entrepreneurs leading to new product development, different ways of doing things and a customer-centric mindset; features that are not best facilitated through prescriptive regulation in a market without effective competition.

Postcomm opened the market in two stages. In January 2003 the market was opened for bulk mail above 4,000 items (approximately 30% of the market by volume). The remainder of the market was opened to competition from 1 January 2006. From that date, any operator could enter the market, the only requirement being the need to obtain a licence from Postcomm.

What has happened?

Postcomm has now granted 17 licences in addition to Royal Mail. The new entrants have a range of backgrounds. Some, such as TNT Post UK and DHL Global Mail, are subsidiaries of incumbent foreign postal operators (Netherlands and Germany respectively). Some are subsidiaries or aligned to established operators in the UK courier and express market (eg, UK Mail/Business Post plc). Others include private equity backed operations, regional players and those seeking to capture specific niche mail streams.

The infant market has already seen some consolidation. DHL Global Mail bought Speedmail and the Candover private equity group has recently acquired both Secure Mail Services and DX and has plans to merge their operations into what will be the second largest delivery network after Royal Mail (albeit still at a small fraction of Royal Mail’s size). The new operators have a range of business models and offer a range of services. Innovative services being offered include a guaranteed 2-day business class product, a service for highly secure items such as credit cards, and enhanced tracking of mail in the postal network.
Sometimes the relatively small things matter to customers – such as flexibility over the latest collection time.

New entrants have mainly targeted the largest mailers. The mail market is heavily concentrated among a small number of large mailers, such as financial institutions, utilities and telecoms, government and charities. Royal Mail’s top 500 customers account for around 50% of volume. Aside from the sheer volume of this mail, these customers are attractive targets to the new entrants because they post predictable streams of mail that can also be easily machine sorted.

Although the senders of mail (and those that pay for it) are mainly businesses, government and charities, the main recipients of mail are households (Figure 1). Social correspondence now represents only 1 in 10 letters. Some mail operators have focussed on the business-to-domestic market given its scale, some have focussed solely on the business-to-business market. None have so far set up a domestic-to-domestic network.

**Figure 1: Distribution of mail flows**

Source: Royal Mail (2004/05)

Postcomm carries out an annual survey of UK businesses to understand what their needs are from postal services and how
well these are being provided. The 2006 survey confirmed (large) customers’ perception that competition had contributed towards lower prices, greater choice and better quality of service. 20% of respondents believed that their mail prices had reduced significantly, 38% believed that the choice of service available to them had improved and 34% believed that Royal Mail’s service quality had improved. However, the survey revealed that a relatively large proportion of respondents found it difficult to access information about alternative operators, with 64% finding it ‘not very easy’, ‘very difficult’ or simply had not having tried to access information. This was a particular problem among the small and medium enterprises (SMEs) where most could not identify an alternative supplier of postal services.

Opening the market has not led to a ‘big bang’ in terms of a sudden influx of competitors operating at all levels. Competition is developing gradually, and has so far largely been confined to the collection and sortation of mail from business customers, most of which is handed over to Royal Mail at one of their 70 mail centres (at a price) for final delivery. This growing activity now accounts for about 11% of total mail volumes. Royal Mail retains the ‘lion’s’ share of revenue from the mail chain. Conversely, alternative delivery operators offering an end-to-end service have made only very modest inroads into Royal Mail’s market share: only 2 in every 1000 letters in the regulated area are delivered by a rival to Royal Mail.

Competition, and the threat of further competition, has started to change behaviour within Royal Mail as it strives to ensure that it can meet the challenges of a competitive market. It is seeking to modernise its network to bring it closer into line with its European peers. It is also seeking to make it easier for customers to do business with it, for example by developing new products and moving away from a ‘production-led’ approach to product development towards a ‘customer-led’ approach. Royal Mail is developing tailored products for specific sectors, such as Direct Mail Users (Mailmedia), with incentives for customers who pre-sort and prepare mail and thus cost Royal Mail less to handle. It
is also seeking innovative technology solutions such as developments relating to printing stamps from your PC (Smartstamp), and secure on-line account management. As a direct response to customer feedback Royal Mail also launched a Sameday service in May 2006 using GPS technology allowing customers to track deliveries in real time.

Spurred by the threat of competition and proportionate regulatory incentives, Royal Mail has significantly raised its game in terms of quality of service. Reliability, in terms of transit time, has improved to record levels from 2003/04 when Royal Mail failed 15 out of 16 of its regulatory targets. The number of addresses that do not get a daily delivery has fallen to a very low number. In addition, Royal Mail is now experiencing few bouts of industrial action that disrupt customers’ service, whereas at one time it accounted for half of all strike days lost in the UK economy. This demonstrates that although some customers, especially social mailers who comprise about 10% of the market, do not benefit from direct competition, they have still benefited from the knock-on effect of Royal Mail’s raising its performance level to compete for the business of the large business mailers.

In terms of value for money, the price of posting letters in the UK compares favourably with most other European countries with similar levels of service, despite recent price rises. Among the fifteen ‘western’ European countries, the UK price for a first class letter below 100g is the second lowest and is among the top third in quality levels. Other countries’ mail services achieving comparable quality typically charge considerably more for a first class stamp between 50 and 100g. Most European countries have not progressed as far as the UK in opening up their postal markets, though in some countries significant capital investment by the incumbent postal operator has made them more efficient technically (though in most cases still more expensive) than Royal Mail.
Barriers remain

Although Postcomm is pleased with the amount of competition that has so far developed and the impact that it has had on Royal Mail’s behaviour it recognises that merely opening the market does not automatically lead to effective competition and innovation if there are non-statutory barriers to entry or other significant and sustained conditions that give Royal Mail an advantage over new entrants.

One of the most obvious distortions in the market is the fact that Royal Mail is VAT exempt, whilst other operators have to levy the full rate on their bills to customers. This matters because some of the largest mailers, such as the banks and government, are VAT exempt and therefore cannot reclaim the VAT new entrants charge them. The price disadvantage is not quite the full 17.5% because Royal Mail cannot reclaim its input VAT. Adjusting for this, the disadvantage is still around 13%. Postcomm recognising that VAT policy is a matter for the Government, has consistently made its position clear that the distortion is unnecessary and should be removed to achieve the objective of a competitive level playing field without significant price rises.

A further factor that gives Royal Mail an advantage over its rivals is its economies of scale arising from it carrying over 80 million items of mail each day. Everybody benefits from these scale economies as they give Royal Mail low unit costs and allow it to offer an affordable price. However, it means that entrants find it difficult to compete even if they are efficient, and even if Royal Mail is not as efficient as it could be. This raises an interesting issue: Royal Mail can be simultaneously less than efficient and cost-competitive. Postcomm has sought to address this issue through the development of third-party access to Royal Mail’s network, which as explained earlier has provided most of the stimulus for competition since the market was opened to competition.
A healthy universal service

The universal service as currently defined by the Postal Services Act 2000 (the Act) requires that all universal service products are priced in a geographically uniform manner, despite potential differences in the cost of delivering to high and low density areas of the country.

The Postal Services Act does not define which of Royal Mail’s many products and services should be considered universal services. After undertaking extensive consultation Postcomm has recently implemented licence conditions to focus the scope of the universal service more precisely on a minimum level of protection for both social and business mailers. The main result of this exercise was that most of Royal Mail’s business mail products were removed from the universal service, allowing Royal Mail more commercial flexibility in the way in which those products are provided. The universal service now covers about 50% of Royal Mail’s addressed mail volume.

As previously discussed by Postcomm in the CRI 2002/2003 Regulatory Review, there might be tension between Postcomm’s duties, in particular between the continued provision of a uniform priced universal service and the promotion of effective competition. The traditional argument for giving the national operator monopoly privileges has been that the monopoly was necessary to ensure that the universal service could be financed. The UK experience – and the trend of the debate within Europe – suggests that a monopoly is not necessary, perhaps not even conducive to the financing of a healthy customer focused universal service. The European Commission is pushing to remove all monopolies on postal services by 2009. Alternative strategies to financing any universal service financial deficits must be considered. Options raised in the European debate include direct government subsidies and industry wide compensation schemes. In the UK, Postcomm’s approach has been based on: (a) encouraging efficiency in the provision of the universal service through competition, and through incentive
based regulation where competition is not effective and (b) enabling Royal Mail to move to a more cost-reflective pricing structure (including removing from the scope of the universal service – which in the UK is linked directly to uniform geographic pricing – may some business mail products where competition might be expected to develop).

Since the low point in 2002/03 when Royal Mail letters business made a loss from operations of £223m (before exceptionals) it generated a profit in 2005/6 of £291m. The part of the business that comprises the universal service has never made a loss in the period in which Postcomm has regulated Royal Mail. However, Royal Mail finances could be weaker this year owing to adverse movements on market volumes, product mix and pension costs.

Royal Mail’s ability to finance a universal service has been helped by the fact that the vast majority of volume competed for by new entrants is handed over to Royal Mail for access to its delivery network. The access price was agreed between Royal Mail and other operators as a commercial arrangement, although Royal Mail now claims that it loses money on access.\(^1\)

### Changing the way we pay for our post

It is no surprise that an organisation with the history of Royal Mail will enter the commercial arena with a pricing structure that it would not necessarily want to start with. Prices before 2000 were determined by many factors, not all of them related to rational commercial decisions about the ‘bottom line’. This was sustainable as long as the business did not face the threat of competition whether from other mail operators or from other media. However, since the market has opened, Royal Mail has argued that its business cannot be financed in the long-term in the face of sustainable competition if its prices remain

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\(^1\) Royal Mail’s 2005/6 regulatory accounts show that Royal Mail made an operating loss on Access products of £18m.
significantly out of line with its costs. It has also argued that it is necessary to change its pricing structure in order that it can compete effectively with the new operators.

Postcomm in turn is required by the European Postal Directive 2002/39/EC (the ‘Directive’) to ensure that tariffs are “geared to costs”. Postcomm has consistently said that in the long-term effective competition must be based on genuine innovation and sustainable competitive advantage rather than artificial distortions in the incumbent’s pricing structure. Postcomm has therefore been sympathetic to moves by Royal Mail to align its prices more closely with its costs.

To ensure that this is done in a transparent and fair manner Postcomm has included in Royal Mail’s licence the criteria that it will use to decide if changes to the pricing structure can be introduced. These include such criteria as the change needing to (a) be more revenue neutral within the context of its price control existing at the time; (b) lead to prices for the service being more reflective of costs than they would be if the existing pricing basis was retained; and (c) be introduced in a manner that avoids unreasonable changes for users of the service; and (d) not lead to a failure to provide services priced in a manner referred to in the European Postal Directive (eg, tariffs must be transparent and non-discriminatory).

‘Pricing in Proportion’

In August 2006, Royal Mail introduced a major change to pricing structure for most of its products from one based solely on the weight of a postal item to one based on both format and weight. This was marketed by Royal Mail as ‘pricing in proportion’ (PiP). Royal Mail argued that its costs were driven by the size of items as well as their weight. For example, costs are driven by the ability of a letter to pass through its sorting machines and through people’s letterboxes as well as by an item’s weight. A purely weight based pricing structure led to some serious
distortions with, broadly speaking, light bulky items being cross-
subsidised by compact heavier items.

Royal Mail’s proposal to introduce PiP was very controversial
among postal users, with Postcomm receiving 8,000 responses to
one of its consultation papers. Postcomm’s decision to endorse
PiP followed an extensive and detailed analysis of Royal Mail’s
costing system to understand the justification for the change.
Perhaps the most difficult part of the criteria was that the new
PiP prices, based on the size and weight of mail, had to be more
cost-reflective than the existing weight based prices. Postcomm
faced the difficult challenge of defining measures to represent
‘cost-reflectivity’.

To do this Postcomm developed what it called the ‘cost-
reflectivity ratio’ (CRR). This was an objective test of the
relative cost-reflectivity of existing weight based prices and
Royal Mail’s proposed PiP prices. It takes a ratio of the
difference between existing prices and ‘reference’ prices and the
difference between the proposed PiP price and ‘reference’ prices
(the reference price is effectively the most cost-reflective price as
calculated by Postcomm). The ratio was calculated based on the
sum of squares, on a percentage basis, giving greater weight to
larger deviations from the reference prices.

Postcomm established that the reference price should be
calculated as objectively as possible. It is based on the attribution
of costs based on causal cost drivers. Costs were established by
looking at the avoidable costs of handling the specified product,
plus a proportionate share of the common costs which could not
be directly attributed. The mark-up rule to allocate these costs
was based on ‘equi-proportional mark-up’ (EPMU), which
allocates common costs in direct proportion to the product’s
share of total directly attributable costs.

A CRR greater than 1 indicates that the proposed prices are more
cost-reflective than existing prices. A CRR of less than 1
indicates the opposite. One of the tricky questions is the degree
of granularity at which the test should be applied. For PiP, Postcomm considered cost-reflectivity at a product and sub-product level as well as at an overall level. However, it did not require every single product and sub-product to be more cost-reflective. Postcomm sees its role as setting a framework within which Royal Mail can set its prices and not to assess and approve every price point in advance. Overall, Postcomm found the CRR for PiP was 1.9, indicating that the proposed new structure was 90% more cost-reflective than the existing structure.

Postcomm worked with Royal Mail and Postwatch, the consumer watchdog, to ensure programme for the implementation of PiP took due regard of the needs of customers. This required effective communication and notice periods, etc. Postcomm required Royal Mail to give the market 12 months notice before PIP could be implemented. The change was introduced without significant problems on 21 August 2006.

Other changes

The next significant proposed change to Royal Mail’s pricing structure that Postcomm must consider is the introduction of ‘zonal’ pricing for some of Royal Mail’s non-universal service business products. This would allow Royal Mail to charge its business customers different amounts depending on where the mail is delivered to – mail delivered to high density areas would be cheaper than mail delivered to low density areas.

An ongoing request by Royal Mail is for it to be allowed to increase the price of stamped products, as it claims that it is currently losing money on both first and second class products. To allow Royal Mail to achieve this increased cost-reflectivity, Postcomm included a rebalancing threshold of 3% in the price control. This allows Royal Mail to increase any one price by 3% each year within the overall confines of the price control, without seeking prior approval from Postcomm.
A further example of Royal Mail seeking to make prices more cost reflective is with the introduction of payment ‘channel’ pricing. This was a change in pricing structure so that customers who pay for postage through meter/franking machines or printed postage impressions (PPI) are charged less than those using stamps. as it is significantly more expensive for Royal Mail to process stamped letters, as it incurs additional costs printing and distributing stamps that are avoided with the other payment channels.

Setting the appropriate regulatory incentives: price control

Postcomm carried out its third price and service quality review of Royal Mail starting the review in April 2004, completing it in May 2006. The new control is set to last for four years with provisions for certain aspects to be reviewed by the end of the second year. It was a challenging review because Postcomm had to consider unique pressing circumstances such as a network in serious need of modernisation, a huge pension fund deficit and the need to establish the right efficiency incentives for a government owned business that is highly labour-intensive with a strong trade union.

Modernisation

Royal Mail’s operations are in need of modernisation to transform its ways of working to focus on customer service, innovation, efficiency and flexibility, and to bring it more in line with best practice among its European peers. To help achieve this Postcomm included in Royal Mail’s price control a capex allowance of £1.2bn over four years. This was considerably more than what was allowed for in previous price controls, approximately double, and therefore Postcomm took the decision to move away from a ‘cash’ approach and to adopt a ‘regulatory value’ approach in setting the revised control. Postcomm saw
the advantages of using such an approach as being able to ensure inter-generational cost sharing between customers, stronger incentives and greater certainty for capital expenditure, and flexibility to deal with changes in the level of capital expenditure.

However, because Royal Mail is not a publicly floated company, and therefore does not have an established market value, the process of establishing an opening regulatory value was difficult. Postcomm had to consider a number of conflicting considerations in setting the value of the regulatory asset base (RAB). It had to be set at a reasonable level in order to retain and attract investment, and to reflect the reasonable costs of setting up a comparable network. Postcomm took the final decision to use a current cost (CCA) value of Royal Mail’s balance sheet assets for the regulated parts of the business. This approach was consistent with the approach adopted by some other UK regulators where they were also regulating non-privatised businesses.

**Pensions**

Royal Mail’s pension fund deficit, in comparison to the assets of the company, is one of the largest in the UK. Its 2005/6 Accounts shows a deficit of £5.6bn, leaving the balance sheet in a position of net liabilities. It also operates a relatively high cost defined benefit pension scheme. Early on in the price control review, Postcomm took the decision that the costs of recovering Royal Mail’s pension deficit should be largely funded through prices. However, Postcomm was concerned about allowing Royal Mail to pass on to customers any additional costs arising from an increased pension deficit during the period of the price control, as this could remove the incentive on the company to manage the deficit effectively.

However, Postcomm’s analysis showed that the volatility of Royal Mail’s pension fund was such that small changes either in demographic factors (eg, increased longevity) or changes in the equity and bond market (changes which were largely outside
Royal Mail’s control) could make significant differences to the deficit and under some circumstances potentially put Royal Mail’s ability to finance the universal service at risk. To address the issue of risk derived from the volatility in pension fund asset returns Postcomm allowed Royal Mail to pass through to customers a proportion of any material variations between the actual and expected outcome above a level of £1.3bn. This introduced an element of ‘risk sharing’ for this important cost item.

**Efficiency incentives**

Postcomm set a level of X in the RPI-X formula at 0.1% for Royal Mail, as a result of an assumed annual efficiency factor on operating expenditure of 3%. However, the nature of Royal Mail’s business created difficulties for Postcomm in setting an appropriate efficiency factor. There are no obvious benchmark comparators for Royal Mail of the ‘yardstick’ kind used in the case of electricity and water distribution. To overcome this, Postcomm used a number of analytical techniques to forecast Royal Mail’s future efficient costs including internal benchmarking, ‘top down’ benchmarking and ‘bottom up’ analysis.

In particular, a great deal of effort was taken with the internal benchmarking. Postcomm compared the relative performance of Royal Mail’s mail centres (69) and delivery offices (c.1400) using a range of econometric and analytical techniques to estimate the opportunities for internal improvement without further investment. Using this methodology it was estimated that a range of 2.2% to 2.8% annual unit cost savings could be achieved. These savings were based on assuming that all mail centres and delivery offices could reach the current performance of the bottom performer in the top decile by 2010/11. The analysis did not assume any investment in the benchmark mail

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centre and delivery offices, despite the opportunities acknowledged by Royal Mail for it to ‘catch-up’ with the efficiency level of leading European postal operators. This was considered before reaching the final estimate in addition to various other analyses techniques. These included what had happened in other UK regulated utilities and productivity trends for postal operators in international markets. Postcomm also sought to benchmark specific Royal Mail functions against close comparable sectors such logistics distribution.

**Future challenges**

Perhaps the biggest challenge facing operators in the postal market is the need to anticipate and respond to changing customer demands. For many years mail volumes tended to grow in line with GDP. However, there is recent evidence of weaker demand. In 2005/06 Royal Mail’s mail delivered volumes including access, increased by only 0.24% on the previous year. In the first eight months of the present financial year (to November 2006), Royal Mail’s mail volumes fell by 1.8% over the same period the year before. With rival networks share of delivered volumes in the regulated area only 0.2%, it would appear that total mail demand is currently experiencing a period of modest decline as it has in other European markets.

Mail is becoming a more challenging market, impacted by e-substitution and by customers exercising choice in search for products that better meet their needs within Royal Mail’s and other operator’s portfolios, such as moving from First Class services to Second Class services. Customers, especially direct mailers, are becoming more price sensitive (as mail competes with other promotional media). Customers’ changing demands also offer opportunities. For example, online shopping orders require a delivery to customers’ doors. According to one source the Christmas online shopping sector was worth about £7bn in 2006 and is growing fast: Christmas 2006 online sales grew 50%
on the previous year. Unaddressed mail (leafletting) has also increased in size to about 13bn items. Royal Mail has about 25% of this market.

These market changes make it even more important that postal operators develop innovative products and services, which will be valued by customers. It also makes it important that Royal Mail completes the transformation of its business, including new products, efficient operations and addressing is substantial pension fund deficit.

**Postcomm’s strategy review**

Postcomm has decided that now is an appropriate time to ‘reflect on’ and how the changing postal market, both in terms of changing demands of customers and the change in businesses operating in the market, may call for changes to the regulatory framework. Postcomm often consults on individual policy initiatives but the aim of its strategy review is for it to take stock in a more holistic way and to assess whether its regulatory strategy is currently best aligned to achieving its vision of the market in the medium to long-term. In particular, Postcomm wants to consider issues related to the definition of the universal service, the promotion of effective competition and its approach to deregulation.

Postcomm has always said that the scope and standards associated with the universal service should evolve over time. Therefore, as part of its strategy review, Postcomm will consider whether the needs of postal users are changing and whether this should lead to a reconsideration of the definition of specific dimensions of the universal service.

Among the competition issues Postcomm is considering as part of its strategy review is whether there is merit in greater ring-fencing or separation of Royal Mail’s vertically integrated

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business to promote effective competition. For example, some argue that greater regulatory ring-fencing or separation of Royal Mail’s operations is necessary to ensure greater cost transparency and to provide competitors with confidence in Royal Mail’s operation of the access regime in the same way as has happened in other regulated industries such as telecoms. Any changes would need to carefully consider the potential impact on the market’s development.

Finally, it has always been Postcomm’s hope that it could progressively withdraw from \textit{ex ante} regulation as competition develops and barriers to entry are tackled. The strategy review seeks views on how this can be best achieved.

**Conclusion**

Since the last CRI Regulatory Review, Postcomm has taken a number of steps towards its vision of a range of reliable, innovative and efficient postal services, including the universal service, valued by customers and delivered through a competitive market.

There is still some way to go – and challenges ahead – but the last two years have seen more change in the postal market, and the framework of the postal regulation, than perhaps the previous twenty years combined.
8 RAIL REGULATION

Paul Plummer

Introduction

Six years ago I wrote the CRI review of rail regulation ‘wearing a different hat’ as chief economist of the Office of Rail Regulation (ORR). I concluded with following statement:

“…. the priority must be to ensure a timely recovery from the post-Hatfield situation and to facilitate further improvements and enhancements to the network. Once the longer term implications of Hatfield have been established it may also be necessary to adjust the level of Railtrack’s charges to take account of these ongoing effects”.

The access charges review which I anticipated six years ago was not completed until 2003, after Railtrack had been into administration and taken over by Network Rail. Shortly after this, the industry went through a government rail review which culminated in a white paper on the Future of Rail and the Railways Act 2005.\textsuperscript{1} By way of background, the main changes proposed were as follows:

- transferring responsibility for safety regulation from the Health and Safety Executive to the Office of Rail Regulation which therefore became the combined economic and safety regulator;

\textsuperscript{1} Further details of rail statistics, the regulatory arrangements, the periodic review, route utilisation strategies and the strategic business plan, can be obtained from the Network Rail and ORR websites www.rail-reg.gov.uk and www.networkrail.co.uk.

Paul Plummer, Director, Planning and Regulation, Network Rail
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- changes to the regulatory review process so that government is better able (and indeed required) to specify the strategy for the railways as an input to regulatory reviews;

- the abolition of the Strategic Rail Authority and transfer of many of its responsibilities, including franchising, direct to government;

- transfer of some of the SRA’s responsibilities to Network Rail (including performance of the network and leadership of industry planning) with Network Rail being expected to work more in partnership with train operators;

- an increased role for the Scottish Executive, the Welsh Assembly Government and the Mayor of London, and more local decision making in England.

In an industry which is seemingly subject to almost continuous review, we are now in the early stages of the 2008 Periodic Review (PR2008). This will set the outputs which Network Rail is expected to deliver and the associated access charges for the period 2009-14. It is therefore a good time to review the progress made by the industry in the last few years.

In summary, we have seen reliability restored to better than pre-Hatfield levels, despite further growth in traffic on an already congested network; we are well on the way to dealing with the legacy of underinvestment and poor asset knowledge, which only became fully apparent following the Hatfield incident; efficiency is greatly improved; rail travel is now widely regarded as being safer than any other mode of transport; both historic and projected growth in demand remain strong; and an increasing number of enhancements are being developed and delivered. In a little more detail:

- Passenger kilometres have increased substantially from 32.5bn in 1991-92 to 43.2bn in 2005-06.
Total freight moved in 2006 increased by 7.5% compared to 2005 and is now at 22.1bn net tonne kilometres.

The moving annual average public performance measure (PPM) has increased from 79.2% in 2002-03 to 86.4% in 2005-06.

Regulatory targets for the asset stewardship index (a composite measure of asset condition) have been beaten by 6% and the more challenging targets set by Network Rail itself have also been exceeded.

Network Rail has delivered the tasks required to date as a result of the asset register licence condition which was imposed on Railtrack.

The industry has achieved and maintained compliance with timetable requirements which enable passengers to be given information about train journeys well in advance.

Over the two years 2004-05 and 2005-06, Network Rail has achieved efficiency savings in operations, maintenance and renewals expenditure of 24%, 19% and 15% respectively, thus outperforming against regulatory efficiency assumptions for operations and maintenance expenditure and meeting regulatory efficiency assumptions for renewals expenditure.

The precursor indicator model (PIM) that seeks to measure major accident risk has reduced from 103.3 in 2002 to 79.6 in 2006 due to the successful introduction of train protection warning system (TPWS) and other initiatives.

Between 2005-06 Q1 and 2006-07 Q1, the number of passenger complaints per 100,000 journeys decreased by 2%. The overall passenger complaints figure is currently 72 complaints per 100,000 journeys.
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• Major investment on the West Coast Mainline has enabled trains to run at 125 mph. This has slashed journey times and seen Virgin’s passenger numbers almost double.

• The Southern Power Supply upgrade allowed the withdrawal of mark 1 rolling stock from passenger service by the HSE deadline of 30 November 2005. Major investment in new trains has led to substantial improvements in passenger satisfaction.

It is certainly fair to say that there is still a long way to go, but the rate of progress made by the industry as a whole is undeniably impressive. This is not just my view – for example:

• Bill Emery, chief executive of ORR, stated on 21 August 2006 “Our first review identifies many positive trends, and many challenges ahead. Overall passenger satisfaction stays at an all time high. There is continuing steady progress in train punctuality, and stewardship of the network”.

• In respect of Network Rail’s part in this, Bill Emery stated on 29 September 2006 “Our assessment concludes that Network Rail has continued to make good progress with managing the network. Two years into the current control period, it is well on the way to achieving the targets laid down in the access charges review in 2003 (ACR2003). In particular, the company has achieved significant further reductions in train delays caused by infrastructure problems, at the same time as supporting more traffic on the network”.

• Douglas Alexander, Secretary of State for Transport, stated on 11 July 2006 “We have established the right structure for the industry, underpinned by stability and record investment - this is already delivering results for passengers”.

• Tom Winsor, the previous rail regulator, said in May 2006 “Despite criticisms from mostly the ill-informed observers, Britain now has the fastest-growing and one of the most
successful railways in Europe. We have falling costs, rising efficiency, some of the best track quality measures since records began, huge increases in demand for freight and passenger services, sustained and substantially improved operational performance and the youngest average age of rolling stock of any European railway. Network Rail is a very different company from Railtrack, and although it is far from perfect and has some way to go, the approach and achievements of the company in many respects have met or exceeded regulatory expectations. It’s a success story”.

So in terms of outputs it would appear that the current structure of the industry is working well. Unfortunately (but perhaps inevitably) some commentators would no doubt say that this impressive progress is in spite of remaining problems in the industry. It is therefore a good opportunity to consider whether some of the key changes made in the last few years are actually helping to improve the situation, and to highlight key implications for the periodic review. The remainder of this review therefore looks back over the last two years and forwards to the next two years in the following areas:

- the new periodic review process;
- Network Rail accountability and incentives;
- partnership between industry parties and funders.

The new periodic review process

The early stages of the periodic review have seen much discussion between government, ORR and Network Rail about precisely how the new periodic review process would work following the Railways Act 2005. There are a number of important differences compared to the last two access charges reviews which concluded in 2000 and 2003 respectively (ACR 2000 and ACR 2003).
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Legal differences

The first and most obvious difference is that government is now required to set out (a) what it wants to buy as part of the review process (the high level output specification or HLOS) and (b) the funding available to buy these outputs (the statement of funds available or SOFA). If ORR is not satisfied that these are consistent with each other, government can modify either the HLOS or the SOFA. Ultimately, if ORR does not believe that the two can be reconciled it must give priority to the SOFA and decide what outputs should be adjusted. ORR then sets Network Rail’s outputs and access charges consistent with this (subject, of course, to the company’s normal ‘right of appeal’ to the Competition Commission). The HLOS and SOFA are due to be published in July 2007.

As a result of devolution of powers to Scottish Ministers, a separate HLOS and SOFA is required for Scotland. In addition to the base line specification of what is expected from each part of the network, this raises a number of new issues including the allocation of risk arising from potential variations in the level of underperformance/outperformance in different parts of the network.

Differences in process and responsibilities

There has already been much more direct engagement with government than in the early stages of previous reviews. In both the ACR 2000 and ACR 2003, there sometimes appeared to be relatively little government (and even the Strategic Rail Authority (SRA)) involvement beyond what was required to respond to formal consultations, particularly in the early stages of the process. By contrast there are now frequent steering meetings between Network Rail, ORR, Department for Transport, and Transport Scotland. Clearly this closer involvement from government in the high level specification stems directly from the formal changes outlined above. However, it also means that there is much more of a common understanding of the key issues
which need to be addressed, and this should mean that there is less likelihood of major surprises.

Much of this initial discussion with government and ORR focused on how the HLOS requirements for improvements in safety, performance and capacity would be expressed, so that this was sufficiently detailed to enable Network Rail and ORR to (a) cost the outputs and ensure that these are delivered while (b) remaining sufficiently high level and output-based to enable these outputs to be delivered efficiently with some flexibility. It will clearly be important to ensure that this balance is maintained throughout the process.

The burden of proof on Network Rail has increased compared to previous reviews. At ACR 2000, the quality of information was poor. Moreover, ACR 2003 was shortly after the acquisition of Railtrack by Network Rail which meant that the company’s understanding of the key issues was emerging as the review progressed. One implication of this was that ORR became more closely involved in detail than is typical in other sectors. By contrast, Network Rail is now expected (understandably) to lead the work and substantiate its submissions with detailed evidence.

Thus, for example, the company was required to publish its initial strategic business plan (ISBP) in June 2006 as an input to decisions about the HLOS. Moreover, Network Rail has developed an infrastructure cost model to develop a better understanding of the cost drivers on the network. It is also undertaking extensive benchmarking and other analysis to reach its own view of the potential scope for efficiency savings in the next control period (which is still two and a half years away), and to provide as much evidence as possible to ORR in support of this view. This will obviously be subject to intense regulatory scrutiny but ORR will not have to start from scratch.

In addition, Network Rail is now expected to develop plans which provide the best possible basis for the industry as a whole to meet the challenges facing it. This involves consideration of
the best way for the industry to meet particular outputs regardless of whether investment is required in the infrastructure or the trains. This is part of the company’s responsibility for leadership of industry planning in partnership with train operators (discussed further below). Given the timescales, however, the ISBP was produced by Network Rail largely in isolation (albeit drawing on extensive joint work as part of route utilisation strategies where these have been completed). One of the main challenges now is for Network Rail to engage with the rest of the industry in developing its October 2007 strategic business plan to ensure that this is widely endorsed.

Differences in context and priorities

Unlike the last two reviews, Network Rail’s projected income requirement for sustaining the existing network is going down. In ACR 2000, there was some early discussion of a ‘regulatory dividend’ but it quickly became apparent that this was unrealistic. With hindsight, the scale of the problem arising from previous underinvestment was still underestimated. This contributed to further increases in ACR 2003.

By contrast, the Figure 1 below shows how future expenditure requirements for sustaining the existing network over the next control periods are expected to fall as a result of (a) achievement of the ORR’s efficiency targets for the current control period, followed by further challenging improvements in subsequent periods, and (b) reduction in the backlog of renewal required as a result of the legacy of past underinvestment. On the other side of the equation, recent franchise bids show how projected demand growth is expected to result in increased income for train operators and enhanced franchise value for government. Subject to the (rather important) point discussed below, these factors would reduce the expected subsidy required from government.

Priorities inevitably change. It is clearly critical that the railway continues to improve efficiency and performance. However, there is now just as much emphasis on the need to provide
additional capacity to respond to the growth in demand for rail travel. These issues are clearly related since the latter is unlikely to be affordable unless we continue to make progress on the former. Much of the investment will need to be in rolling stock, but investment in the network will also be needed to accommodate more and longer trains.

**Figure 1: Base expenditure**

This shift of emphasis reflects a number of factors including (a) good progress on efficiency and substantial improvements in performance (b) years of strong growth resulting in a heavily congested network (c) projections that this growth will remain strong as shown in **Figure 2** below and (d) an increasing recognition that rail transport is important both for economic growth and sustainability. One of the key questions for government therefore concerns the extent to which the reduction in subsidy arising from the changes outlined above is used to fund these enhancements on the railway rather than investment in other public services.
Figure 2: Passenger and freight demand

Freight – not a difference

There is also an issue concerning freight charging. This is always a difficult issue at reviews since freight operators are often ‘price takers’ based on competition with other modes of transport. The principle is broadly established that freight operators should pay the incremental cost that they impose rather than contributing to common costs. However, this can still leave a lot to interpretation and it will be important to provide clarity about both future charges and what freight operators can reasonably expect from the network in return for these charges.

The Freight RUS has provided an important input to this process by providing an agreed industry view of likely demand growth. Moreover, although the HLOS is not expected to specify outputs for freight, the reasonable requirements of operators will clearly be taken into account in Network Rail’s strategic business plan. At the same time there is the prospect of substantial funding for freight-related investment funded by the government’s transport innovation fund (TIF).
Common methodology

In other respects, the approach to the review is much the same as previously and the methodology is essentially the same as in other regulated network businesses.

Network Rail accountability and incentives

The debate about Network Rail’s accountability and incentives has remained live ever since it was created. This is in spite of the fact that any measure of output would appear to suggest that ‘it works’. The question often asked is whether this can be expected to continue working. The debate on incentives is often oversimplified and presented in very black and white terms. Particular attention is often given to two issues:

- Network Rail is a private company with members instead of shareholders and with a goal to re-invest surpluses in improvements to the railway;

- at first it was necessary for Network Rail’s debt to be supported by a government guarantee.

Network Rail has no plans to change the first of these. Its members have an important role in relation to corporate governance just as in any other company. However, in relation to the second issue, the company has been proactively investigating the potential for issuing debt which is not supported by the government guarantee in order to reinforce its accountability and incentives for continuous improvement. Whether or not this is successful, ORR will clearly have a critical ongoing role in relation to Network Rail’s accountability. The importance of independent economic regulation has been confirmed repeatedly in various reviews of the sector. However, this should not rule out a significantly ‘lighter touch’ in some areas and the
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integration of safety and economic regulation has only just begun. These issues are therefore examined in turn below.

The nature of incentives

Contrary to popular perception, Network Rail already has strong incentives to improve efficiency while delivering the required outputs to meet the needs of our customers and funders. These incentives stem from a combination of incentives at both the company level and the individual level. The latter is often understated. Regardless of structure, it is world class people from all levels in the business who contribute to its success. However, the regulatory and contractual framework for the industry clearly has an important impact on the ability to recruit, retain and motivate these people. This motivation also stems from a range of sources including:

- obvious financial effects of management and employee incentive arrangements;

- reputational effects of being associated with a highly successful private sector company;

- reputational effects arising from recognition of the individual’s personal contribution to that success;

- motivational effects from having the opportunity to make a difference in an environment which is not subject to excessive government or regulatory interference.

These incentives are reinforced by the transparency of Network Rail’s performance which is provided by the regulatory regime. They are further reinforced by the opportunity for Network Rail to reinvest outperformance to deliver improvements in the railway since this is a key motivating factor for many railway employees – this can be far more powerful than giving money back to shareholders or government. There is therefore a strong focus on delivering whatever priorities are reflected in the
regulatory settlement whether this is improvements in performance, efficiency, capacity or network availability (or more realistically a combination of those).

The future role of Network Rail and the affordability of growth on the railway depends to an extent on the company’s ability to take a balanced industry-wide and long-term view on key issues. The company and its employees therefore have a clear incentive to adopt a whole-industry and whole-life approach to issues such as the interface between the network infrastructure and the rolling stock. Since Network Rail cannot do this on its own, there is also a clear incentive to engage constructively with its stakeholders on these long term issues.

The periodic review provides the opportunity to consider whether the industry incentive arrangements are working effectively. Incentives clearly play an important role in creating an industry in which the different parties are able to work together in an effective partnership focused jointly on the end-user without having to rely upon direction alone. At the same time, however, it is important to recognise the subtle nature of incentives and to avoid overcomplicating the regime. Given the increasing importance of growth, the priority should be to ensure that the regulatory regime enables the industry to respond effectively to this growth in a flexible way. It is not apparent that this requires additional incentive mechanisms which could easily have unintended consequences. To the contrary, it requires changes which facilitate effective partnership working as discussed further below.

**Unsupported debt and incentives**

Despite the progress which has been achieved, it is recognised that further progress will become harder and will require even greater engagement and commitment throughout Network Rail. Network Rail is therefore investigating options for raising debt finance without government guarantee. The transformation in the financial and operational performance of the company over the
past four years now makes this a realistic proposal – which is an achievement in itself. Moreover, the company believes that this would result in beneficial incentive effects which would outweigh the additional financing costs:

- incentives arising from the monitoring and scrutiny by the rating agencies and investors arising from the requirement for a rating and the existence of investors with capital which is at risk;

- incentives arising from the hard budget constraint arising from Network Rail only raising incremental debt without government support;

- further reinforcement of these incentives arising from the fact that surpluses would be seen to be reinvested in the railway;

- further reinforcement of these incentives arising from potential refinements which Network Rail may make to the management incentive plan;

- additional benefits in terms of recruitment and retention of world class employees arising from strong confirmation of the company’s status as a private sector company, with control over how it delivers the high level output requirements of government and subject to light touch regulation by ORR.

This is clearly a major issue for the periodic review. It could provide a further underpinning of the conventional building block approach based on a conventional weighted average cost of capital applied to the established regulatory asset base. In this case, however, the surpluses which are generated could be reinvested in the railway in a way which reflects the priorities of its end users and funders.
Lighter touch regulation

It is often easy to agree that lighter touch regulation would be a good thing. Making it happen is often much harder. Lighter touch regulation is entirely consistent with strong accountability. Indeed, close regulatory (or government) involvement can discourage businesses from being accountable for normal business decisions thereby creating the justification for continuing regulation. It becomes a self-justifying role. For example, if the regulator has to consult the industry and approve any significant asset sales, this hardly encourages people in the business to consider the wider industry issues fully for themselves and take a balanced view with the regulator in the background for when things go wrong. Similar issues arose with the SRA, where it sometimes sought to play a greater role in detailed business decisions, which discouraged accountability in some areas and may have slowed the rate of progress, even though it appeared that SRA was adding value. In these areas, the abolition of the SRA empowered the people who are best placed to make decisions to do so in a responsible manner. But they do so against the backdrop provided by the regulatory regime.

There is also a question about the extent to which ORR plays an arbitral rather than deterministic role in relation to issues between Network Rail and its customers and funders. Clearly ORR has an important role to ensure that Network Rail acts reasonably and that third parties are not adversely affected when it reaches agreement with a particular customer or funder. It is unlikely that the industry would be comfortable with ORR moving very far from the current position in the near future. However, there is now widespread agreement that the industry rather than ORR should own its commercial framework and this implies that ORR should adopt a lighter role in some areas. For example, wherever possible the industry should reach a consensus on changes to the network code and the structure of charges, with areas of disagreement being referred to ORR.
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Clearly these changes require an element of trust. A key challenge for Network Rail is therefore to show that it can act in a reasonable and balanced way so that the regulator can take a lighter touch and its customers/funders can have confidence in the outcome. The challenge for ORR is to provide sufficient room for Network Rail to act in this way, while maintaining sufficient awareness of the issues to intervene where necessary.

*Combined safety and economic regulation*

In April 2006 ORR became the health and safety regulator for the rail industry when responsibility was transferred from the Health and Safety Executive (HSE). The initial transition was a major task for both organisations but is now complete. The underlying principles of this change remain appropriate. It is still very early to see the effect of this. However, we are already aware of examples in which an alignment of safety enforcement and ORR economic regulation input has enabled an efficient solution to be found. It is also good news that the economic and safety policy functions within ORR have now been merged and this should help to drive further change.

**Partnership between industry parties and funders**

ORR’s stated long-term vision for the railway industry is ‘a successful partnership of Network Rail, operators, suppliers and funders, working together to meet the needs of passengers and freight customers, and deliver a safe, high performing, efficient and developing railway’. This vision of partnership was fundamental to the white paper and appears to be increasingly bought into by the industry. A highly simplified version of these relationships is shown in **Figure 3**.
The remainder of this section outlines how this partnership is working in practice with particular emphasis on the partnership with train operators and funders, and the implications for the ongoing debate about industry structure.

The most obvious area of partnership working relates to the day to day operation of the railway. In particular, joint performance improvement plans (JPIPs) have been developed to drive continuous improvement in overall performance for passengers. Other aspects of this relate to the development of co-located and then fully integrated control centres, and the codification of operational management through the railway operational code (ROC). More of an emerging area of partnership between train operators and Network Rail relates to the specification of what outputs we are seeking to deliver. There are a number of elements to this:

- Route utilisation strategies (RUSs) – following the transfer of responsibility for RUSs to Network Rail these have been developed through a highly inclusive industry process;
• Route investment review group (RIRG) – the industry now has an effective forum at route level where Network Rail and train operators discuss the potential opportunities for enhancement or rationalisation associated with investment schemes which often represent a one in thirty year opportunity to change things in an affordable way.

• Incremental enhancements – the dialogue with operators includes discussion about how to make best use of funds available to Network Rail to achieve benefits for passengers and freight users. This includes the Network Rail discretionary fund (£200m funded by government through an addition to the regulatory asset base) and the outperformance fund (a further £200m funded by Network Rail’s Outperformance of the regulatory targets in the current control period).

• Strategic business plan (SBP) – following the June 2006 ISBP discussed above, the October 2007 strategic business plan should, as far as possible, be a plan which the industry as a whole understands and supports.

• Route plans – the annual plans produced by Network Rail have been restructured to provide useful information on the strategy for each route as well as the medium term plans (and the next stage is to build on the dialogue around the ISBP to ensure that these plans are more jointly owned by the industry).

• Station plans – discussions are beginning about applying a similar approach to stations.

Similar working arrangements apply to relevant funders. In particular, we work closely with funders such as Department for Transport, Transport Scotland, Welsh Assembly Government, Transport for London and Passenger Transport Executives on issues such as:
• RUSs and HLOS;
• franchise specification;
• rolling stock specification;
• specific investment projects.

The effect of these arrangements is that we gain the best of all worlds with regard to the vertical integration debate. In particular, we gain from:

• separate and strong management focus on the very different roles of infrastructure management and operating trains;

• local specification of the outputs which funders want to buy from the railway;

• national consistency of approach in the management of infrastructure which has the potential to continue to drive out significant cost;

• an infrastructure manager which is neutral between train operators creating assurance for freight that it will not be disadvantaged and flexibility for government to refine the franchise map to reflect market conditions.

My view is that the industry should be allowed to get on with improving efficiency and service within the existing structure. The railway has such a propensity for being reviewed that the question of structure will come up from time to time, but the temptation to tinker, or even to raise the question, should be resisted if we want to avoid distraction from continued progress.

Conclusions

This review paints a positive picture of the rail industry. This is not intended to play down the scale of the remaining challenges and the importance of building trust across the industry.
However, it is quite difficult not to be positive as there is a growing optimism in much of the industry that things really are getting better and that we are on the way towards being able to provide an even better and more affordable railway. By the time the next review comes to be written in two years time, we will know whether the current periodic review will build on the progress which will have been made in tackling many of the problems of the past by reinvesting the ‘dividends’ in improved railway capacity to provide for continued growth.
9  SOCIAL CARE REGULATION

Rodney Brooke

The new model regulator

Through the Care Standards Act 2000, the government created the General Social Care Council (GSCC) as a new model regulator, committed to keeping service users and the public at the heart of what it did. It was established to register and regulate the social care workforce. That includes 75,000 qualified social workers and 1.6m other social care workers, not necessarily professionally qualified. This is a workforce larger than that employed in the National Health Service. Registration was intended to ensure that the workers met rigorous registration requirements and that they could be held to account for their conduct through codes of practice.

The legislation followed the Teaching and Higher Education Act 1998 which created General Teaching Councils (GTCs) for England and Wales; and the Health Act 1999, which created a Health Professions Council (HPC) to regulate healthcare professionals, such as dieticians, radiographers, occupational therapists and chiropodists. It preceded the NHS Reform and Healthcare Professions Act 2002 which created the Council for Healthcare Regulatory Excellence (CHRE) – a body to monitor the General Medical Council (GMC) and the other eight healthcare professional regulatory bodies, with the right to refer conduct panel findings of undue leniency to the high court.

Social work as a clear and distinct profession was entrenched by the reforms which followed the Seebohm report of 1968. The Local Authority Social Services Act 1970 brought together the different areas of social work into generic social service departments. Ironically, the social service departments which it created are being disbanded just as the GSCC has completed
registration of the country’s social workers. Social workers now work in a diaspora of different environments where the discipline of social work is perceived as important to client needs.

Pressure to create a GSCC and its siblings in the devolved administrations followed the 1970 Act and can be traced back for at least 25 years before the 2000 legislation. The Joseph Rowntree Foundation, in particular, lent its weight to the creation of the new professional bodies. So did the Social Care Association and the all-party Parliamentary Social Care Group. The pressure prompted the tabling by the then chair of the all-Party Social Care Group of a ten-minute bill in the House of Commons in 1996, followed, after the Labour general election victory in 1997, by the Care Standards Act 2000.

Given the years of pressure for a social care regulatory body, it is not surprising that there was general acclaim for the new body. Sir William Utting, former Chief Inspector of Social Services, enthusiastically welcomed the government’s announcement on behalf of the Joseph Rowntree Foundation. Don Brand, the director of the development body created to establish the GSCC, said:

“The proposals will benefit service users by giving them a clear statement of what they can expect from staff. They will also benefit the vast majority of staff, who are trying to do a good job, by giving them a published national statement of the standards to which they are working”.

Constitution

Defined in the Care Standards Act 2000, the constitution of the GSCC was designed to avoid the problems of self-regulation which were seen to beset other professional regulatory bodies, like the General Medical Council and the Law Society. Similar principles illuminated the constitutions of the social care
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professional bodies set up with similar powers to the GSCC in Northern Ireland, Scotland and Wales, the Northern Ireland Social Care Council (the NISCC), the Scottish Social Services Council (the SSSC) and the Care Council for Wales (the CCW).

In creating the GSCC and its siblings, the government was clear about the need for a new model of professional regulation. The governing councils of the older regulatory bodies include a number of professional members elected by their peers. Bodies of some antiquity, like the Law Society, founded in 1825, or the GMC, founded in 1858, had councils which included only the relevant professionals elected by their peers. Over the years the proportion of elected professionals on the professional regulatory councils diminished.

Lay members were drafted in, though the governing bodies usually retain a professional majority. The GMC, for example, now has a Council of 35 members: 19 doctors elected by doctors on its register; two doctors appointed by educational bodies; and 14 lay members appointed by the Appointments Commission. The Nursing and Midwifery Council (NMC) has 23 voting members: 12 registrants (or their alternates) elected by their peers and 11 lay members appointed by the Appointments Commission. The General Dental Council has 29 members: 19 dentists or dental technicians elected by their peers and 10 appointed by the Appointments Commission.

Those sceptical of a majority of Council members elected by their fellow professionals harked back to the early days of professional self-regulation, when the main object of professional bodies was to create a closed shop to protect the profession from encroachment from others. The older self-regulatory professional bodies acquired statutory backing to their sanctions, without which they were powerless to keep out undesirables. Indeed, the current motivation from new professions for statutory self-regulation, from funeral directors to the security industry, is to protect the reputation of the profession or trade by excluding those who might give it a bad name by not measuring up to the
standards expected by the public. Statutory backing to self-regulation is required to keep out the cowboys. Regulation is usually sought by those being regulated more vigorously than by the general public, even though the latter might be thought to anticipate the greater benefit from regulation. The profession and its regulator have a symbiotic relationship.

Unsurprisingly there is a public perception that the main objective of the older professional regulatory bodies was to protect the profession rather than the public. So long as professionals themselves elected council members, it was perceived that the interests of their constituents would influence the council members. Their votes might hold up only if the council members satisfied their electorate that they were minimising the burden of regulation by the professional body. This problem acquired public salience as a result of the fifth report of Dame Janet Smith into the case of Dr Harold Shipman. She concluded that, despite significant improvements, the prevailing culture of the GMC still in many ways reflected the reactive, doctor-protective, complaints-driven mindset of an earlier era. Any remaining ideas of the GMC as yet another doctors’ representative body should be dispelled, she insisted.

The report prompted the government in 2006 to issue a report from its Chief Medical Officer, Sir Liam Donaldson (the Donaldson report), canvassing a change in the governance of the GMC. Commenting on the Donaldson report, Sir Donald Irvine, a former President of the GMC, conceded that the GMC was still not a truly patient-centred organisation. It needed, he wrote, members – medical and lay – who were appointed to the Council because they believed passionately in the mission of a GMC which unambiguously put patients first. Indeed Sir Donald proposed that the whole of the present membership of the GMC be replaced by a new set of members. In the legal field, the current Legal Services Bill would introduce similar changes by introducing a lay-dominated board with a role in the regulation of solicitors.
These considerations were much in the minds of Department of Health ministers when the Care Standards Act 2000 was drafted. The chair of the GSCC must be a member of the laity, ie, someone who has not practised as a social worker in the previous five years. The majority of members of the GSCC Council, currently 12-strong, must also be lay. None are elected: the Appointments Commission appoints them all. The majority of members of the GSCC’s Registration and Conduct Committees must also be lay people.

Codes of practice

Like other professional bodies, the GSCC issues codes of practice which describe the standards of professional conduct and practice required of social care workers as they go about their daily work. The codes are intended not only to guide social care workers, but also to inform service users of the standards which they are entitled to expect. Until the formation of the GSCC those working in social care were not required to comply with any nationally agreed standards. Social care workers were sometimes unclear as to what was expected from them. An independent survey of nearly 7,000 social care workers, showed that 98% were aware of the codes; 88% believed that they had clarified their responsibilities; and 80% referred to them regularly for guidance.

The key tenets in the codes are that social care workers must:

- protect the rights and promote the interests of service users and carers;
- strive to establish and maintain the trust and confidence of service users and carers;
- promote the independence of service users while protecting them as far as possible from danger or harm;
SOCIAL CARE REGULATION

• respect the rights of service users whilst seeking to ensure that their behaviour does not harm themselves or other people;

• uphold public trust and confidence in social care services;

• be accountable for the quality of their work and take responsibility for maintaining and improving their knowledge and skills.

The codes are unusual – perhaps unique – in two particulars. The first is that they are binding on workers who do not necessarily have a relevant professional or, indeed, any relevant qualification. The initial criterion for registration by most regulatory bodies is the possession of the relevant professional qualification. Not so the GSCC. The criterion for registration is employment in the sector. Registrants will range from qualified social workers to domiciliary care assistants who may have received no more than simple induction training and may possess no relevant qualification.

The second unique feature of the Codes is that they apply to employers as well as to employees. There are over 25,000 employers in the sector, two-thirds of which are in the private and voluntary sectors. They vary from large national organisations and charities to one-person bands. Since the codes are statutorily binding, the Commission for Social Care Inspection takes them into account in its enforcement of care standards.

The obligations placed by the code upon employers in relation to regulating the social care workforce reciprocate those placed on the employee. They are to:

• make sure people are suitable to enter the workforce and understand their roles and responsibilities;

• have written polices and procedures in place to enable social care workers to meet the GSCC’s code of practice;
• provide training and development opportunities to enable social care workers to strengthen and develop their skills and knowledge;

• put in place and implement written policies and procedures to deal with dangerous, discriminatory or exploitative behaviour and practice;

• promote the GSCC’s Codes of Practice to social care workers, service users and carers and co-operate with the GSCC’s proceedings.

Registration

The other post 1997 election new regulators, the GTC, the HPC and the CHRE, all inherited existing databases of registrants. The GSCC did not. One had to be created from applications for registration. The obvious place to start was with qualified social workers, who had yearned for registration for so long. After a substantial consultation process, a procedure was established. Registration would be for a period of three years. There was to be an annual fee of £30, the same as that then charged by the NMC and the GTC. Before re-registration, registrants would be required to produce evidence of 15 days training and learning, interpreted flexibly.

Applications for registration were solicited in April 2003. Identification of the registrant and certification of jobs were sought from employers. Qualifications were checked. The GSCC’s international recognition service adjudicated on whether social work qualifications obtained overseas ranked with British qualifications and could be accepted without further training.

Despite their enthusiasm for registration with a professional body, social workers submitted their applications for registration only slowly. Research showed no basic resistance to registration. But since there was no urgency, the application forms never
reached the top of the in-tray. Government acted. In January 2004 the appropriate Health Minister, then Stephen Ladyman, announced that protection of the title of social worker would be introduced from 1 April 2005. The legal effect of this was to make it a criminal offence for people to represent themselves as social workers unless they were registered with the GSCC. To avoid a snowstorm of applications in the last few days before protection of title, the GSCC announced that it could not guarantee processing applications by 1 April 2005 if they were received after 1 September 2004. This did provoke a snowstorm of applications. Nearly 40,000 applications flooded the GSCC’s post immediately before 1 September 2004. Remarkably, the GSCC managed to process all non-problematic applications in time for the 1 April 2005 deadline.

Before the exercise started, it was believed that there were about 40,000 practising social workers. By now over 75,000 have registered. Not the least of the advantages of registration is that it gives some idea of the size, location and qualifications of the workforce. Bearing in mind that undergraduates taking the social work degree must work with clients, they have also been required to register. A further 10,000 social work students are now registered.

Registration and conduct committees and standard of proof

As well as satisfying itself that an applicant for registration as a qualified social worker is appropriately qualified, the GSCC must satisfy itself that the registrant is of good character and is physically and mentally fit to perform the whole or part of the normal work of a qualified social worker.

To create a mechanism for arbitrating on the right of a registrant to be registered, the GSCC has appointed panels of independent people from whom it can constitute a Registration Committee.
The same members can also be empanelled to form Conduct Committees to consider allegations of breaches of the code of practice. It is the GSCC’s job to present evidence to the Committees, but the decision of their members is taken independently of the GSCC. There is a rigid separation of powers. Unlike other regulatory bodies, GSCC Council members are debarred from sitting on Registration and Conduct Panels until at least a year after they have ceased to be a Council member.

In order to ensure that the balance was firmly tilted in favour of public protection, the standard of proof in cases of misconduct considered by the GSCC’s registration and conduct panels was specified to be the civil standard. It is thus possible for a GSCC registrant to be removed from, or not placed on, the GSCC’s register as a result of an offence for which that registrant has been acquitted in the criminal courts. Many professional regulatory bodies, like the GMC and the NMC, use the criminal standard of proof. Some other regulatory bodies use a sliding scale of proof depending on the gravity of the alleged misconduct, ie, the more serious the offence, the greater the standard of proof required. This, for example, is the test used in investigating complaints against the police (arguably the converse might be thought to be justifiable when protection of the public is the main objective, so that a regulatory body might think it reasonable to use a lesser standard in respect of a serious accusation, like child abuse).

The debate over standards of proof to be used by healthcare regulatory bodies continues. In 2004 the NMC considered moving to the civil standards of proof but ultimately rejected the change. The Donaldson report proposes changing the standard of proof used by the GMC to the civil standard, following Dame Janet Smith’s recommendations. If that change were implemented, it seems likely that the other eight healthcare regulators would be asked to follow suit. When different healthcare regulatory bodies use different standards of proof, it is possible for professional conduct panels to come to different
conclusions in respect of the same act committed jointly by two professionals regulated by different bodies. Clearly this is an anomalous and undesirable result (though, of course, it is possible for different panels to come to different conclusions on the same facts and the same standard of proof).

The GSCC’s Registration Committees have already taken a number of decisions not to admit a registrant to the register of qualified social workers. The most common ground has been on the issue of qualifications. The Care Standards Regulations specify the nine qualifications that can be accepted by the GSCC. The GSCC has no discretion on the matter. On the other hand, the GSCC or its Registration Committee can allow a registrant who qualified overseas some leeway to remedy deficiencies in that training. This perceived anomaly has caused some continuing controversy. Applicants denied registration have a right of appeal to the Care Standards Tribunal, an independent body chaired by a circuit judge. Several have appealed on the issue of qualifications.

The other controversial element in the decision to register is the statutory healthcare requirement: the registrant must be physically and mentally fit to perform the whole or part of the work undertaken by those registered in the relevant part of the register. The health requirement was not included in the Scottish legislation. It presents problems in the other three countries. What are the physical and mental conditions that should disqualify an applicant from registration? The GSCC would defend to the death the right of disabled people to employment. Indeed they enjoy statutory protection, even if the GSCC did not have its own commitment to disabled people. Though the GSCC must exercise its discretion in each individual case, it is difficult to think of physical disabilities that would constitute a blanket disqualification for working – though there are obviously some tasks which could not be performed by people with certain disabilities. Employers would clearly recognise any which would cause problems.
Mental illness presents a more difficult issue, especially bipolar personality disorder. Registration committees have asked the question as to whether registrants have sufficient insight into their condition not to work when unfit to do so. Some have sought to impose on registrants a condition requiring notification to their employer. Such a condition has been rejected by the GSCC’s appellate body, the Care Standards Tribunal. Registrants have a general duty to notify their employers of anything which might damage their ability to work. Should a further specific duty be imposed on them? It is certainly arguable that the Scottish legislation is preferable: leave it to employers to make their own judgment rather than expect a Registration Committee to find a permanent solution to a health problem which may be liable to constant fluctuation. The GSCC is now working with the Disability Rights Commission to find a solution to this conundrum.

The third criterion which registrants must meet – good character – is less contentious than qualifications or disability. Where the GSCC bring conduct cases against a registrant, allegations are specifically linked to breaches of the code of conduct. The registrants have a right of appeal to the Care Standards Tribunal.

The institution of disciplinary proceedings over conduct has become a spectacular growth industry. Conduct cases conducted by the General Dental Council have multiplied almost tenfold over the last ten years. The GMC has seen a similarly spectacular increase: of the GMC’s budget of £68m, £45m is now spent on conduct cases. One may speculate that the increase is not due to a decline in standards, but rather to a greater awareness by the general public, the attention of the media and a greater vigilance by the professions themselves.

Education for social work

Social workers are severely undertrusted. Their bad press stems from a few disastrously tragic incidents. The names of the
victims, like Victoria Climbie, achieve a sad immortality. The
neighbourhoods in which they lived take on a resonance of
abuse: South Ronaldsay, Rochdale, North Wales, Islington,
Cleveland, all associated with child abuse, justifiably or not. And
blamed for failing to prevent that abuse, or for inappropriate
interventions, are social workers.

Part of the motivation for the creation of a General Social Care
Council was undoubtedly the feeling that the status of, and
regard for, social workers needed improvement. Despite the vital
work they do, their standing in public confidence lags well
behind that of healthcare professionals. Doctors, in particular,
seem able to survive a series of scandals – Drs Shipman, Ayling,
Neale, Kerr and Haslam, the Bristol babies, the Alder Hey body
parts – without loss of public confidence. When the Committee
on Standards in Public Life commissioned a survey, 93% of
people questioned said that they trusted family doctors to tell the
truth (compared with 23% of politicians).

A first step in improving the status and morale of social workers
was to tackle the qualification for social work. In 2000, a social
worker qualified through a diploma gained after two years of
study. An immediate hoist in prestige (and skills) was obtained
by bringing social work into line with the remainder of western
Europe by requiring a qualification at degree level. Within three
years, the GSCC had accredited over seventy institutions
providing the new social work degree. Unusually, the new degree
requires its students, as part of their course, to acquire two
hundred days of practical experience in hands-on social work.
2006 saw the graduation of the first students of the new social
work degree accredited by the GSCC.

The GSCC also became the agent for a scheme to encourage
undergraduate recruitment to social work degree courses by
giving students an annual bursary of around £3000 each during
their course, together with travelling expenses. Each year the
GSCC now dispenses £65m in undergraduate bursaries to nearly
10,000 students. Spectacularly for a new system, in its first year
of operation it attracted only 9 complaints, of which 2 were upheld. Its main objective has also been achieved: the number of social work students is rising. In the days of the diploma, the average age of qualification was 32. There is evidence that the new degree students are significantly more mature than the average undergraduate. Those starting on social work have usually done something else first – in the course of which they have acquired a wish to ‘make a difference’, the usual phrase employed by social workers to describe their vocation.

As in other professions, further qualifications lie beyond the degree. The GSCC inherited a post-qualification framework of further social work study and qualifications, unchanged for over fifteen years. The GSCC has brought this up-to-date by modernising the approach, bringing in three different levels – the advanced, the specialist and the advanced specialist. The first is at graduate level, the second corresponds to the master’s level and the third is at doctorate level. At each level is a module constructed around a speciality – like children, adult services, and mental health. Given the different arenas in which social workers are now active – and the increasing integration of professional practice – the GSCC has been at the forefront of pioneering inter-professional modules. It is now even possible to read for a degree which will entitle the graduate to practice as a nurse or a social worker, or, indeed both. Graduates may choose their profession after graduation by registering with the NMC or the GSCC – or both.

Further progress on registration

The GSCC now faces its ultimate test, the start on the gigantic task for which it was designed: the registration of the remainder of the social care workforce. Registration of a professional elite – like doctors, lawyers, social workers – is relatively straightforward. Regulation and registration are accepted as part of the obligations of a professional. But social care workers - like residential and domiciliary care assistants - have not traditionally
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regarded themselves as professionals. Indeed the majority have no relevant qualifications, despite the endeavours of the skills councils over the last few years.

In pushing through the Care Standards Act 2000, it was the government’s intention to procure the registration of this workforce. The standing of the profession was part of the motivation. Equally important was the use of registration to raise standards among social care workers by requiring a qualification as a condition of registration or re-registration, and by providing a sanction if social care workers broke the code of conduct. The GSCC would be able to remove the bad apples in the barrel. No longer would it be possible for a social care worker to be dismissed from one job for an abuse and to walk down the road to get a similar job with another employer. Social care workers work with service users in one-to-one situations which offer the same opportunities for abuse as those afforded to doctors and other healthcare workers. 93% of the public support registration for that reason and because they believe that it will raise standards. Indeed, research shows that members of the public already believe that social care workers are registered.

Following the intention in the 2000 Act, the government has now asked the GSCC to prepare for taking registration into the social care field by registering the next tranche of 750,000 care workers, those operating in the residential and domiciliary sectors. The GSCC has made recommendations on the level of fee for registration, the length of the registration period and the post-registration training requirements. Compulsion will be a prerequisite of moving registration into the social care field: after registration has been introduced it will become illegal to work in the social care field without registration with the GSCC.

The thrust of government policy and the overwhelming demand in health and social care is towards a personalisation of the care package, a more flexible approach. This is spelled out in the 2006 Department of Health White Paper ‘Our Health, Our Care, Our Say’. No longer are recipients of care to be required to
accept whatever service the provider happens to have available. They are entitled to choice. But there is a major obstacle to choice. Users encounter an inflexible workforce with little resource to satisfy the demands that increasingly are placed upon it. NHS employees are being required to work more flexibly. A more flexible social care workforce could take over some NHS tasks more effectively and more economically. Half the cost of NHS medical care afforded to the average person is incurred in the last six months of life. A better trained and more flexible social care workforce could relieve some of the pressures on the NHS in catering for older people. The introduction of direct payments for service users would be greatly assisted if they could have confidence in carers who offered the safeguard of registration from the GSCC.

Conclusion

Regulation – and not only professional regulation – has undergone a turbulent half-decade. There is a natural tension between a desire to lessen the regulatory burden and to ensure that the public has adequate protection. Reports such as that of Lord Laming into the death of Victoria Climbie (2003), the fifth report of Dame Janet Smith into Dr Harold Shipman (2004) and Sir Michael Bichard on the Soham murders (2004) prompt further regulation or the extension of existing systems.

The high water mark of independent inspection and target-setting was marked at the turn of the millennium. Since then there has been a general move to more ‘intelligent’, targeted regulation. There is also a strong move towards fewer regulators. The 2005 Hampton Report, ‘Reducing Administrative Burdens: Effective Inspection and Enforcement’ proposed to reduce 31 inspectorates to seven. In his 2005 budget report, the chancellor of the exchequer announced the reduction of the public sector inspectorates from 11 to 4. Also in 2005, the Better Regulation Task Force published its report with the self-explanatory title, ‘Less is More’. In recognition of the need for its continuing
contribution, it was elevated to the status of a permanent commission. In 2006 the secretary of state for communities and local government set up a further task force on lifting burdens.

The Davidson Report (2006) reviewed the implementation in this country of European Union legislation. It condemned gold-plating (extending the scope of European legislation); double-banking (failing to streamline the overlap between UK and EU legislation); and regulatory creep (uncertainty and over-zealous enforcement). The Legislative and Regulatory Reform Act 2006 specified a statutory Regulators’ Compliance Code, due to come into force on 1 April 2008. The Code will impose a legal obligation on regulators to have regard to the principles of the Hampton Report in deciding policies and priorities, setting standards and giving advice.

Already new regulation must be accompanied by a full risk assessment and a consideration as to whether there is an alternative to regulation. Above all it must be proportionate to the risk. Regulators have responded. Nine regulators joined together to inspect children’s services. According to chief executive Steve Bundred, the Audit Commission has cut its inspections by 20%. At Ofsted David Bell plans more joint inspections to cut out duplication. At the Social Care Commission, Chair Denise Platt and her Chief Inspector are committed to concentrating on outcomes, not process and to being more selective. The government has played its part: previous government regulations stipulated that the Commission must inspect most adult services at least twice a year. Now the Commission is obliged to inspect only once every three years, enabling it to target its inspections on those establishments needing most support.

In professional regulation, the tide seems to be going in the opposite direction. Cases such as Victoria Climbie and Harold Shipman arouse public pressure for increased regulation. The Donaldson report recommends the introduction of regulatory powers into the workplace through appointment of local GMC
affiliates. He recommends that medical students should be registered; that medical schools should have a GMC affiliate on their staff to monitor student registration; and that there should be regular feedback on locums. In a simultaneous report, the government proposes to introduce statutory regulation of certain healthcare support workers; canvasses UK-wide employer-led regulation of other healthcare support workers; and recommends an extension in the regulatory powers of the CHRE.

The GSCC, the newest regulator in the block, will not be immune to these tides. But there are ten times more social care workers than there are doctors practising in England. They enjoy a much lower level of public trust. It seems likely that the GSCC will continue to be seen as a main vehicle for enhancing public protection and confidence in the social care sector and of enhancing the morale and status of social care workers.
10 WATER REGULATION

John Smith

Introduction

This chapter covers the period since the outcome of the periodic review of prices 2004 (PR04) was announced in December 2004. In writing the previous review of water regulation, Philip Fletcher observed that the success of the outcome was for others to judge, although he believed it was a job well done. Two years on, it is possible to offer a perspective on PR04 as well as to anticipate some of the issues likely to feature prominently in the 2009 review.

This review can also be written from a wider UK perspective since, in 2005, we saw the outcome of the first full review of charges in Scotland undertaken by what is now the Water Industry Commission, chaired by Sir Ian Byatt. Taken together with developments in Northern Ireland, where plans are well advanced to create Northern Ireland Water Limited (NIWL) as a government-owned business from April 2007 under a combined water and energy regulator, we see the development of parallel water regimes across different parts of the UK.

PR04 perspectives

The market reaction was positive – and in marked contrast to what occurred in 1999 when the outcome of the review was seen to have precipitated a flight of equity and led companies to trade at a discount to their regulatory asset base (RAB). It was also seen to have acted as a catalyst for a series of structural changes.

Acknowledgement: Thanks are due to John Earwaker, Duncan Hannan and Matthew Parr for comments on earlier drafts. Responsibility for remaining errors and omissions is mine.

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in the sector – with the emergence of highly-geared companies with structured debt finance.

A principal aim of PR04 can be seen as re-establishing investor confidence in the sector and reducing perceptions of regulatory risk. In these respects, the outcome of the review was successful as shown in subsequent investor surveys. Moreover, unlike earlier reviews, there were no referrals to the Competition Commission. The other main change from PR99 was in the implications for bills. Whereas water consumers in England and Wales enjoyed 12% average reductions in bills in 2000/01, in 2005/06 they saw bills rising on average by almost 10% – and the prospect of further increases in subsequent years.

The outcome of PR04 also involved changing expectations about investment requirements for the industry. At privatisation, it was anticipated that the industry faced the prospect of 10-15 years of heavy investment requirements to meet EU water and environmental standards, after which investment levels would fall back to a lower ‘steady state’ level. It is now clear that high levels of investment will be a continuing feature of the industry, along with its cash negative position. Consequently, financeability of capital programmes seems set to remain a key issue for the sector.

**The review of PR04**

Following completion of the review, Ofwat commissioned an independent steering group under John Baker to examine the way they had conducted PR04 and to draw lessons for future reviews. The review group commissioned market research and conducted interviews, collecting views from almost 200 stakeholders. It reported in August 2005.\(^1\) Recognising that water reviews required effective co-ordination among a number of players – government, quality regulators, customer bodies (WaterVoice at

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the time), as well as dialogue with the investor community – the group considered the effectiveness of the wider processes for PR04.

PR04 was seen as a major improvement on what had gone before – a more open and transparent process, with Ofwat being more willing to listen to representations and provide feedback to companies – for example, on draft business plans. The overall process was seen as well planned and managed, with a greater willingness to work collaboratively. At the same time, ministers respected the independence and integrity of the regulator. The group concluded that the periodic review process was now seen to be very much on the right lines and required refinement rather than radical change. The report’s main recommendations focused on two main areas:

- clarity of respective roles and ‘rules of the game’;

- development of a longer term investment planning framework, seen as essential in the context of water resources and the Water Framework Directive.

Clarity of roles is seen as particularly important in relation to decisions on the environmental programme where tensions between the regulators were exposed. While PR04 saw a major advance in the use of economic appraisal methods, there were differences between Ofwat, Department for Environment, Food and Rural Affairs (Defra) and the Environment Agency on the appropriate decision criteria for including schemes in the investment programmes. For the future, the group favoured more extensive use of cost-benefit analysis to improve value for money from the environmental programme, and so protect the interests of water consumers. There are also wider implications for the basis on which European directives are drawn up. It should not be left to a periodic review to cost the implications of new directives. The group also supported the use of a high level strategy document, with scenarios, to provide an effective framework for the review – further developing the approach
started with ‘Directing the Flow – Priorities for Future Water Policy’ which Defra had published in late 2002.²

There were concerns that a five year planning cycle failed to encourage longer term planning by companies and may militate against major investment schemes. It was also becoming increasingly difficult to synchronise environmental decision-taking around a five year review cycle, a problem likely to be exacerbated by the Water Framework Directive. Without wanting to prejudge the outcome of Ofwat’s consultation on the periodic review cycle, the Group felt that even in the context of medium term price determinations, there was a strong case for longer term investment planning framework for the industry. Finally, the review identified a number of aspects of Ofwat methodology where criticisms had been made by companies. These included the perceived lack of transparency over the basis for setting efficiency targets, and also concerning the way financeability adjustments were calculated.

In their detailed response to the group’s report (March 2006), Ofwat appear to have accepted many of its recommendations. In particular, they are committed to a longer term investment planning framework; support the greater use of cost benefit tools to inform decision-making; and have initiated a number of joint reviews of current methodologies.

**Unfinished business – financeability**

The price limits in PR04 were set to support companies continuing to raise necessary finance in the capital markets to undertake their investment programmes, with a key funding requirement being the maintenance of good credit quality. Whilst this was in the context of an industry with a much wider range of capital structures and gearing levels, the financial projections used by Ofwat to assess financeability were based on a notional

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gearing level of 55% for all companies. The future revenues of some companies were subsequently adjusted to ensure that, on the basis of this notional gearing, key financial indicators would be met. These financeability uplifts, while not new, assumed greater significance in PR04 and had the effect of increasing the effective allowed rate of return for some companies in later years.

The key questions arising concerned transparency and sustainability – whether the basis for these uplifts in PR04 should have been better explained and whether the approach would be replicated in the next review (PR09). The case for financeability adjustments can be seen as a response to the trend towards debt financing combined with Ofwat’s approach of allowing companies to earn real rates of return on a regulatory asset base inflated by retail price index (RPI), while debt investors generally require compensation for inflation through nominal interest rates. This produces cash flow differences between the allowed return in price limits and company payments to investors.

Financeability was one of the issues covered in a joint consultation exercise conducted by Ofwat and Ofgem early in 2006. In their summary of responses, they noted that while revenue uplifts were generally perceived by water companies as a successful approach to dealing with the problem, in practice, this may be difficult to achieve. In contrast, electricity sector respondents favoured accelerated depreciation as the preferred approach – effectively bringing forward compensation for inflation from future control periods. Ofwat’s use of notional, rather than actual, gearing in its financeability tests was intended to maintain its position of neutrality on companies’ capital structure. It may be difficult to maintain this approach at PR09 if

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4 See also, First Economics (2006), Financeability: What Happens Next?, Discussion Note, April.
the diversity in capital structures increases, or even polarises, between highly and lowly geared companies. However, moving to the alternative approach of assessing companies on their actual balance sheets would seem a difficult step for Ofwat to take.

This issue needs to be set in the wider context of concerns by Treasury and some commentators over the trend towards debt financing across the utilities and the adoption of thin-equity models. Treasury has initiated a number of studies to assess the effect that this might have on incentives and the long term interests of customers. A particular concern in the water sector has been the continued ability to finance major capital investment programmes, with high levels of gearing, with the suggestion by Dieter Helm that balance sheets are becoming ‘exhausted.’ What is clear is that with the prospects of major investment requirements in water and energy networks, a more consistent approach to financing questions from Ofwat and Ofgem in future reviews would be desirable.

Industry performance since PR04

Two years from the outcome of PR04, the industry has lost some of its glow among key stakeholders. Two main factors have been responsible:

- failings in the provision of reliable customer service information by three companies – Severn Trent, Southern and Thames – with allegations of fraud affecting two of the companies concerned;

- the drought affecting southern England in summer 2006 which has once again, put the focus on the industry’s leakage and, in particular, the poor leakage record of Thames.
Customer service failings

In March 2006, following allegations by a company whistleblower, Ofwat published interim findings of an investigation into whether regulatory data on leakage had been miscalculated by Severn Trent, leading to higher price limits than were justified. As a result, the company agreed to return £42m to customers and the Serious Fraud Office were called into investigate. Later, in June, Ofwat announced its intention to impose a financial penalty on the company for a separate failure to achieve customer service standards under the guaranteed standards scheme (GSS).

A similar situation appears to have arisen with Southern Water where the company informed Ofwat in October 2005 of inconsistencies in its reporting and handling of response levels to customer enquiries and complaints, and payments made under the GSS. Again, Ofwat announced in March its intention to impose a financial penalty for these failures, following an independent investigation. The ‘Thames case’ also involved failures in achieve customer service performance standards under the guaranteed standards scheme, including failures to make payments to customers as required under the scheme. After the company reported these failings to Ofwat early in 2006, an independent investigation was jointly commissioned. In June, Ofwat announced its intention to fine the company.

It is difficult to know whether this cluster of cases is a statistical quirk or represents a wider malaise. Certainly, it is difficult to recall earlier examples of this kind. Nevertheless, the proposed fines mark a significant toughening of the water regulatory regime, and represent the first use of powers conferred on the regulator by the Water Industry Act 2003. Ofwat have also written to all companies emphasising their responsibility for providing reliable, accurate and complete regulatory information.

Such cases serve to undermine trust between companies and Ofwat and as well as tarnishing the reputation of the industry. It
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may also encourage tougher, more intrusive, regulation at a time when many were hoping to see moves towards a ‘lighter touch’ regime.

The 2006 drought, supply restrictions and leakage

Since 1995, water customers have generally been unaffected by hosepipe bans and water restrictions. However, following two consecutive dry winters and the longest dry period since 1933, three water companies in the South East – Southern Water, Mid Kent and Sutton & East Surrey – applied in March 2006 for non-essential use drought orders which would enable them to apply a wide range of restrictions on water use for both households and businesses. Subsequently, following pressure from the Environment Agency, Thames Water also applied for a drought order. In the event, only Sutton & East Surrey brought their drought order into force and Thames withdrew their application in September. The hottest July on record was followed by heavy August rains. Nevertheless, the drought focused attention, once more, on the industry’s leakage performance.

Thames has long been known to have the highest level of leakage in the country (accounting for almost 30% of total leakage in England and Wales in 2004/05) – a legacy of its Victorian water mains. However, in 2005/06 it failed to meet its leakage targets for the third consecutive year. Other companies missing their targets for 2005/06 were United Utilities, Severn Trent, and Southern. Following a conference in June, ministers called on Ofwat to ensure that companies met their targets and match the efforts of consumers in reducing water use. Leakage became a major issue at the time of the 1995 drought and was a political target by the incoming Labour government. Indeed, John Prescott convened a series of water summits in 1997 to call for improvements. Thus 2006 had a sense of history repeating itself.

Failure by Thames to meet its leakage target led Ofwat to consider the case for fining the company. Instead, it secured a binding undertaking to replace an additional 368 kms of leaking
water mains at a cost to shareholders of £150m. As Ofwat pointed out at the time, this was double the maximum possible fine which could have been imposed. Moreover, a fine would have been passed to the exchequer whereas the undertaking would secure benefits for customers and London. Whereas a number of commentators saw this as a pragmatic and sensible regulatory response, others (such as The Economist) viewed the regulator as a ‘soft touch.’

The NAO, in a report published at the time of going to press, observed that customers would have benefited if Ofwat had taken action sooner.

While only a minority of companies – those in the south east – were experiencing supply problems in summer 2006, what was difficult to understand was why the improving industry trend on leakage from 1994/05 to 2000/01 – when leakage was reduced by 36% – was reversed over the next three years from 2000/01 to 2003/04, only falling once again in 2004/05 as shown in Figure 1. A major component of the increase was attributable to the Thames.

Figure 1: Total industry leakage

![Total industry leakage graph](source)

Source: Ofwat

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6 National Audit Office (2007), Ofwat: Meeting the Demand for Water report by the National Audit Office, January.
WATER REGULATION

Some commentators linked the renewed problem of leakage to PR99 with its limited provision for capital maintenance expenditure – an issue to some extent rectified in PR04. But there is also the perception that, with favourable supply conditions, that some companies took their eye off the ball.

The concept of ‘economic levels’ of leakage (ELL) is not understood by most customers – nor the fact that part of the leakage concerns customer supply pipes. Ofwat have now instituted a review of the ELL model to address stakeholder concerns. It remains the case that reputational issues remain important in relation to leakage control. As in 1995, public tolerance of water restrictions – actual or threatened – is reduced when companies are seen to be making large profits and wasting water through leakage.

Water resources, security of supply and demand management

The drought – combined with planned increases in housing and population in the south east – has put the issue of water resources firmly on the agenda. So too has the decision by Ken Livingstone to direct Newham Council to turn down a planning application by Thames Water in 2005 to construct a desalination plant on the Thames at Beckton to address security of supply problems. A prime reason given was the high energy use involved. The case is now subject to appeal. For the longer term, Thames has announced its intention to construct a new reservoir in Oxfordshire to meet growing demands in the region.

Against a background of concerns about security of supply in the South East, the Environment Agency commissioned a review into the concept of a ‘water grid’ for transferring water from the north to the south-east of England. However, it concluded that such transfers would be both expensive and environmentally-

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7 Environment Agency (2006), Do We Need Large-scale Water Transfers for South East England?
damaging and could not be justified in current circumstances. They noted water companies’ plans to meet future demands in the South East over the next 25 years, and saw considerable scope for water efficiency measures. What is clear is that developing new water resources – such as reservoirs – takes many years, with significant planning obstacles to be overcome. That is why many favour demand management as a better option, although arguments continue as to its effectiveness.

One of the more surprising developments in recent years has been the broad consensus that has developed in favour of water metering – by government, environmental and also consumer bodies. This marks a big change from the 1990’s when politicians and customer bodies were often anti-metering. Anglian – the lead company among the WASCs on metering with 57% of domestic customers on metered supplies – is able to show that its overall approach to demand management means that it supplies around the same volume of water to the region as it did at the time of privatisation, despite a 20% growth in the number of households served. To date, one company – Folkestone & Dover – has applied, and been granted by the secretary of state, designation as an ‘area of water scarcity’, which allows the company to compulsorily meter. Thames Water is pursuing selective metering trials. The government are looking to have 75% of households metered within 20 years.

However, the economics of metering is still the subject of strong debate within the industry with the demand effect generally seen to be around 10-15%. The economic case for metering also varies between parts of the country depending on the regional supply situation as well as local area characteristics – the contrast being between high density urban areas, with limited discretionary use, and leafy suburbs and rural areas. The NAO, in their recent report, called on Ofwat to press companies for improved data on both leakage and consumption, and to take the lead on encouraging water efficiency projects by companies and the promotion of good practice. Currently, around half a dozen
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companies have consumption monitors to measure patterns of household consumption.

There is growing recognition that the wider adoption of metering would probably require special tariffs for low income households. The issues of security of supply, demand management and water resources will continue to be addressed in the context of the 25 year water resources plans which companies are now required to produce.

Developments in industry ownership and structure

The period following the 1999 review saw major changes in ownership and financial structures in the water industry, some (Glas Cymru, Wessex) precipitated by financial failures in parent companies. The period since completion of PR04 has further changes with four water-only companies (WOCs) and (at the time of writing) two WASCs subject to acquisition. The principal changes are summarised in Table 1 below:

Table 1: Changes in company ownership 2004-2006

**South Staffordshire Water** (SSW) and its parent company: acquired by Arcapita Bank BSC (previously First Islamic Bank) in November 2004.

**Sutton & East Surrey Water** and its parent East Surrey Holdings: acquired by Aqueduct Capital (UK), a company owned by Deutsche Bank AG in December 2005. (East Surrey Holdings had previously been acquired in October 2005 by Kellen Acquisitions Limited).

**Bristol Water** – the third largest water-only company: acquired by Sociedad General de Aguas de Barcelona (Agbar) in May 2006.
South East Water: sold by Macquarie to Westpac, a fellow Australian Banking Group in October 2006.

Thames Water: sold by RWE to Macquarie, the Australian Bank and infrastructure fund in October 2006.

AWG, owner of Anglian Water: subject to a recommended bid by Osprey Acquisitions, a consortium, also in October 2006 (since completed).

Of these changes, most attention has focused on Thames Water, RWE, the German utility, announced its intention to sell its water businesses, principally Thames Water and American Water in late 2005. Thames had been bought for £4.3bn in 2000 – a price which, at the time, represented a substantial premium to its RAB. Plans for a stock market flotation, initially favoured by RWE, were abandoned following the flow of bad publicity associated with Thames during 2006. Following a competitive auction, Thames Water was finally acquired by Macquarie, the Australian Bank and infrastructure fund, for around £8bn, representing a 17% premium to the RCV. For Macquarie, this represents a step change in their involvement in the sector, although as a consequence they have had to relinquish control of South East Water.

The sheer scale of Thames Water – which services one in four sewerage customers in England and Wales – and its high profile, along with current regulatory investigations into customer service failures, raises particular challenges for the new owners. There is also the prospect of having to finance one or more major projects – the Thames Tideway scheme to deal with sewage discharges, a major new reservoir in Oxfordshire and a £200m desalination plant at Beckton, the latter now subject to planning appeal having been turned down by the mayor of London.

At around the same time, directors of AWG, owners of Anglian Water, recommended to shareholders a £2.2bn bid from Osprey Acquisitions, a consortium made up of Canadian, Australian and
British infrastructure and pension funds. In some respects, the bid for Anglian was more surprising given that it is already one of the most highly-geared companies in the sector, following an expensive re-structuring in 2003 – although since then its gearing has fallen from around 90% to below 80% in 2005/06. Nevertheless, the scope for increased debt financing would seem limited in this case.

Following each acquisition, Ofwat has launched a consultation exercise on the issues raised by the change of ownership. These include the requirement to secure, under Condition P of the licence, legally enforceable undertakings from the owners to protect the independence of the licensed business within the group to which it belongs; and updating the ring-fencing provisions of the licence (Condition F). The latter involve inter alia, requiring the licensed water business to operate as if it were a separate company and strengthened independence from the parent. A further aspect is the requirement for the licensed businesses to maintain investment grade credit ratings.

In the case of Thames, Ofwat published a position note on RWE’s proposed capital restructuring undertaken in preparation for the sale. In this they re-iterated that it was for the management of each water company to determine its optimal capital structure “but within limits which prevent the transfer of undue risk to consumers”. A key element in this is the licence requirement that companies should maintain a credit rating within investment grade. Further regulatory safeguards are proposed through strengthen financial ring-fencing of the water business and the introduction of ‘cash lock-up’ provisions similar to those used by Ofgem. Ofwat has written to managing directors confirming its intention of introducing such provisions in all company licences as suitable opportunities arise.

More generally, these developments demonstrate the continued attractions for pension funds, private equity and infrastructure

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funds of water companies, with their stable cash flows and rate of return based on rising capital value. They are mirrored in other sectors such as aviation with the takeover in 2006 of BAA, the airport operator, by a consortium led by Ferrovial of Spain. However, they undermine one of the original tenets of privatisation which was to widen shareholding among the population, including customers and employees.

It remains to be seen how far ownership of local and regional water companies by remote financial investors weakens the legitimacy of these companies among local stakeholders. Such developments, to the extent that they further reduce the number of listed companies, also eliminate an important indicator – the share price. With these acquisitions, the prospect must be of further increases in gearing in the sector (the ratio of net debt to RCV) after a recent downward trend from a peak of 61.2% in 2004/05 to 58.5% in 2005/06 (see Figure 2). Prior to its financial re-structuring before acquisition, Thames had one of lowest levels of gearing in the sector (44%).

These developments once again, raise questions concerning the characteristics of these new forms of equity in the sector –their incentive properties and appetite for investment and risk-taking.
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To what extent will pension and infrastructure funds be prepared to finance major investment programmes and projects which carry construction and revenue risk? Does this new equity provide the same risk-cushion for shocks and stimulus for innovation as conventional equity?

One has also to question the assumption that political and regulatory risk in the sector is inherently low. Certainly this was the perception following PR04, but the situation can change. Well-publicised failures by water companies, at a time of high profits, creates the conditions for regulatory and political intervention; competition could also reduce the stability of future cash flows. In a recent city briefing Philip Fletcher also signalled strongly that the cost of capital at the next review was likely to be lower. Moreover, acquirers of water companies needed to be very clear about what they were getting into. There should be no expectation of soft regulatory settlements, or bail outs – and delivery of required outputs would be rigorously enforced.

While the pace of acquisition activity in the industry remains at least as strong as in the 1999-2004 period, the drivers are now somewhat different. Then it was more to do with the flight of equity from the sector following a tough review, reducing financing costs through innovation, together with corporate failures (Hyder, Enron). Now the changes in corporate control are driven more by the availability of funds seeking stable returns, the attractions of regulated assets generating predictable cash flows combined with favourable debt market conditions. But it is less clear why such funds look for corporate control of utility companies rather than investing in them.

One by-product of all this activity is a Competition Commission inquiry into the acquisition by Westpac – an Australian banking group and owners of Mid-Kent – of neighbouring South East Water, following its sale by Macquarie. This is the first water merger to be considered under the new guidelines and will

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9 City Briefing, Philip Fletcher and Regina Finn - 1 November 2006, Ofwat.
involve reviewing the value of comparators in the current regulatory regime.

Developments in the regulatory regime

_Institutional_

The 2003 Water Act has brought about changes to the institutional framework of regulation and introduced new powers and duties. On the institutional side, a new Consumer Council for Water (CCW), chaired by Dame Yve Buckland, replaced WaterVoice from October 2005 while the director general of Water Services (Ofwat) was superseded by a new Water Services Regulation Authority (also called Ofwat) from April 2006. The new arrangements follow established better regulation provisions in other sectors. Welcome continuity was provided by the appointment of Philip Fletcher as chair of the new authority with Regina Finn, formerly with the Commission for Energy Regulation in Ireland, being appointed as chief executive.

The authority has new duties relating to sustainable development and for promoting competition. In addition, as noted above, the new Ofwat has powers to fine companies up to 10% of turnover if they fail to meet licence conditions or required standards of performance. Of these, it is the new sustainable development duty which has led to the most heart-searching. Ofwat have run workshops and undertaken consultation on how the new duty might be applied. It is seen as a duty which has implications for all its activities and for all industry players.

Ofwat’s approach to the new duty was set out in a document towards the end of 2006, which brought together responses to a number of interlinked consultations – on how it should contribute to sustainable development; on the length of control period (‘is five years right?’) and on the approach to assessing capital
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maintenance requirements. A common theme seen in all three is recognition of the need for a long term approach to investment planning and regulation. The paper establishes some key principles on sustainable development including securing value through the wider use of cost benefit analysis; recognising environmental limits particularly in the context of climate change; and the use of the polluter pays principle – viewed as particularly important in the context of the Water Framework Directive.

While reaffirming commitment to the five year review cycle – in line with stakeholder preferences – Ofwat have signalled their intention to require companies to produce 25-year business plans for PR09, in line with existing water resource plans. They have also accepted the need to work with industry stakeholders in promoting a more strategic long term approach for the industry. As a first step they have established a high level group under the Regina Finn, the chief executive, to develop a more coordinated approach to the next price review – on issues such as the Water Framework Directive. Putting together 25 year business plans will represent a major challenge for companies and will require formulating a wider vision for the industry.

Competition

The 2003 Water Act contained provisions to extend the scope of competition in the industry through a new water supply licensing regime (WSL) for new entrants to supply large non-household users. The new provisions took effect from the end of 2005. Twelve months later, Regina Finn wrote to the minister expressing concerns about the lack of progress in developing the new licensing regime. Ofwat argue that a review is needed of why the new regime is not working – including identification of the barriers to competition. They also suggest that Defra should review the main elements of the WSL regime as set out in

10 Ofwat (2006b), A Sustainable Water Industry – To PR09 and Beyond, October.
legislation to see if changes are required. Certainly, the progress of competition under the old inset appointment regime over the past decade has been painfully slow with only eleven granted to date.

A critical report in late 2006 by the Competition Appeal Tribunal into a case brought by Albion Water could promote further activity in this area. This relates to an inset appointment granted in 2000 for Albion Water to serve Shotton paper mill, and the access price for common carriage set by Welsh Water.

There has never been a serious debate about competition in the water sector. Initially, Ofwat was under a weaker duty to ‘facilitate’ rather than ‘promote’ competition as other sectoral regulators. While government has periodically pushed the competition agenda for water, it is difficult to detect much enthusiasm for extending competition in the sector either from customers or companies. Late in 2006, Ofwat and the Consumer Council for Water (CCW) commissioned some joint research into the views of business customers on competition in the industry and, against this background, there will particular interest in their findings. Nevertheless, there remains scope for competition in a number of areas – in the provision of water services for new developments; and in competition for major infrastructure projects such as new reservoirs. Without strong pressure from industrial users, and a supply of new entrants, it is hard to see much progress being made in this area before PR09. This is subject to one caveat – whether developments in Scotland (described below) are seen to be more effective in promoting competition for business users.

Thus, with a new board in place, and new duties either being directly exercised (as with financial penalties), evaluated or appraised, we are beginning to see markers on how the regime is likely to evolve and signals on the approach to PR09. Apart from financial penalties, the approach is evolutionary – but involves a greater commitment to longer term planning frameworks, and more joint working on a number of methodological issues.
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Whither regulation?

There was a view in the lead up to PR04 that the currently regulatory regime for water was looking stale and due for re-appraisal. Comparative competition had run its course over the past fifteen years with its value subject to diminishing returns. And, unlike in, say, communications, there was limited signs of fresh regulatory thinking in water – in part perhaps a reflection of its continued monopoly status.

Some of the pressure for reform dissipated with the outcome of PR04 which restored investor confidence and reduced perceptions of regulatory risk. Nevertheless, following PR04, Water UK undertook an extensive consultation exercise as a basis for developing an agenda for regulatory change, drawing on aspects of the Better Regulation Agenda. The consultation was focused around a number of key themes:

- developing a robust and clear long term/strategic framework;
- more consistent and coordinated regulation;
- delivering the right risk/reward balance;
- simpler, smarter regulation;
- greater accountability of government, regulators and industry.

While there was broad support for these objectives, the consultation appeared to support a pattern of evolutionary change with overhaul of key elements such as the approach to efficiency targets. Consequently, there is scope for developing a joint industry/regulator approach on a number of the issues identified. Some of the proposals also find echoes in the recommendations from the Baker review of PR04.

Among the financial community, although there was no significant concern over the industry’s ability to finance future long term investment, there was recognition that new approaches might need to be developed for the financing of very large capital projects spanning control periods. It was also felt that the issue of affordability would become more important; customers’ tolerance of continued increase in charges could not be taken for granted. While the case put forward for ‘simpler, smarter regulation’ to reduce the overall burden of regulation may have been set back by recent events, Ofwat’s acceptance of the need for a long term approach to planning and regulation begs important questions about the future evolution of the current model of water regulation.

There may be some value in a more general review of regulatory ‘best practice’ to consider whether elements in other regimes might usefully be applied to water. One particular concern with the water sector has been the lack of incentives for innovation and the low level of research and development spend. A significant incentive for research and development programmes in the mid 1990s was the ambition to develop non regulated business, particularly in overseas water markets. With retrenchment back to core UK water activities, that incentive has disappeared. In a report on water management published in June 2006, the House of Lords Science and Technology Committee criticised Ofwat for their lack of interest in innovation in the sector. Ofwat’s recent paper on ‘A sustainable water industry’ acknowledges concerns by a number of stakeholders that regulation may inhibit research and development activity and contains a commitment to work with other stakeholders to promote innovation. The experience of Ofgem’s Innovation Funding Incentive to encourage the technical development of distribution networks would be worth examining in this context.

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Towards PR09: prospects and challenges

What are likely to be the key issues for the next review PR09? At this stage before publication of the initial document from Ofwat setting out their approach to PR09, we can only speculate on the key issues. However, if PR04 was about restoring investor confidence in the industry, PR09 may need to have more regard to customers, affordability and wider stakeholder concerns.

First, there is the Water Framework Directive, currently the subject of much collaborative work between water companies and the Environment Agency in developing river basin plans. There remains much to do on developing long term projections and evaluating options. Also while the approaches to catchment planning appear relatively straightforward in rural areas, the process of stakeholder engagement are much less developed in urban areas. There is continuing industry concern that the lack of mechanisms for cost recovery from sectors such as agriculture, and commitment to the polluter pays principle. In terms of PR09, there are issues about how far the programme of measures for WFD implementation will have got by 2009 – with clear risks of trying to incorporate schemes into the PR09 process before proper evaluation of the options has been completed. The directive requires achievement of the outcome of ‘good ecological status’ by 2015 – a concept which, in turn, requires clearer definition.

While the objectives of the directive may be admirable, there would seem good grounds for caution. Customers may well ask, after funding more than £70bn investment in the industry since privatisation, what environmental benefits are likely to accrue from a further programme of investment. It was much easier to persuade customers in the 1990s of the benefits from the bathing water programme or improved sewage treatment. What commensurate benefits would they see from environmental programmes beyond 2009? The privatisation model of water customers paying for environmental improvements could become subject to challenge.
A further factor which justifies caution is energy costs and emissions. The gains to water quality since privatisation have come at a substantial cost in terms of increased energy consumption. Water companies are now major energy users – with costs to the environment as well as customers. A more holistic approach to environmental regulation would point to tradeoffs between water and air quality.

Second, it remains to be seen how far climate change – an issue not really addressed in PR04 but now given added impetus by publication of the Stern Review – will feature in PR09. At a political level, these issues seem to be becoming more pressing. For the water industry, the recent drought and issues of security of supply have been linked to climate change. Equally, the incidence of more extreme weather events, such as torrential rains, highlights the limitations of sewerage systems – and raise questions about future design capacity.

Realistically, the industry must look to Defra to set out future planning guidelines for the industry on climate change. However, it must undertake its own review work on security of supply and scenario planning. As with other utilities, security of supply has to be the absolute priority – and the one on which company performance will ultimately be judged. These concerns point to a stronger emphasis on capital maintenance in PR09 within the UKWIR risk assessment framework. Ofwat figures show that the average annual rate of water mains replacement/rehabilitation has been running at about 1.5% since 1996/97.

Third, the supply/demand balance and security of supply is likely to feature prominently for companies in Southern England with government proposals for 200,000 new houses per year in the region. Companies already produce 25 year water resources plans – and issues of how to meet projected demands through new resources and demand management measures are likely to be a focus of particular debate for PR09.
Fourth, a related issue concerns the framework for financing large infrastructure projects – a new phenomenon for the industry. Thames Water has highlighted the need for a new reservoir in Oxfordshire to meet projected growth. On the waste water side, the Thames Tideway proposals – a project with a projected cost of more than £2bn – continues to be subject to evaluation. There may be lessons to be drawn from other sectors such as aviation, concerning the approach to funding major projects.

Finally, we can also expect that consumer bodies will play a more active role in PR09 – particularly through the new CCW. With the higher profits which investors have seen in AMP4, PR09 will be more about justifying to customers the case for higher charges and the need for investment to improve security of supply. In his November 2006 city briefing, Philip Fletcher signalled that investment for the period after 2010 was likely to continue at much the same level as for the current control period – and that water bills would continue to rise. However, following a period of rising water charges and against the background of rising utility bills for energy, we can expect customer affordability issues to feature more strongly.

Developments in Scotland and Northern Ireland

The period since 2004 has seen significant developments in the regulatory regime for Scottish Water and moves towards establishing a regime for Northern Ireland Water which is to be established as a government-owned company (‘Go-Co’) from April 2007. In November 2005, the newly constituted Water Industry Commission for Scotland, chaired by Sir Ian Byatt, published the final determination from the Strategic Review of Charges 2006-10 – the culmination of more than a two year process which had also seen significant developments to the framework of regulation.
The process for SR06 was initiated by Scottish ministers in 2004, and ran in parallel with legislation to strengthen the regulatory framework. In particular, the Water Services (Scotland) Act (2005) replaced the Water Industry Commissioner with his then advisory role, with a Water Industry Commission with deterministic powers for setting charges for different customer groups. In setting charging limits, the new Commission is subject to a duty to ensure that Scottish Water could perform its core functions and meet stated ministerial objectives at lowest overall cost. In parallel, Scottish Water was given a right to appeal to the Competition Commission.

An important difference from the regime in England and Wales is that Scottish ministers have a duty to set standards and objectives for the company as part of the SRC process. Indeed, in February 2005, ministers formally set the objectives that Scottish Water were required to meet – to be set out in their second draft business plan for the period 2006-14, although charging limits for SR06 would only cover the first four years of this period. As part of this, Scottish Water were given a set of ‘essential’ and ‘desirable’ investment objectives – covering capital maintenance/serviceability, environmental quality, drinking water and provision to overcome development constraints. At the same time, ministers provided a strong steer to the WIC that they wanted these objectives delivered within a framework of stable water charges and within a size of capital programme that could be delivered efficiently.

In the event, Scottish Water’s second draft business plan indicated that even to deliver those objectives considered ‘essential’ would require a substantial increase in water charges over the period 2006-10 and a rate of investment beyond that which appeared capable of being delivered efficiently. The draft determination (DD) produced by Alan Sutherland, the Water Industry Commissioner in June 2005 proposed what was described as the largest per property investment programme in the UK water industry – but with a range of estimated costs significantly below the £3.4bn estimate by Scottish Water (to
meet in full ministers’ objectives). It also envisaged that customers would enjoy stable prices. The implications were that Scottish Water would have to make very large efficiency savings – beyond those achieved in their first four years of existence.

The new Water Industry Commission, on its appointment in July 2005, had the task of taking forward the draft determination leading to a final determination (FD) five months later. The FD confirmed key elements from the draft determination, and proposed a level of capital investment (post efficiency) of £2.15bn over the four years – more than £1bn less than estimated by Scottish Water in their second draft business plan. In contrast to PR04 in England and Wales, the FD required the investment programme outputs to be delivered with charging caps slightly below RPI. One of the ways in which charges have been kept down in Scotland is through a lower cost of capital, using a pre-tax cost of debt of 4.6% and a pre-tax allowed rate of return on the ‘equity’ element of RCV of only 3.2%, equivalent to the post tax allowed rate of return on debt. At the same time, the Commission have used Ofwat’s financial ratios.

There is a debate to be had about the appropriate financial framework for public corporations – and whether they should benefit from the lower cost of public borrowing, or should reflect market rates. To some extent, this must depend on expectations as to future corporate structure and whether the business should at some stage be able to borrow from the financial markets. There is also an issue about the role of government as shareholder – and whether a dividend should be paid to the shareholder, as has been proposed in Northern Ireland.

There are also issues around risk accommodation. With the public sector model, it is taxpayers and not shareholders who bear the risk from under-performance or cost shocks. The FD for Scottish Water contains proposals for managerial incentives linked to out-performance; proposes that SW should invest the proceeds of out-performance in index-linked gilts to build up a financial buffer; and also proposes establishing a £50m
borrowing reserve to cover costs outside prudent management control, which are below the threshold for triggering an interim review. Recognising the large gap between the company’s second draft business plan and the final determination which, on the face of it might have led to an appeal to the Competition Commission, the WIC has proposed review arrangements with SW and quality regulators to consider the most effective ways of delivering some of the outputs. Some flexibility would seem necessary in the circumstances.

In Northern Ireland, the Department for Regional Development (DRD) has announced plans to transfer the Water Service, currently an executive agency, into Northern Ireland Water Ltd from April 2007. In the transition year (2006/07) a board has been for the new government-owned business which will be regulated by a combined Northern Ireland electricity and water regulator (NIAUR). A business plan covering the period up to 2008/09 will define a transitional ‘regulatory contract’ pending completion of a first strategic review of charges (SRC) which seems likely to run in parallel with PR09 in England and Wales. A licence, broadly modelled on the Ofwat licence for companies in England and Wales has been drawn up and issued for consultation.

From April 2007, domestic consumers in 690,000 households will face water charges for the first time which will be phased in over the first three years. This is a major challenge not faced elsewhere in the UK. Just as Scottish Water operated under a revenue cap regime between 2002-06, before the introduction of a standard price cap form of control, so NIWL will operate initially with a revenue cap, with the prospect of a conventional price cap after 2010.

The regulatory regimes in both Scotland and Northern Ireland will draw heavily on the Ofwat regime, with comparative competition likely to a key feature. However, such comparisons beg the question of how quickly companies in Scotland and
Northern Ireland should be expected to close efficiency and performance gaps with England and Wales.

In a 2006 Beesley lecture, Alan Sutherland, chief executive of the Water Industry Commission for Scotland, used the analogy of the hare and tortoise to describe the progress of the water industry in Scotland in catching up its counterparts south of the border. The analogy holds for the industry in both Scotland and Northern Ireland and raises interesting issues about the incentive properties of the public sector model. He points out that in the first 2002-06 control period, Scottish Water achieved a 40% reduction in operating costs – outperforming their targets.

Attention is also likely to focus on differences between the regimes in different parts of the UK. For example, under the Water Services (Scotland) Act, as a means of complying with the provisions of the 1998 Competition Act, provision is made for retail separation to allow a competitive market to develop for 130,000 non-household customers in Scotland. At the same time, retail competition for households is precluded, together with common carriage.

As a consequence, Scottish Water is having to create separate retail and wholesale arms. The wholesale arm will continue to be sole supplier of water and sewerage services on the public network while the retail arm will operate in competition with licensed new entrants – with retail business markets opening up from April 2008. This represents a distinctive approach to water competition within the UK. Moreover, while NIWL will operate within a conventional licence framework, modelled on that for England and Wales, currently only the retail arm of Scottish Water has a licence. There are other differences. Governance and shareholder issues appear to have been addressed at an earlier stage in the development of Northern Ireland Water Ltd, through involvement of the Shareholder Executive. While the 2005 final

determination for Scottish Water marked an important step forward in strengthening governance arrangements, incentives and financial disciplines for the company, as was acknowledged in the Beesley lecture, there is still some way to go in clarifying responsibilities of Scottish ministers as owners of the company and managing potential risks to the taxpayer.

Conclusions

Since PR04, some of the shine has been lost from the industry in England and Wales partly as a result of the drought affecting the South East, with the renewed attention this has brought to the industry’s leakage record. Thames, in particular, has been the subject of a stream of bad publicity over leakage and performance levels and its record on dealing with the legacy of its Victorian infrastructure. At the same time, compliance failings over regulatory reporting data affecting two WASCs, have raised questions about the effectiveness of the regulatory regime in water. The first fines levied on water companies mark a significant toughening of the regime.

During 2006, we have seen another spate of industry acquisitions, mostly involving overseas pension and infrastructure funds, with the prospect of the water sector ceasing to have listed companies. The drivers for these acquisitions would seem somewhat different from those after the 1999 review. However, they raise longer term concerns about accountability, levels of gearing, risk accommodation and the appetite for investment among the new owners. While there would seem merit in retaining diversity in corporate structures within the sector, the prospects of this appear to have diminished. There is general acceptance of the need for the industry and its regulators to develop longer term frameworks of planning and regulation with companies face the challenge of having to produce 25 year business plans for the PR09 review. Nevertheless, there remains a lack of clear vision for the industry and a coherent view of how its regulatory regime should evolve.
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It would be rash to assume that competition will ride to the rescue. However, there seem no models to draw on of how regulation of monopoly businesses can continue to provide effective incentives for out-performance and innovation.

Developments in Scotland and Northern Ireland involve parallel systems of regulation drawing heavily on the Ofwat system and comparisons of efficiency and performance with companies in England and Wales. They beg the question of how far an incentive-based system of regulation, designed for plcs, can be applied to public corporations and what the distinctive features of such regimes should be. It will be interesting to see how long it takes for these new(er) water businesses to match performance standards with companies privatised seventeen years ago.

There is also the question of the sustainability of these public sector models and whether, at some stage, providing access to private capital markets becomes a better way to financing the high levels of investment required. While political and public acceptability would seem to rule out privatisation in Scotland and Northern Ireland for the foreseeable future, other models such as the Glas Cymru CLG model may have rather more appeal.

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11  ACHIEVING BETTER REGULATION – THE ROLE OF THE BRC

Penelope Rowlatt

Introduction

On 1 January 2006, the Better Regulation Commission (BRC) formally came into being, replacing the Better Regulation Task Force (BRTF). The Task Force had been set up in 1997 by the new Labour government, but was itself a successor to similar groups that worked throughout the 1980s and early 1990s with Conservative governments on a variety of initiatives around deregulation, better regulation, reducing bureaucracy or cutting red tape. Governments of different political colours, and with different policy and regulatory priorities, have felt the need to have an independent body to advise and challenge them on how they manage their regulation. This paper sets out to explore why this should be so and to review the role of the BRTF and more recently the BRC in helping to promote better regulation.

The role of independent advice and challenge

The BRC and their predecessor bodies share some important characteristics that help to clarify the role that governments have envisaged for them and to explain how they have chosen to undertake their work. The most important are:

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Independence: The BRC/BRTF is independent of government. Indeed, members have often said that they could not serve without the safeguard and guarantee of independence. Independence means that the BRC/BRTF is free to give impartial, apolitical advice, usually in public, on government’s regulatory proposals and performance without fear of adverse consequences. Independence means they can define their own work programme and choose when to comment and on which subjects.

It means they decide for themselves what recommendations they make to government and when and how robustly to challenge government proposals. It may seem counter-intuitive for a government to set up an independent body specifically to challenge it, in public, on its regulatory programme. At one level, it can be seen as a symptom of a mature and confident democratic system. At a more fundamental level, though, it suggests to me that governments recognise their instinctive fondness for regulation and the tendency for a regulatory programme to evade a government’s own control mechanisms. Under these circumstances, a strong, trusted, external independent challenge becomes a vital check on a government’s own regulatory instinct, and essential to the delivery of high quality results.

Advisory: The BRC/BRTF has no formal power or statutory duties. Their role is simply to provide advice and challenge, which the government of the day can choose to accept, adapt or ignore. The only power that the BRC has is the power of persuasion through the logic and evidence base of its arguments. Our role has been compared to that of a non-executive director, external to an organisation but invited to bring his or her expertise and experience to bear on important decisions. While they may have no formal power, they can profoundly influence outcomes by asking the right questions at the right time.

Balance: The BRC/BRTF has always sought to have a balanced membership, drawn from a wide variety of interests across the
public, private and voluntary sectors, trades unions, the professions and academia. Members are appointed in their own right, not as representatives of particular organisations or interest groups. They bring a rich diversity of experience to the discussions and the balance ensures that no single set of interests can dominate the thinking. It is therefore peculiar that some commentators still believe the BRC to be nothing more than a business lobby group. Our position is that better regulation, properly understood and implemented, brings benefits to all parts of the economy and society. For us, better regulation is too important to allow it to be highjacked by any single interest group.

**Unpaid volunteers:** All BRC members, like the BRTF members, are unpaid volunteers. They apply for a place on the Commission and are appointed by ministers following an open competition in line with the Commissioner for Public Appointments (OCPA) Code of Practice. We believe that being unpaid volunteers is extremely important to maintaining the credibility, independence and balance of our work.

**The distinctiveness of the Better Regulation Commission**

One of the less useful results of the change in January 2006 from the BRTF to the BRC has been an ongoing confusion between the Better Regulation Commission (BRC) and the Better Regulation Executive (BRE). This confusion is understandable, given that the two bodies have similar names and acronyms and occupy adjacent premises in the Cabinet Office. It is easy to see why people would assume that the BRC and BRE have the same responsibility – to promote better regulation. However, there is an important distinction and it goes to the heart of why government considers it necessary to have an independent body to provide advice and challenge to its regulatory performance.
The Better Regulation Executive (BRE) is ‘part of government’, charged with driving the delivery of the government’s better regulation programme. As such, it carries out some of the classic Cabinet Office functions of supporting the prime minister, government and civil service, co-ordinating better regulation activity across government, monitoring and reporting on progress and setting the future direction. The Better Regulation Commission is an independent body ‘outside government’ whose role is to advise and challenge government, including from time to time the BRE, on better regulation.\(^1\) Although the bodies need to work closely together, the independence of the Commission means that it can provide advice and issue challenges to government, often in public, that the BRE as part of government is unable to do. In this role, the BRC is the government’s regulatory conscience. Of course, like any conscience, our advice is sometimes unwelcome, but it has a habit of proving to be right in the long run.

Better Regulation – what do we mean?

It was no accident that the incoming Labour government in 1997 renamed the ‘Deregulation Unit’ in the Cabinet Office the ‘Better Regulation Unit’ and set up a Task Force of the same name. This reflected its political instincts and was an acknowledgement that more regulation would inevitably be required for the new government to deliver its manifesto commitments and priorities. However, people understand ‘better regulation’ in different ways. Some see better regulation as the ultimate oxymoron. They want to see wholesale deregulation and the ‘freeing up’ of people, businesses and the public and voluntary sectors from what they see as the ‘dead hand of state regulation’. Others, while accepting in principle the need for state regulation, view it very much as a last resort, to be used only where alternatives such as voluntary agreements, fiscal incentives, providing information and

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\(^1\) Formally a non-departmental public body (NDPB) attached to the Cabinet Office.
education, and ‘do nothing’ have failed. At the other extreme are those who look with confidence to regulation as a means of solving society’s problems and are happy to lead calls for new or stronger regulation in a growing number of areas of our daily lives.

It is obviously difficult to penetrate far into this kind of debate without taking a position based more on ideology or politics than on the merits of regulation per se. However the BRC, like the BRTF before it, cannot afford the luxury of taking a position for or against regulation. The reality is more complex and nuanced and, from the outset, the credibility of the new Task Force depended on it setting out a convincing statement of what it believed better regulation to be and what it was trying to achieve. Considerable effort was expended on establishing the BRTF as the clear, calm voice of reason in what is so often a debate that relies more on emotion than on fact or evidence.

The first issue was to establish a workable separation between regulation and policy. Government set up the BRTF specifically to provide independent advice on regulation, not to comment on its policy objectives. Without some clarity on what the BRTF could and could not legitimately comment on, there would be a serious risk that Task Force advice would be seen as unwarranted interference in the affairs of a democratically elected government. As a starting point, the BRTF set out clearly its understanding that governments set policy and the BRTF advises on how regulation might be used appropriately to deliver it. This distinction has consistently been reflected in the BRTF terms of reference. The original 1997 terms of reference of the BRTF were:

“To advise the government on action which improves the effectiveness and credibility of government regulation by ensuring that it is necessary, fair and affordable, and simple to understand and administer, taking account of the needs of small businesses and ordinary people”.
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There is a close parallel here with the 2006 terms of reference of the new Better Regulation Commission. These are:

“To advise the government on action to reduce unnecessary regulatory and administrative burdens and to ensure that regulation and its enforcement are proportionate, accountable, consistent, transparent and targeted”.

There is nothing here about the BRTF or BRC interfering in or commenting on policy, although it may sometimes be an intellectual challenge to arrive at a view on whether or not a particular regulation is ‘necessary’ without considering the merits or otherwise of what the regulation is designed to achieve. The BRTF was conscious of this difficulty and decided to take a pragmatic view of what constitutes better regulation. As Lord Haskins, the first BRTF Chair said, “The Task Force’s approach is based on pragmatism and common sense rather than ideology, but regulatory issues cannot always be entirely divorced from policy”.

The BRTF and BRC have always defined “regulation” rather broadly. This means that, as well as evaluating regulation, the BRTF has also promoted non-regulatory solutions where these would work better or more efficiently than classic regulation. However, pragmatism has remained important and the BRTF and BRC have never taken a position against regulation per se, although many have expected us to.

Sir David Arculus, who succeeded Lord Haskins as BRTF Chair in 2002, elaborated the point as follows in his foreword to the 2005 BRTF annual report, when reflecting on the high and growing cost of regulation to the UK economy.

“This does not mean that all regulation is bad or unnecessary. Within the total are laws covering

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social, economic, political and technical priorities such as minimum wage, maternity rights, environmental protection and consumer safety. I do not advocate dismantling necessary legal safeguards at either the UK or European level. However, I do believe that regulators have a duty to take account of the costs that they impose on those being regulated and to find innovative ways to achieve their objectives while minimising those costs. People may rightly vote for cleaner air, longer holidays or safer travel. No-one votes for red tape or excessive monitoring, inspection and form-filling”.

Having set out the distinction between policy and regulation, the Task Force then had to decide how it would judge whether or not any particular regulation was good. The aim was to strike a balance between simplicity (a small number of easily remembered, high-level principles that don’t change too often) and effectiveness (do they help people to improve the quality of regulation). The criteria it chose were published in January 1998 as the BRTF ‘Five Principles of Good Regulation’ – proportionality, accountability, consistency, transparency and targeting. The principles were updated in October 2000. This left unchanged the five ‘headline’ principles but added some more detailed requirements (set out in Annex A) that helped the BRTF, and indeed regulators, to distinguish between good and less good regulatory proposals.

While winning wide acceptance both in the UK and elsewhere, the five principles have not been without their critics. Some have complained that they are nothing more than high-level, self-evident truths. Who could credibly argue for disproportionate or inconsistent regulation? Others, while accepting the form and intent of the Five Principles, have considered them incomplete and called for additional principles such as necessity, coherence,

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objectivity and rationality. The Task Force itself found a need to supplement its principles with the requirement for a regulatory impact assessment, consultation and the consideration of alternatives, as described below.

Achievements of the BRTF, 1997 - 2005

In its early years, as we have seen, the BRTF set about establishing its credentials, operationalising its terms of reference and publishing the five principles against which it would judge regulatory proposals. It also set out in its 1997/98 annual report a series of issues that, remarkably, have continued to dominate thinking about regulation during the intervening years. These included:

**Risk.** The Task Force stated that “citizens have some responsibility for managing risks which only affect them and their dependants. The state must provide information to enable people to take personal responsibility for the risks of everyday living. Generally the state must concentrate on the protection of those who are particularly vulnerable to risk, for example the young and some elderly or disabled people. For the rest of us, risk decisions affecting only ourselves need not be subject to government regulation” BRTF, 1998). It is interesting to note that the Better Regulation Commission has come back to this issue of risk and who should bear the responsibility for managing it in its study on Risk, Responsibility and Regulation – Whose risk is it anyway?, published in October 2006.

**Enforcement.** The early Task Force found that enforcement issues arose in nearly every area of regulation that they investigated. They drew attention to the issue of national versus local enforcement, and the problems of inconsistency, which

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4 See, for example, House of Lords Select Committee on the Constitution 6th Report, 31 March 2004.
were to resurface in the Hampton Report in March 2005. They also said that sanctions had to command public confidence and should fit the offence, issues that have now been reviewed by Professor Richard Macrory. They also championed the embryonic Enforcement Concordat, the successor to which is part of the Legislative and Regulatory Reform Act, passed in 2006.

**Relevance.** The early Task Force found examples of regulations that had become out of date and called for their reform. They drew attention to the need for laws to reflect our modern, informed and secular society rather than the paternalistic moral tone of Victorian times. In a passage that could have been written today, they stated that: “*Procedures for repealing redundant regulations are unsatisfactory, in that departments are more interested in using their allocated parliamentary time and their resources to introduce new legislation rather than to repeal old regulation*” (BRTF, 1998). The current drive to simplify regulations and to find a less bureaucratic way to amend existing legislation arises directly from this early work of the BRTF.

**Europe.** The early BRTF drew attention to the regulatory implications of EU membership, the fact that some aspects of EU directives appear over-prescriptive and unnecessary, and the importance of transposing EU directives into domestic law on a fair and consistent basis. These themes were to resurface in 2004/5 when the BRTF undertook a major programme of work directed at improving EU regulation in terms of simplification, consultation and alternatives.

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7 Cabinet Office, BRTF suite of Reports on EU better regulation. 2004-5.
An assessment of progress

In its 2005 annual report, the BRTF looked back and assessed its achievements since 1997. It identified four stages of its work:

**Stage 1.** In the early years the BRTF was establishing the five principles and challenging particular regulations or areas of legislation that did not meet them, for example, early education and day care regulation and packaging waste (1998), anti-discrimination legislation and regulating small firms (1999) and hotels and restaurants, and environment and farmers (2000).

**Stage 2.** This was followed by a period during which, although work on reviewing specific areas of regulation did not stop, there was more of a focus on putting in place a systematic and rigorous process for managing regulation. Some have described this process as setting up a bureaucracy to tackle a bureaucracy, a charge that many of us were happy to admit. It involved setting up hurdles that ministers and civil servants had to go through before bringing in new regulation. The hurdles included:

- **Regulatory impact assessments,** which were made mandatory for all major proposals, setting out the justification and expected costs and benefits.

- **A consultation code** that sets out high standards for consultation, including a minimum 12 weeks consultation period.

- **Consideration of alternatives.** All proposals had to include consideration of different regulatory and non-regulatory options for achieving the desired objectives.

- **The panel for regulatory accountability** was set up to review proposed regulations likely to impose significant burdens and hold departments to account for their better regulation performance.
Common commencement dates – wherever possible departments should bring in new measures affecting businesses on 5 April or 1 October each year.

This macro level framework provided a systematic approach to the difficult task of turning political commitments and aspirations into good regulation. Partly thanks to this framework the UK is now seen by international observers, like the IMF, OECD and the World Bank, as a leader in the field of regulatory reform.

Stage 3. However, it is one thing to set up a framework but quite another to ensure that everyone follows it. In the third phase of its work, the BRTF turned its attention to the issue of culture change in government departments and regulators. Better regulation would never succeed if it remained an externally imposed discipline that ran counter to the natural tendencies of the organisations it was intended to influence. Better Regulation had to become part of the culture of departments, reflected in the organisation, their objectives and incentive structures. In this phase of the work, the BRTF pushed for each department to have better regulation ministers and board level champions, internal challenge panels, non-executive directors on the boards, better regulation units and better regulation written into the performance agreements of permanent secretaries. This was matched by a series of more strategic reports, looking at the culture of regulation in the UK, such as ‘Imaginative Thinking for Better Regulation’ (2003) and ‘Better Routes to Redress’ and ‘Regulatory Creep’ (2004). The BRTF also worked closely with independent regulators on issues around governance and accountability and published major reports on ‘Economic Regulators’ (2001) and ‘Independent Regulators’ (2003).

Stage 4. In the fourth and final stage of its work, the BRTF faced up to an uncomfortable fact. Despite the progress and apparent success of its activities since 1997, the volume, numbers and cost of regulation in the UK have continued to rise. In its report ‘Regulation – Less is More’, the BRTF set out the case for reducing the burden of regulation. It advocated measuring the
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administrative burden of regulation and then reducing it as far as possible – on the basis that insufficient attention had been paid in the past to keeping it under control so a one-off effort at reduction was appropriate. Also, under the challenging metaphor of ‘one in, one out’ it recommended that departments actively remove, simplify and rationalise regulations when they introduce new ones.

As a result of this work, the government has embarked on a far-reaching programme that will change the way it manages regulation. In particular, it has committed to:

• measure and set targets to reduce the administrative costs of regulation on business and the voluntary sector;

• adopt a ‘one in, one out’ approach to new regulations;

• implement a programme across all government departments and independent regulators to simplify existing regulations.

This marks a turning point in the way the UK government manages regulation. It represents a formal recognition that regulation is not a free good but has costs and implications every bit as important for the nation and the economy as the annual budget statement. Indeed, the final recommendation in the report ‘Regulation – Less is More’ is for the government to research whether regulatory budgeting would be a useful discipline and we are awaiting the results of this work with interest.

It remains to be seen how successful the government will be in implementing these commitments. However a good start has been made:

• All regulations that impact on business and the voluntary/community sectors have been mapped and their administrative burden estimated using the standard cost model. The government has said it will set targets to reduce these administrative costs.
• All departments and major regulators, in consultation with stakeholders, have now prepared their first simplification plans. These set out how they propose to simplify regulations and achieve the target reductions in the administrative costs of compliance.

• The Better Regulation Commission has acted as the independent reviewer of these first year plans and has assessed each one for its credibility, ambition, deliverability and the quality and extent of its quantification. These opinions are available on the BRC website.

The BRTF Legacy

The achievements of the BRTF are best summarised in the words of Sir David Arculus:

“Although it is possible to argue that we should have done more and that there is still too much regulation, my guess is that the original members of the Task Force would be quite surprised by how far we have come since we were established in 1997 and the changes in government thinking and practice that we have brought about. Comparing now with the position in 1997:

- Better regulation is a government priority with a higher profile than ever before. We have been able to secure the personal support of both the prime minister and the chancellor and all political parties are broadly in support of the agenda we have laid out.
- Government departments now have better regulation ministers, board level champions and better regulation units, accountable for delivering reductions in administrative burdens and achieving regulatory simplification.
- Many independent regulators have adopted our five principles, established senior posts with
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responsibility for better regulation and are using impact assessments, the consultation code and a risk-based approach.

- The Better Regulation Executive has been set up in the Cabinet Office to co-ordinate delivery of better regulation.
- The government has made better regulation one of the UK’s top priorities for its presidency of the EU in 2005. The European Commission is taking forward an ambitious programme of better regulation and has made a commitment to reduce administrative burdens by 25%.
- In recognition of our success, the BRTF will become permanent from January 2006 as the new Better Regulation Commission, with additional responsibilities to challenge departments and regulators on their performance against the better regulation targets”.

The Better Regulation Commission – the way ahead

With the change from the BRTF to the BRC, Sir David Arculus stepped down as chair to be replaced by Rick Haythornthwaite. Rick has set out the challenges that he sees facing the new Commission as follows:

“I want us to have the world’s best regulatory environment. That means stopping regulating in response to every problem and only regulating where necessary. It means designing rules that support innovation, competitiveness and productivity as well as providing safety nets. It means finding the balance that encourages and rewards sensible risk taking but punishes the irresponsible and criminal. It means
removing unnecessary rules and releasing the energy of our public, private and voluntary sectors.
Our role as an independent body is to advise and challenge government and regulators. We question the need for new legislation, we challenge government to reduce regulatory burdens and we recommended changes to the way that legislation is implemented and enforced. We do this with one aim in mind - to ensure that better regulation results in real improvements to people’s lives”.

Following the tradition of the BRTF, one of the BRC’s first tasks was to define what it is they are looking for – what they understand by good regulation. The BRC has stated that it will test whether a proposed or existing regulation is good by asking:

- **Is it necessary?** – When it is not necessary to regulate, it is necessary not to regulate. The best action is sometimes no action at all.

- **Is there no better alternative?** There are many ways to change behaviour and ‘classic regulation’ should be used as a last resort.

- **Does it respect the five principles of good regulation?** The five principles are a tried and tested way of assessing regulation.

- **Is there a sensible balance and allocation of risk?** We ask what risk is being addressed, why and at what cost, what are the trade offs and who will benefit from and pay for mitigating the risk.

- **Does it deliver the desired outcomes with the least possible burden?** A cost-benefit assessment. We want to ensure that benefits exceed costs, that a regulation will work, will avoid

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8‘What is the BRC’, leaflet – December 2006
unintended consequences and will not impose unnecessary or unreasonable costs.

It will be clear that, once again, the new Commission will have to grapple with the familiar but critical distinction between policy and regulation. In its first report, a review of the implementation of the 2003 Licensing Act, the Commission raised serious questions not only about the technical details of implementation but also about the approach taken to the new licensing regime. Critically, the Commission tried to probe what assumptions about the industries and activities that they were to regulate lay behind their extremely complex, bureaucratic and burdensome approach. Was such an approach justified by the risks that the department was required to control? If so, were those risks equally relevant to city centre pubs as to village halls?

Having raised these kinds of question, the Better Regulation Commission has recently published a report on risk and regulation. This looks at the way in which the government’s (and our society’s) approach to and expectation of regulation are coloured by our perceptions and understanding of risk. We ask how we might identify the right balance between providing greater protection and preserving productive risk in different areas of regulation. Finally, the report looks at who has been allocated the responsibility for managing risk in different regulatory contexts and whether this is the optimum solution.

It will be clear from the above that Lord Haskins was absolutely right when he observed in 1997 that, “regulatory issues cannot always be entirely divorced from policy”. The BRC will need to push the boundaries and ask some fundamental ‘why’ questions about central government regulation if we are to understand and challenge the complex forces that drive the current regulatory machine. Calling on individuals to take more responsibility, rehabilitating caveat emptor as a positive incentive, challenging regulations that can only achieve their objectives by imposing

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excessive costs or bureaucracy – all these will inevitably raise some difficult regulatory, policy and political issues.

It is only an independent, balanced and objective body of regulatory experts with no political axe to grind that can lead and facilitate this debate. We need to continue to be the calm voice of reason, relentlessly separating fact from emotion and creating a space in which difficult, value-laden questions can be raised and discussed.

That is why we need the independent Better Regulation Commission working with but remaining strictly separate from, the Better Regulation Executive and the rest of government. As a critical friend, the BRC can know, understand, sometimes sympathise, and often empathise with, what the government wants to achieve. However, as only a critical and trusted friend can do, we can and will point out where government has got it wrong as well as right. We shall also push hard to correct what we believe to be an ultimately damaging tendency of the government to rely too much on classic regulation to solve problems. Instead, we shall promote the wider use of alternatives and self-regulation, seeking to replace a compliance culture with one built on trust and accountability.

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


House of Lords Select Committee on the Constitution 6th Report, 31 March 2004. (4)
Annex A

Five Principles of Good Regulation

The table below describes the Five Principles of Good Regulation and what regulators should bear in mind when devising, implementing, enforcing and reviewing regulations.

<table>
<thead>
<tr>
<th><strong>Proportionality</strong></th>
<th><strong>Regulators should only intervene when necessary. Remedies should be appropriate to the risk posed and costs identified and minimised.</strong></th>
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<tbody>
<tr>
<td></td>
<td>Policy solutions must be proportionate to the perceived problem or risk and justify the compliance costs imposed – don’t use a sledgehammer to crack a nut</td>
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<td></td>
<td>All the options for achieving policy objectives must be considered – not just prescriptive regulation. Alternatives may be more effective and cheaper to apply</td>
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<tr>
<td></td>
<td>“Think small first”. Regulation can have a disproportionate impact on small businesses, which account for 99.8% of UK businesses</td>
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<td></td>
<td>EC Directives should be transposed without gold plating</td>
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<td></td>
<td>Enforcement regimes should be proportionate to the risk posed</td>
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<td></td>
<td>Enforcers should consider an educational, rather than a punitive approach where possible.</td>
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</table>

<table>
<thead>
<tr>
<th><strong>Accountability</strong></th>
<th><strong>Regulators must be able to justify decisions and be subject to public scrutiny</strong></th>
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<tr>
<td></td>
<td>Proposals should be published and all those affected consulted before decisions are taken</td>
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<td></td>
<td>Regulators should clearly explain how and why final decisions have been reached</td>
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<td></td>
<td>Regulators and enforcers should establish clear standards and criteria against which they can be judged</td>
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<td></td>
<td>There should be well-publicised, accessible, fair and effective complaints and appeals procedures</td>
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<td></td>
<td>Regulators and enforcers should have clear lines of accountability to Ministers, Parliaments and assemblies, and the public</td>
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### Consistency

**Government rules and standards must be joined up and implemented fairly.**

- Regulators should be consistent with each other, and work together in a joined-up way.
- New regulations should take account of other existing or proposed regulations, whether of domestic, EU or international origin.
- Regulation should be predictable in order to give stability and certainty to those being regulated.
- Enforcement agencies should apply regulations consistently across the country.

### Transparency

**Regulators should be open, and keep regulations simple and user-friendly.**

- Policy objectives, including the need for regulation, should be clearly defined and effectively communicated to all interested parties.
- Effective consultation must take place before proposals are developed, to ensure that stakeholders’ views and expertise are taken into account.
- Stakeholders should be given at least 12 weeks, and sufficient information, to respond to consultation documents.
- Regulations should be clear and simple, and guidance, in plain language, should be issued 12 weeks before the regulations take effect.
- Those being regulated should be made aware of their obligations, with law and best practice clearly distinguished.
- Those being regulated should be given the time and support to comply. It may be helpful to supply examples of methods of compliance.
- The consequences of non-compliance should be made clear.
<table>
<thead>
<tr>
<th>Targeting</th>
<th>Regulation should be focused on the problem, and minimise side effects</th>
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<tbody>
<tr>
<td></td>
<td>Regulations should focus on the problem, and avoid a scattergun approach</td>
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<td></td>
<td>Where appropriate, regulators should adopt a ‘goals-based’ approach, with enforcers and those being regulated given flexibility in deciding how to meet clear, unambiguous targets</td>
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<td></td>
<td>Guidance and support should be adapted to the needs of different groups</td>
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<td></td>
<td>Enforcers should focus primarily on those whose activities give rise to the most serious risks</td>
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<tr>
<td></td>
<td>Regulations should be systematically reviewed to test whether they are still necessary and effective. If not, they should be modified or eliminated</td>
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12 THE DECENTRED REGULATORY STATE?

Julia Black

Introduction

According to a recent Cabinet Office report, there are over 75 governmental regulatory bodies in the UK, not including those which are specific to the devolved administrations.¹ Since 2000, at least a dozen new regulatory agencies have been created. A new regulator does not necessarily mean more regulation: some of the new regulators have been created through mergers of pre-existing bodies, such as Ofcom or the Financial Services Authority, or are the restructured form of an existing body, such as the Gambling Commission or the Charities Commission. Others, such as the Gangmasters Licensing Authority, have been created to regulate a previously unregulated sector, however, or to implement enhanced regulation over a particular sector, as with the Pensions Regulator. Moreover, restructuring of the regulatory infrastructure often entails an extended remit for the organisation and a range of new powers, as in the case of the OFT, the Gambling Commission, the Commission for Equality and Human Rights or the Serious Organised Crime Agency.

Governmental regulation of the professions, typically strongholds of self-regulation, is also being considerably

¹ Cabinet Office (2005a), Public Bodies 2005, available at www.civilservice.gov.uk (see also 2006 edition). In fact the Cabinet Office’s figure is somewhat misleading, as the list excludes non-ministerial departments which are significant regulators, such as the Office of Fair Trading, Ofgem, Ofwat, Postcomm and the Food Standards Agency, and includes bodies such as the Engineering Construction Industry Training Board and the Northern Ireland Museums Council, which have no regulatory function.

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enhanced. The roles of governmental and non-governmental regulators in regulating the professions are being radically, and controversially, re-configured in accounting, medicine and the law, as central government seeks greater powers to steer the activities of traditionally autonomous professional bodies. In each area, a governmental body has been, or is being, introduced to oversee the self-regulation of the professions.

These ‘meta-regulators’, or regulators of regulators, include, in medicine, the Council for the Regulation of Healthcare Professionals (CRHP); now known as the Council for Healthcare Regulatory Excellence (CHRE) to oversee the work of the regulatory bodies for all health professionals. Its powers include a power to refer certain ‘fitness to practice panel’ decisions of the General Medical Council to the High Court on the basis that they are unduly lenient or should not have been made. In accountancy, the Financial Reporting Council has been designated powers under the Companies (Audit, Investigations and Community Enterprises) Act 2004 to oversee the regulatory activities of the accounting professional bodies. The Legal Services Bill seeks to implement the recommendation of the Clementi Review that a Legal Services Board be introduced to oversee the regulatory activities of the legal professional bodies. In financial services, the role of self regulatory bodies was severely dented by the Financial Services Act 1986, and largely removed by the Financial Services and Markets Act 2000, which gave extensive regulatory powers to the Financial Services Authority. Indeed, these developments have been collectively described as marking the demise of ‘club government’ (Moran, 2003).

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2 Moran M (2003), The British Regulatory State: High Modernism and Hyper-Innovation, OUP.
3 National Health Service Reform and Healthcare Professionals Act 2002 s. 29.
Moreover, within government, regulation of public and private service providers is being enhanced. This is manifested in part through the creation of new regulators or overseers, such as the Commission of Social Care Inspection, the Healthcare Commission and the School Food Trust. The increase in central government controls over the provision of public services builds on a significant base. Writing in 1999, Hood et al showed that formal, arm’s length overseers of public service providers had doubled in size and real term resources over two decades since 1980, at a time when the UK civil service was cut by 30% and local government by 20%. These ‘waste-watchers, quality police and sleaze busters’ were applying ever more codes and procedural guidelines over functions being exercised by other governmental bodies, bodies which were meant to be enjoying greater managerial autonomy.5

Together these developments reinforce the notion of the ‘regulatory state’. This image of the rise of the regulatory state, manifested in the creation of specialised regulatory agencies to oversee private and public actors, has grasped political and academic imaginations since the first wave of privatisations of the 1980s.6 In fact the regulatory state, in the sense of government regulation of public and private actors, has a far longer history (Moran, 2003).7 Privatisation did not give birth to

regulation per se, simply one form of regulation (mainly price controls) over one particular set of economic actors (ex-nationalised industries). The history of the English regulatory state, at least, is far longer. Indeed Moran argues that the UK is now a ‘hyper-regulatory state’, the teleology of which is “the incessant drive towards synoptic legibility: installing systems of comprehensive reporting and surveillance over numerous social spheres; the consequential pressure to standardise and to codify, which is to make explicit what had hitherto been tacit; and the creation of new institutions (notably specialised regulatory agency) to help enforce all this” (Moran, 2003, p154).

In contrast to this image of increasing centralisation and governmental control over regulation invoked by the discourse of the regulatory state, other commentators have taken the governance turn. Governance is a much debated term, but most definitions revolve around the observation that both public and private actors are involved activities of steering or guiding the governed in ways that may or may not be interrelated.8 To follow Rosenau, both governments and governance consist of steering mechanisms through which authority is exercised to preserve the coherence of the governed and enable it to move towards desired goals. Governance refers to any collectivity, public or private, that employs formal and informal steering mechanisms to make demands, issue directives, pursue policies and generate compliance.9 Thus defined, governance is a broader notion than regulation, in that it comprises activities usually described in terms of public service provision (health care, education, housing), as well as activities which seek to exercise control and change behaviour (or at least maintain a certain pattern of behaviour). The conception of regulation which is a

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9 Rosenau J (1997), Along the Domestic-Foreign Frontier: Exploring Governance in a Turbulent World, CUP.
counterpart to that of governance is decentred regulation. Regulation is that aspect of governance which is concerned with changing (or maintaining) the behaviour of others in order to attain an identified goal, but like governance, it can be performed by both state and non-state actors, or through a complex interaction of both, using a range of strategies.

Both the governance turn and its regulatory counterpart, decentred regulation, offer a set of analyses which emphasise the fragmentation of power, the interdependence of public and private actors in achieving their goals, and the significance of networks of public and private actors at the transnational, national and subnational levels in the practice of regulation. The theoretical bases of these analyses include Foucauldian theories of governmentality and systems theory.¹⁰ There is a minor academic industry in identifying further refinements to the regulatory state which will incorporate this expanded conception of regulation, such as the new regulatory state and the ‘post-regulatory’ state (Black, 2001; Scott, 2004).¹¹ ¹² Indeed, following the inevitable academic trajectory, the regulatory state has been debunked as an epithet by some to be replaced by ‘regulatory capitalism’. Levi-Faur argues that ‘regulatory capitalism’ best captures the complex interdependence of state, society and economy in the creation of a political-economic and social order.¹³

Almost regardless of the title, these re-descriptions of regulation emphasise the fragmentation and decentred or poly-centred nature of contemporary regulatory regimes, in contrast with a state-centric, hierarchical model of government and regulation. These analyses are in turn associated with the advocacy of particular approaches to governing behaviour, usually referred to collectively as ‘smart’ regulatory techniques. Smart regulation stands in contrast to ‘command and control’ regulation. It is a pragmatic, flexible and pluralistic approach to regulation involving the use of multiple regulatory techniques and a wider range of regulatory actors to implement a regulatory regime. The fashion is thus to talk of decentring regulation; collaborative governance, outsourcing regulation, enrolling regulatory actors; finding ‘complementary mixes’ of instruments; sequencing instruments and maximising the opportunities for ‘win-win’ solutions.

However, there is an apparent tension between analyses which focus on the enhanced centralisation of government and development of internal government controls, and those which focus on decentring and on regulatory hybridity. Recent developments in the institutional structures and practices of governmental regulators appear to provide support for both propositions. Fragmentation and polycentricity can be observed in the persistence of non-state regulation, the fragmentation of functional responsibility for regulation across state and non-state bodies in particular domains, and in the ‘hollowing out’ of the

state itself. Centralisation and consolidation can be seen in the enhancement of powers being given to state-based regulators to regulate private social and economic actors and non-state regulatory bodies, and the ‘filling in’ of the core executive: with the increased role of the Cabinet Office and the Treasury in driving and overseeing state-based regulators. So are we witnessing the ‘decentred’ regulatory state, or is it a case of ‘command and control regulation is dead; long live command and control regulation’?

The rise of the regulatory agency

There is a political fondness at present for the creation of independent regulatory agencies, both here and in other OECD countries, although debate continues on the reasons why. Moreover, there is a shift, at least in the UK, in the types of powers and governance structures being given to regulatory

16 Recent proposals by Gordon Brown to create an independent board to manage the NHS are thus part of a far longer trend to devolve power within the central executive away from departments and into organisations which are more or less independent from them. On the NHS story see http://news.bbc.co.uk/1/hi/health/5372920.stm
bodies. Agencies that were formed in the 1970s bore the stamp of corporatism on their institutional structures. Their governance bodies included representatives of labour, capital and state – the Health and Safety Commission still bears traces of this imprint. Contemporary regulators have consumer panels instead (eg, FSA and Ofcom). Indeed, since the turn of the 21st century, a new breed of regulator has emerged – one which has greater operational distance from Whitehall but whose obligations of ‘good governance’ are specified to an increasing degree in legislation and codes of practice, which recruits through open competition rather than via the civil service, which is funded by the industry it regulates, and most significantly, which has far greater sanctioning powers. The most complete example of this breed of ‘new millennium’ regulators is the Financial Services Authority. It is a company limited by guarantee; it has extensive legislative powers and extremely wide powers of sanction, including the ability to impose fines and order restitution. The Pensions Regulator has similarly wide enforcement powers, for example to impose fines, recover unpaid contributions and order restitution. The same is true of the

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19 Governmental regulatory bodies can be non-departmental bodies, non-Ministerial departments, public corporations or executive agencies. The government has attempted to impose some systematic order on which organisational structure that is used, but the rationale behind individual decisions is often obscure. The core executive has attempted to take some control over the issue, and those departments wanting to set up a new body have to first complete a ‘classification questionnaire’ from HM Treasury, and gain confirmation from the Office of National Statistics that it will be a public body for accounting purposes. If so, the Cabinet Office then determines its classification in accordance with its own guidance: Cabinet Office (2005b), Classification of Public Bodies – Guidance for Departments, London.

20 This varies with the type of public body the regulator is. Most newly established regulators are non-departmental bodies, whose employees are not civil servants. Nevertheless, some significant regulators who have been recently reformed, such as the OFT, are non-ministerial departments, whose staff are civil servants.


Gambling Commission.\textsuperscript{23} Other regulatory bodies with enhanced investigatory and sanctioning powers, including powers to impose fines, include the Office of Fair Trading, Ofcom, Ofgem and Ofwat.\textsuperscript{24} \textsuperscript{25} \textsuperscript{26} \textsuperscript{27} In an important recent development, the Macrory review is proposing to extend the powers to impose regulatory penalties to other regulatory bodies, effectively removing reliance on prosecution as the only means of imposing monetary and other sanctions for non-compliance.\textsuperscript{28}

These developments are part of a general trend in the rise of the regulatory agency in England and Wales, initiated in the 19\textsuperscript{th} century.\textsuperscript{29} The ‘Victorian revolution in government’, manifested in the development of inspectorates, commissioners and boards to carry out an increasing range of regulatory tasks, was described over 50 years ago as marking the growth of the ‘regulatory state’.\textsuperscript{30} Concern at the excessive fragmentation within central government, not least through Parliamentary pressures for increased control over the administration, led in turn to the rise of departments in the early 20\textsuperscript{th} century.\textsuperscript{31} Inspectorates, commissioners, operational and marketing boards continued to exist, however, and by the 1960s the pendulum had swung back again in favour of giving such bodies greater

\begin{itemize}
  \item \textsuperscript{23} Gambling Act 2005.
  \item \textsuperscript{24} Enterprise Act 2002.
  \item \textsuperscript{25} Communications Act 2003.
  \item \textsuperscript{26} Utilities Act 2000.
  \item \textsuperscript{27} Water Act 2003.
  \item \textsuperscript{29} MacDonagh O (1958), The Nineteenth Century Revolution in Government: A Reappraisal, 1 (1) Historical Journal, 52.
  \item \textsuperscript{30} Greaves H R (1949), The Civil Service in the Changing State, Harrap. Greaves distinguishes three stages of development in the civil service: the ‘oligarchic maladministration and interfering paternalism’ of the 18\textsuperscript{th} century; the ‘regulatory state’ of the 19\textsuperscript{th} century, and the ‘social service democracy’ of the 20\textsuperscript{th} century.
  \item \textsuperscript{31} Wilson F M G (1954), Ministers and Boards: Some Aspects of Administrative Development since 1832, 32 Public Administration 43.
\end{itemize}
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operational independence from central government.\(^{32}\) Although it was the wave of privatisations in the 1980s which drew political, and academic attention, to regulatory agencies, it had been the 1960s and 1970s which saw the renewed move to establish regulatory bodies. Many of these were themselves mergers or re-formations of existing bodies, and some have continued to exist in almost unmodified form, for example, the Civil Aviation Authority (1972) and the Health and Safety Commission and Health and Safety Executive (1974), or only recently modified, such as the Gaming Board (1964) which reformed as the Gambling Commission in 2005; the Independent Television Commission (1954) which merged into Ofcom in 2003, and the Commission for Racial Equality (1976) and the Equal Opportunities Commission (1977), which will merge and transform into the Commission for Equality and Human Rights in 2007.

It was the creation of regulatory agencies for the privatised industries, together with the development of the next step agencies and other aspects of the managerial reforms of the 1980s and 1990s and the increasing role of the EU in setting standards, which prompted the analysis of the hollowing out of the state.\(^{33}\) Hollowing out referred to the change in the delivery of public services through the increased use of executive agencies, contracting out, and the creation of quasi-markets; privatisation; the increased role of the EU in determining public policy; and the development of the new public management. Since then there has been a constant debate over the extent to which the state has been hollowed out, and on the nature, trajectory and effectiveness of the new public management reforms both in the UK and elsewhere.

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\(^{32}\) Fulton Committee (1967), The Report on the Committee on the Civil Service, Cmnd 3638, HMSO.

The pervasiveness of decentred regulation

How do these developments in the regulatory state fit with the decentred analysis of regulation? ‘Decentred’ regulation is at its simplest a counterpoint to the notion that regulation is something delivered by the state through the use of legal rules backed by (often criminal) sanctions: command and control or CAC regulation. At its simplest, the institutional aspects of the decentred analysis observe that regulators may operate at a transnational, supranational, national or sub-national level, and boundaries between regulator and regulated might shift. Both regulators and the regulated may be governments, formal or informal associations, firms, individuals, and play other roles: professional advisors, accreditors, auditors, non-governmental organisations, charities, voluntary organisations, and so on. Regulation in these analyses is thus not simply an activity carried out by the state using laws backed by sanctions; it is a broader enterprise consisting of sustained and focused attempts by state or non-state actors to govern the behaviour of others using a range of strategies with the intention of producing a broadly identified outcome or outcomes.34

Central to the decentring analysis, as to the broader governance debate, is the polycentricity of regulation and its hybridity; its combination of state and non-state actors. There is ‘regulation in many rooms’, and not all of them are state-based. Critically, this polycentricity is a characteristic which pervades regulatory regimes: in other words, a single regulatory regime (food, health and safety, environment, reproduction, financial services, broadcasting, corporate governance) is characterised by the complex and dynamic interaction of a number of regulatory actors, both state and non-state, even at the national level.

Examples exist in almost any area of regulation (O’Rourke, 2003). The complexity is enhanced as the analytical focus moves to the transnational level. Indeed, international lawyers and political scientists are experiencing their own governance turn: networks, hybridity and complexity are all features of (the analysis of) the ‘new world order’.

Four dominant characteristics of decentred regulatory regimes quickly become apparent when one tries to analyse the nature of relationships which exist between participants: the sheer number and variety of regulatory actors involved; the mutual dependence that often exists between regulators (both governmental and non-governmental) in any one regulatory regime; the frequent inversion of the assumed hierarchy of governments and governed (governments are governed as much as they themselves seek to govern) and that in any regulatory regime, different actors have different capacities to regulate, and perform different functions.

In order to illustrate at least the institutional complexity of decentred regulation, we will focus here on the latter characteristic, differential regulatory capacities. It is suggested that understanding this institutional complexity, as well as some of the dynamics of regulatory regimes, can be furthered if we use the notions of enrolment and of regulatory capacity. Actors within regulatory regimes can seek to exploit the differential regulatory capacities of other actors to enhance the effectiveness of their own regulatory efforts, and if there is sufficient coordination, of the regime as a whole. Much more can be said

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36 See, for example, Slaughter A M (2004), A New World Order, Princeton University Press.
on the notion of regulatory capacity, but it is here defined as the possession of resources such as expertise, legitimacy and strategic position, and embeddedness in an institutional structure which is such that those resources will be used to achieve the aims of those enrolling.37

Regulatory capacities are enrolled through inter-linkages between actors in the regulatory regime. Enrolment expresses a relationship of power between actors: an actor can enrol another to achieve the former’s aims.38 Through inter-linkages with other actors, enrolment can, at best, enhance the capacity of another regulatory actor. The significance of interlinkages in enhancing regulatory and governance capacity has been noted in the literature on governance, on the sociology of control, and on regulation, particularly at the transnational level (Stirton and

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Lodge, 2002; Braithwaite, 2006). Sometimes described as ‘webs’, more frequently as ‘networks’, the significance of such interlinkages is that they enhance the capacity of any one actor to achieve its goals. Much of the analysis stems from Granovetter’s seminal argument on the ‘strength of weak ties’. Linkages between actors that are relatively weak in terms of mutuality, time, and degree of reciprocity may nonetheless serve a cohering function, and the more an individual is embedded in a network of weak ties, the more their capacity for action may be enhanced. Whether or not capacity is in fact enhanced, however, depends, as institutionalist analyses remind us, on the institutional structures in which the networks are in turn embedded (Stirton and Lodge, 2002; Black, 2003).

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41 Braithwaite J and Drahos P (2000), Global Business Regulation, OUP.

42 At the EU level see, for example, Eberlein B and Grande E (2005), Beyond Delegation: Transnational Regulatory Regimes and the EU Regulatory State, 12(1) Journal of European Public Policy, 89; Christou G and Simpson G (2006), The Internet and Public-Private Governance in the EU, 26(1) Journal of Public Policy, 43; at the transnational level see, for example, (Slaughter, 2004); Risse-Kappen T (1995), Introduction: Bringing Transnational Relations Back In, in Risse-Kappen T (ed), Bringing Transnational Actors Back In: Non-State Actors, Domestic Structures and International Institutions, New York, CUP.

43 Granovetter M (1973), The Strength of Weak Ties, 78(6) American Journal of Sociology, 1360.
Analysing decentred regulation in terms of enrolment

Many regulatory regimes at the sub-national, national and transnational level can usefully be analysed in terms of enrolment of the differential regulatory capacities of actors in that regime. A regulatory regime is the set of interrelated units which are engaged in joint problem solving to address a particular goal, its boundaries are defined by the definition of the problem being addressed, and it has some continuity over time. Different actors are enrolled by other actors within a regulatory regime to perform different regulatory functions. Enrolment can be voluntary or involuntary, formal or informal. Governments may enrol others, or themselves be enrolled. Relationships between governments and non-governmental actors in a regime are often termed ‘co-regulation’, a useful label but one which can obscure the variety of interrelationships that may exist.

Governments may enrol the regulatory capacities of regulators who are performing the full range of regulatory functions: formulating goals, setting rules/standards; monitoring compliance and using a range of strategies to change behaviour. Enrolment may be simply through giving a non-legal mandate to a regulator to operate, such as with the Panel on Takeovers and Mergers or the Press Complaints Commission, or a legal mandate, as with the professions. It may merely be through a threat to regulate, or through encouragement to non-governmental actors to regulate, for example the encouragement by the EU of non-governmental regulation of content on the internet (Newman and Bach, 2004).

Conversely, non-governmental actors can enrol governmental actors in their regulatory regimes, through seeking adoption of their rules in legal form within that country; for example Human Rights Watch produces reports on human rights violations in an

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attempt to get governments to reform. However, non-
governmental actors may find their rules are enrolled in
governmental regulatory regimes without them necessarily
seeking or agreeing to this arrangement. For example, the EU
now requires all member states to comply with the rules of the
transnational, non-governmental International Accounting
Standards Board (IASB).45

Government may also co-ordinate its regulatory activities with
non-state regulators in a manner which is intended to facilitate
and support the non-state regulator. In the UK, one example is
the regulation of advertising of medicines to the general public
and to health professionals. The regulatory regime consists of a
combination of governmental and non-governmental regulators
at EU and national level. Pharmaceuticals advertising and sale to
health professionals is regulated under EU directives, transposed
into UK law and administered by the Medicines and Healthcare
Products Agency (MHRA).46 It is also regulated under self-
regulatory codes formulated and implemented by the Prescription
Medicines Code of Practice Authority (PMCPA), an independent
division of a trade association, the Association of the British
Pharmaceutical Industry (ABPI), the Advertising Standards
Authority and the Proprietary Association of Great Britain (for
over the counter medicines). The ABPI Code is binding on all
members of the ABPI, and a further sixty companies comply
voluntarily. Under a memorandum of understanding agreed
between the MHRA and the PMCPA, where a complaint is
presented to the MHRA which does not involve a breach of the
legislative requirements, and concerns a company which has
agreed to abide by the Code, the MHRA will refer the complaint

45 Regulation EC 1606/2002.
46 The MHRA is an executive agency of the Department of Health.
to the PMCPA to see if it breaches the Code. However, where a company declines the jurisdiction of the PMCPA or is expelled by the ABPI, the MHRA agrees to take over consideration of the complaint. Thus each regulator aims to be a backstop to the other to provide a mutually reinforcing regulatory regime.

Governmental regulators can also outsource their regulatory functions to non-governmental actors (O’Rourke, 2003). For example, Ofcom has outsourced its responsibilities for regulating advertising on the broadcast media to the Broadcast Committee of Advertising Practice (BCAP) and the Advertising Standards Authority (ASA). Under a memorandum of understanding, the BCAP will develop and monitor compliance with standards for advertising, and the ASA will handle and resolve complaints under the Code.

In trying to impose some analytical order on the myriad of relationships which exist, we can think initially in terms of the functions or the roles that different actors are performing within a regulatory regime (Black, 2003). There are broadly three interrelated functions that have to be performed in any regulatory regime: defining goals and setting rules or standards; gaining/certifying information on compliance with those standards; and changing behaviour to achieve the defined goals (this is a modification of Hood et al, 2001). In the examples given above, governmental regulators are enrolling non-governmental actors to perform all of these functions. But


As the Code extends beyond the legal requirements, it is possible that a promotion can be in compliance with the law but not the Code; the aim of the Code however is that compliance with the Code is also compliance with the law.

enrolment can be ‘unbundled’ – actors can be enrolled to perform just one or part of these functions.

**Enrolment and rule making/standard setting**

Governmental actors can enrol the standard setting capacities of non-governmental actors. As noted above, the EU has in effect enrolled the International Accounting Standards Board to formulate accounting standards for EU member states by requiring those states to comply with the IASB’s rules. In environmental regulation, the EU encourages firms to adopt a non-legal standard of environmental management: EMAS (Eco-Management and Audit Scheme). After a brief period where it differentiated itself from other standards, EMAS now incorporates the environmental management standard ISO 14001, formulated by the transnational, non-governmental standard setting body, the International Standards Organisation. At the national level, the UK Environment Agency encourages firms to adopt EMAS through bureaucratic incentives: firms that comply with EMAS will be regarded as posing lower risks under the Agency’s risk based rating framework, and thus will receive fewer inspections.

In financial services, the Financial Services Authority has delegated responsibility for setting rules on the disclosure of commission arrangements between fund managers and brokers relating to deals for institutional investors to a group of trade associations representing dealers, managers and pension funds. It will have regard to compliance with the rules in determining whether a firm has breached its own rules. It is currently consulting on extending this model to other areas. In regulating

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50 Investment Management Association Pension Fund Disclosure Code, drawn up with the London Investment Banking Association and the National Association of Pension Funds - FSA Confirmation of Industry Guidance DP06/05 (FSA, November 2006).
money laundering, the FSA has recently deleted most of its own rules on money laundering from its rule book, and now relies instead on provisions in statutory instruments and on rules produced by the non-governmental Joint Money Laundering Steering Group, which is comprised of the major financial industry trade associations.\(^51\)

Transnational regulation is frequently characterised by a complex system of enrolment of rule makers across national and transnational boundaries. Transnational standard setters can be groups of governmental regulators, such as the Basle Committee of Banking Supervisors, or be non-governmental actors, such as Transparency International, the Internet Engineering Taskforce, the International Swaps Dealers Association, or some combination.\(^52\)\(^53\) In banking, the BCBS relies on national governments to implement its standards, and national governments can use BCBS rules to define their capital adequacy rules: each enrolls and is enrolled by the other. It is important to note that governmental regulators can thus be both the authors and the recipients of the rules in a very direct sense: they sit on the committees which form the rules which they in turn implement.

Whilst there are many examples where governmental regulators will enrol non-governmental rules or standards, there are also plenty of examples where they do not. In the chemical industry, for example, many firms, particularly large firms, are part of the Responsible Care initiative, a transnational, industry-based regime governing the health, safety and environmental management norms and practices of the chemical industry,

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\(^{51}\) FSA, Reviewing our Money Laundering Regime PS06/1 (FSA, 2006); Joint Money Laundering Steering Group, Prevention of Money Laundering/Combating the Financing of Terrorism, Guidance for the UK Financial Sector, January 2006 available at http://www.bba.org.uk/.


\(^{53}\) Froomkin A M (2003), Habermas@Discourse.net: Toward a Critical Theory of Cyberspace, 116(3), Harvard LR, 751.
accompanied by certification and verification procedures. The UK branch of Responsible Care has developed a detailed set of standards and procedures which large UK chemical companies follow. However the Health and Safety Executive does not take into account these standards in setting its own guidance, nor does it take into account compliance with the Responsible Care regime in its compliance activities. In a finding which illustrates the dangers of assuming that legal norms will always trump other operating norms, the HSE’s own research found that whereas HSE see their own guidelines as the critical guidelines for industry to follow, larger firms did not share this view, rather they were just one of a range of sets of standards they had to comply with. As a result there have been calls to make more use of initiatives such as Responsible Care in promoting HSE goals, for example in promotion of the awareness of the role of human factors in causing accidents in hazardous industries.

Enrolment and gaining information on/certifying compliance

Transnational, non-governmental regulators can rely extensively on third party verification to certify compliance with their regulatory norms, particularly in social and environmental regulation. Well known examples include the Forest Stewardship Council, the Marine Stewardship Council, the Fair Trade labelling initiatives, Rainforest Alliance and the Social


55 Health and Safety Executive (2003), The Promotion of Human Factors in the Onshore and Offshore Hazardous Industries, Research Report 149, HSE.

56 See, for example, Courville S (2003), Social Accountability Audits: Challenging or Defending Democratic Governance?, Law and Policy, 25(3) pp269-297.
Accountability Initiative. These bodies develop standards at transnational and national levels, and certify others to be accreditors to certify compliance by producers with the standards. Those who are certified can then label their products with the organisation’s label. The regimes thus seek both to create and regulate a market, and rely on consumers and others further up the supply chain taking into account the peripheral attributes of a product (the circumstances of its production rather than the price or the quality of the product itself) in their purchasing decisions.\(^{57}\)

Governmental regulators also rely on non-governmental actors to certify compliance. These ‘gatekeepers’ include the familiar list of lawyers, auditors and actuaries, but certifiers are used in other areas of regulation as well (Gunningham and Grabovsky, 1998, pp408-413).\(^{58}\) All medical devices, for example (although not medicines), are approved by private sector organisations which are recognised for this purpose by the Medicines and Healthcare Products Regulatory Agency.\(^{59}\) An example more familiar to UK consumers is the role of non-governmental bodies in certifying organic food. There are detailed legislative provisions on organic food production, but certification of compliance is conducted by non-governmental organisations, of which the Soil Association is probably the most well known.\(^{60}\)

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\(^{57}\) The Forest Stewardship Council, for example, targets major DIY retailers, as they are the main sellers of timber to consumers. See generally, Meidinger E (2006), The Administrative Law of Global Public-Private Regulation: The Case of Forestry, 17(1) European Journal of International Law 47.


\(^{59}\) Medical Devices Regulations SI 2002/618.

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Governmental bodies can also seek certification themselves from non-governmental regulators. The Forestry Commission, as a manager of woodland and supplier of wood, has sought and gained certification for its wood products from the Forest Stewardship Council. The Environment Agency is accredited under the ISO 14001 standard for its own internal environmental management. Governments are assessed by non-governmental actors for compliance with their norms – Transparency International again provides an example.

Governmental regulators can also facilitate non-governmental regulators by enabling certification with their standards by producers within its jurisdiction. Again in forestry, the Forest Commission has produced a set of standards, the UK Woodland Assurance Scheme, which combine EU and national laws on the sustainable management of forests with the FSC standards, EMAS and the ISO 14001 standards. The Forestry Commission also formulated the UK Forestry Certification Standard for the UK Woodland Assurance Scheme, a voluntary management standard which accreditation bodies and others can use to certify compliance of woodland and forest management under UKWAS. The Standard has been signed by over 300 producer, consumer and environmental groups and has been recognised by the FSC, illustrating the mutually reinforcing, and hierarchy-inverting, relationships that can exist between non-governmental and governmental actors in a regulatory regime. Again, more could be done. The Royal Commission on the Environment, for example, has urged the government to work with industry, producers, retailers and existing standard setters to ensure the

61 See, for example, Scott C (2002), Private Regulation of the Public Sector: A Neglected Facet of Contemporary Governance, 29, Journal of Law and Society 56.
63 See, www.environment-agency.gov.uk/commercial/1075004/399393/1072778
reliability of eco-labelling schemes for fish by developing appropriate standards and auditing procedures.\textsuperscript{64}

Governmental regulators can also take into account assessments made of firms by non-governmental actors and use them for their own purposes, albeit the assessment was made against a different set of criteria. The use of the ratings given to banks by credit rating agencies in establishing capital standards is a good example. Credit ratings agencies (CRAs) rate the credit worthiness of banks according to their own criteria. However, under the new Basle Accord issued by the inter-governmental regulatory body, the Basle Committee on Banking Supervision, which has been adopted by the EU, banking supervisors can take the ratings given to banks into account in setting their own capital requirements.\textsuperscript{65} Becoming enrolled in a regulatory regime can have consequences for the actor itself: as a result of their enrolment into the regime of banking supervision, the international group of securities regulators, IOSCO, has formulated a statement of principles and code of conduct to which CRAs have agreed to comply. In a move which illustrates the potential complex regulatory regimes offer for political forum shopping, this has in effect warded off more formal regulation by the EU, which has contented itself for the moment with monitoring compliance by the CRAs with IOSCO’s code.\textsuperscript{66}

\textsuperscript{64} Royal Commission on the Environment (2004), Twenty-Fifth Report, Turning the Tide: Addressing the Impact of Fisheries on the Marine Environment, Cmd 6392, December.
\textsuperscript{66} IOSCO, Statement of Principles Regarding the Activities of Credit Ratings Agencies (September 2003); IOSCO, Code of Conduct Fundamentals for Credit Ratings Agencies (December 2004), available at www.iosco.org. The Committee of European Securities Regulators (CESR) is to monitor compliance.
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*Enrolment and changing behaviour/attaining regulatory goals*

Governmental and non-governmental actors can enrol other actors in regulatory regimes to facilitate enforcement of the regulatory rules, or in other ways in an attempt to change the behaviour of others. Governmental regulators can lend their legal authority and powers to non-governmental regulators to extend the enforcement capacity of the latter. The non-governmental Panel on Takeovers and Mergers, for example, can ask the Financial Services Authority to take enforcement action against firms that do not comply with the Panel’s Code.67 Conversely, non-governmental actors can be enrolled to extend the enforcement capacity of governmental regulators. This is not a new phenomenon. The NSPCC, for example, has had powers to bring criminal prosecutions under child protection laws since the 1920s. More recently, Which?, formerly known as the Consumers’ Association, a non-governmental consumer campaigning body, has been given powers to enforce provisions under the unfair contract terms legislation.68

Private individuals can bring civil actions to enforce regulatory provisions where their breach has given rise to a breach of contract or tort. In a negligence action the courts can take into account non-legal standards with which the defendant has complied in its assessment of the appropriate standard of care.69 Regulatory regimes, such as for financial services in the UK and Australia, may deliberately confer rights of action on individuals to enable them to take civil actions against firms that breach

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67 FSMA s.143 enables the FSA to endorse the Panel’s rules; if it has done so, the Panel can request the FSA to enforce them.
69 For discussion see Webb K and Morrison A (2004), The Law and Voluntary Codes: Examining the ‘Tangled Web’ in Webb K (ed), Voluntary Codes: Private Governance, the Public Interest and Innovation, Carleton University.
regulatory rules where an action might not otherwise exist.\textsuperscript{70} Private rights to enforce regulatory norms are not limited to national legal regimes. International treaties, for example, can confer rights on private individuals to bring private arbitration actions against governments which they consider are infringing trade agreements, which raises significant issues not least of the accountability of the arbitration regimes.\textsuperscript{71}

Decentred regulation and the problems of control

At its best, the performance of decentred regulation can create synergies between regulatory actors, enhancing the capacity of each. However it also poses a number of challenges, not least for governmental regulators. At least six key challenges can be identified, though the nature of the challenge varies with the participant/observer. These are the challenges of implementation, control, accountability, technisation/fragmentation, the complexity of compliance, and, for law, the challenges of legal pluralism. Much has been and can be said on each of these. This chapter focuses on the first two challenges: implementation and control.

From a governmental perspective, decentred regulation is unsettling as it involves a loss of control, or more accurately, a recognition of the limits of government’s ability to control. Attempts to design and implement regulatory regimes which involve a formal recognition and enrolment of the regulatory capacities of non-governmental actors are frequently exhorted by parts of government, but can be difficult to implement in

\textsuperscript{70} FSMA s.150.
practice. For example, it is fashionable to talk of government ‘meta-regulating’ others’ attempts to regulate, both at the level of individual firms, and more generally to regulate the collective regulatory activities of others (Braithwaite, 2000).

But meta-regulation is harder than its proponents sometimes suggest. The experience of meta-regulation in financial services regulation in the 1980s-1990s was one of complexity, duplication, regulatory in-fighting and ultimately, in some areas, ineffectiveness. The institutional structure proved unstable, and was replaced by a single statutory body (albeit elements of meta-regulation remain, and the FSA has engaged in various strategies of enrolment, as illustrated above). The current debates on the powers and structures of the proposed Legal Services Board illustrate how hard it can be for governments not to seek powers to control, and how difficult it can be to design and implement meta-regulatory strategies in which the tension between regulatory autonomy and meta-regulatory control is such that a stable institutional equilibrium can be maintained in practice (department of Constitutional Affairs, 2005 and 2006). Disputes between the General Medical Council and its overseer, the CHRE, illustrate similar difficulties in the operation of meta-regulation.

Even the performance assessment processes of policy makers can present obstacles to the strategic development of smart regulatory strategies. Baldwin has argued, for example, that the Cabinet


74 Jessop B (2004), Multi-level Governance and Multi-level Metagovernance, in Bache I and Flinders M (eds), Multi-Level Governance, OUP.

75 Black J (1997), Rules and Regulators, OUP.

Office requirement that each policy proposal is to have a regulatory impact assessment (RIA) may well itself operate against the use of the smart regulatory techniques that are simultaneously being advocated.77 The RIA is the centrepiece of the ‘better regulation’ approach, but it is arguably more attuned to measuring the effects of traditional command systems of regulation than the hybrid techniques of smart regulation, and to measuring the effects of a single strategy rather than a combination of strategies. Moreover the bureaucratic disincentives to opt for smart regulation are significant (Baldwin, 2005). So while the government may be attracted by the rhetoric of pushing regulation out beyond the state, Baldwin argues that in practice the attractions of rationalised, streamlined institutional structures and enhanced governmental control over non-state bodies are moving it towards increased centralisation.

The dispersal of regulatory power even just within the state, from departments to agencies, for example, has placed a strain on the capacity of the core executive to co-ordinate and control, or steer, these regulatory bodies, in the UK and elsewhere (see for example, OECD, 2001). The core executive has responded to the dispersal of the state’s regulatory functions to independent regulatory bodies mainly by enhancing its practices of ex-post review. This is part of a more general trend in new public management – the replacement of ex-ante control with ex-post reviews, coupled with an expansion in the role, and personnel, of the core executive in conducting these reviews. The hollowing out of the state is thus being accompanied by a ‘thickening at the centre’: an expansion and enhancement of the role of the core executive, notably the Treasury and the Cabinet Office, in monitoring and attempting to direct the activities of regulators to

whom it nonetheless wants to give a reasonable degree of operational autonomy (Flinders, 2002).\textsuperscript{78}

In their detailed study of regulation inside government, Hood and co-authors drew on the grid/group analysis of cultural theory to distinguish four types of control: mutuality, competition, contrived randomness and competition (Hood et al 2004 and 2006). Control can be of any of these four types individually or in combination. Mutuality denotes control of individuals by formal or informal group processes, whether by deliberate design or otherwise. Mechanisms such as peer reviews, or group decision making processes, or the operation of informal institutional norms can be examples of control through mutuality. Competition denotes control of individuals by processes of rivalry: for career advancement, budgets or remits, and can be promoted through, for example, league tables and other systems of individual or institutional performance rating. Contrived randomness denotes control of individuals by more or less deliberately making their lives unpredictable in some way, through random audits or inspection, for example (control strategies that link randomness with oversight). Finally, oversight denotes scrutiny and steering from some point above or outside the individuals in question. Overseers include reviewers, monitors, inspectors or regulators that are to some degree detached from line management structures within executive government organisations (Hood et al, 2006, pp6-13).

Hood et al’s work focused primarily on public service providers: prisons, schools, higher education institutions, and the elite civil service. Whilst these organisations may have some regulatory functions (for example local authorities), on the whole,

\textsuperscript{78} Following Dunleavy and Rhodes (1990) the ‘core executive’ refers to ‘those organisations and structures which primarily serve to pull together and integrate central government policies, or act as final arbiters within the executive of conflicts between different elements of the government machine’. It is not synonymous with Cabinet: Dunleavy P and Rhodes R (1990), Core Executive Studies in Britain, 68, Public Administration, 3. On the ‘filling in’ of the state, see, Taylor, 2000.
regulation is not their main activity. The control strategies used over regulators by the core executive in the UK are not, at first glance, as varied as those used over these other bodies, and are restricted mainly to various forms of oversight. The reasons for choosing only from this comparatively limited group of control tools is a question for another time, but for now at least four types of oversight tools can be identified: hard law, soft law/codes, self-assessments and audit. Control has been sought over four main aspects of the governmental regulators: remit (unsurprisingly), governance arrangements, finances, and performance.

Control over remit is exercised through the legislative delineation of the regulators’ powers, duties and objectives, and is nothing new; neither are instruments of financial control. What is more recent is control over the governance of regulatory bodies which goes beyond ministerial appointment of the chair and/or members of the Board. In common with the increased regulation of the internal organisation of firms, regulators’ own governance arrangements and operational practices, including the composition and role of audit committees, are being stipulated either in legislation or by reference to codes such as the Code on Public Appointments, the Better Regulation Taskforces’ Principles of Good Regulation, the Enforcement Concordat, and the Code on Corporate Governance that applies to listed companies. The Legislative and Regulatory Reform Act is a further step in this direction, requiring all regulators, not just local authorities, to comply with a new Compliance Code in their enforcement activities, and indeed to only receive enhanced enforcement powers if they can demonstrate compliance.

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79 There are also differences between Whitehall and the devolved administrations. The Welsh Assembly has pulled back some of powers given to outlying agencies and it has been argued that the growth and scale of regulation inside Scottish government is more modest: Midwinter A and McGarvey N (2001), In Search of the Regulatory State: Evidence from Scotland, 79(4) Public Administration, 825.
80 Legislative and Regulatory Reform Act 2006.
There has also been a significant increase in the formal mechanisms of ex-post performance evaluations of state-based regulatory bodies. Managerial tools such as performance service agreements, strategic plans, output and performance measures, and reporting against targets are now a common feature of regulators’ own governance arrangements. The National Audit Office’s role has also expanded from audit to a much broader evaluation of the effectiveness of the powers, organisational structures and operational practices of regulatory bodies.

A decentred regulatory state?

The question has to be asked: does the increased role of governmental regulators in regulating other regulators, both state and non-state, mean that regulation is not decentred? The rise and rise of the governmental regulatory agency, coupled with changed role of the core executive in managing those agencies, certainly challenges the decentring analysis, particularly the more radical versions. In its most radical form, the decentring thesis is underlain by a particular theory of power: that power is dispersed amongst actors, circulating in ways which no single (‘centred’) body has the capacity to command. No one actor in a network of regulatory actors can command or control the whole: heterarchy, not hierarchy, dominates. However, as Hoggett has noted, the danger with this approach is that by focusing on the dispersal of power it draws our attention away from other forms of power which are concentrating within more remote and less visible

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82 See, for example, Hoggett P (1996), New Modes of Control in the Public Service, 74, Public Administration 9.
83 For example, the NAO’s role in reviewing regulatory impact analyses, for example, NAO, Evaluation of Regulatory Impact Analyses HC1305 2005-6 and in assessing the organizational challenges of merging regulatory bodies see, NAO, The Creation of Ofcom: Wider Lessons for Public Sector Mergers of Regulatory Agencies HC1175 2005-6. In Australia see, Scott C (2003), Speaking Softly without Big Sticks: Meta-regulation and Public Sector Audit, 25(3) Law and Policy 203.
centres of corporate and state governance (Hoggett, 1996). The role of governmental regulators, with enhanced legal powers, and the increased attempts by the core executive to exert control over both governmental and non-governmental regulators, suggest that a role for hierarchical relationships of control remains. The control strategies of the core executive may be ineffective, have unintended consequences, or may simply be symbolic attempts to control, but even those most in the grip of the decentred analysis find themselves coming up against them in their own empirical work.\(^4\)

On the other hand, decentred analyses challenge those accounts of the centralisation of the regulatory state which focus almost uniquely on the development of particular organisational structures and reformed public management techniques (Moran, 2003). The regulatory state thesis in particular, with its focus on privatisation and regulatory agencies, suggests that regulation is an entirely state activity performed through independent agencies whose role has only increased. Decentred analyses offer a counterpoint to this image (Moran, 2003).\(^5\) The difference between them is due in part to the fact that the two sets of analyses focus on different institutional levels. Decentred analyses do not focus on a single organisation or type of organisation: a particular governmental regulatory agency or self regulatory body. The focus is on the regulatory domain (environment, food, health and safety), and the analyses operate at the regime level. As noted above, a regulatory regime is the set of interrelated units which are engaged in joint problem solving to address a particular goal, its boundaries are defined by the definition of the problem being addressed, and it has some continuity over time (Hood, Rothstein and Baldwin, 2001, pp9-17). A regime perspective draws attention to the importance of

\(^4\) For example, Kickert W (1995), Steering at a Distance: A New Paradigm of Public Governance in Dutch Higher Education, 8(1), Governance 135.

\(^5\) As Moran notes, there are competing images of the regulatory state; this draws on that of Majone, which is that with which the phrase is usually associated.
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examining the interaction of participants within the regulatory system, both state and non-state, to understanding its operation. Whilst there may be institutional consolidation in one part of the regime, the regime as a whole may still display characteristics of a decentred regulatory regime. Moreover, even though parts of a regulatory regime may look at the institutional level to have become more centred, within that regime different actors can be enrolled in a way that a focus on formal institutional structures overlooks (Black, 2003, 63-91). So a focus on one organisation or type of body may lead to the conclusion that the regulatory state is more centred; but lifting the eyes beyond that bounded horizon reveals a far more complex view.

Finally, rather than negating the decentred analysis, the observation that the state is increasing its attempts at centralised control is its naturally corollary. Either through the establishment of ‘meta-regulators’ to regulate non-state regulators, as in the case of the accounting, medical and legal professions, or through the internal regulation of other governmental regulators, central government is seeking to enhance its steering capacity. As Rhodes noted a decade ago, fragmentation and centralisation co-exist. There is a persistent tension between central government’s wish for authoritative action and its reliance on the compliance and actions of others to deliver on its policies (Rhodes, 1997, p15; Hoggett, 1996). The central executive’s capacity to steer and co-ordinate is at a premium, and the UK government is not alone in focusing on mechanisms to improve control over the political agents of ‘the regulatory state’ (OECD, 2001). Decentred regulation, yes, both within and beyond government, but the tools used to try to steer decentred regulation are still based largely on hierarchically-based strategies of oversight, not withstanding the use of alternative types of strategies to control other parts of government, and are producing, and being produced by, an ever-increasing ‘thickening’ of the centre.
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13 SELECT COMMITTEES AND THE ACCOUNTABILITY OF THE REGULATORY STATE

Lord Norton of Louth

Introduction

Select committees are committees appointed by either House of Parliament (or occasionally by both) to examine particular matters referred to them. They are distinguishable from what have traditionally been called standing committees (known since the start of the 2006-07 session as public bill committees), which are appointed by the House of Commons to consider the detail of bills. These descriptions are, on the face of it, misleading, since they may be taken to imply that select committees are temporary – existing only long enough to consider a particular issue – and that public bill committees, as their old name implies, are permanent bodies.

In practice, public bill committees are permanent only in name and not in membership. Once one has considered a bill, its members are discharged and new members appointed for consideration of another bill. Discussion of amendments and clauses is essentially partisan – seen as an extension of the debate in the chamber on second reading – and the government usually gets its way in any division. Service on these committees has usually been seen as unproductive; members are not usually keen to serve. In historical terms, the regular use of committees to examine bills is a relatively new feature of parliament.

Select committees are of a very different nature. They are well established features of parliament. They were variously
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employed in Tudor and Stuart times.¹ Their use diminished in the late 19th century, as the parties came to dominate parliament – the party leaders in government not being keen on creating critical bodies of scrutiny – but they have recently re-emerged as key features of both Houses. After some experimentation with select committees in the 1960s (and an earlier experiment, in the 1950s, with a Select Committee on Nationalised Industries), the House of Commons in 1979 voted to establish a series of departmental select committees “to examine the expenditure, administration and policy of the principal government departments... and associated public bodies”.²³

Twelve were created, soon joined by two others. Today, there is a select committee for each government department. They are established by standing order and are thus permanent bodies. They have the usual powers of select committees, including to ‘send for persons, papers and records’, that is, to take evidence.⁴ They also determine their own agenda and, unlike public bill committees, seek to work in a bi-partisan manner. Serving on them, certainly the more high-profile committees such as Treasury and Foreign Affairs, is something sought after by members.

The departmental select committees are complemented by a number of other investigative select committees.⁵ Of these, the longest serving is the Public Accounts Committee (PAC),

established in 1861 to ensure that expenditure was properly incurred for the purpose for which it had been voted and in conformity with the relevant act.\(^6\) Most of its time is now given over to value-for-money inquiries. It is also seen as the most influential of the investigative committees, given that it considers reports from the comptroller and auditor general, who heads the eight hundred-strong National Audit Office. More recent creations include the Public Administration Committee, the European Scrutiny Committee and the Environmental Audit Committee.

The House of Lords has also seen a notable expansion in the use of investigative committees, starting with a European Communities Committee – now the European Union Committee, working through seven sub-committees – and then complemented by a Science and Technology Committee in 1979 and a Delegated Powers Committee, now the Delegated Powers and Regulatory Reform Committee, in 1993. In 2001, the House created a Constitution Committee and an Economic Affairs Committee. In the same year, both Houses established a Joint Committee on Human Rights. Two years later, the Lords created a Select Committee on the Merits of Statutory Instruments. The House has also variously made use of its powers to appoint *ad hoc* committees to investigate particular issues, such as BBC charter renewal, scientific experimentation on animals, and religious offences.

These developments are significant, not least in their timing, in relation to the parliamentary accountability of the regulatory state. Though regulators have existed in different forms for many years, the past twenty years have been notable for the number of regulators created by statute in order to engage in rule making or standard setting for different bodies in a range of sectors. The regulation encompasses economic regulation,

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regulation of public goods, and social regulation. Some of the regulatory bodies are extensive in terms of powers, budget and scope. The Environment Agency, for example, is the largest of its kind in Europe and the second largest in the world. Its budget in 2005-06 was £1bn. Other notable agencies include the Financial Services Authority and the Office of Communications (Ofcom). So extensive has the change been that it has been argued that we live in the age of ‘the regulatory state’. This has created a new dimension to the nation’s constitutional arrangements and it creates particular questions in relation to parliament.

Regulators are appointed by statute to exercise powers at arm’s length from government. There are various compelling or persuasive legal, practical, economic and political reasons for this. Some are created as a consequence of EU obligations. They help reduce the burden on government. They may be created to encourage competition, while protecting the consumer. They may help bolster confidence, both among the public and the regulated, by being seen as independent of government. They are in a position where they are likely to deliver greater consistency, and ensure greater knowledge and awareness of what is happening in the regulated sector, than is the case with a busy and diverse government department. Though the logic of creating regulators to encourage competition is that, once competition is achieved, the need for regulators disappears, the reality is that regulation is likely to remain a significant and ongoing feature of the British polity. Regulation is a feature of the modern state.

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This situation creates a particular challenge to parliament. Parliament creates independent regulators and endows them with certain powers, including those to make rules, issue licenses and, in some cases, levy substantial fines. They are created by parliament to implement particular measures of public policy, but to do so at one remove from government. Independence is a necessary feature of the regulatory bodies. Yet at the same time they are bodies implementing public policy, absorbing, and in some cases dispensing, considerable sums of public money, and having a significant impact on commercial (and non-commercial) bodies and the consumer. Independence thus has to be matched by accountability.

In its report on the regulatory state, the House of Lords Constitution Committee identified what it termed 360 degrees of accountability. Regulators, it argued, were accountable to consumers, the public, interest groups, regulated bodies, the courts, the government, and parliament.10 This accountability took different forms, not least in terms of transparency and answerability for what they did. The most important formal accountability, though, was through independent review and scrutiny. Independent review was exercised by the courts. The regulators are creatures of statute and are subject both to the Act establishing them as well as to administrative and EU law. Judicial review, however, is an expensive and lengthy process. The courts are not in a position to exercise regular scrutiny of regulators; they become engaged only when a legal challenge is mounted. Regular and authoritative scrutiny comes through ministers and parliament.

Government is responsible for the legislation creating regulators and for the public policy that they implement. There will be contact between departments and regulators. Occasionally, there is a clash between a minister and a regulator, but generally ministers do not interfere with the work of regulators; to do so would undermine the rationale for having statutory independent regulators. Government itself is answerable to parliament.

10 The Regulatory State: Ensuring its Accountability, para. 48.
There is thus a particular onus on parliament to ensure that regulatory bodies are subject to scrutiny. The place of parliament is not to substitute the judgement of parliamentarians for that of the regulators. Rather, the role of parliament is to determine whether regulatory bodies are working as intended and whether they are operating effectively and efficiently. Regulators may achieve desired outcomes, but in a manner that is inefficient. They may have unforeseen or unintended consequences for consumers or the regulated bodies. Consultation is a desirable aspect of regulators’ activities but the combined effect of consultation by one or more regulators may be unduly burdensome for the regulated bodies. Scrutiny may identify deficiencies in the original legislation, requiring some new measure to remedy it. Parliamentary scrutiny – public examination by authoritative bodies – also contributes to transparency.

Regulators thus come within the ambit of parliamentary scrutiny. To what extent, then, does parliament scrutinise their activities, and with what effect? This is where timing is important. Parliament has acquired the means to engage in sector-specific scrutiny and has done so prior to the emergence of the regulatory state. Fortuitously, departmental select committees were in place, and establishing themselves as a core part of the parliamentary landscape, as parliament began enacting measures creating a swathe of independent regulators. The means for scrutiny were thus in place. One may infer from the foregoing discussion of select committees that each regulator would be covered by one or more committees and that the PAC would be in a position to ensure some degree of overall oversight. How valid is this inference?

We can consider scrutiny at two levels – the individual and the collective – and in doing so we identify an apparent paradox. On the face of it, there is considerable scrutiny by the different bodies identified earlier. Baroness Young of Old Scone, Chief Executive of the Environment Agency, said in her evidence to the Lords Constitution Committee: “In fact we regard ourselves
almost as accountable to everybody, sometimes too many people”. In terms of parliamentary scrutiny, each regulatory body does indeed fall within the remit of one or more committee and may be the subject of a full-scale inquiry. For the individual regulator, therefore, parliament is a significant part of the scrutinising milieu. However, regulators collectively, as a particular species of institution, have not been subject to such scrutiny. Up to 2006, regulators fell within the existing means of scrutiny, but the regulatory state did not.

Regulators

Each regulatory body has a particular remit which puts it within the purview of one or more select committees. Each will fall within the reach of a departmental select committee as well as usually one or more of the over-arching committees, notably the Public Accounts Committee. There are thus parliamentary bodies with the formal capacity to scrutinise the work of regulatory bodies in their sector. In 2002, the House of Commons agreed principal duties for select committees. These included “taking evidence from independent regulators and inspectorates”. There is thus the capacity for scrutiny and some expectation that it will be utilised. How effectively has it been utilised?

The extent of scrutiny is limited. Select committees receive material from regulators – some have a statutory duty to lay an annual report before parliament – but the number of occasions when committees engage in a formal inquiry into the activity of regulators is a relatively small one. A Hansard Society study of committee reports covering two sessions found that, of 258 reports published by select committees, only 21 dealt with

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11 The Regulatory State: Ensuring its Accountability, para. 49.
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regulators.\textsuperscript{13} An examination of the reports issued by select committees in the first session of the new parliament elected in 2005 reveals a similar, though proportionately slightly more positive, picture. Up to the summer recess in 2006, departmental select committees issued a total of 99 reports (excluding special reports, usually government responses to reports); of these, fourteen covered regulators or touched upon the role of regulatory bodies. Of 57 reports published by the Public Accounts Committee, four covered or drew upon the evidence of regulators. None of the reports issued by other investigative select committees covered regulators at all.

What this suggests is that the bottle of parliamentary scrutiny for regulators is only a quarter to a half full. There is some scrutiny and some of the reports are substantial pieces of work. Some address directly the work of regulators. The Environment, Food and Rural Affairs Committee in the 2005-06 session, for example, decided that, ten years after the creation of the Environment Agency, it was opportune to examine the Agency’s effectiveness and funding, as well as its relationship with the Department for the Environment, Food and Rural Affairs and other key bodies.\textsuperscript{14} It took evidence from a range of witnesses as well as receiving more than seventy written submissions. It also investigated the Rural Payments Agency. Regulators were the subject of inquiry by, or gave evidence to, six other select committees.

Furthermore, there is always the possibility that a committee may decide to examine the activity of a regulator. That has the potential to create a considerable deterrent effect. Regulators may be wary of engaging in an exercise that they feel they could not justify if called before a select committee. They also know that a committee inquiry is not likely to be confined to taking

\textsuperscript{14} Environment, Food and Rural Affairs Committee, House of Commons, The Environment Agency, Seventh Report, Session 2005-06, HC 780-I.
evidence from the regulator. Representatives of the regulated bodies as well as consumers are likely to be called and, even if not called to give oral evidence, may submit written evidence. The call for evidence may elicit, and serve to identify, a particular body of concern.\footnote{15}

However, there is clearly evidence that the scrutiny bottle is at least half empty. Most departmental select committees undertook inquiries in the 2005-06 that did not engage with the regulators. As we have seen, only a minority of the reports emanating from committees dealt with or drew upon regulatory bodies. Most regulatory bodies escaped parliamentary scrutiny. A few, however, were very much the subject of parliamentary concern. The nature of select committees means that it is possible for some regulators to escape scrutiny and for others to be called upon by more than one committee. There is no formal coordination between committees. Two may thus engage in inquiries that cover the same regulatory body. Where there is overlap, one committee may leave it to the other; if both take the same view, there is no scrutiny. Where both decide to pursue inquiries, regulators may be in great demand. Some regulators may thus find themselves hard pressed in a session by having to give evidence to more than one parliamentary committee.

In 2005-06, for example, the Environment Agency had to prepare for the Environment Committee’s inquiry into its activities. It was also the subject of a report by the Public Accounts Committee on the efficiency of water resources management. It gave evidence to the Trade and Industry Committee in its inquiry into the future of nuclear energy and provided written evidence to the same committee in its inquiry into the work of the Nuclear Decommissioning Authority (NDA) and UK Atomic Energy Authority (UKAEA). The Financial Services Authority gave

\footnote{15 When the Lords Constitution Committee invited evidence in its inquiry into the regulatory state, a disproportionate number of responses came from the financial sector, especially independent financial advisers expressing concern about the Financial Services Authority. See The Regulatory State: Ensuring its Accountability, Appendix 8, Table 2, p90.}
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evidence to the Treasury Committee in two of its inquiries (on European financial services regulation and on the design of the National Pensions Savings Scheme and the role of financial services regulation). The Strategic Rail Authority and its successor, the Office of Rail Regulation, falls within the departmental remit of the Transport Committee but was engaged in giving evidence to the PAC on the South-Eastern Passenger Rail Franchise and maintaining and on improving Britain’s railway stations.

Parliamentary scrutiny is thus sporadic – some regulatory bodies are examined, others are not – and sometimes skewed; some regulators may be hard pressed to produce evidence for a number of committees in one session, while others are not troubled at all. There is scope for overlap, especially between the work of a departmental select committee and the PAC.

That there is not more systematic scrutiny, despite attempts by the Commons to ensure that it is a regular feature of committee work, is not that surprising. The remit of committees can be considerable. A full-scale inquiry may take up most of a session, yet cover only a small part of the remit of the relevant department. Even if a committee seeks to examine the main regulators within its sector, there may be a gap of several years before it can return to the same regulator. Even if each committee devoted considerable time each year to regulators, they would still have to be selective. However, most do not choose to devote a great deal of time. Regulation is but one subject that has to compete with others for the attention of committees. The duty to take evidence from independent regulators is but one of eleven agreed by the House. Departmental select committees, as we have seen, were established to examine the expenditure, administration and policy of government departments and associated public bodies. For political reasons, they prefer to focus on policy: this is more politically salient and likely to attract media attention. If regulators engage in activities that are controversial, then they may be the subject of committee inquiry. If they are working
away from the realms of public controversy, then they may escape parliamentary attention.

In short, parliament has the capacity to scrutinise the activity of regulators, but it exercises that capacity on a sporadic basis. There is some scrutiny – and the reports from committees can be substantial, educative and influential – but it is far from comprehensive.

The regulatory state

Parliament may have the capacity to examine regulatory bodies but, prior to 2006, it lacked the capacity to engage in consistent scrutiny of the regulatory state. Collectively, regulators have a major impact on society and the economy, yet there was no means of looking holistically at what they do.

The regulatory state has grown in an unplanned way. Regulatory bodies have been created to fulfil specific tasks. Though there are some discernible trends – for example, from individual regulators (Director Generals) to boards (regulatory authorities) – there is no generic legislation covering their activities. Some are subject to the same powers – the energy, postal and water regulators, for example, are now required to have regard to government guidance on social and environmental objectives – but they are usually created as specific, free-standing entities, with differing powers, and, indeed, differing status. Some are established as non-ministerial departments, some are public corporations, and some are executive non-departmental public bodies. The regulatory state thus comprises a mass of differing bodies, with differing powers and differing relations with government. Over time, more regulatory bodies have been created; some have been merged into major regulatory bodies (such as Ofcom). The result has been a significant growth in regulation. Each regulator, as we have seen, is subject to scrutiny by a parliamentary committee. However, as the regulatory state emerged, there was no committee vested with
The closest that a committee came to having the capacity to examine the regulatory state was the Public Accounts Committee. Most regulators come within its purview. However, there are two limitations. First, it is not comprehensive in its coverage. Public corporations and nationalised industries fall outside its remit. The Civil Aviation Authority and the Financial Services Authority also are excluded from its remit (the Lords Constitution Committee recommended that they should come within its remit, a recommendation resisted by the Government, although the Treasury has now invited the NAO to carry out a review of the FSA). Even if its coverage was comprehensive, it would be limited in that it is concerned with financial accountability. Though value-for-money investigations have considerably extended the scope of the committee, it cannot go beyond such investigations. Furthermore, its broad responsibilities mean that it has limited capacity itself to examine regulators. As we have seen, they are the concern of only a minority of the reports published by the committee.

Parliament has thus lacked a committee with the capacity to engage in over-arching scrutiny of the regulatory state. The nearest exception prior to 2006 was the Lords Constitution Committee. It could look at the regulatory state in the context of the nation’s constitutional arrangements. It addressed the issue of the accountability of the regulatory state in a year-long inquiry.

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16 Select Committee on the Constitution, House of Lords, The Regulatory State: Ensuring its Accountability: The Government’s Response, Twelfth Report, Session 2003-04, HL Paper 150, paras. 51-7. The Commons Transport Committee in its 13th report of 2005-06 also recommended that the NAO should have access to the CAA.
in 2003-04, the first ever comprehensive review of its kind.\(^{17}\) However, given its broad remit, it recognised that it could not engage in regular scrutiny of regulation (the report on the regulatory state was but one of 33 reports published in the first three years of its existence). It recommended therefore that there should be a dedicated committee on regulation. After weighing the evidence it had taken, it felt that a joint committee of the two Houses would be appropriate, drawing on the strengths of both Houses. It considered that with expert staff at its disposal, such a committee would be able to engage in consistent scrutiny through examining annual reports and Regulatory Impact Assessments. It would be in a position to look at standard setting across the regulatory state, promote good practice and offer advice on legislation designed to create or amend regulatory powers. It would also be in a position to address whether regulation is guided by the OECD check list for regulatory legislation and decision making and the principles of better regulation adumbrated by the Better Regulation Task Force (now the Better Regulation Commission).\(^{18}\)

A joint committee, in the view of the Constitution Committee, would serve to complement the work of departmental select committees rather than constitute a substitute for it. The departmental select committees would continue to examine the work of particular regulators; the regulation committee would take a more pervasive view of regulation \textit{qua} regulation. The Constitution Committee did, however, recommend that departmental select committee scrutiny of regulators should be focused on annual reports and published Regulatory Impact Assessments in order for the scrutiny to be more consistent and co-ordinated.

In its response to the Constitution Committee’s report, the government noted that the proposal for a joint committee was an

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\(^{17}\) The Regulatory State: Ensuring its Accountability. The evidence given to the committee was published as HL Paper 68-II.

\(^{18}\) The Regulatory State: Ensuring its Accountability, para. 201. See also paras. 139-42.
issue for parliament rather than government. The ball was thus in parliament’s court. In the event, parliament – or at least the House of Lords – decided to pick it up and run with it.

A committee on regulation

The Lords Constitution Committee placed its recommendation for a dedicated regulation committee before the Liaison Committee of the Lords, the body charged with making recommendations on the appointment of select committees. The chairman of the Constitution Committee, Lord Holme of Cheltenham, wrote to the Liaison Committee in July 2005 reiterating the points made in the committee’s report:

“The most urgent need for reform is in the area of parliamentary scrutiny. In our view, it is not simply a question of regulators having to be answerable to parliament, but also the need for parliament proactively to ensure that its scrutiny is effective. At present, parliamentary scrutiny is fragmented and inconsistent, dependent on individual committees deciding to investigate a particular regulator or regulatory decision. In the absence of formal mechanisms, consistent and coherent scrutiny of regulation is not possible”.

19 It did, though, sound less than enthusiastic, stressing that scrutiny should play a central, but proportionate, role in the accountability mechanisms faced by regulators, adding: “The House Authorities will need to consider carefully what additional scrutiny would be achieved over and above that of the Departmental Select Committees and the NAO (where this applies)”. The Regulatory State: Ensuring its Accountability: The Government’s Response, para. 50.

Lord Holme, accompanied by his predecessor as chairman of the Constitution Committee (this writer), appeared before the Liaison Committee to speak to the memorandum. The committee recognised the case but was somewhat ambivalent in the report it made to the House. “While some members of the Liaison Committee thought that the subject was important, the Committee continues to be reluctant to commit resources to the establishment of additional permanent sessional committee”.21 Nevertheless, it agreed that inquiry should be made informally of the Commons as to the desirability of setting up a joint committee. When, after nearly a year there had been no response from the Commons, Lord Holme wrote again to the Liaison Committee suggesting that – as the absence of any response from the Commons suggested a lack of enthusiasm on their part – that a Lords select committee be established.22 He noted that, as the BBC Charter Review Committee established by the House was coming to the end of its tenure, it could be replaced by a Committee on Regulation (thus addressing the concern about resources voiced by the Liaison Committee in its first report). He, along with this writer, were again invited to appear before the Liaison Committee to make the case for a dedicated Lords Committee. Having received requests to establish committees on broadcasting and on a Civil Service Act, the committee also invited the peers making these proposals to attend to make their case.

In the event, the recommendation for a committee on regulation was the one that was favoured by the Liaison Committee. In its second report, it adopted a far more positive tone than in its first report. It was, it said, attracted to the proposal.

“The remit of such a committee would be cross-cutting, dealing with important issues that are not dealt with thematically by any committee of the House of Commons. It was made clear to us that the

21 First Report, 2005-06, para. 6.
SELECT COMMITTEES

proposed committee would not seek to consider statutory regulation in the broader sense but only in the context of the regulatory bodies. Accordingly, the Committee recommends the establishment in the autumn of an ad hoc committee on the regulatory process, to be known as the Select Committee on Regulators”\textsuperscript{23}

When the report was debated by the House on 14 June, the failure of the Liaison Committee to recommend a broadcasting committee encountered opposition (and was referred back), but the proposal for a committee on regulators was approved without anyone, other than the Chairman of Committees in moving the motion, making reference to it\textsuperscript{24}

The start of the new parliamentary session for 2006-07 thus saw a new committee join those operating in the Upper House. The twelve-member Committee on Regulators was appointed on 23 November under the chairmanship of former minister, Lord McIntosh and Haringey. The following month it announced it was conducting an inquiry into the working methods and effectiveness of the UK’s major economic regulators. The inquiry would encompass the impact of regulators on competition within their industry and on the UK’s economic competitiveness internationally. The committee made clear that it would also examine regulators’ effectiveness in protecting the interests of consumers and what further steps exist for better cooperation between regulators. It was interested to learn what British regulators could learn from international regulatory models.

\textsuperscript{23} Liaison Committee, Second Report, 2005-06, para. 7.
Conclusion

The growth of the regulatory state over the past twenty years has been a significant element of constitutional change in the United Kingdom. Parliament already had in place committees that had the power to examine the activities of each regulatory body. That power has been variously employed, so much so that on occasion some regulators have been hard pressed to meet the demands placed on them by select committees.

Parliamentary scrutiny has nonetheless been disparate. Some regulators have been the subject of more regular attention by committees than others. There is no systematic schedule of review. Scrutiny of individual regulators has nonetheless been more substantial than parliamentary oversight of the regulatory state. Parliament has had no mechanism in place to examine regulators collectively and on a regular basis. The committee with the remit to look across the board at most regulators is the Public Accounts Committee, but with over fifty reports a year from the comptroller and auditor general to consider – each usually allocated one session of the committee – it does not have the time to examine the regulatory state on a comprehensive and ongoing basis. Its remit, furthermore, is not comprehensive.

The situation has changed, however, as a result of the actions of the House of Lords in agreeing to establish an *ad hoc* Committee on Regulators. The committee benefits from the particular strengths of the House, one of the arguments made for its creation by various witnesses, such as Clare Spottiswoode, in evidence to the Constitution Committee. As Ms Spottiswoode noted, it is “where members may have a professional background in the relevant areas, and where politics is less of a driver” (this latter point may also be relevant in explaining the lack of interest on the part of the Commons in establishing a joint committee).

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26 The Regulatory State: Ensuring its Accountability, para. 196.
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The Lords has members who are, or have been, regulators, who have served on regulatory bodies, have run or been involved in regulated bodies, as well as those who have been ministers with responsibility for dealing with regulators and experts in the fields covered by regulators. Lords committees also enjoy some degree of continuity in membership.

The start of the 2006-07 parliamentary session represents a considerable step forward in parliamentary scrutiny of the regulatory state. Though the new Select Committee on Regulators is not a sessional (in effect, a permanent) committee, it has the opportunity to prove its worth. Its proposers envisage that, if it does so, it may be converted to the status of a sessional committee. Much, though, depends on how the committee acquits itself. The potential is considerable. For the first time, parliament has the opportunity to examine thoroughly and holistically the regulatory state.
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SELECT COMMITTEES


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Introduction

The National Audit Office (NAO) entered the world of regulation not with a whimper but a thud. Our first report on economic regulators, the snappily titled ‘The Work of the Directors General of Telecommunications, Gas Supply, Water Services and Electricity Supply’, was published just over ten years ago, in July 1996.¹ It weighed in at around 400 pages and measured some 2.5 centimetres in thickness. It was so large that it earned the affectionate title ‘the telephone directory’ within the NAO’s regulation practice.

The NAO’s reports have shrunk in size since this monumental first statement. But the significance of regulation as a tool of economic policy has grown, and the reach and volume of the NAO’s reports has grown accordingly. This chapter shows how, in the eleven years since the publication of the telephone directory, the NAO has developed work on regulation in three areas:

- economic regulation;
- competition regulation;
- better regulation.

It is increasingly fashionable to link risk to regulation. In 2005, for example, the Hampton Review advocated a risk-based approach to regulation, arguing that regulators should target their efforts to the riskiest entities and areas. In October 2006, the Better Regulation Commission argued that society’s demands for protection from risk is the driver behind new regulations. The risk-based approach to regulation has spawned a minor industry of consultants, conferences and academic research – with two major centres dedicated to the risk-regulation link within 500 metres of one another in central London.

This chapter echoes the risk-regulation link. It focuses on the risks that regulators have been created to address and sets out the challenges faced by regulatory institutions in this role.

Economic regulation

Economic regulation addresses the risk of market abuse by dominant companies. Because private sector monopolies may have an incentive to charge excessive prices, the government has created independent regulators to constrain this risk. In the case of natural monopolies the risk of market abuse is so severe that ex-ante restrictions on economic decisions are required. This is not a position based on a moral assessment of the mind of the monopolist – that the monopolist is malevolently choosing to abuse. It is that ‘even with the best will in the world’ the monopolist makes less efficient choices unconstrained than when constrained by an independent decision maker.

2 HM Treasury (2005), The Hampton Review of Inspection and Enforcement.
4 The Centre for the Analysis of Risk and Regulation at the London School of Economics, and the Kings Centre for Risk Management at King’s College, London.
Following this logic, the privatisation of formerly public monopolies was accompanied by the creation of economic regulators. Even after significant structural change in both the industries and in the regulatory institutions, independent regulators retain an important role as economic decision-makers. They include the water regulator (the Water Services Regulation Authority, or Ofwat); the energy regulator (the Office of Gas and Electricity Markets, or Ofgem); and the telecommunications regulator (initially Oftel, whose role has been absorbed into the Office of Communications, or Ofcom). Though Royal Mail remains publicly owned, there is now also an independent economic regulator for postal services (the Postal Services Commission or Postcomm).

The challenge faced by these regulators is therefore to make sound economic choices. The NAO’s work has focused on this challenge. We started by comparing the overall methodology adopted by each of the regulators. ‘The Work of the Directors General of Telecommunications, Gas Supply, Water Services and Electricity Supply’ set out the essential framework of economic regulation. Other reports have subsequently also addressed this theme. The ‘Pipes and Wires’ report, for example, looked at how regulators had evolved the RPI-X approach to price regulation to create incentives for productive efficiency, and to impose price cuts to deliver allocative efficiency. Our recent report ‘Ofgem: Sale of Gas Networks’ demonstrates how we evaluate issues of efficiency and incentivisation. We looked at how far Ofgem’s process for approving the sale of the gas networks took into account the economic interest of consumers. We concluded that the introduction of three new companies would improve the efficiency of the networks (productive efficiency), leading to potential consumer benefits of £325m up to 2023 (allocative efficiency) – but that Ofgem would have to gather robust, comparative data to secure these benefits.

We have also supported regulators as they fulfil statutory duties to increase competition. Reports which look at the introduction and increase in competition include studies of retail gas
competition (published in 1999), which examined the process and outcomes of giving domestic customers a choice of gas supplier; retail electricity competition (published in 2001) which examined the subsequent extension of choice to domestic electricity supply; changes to the way wholesale electricity competition was structured (our report on the New Electricity Trading Arrangements, published in 2003); the role of the regulator in representing consumer interests in telecommunications competition (2003); and the potential for postal competition (‘Opening the Post’, published in 2002, and which looked at the risks confronting the postal regulator Postcomm). But we have not been mindless cheerleaders for competition. Our report on directory enquiries showed how the liberalisation of this market did not achieve many of outcomes – lower prices, better quality of service, more choice – that Oftel expected of it.

Regulators use the phrase ‘competition is the best protection’ and variants thereon. This is an almost universally held view. But while it is clearly a core belief of economic regulators, they can struggle with its practical consequences. Not because they do not believe it, but because it offers them an idyll, a world of non-regulatory intervention that they can never quite attain. If monopoly offers the businessman a quiet life, then ‘placing greater reliance on competition’ appears to hold out the quiet life for regulators.

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6 National Audit Office, Directory Enquiries - From 192 to 118 (HC 211 2004-2005).
Unfortunately, they gradually discover that competition, for all its merits, is not that idyllic for a regulator. In fact, it is a nasty world: highly litigious, technically complex, riddled with expert dispute over basic legal and economic analysis, and voracious in the demands it places on regulators to obtain robust information. This has been the experience in the telecommunications sector, and relatively recent developments in postal services (Postcomm have to monitor Royal Mail’s arrangements for allowing rival operators access to the company’s facilities and have fined Royal Mail for breaches these agreements), and in water (where Ofwat’s methodology has been questioned by the Competition Appeal Tribunal), suggest that it may be the experience elsewhere too.

Competition regulators

What of competition regulators themselves? There is little doubt that the competition authorities – by which I mean the Office of Fair Trading, the Competition Commission and the Competition Appeal Tribunal, although of course economic regulators tend to have concurrent competition powers – have become more important economic actors in recent years. Their independence has increased, as have their budgets. The Office of Fair Trading’s (OFT) competition powers had been strengthened by the Competition Act in 1998 and the Enterprise Act in 2002. This was matched by an increase in the OFT’s budget (up 70% since 2000-01).

The current government also sees competition as key to productivity improvements. According to HM Treasury, competition constitutes one of the five main drivers of productivity (the other four are promoting enterprise, supporting science and innovation, raising skills levels, and encouraging efficient investment by the private sector). These drivers were first identified in the 2000 Treasury publication ‘Productivity in the UK’, which argued that effective markets and competition
provide the best means of ensuring that the economy’s resources are allocated efficiently.\(^7\)

Competition enforcement exists to address the risk of anti-competitive behaviour. Even competitive markets can relapse into less competitive conditions. Anti-competitive behaviour manifests itself in the creation of cartels or abuse of dominance. As a result, *ex-post* regulation involves enforcement action against anti-competitive behaviour. Note that this *ex-post* form of regulation has a stronger moral angle: the behaviours caught by *ex-post* regulation of this kind – price fixing, abuse of dominance – are unequivocally seen as wrong-doing.\(^8\)

The NAO’s work on the effectiveness of the UK’s competition regime is a newer element of our coverage of regulation. The first report in this area looked at the work of the OFT. The challenge facing a competition regulator is one of constrained resource and prioritisation. Unlike sector regulators, the scope of a competition authority’s focus is not neatly bounded – competition concerns can arise in practically any part of the economy at any time. As a result, competition authorities need to consider carefully how to make best use of scarce resources. Our report set out how well OFT had faced this challenge.\(^9\) The report found that, while the UK competition regime is still relatively young compared with those of many other major economies around the world (it dates from the implementation of the Competition Act in 2000), the OFT has established a growing

\(^7\) HM Treasury (2000), Productivity in the UK: The Evidence and the Government’s Approach, November.
\(^8\) Karen Yeung has set out the emphasis on behaviour clearly in her analysis of the regulation of competition in different economies. She defines regulation as “the sustained and focused attempt by the state to alter behaviour thought to be of value to the community” (Karen Yeung, Securing Compliance, Oxford, 2005, p5.
reputation internationally. It is consistently ranked among the best in the world and is recognised for its intellectual leadership.

Until recently, attention in the world of competition enforcement, both in the UK and internationally, has tended to focus on issues of law and economics. There are, however, issues of institutional capacity which influence how effective a competition enforcement body like the OFT can be. Effective management of people and processes is as important as the correct analysis of market definition or abuse of market power – and we emphasised that recruiting and retaining suitably qualified staff, in a competitive labour market, is also an important success factor.

In terms of case work, competition investigations sit at the intersection of law and economics. The complexity of this intersection means that cases can be time-consuming and require tight quality control. Perhaps unsurprisingly, the NAO report found that many cases took a substantial amount of time to complete – at least three years in several cases. The OFT is taking steps to address some of these concerns – renewed approaches to how cases are prioritised, planned and resourced; changes to the structure of its investigation teams to improve their flexibility; and the development of project management disciplines. In its response to the House of Commons Public Accounts Committee, the OFT undertook implement changes to its approach to case management. A number of steps have been put in place to ensure more effective delivery of cases including larger case teams; clearer case timetables; a case management framework; and better use of outside experts during the life of a

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10 A fuller description of the report’s main arguments is set out in an article in Oxera Agenda in December 2005 by my colleagues Peter Langham and Louise Campbell, from which this and subsequent paragraphs are largely drawn.

11 KPMG (2004), Peer Review of Competition Policy, report prepared for the Department of Trade and Industry. The report concludes that the UK’s competition regime has been ranked third highest (behind the USA and Germany) by expert commentators.
The report also recommended that the OFT considered how to measure its wider economic impact. In response the OFT has embarked on an ambitious measurement programme. The OFT provided a preliminary estimate to the Public Accounts Committee in January 2006, that the consumer benefit from its investigations could amount to £110m over five years – and this figure does not include any wider economic or deterrent effects.

As we undertook this work, we realised increasingly that debate over issues of substantive economic and legal analysis obscured questions of institutional performance and how to target resources. Perhaps because we were asking new questions about competition authorities as institutions, the OFT report has been one of our most influential in its effect on the organisation we have studied. For example, in October 2006, the OFT announced a revised approach to case work and case prioritisation, “in line with National Audit Office recommendations that the OFT publish more information on the way it selects cases for investigation”.13

Better regulation

The Better Regulation agenda is concerned with improving the way government, as a whole, impacts on business, voluntary organisations and the public sector itself. It sees poorly designed regulation as burdensome and costly, and aims to improve productivity by releasing resources from regulatory functions in companies, so that they can focus more on their core activities. The Better Regulation Task Force’s report ‘Less is More’ estimated that reducing unnecessary regulatory burdens could produce “potentially greater than a 1 per cent improvement in GDP”.14

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13 OFT Press Notice 146/06, 12 October 2006.
The Better Regulation Commission – successor to the Better Regulation Task Force – has highlighted another cost of regulation. Its report on risk concludes that the cumulative effect of regulating to reduce risk is the erosion of personal responsibility and risk-taking. An overly protective approach to regulation reduces the incentive on individuals to manage their own lives. As the Better Regulation Commission concluded:

“There is a sense that the current public debate about risk places an over reliance on government to manage all risks, at the cost of eroded personal responsibility”.
(Better Regulation Commission, 2006, Chairman’s foreword)

On the other hand, there are some areas where society is worried that there is too much risk borne by individuals: long-term pension provision is one example. Overall, however, the Better Regulation Commission considered the political drivers led overwhelmingly to increased regulation, and highlighted the demand for risk protection as key in this process. In a similar vein, a recent article by Dieter Helm has examined the political factors that lead to excess regulatory supply and demand of regulation (in essence interest group pressures).15 The main tools of Better Regulation have been:

- regulatory impact assessments, which seek to ensure that the ‘flow’ of new regulation is properly evaluated and assessed;

- administrative burden reduction, which seeks to address the ‘stock’ of existing regulation by reducing unnecessary information requests made on companies and voluntary organisations;

- the Hampton Review recommendations for consolidation of the existing regulatory structure into a more streamlined system of thematic bodies.

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THE NAO AUDIT PROGRAMME

The NAO has reported extensively on regulatory impact assessments (RIAs).\textsuperscript{16} RIAs have been used since 1998 and around 200 are produced each year. RIAs are required for any form of regulation which impacts on business, the public sector and voluntary organisations. They allow policy makers to analyse the likely impacts – economic, social and environmental – of a policy change and the options for implementing it.

The NAO first explicitly examined RIAs in our report, ‘Making Good Use of Regulatory Impact Assessments’, published in November 2001.\textsuperscript{17} Following this, the Cabinet Office formally invited the NAO to audit a sample of RIAs each year. Since then the National Audit Office has produced three annual evaluations of RIAs.

The 2004 report focused on the technical content of RIAs.\textsuperscript{18} It found that, perhaps unsurprisingly, there are a wide range of practices and approaches used across government departments. But from within this spectrum, the following general messages emerged:

- RIAs were becoming embedded within government as part of the policy-making system.

Within the sample, there was an insufficient degree of attention paid to the generation of alternative options, including alternatives to regulation where appropriate. In most cases, the RIAs did not even consider a ‘do-nothing’ option.


\textsuperscript{17} National Audit Office, Better Regulation, Making Good Use of Regulatory Impact Assessments, HC 329 2001-02.

By contrast, consultation was the strongest element of the sample.

Quantifying costs and benefits was a methodological challenge for departments. The sample contained some attempts at quantification, especially of the risks or hazards that regulation is designed to reduce, but rarely were the benefits quantified. RIAs often acknowledged information deficiencies, but failed to reflect uncertainties in quantified estimates. So there was a tendency towards spurious accuracy in quoted figures.

The second report again considered a sample of ten RIAs.\textsuperscript{19} This report moved on from simply identifying technical issues. It proposed that the technical quality of an RIA reflected the way a departmental team approached the challenge of writing it. The report identified three approaches:

- **Pro-forma RIAs:** These have no impact on policy and are produced merely because there is an obligation on departments to do so. They may be started after the decision has been made. This tends to lead to RIAs that are inadequately resourced and produced too quickly.

- **Informative RIAs:** These RIAs are not integrated into the policy-making process; for example, they may have been started fairly late. Although the RIA will have only limited relevance, a department can still produce a high quality RIA that clearly outlines the expected impacts, and it is therefore a useful communication tool.

- **Integrated RIAs:** These inform and challenge policy-making. These RIAs are started early and are properly resourced, which allows for better gathering and analysis of evidence. In these cases the RIA can help shape the policy making process and communicate the reasons for the department’s decision to

regulate in the chosen way. In some cases the role of the RIA in challenging policy makers will lead them to a non-regulatory response.

The third report, published in June 2006, concentrated to a greater extent on departmental culture than the first three reports.\(^\text{20}\) It focused on the regulatory work of four large departments: the Department of Trade and Industry; the Home Office; the Department of Culture, Media and Sport; and the Department for Transport, and asked a range of questions focusing on the link between RIAs and departmental management decisions. It concluded that RIAs were often not used in the right way. The purpose of RIAs was not always understood by policy-makers, there was a lack of clarity in the presentation of the analysis and persistent weaknesses in the assessments. As a result, RIAs had not offered a robust challenge to proposals to regulate, and were often seen as a paper output rather than being integral to the process of policy making.

The NAO’s role here is seen as an exemplar internationally. A recent report by the European Policy Forum, for example, drew attention to the UK model of audit of RIAs. Its discussion of how best to embed impact assessment in the European Commission’s policymaking argued that:

“[It is] desirable to establish systems which will ensure that the benefits of integrated impact assessment are entrenched among European institutions….Those suggesting a ‘systems’ approach were perhaps influenced by the approach of the UK’s National Audit Office which is now following this approach in respect of Whitehall departments and agencies”.\(^\text{21}\)

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We will report in future on the administrative burden reduction programme. The programme involves an extensive cross-government measurement programme, led by the Better Regulation Executive and implemented by PwC and KPMG, to establish a baseline estimate of the total cost of administrative obligations under UK law and regulations.\textsuperscript{22} Departments will then be expected to deliver cuts against the baseline. While it is important that we do examine the content of the baseline and department actions to reduce it, we will focus on evaluating the outcomes of this programme. The crucial test is whether it really is achieving the ambitious improvements in the environment for business and the voluntary sector (and therefore in the UK’s productivity) that are expected of it.

On the Hampton proposal to consolidate the regulatory structure, we published a report in the summer of 2006 on good practice in public sector mergers.\textsuperscript{23} The target audience for this report included those responsible for designing and carrying out future mergers of regulators and other public bodies. By focusing on the experience of a largely successful and complete merger (the creation of Ofcom in 2003-04) and validating this experience against other merger activity, we identified the key success factors in delivering this kind of change and how the cost-benefit framework underlying a merger decision can be tracked.

Conclusion

Institutions matter. This may not be a very fashionable thing to argue, but the overall conclusion of the NAO’s work on regulation is that institutions have had important economic impacts and that the way they approach problems – whether it be their price-setting methodology (for an economic regulator), their

\textsuperscript{22} PwC have implemented the model for most government departments, while KPMG have undertaken the same exercise for HM Revenue and Customs.

prioritisation (for a competition authority) or the way they do RIAs (for a major department) – can have a profound impact on their effectiveness as organisations. For this reason alone, the NAO’s programme of work on regulation is unlikely to diminish in the near term.

Where we are going? Much of the debate about regulation at present is characterised by a focus on business interests. The NAO forward programme may seek to counterbalance this with a greater focus on consumers – who bear the indirect costs of regulation in the prices they pay, and often direct costs, for example when consumers themselves face form-filling burdens. Our forward programme may also increasingly address the regulatory consequences of sustainable development. As the recent Stern Review suggested, addressing the risk of climate change may be an important source of new regulation.

Regulation therefore remains an important aspect of policy debate, with ‘better regulation’ an important concept. Indeed it is Better Regulation which stands out as the defining development of the ten year period. Ten years ago, we hardly looked on regulation as a separate category. Of course, people talked about better regulation in 1996; everyone desired regulation in any sector to be better rather than worse, improving rather than worsening. But they did not put this desire for regulation that was better into capital letters – they did not speak of Better Regulation. Better Regulation holds that regulation is important to economy and society; and that regulation is not just a series of domain-specific arrangements, but has common threads and themes and hence can be analysed by reference to common principles. It is this – that the regulation of water and insurance, food safety and mobile phones are all branches on the same tree – that defines Better Regulation; far more than common principles themselves, on which there seem to be as many better regulations as there are commentators. But the elasticity of the ‘better’ in Better Regulation is a subject for another article.
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THE NAO AUDIT PROGRAMME

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15 SOCIAL ISSUES IN ENERGY AND WATER

Cosmo Graham

Introduction

This chapter focuses on what are loosely called ‘social issues’ in the energy and water industries, that is, the arrangements for those consumers with particularly limited means, such as those who survive on state benefits or other fixed incomes like pensions. The period 2004-06 was a time when prices paid by consumers have been rising, especially in the energy sector since 2004, which has been a reversal of a long run trend in energy, although in water the increase in bills comes after a four year period of relative stability.\(^1\) Because of these changes, there has been increasing interest in the question of the affordability of water, as well as questions about the implications of these price rises on the government’s fuel poverty strategy.

The government has concluded that around 1.2m vulnerable households will remain in fuel poverty by around 2010, on mid-range assumptions, which means that the target of eliminating fuel poverty amongst vulnerable groups by 2010 will be missed. The problem seems to be a combination of the type of housing stock, proximity to the gas network and very low incomes, which means that energy efficiency measures on their own will be insufficient.\(^2\) Having said this, it may be the future outlook for energy prices is not as bleak as it has been in the last couple of years.

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\(^1\) Ofwat (2006), Water and Sewerage Charges 2006-07 Report, Figure 1, p14.
The remainder of this chapter looks at a variety of issues that have come into prominence during the review period: debt and disconnection in energy, Ofgem’s supply licence review, water affordability and the Department of Trade and Industry’s (DTI) proposals for new structures for consumer representation.

Debt and disconnection

Ever since the Bates case at the end of 2003 occurred, where two pensioners were found dead after their gas supply had been cut-off, the issue of disconnections in the energy field has been higher up the political agenda, beginning with attempts during the passage of the Energy Act 2004 to introduce a ban on disconnections for failure to pay energy bills and culminating in a report by the Trade and Industry Select Committee. There were responses at industry level by the Energy Retailers Association, which set up a safety net procedure in 2004 and British Gas, which stopped disconnections voluntarily for a period of time. It has been noticeable that disconnections for debt in electricity and gas came down to very low levels in 2004 and 2005, as illustrated by the table below. In particular, British Gas’s actions have cut the number of disconnections to the lowest level ever in gas (see Table 1).

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gas</td>
<td>26,088</td>
<td>21,780</td>
<td>15,973</td>
<td>2,553</td>
<td>2,309</td>
</tr>
<tr>
<td>Electricity</td>
<td>375</td>
<td>9,950</td>
<td>1,361</td>
<td>727</td>
<td>604</td>
</tr>
</tbody>
</table>

Source: Ofgem

For its part, Ofgem commissioned, with energywatch, research on the implementation by suppliers of the guidelines on debt management and recovery and reducing disconnections.³ The

³ Sohn Associates (2005), Preventing Debt and Disconnection – the Review, Ofgem.
monitoring report was generally positive about the effect of the guidelines while it noted that supplier performance had varied significantly from EDF Energy and Scottish Power, who had done the most to implement the guidelines, to npower, who had made the least progress. The report concluded that the indicators set out in the guidelines did not provide a good basis for assessing progress and recommended a revised set of measures. In addition, no supplier was able to produce forward projections or targets covering the indicators in the guidelines and thus it was difficult to quantify progress (Sohn Associates, 2005, p9). Its consumer research also highlighted that there was significant scope for improved communication between suppliers and consumers, especially where vulnerable consumers were involved. It thought as well that suppliers could be more proactive in obtaining information and use this as an integral part of debt prevention strategies for vulnerable consumers.

The Trade and Industry Select Committee’s report, although not uncritical of the industry, did not find any major flaws in existing procedures or rules. It did, however, warn the companies that if they were to be allowed to retain the right to disconnect supplies, they must clearly demonstrate that they have taken all practicable measures to resolve the problem earlier, they must provide more support and advice to vulnerable consumers, the gas companies need to make more efforts to install prepayment meters and the number of billing errors must be reduced, particularly in relation to customer transfers.4

In the context of the supply licence review, Ofgem has decided to remove the distinction, which has been in the licence condition for some time, between those who cannot pay their bills and those who won’t pay their bills on the ground that it is impractical in practice. The starting presumption should always be that a person is having difficulties paying, unless this is shown

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4 Trade and Industry Select Committee (2005), Debt and Disconnection HC 297, para 79.
not to be the case. By contrast, in the water industry, it looks as if this distinction remains very much alive, particularly from the point of view of the companies seeking to recover debts.

Supply licence review

Ofgem’s major piece of work over the last eighteen months which directly impacts upon vulnerable consumers has been the supply licence review. The background to this was Ofgem’s assessment of competition in the domestic energy market, published in 2004, combined with new duties placed on it through the Energy Act 2004 which required Ofgem to consider an approach to regulation that is transparent, accountable, proportionate, consistent, targeted only at cases in which action is needed, and any other principles which appear to it to represent best regulatory practice. Since the energy supply licences ran to over 170 pages, Ofgem thought that it was time to review them in order to develop licence conditions which provided proportionate protection for consumers, allowed greater entry and exit into the market for companies and provided a flexible framework within which the markets could evolve.

One of the issues of principle at the start of this process was to what extent the provisions within the supply licences simply replicated protection which was provided by general consumer protection law, such as the Unfair Contract Terms Regulations and the Distance Selling Directive. It did become evident that a wholesale reliance on general consumer law did not look feasible or sensible, partly because there was not a complete overlap in protection, partly because the enforcement powers given to the regulators were different under licence provisions and general consumer protection law and, arguably, because European law seemed to suggest that there still needed to be sector specific protections.

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Although treating energy services as just another consumer commodity did not prove feasible, there was also interest in moving towards more self- or co-regulatory options, as well as coming up with means of protection which gave companies more flexibility in tailoring their operations to the market, rather than constraining them within a single framework. Throughout the review, there was substantial focus on the position of vulnerable consumers and a great deal of work went into ensuring that their position would not be inadvertently worsened by any changes. As regards vulnerable customers, one of the most interesting outcomes was the consensus between the industry and consumer groups that the most appropriate way forward in terms of structure was a combination of licence based conditions, supported by self-regulation and voluntary initiatives. One of the results of this will be that the need for the industry to prepare Codes of Practice and have them approved by Ofgem will be removed, to be replaced with a requirement to explain in plain English the licence obligations that the companies are subject to (Ofgem, 2006, paras 3.10-3.17).

As regards voluntary initiatives, it is clear that the supply companies have undertaken substantial activities, which were summarised and assessed for Ofgem in a report in 2005, which found that there had been a marked increase in this initiatives over the last couple of years and identified a range of best practice initiatives, as well as making recommendations for improvements in this area. It is worth mentioning as well that, seemingly following the example of certain water companies, a number of energy companies have set up charitable trusts which are responsible for, among other things, helping consumes who have difficulties with their bills.

At a self-regulatory level the most significant development has been the creation of the Energy Supply Ombudsman (ESO) in

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6 Energy Services Partnership (2005), Review of Suppliers’ Corporate Social Initiatives.
7 EDF Energy Trust (established 2003); British Gas Energy Trust (established 2004) are a couple of examples.
The background to this was a complaint by energywatch to Ofgem over suppliers’ performance in terms of billing. Although Ofgem did not find any cause to take action in most areas, it did recommend that the suppliers create an ombudsman to deal with billing disputes. In the course of discussions and consultation over the year, this has now become an organisation with a wider remit than just billing disputes. Organisationally and procedurally, the ESO is modelled on the Office of the Telecommunications Ombudsman (Otelo) and the administration of both schemes is done through a shared company; the Ombudsman Service Ltd. This is a somewhat different model from a number of schemes that exist in Australia, which seems to be the main country placing reliance on such ombudsman.

The ESO is funded by its member companies who pay subscriptions to the service as well as case fees. The service itself is free to consumers. The ombudsman reports to a Council, not the Board of the members and is charged with acting independently in the resolution of disputes. The ombudsman’s decisions are binding on the member companies, although not on the consumers, and compensation up to £5,000 may be awarded by the ombudsman. This is, in its broad outlines, a model which has been adopted for other private sector or self-regulatory ombudsman schemes and there is no reason that it should not prove to be effective in the energy area. It does mark an improvement in the position of customers who, for the first time, will have access to a free, relatively speedy service which can give an authoritative resolution to their dispute with a supplier. It will be interesting to see how the service develops in the future and just how successful it will be.

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9 Although there are certain exclusions, such as the selling of energy services.
Affordability of water

This has become an issue since the 2004 price review due partly to the companies’ concerns over the rising level of debt as well as work on the issue by academics and activists.\(^{11}\) Similarly to debt and disconnection, the issue has been addressed by a Parliamentary Committee, the House of Lords Science and Technology Committee but in this case within a wider context of water management.

There is some debate about whether or not a problem exists and exactly how the issues should be conceptualised. Sawkins and Dickie emphasise the difference between calibrating water affordability measures, that is, seeing how much relative to income particular households spend on water, with setting a benchmark for water affordability, which they point out has not been done in the UK (Sawkins and Dickie, 2005). Campaigners, on the other hand, have taken a different approach and suggested that the setting of water charges is a matter of social policy and raises issues of justice and fairness (Fitch and Price, 2002, note 8). From this perspective more emphasis is placed on the tax like nature of water charges and less on seeing them as an ordinary good or commodity.

The government’s cross-departmental review of water affordability in 2004 used a benchmark of 3% of household income being spent on water charges as a measure of affordability, presumably on analogy with that used for fuel poverty but saw the issue as one that was limited to particular household types and more important within particular regions, notably the south west.\(^{12}\) The problem therefore was to find better ways to target the most affected groups and a number of

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suggestions were put forward, including increasing eligibility under the ‘vulnerable groups regulations’ and doing a local pilot study on water affordability.

The Science and Technology Committee started from the general observation that, in its view, charges for water and sewerage were too low to ensure a truly responsible and sustainable management of water resources and that some of their recommendations would see a rise in prices in England and Wales. Because of this, they felt that the issue of water affordability needed to be tackled urgently. They described that current level of unpaid bills as completely unacceptable, highlighting South East Water’s claim that non-payment added £10 to every other customer’s bill. They were impressed with the idea of trickle flow meters used in Australia and suggested that the government ought to look at this, “with a view to introducing more effective strategies for reducing the number of people who can afford to pay their water bills but refuse to do so” (House of Lords Science and Technology Committee, 2006, para 3.84).

On affordability, they were particularly critical of the vulnerable groups regulations, for which they described eligibility as “far too narrow” and thought that Defra’s response when questioned was, “alarmingly complacent” (House of Lords Science and Technology Committee, 2006, paras 3.88 and 3.91). They urged the government to draw up plans to help the most vulnerable through the benefits and tax credits system, pointing to winter fuel payments as a scheme that could serve as an example. In its response, the government said that it had no plans to introduce a lump sum payment for water costs for people on means tested benefit and referred to the affordability pilot that Defra was conducting in the south west, the results of which are expected in mid 2007 and focus mainly on benefit take-up and demand.

13 House of Lords Science and Technology Committee (2006), Water Management, HL 191.
management. The government response showed no interest in taking up the idea of trickle flow meters and no promises were made in relation to extending eligibility for the vulnerable groups’ regulations.

Paradoxically, the continuing issue of water scarcity may provide one means for tackling the issue of water affordability. If metering becomes more widespread, and there are some surprising proponents of metering, this opens up the possibility for the design of innovative tariffs which could, in theory, take into account the issue of people’s ability to pay.

Consumer representation

One of the biggest overarching issues during the review period has been the question of future arrangements for consumer representation. A series of studies and papers have emanated from government and parliament examining the efficiency and effectiveness of consumer representative bodies, with a particular focus on energywatch and Postwatch. This culminated in a DTI consultation paper which proposed the abolition of energywatch and Postwatch, as well as the Ofcom Consumer Panel and the Financial Services Authority Consumer Panel and

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16 DTI (2006b), Strengthen and Streamline Consumer Advocacy, URN 06/682, January.
the rolling of their functions into a new body, ConsumerVoice, which would be developed from the existing National Consumer Council. Individual redress for consumers would be handled by a combination of self-regulatory ombudsman, such as the ESO, and Consumer Direct, leaving the new body free to concentrate on policy advocacy. These changes were planned to take place by around 2009.

These policy proposals received a mixed welcome; as the choice of bodies seemed a bit arbitrary, for example rail was excluded but financial services included and they were light on supporting detail.18 There was particular criticism from the Consumer Council for Water, whose view was that to review their role in 2008, that is during a crucial time for the periodic review process, would be a distraction from their core role. The Financial Services Consumer Panel, for its part, could not see the logic in changing its role. The DTI had promised to reply to the responses to the consultation document by July 2006 but nothing had come from the Department by mid October of that year. One of the difficulties with this delay, the extended timescale for implementation, and the sketchy practical details provided, is that it makes it very difficult for a body such as energywatch to plan for the future since it is very unclear what shape the future will indeed take.

Conclusions

The period under review has been a relatively quiet one but there are a number of issues that are bubbling under the surface and could create problems in the near future. Paying for water continues to be a rather odd compromise with domestic customers having a de facto right to water from regulated commercial companies whose charging is meant to be cost-reflective. There is, therefore, in some sense a subsidy from one

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group of customers to another. Whether this can remain the basis for water charging is an important question but there are of course large costs in trying to create and implement any new system. It may be that, because the absolute level of water charges for most household are quite low, we will continue down the present track of simply incremental changes, such as increasing the number of metered customers.

In the energy sector the structure of the regime for protecting vulnerable consumers is set to switch as a result of the supply licence review, although the substance of the protections seems set to remain. The new approach, combined with the simplification and re-drafting of the licence conditions offers the promise of greater clarity in terms of company obligations and, with the creation of the Energy Supply Ombudsman, a more effective enforcement mechanism for individual disputes. If, however, the DTI’s proposals for the reform of consumer representation go ahead, there is a danger that certain cases, more complicated disputes which require quick intervention, may fall between the Ombudsman and Consumer Direct if energywatch’s complaint handling function is wound up.

As regards social measures, this period marks a continuation of the trend whereby such initiatives are left up to the suppliers, with some encouragement from government and the regulator, and the workings of the competitive market, as the available information suggests that switching supplier is reasonable common amongst all social classes and payment mechanisms, with perhaps the exception of those in debt to their supplier.
SOCIAL ISSUES IN ENERGY AND WATER

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SOCIAL ISSUES IN ENERGY AND WATER
16 ACCOUNTABILITY AND MULTI-LEVEL GOVERNANCE IN UK REGULATION

Stephen Wilks and Bruce Doern

Introduction

This chapter does not attempt to summarise the by now substantial literature on regulatory accountability. Instead it focuses on one theme, or perhaps set of themes, in current political science research on administration and accountability. The overall theme upon which the article focuses is the burgeoning literature which examines the location of British government in a system of ‘multi-level governance’. The multiple levels are explored below and draw their significance not only from the challenges to policy implementation but also in challenges to the constitutional basis of contemporary British liberal democracy.

The sub-themes explored below embrace the increased complexity of regulation and the need for regulators to look upwards, downwards and sideways in responding to the demands and needs of multiple stakeholders. It is argued that one simplifying approach in assessing current change is to explore the role of boards of directors in industry regulators and their potential for acting as a focus for accountability. In turn the chapter concludes with a review of the possibilities of redefining accountability in the context of severe tension between traditional democratic accountability in the ‘whitehall model’, and the demands of efficient management and consumer satisfaction.

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Redefining accountability

The accountability of British regulatory agencies, much like the accountability of the whole public sector, has conventionally been seen as an expression of the democratic process and secured through the ‘westminster model’. The westminster model involves a very simple chain of accountability that is second nature to British public servants, and very familiar in most of the countries of the English speaking world. That chain involves electors sending representatives to a sovereign parliament, which designates ministers to form a government, which exerts control over an established civil service, which administers on behalf of the government. The principles of collective cabinet responsibility, and particularly of ministerial responsibility, ensure that ministers are accountable to parliament, which is in turn accountable to the electorate through the electoral process. This system of political accountability could also be termed democratic accountability, which gives it an accurately legitimising flavour, or alternatively ‘majoritarian’ accountability in that public servants are accountable to a representative elected majority. Each of the stages of accountability are taken extremely seriously and regarded as sacrosanct although, as observers of government are only too aware, they have no formal constitutional protection and aspects of the process are, in Bagehot’s word, effectively ‘ceremonial’.

Regulatory agencies are therefore subject to political accountability supplemented by the conventional measures of Treasury control, audit, legal appeal and consumer satisfaction. In other words, a sensible industry regulator will seek to satisfy the minister and the sponsoring department since they appoint the regulator and provide the budget. In turn, regulators are aware that ministers will expect the agency to fulfil its statutory duties which will also be assessed by parliament (often through the committee system), by consumers and by the courts through legal challenge. Ministers will take note of the views of all of these guardians of accountability in dealing with the regulators.
Both the theory and the practice of regulation under the whitehall model have been extensively discussed, not least in a series of CRI publications.¹

It can be argued that this system has been strained beyond tolerance by a series of developments in contemporary governance which amount to constitutional amendments. These developments have increasingly been analysed through the concept of ‘multi-level governance’.² Put simply, the highly centralised British state and its sovereign parliament has begun to share power. The main partners are the European Union and the devolved administrations in Scotland and Wales but sharing also extends to the Greater London Authority. Each of these new levels of governance has its independent source of electoral legitimacy which in each case draws on a variant of proportional representation which could be regarded as more legitimate than the crude first past the post result in Westminster (which gave Tony Blair’s third government a majority on a mere 21% of those eligible to vote). Each of these new levels is also building up its own political space and governance arrangements which draw in interest groups, policy constituencies and decision making processes (including coalition bargaining) which provide political arenas separate from Westminster.

For England, the most significant alternative level is the European level, which has a profound influence in some areas (such as agriculture and the environment) and a rather lesser influence in others (such as health and defence). The multiple levels reflect also a weakening of the central state in an era of globalisation and, to a significant extent, the levels of governance


² Bache I and Flinders M (eds) (2004), Multi-level Governance, Oxford University Press.
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become global in respect, for instance, of the global reach of competition authorities, the impact of global agreements in areas like intellectual property, and the international implications of major legislative requirements, such as the 2002 US Sarbanes-Oxley Act which has so exercised the Financial Services Authority.

Multi-level governance has come of age since 1997 and has been accompanied by a second set of quasi-constitutional developments in the shape of the growth of independent administrative agencies. New Labour, and Gordon Brown in particular, embarked on a ‘love affair’ with agency independence after the 1997 election and the creation of an independent Bank of England to administer monetary policy. In Labour’s second term this stunningly successful piece of administrative engineering in the field of macro-economic policy was reproduced in the micro-economic field by the independence granted to the competition authorities in the 2002 Enterprise Act.

These are simply two examples of a blossoming of independent agencies which extends to more qualified agency independence stretching into Whitehall departments through the agency independence enjoyed by ‘next steps’ agencies. The level of independence in these cases in necessarily more qualified since it is not based on separate legislation but, nonetheless, it has become increasingly standard for the chief executives of agencies, such as Jobcentre Plus or the Criminal Records Bureau to speak with an independent voice and to account directly to parliament. So marked has this recourse to agency independence become that analysts are developing a concept of ‘depoliticisation’ to seek to explain the Labour Government’s willingness to detach itself from direct administration and responsibility for distinct areas of policy implementation.3 The spectrum of interpretations stretches from rational desires to

exploit technical efficiency and expertise, to a more cynical view that ministers are seeking to ‘avoid blame’ or that they are simply concealing real influence behind a facade of independence.\(^4\)

The pattern, then, is of a dispersal of political authority into varying levels of governance, the granting of formal and informal independence to multiple agencies of government and, associated with both trends, the increased inclination to govern through networks and partnerships that draw on various government bodies and which incorporate private sector actors and NGOs. These trends are seen to have several positive aspects. They create alternative political arenas and therefore increase access for individuals, groups and companies. They increase transparency within government as each level, and each agency, seeks to promote its powers, interests and importance, and it also creates competition within government as, for instance, the European, the UK, the Scottish (and the London) levels of government develop alternative policies on renewable energy.

But where does this leave the routes of accountability under the westminster model? These multi-level arrangements mean that ministerial responsibility becomes an even more moth-eaten curtain behind which public administration takes place. Ministerial responsibility is not dead, as the enforced resignation of Charles Clarke as Home Secretary in May 2005 demonstrated, but its life is only being prolonged by the absence of any credible constitutional principle to put in its place. There is a well-tried argument that democratic accountability can be reformulated through a distinction between strategy and management so that ministers give strategic guidance and agencies manage their responsibilities independently to deliver the strategy. But this formulation carries the danger of reproducing an equally misleading myth, the conceit that means can be divorced from ends, and that the administration of policy can be conducted without transforming the policy itself. Decades of study have

established that policy and its administration are in a constant state of reciprocal influence. We need to reconceptualise political responsibility, and here the role of the industry regulators is instructive.

Accountability of the industry regulators displays the collapse of the westminster model in a particularly stark light. The industry regulators are the extreme example of agency independence and they also experience the pressures of multi-level governance. As the House of Lords report recently outlined, the regulators have a wide range of obligations of accountability, the report outlined a whole web of commitments which it expressed as a 360 degree horizon of responsibilities, upwards, downwards and to each side (Vass, 2005). But the report also retained the assumptions of ultimate parliamentary accountability, as one would expect from a central institution of the westminster model, It is, in fact, increasingly doubtful that the westminster model provides the dominant or the most effective channel of accountability for the industry regulators, and we can examine recent developments to explore alternative conceptualisations of models of accountability.

Structures and processes in the agencies

Industry regulation, from financial services to communications, has become steadily more complex over the 20 years since the Office of Telecommunications (Oftel) was cloned from the Office of Fair Trading (OFT) as an agency supporting a single regulator director general. Four trends that have developed since the turn of the century merit particular emphasis, they are ‘boardisation’, new responsibilities, regulatory norms and network coherence.

‘Boardisation’ is a dreadful neologism but it perfectly describes one aspect of the depoliticisation strategy mentioned above. Following Labour’s review of utility regulation after the 1997
election, the model of single person regulators was phased out and the leadership of each agency has been reconstructed as a board of directors. The model of part-time chairman, chief executive, executive and non-executive directors has been incorporated in the respective constitutive statutes or organisational arrangements for each agency, although in a variety of ways. For the Bank of England, the Court of the Bank is effectively the board of directors with a huge and dominating majority of no less than 16 non-executive directors. The Office of Fair Trading, in contrast, has a much smaller, seven person board with the partnership of Philip Collins as part-time chairman and John Fingleton as chief executive supplemented by five non-executive directors (and no executive directors). The statutes and governing protocols typically oblige the directors to take full responsibility for the discharge of statutory duties so that, for instance, the decision to refer market inquiries to the Competition Commission is taken by the full board of the OFT. We come back to the role of the agency board below.

A second area of complexity is the adoption of new responsibilities by industry regulators, either explicitly by statute or as a result of major shifts in the policy agenda. Examples include energy (and perhaps water) security, and the supplementation of traditional economic regulation with a stress on the environment and a sustainable development agenda which has caused government to impose added duties on energy, water and rail regulators to encourage sustainability. There has been an urgent debate about how that duty can best be undertaken and how it will require adaptation of the prime focus of economic regulation on promoting competition and coping with externalities. The broadening of responsibilities means that regulators can no longer restrict themselves to the narrower issues of price and quality of service, or limit their major responsibility to consumers in market settings. Increasingly the regulators are regarded as responsible for the mix of impacts that

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‘their’ industry has on social and environmental, as well as economic, well being. The so-called ‘triple bottom line’ (of commercial, social and environmental outcomes) could now be applied equally well to the performance of at least some of the regulators.

The third area of development is the increased sophistication of regulatory expectations, incorporating standards of regulatory design, due process and intelligent application based on risk assessment. It could be said that important norms of regulation have come into being and are being presented as unavoidable constraints through the work in Britain of the Better Regulation Executive and the requirements for regulatory impact assessment (RIA), and beyond Britain, in measures promoted by the European Commission and even the OECD. Thus government has accepted that the regulators should utilise RIA for all major new initiatives and the House of Lords Select Committee also endorsed the OECD regulatory checklist. Regulatory processes are therefore becoming ‘professionalised’ with expectations from stakeholders in areas such as transparency, consultation, risk estimation, cost and proportionality. Pressures for conformity to regulatory expectations are often subtle and analogous to ‘soft law’, but agencies are aware that in the event of legal challenge and judicial review the courts will expect agencies to have acted ‘reasonably’, and regulatory norms can be taken as a first approximation to ‘reasonableness’.

Fourthly, as the regulatory regimes in the regulatory sectors have become established they have generated their own regulatory networks, incorporating stakeholders, interest groups and the regulated companies themselves. We examine the range of stakeholders in more detail below, but it might be noted that the regulatory networks have taken on a European dimension which is to be expected as a manifestation of the increasingly transnational nature of markets and the importance of the

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European level of governance. The European Commission has encouraged the creation of European networks of regulators. The best developed thus far are the CESR (Committee of European Securities Regulators) and the ERG (European Regulators Group – for telecommunications). Established in 2001 and 2002 respectively, these networks seek to compare and harmonise regulatory practice within the internal market and have formal powers to advise the Commission.\(^7\) The development of such networks allows national regulatory agencies to project their preferences onto the European level in an awareness that many of the regulatory issues they pursue do not stop at the border. There is also a potential reciprocal possibility of using developments at the European level, and citing precedents from sister regulatory bodies, to bring pressure to bear on the British government and domestic regulatory networks.

This changing scene of new responsibilities, evolving regulatory norms and the growth of sectoral networks redirects attention to the locus of responsibility and decision within the regulatory agencies. All the regulatory agencies are now directed by boards of directors who operate in accordance with the Combined Code of Corporate Governance.\(^8\) Corporate governance is a very familiar regulatory framework within the private sector and has been examined in depth in several CRI publications as it is applied within the regulated companies.\(^9\) What is less familiar is the idea that it should apply to public sector bodies. Nonetheless, in a striking recent development, the Treasury and the Cabinet Office have extended private sector-style corporate governance as the standard set of management procedures, not only in all

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non-ministerial departments and non-departmental public bodies, but also in departments and executive agencies. Most of the industry regulators are classified as ‘non-ministerial government departments’ and have been led by boards of directors for some years. Over the last three years, however, they have aligned themselves with the combined code model of part-time chairman, CEO, executive and non-executive directors. Thus, for example, the board structure in four leading regulators takes the following form as shown in Table 1:

Table 1: Board structures

<table>
<thead>
<tr>
<th></th>
<th>CAA</th>
<th>FSA</th>
<th>GEMA</th>
<th>PostComm</th>
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<tbody>
<tr>
<td>Chairman</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>CEO</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Executive directors</td>
<td>6</td>
<td>3</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Pt-time directors</td>
<td>3</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Non-exec directors</td>
<td>2</td>
<td>10</td>
<td>7</td>
<td>5</td>
</tr>
<tr>
<td>Total</td>
<td>13</td>
<td>15</td>
<td>12</td>
<td>8</td>
</tr>
</tbody>
</table>

Note: CAA (Civil Aviation Authority); FSA (Financial Services Authority); GEMA (Gas and Electricity Markets Authority, responsible for Ofgem); PostComm (Postal Communications Authority). Sources, annual reports and websites at November 2006.

The CAA still has part-time directors who are effectively non-executives. Each board therefore conforms to the combined code by having a majority of non-executives. The independence of the non-executives can be a matter of judgement. They tend to be establishment figures with some background in the industry, but the Cabinet Office has pressed for genuinely independent appointments and some non-executives are clearly prepared to flex their muscles. The reproduction of private sector governance arrangements in the public sector might seem rather incongruous and, as we explore in the conclusions, it does pose acute problems of accountability. On the other hand, the adoption of

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‘businesslike’ processes and assumptions has been hallmark of public sector reform ever since the late 1980s, and the move to ‘boardisation’ could be seen as the culmination of that cycle of reform. Certainly the move to management of agencies through boards of directors provides strategic focus and carries several advantages.

Boards of directors in regulatory agencies can operate within a recognised institutional setting that is very familiar to regulated companies. The official encouragement of their powers through legislation and guidance and training from the Treasury and the Cabinet Office builds self-confidence in boards and allows them to be regarded as legitimate seats of leadership through conformity to robust principles of selection and organisation. Selection is operated through the Nolan principles policed by the respected Commissioner for Public Appointments to ensure a degree of real independence for the non-executive directors which serve on nearly all boards. Board processes increasingly reflect the combined code requirements of independent chairmen and audit, risk and appointment committees populated with non-executives. The structure and philosophy of corporate governance empowers boards and allows directors to challenge, to innovate and increasingly to control agency operations. Boards provide continuity and, where they work well, allow the development and collective ownership of strategy.

The argument, then, is that boards of directors in regulatory agencies have become more formalised, more self-confident and more visible in ways that have reinforced their legitimacy and built their self-confidence as collective sources of leadership and control. These trends have deliberately been encouraged by ministers and by the civil service through the Cabinet Office and the Treasury. For government at the centre, boards provide a point of engagement and a source of delegated policy development. They offer the great advantage of blame avoidance, but in an era where the Treasury puts immense emphasis on ‘delivery’ they also offer an authoritative body which can negotiate, pursue and deliver Treasury objectives and
targets in a measurable and transparent fashion. But if boards of directors offer advantages for top-down delivery of policy, they may also offer advantages for the organisation itself in terms of leadership and internal control, and for stakeholders who can focus on a source of responsibility and strategic development. As the boards balance their obligations within a multi-level, internationalised and functionally diverse environment they will engage with a complex cross-section of stakeholders, and we turn to them below before coming back in the conclusion to the dilemmas of effective accountability.

The changing world of stakeholders

As stressed above, accountability relations and information flows no longer involve simple agency accountability relations ‘up’ to ministers and parliament. They also embrace accountability relations ‘down and out’ to businesses, business interest groups, scientists and knowledge communities, and NGOs of diverse kinds, and ‘across’ to other parts of the government and other levels of government.11 The regulatory world for these diverse and intersecting stakeholders has changed considerably and is increasingly linked to theories which focus more on networks and complexity per se.12 In this section, we take note of only two such stakeholders, namely companies and consumers, and evaluate the changing nature of the trade-offs facing these players in contemporary multi-level and networked regulatory

regimes. In the final section of the paper we also look at state agencies other than the prime sectoral regulator as stakeholders.

We examine stakeholders with the aid of Figure 1 which simply shows that British utility regulatory governance consists of a sectoral or economic regime, represented by the arrows running ‘north and south’, and a horizontal regime dealing with environment, competition, corporate governance, social or quality regulation, including aspects of distributive equity.

**Figure 1: The sectoral and horizontal regulatory regimes and business and consumer stakeholders**

**Businesses and business interest groups**

Figure 1 deals mainly with competition and environmental regulation as examples. The latter elements are captured by the
horizontal or ‘east-west’ arrows in the diagram and include other state regulators which are both co-regulators and ‘stakeholders’ themselves in a complex multi-level regulatory regime (see next section). Both the vertical and horizontal elements interact with and cross through, in complex ways the specific regulatory bodies or institutions, the regulated companies, and consumer-citizens. Each set of stakeholders raise different accountability issues. They may operate through the westminster model by lobbying ministers but are equally likely to stress process or deliberative models of accountability.

Businesses and business interest groups show up in the political economy of regulatory stakeholder behaviour and strategising in ever more complex ways. Figure 1 notes the roles of incumbents and new entrants to liberalising regulated markets and highlights the key importance of multi-national firms. The business interest groups that interact with regulators and often share governance tasks of regulation in the realm of codes, standards, and customer complaints, are extremely diverse and include sectoral associations, industrial user groups of the regulated commodity or service, horizontal or peak association groups, such as Confederation of British Industry (CBI) and newly forming associations organised by new entrant companies. In Britain large firms tend to lobby directly and, of course, for regulated firms their government affairs function is typically centralised, influential, well resourced and attuned to the opportunities offered by multiple levels of governance.\(^\text{13}\)

In the classic UK sectoral regulatory regime model captured by the north-south elements of Figure 1, the regulator has a statutory duty to firms to take into account their needs for investment capital and the ability to raise such capital in order to provide regulatory tasks and services. They (and other regulators) may also regulate prices or price caps and conditions of entry into the

\(^{13}\) Coen D and Grant W (2006), Managing Business and Government Relations, in Coen D and Grant W (eds), Business and Government: Methods and Practice, Opladen, Barbara Budrich.
industry, and exit from it as well. Companies and their interest groups may also engage in forms of co-regulatory governance with NGOs and consumer groups on key business issues ruled through voluntary codes, standard-setting processes, and voluntary arrangements.

Some of the latter business interactions certainly deal with environmental regulators and sustainable development values, and also corporate social responsibility and sustainable production whose impacts have been growing both through regulatory push and through market competitive strategies of firms. But the horizontal regime elements in Figure 1 also crucially include the regulatory interactions with framework regulators that include those dealing with firms in general on matters of corporate governance, competition, financial markets and the City, trade, and intellectual property. Competition policy illustrates the complexity of horizontal relations rather well.

Since most of the sectoral regulators also have competition powers they have to manage their jurisdictional overlaps with the OFT (through concordats), with the European Commission, involving DG Competition and in some cases sectoral DGs, and with the Competition Commission through the risk of appeals against licence settlements and the possible referral of mergers and market investigations. The position is illustrated currently by the prospective engagement of the CAA with the Competition Commission involving a quinquennial review of regulated airport pricing during 2007 together with the OFT’s almost certain reference of a market inquiry to investigate the position of BAA. In the current British regime all these relationships are handled without any formal intervention of ministers and the avenues of accountability therefore rest on statutory powers, judicial review and the softer avenues of consultation, transparency and due process.

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Consumers, consumer organisations and the consumer-citizen

Consumers function independently as market participants and are also represented by various national and sectoral consumer bodies. There are also, now, any number of internet consumer price and quality comparison services supplied either by consumer bodies or commercial intermediary firms. Each of the sectoral regulators such as, Ofwat and Ofgem, also have statutory obligations to take into account consumer interests and they typically have a specialist independent consumer watchdog arm attached to that sectoral regime. What these regulatory governance changes bring out as well is the complexity and nuanced nature of what the modern consumer-citizen actually is.¹⁵ The consumer is best seen as being always hyphenated with some aspect of his or her role as citizen and economic and social actor:

- the individual buyer-consumer;
- the family-delegate-consumer;
- the remote, or rural-consumer;
- the low-income or socially-vulnerable-consumer;
- the rich or high income-consumer;
- the employee-consumer;
- the environmental-consumer concerned about how goods/services are made;
- small businesses as consumers;
- big business users-consumers;
- the private and public goods consumer with views about balances between public and private goods;
- the future-consumer.

When seen as the ultimate beneficiary of regulated services and products, such as energy and telecommunications, it is of course important to cast such persons as being ‘individual consumer-buyers’ desiring a reasonably priced and efficacious product or service. When the hyphenated consumer list is made more complete as in the above list, one ends up with other crucial categories of consumption and need. Citizen-consumers who are poor, vulnerable, sick, or who live in remote or rural areas become a different part of the consumer-citizen realm. Here also emerge different concepts of regulated services as an essential service and socially networked industry but supplied by largely private firms.\footnote{De Bruijn H and Dicke W (2006), Strategies for Safeguarding Public Values in Liberalized Utility Sectors, Public Administration, 84(3), pp717-736; Doern B and Gattinger M (2003), Power Switch: Energy Regulatory Governance in the 21st Century University of Toronto Press and Princen T, Maniates M and Comca K (2002), Confronting Consumption, MIT Press.} Forms of environmental-consumerism also become part the hyphenated consumer while the new statutory duties in respect of sustainable development discuss a new, and necessarily inarticulate, category of the ‘future consumer’.

But consumers also include business users of such regulated services as well as the average consumer. Very small businesses (entities with 3 or 4 employees) often behave in ways that are identical to the individual consumer. When such distinctions are made there is almost immediately a different equation of political power and market power, with the power of big business users being arguably greater than small businesses and the average consumer.

Conceptions of the consumer in regulated sectors (and more generally as well) have also taken more explicit account of regulating in the information society, where more information is available to consumers. This work has identified a number of discrete clusters of consumers in terms of their service expectations and their attitudes and behaviour. Behaviour can refer to how ‘compliant’ versus ‘active’ they are and attitude can
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refer to how ‘convinced’ or ‘sceptical’ they are.\textsuperscript{17} In regulated essential-service networked sectors consumers are given, in widely varying degrees, more choice, but it is unclear often how real these choices are and how often consumers are prepared to act on them and change suppliers.

The notion of sustainable consumption and the future consumer increasingly enters the consumer realm of regulatory governance.\textsuperscript{18} It refers to ever greater consumer-citizen concerns about not only what they buy but how it is made in terms of environmental and sustainability criteria. It is the logical complement to the paradigm of sustainable development which focuses on the need by current decision makers to leave the environment and its eco-systems in at least as good a state for the next generation as it was for the current generation. Sustainability therefore implies more preventative approaches rather than just remedial clean-up. It is also often defined by governments and business more loosely as ‘the triple bottom line’ approach to policies, rule-making and practices where decision makers explicitly take into account the economic, environmental and social consequences and effects of their decisions. Sustainability is also central to some notions of corporate social responsibility which regulators need to recognise as the companies they regulate share in an ambitious and complex transformative agenda in which changing patterns of production and consumption decrease the loading imposed upon the global environment.

Multi-level regulation and engagement

The final crucial development influencing the politics and accountability of UK regulation is the increasingly complex and intricate forms of multi-level regulatory governance that interact with national regulators. Figure I only hints at this realm of interactions and we also referred to it briefly in our initial mention of other state agencies as stakeholders. In the UK, multi-level regulatory engagement obviously includes the European Union which is cast often as the quintessential example of a supranational regulatory state. Because some EU issues are dealt with in other chapters in this book, we focus in this section on multi-level regulatory governance and engagement at the international, national and also local government levels, though these three all interact with EU processes. In addition to multiple levels, there are the issues raised by an over-emphatic sectoral focus. As sectoral regulators are required to engage with non-economic areas, such as sustainability, there is an imperative to look beyond their sectors and to engage with horizontal or generic regulators such as the Environment Agency. This has raised concern with ‘whole of government’ aspects of regulation and led to proposals for “a model which enables regulators to engage in a more coordinated and explicit way with other governmental bodies” (Bartle and Vass, 2006, p77).

Multiple-levels of rule-making, and the potential and actual coordination and congestion challenges and problems they create, are seen by many economic interests as an inhibitor of economic growth, efficiency, and innovation both in global markets and in ‘internal markets’. But such levels are also arenas and avenues to enhance democracy, to experiment with new solutions, and to pursue health, safety, environmental and fairness-related public interest purposes. They can also potentially increase or confuse basic aspects of democratic accountability, trust, transparency and legitimacy.

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In an overall sense, multi-level regulation involves interacting, reinforcing, and colliding rule-making and governance at the international, national, sub-national (Scottish and Welsh devolution) and city/local/community levels, or other connected spatial realms (such as endangered species and habitat, or electricity grids). Multi-level regulatory governance is a part of the larger study of multi-level governance which itself originated mainly in the study of the European Union as a novel type of multi-level, supra-national entity, that is, less than a state but more than an international agency or treaty/regime. But it has also been a part of studies of federal systems of government. It emerged as a distinct subject largely because the conventional approaches to understanding politics, including national politics, comparative politics, and international relations among states, simply do not adequately capture the kinds of politics and governance extant in the early 21st century world.

It can be argued that the central pressure to merge, collapse or rationalise levels of regulation is mainly driven by business interests and efficiency and liberalised trade ideas and related technological changes, including internet and virtual reality.

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governance possibilities. It is also closely tied to related economic concerns about UK productivity compared to the US and EU, not to mention China and India, about renewed concerns regarding the costs of regulation, and newer concerns about so-called cumulative regulatory burden. In a post 9-11 era, issues of security and terrorism, and thus border issues, are interwoven with these core business and economic agenda concerns. This overall pressure often manifests itself in the call by some commercial interests and other advocates to end the so-called ‘tyranny of small differences’ in rules and compliance requirements (between countries, regions, sub-national governments, and even cities).

This corporate political pressure must be juxtaposed against other pressures and values of democratic governance at each of the levels of regulation. The growing pressure of NGOs, civil society and the above noted consumer interests operating at all levels of regulatory governance are also crucial. There are inevitable issues about inherent institutional inertia and failures to learn and adapt to new, fast moving political-economic circumstances. This led globally to overall efforts to foster ‘better’ regulation or ‘smart’ regulation, where innovation agendas are an explicit force for change.

Multi-level regulation has also generated its own set of reform principles and mechanisms as discussed further below. But for Britain and for countries, jurisdictions and international bodies/regimes with which it is interacting, it necessarily follows that the approaches to the principles noted below will depend on the status-quo starting point extant in that given country or jurisdiction, and on the nature of the problems emerging in a given policy or regulatory field. It must also be stressed that

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choices from or among these lists of principles (and their accompanying administrative mechanisms) are often made in the context of complex and high pressure international negotiations and time-frames. The four reform principles which have gained increased prominence in the last fifteen years or so are: harmonisation; mutual recognition; uniformity or tacit cooperation and capacity-building; and competitive regulation and best practice benchmarking. In the EU context there is also the key principle of subsidiarity. These are purposeful norms and ideas which indicate the possible extent and degree to which nations or sub-national governments (or even cities and communities within a country) might give up or change their sovereign law and regulatory policies in the interests of international and national or regional cooperation and shared sovereignty, or under the pressure and power from global forces and so-called hegemonic global or regional powers, such as the US and EU or powerful states or provinces within countries.24

While it is important to list and define these principles as separate kinds of ideas for improvement and reform, it is also important to stress that they are contested ideas with various regulatory bodies and stakeholder interests (within countries, and among countries) having strong and often conflicting views about which principle should prevail and also about what exactly these principles mean in specific regulatory situations and circumstances. It is also crucial to see at what level of expression or aggregation these principles are enunciated and advocated. Such principles are almost by definition expressed at a fairly high level of abstraction, but when applied to specific areas of regulation or policy, they are rarely debated alone. Other norms and ideas specific to that regulatory realm are also combined in debate, negotiation, and decision making. For example, in the environmental policy realm, harmonisation as a principle is entwined with views about whether one is harmonising up to the highest level or down to the lowest common denominator. In the

energy realm, ideas may also encompass concerns about energy security, and about energy as an essential service industry and an industry with national security impacts and importance. The inevitable presence of these other accompanying values and norms must be kept fully in mind. The four principles noted above do not lead a solitary life. They almost always come with other related purposeful ideas which countries, levels of government and interests also see as principled.

Examples of these kinds of multi-level regulatory interactions among regulators, stakeholders, and overlapping principles and ideas are not difficult to find. We note just one such example in the field of energy regulation. The Office of Gas and Electricity Markets (Ofgem) is a classic British sectoral regulator for the energy sector. Previously functioning as Ofgas and Offer, the combined energy regulator and its predecessor twins have presided over a considerable liberalisation of the British energy sector, particularly regarding electricity and gas. As long as North Sea oil and gas was plentiful and provided growing supplies, energy regulatory policy was largely national in scope and also concerned about reasonable prices for consumers, and also, along with others British agencies, specialised concerns such as pensioners access to home heating in the colder winter months.

However, as North Sea oil and gas reserves were reduced and as different levels of energy liberalisation occurred in the EU and among some neighbouring oil and gas supplier states, then Ofgem became more concerned with overall issues of security of supply and the ability of liberalised and controlled markets to enhance supply and supply margins.\textsuperscript{25} Terrorism concerns also meant that there had to be more regulatory attention by Ofgem and other national security institutions about the physical security of pipelines and networks. Ofgem has had to develop more sophisticated assessments of foreign supply and new pipelines from Norway, Russia and other states though which key

\textsuperscript{25} Bream R (2006), Gas Forecast is a Winter Comfort for Ofgem, Financial Times, August 24, 3.
pipelines traverse. These international networks are not harmonised in some perfect way but they are certainly more integrated and linked than twenty years ago.

Ofgem still has to monitor the behaviour of core incumbent firms, such as British Gas and Powergen, and must regulate, talk and cajole them into bringing prices down as quickly when supply increases as they increase prices when supply problems are present. Ofgem must also encourage new entrants and smaller firms with alternative energy supply sources and technology. But Ofgem has also been a strong critic of the EU’s lack of action in fully liberalising its energy market. For example, it noted that in the winter of 2005-2006, gas imports from Belgium were limited despite the lure of higher prices in Britain. The larger sense of a combined vertical and horizontal regulatory regime for energy was also exhibited when EU competition authorities raided the offices of French and German energy giants and warned that anti-trust actions would be taken in order to correct serious malfunctions in the EU’s gas and electricity market. A further interesting manifestation of the multi-level nature of energy regulation for Britain comes in the fact that the Chairman of Ofgem, Sir John Mogg, has simultaneously headed up two European union entities, the European Regulators Group for Electricity and Gas and the Council of European Energy Regulators.

Of course, this brief illustrative glimpse into the energy regulatory world for Britain is only a very partial and truncated one. A complete picture of the multi-level regulatory regime for energy would have to include other international regulatory and monitoring bodies such as the International Energy Agency, the International Atomic Energy Agency, the power of OPEC, and national and international (and local) agencies dealing with the environment, climate change, and sustainable development more generally.
Conclusions

We opened the discussion with the observation that the whitehall model of democratic accountability remains a powerful constitutional principle but that, especially in relation to industry regulators, it has effectively broken down. The main principles of the model require an impartial, anonymous civil service accountable only to their minister who, in turn, is exclusively accountable to a sovereign parliament which, in turn, is fully accountable to the electorate. These principles have each been, for some time, seriously problematic across much of government, and multi-level governance, combined with agency independence, have made them particularly inappropriate for industry regulators. The question remains as to what principles are operating if the westminster principles are not, and how the system can be reformed to establish alternative and more effective principles of accountability.

It has been suggested above that accountability has come, almost by default, to be centred in the boards of directors of the industry regulators. This has happened almost by legislative and organisational accident. It is entirely characteristic of administrative reform in the British public sector that it happens in a haphazard, unplanned and pragmatic fashion. In similar fashion, boards of directors have evolved towards modes of accountability which offer an alternative to the democratic accountability of the westminster model. They have been encouraged to emulate principles of corporate governance in the private sector and board directors, especially non-executive directors, are becoming the key agents of accountability. They have therefore developed process accountability, deliberative accountability, and outcome accountability.

By process accountability we mean the evolution and dissemination of good regulatory practice based on the regulatory norms developed by the Better Regulation Executive and embodied in regulatory impact assessments (RIAs). By deliberative accountability we refer to the processes of
consultation, discussion, informed debate and learning from other systems before major regulatory changes are undertaken. By outcome accountability we mean the opportunity to judge regulators by results, by outcomes in the market. It is possible for consumers and stakeholders to observe and evaluate outcomes, such as standard of service, price, universal service and company performance. When things go badly, as they did with rail regulation, the reaction from stakeholders can provoke ministerial responses. When economic performance is good, regulators’ independence is secure.

We see, therefore, a pattern in which inadequate democratic accountability has been compensated for by managerial change within the regulators and the development of modes of accountability better suited to a wider body of stakeholders. In other words, a pattern whereby democratic accountability has been supplanted with accountability through efficiency. From a constitutional perspective we regard this swing away from democratic and towards business modes of governance with considerable concern. What is needed is a mature debate about how the westminster model can be replaced by principles which are logically formulated, sensibly debated, and can form the essence of a new constitutional settlement.

The recent inquiry by the House of Lords Select Committee illustrates that our concern is shared even within the institutions of the westminster system and the Lords is following up its accountability report with a new ad hoc Select Committee on Regulators which is undertaking during 2007 an inquiry into ‘UK Economic Regulators’.

To end with an imaginative example of some of the braver options that the Committee could consider we can draw a US parallel. One of the most creative analysts of the European regulatory state is Giandomenico Majone. In analysing the operation of European regulatory agencies he has sought to grapple with the ‘democratic deficit’ and to suggest alternative
modes of accountability. He suggests a parallel with the Independent Regulatory Commissions of the United States which are often termed the ‘fourth branch of government’. These bodies are controlled by legal procedural requirements, such as the Administrative Procedures Act of 1946, by transparent appointment of commissioners, and by elaborate judicial review. He argues that similar controls could be set in place in Europe to create “an independent fourth branch of government [that] also meets high standards of public accountability”.26 Perhaps we might discuss a ‘fourth branch’ in the UK, with boards of directors as the equivalent of Commissioners? The possibility might or might not find favour but our suggestion would be to undertake a similarly imaginative debate and not to return to the clichés that surround the westminster model.

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17 REGULATION IN THE EUROPEAN UNION – REGULATING THE REGULATORS

Leigh Hancher

Introduction

It is well known that the principal resource of the institutions of the European Union is its ability to adopt rules and regulations. The European Union does not have access to extensive financial means but it has, at least when compared to other international institutions, unparalleled powers to promote legislative and regulatory measures. The liberalisation of the Union’s utility or, as they are also referred to – network sectors – has been a process, which has been accomplished by regulation. Although this process is euphemistically referred to as ‘controlled competition’, it is becoming increasingly apparent that it is not necessarily a process which will lead to the abolition of specialised sectoral regulation and its eventual substitution by the Community’s general rules on anti-trust control – Articles 81 and 82 EC. If anything the ‘writing on the wall’ promises more, not less specialised and detailed, regulation for most of the sectors in question. In other words, more control even if there is more or less competition.

This chapter sets out to do three things. First, it will pose the rhetorical question – why after almost twenty years of EC policy on liberalisation in the network sectors – do we perceive a tendency towards more and not less regulation? Second, it will then turn to the question of what the aim and purpose of the

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increasing body of regulation is proving to be. It will be argued that a discernible trend in network sectors is the adoption of European regulation to regulate the regulators – at least in the first instance – as opposed to the industries, which these regulators in turn regulate. Finally, and in connection with this latter trend, we will examine the increased resort to soft law instruments – a practice that is also referred to as ‘regulation in the shadow of hierarchy’.¹ My purpose is to give a short account of each of these three issues.

This chapter does not claim to be an exhaustive account of the development of Community regulation in each of the post, water, telecommunications, energy or transport market. Other contributions to this volume address recent developments in each sector. It rather aims, if perhaps ambitiously, to provide some provocative reflections on the emerging trends over the last two decades of network regulation at European Union level, and in doing so this chapter cannot pretend at comprehensive or extensive coverage of each sector.

Why more and not less regulation?

Looking back at the early debates surrounding the initial plans to liberalise the European network sectors – and in particular energy and telecommunications – one is struck by the persistent hope of many commentators that sectoral regulation was merely a temporary phenomenon – a means to an end. The end was invariably the (gradual) introduction of competition into sectors which had hitherto been the preserve of tightly controlled state monopolies or oligopolies, or which had been effectively sealed off from the outside world by a panoply of exclusive rights and privileges conferred by states on their national providers (also referred to as incumbents). In telecommunications, post and

energy, the inherent model was first to change the market structure – ie, expose national markets to competition from new players, either entering into that market by establishing new companies or by supplying goods and services from a home Member state into that market, and to give (at first only a selective groups of) consumers greater freedom of choice to select suppliers of their choice. Given the essentially network bound characteristics of much of the utility sector, steps were also introduced to encourage and secure access to these networks. Having secured an alteration in the basic structure of national markets it was expected that the behaviour of the players would invariably change as they became subject to the winds of competition. Once the right structures were in place and the markets were functioning properly, there would be a shift away from *ex ante* specialised regulation to an increased, if not total reliance on the general *ex post* controls which are characteristic of national and European competition or anti-trust law. Consumers’ interests could be protected by regulatory measures, which were more akin to general consumer protection legislation.

Much of the early discussion and academic debate focused on the pros and cons of sectoral regulation versus general competition law as the best model on which to go forward. Yet in late 2006, the promise of less regulation and more competition law seems remote. In the telecommunications sector – nowadays known as the electronic communications sector – we are confronted with proposals for further reforms which will, in all likelihood, lead to further, detailed regulation. The same is true of the gas and electricity sector, and, although still lagging behind, the rail transport sector. The postal sector is likely to be the subject of a third directive in early 2007 abolishing the remaining monopoly privileges in the area of basic postal services, and this measure will no doubt mark the adoption of stricter Community rules on quality of service, access to clearing and sorting facilities, universal service obligations and pricing.
The changing nature of regulation

Not only is sector specific legislation still very much the order of the day, but also we see a greater reliance on Community regulations as opposed to the more flexible instrument of directives. Regulations are directly applicable in national legal orders; unlike directives, which are essentially framework measures leaving some scope to member states, they do not require national governments to adopt implementing legislation. The gas and electricity sectors offer useful examples. In 2003 the Council and parliament adopted a regulation on cross-border electricity trade to deal with the specific problems of congestion and tariffs and terms of access to national networks. In 2005 a second Regulation was adopted on access to Gas Transmission. This trend is important for a number of reasons. First, the regulations concerned impose clearly defined rules on national energy regulators without the intervention of national governments. Second, and in order to ensure that the terms of regulations are not overtaken by economic and technical developments, mechanisms have been included to allow their rapid amendment through revision of the various technical annexes and guidelines appended to these regulations. In many respects these types of European regulations displace the need for future national regulatory mechanisms because the very existence of divergent national measures will prevent the development of cross border trade and hence, competition.

A relevant question is why has the Community chosen to opt for more detailed regulation? One possible reason is that the process of liberalisation of technically complex markets, such as the energy market, has unleashed unexpected problems, or at least problems which are entirely novel and indeed arise as a result of greater cross-border trade. A good example here is the issue of congestion management techniques for the allocation of scarce capacity in electricity networks. As trade in energy has increased it has been necessary to find suitable methods to allocate scarce

2 Regulation 1228/03, OJ 2003 L176/1.
capacity among market players. Initially transmission system operators (TSOs) tended to do this on a first-come first-served basis, but this often resulted in incumbent firms maintaining their advantageous market positions. Some countries introduced auctions, but this too was not seen to be optimal as the auction price often eliminated price differences between different markets. The regulation of 2003 introduced the principle that congestion management techniques should be market-based and provided various options to achieve this. On 9 November this year, after lengthy consultations, the Commission finally adopted a set of guidelines on congestion management which will become legally binding on national authorities and TSOs.

Another possible explanation for the continued reliance on specialised regulation is that, in reality, many of the sectoral initiatives have not led to fundamental changes in market structures, and as a result the liberalisation exercise seems not to have delivered on its original promise. Public or state owned monopolies have given way to powerful private incumbents who are in a strong position to control and even dampen competition, not only in their traditional markets but also, potentially, in related markets. For example, the possibility of former incumbent operators to use their strong market position in the telecommunications sector to expand into new media technologies is a cause of concern for national regulators and the Commission.

A final factor, which cannot be overlooked, is the increased concentration levels in many sectors. The easiest way to obtain a market presence in another member state is to acquire an existing player – and the bigger the better. This has resulted in a huge wave of merger activity, and in some countries, a backlash, as certain governments struggle to preserve or promote national champions. In the final event, market structures have not evolved as initially anticipated – we do not see a hungry tide of new players competing aggressively for market share. If there are any new players on the horizon these are likely to take the form of private equity companies and pension funds whose main focus
and interest is on the valuable assets locked up in ex-incumbents. Sectoral regulation may prove a useful tool to address, some but no means all, of these trends, especially if the controls on mergers provided under the EC Merger Regulation are not fully applicable to each and every situation as the Gas Naturel/Endesa take-over battle recently illustrated.³

It would appear that, for better or worse, sectoral regulation is not only here to stay but it is likely to become more pervasive both in form and scope.

Regulating regulators?

A second important trend is the purpose and aim of recent and pending legislation in several sectors. Again the debate about whether one-stop European regulatory ‘shops’ as opposed to 25 national or even a larger number of sub-national regulators was to be preferred as the best approach to market liberalisation was one which characterised much of the early discussions on sectoral regulation. In the final event, a pan-European telecom or energy or post regulator looks unlikely to find acceptance at national level, even if this discussion is a recurrent one. It re-emerges in every periodic assessment the European Commission conducts of each of the regulated, network sectors. The only European-wide body to have been created in recent years is the European Rail Agency but this body has a more limited mandate and is focused on safety and interoperability issues. The decision leading to the creation of the European Network and Information Society Agency has been unsuccessfully challenged before the Court of Justice by the United Kingdom.⁴ Instead we have seen the emergence of national regulators (NRAs), whose activities

are linked together with greater and lesser degrees of formality, through transnational administrative or regulatory networks.

**Networks and agencies**

Indeed a wide variety of European regulatory networks have emerged in recent years with divergent functions and structures. First, there are the genuinely European regulatory bodies, which operate on the basis of the network model. The European Medicines Evaluation Agency (EMEA) is perhaps the best-known example. The EMEA has the duty, inter alia, to provide scientific advice of the highest level to the Commissions and the member states on applications for Community-wide product marketing authorisations. On the basis of that advice the Commission adopts a decision on the authorisation. The EMEA is referred to as a regulatory independent agency on account of the substantive expertise it brings to evaluating individual applications as required by a highly complex, as well as technical, body of European rules. Formally speaking, the final decision is taken by the Commission, but in practice the latter adopts the EMEA’s opinion.

In addition to the networks of centralised agencies, a number of independent decentralised networks have been set up which are not attached to an independent European agency but must cooperate directly with the Commission. In the majority of cases these networks have been created by a Commission decision, but the European Competition Network (ECN) – the network of

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6 Originally created by regulation. This regulation has been replaced by Regulation 726/2004.

7 See further Vos E and Joerges C (1999), EU Committees, Social Regulation, Law and Politics, Hart Publishing.
National Competition Authorities (NCAs), discussed below, owes its origins to a non-binding notice. These networks do not enjoy independent powers but operate as a forum for the decentralised co-ordination and enforcement of European directives and regulations. They have neither legal personality or separate administrative boards.

The independent Committee of European Securities Regulators (CESR) is an example of a decentralised, regulatory network of national authorities.\(^8\) The CESR was established following the recommendations of the famous Lamfalussy report, which had recommended a new regulatory model for the financial sector in order to overcome the delays and obstacles inherent in the reform of traditional European regulation and to provide the necessary powers for the Union to react swiftly to the fast-developing capital market.\(^9\) The CESR, unlike the EMEA, adopts generic regulatory measures, as opposed to individual decisions, measures that involve complex policy choices. It also advises the Commission on the drafting of new guidelines to implement the general principles espoused in directives adopted by the Council and the European Parliament. This advisory function is exercised in extensive and transparent consultation with the relevant stakeholders. Acting on the basis of the regulatory procedure as set out in the European Council’s Comitology Decision of 1999, the Commission adopts the relevant guidelines, on the advice of the European Securities Committee (ESC), a political organ.\(^10\) The CESR is also responsible for securing the coherent and timely implementation of European legislation, for example, through soft law measures and codes of best practice.

With respect to the energy and communications sectors, as well as for general competition matters, the Commission has opted for the creation of essentially decentralised networks of regulators, including the European Regulators Group for Communications


Networks (ERG), the European Energy Regulators Group (ERGEG) and the ECN. As yet no equivalents exist for the post or the railways sector, although informal networks appear to be gaining ground. In the following section we will look at the organisation and functions of the ERG, the ERGEG and the ECN in closer detail.

The ERG – the regulatory network for the electronic communications sector

The original Open Network Provision (ONP) Directives for the telecommunications sector required the Member states to create independent regulatory authorities to oversee the implementation of the rules on market liberalisation in the telecommunications sector. The original directives have now been superseded by the new framework on electronic communications. The ONP Directives did not provide for an official co-ordination mechanisms, although the ONP comitology committees were responsible for drawing up technical norms for networks and services as opposed to the implementation of the basic underlying principles set out in the directives – for example non-discriminatory, cost-oriented and transparent access pricing.

Two unofficial co-ordination bodies also emerged in the early years – on the one hand the High Level Group of National Administrations and Regulatory Authorities’ – comprising representatives of government, NRAs and the Commission; and on the other the Independent Regulators Group – an initiative of the NRAs to formalise consultation on regulatory issues and problems in different member states. Although these two bodies fostered a certain degree of co-ordination, this remained limited in its coverage, and as a process offered few procedural

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guarantees. The sector itself was of the opinion that its interests were not properly represented.12

The ONP Directives required the Commission to evaluate the contribution of the NRAs to the proper implementation of the European directives. On the basis of an external expert review the Commission conceded that there was little national support for the idea of a European Telecom Agency, and that the costs of such an institution were likely to outweigh the benefits.13 Instead, the focus shifted to ways of ensuring better co-ordination and co-operation between the NRAs. This has in turn been formalised in the new regulatory framework for the electronic communications sector. The Framework Directive announced the intention to set up the ERG and its Article 7(2) calls for the coherent implementation of the directives by a more transparent co-operation among the NRAs and in co-operation with the Commission.14 In particular the NRAs are expected to reach a consensus on the most effective instruments and solutions for specific market issues. The Commission decision on the setting up of the ERG is based on these provisions.15

The ERG comprises the heads of the NRAs – that is the authority which has been entrusted at national level with the regulatory tasks specified in the Framework Directive. The members of the ERG choose a chairperson and can choose its working methods – eg, in expert groups or sub-groups. The ERG enjoys limited autonomy from the Commission: it has neither a secretariat nor a budget, being dependent on the Commission for both. Meetings of the ERG are scheduled in agreement with the Commission, which must also approve the procedural rules.

Tasks

The ERG can advise the Commission either at the latter’s request or, on its own, initiate on issues relating to the consolidation of the internal market for electronic communication. In particular it advises the Commission on the exercise of its powers in relation to the drafting of Recommendations relating to the relevant market definitions and on guidelines on market analysis. The NRAs must in turn take these soft law instruments into account at national level. Further, the ERG advises the Commission on the application of its regulatory powers in concrete instances. The ERG is also expected to function as an interface between the national rule makers and the Commission, with a view to promoting greater consistency in this process across all member states.

The nature of the ERG’s powers

Unlike the individual member NRAs, the ERG itself has no powers to adopt binding decisions – it can only exert an indirect influence through its advice to the Commission. It can influence the economic criteria to be applied in market definition exercises, for example, or in market analysis documents. Policy issues can well surface here. The ERG can also exchange information, and can draft opinions and other soft law instruments to be addressed to the NRAs. The NRAs are entrusted with an important role with respect to the implementation of Articles 14 to 16 of the Framework Directives, market analysis, designation of undertakings with significant market power (SMP) and the imposition of legal obligations. In this context the ERG has issued guidelines – as a common position – explaining the economic principles, which will inform the decision to impose certain obligations on undertakings with SMP. Once again, policy choices are evident in this document.

17 In particular on the adoption of a decision on the designation of a transnational market – see Article 15(4) of the Directive 2002/21.
In addition to these primarily advisory functions, the ERG is also entrusted with a formal role in national decision-making procedures. Article 7(3) requires an NRA, which intends to adopt a decision with respect to SMP designation, and related obligations, to provide its opinions to the Commission and to the remaining NRAs, and the latter must provide the former with their views within a strict time frame. Article 7(5) stipulates that the NRA in question should take these views into account as far as possible when reaching its own decision. The opinions provided should reflect expertise as well as experience with the implementation of relevant Commission and ERG ‘soft law’ documents. Although the Commission appears to be an equal partner in the ERG, closer scrutiny reveals that the Commission retains an important power of veto.

At first sight the ERG would seem to enjoy a substantial degree of autonomy from the Commission – it can for example take its own initiative to offer advice to the latter and can draw up its own ‘soft law’ instruments which can touch on policy issues. The ERG can also comment on decisions of individual NRA’s interpreting the relevant provisions in the directives. Nevertheless, the Commission enjoys a special role, which it can also use to restrict the role of the ERG either through the exercise of substantive or organisational powers – both ex post and ex ante. The Framework Directive entrusts the power to the Commission to adopt soft law guidelines addressed to the NRAs, as well as investing it with a veto power if a particular national decision could infringe European law. Although the Commission may resort to various instruments to influence the substance of the activities of the network, the Framework Directive provides no indication as to whether it should take account of the ERG’s views, and under what procedures. The Decision setting up the ERG obliges the latter to operate in an open and transparent manner, while at the same time imposing on the network an obligation to maintain confidentiality. But there is a certain danger that a considerable lack of transparency will surround the actual operation of the network and, in particular, the role of the Commission. The existence of the network can function as a
vehicle of the Commission to impose its policy line on both the NRAs and the market parties – as opposed to a brake on its discretionary powers.

Energy - the ERGEG

The original gas and electricity directives were merely framework directives, which aimed at minimum harmonisation and conferred considerable freedom on the member states to adopt the necessary institutional structures to implement the substantive provisions. It was therefore hardly surprising that member states adopted very different institutional approaches, which in turn hindered the coherence and effectiveness of the very objectives of the directives. In 2004 two further directives came into force imposing stricter rules on member states with respect to the regulation of the two energy markets, requiring the designation of one or more regulatory authorities which must operate independently from sectoral interests. The absence of harmonising rules for cross border energy trade and the imbalances in the national administrative structures forced the Commission to consider alternative methods to enhance the realisation of the objectives set out the earlier directives. This led to the creation of the Florence Electricity Regulatory Forum and the Madrid Gas Regulatory Forum, which bring together stakeholders on a regular basis (initially twice per year and latterly, annually).

Neither forum is endowed with legal powers to adopt binding decisions but instead the aim is to achieve consensus on eliminating the technical and legal obstacles to cross-border

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20 For an analysis see Hancher L and Delguayo I (2006), in Barton B and Lucas A (eds), Regulating Energy and Natural Resources, Oxford University Press, p243 ff.
trade.\textsuperscript{21} The forums offered the different stakeholders the opportunity to unite together and to develop their views on particular issues. In turn the European Transmission System Operators founded its own group – ETSO, while the NRAs grouped together in the CEER. These different bodies engaged in constructive dialogue with a view to identifying and resolving the main issues confronting the further regulation of crucial aspects of the emerging European-wide energy market. Consensus emerged as to the basic principles, which should inform the European regulatory process for cross-border trade: transparency, cost-oriented tariffs and non-discrimination. Nevertheless, continuing opposition from certain member states and their incumbents prevented the Madrid and Florence forums from developing these principles into more detailed economic and technical rules, forcing the Commission to seek alternative solutions.

The final regulatory model which has emerged in the electricity and gas sector offers many similarities with the Lamfalussy model for the financial sector. The 2003 directives and the two regulations provide the basic regulatory principles for the energy sector. Regulation 1228/2003 sets out basic principles on tariffs and access conditions for cross-border electricity transmission – principles developed in the Florence Forum.\textsuperscript{22} A further Regulation for the gas transmission was adopted in 2005.\textsuperscript{23} The Commission is empowered to adopt further concrete guidelines fleshing out these basic principles via the comitology procedures. The NRAs must in turn take these guidelines into account in their decision-making procedures. A network of energy NRAs – the ERGEG – in turn advises the Commission on the content of these draft guidelines. The recent adoption of the guidelines on congestion management, discussed above, is an example of this process.

\textsuperscript{22} OJ 2003 L176/1.
\textsuperscript{23} OJ 2005 L289/1.
Legal basis and organisation of the ERGEG

The Energy Directives require the NRAs to guarantee the functioning of the internal market as well as equality of competition through transparent co-operation between themselves as well as with the Commission. The recitals to the directives of 2003 laid the basis for the ERGEG as a suitable advisory mechanism for the enhancement of co-operation and co-ordination across national boundaries. The Commission adopted a decision setting up the ERGEG in December 2003. The heads of the various NRAs are represented in the ERGEG. The group elects a chairperson from its members and if so desired can appoint expert working groups with the mandate to study particular issues. Unlike the CESR however, the ERGEG enjoys only a limited autonomy vis à vis the Commission. The Commission provides the secretariat and approves its internal procedural rules and is also responsible for all financial costs attached to its functions. As with the ERG, the ERGEG can take the initiative – or acting on the request of the Commission – to provide advice to the Commission on the consolidation of the internal energy market, including advice on draft guidelines as foreseen in the regulations. In addition the Group will encourage consultation, co-operation and coordination between the NRAs in order to secure a more coherent implementation of the current body of European law with respect to electricity and gas in the member states.

The nature of the ERGEG’s powers

Neither the directives nor the decision on the ERGEG contain any procedural rules governing the operation of the ERGEG – the decision merely requires that the group base its deliberations on extensive, timely and open consultation with relevant stakeholders. However information cannot be released into the public domain if the Commission has announced that an opinion

24 OJ 2003 L296/34.
25 For a full list of ERGEG activities see www. ergeg.org.
it has requested or a question it has addressed to the group should be kept confidential. On the one hand, the ERGEG seems to enjoy more far-reaching powers than the ERG given its role in providing advice on the drafting of legally binding rules. On the other hand, the ERGEG lacks the concrete regulatory powers entrusted to ERG with respect to certain decisions. The status of the ERGEG’s advice to the Commission is unclear. In the final event the Commission takes its decision on the basis of the comitology procedures. In contrast to the Lamfalussy process, the Commission has not obliged itself to engage in extensive consultation with the European Parliament in the adoption of the guidelines annexed to the regulations.

As with the electronic communications sector, the Commission has extensive *ex post* and *ex ante* powers and instruments to control whether the NRAs have properly implemented the guidelines, the regulations and the directives. It also enjoys the power to veto decisions, which infringe European law, and to veto important decisions with respect to investment in new infrastructures. Given this situation, the scope for the ERGEG to exercise any meaningful influence on the further implementation of the directives, and the implementation of European law generally will depend on the extent to which the Commission leaves it the requisite room to manoeuvre. The current legal framework offers few assurances that the ERGEG will operate in a fully transparent and objective manner. In particular controversy has arisen over its proposed guidelines for inter TSO compensation – a complex measure aimed to compensate those TSOs who host additional flows of energy in transit.

*The European competition network*

The ‘Modernisation’ Regulation 1/2003 on the application of Articles 81 and 82 EC and replacing Regulation 17/62 entered into force on 1 May 2004. The most important amendment introduced by the new regulation is of course the abolition of the

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26 OJ 2003 L1/1.
Commission’s exclusive right to apply Article 81(3) EC. The national competition authorities (NCAs) and the national courts are empowered with direct application of Article 81 EC in its entirety, albeit under the supervision of the Commission. Article 35 of the regulation requires that member states ensure that their national authorities are able to apply Article 81 and 82 EC in a manner, which guarantees the effective implementation of the regulation’s various provisions.\(^{27}\) Now that the Commission is no longer required to rule on exemptions and negative clearances, this should free up resources to pursue serious infringements. However, the decentralised implementation of European competition law could mean that the NCAs and national courts could arrive at diverging interpretations of the relevant European competition law principles, albeit in broadly similar sets of circumstances, and as a result could arrive at different decisions and impose divergent sanctions. This could prove especially problematic if the same anti-competitive behaviour manifested itself in different jurisdictions (parallel inquiries).

In order to secure a more consistent application the Regulation provides for a number of instruments to guarantee co-operation between the courts and the Commission and also the latter and the NCAs in respect of the national procedural rules governing the application of European competition law.\(^{28}\) Further the regulation provides for the basis for cooperation between the NCAs as such, and between the Commission and the NCAs. The Commission has subsequently adopted a Notice on Co-operation Within the Network of Competition Authorities.\(^{29}\) In contrast to the ERGEG and the ERG, the Commission is a full member of the ECN given that it is also empowered to apply Articles 81 and 82 directly.

\(^{27}\) It should be noted that the majority of member states had already set up national authorities with the power to apply Articles 81 and 82 EC.

\(^{28}\) Article 15.

\(^{29}\) OJ 2004 C101/34.
The notice spells out the division of tasks, the procedure for case allocation and the procedures governing information exchange. The role of the ECN differs substantially from that of either the ERG or the ERGEG. Obviously the ECN is dealing with directly applicable European, which can be applied, in parallel as opposed to directives. The Commission has, on the other hand, a specific responsibility for the development and application of Community competition law: it can take individual decisions, adopt group exemptions and guidelines and notices. Hence the NCAs enjoy more limited discretionary powers in the performance of their tasks, as compared to the NRAS entrusted with the implementation of sector specific directives. The legal basis for the ECN’s powers is not the same as that of either the NCAs or the Commission, which are empowered at national and European level respectively to enforce Community competition law. The ECN itself cannot take any legally binding decisions.

The ECN is therefore not expected to perform advisory roles in respect of the development of legally binding Community instruments or guidelines. It has the more specific task of promoting information exchange and to guarantee a proper allocation of cases. These tasks are carried out primarily through a virtual network – via an internal website.

**The duties of the ECN**

The ECN is charged with an efficient division of responsibilities and an effective and coherent implementation of Community competition law. It is a forum in which the NCAs and the Commission can exchange information, agree on the authority which is most suited to take charge of a particular case and can agree on wider policy. In the event of parallel procedures, the national authorities concerned should ensure the allocation of the case to the authority best suited to restore competition or to supervise a specific market. The allocation will depend on a number of factors including the market(s) on which the most

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30 Notice, paragraph 3.
significant effects of the anti-competitive are alleged, as well as the possibilities for gathering evidence, and for ending infringements and imposing effective sanctions.\textsuperscript{31} Hence, despite its different aims and powers, agreement and coordination on policy issues can also, albeit more indirectly, be secured through the ECN.

\textbf{Regulatory independence}

Not content with ensuring the independence of the NRAs and NCAs from the industries which they have been set up to regulate, and as well as taking measure to promote their interdependence through the networks described above, the Commission has expressed growing concern about their independence from national governments – in particular if the regulatory agencies are under-funded and under-staffed, but also given that certain member states may still have extensive shareholdings in the major players which these agencies are expected to regulate. The relevant sectoral regulations only stipulate independence from industrial interests, leaving it by and large to the member states to choose how they organise and equip these national bodies. In certain cases, the sectoral measures will stipulate the types of decision these authorities should take, while in other cases their exact role and status is left to the member state, who may merely delegate to them certain advisory functions, retaining the power to take final decisions for ministers. Whereas in certain cases, the regulator in question may only be empowered to settle disputes or fashion executive powers to implement national regulations, in other cases the regulator enjoys considerable regulatory powers. Hence there is a considerable lack of consistency in approach. Yet independent regulators do not fit easily into the constitutional systems of each and every member state, making it difficult for the Commission to propose a uniform approach. Two types of initiative which have been touched upon in the previous sections describing the tasks of the sectoral regulatory networks can also be identified as

\textsuperscript{31} Notice, para. 8.
a response to these concerns: the growth of soft-law and the development of veto powers.

Soft-law

The creation of these new networks of NRAs – in turn building on earlier, informal co-operation between national authorities, industry and the Commission – have, as it has been made clear in the preceding description of the functions of both the ERG, the ERGEG and the ECN – led to a large expansion of a particular form of regulation: regulation through co-ordination and regulation through soft-law instruments, such as guidelines and codes of practices. In practice, the growth of these types of instruments may raise the question of just how ‘decentralised’ these networks are in practice. Although the primary aim is to ensure a more harmonised approach to the application of Community regulations and directives – the classic ‘hard law’ instruments – at national level and to secure a more consistent treatment of market players across the member states, the practical effect of many of the measures adopted is to limit the discretion of national regulatory authorities in dealing with particular cases. This in turn has implications for national governments who, for both constitutional and policy reasons, might be reluctant to confer wider rule-making powers on independent regulators and who hence prefer to take key decisions at a higher level where fuller political control can be asserted. The adoption of soft-law techniques may in fact require national governments to delegate further powers to their national regulators so that their decisions can be aligned with those of their other EC colleagues.

Veto powers

The Commission has not been content to leave the key decisions to the networks of national regulators in the energy and
communications sector. The Gas Directive of 2003 and the Electricity Regulation, also of 2003, make provisions for so-called merchant investments in new gas infrastructure or in cross-border interconnectors. These types of investment are not funded by the revenue earned by the transmission system operators from their regulated activities but are funded independently either by the TSO themselves on the basis of project finance, or are constructed and funded by private investors. As such they may qualify for a special regime which in effect amounts to an exemption from the standard (harmonised) national rules on third party access (TPA) and tariffs for access. The relevant provisions of the Gas Directive (Article 22) and the Electricity Regulation (Article 7) provide that the national authorities should adopt a decision granting the exemption.

The conditions on which the exemption is to be based are spelled out in the directive for gas and in the regulation for electricity. Additional, and more stringent criteria as to how the applications are to be assessed at national level, are contained in a non-binding ‘note’ published on the DG Tren’s web site in January 2004. Even if this ‘note’ has no legal status as such, a failure to comply with its terms will inevitably lead to difficulties in obtaining the Commission approval that is required under the directive or, as the case may be, the regulation in order for the exemption regime to be applied at national level. The Commission may reject or amend the national decision, albeit that if it proposes to do so it must submit its own proposal to a form of comitology procedure. Interestingly even although national authorities will usually publish a draft decision and call for comments from third parties before finalising national procedures, the Commission merely publishes an announcement that it intends to take a decision, and invites comments. Neither its proposed nor final decision is published.

Article 7 of the Electronic Communications Framework Directive

As we have mentioned in the section describing the functions of the ERG, the Framework Directive 2002/21 also allows the Commission as well as the ERG itself to exercise a variety of controls over individual national regulatory decisions. Its Article 7 provides the Commission with an important veto over draft national decisions on whether particular markets should be subject to *ex ante* regulation. The NRA must carry out an analysis of the relevant markets identified by the Commission in a non-binding set of guidelines as markets susceptible to *ex ante* regulation. Where a market is considered not to be effectively competitive as a result of an undertaking having significant market power then the NRA must impose certain obligations on this undertaking. Although NRAs are accorded discretionary powers correlative to the complex character of the factual, economic and legal situation at national level, in accordance with Article 7 it must make its draft measure designating SMP available to the Commission.

If the Commission has serious doubts as to the compatibility of the draft measure with Community law, it may issue a ‘serious doubts letter’ requiring that the draft measure should not be adopted for two months. If the Commission’s concerns are not alleviated within this period it can take a decision requiring the NRA to withdraw the draft measure. This decision should contain a detailed analysis of why the Commission considers that the draft should not be adopted, together with specific proposals for amending it. NRAs are expected to take into account the Commission’s recommendation of 2003 on markets deemed susceptible for *ex ante* regulation together with the Commission’s 2002 guidelines on market analysis and the assessment of SMP when deciding whether or not a particular market is to be subject to *ex ante* regulation. In three cases the Commission has vetoed national decisions on the grounds that
these decisions had not properly applied European competition law principles as reflected in these non-binding measures.33

Conclusion

As we noted in the introduction, despite initial optimism that sectoral specific regulation was only a temporary phenomenon, which would eventually give way to general competition law-based control, the liberalisation of the European Union’s utility or network sectors has produced a plethora of rules, new regulatory institutions and more recently, formalised administrative and regulatory networks. Regulators are of course unlikely to abolish themselves – they are more than likely to devise new powers and functions to justify their continued existence. Once united into a mesh of European wide networks they are all the more likely to form a mutual support group for self-preservation. We can only expect more not less regulation, and much of that regulation will be increasingly targeted at the regulators themselves as opposed to the industry they regulate. This is especially likely to remain the case as long as the Commission is not entirely satisfied as to the independence of national regulators from government. We can expect to see a continued trend towards more detailed regulation, gradually eroding the room for discretionary manoeuvre at national level.34

In addition the increased reliance on soft law at European level often keeps many of this type of regulatory co-ordination beyond the scope of judicial review, at both European and national level.

33 For a discussion, see Grewe D et al (2005), Two Recent Veto Decisions, in Competition Policy Newsletter, Spring, no 1, pp49-52.

Is this all to be welcomed? The response we can offer on the basis of our analysis in this short chapter is not wholly positive. Improved co-ordination and consistency are certainly to be lauded but this also comes at a price, not least in terms of the costs of regulation which industry and indirectly, consumers must bear. But perhaps there is an even higher price to be paid in the longer term. The narrow focus on technicalities may mean that the bigger picture is obscured. Instead of (re) examining and re (assessing) the very goals of the liberalisation exercise, and whether the overall design and aims of the regulatory regimes are on target to meet those goals, and questioning whether further fine-tuning is needed, there is a danger that the focus remains on the instruments of regulation alone – and fails to move beyond the interminable, inexorable task of sharpening and honing regulatory rules down to the finest detail. We should not just ask what regulatory networks can deliver or cannot deliver in terms of better co-ordination, improved governance and so forth, but seriously question whether their very existence might contribute to the marginalisation of major policy issues confronting the organisation of the European network industries and the services they should deliver in the coming decades.

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Richard Whish

Introduction

The Competition Act 1998 entered into force on 1 March 2000. The ‘Chapter I prohibition’ in the Act, closely modelled on Article 81 of the EC Treaty, prohibits agreements that have as their object or effect the prevention, restriction or distortion of competition. The ‘Chapter II prohibition’, modelled on Article 82 EC, prohibits the abuse of a dominant position. Decisions finding infringements of the Act (or of Articles 81 and 82 EC) may be made by the Office of Fair Trading (the OFT) and, within their respective spheres of activity, by the sectoral regulators, that is to say by the Office of Communications (Ofcom), the Gas and Electricity Markets Authority (GEMA), the Water Services Regulation Authority (WSRA), the Office of Rail Regulation (ORR), the Civil Aviation Authority (CAA) and the Northern Ireland Authority for Energy Regulation (NIAER). Full appeals on the merits may be taken to the Competition Appeal Tribunal (the CAT) against ‘appealable decisions’, as set out in sections 46 and 47 of the Competition Act: the list includes both decisions that the Act has been infringed and decisions that it has not been

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infringed. Other decisions of the OFT and the sectoral regulators may be challenged by way of judicial review before the Administrative Court.

A further piece of competition legislation, the Enterprise Act 2002, entered into force on 20 June 2003. This Act makes provision for the investigation of markets and for the control of mergers. The OFT has the function of conducting a first screening of markets and mergers and it has a discretion (in relation to markets) and a duty (in relation to some mergers) to make a reference to the Competition Commission (the CC) for a deeper investigation. The Enterprise Act provides that persons aggrieved by decisions of the OFT or the CC under the Act may apply to the CAT for judicial review. The CAT also has jurisdiction in relation to certain regulatory decisions of Ofcom under the Communications Act 2003. This chapter will identify some of the key themes in the appeals and judicial reviews brought before the CAT over the six years that the Competition Act and the three years that the Enterprise Act have been in force.

Statistics

The *Annual Review and Accounts* of the CAT for the period 1 April 2005 to 31 March 2006 contain an interesting statistical review of its activity during that period.¹ Ten new appeals were received during that year, five under the Competition Act, two under the merger provisions of the Enterprise Act, one under the market investigation provisions of that Act and two under the Communications Act. 41 judgments were handed down (compared to 26 in 2004/05 and 34 in 2003/04); of those 41 judgments, 13 disposed of the main issue or issues, 11 were concerned with procedural and interlocutory matters, and 17 with ancillary matters such as costs. The *Annual Review* contains a case-by-case summary of the judgments handed down during the

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¹ Available at www.catribunal.org.uk.
year, and also tracks the activity in each case within the period.\textsuperscript{2, 3} In the subsequent period from 1 April to 30 November 2006, the CAT has received 14 further appeals and has handed down 25 judgments.

**Infringement decisions**

It is a striking fact that, in the six years that the Competition Act 1998 has been in force, only one decision of the OFT finding an infringement of competition law has been overturned by the CAT. The OFT has adopted 19 infringement decisions since 1 March 2000, of which 12 have been appealed to the CAT. All of those decisions, with the exception of *Attheraces*, were upheld, or substantially upheld, on appeal to the CAT, although in some cases the level of the penalty was varied (see section 3 below). The OFT’s findings of infringements of Chapter I of the Act in *Hasbro II\textsuperscript{4}*, *Football Replica Kits\textsuperscript{5}* and in *West Midlands Roofing Contractors\textsuperscript{6}* were all upheld\textsuperscript{7}, as were the Chapter II decisions in *Napp\textsuperscript{8}*, *Aberdeen Journals\textsuperscript{9}* and, for the most part, *Genzyme*.\textsuperscript{10} Further appeals were taken to the Court of Appeal against the judgments of the CAT in relation to the *Hasbro II* and *Football Replica Kits* decisions, but these were rejected in a single

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\textsuperscript{2} See pp 16-29.
\textsuperscript{3} See pp 30-34.
\textsuperscript{4} Case Nos 1014/1/1/03-1015/1/1/03 *Argos Ltd v Office of Fair Trading* [2004] CAT 24, [2005] CompAR 588.
\textsuperscript{5} Case Nos 1021/1/1/03-1022/1/1/03 *JJB Sports Plc v Office of Fair Trading* [2004] CAT 17, [2005] CompAR 29.
\textsuperscript{6} Case Nos 1032/1/1/04-1033/1/1/04 *Apex Asphalt and Paving Co Ltd v Office of Fair Trading* [2005] CAT 4, [2005] CompAR 507.
\textsuperscript{7} The CAT annulled some of the OFT’s findings of infringements in the *Football Replica Kits* case
\textsuperscript{8} Case No 1001/1/1/01 *Napp Pharmaceutical Holdings Ltd v Director General of Fair Trading* [2002] CAT 1, [2002] CompAR 13.
\textsuperscript{9} Case No 1009/1/1/02 *Aberdeen Journals Ltd v Director General of Fair Trading* [2003] CAT 11, [2003] CompAR 67.
\textsuperscript{10} Case No 1016/1/1/03 *Genzyme v Office of Fair Trading* [2004] CAT 4, [2004] CompAR 358.
judgment given on 19 October 2006.\textsuperscript{11} The appellants were
denied permission by the Court of Appeal to appeal to the House
of Lords, but they are now petitioning the House of Lords itself
for permission to do so.

The one infringement decision of the OFT to have been annulled
was Attheraces.\textsuperscript{12} The OFT had concluded that the collective
selling by the Racecourse Association of the non-licensed betting
office (non-LBO) media rights to horseracing at 59 racecourses
in Great Britain infringed the Chapter I prohibition; and that it
did not satisfy the criteria of section 9 of the Competition Act,
which provides a defence for restrictive agreements that produce
economic efficiencies. The Racecourse Association (and the
British Horseracing Board) appealed to the CAT, which
disagreed with the OFT’s analysis.\textsuperscript{13} In the CAT’s view the OFT
had failed to define the relevant market correctly. The OFT had
defined a market for non-LBO media rights, but the CAT
considered that this was too narrow: the CAT concluded that this
was a sufficient reason in itself to set the decision aside.\textsuperscript{14}
However the CAT also went on to consider whether, assuming
the OFT had correctly defined the relevant market, the collective
selling amounted to an infringement of the Chapter I
prohibition.\textsuperscript{15} In the CAT’s opinion, the collective selling of the
media rights in question was objectively necessary:

\begin{quote}
``an acquisition via a central negotiation was the only
realistic way forward both from the viewpoint of both
bidder and sellers (\textit{sic}) and we regard is as probable
that any initial attempt at a self-assembly exercise via
\end{quote}

\begin{flushright}
\textsuperscript{11} Argos Ltd and Littlewoods Ltd \textit{v} OFT and JJB Sports plc \textit{v} OFT [2006] EWCA Civ 1318.
\textsuperscript{12} OFT decision of 10 May 2004, [2004] UKCLR 995.
\textsuperscript{13} Case Nos 1035/1/1/04-1041/2/1/04 The Racecourse Association \textit{v} Office
\textsuperscript{14} See paras 135-150.
\textsuperscript{15} See paras 160-176.
\end{flushright}
individual negotiations would have led quickly to a centrally negotiated one”.

The CAT also concluded that the OFT had failed to demonstrate that collective selling led to an appreciable increase in price; nor that it resulted in a loss of non-price competition. The CAT’s judgment in this case is a most interesting one, in which it takes a robust, ‘common sense’ approach to the question of whether competition was restricted on the facts of the case. The discussion of the necessity of collective selling acknowledges that the ‘evidential’ burden of proving such necessity lay with the parties to the agreement rather than with the OFT, even though the overall burden of showing an infringement of Chapter I was on the OFT. The CAT noted the difficulty of reconciling the judgments of the ECJ in Wouters and Gøttrup-Klim with the CFI’s judgment in Métropole v Commission, concluding, in relation to the ECJ’s judgments, that:

“What these cases show is that ostensibly restrictive arrangements which are necessary to achieve a proper commercial objective will not, or may not, constitute an anti-competitive infringement at all. Whether or not they will do so requires an objective analysis of the particular arrangement entered into by the parties, assessed by reference to their subjective ‘wants’ and against the evidence of the particular market in which they made their arrangement. The task then is to consider whether the restrictive arrangement of which

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16 See para 171.
17 See paras 177-202.
18 See paras 207-211.
19 See paras 130-134.
An interesting feature of this case is that it originated as a notification to the OFT by the Racecourse Association, in the days when it was possible for the parties to agreements to notify them to a competition authority for guidance or a decision as to whether they were lawful or not. That system was abolished by the *Competition Act 1998 and other enactments (Amendment) Regulations 2004* as part of the UK’s response to the abolition of notification at Community level by the so-called ‘Modernisation Regulation’, Regulation 1/2003. If the agreement had not been notified by the Racecourse Association to the OFT, it is quite possible that it would never have been investigated at all; more particularly, if it had come to the attention of the OFT since the adoption of its ‘competition prioritisation framework’ in October 2006, it is unlikely that it would have merited consideration under the criteria for the selection of cases set out in that document.

An infringement decision of the OFT that raised issues of great complexity and importance was *MasterCard UK Members Forum Ltd*, which dealt with the so-called multilateral interchange fee (the MIF) payable by acquiring banks to issuing banks within the MasterCard system. The OFT’s view was that the MIF amounted to collective price fixing and that ‘extraneous’ costs were included in its calculation, making it higher than it should have been; the OFT was also of the opinion that the arrangements were not justifiable under section 9 of the Competition Act (nor under Article 81(3) EC). The decision was appealed to the CAT, but was then withdrawn before a judgment on the substantive matters in dispute between the parties and the OFT had been given: the OFT’s view was that, since the

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23 See para 167 of the judgment.
24 SI 2004/1261.
26 Available at www.oft.gov.uk.
MasterCard system had now been amended, it would be more fruitful for it to expend its resources on examining the new arrangements than to defend the old ones on appeal. The CAT gave a judgment on 10 July 2006 consenting to the decision being set aside; however, in the course of doing so, it expressed its view that it was:

“highly regrettable that, after over 6 years of administrative proceedings, the OFT has reached the view that it should withdraw the Decision, especially in such an important ‘flagship’ case which has commanded widespread attention in Europe and elsewhere”.

As we shall see below, this is by no means the only occasion on which the CAT has expressed frustration at what it perceives to be the slow progress of administrative procedures under the Competition Act (and the Enterprise Act).

The CAT has not received any appeals against infringement decisions of the sectoral regulator, for the simple reason that, until very recently, there had not been any: a point that was noted, with a certain amount of dismay, by the President of the CAT, Sir Christopher Bellamy, in his Beesley lecture of 28 October 2004. On 17 November 2006 the Office of Rail Regulation became the first sectoral regulator to adopt an infringement decision in the case of English, Welsh and Scottish Railway Ltd, finding that EWS had concluded contracts for the haulage of coal by rail that had abusively excluded competitors...

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30 Para 28.
31 See also, Peter Freeman (2007), Regulation and Competition - Chalk and Cheese? The Role of the Competition Commission in, CRI, Frontiers of Regulation - Assessing Scholarly Debates and Policy Challenges, Academic Conference Proceedings, University of Bath.
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from the market.\(^{32}\) Given that the ORR’s Press Notice states that EWS has accepted the finding of abuse, one can assume that there will be no appeal to the CAT in relation to the finding of a substantive infringement of the Competition Act. A penalty of £4.1m was imposed on EWS, a sum arrived at after allowing a 35% discount to reflect EWS’s co-operation with the ORR.

Penalties

There have been numerous appeals to the CAT in relation to the penalties imposed by the OFT for infringements of the Competition Act. In some cases the CAT decided not to interfere with the OFT’s determination; however the CAT has amended the OFT’s decisions on penalties on several occasions, usually downwards but on one occasion upwards.\(^{33}\)

The position on penalties is that the OFT has issued guidance, as required by section 38 of the Competition Act.\(^{34}\) The OFT’s guidance sets out a five-step approach to determining the level of the penalty. The Court of Appeal has explained that the guidance is not binding on the OFT, but that it must give reasons for any significant departure from it.\(^{35}\) The CAT is not bound by the OFT’s Guidance.\(^{36}\) The CAT’s practice has been to review the OFT’s application of the guidance and then to set out its own views on the seriousness of the infringement and to make its own assessment of the level of the penalty on the basis of a ‘broad brush’ approach, taking the case as a whole. It then carries out a

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\(^{32}\) See the Press Notice ORR/33/06 of 17 November 2006, available at www.rail-reg.gov.uk.


\(^{34}\) OFT's guidance as to the appropriate amount of a penalty, December 2004 (OFT Guideline 423).

\(^{35}\) Argos Ltd and Littelwoods Ltd v OFT and JJB Sports plc v OFT [2006] EWCA Civ 1318, para 161.

\(^{36}\) See para 160.
‘cross check’ to see whether the amount it has arrived at would be within the parameters set out in the OFT’s guidance. The Court of Appeal has said that it thinks that this is an appropriate approach for the CAT to take.\(^{37}\)

The CAT’s approach can be seen, for example, in \emph{Napp Pharmaceuticals}, where the penalty of £3.21m imposed by the OFT was reduced by the CAT to £2.2m; and in \emph{Aberdeen Journals}, where a penalty of £1.3m was reduced to £1m.\(^{38}\)\(^{39}\) Similarly in both \emph{Hasbro II} and \emph{Football Replica Kits} the CAT reduced the penalties imposed by the OFT (in the case of \emph{Football Replica Kits} this was in part because some of the findings of infringement were set aside).\(^{40}\)\(^{41}\) On appeal to the Court of Appeal in these two cases the CAT’s determinations on penalties were upheld, the Court noting that the CAT is an expert and specialised body with whose assessment it should hesitate to interfere.\(^{42}\) The Court of Appeal’s comments in these two appeals make clear that the CAT is entitled to review the level of penalties imposed by the OFT in the way in which it has done. However it is at least open to question what policy objective is served by varying the OFT’s penalties in this way: if the OFT has applied its guidance correctly, and yet the CAT is prepared to reduce a penalty because, on a broad-brush basis, it thinks that the penalty should be lower, that can only encourage undertakings to appeal, with serious implications for the resources of the OFT and, indeed, the CAT: resources which might be better deployed on the investigation of possible infringements of the Act than the hearing of appeals.

\(^{37}\) See para 163.

\(^{38}\) Case No 1001/1/1/01 \emph{Napp Pharmaceutical Holdings Ltd v DGFT} [2002] CAT 1, [2002] CompAR 13.

\(^{39}\) Case No 1009/1/1/02 \emph{Aberdeen Journals Ltd v DGFT} [2003] CAT 11, [2003] CompAR 67.

\(^{40}\) Case Nos 1014/1/1/03-1015/1/1/03 \emph{Argos Ltd v OFT} [2005] CAT 13, [2005] CompAR 834.

\(^{41}\) Case Nos 1019/1/1/03-1022/1/1/03 \emph{JJB Sports Plc v OFT} [2005] CAT 22, [2005] CompAR 1060.

\(^{42}\) \emph{Argos Ltd and Littlewoods Ltd v OFT} and \emph{JJB Sports plc v OFT} [2006] EWCA Civ 1318, para 165.
This is not to say that there are no potential pitfalls for appellants in appealing to the CAT. In the case of Football Replica Kits the CAT actually increased the penalty on one of the appellants, Allsports Ltd, by £170,000. The OFT had allowed a 5% decrease of the penalty that would otherwise have been imposed on Allsports in recognition of its co-operation. In the proceedings before the CAT it became clear, when witnesses were subjected to cross-examination, that Allsports had been less co-operative than the OFT had thought, and the reduction was therefore revoked.

Non-infringement decisions

As we have seen in the section on infringement decisions above, the CAT has, for the most part, upheld the OFT’s infringement decisions, having only annulled one such decision in its entirety. However, the CAT has been much more active in relation to cases in which the OFT, or a sectoral regulator, has adopted a non-infringement decision, or where the case-file has been closed without the adoption of an explicit decision as to infringement at all. It is possible to form an impression that the CAT is of the belief that competition law infringements are more common, or at least less difficult to establish, than the competition authorities appreciate. A different way of putting the same point is that it may be the case that, whereas the OFT and the sectoral regulators are keen to avoid false positives (findings of infringement where, in fact, no infringement has taken place), the CAT is keener to avoid false negatives (findings of non-infringement where, in fact, there has been an infringement). If, indeed, such a difference exists, this is something that will need, in due course, to be resolved by the Court of Appeal and, ultimately, the House of Lords. It is interesting to note, in passing, that the Court of Appeal did suggest, in its judgment on Hasbro II and Football Replica Kits, that the CAT may have adopted an interpretation of

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the meaning of ‘agreement and concerted practice’ for the purpose of the Chapter I prohibition and Article 81 EC that was a little too broad, although it did not actually make a ruling to this effect.44 45

Section 47 of the Competition Act gives third parties the right to appeal against a decision as to whether the Chapter I or Chapter II prohibitions, or Article 81 or 82 EC, have been infringed. There have been many third party appeals to the CAT. Several have been against explicit decisions by the OFT or a sectoral regulator that there had been no infringement; several others have arisen from case-closures in which the CAT has had to decide whether, at least implicitly, a decision of non-infringement had been taken.

**Explicit non-infringement decisions**

There have been a number of appeals against explicit decisions by the OFT or a sectoral regulator that the Act had not been infringed. For example the first decision of the OFT under the Competition Act, *General Insurance Standards Council*, was taken on appeal to the CAT.46 47 The CAT disagreed with the OFT’s finding that the rules of GISC, which prevented its insurer members from dealing with insurance intermediaries unless they were themselves members of GISC, did not infringe the Chapter I prohibition in the Competition Act and remitted the case to the OFT for further consideration. As the rule to which the appellants had taken objection was then dropped, the OFT was able to adopt a second non-infringement decision.48 An appeal was brought by a third party against a decision by the OFT that there had been no infringement of the Chapter II prohibition in

44 See footnote 12 above.
45 See paras 91 and 141 of the Court of Appeal’s judgment.
47 Case Nos 1002-1004/2/1/01 *Institute of Independent Insurance Brokers v Director General of Fair Trading* [2001] Comp AR 62.
Refusal to supply JJ Burgess Ltd with access to Harwood Park Crematorium. The case concerned a refusal on the part of W. Austin, a funeral director, to provide access to a competitor, JJ Burgess, to its crematorium. In *JJ Burgess & Sons v OFT* the CAT set aside the OFT’s non-infringement decision and made its own finding that there had been an infringement (this is the only occasion on which this has occurred). The CAT was frustrated at the amount of time that the administrative proceedings had taken, and was concerned that a small operator such as JJ Burgess had failed to get redress from the OFT. It is of interest to note that the Consumers’ Association (now known as Which?) intervened in this case in support of JJ Burgess, and that the CAT welcomed the intervention. It remains to be seen how the CAT’s concern that small operators should be able to obtain redress can be reconciled with the OFT’s prioritisation criteria, according to which the OFT will select cases, *inter alia*, where the greatest consumer harm might be occurring.

In *Floe Telecom Ltd v Oftel* the CAT annulled a non-infringement decision of Oftel (now Ofcom), *Disconnection of Floe Telecom Ltd’s Services by Vodafone Ltd.* As in the case of *JJ Burgess*, the case involved a small operator, whose complaint was against Vodafone, and the CAT was concerned at the amount of time that the proceedings had taken in this case; it imposed a timetable on Ofcom for its reconsideration of the matter. Ofcom appealed to the Court of Appeal on the question of whether the CAT had the power to set a time limit in this way; the OFT also appealed. In its judgment of 15 June 2006 the Court of Appeal held that the CAT did not have the power to do so.

In the opinion of Lloyd LJ:

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49 OFT decision of 12 August 2004. [2004] UKCRL 1586; there had been an earlier decision to the same effect in *Harwood Park Crematorium* OFT decision of 6 August 2002.


53 *Ofcom and OFT v Floe Telecom Ltd* [2006] EWCA Civ 768.
“[W]ith respect to the CAT, it seems to me that, in the present case, once it had set aside the decision and remitted the matter to Ofcom by the order dated 1 December 2004, there was nothing left of the appeal”.

Later in the judgment Lloyd LJ continued:

“The Tribunal, as a statutory body, has the task of deciding such appeals as are brought to it in accordance with the provisions of the 1998 Act and the rules, but it does not have a more general statutory function, of supervising regulators. On that basis it seems to me that the CAT’s reasoning is based on a misconception of the relationship between the Tribunal and the regulators. When a decision is set aside and remitted to the relevant regulator, that particular matter is then to be dealt with by that regulator in accordance with its own statutory duties and functions”.

The Court of Appeal’s judgment is a helpful clarification of the respective roles of the OFT, the sectoral regulators and the CAT. Ofcom adopted a second decision in this case, again finding that there had been no infringement of the Act. The second decision was upheld by the CAT on appeal, albeit on different grounds from those given by Ofcom: it is therefore possible that Ofcom will seek permission to appeal to the Court of Appeal against the CAT’s judgment. The CAT was also critical of Ofwat’s finding of non-infringement in Albion Water/Dŵr Cymru, although it has yet to be decided whether Dŵr Cymru had abused its dominant position (see section on delay below).

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54 See para 28.
55 See para 34.
Implicit non-infringement decisions

The CAT has handed down a number of judgments in which it has held that the OFT or one of the sectoral regulators had adopted an appealable decision under section 47 of the Competition Act that the Chapter II prohibition had not been infringed, despite their protestations that they had simply closed their file on administrative grounds (such a decision would be amenable only to a judicial review before the Administrative Court). This case-law is important. There is little doubt that the OFT and some of the sectoral regulators were somewhat shocked in the early days to be told that they had adopted non-infringement decisions despite their apparent ignorance of the fact; however it is difficult to resist the reasoning of the CAT that such a conclusion is possible. The case-law requires that the competition authorities must be much clearer about their selection of cases for investigation and, as a consequence, of their rejection of others on the ground that they are not an administrative priority. This is why the OFT has now published its ‘competition prioritisation framework’.

In the *Claymore* judgment the CAT summarised the position as follows. First, the question of whether an appealable decision has been taken is primarily a question of fact, to be decided in accordance with the particular circumstances of the case. Second, whether such a decision has been taken is a question of substance, not form, to be determined objectively, taking into account all the circumstances of the case: the test to be applied is whether a decision has been taken on an appealable matter, ‘either expressly or by necessary implication’. Thirdly, there is a distinction between the mere exercise of an administrative discretion not to proceed to the adoption of a decision, and the actual adoption of an appealable decision. This issue is now before the CAT again in three different cases, *Casting Books Ltd*

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59 See footnote 27 above.
60 Case No 1008/2/1/02 *Claymore Dairies Ltd v Office of Fair Trading* [2005] CAT 30, [2006] CompAR 1.
It will be of great interest to see how the CAT proceeds in these cases, particularly given its apparent concern as to under-enforcement of the Act and the need to provide redress to small operators, such as JJ Burgess and Floe. In each of the cases currently before the CAT, the OFT argues that its reason for not proceeding with its investigation was lack of administrative priority. If the CAT decides that, nevertheless, the OFT had adopted non-infringement decisions, the matter may have to be taken further to the Court of Appeal.

Delay

There is little doubt that the CAT has been frustrated at what it considers to be the slowness of the administrative procedures of the OFT and the sectoral regulators under the Competition Act. This has already been noted in the MasterCard, JJ Burgess and Floe Telecom cases discussed above. The same point has arisen in the case of BT/Openworld, where Oftel’s non-infringement decision was adopted in January 2003 but which remains unresolved in December 2006. The CAT was also dismayed at the amount of time that had been taken, and that would in the future be taken, by the OFT in deciding whether to make a market investigation reference to the Competition Commission under the Enterprise Act in Association of Convenience Stores v OFT. Perhaps it was this frustration that led the CAT to impose the time limit on Ofcom in Floe Telecom, although, as we have seen, the Court of Appeal concluded that in doing so it had gone beyond its powers as an appeal tribunal. While the CAT’s concern as to the apparent slowness of proceedings may

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61 Case No 1068/2/1/06.
62 Case No 1071/2/1/06.
63 Case No 1073/2/1/06.
be understandable, equally the OFT and the sectoral regulators have a real problem in determining how to deploy the limited resources at their disposal. As Lloyd LJ said in the Floe case:

“The Tribunal cannot know what are the competing demands on the resources of the particular regulator at the given time. It may well be that it cannot properly be told of this by the regulator because of issues of confidentiality as to current investigations. It cannot, therefore, form any proper view as to the relative priority of one case as compared with others”.66

On the subject of delay, it is noticeable that the CAT’s own proceedings have on some occasions been somewhat protracted. For example, Ofwat’s decision in Albion Water/Dŵr Cymru was adopted on 27 May 2004, and appeal proceedings were initiated before the CAT on 30 July 2004.67 The CAT handed down an interim judgment on 22 December 2005, and a further judgment on the issue of abuse on 6 October 2006.68 69 The CAT noted in the latter judgment that the issue of whether Dŵr Cymru was in a dominant position had still to be decided, and the matter remained unresolved at the end of November 2006, some two and a half years after the decision of Ofwat. The case raised complex issues in relation to the abuse of margin squeezing, and in particular the so-called ‘efficient component pricing rule’; it may perhaps have provided the CAT with an insight into the difficulties in which the OFT and sectoral regulators sometimes find themselves.

The CAT has been extremely meticulous in its work, producing lengthy and very detailed judgments, but perhaps a little too

66 Ofcom and OFT v Floe Telecom Ltd [2006] EWCA Civ 768, para 37.
much so. The Court of Appeal in the *Hasbro II* and *Football Replica Kits* judgment remarked that:70

> “it may be hoped that the Tribunal will, over time, find it possible to deal with such appeals in judgments which are not so long as those under appeal in the present cases’ ... We therefore express the hope that, in future, it will be possible for the Tribunal to express its findings of facts and its reasoning in more succinct form”.71

**Actions for damages**

An interesting feature of the Competition Act 1998, as amended by the Enterprise Act 2002, is that section 47A provides for ‘follow-on actions’ for damages to be brought to the CAT where the European Commission, the OFT or a sectoral regulator have found an infringement of competition law. The first case to be brought to the CAT arose from the European Commission’s decision in the *Vitamins* case.72 The case was settled before the CAT had given a final judgment; however in a ruling on costs, *BCL Old Co Ltd v Aventis: security for costs*, the CAT declined the defendants’ request that the claimants should be required to give security for costs.73 The CAT was obviously concerned not to place undue obstacles in the way of the claimants, in particular in circumstances where the defendants had undoubtedly infringed Article 81 EC. In *Healthcare at Home v Genzyme* a follow-on action has been brought before the CAT by a firm that had been the victim of a margin squeeze by Genzyme Ltd. Interestingly, in this case, an award of interim damages has been made, the first time that this has happened in a competition law

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70 [*Argos Ltd and Littlewoods Ltd v OFT* and *JJB Sports plc v OFT* [2006] EWCA Civ 1318, para 161.
71 Ibid, paras 5 and 6.
case in the UK.\textsuperscript{74} The CAT held in its judgment that the claimant could claim damages not only for the period that the OFT and the CAT itself had held that the Chapter II prohibition had been infringed, but also for the subsequent period in which the infringement continued, a very sensible interpretation of the Act.\textsuperscript{75}

Mergers

There have been several appeals to the CAT under the merger provisions of the Enterprise Act 2002. It is noticeable that merger control generally has become much more litigious in recent years, both under the EC Merger Regulation and under UK domestic law. In particular third party competitors have become much more active in challenging mergers that have either been cleared by a competition authority, or cleared subject to remedies deemed to be ineffective. The most high-profile example of this is the successful challenge by IMPALA to the \textit{Sony/Bertelsman} merger.\textsuperscript{76} The Enterprise Act 2002 imposes a duty on the OFT to refer certain mergers to the Competition Commission, and it is perhaps not surprising that third parties have gone to the CAT to complain of a failure by the OFT to comply with this duty. In \textit{IBA Health} the CAT interpreted the duty of the OFT to refer very broadly.\textsuperscript{77} As a result the OFT appealed to the Court of Appeal, which gave a more restrictive interpretation of the duty, while agreeing with the CAT that the decision in that particular case should be set aside.\textsuperscript{78}

\textsuperscript{74} Case No 1060/5/7/06 [2006] CAT 29.
\textsuperscript{75} Ibid, para 59.
There have been two further appeals against OFT decisions not to refer, the former partly successful and the latter not so. The interesting debate in relation to this matter concerns not the jurisprudence of the CAT and the Court of Appeal, but rather the reference test itself as set out in the Enterprise Act. There is a concern that perhaps too many mergers are being referred by the OFT to the CC because of the way in which the legislation is written, and that therefore it may need to be revised.

There have been two appeals to the CAT from the Competition Commission. In each of these the CAT upheld remedies required by the CC, in the former case as to the divestiture of certain assets and in the latter to hold separate assets already acquired pending the outcome of the CC’s investigation.

Costs

The CAT has a broad discretion as to awards of costs. It does not apply the conventional rule in civil litigation that ‘costs follow the event’: instead it has repeatedly said that ‘the only rule is that there are no rules’. The CAT’s determination not to fetter its discretion in relation to costs in the early days of the new regime is sensible: it needs to obtain experience of the full range of matters that might arise before it begins to formulate specific rules. However some trends in its judgments can be discerned.

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82 See for example, Case No1062/1/1/06 The London Metal Exchange v OFT [2006] CAT 19, para 108 and Case Nos 1054/1/1/05-1056/1/1/05 Mastercard UK Members Forum Ltd [2006] CAT 15, para 46.
First, it has not wanted to deter small or medium-sized firms from appealing against cartel decisions of the OFT for fear of having to pay the OFT’s costs if unsuccessful: this can be seen in the case of the unsuccessful appeals of two firms against the OFT’s decision in *West Midlands Roofing Contractors*. 83

Second, the CAT clearly had a similar concern in the case of the follow-on action brought by BCL Old in the *Vitamins* case, where it declined to make an order of security for costs against the defendants. 84

Third the same concern (not to deter applications) was not shown in the case of more substantial firms such as Genzyme and Argos and Littlewoods that unsuccessfully appealed to the CAT. 85 86

Fourth, the CAT’s frustration with the OFT’s administrative procedures could explain the costs awards against it in *London Metal Exchange* and *MasterCard*. 87 88

Fifth, the CAT in *Celesio* was not inclined to accept the invitation of the OFT to make an award of costs against *Celesio*. 89 The OFT advanced the argument that Celesio’s interest in appealing to the CAT was not that of a customer that was fearful that the merger could lead to it being charged higher prices by the merged entity, but of a competitor with an interest in frustrating an agreed merger between two rivals. The CAT refused to make this distinction and each party was required to bear its own costs. It remains to be seen whether in future cases under the merger provisions of the Enterprise Act the CAT might wish to revisit this point if it appears that some third party appeals are being

85 Case No 1013/1/1/03 (IR) and Case No 1016/1/1/03 Genzyme Ltd v OFT, the CAT made orders by consent concerning costs on 14 and 29 November 2005.
86 Case Nos 1014/1/1/03-1015/1/1/03 Argos Ltd v OFT [2005] CAT 15, [2005] CompAR 996.
87 Case No 1062/1/1/06 The London Metal Exchange v OFT [2006] CAT 19.
88 Case Nos 1054/1/1/05-1056/1/1/05 Mastercard UK Members Forum Ltd [2006] CAT 15.
taken not in the interest of consumer welfare but in the private self-interest of disappointed competitors. Finally, it is clear that the CAT has, on some occasions, felt disquiet at the level of the fees charged by City law firms for their advice; and in particular at the number of hours charged by partners as opposed to associates.90

Conclusion

The CAT has dealt with a wide range of issues in the last six years, and has established an important body of case-law. At times it has not hidden its frustration at the slowness of the competition authorities’ proceedings, and their failure to establish infringements of the Competition Act; the OFT has also received criticism of its procedures under the Enterprise Act. Many challenges lie ahead, not least the debate as to the prioritisation of the case-work of the OFT and the sectoral regulators, and the meaning of appealable decisions under the Competition Act.

19 FINANCEABILITY

Keith Mason

Introduction

The regulated utilities sector is typically characterised by being capital intensive. This has been the case since privatisation for the water companies, and is increasingly characteristic of other regulated sectors, such as energy. These capital programmes have significantly improved the quality of service and performance that companies achieve. Continuing large capital programmes can place a financing strain on the companies and is therefore an important consideration for regulators in determining price limits. For example, in the water sector it is clear that a consequence of requiring companies, even efficient ones, to undertake large capital programmes is persistent negative cash flow. This can lead to a deterioration in credit quality which could restrict the access of companies to capital markets, despite earning their cost of capital, or could significantly increase the cost of finance. This could jeopardise their ability to deliver services and the improvements required.

An important consideration for regulators, therefore, is whether companies are ‘financeable’ when determining price limits or in other words, whether efficient companies’ revenues, profits and cash flows enable them to access the financial markets at reasonable cost. In practice, financeability issues arise from a number of interrelated factors which are discussed in this chapter.

First, I want to go back to basics and explain the basic principles of the price setting process in the water industry, and what

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factors may give rise to the financing strain referred to above. I will then summarise how regulators have dealt with the financeability issue at previous reviews (in particular Ofwat and Ofgem). This chapter then draws out some of the financial issues explored in a joint discussion paper, Financing Networks published by these regulators in February 2006, which regulators, companies and investors have usefully explored in the build up to the next price limit review for each sector. This paper includes a discussion of proposals that have been put forward in relation to wider regulatory reform, including the concept of a ‘split cost of capital’ on new and past investment (put forward most notably by Dieter Helm). I will touch on these related issues as well as the alternative approaches to the financeability that were set out in the financing networks paper. I will conclude this chapter by setting out Ofwat’s next steps following the financing networks project.

The price setting process

Each company needs to collect sufficient revenue to cover its operating expenditure and to finance its capital investment programme. It also needs to be able to finance previous capital investment through the return the company earns on its regulatory capital value (this is the capital base used in setting price limits and represents the value of the regulated business that earns a return on investment) and to take account of its use through depreciation. In addition, the water industry pays tax. We also allow for any incentive allowance for out performance in the previous five-year period. The sum of these costs is called the revenue requirement. This is shown in Figure 1 below:

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Figure 1: The revenue requirements

The return on capital above represents each company’s weighted average cost of capital multiplied by its regulatory capital value. The return on capital is particularly important. Ofwat has a primary duty to secure that the functions of each undertaker are properly carried out and that they are able to finance their functions, in particular by securing a reasonable rate of return on their capital. Very significant capital programmes have been a feature of the water industry – some £70bn will have been spent from privatisation to the end of the current price period (2010).

Customers’ annual bills do not provide for the annual capital expenditure on a pound for pound basis. Rather, there is an element of customers’ annual bills that allows for the investment over the economic life of the asset, once constructed. This is done by way of the depreciation charge. Therefore companies need to raise, via the capital markets, the difference between annual expenditure and revenue allowed to cover the annual depreciation charge. Providers of this capital expect to be rewarded for their investment ie, via interest payments or dividends. Therefore, Ofwat must allow a return on capital sufficient to attract investors.

Ofwat assumes that companies can earn a return equal to their weighted average cost of capital (WACC). The ‘weighting’ is by
means of an assumption of how much debt and equity is invested in the business. At the price review in 2004 Ofwat assumed that 55% of investment was provided by debt and 45% by equity (ie, 55% gearing). Therefore, based on Ofwat’s assumption of the cost of debt of 4.3%, and the cost of equity of 7.7%, this gave an overall real weighted average cost of capital (WACC) of 5.8% (or 5.1% on a fully post tax basis).

The cash flow gap

Where the level and treatment of capital expenditure (including the approach to depreciation) under a particular regulator’s methodology is such that companies’ capital bases are increasing quickly over time then significant new injections of debt or equity finance will be required in order to finance the purchase of fixed assets. In setting price controls Ofgem and Ofwat have assumed that when such circumstances arise most of the new finance comes from debt. Generally this reliance on the debt markets has been mirrored in companies’ actual financing strategies. This tends to lead to pressure on key financial ratios (such as interest coverage) that are used by credit rating agencies to assess companies’ credit quality.

But there is another factor to consider. And that is the mismatch in the timing between how the regulatory model calculates the amount that can be recovered from customers as an allowed return and companies’ actual payments to investors in any one year. When we set price limits we model a real return. Because the value of the money investors lend upfront is eroded over time by inflation, investors need to be compensated. This is achieved in the regulatory model by increasing the capital base on which returns are allowed by RPI. This ensures that over the life of the asset the company has adequate revenues to make payments to investors. The absolute value of this return can be recovered from customers and therefore is part of the revenue allowance.

Providers of equity finance generally accept compensation for inflation via real dividend growth and the increase in equity
provided by the inflation of the capital base, ie, the regulatory capital value. However, generally speaking debt providers – eg, large banks and the bond markets, traditionally expect immediate compensation for inflation via their interest payments. So, companies will pay a nominal interest rate that includes an expectation of the rate of inflation over the life of the loan they have taken out. The absolute value of this nominal interest payments are a cash outflow of the business.

The different approaches to compensation for inflation employed by the regulator and investors can produce a stark difference in the timing between payments to investors and revenue recovery from customers. We refer to this as the ‘cashflow gap’ in the financing networks paper. This cash flow gap unwinds over time but in the shorter term can put pressure on the companies’ financial projections because the company has to borrow more to finance this cashflow gap. This extra borrowing is in addition to the capital required to finance the investment in the first place.

Figures 2 and 3 illustrate this point. They are based on generalised financial assumptions used by Ofwat at the price review in 2004 (see Table 1 below).

Figure 2 is for an illustrative company in steady state, where regulatory depreciation is equal to annual capital expenditure (ie, no real growth in the regulatory capital value). There is no requirement for the company to raise additional capital from the markets other than to finance the cash flow gap. But because the capital base is stable in real terms and the level of equity invested in the business is assumed to grow each year (in line with retained earnings and inflation of the RCV) then the proportion of debt finance or gearing declines over time. The level of revenues increases more quickly than interest payments and debt-based ratios improve over time. In these circumstances debt-based financial ratios should not act as a constraint on the regulator in determining price control revenue because they will not be indicative of a company whose credit quality is at risk of deterioration.
Table 1: Generalised financial assumptions

<table>
<thead>
<tr>
<th>Assumption</th>
<th>Assumption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real vanilla WACC (pre tax cost of debt and post tax cost of equity)</td>
<td>5.8%</td>
</tr>
<tr>
<td>Real cost of debt</td>
<td>4.3%</td>
</tr>
<tr>
<td>Real cost of equity</td>
<td>7.7%</td>
</tr>
<tr>
<td>Dividend yield</td>
<td>5.8%</td>
</tr>
<tr>
<td>Dividend growth</td>
<td>1.9%</td>
</tr>
<tr>
<td>Initial gearing</td>
<td>55%</td>
</tr>
<tr>
<td>Annual Inflation</td>
<td>2.5%</td>
</tr>
<tr>
<td>Average asset life remaining for depreciation</td>
<td>25 years</td>
</tr>
<tr>
<td>Level of infrastructure renewals expenditure</td>
<td>1.25% of RAV</td>
</tr>
</tbody>
</table>

Figure 2: Real returns vs nominal interest and dividends - steady state

However, in the situation where a significant capital programme must be undertaken, annual capital expenditure will exceed regulatory depreciation. In this example the combination of the borrowing required to finance real growth in the capital base and
to close the cash flow gap exceeds growth in equity arising from the assumption of retained earnings and the inflation of the capital base. Consequently, the proportion of debt finance, or gearing, increases each year as shown in Figure 3.

**Figure 3: Real return vs nominal interest and dividends - capital programme**

This increasing gearing puts pressure on the metrics used by the credit rating agencies to assess a company’s financial position and could ultimately lead to a deterioration in credit quality. As long as companies are required to undertake significant capital programmes it would appear that the pressure on gearing and financial ratios is perpetuated.

**How have regulators addressed financeability in the past?**

At previous price control reviews, both Ofwat and Ofgem have emphasised the importance of strong credit quality for the companies they regulate in the context of the significant capital investment programmes they are required to deliver. Both
regulators have taken steps to ensure that price limits are set to allow the companies to sustain credit quality well within investment grade ratings. The financial indicators used to assess companies’ financeability are consistent with such ratings. In a number of cases Ofwat allowed extra revenue to ensure that the level and trend of these indicators would be consistent with these objectives (the financeability or revenue uplift). However, this solution leads to higher bills for customers because the additional revenue allowed feeds straight through, pound for pound, into customers’ bills. Ofwat assumed a generic level of gearing and used the same package of indicators for all companies, regardless of their actual capital structure and associated debt covenants.

Ofgem made a similar adjustment for one electricity distribution business in its 2004 electricity distribution price control review, but the materiality of the adjustment was small. Financing constraints have been less acute in electricity distribution because Ofgem has adopted an approach that involves allowing accelerated depreciation in price limits, which also increases cash flow and improves financial ratios. This approach, whilst increasing customers’ bills in the shorter term, will theoretically be net present value neutral in the longer term because depreciation charges will be correspondingly lower in the future.

Ofwat did not assume full distribution of the equity component of the cost of capital. An element was retained to mitigate the financeability issue. Ofwat has been clear in its statements to the City that amounts allowed for financeability are not a matter of simply providing higher returns for the companies to disburse in dividends. Ofwat does not intend to claw back the financeability uplift allowed in price limits determined in 2004. But the decision to increase companies’ revenues in certain cases came with a warning that we would expect prudent companies to retain an appropriate proportion of earnings to alleviate the financial strain caused by heavy capital programmes, both in the current period and beyond 2010. In the context of continuing high levels of capital investment, the combination of revenue uplift and assumptions on dividend growth and yields were judged to be
appropriate in order to continue to attract capital (both debt and equity) to the water sector, and to allow companies to maintain adequate credit quality based on projected ratios over the price limit period.

This approach, and in particular whether it is sustainable, has been the subject of considerable debate since price limits were finalised in 2004. One criticism of Ofwat’s revenue uplift is that it was not been implemented in a net present value neutral way. Some commentators have argued that the impact of financeability revenues on returns is one factor that has led to a re-rating of the utilities and the current apparent willingness of acquirers to pay significant premiums to companies’ regulatory asset values. Others have expressed concern that regulators have relied too heavily on the metrics used by credit rating agencies to assess financeability. Ofwat and Ofgem continue to think that their approaches were appropriate given the circumstances leading to the final determinations in 2004. Nevertheless, it has been appropriate to consider how best to address these matters in the future.

The financeability issue has had to be addressed by other regulators, although specific circumstances in particular sectors has meant that it has not necessarily been such a major area of debate compared to the water sector. For example, the CAA’s approach in the latest airports review has been to put the onus on the new owner of the airports to introduce a financing structure that is designed to support future investment, and as such it has said that it did not expect to carry out an assessment of financeability as part of the review process. The Office of Rail Regulation has acknowledged that its approach to setting access charges must not make it unduly difficult for the company to finance its relevant activities. However, it notes that under current arrangements, whereby all of Network Rail’s debt is supported by government, issues of financeability are less relevant because investors are largely protected from business risk.
The Financing Networks discussion paper

Back in 2004 the Treasury and the Department of Trade and Industry (DTI) expressed concern about the proportion of debt finance used by regulated businesses and whether there were any new ideas for encouraging equity to remain in the utility sector. This was in the context of concerns about some very highly geared structures emerging in the utility sector in the years after the 1999 price reviews. There were also concerns about the ‘flight from equity’ from utilities to other opportunities, particularly the ‘TMT’ sectors but in retrospect the ‘dot.com boom’ was short lived and can be seen as a bubble. As a consequence of these concerns, Ofwat and Ofgem undertook a study on these issues and produced the financing networks discussion paper. Ofgem and Ofwat carried out this study after completing their respective price determinations in 2004 but widened the scope of the original remit to recognise that the markets have moved on since the report was initially commissioned.

Four main topics were covered in the financing networks paper:

• Issues relating to capital structure, and specifically the impact of relatively highly leveraged structures on management incentives and the ability of management to deliver efficient levels of investment. It also deals with questions around the robustness of debt markets and the implications for regulated businesses (including highly leveraged companies) of possible disruption to these markets.

• Issues relating to how levels of gearing impact on the regulatory framework. The financial ring-fencing arrangements are explained and the importance of them in ensuring that regulated businesses continue to have access to debt finance on reasonable

4 Department of Trade and Industry and HM Treasury (2004), The Drivers and Public Policy, Consequences of Increased Gearing: A Report by the DTI, October.
terms. In this context there is a discussion about whether highly leveraged structures will restrict a regulator’s ability to require companies to fund capital expenditure programmes. The paper also explains the ‘special administration’ regime and discusses the impact of financial distress, on capital expenditure programmes, the costs of financial distress, and where these might fall.

- As context for the debate on proposals for encouraging equity investment, the paper set out recent developments in the approach to setting price controls and the likely effect of these on the incentives for the equity financing of regulated businesses. It then discusses the ideas that have been advanced for reducing the uncertainty around the risk of allowed revenues for capital investment, including the ideas of Dr Dieter Helm and Professor Colin Mayer.

- Whether aspects of the present approach to setting price controls make it unduly difficult for utilities to finance their activities. Subsequently it discussed a number of options for dealing with these financeability constraints and asked whether regulators should change their approaches, which at present tends to take the metrics used by the credit rating agencies to assess financial robustness.

In the remaining part of this chapter I draw out some of the debate on two important ongoing regulatory issues that run through the financing networks discussion paper – the concept of ‘regulatory commitment’ and, secondly, how regulators should approach financeability issues in the future. I provide background on each – drawing heavily from the financing networks paper – then set out respondents’ views. I finish by explaining the regulators’ next steps.

**Regulatory commitment**

The financing networks paper summarised a number of proposals for regulatory reform. A common theme is how regulators deal
with the issue of regulatory commitment. This issue arises because there is an inherent timing mismatch between the current five-yearly price setting cycle and the much longer timeframe for financing regulated businesses. Uncertainty in the financial markets about future price control reviews and the allowed cost of capital tends to increase the regulatory risk premium in the cost of capital. Given that the capital expenditure programmes of regulated businesses can extend out over many years (and more than one price period) it is important to consider whether regulation should adapt to deal with these timing issues. This is exactly what the proponents of reform have done by challenging regulators to consider ways of reducing regulatory risk to allow for the efficient funding of capital investment. This could benefit customers if it resulted in a lower cost of capital.

Dr Dieter Helm has been at the forefront in challenging regulators’ current approaches. Central to his proposals for improving regulators’ commitment to allowed financing costs is the so-called ‘split cost of capital’. The details of his proposals are set out elsewhere, but his basic argument is that once investment has been added to the capital base (and there needs to be clear rules for this) it is relatively low risk and is suitable for debt finance (Helm 2003 and 2006). He suggests that managing the day to day operations of the business and project managing new investment is higher risk (as there are added uncertainties around procurement, project management and whether outturn expenditure is fully reflected in the capital base) and so should attract a higher return consistent with the provision of equity capital. Helm’s package of reforms also includes the idea of indexing the cost of capital using appropriate market indicators eg, for debt financing using current bond yields. This would differ from the existing approach where regulators set the cost of capital every five years. He suggests that this would reduce the regulatory risk created by the interaction of the current five-year price control cycle and regulated businesses needing to finance investment over a longer time scale.
Helm believes that overall his package of reforms would result in a lower cost of capital for regulated businesses because a very significant proportion of the business would be funded by debt finance and any ‘regulatory risk premium’ in the cost of capital would be reduced. In his analysis he recognises that the cost of equity, for the risks involved in operating the business, would need to be higher than currently allowed by Ofwat and Ofgem and more akin to those required by service providers.

Other suggestions for improving regulatory commitment include setting price limits or some elements of the price limit package (eg, the cost of capital) for longer than the current five year period. For example, Keith Palmer in his foreword to the financing networks paper suggested that the need for regulatory commitment might be addressed by setting allowed revenues in respect of depreciation and the cost of capital – for sunk capital and capital expected to be incurred over the forthcoming review period – for the full life of those assets (or at least for a considerably longer period than five years). In his view this approach would reduce regulatory uncertainty and should therefore lower the cost of capital and strengthen companies’ credit quality as assessed by ratings agencies. He recognises that a downside of this approach is that it would lock-in the allowed cost of capital and preclude consumers from benefiting in the event that companies refinance their debt at a lower cost in the future.

The length of the period between price reviews has an impact on the strength of regulatory commitment. Ofwat has recently consulted on the length of the price control to be set in 2009. The overwhelming response was that Ofwat should set price limits for five years in 2009 and this is what it recently concluded. The five-year cycle represents an appropriate balance between stability and incentives, and the need to be flexible to changing circumstances. The five year cycle also has the advantage of being well understood and established. In our view major change

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5 Ofwat (2006), A Sustainable Water Industry – To PR09 and Beyond, October.
could potentially add to (as oppose to reduce) perceptions of regulatory risk or uncertainty and potentially increase the cost of capital to these businesses. However there has been considerable debate recently about the need to provide a longer term planning horizon – beyond the traditional five year price setting cycle – to allow and encourage companies to take a more strategic approach to planning their investment and service provision. Ultimately such an approach should benefit customers by improving long term efficiency.

In particular, we intend to set price limits within a longer-term context and to do this we will ask each company to publish a strategic direction statement before it prepares its draft business plan. The strategic direction statement will set out for consultation with consumers, other stakeholders and Ofwat, the priorities the company sets itself for the next five years and beyond, with an early indication of what that will mean for consumers. Each statement should cover at least the following areas: resources; drinking water quality issues; environmental priorities and obligations; capital maintenance; consumer service; scope for efficiencies; and financing issues.

We will be asking companies to highlight any large projects and when they might be needed, and any other significant investment needs. Companies can choose their own format for the draft statements. We expect them to be presented in a consumer-friendly way. We have proposed that companies publish their statements, and consult consumers and stakeholders on their strategies as they formulate their business plans. Each company should send us its strategic direction statement when it is ready, and at the latest by December 2007. We have also suggested that the companies may also wish to discuss their strategies earlier with us as they are developing them. We will discuss each company’s statement with them.

For the 2004 review companies provided longer-term views on capital maintenance and 25-year water resource plans. When companies submit draft and final business plans for the period
2010-15, we will expect these to include a 25-year forward look. We will expect each company to review the costs and benefits of its proposals and to set these out clearly.

**Financeability**

The work that Ofwat has been doing on scenario modelling has reinforced the view that a large capital programme beyond 2010 is likely. The financial markets continue to place considerable weight on financial ratios, particularly debt to RCV, so the issue of maintaining access to the capital markets is not going to go away. Given the earlier analysis set out in this paper you might think this would give rise to even more significant financeability problems.

But in some respects the markets themselves have moved on since the price limits were set. The financing networks discussion paper points up the potential of the increased appetite for, and capacity of, the index-linked debt market, improved conditions for equity injections and rights issues, or a more flexible interpretation of financial indicators as ways of mitigating, or removing completely, financeability issues. For example, index-linked debt more closely aligns the interest payments a company must make on its debt with the revenue it receives under the price limits we set. This would have the effect of improving a company’s short term financial cash interest coverage profiles. At its 2004 price review, Ofwat did not make an assumption of the proportion of index-linked debt in companies’ balance sheet. The discussion paper explained that regulators could also deal with issues of financeability in setting price controls by accelerating depreciation or using a nominal cost of capital to reduce pressure on cash flow.

All of the options discussed in the financing networks Paper would have different impacts on consumers' bills and the timing

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of investors’ returns. All need to be considered in relation to the objectives of not unnecessarily increasing perceptions of regulatory risk and ensuring that risks are allocated to the parties best able to manage the risk in a cost effective manner. Respondents’ views on these alternative approaches are set out in the next section.

Summary of responses to the Financing Networks paper

The overall thrust of the responses from the regulated companies and investors is opposition to radical change, general support for the regulatory framework and recent developments, and calls for more consistency and stability. The overall tone of the responses was that there was no need for radical reform.

Regulatory reform

There was quite strong opposition to the concept of a ‘split cost of capital’ on new and past investment because it was felt that this would increase regulatory risk, and changing the regulatory regime in such a fundamental way would undermine investor expectations of the returns they receive on their investment. Other problems cited with this proposal include an unhelpful diminution of the role of equity, and the difficulties of separating the risks associated with asset growth from asset maintenance. Two conclusions reached by the majority of respondents were:

- that it will lead to an increase in the proportion of debt finance in companies’ financial structure (in the electricity and water sectors assets under construction typically form only a small proportion of the overall asset base. Therefore, respondents argued, if equity was used to fund only operating costs and the delivery of new investment, then it would play only a limited role in the financial structure of companies within these sectors);
• that of itself it will not lead to a reduction in risk and therefore
  the overall cost of capital will remain the same and that risk
  can only be reduced if it is transferred elsewhere.

Respondents felt that the proposals by Helm understate the
nature of the risk of the capital base (RCV). They consider the
RCV to carry significant risk not least because a large proportion
of a regulated businesses capital expenditure relates to the
maintenance of assets contained in it. At the seminar the
example of Railtrack and the Hatfield rail crash was cited as an
example of the risk associated with existing assets in the RCV.

There was some support however for the idea that a differential
cost of capital could be applied to large investment projects.
Heathrow’s Terminal Five construction project is cited as an
example where such a regulatory approach has been applied.
However, respondents note that the vast majority of investment
projects undertaken in the water, electricity and gas sectors are
relatively small and limited in duration, although it is recognised
that this may not remain the case in the future. That said, it is
widely recognised that Helm’s proposals have brought focus to
the debate of how risk is allocated in utility businesses, and also
how important regulatory commitment can be in reducing the
overall risk of these businesses. A constant theme emerging from
the seminar was the principle that greater regulatory commitment
and transparency would lead to improved investor confidence,
and was cited in relation to the appetite for issues of new equity.

**Alternative approaches to financeability**

There were a variety of views on the alternative approaches to
financeability but most felt that because of the scale of
investment required, regulators were right to test for it, and that
there may be a need for regulatory intervention under some
conditions.

There is a mixed view about whether regulators should assume
that companies’ debt portfolios comprise a proportion of index-
linked debt. Some water sector respondents were of the view that this would be a reasonable regulatory assumption, subject to certain caveats, for example:

- that it would be reasonable only if it is apparent that this is what the sector is doing in practice;

- that any assumed proportion should be limited to the weighted average for the sector.

However, energy sector respondents were generally of the view that decisions on the overall mix of debt instruments in a company’s portfolio should be taken by companies and not the regulator, and this is consistent with a view that decisions on capital structure lie with companies. It was generally recognised that whilst index-linked debt may help cash flow in the short term, it does not fundamentally alter the debt position of the company going forward.

On the role of equity, a number of respondents make the point that equity funding is already available, particularly to well run companies. Evidence cited for this is the rights issue by United Utilities and the fact that equity funding has been available to facilitate the acquisition of the gas distribution networks in 2005, and more recently the sale of network businesses at premiums to RCV suggests considerable appetite amongst the investment community for these assets.

The allowed return on equity is highlighted as a key determinant of the ability of companies to raise equity finance. Some respondents believed that the costs of issuing equity are potentially prohibitive and suggest the regulator should specifically allow for these costs in price determinations. However, some respondents argue an assumed higher cost of equity might not necessarily lead to companies adopting a financial structure that contains an increased proportion of equity, and that it might actually increase the incentives for companies to adopt higher gearing. Some conventionally
structured companies argue that if concerns persist about higher gearing then this can only be addressed by positively incentivising conventional gearing by allowing higher returns for lower geared companies.

The vast majority of respondents believe that when conducting financeability tests the regulator should adopt definitions of ratios that are consistent with those used by credit rating agencies, accepting that there are different approaches between various agencies. The consensus is that the adoption of different ratios would not only have little effect on the capital markets’ assessment of companies’ financial strength, but could increase perceptions of regulatory risk. Most consider that it is the overall level and trend of the ratios that is important to credit quality. This is the approach taken by credit rating agencies, and the regulators should mirror this approach.

There would be widespread concern if there were a majority of utilities companies with a BBB/Baa2 credit rating. A BBB/Baa2 credit rating would leave little headroom against cost shocks, and as a result there is a danger that a number of firms could fall below investment grade credit rating. The implication for the utilities sector of firms falling below investment grade credit rating could be a significant increase in the cost of debt finance.

Respondents felt that different solutions to financeability may be appropriate in different sectors but with clear explanation as to why this is the case. There is an element of past experience colouring these views. The option of accelerated depreciation was favoured by most of the electricity companies, and revenue uplift was the preference of most of the water company respondents. Some respondents felt that to implement the revenue uplift in an NPV neutral manner would be fairer to customers, although there may be practical issues with this approach. The use of a nominal weighted average cost of capital, to overcome the cash flow timing problems associated with a real return and nominal financing costs was generally rejected because of its significant implications for customers. It would
result in a large incremental increase to prices, and may ultimately not resolve financeability issues over the longer term.

**Next steps**

So, in the light of all this, what are Ofwat’s next steps with regard to these important financing issues?

**Introducing a cash lock up provision**

The financing networks paper includes a discussion on the licence conditions that have been put in place to ring fence the regulated business from the activities of the wider group. For many regulated businesses this includes a requirement that they should retain an investment grade issuer credit rating. These arrangements have been designed to reduce the risk of financial distress by constraining the conduct of the company, ensuring its resources are not diverted, and that it is not exposed to undue risk. Their presence helps to reassure the regulator that companies remain in a position to finance their functions, and consumers’ interests are not adversely affected by a company’s capital structure.

The first ‘outcome’ from the financing networks paper was the announcement by Ofwat that it will be modifying companies’ licences when the opportunity arises to introduce cash lock-up provisions. It is considering the precise legal drafting of the cash lock-up provision. It intends to roll out the cash lock-up provision into other water companies’ licences as suitable opportunities arise. There is precedent for such a licence condition contained in the energy distribution companies’ condition of appointment.

The cash lock up would be triggered should the regulated company be assessed by the rating agencies as at the bottom of the investment grade on negative watch. Consequently, the appointee would be prohibited from making, without Ofwat’s
prior consent, any transfer of cash or other asset to an affiliate in circumstances where the regulated business no longer holds an investment grade credit rating or holds a rating at the minimum investment grade level, and that rating has been put under review for possible downgrade or is assigned a negative outlook. The prohibition continues in effect until the regulated business’s credit rating has been restored to a level above the trigger level.

This should not undermine those companies that do not yet have this condition because the majority have a licence condition that requires them to maintain investment grade credit quality. If a water company’s credit rating were downgraded to the brink of non-investment grade, Ofwat might reasonably consider this as evidence of the likelihood of the company ultimately breaching the licence condition requiring it to maintain an investment grade rating. In those circumstances, under the existing ring fencing conditions, Ofwat would be very likely to take enforcement action to prevent cash and assets from leaving the regulated company. There are benefits from a cash lock-up provision in the licence. It provides a transparent, instantaneous response to a breach or a likely breach of the requirement to maintain an investment grade issuer credit rating.

Improving regulatory commitment

Ofwat believes that it has focused on regulatory commitment for some time, as evidenced through its consistent and transparent approach to regulation. Ofgem has published a letter setting out its conclusions on some of the issues raised in the financing networks paper. Ofgem has said that it intends to focus on regulatory commitment as a key plank of its framework for delivering investment.⁷ This framework includes moving to rolling incentives, instituting annual cost reporting based on detailed rules and templates, annual publication of an indicative RCV figure, setting the cost of capital based on longer term trends, and regular city briefings. Ofwat already has these

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principles well established to a large degree within its current regulatory regime. It has said that it will continue to consider how to improve regulatory commitment further within the longer term framework set out above.

Ofgem sets out two areas of further work in its letter. Together with regulatory commitment, these follow up on some aspects of Dr Dieter Helm’s proposals, although Ofgem and Ofwat reject the full split cost of capital approach. Ofwat is also going to be working with Ofgem on these workstreams.

The first is the idea that revenues recovered annually from customers could be linked to a market index of debt costs. This would transfer interest rate risk from companies to customers by allowing bills to fall or rise in relation to movements in this index. Consultancy work commissioned by British Airways suggested that the Civil Aviation Authority (CAA) should consider a similar mechanism for BAA allowing, in the consultant’s view, the regulator to make a very low assumption on the cost of debt initially. The CAA, in its December 2006 document setting out initial proposals for Heathrow, Gatwick and Stansted Airports, has not adopted this approach but has specifically said that it intends to raise this issue with the Competition Commission as part of its own wider considerations of the risk-free rate.

The second area of work is an analysis of the variability of returns across the regulated sectors aimed at delivering a better understanding of the differences in risk across the sectors.

*Financeability*

On allowed returns it does appear that equity and other city analysts are advising investors not to expect Ofwat to come to the same conclusions at its next price review in 2009, either on the cost of capital or on its approach to financeability. Those acquiring water companies at significant premiums to RCV are doing so against this background.
Improving regulatory commitment may reduce concerns about short term financial ratios, and there is evidence that regardless of capital structure companies are raising a significant proportion of index-linked debt, which also benefits shorter term cash interest cover ratios (though not gearing). And there is no evidence of a lack of equity funding to the industry as demonstrated by the premiums being paid at present. In its recent conclusions for the electricity transmission review (December 2006) Ofgem has concluded that the baseline positions for the companies can be funded without any requirement for equity or any other financeability adjustment beyond the ‘depreciation tilting’ adopted for its final proposals. It has said, however, that in certain higher capital expenditure scenarios, two transmission companies may need to inject equity to stay financeable, and it has set price controls on that basis making an allowance for the cost of raising the new equity required.

Ofwat’s approach to financeability at its next price review will be developed after consultation with stakeholders. It has not yet shut down any options but it has said that if there needs to be an allowance for financeability (through whatever mechanism) it should be implemented in a NPV neutral manner in the future. The financing networks consultation has meant we have a wealth of views and information available for us to develop our approach. Expect a methodology paper later this year.
FINANCEABILITY

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Introduction

Railways policy in Great Britain never seems to settle down. In November 2006 the Strategic Rail Authority (SRA) was finally wound up under the provisions of the Transport Act 2005. The creation of the SRA was one of the most important changes in administrative arrangements since privatisation under the 1993 Act but it only survived for five years. Now the Office of Rail Regulation (ORR) and the Department for Transport (DfT) are in the throes of making the latest new system of strategy and regulation operational.

In order to appreciate the significance of the changes over the last couple of years and the next several years, it is worth summarising the guiding principle behind the 1993 reform of British Railways. It was the achievement of greater efficiency through competition and commercial incentive. As with the other utility privatisations the government recognised that the rail infrastructure network, like the pipes and wires, was an essential facility and a natural monopoly. Thus, Railtrack was sold as a ‘for-shareholder-profit’ monopoly subject to powerful, independent public interest regulation under legislation that had a great deal in common with the other utilities. Amongst other things, the Rail Regulator, like its successor body, the Office of Rail Regulation had a duty “to promote competition in the provision of railway services for the benefit of users of railway services”. Competitive, for-profit train operating companies (TOCs) were to provide passenger and freight services with the
option of using rolling stock leased from the three competitive, for-profit rolling stock companies (ROSCOs). Engineering services were to be bought in under contract from for-profit engineering companies.

So far as possible the day-to-day running of the railway was to be kept out of government, on the view that governments had generally shown themselves not to be good at running railways. But the necessity for continuing state subsidy was recognised and dealt with by the creation of a feature not to be found in the other utility administrations: the Office of Passenger Rail Franchising (OPRAF). This was a semi-autonomous arm of government whose role was to act as the only channel of public subsidy to the industry, via the train operating companies through to Railtrack.

The 1997 Labour Government, in spite of stating that they were fundamentally out of sympathy with the reforms, actually did very little apart from creating the SRA to absorb the functions of OPRAF and to introduce more ‘strategy’. But the ‘assisted suicide’ of Railtrack in 2001 was contrived to give the Labour Government the opportunity to convert the infrastructure owner and operator into a not-for-dividend company limited by guarantee overseen by over one hundred ‘members’ with various interests in the industry, and vague powers and duties. The new Network Rail promptly took the engineering functions back ‘in house’. Then the government abolished the SRA and took the high level strategic functions into the bosom of the Department for Transport, leaving some of the SRA’s lower-level responsibilities with Network Rail. The TOCs and the ROSCOs have survived as for-profit companies, but many of the TOCs, having got into financial difficulties, have had their commercially-binding service contracts converted into something akin to cost-plus management arrangements.

The upshot of all this is that by mid-2006 the railway in Britain had less clearly defined objectives and incentives, and more direct administration from within a government department than it has ever had in its history.
Regulation after the Transport Act 2005

New procedures now being implemented under the 2005 act are, sensibly, beginning the attempt to address the new problems presented by this slide from a system driven by commercial incentives to one that amounts to a mammoth task of government administration. By July 2007 the Secretary of State for Transport and Scottish ministers must publish a high level output statement (HLOS) and a statement of funds available (SoFA). In principle this should remedy a problem that has bedevilled railways policy since the 1920s – that governments have been unwilling to discuss explicitly what they want and how much they are prepared to spend. Although it is not the place of the Office of Rail Regulation to comment on the HLOS and SoFA it will adjudicate on whether the money on offer is adequate to fulfil the expectations and, if necessary, negotiate a reconciliation. As ever, there are admirably clear documents on the ORR internet site outlining the ORR’s general approach. In February 2007 the ORR will publish advice to ministers including a statement on requirements for the HLOS and SoFA – not the least important of which will be a view about how outputs are to be measured.

This process must mesh in some Byzantine way with two other, related exercises. The ORR has started the normal process of consultation for the October 2008 periodic review of Network Rail’s charges for the control period from 2009. And government as a whole is deeply emerged in the overall spending review 2007.

These processes require analytical equipment that has not been developed until now – though it ought to have been. All of this demands a proper understanding of cost causation in the industry and the DfT are working on that. Network Rail is leading work to help develop more cost-reflective charges as part of development of the infrastructure costs model that the ORR initiated as part of the Structure of Costs and Charges Review, published in October
2005. The ORR and DfT are jointly engaged in developing a strategic forecasting model and creating core data for assessing the HLOS options. Network Rail is being pressed to provide better understanding of signalling issues, capacity issues through a programme of route utilisation strategies and to improve knowledge of the state of its assets. In March 2006 the ORR imposed a penalty of £250,000 on Network Rail because it found it to be in breach of its licence in respect of the discrepancy between actual and published information on infrastructure capacity.

The ORR is taking a lead in stimulating this welcome set of analytical improvements. It may be that the intellectual background of Chris Bolt, chairman of ORR since July 2005, is becoming felt in the nature of the contribution made by the Office, as it was with his predecessors. They were lawyers and the prime contribution in their time was the establishment of a proper matrix of commercial contacts (against many odds), deep understanding of the legislation and constitutional context, and establishing a tradition of rigorous due process. The current incumbent is well placed to oversee the development of the necessary analytical equipment the new situation particularly demands. Apart from its essential role in formulating a coherent long term strategy for the industry, this will be an improved basis for the ORR’s current drive to secure more cost-reflective charges. On 1 April 2006 the ORR took combined responsibility for safety and economic regulation for railways in Great Britain.

**Incentives**

The ORR has shown concern about the adequacy of the incentives in the industry, recognising the economists’ point that in the end people respond to incentives, so if they are misaligned it would be unwise to expect a good outcome. One area of concern is Network Rail’s financial structure.

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1 Office of Rail Regulation (2005), Structure of Costs and Charges Review: Conclusions, October.
A matter in the competence of the Office of National Statistics rather than the ORR is the classification of Network Rail’s debt, approaching £20bn, as off the public balance sheet, in spite of the fact that it enjoys borrowing costs close to those for sovereign debt by virtue of the formal financial indemnity provided by government. Arguably it was the imperative to keep this debt as ‘private’, whilst being seen to exert a measure of strategic government control that drove the government to the particular structure it chose for Network Rail – the chancellor’s guidelines for the public accounts would be seriously threatened were the classification to change. Yet there are many commentators who judge this classification to be anomalous – from the Transport Select Committee of the House of Commons, which described it as a ‘fudge’, to the comptroller and auditor general. Either way, the ORR has expressed concern that there may be inadequate incentives for Network Rail to behave prudently, lacking the disciplines of either shareholders or capital markets. As the ORR’s Director of Regulatory Economics, John Thomas, put it:

“... how can incentives on Network Rail to increase capacity and performance and reduce costs be strengthened? What is the impact of the government indemnity on Network Rail’s borrowing, given that this effectively means there is no hard budget constraint for Network Rail and the usual monitoring role of creditors is non-existent? We will be examining further over the coming months a number of ways in which incentives might be improved. These include... the possibility of introducing scarcity/reservation fees to encourage optimal use of capacity; improving corporate financial incentives by restricting the use of the financial indemnity mechanism... Network Rail would have to seek any additional debt on a non-guaranteed basis from the capital market. The introduction of risk capital would have the effect of strengthening the efficacy of

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corporate financial incentives by helping to restore the usual monitoring role of creditors, and the operational and financial discipline that brings…” (Regulation and the 2008 Periodic Review in CRI Proceedings 33, 2006 – that article reports performance data for the industry so they are not repeated here).

The fundamental weaknesses of the incentive mechanisms under the governance arrangements for Network Rail have been remarked upon since it was first created, but they seem to have caused less of a problem than some commentators anticipated. Success was always going to depend upon the capabilities of the particular individual and, by common consent, Network Rail’s performance has been considerably helped by the strong leadership of its chief executive, John Armitt and his deputy, Iain Coucher. In December 2006 John Armitt announced his retirement from the post, to be replaced by Iain Coucher.

The ORR’s long-standing responsibilities on competition matters have played an important role recently. In November 2006 it announced that following a request from DfT it had made a study of the rolling stock leasing markets (accounting for around £1bn per annum of costs) and, having observed limited liquidity, is minded, pending consultation, to refer the matter to the Competition Commission for further investigation.

More excitingly, in July 2006 the ORR won a judicial review of an important decision it made in March. The incumbent company had won the competition for the right to retain operation of the GNER passenger rail franchise with an aggressive bid. Allegedly, the bid had initially been contingent on the ORR not granting other companies their outstanding requests for competitive access rights on some of the routes, but at a late stage GNER had been persuaded to withdraw the condition on the assurance that such competition was against government policy and would not occur. In the event, undoubtedly having regard to its statutory duties, and exercising its independence of
The challenge in the courts “centred around GNER’s claims that the access charging regime contravenes regulations implementing EU rail directives by discriminating between franchise operators and open access operators, and amounts to an unlawful grant of state aid to open access operators” (ORR Press Notice, 27 July 2007). In rejecting the grounds of GNER’s challenge the judge stated that he was “satisfied that the ORR’s approach is consistent with the directive and with the regulations purposively construed as a whole. ... the ORR (and previously the Rail Regulator) engages in a remarkably thorough consultation process with the railway industry in respect of all of its statutory functions, including the review of track access charges and the consideration of track access applications”. During the hearings GNER withdrew its claim that ORR had failed to apply its own policies of ‘moderation of competition’ and revenue abstraction.

The outcome of this case is an important demonstration that it does matter that, like all the regulatory commissions, the ORR is bound by the legislation and not by current government policy, and, in particular, that legislation still retains competition duties that were fundamental to the original concepts under the 1993 act. The DfT and the bidder had been unwise to discount the possibility of this outcome.

GNER declared itself unable to fulfil its commitment and the DfT promptly let it ‘off the hook’, put it onto a temporary management arrangement and, in December 2006, announced that the contract would be re-tendered. This is the latest of a long series of events in which TOCs have won competitive competitions with bids that they have subsequently found themselves unable to honour. In almost all cases government has renegotiated or found some other accommodation. The risk transfer that is the essence of the incentive to efficiency in competitive procurement has thus been severely compromised and the industry must have learned by now that competition for franchises is not all that it is supposed to be. It forces one to
question whether the manifest inability of government – now in direct control and therefore even more obviously ‘to blame’ in the eyes of the public – to enforce commercial contracts for provision of sensitive public services, leads one to the conclusion that good value for public money is unlikely to be achieved. If risks are not successfully transferred, the state may end up paying commercial risk-bearing rates of return but also paying the costs of picking up the pieces when things go badly.

Expanding or maintaining the railways

At the highest level of national policy the railways find themselves in a strangely ambiguous position. There is almost no money in current budgets for capacity enhancements – as distinct from maintenance and renewals. The government is in the throws of a particularly ‘difficult’ spending review, with pressures on overall spending opposing politically powerful demands from the health, education and defence sectors, so it seems unlikely that the HLOS and SoFA process will produce new state funds for the railway. In an interesting new development, on 10 May 2006 the Prime Minister wrote a public letter to the incoming Secretary of State for Transport setting out what is required of him. Once the platitudes have been discarded, the letter is quite short and pithy. It contains a good diagnosis of the reasons for anticipated growth in demand for roads and railways. But crucially this short letter has two separate mentions of the current constraints on public expenditure. There is an important steer here that the secretary of state should not expect to be able to solve his problems with large quantities of new Treasury resources.

In any case, the railway is already costing the taxpayer over £4.5bn per annum, relatively few people outside London use the railways, and it is hard to point to objective, quantitative evidence in justification. The public service agreements for railways contain a number of relatively low level management targets such as ‘make them more reliable’. They also contain
secondary objectives such as ‘increase the use of public transport’. But there is not much in a way of primary objectives stating ‘what we are trying to achieve’. Recent research for the Commission for Integrated Transport usefully confirms that it is hard to relate railway subsidy to delivery against likely government policy objectives – such as assistance to the disadvantaged or reduction of greenhouse gas emissions, where rail loadings are low.

Part of the problem is that, whereas it is relatively easy to point to many road infrastructure investments with published assessments of benefits well in excess of costs, it is hard to find comparable evidence for rail schemes, with the exception of one or two very large schemes such as Crossrail. If the appraisals are done they are not readily available in the public domain. Sir Rod Eddington’s review of transport in relation to productivity, stability and growth perfectly reasonably said that the way to obtain the best value from a limited public budget is to select the schemes with the greatest benefits in relation to their costs.\(^3\) He reviewed a portfolio of schemes but careful reading of his report does not reveal strong support for increasing expenditure on railways. And according a press report “It has since been established that three-quarters of the 186 projects ... Sir Rod Eddington considered which showed the benefits outweighed the costs involved were road schemes. Just 14 were rail improvements, the rest involved trams, buses, walking and cycling proposals” (Juliet Jowit, The Observer, 17 December 2006).

So generous increases in state funding for the railway seem unlikely. And yet, the economy is growing, stimulating the demand for movement. Also, the roads are becoming congested so the demand for some of the major railways is growing whilst there are already some severe capacity shortages. This is a prospect that was correctly diagnosed in the ill-fated Ten Year Transport Plan of 2000. The problems are acute for the commute

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into London: Transport for London in its Transport 2025 pressages demand growth of 30% and more on many of the commuter railways.\(^4\) This is a consequence of the forces of population growth and its disposition in relation to the expected location of new jobs. One only has to look at a map of the anticipated growth in population in a ring of housing development areas circling London and compare it with the expected location of employment growth largely in inner London to understand that the peak capacity problem for the London commuter railway will get worse. This magnitude of extra capacity could be found by building the major schemes such as Crossrail and Thameslink together with a myriad of smaller schemes such as signalling improvements, junction layout improvements, platform and train lengthening. Some of the minor schemes may be financially viable but it is hard to identify and capture the incremental revenues. To deliver TfL’s ‘shopping list’, which is a coherent and costed proposal for dealing with the pressures of a growing London and responding to climate change, set out in *Transport 2025* (November 2006), would cost several tens of billions of pounds of additional infrastructure spending.

*Productivity, competitiveness and the benefits*

The Eddington Report supports two new arguments that call for careful scrutiny lest they descend into mere fashions. One is a concentration on ‘productivity’, GDP and ‘competitiveness’. Some of this is already drafted into the guidance on the Transport Innovation Fund. Of course such objectives are different from the traditional ‘economic welfare’ which is fundamentally based on private individuals’ willingness to pay. In certain circumstances these different criteria will lead to different decisions, most obviously for schemes that generate economic welfare through leisure time savings, or that offer benefits to individuals in activities that are not recognised for GDP purposes.

The other argument relates to ‘agglomeration benefits’. There is no doubt that agglomeration effects are real. That is why cities exist. They should certainly be estimated. Interesting progress has been made recently on how these effects might be accounted for in scheme appraisals. But much more work is required to obtain robust quantitative estimates that can be used in an objective and scientific way to improve our appraisals of specific projects. Nor is the economics of how to incorporate them into appraisals straightforward.

**Road pricing**

The introduction of official policy to introduce national road pricing is strongly endorsed by Eddington and it is very welcome. It is the only realistic way to deliver more efficient use of our very inefficiently used network. But also – and this has not yet been widely discussed – for the longer term it would provide both a much clearer signal about where it is worth investing in new road capacity and the wherewithal to build it. In other words it would bring a welcome new coherence to roads provision, considered, as it should be, like any other major piece of public or private infrastructure. It will bring together the consideration of the price to be charged by time-of-day, the capacity to be provided and the revenues available to fund new capacity. These things need to be decided together, yet presently each of them is decided separately. The consequence has been a distorted road investment programme and inefficient use of what we have.

The development of thinking about national road pricing is relevant to railways policy for at least three distinct reasons. Most obviously there are the direct implications for modal transfer. At the national scale, modal transfer from road to rail is not likely to be very important simply because there are few viable railway services available to compete with the priced road trips. But it could be significant in specific markets, such as the commute into London, where road charges would be relatively high and, as we have noted, rail capacity is already under severe
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pressure. And if it should be the case that part of the road pricing policy package is a substantial reduction in motoring taxes paid in rural areas, then the competitive position of railways serving such areas would be further weakened.

There are two indirect implications for railways policy. First, principles that are good for roads are equally good for railways. It is an inefficient use of the rail network to tolerate extreme crowding in the peaks and under-use of capacity at other times. If, as must be the case, expanding capacity in suburban London is very expensive – unfundable or physically infeasible – then the implication of the pricing principles is that we should have more aggressive pricing for the peak period than we have now. That would reveal a meaningful signal showing willingness to pay for extra capacity which can be related to the costs of providing that capacity. Similarly, it would provide more sensible signals to those planning new housing developments: presently much new housing is being planned on a presumption that fast, cheap and high-capacity rail services will be available to take the new residents to their employment, expectation that nobody will be willing to fulfil. Of course, as the Office of Rail Regulation well-recognises, these principles read across to the setting of charges for the use of scarce track capacity to more nearly reflect both the value of that capacity to the marginal user and the long-running costs of expanding it. All this is the same triad as for roads: price, capacity, and funding to be simultaneously determined, thereby delivering a clearer signal on value for money. Arguments of this kind are firmly endorsed in Sir Rod Eddington’s Report.

Road pricing has another indirect implication for railways policy. It would involve public authorities handling and being accountable for large amounts of money. It seems unlikely that the public would accept all of this falling under the direct control of the exchequer, as is presently the case with fuel duty and the vehicle excise duty. The policy seems much more likely to be acceptable if some authority corresponding to the natural local traffic area performs these functions, and if it has the powers and
duties to spend a substantial portion of the money that is collected in their area. This is precisely what happens in the case of the London Congestion Charge. But outside London there are no appropriate authorities. The Passenger Transport Authorities, which no longer have the span envisaged for them when they were created in 1968, do relate to suitable geographical areas, and they could be reinvigorated as an essential component of national road pricing. They would have to take over some of the powers that presently reside with their constituent local authorities. New bodies might need to be created to serve areas such as Bristol, Southampton and Portsmouth. Alternatively, the government appears to be reasonably content with the way that the new London government has worked, so they might decide to replicate that structure in some other city regions.

These are matters under active consideration and the DfT’s discussion document Putting Passengers First (December 2006) suggests that provision will be made in a forthcoming Road Traffic Bill.\(^5\) Whatever the outcome, if there were more devolution to powerful local transport authorities, then it is certain that they will expect to gain more control over local railway systems and the budgets that go with them. Of course, this is already a live issue between the Mayor of London and the government. And government has made general noises about devolution of railway budgets but it is not yet clear what that might mean in practice.

**The ‘Lyons’ review**

That takes us to Sir Michael Lyons’ review of local government finance. He was due to report by the end of 2006 but in December it was announced that it will be further delayed in order to allow him to consider the implications of the Eddington (transport), Barker (planning) and Leitch (skills) reviews. It seems inevitable that he will become involved in the issues of

local taxation, central government grant, and local governance. The government’s response to Lyons will have its own implications for railways policy. For instance, the Secretary of State for Transport has already announced that the decision on government funding for Crossrail has been delayed pending the government's consideration of the Lyons report.

**London Underground PPP**

Remarkably, Chris Bolt’s post as chairman of the Office of Rail Regulation is part-time. To ensure that he is not short of things to do he holds concurrently the post of arbiter for the public private partnership (PPP) for the renewal and maintenance of the London Underground. From the legal point of view this is a somewhat different regulatory function in respect of a somewhat different railway. Yet many of the technological and economic issues are essentially the same: economy and efficiency and a rate of return to be earned.

The 30 year PPP contracts were completed in 2003 with provision for a review of the terms every seven and a half years and in addition extraordinary reviews may be called for. There is also a requirement for an advisory annual report on Metronet (the infrastructure company that owns two of the three PPP contracts) and the arbiter published the first of these in November 2006 (the process having been deferred by one year by mutual agreement). This offered the preliminary opinion that Metronet has not been ‘economic and efficient’ in some important activities. It also identified a large sum of money over which there is potential for dispute. Unsurprisingly, this suggests that exercising the functions of the PPP arbiter is not going to be straightforward and, as with the national railway, there will be a strong need for the best possible analytical capacities. The various parties – the arbiter, London Underground and the infrastructure companies – are in the process of putting these together.
Conclusion

‘Integrated Transport Policy’ is a popular phrase which has many meanings to many people, yet it is hard to give a precise definition to any of them. But, for sure, policies on rail and road – a pair of interdependent industries, each with its own long-lived set of assets – can never be ‘integrated’ so long as government continues to attempt to determine pricing, funding and capacity investment independently and inconsistently. For the first time ever, English central government has direct control of and responsibility for national roads and railways. The welcome advent of an ‘in principle’ policy in favour of efficient road pricing could offer the opportunity for the evolution of a coherent policy.

The talk so far has been about how and when national road pricing might be implemented. There has been little discussion about the long term implications for the nation’s road investment programme or what it might imply for the funding of that programme, although the Eddington Transport Study did contain interesting material on this which deserves more attention. The public debate about the implications of these same principles for railways has been poor, partly because of a fear that implications may be uncomfortable. They are certainly likely to imply changes to both pricing and investment in railway capacity.

The demand for both major roads and major railways is growing relentlessly and is likely to continue to do so under any realistic set of transport policies so the need for investment and for the funds to pay for it cannot be escaped. The publication of the Eddington Transport Study and the Lyons Review on local government finance, development of the government’s high level output statement for the railways for publication in summer 2007, with the general spending review for publication soon afterwards should between them crystallise some of the issues. However, progress will be limited until there is a better understanding of the determination of long term capacity costs in the two industries – something that has been extraordinarily
weak in such important enterprises accounting for so much public money.

What with the growing shortages of rail capacity colliding with the strictures on public spending; the evolution of new national policies on pricing and the environment; and the prospect of spectacular litigation over the London Underground it seems likely that there will continue to be plenty to keep transport-watchers amused over the next few years.

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21 SUSTAINABILITY AND GOVERNMENT POLICY

Neil Witney

Introduction

In July 2006, Stephen Hawking asked on Yahoo Answers “How can the human race sustain another hundred years”. He received over 25,000 responses. When asked what his own thoughts were, he replied, “I don’t know the answer. That is why I asked the question”.

No one is able to predict with certainty what the future will hold, but drawing on horizon-scanning or foresight research we can predict some of the key challenges for sustainable development. For the UK government, and the other devolved admissions, these have been identified in sustainable development strategies as climate change and energy; sustainable consumption and production; creating sustainable communities, and natural resource protection and environmental enhancement. But current strategies set out not only evidence-based analyses of the current and future geopolitical situation and the resulting priorities, but also proposals for addressing the problems raised. These proposals take the form of preferred approaches and principles, as well as concrete actions.

1 http://www.guardian.co.uk/science/story/0,,1836051,00.html
2 UK Government, Scottish Executive, National Assembly of Wales and Northern Ireland Office (2005), One Future, Different Paths.
5 DOENI (2006), First Steps Towards Sustainability.
6 National Assembly of Wales (2006), Starting to Live Differently.

Neil Witney, Sustainable Development Unit, Department for Food, Environment and Rural Affairs
This chapter focuses on the preferred approaches in government policy for tackling issues such as sustainability which addresses long-term issues and intergenerational needs; and which have to meet both the needs of local communities in the UK and address global perspectives. The goal of sustainable development is to enable all people throughout the world to satisfy their basic needs and enjoy a better quality of life, without compromising the quality of life of future generations.

Government approaches to sustainability – the role of regulation and other levers

We all – governments, businesses, families and communities, the public sector, voluntary and community organisations – need to make different choices if we are to achieve the vision of sustainable development. The government recognises it has a wide range of levers – not just regulation. It also recognises that some of the social and practical factors that influence and limit our choices require much more dynamic and sensitive approaches to support a change in personal habits or individual lifestyles.

Traditionally regulation has been a driver of higher environmental standards and rising levels of social protection. It will continue to have a role to play where there is a clear rationale. Any government intervention must have a clear rationale. This usually relates to market failures or government objectives around equity but can cover other issues. However, even if a rationale for government intervention can be made it does not mean that regulation is required. The government’s approach to regulation means looking for alternatives to ‘classic’ command and control regulation, and promoting in addition voluntary agreements, advisory services and the use of economic instruments, such as taxes or trading schemes. Where regulation remains the preferred option, the best results will be delivered
through regulations which are focused on outcomes and are backed up by clear information and consistent enforcement.

The government is promoting simplification and deregulation to cut red tape across the private, public and voluntary sectors so that businesses can be more productive, so public services can be more efficient and so social enterprises are freed from bureaucracy. The Better Regulation Executive, part of the Cabinet Office, works across government to reduce and remove unnecessary regulation for the public, private and voluntary sectors. They promote five principles of good regulation from the Better Regulation Commission, principles which will be supported by legislation currently going through parliament. These principles suggest that regulation should be:

- **Proportionate:** Regulators should only intervene when necessary. Remedies should be appropriate to the risk posed, and costs identified and minimised.
- **Accountable:** Regulators must be able to justify decisions, and be subject to public scrutiny.
- **Consistent:** Government rules and standards must be joined up and implemented fairly.
- **Transparent:** Regulators should be open, and keep regulations simple and user friendly.
- **Targeted:** Regulation should be focused on the problem, and minimise side effects.

While there will continue to be a very important role for regulation and enforcement, regulation alone will not be able to deliver the changes we want to see. The government is trying to make sure that we are using all the levers available in a consistent way. At the same time, there is growing understanding that a single intervention – regulatory or other – is unlikely on its own to be sufficient or effective in achieving behaviour change.

The UK government’s sustainable development strategy therefore focuses on the need to ‘enable, encourage and engage’ people and communities in the move toward sustainability;
recognising that government needs ‘to lead by example’. Figure 1 below sets out the kind of activities and approaches under each of these headings. The diagram illustrates a model of behaviour change which was a key theme of the 2005 sustainable development strategy. It is based on research into the drivers of pro-environmental behaviours, primarily for individual consumers but it is also applicable to organisations.

**Figure 1: Model for behavioural change**

While these elements are all necessary for change to take place they may not be sufficient to bring about the changes we need when behaviour is entrenched. In these circumstances, we may need to go further and think about how we design policies to catalyse people to behave differently. Over time the aim is for the new behaviour to become the social norm. That in turn can open up new opportunities for progress. London’s congestion charge provides an example of how this model can work in practice. A combination of charging, combined with increased provision of buses was introduced with a huge amount of accompanying publicity. It has had effects that have been far greater than
originally forecast. There has been a 30% reduction in congestion as people consider alternatives including public transport with an increase of 29,000 bus passengers entering the zone in the morning peak.

**Fiscal incentives and taxation**

Incentives can take a number of forms including subsidies, voluntary initiatives, trading schemes or taxes. The reasons for using incentives can be to correct externalities or market failures – where the private costs do not reflect the real cost – or as a way of changing behaviours to achieve particular targets. Changing behaviour through ensuring we give the right price signals can be a very effective way of delivering our objectives at least cost to the economy. The government’s thinking on using economic instruments to tackle environmental issues were most recently set out in Tax and the Environment: using economic instruments. This document sets out the key principles that government will apply when determining whether there is a role for economic instruments to tackle particular environmental issues. Environmental taxes are fundamentally different to most other taxes; their principal aim is to deliver more efficient and better environmental outcomes, not necessarily to raise revenue.

So, in designing environmental taxes, all stakeholders need to have a great deal of advance notice with extensive consultation to allow people or firms to adapt their practices. There is greater incentive to recycle some of the proceeds from the tax back into the sector paying the tax to create a virtual cycle of taxation and incentivisation. There are opportunities to reduce levels of taxation (for example, council tax) if people adopt more sustainable behaviours – and encourage those benefiting to reinvest the money saved into more efficient ways of living.

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In other cases, taxes might not be the right choice, and better results can be achieved through regulation (where, for example, we need to control local pollution impacts), trading schemes or voluntary agreements. Often the best approach will involve a package of measures, which could include some market incentives such as, for example, carbon emissions trading or the renewables obligation which places an obligation on all licensed electricity suppliers to produce evidence that they have sourced a specified proportion of their electricity supplies from renewable energy sources. In all cases our aim must be to apply these measures in ways that support sustainable development.

**Public engagement**

Given that sustainable development requires action by citizens and communities, the current approaches to policy making stress the engagement and participation of the citizen and the community. There are a very wide range of participative techniques for engagement which are more dynamic and interactive than traditional advertising campaigns. They also place emphasis on working with communities and individuals so that it is not attitudes that are influenced by engagement but behaviours. If there are widespread changes in lifestyles, or changes in lifestyle by opinion formers and those respected in the community, the hypothesis is that these responses collectively help to produce a ‘tipping point’ where lifestyles which promote good health, or a better environment, or safer roads become the social norm voluntarily without the need for heavy-handed regulation. Key to these approaches are social marketing and deliberative techniques. Both these approaches allow the government to enter into a dialogue with citizens, understand their needs better and promote and enable a better quality of life.

Hence, for example, the Department of Health is committed to developing a social marketing strategy for health to build public awareness and influence attitudes in order to improve the lifestyles for people to achieve better health for the nation. It is not a matter for the government to dictate to the individual what
they can and cannot consume, or what to do or what not to do. Instead, it is a case of access to information that will show the options of adopting a healthy lifestyle, and knowing the dangers of excess drinking, smoking, taking illegal drugs or having unsafe sex. However, we know that information alone does not always lead to behaviour change, so part of this work has identified a need for better understanding of people’s daily lives and routines.

Through the ‘Together We Can’ programme, the Civil Renewal Unit in the Department for Communities and Local Government works to enable people to engage with public bodies and influence the decisions that affect their communities. It actively promotes deliberative techniques to support this work – and there are resources and materials to promote this approach at the website.8 One of the key purposes of community engagement and civil renewal is to give people a better understanding of how public policy and the governance of public institutions and services, work. The aim is to ensure that this, and future generations, are engaged in politics. People should be aware of the role of citizen in society and feel that they have a say in decisions about their lives. By extension, part of being a citizen in society is the right to be able to press for changes to services, and political and legislative reform if a situation is thought to be unfair, unjust, unethical or a consequence of market failure.

Assessing whether policies, strategies and regulations are sustainable

The UK government sustainable development strategy sets out five principles for sustainable development policy. These principles say that any measures or policies have to:

8 http://www.togetherwecan.
• use sound science responsibly;
• promote good governance;
• help achieve a sustainable economy;
• ensure a strong, healthy and just society;
• help us to live within environmental limits.

In this instance this means that any measures we want to promote must have robust evidence behind it to show that it will achieve the environmental benefits we want. We need to choose the measure that will impose least economic cost and with the most potential for economic benefit (for example, encouraging innovation). We have to make sure that any change arising from the measure is fair, and in particular, that it does not place too high a burden on any vulnerable group. We also need to ensure that society will accept the changes that we are proposing – that the timing is right.

The government tests this by drawing up a draft impact assessment. This sets out the costs and benefits – it also accompanies any public consultation on regulations in draft, and increasingly on strategic documents, so the public has the opportunity to comment on the assumptions and costings used to justify the approach taken. As at July 2006 there were proposals out to consultation to simplify the Impact Assessment and ensure that sustainable development principles were considered in an assessment of impacts. Tools such as these allow appropriate forms of regulation and ensure integrated assessment of costs and benefits in a way that allows the economic, social and environmental consequences to be considered at the same time. However, it should be acknowledged that evaluating environmental and social impacts is difficult and complex.

9 http://www.cabinetoffice.gov.uk/regulation/ria/consultation/index.asp
Conclusions and current thinking

This short chapter sets out, using sustainable development as an example, how government is explicitly seeking to achieve its outcomes through a very wide range of policy levers which may include regulation, but increasingly look at existing processes and non-regulatory means, as part of strategic policy making, to meet those goals.

By assessing how society changes over time, it is possible to make better assessments about the kind of policy levers that will be necessary and when they might need to be introduced. Looking at attitudes to smoking or drink-driving over the decades shows that a combination of policy levers, adapting over time as society’s norms changed, may suggest opportunities to help reach some of government’s longer term sustainable development targets. Work in Defra has suggested the following conclusions.\(^\text{10}\)

\textbf{Behaviours are complex}

- behaviours are undertaken by individuals in the context of groups and wider social networks;
- behaviours are determined by various (often inter-related and inter-dependent) factors, many of which need addressing simultaneously to facilitate change;
- individual behaviour change is obstructed by three principal internal barriers (agency, norms and habit) and three principal external barriers (external conditions, social context and lock-in);
- holding positive attitudes does not automatically lead to undertaking positive actions - this phenomenon is commonly known as the value-action gap;
- not everyone is a profit maximiser. The behaviour of individuals and organisations is not always economically

‘rational’ and can not be fully determined by the assumption of profit maximisation (any modeling needs to take account of other factors);
- policy interventions based solely on ‘information deficit’ models are unlikely to be successful;
- interventions should:
  - combine multiple instruments in a ‘package’ of measures (eg, infrastructure, fiscal instruments, and information);
  - work on multiple factors and on multiple levels - individual and collective - ultimately addressing society as a whole in order to achieve sustained change;
  - first address external factors (most notably infrastructure and pricing) and then internal factors (eg, psychological or attitudinal);
  - be challenging: for example, there may be situations where people would accept a restricted choice but incentives are generally more acceptable than penalties: measure actions rather than attitudes as past behaviour is a more reliable indicator than beliefs or intentions.

Outcomes of interventions are difficult to predict...

- setting targets or accurately predicting outcomes is likely to be difficult;
- policy measures need to be highly context specific. Government should provide the overarching strategy for change and identify headline targets and milestones, and then devolve as much responsibility for policy design and implementation to organisations that are closest to the end behaviour they are intended to affect. Devolving responsibility for policy development and delivery to local bodies can also help ensure suitability and build their legitimacy;
- given the inherent uncertainty of social structures, changing behaviour requires acceptance of the fact that a proportion of interventions may not have any effect. Greater tolerance of risk
is therefore a necessary part of behaviour change policy-making.

... with behaviour responses to policy interventions varying by target group

- different audiences behave differently and require targeted and/or tailored interventions;
- no two individuals (consumers) or businesses are exactly the same but they can be ‘segmented’ using marketing techniques to identify who is most likely to respond to what kind of issue;
- recognise diversity. Key influencing variables vary for different groups and so policies and communications need to carry nuanced messages for maximum impact;
- view target audiences and other key stakeholders as ‘actors’ at the heart of the change process. Ideally, a total partnership working approach should be adopted in which change partners (including members of the public) are involved from the start in defining and redefining the problem through a continuous cycle of action and reflection;
- be ‘market-orientated’: social marketing techniques might prove a useful policy tool for encouraging pro-environmental behaviour amongst individuals and households.

Change is an ongoing and slow process, not a one-off event

- instead of understanding changing behaviour as a single event, it should be viewed as an ongoing process characterised by feedback loops and continuous learning;
- change is a slow process – for example, very few businesses are keen to adopt a radically different business model, but most are willing to make incremental adjustments;
- interventions should incorporate opportunities to learn from policy audiences – learning captured and fed back from the change process should influence subsequent policy;
• policy making should be reflexive. Evidence of failure should be greeted as an opportunity to build feedback into an adaptive system;
• more effective and consistent monitoring and evaluation is required in order to facilitate this sort of reflexive policy making.

Local networks and change champions can act as brokers between government and target groups

• individuals, businesses all respond to social norms, peer pressure and support from localised networks and change champions;
• change processes are characterised by tipping points where ideas products, messages and behaviours spread in a viral manner;
• within all network systems there are focuses of greater influence, either because of the strength of linkages, the frequency of linkages, or linkages to other networks;
• engaging and nurturing key individuals may be more effective in bringing about system-wide change than targeting the behaviour of all individuals;
• joining interested individuals together in action networks represent a new way forward for encouraging change;
• foster advocates and opinion-leaders. There is an advocacy role for those who are more committed to positive behaviour goals to raise awareness amongst those who are more sceptical;
• a network approach will help identify the key intervention points to maximise the chance of having any influence at all on the system in question;
• an alternative approach through nodal change agents provides a focus on groups whose network properties best lend them to the diffusion of change, in order to boost the probability of success;
• identify what makes a network. Interventions should focus on the basis for belonging to groups and networks - if the linkages
are inherently spatial, then spatial interventions will have the greatest chance of ‘traction’;
• businesses are similar to the public. Peer pressure, social referents and business to business learning are effective ways of sharing best practice including demonstrating the benefits of sustainability.

**Collective action can deliver responsible consumption of scarce resources**

• collective action theory can be used for finding new ways of motivating people to produce and consume in a more sustainable manner, particularly in areas concerned with scarce environmental resources;
• collaborative planning does work in a local context – demonstrated by co-operation and mutual self-restraint in resource consumption;
• stimulate collective action. In policy areas characterised by scarce environmental and other resources, efforts should be made to facilitate the creation of mutually imposed, self-financed and binding contracts that limit individual consumption;
• participatory planning (and common-value identification) can increase compatibility between individual self-interest and the common good (private/public benefits).

**Future research should be policy-focused, primary research**

• new models do not need to be developed as existing change frameworks can be applied to individual policy questions.

Even in summary it can be seen that there are some complex messages to communicate to ensure that policy-making is flexible enough and sensitive enough to be able to incorporate long-term and behavioural approaches to meeting societal goals. What is clear is that regulation, even for transnational and global
problems, will in future be seen as only part of the solution – particularly if there is a continuing emphasis on providing choice and opportunity to people. Evidence to date is weak on whether a heavily regulated society or a lightly regulated society is better or worse for people’s wellbeing. It is clear from most accounts of what drives human society and happiness that freedom and autonomy are strongly valued.\(^\text{11}\) Of course, regulation has been seen, and still is seen, as a strong tool to protect the freedoms that society enjoys.

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National Assembly of Wales (2006), Starting to Live Differently. (6)

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\(^{11}\) See current Defra evidence base at http://www.defra.gov.uk/research/
22 INDEPENDENT DIRECTOR GENERALS 1984-2006
– A GOLDEN AGE?

Peter Vass

Introduction

The year 2005 was, in one respect, a special year; twenty one years since the first Director General was put in place to regulate the utilities and network industries as they were progressively privatised over the years 1984-1997. So was this to be a celebration of ‘coming of age’, looking forward expectantly to the coming years? No, it was more the end of an era.

In one sense, the Railways and Transport Safety Act 2003 and the Water Act 2003 put an end to independent director generals before the species was out of its ‘teens’. In practice, however, Tom Winsor, the last rail regulator, was dispatched in 2004 when the Office of the Rail Regulator (ORR) was converted into the Office of Rail Regulation (ORR). And the last director general of all, Philip Fletcher, did continue until he was formally disempowered in April 2006, but that was just a formality (and the director general ran his office during 2005 as though it was a regulatory authority). The 2003 Act replaced the director general of water services with a Water Services Regulation Authority (WSRA), but the timing of the implementation of the legislation was conditioned by the need to complete the 2005 periodic review of water prices under the existing regime. Between them, therefore, an average departure date of 2005!

At the same time, an end date of 2005 was reinforced by the passing of the Transport Act 2005, which transferred safety in relation to rail from the Health and Safety Executive to ORR, and

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abolished the Strategic Rail Authority, transferring most of its functions to the Department for Transport. The new form of the regulatory state for utilities and network industries was therefore finalised in 2005.

Hence we can now fairly ask what the 21 years of independent director generals represents, just as they came of age. Have they been cut off in their prime, or has it been a necessary metamorphosis in the life cycle of the regulatory state?

Director Generals – the species

First, the context. The director general of telecommunications, accompanying the privatisation of BT in 1984, along with the Office of Telecommunications (OfTEL), was not the first director general – before it, for example, there had been the director general of fair trading since 1973, accompanied by the Office of Fair Trading (but in this chapter we focus on the sectoral, rather than the national, competition authorities). He was, however, the first sectoral economic regulator, which presaged a dramatic ‘unbundling’ of the regulatory state as successive privatisations took place, accompanied by ‘off this’ and ‘off that’.

The pattern has been repeated across the regulatory state (eg, the Office of Standards in Education – Ofsted), installing ‘technocratic’ regulation at arms length from ministerial intervention. It represents the institutionalisation of what Professor Michael Moran has termed ‘high modernism’ in the approach to steering the regulatory state, based on ideas of coherence, commitment, consistency and rationality, and the codification of practice principles, most notably the five ‘principles of good regulation’.1 One way of representing this is

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1 Moran M (2003), The British Regulatory State, High Modernism and Hyper-Innovation, OUP.
set out in Table 1, all elements being required to underpin the legitimacy and effectiveness of the regulatory state.²

Table 1: The elements of regulatory governance

<table>
<thead>
<tr>
<th>Elements</th>
<th>Characteristics</th>
<th>Guiding principles</th>
</tr>
</thead>
<tbody>
<tr>
<td>regulatory purpose</td>
<td>objectives (outputs) ‘The problem to be addressed’</td>
<td>objectivity, coherence, rationality</td>
</tr>
<tr>
<td>regulatory means</td>
<td>instruments (inputs) ‘The options available to solve the problem’</td>
<td>proportionality targeting consistency</td>
</tr>
<tr>
<td>regulatory framework</td>
<td>structure and process (governance) ‘The control mechanisms aimed at optimising regulatory outcomes’</td>
<td>transparency accountability</td>
</tr>
</tbody>
</table>

For the privatised essential service industries, covering water, energy, transport and communications, such principles were clearly needed if both investors and the public were to be confident that regulatory and political risk would be managed, fair returns secured, and continuity and standards of service assured.

In the same way, their mode of operation (incentive-based regulation by periodically setting price controls) was not the first time price controls had been a remedy for controlling the abuse of monopoly power. The national competition authorities well understood their efficacy, but the new director generals were the first to apply the techniques in an entrenched and formally *ex ante* context, and to develop the techniques progressively over

time from the base established by Professor Littlechild in his seminal report preceding the privatisation of BT.³

The independent director generals for utilities and network industries can therefore be viewed as a special innovation.⁴ The powers were vested in the individual, and the individuals can be said to have risen to the occasion, the occasion giving them the opportunity to do so. The successful privatisation of BT (ie, the oversubscribed flotation) led inexorably on to the privatisation of British Gas (1986), the British Airports Authority (BAA, 1987), the ten water and sewerage companies in England and Wales (1989), the UK electricity industry (1990-1996) and British Rail (1994-1997). This was a bold experiment in transferring public ownership (the nationalised industries) into public services-privately provided. Not surprisingly there was, at best, public uncertainty, and, at worst, political resistance. In Scotland, water privatisation proved politically impossible, and the Labour party committed itself to taking the railways back into public ownership if they gained power in 1997.

The independent regulators could therefore play a key role in putting a human, accountable face to regulation and public protection. If the people appointed to be independent regulators could be seen to represent the best traditions of British public and civil service, and acted transparently, rationally, consistently and authoritatively, then public concern could be assuaged and the evidence of the benefits of privatisation allowed to accumulate to a point at which it was compelling in its own right. At the same time, the confidence of investors meant a lower cost of capital, and thereby lower prices to consumers; confidence arising from reduced risk of unwarranted political intervention, and reduced regulatory risk because of the clear statutory constraints founded in the powers and duties placed on independent economic regulators.

³ Littlechild S (1983), Regulation of British Telecommunications’ Profitability, DTI, HMSO.
Their special character

The new director generals brought with them therefore some clear advantages. The new system was essentially ‘technocratic’, rather than political, and where there was a perceived problem of legitimacy in relation to ‘appointed’ director generals, this was soon countered by setting the system in a highly accountable framework. They could say, ‘I have made the decision’, and be held personally accountable for it, appearing on television, and facing the ‘Paxman’ test (like the Birkenhead drill – a damned tough bullet to chew). But most importantly they could engage the public directly, and challenge their critics. They brought speed of decision making, and innovation, enabling them to operate as an effective ‘learning organisation’, such that regulatory practice could be developed to meet the needs, and remain consistent with, the underlying objectives of regulation. The National Audit Office underlined the credentials of the system in successive reports to parliament.

The possibilities for regulatory ‘capture’ were also undermined by the extent of personal accountability. The legal framework that gave them their powers and duties also enabled them to defend their independence against the predations and interventions of ministers beyond the bounds of the consensus regulatory settlement (ie, independence within the regulatory state). Finally, there was collective reinforcement, given there was a sizeable group of independent director generals, both in terms of comparative analysis of good and bad practice, and

8 Hood C, Rothstein R and Baldwin R (2001), The Government of Risk - Understanding Risk Regulation Regimes, OUP.
mutual support when under political attack. It is also interesting to note the degree of mutual reinforcement occasioned by transfers of staff between regulated sectors; two notable cases being Chris Bolt and Bill Emery moving from water to rail regulation and Callum McCarthy moving from energy to financial services regulation (the FSA).

Lest we forget, who were these director generals, now replaced by regulatory authorities (see Table 2)? In relation to the table it is interesting to note that the regulatory bodies have merged and developed as the technical characteristics and interrelationships between the sectors has changed over time. In particular, Offer and Ofgas were merged into the Office of Gas and Electricity Markets (Ofgem – thereby giving expression to the legislative imperative on regulators to introduce competition wherever possible and appropriate), and the Office of Communications (Ofcom) incorporated Oftel along with the Broadcasting Standards Commission, the Radiocommunications Authority, the Radio Authority and the Independent Television Commission. The regulation of rail franchising has also developed alongside ORR, first being the responsibility of the Office of Passenger Rail Franchising (Opraf), followed by the Strategic Rail Authority (SRA), and finally taken over by the Department for Transport.

**The end of an era**

So why did the independent director general become extinct? Climate change is probably the answer. Various factors could be said to have facilitated their demise, but no one factor could be said to be decisive, since there is no compelling reason to say that the existing system of independent director generals could not have continued as successfully as it had in the past. The pivotal date was, however, 1997, the year in which the new Labour government came to power and replaced the Conservative administrations that had overseen the privatisations and their system of regulation.
Table 2: The independent director generals and their successor bodies

<table>
<thead>
<tr>
<th>Office</th>
<th>Director General</th>
<th>Regulatory Authority</th>
<th>Chairman</th>
</tr>
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<tbody>
<tr>
<td>Oftel</td>
<td>Bryan Carsberg</td>
<td>Ofcom</td>
<td>David Currie</td>
</tr>
<tr>
<td></td>
<td>David Edmonds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ofgas</td>
<td>Jim McKinnon</td>
<td>GEMA Ofgem</td>
<td>Callum McCarthy</td>
</tr>
<tr>
<td>Offer</td>
<td>Stephen Littlechild</td>
<td>GEMA Ofgem</td>
<td>Douglas McIldoon</td>
</tr>
<tr>
<td>Ofreg</td>
<td>Geoff Horton</td>
<td>NIAER</td>
<td></td>
</tr>
<tr>
<td>Ofwat</td>
<td>Ian Byatt</td>
<td>WSRA</td>
<td>Philip Fletcher</td>
</tr>
<tr>
<td>ORR</td>
<td>John Swift</td>
<td>Office of Rail Regulation</td>
<td>Chris Bolt</td>
</tr>
<tr>
<td></td>
<td>Tom Winsor</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cliff Paice</td>
<td>CAA – Head of</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Economic Regulation (1986)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(CAA established 1972)</td>
<td>Douglas Andrew</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Harry Bush</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Postcomm</td>
<td>Graham Corbett</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(2000)</td>
<td>Nigel Stapleton</td>
</tr>
</tbody>
</table>

The first half of the 1990s had been a troubled time for utilities regulation because excessive profits and directors’ salaries in the newly privatised water and electricity sectors had angered the public and the press. Whilst this could be fairly attributed to government failure in setting price controls at the time of privatisation (ie, regulators only take over responsibility some five years after privatisation), the regulators became tarnished by association, and the new Labour prospectus offered a review of regulation if they came to power, and the prospect of new consumer bodies to challenge regulators and protect the customers and the public against weak regulators. Labour, on assuming power, reviewed utility regulation in 1998, but the outcome was more an affirmation of the existing incentive-based regulatory system for public services privately provided.  

Regulatory independence was also retained, but some change had

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9 Department of Trade and Industry (1998), A Fair Deal for Consumers - Modernising the Framework for Utility Regulation, DTI.
to be effected, lest a too transparent ‘u turn’ would be evident. Independent consumer councils were created (notwithstanding the government’s review also announced that all economic regulators would be given a primary statutory duty of customer protection – reinforcing their on-going obligation to hear the customer ‘voice’ in the discharge of their functions), and it was announced that the independent director generals would be replaced by ‘boards’ (ie, regulatory authorities). Hence, for example, the director generals of electricity and gas supply were replaced by the Gas and Electricity Markets Authority (GEMA), serviced by the Office of Gas and Electricity Markets (Ofgem).

The new boards could be seen to meet the interests of various parties to the ‘regulatory game’. New Labour ministers sought more influence with the independent economic regulators in the name of integrating environmental and social concerns into regulatory decision making. The independent director generals were, however, in recognition of their specific roles and responsibilities in the jigsaw of the regulatory state, either explicitly or implicitly, resistant to this intrusion. Ministerial ‘guidance’ became more form than substance in this context (although it has become an essential element now in a reworking of the integration of the regulatory state around iterative decision making which explicitly supports the independence of the economic regulators). Nevertheless, at the time, the regulatory board would have seemed to politicians an attractive possibility as something likely to be more amenable and ‘collegiate’, and with less danger of transparency and exposure where their involvement was inconsistent with the underlying principles of an effective, unbundled regulatory state.

For the regulated companies, the economic regulators had given them the opportunity of a ‘good life’ earning economic profits and higher returns through efficiency improvement and outperformance of their regulator’s forecasts. They had defended them against ‘envious taxation’ of the rewards of past managerial effort, and consistently sought to apply an incentive-based regulatory philosophy (notwithstanding the New Labour
‘windfall’ tax, which was politically presented as a pure, one-off correction for the largesse granted to investors by the Conservative government when privatising the industries, and thereby something which should not undermine future incentives on management to improve efficiency). Nevertheless, the regulated companies, along with some commentators, developed the theory of the excessive personalisation of regulators, with an emphasis on arbitrary decision making and the risk of instability. Nobody thought to ask whether ‘they would say that wouldn’t they’ in the pursuit of an easier life or easy profits, based on the possibility of more ‘manageable’, or risk-averse, regulatory boards.

At the same time, corporate collapses focused attention on corporate governance as a policy issue, with its prescription of balanced boards of executives and non-executives to ensure checks and balances, and to avoid over-concentration of power.\(^{10}\) Whilst the situation of a transparently accountable director general was in complete contrast to the opaque power of the typical company board, the prescriptions of the code of practice on corporate governance was seen to fit the needs of the government and the regulated companies. This was notwithstanding that the director generals had in place advisory boards to assist them in their decision making. Finally, the director generals themselves had, on occasion, said that they found their position ‘lonely’, and it is not too far down the road from that to a loss of their confidence – it being easier and less exposed to place responsibility on the ‘authority’.

Effective accountability is the foundation of effective regulation, and there is no reason to believe that independent director generals were any the less exposed to the disciplines of effective accountability than regulatory authorities – indeed, it was likely

\(^{10}\) Financial Reporting Council (2006), The UK Approach to Corporate Governance (November), and The Combined Code of Corporate Governance (June), FRC.
to have been more of a discipline on them as individuals. The independent director generals were under no less of an obligation than a regulatory board to show that their decisions were ones which any reasonable, disinterested person would have arrived at given the same evidence (and both are subject to appeals to judicial review and tribunals where the decision cannot be shown to be so derived). Nevertheless, a combination of circumstances led to their demise, and as a ‘regulatory experiment’ we will never know the counterfactual of what the world would have been like if they had continued. However, it can be said that the independent director generals evidently played a constructive role in developing the regulatory state. If effective accountability is the discipline on both regulatory boards and director generals, then perhaps the most constructive thing to do is to set the golden age of independent director generals into an evolutionary framework, and not to regret their passing. The following sets out one perspective, and the challenges ahead.

Evolutionary stages

If we are, therefore, to inform ourselves about where we are now, and the prospects for the future, we should have some regard to the past. One view is that we can identify three stages of evolution, with the ‘golden years’ of independent director generals cutting across the first two stages:

1984-1997 – The early years, or adolescence, characterised by innovation and experiment, which forged the character of independent incentive-based regulation. In one respect the emphasis was deregulatory, with the economic regulators expected to protect consumers wherever possible by introducing competition. As Professor Littlechild famously observed, the

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11 Vass P (2003), Regulatory Practice and Design - A Collection of Reviews Relating to Utilities and Network Industries, CRI Collections Series 2, Centre for the study of Regulated industries, University of Bath.
regulatory objective was to ‘hold the fort until competition arrives’.

1997-2007 – The middle years, characterised by reassessment and review, reaffirmation, reform and reorganisation, re-reorganisation and rectification. The emphasis moved from deregulation to the ‘better regulation’ agenda, and the balance of accountability was redressed from purely a focus on the regulated companies to the regulators as well. Good regulatory governance became as important as good corporate governance. Institutionalisation and codification of the better regulation agenda became a feature of the regulatory state, but accompanied by, in the words of Professor Moran, ‘hyper-innovation and policy fiascos’.

2007 onwards – The later years, or maturity, characterised by consolidation and completion of the regulatory state. The maturity of the regulatory state will be tested, however, by the challenges ahead, and which are challenges concerning collective action over the externalities of human activity and lifestyle that can only be met by a mature regulatory state. We may, therefore, have cause to thank the developments of the earlier years if they have built foundations suitable to meet the challenges of climate change, erosion of bio-diversity, and resource depletion. In a sense, the challenge is to address the re-emergence of a Malthusian concept of resource constraints, which requires us to redefine the role of the regulatory state in the context of sustainable development, and to reconceive the three pillars of sustainable develop (the economic, environmental and social) as three nested rings contained within the overall environmental constraint of the natural world.

Within this periodic classification, five themes can be discerned:

Unbundling the regulatory state

– characterised by privatisation and the formation of ‘independent’ economic regulators: the ubiquitous ‘Office of….’.
The early regulators quickly learned their art, and if they were accused by some of being econocentric, that was to be expected because the government appointed people who were economically literate for the task. Bryan Carsberg, the first telecoms regulator, was a professor of accounting at the London School of Economics; Stephen Littlechild, the first electricity regulator, was a professor of commerce at Birmingham University; and Ian Byatt, the first water regulator, had been the deputy chief economic adviser at the Treasury. In later years the mix changed, with administrators and civil servants coming to the fore, raising concerns for some about the purity of economic regulation, but perhaps the most significant departure from tradition was the appointment of lawyers to head rail regulation. Whilst it could be argued that rail privatisation was predicated more on contract than licence, the essential nature of the job remained economic regulation.

Communication and the power of publicity were soon understood to be powerful weapons in the hands of David versus Goliath. Bryan Carsberg noticed quite quickly that BT could abuse its monopoly power by reducing the quality of service, rather than increasing its prices. When the lamentable state of BT’s public telephone boxes was publicised by the regulator, the reputational damage was sufficient to bring a rapid improvement. Jim McKinnon, the first gas regulator, understood why British Gas had been privatised by the government as a vertically integrated monopoly, but did not take it as his brief to maintain the status quo. His duty was to protect customers and not the pre-privatisation settlement. His battles with British Gas were legendary in regulatory circles, and Ofgas’s annual reports in the early year’s made for lively reading compared with the normally anodyne public document, with its references to ‘unreconstructed monopoly attitudes which need to be broken’. In due course, they were, and BG probably heaved a sigh of relief when it gave up defending its monopoly in 1996 and demerged into infrastructure (Transco) and supply businesses (British Gas

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12 Foster C (1992), Privatisation, Public Ownership and the Regulation of Natural Monopoly, Blackwell.
Energy, now part of Centrica), paving the way for horizontal integration across electricity and gas transmission and distribution services.

Don Cruickshank, the second telecoms regulator, was also an effective communicator, using the first line of each of his annual reports to declare that everything Oftel did was aimed at the customer benefit (and this before the government placed a primary duty of customer protection on the regulators). His approach was an interesting contrast with many of Ofwat’s annual reports at the time, which usually started off reiterating their statutory obligation to ensure that the regulated company could earn a reasonable return – an emphasis which unfortunately played into the hands of the consumer lobbies who were encouraging Labour to establish independent consumer bodies to redress the regulatory balance they saw in favour of the companies.

The assertion of independence facilitated by the unbundled regulatory state was not only felt by the companies, therefore, but helped define what the ambit of that independence was about. The customer orientation of the economic regulators was made real before it was given ex post formal recognition in the new primary duties introduced by the Labour government. Another example in defining separate roles and responsibilities within the regulatory state was the clarification of responsibility for environmental standards and policy. The debates between Jim McKinnon, who introduced an environmental factor into the price control formula (the E factor), and his successor, Clare Spottiswoode, who disagreed, saying, in effect, that it was the government’s job to address environmental externalities, not hers, helped clarify roles and responsibilities in the unbundled regulatory state.

Another example is the debate between the economic regulator, Ian Byatt, and the Environment Agency, about the profiling of water charges from the year 2000. The water formula is an aggregation of two major price effects (apart from inflation).
First, efficiency improvements which drive prices down, and, secondly, higher standards which drive prices up. The director general wanted to separate these two effects, thereby showing who was responsible for which, but the Environment Agency wanted to aggregate them into a smooth, but less increasing price path than would have been the case if there was a one off price cut at the start of the regulatory period to reflect the passing on to customers of the benefit of the economic efficiency improvements made in the last period. There was a suspicion that the Agency wanted to hide the price impact of higher standards, given ministers might have accepted (in the face of steeper price rises due to higher standards imposed by ministers) that affordability should be given more weight than those higher standards. The economic regulator’s view prevailed, and reinforced that ministers must take direct responsibility for the economic consequences of environmental standards, alongside the benefits of having those higher standards.

A learning regulatory state

– characterised by the flexibility to evolve, consistent with the underlying purposes of regulation and the public interest. Two notable examples are:

• When Professor Littlechild, then the electricity regulator, realised he had made a methodological error in his first distribution review for price controls from 1995 through allowing arbitrary market value uplifts to the companies’ regulatory asset values (thereby giving shareholders’ windfall gains), he was willing, contrary to much pressure not to ‘second guess’ his original decision, to reopen the review at the last moment and reduce the proposed price cap dramatically.  

through Monopolies and Mergers Commission (MMC) inquiries. It is ironic that Professor Littlechild’s clear reasoning was disguised at the time by the public distraction of Trafalgar House’s proposed takeover bid for Northern Electricity, whose defence suggested to some that regulated companies were hiding key information from their regulators during periodic reviews, and hence was perceived by many as the real reason for the reopening of the review.

• The MMC, when it realised it had made a methodological error over the discount to investors at privatisation in judging the required price cap for British Gas in its 1993 inquiry (discounts of some 60% – the treatment of which has forever become known as “the ‘arcane’ accounting adjustment”), it was willing to change its methodology for its 1997 inquiry and eliminate the windfall gain to shareholders. This was in the face of much pressure from British Gas, which argued publicly that the regulator was being ‘inconsistent’.

These events contributed notably to the development of consensus and legitimacy for the regulatory state. The MMC has played an important role in two other cases which are of interest in the context of the overall development of the regulatory state. First, it is a peculiarity that airports are regulated by the Civil Aviation Authority (CAA), but that the CAA has then to pass on its recommendations to the MMC for its advice before it can implement its decisions, rather than the MMC being there simply to act as an appeal body for the airport companies if they are unwilling to accept the regulator’s decision. Doug Andrew proposed on behalf of the CAA a long term price control, but the Commission recognised the danger of forecasting errors undermining commitment to the regulatory settlement, and

14 Monopolies and Mergers Commission (1993), Gas and British Gas plc, Reports under the Gas and Fair Trading Acts, vols 1-3, Cm 2314, 2315, 2316 and 2317, HMSO.
15 Monopolies and Mergers Commission (1997), BG plc, A Report under the Gas Act 1996 on the Restriction of Prices for Gas Transportation and Storage Services, HMSO.
therefore reaffirmed the ‘truncated’ regulatory methodology based around price control periods of five years. It should be noted that the truncated methodology does not suggest ‘short termism’, or undermine long term investment needs in capital intensive utility industries. This is because economic regulators have learnt to carry out their periodic reviews within a long term planning framework, revising the long term forecasts as each review period is rolled forward and new information becomes available. Secondly, Northern Ireland Electricity, when Douglas McIldoon tried to unwind some of the financial excesses granted by the government at the time of privatisation in the province. The company appealed to the MMC and the resulting inquiry and judicial reviews realigned the relationship of MMC decisions to the regulatory discretion available to the director generals, as director generals became obliged to implement MMC remedies.

The learning regulatory state has also been well demonstrated in the difficult area of security of supply. Economic concepts have been well applied in determining such things as the ‘economic’ level of leakage. When droughts occur, and particularly when private, profit-making companies are supplying the water, there can be a political response that says all leakage is wrong and must be fixed, and that capacity must be put in place to ensure that all demands are met at all times. Economic analysis can show that leakage should be allowed where the marginal cost of fixing the leaks is greater than the marginal cost of the water lost, and that the cost of excess capacity unused for many years can be greater than the benefit of continuity of supply at all times. Ministers have accepted this logic as the basis for capacity and leakage targets.

But we should not think that the learning process is always sufficient reason for overlooking what could be seen as avoidable mistakes. Two areas of concern were, first, the introduction of NETA and domestic supply competition into the electricity industry, and whether it passed the cost-benefit test (and the ‘where appropriate’ test of the legislation), and secondly, the emphasis of the early rail regulators on the legal framework
rather than the imperatives of standard economic regulation, in particular, the need to audit the activities of the then Railtrack through the use of ‘reporting engineers’.

‘Reintegration’ of the regulatory state

– characterised not by recentralisation but the development of a rational framework (vertical and horizontal) for the regulatory state as a whole, and which informs the relationships between the various parties as to who does what and why (the overall picture made up of the pieces of the jigsaw of the regulatory state). Two notable examples are:

• The ‘cost of quality’ debate initiated by Sir Ian Byatt, then the water regulator, in 1992-4.\textsuperscript{16} This brought the cost-benefit test centre stage, and which became a requirement on ministers in setting environmental standards through the Environment Act 1995.\textsuperscript{17} At the same time the ‘iterative process’ of determining a balanced price control was instigated with the quadripartite process of meetings between regulators, ministers and companies.

• The Tom Winsor furore (then the Rail Regulator) at the time of Railtrack being forced into administration by the government and replaced by Network Rail.\textsuperscript{18} The independence of the regulator was confirmed and, once again, the iterative process of decision making, with clear constraints and responsibilities assigned to either ministers or regulators, has been introduced. This became a statutory requirement through the Transport Act 2005, resulting in statements of funding availability (SOFAs) and high level output specifications (HLOSs) becoming ministerial obligations.

\textsuperscript{16} Ofwat (1992), The Cost of Quality: A Strategic Assessment of the Prospects for Future Water Bills, Ofwat.
\textsuperscript{17} Ofwat (1993), Paying for Quality - The Political Perspective, Ofwat.
\textsuperscript{18} Winsor T (2004), DfT Rail Review 2004 - Submission by the Rail Regulator, 6th May, ORR.
A better regulatory state

- characterised by promoting good regulatory governance. The three notable developments are:

• The change of focus from a purely deregulatory to a better regulatory agenda;

• The codification and institutionalisation of good regulatory governance principles and processes. The Better Regulation Task Force (now the Better Regulation Commission) set out its five principles of good regulation (transparency, accountability, consistency, proportionality and targeting). The Regulatory Impact Unit (now the Better Regulation Executive) developed and codified the regulatory impact assessment (RIA) process. The RIA has the capacity to become the foundation of both effective accountability and the information flows necessary to achieve ‘policy integration’ where required.

• The report of the Constitution Committee of the House of Lords (The Regulatory State – Ensuring its Accountability, May 2004) which demonstrated that effective regulation requires effective accountability built on the three elements of: giving reasons for decisions, exposure to scrutiny, and the possibility of independent review of decisions.

Table 3 extends the regulatory framework element identified in Table 1.

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Table 3: The regulatory framework

<table>
<thead>
<tr>
<th>Structure and process considerations</th>
<th>Three stages of accountability</th>
</tr>
</thead>
<tbody>
<tr>
<td>• the legal framework</td>
<td>• giving reasons for decisions</td>
</tr>
<tr>
<td>• separation of roles and responsibilities</td>
<td>• exposure to scrutiny</td>
</tr>
<tr>
<td>• principles of good regulation</td>
<td>• the possibility of independent review</td>
</tr>
<tr>
<td>• forming a ‘whole of government view’</td>
<td></td>
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<tr>
<td>• provision of relevant information</td>
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The cycle of regulatory process, development and accountability was also covered in the report, and well illustrated in their diagram, shown as Figure 1.

**Figure 1: The circle of accountability through the regulatory cycle**

These developments showed how regulators can engage with regulatory policy outside of their core decision-making areas (the focus of their independence), and helped define independence as independence ‘within’ rather than ‘of’ the regulatory state.
Consolidating the regulatory state – the ‘final frontier’

– characterised by five areas to be addressed which emerge from the preceding developments:

1. Avoiding an undue focus on inputs to regulation rather than the desired outputs, including mechanistic rules such as ‘one in-one out’.  

2. Utilising the ‘technology’ of information gathering and publication, and the lever of reputation, to promote more self-regulation and thereby a move from ex ante to ex post regulation. The relationships between strategic, ‘oversight’ regulation in the public domain and devolved self-regulation in the private domain (perhaps best termed ‘co-regulation’) is illustrated in Figure 2. The philosophy was innovatively developed by the CAA to encourage prior agreements between BAA and the airlines, and the Communications Act 2003 placed a duty to promote self-regulation on Ofcom.

Water and transport are sectors which afford opportunities in this regard. In electricity and telecoms competition has given the opportunity to introduce an ombudsman system to deal with consumer redress.

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24 Littlechild S (2005), Beyond Regulation, the Beesley lectures on regulation, Series 15, Institute of Economic Affairs and London Business School.
26 Civil Aviation Authority (2005), Airport Regulation, the Process for Constructive Engagement, CAA.
This could apply to rail, but in water, where competition is restricted, self-regulation means that the potential role of the Consumer Council for Water (given the abolition of bodies such as Energywatch and Postwatch) is of particular interest, both from the perspective of promoting self-regulation, and with a view to sustainable development below, which would require an expanded remit.  

3. Incorporating sustainable development into the regulatory state. This may require further codification and institutionalisation of overarching (‘meta’) principles, such as objectivity, coherence, credible commitment, the precautionary principle and the polluter pays principle (requiring the internalisation of externalities to give full cost-reflective

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28 Department of Trade and Industry (2004), Consumer Representation in Regulated Industries, A Report by the DTI and HM Treasury, DTI.
29 Department of Trade and Industry (2006), Consultation on Consumer Representation and Redress - Summary of Responses and Governmental Response to Consultation, DTI.
INDEPENDENT DIRECTOR GENERALS

New bases for international trading may result, given the GATT and WTO trading systems should be based on ‘cost-reflective’ prices, that is, incorporating material external costs of production.

Also, the Cabinet Office and other central departments may need to set a framework for achieving ‘a whole of government voice’ through ‘joined-up’ government and mechanisms such as ‘policy packages’ to deal with all three pillars of sustainable development in an integrated and coherent way. Figure 3 illustrates an integrated framework for aligning the five principles of sustainable development with the operations of the regulatory state. It is particularly relevant to the climate change debate and associated policy development.

4. Taking forward the idea of risk-based regulation into practice, given the recent BRC report on the ‘risk-averse’ society and the reality of practice as exemplified by the Qualifications and Curriculum Authority, which rightly professes to be a risk-based regulator but is faced by very risk-averse ministers.

5. Transparency and accountability – revisiting the question as to whether the regulatory boards which replaced individual director generals have enhanced accountability and transparency in practice, and whether RIAs ‘content’ in practice is a good basis

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34 HM Government (2005), Securing the Future, Delivering the UK Sustainable Development Strategy, CM 6467, HMSO.
for policy transparency and integration, and the prime information base for exposing regulators to scrutiny? The former question has, to some extent, been answered because the chairmen of the regulatory authorities have had the opportunity to take on some of the characteristics of the independent director generals in their communication of regulatory decisions.

Figure 3: Governance strategy for sustainable development – developing the integrated policy package

Conclusion

Taken together, these developments reflect the aim of achieving a ‘legitimate’ and effective regulatory state, an aspiration also being adopted by the European Union. The golden age of independent economic regulators can therefore best be seen as having built foundations for what may emerge as an effective,

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unified, but decentralised regulatory state. Given the risks facing the world through resource depletion, erosion of bio-diversity, climate change, and technological intervention, the requirements on the regulatory state to consolidate effectively and contribute to achieving sustainable development are of the highest priority.  

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