CCP Response to BIS consultation – Principles of Economic Regulation

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The principles themselves

Questions

1. Do these principles sufficiently encapsulate the characteristics of a successful framework for economic regulation? If not, how could they be improved?

In assessing regulatory framework it is useful to remember that the purpose of regulation is to provide ex ante rules in markets where companies are dominant, and where such dominance cannot sensibly be addressed by structural remedies. Such limitations may arise either from the inherent market structure, if a natural monopoly exists, or because governments wish to deliver objectives (particularly social and environmental) which cannot be adequately addressed through markets.

Accountability

Parliament, government, regulators and regulated industries need to be accountable to different constituencies or bodies, and for different types of activity. The principles laid down seem appropriate and comprehensive, recognising in particular the dual accountability of private regulated companies to both shareholders and regulators.

Predictability

The proposed principles capture well both the experience of regulation in the UK and theoretical developments in regulation, especially in Europe and the USA. One of the greatest problems for regulators (and governments) is credible commitment. Credibility is crucial from the moment of privatisation, when the time inconsistency of the government's wish to promise minimum regulation before selling their assets and then to tighten regulation once the industry is in the private sector. The continued difficulty of regulatory commitment is clear both in the theory, and, now, in practice as the UK faces the challenge of attracting investment to private industries which face uncertain regulatory futures. Given the central positions which many regulated industries hold in sectors which are sensitive both commercially and socially, it is crucial that legitimate government interest is identified clearly and predictably; and that the boundary between government responsibility (and likely activity) and that of the regulator is clearly and consistently defined. Such a balance is not easy to

[1] The ESRC funded Centre for Competition Policy is an independent research Centre which provides research of real world relevance with academic rigour. The Centre includes expertise in the law and economics of regulated industries, of competition policy, and of the interaction between the two. The current response is from three members of the Centre in their role as independent academics. We provide references to relevant publications as part of our evidence. The views expressed are those of the three authors and not of the Centre. Contact details: c.waddams@uea.ac.uk; m.harker@uea.ac.uk; s.greasley@uea.ac.uk.

achieve, as the volume of literature on regulatory commitment demonstrates, and the outline of the principles provides an excellent basis.

Coherence and Adaptability

The focus on both vertical and horizontal coherence is welcome, in particular the accountability to Parliament. The horizontal coherence is particularly helpful at a time when different regulators may be asked to address similar issues (for example affordability) within their own sectors. Given the current government's attempts to unify the benefits system, co-ordination between regulators would form a sensible part of such an integrated system.

Governments must be able to (and have a responsibility to) respond - and direct regulators to respond - to changing circumstances, and the consultation notes the tension between such responsiveness and the need for predictability and regulatory/government commitment. Companies face changing circumstances in their markets and regulation itself provides protection from some forms of uncertainty which suppliers in unregulated markets face, both on the revenue and cost side. However, if regulators or government are seen as capricious or opportunistic, regulatory uncertainty can raise the cost of capital. The companies' interest in emphasising such potential costs make their exact determination a difficult negotiation process. Some adaptability by government might be used in a countercyclical way to offset such market variance (for example through tax rates inversely related to oil prices), though such micro management carries its own dangers. More generally, companies need appropriate protection from what they see as capricious government interference (directly or indirectly) in the regulatory process and environment, while governments need to make difficult trade-offs between objectives and groups within society; these may change, for example during times of economic downturn which particularly affect certain sectors of society. Therefore safeguards need to be incorporated which guard against such short term politically motivated changes which could frustrate longer term objectives. One disincentive for frequent adaptation would be to make such changes 'costly' for the government, perhaps by making government justify such interventions to the relevant parliamentary select committee.

Focus

The responsibilities of regulators should indeed be clearly defined, prioritised and focussed on outcomes rather than inputs or processes, using the tools which their specialist knowledge of the market indicates are best suited to the purpose. However, the boundaries of the economic considerations to which their duties should be restricted may be rather more difficult to identify and defend. The example of protecting consumers immediately raises the question of how far regulators should be concerned with particular groups of consumers, since they do not form a homogeneous group. The issues will vary according to whether consumers have any choice of supplier and the nature of the market. If a separate statutory body exists to

represent consumer interests, this will also affect the nature of the regulator's responsibility[2].

Ofgem's recent intervention to protect a particular group of consumers (those who have not switched supplier) illustrates potential conflicts for the regulator. In this case Ofgem acknowledged that the introduction of non discrimination clauses might have adverse effects on competition and so harm consumers on average[3]; and following the Walker review, Ofwat is developing a measure of water affordability which carries the danger of drawing it into pressure for intervention on behalf of specific water consumers. In this area it is crucial to separate the role of the regulator as expert giver of advice or implementer of policies, from the task of making trade-offs between different objectives, which should reside with government.

2. Would their application deliver greater clarity about the respective roles of Government, regulators and producers, and greater policy coherence, and hence reduce uncertainty generated by the lack of clarity?

Yes, if the boundaries can be appropriately defined and protected. As in all such cases, the devil lies in the detail, and it is the specifics of implementation, and the confidence which they inspire, which are crucial.

Applying the principles in practice

3. Is the division of responsibilities, currently divided between regulator and Government, sufficiently clear?

Does the regulatory framework allocate responsibilities to regulators that are inherently political in nature and which should be taken by Government?

Such responsibilities inevitably arise where a number of competing responsibilities are imposed on the regulator, who then has to determine relative priorities. Under an effective mechanism, the government determines such relativities, without interfering with the detailed conduct of the regulator's functions. This may require interaction between the regulator and the government which will pose challenges for demonstrable (and perhaps actual) independence[4]. Here transparency, if appropriately applied, should assist in clarifying the boundaries.

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[2] For papers on consumer choice and representation in regulated sectors see: Consumer Choice in the Water Sector by Kerry Gardner and Catherine Waddams Price, Ofwat 2010; http://www.ofwat.gov.uk/publications/commissioned/rpt_com_1010fplchoice.pdf; Do consumers switch to the best supplier? By Chris M. Wilson and Catherine Waddams Price, Oxf. Econ. Pap. 2010 62: 647-668; and "Regulation and Consumer Protection" by M Harker, L Matthieu and C Waddams Price in D Parker (ed) Intern*ational Handbook of Economic Regulation*, Edward Elgar, 2006, Ch 10.

[3] Non-discrimination clauses in the retail energy market, by Morten Hviid and Catherine Waddams Price, CCP Working Paper 10-18 http://www.uea.ac.uk/ccp/CCP_Working_Paper_10_18 For an historical review and assessment of deregulation in domestic energy supply see: ., Introducing competition and deregulating the British domestic energy markets: a legal and economic discussion by Harker, M and Waddams Price, C, Journal of Business Law, 244-268, May 2007.

[4] Equity, Fuel Poverty and Demand by Catherine Waddams Price in Jamasb, T. and Pollitt, M., Eds. Electricity and Heat Demand in a Low-Carbon World: Customers, Citizens and Loads, Cambridge University Press, forthcoming, 2011.

Are there areas where the Government should step back, having set out its objectives, and leave the regulator to take decisions?

We agree an independent regulator needs to take decisions within a framework of statutory duties and policies settled by government and parliament. Further, that in allocating responsibilities as between government and the regulator, regard should be had to the relative legitimacy, expertise and capabilities of the two.

Democratic legitimacy is clearly most at issue when trade-offs are between efficiency considerations (most appropriately left to the expert economic regulator) and social and environmental goals. It is the case, however, the Regulators' statutory duties have always been designed to at least structure the weight to be given to the various, often conflicting, goals to be pursued, and the use of Social and Environmental Guidance (introduced first under the Utilities Act 2000) had the potential to further elaborate upon how these trade-offs should be made, and set the broader policy context.

There is nothing inherently inconsistent between the need for a credible regulatory system and the pursuance of non-economic goals. The danger lies rather in the government using its functions in a manner which promotes short-term political goals which may run counter to its longer term strategic priorities. This may be a particular danger where there is a vociferous lobby group, for example the 'poverty lobby' which seems to have persuaded the government to intervene with the energy regulator in initiating the retail market probe in 2008 or, perhaps more likely but less visibly, from the industry itself. One safeguard – or commitment device – is to ensure that functions exercised by government are fully specified under the regulatory statute and that they are exercised within the same broad framework of duties to which the regulator is bound. This is the current position under the statutes and has the advantage of increasing predictability not least because it does allow for the exercise of discretion to be scrutinised ex post by the courts.

4. How clearly is the division of responsibilities articulated, for example through statutory duties, in a way that provides the necessary focus?

Are regulators' duties easy to understand and clearly prioritised?

Is the range of issues regulators are required to consider too broad?

As we noted in previous consultations, the regulatory duties are now too complex and inclusive to be meaningful.

There is much, however, to be said for the use of duties, specifying the relevant factors which a regulator / government ought to take into account, and the use of a hierarchy in the prioritisation of those interests.

To what extent should regulators' duties be more outcomes-focused and avoid specifying means, tools or inputs to achieve policy goals?

Duties should be outcome focused – the duties structure the way in which regulatory functions should be used.

The guiding principle for regulatory independence should be that the government specifies output, but that the regulator should identify the best way of achieving these ends. Thus, for example, the specification of how smart meters should be introduced as part of guidance for Ofgem was probably an example of where the government should indeed have stepped back and allowed the regulator to specify the most appropriate way of achieving government's objectives.

5. To what extent is the decision making of the regulators sufficiently transparent (for example in consultation practice, publication of the reasons for decisions and accessibility of tools and models) to enable sectors to predict likely outcomes and scrutinise decisions?

The regulators have traditionally attached much weight to the need to ensure that their decisions are transparent and capable of scrutiny. Indeed, the need for this is in part because of the recognition that they will be making decisions – or trade-offs – that are inherently political in nature. The statutes already clearly specify the need for consultation and a duty to give reasons.

6. Are the existing appeal mechanisms appropriate, in terms of the:

- **bodies with the right to appeal/object**
- **appeal-hearing body**
- **basis of appeal**
- **role of government?**

There are various different routes of "appeal" as between both the regulators and their differing functions. Licence modifications without the consent of the firms – including the setting of price-caps – has traditionally been a matter for the Competition Commission to determine. For telecommunications, as a result of EU law, appeals from Ofcom are heard by the CAT. Appeals on modification to the Energy Code are heard by a special, quasi-judicial panel comprising members of the CC. Clearly the proposed merger of the OFT and the CC will have implications here, especially if its independence is undermined by the merger. It will also be important to ensure that sufficient resources and expertise are available for the likely workload of a reformed organisation.

It is important that the regular appeal mechanism should not be bypassed, either by companies (as has occurred elsewhere, for example the Spanish energy sector) or by the regulator. When Ofgem's proposed Market Abuse License conditions were dismissed by the Competition Commission,[5] a legislative route was sought to introduce them.[6] While legislation is appropriate for government objectives which

[5] *AES and British Energy: A report on references made under section 12 of the Electricity Act 1989* (CC, 2001) http://www.competition-commission.org.uk/rep_pub/reports/2001/453elec.htm.

[6] Section 18 of the Energy Act 2010 contains an enabling power for the Secretary of State to make licence modifications (including a MALC). However, this provision has not yet come into force.

are outside the expertise of the regulators and their appeal panels, this seems a clear case where the expertise on competition lay with the competition authority, and other overarching government objectives which would have justified over-ruling the competition expert in this case are not obvious. This is a clear instance of where the government – perhaps after lobbying from the regulator – has undermined the credibility of a institutional structure designed to control the discretion of the regulator in modifying licences.

While appeal mechanisms are clearly an important part of a credible regulatory regime, there are dangers, especially where the processes are prolix and costly. Indeed, when the stakes are high, firms may have an incentive to use appeals procedures in order to deter regulatory interventions where the costs to the agency of defending the appeal will be considerable. This may be one factor which explains the apparent under-use of concurrent Competition Act powers by some of the regulators (these powers are subject to full merits appeal before the CAT).

The prospect of appeals, especially where the cases are not swiftly concluded, may have the effect of increasing uncertainty for firms in their reliance on regulatory interventions, especially new entrants. Consider the recent Ofcom decision into the Pay-TV market. The investigation itself lasted around three years. The formal decision was made in March 2010, yet the oral hearings before the CAT will only begin in May 2011. This may have the effect of frustrating the effectiveness of the remedies altogether.

There is also the potential danger that the court will impose unrealistic standards of proof on the regulator. While a cost-benefit analysis is an important part of good regulatory decision-making, if the court imposes an evidential burden on the regulator this may reduce the scope for interventions (the recent decision of the CAT in *Barclays v Competition Commission* [2009] CAT 27 illustrates how rigorously the CAT will scrutinise CBA even where its powers are circumscribed by the ordinary principles of judicial review).

At the level of general principles, therefore, appeal mechanisms need to be designed so that the there is an appropriate institutional balance between the regulator and the appeals tribunal. The standard of review needs to be appropriate given the need often in regulated sectors to address the potential for the abuse of market power by incumbents. Further, resources have to be in place to ensure that appeals can be decided swiftly.

7. How effective are mechanisms to review the operation and delivery of economic regulation?

Should periodic reviews of sector regulation and the role of the regulators be undertaken, to identify possible areas for improvement and provide greater confidence in the framework?

If so, the scope of reviews should be clear. Such reviews may have the potential to identify whether regulators are drifting away from the agreed principles of good

regulation or the line between government and regulators is blurring. Reviews are likely to be most effective if there is a clear and agreed model of good regulation against which to compare practice.

If the goals of these reviews are to monitor adherence to the principles set out in the consultation document then some understanding of how it is that regulators come to diverge from those principles would be instructive. For example, if the blurring of lines between government and regulator is driven by departmental interest then the reviews could act as a mechanism to ensure that these do not occur 'under the radar' of other parts of government and parliament.

Who should undertake such reviews? Should they be by an independent third party, for example, to provide an external challenge and how frequently should they be undertaken?

A third party which is independent of all those involved may struggle to be taken seriously and may be easy to mislead if it contains inadequate expertise or resources. Presumably some knowledge of the operation of regulators and sector would be required and this may make independence difficult to achieve. If the problem is the relationship between government and the regulators then parliamentary committees may be an appropriate forum.

We are not in a position to say anything specific about the frequency of such reviews, but neither their frequency nor their nature should be such as to increase uncertainty in the market. It is unlikely that a frequency greater than once in ten years would be appropriate.

As we have previously noted, leaving the discretion with the regulator whether to make a market investigation reference to the Competition Commission is inappropriate given the incentives of the regulator to avoid criticism of the policies for which it has been responsible. We suggested that this power ought to lie exclusively with the OFT, though the proposed merger of the OFT and the CC will clearly have implications for the future of the market investigation regime. If used appropriately, this mechanism may bring to bear an objective assessment of whether the regulator is effectively achieving its goals and whether there is need for reform of the sector and perhaps the regulator’s powers.

8. What is the optimum way of balancing the need to make the frameworks stable and predictable, coherent with broader public policy and able to adapt to changes in sectors and technologies?

How effectively does Government articulate the broader policy priorities under which regulators carry out their statutory functions? What is the impact on regulatory decision making and does this deliver a coherent overall regime?

Governments have traditionally found this difficult (one of the original reasons given for privatising the utility industries) and any regulatory system needs to acknowledge the challenge of making explicit statements about trade-offs. The further government

can distance itself from everyday regulatory decisions, the more the system can be designed to be effective and independent.

Would a more formalised, pre-announced process (such as a Government strategy statement) for articulating policy priorities, reviewing the effectiveness of regulation and implementing changes on a cyclical but infrequent basis be beneficial in balancing these three principles in particular?

Yes, if this can remove ongoing pressure from citizens and companies both for government changes and on regulatory decisions between reviews. The reviews themselves should be designed so far as possible not to increase uncertainty in the markets.

9. Are there sufficient and efficient mechanisms in place to facilitate cross-sector work by regulators?

Should regulators' approach to similar issues (e.g. aspects of the price control, promoting competition and addressing consumer impacts including affordability) be more coordinated?

Yes, where these arise from a commonly inspired government priority beyond the regulators' own responsibility. This would enable a common policy both for consumers and suppliers in the industry, particularly important where companies operate across sectors. Such co-ordination is likely to increase the regulators' information and strengthen their hands in managing relations with companies on such issues

Would shared non-executive board members across regulators helpfully reinforce collaboration, learning and coherence in approach?

In principle, this would appear to be a sensible proposal. It should be borne in mind, however, that non-executive board members may bring with them expertise particular to a sector, and that is a strength of the current institutional framework. It may also be a concern if well qualified persons were deterred from serving if the workload of cross-membership were to impose expectations that they were unable to square with their other professional responsibilities.

Such liaison at board level would need to be reinforced by co-operation at official level, to ensure shared understanding of issues which were subject to government guidance and priorities (such as affordability) though these may well be implemented differently in different sectors. Moreover such cross sector experience could provide information for government in framing its guidance on such matters.

10. How cost-effective are the regulatory frameworks overall in terms of regulatory burdens, benefits delivered and efficiency of regulatory institutions?

Such questions are difficult to answer because of the unmeasurable effect of deterrence which is a key outcome of effective regulation. While crude comparisons

exist based on employees and financial costs, a more thorough response to this question cannot be separated from the policies which the regulators are enforcing, and would require in depth investigations, similar to that which has been undertaken for competition authorities[7]. A new regulatory framework could usefully include development of a methodology for making such comparisons and judgements; it would be cost effective to apply such methodology across regulators and sectors and maintain the information on a rolling basis, which could then be used in the periodic reviews of each regulator. Such continual monitoring would also ensure that such reviews were less likely to deliver untoward 'surprises' for government, regulator or market.

[7] See for example Assessing Competition Policy: Methodologies, Gaps and Agenda for Future Research by Stephen Davies and Peter Ormosi http://www.uea.ac.uk/ccp/ Working_Paper_10-19