Response to the DECC's Ofgem review: call for evidence

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Non-confidential

Summary of key points

- We welcome this opportunity to review the role of the regulators and their relation to government. The challenge for the review is to develop a system whose legitimacy and credibility is accepted by all those with interests in the industry.

- We note the importance of the government having the ability to set long-term objectives and targets which the regulator is mandated to achieve, and to identify the instruments at the regulator's disposal. There is an important line to be drawn between setting the broad policy framework and substantive goals, on the one hand, and detailed implementation, on the other. Given the specialised knowledge and expertise of the regulator policy objectives are more likely to be secured if the regulator is left with the task of choosing as between different instruments. The setting of clear and achievable targets will ensure that the regulator is held sufficiently to account.

- We recommend that Ofgem should no longer enjoy concurrent competition powers, rather the OFT should have exclusive competence. Any comparative advantage that the regulator enjoys by reason of its superior expertise can be harnessed by the OFT by liaising closely with the regulator in the course of its investigations. This reflects the position with respect to mergers in the energy sector. Where the use of sectoral powers are more appropriate the OFT should have the power to remit the case to the regulator.

- We recommended that decisions over market investigation references should be taken by the OFT, in consultation with the regulator.

- We recommend that the statutory duties should be reformulated so that they contain a simple statement of regulatory objectives which endure in the medium to longer-term. Further clarification of these duties can be made through the use of statutory guidance.

[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 two senior 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 those authors and not of the Centre. Contact details: c.waddams@uea.ac.uk; m.harker@uea.ac.uk.

- The current social and environmental guidance provides a mixture of aspiration, objectives, methods and targets. It would be helpful to separate these out into government objectives, the appropriate instruments to achieve these objectives, and government set targets.

- We recommend greater coordination between government departments and agencies with respect to achieving broader social and environmental objectives.

Introduction

The original vision for economic regulation was intellectually robust and offered a practical short term solution to the problem of controlling monopoly power held by newly privatised companies. In economic terms, competition was expected to develop so that regulation would be needed only on a temporary basis (though the long term need to regulate the network parts of the businesses was never in doubt). The industries had been privatised partly to release them from short term government objectives and interference, and so the independence of regulators (from government) was an important dimension of the new arrangements. The strengthening of general competition law in the early 2000s was another way to curb economic power of the incumbents. These powers were seen as particularly important given the gradual lifting of price controls in respect of domestic supply markets in the period 1997-2002.[2]

The forces which had led governments to intervene in the nationalised industries remained, even if the route for such intervention had changed. Governments addressed this by making legislative arrangements for and issuing environmental and social guidance. Governments appointed regulators (and approved but did not generate their budgets) and inevitably they were tempted to influence them, particularly under pressure from interest groups and the media who sought a particular solution for environmental and social issues. The result was frequent amendment of legislation (an Energy Act in 2000, 2003, 2004, 2006, 2008 and 2010) and social and environmental guidance which trod a difficult line between generality and specificity. We welcome this opportunity to review the role of the regulators and their relation to government. It occurs in a particular context; the need for extensive investment in infrastructure at a time of financial stringency, and for the regulators themselves to demonstrate that their activities provide good value for money.[3] The challenge for the review is to develop a system whose legitimacy and credibility is accepted by all those with interests in the industry.

We address several of the questions asked in the review in turn:

[2] For an historical review and assessment of deregulation in domestic energy supply see: Harker, M and Waddams Price, C., Introducing competition and deregulating the British domestic energy markets: a legal and economic discussion, Journal of Business Law, 244-268, May 2007.

[3] The regulators are funded from licences rather than taxation, so their costs are born by consumers rather than citizens, but since they provide necessities, the practical distinction is moot.

1. Government's objectives for independent regulation of the energy sector and boundary of responsibility between Ofgem and Government

Any government clearly has multiple objectives, and elections can be seen as a way of choosing the government who will best be able to make these inevitable trade-offs. One of the difficulties with the way the regulatory system has developed is that many of these trade-offs have been made by regulators rather than government, raising the conundrum that an unelected body which is independent of government (albeit appointed by it) is left to make such, essentially political, decisions. Conflicts are inherent in developing any policy, and we see it clearly in energy policy[4] where, for example, the need for sustainable and secure energy supplies both put upward pressure on energy prices, challenging the achievement of affordability. How should responsibility for addressing such difficult issues be allocated, and how can the structure of regulation support a robust system of doing so?

To deliver objectives, the government and regulator need instruments and targets. We see the government as taking responsibility (and ownership) for setting all three, but with close input from the regulator. The objectives, and their relative importance, must be a matter for Parliament. The exact interaction between them in a particular sector will, however, be better understood by a specialist regulator .

Once the government has established what it wants to achieve and identified the instruments which the regulator (or relevant others) can use to achieve it, targets should be set for the regulator and the industry. If multiple objectives are to be achieved it is crucial that such targets should remain stable over a number of years, and if they are reviewed, this should be undertaken openly and with clear consultation. A commitment to change objectives (both legislative and under social and environmental guidance) only once every five years (or the lifetime of a Parliament) would ensure the right balance between flexibility and the need for stable predictable rules.

The guidance itself should be clear about the objectives and might include specific targets for achievement, i.e. it should focus on the end to be achieved, and how it is to be measured, rather than the means. The detailed means of how to achieve the targets should be left with the regulator, though of course they will inform what is seen as a realistic target. For example, in the current guidance the decision to use smart meters might be seen as a possible instrument to deliver energy savings or assist with affordability issues. But the details of its introduction and how it can most effectively deliver these ends is better left to the regulator.

Limiting the opportunities for government intervention to broad objectives and guidance will provide confidence and greater stability for the industry, and so encourage more investment and lower its cost. It is also important that other interest groups, for example, those campaigning for disadvantaged consumers, have been

[4] Waddams Price, Catherine, Equity, Fuel Poverty and Demand (maintaining affordability with sustainability and security of supply) 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.

consulted sufficiently and have enough confidence in the system that they will not seek to undermine it. For this reason it is crucial to have a system where all interested parties feel they have had sufficient input into the policy, even if they are dissatisfied with the outcome. One particular challenge in this area is how to capture the interests of consumers who do not have a direct say in the market through choice, for example where their choice is limited by circumstances as is the case with many vulnerable groups of consumers. Various groups claim to speak on behalf of consumers, or particular groups of consumers, and the best way of ascertaining such views in the most legitimate way needs to be explored. While the issue is less of a challenge in energy than in water, where there is no choice of provider for domestic consumers[5], doubts about how the competitive market operates, and about whether consumers can always make the best choices for themselves[6], particularly with reference to vulnerable consumers, may raise similar issues in energy. Finding ways to capture such views 'legitimately' may be an important aspect of the regulator's specialist role which the review may want to consider.[7]

It is important in identifying these instruments and setting targets that their likely impact is fully considered. Delivering social and environmental objectives through energy prices will adversely affect both consumers as a whole and the competitiveness of UK businesses, as compared with overseas companies which do not carry such burdens – handicapping the UK businesses which bear the burden, when this cost is borne by the taxpayer elsewhere. If government believe this is appropriate, its impact should be measured through a rigorous cost benefit analysis in a regulatory impact assessment, which must be more than a mere box ticking exercise if the process is to retain the confidence (and so avoid attempted subversion) by all parties.

This confidence building exercise also needs to encompass belief that the regulator will in fact follow the objectives set by Ministers, and there needs to be a clear methods of accountability (beyond the annual report to Parliament). This accountability process needs to be clearly set out and accepted by parties in advance to ensure stability of the system, and that Ministers can resist the temptation to intervene inappropriately with details.

In summary, we note the importance of the government having the ability to set long-term objectives and targets which the regulator is mandated to achieve, and to identify the instruments at the regulator's disposal. There is an important line to be drawn between setting the broad policy framework and substantive goals, on the one hand, and detailed implementation, on the other. Given the specialised knowledge and expertise of the regulator policy objectives are more likely to be secured if the

[5] Kerry Gardner and Catherine Waddams Price, Consumer Choice in the Water Sector to be published by Ofwat as part of their Future Regulation project, 2010

[6] Chris M. Wilson and Catherine Waddams Price, Do consumers switch to the best supplier? Oxf. Econ. Pap. 2010 62: 647-668

[7] M Harker L Matthieu and C Waddams Price "Regulation and Consumer Protection" in D Parker (ed) Intern*ational Handbook of Economic Regulation*, Edward Elgar, 2006, Ch 10.

regulator is left with the task of choosing as between different instruments. The setting of clear and achievable targets will ensure that the regulator is held sufficiently to account.

2. Boundaries of responsibility between Ofgem and OFT

We address two issues here. First, whether the regulator should continue to enjoy concurrent powers with the OFT to enforce the general competition law provisions. Second, whether the relationship between the OFT and Ofgem needs to be realigned, with the possibility of strengthening the accountability of the regulator in the implementation of policy.

Concurrency

Under the Competition Act 1998 (Chapter I and II prohibitions) and Enterprise Act 2002 (market investigations), Ofgem enjoys concurrent powers with the OFT.[8] The coordination of these powers is now governed by the Concurrency Regulations.[9] The OFT concurrency guidelines contains a general presumption that the regulator is best placed to exercise competition powers in respect of its industry sector.[10] As a result of recommendations emerging from a joint report by the DTI and the Treasury, significant changes have been made to ensure consistency in the use of competition powers as between the OFT and the sectoral regulators.[11]

The concurrent jurisdiction of the regulator and the OFT may have a number of advantages. First, the regulator has specialised expertise in relation to the sector which is not the case for a generalist competition authority such as the OFT. Second, the regulator has a more extensive "tool kit" with sectoral complementing competition enforcement powers. There are, however, some potential problems. There is the danger that the regulator's philosophy with differ from those of the general competition authorities, with perhaps a presumption in favour of intervention. There is little evidence to suggest that, with respect to Ofgem, this has been a problem. Indeed, it could even be argued that the regulator has been reticent to use its competition powers. This may result from a lack of capacity, both in terms of

[8] The regulator also has powers to enforce the corresponding EU provisions (Article 101 and 102 TFEU).

[9] Competition Act 1998 (Concurrency) Regulations 2004 SI 1077/2004. See: http://www.statutelaw.gov.uk/legResults.aspx?LegType=All+Legislation&title=concurrency&searchEnacted=0&extentMatchOnly=0&confersPower=0&blanketAmendment=0&TYPE=QS&NavFrom=0&activeTextDocId=918553&PageNumber=1&SortAlpha=0

[10] OFT Concurrent application to the regulated industries (OFT 405, 2004), para. 3.13. See: http://www.oft.gov.uk/shared_oft/business_leaflets/ca98_guidelines/oft405.pdf

[11] DTI Concurrent Competition Powers in Sectoral Regulation (May 2006) URN 06/1244: http://www.dti.gov.uk/files/file29454.pdf.

resources and experience. To date, five cases have been investigated by Ofgem under the 1998 Act, none of which resulted in an infringement decision.[12]

If it is the case that Ofgem has under-used its powers in this area, then one might question whether the competition rules are serving their core purpose as a credible deterrent against anticompetitive behaviour on the part of firms. The application of the competition powers provides, potentially, an important backstop against regulatory inaction or failure. For this reason, we recommend that Ofgem should no longer enjoy concurrent competition powers, rather the OFT should have exclusive competence. Any comparative advantage that the regulator enjoys by reason of its superior expertise can be harnessed by the OFT by liaising closely with the regulator in the course of its investigations. This reflects the position with respect to mergers in the energy sector. Where the use of sectoral powers are more appropriate – perhaps because there is no discrete breach of competition law but nevertheless the conduct of firms or structure of the market is impeding effective competition – the OFT should have the power to remit the case to the regulator or make a market investigation reference to the CC.

Institutional architecture: the need for external checks and balances in the monitoring of regulatory outcomes

It is important to recognise that one of the policy failures which the regulatory regimes were designed to address was the ability of government to interfere in the industries for extraneous political reasons. With privatisation, it was thought that firms would not invest at optimal level unless they were certain that regulatory policy would be set on the basis of clear and stable rules, implemented by an independent regulator. The initial model was to appoint a single individual as the regulator but this led to claims that there were insufficient safeguards to ensure to control the exercise of broad discretionary powers, subject to limited control by the courts. This model was significantly changed with the Utilities Act 2000 which saw the creation of regulatory boards in place of a single regulator. Furthermore, more recent legislative changes have seen greater judicial control of regulatory functions (e.g., appeals to CC concerning the Energy Code). All of this strengthens the accountability of the regulator and ensures greater stability as regards the longer-term implementation of policy.

More could be done, however, to ensure that the regulator is more effectively held to account. Specifically, the OFT should have a role in the monitoring the substantive outcomes of regulatory policy and, where appropriate, referring problematic issues to the Competition Commission should intervention be required.

We recommended that decisions over market investigation references should be taken by the OFT, in consultation with the regulator. We think it inappropriate that this power de facto lies with the regulator rather than an external body. This is because it is very difficult for the regulator credibly to claim that it can scrutinise the success of the policies it has been responsible for devising, implementing and

[12] See the OFT's concurrency register: http://www.oft.gov.uk/about-the-oft/legal-powers/legal/competition-act-1998/Concurrency/Register.

indeed championing itself. Furthermore, there is the danger that it is unlikely to voluntarily surrender control over policy by referring a matter to an external body; we note in this regard that the regulator has not once exercised its powers to refer a market to the Competition Commission. External scrutiny of the regulatory policy by the OFT will guard against regulatory failure.

3. Clarity of regulator's objectives: the statutory duties

The regulator generally exercises its powers against the backdrop of statutory duties, which disclose a hierarchy of interests. Under the original legislation (Gas Act 1986 and Electricity Act 1989), these duties were relatively straightforward – the regulator was required to ensure reasonable demand was met, that firms were in a position to finance their activities, as well as promoting efficiency. There were a number of secondary duties, including the need to take into account the interests of vulnerable consumers. The Utilities Act 2000 introduced a "principal duty" – another level in the hierarchy – to promote the interests of consumers, wherever appropriate through the promotion of effective competition. It further required that it took into account the interests of low-income consumers. A further significant change to the duties came with the Energy Act 2010 which appears to downgrade the importance of competition – it is no longer the presumptive means of promoting the consumer interest – while further clarifying the interests of consumers to include the achievement of environmental targets and security of supply.[13]

The duties of the regulator are, in their current form, complex and confusing and given their inclusiveness, prone to the charge that they are designed "to mean all things to all men". In balancing various different interests, important trade-offs may have to be made, for example as between the interests of consumers in facing lower fuel costs and the need to achieve longer-term environmental goals. There is the danger that the duties have become practically meaningless.

We recommend that the statutory duties should be reformulated so that they contain a simple statement of regulatory objectives which endure in the medium to longer-term. Further clarification of these duties can be made through the use of statutory guidance.

4. Effectiveness of social and environmental guidance

Since the enactment of the Utilities Act 2000, the Secretary of State has been empowered to issue statutory guidance to the regulator on social and environmental issues. This provision was designed to ensure that government had an input into regulatory decision-making, while preserving independence of the regulator and the transparency of the system as a whole. Furthermore, it enabled the regulator to understand better how the use of its instruments could contribute to the

[13] Gas Act 1986, s.4AA (as amended by Energy Act 2010, s.16); Electricity Act 1989, s.3A (as amended by Energy Act 2010, s.17); for a consolidated list of duties see http://www.ofgem.gov.uk/About%20us/Authority/Pages/TheAuthority.aspx.

government's broader energy policy. The guidance has been changed twice since its initial introduction in 2002 – first in 2004 and then in 2010.

The current social and environmental guidance provides a mixture of aspiration, objectives, methods and targets. It would be helpful to separate these out into government objectives, the appropriate instruments to achieve these objectives, and government set targets (as suggested in the response to bullet point 1).

5. Lessons from other regulatory models

The simultaneous review of Ofwat offers opportunity for consistency across regulation, particularly in regard to environmental and social guidance, in identifying both the objectives (which should be consistent across government departments) and the appropriate instruments (which may well differ between regulators). We welcome the coordination between DECC and DEFRA in conducting the reviews, and hope that both will be able to draw on the work already undertaken by BIS, as well as with the Treasury who also have a close interest both in the finance of the regulators and their influence on wider economic issues, particularly investment. It seems unlikely that the original model of pure economic regulation, without regard to other objectives, is realistic at this stage. However, there are dangers in identifying inappropriate (and inconsistent) instruments to achieve different objectives – a recent example shows that while competition may reduce the overall level of price and offer choice in the market as a whole, it cannot simultaneously address issue of low income. Attempts to use this instrument to meet these different objectives is likely to result in harm to the competitive process, including detriment to vulnerable consumers[14]. Equally if vulnerable consumers are to be protected, they may face a confusing array of rights and opportunities if, say, Ofgem and Ofwat were to introduce these independently of each other – quite apart from other agencies who might seek to intervene. The importance of coordination between departments – in providing objectives, identifying instruments and setting targets, and of joined up agencies in delivering these objectives, is crucial if the regulation system is to encompass wider goals than purely economic ones.

Other models are available both from historical UK experience, and from experience elsewhere. Many other regulatory systems have been adapted from the UK model, and identifying what has worked well in different circumstances can provide valuable information for the current review. Information within the Better Regulation Executive can provide a lead on this.

We recommend greater coordination between government departments and agencies with respect to achieving broader social and environmental objectives.

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[14] See for example evidence to Ofgem consultation, http://www.ofgem.gov.uk/Markets/RetMkts/ensuppro/Documents1/Response%20from%20Catherine%20Waddams.pdf.