BIS Consultation: Principles for Economic Regulation

1. The Context

I welcome the chance to provide evidence to this consultation. My views reflect further thoughts from my 2007 Submission to the House of Lords Select Committee on Regulators

The BIS Consultation is taking place in the context of discussions around the National Infrastructure Plan. This has identified major investment requirements over the next 10-20 years and the question has arisen as to whether the current regulatory framework is adequate to support this. In addition, for these and other reasons, the Coalition Government has clearly signaled that it wants government policy to set objectives for infrastructure policy. Various public statements have suggested concerns that the economic regulators may have taken too great a role in setting infrastructure industry objectives relative to government Departments. This trend is most obvious in energy policy but also has affected broadcasting and is, to a lesser extent, affecting water and ICT[1].

The moving of the policy-regulation boundary towards policy is neither new nor is it necessarily unwelcome. That boundary is different between sectors and between countries. It also regularly shifts one way or the other over time within sectors and countries. Hence, the shifting of the boundary towards a greater role for policy by the Coalition Government is not in itself a cause for concern as new challenges arise. However, it does raise important issues over (a) transparency, (b) consistency and policy coherence and (c) the distinction between regulating outcomes, outputs and inputs and the implication of this last for the role of markets.

In my comments on the proposed principles, I will focus on these three topics.

2. The Principles Themselves

The Principles proposed in this document are:

- Accountability
- Predictability
- Coherence
- Adaptability

[1] This has always been present in railway policy, primarily because the financial revenues earned by Network Rail and the TOCs (train operating companies) depend heavily and consistently on subsidy payments.

- Efficiency and
- Focus

This list has many similarities to the original (late 1990s) BRE and similar criteria but also some important differences.

The original BRE (and BRC) Criteria were:

(a) Proportionality
(b) Accountability
(c) Consistency
(d) Transparency and
(e) Targeting

The Stern-Holder 1999 criteria (primarily referring to regulatory governance in middle-income developing countries) were very similar, as were other sets of regulatory governance criteria from the late 1990s. The Stern-Holder criteria were:

(i) Clarity of roles and objectives
(ii) Autonomy
(iii) Accountability
(iv) Participation
(v) Transparency and
(vi) Predictability

Finally, the 2006 World Bank Handbook on Infrastructure Regulatory Frameworks gave a list of 10 Key Principles, namely:

- Independence
- Accountability
- Transparency and Public Participation
- Predictability
- Clarity of Roles
- Completeness and Clarity in Rules
- Proportionality in Application
- Requisite Powers
- Appropriate Institutional Characteristics
- Integrity of Conduct

Comparing these criteria with the proposed new BIS principles, the following points stand out:

1) ***Transparency is a prime objective in all the other lists but is relegated to a second-level objective and arguably seriously weakened in the proposed new BIS principles.***

This proposed downgrading of transparency is important and much to be regretted in any event. It is even more important in a world where government policy is given a greater role relative to the deliberations and decisions of regulators. The question of what is a 'government policy statement' is crucial and should clearly only include openly spoken and/or written statements that (security and confidentiality reasons aside) are in the public domain.

There are frequently press stories of governmental 'behind closed doors' attempts to influence regulators. It is noticeable that the UK government has made little if any use of its powers to give Ofgem and Ofwat formal advice on environmental and social aspects of regulation under the Utilities Act 2000. However, there have regularly been claims that it has used the *threat* of doing so to obtain concessions from regulated companies. Such actions (if true) undermine the framework of independent regulation.

I note that within the proposed BIS Accountability Principle, the transparency criterion in the third bullet point is highly qualified. It is also subsidiary to an extremely ambiguous policy-regulatory division as proposed in the second bullet. (See below for more on the latter.)

2) ***There is no mention of proportionality or public participation or clarity of roles.***

The last of these is particularly important and where the proposed Principles are weakest.

Presumably, the second bullet under accountability is intended to provide guidance on how to allocate functions between policy (for government) and regulation (for regulatory agencies). If this is correct, the attempt is a total failure. The long sentence in the bullet is a deeply ambiguous piece of prose which increases policy (and regulatory) uncertainty rather than clarifying issues or defining the relative scope and roles of policy and regulation

3) ***Adaptability is a newly proposed Principle but is unsufficiently anchored within a Consistent framework***

The new criterion is not in itself unwelcome and the bullet underneath is satisfactory <u>but</u> it needs to be bolstered by some consistency criterion. It is noticeable that "coherence" has replaced consistency throughout these draft Principles thereby removing the anchoring and time dependent aspect of consistency. The proposed Predictability principle also provides noticeably less forthright statements, particularly in its second bullet ("… should not *unreasonably* unravel past decisions …" My emphasis.)

4) ***The only mention of consumers is a third-order criterion under Focus***

This is very weak.

My conclusion (and answer to Questions 1 and 2) is that the proposed principles do not sufficiently encapsulate the characteristics of a successful framework for economic regulation and need significant further thought and redrafting. Hence applying these principles would not deliver greater clarity. In particular, as discussed in more detail below, application of them in their current form might well increase rather than reduce policy and regulatory uncertainty.

The lack of clarity or coherence regarding the roles of government and policy relative to regulation are very worrying. This is irrespective of any desired greater role for policy relative to regulation. The problem is to define a workable, consistent and coherent approach to defining the boundaries. The published principles do not improve on the current approach and arguably worsen it.

3. Applying the Principles.

In this section, I would like to make the following points:

1) ***The importance of a competition policy framework for effective economic regulation.*** It is frequently argued that economic regulation should be considered as the application of competition policy to monopoly network infrastructure industries[2]. In consequence, it is very surprising indeed that, the Principles document makes no mention anywhere of competition policy or the role of the Competition Commission. This is a major weakness. Indeed, the greater the policy role that Ministers and government wish to have, the more important it is that economic regulation should be seen as part of and legally subject to competition policy laws and institutions.

   The final version of these principles should clearly discuss competition policy and its role in economic regulation.

   (I note that para 50 discusses – clearly and sensibly – the role of competition in and for the market, but that is the only place where that is done. Adding something in there on the role of competition policy as well as regulation would make that para more effective.)

[2] Electricity, gas, water, rail, and roads all have physical natural monopolies at their heart. Telecoms, broadcasting and ICT have some network monopoly elements while airports have a virtual network.

2) ***Clarity and coherence of policy guidance.*** Para 25 sets out the role of role of Ministers and government better than the second bullet in the Accountability Draft Principles. However, it still fails to set out how Ministers (individually and/or collectively) can be induced or persuaded to provide coherent and consistent guidance. The same issue arises with para 41.

   This is a difficult and contentious area but not addressing it at all leaves a major hole in the Principles and their application.

3) A standard element in regulatory Accountability is ***appeal rights***. These are nowhere mentioned explicitly. The only references are:

   (a) the 3rd bullet in para 26 – which is very weak and not specific enough; and

   (b) Para 33 which is, if anything, even weaker than the statement in para 26

   The regulatory governance literature makes it clear that appeal rights are crucial in keeping regulators (and policy makers) in check.

   Currently, the UK has strong and well-defined appeals rights and both Ofgem and Ofwat have proposed extending these to Third Parties (particularly consumer groups). The Principles Document could be interpreted as intending seriously to reduce those rights. It needs to be made clear that this is not intended (assuming it isn't).

4) ***Effective oversight of regulatory performance is clearly vital***. In consequence I greatly welcomed para 27 and its discussion of the role of the NAO (National Audit Office) and Parliament. Indeed, the main point in my evidence in 2007 to the House of Lords Select Committee on Regulators was to urge greater emphasis of ex post evaluation of the economic regulators plus a greater role of Parliamentary Select Committees. This is clearly a crucial element in achieving the effective accountability of regulatory agencies.

   More regular ex post evaluation of regulators is also relevant for para 46.

5) Outcomes, outputs and inputs. The nearest to a clear discussion of these in the draft principles is in Paras 43 and 55. Para 45 refers to "… desired outcomes and priorities .,," over which goverments are required " to be clear …".

   Evan as stated, the para raises a number of problems. The first is what incentives and pressures there are for Ministers to be clear in defining and inducing outcomes and priorities. The second problem is what is expected (and/or intended) to happen if they do not give clear, public and consistent guidance – and, even if they mostly do so, there are bound to be exceptions.

However, the major problem in this area is establishing the *boundary* between the categories, especially between outputs and outcomes. This is a topic which has exercised both Ofgem and Ofwat recently. Ofgem in 2010 published their recommended RIIO approach which focuses on the delivery of ***outputs*** via incentives to deliver innovation. Ofwat have also been working in this area and have announced their intention to publish a discussion paper on the topic of outcomes, outputs and inputs, but they have publicly stated already that they "… are keen to focus more on incentivising ***outcomes***, rather than outputs or inputs[3]."

It is sometimes suggested that outputs and outcomes are essentially the same. That seems to me to be mistaken. The key distinction is that outcomes represent high level outputs e.g. safe drinking water or low carbon electricity. However, outputs concern the delivery of high or lower level mechanisms to achieve these outcomes such as targets for pesticide removal from water or target levels of supply of renewable energy sources. Hence, renewable energy targets represent output regulation and not outcome regulation whereas maintaining environmental stability in water is an outcome target.

The reason for rehearsing these issues at some length is that, while it is reasonable for governments and Ministers to specify agreed regulated industry outcomes, the more that they pursue the path of specifying outputs and output priorities, the more endangered is the effectiveness of regulation. There is a welcome recognition of this in para 55. However, there are no clear mechanisms by which government and Ministers can be restrained from specifying sector and regulatory outputs. Indeed, I and others have suggested that this has been happening with energy regulation with regards to renewable generation targets where we have government mandated output targets[4].

It is interesting to contrast the Ofgem position with the emerging Ofwat picture because Ofwat has, in the past, been the most criticised regulator for specifying outputs in detail and even at times straying into input specification. Ofwat's experience appears to have led them to move towards outcome regulation at the time when Ofgem is moving towards output regulation. The latter is very clearly a direct result of governmental policy targets which have gone a long way beyond specifying outcomes. Intriguingly, Ofcom has recently been criticized by the Public Accounts Committee for not having any specified outcome measures.

Given the discussion above, para 43 seems wholly inadequate as the basis for effective regulation. There are major issues in how far should government and Ministers intervene in the outcome, output and input chain. There are also unstated questions as to whether there can or should be a common approach

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3 Ofwat, July 2010, 'Beyond limits – how should prices for monopoly water and sewerage services be controlled?'. See p.23.

4 I have suggested that the 20-20-20 EU targets may yet be seen as Potemkin Targets (c.f. Potemkin Villages).

across all regulated infrastructure industries or whether different approaches are needed in different industries. Failing to address these questions sufficiently is likely to result in growing policy and regulatory uncertainty. The discussion in para 55 recognises some of the dilemmas but offers no solutions other than EU mandated competition.

6) ***Interdependence between regulators***. This is discussed in para 45. The paragraph rehearses various issues without coming to much of a conclusion other than possibly sharing non-executive directors. However, this is an obvious area where Competition Commission organized discussions e.g. of the Joint Regulators Group and more informal co-operation are the obvious answer. This has now existed for a number of years. This is particularly true the more that competition policy is considered as the intellectual organizing framework for infrastructure regulation.

   Note that extensive sharing of non-executive directors between economic regulators runs the risk that regulation becomes even more of a 'magic circle' of a small number of regulatory professionals. A major role of non-executive directors is to bring in new, high-level experience.

In answer to the questions 3 – 10, my responses are as follows:

Q3 The current division of responsibilities does not clearly divide the responsibilities between regulator and government but the proposed new framework increases rather than decreases the clarity. It is not that regulators are currently wrongly assigned policy responsibilities - it is up to government to decide where the boundary should lie in the light of circumstances. In some cases, regulators have had to define policy in the absence of adequate policy guidance from government.

There are also clearly areas where competition policy – including regulators' concurrent competition powers should dominate with the government stepping back.

Q4 The main question and the second bullet point question are extremely difficult to answer because, although it is possible to provide a good definition and boundary for regulation, it is not possible to do that for policy. Hence, the question needs recasting.

Policy areas are what governments say they are – provided they are within the law, and they almost always are. (Experience in trying to draft the content of infrastructure regulatory laws in Central European and other countries has shown me clearly how impossible it is to define the boundary for policy.)

Regulation should certainly, in my view, become more outcomes and less outputs focused. Further, clear and published guidance from government on outcomes

and their priorities is essential for effective regulation. But, this guidance should not extend into regulatory outputs, let alone inputs.

Q5 Current practice over transparency of regulatory decision making is pretty good. I note that however critical the NAO has been of the Impact Assessments (IAs) of regulators, it has been very much less critical of them than of those produced by government Departments.

More ex post evaluation of regulators and their major decisions under the aegis of Parliamentary Select Committees is the main improvement that I would suggest.

Q6 The current UK position on appeals (e.g. the role of the Competition Commission and the courts) seems to provide a good balance between allowing effective appeals procedures but without encouraging appeals against all decisions[5].

There is nothing, as far as I know, that prevents the government from commenting on "Minded" decisions or from using appeals mechanisms. They also have emergency powers, specific guidance on policy issues and defined override powers. Anything more general – and anything non-transparent – would seriously endanger the regulatory framework and increase regulatory uncertainty.

The main likely desirable extension of appeals powers is probably to third parties in general and consumers in particular. (These extensions are actively being considered by both Ofgem and Ofwat.)

Q7 My answer to this is clearly Yes. The NAO plays –and should continue to play - a major role.

Such reviews (e.g. every 3-5 years) are best done by independent consultant and/or academic agencies. It has been suggested by some regulatory agencies that this last might create legal problems if the evaluation showed that the regulators decisions may not have been fully justified. If so, the legal anomaly should be removed. At the least, even if done internally by the regulators, they should be subject to investigation and peer review by independent expert reviewers.

Parliamentary Select Committees could usefully be involved in the commissioning and discussion of such reviews.

Q8 I strongly doubt whether there is an optimum way to achieve the balances discussed in this question *either* in any regulated infrastructure industry *or* in any given country. The point is surely how one can avoid pessimising solutions. My main concern with this document is that some of the policy regulatory-boundary

[5] There are some possible exceptions to this general statement viz. the "wrong-way-round" procedures of the CAA and CC and the issue that appeals against Ofcom decisions go initially to the CAT.

ambiguities that would result from implementing the draft Principles and their proposed application might indeed result in more rather then less uncertainty.

On government articulation of policy objectives and priorities, the record since 2000 is very mixed. There have been overall successes (as in broadband rollout) and failures (as with the handling of climate change and renewables targets. As one might expect, the results depend on which Department and which Minister develops and sets out the policy.

Changes in statutory duties have not been an effective way to adapt the focus of regulation. The temptation is always to add to statutory duties e.g. as the Pitt Review proposed for Ofwat over flood control. If followed, this leads to a proliferation of priorities for regulators and regulators rather than governments perforce establishing trade-offs and priorities.

The question of government self-imposed restraints on regulatory changes is a fascinating one. The one very clear restraint should be transparency – no "behind the arras" communications. For the rest, it is very difficult to see what could be made binding, particularly on the frequency of changes. Improving Impact Assessments is the most obvious but NAO and other criticisms have persisted over the last 10 years or more with no measurable effect.

On the last bullet, a more pre-announced process – as in Government strategy statements – would help improve transparency and thus should be welcomed. Reviewing the regulatory process on a regular basis makes obvious sense (and I have supported elsewhere). The last point in this bullet I fail to understand.

Q9 Continuing and enhancing the work of the Joint Regulators' Group and the Competition Commission makes obvious sense. Sharing non-executive directors on a limited basis might be appropriate but, if dome widely, threatens the ability of non-executive directors to bring a fresh and uncommitted judgment to regulatory issues.

More use might be made of conferences and workshops – particularly if policy makers would be willing to contribute candidly. That may require smaller "invitation only" and Chatham House Rule protection. Regulatory agencies have been making increasing use of such mechanisms (including academic panel discussions) but, as yet, senior Departmental officials have been more cautious.

Q10 The cost effectiveness of regulatory frameworks inevitably varies but, as the House of Lords Select Committee 2007 Report indicated, there do not appear to have been any obvious major problems or blatant disasters.

There is no obvious requirement for remedial action although an increased emphasis on, firstly, a competition policy based analytic framework; and

secondly, regulators focusing more on outcomes relative to outputs or inputs would both help promote cost effectiveness.

However, from the perspective of the BIS Document, the key priority seems to be how greater and wider government policy involvement can be reconciled with maintaining high and stable policy and regulatory certainty. I am not persuaded that the draft Principles and their proposed application as set out in this document would achieve that. The current version contains too much ambiguity and a lack of full commitment to transparency regarding means as well as ends.

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