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HOUSE OF LORDS SELECT COMMITTEE ON REGULATORS 2007

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Further to my oral comments at the meeting on 5 June, I would like to add the following:

(i) UK utility regulators have now been operating for over 20 years. However, as yet, there are no formal ex post evaluation procedures or processes in place beyond periodic NAO investigations into specific decisions (e.g the introduction of retail competition into electricity and gas, the introduction of competition to telecom directory enquiries).

The NAO studies are very useful but are not based on a formal methodology and focus on a very limited number of cases

(ii) There is considerable interest, as reflected in the questions posed by Select Committee members, into whether or not the activities of the Regulators are beneficial in net terms to UK industry and UK citizens. This is not a question that one can answer directly since it is virtually impossible to know what would have happened had the Regulator(s) not existed – the "counter-factual" of no regulator makes no sense. However, it is possible to look at the costs and benefits of major individual decisions and to make provisional conclusions from such evaluations as to whether the outcomes from the decisions of an individual regulatory agency appears to be net positive or negative.

My provisional conclusion from considering the results of evaluations that have been done and the general performance record is that the main utility regulators, on balance, have a good record.

a. There have been some less than optimal decisions (e.g. the first electricity distribution review and the introduction of competition to telecom directory enquiries) but they have not been major and there have been few bad decisions on major issues. Typically, the regulators have learned from their mistakes and not repeated them.

b. The obvious UK failure has in been rail regulation where the formal relationship and responsibilities between ORR, the SRA and the responsible Ministry were clearly flawed. However, rail is a special case because – unlike all the other utilities – it is dependent on regular sustained subsidy payments to cover its costs. Hence, the rail regulator <u>cannot</u> be independent of government. This is recognised in the post-2004 rail regulatory regime where the regulator is more of an umpire between consumers, government and the rail industry than a fully independent regulator setting and controlling the basis of the revenue requirement.

c. In general, the performance of UK regulated industries looks good certainly in comparison with other EU countries and broadly

comparable with the US, Australia and New Zealand. On the latter, it seems to me maybe better in some areas and not as good in others.

d. UK utility regulation (and financial regulation) has evolved substantially and primarily in response to market developments. But UK regulation has also been heavily involved in encouraging market changes that have improved competition and outcomes. The clearest examples of these are Offer/Ofgem action to bring effective competition into the wholesale electricity generation market and Ofcom action leading to the semi-separation of BT via the establishment of OpenReach.

   UK utility regulation is now also much more rooted into a competition policy framework, especially for telecoms but also for energy and, to a lesser extent for rail. This, however, is much less true for water.

e. Although some commentators (including Keith Boyfield) take the abolition of sectoral regulation and its replacement by competition policy for utilities as a credible option, this does not seem plausible to me. For utilities with a monopoly fixed network of wires, pipes or rail at their core, there is no alternative to continued ex ante regulation – as was recognised by Stephen Littlechild in his 1986 study of options for water regulation. Indeed, Australia has (like New Zealand) now established an independent electricity regulator to regulate the federal transmission network and associated functions – tasks previously assigned to the ACCC, its competition agency.

   In my view, the only "utility" industry for which ex ante regulation might conceivably be replaced by ex post competition policy without radically different new technologies is telecoms. Even there, it is highly unlikely. Even there, it is highly unlikely unless there is sufficient network/platform competition across the whole country. Cable now provides some of this in towns but not outside towns and wireless is still a lot more expensive for non-voice telecoms (including internet access).

   Different major OECD countries have different institutional architectures but all have some combination of (a) ex ante utility regulation and (b) ex post competitive oversight. The chosen UK architecture of concurrent regulatory powers between sectoral regulators and OFT seems to me to work well in practice and as well as different institutional architectures in other EU and OECD countries.

f. UK utility regulation (and financial regulation) has demonstrated dynamic efficiency in the sense that the arrangements have evolved effectively and smoothly to respond to new challenges.

   This is most obvious for the huge technical and commercial opportunities in telecoms and the growing environmental and fuel supply challenges in energy. In both of those industries, the initial

"asset sweating" emphasis on RPI-X price controls to improve efficiency have evolved into very different mechanisms to ensure that there is sufficient investment in core networks e.g. the new style incentives on electricity and gas network investment incentives and the joint establishment of BT OpenReach with the deregulation of most telecom network prices. However, some other regulators (including Ofwat) have moved a lot less down this route – maybe because of less pressure from industrial users than in energy or telecoms.

(iii) Ex post evaluation of regulatory decisions is much less developed than ex ante regulation via Regulatory Impact Assessments (RIAs). However, this is now beginning to change thanks to the work of the NAO and similar bodies in other countries e.g. the GAO in the US – encouraged by the AEI-Brookings Joint Center for Regulatory Studies and similar entities.

In this context, the World Bank's recently published Handbook for Evaluating Infrastructure Regulatory Systems (of which I am a co-author) should assist in developing a more systematic and comparable approach. Much of the Handbook focuses on developing country issues but the implications for the UK and similar countries are set out in my recent CRI Lecture 'Evaluating Regulators – Developing UK and International Practice'

(iv) Any development of ex post evaluation on the lines recommended should be linked in with specifying

a. why regulation is necessary;
b. the objectives of regulatory interventions; and
c. ex ante assessments via RIAs (always including a do-nothing option[1].

This framework (the ROAMEF circle) is recommended for public expenditure decisions in the Treasury Green Book and is equally if not more applicable to regulatory decisions. This is true for all the regulatory agencies being considered by the Committee, including the FSA and the Pensions Regulator.

Ensuring such a framework is in place and effectively used would provide a strong basis for regulators to learn from experience. It enables them to build in good practices and to identify and rectify deficient practices. This is generally recognised by UK regulators and the FSA has publicly acknowledged it.

(v) As the Select Committee's questions recognise, it is crucial to have at the outset effective RIAs that clearly specify at the outset (a) the market failure that leads to a call for regulatory intervention and (b) the objectives of any proposed regulation. Ex post evaluation or regulatory decisions is

[1] It is worth noting that Ofcom did not have a do-nothing option for the directory enquiry decision. That was not included in the Ovum appraisal. The NAO were rightly critical of that and my reading of the NAO report suggests to m that this omission together with the relatively limited sensitivity analysis was a major cause of the flawed decision.

very much harder in their absence and almost impossible when regulators only assess ex ante their chosen option.

This again has been publicly recognised by FSA and is generally recognised by other regulators. For instance, Ofcom have been very careful to do a full ex ante appraisal of the need for and objectives of regulations covering the advertising of food and drink products to children

Criticisms of utility and utility regulators' RIAs can reasonably be made but my view is that RIAs fit much more easily into regulatory processes than into the decisions of Government Ministries. For Ministries, there is a much greater temptation to do the RIA just as an easy-to-pass "hurdle" on the chosen option; for Ministries, unlike the regulators, there are no open, transparent and enforceable procedural safeguards.

One important point on RIAs is that they have a major role where the UK is involved in implementing EU decisions. They can – and should – be used (a) as an analytic tool in negotiations with the Commission and other Member States as well as (b) when considering options for incorporating into UK legislation. Further, ex post evaluations of some key decisions should help significantly improve the quality and robustness of the RIAs.

(vi) A major question is who should commission and who should carry out ex post evaluations.

a. Commissioning evaluations

Regulatory agencies (e.g their Boards) may wish to commission them for their own internal learning processes. However, ex post evaluations also have a major role in terms of *accountability*. Hence, I would hope and expect to see such evaluations becoming a routine requirement by Select Committees eg House of Commons Departmental Committees as well as general Committes such as this House of Lords Committee. That would still leave institutional space for NAO evaluations on specific topics for the PAC (Public accounts Committee).

b. ***Carrying Out Evaluations***

It is far superior if ex post evaluations are carried out by someone other than the organisation being evaluated. There are many academic and private sector facilities and companies who can do this.

At the least, if regulatory agencies decide to carry out their evaluations in-house, these should, as a matter of principle: firstly, be openly published (and publicised); and, secondly, be subject to peer/quality review by publicly named outsiders.

Jon Stern
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ANNEX: THE ROAMEF CYCLE

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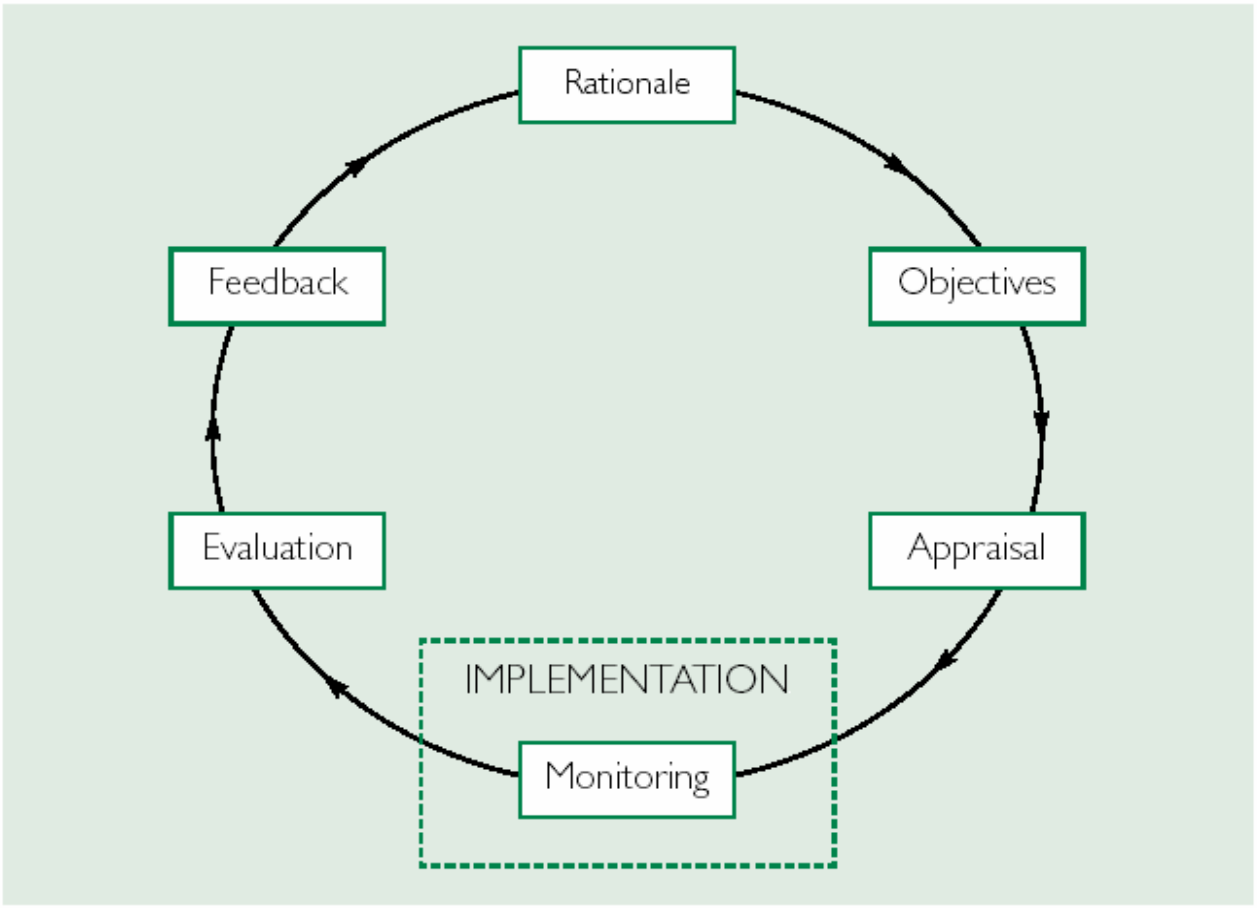
BOX 2: ROAMEF CYCLE



Source: HM Treasury Green Book: Appraisal and Evaluation in Central Government Section 2.2