

# Agenda

## Advancing economics in business

### Independent economic regulation: a tale of two paradoxes

**The regulated sectors are central to the UK economy, so the government is naturally interested in how they are regulated. However, the independence of regulators is vital for the achievement of public policy goals, including consumer protection, competition and investment. Cathryn Ross, Chief Executive of Ofwat, the economic regulator of the water industry in England and Wales, analyses this relationship between government and regulators and asks how economic regulation might best be used for the benefit of the UK economy and society**

Independent economic regulation was essential for the success of the UK government's privatisation programmes of the 1980s and 1990s. By insulating investors from political risk, and by providing stability and predictability in the application of regulatory frameworks, independent regulators were key to the delivery of massive programmes of privately financed and funded investment at low cost. This has benefited customers by keeping bills down and enabling quality of service improvements, and has benefited society more widely by enabling the delivery of broader public policy objectives such as environmental improvements. The box below illustrates this by reference to the benefits delivered for customers and society since privatisation of the water industry.

#### **Benefits for customers and society since privatisation of the water industry in England and Wales in 1989**

Water customers immediately after privatisation, compared with now, were:

- more than five times as likely to be at risk of an unplanned supply interruption;
- eight times more likely to be at risk of having their house flooded by sewage;
- well over 100 times more likely to be at risk of low water pressure.

More widely:

- at privatisation, only 12 beaches were awarded Blue Flag status—now there are more than 100;
- leakage is about a third lower than at its peak in the mid-1990s;
- companies have invested about £116bn in improving services to customers and the environment since privatisation.

Source: Ofwat.

Recently the future of independent economic regulation has come into question, however. There have been suggestions that the regulated sectors and, by implication, their regulators have failed to deliver, and some are suggesting that the model itself is broken, or at least in need of substantial reform.<sup>1</sup>

Reports of the death (or serious illness) of independent economic regulation are premature, but what is clear is that a fundamental re-examination of what the UK wants from its regulated sectors is taking place, and that this is being accompanied by a reconsideration of the toolkit available to decision-makers in government at all levels and those within regulation.

In this article I will argue that government interest in regulated sectors is not surprising, and that a more constructive conversation is about how they might be involved in ways that do not compromise independent economic regulation, which has been a critical success factor for the post-privatisation sectors.

#### **Back to basics: the twin paradoxes of independent regulation**

For the most part, those industries that were privatised in the 1980s and 1990s—telecoms, electricity, gas, water, rail, airports—all provide services that are essential, or at least extremely important, for a modern economy and society. The standard answer to the question 'why regulate?' is 'because effective competition is absent, and it is necessary to promote it and/or protect consumers from market power'. But a further critical factor in giving rise to the need for regulation of these sectors is the importance of the products and services they provide—for those who consume them directly, and for society more widely.

Different sectors vary in the nature of this importance. Some are directly critical for life itself, such as water and—these days—energy. All are essential building blocks of a modern society and a thriving economy.

The first paradox of independent economic regulation, then, is that one of the key reasons for its creation is also one of the key motivators of government intervention.

The second—closely related—paradox is that, notwithstanding the fact that the government established regulators in order to deliver a set of important public policy goals, independence from government was critical to the delivery of those goals. The ability of economic regulators to take a long-term view, to create stable, predictable regimes not subject to short-term political pressures, has been key for the delivery of infrastructure investment at relatively low costs of capital and for the evolution of competitive markets.

The good news is that the law and policy allow for a constructive dialogue between government and regulators that both facilitates and channels government interjections in ways that rightly influence but do not compromise the exercise of regulators' discretion. I discuss a number of these in turn below.

## Statute

At their core, regulators are creatures of statute. We pursue duties that are set out in statute by exercising our functions and powers, which are also set out in statute. Those statutes were proposed by governments and enacted by Parliament. Most economic regulators have a similar set of core statutory duties, including the promotion of competition and the protection of consumers, which reflected the key public policy priorities at the time. It is unsurprising, then, that regulators in the 1980s and 1990s were left to pursue these goals relatively undisturbed. As we get further—in time and in public policy thinking—from these original statutes, government will be more predisposed to intervene.

One way in which government may legitimately intervene is by proposing changes to regulators' statutory duties, again to be enacted by Parliament—and this has happened. For example, it is now common to see duties in relation to contributing to the achievement of sustainable development, which vary between regulators, reflecting different policy objectives.

## Strategic steers

The social costs and benefits associated with regulated sectors give government a legitimate interest in what the sector delivers for wider society. Government has a way of setting out this view through the provision of strategic steers to regulators.

The desirability of this was set out in the UK government's principles for economic regulation, in which it committed to put in place, for each regulated sector, strategy and policy

statements for the individual regulators to provide context and guidance about priorities and desired outcomes.<sup>2</sup> The government also made it clear that it expects to do this no more frequently than once in each Parliament and, while there may be circumstances or specific triggers that would necessitate action outside of this once-a-Parliament process, this would be done only on an exceptional basis.

In water, the UK Department for Environment, Food and Rural Affairs (Defra) issued its 'strategic policy statement' to Ofwat earlier this year, which sets out the priorities for regulation of the water industry that the government expects Ofwat to reflect in its decision-making.<sup>3</sup> This seeks to provide stability for both the regulator and the industry by providing a long-term view of the government's overarching priorities.<sup>4</sup>

There is an element of variable geometry here, which is appropriate. For those industries that receive substantial public financial support, the government is entitled to set out what it wishes to buy—on behalf of society—from the sector. In the case of rail, for example, the UK and Scottish governments set out their 'shopping lists' in the high-level output specifications (HLOSs), which are accompanied by their statements of the funds that they are prepared to make available to buy this. The HLOS process means that the UK Department for Transport has not felt the need to provide a separate 'strategic steer' to the rail regulator, the Office of Rail Regulation (ORR).<sup>5</sup>

## Guidance

While the strategic steers are necessarily high-level, the government can also provide guidance to regulators. In water, for example, this currently takes the form of 'social and environmental guidance', focusing precisely on those aspects of the regulated industry that are most relevant to wider society.<sup>6</sup>

This guidance—especially taken together with the strategic steer—can provide a useful indication to a regulator of the government's views on some of the key trade-offs facing the sector.

Typically, a regulator is required by its statutory duties to 'have regard' to the guidance it receives from government. It is easy for the cynics to attach a low priority to this, but in my experience such guidance is taken very seriously. At Ofwat, for example, I fought a judicial review, one element of which concerned whether and to what extent we had had regard to social and environmental guidance from the then Welsh Assembly government.<sup>7</sup>

It is important that the duty to have regard to guidance is just one of the regulator's statutory duties. This means that, in reaching a decision, the regulator must weigh the guidance it has received alongside its other statutory duties. Thus, while it must inform a regulator's choices, it does not compromise independence.

## The wider context

Regulators do not operate in a vacuum. In deciding on whether, when and how to make an intervention, we consider the wider context in which we operate, which has various aspects.

One element of this wider context is legislation beyond sector-specific legislation that affects the regulatory toolkit and the way in which it may be used. The recent Enterprise and Regulatory Reform Act 2013 did not reform concurrency, but it could have done. It also created the new Competition and Markets Authority (CMA), whose rules (to be made by statutory instrument) and guidance<sup>8</sup> will mean big changes in the way that regulators operate concurrency. These changes create a ‘competition primacy’ duty for regulators, as well as making it easier to use competition powers and giving the CMA an enhanced role in the operation of a UK Competition Network.<sup>9</sup> In this way, they have potentially wide-ranging implications for regulators’ choice of tools, such as between sector-specific regulatory tools (such as licence enforcement) and competition law, as well as for the structure of decision-making.<sup>10</sup> Similarly, the Regulatory Enforcement and Sanctions Act 2008, which resulted from a government impetus to reduce ‘burdens on business’, places a duty on certain regulators<sup>11</sup> to keep their functions under review and make sure that, in exercising them, they do not impose or maintain unnecessary burdens.<sup>12</sup>

A further element of the wider context through which government may influence action by regulators includes legislation and policies that affect the regulated sectors. In the 2013 periodic review in rail, for example, when deciding on the appropriate level of access charges for the haulage of coal by rail, the ORR took account of the government’s renewables policies on the market for power station coal. In water, EU environmental protection Directives have set standards for environmental outcomes, and Ofwat must take the cost of meeting these into account in setting price limits.

Ways of working in Whitehall also have a way of becoming relevant to regulators. Regulators have escaped the strictures of the Regulatory Policy Committee and ‘one in, one out’—largely, I think, because of an acceptance that not all regulation is bad and, indeed, some is necessary in order to make markets work well for consumers. However, any regulator who has discussed legislative change with a government department will have felt its influence most acutely. As already discussed, the general pressure to reduce undue regulatory burdens also remains.

Budgetary restraints are also increasingly becoming an issue. Several regulators—Ofwat included—have had communications recently from HM Treasury notifying us that we will be part of the Comprehensive Spending Review settlement from 2015/16. In Ofwat’s case, HM Treasury’s decision to claw back the underspend that we have routinely accumulated in the early years of a control period to fund the periodic review in the last two years substantially contributed to our need to go to companies this year to seek licence changes to allow for fee increases to fund our 2014 periodic

review.

The wider public policy debate is also of relevance. It can have passed nobody by that we are now living in a climate of heightened awareness of the impact of utility bills on ‘hard-pressed families’ in the run-up to the ‘cost of living election’. Like it or not, this colours the debate, and the debate at some level must affect what we do, not least because—rightly—it affects the actions of those in the markets that we regulate.

## So what?

I firmly believe that independent economic regulation has delivered great benefits for customers in regulated sectors and for society more widely. But independence does not mean—and never has—that regulators can be oblivious to government or immune from government intervention.

Regulated sectors produce not only private goods and services for private consumption, but also public goods and services that matter immensely to the UK economy and society. In the UK this is something that we have perhaps realised only recently. During the decades-long public policy consensus that was largely reflected in core regulatory statute, the implications of the two paradoxes at the heart of independent economic regulation were less obvious. As the public policy consensus shifts, however, they are becoming clearer.

This is not a threat to independent economic regulation—but it does present challenges.

The first challenge is the need for government and regulators to ensure that any government intervention in regulated sectors is transparent and clearly focused on those things in which government has a legitimate interest on behalf of society, such as inter-generational effects and social transfers. In this way the role of government and the role of the regulator remain clear, logically distinct, and complementary.

The second challenge is the need for regulators to ensure that they maintain their legitimacy. While acting entirely in line with their statutory duties, regulators need to act in ways that are demonstrably in the interests of customers and, where appropriate, society more widely. Strategic steers and guidance have a part to play in helping regulators maintain this legitimacy. Beyond that, however, regulators need to ensure that—while avoiding sunshine regulation—they are not deaf to public needs, wants and concerns.

In my view, the core objectives of economic regulators—i.e. the protection of consumers and the promotion of well-functioning markets—have never been more important. The heightened public debate about utility bills and the cost of living amplifies this, rather than detracts from it. One of the key strengths of UK-style regulation has always been flexibility within an enduring framework. Provided that government and regulators find a *modus vivendi* that allows government interest in regulated sectors to be expressed in a transparent and focused way, and provided that regulators

can demonstrate continued legitimacy in a changing landscape, independent economic regulation has a bright future—and I see no reason why this should not be the case.

**Cathryn Ross**

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<sup>1</sup> On one side of the political spectrum see, for example, the recent speech on the cost of living by Ed Miliband, UK Leader of the Opposition: The Spectator (2013), 'Ed Miliband's speech on "dealing with the cost of living crisis": full text', November 5th 2013, available at: <http://blogs.spectator.co.uk/coffeehouse/2013/11/ed-milibands-speech-on-dealing-with-the-cost-of-living-crisis-full-text/>. On the other side see John Penrose MP in his April 2013 report, 'We Deserve Better: Replacing Failed Economic Regulators With Consumer Reforms, So We All Get A Better Deal On Our Utilities', available at: <http://www.johnpenrose.org/images/wedeservebetter.pdf>.

<sup>2</sup> Department for Business, Innovation and Skills (2011), 'Principles for Economic Regulation', April, available at: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/31623/11-795-principles-for-economic-regulation.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31623/11-795-principles-for-economic-regulation.pdf).

<sup>3</sup> Department for Environment, Food and Rural Affairs (2013), 'Defra's strategic policy statement to Ofwat incorporating social and environmental guidance', May, available at: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/221043/pb13884-sps-seg-ofwat-201303.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221043/pb13884-sps-seg-ofwat-201303.pdf).

<sup>4</sup> The latest version of the Energy Bill (July 2013) currently before Parliament provides (at Part 5, clauses 122–125) for a strategy and policy statement. See [http://www.publications.parliament.uk/pa/bills/lbill/2013-2014/0057/lbill\\_2013-20140057\\_en\\_1.htm](http://www.publications.parliament.uk/pa/bills/lbill/2013-2014/0057/lbill_2013-20140057_en_1.htm). The strategy and policy statement is defined (at clause 122(2)) as 'a statement prepared by the Secretary of State that sets out (a) the strategic priorities, and other main considerations, of Her Majesty's government in formulating its energy policy for Great Britain ("strategic priorities"), (b) the particular outcomes to be achieved as a result of the implementation of that policy ("policy outcomes"), and (c) the roles and responsibilities of persons (whether the Secretary of State, the Authority or other persons) who are involved in implementing that policy or who have other functions that are affected by it'. Clause 125(1) provides that the Secretary of State must review the strategy and policy statement if a period of five years has elapsed since it was designated or last reviewed.

<sup>5</sup> In some cases the government contracts directly to achieve policy outcomes. This takes place, for example, through rail franchising. In the case of energy, the UK government is increasingly contracting for energy from renewable sources in order to deliver environmental outcomes.

<sup>6</sup> See Department for Environment, Food and Rural Affairs (2013), 'Defra's strategic policy statement to Ofwat incorporating social and environmental guidance', May, available at: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/221043/pb13884-sps-seg-ofwat-201303.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221043/pb13884-sps-seg-ofwat-201303.pdf).

<sup>7</sup> R (on the application of Welsh Water Ltd) v Water Services Regulation Authority (Ofwat) [2009] EWHC 3493 (Admin).

<sup>8</sup> Such as the proposed Competition Act 1998 (Concurrency) Regulations 2014, and Competition and Markets Authority (2013), 'Regulated Industries: Guidance on concurrent application of competition law to regulated industries. Consultation document', September, available at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/243707/3-guidance-on-concurrent-application-of-competition-law-to-regulated-industries-consultation.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/243707/3-guidance-on-concurrent-application-of-competition-law-to-regulated-industries-consultation.pdf), which are currently the subject of consultation.

<sup>9</sup> Department for Business, Innovation and Skills (2011), 'A Competition Regime for Growth: A Consultation on Options for Reform', March, available at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/31411/11-657-competition-regime-for-growth-consultation.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31411/11-657-competition-regime-for-growth-consultation.pdf).

<sup>10</sup> Section 51(5) of, and Schedule 14 to, the Enterprise and Regulatory Reform Act 2013 also introduced a requirement for regulators to consider using their concurrent competition law powers before enforcing them under sector-specific tools, going so far as to preclude them from using such sector-specific tools where they consider that concurrent competition law powers would be more appropriate.

<sup>11</sup> Namely Ofgem, Ofwat, the ORR, the Office of Fair Trading (OFT), Ofcom (in relation to postal services), and the Civil Aviation Authority (CAA). Ofcom also has a similar duty (in relation to telecoms) under the Communications Act 2003.

<sup>12</sup> Section 72 (Duty not to impose or maintain unnecessary burdens) of the Regulatory Enforcement and Sanctions Act 2008.

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