Written evidence presented to the House of Lords Select Committee on Regulators

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1. How do regulators interpret their statutory remit? Do they set themselves aims and objectives that take their work beyond fulfilling their statutory obligations? And, if so, why?

The positions of the sectoral and functional regulators differ, and it is appropriate to consider them separately.

Sectoral regulators

The interpretations of statutory remits depend substantially upon the particular specifications of duties. Where the specification is narrow, or where duties are hierarchically ordered, regulators tend to stick fairly closely to their remits. Where statutory duties are broad and imprecise – as, for example, when multiple aims are set out in legislation, but with no indication of the relative weights to be attached to each – regulators will necessarily exercise broad discretion, including over choice of objectives. In the latter circumstances, instability of objectives over time is liable to become a major problem, just as it was in the days of the nationalised industries (whose boards had broadly defined 'public interest' objectives).

Where statutory duties are broadly and imprecisely specified it can be difficult to determine whether or not there are tendencies to go beyond the statutory remits, since the boundaries of those remits may not then be very clear.

Independent regulation works best when duties/objectives are limited and precise. For example, focused objectives:

- tend to be associated with greater legitimacy of the regulatory process – whereas, in contrast, broadly defined duties imply the delegation of choices about trade-offs among ends (not just means) which are more appropriately determined by legislatures;

- make is easier to monitor regulatory performance and hold regulators to account;

- facilitate better management of regulatory agencies – a very important point given that largish executive agencies can be exceptionally difficult to manage well; and

- tend to provide greater stability in objectives, leading to greater consistency in decision making – which is important for regulatory certainty and investment.

Functional regulators

Broadly similar points apply in relation to the Competition Commission (CC) and the Office of Fair Trading (OFT), although for these two bodies it is easier to be more specific about at least one of the potential problems. The CC and OFT are responsible

not only for the enforcement of competition law but also for activities that are, in a very traditional sense, regulatory in nature. Examples include the making of merger approvals contingent on certain undertakings being given by the companies concerned, and sectoral inquiries which lead to measures, or proposals for measures, that are intended to affect the way in which the relevant market operates.

Whilst the interventions may be justified in terms of the aim of promoting competition and protecting consumers, in which case it can be said that the functional regulator is not going beyond the relevant statutory remit, there can be a tendency to neglect what should be the normal disciplines (e.g. as set out in regulatory impact assessment guidelines) when assessing interventionist measures. This used to be a particular issue in relation to Monopolies and Mergers Commission monopoly investigations, when, following a long and intensive investigation of the warts of a particular market, a wart-remedy might be produced out of a metaphorical hat, at a late stage in the process, with little attention given to any assessment of either the likely efficacy of the remedy or of the potential availability of alternative measures (questions that would be central to a well-conducted regulatory impact assessment).

The Competition Commission has improved its procedures substantially over recent years, including by devoting more resources to the assessment of 'remedies', starting the process of considering potential 'remedies' at a much earlier stage of an investigation, and, of particular importance, revealing more of its thinking during the course of an investigation so that interested parties have an opportunity to comment (similar to the opportunities typically available during a sectoral regulatory consultation). However, the OFT processes appear to be much less open/transparent, and there remains a general question as to whether the functional regulators are subject to sufficiently rigorous scrutiny and assessment when engaging in those of their activities that are regulatory in nature.

The issue is important because the good intentions of promoting competition and protecting consumers can potentially be used as a pretext for highly interventionist public policies (and supported by whatever version of Newspeak is at hand), and because of the risk of adverse, unintended consequences when insufficient care and attention has been paid to assessing regulatory impacts.

2. Are regulators sufficiently independent from government to allow them full operational freedom of action? To what extent does the method by which they are funded have an impact on the measure of their independence?

The degree of independence of regulators varies from context to context, and the 'sufficiency question' can only be settled on a case by case basis. A number of factors can potentially affect the degree of independence, including, for example, the appointment process and the personal characteristics of senior regulators. (Are they of independent mind? Do they want to be popular with politicians or the media?) Funding is one of these factors, although I am not aware that it has had any very significant effect on the conduct of regulators in the UK.

3. How can we assess whether regulators provide value for money?
a. Do their internal structures facilitate or hinder them in meeting their objectives with regard to providing value for money?
b. Does the work of the National Audit Office help to ensure that regulators provide value for money?
c. Have regulators sought to make appropriate efficiency savings through co-operation with other regulators, by selecting particular lines of inquiry and/or by other means?

If it is asked, could regulators do better in meeting their objectives within current budgets, or could they do what they do now for less, the answer is almost certainly yes. These are administrative agencies, with all the management problems that such agencies bring. Those problems tend to increase with the size of the organisation.

The NAO can certainly help in improving regulatory effectiveness, but, in my view, the most powerful stimulus to improved performance would be closer judicial supervision. In competition law the courts have increasingly been willing to insist on the achievement of minimum standards of analysis. For example, decisions should take account of all relevant facts, reasoning should be substantiated, inferences should flow from the facts, and so on (see the response to question 17 below). Whilst these may seem like obvious requirements, it is remarkable how frequently they are not met in regulatory decision documents. Subjecting both regulatory impact assessment documents and, in the case of the functional regulators, the nearest comparable reasoning/analysis given in association with 'regulatory' decisions to these sorts of requirements would be a near revolutionary step, which would greatly strengthen performance incentives.

Judicial supervision is probably the closest we can get to putting monopolistic institutions under competitive pressure to improve performance. Its role could usefully be expanded.

4. Have individual regulators established effective collective working arrangements with both functional and sectoral regulators? Is the current Concurrency Working Party system providing sufficient opportunities for co-operation, communication and co-ordination between sectoral regulators and the Office of Fair Trading and Competition Commission?

The working relationships among regulators appear to be broadly satisfactory, although, as always, there is no doubt scope for further improvement. It is also worth bearing in mind that frictionless joint working is not necessarily a desirable end state, since it may signify a brain-dead (or fully cartelised) system. When dealing with complex issues there will inevitably be differences of view, and such differences can be productive in the search for ways forward. Further, the regulatory innovations required to keep pace with changing markets will likely be delayed if all have to move at one pace.

5. Have regulators created communications systems with their relevant industry or industries, which provide for accurate receipt and provision of information? Do regulators specify clearly, and with adequate notice, what information they require from companies?

In general, communications have improved greatly over the last few years, but there remain question marks over what it is that is being communicated (is it informative, is it just spin, is it misleading?) Perhaps motivated by pressures to justify their existence, activities and budgets, there can be a tendency for regulators to become over-concerned with public relations; a tendency that, in extreme cases, can even amount to a form of mis-selling of their outputs.

6. Are regulators sufficiently clear in presenting the reasoning and financial models that underpin their decisions? Are regulated companies given enough early warning before enforcement action to allow for self correction?

The presentation of reasoning underpinning regulatory decisions is variable, as is the quality of the reasoning itself. Where subject to judicial supervision, courts and tribunals have sometimes been less than impressed with the standards achieved. See further in the response to question 17 below.

7. In summary, how successful have the economic regulators been? What changes, if any, could improve their effectiveness?

In broad terms, the UK can be said to have a successful regulatory system. The 'UK sectoral model' has been highly influential in international terms, and it has produced policy environments conducive to improved economic performance in the sectors concerned. The UK competition policy framework is more idiosyncratic, and less copied, but it too is well regarded internationally – perhaps because, as has sectoral regulation, it has been blessed with some exceptionally able public officials of great integrity.

The structures that have helped contribute to this success are, however, under some pressure. There has been a trend toward re-politicisation of decision making, and also a tendency for more and more responsibilities to be given to regulatory agencies. The second of these tendencies gives rise to a risk that an analogue of the Peter Principle might emerge: *the scale and scope/remit of regulatory agencies are expanded to the point at which the organisations become incompetent.*

If the aim is to improve regulatory effectiveness, therefore, the first thing to do is to buttress the existing position so as better to resist these unhelpful pressures, and, if possible, refocus each regulatory agency on its core aims and functions, wherever appropriate by narrowing its remit. That accomplished, facilitation of closer judicial supervision of regulatory decisions is probably the single most effective thing that could then be done. If courts were to declare that a particular decision was invalid/illegal because the regulatory impact assessment upon which it was based either failed to take account of relevant and available evidence or contained unsubstantiated reasoning/conclusions, that would send a galvanizing shock through the whole of the policy development process.

8. What is the most appropriate definition of the 'public interest' in respect of the activities of the economic regulators? Is there a divergence between

consumer interests and wider societal concerns encompassed by the term 'public interest'?

Regulators should not be required to pursue the 'public interest': it is far too vague a concept to be helpful. Decades of academic work on the conduct and effects of regulation, and decades of practical experience from the days of the nationalised industries, corroborate this view. Similarly, moves toward 'public interest' aims, such as a references in remits to 'citizens', alongside references to 'consumers', are generally unhelpful.

9. Have regulators been effective in protecting consumers from firms abusing their dominant positions in markets and restricting practices between firms that reduce competition? Have regulators successfully promoted the ability of consumers to switch firms at reasonable cost and without undue restrictions?

Regulators have been broadly successful in these areas. It should be recognised, however, that there are limits beyond which it would be unreasonable to go in seeking to protect consumers, and that a well functioning policy framework will rely upon consumers taking significant responsibility for their own actions.

10. To what extent should the public interest influence regulators' decisions on maintaining restrictions on competition? How should regulators ensure that regulatory restrictions on competition are limited and proportionate to the public interest(s) they serve?

Restrictions of competition should only be tolerated if they are indispensable /necessary for the attainment of legitimate regulatory objectives, and if those objectives carry sufficient weight to justify the necessary restriction. For example, a restriction of competition should be unacceptable if (a) there is an alternative, less restrictive way of achieving the objective, and (b) the cost of the alternative is not disproportionate (i.e. substantially higher). See also the response to question 8 above on the futility of relying upon the 'public interest' criterion in systems of delegated regulation.

The 'indispensability/necessity principle' is very useful in helping guide regulatory decisions away from measures that tend to restrict competition, and which are therefore liable to impede economic progress over the longer term (by reducing the effectiveness of market processes). It can also help regulators find their way through complex regulatory assessments, since it provides a criterion – the degree of restriction – that can be powerful in creating rankings in the options that might be available.

11. What research have regulators commissioned into the public interest(s) they serve, amongst the industries they regulate and those industries customers? What use have they made of any such research?

UK regulators have generally been very active in these areas, and the regulatory agencies have themselves become sources of much learning on the relevant matters.

12. What scope do sectoral and functional regulators have to improve economic performance either within specific markets or the wider UK economy?

The scope of what regulators can do is limited by statute. As argued above, the system works best when that scope is narrow. If regulators do their jobs well, there will be beneficial effects on the performance of the markets that they deal with and, in more diffuse and incalculable ways, on the economy more generally. Some of those benefits are clearly visible from recent UK economic performance in sectors such as communications, energy and financial services.

Since regulatory performance in the UK has generally been good, there may be a temptation to ask regulators to do more 'to improve economic performance'. For reasons given, that temptation should be resisted. Well-intentioned meddling or intervention in markets can easily cause significant harm.

13. Have regulators successfully facilitated the transition from public utility monopolies to effective competition within and between privatised or liberalised utilities? How has the restructuring of markets by regulators led to the development of better competition?

The transition from regulated monopoly to reasonably competitive markets in a number of important areas of economic activity has been one of the great success stories of UK economic policy. Traditional utility regulation sought chiefly to prevent excessive pricing by monopolies, and this was usually achieved by some or other variant of cost-of-service regulation (or rate-of-return regulation as it is sometimes, less appropriately, known). In addition to the innovation of substituting a price-cap or RPI-X approach for the traditional cost-of-service approach, UK policy gave sectoral regulators the new remit of promoting or facilitating competition; and it has been the vigorous pursuit of this aim that has led to a significant liberalisation of markets in what can only be described as a very short historical period.

14. Is there any evidence to suggest that regulatory activity affects industry investment levels? How can regulators improve market signals and incentivise longer-term investment in regulated markets? How should regulators improve and sustain business confidence in regulatory decisions?

The establishment of independent regulation has been key to attracting large scale investment in network infrastructure at reasonable cost. To give just one example, there has been substantial investment in gas pipeline infrastructure over the past decade or so, including the construction of two 'interconnectors' linking the GB system to continental European pipeline systems, new gas storage facilities, and new LNG import facilities. That infrastructure investment has scarcely registered on the political radar – which could be read as one sign of a regulatory system that is working well – and companies making the (large) investments have, in accounting for their decisions to their shareholders and others, made reference to the 'stability' of UK regulatory arrangements as a positive factor in the relevant decisions. The other side of this coin is that when regulatory arrangements become unstable and uncertain, most usually as a result of the politicisation of decision making (since political

priorities are notoriously fickle), investment tends to be chilled. Examples include delayed capital expenditure in the electricity sector in Italy, and the relative decline in investment in the pharmaceutical sector in continental Europe.

Independent regulation, working with narrow, delegated objectives, relying heavily upon a relatively small and identifiable set of economic principles, and free from short-term political meddling, is the best model we have available for encouraging investment in network infrastructure.

15. By international standards, have UK regulators succeeded in promoting the international competitiveness of the UK economy? How do the UK's institutional and regulatory arrangements to promote competition compare with those of other countries?

It is typically not part of the remit of regulators, including the functional regulators, to 'promote competitiveness', which would be something different from 'promoting competition'. Nevertheless, successful regulation will tend to have the effect of improving UK competitiveness, as a side-product. The UK is generally considered to be an international leader in the promotion of competition.

16. Does foreign ownership of UK companies (particularly within utility markets) present specific and identifiable problems for the domestic regulatory framework?

In general, foreign ownership creates no major problems for utility regulation, and, by bringing different perspectives and experiences to the relevant markets, tends to enrich those markets. Companies are subject to the same regulatory regimes irrespective of ownership, and foreign-owned businesses have complied with those regimes in much the same way as have domestically-owned companies.

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It is, nevertheless, possible to imagine exceptional circumstances where foreign ownership could be problematic. One such circumstance would be where it could reasonably be expected that the control of a company would be used for political purposes, and in ways that would have significantly harmful effects on domestic consumers.

17. To what extent have regulators established a Regulatory Impact Assessment process that:

a. Is properly resourced and transparent;

b. Produces high quality consistent analysis;

c. Targets resources at areas of greatest economic risk;

d. Provides genuine consultation with stakeholders;

e. Requires regulators to explain why non-regulatory options have not been pursued; and

f. Is a policy-making tool rather than an explanatory tool (i.e. do regulators produce impact assessments as part of the development of policy and not just to justify it once established)?

The average standard of regulatory impact assessment is, I regret to say, not good. There are examples of good quality work, but it cannot be said that the quality is consistently good across the regulators as a whole (which it should be).

There are some exceptions to this downbeat conclusion. First, the work of the Competition Commission (which, although it does not formally produce impact assessments, nevertheless covers much the same ground in its 'remedies' work) tends to be reasonably consistent. One likely reason for this is that the CC is an organisation that is very much focused on economic assessment and, more than any other body, it has developed clear processes and procedures to be relied upon when conducting that work. Second, within the sectoral regulators, the consultation aspects of regulatory impact assessment tend to be well handled.

That said, and recognising that the quality of regulatory impact assessment is, in my experience, higher among the regulators than in government more generally, assessments continue to exhibit a number of persistent and systematic weaknesses, including:

- Failure to identify, clearly and precisely, the relevant problems and issues of interest.

- Failure to identify, clearly and precisely, the relevant objectives, including the place and significance of those objectives within wider policy aims.

- A bias toward believing that (a) "something must be done" and (b) "something must be done" implies that "we must do something" (neglecting the possibility that when "something must be done" someone outside government might well be already doing something).

- Lack of creativity in considering possible policy options, and lack of precision in developing sub-options.

- A difficult-to-eradicate view that conducting regulatory impact assessment is equivalent to performing a cost-benefit analysis; which, given statutory objectives, it cannot logically be, and which is a rather silly thing to want to do anyway (since, for the great majority of decisions, formal cost-benefit analysis is non operational).

- Failure to apply the indispensability/necessity principle in relation to potential impacts on competition

- A tendency for officials to adopt or favour or become attached to a particular option during the course of the assessment, leading to bias in subsequent analysis.

- Use of regulatory impact assessment to 'justify' or support a particular option, rather than as a process of first discovering and then presenting information that is required to make regulatory decisions.

- Lack of 'space' and time for officials, at an early stage, to reflect and ponder on what are often difficult issues.

There have been many attempts now to address some of these problems internally, within the executive arm of government, including most recently by the Better Regulation Executive. I am pessimistic about the prospects for physicians to heal themselves, and am now of the view that things will change only when domestic judges, looking at manifestly poor regulatory decision making processes, are willing and able to strike down decisions on grounds similar to those set out by the European Court of Justice in *Tetra Laval v Commission*:

"Whilst the Court recognises that the Commission has a margin of discretion with regard to economic matters, that does not mean that the Community Courts must refrain from reviewing the Commission's interpretation of information of an economic nature. Not only must the Community Courts, inter alia, establish whether the evidence relied on is factually accurate, reliable and consistent but also whether that evidence contains all the information which must be taken into account in order to assess a complex situation and whether it is capable of substantiating the conclusions drawn from it."