



HOUSE OF LORDS

Select Committee on Regulators

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1st Report of Session 2006–07

# **UK Economic Regulators**

## **Volume I: Report**

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### *The Select Committee on Regulators*

The Select Committee on Regulators was appointed by the House of Lords on 23 November 2006 with the orders of reference “to consider the regulatory process”

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NOTE: The Report of the Committee is published in Volume I (HL Paper 189-I); the evidence is published in Volume II (HL Paper 189-II).

References in the text of the Report are as follows:

(Q) refers to a question in the oral evidence

(p) refers to a page of written evidence

## **ABSTRACT**

The House of Lords Select Committee on Regulators was appointed on 23 November 2006 with a broad remit to “consider the regulatory process”. Presented with such a broad remit and only one parliamentary session in which to operate we were forced to set strict limits on the scope of the work we wished to complete. We agreed to narrow the scope of our inquiries to focus on regulators rather than regulation; and to look only at the economic regulatory work of the major UK economic regulators.

Within this remit we have considered the statutory remits of the regulators; their working methods; working relationships; and the value for money they provide. We have also looked at the extent to which the regulators have successfully promoted competition and de-regulated where possible and we ask whether they should now be given an additional statutory duty to facilitate the competitiveness of UK firms.

In March 2007 we invited the National Audit Office to conduct a review of the way in which Impact Assessments are used by regulators—their report is published in full as an Appendix to our Report.

August and September 2007 brought the liquidity crisis at Northern Rock. Due to time constraints we have not been able to consider these events in this Report. We note, however, that the House of Commons Treasury Select Committee is currently inquiring into the Northern Rock crisis in the context of a wider inquiry into Financial Stability and Transparency.

Our conclusions and recommendations are listed in full at the start of this Report. We conclude that, broadly speaking, the legislation establishing the regulators is working well. Whilst we do not recommend any immediate re-writing of legislation we propose that over time, as opportunities arise, a measure of standardisation of regulators’ remits should be introduced with the aim of ensuring that they are all statutorily required to follow best practice.

We would encourage other regulators, in addition to the FSA, to complete more Impact Assessments and to improve those they produce by strengthening their use of cost/benefit analysis, introducing clearer sign-posting and including an executive summary. We encourage regulators to commit to evaluating the impact of their work and monitoring the extent to which they are providing value for money, using post-implementation evaluation where appropriate and possible.

We welcome the willingness of the regulators to develop relationships between themselves to increase their effectiveness and recommend that the Joint Regulators Group be formalised. We further recommend that an inter-ministerial forum be established to require ministers to compare views and share best practice.

We conclude that in most sectors regulators have played an important role in helping to promote competition and we examine possible reasons for the lack of competition in the water industry. We do not accept that there is something specific about the nature of water itself which means that the sector can never develop effective competition. Whether or not the argument that the physical nature of water is a barrier to competition is a valid one will never be put to the test until the obstacles to competition presented by the threshold and the access

pricing rule have been removed. We urge Ofwat to take account of the general comments made by the Competition Appeal Tribunal on its access regime.

We conclude that there is a crucial need for greater parliamentary oversight over regulatory bodies and we recommend that a Joint Committee of both Houses be set up in line with the recommendations given in Chapter 10 of the House of Lords Constitution Committee Report, 6th Report (2003-04): *The Regulatory State: Ensuring its Accountability* (HL 68). If it proves impossible to set up such a Committee we recommend that a sessional Select Committee be established in the House of Lords.



# UK Economic Regulators

## CHAPTER 1: SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

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### Regulators' statutory remits

- 1.1. We conclude that:
  - Independent regulators' statutory remits should be comprised of limited, clearly set out duties and that the statutes should give a clear steer to the regulators on how those duties should be prioritised.
  - Government should be careful not to offload political policy issues onto unelected regulators. (para 3.13)
- 1.2. Our evidence suggested that, on the whole, the legislation is thought to be working well and the regulators and regulated industries are satisfied with its provisions. Although it is clear that the current framework is not what would now be devised were it possible to start again it serves its purpose. We do not, therefore, recommend the drafting of a tidying up bill. However, we recommend that, as the opportunity arises, further standardisation of regulators' remits should be introduced with the aim of ensuring that they are statutorily required to follow best practice. (para 3.28)
- 1.3. It seems that most of the regulators are interpreting their remits both appropriately and effectively. As an exception to this general picture there is a question mark over whether Ofwat has explored the full extent of its remit and whether it has implemented that remit effectively. (para 3.35)

### Working methods and value for money

- 1.4. We have not heard convincing criticism of how regulators approach their commitments to trim their operations and to work as cost effectively as possible. Although the operating costs of regulators have generally increased in recent years this trend can largely be attributed to significant extensions to their remits. We recommend that all regulators' operating costs be routinely kept under scrutiny by a sessional Select Committee established in line with our recommendation in paras 1.29-1.30 and by the National Audit Office (NAO). (para 4.17)
- 1.5. Regulators should commit to evaluating the impact of their work and monitoring the extent to which they are providing value for money. We recommend that regulators should jointly develop methodologies to quantify the impact they have in line with current best practice represented by the Office of Fair Trading and Competition Commission's methodologies. Whilst we recognise that this is an inexact science we believe that the process of trying to quantify value for money imposes a good discipline and encourages healthy self-evaluation. (para 4.25)
- 1.6. We would encourage regulators other than the Financial Services Authority (FSA) to consider risk-based regulation more explicitly, particularly as a means of using regulatory resources more efficiently. (para 4.36)

- 1.7. We encourage the FSA to continue its work in the area of principles-based regulation. We would also encourage other regulators to investigate the scope for replacing detailed rules by a move to a principles-based approach in their own areas of activity, and consumer bodies to monitor consistency. In doing so they could together help to identify the criteria for determining where, in the spectrum described by Ed Balls MP in Chapter 4, such an approach could usefully be employed, taking account of the possible consequences for regulatory uncertainty. (para 4.45)

### **Regulators' use of Impact Assessments (IAs)**

- 1.8. We agree with the recommendations of the NAO's Review of Economic Regulators' Impact Assessments (IAs) (contained in Box 1, after para 4.57). We recognise that all the regulators included within that review, and the FSA, have developed good, iterative consultation procedures. However there is room for improvement across the board in regulators' IA processes. Regulators should strengthen their cost/benefit analyses, using quantitative estimates where they can be made robustly, and should improve the presentation of their IAs with clearer sign-posting and a commitment to conciseness and clarity. All regulatory IAs should include executive summaries to make them more accessible and all should be placed in the public domain. Regulators should ensure that IAs are not used as a tool to justify policy but as a policy-making tool. (para 4.71)
- 1.9. Furthermore, we recommend that where they have not done so already, regulators should be required to publish their own policy documents setting out the approach they intend to take towards completing IAs. Policy teams should be supplied with written guidance and given formal training to help them to complete IAs. (para 4.72)
- 1.10. We recommend that:
- Post-implementation evaluation should be conducted with greater frequency and should always be carried out where a step change in regulatory policy has been implemented.
  - Such evaluation and monitoring should generally be carried out by the regulators themselves, but on occasion an independent body (preferably the sessional Select Committee recommended in paras 1.29–1.30, or the NAO) should monitor the quality of assessments and the objectivity shown by regulators in completing them.
  - Post-implementation evaluation should always be made publicly available.
  - The original IA makes clear that a post-implementation evaluation will be completed in cases where it is felt that a post-implementation evaluation would add value. Meaningful evaluation is not possible without clear targets and objectives. The regulator's original IA should set such targets in anticipation of a post-implementation evaluation. (para 4.76)

### **The relationship between regulators and the regulated**

- 1.11. We recognise the dissatisfaction of many Independent Financial Advisors (IFAs) with the work of the FSA. We welcome moves by the FSA to improve relations with the large number of smaller firms that it regulates. The FSA must continue to cultivate these relationships. (para 5.15)

- 1.12. Regulated industries recognise the need for regulators to receive timely and accurate information on their activities. The regulators should ensure that systems for providing such information work effectively. To enable the success of such systems, regulators should ensure that data requests are well co-ordinated and sent out in consistent form and should always be mindful of the burden that their information requests place on their regulated industries. Regulators should strive to keep this burden to the necessary minimum and should always explain and justify why data are required. (para 5.23)
- 1.13. Industry needs reassurance that the time it invests in consultation is time well-spent and is meaningful in the decision-making process. Whilst recognising that, by and large, consultation procedures are working well, we urge regulators to continue to look at ways in which they might be improved. In particular, we recommend that wherever possible regulators allow for at least a 12 week consultation period in their forward planning to give industry a reasonable amount of time to respond to their papers. (para 5.34)

### **The protection of the consumer interest, the citizen interest, and the public interest**

- 1.14. Regulators should normally be expected to be charged with responsibilities which reach beyond consumers to the interests of citizens or the general public. However, their duty to act outside the areas of consumer interest may, and if possible should, be circumscribed by legislation or by social and environmental guidelines issued by ministers in accordance with legislation. The interests of citizens and the general public are for Government and Parliament, and not for the regulators, to define and promote. (para 5.50)
- 1.15. Different consumer representation models operate in the regulatory state and all the regulators were vociferous in justifying their particular model. However, we believe that stand alone consumer representation bodies are more transparent and more effective. (para 5.65)
- 1.16. A new landscape for consumer representation has been created by the Consumers, Estate Agents and Redress Act. We are sceptical that the proposed new arrangements will lead to improvements in consumer representation but we recognise that it is too early to judge whether our scepticism is justified. The new arrangements will need careful monitoring and this is a role that might be taken up by a sessional Select Committee (as recommended in paras 1.29–1.30). (para 5.66)
- 1.17. In the energy sector, the voluntary nature of the Energy Supply Ombudsman scheme is likely to change as a result of the Consumers, Estate Agents and Redress Act and it would therefore be premature to recommend changes in this area. (para 5.73)
- 1.18. We recommend that the Government commission the NAO to conduct a review of the economy, efficiency and effectiveness of the Financial Ombudsman Service (FOS). The review should include consideration of the extent to which the FOS acts as a “pseudo-regulator” and the effectiveness of the working relationships between the FOS and other bodies such as the FSA and Office of Fair Trading (OFT). (para 5.74)

### Co-operation between regulators

- 1.19. We think that action is necessary to improve regulators' joint working. There needs to be more structured and formal cooperation between the regulators if it is to be meaningful. We welcome the regulators' willingness to develop relationships between themselves to increase their effectiveness. (para 6.15)
- 1.20. We believe that if the Joint Regulators Group (JRG) is to prove a successful forum for the sharing of best practice, it needs to be formalised. The JRG should establish a secretariat, and suitable arrangements for leadership, to ensure greater consistency of focus and a clearer direction of effort. The JRG should publish its agendas and minutes of its meetings on a tailored JRG website online to enable interested parties to have easy access to them. Additionally, the JRG should produce an Annual Report outlining the discussions it has had over the course of the year and the details of any joint work it has undertaken. (para 6.16)
- 1.21. Whilst relationships between the sectoral regulators and the competition authorities seem to be broadly sound, there is clearly a need for improved communication between the various bodies over the timing and content of their investigations of particular markets. (para 6.25)
- 1.22. We recommend that, where possible, utility regulators should look to bring more cases to the competition authorities and that the regulators should work to ensure that the cases most likely to establish useful precedents are brought to the Competition Commission (CC). (para 6.26)
- 1.23. We recommend the following:
  - Concurrency arrangements (the arrangements under which decisions are made about whether competition law is applied in particular sectors by the relevant sectoral regulator or by the OFT) should be retained.
  - In some cases complainants perceive that a sectoral regulator is so deeply involved in regulating the industry as it stands that it pays insufficient attention to the importance of establishing and maintaining effective competition. Complainants should therefore be given the option of requesting the OFT rather than the sectoral regulator to take the lead in investigating complaints.
  - In cases where regulators do not have concurrent powers, even though they are carrying out very similar functions to regulators which do have such powers, there is a case for giving them concurrent powers. (para 6.41)

### The relationship between regulators and Government

- 1.24. We recognise that there is a perception that Postcomm's independence might be compromised by its method of funding. We believe that whilst in theory the funding of Postcomm by Royal Mail (and therefore effectively by the Department for Business, Enterprise and Regulatory Reform—formerly the DTI) may compromise its independence, in practice this is not the case. Moreover, as competition increases other operators in the industry will be liable to contribute to the funding of Postcomm. (para 6.48)
- 1.25. Energy is now again a public policy issue and security of supply and sustainability are ever more important considerations. In this context, Government will need to be careful to ensure that Ofgem is not sent mixed

messages. Government must be explicit in the political decisions it makes and the consequent guidance it issues to regulators. (para 6.50)

- 1.26. Complexity in the relationship between the Department for Transport (DfT) and the Office of Rail Regulation (ORR) is not necessarily undesirable if the system is working. The Minister, Tom Harris MP, put in a sensible plea for “a long-standing period of settling down into the current regulatory framework”. We believe this would be advisable and we recognise that the early signs of a productive relationship developing are promising. (para 6.56)
- 1.27. Relationships between regulators and government seem generally to be functioning well although an effective and transparent mechanism needs to be put in place for resolving potential policy conflicts so that the regulators are able to carry out their economic function without interference. (para 6.59)
- 1.28. Relations between government departments on regulatory issues are in their infancy. We recommend that an inter-ministerial forum be established to require ministers to compare views and share best practice. (para 6.60)

### **The accountability of regulators**

- 1.29. We agree with the conclusion of many of our witnesses that “there is a crucial need for greater parliamentary oversight ... over regulation bodies”. The question of who regulates the regulators has not been answered and will not go away. There is a need for a committee to pursue cross-sector best practice and to ensure that the recommendations of this Report are implemented. As we emphasise in paragraph 2.18 we have examined only a part of the regulatory state. We have considered only regulators, and not regulation, and we have looked at only the economic regulators. There is a need for a wider, and continuing, review. No existing committee of either House is in a position to undertake such a continuing and over-arching review as Departmental Select Committees in the House of Commons are restricted to considering the regulators within their own sector. (para 6.65)
- 1.30. We therefore recommend that a Joint Committee of both Houses be set up in line with the recommendations in Chapter 10 of the Constitution Committee’s Report on the Regulatory State (6th Report of Session 2003–04). If it proves impossible to set up such a committee we recommend that a sessional Select Committee be set up in the House of Lords. (para 6.66)

### **The promotion of competition by regulators**

- 1.31. In most sectors, regulators have played an important role in helping to promote competition, but there are significant variations between the sectors. Whilst not all regulators have a primary statutory duty to promote competition, the duties they do have are often framed or interpreted in such a way that they point in the same direction. In a few cases, regulators lack the necessary powers under sector-specific regulation to take measures that would stimulate competition and, as discussed in Chapter 6, do not have concurrent powers with the OFT under general competition legislation. This particularly applies to the Civil Aviation Authority (CAA) which lacks both concurrent competition powers and the power to designate or de-designate airports for price control purposes. The decision about whether or not to apply price control regulation is essentially economic rather than political

and there is a strong case for transferring that power from the Secretary of State to the CAA. (para 7.14)

- 1.32. We recommend that the Government considers the case for transferring the power to designate or de-designate airports for price control purposes from the Secretary of State to the CAA. This matter could be addressed as part of the strategic review of the CAA that is being conducted by the Department for Transport. However, we recognise that the implementation of the EU Directive on Airports (discussed in Chapter 7) might make this impracticable. (para 7.15)

### Competition in the water sector

- 1.33. Whilst each of the sectors within our inquiry has distinct characteristics, we find it hard to accept that there is something specific about the nature of water itself which means that the sector can never develop effective competition. Three reasons have been advanced as to why this has not happened—the physical nature of water as a commodity; the eligibility threshold; and the access pricing rule. Whether or not the physical characteristics argument is a valid one will never be put to the test until the barriers to competition presented by the threshold and the access pricing rule have been removed. As regards the latter, since virtually everyone agrees that the rule should be changed, it is very unfortunate that an impasse has been allowed to develop over what needs to be done to make the change. Ofwat maintains that legislation is required, whereas potential entrants claim, on the basis of the Competition Appeal Tribunal's (CAT's) general comments on the access regime, that a change in Ofwat's interpretation of the legislation is all that is necessary. In their view, Ofwat is ignoring the competition authorities and failing to change its interpretation in a way that would make entry more attractive. The Government has so far done little or nothing to clarify the situation. (para 7.22)
- 1.34. It seems to us unwise of Ofwat to claim that it need take no account of the general comments made by the CAT on its access regime. Ofwat should examine critically whether it could not find a more constructive approach to implementing the CAT's findings. (para 7.23)

### Regulators' attempts at de-regulation

- 1.35. Regulators have taken important steps to de-regulate but there is still room for progress. Alternatives to classic rule-based regulation, such as risk-based and principles-based regulation, can assist sectoral regulators in moving towards an *ex-post* competition authority approach and there is a case for providing regulators across the board with a duty to promote self-regulation. (para 7.32)
- 1.36. It might be possible for sectoral regulators to disappear but certainly not in the immediate future. If sectoral regulators are phased out, the core, irreducible functions that they perform would have to be performed by other organisations, such as the competition authorities. If possible, it would be worth instituting measures that lead in this direction without necessarily expecting the demise of sectoral regulators to come soon. (para 7.45)
- 1.37. We recommend that the sessional Select Committee proposed in paras 1.29–1.30 takes on the duty to ensure that the sectoral regulators it oversees are

promoting competition and withdrawing from sectoral regulation wherever appropriate. (para 7.46)

- 1.38. We recommend that, subject to any restrictions imposed by its statutory remit, the Competition Commission conduct a periodic review on whether effective competition exists in the markets overseen by sectoral regulators, with the aim of scaling back sectoral regulation to the greatest extent possible. (para 7.47)
- 1.39. We endorse the OFT's proposal (in response to the joint report by the DTI and HM Treasury on concurrency) that it reports to the Joint Regulators' Group on an annual basis, providing an overall view about whether competition law is being applied consistently and pro-actively across all the sectors. The OFT could also report on the compliance of regulators with the Better Regulation Executive's (BRE's) principles of good regulation. (para 7.48)

### **The impact of regulators on the competitiveness of UK firms**

- 1.40. Economic regulators promote competition which, in turn facilitates—but does not ensure—competitiveness. The positive effect that regulators have on competitiveness is achieved indirectly because promoting the competitiveness of UK firms does not normally form part of the regulators' remit. Given the importance of the role played by the regulated sectors in supporting UK industry, we think it is vital that economic regulators fully consider the impact of their decisions on UK firms' competitiveness. (para 7.68)
- 1.41. We recommend that, as legislative opportunities arise, economic regulators be statutorily required to facilitate the competitiveness of UK firms by: i) promoting competition; and ii) removing regulatory burdens from firms wherever possible. (para 7.69)

## CHAPTER 2: BACKGROUND

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### The history of the regulators

- 2.1. Most of the regulators with which this report is concerned were founded in the 1980s or even earlier.<sup>1</sup>
- 2.2. The privatisation movement in Britain, which began under the Conservative governments of the 1980s, provided the main impetus for the growth of economic regulation in the last two decades of the 20<sup>th</sup> century and the early years of the twenty first century. Most of the nationalised industries had statutory monopolies and, when privatised, retained monopoly power, or, depending on the new structures, established some elements of monopoly power, which required regulation to prevent abuse of that power via higher prices and/or lower standards of service than there would have been in competitive markets.
- 2.3. The relevant Acts of Parliament established independent sector-specific regulatory offices. The regulators, who were appointed by government usually for a five year term, were given specific statutory duties and powers, but the activities of the regulators were otherwise free from the direct political intervention that had been frequent under nationalisation. Companies subject to regulation were issued with their original licences by the government, setting out their rights and obligations, and had the safeguard that changes to licence conditions proposed by the regulator were subject to appeal to the Monopolies and Mergers Commission (now the Competition Commission).
- 2.4. Although the statutory duties set out in the Acts of Parliament which privatised the industries differed to some extent from sector to sector, regulation as it evolved tended to have common features. In particular, it is recognised that the “natural monopoly”<sup>2</sup> sectors of the utilities (for example, the networks of pipes and wires used to transport wholesale gas and electricity supplies to retail customers) have to be regulated for the foreseeable future to avoid the companies exploiting monopoly power. However, in the remaining parts of the industries, pro-competition regulation is required, but only as a temporary measure until potentially competitive sectors become actually competitive. Thus the scope and size of the regulatory offices were expected to reduce over time as the parts of the industries which had become effectively competitive became subject only to general *ex ante* competition regulation.
- 2.5. The first utility regulatory office was the Office of Telecommunications (OfTel), set up to regulate the telecommunications industry when 50 per cent of British Telecommunications was sold by public offering in 1984, in the first major utility privatisation. Other regulatory offices soon followed—the Office of Gas Supply (Ofgas) in 1986, the Office of Electricity Regulation (Offer) in 1989, the Office of Water Services (Ofwat) in 1989, the Office of the Rail Regulator (ORR) in 1993, all with Directors General. The Postal

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<sup>1</sup> The dates of formation of the existing regulators and the names of predecessor organisations are listed in Chapter 3.

<sup>2</sup> Where natural monopolies exist, entry by competitors, even if free, is unlikely to be effective because of economies of scale enjoyed by the incumbent.

Services Commission (Postcomm) which regulates postal services (where Royal Mail is still in government ownership), came later, in 2000.

- 2.6. The Civil Aviation Authority (CAA) is different from the utility regulators in that it was in existence before the privatisation in 1987 of the nationalised British Airports Authority, having been established in 1972. The task on privatisation was therefore not to establish a regulator but to remodel the existing one, by adding the economic regulation of airports to its functions. Another important difference as between airport regulation and regulation of the privatised utilities is that the CAA does not have a duty to promote competition (this difference may be associated with the fact that it was thought that—short of divestment—the scope for competition among airports was constrained).<sup>3</sup>
- 2.7. The two financial service regulators were founded more recently. In May 1997, the government announced its intention to create the Financial Services Authority (FSA) as a single financial services regulator, independent of government, responsible for both financial services prudential regulation and the conduct of business regulation. The regulator's duties and powers were set out in the Financial Services and Markets Act (FSMA) which came into force in 2001. The FSA does not have a duty to promote competition in the industry nor to regulate prices since the regulated companies already operate in competitive markets. However, the regulator is required to meet its statutory objectives in ways consistent with facilitating and maintaining competition (internationally and domestically) and minimising adverse effects on competition from regulation. The Pensions Regulator (TPR), which replaced the Occupational Pensions Regulatory Authority, was created by the Pensions Act 2004 and began work in April 2005. Its role is to regulate work-based pension schemes with the objectives of protecting the interests of scheme members, promoting good administration and reducing the risk of claims on the Pensions Protection Fund.
- 2.8. The two competition authorities considered in this report—the Monopolies and Mergers Commission (now the Competition Commission-CC) and the Office of Fair Trading (OFT)—which regulate UK companies generally to maintain competition and prevent abuse of market power, were already in existence by the time the privatisations of the 1980s began.<sup>4</sup>
- 2.9. There have been some significant changes to the regulatory regime in the last twenty years though and, apart from the railways, the changes have been primarily evolutionary. The incoming Labour government of 1997 carried out a review of utility regulation which reported in 1998.<sup>5</sup> The new government retained the main elements of the previous regime, including the independence of the regulators.
- 2.10. However, following the review, a number of changes were made, including mergers of regulatory offices, most notably of the two energy regulators, Ofgas and Offer, into the Office of Gas and Electricity Markets (Ofgem) in 2000 and of the various communications regulators including Ofcom into the

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<sup>3</sup> C.Chataway, 'Airports and Airport Regulation' in M.E.Beesley (ed.) *Major Issues in Regulation*, Institute of Economic Affairs, 1993.

<sup>4</sup> At that time the OFT was formally the office of the Director General of Fair Trading. The Enterprise Act 2002, required that the office of the DGFT was known as the OFT.

<sup>5</sup> DTI, 'Fair Deal for Consumers: Modernising the Framework for Utility Regulation—the Response to Consultation', July 1998.

Office of Communications (Ofcom) in 2002. The original organisational structure of a regulatory office, with an individual (Director General) responsible for regulating the relevant industry, was also changed. Newer regulators have been established with Board structures and the original statutes have been amended so that there are Board structures for all the regulatory offices (normally with a Chairman, Chief Executive and several executive and non-executive directors), and for the two competition authorities, the Competition Commission (previously the Monopolies and Mergers Commission) and the Office of Fair Trading. The Competition Commission was for a time separated into two parts, one of which was the Competition Appeal Tribunal (CAT). The CAT is now an independent body which, *inter alia*, hears appeals from decisions of regulators and the OFT.

- 2.11. The greatest changes have taken place in rail regulation, which has always been rather different from regulation of the other privatised industries because of the continuation of substantial government subsidy which has resulted in ongoing government involvement. But since privatisation there have been significant changes to the rail industry which have also changed the regulatory system—for instance, the abolition of the Office of Passenger Rail Franchising (OPRAF) which used to run the franchising system for the Train Operating Companies; the creation and subsequent abolition of the Strategic Rail Authority (SRA) which had been charged with formulating a strategy for the railways; the move of franchising (previously OPRAF) and strategic functions (previously SRA) to the Department of Transport; the replacement of the original network owner, Railtrack, by Network Rail (a not-for-dividend company) in 2001; and the transfer of health and safety functions to the ORR. Together these represent major changes to the system of regulating the railways, with much more government involvement than in the other regulated utilities.

### **The Formation of this Select Committee**

- 2.12. This Committee was set up on the recommendation of the House of Lords Constitution Committee in their 2003 Report entitled *The Regulatory State: Ensuring its Accountability*.<sup>6</sup> The Report concluded that Parliament was crucial to ensuring the accountability of regulators and that, at that time, parliamentary scrutiny of the regulatory state was not sufficiently extensive, consistent or co-ordinated.
- 2.13. The Constitution Committee therefore recommended that a “dedicated parliamentary committee should be established to scrutinise the regulatory state”.<sup>7</sup> Furthermore, they recommended that such a committee should “preferably be a joint committee of both Houses”<sup>8</sup> and should focus its work around “the annual report and the published RIAs”<sup>9</sup> of each regulator.

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<sup>6</sup> 6th Report, Session 2003-04, HL Paper 68

<sup>7</sup> *ibid*, para 199

<sup>8</sup> *ibid*, para 200

<sup>9</sup> *ibid*, para 203

- 2.14. In their response to the Constitution Committee’s Report the Government noted that “These recommendations [were] for the House Authorities to take forward as they deem[ed] appropriate”.<sup>10</sup>
- 2.15. Accordingly, Lord Holme of Cheltenham, the then Chairman of the Constitution Committee, took a proposal for a sessional<sup>11</sup> joint committee on regulators to the Lords Liaison Committee.<sup>12</sup> The Committee considered the request, and agreed that the “subject was important” but reminded Lord Holme that the Committee was, at that time, “reluctant to commit resources to the establishment of additional permanent sessional committees”.<sup>13</sup> The Committee agreed to approach the Commons informally to discuss the possibility of setting up a joint committee but found that enthusiasm in the Commons was lacking.
- 2.16. Consequently, at the next meeting of the Liaison Committee Lord Holme returned with a new proposal for an *ad hoc*<sup>14</sup> select committee on regulators to be formed solely of Lords members. The Committee heard the proposal and recommended the “establishment ... of an *ad hoc* select committee on the regulatory process, to be known as the Select Committee on Regulators”.<sup>15</sup>
- 2.17. In line with the Liaison Committee’s recommendation this Committee was appointed on 23 November 2006. We were appointed with a broad remit—“to consider the regulatory process”.

### What this Committee set out to achieve

- 2.18. Presented with such a broad remit and only one parliamentary session in which to operate we were forced to set clearly defined limits on the scope of the work we wished to complete. At our first deliberative meeting, we therefore agreed to narrow down the scope of our inquiries by deciding to focus on regulators rather than regulation. We also agreed to look only at the economic regulatory work of the major UK economic regulators. We have not looked at all regulators operating in Northern Ireland and Scotland. There is no universally accepted “list” of the major UK economic regulators so, for the purposes of our inquiry, we made clear that we would be considering the work of Ofwat, Ofgem, the ORR, the CAA, the FSA, Postcomm, Ofcom, the Pensions Regulator, the OFT and the CC.
- 2.19. Our first Call for Evidence, released in December 2006, outlined the four areas of inquiry that we intended to focus on, namely:
- Regulators’ working methods and their effectiveness;
  - Regulators and the public interest;

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<sup>10</sup> The Regulatory State: Ensuring its Accountability: The Government’s Response, 12th Report, Session 2003-04, HL Paper 150, para 48.

<sup>11</sup> i.e. permanent

<sup>12</sup> The Liaison Committee’s terms of reference are: “To advise the House on the resources required for select committee work and to allocate resources between select committees; to review the select committee work of the House; to consider requests for ad hoc committees and report to the House with recommendations; to ensure effective co-ordination between the two Houses; and to consider the availability of Lords to serve on committees”.

<sup>13</sup> 1st Report, Session 2005-06, HL Paper 29, para 6.

<sup>14</sup> An ad hoc select committee is a Committee that exists for only one parliamentary session.

<sup>15</sup> 2nd Report, Session 2005-06, HL Paper 174, para 7.

- Regulators' promotion of competition within domestic industries and the regulators' effect on the UK economy's international competitiveness; and
  - Regulators' use of Impact Assessments.
- 2.20. With our Call for Evidence released we set out to take a substantial amount of oral evidence from the regulators themselves, representatives of the regulated industries and other interested parties.<sup>16</sup> A second Call for Evidence, expanding on some of our economic lines of questioning, was released in May 2007.<sup>17</sup>
- 2.21. August and September 2007 brought a liquidity crisis at Northern Rock, which ultimately led to the first run on a bank in Britain since 1866.
- 2.22. Inevitably, the Northern Rock crisis casts a new light, and indeed casts doubt, on the claims of financial regulators to prioritise effectively their supervisory activities, especially for such major financial institutions as Northern Rock. It also raises questions of the effectiveness of joint working between the FSA, HM Treasury and the Bank of England.
- 2.23. We have not been able to consider these events in this Report. Neither time nor our self-imposed terms of reference would have permitted the full examination that their importance required. Furthermore, in September 2007, the Treasury Select Committee in the House of Commons launched an inquiry into Financial Stability and Transparency and began to take evidence on the Northern Rock crisis. To date, the Treasury Select Committee has taken oral evidence from the Bank of England, the Financial Services Authority, Northern Rock and HM Treasury. That Committee will publish its Report in due course. Meanwhile, evidence taken can be found on their website.<sup>18</sup>

### Structure of this Report

- 2.24. In Chapter 3 of this report we consider the nature of the regulators' various statutory remits and make a judgement on whether or not any re-writing needs to be done.
- 2.25. Chapter 4 looks at how regulators work in terms of self-discipline and self-evaluation. We consider the extent to which regulators provide value for money, make use of light-touch, risk-based or principles-based regulation and take seriously the process of carrying out Impact Assessments (IAs).<sup>19</sup>
- 2.26. Chapter 5 examines regulators' relationships with their regulated industries and end consumers. We take a close look at how consumer interests are considered by regulators and we summarise our findings on the concept of the "public interest".
- 2.27. Chapter 6 covers regulators' relationships with each other and with their sponsoring departments. We look at the extent to which best practice is

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<sup>16</sup> For a full list of witnesses see Appendix 2.

<sup>17</sup> For both calls for evidence see Appendix 3.

<sup>18</sup> [http://www.parliament.uk/parliamentary\\_committees/treasury\\_committee.cfm](http://www.parliament.uk/parliamentary_committees/treasury_committee.cfm).

<sup>19</sup> An Impact Assessment (IA) is a tool for ensuring that new regulation is necessary and carried out with minimum burdens. It is similar to the previous Regulatory Impact Assessment (RIA) but designed to offer a simpler and more transparent process. The new Impact Assessments process was announced by the Government on 2 April 2007, and from November 2007, policy makers are expected to use the new IA format.

shared between them and consider the effectiveness of concurrency arrangements.

- 2.28. Chapter 7 brings together our inquiry and looks in detail at competition and competitiveness issues. We ask whether regulators have successfully promoted competition in the sectors they regulate and whether, having done so, they are de-regulating in areas where it is proper for them to do so. We also look at the issue of competitiveness and consider the extent to which regulators, collectively, impact on the competitiveness of the UK economy. Lastly we ask whether it will ever be possible for sectoral regulators to disappear completely and transfer their essential functions to the competition authorities.

### CHAPTER 3: STATUTORY REMITS

- 3.1. As Chapter 2 explained, the regulators within the scope of our inquiry<sup>20</sup> were set up at different times, under different governments, with different statutory remits. Philip Cullum, of the National Consumer Council, said in relation to the statutory duties of the regulators that “It is a bit like cutting open a tree and seeing the rings ... you can tell which statute was passed when by the way in which it has been written” (Q 370). The table below outlines the current name of each regulator, year of inception in its current form, the primary enabling legislation and, where applicable, its immediate predecessor.

**TABLE 1**

**Regulators’ years of inception and establishing legislation**

<b>Name of Regulator</b>	<b>Year of Inception</b>	<b>Legislation</b>	<b>Predecessor regulator</b>
Postcomm	From 2000	Postal Services Act 2000	N/A
The Water Services Regulation Authority (Ofwat)	From 2006	Water Industry Act 1991, as amended by Water Act 2003	Director General of Water Services
Office of Gas and Electricity Markets (Ofgem—governed by Gas and Electricity Markets Authority)	From 2000	Utilities Act 2000	Directors General of Gas Supply (Ofgas) and Electricity Regulation (Offer)
Civil Aviation Authority (CAA)	From 1972; economic regulation of airports from 1986, regulation of Air Traffic Services from 2001	Civil Aviation Act 1971, replaced by Civil Aviation Act 1982. Airports Act 1986 (for economic regulation of airports) and Transport Act 2000 (for regulation of air traffic services)	N/A
Office of Communications (Ofcom)	From 2002; empowered December 2003	Communications Act 2003	Several, inc Director General of Telecommunications (OfTel)
Financial Services Authority (FSA)	From 1997; Banking supervision and investment services merged into the Securities and Investments Board which was absorbed into the FSA	Financial Services and Markets Act 2000	Many, inc. Building Societies Commission, Personal Investment Authority

<sup>20</sup> Hereafter referred to as ‘the regulators’ or ‘regulators’.

Office of Rail Regulation (ORR)	From 2004 (with a board structure)	Railways Act 1993, as amended by the Railways Act 2005	N/A
The Pensions Regulator (TPR)	From 2004	Pensions Act 2004	Occupational Pensions Regulatory Authority (OPRA)
Office of Fair Trading (OFT)	From 2003 (with board structure)	Powers most recently codified by the Enterprise Act 2002	Director General of Fair Trading
Competition Commission (CC)	From 1999	Competition Act 1998	Monopolies and Mergers Commission

- 3.2. We gave ourselves the task of looking at these very different regulators collectively. Our obvious starting point was the legislation that set their statutory remits: are their remits rigidly sector-specific or do they set them similar aims and objectives? How have the different remits worked in practice? Have they proved satisfactory for the regulators and those they regulate? In summary, should Parliament still be satisfied that they enable the regulators to do the job it requires of them?
- 3.3. The purpose of this chapter is fourfold: to assess what constitutes an effective statutory remit for a regulator; to outline the similarities and differences between the statutory remits of the regulators; to make a judgement on whether they are suitable for the purpose intended or whether they need revising; and to examine the extent to which the regulators interpret them appropriately and effectively.

### **What constitutes an effective statutory remit for a regulator?**

- 3.4. All the regulators stressed that they were “creature[s] of statute” (Q 43). They lived by the legislation that established them and all were mindful that they must not stray from the duties prescribed by Parliament. The statutory remit of a regulator is therefore crucial to the success of its operations. In this context we felt it important to seek opinions on what constitutes an effective statutory remit.
- 3.5. The regulators were unanimous in their belief that clarity was the most important quality a statutory remit could have (Q 25, Q 191, Q 772, Q 799). Clarity enabled regulators to readily understand their purpose “so that [they] do not march off, wandering around trying to work out what [they] are for” (Q 25) and to focus their mind quickly on the work in hand.
- 3.6. In addition, clarity in a remit brought other major benefits:
- Increased legitimacy for the regulator;
  - Greater consistency in regulators’ decision making;
  - A greater likelihood of an internally well-organised, well-run regulator;

- Greater opportunities to monitor regulatory performance successfully (p 594); and
  - An increased ability for regulated industries and consumers to judge the legitimacy and appropriateness of regulatory policies and actions.
- 3.7. Regulators were most likely to be effective when they are working towards limited and relatively narrowly defined duties and objectives (Q 1, p 594). Where a regulator was handed an unclear remit, comprised of broad and imprecise duties, it would necessarily have to exercise broad discretion over how it handled that remit and, in a worse case scenario, objectives which Parliament intended to be central to that regulator's work could fall by the wayside (p 594).
- 3.8. Even where the statutory remit of a regulator is clear in prescribing well defined duties there can be problems when the regulator is given no statutory guidance on how to prioritise those duties. There is an acknowledgement that the regulators are required to fulfil a range of duties and pursue a variety of different objectives which may not be consistent with one another and that occasionally this can produce conflicts (Q 337, p 207, p 602).
- 3.9. BAA<sup>21</sup> has suggested that the CAA's remit suffers from this problem—"there is no explicit weighting of these statutory duties. This can lead to regulatory uncertainty when conflict arises between the statutory duties" (p 354). The Department for Transport (DfT) recognise the same problem in the ORR's remit—"In taking its decisions, ORR has to reconcile a raft of statutory duties, which do not have a hierarchy of priority and may pull in different directions" (p 402). Several witnesses have also commented on this problem in relation to Ofgem (Q 429, p 227, p 520, p 532). Indeed, Ofgem itself recognises that "there is arguably [a] clash between [its] social and [its] environmental" duties (Q 110).
- 3.10. It is also important that regulators' remits are not continuously expanded. We were told that there is a danger that regulators could become overloaded and unfocused as a result of ongoing extensions to their remits, often not related to their economic function but to social and environmental concerns. Nick Goodall, of the Energy Networks Association (ENA), made this point in relation to Ofgem, saying that "It may be that in due course broadening Ofgem's range to cover a wider palette of issues ... is perhaps too much to ask of a regulator" (Q 427). In particular, it was felt that government should be very careful in ensuring that it is not expanding the remits of regulators to avoid tackling politically sensitive issues itself. As the Association of Electricity Producers said, "it can be very tough for a regulator to have put on its desk the very same problems that politicians have to wrestle with when they are trying to reconcile different strands of energy policy" (Q 429). Their point was clearly made in relation to energy policy and Ofgem but is still valid in relation to other sectors and regulators.
- 3.11. When the original privatisation statutes were put in place, the regulators' duties were more focussed than they are now on their economic roles of regulating monopolies, promoting competition and setting prices. Determining which policy issues were for government and which for regulators was therefore relatively clearcut. However, the later increase in the importance within the regulators' roles of other duties (particularly social and

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<sup>21</sup> Formerly the British Airports Authority.

environmental duties) means that there is now a less clear distinction between what policy issues should be dealt with by government and which by regulators. Such an expansion of duties, along with a lack of clarity about the respective roles of government and regulators, can arguably reduce the effectiveness of the regulator, create regulatory uncertainty and risk compromising the independence of the regulator.

3.12. This problem can be (and to some extent has been) ameliorated by the issuing of statutory guidance by the government to the regulators. For instance, Ofwat's written submission explains:

“The Secretary of State and the Welsh Assembly Government also have specific roles in relation to some of our functions. In particular, they provide social and environmental guidance. This includes guidance on matters relating to the approval of companies' charges schemes and the environmental and drinking water quality programme needed to deliver the United Kingdom's obligations” (p 101).

3.13. **We conclude that:**

- **Independent regulators' statutory remits should be comprised of limited, clearly set out duties and that the statutes should give a clear steer to the regulators on how those duties should be prioritised.**
- **Government should be careful not to offload political policy issues onto unelected regulators.**

**What are the similarities and differences between the regulators' various statutory remits?**

3.14. The table below analyses, in crude form, the similarities and differences between the regulators' statutory remits in the areas with which this inquiry was especially concerned:

**TABLE 2**  
**Summary of Economic Regulators' Statutory Duties**

Statutory Duties	Ofcom	Ofwat	ORR	Ofgem	CAA	Postcomm	FSA	TPR	OFT
Further/Protect the interests of consumers	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Further/Protect the interests of citizens	Yes	No	No	No	No	No	No	No	No
Protect specified vulnerable groups	Yes	Yes	Yes	Yes	No	Yes	No	No	No
Promote competition	Yes	Yes	Yes	Yes	No	Yes	No	No	Yes
Facilitate market innovation	Yes	No	No	No	No	No	Yes	No	No
Encourage market investment	Yes	No	Yes	No	Yes	No	No	No	No

Maintain security of supply	No	No	No	Yes	No	No	No	No	No
Maintain the competitive position of the UK	No	No	No	No	No	No	Yes	No	No
Implement the 5 principles of good regulatory practice <sup>22</sup>	Yes	No	No	Yes	No	No	No	No	No
Facilitate the development of self-regulation	Yes	No	No	No	No	No	No	No	No
Promote public awareness	Yes	No	No	No	No	No	Yes	Yes	Yes
Carry out impact assessments	Yes	No	No	Yes	No	No	Yes	No	No
Provide advice to the government	No	No	No	No	Yes	Yes	No	No	Yes

3.15. There are several notable similarities between the remits though it is perhaps the breadth and depth of the differences between them that are most striking.

3.16. The only duty common to all the regulators is the duty to further/protect the interests of consumers. Beyond this, it is a mixed picture. No regulator, bar Ofgem, has a duty to ensure security of supply. No regulator, bar Ofcom, has a duty to further/promote the interest of citizens, though many have to protect the interests of consumers present and future. All the regulators, bar the CAA, the FSA and TPR have a duty to promote competition, but the FSA is the only regulator to have an obligation under the “principles of good regulation” prescribed by the FSMA, to maintain the competitive position of the UK.

3.17. Sometimes these differences between statutes are readily understandable and relate to differences between sectors. For example, Ofcom and the FSA have a duty to prevent/reduce crime, a particularly pressing concern in financial services. Ofgem has a particular duty to ensure security of supply in a sector where security is regarded as particularly important.

3.18. In other places the differences seem more like anomalies. Why, for example, does the CAA have no responsibility to promote competition? Why do only Ofcom and Ofgem have a duty to complete impact assessments? Why is the FSA the only regulator to have an obligation to maintain the competitive position of the UK? Why do only Ofcom and Ofgem have the duty to implement the five principles of good regulatory practice?

<sup>22</sup> The five principles of good regulatory practice were originally set out by the Better Regulation Taskforce, now the Better Regulation Executive, in 1997. They are: Proportionality, Accountability, Consistency, Transparency and Targeting. More information on the BRE can be found on their website at: <http://www.cabinetoffice.gov.uk/REGULATION/>

3.19. The statutes have grown up over time—it was never intended that all regulators would have exactly the same remit. In the next two sections we consider whether this has resulted in a satisfactory statutory framework. Do the statutory remits of the regulators need re-writing in any way?

*Are the statutory remits of the regulators suitable for the purpose intended?*

3.20. Most of the regulators seem content with their statutory footing. There was a widespread feeling that they know what they are set up to do—as Ofcom put it “we know very clearly what we are for and we know very clearly what we are supposed to be trying to achieve” (Q 25). Postcomm praised the clear hierarchy of duties prescribed in its remit (Q 56), as did TPR (Q 191), the OFT saw the framework it operates in as “very satisfactory” (Q 230) and the FSA claimed to be “absolutely” happy with the Act that established it (Q 309). Those regulators that had had the principles of better regulation incorporated into their newer statutory frameworks felt that this had been a constructive development (Q 25).

3.21. Other witnesses have agreed with the regulators’ assessment of their statutes. The Mail Users’ Association (MUA) believes that “Postcomm’s statutory remit is coined in succinct enough terminology to provide it with a clear rationale within which to carry out its duties” (p 320) and Allan Asher of Energywatch, saw Ofgem’s remit as “for an economic regulator entirely appropriate” (Q 410). Although witnesses agreed that the system for regulating the rail industry was complex, almost all believed it worked—“despite its complexity it works quite well” (Q 537). Likewise there was recognition that the CAA’s remit was dated but nevertheless witnesses were not clamouring for change—“You could change and update it. I do not think it would bring huge benefits in terms of changing the way they would regulate us” (Q 566).

3.22. There are however obvious anomalies and there is a feeling that, if Parliament was given the opportunity to start again and re-draft all the statutory remits for the regulators, there would be a different end result. The CC’s view is representative of the submissions on this point—“the regulatory and competition institutional structure is rather complicated. It came into being over time, for a variety of reasons, and I dare say, if you were starting again with a blank sheet of paper to plan the ideal system, you would not produce what we have” (Q 252). In addition to this general sense that the statutes could be improved there are a couple of specific problems with individual statutes.

3.23. As mentioned earlier, the legislation establishing the CAA is dated. As BAA explained: “The Airports Act is 21 years old and it has not been changed. All the other utility regulators have had their statutory objectives changed, so we are looking at an Act that has not been adjusted for quite a long time” (Q 560). The issue here has not gone unnoticed by the Government and the Aviation Minister, Gillian Merron MP, outlined their response to concerns, “the airport regulatory regime is over 20 years old, so to say it is in need of a bit of smartening up, I think, would be putting it appropriately. We have agreed, as the House of Commons Transport Select Committee inquiry suggested,<sup>23</sup> to undertake a strategic review of the role and the remit and the objectives of the CAA, and we would seek that to be complete in terms of its

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<sup>23</sup> The Work of the Civil Aviation Authority, 13th Report, Session 2005-06, HC 809

role and duties by 2008” (Q 617). We look forward to the outcome of this review.

- 3.24. In a significant departure from the feeling that the regulators’ remits are generally satisfactory, there are differing opinions on whether Ofwat’s statutory remit is suitable for the purpose intended. Ofwat itself expressed doubts. It felt that the Water Act 2003, and in particular the Costs Principle enshrined in the Water Industry Act 1991 (and updated in the Water Act 2003), places significant constraints on its ability to introduce competition into the industry (Q 158). Ofwat is currently conducting a review into competition in the water industry and it “believe(s) that when [it has] considered [its] role ... there will be issues which relate to the constraints imposed by the legislation passed in 2003, which constrain the particular approach being taken in water to competition” (Q 158).

*Do the remits need re-writing/tidying up?*

- 3.25. The remits of the regulators are not set in stone. Since 1998, some significant tidying up of regulators’ statutory remits has been undertaken, as Tony Prosser, Professor of Public Law at Bristol University, reminded us—“The tidying up of the statutory duties of the utility regulators since 1998, with the creation of a common primary duty to protect the interests of consumers, wherever possible by promoting effective competition, plus a number of subsidiary duties, is a welcome clearing up of what was previously an untidy mix of different duties with an uncertain relationship between them” (p 592). We were interested to hear witnesses’ views on whether any further statutory tidying up was necessary.
- 3.26. In oral evidence to us Sir John Bourn, Comptroller and Auditor-General, suggested that there might be a case for recommending a further tidying up bill—“what we might think about is a kind of bill which tidies up the removal of very often provisions which have had unintended consequences which have led to surprising results” (Q 729). Such a bill could conceivably correct any anomalies in the current framework and ensure greater consistency between the statutory remits of the different regulators.
- 3.27. Most other witnesses, however, did not feel there was a need for such a bill on the grounds that the end result would not justify the time and effort that would need to be put in (Q 766). Above this there was a feeling that a one size fits all model would not be appropriate for regulators’ enabling legislation. The regulators themselves were strongly resistant to the suggestion that they should all be shoehorned into a common statutory framework. Sarah Chambers of Postcomm seemed to speak for all those present at the regulators’ roundtable<sup>24</sup> when she said, “The idea of putting everybody into a common format is not the right way to do it at all” (Q 803). Philip Fletcher of Ofwat expanded on why the regulators were of a common mind on this issue; “I would suggest that there are great doubts about whether just simply trying to force all the regulators into precisely the same statutory mould is the right way to go. It would create a lot of confusion ... I suppose it may look complacent but “if it ain’t broke, don’t mend it” is not a bad principle” (Q 800). The *status quo* was deemed by the regulators to be satisfactory.

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<sup>24</sup> Held in public session, on 19 June 2007

3.28. **Our evidence suggested that, on the whole, the legislation is thought to be working well and the regulators and regulated industries are satisfied with its provisions. Although it is clear that the current framework is not what would now be devised were it possible to start again it serves its purpose. We do not, therefore, recommend the drafting of a tidying up bill. However, we recommend that, as the opportunity arises, further standardisation of regulators' remits should be introduced with the aim of ensuring that they are statutorily required to follow best practice.**

*Do the regulators interpret their remits appropriately and effectively?*

3.29. Regulators are given a remit by Parliament and are required to carry out the duties outlined in that remit. How they go about fulfilling their statutory duties is, however, largely up to them. A well thought out remit is not sufficient on its own—it requires well thought out implementation to be effective.

3.30. The regulators themselves recognise the issue here. They acknowledge that they consciously take the essence of their remit and turn it into something more practical and workable on the ground. Ofcom said that it “turn[s] [its] general remit ... into practical action on the ground” (Q 37), TPR claimed to “have taken [its] broadest statutory remit and ... developed a series of regulatory themes” (Q 194), the FSA has “interpreted [its] objectives into two, what [it] call[s] ‘strategic aims’” (Q 283).

3.31. Most regulators seem to be doing this effectively; we have heard few complaints. Paul Plummer’s (Network Rail) comment is representative of the sum of evidence we have heard on this issue—“we have no problem with the way in which they take their statutory duties and translate them into their overall aim. We think their aim at that level is entirely appropriate” (Q 546).

3.32. The only general criticism made by some witnesses was that the regulators could be more transparent about the way in which they prioritise their duties and allocate resources. This comment was made particularly with reference to Ofgem. The Association of Electricity Producers felt that “Ofgem need[ed] to be clearer as to how it reaches a balance between its many objectives ... [and] need[ed] to be more transparent as to why it allocates resource between aims in the way it does” (p 221). British Energy agreed with this view—“Ofgem needs to be more transparent in the way in which it prioritises its aims and objectives and how it allocates resources to these” (p 503).

3.33. The one significant exception to this general picture was Ofwat. Witnesses who commented were unhappy with the way in which Ofwat interprets its remit. Albion Water placed the blame for the lack of competition in the water industry squarely on Ofwat and its interpretation of its remit—“Why has Ofwat so signally failed to discharge its duty to promote competition? The problem lies not with the legislation, as Ofwat contends, but with its implementation” (Q 432). Jerry Bryan, speaking on behalf of Albion, went on to say “Ofwat has yet to explore the full extent of its statutory powers ... I have yet to be convinced that a reasonable interpretation of statute would in any way constrain it” (Q 433). Other witnesses agreed with this view including Jeanne Golay of Water UK who felt that “The statutory remit as such could be used to much greater effect before it is decided that it needs changing” (Q 436) and Peter Hooker of the Major Energy Users’ Council

who criticised Ofwat for concentrating “too heavily on its duty to finance efficient companies” at the expense of customers (Q 434).

- 3.34. Ofwat itself strongly rebut the suggestion that it has mis-interpreted its remit. We discuss this issue fully in Chapter 7 when we consider the current lack of competition in the water industry in more detail.
- 3.35. **It seems that most of the regulators are interpreting their remits both appropriately and effectively. As an exception to this general picture there is a question mark over whether Ofwat has explored the full extent of its remit and whether it has implemented that remit effectively.**

## CHAPTER 4: HOW REGULATORS WORK—SELF-DISCIPLINE AND SELF-EVALUATION

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- 4.1. The next three chapters are concerned with different aspects of the way in which regulators work. This chapter looks at how regulators manage their internal operations—the following two look at their external dealings. This chapter is particularly concerned with how the regulators impose discipline on their internal operations and with how they evaluate their work.
- 4.2. As regards the first concern—how they discipline their operations—we took evidence from regulators and the regulated around three central questions: do the regulators provide value for money in terms of the efficiency of their operations? Have they succeeded in avoiding excessive bureaucracy? And have they prevented regulatory creep? As part of considering the extent to which regulators are striving for efficiency and utilising their resources effectively we also took evidence on what use regulators make of light-touch, principles-based and risk-based regulation.
- 4.3. In exploring the second concern—how they evaluate their work—we looked primarily at the regulators’ use of Impact Assessment. We enlisted the help of the National Audit Office (NAO) to aid our inquiries in this area and we are very grateful to them for the assistance they have provided throughout the course of this inquiry and, in particular, for the study of the regulators’ use of IAs that they have produced for this Committee. The NAO study is published as Appendix 4 to this report and we refer to it throughout this chapter.

### **Do the regulators provide value for money in terms of the efficiency of their operations? Have they succeeded in avoiding excessive bureaucracy and regulatory creep?**

- 4.4. We have heard evidence to suggest that regulators are conscious of the need to slim their costs (both costs incurred by themselves and costs incurred by the industries they regulate) and to make efficiency savings where possible. Certainly the regulators themselves claim to be trimming their operations wherever reasonably practicable.
- 4.5. Lord Currie of Marylebone, Chairman of Ofcom, gave us a vivid example of this, relating to the position of the Chairman’s office within the Ofcom building—“whereas my office started on the eighth floor it moved to the seventh floor and is now on the fifth floor and our objective for the Chief Executive is to move it down by slimming the organisation over time” (Q 26).
- 4.6. The industries Ofcom regulates are taking note of its endeavours and are pleased with its commitment to providing value for money. Christy Swords, of ITV, said—“I think Ofcom has borne down on their internal costs over the past few years and I think ... They are very conscious of the need to continuously improve efficiency” (Q 483). BT agreed, adding that “[they] support the fact that Ofcom is an ‘RPI-minus’ regulator with its overall budget for the current financial year, 2006/07 5% lower in real terms than the previous year” (p 293).
- 4.7. A number of witnesses welcomed Ofgem’s self-imposed RPI-X cost control as a way of ensuring that its cost regime is efficient. On 1 June 2007, Ofgem

wrote that it had “beaten this price control for the second year running, and [was] now forecasting that [it would] reduce costs by nearly £12 million over the five year cost control period” (p 83).

- 4.8. Despite this, witnesses still raised substantive concerns in this area in relation to Ofgem and also in relation to the FSA. We heard some general criticism of Ofgem’s size and budget and several unfavourable comparisons were made with European energy regulators. The Association of Electricity Producers (AEP) believes that “Ofgem is far too large an organisation for so liberalised a market and the level of regulatory activity is too high” (p 220). Similarly, British Energy, whilst it welcomes Ofgem’s “self-imposed cost control of RPI-3 which is designed to incentivise it to operate efficiently and effectively and to prioritise its work plan”, notes that it “remains one of the most expensive energy regulators in Europe” (p 504).
- 4.9. The Association of Independent Financial Advisors (AIFA) criticised the FSA for increasing its costs, despite its move into principles-based regulation which AIFA would have expected to reduce costs, without providing a proper cost-benefit analysis of the shift in policy—“On principles-based regulation, the FSA have said that this move will cost over £50 million in the next three years but so far we have not seen a cost-benefit analysis of this move, we have just been asked to believe that the journey is worth going on” (Q 583). Others however, noted that the FSA was making efforts to slim its operation and increase the value for money it provides, even if its net overall budget for 2006/07 has increased 3.25% on the budget for 2005/06. Stephen Haddrill of the Association of British Insurers, for example, felt that “The FSA has put itself on a bit of a diet looking forward. I think that is the right thing to do” (Q 583). The FSA itself defended the increase in its budget and pointed out that in the last two years the portfolio of firms that it has to regulate has doubled and it is now dealing with two new sectors—mortgage advice and general insurance broking and mediation (Q 298). The FSA also claims to use its resources in the most cost effective way possible. It explained how it goes about doing this—“The way in which we prioritise how to use our resources is really to say what are the areas of our responsibilities where, if there was a failure, it would have the greatest impact on our constituency, on our consumers, on British consumers, or on the state of markets if it is a wholesale market issue” (Q 298).
- 4.10. The FSA noted that if its remit (and therefore its budget) expands, it is often due to events outside of its control. As Ofcom made clear “It is Parliament and Government that tend to expand the roles of regulators” (Q 41). Additionally, the CAA noted this is not always a bad thing, that it may sometimes make financial sense to increase both the responsibilities and the budget of a regulator—“it may sometimes make sense for a regulator to become a little larger if, at the same time, it is absorbing responsibilities from somewhere else and doing them more efficiently or reducing overlaps” (Q 778).
- 4.11. Regulators all seem to be very careful to avoid leaving themselves open to accusations of engaging in regulatory creep. (The extent to which regulators have been successful in de-regulating in areas where it is possible for them to do so is discussed in Chapter 7). Ofcom’s comments here are representative—“Certainly in what we can do to make sure we do not engage in regulatory creep, one of the things we are doing at the moment is consulting on the Annual Plan and one of the priorities is to look for cases of where we can

remove or reduce regulation” (Q 42). Indeed Ofcom’s written submission to this Committee lays out in detail the areas in which cuts have been made. Occasionally however, as with extensions to their remits, issues of regulatory creep are beyond the control of the regulators. Ofcom noted that the European Union plays a central role in adding to the regulators’ workloads—“I said Parliament and Government can be a cause of the extension of the remit. I left out another major candidate which is of course Europe” (Q 44).<sup>25</sup>

4.12. At the end of July and beginning of August 2007, we gathered data on the operating costs and headcount of the economic regulators (including the competition authorities) for the past three financial years. The information we gathered on the regulators’ operating costs is shown in the table below, and the full results of our research can be found at Appendix 5.

**TABLE 3**

**Total operating costs out-turn by regulator by financial year (£000s)**

Regulator	2004/05	2005/06	2006/07	% increase (decrease) 2004/05 to 2006/07
CAA <sup>1</sup>	78,169	75,860	74,551	-4.63
CC	22,800	26,388	21,617	-5.19
FSA <sup>2</sup>	241,600	256,300	263,700	9.15
Ofcom	121,555	128,986	129,420	6.47
Ofgem <sup>3</sup>	32,919	32,722	35,849	8.90
OFT <sup>4</sup>	51,678	54,845	74,526	44.21
Ofwat <sup>5</sup>	11,196	10,571	11,511	2.81
ORR	13,010	27,829	29,181	124.30
Postcomm <sup>6</sup>	9,026	9,693	8,763	-2.91
TPR <sup>7</sup>	22,599	27,434	31,607	39.86
Totals	604,552	650,628	680,725	12.60

1. The CAA’s figures exclude the costs of its non-regulatory activities. These include costs associated with the CAA’s subsidiary undertakings, the UK Airprox Board, meteorological services, provision of en-route air traffic services, Eurocontrol, administration of the CAA Pension Scheme, EASA transition and sub-letting activities.

2. The FSA’s figures exclude taxation.

3. Ofgem’s figures exclude accommodation costs recharged to tenants. The deductions made are: £3,548k (2004/05), £3,923k (2005/06) and £3,659k (2006/07).

4. Gross operating costs

5. The 2004/05 figures exclude WaterVoice which was part of Ofwat until 30 September 2005.

6. Staff costs are included in total operating costs.

7. Expenditure net of income from out-placed secondees and Pension Protection Fund (PPF) levy collection charges, interest received and tax on interest.

<sup>25</sup> The impact of Europe on regulators’ remits is discussed briefly in Chapter 7.

- 4.13. Comparing the financial years 2004/05 and 2006/07, the data show that some regulators have managed to decrease their operating costs, whilst others have kept increases at low levels. At first sight, the main exceptions seem to be the ORR and OFT, where operating costs have increased by around 124 per cent and 44 per cent respectively. However, further analysis of these results provides useful insights. For the ORR, the great increase in operating costs was caused by the inheritance of a health and safety regulation function from the Health and Safety Executive on 1 April 2006. In the case of the OFT, the apparently large increase in costs in 2006/07 was due to the addition of Consumer Direct to the OFT's responsibilities (representing a cost of around £19 million). The results of our research therefore support the evidence from regulators that increases in their costs and headcount are mainly due to events outside their control.
- 4.14. Three other issues were also raised in response to lines of inquiry related to value for money. First, the question of salaries came up often. Salaries for positions within regulators had been publicly criticised for being too high on occasion,<sup>26</sup> but in evidence to us regulators stressed that if good people were to be attracted to the work competitive salaries had to be paid. Regulators robustly defended their pay structures and they seem to have the support of those they regulate in this. To take one example, Ofcom explained its need to pay market rates for staff—"fulfilling our broad range of responsibilities against the backdrop of such a diverse and quickly changing sector is a complex task that places substantial demands on Ofcom's Board and staff. This means that we need to invest in attracting and retaining people of the highest calibre" (p 15). Orange agreed with Ofcom's approach saying that "[they] recognise that 'good regulation is not cheap regulation'. [They] believe that salaries should be commensurate with those paid in the private sector in order to attract high quality staff" (p 588). The Mobile Broadband Group (MBG) offered similar sentiments—"Ofcom are able to attract people from the private sector and they have moved to Ofcom and then they move back to the private sector. I think that is very healthy" (Q 481). Both regulator and industry recognise the need to attract people from the private sector to the work, and the necessity of paying competitive salaries to achieve this.
- 4.15. Second, some regulators were asked about the extent to which they share services between themselves and the feasibility of extending the scope of these shared services in the future. Currently the only example of shared services is that Ofgem provides an accounting and financial management service, as well as a payroll service, for Postcomm (p 69). When questioned on the subject the ORR felt that there might be scope for more shared services to develop across the regulators—"could we actually do more to combine back office services in terms of for instance HR and finance? That is [an] ... issue and one which might be examined further" (Q 137). Ofgem too committed to exploring the issue further—"We will continue to explore further the idea of shared services with other regulators" (p 69).
- 4.16. Third, most witnesses thought that the relationship between the two competition authorities was working well. The working relationship between

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<sup>26</sup> House of Commons Trade and Industry Select Committee evidence session (Joint Session with the Culture, Media and Sport Committee) on Ofcom's Annual Plan for 2007-08, 17th April 2007. A transcript of the evidence session can be found online at: <http://pubs1.tso.parliament.uk/pa/cm200607/cmselect/cmtrdind/459/7041701.htm>

the two bodies is discussed fully in Chapter 6 but here we note that some witnesses raised with us the potential problem of work being duplicated across the two bodies. Obviously duplication of work impacts on inefficiency and potentially on the bodies' ability to provide value for money. The concern was raised specifically with reference to merger cases. The CC told us that they "do see inefficiency and possible duplication, particularly in mergers, where OFT feel they have to carry the investigation quite a long way down the line before they feel confident enough either to clear it or to refer it" (Q 267). Whilst they did recognise that this was a disadvantage of the two-stage system they felt that it was outweighed by the advantages the system had to offer.

- 4.17. **We have not heard convincing criticism of how regulators approach their commitments to trim their operations and to work as cost effectively as possible. Although the operating costs of regulators have generally increased in recent years this trend can largely be attributed to significant extensions to their remits. We recommend that all regulators' operating costs be routinely kept under scrutiny by a sessional Select Committee, established in line with our recommendations in paras 1.29-1.30, and by the NAO.**
- 4.18. As well as inquiring into the regulators' commitment to providing value for money we were interested to take evidence on how they monitor their own efficiency and how, if at all, they seek to measure their impact on industry, consumers and the UK economy as a whole. The related, though more specific questions of the extent to which IAs are used and their effectiveness are considered at the end of this chapter.
- 4.19. The OFT routinely evaluates the effectiveness of its work through its evaluation programme and is leading the way in terms of the general assessment of the value for money it provides. It told us that "[we] are trying to embed ... evaluation work into [our] casework ... so that over time [we] can do even better evaluation" (Q 233).
- 4.20. It contracts evaluation work out to independent third parties and commissions research in an attempt to analyse the wider impact of its work, beyond its direct impact on consumers. It recently signed a performance framework agreement with HM Treasury for the spending review period 2008-11. The agreement requires the OFT to provide quantitative evidence of how it delivers direct financial benefits to consumers of at least five times that of its cost to the taxpayer across the spending review period (pp 145-149).
- 4.21. Its work in this area has led to it being able to estimate the impact of its competition enforcement work—"A very conservative analysis of the impact of our competition enforcement work suggested it saved consumers at least £750 million over the years 2000-2005 compared to a cost to OFT/CC of £98m over the same period" (p 132). The figure of £98m includes all costs associated with the OFT and the CC, such as building rent and pensions and so represents the full gross cost to the exchequer. The figure of £98m excludes costs to businesses. Although the OFT says that it is mindful of the burden that it may place on business<sup>27</sup> it is not required to publish cost to

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<sup>27</sup> When making interventions the OFT considers the burden they place on businesses by taking their impact on the productivity and efficiency of a market into account in their Prioritisation Criteria. See Point 3 of the Impact Section of their Prioritisation Criteria:  
[http://www.of.gov.uk/sahred\\_of/consultations/oft953con.pdf](http://www.of.gov.uk/sahred_of/consultations/oft953con.pdf)

business estimates and has no plans to start doing so. The figure of £750m covers only the OFT's Merger and CA98 investigation work<sup>28</sup>; it does not cover the benefits of Market Studies, Consumer Protection, Government Advocacy, Market Investigation References, or Scambusting.

- 4.22. In 2006/7, the OFT estimates that the OFT's merger, CA98 and scams enforcement work has saved UK consumers an average of £126m per year. Of this total, £52m is attributed to OFT merger work,<sup>29</sup> £64m to market interventions following CA98 infringement decisions, and £10m per year to OFT actions to stop illegal scams.<sup>30</sup> This compares to OFT internal costs of £1m per year for scams enforcement, £4m per year for merger work, and £23m per year for CA98 enforcement for the financial year 2006/7. A recent evaluation of the OFT "Car Warranties" market study estimated that the total benefit to customers from the OFT's actions had been approximately £120m-170m. These benefits compared very favourably with the £300,000 cost of the original market study and following actions.
- 4.23. The CC, too, has begun to quantify the benefits of its work in terms of avoidance of consumer detriment. It estimates that in 2005/06 its decisions avoided a consumer detriment that would have amounted to over £85 million annually. It would conservatively expect this annual benefit to play out in the market over at least a three year period which would bring the total figure of consumer detriment avoided through their decisions taken in 2005/06 to over £250 million (p 154).
- 4.24. Other sectoral regulators, however, do not seem to have engaged with evaluation work in the same way as the OFT and CC have.
- 4.25. **Regulators should commit to evaluating the impact of their work and monitoring the extent to which they are providing value for money. We recommend that regulators should jointly develop methodologies to quantify the impact they have in line with current best practice represented by the Office of Fair Trading and Competition Commission's methodologies. Whilst we recognise that this is an inexact science we believe that the process of trying to quantify value for money imposes a good discipline and encourages healthy self-evaluation.**

### **What use do regulators make of light touch, principles-based and risk-based regulation and to what effect?**

- 4.26. Recent years have seen a growing concern to reduce bureaucratic excess in all aspects of national and local government. So far as regulation is concerned this has been evidenced by a succession of reports from the Better Regulation Task Force (BRTF) and its successors, the Better Regulation

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<sup>28</sup> See their Report 'Positive Impact 2005': [http://www.offt.gov.uk/shared\\_offt/reports/evaluation/offt827.pdf](http://www.offt.gov.uk/shared_offt/reports/evaluation/offt827.pdf)

<sup>29</sup> The total consumer savings for the UK merger regime as a whole (OFT and Competition Commission) is estimated at £92m (\$184m) per year. Of the savings total for the OFT, £42m (\$84m) is due to undertakings in lieu of a Competition Commission reference taken by the OFT, and the remaining £10m (\$20m) acknowledges the OFT's role in consumer savings resulting from mergers blocked or amended by the CC following a reference.

<sup>30</sup> The figure for scams goes back only to June 2005, the date of inception for the OFT's specialist scams unit.

Commission and Better Regulation Executive, by the Hampton report,<sup>31</sup> and by the work of the NAO. The five principles of good regulation, first developed by the BRTF in 1997, have become firmly established in every regulator's mind and are often enshrined in codes of practice. These include the principles of proportionality and targeting, both of which address aspects of efficiency.

- 4.27. We were therefore interested to discover how rigorously regulators pursued efficiency in both its narrow and broad applications.
- 4.28. We identified four outcomes of efficiency which we note in widening order of their impact:
- the most efficient use of regulators' resources to achieve the desired goals;
  - regulatory intervention designed to minimise the burden on those regulated;
  - the development of regulatory solutions which can be easily understood and applied by consumers; and
  - the design of regulatory goals to achieve the greatest benefit to the economy.
- 4.29. These necessarily overlap and while we were clear that the second and third elements did not fall directly within our remit we saw no benefit in a hair-splitting attempt to define precise dividing lines. In this section we look at the first of these aspects, with implications for the second. The next section on IAs focuses on the fourth with implications for each of the first three.
- 4.30. The Better Regulation Executive (BRE) provides a definition of light-touch regulation. It writes that "Better Regulation is about providing protection whilst minimising the cost to business, the public and third sectors ... To this end, the Better Regulation Executive is working to change the culture of regulation in the UK towards a light touch approach that regulates only when necessary and keeps protections high, but burdens low".<sup>32</sup> In Chapter 7 we discuss the extent to which regulators have successfully promoted competition and deregulated when appropriate, consistent with light-touch regulation.
- 4.31. The greater focus coming from the reports of the BRTF and its successors has added to the term light-touch more specific references to risk-based regulation and, more recently, to principles-based regulation. However, we were surprised to find that despite the widespread support for these concepts, few regulators had specific procedures to implement them. Sir John Bourn told us that "a further challenge for the future is to really make something of risk based regulation. Everybody says that that is what they want but what does it actually mean?" (Q 710).
- 4.32. The notable exception to this observation was the FSA, which has taken a lead in both defining how it uses these terms and implementing them in practice. The NAO commented that "As a result of its success in creating a

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<sup>31</sup> Reducing Administrative Burdens—Effective Inspection and Enforcement, HM Treasury, April 2005. The Report can be found online at: <http://www.hm-treasury.gov.uk/media/7/F/bud05hamptonv1.pdf>

<sup>32</sup> Better Regulation Executive, [www.betterregulation.gov.uk/help/about.cfm](http://www.betterregulation.gov.uk/help/about.cfm)

common methodology, the FSA in 2007 is an organisation rich in process”.<sup>33</sup> John Tiner, of the FSA, told us “there are two guiding principles about how we do our work. One is what we call ‘risk-based regulation’. That means in the financial services markets there will be failures and there should be failures—that is the essence of a marketplace, and that is the essence of risk transfer which, after all, is what financial services is all about. We do not seek to stop all failures, and that is an important underpinning of how we go about our work. Secondly, we believe very strongly that high level principles create a better way of delivering those statutory objectives in a marketplace which is competitive, vibrant and innovative, than lots and lots of very detailed rules. We will always have detailed rules because we live in a world where that is necessary in some areas and required in others by European legislation. As a way of thinking about regulation, I think we regard principles as being very important” (Q 283).

- 4.33. The FSA website contains a number of thoughtful papers delivered by its Chairman and others on the methodology it has developed for both risk-based and principles-based processes and the NAO report reviews in some detail the effectiveness of its risk-based approach, finding that there was a “relatively strong” correlation between the assessment of risk under the FSA ARROW programme (Advanced Risk-Responsive Operating Framework) and the resources committed.<sup>34</sup>
- 4.34. In the absence of an agreed definition of the terms, for the purposes of this inquiry, we have concluded that in essence risk-based addresses the question of where regulatory effort should be applied, whereas principles-based addresses the question of how it should be applied. Our conclusions on each of the techniques are different, and we deal with each in the following paragraphs.

### Risk-based regulation

- 4.35. We have not heard, nor did we expect to hear, any argument against the concept of applying resources to the areas of greatest risk. The only question has been how to do it. We are aware that all regulators seek to allocate resource according to risk to a greater or lesser extent, but not always on a particularly disciplined basis. The FSA’s ARROW program which it applies to larger companies is built around the assessment of risk under four main headings: environment risks, business model risks, control risks and oversight and governance risks. It represents a carefully thought through approach to the assessment of risk.
- 4.36. **We would encourage other regulators to consider risk-based regulation more explicitly, particularly as a means of using regulatory resources more efficiently.**

### Principles-based regulation

- 4.37. The arguments in favour of principles-based regulation are more nuanced. While the NAO reports that senior executives in larger firms are supportive

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<sup>33</sup> NAO review of the FSA, April 2007, Executive Summary, paragraph 7. The Report can be found online at: [http://www.nao.org.uk/publications/nao\\_reports/06-07/0607500.pdf](http://www.nao.org.uk/publications/nao_reports/06-07/0607500.pdf)

<sup>34</sup> op. cit. paragraph 1.11

of the move, their legal departments are nervous at the loss of certainty that comes from prescriptive rules.<sup>35</sup>

- 4.38. The Association of Personal Injury Lawyers (APIL) told us that “The FSA’s rules are particularly difficult to deal with, as they are not specific. Instead, the FSA takes a principled approach to regulation. We understand that this approach can prevent loopholes in rules being exploited. We have found, however, that this rather broad brush approach means that it is difficult to predict with any certainty the point of view that the FSA will take on a particular issue” (p 489).
- 4.39. We heard also from Citizens Advice that “the [FSA’s rule book] ... operates at a high level leaving firms with a good deal of freedom to interpret them. This would be sufficient if firms were required to do this through public commitments that consumers can hold to account and challenge. However the FSA does not require this commitment in key areas. High level principles without a process of consumer engagement will effectively operate as a sophisticated form of voluntary regulation” (p 388).
- 4.40. The British Bankers’ Association (BBA) told us “while banks are supportive of the concept of principles-based regulation they are not yet certain that the balance between rules and guidance has been struck in the right place” (p 370). Competent implementation of the concept was all important because, as Angela Knight of the BBA noted, “the devil [was] in the detail” (Q 586).
- 4.41. However, it may be too simple to distinguish between wholesale activity, for which principles-based techniques are suitable, and retail, for which they are not.
- 4.42. Ed Balls MP, then Economic Secretary to HM Treasury, summed up many of these concerns when he said “The truth about principles-based regulation is that there is a spectrum and the more you move towards a more decentralised, more atomised, retail direction, the more you will end up needing to have guidance and some form of rule in order to allow people to have the certainty and predictability they need” (Q 651).
- 4.43. He went on to say “Clarity and certainty are to some extent [in tension] with a principles-based approach. There may be an important distinction to be made between a risk-based approach on the one hand, which is absolutely the direction in which we are going, and a principles-based approach, which requires quite strong leadership and is harder when you have a number of small firms who are dealing from the users’ end with regulation” (Q 656).
- 4.44. We see the benefits that could flow from principles-based approaches as regards both the first and the second aspects of efficiency noted in paragraph 4.28. But we sound a note of caution that the principles basis may make regulation less predictable and so increase regulatory uncertainty with the possible consequence of increasing the cost of capital. This concern applies with increasing force as one moves towards smaller regulated businesses which will not have the same lines of contact with the regulator as will the larger ones. Nevertheless, we recognise that principles-based approaches hold out an important opportunity for the regulation, certainly of larger companies, to be significantly less restrictive.

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<sup>35</sup> op. cit executive summary paragraph 8

4.45. **We encourage the FSA to continue its work in this area. We would also encourage other regulators to investigate the scope for replacing detailed rules by a move to a principles-based approach in their own areas of activity, and consumer bodies to monitor consistency. In doing so they could together help to identify the criteria for determining where, in the spectrum described by Ed Balls MP, such an approach could usefully be employed, taking account of the possible consequences for regulatory uncertainty.**

#### **Are IAs an effective regulatory tool?**

- 4.46. Throughout the remainder of this chapter it will be important to remember that the IAs the regulators produce are different from those that Government departments produce. As was noted earlier in this report it is the Government's job to create a policy framework, and to produce IAs as part of the policy-making process, and it is the regulator's job to work within that framework. IAs can be used by regulators as a tool to help them decide how best to implement a policy. They are also a form of protection for the regulated—avoiding excessive burdens, being cost-effective and one means of preventing regulatory creep. Unlike Government Departments, most regulators are not statutorily obliged to produce IAs. The exceptions to this are relatively young regulators—Ofcom, Ofgem and the FSA—which are all required to carry out impact assessments for major regulatory decisions.
- 4.47. Before looking in detail at the use regulators are making of IAs we wanted to take evidence on whether or not witnesses thought they were an effective regulatory tool. In principle, if carried out correctly, would an IA prove beneficial to a regulator when taking an important decision?
- 4.48. Not surprisingly perhaps, most witnesses thought that, in principle, IAs were a good policy-making tool. Various reasons were given for thinking so. Witnesses commented that IAs were useful in informing policy, “IAs are about informing the policy” (Q 117) and helpful in that they allowed for more enhanced scrutiny of regulators' decisions. There was a general feeling that the principles behind the IA process were “quite right and proper”, as the then Minister for Aviation, Gillian Merron MP, put it (Q 640).
- 4.49. As well as being a useful policy-making tool full IAs, that set clear targets and objectives, enable meaningful evaluation of a regulators' work to be carried out through post-implementation impact assessments that measure the actual outcome of the regulatory action against its intended outcome.
- 4.50. Several warning notes were sounded. Some witnesses felt that the successful use of IAs would always be bedevilled by policy makers' temptation to use them to justify policy rather than inform it. It is widely recognised that it is much easier to complete an IA when you have decided what you want to do than it is to complete it as an integral part of making that decision. Ofgem noted the problem here saying that “there is always a danger ... that you get the answer that you want, you work back from that and then you put the assumptions in to give you that answer” (Q 117).
- 4.51. Most witnesses also agreed that the quality of regulatory IAs is affected by the fact that it is very hard to assess the benefits of a regulatory decision. Costs can be assessed and quantified far more readily than benefits. It is particularly hard to measure the benefits of a proposal when they may arise a long time after implementation or when they are liable to come from a

“deterrent effect” (Q 233). BT was among those who called for more clarity over benefits in regulators’ IAs<sup>36</sup>—“A little more being explicit about the benefits rather than the costs of regulation in the IAs in our part of the industry would be helpful” (Q 503)—but both the regulators and a large proportion of the regulated agreed that this is a difficult ask. The FSA put its hands up to this criticism—“The area that we have most difficulty with ... is quantifying benefits. We can do a pretty good job on analysing costs, direct and indirect costs of any regulatory intervention, but to quantify benefits is really difficult” (Q 308) and the Mobile Broadband Group’s comments are representative of those of the regulated more sympathetic to the regulators’ protestations here—“trying to quantify some of the costs and benefits of any particular policy ... It is fundamental but I acknowledge that occasionally it is extremely difficult to do” (QQ 501-502).

- 4.52. The ORR and CAA have concluded that IAs are unnecessary in their industries and they rely instead on full consultation. The regulated industries in these sectors seemed to agree that this was the right approach and expressed no desire for the regulators to start producing IAs. The BAA explained their thinking in agreeing with the CAA that IAs were not necessary in their industry—“Having done them and seen how burdensome they can become, we would not, as a company, recommend regulatory impact assessments in the airport sector, partly because the CAA already does quite a good job of taking into account the costs benefit proposals” (Q 559). The Rail Freight Group felt the same in relation to ORR—“I do not get many regulatory impact assessments coming across my desk. The process, as Paul [Plummer] said, is much better done by the kind of gently-gently approach that the Regulator uses” (Q 538).
- 4.53. Overall however, it seems that in principle, most people believe that IAs are a useful policy-making tool when utilised effectively even if there is a widespread recognition that they are necessarily an inexact science.

### **Are IAs being used to good effect by regulators?**

- 4.54. Having concluded then that most regulators believe IAs to be a useful tool in theory we wanted to explore what use they made of them in practice.
- 4.55. At our invitation the National Audit Office has carried out a review of the way impact assessment is performed by five regulators: Ofcom; Ofgem; Ofwat; Postcomm; and the ORR. These regulators were selected because they operate within broadly similar statutory frameworks; were expected to carry out largely comparable approaches to impact assessment; and all fall within the NAO’s statutory remit. The NAO considered ten IAs, two from each regulator, and employed a “very wide and flexible understanding” of what constitutes an IA, as only Ofgem produces stand alone IA documents. The IAs were assessed against the NAO’s evaluative criteria and the results highlight areas where regulators are generally performing well and others where there is room for improvement.
- 4.56. The results of the NAO study are explored in detail in this chapter but it is interesting to note that before that study had really got underway, when Sir John Bourn gave evidence to the Committee, he was optimistic about its results. Sir John and the then NAO Director of Regulation, Ed Humpherson,

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<sup>36</sup> Others included the Association of British Insurers.

felt that the culture in which the regulators operated should lead to them producing high quality IAs. Ed Humpherson described this culture to us—“the culture in which they operate is one of analysis, consultation, a strong focus on information and evidence” (Q 719)—and Sir John agreed that they were likely to “have a mind which incline[d] them ... to analyse carefully or at least with some degree of care” (Q 719). Was their optimism justified retrospectively once the study had been completed?

- 4.57. The NAO’s Report presents a mixed picture. The overall conclusion of the Report is that “All five regulators have made the impact assessment process an integral part of their policy making process by using it to consult iteratively with their stakeholders”. The Report commends regulators on their ability to consult effectively but also notes that regulators’ analyses of costs and benefits are often weak and that regulators are not comprehensively assessing the impact of policies post-implementation. The NAO’s recommendations are set out in full in the Box below.

### **BOX 1**

#### **Recommendations of the NAO Report**

**A** Whilst working within their statutory duties, regulators should ensure that important decisions are taken on the basis of proportionate, objective analysis as well as stakeholder views. If not, there is a risk that regulators may not fully understand the impacts of the proposed policy or method of implementation. Regulators should, therefore, ensure that the principles of impact assessment are embedded in both their processes and the documents they produce.

**B** In order to improve the quality of impact assessment documents, regulators should:

- produce impact assessments that ensure that key information is easy to find, and either sign-posts or summarises additional analysis or technical information;
- ensure that impact assessments contain a proportionate analysis of costs and benefits using quantitative estimates where they can be made robustly and making clear comparisons between options; and
- set out clearly when and how they intend to measure a policy’s impact.

**C** In order to ensure that the quality of their impact assessments improves, regulators should find a way of sharing good practice regularly. There is already some evidence of this occurring. Ofwat and Postcomm are developing formal, written impact assessment guidance with the cooperation of Ofcom and Ofgem respectively.

- 4.58. The Report found the major strength of regulators’ IA processes was their consultation—“We found that consultation was the key strength in the use of impact assessments of the regulators”. All ten IAs considered were rated as “good quality” in this respect. Examples of good practice were found across all regulators and included the use of focus groups, industry workshops, regional road shows, expert technical groups and input from external consultants.

- 4.59. In the evidence we ourselves took there was widespread agreement that although some improvement has been made, the quality of IAs being produced by the majority of regulators remains poor. Ofwat itself admits that there is a way to go before they could routinely produce good quality IAs. It says that it is not “very good at them yet ... we are not at any point where we think we present a model that others should copy” (Q 187) and Water UK agree that “there is a long way to go on regulatory impact assessment” before Ofwat will be using them in the way that they are intended to be used (Q 471).
- 4.60. Ofwat is not alone. Tim Keyworth, from the Regulatory Policy Institute, thinks that “In general the level of RIAs is very low” (Q 9) and the Regulatory Policy Institute claim that “The average standard of Regulatory Impact Assessment is not good. There are examples of good quality work but it cannot be said that the quality is consistently good across the regulators” (p 598).
- 4.61. In line with these comments, the NAO review found several weaknesses in the regulators’ IA processes. The Report states that “generally regulators’ assessment of costs and benefits was the most significant weakness in the impact assessments we reviewed”. The NAO’s findings chimed with evidence we heard which suggested that regulators frequently adopt too qualitative an approach to filling the content of IAs. This complaint was made by witnesses with reference to more than one regulator. The Gas Forum told us that “A number of Gas Forum members have frequently raised concerns in response to IAs published by Ofgem with respect to the heavily qualitative approach which is generally used” (p 535) and Nokia raised similar concerns with regard to Ofcom—“Ofcom RIAs tend to be most qualitative. Where figures are given to support policy, there is often wide uncertainty” (p 579).
- 4.62. In contrast to Nokia’s comments the NAO found that there were examples of good practice in both of Ofcom’s sample IAs but also found that two regulators [ORR and Ofwat] had serious weaknesses in this area in one of their IAs and altogether a further six from these and other regulators had room for improvement. In six of the sample IAs, cost/benefit analysis was not presented clearly, being spread throughout the IA rather than being contained in a separately titled section. Lack of quantitative analysis was another common weakness. The Report recognised the limitations on accurately quantifying the costs and benefits of proposals but criticised the lack of effort shown by regulators and suggested that, at the very least, regulators should explain why they have not attempted any quantification of costs and benefits.
- 4.63. The Report also criticised the presentation of many of the sample IAs. Of the ten sample IAs considered, six were found to have “room for improvement” because key information was difficult to locate. The Report explains why this was the case—“Key information was difficult to locate within the impact assessments for a number of reasons. They were poorly structured, repetitive and it was sometimes unclear how the different documents making up the impact assessments related to each other”—and noted that the Better Regulation Executive published new guidance in May 2007 on the presentation of IAs to encourage greater conciseness and consistency.
- 4.64. The Report found several weaknesses in the support structures provided to policy teams. Although all regulators provide specialist support and have

some form of internal challenge process, only Ofcom and Ofgem have produced written guidance, although Ofwat is in the process of revising their outdated guidance. Only Ofcom and Ofgem provide formal training to their staff.

- 4.65. Evidence that we took raised three further concerns with regulators' IA processes. The first, and by far the most widely heard, was that IAs are commonly used to justify decisions and are completed merely as a tick-box exercise (Q 355, p 187, p 231, p 244, p 518, p 526, p 536, p 599). Regarded in this light IAs become merely a "defence mechanism to justify what they [i.e. the regulators] think is right" (Q 401). There was a feeling that regulators are "conforming to the letter but not the spirit of the RIA process" (p 461) by completing the documents but not integrating them into the policy-making process (p 374, p 506). The Regulatory Policy Institute extended this complaint by saying that often regulators not only make the decision before they complete the IA but that the decision reflected in the IA is more often than not "that 'something must be done'" and that "'something must be done' implies that 'we must do something'" (p 599), i.e. regulators often start with the presumption that they will take some form of action on a particular issue.
- 4.66. The second concern was raised by the British Chambers of Commerce who feel that IAs often do not adequately take into account the impact of a regulatory decision on small businesses—"One of our major concerns about regulatory impact assessments from a small business perspective is that many of those officials who engage in drawing up RIAs tend not to understand the economics of small businesses" (Q 355).
- 4.67. The third and final complaint was made by Peter Vass, from the Centre for the Study of Regulated Industries, who noted that even where good IAs are produced they are often not well used. More thought needed to go into who had sight of them, when, and what effect they were designed to have—"I think one of the issues is perhaps not that the RIAs are necessarily badly done, but the use of RIAs is poor" (Q 759).
- 4.68. The NAO noted that of the five regulators they reviewed "only Ofcom and Ofgem have a statutory duty to carry out an impact assessment on important policy proposals" and these two are the only regulators within the scope of the review to regularly undertake IAs. In 2006/07 Ofcom and Ofgem published 59 IAs between them—Ofwat, Postcomm and the ORR did not produce any.
- 4.69. The evidence that we took suggests that the regulators that are currently producing a good number of quality IAs are Ofcom, Ofgem and the FSA, which suggests that there is a correlation between a statutory duty to produce IAs and a good quality document emanating from the regulator.
- 4.70. Ofcom told us that it "do[es] regulatory impact assessments in at least 75% of [its] work" and that "that number is rising" (Q 50) and the FSA claimed to "put a lot of effort into [its] market failure and cost-benefit analyses which wraps up into the regulatory impact analysis" (Q 305). It seems that their efforts are paying dividends as witnesses have noted that their commitment is leading to genuine improvement in the quality of IAs being produced. As regards Ofcom, the Mobile Broadband Group (MBG) says "In July 2005, Ofcom published its own views on regulatory impact assessments. They have committed to making IAs integral to policy making rather than a

bureaucratic afterthought and, in general, they do” (p 300). The FSA received similar praise from David Thomas of the Financial Ombudsman Service—“The FSA does genuinely use regulatory impact assessments and cost-benefit analyses in the development of its policy rather than after-the-fact justification of its policy” (Q 615)—and from the London Investment Banking Association (LIBA) which was effusive in its praise—“Overall, our experience is that on all of the Committee’s questions on IAs, the FSA sets the standard internationally and nationally, both in terms of thought leadership and increasingly as regards practical implementation” (p 569).

- 4.71. **We agree with the recommendations of the NAO Review (contained in Box 1 and Appendix 4). We recognise that all the regulators included within that review, and the FSA, have developed good, iterative consultation procedures. However there is room for improvement across the board in regulators’ IA processes. Regulators should strengthen their cost/benefit analyses, using quantitative estimates where they can be made robustly, and should improve the presentation of their IAs with clearer sign-posting and a commitment to conciseness and clarity. All regulatory IAs should include executive summaries to make them more accessible and all should be placed in the public domain. Regulators should ensure that IAs are not used as a tool to justify policy but as a policy-making tool.**
- 4.72. **Furthermore, we recommend that where they have not done so already, regulators should be required to publish their own policy documents setting out the approach they intend to take towards completing IAs. Policy teams should be supplied with written guidance and given formal training.**

### **Assessing regulatory decisions post-implementation**

- 4.73. Nearly all witnesses agreed that post-implementation evaluation was a very worthwhile discipline and should be more widely used (p 367, p 374, p 605). Chris Cummings, from AIFA, explained why post-implementation evaluation was important for industry—“I do think it is absolutely essential that post-implementation reviews are conducted. That brings confidence back to the industry that, for the ideas the regulator has that were justifiable on the way in, the benefits have been accrued and are measurable on the way out” (Q 589). Jon Stern, Research Director of the Centre for Competition and Regulatory Policy, explained how post-implementation evaluation can also be beneficial to the regulator—“having more ex-post evaluations that go back and do look at critical decisions and enable people to learn from their mistakes and build in good practice and identify and not repeat bad practice that is one of the things that we really need to do if we are going to get any kind of real progress on the ex-ante” (Q 757).
- 4.74. However despite this enthusiasm for evaluation, the results of the NAO review suggest that regulators’ performance in completing post-implementation evaluation and monitoring exercises is mixed. Postcomm’s “Pricing in Proportion” IA is cited as an example of good practice but the Report notes that “Only two impacts assessments set out how they would measure the outcomes of the policy changes in detail”. Another three impact assessments stated their intention to do so, and provided some discussion of their criteria for success. It seems that regulators’ are not going about evaluation work in a systematic or proactive way.

4.75. Who should be responsible for conducting post-implementation evaluation? There was some suggestion that whilst regulators should always be responsible for completing the initial IA and integrating it into the policy making process, an external body might produce a more objective, and therefore more useful, post-implementation evaluation document. Jon Stern, for example, suggested that evaluation should “be done by independent people, maybe reporting to a legislative committee” because “One of the difficulties that arises when it is the organisations themselves that do it is that it lacks that degree of independence and objectivity” (Q 757).

4.76. **We recommend that:**

- **Post-implementation evaluation should be conducted with greater frequency and should always be carried out where a step change in regulatory policy has been implemented.**
- **Such evaluation and monitoring should generally be carried out by the regulators themselves, but on occasion an independent body<sup>37</sup> should monitor the quality of evaluation exercises and the objectivity shown by regulators in completing them.**
- **Post-implementation evaluations should always be made publicly available.**
- **The original IA makes clear that a post-implementation evaluation will be completed in cases where it is felt that a post-implementation evaluation would add value. Meaningful evaluation is not possible without clear targets and objectives. The regulator’s original IA should set such targets in anticipation of a post-implementation evaluation.**

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<sup>37</sup> Preferably the proposed sessional Select Committee (see paras 1.29-1.30) or the NAO

## **CHAPTER 5: HOW REGULATORS WORK—RELATIONSHIPS WITH REGULATED AUTHORITIES AND CONSUMERS**

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- 5.1. The first part of this chapter examines the relationships the regulators have with their regulated industries—both with existing firms, where applicable, and new market entrants. We look at the nature of an “effective working relationship” between regulator and regulated and we ask whether regulators’ consultation procedures are working well.
- 5.2. In the second half of the chapter we turn our attention to the relationship between regulator and consumer. We ask whether there is a substantive difference between the “consumer interest” and the “public interest” and whether regulators should be obliged to have regard to the latter. In addition we consider the nature of the “citizen interest” which Ofcom are statutorily required to take account of. The Communications Act 2003 requires Ofcom to “further the interests of citizens in relation to communications matters”. Lord Currie explained how this works in practice—“It does mean that we think not simply about the consumer as an individual purchaser of telecommunications, broadcast services and the like, but we also have an obligation to think of the broader citizen interests in plurality in media provision, for example, in access, widespread ubiquitous access to such services” (Q 796). We consider whether the citizen interest might be a more useful concept than the public interest and whether regulators ought to be statutorily obliged to have regard to it.
- 5.3. We look at the different models regulators have implemented for protecting the consumer interest and we ask whether any particular model is superior to the rest. Lastly, we look at consumer appeals processes, and in particular at the Financial Ombudsman Service.

### **Have the regulators built effective working relationships with the industries they regulate (both with incumbents and competitors)? What is the nature of such an ‘effective working relationship’?**

- 5.4. The evidence we have taken from both regulators and regulated suggests that relationships between the two are good. Exceptions to this are relations between some players in the water industry and Ofwat, and various players in the financial services industry and the FSA.
- 5.5. The regulators all realise that effective working relationships between them and their regulated industries are vital to the success of their operations. Such relationships largely come from good communication and regulators all recognise this and are taking steps to improve communication channels with their regulated industries wherever necessary and possible. Ofgem’s comments are representative—“we set great store by having effective communications with our stakeholders and have recently taken a number of steps to improve them” (p 70). Regulators also recognise that transparency is vital if trust is to be built and maintained between regulator and regulated and so all seek to operate in as open a way as possible as Ofwat made clear—“We seek to communicate effectively and operate transparently. We consult on our forward programme and on all our main proposed policy changes” (p 102).
- 5.6. The regulators’ efforts seem to be paying off. Several representatives of regulated industries have told us that communication channels are working

well and they feel fully consulted and in the loop. To highlight a couple of examples the Network for Online Commerce (NOC) told us that they enjoy “good communications with Ofcom” (p 577) and RWE npower welcomed Ofgem’s “Accessibility and openness to informal discussions” (p 603). The Mail Users’ Association (MUA) thinks that “Following teething problems at start up ... Postcomm has now created an effective communication system between itself and key stakeholders in the industry” (p 321). With the exception of Independent Financial Advisors (IFAs), and some water companies, witnesses did not take the opportunity, offered to them in our Call for Evidence, to criticise their regulator’s approach to maintaining effective relations with them.

- 5.7. Indeed relations seemed so good that we began to entertain concerns that perhaps they are too “cosy”. Jon Stern suggested that regulators become uncomfortable when relations with their regulated industries become too close:

“It has been argued that in England and Wales the relationship between the companies and the regulator has at times become too cosy. I think both sides are aware of it ... both sides, it seems to me, are uncomfortable when it gets too cosy” (Q 752).

He also pointed out that, on occasion, relations were far from cosy—“I would hardly describe the current rows going on of BSkyB and Virgin with Ofcom as cosy” (Q 752).

- 5.8. It seems that regulators are making themselves available for discussion and inviting consultation and their regulated industries are content that their views are heard and welcomed. As mentioned earlier, there are two notable exceptions to this—relations between IFAs and the FSA and relations between some players in the water industry and Ofwat.
- 5.9. We received evidence from many IFAs that was almost unanimously critical of the FSA. Although the Association of Independent Financial Advisors (AIFA) told us that the “IFA profession values the current regulatory regime” (p 365) we have heard from several IFAs who are less positive about current financial services regulatory arrangements.
- 5.10. The IFA Defence Union quoted a section from the House of Lords Constitution Committee’s 2003 Report in their written submission—“Most submissions claimed that the FSA’s bureaucracy is excessive, and state in general terms that the FSA is high-handed and insufficiently accountable” (p 542). The Constitution Committee was summarising the evidence they had heard from IFAs on the FSA—the IFA Defence Union, in their submission to this Committee, say that the Constitution Committee’s summary of the evidence they took still expresses their concerns over the FSA.
- 5.11. Highclere Financial Services said that they believe that the FSA “has failed and continues to fail in achieving [their] objectives”. They go on to criticise the FSA’s size and budget—“The FSA is not only a costly extravagant organisation it is also growing rapidly with a proportionate increase in cost”—and the FSA’s failure to “provide a cost/benefit breakdown regarding the move to a principles-based system”. They claim that the regulator is arrogant and that “this arrogance typifies the relationship between the regulator and authorised firms” (pp 537-539).

- 5.12. The Whitechurch Network criticise the FSA’s risk-based approach, claiming that it is “fundamentally flawed” and that its “long term effect is to open consumers to a growing sector that can side-step rigorous regulation” (p 639).
- 5.13. In oral evidence Chris Cummings, of the AIFA, noted that the FSA, necessarily and in line with its risk-based approach, has very different relationships with the large, and nearly 18,000 small firms, it regulates—“The whole dynamic of the relationship is completely different. A large firm would have a proactive relationship with the FSA: the FSA would come to call and would remain in contact with them. With smaller firms, it is a reactive relationship: We have to contact the FSA” (Q 585).
- 5.14. The FSA seems to be taking steps to address this issue and to ensure that they have made proactive contact with smaller firms, moves which Mr Cummings welcomed—“The establishment of the small firms division has really helped the FSA try to assist small firms” (Q 585). However he also noted that “it is a long journey and they are just starting off. I think there is still a long way to go before they are communicating in a language that small firms can really understand and grapple with” (Q 585).
- 5.15. **We recognise the dissatisfaction of many IFAs with the work of the FSA. We welcome moves by the FSA to improve relations with the large number of smaller firms that it regulates. The FSA must continue to cultivate these relationships.**
- 5.16. Some players in the water industry have criticised Ofwat in evidence to us for not, as they see it, interpreting its remit fully and for holding up the introduction of competition to the water industry. Aquavita, for example, finds it hard to avoid coming to the conclusion that “the actions of Ofwat have, in practice, erected additional barriers to entry and protected incumbents” (p 493). These contentious issues have led to strained relations between regulator and regulated in this industry and to particularly strained relations between regulator and prospective market entrants. These issues are discussed fully in Chapter 7 and so we do not draw them out here.

### **Have the regulators developed satisfactory consultation procedures?**

- 5.17. There are two main ways in which information passes between regulator and regulated. Regulators require information from those they regulate at regular intervals in order to fulfil their regulatory function. In addition, regulators often consult those they regulate for their opinions on proposals to change the way they regulate the industry. We were interested to explore the extent to which these information exchanges work smoothly in practice.

### *Information provision*

- 5.18. Most of the witnesses we heard from on the side of the regulated industries praised the systems that the regulators have put in place for obtaining routine information from them. Such systems were frequently described as clear and well-established. However concerns were raised over the burden that information requests put on regulated industries. On occasion it was felt that regulators asked for too much information in too short a time period and tended to be insufficiently mindful of the pressures that such requests would have on industry.

- 5.19. Orange raised such concerns with us saying that “Ofcom has well established and clear systems for requesting information” but that they have concerns over “the nature and volume of information requested”. They point out that “practical problems can also arise in respect of the quantity of information requested in tight timescales” and stress that “Ofcom should be mindful of the administrative and resource burdens which it is imposing” (p 588). BT echoed these comments saying that they “believe that Ofcom’s information requests are not always proportionate to the issues it is seeking to address and while Ofcom is often willing to discuss ad hoc or investigation-driven information requests, we remain concerned about the burden of providing information and extent of our ex ante regulatory reporting requirements” (p 294).
- 5.20. Similarly, the Royal Bank of Scotland Group (RBSG) said that whilst they “accept[s] and acknowledge[s] the need for regulators to gather sufficient evidence to reach an informed view and thereafter justify any decisions made” they would “welcome discussions with the functional regulators in particular to examine whether there are ways of reducing the information burden placed on businesses in an industry under scrutiny”. Like Orange, they say that timescales can be too tight, thereby placing substantial pressures on industry, and note that the regulators can sometimes ask for information which may already have been submitted—“There can be instances where information appears to have been requested without obvious consideration of evidence submitted earlier in the process” (p 600).
- 5.21. Other witnesses highlighted this problem of the co-ordination of data requests and noted that un-coordinated requests can lead to duplication of effort on the part of the regulated. Christy Swords from ITV said that “Quite often we will have various data requests coming in in different forms for the same kind of data and you think ‘Are people in Ofcom not talking to each other about stuff we may have provided just a few weeks or months before?’” (Q 477).
- 5.22. Witnesses felt that data requests were on occasion un-coordinated and sometimes insufficiently focused. Hamish MacLeod, speaking on behalf of the Mobile Broadband Group (MBG), said that he thought there were “occasions when they are a bit too general and a bit too in the nature of fishing expeditions” (Q 477).
- 5.23. **Regulated industries recognise the need for regulators to receive timely and accurate information on their activities. The regulators should ensure that systems for providing such information work effectively. To enable the success of such systems regulators should ensure that data requests are well co-ordinated and sent out in consistent form and should always be mindful of the burden that their information requests place on their regulated industries. Regulators should strive to keep this burden to the necessary minimum and should always explain and justify why data are required.**

### *Opinions*

- 5.24. Regulators seem to have put a lot of effort into developing their consultation procedures. Witnesses from regulated industries frequently commended the regulators for developing consultation procedures that are thorough, open and continually improving.

- 5.25. We have heard no evidence to suggest that regulators' consultation exercises are lacking in depth; indeed, quite the opposite. Jon Conolly, from NATS, praised the CAA's "lengthy and very robust consultation process" (Q 559). George Muir, from the Association of Train Operating Companies (ATOC), described the ORR's consultation procedures as "dauntingly thorough—famously dauntingly thorough" (Q 538). The British Banker's Association (BBA) thought that the "FSA generally communicates increasingly well with the industry and its consultation papers, and discussion papers, while sometimes controversial, are generally well considered" (p 371).
- 5.26. As well as being thorough, regulators' procedures were praised for being open. The Rail Freight Group (RFG) claim to "have found the ORR's processes to be consistently open and consultative" (p 337). The Department for Transport (DfT) notes, in similar terms, that the "ORR appears to have effective, transparent communication channels with the railway industry and its other key stakeholders" (p 402). The MUA spoke warmly of Postcomm's "established three month consultation process" saying that it "allows key stakeholders and postal users the opportunity to submit opinion on any given subject" and that Postcomm follow up this open dialogue with "face to face meetings ... for the purpose of clarification and further exploration" (p 321).
- 5.27. Witnesses from the regulated industries also praised the regulators' commitment to continual improvement of these processes. There is a recognition that communication between regulator and regulated has improved considerably in recent years. The regulated industries welcome this and look forward to building on these foundations with the regulators to create even more effective communication procedures. E.ON UK's comments, whilst they refer specifically to Ofgem and the FSA, are representative here—"In general both regulators [Ofgem and the FSA] put great efforts into effective consultation processes and communicating with companies in their respective sectors. There is also evidence of continuing improvement in these areas, and these efforts are strongly supported by industry" (p 521).
- 5.28. There is certainly a positive story to tell here but it would be wrong to overlook the more critical comments we have received from witnesses from the regulated industries. Four complaints were raised by witnesses in relation to regulators' consultation procedures—some raised doubts over the extent to which regulators took seriously the responses of the regulated; some were critical of timescales imposed on consultations; some complained that the burden consultation exercises put on them was too great; and some felt that, on occasion, certain regulators side-stepped the consultation process altogether when formulating policy.
- 5.29. The most commonly heard complaint was a feeling that regulators did not take the input of the regulated industries seriously. It is a similar problem to that which was raised in relation to IAs—the regulated feel that sometimes regulators have decided what they want to do before they ask the regulated for their opinion. In this situation the responses of the regulated industry are redundant and a lot of wasted effort has been spent.
- 5.30. Orange raised this concern in relation to Ofcom—"questions can arise over the extent to which consultations are genuine ... or whether Ofcom may have already decided on its preferred policy option without properly considering the specifics of the particular issue. On occasion, Ofcom's preferred option

may contradict the findings of its own research, which significantly undermines credibility in the consultation and decision making process” (pp 586-587). The Association of Electricity Producers (AEP) raised it in relation to Ofgem “We sense that consultation is sometimes only undertaken as a formal exercise, with the regulator’s view already decided at the outset” (p 222) and the Federation of Small Businesses raised the concern in general terms on behalf of their members from across various industries—“Many feel that they [i.e. the regulators] are still operating with pre-determined views and that ... the business community is then asked (or brow-beaten) into agreement” (p 186).

- 5.31. Other witnesses, from the electricity industry, pointed out that Ofgem’s consultation exercises put a significant burden on them. The AEP, while welcoming “Ofgem’s willingness to consult effectively” feel that “the level of regulatory activity is so high that excessive burdens can often be imposed on companies”. They note that “In 2006, Ofgem published 218 consultations and other documents, (295 in 2005 and 290 in 2004)” (p 222). The Energy Networks Association (ENA) put in a plea for Ofgem to carefully monitor the amount of consultations it is issuing to ensure that the burden put on the regulated industries is kept within reason—“The number and scope of consultations should continue to be reviewed by Ofgem in order to achieve the minimum level necessary to achieve its objectives” (p 228).
- 5.32. As with information requests, some witnesses were concerned that the timescale imposed on consultation exercises was sometimes too short. Lisa Kerr, from the RadioCentre, raised an example of this in relation the Future of Radio consultation—“complex issues such as the Future of Radio consultation that Ofcom has just launched which is a really fundamental review of the entire sector to which we only have ten and a half weeks to respond” (Q 477). Centrica made the same point in relation to Ofgem, saying that—“The timescale for responding to Ofgem consultations is on occasion too short ... we note that the statutory period for government consultations is 12 weeks. Centrica believes that the major strategic or policy documents Ofgem should adopt this 12 week period” (p 514).
- 5.33. The British Bankers’ Association (BBA) claimed that, from time to time, the FSA introduces new policy initiatives without instigating thorough consultation—“FSA from time to time appears to introduce new policy initiatives through public speeches and letters to Chief Executives ... rather than Consultation Papers”. They cite the development of the Treating Customers Fairly proposals and the FSA’s Principles-Based Regulation approach as examples of this. BBA notes and acknowledges that the FSA may argue that these are “initiatives where they had no formal obligation under FSMA to consult” they suggest that “it would make sense for far reaching changes of this sort to be consulted on at an early stage” (p 371).
- 5.34. **Industry needs reassurance that the time it invests in responding to consultation is time well-spent and is meaningful in the decision-making process. Whilst recognising that, by and large, consultation procedures are working well, we urge regulators to continue to look at ways in which they might be improved. In particular, we recommend that wherever possible regulators allow for at least a 12 week consultation period in their forward planning to give industry a reasonable amount of time to respond to their papers.**

### Should regulators distinguish between the consumer/public/citizen interest?

- 5.35. Economic regulators work within a statutory framework that includes references to the terms consumer interest, public interest and (in the communications sector) citizen interest. There is considerable debate about what these terms mean in practice but it is helpful to offer some broad definitions at the outset. Drawing on a Note from the Government Departments sponsoring the Communications Bill, the consumer interest can be defined as the interest of a purchaser or other user of a good or service, normally based on an economic relationship between the individual and the supplier of the good or service in question.<sup>38</sup> In comparison, the citizen interest may be defined as the interest of the individual in his or her capacity as a member of society<sup>39</sup> and the public interest as the interest or good of society as a whole.
- 5.36. A number of witnesses suggested that there was little practical difference between the consumer interest and the public interest, and by implication no great need for regulators to distinguish between the two terms. One line of argument is that, where regulators are required to act in the consumer interest, the term “consumer” is often defined to include both current and future consumers. If one then adds the fact that the whole population consumes basic services such as water and electricity, there is often little difference between the groups covered by the two terms. Ofwat wrote, “Our duty is to protect the interests of consumers, but given that water and sewerage services are essential to all, we consider the public interest and our duties are closely aligned” (p 103).
- 5.37. Sarah Chambers, of Postcomm made a similar case for postal services: “Our statutory duties, of themselves, do not mention the phrase ‘public interest’ ... in effect though the interests of postal users ... are so wide, and if you interpret that widely to include the interests of postal users for the future as well as the interests of postal users today ... there is very little difference, in practice, between the public interest and the interest of users” (Q 59).
- 5.38. Other witnesses emphasised the overlap between the consumer and public interest by pointing out that both types of interest are usually served by promoting competition. John Fingleton of the OFT told us, “effective market competition generally promotes the public interest, it drives not just efficiency but also consumer benefits ... in general, I would say that a consumer-focused competition test is aligned very closely with the public interest” (Q 240). Similarly, David Newbery wrote that, “competition where possible is an ideal guarantor of the public interest” (p 11). In practice, this was also a view that gradually came to be established in the UK competition regime. Peter Freeman of the Competition Commission told us that “for a number of years before the Enterprise Act [2002], probably ten, maybe 15, the public interest test which the Commission applied was interpreted, essentially as a competition test ... so, in a sense, it had got ahead of the black-letter law. The Enterprise Act made that explicit” (Q 280).

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<sup>38</sup> DTI/DCMS, Note by the Department of Trade and Industry and the Department for Culture, Media and Sport on the meaning of “Customer”, “Consumer” and “Citizen” (June 2002), <http://www.parliament.the-stationery-office.co.uk/pa/jt200102/jtselect/jtcom/169/2070808.htm> (accessed 16 July 2007)

<sup>39</sup> Ibid

- 5.39. However, the Communications Act 2003 specifically relates the promotion of competition to being (where appropriate) the means of furthering the consumer interest. Section 3(1)(b) of the 2003 Act states that it shall be the principal duty of Ofcom, in carrying out its functions “to further the interests of consumers in relevant markets, where appropriate by promoting competition”. Section 3(1)(a) of the same Act provides Ofcom with a separate duty to “further the interests of citizens in relation to communications matters”.
- 5.40. The competition authorities acknowledge that there are some wider interests that cannot be met by promoting competition. Peter Freeman, of the Competition Commission, said “... we are very confident that competition works in the public interest but it does not cover everything, like balance of payments, foreign ownership ... effect on employment” (Q 280). John Fingleton, of the OFT, accepted “that a competition approach cannot deal with every issue, so there are issues like the retail environment, small shops versus ‘out of town’ shopping centres, that competition is not a good instrument to deal with” (Q 240). In addition, he says, “There are some cases, and I think media is a good example of this, where you may want to tolerate some inefficiency, in terms of competition, for wider policy objectives” (Q 240).
- 5.41. Some witnesses went further by suggesting that there was a clear difference between the public or citizen interest on the one hand, and the consumer interest on the other, and that these interests could be in tension with each other and needed to be balanced. John Howard, of the Financial Services Consumer Panel, said that imposing a statutory duty on the FSA to act in the public interest “would be quite a difficult thing in some respects to ... do because the public interest is quite often different from consumer interests, so there might be conflict with some of the other duties that the FSA has” (Q 607). Ofcom wrote that its duty to further the interests of both citizens and consumers meant it “may have to make trade-offs between the interests of individual consumers and the interests of society as a whole” (p 18).
- 5.42. A number of examples were given of ways in which the public and consumer interest might be in tension. Ofcom suggested that placing obligations on broadcasters to provide public service broadcasting and thereby promote a more inclusive society (in the public interest) might not be in the interests of consumers who chose not to watch such programmes (p 18). The Association of British Insurers (ABI) wrote, “There is some tension ... between the FSA’s focus on protecting individual customers, and the broader consumer or public interest. For example, in trying to prevent a customer buying any savings product other than the ‘most suitable’, FSA regulations can mean that many do not purchase any product at all. This may not be in the public interest, if the result is lower than desirable savings rates” (p 372).
- 5.43. Of most fundamental importance is the tension that many witnesses identified between regulators’ reliance on unfettered market forces to carry out their duties, and the need to consider wider social and environmental issues (Q 39, Q 637, pp 572-574, p 592, p 593). By promoting competition, a regulator was likely to be encouraging efficiency and bringing down prices, thereby acting in the consumer interest. However, this was unlikely on its own to meet wider public interest concerns. National Energy Action (NEA) argued that “In the provision of essential services such as gas and electricity the public interest is paramount. Both social and environmental concerns

may be seen to interfere with consumer interest if this is defined in the narrowest possible way as simple economic advantage” (p 573). Ian Pearson MP, then a Minister at the Department for Environment, Food and Rural Affairs (DEFRA), said, “if you have economic regulation that is focused narrowly on the economics you miss all the important externalities, such as the impact on the environment ... There are those wider public interest issues that I do believe need to be taken into account by our economic regulators, while at the same time they have an absolute duty to ensure that they get the best deal possible for customers” (Q 637).

- 5.44. If one accepts that the consumer interest and the public interest differ at times, and that economic regulators should take account of issues that fall outside the scope of the consumer interest, one option would be to introduce a statutory duty for economic regulators to act in the public interest. Sir John Bourn pointed out that “the concept of the public interest—like the accountant’s concept of the true and fair view—is a concept which encourages change and debate ... That is the value of the public interest ... That means of course it has to have some degree of specificity in it” (Q 726). Herein lies the problem. The generality of the concept of the public interest is at once both its strength and its weakness. It encourages debate but most witnesses thought that providing regulators with a duty to act in “the public interest” without further definition or qualification was of little practical use and allowed too much scope for interpretation in the hands of unelected officials (Q 670, Q 706, QQ 797-799, p 523, p 596).
- 5.45. Peter Freeman, of the Competition Commission, said, “we are an independent competition authority and we have a substantial delegation of power from Government ... The danger of giving an authority like us unlimited power to break up companies on the grounds of really quite general and sort of soft public interest, is that I think people would say, ‘Well, that’s too much delegation’ ... I think the old days have gone, in that respect” (Q 280). George Yarrow, Director of the Regulatory Policy Institute, wrote, “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” (p 596).
- 5.46. This does not mean that the regulators should only be concerned with issues of price and quality of service for consumers in the short term. What it does mean is that where regulators are required to take account of wider issues, these objectives should be defined clearly and carefully by Government and Parliament. Most economists would probably agree that competition does not provide a solution to wider objectives, such as social and environmental objectives. It is current practice (frequently enshrined in legislation) for Ministers to issue guidance on social and environmental matters to regulators, which helps to ensure that these wider objectives are properly taken into account by regulators.
- 5.47. We concur with the view expressed by Ed Balls MP: “It seems to me that the job of the regulator is to implement the principal will of the Executive and Parliament in its particular sector, but it is the job of the Executive, accountable to Parliament, to define the public interest, not the regulator. To leave too much discretion to the regulator about objectives is, in my view, not the right way to go” (Q 670).

- 5.48. In practice, this is the model that is now generally adopted for the regulators. The ENA wrote, “It is therefore arguable that, taken in the round, Ofgem’s principal objective and general duties do cumulatively approximate to a concept of the public interest ... and that wider societal concerns of the kind encompassed by the term “public interest” are in fact addressed, or are capable of being addressed, by Ofgem’s activities in relation to the energy sector” (p 229). ORR stated, “It is our view that the public interest is defined by our statutory duties” (p 88), whilst the London Investment Banking Association (LIBA) explained that the “FSA’s responsibilities are established by the regulatory objectives set out in the FSMA: these cover a wider public interest than consumer interests” (p 568). Likewise, David Thomas of the Financial Ombudsman Service said “I wonder whether the objectives that Parliament set for the FSA in FSMA, market confidence, maintaining confidence in the financial system, public awareness, promoting public understanding ... were a summary of what Parliament thought was the public interest in any event in the area that the FSA is operating in” (Q 607).
- 5.49. Regulators can therefore be given specific duties that are considered by Government and Parliament to represent the public interest, without being given a general duty to act “in the public interest”. This takes us back to our conclusions in Chapter 3, where we underlined the importance of providing regulators with clear, well defined duties. A balance must also be struck between providing regulators with specific duties that go beyond the pursuit of the consumer interest, and expanding the range of regulators’ duties to the point at which they become unfocused and inefficient. The scope of regulators’ duties is more likely to be kept manageable if one recognises that matters of social equity and distributive justice are often best addressed, essentially by Government and Parliament, through other means such as the tax system.
- 5.50. **Regulators should normally be expected to be charged with responsibilities which reach beyond consumers to the interests of citizens or the general public. However, their duty to act outside the areas of consumer interest may, and if possible should, be circumscribed by legislation or by social and environmental guidelines issued by ministers in accordance with legislation. The interests of citizens and the general public are for Government and Parliament, and not for the regulators, to define and promote.**<sup>40</sup>

### How are consumer interests protected in the regulatory state?

- 5.51. A number of different bodies have a role to play in protecting consumer interests. Economic regulators usually have a statutory duty to protect the interests of consumers. The companies operating in the regulated sectors are expected to have internal complaints procedures, based on approved codes of practice, which are intended to be the first port of call for dissatisfied customers. If customers remain dissatisfied after exhausting companies’ internal complaints procedures, some consumer bodies will investigate complaints referred to them, in addition to their role in representing consumer views and providing advice and information. Ombudsmen and the courts offer additional routes to redress for consumers with grievances. In

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<sup>40</sup> This recommendation applies to regulators other than the two competition authorities considered in this report (the Office of Fair Trading and the Competition Commission) which, as their written evidence makes clear, have powers and duties under a number of statutes within which they must work.

this section we focus on the role played by regulators, consumer bodies and Ombudsmen in protecting consumer interests.

- 5.52. One of the ways in which economic regulators seek to protect consumers is by promoting competition. In general, witnesses agreed that competition helped to protect the consumer interest. Centrica said, “Ofgem rightly believes that competition in a market acts as the main protection for consumers and seeks only to impose restrictions where necessary” (p 516). David Newbery explained that “Most regulators have a duty to promote competition, and competition has been effective in bringing down costs and prices, notably in telecoms, gas and electricity” (p 11). Millie Banerjee of Postwatch told us, “the very fact that there is competition I believe makes Royal Mail sit up and think about what their costs are, how they are going to operate in the market place, and how they are going to deliver to their customers” (Q 531).
- 5.53. However, some witnesses were concerned that, whilst competition often protected consumers, this was not always the case, and regulators had, on occasion, promoted competition in a way that acted against the consumer interest. BT wrote that “The opening of the Directory Enquiries market was an example of regulatory intervention in the interests of competition despite a clear and continuing consumer lobby that this was not in the interests of consumers” (p 294). Energywatch observed that “Over time, Ofgem’s interpretation of its statutory duties and regulatory principles has evolved to a position where competition is seen as the most effective form of consumer protection and regulation [as] an undesirable last resort. The primary duty to protect customers has not always been well served by Ofgem’s approach to the liberalised energy market” (p 235). It is also important to recognise that regulators have enjoyed varying degrees of success in promoting competition. This is explored further in Chapter 7.
- 5.54. In order to protect consumer interests, regulators must take effective enforcement action if companies infringe sectoral and competition rules. The evidence suggested that regulators had not always succeeded in this respect. Which? wrote that “what we need is better regulation and the FSA to use its existing powers and tools more flexibly and imaginatively to ensure proper enforcement and an effective deterrent for industry” (p 635). Sir John Bourn told us that the NAO’s decision to produce a report on Ofwat was influenced by the fact that “A lot of people were feeling that [Ofwat] did not look after the consumers”. According to the NAO Report,<sup>41</sup> Ofwat “had not been tough enough on the companies, particularly over water leakage” (Q 715).
- 5.55. However, there does appear to have been some evidence of improvement over time, at least in relation to the competition authorities. According to the National Consumer Council (NCC), “Over the years, we have criticised the competition authorities in specific cases, for example when they have suggested weak remedies to tackle market problems ... Some recent interventions are more encouraging” (p 203).
- 5.56. The OFT pointed out that “in the first five years since implementation of the Competition Act 1998, [it] made a number of high profile prohibition decisions ... and imposed fines originally totalling £60 million”. It goes on to say, “A very conservative analysis of the impact of our competition

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<sup>41</sup> *Ofwat—Meeting the demand for water*, published 19 January 2007, (HC 150, Session 2006–07). The Report can be found online at: [http://www.nao.org.uk/publications/nao\\_reports/06-07/0607150.pdf](http://www.nao.org.uk/publications/nao_reports/06-07/0607150.pdf)

enforcement work suggested it saved consumers at least £750m over the years 2000-2005” (pp 130-132). According to E.ON UK, “Ofgem has shown that it is prepared to exercise its powers to combat abuse of dominance and restrictive practices both before and after it received those powers formally under the Competition Act” (p 523).

- 5.57. If regulators are to protect the interests of consumers, they need a way of establishing what those interests are. In the words of the NCC, “Regulators should have the means to listen, understand and give sufficient weight to consumer interests in their decision-making” (p 203). A number of business associations emphasised the fact that businesses can also be consumers but regulators often ignored this (QQ 337-341, Q 435, p 295). Sally Low from the British Chambers of Commerce (BCC) said, “From the perspective of our members ... there is very often a neglect of the small business as a consumer in its own right” (Q 337). A similar message came from Peter Hooker of the Major Energy Users’ Council (MEUC): “We believe that business customers are discriminated against. For example ... Business customers can have their water supplies cut off if they do not pay their bills, and it happens; domestic customers cannot be. Now I understand that this is because of statute but, nonetheless, it is a discrimination and one would expect the regulator, who is not supposed to discriminate, would highlight that with government” (Q 435).
- 5.58. Consumer bodies have an important role to play in articulating the consumer interest, and just as we noted in Chapter 3 that regulators for different sectors were set up at different times, with different remits, the same is true with consumer bodies. The table below shows the consumer bodies that exist in each of the sectors within our remit, the year in which they were established and whether the body is integrated into the regulator or stands alone.

**TABLE 4**  
**Models of Consumer Representation**

Sector	Consumer Body	Est	Model	Predecessor bodies (and models)
Communications	Ofcom consumer panel	2004	Integrated	Advisory Committees on Telecommunications / Telecoms Advisory Panel (Integrated)
Post	Postwatch (Consumer Council for Postal Services)	2001	Standalone	Post Office Users’ National Council (Standalone)
Energy	Energywatch (Gas and Electricity Consumer Council)	2000	Standalone	Gas Consumers’ Council (Standalone)
				Electricity Consumers’ Committees (Integrated)
Water	Consumer Council for Water (CCWater)	2005	Standalone	Watervoice [previously Ofwat Customer Service Committees] (Integrated)

Rail	Passenger Focus (Rail Passengers Council)	2005	Standalone	Old Rail Passengers Council and Rail Passengers Committees (Standalone)
Aviation	Air Transport Users Council (AUC)	1973	Integrated	No comparable predecessor
Financial Services	Financial Services Consumer Panel	1998	Integrated	No comparable predecessor

5.59. In addition to sector-specific consumer bodies, there are cross-sector consumer bodies such as the NCC, Which? and Citizens Advice. The Consumers, Estate Agents and Redress Act 2007, which received Royal Assent on 19 July 2007, provides for the establishment of a new National Consumer Council (NCC), replacing the existing NCC, Postwatch and Energywatch. The Act also contains a power to dissolve the Consumer Council for Water and transfer its functions to the new NCC.

5.60. The table above illustrates the way in which different models of consumer representation had been adopted in different sectors, prior to the recent enactment of the Consumers, Estate Agents and Redress Act 2007. The arrangements for consumer representation in the communications, rail, aviation and financial services sectors remain unaffected by the provisions of the Act. In the communications and financial services sectors, consumer panels have been established. The panels are part of the sector regulator (whilst retaining full operational independence) and assist the regulator in fulfilling its duty to protect the consumer interest. The Air Transport Users Council (AUC) is similar in that it was set up by the CAA to assist it in its statutory duty of furthering the reasonable interests of users of air transport services. The AUC receives its funding from the CAA as an Auxiliary Group within the CAA corporate structure. In post, energy, water and rail, the Government has established standalone statutory bodies to represent the consumer interest.

5.61. The evidence we received suggested that it would be wrong to conclude that one model is superior to another in helping to protect consumers in all sectors. Every regulator justified the model they employed for consumer representation. Regina Finn of Ofwat, said, "There have been several different consumer representation models; they differ from sector to sector and there is an element of horses-for-courses in that different consumer representation models may suit different sectors" (Q 792). Ed Balls MP agreed: "You have to be careful about deciding there is one model for how it should be done ... I think probably the nature of the products and the structure of the industry will shape different approaches in different areas. I do not think that imposing one view is the right way to go" (Q 673). Lord Currie, of Ofcom, told us, "we feel our consumer panel works very well for us, but the general point that different arrangements can work effectively in different circumstances is an important point as well" (Q 793).

5.62. A number of witnesses also pointed out that internal and external consumer bodies are not mutually exclusive. Phillip Cullum of the NCC said, "Our

argument in a way would be to try to get the best of both worlds, which is both to have an internal voice [for consumers] and to have something externally” (Q 373). Lord Truscott, Minister for Energy, argued that “independent consumer advocacy bodies and consumer panels may play different but complementary roles. We believe that there is a good case for deploying these capabilities across sectors within an overall context of seeking to maximise consumer benefit” (Q 701). Peter Tutton, from Citizens Advice, illustrated how the two models complemented each other in the financial services sector: “We feel that the consumer panel in their batting for consumers has a more specialist knowledge which is closer to the decision-making. We can liaise and we put information to the consumer panel and have a dialogue with them. If the consumer panel was not there, it is not like we could fill the gap easily” (Q 610).

- 5.63. Some witnesses expressed concern that, in dissolving Postwatch and Energywatch in favour of a new NCC, the Consumers, Estate Agents and Redress Act 2007 would weaken consumer representation in those sectors. Eddie Proffitt from the MEUC observed that “There has been action in the energy industry and to a great extent we would see a weakness if that is broken up, in other words if Energywatch disbanded and we had a more general representative body, the National Consumer Council, taking on a much wider role where their attention would naturally be spread across a far broader spectrum of problems” (Q 396). Howard Webber of Postwatch said “Postwatch will be merged in the next year or two into the new National Consumer Council which will inevitably have a less focused approach to postal issues” (Q 522).
- 5.64. However, Lord Truscott explained the rationale behind the Consumer Voice provisions in the Act: “This was really about bringing together existing bodies under a new umbrella to ensure that there is more effective advocacy for consumers” (Q 701). The Energy Retail Association (ERA) pointed to the advantages of the new arrangements: “in our view by combining the resources currently used to support sector specific agencies, the new organisations ... will be better able to provide all round support for customers. For example, with the growing concern about indebtedness in the UK, a non sector-specific organisation, such as Citizens Advice ... will provide a more holistic view of tackling debt, including engagement with energy suppliers”(p 270). Clearly, it will be important to monitor the impact of the new arrangements to ensure that consumer interests are adequately protected.
- 5.65. **Different consumer representation models operate in the regulatory state and all the regulators were vociferous in justifying their particular model. However, we believe that stand alone consumer representation bodies are more transparent and more effective.**
- 5.66. **The new landscape for consumer representation has been created by the Consumers, Estate Agents and Redress Act 2007. We are sceptical that the proposed new arrangements will lead to improvements in consumer representation but we recognise that it is too early to judge whether our scepticism is justified. The new arrangements will need careful monitoring and this is a role that might be taken up by a sessional Committee on regulators.**

### Are the consumer appeals processes (Ombudsmen etc) working well?

- 5.67. In contrast to stand alone consumer bodies, consumer panels do not have a complaints-handling role, so there are separate arrangements for complaint-handling and dispute resolution in the communications and financial services sectors. Communications providers must belong to one of the dispute resolution schemes approved by Ofcom. Currently there are two: the Office of the Telecommunications Ombudsman (Otelco) and the Communications and Internet Services Adjudication Scheme (CISAS). In the financial services sector, the Financial Ombudsman Service (FOS) operates the scheme for resolving individual disputes between consumers and financial services firms. A voluntary ombudsman scheme, the Energy Supply Ombudsman, was established in the energy sector on 1 July 2006 in response to a decision from Ofgem (following a supercomplaint<sup>42</sup> from Energywatch) that energy suppliers should establish a scheme to resolve outstanding billing disputes in a fair and independent way.
- 5.68. We did not specifically request evidence on consumer appeals processes such as Ombudsmen, but a number of witnesses made comments about the FOS and the Energy Supply Ombudsman. Witnesses from the financial services industry tended to argue that the scheme operated by the FOS was weighted against them and attracted frivolous and opportunistic complaints. The BBA wrote that “as [the FOS] sees itself as a ‘dispute resolution service’ rather than a non-judicial decision making body then the tendency is for it to seek a compromise which we feel is weighted in favour of the complainant and against firms, rather than a balanced equation” (pp 368-369). According to the AIFA, “The IFA community receives very few complaints, making up only 14% of the complaints received by FOS. Further, of that 14%, more than 70% go in favour of the firm. Yet on every occasion, the firm must pay a case fee” (p 366). The industry associations also told us that “there is a danger with the Ombudsman of creating pseudo regulation” (QQ 587-589) and argued that the FOS should be exposed to the same sort of scrutiny as the FSA (Q 587).
- 5.69. David Thomas, of the FOS, told us that “the Financial Ombudsman Service is part of the statutory arrangements for underpinning consumer confidence in financial services but it is not a regulator, it is an alternative to the civil courts.” He advised that “For an impartial view of the Ombudsman service one could perhaps look to the Council on Tribunals, which within the last couple of months was kind enough to say: ‘The Financial Ombudsman Service has a justifiably high reputation for effectiveness and cost efficiency’” (Q 594).
- 5.70. In contrast to the FOS, the evidence we received in relation to the Energy Supply Ombudsman mostly came from consumer bodies and suggested that the Ombudsman was too weak. The NCC wrote that “Ofgem approved a weak ombudsman scheme developed by the energy industry despite warnings from Energywatch. It has not set any performance requirements and

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<sup>42</sup> A super-complaint is a special type of complaint, defined by section 11 of the Enterprise Act 2002. It is one made by a “designated consumer body” to the OFT and specific sectoral regulators that “any feature, or combination of features, of a market in the UK for goods or services is or appears to be significantly harming the interests of consumers”. Only consumer bodies designated by the Secretary of State for Business, Enterprise and Regulatory Reform (formerly the Secretary of State for Trade and Industry) can make super-complaints. These complaints receive “fast-track” consideration: the regulator must respond within 90 calendar days from the day after the complaint is received.

companies have been given three months to resolve disputes before customers may contact the Ombudsman” (p 202). Energywatch stated that, in support of its supercomplaint, “self-regulatory measures were promised despite being untested and without any regulatory supervision and there was no guarantee that any of the underlying problems would be resolved” (p 237).

- 5.71. The Energy Retail Association (ERA) argued the opposite case. It wrote that “The [Billing] Code is strengthened further by an industry funded Energy Supply Ombudsman Scheme to adjudicate on unresolved disputes between suppliers and customers. Customers can use the service without charge and suppliers are obliged to accept the findings of the Ombudsman, which can make awards of up to £5,000 ... We are keen to work with Ofgem on the creation of an industry-wide self-regulation agreement on handling complaints, and feel that the industry’s work in other areas, such as setting up Codes of Practice and the Energy Supply Ombudsman show our commitment to customers and our ability to self-regulate” (p 232).
- 5.72. Where Ombudsman schemes exist, it is important that they are properly monitored and are seen to be effective.
- 5.73. In the energy sector, the voluntary nature of the Energy Supply Ombudsman scheme is likely to change as a result of the Consumers, Estate Agents and Redress Act 2007 and it would therefore be premature to recommend changes in this area.**
- 5.74. However, we recommend that the Government commission the NAO to conduct a review of the economy, efficiency and effectiveness of the Financial Ombudsman Service (FOS)<sup>43</sup>. The review should include consideration of the extent to which the FOS acts as a “pseudo-regulator” and the effectiveness of the working relationships between the FOS and other bodies such as the FSA and OFT.**

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<sup>43</sup> The FOS was outside of the remit of the NAO’s recent review of the FSA.

## **CHAPTER 6: HOW REGULATORS WORK—COOPERATION BETWEEN REGULATORS AND THE RELATIONSHIP BETWEEN REGULATORS AND GOVERNMENT**

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- 6.1. This chapter is concerned with three different types of relationship—relationships between the sectoral regulators; relationships between the sectoral regulators and the competition authorities; and relationships between both types of regulators and the Government.
- 6.2. In examining these three types of relationship this chapter seeks to answer the following three questions: Do the regulators work together to ensure that best practice is shared and unnecessary duplication of work is avoided? Do the regulators work effectively with the competition authorities and are the concurrency arrangements functioning well? What is the nature of the relationship between regulators and government departments—are the regulators sufficiently independent from the Government?
- 6.3. This chapter also takes a look at the issue of the accountability of the regulators. As explained in Chapter 2, the Constitution Committee of the House of Lords covered this issue comprehensively in their 2004 report. We do not seek to duplicate their work here by covering the issue in detail again. Rather we make recommendations on the arrangements that we believe should be put in place to ensure the ongoing effective scrutiny of regulators' work at the parliamentary level.

### **Do regulators work together to ensure best practice is shared?**

- 6.4. Some regulators have a clear need to work with one another. For example TPR claims to work very closely with the FSA, “we have very structured and regular contacts, as you might expect, with the Financial Services Authority with which we have a great deal of common interest” (Q 225). Such relationships are clearly necessary and are to be welcomed. However, in this inquiry, we were more interested in relationships between sectoral regulators whose paths do not cross so naturally. Is there a need for sectoral regulators to work together? If so, do they do so effectively?
- 6.5. The regulators all seem to believe in the principle of sharing best practice. They think that they have something to learn from each other and in evidence sessions there was mention of a core transferable skills set—“there is a core regulatory skill set which is transferable between different economic regulators” (Q 70).
- 6.6. In theory then, the sectoral regulators are signed up wholeheartedly to the idea of working together. How much of this intent translates into practice?
- 6.7. A Joint Regulators Group [JRG], comprising the regulators that call themselves “economic regulators” (Q 784), does exist and seems to meet fairly regularly, every quarter (Q 136). Minutes of these meetings are published on regulators' websites once they have been agreed by the Group as there is no separate JRG website. The group is “self-started” and there is no ministerial requirement for it to exist (Q 785) so it should be said that the regulators have taken the initiative here. However opinions vary as to the effectiveness of this body, the level of formality it operates at and the opportunities for “joined up thinking” it provides.

- 6.8. The ORR felt that “the JRG and CWP<sup>44</sup> provide sufficient opportunities for co-operation, communication and co-ordination between the sector regulators” (p 88). Others were less positive. More striking than any explicit criticism, however, was the extent to which the Group was simply ignored in evidence. Many of the regulators did not mention the JRG in their written submissions<sup>45</sup> or merely gave it a cursory mention<sup>46</sup>, and other witnesses from the regulated industries said they were unaware of any arrangements in place to enable individual regulators to establish good working relationships with other regulators (p 540).
- 6.9. In addition to joint working through the JRG, individual regulators have sometimes got together to complete mutually interesting pieces of work. Ofgem told us that they have done some joint working with Ofwat—“we recently concluded a joint study with Ofwat that examined a number of important issues (such as gearing levels, regulatory risk and the cost of capital) relating to the financing of networks” (p 70).
- 6.10. The regulators also stressed the value of the informal networks that exist between them. Sarah Chambers, of Postcomm, explained how these networks operate—“the things that really matter as well are the informal networks between us which are ad hoc informal networks but [which are] actually quite strong in terms of sharing best practice ... [and] finding ways to share resources” (Q 784).
- 6.11. So the regulators were broadly positive about the state of relationships between them. Regulated industries and other commentators’ opinions on how successful the regulators’ efforts at joint working had been, however, were largely negative. Although most agreed with David Newbery that “for the public utilities there has been a great deal of learning and establishing precedents” (Q 8), there was a feeling that the learning and sharing had not gone far enough.
- 6.12. The Regulatory Policy Institute thought that although “The working relationships among regulators appear to be broadly satisfactory ... there is no doubt scope for further improvement” (p 595)—an opinion that was shared by many of our witnesses. The Royal Bank of Scotland Group (RBSG) pointed in particular to problems caused by regulators not communicating consistently with one another. They were especially concerned by “the lack of consistency resulting from various regulators pursuing different agendas (or indeed interpreting the same agenda in a different fashion)” and said that they “would therefore welcome moves which ensure clear and consistent decision making from the variety of regulators involved in any specific industry” (p 600).
- 6.13. Sir John Bourn expanded on the areas in which more joint working between the regulators would be genuinely helpful: “what I do think could be developed helpfully is cooperation between the regulators ... what one is looking to see is more cooperation between regulators and more learning from each other ... to the extent that the economics of sustainable development is something they are all going to have to pay more attention to,

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<sup>44</sup> Concurrency Working Party

<sup>45</sup> CAA, FSA, Ofcom

<sup>46</sup> Ofgem, Ofwat

it may be on things of that kind they could work together and produce reports which all of them could have their work informed by” (Q 712).

- 6.14. Stephen Haddrill, of the Association of British Insurers (ABI), suggested that relationships between regulators are much less developed than they might be because regulators naturally gravitate towards their own policy silos and to varying extents tend to forget the bigger picture—“we have this kind of spaghetti of relationships between a very large number of regulators. From my own experience in government it is not a natural state of being for regulators to be intimate with each other: they tend to do their own bit, driven by their own objectives” (Q 587). The views of most of our witnesses seemed to be summarised by the Finance and Leasing Association (FLA) who put in a plea for “much more joined up thinking and approaches by the economic regulators” (p 526). They stressed the importance of “actions rather than just words and commitments, as currently appears to be the case” (p 526).
- 6.15. **We agree that action is necessary to improve regulators’ joint working. There needs to be more structured and formal cooperation between the regulators if it is to be meaningful. We welcome the regulators’ willingness to develop relationships between themselves to increase their effectiveness.**
- 6.16. **We believe that if the Joint Regulators Group is to prove a successful forum for the sharing of best practice it needs to be formalised. The Group should establish a secretariat, and suitable arrangements for leadership, to ensure greater consistency of focus and a clearer direction of effort. The Joint Regulators Group should publish its agendas and minutes of its meetings on a tailored JRG website online to enable interested parties to have easy access to them. Additionally the JRG should produce an Annual Report outlining the discussions it has had over the course of the year and the details of any joint work it has undertaken.**

**Do regulators work effectively with the competition authorities? Is concurrency working?**

- 6.17. The regulators all claim to work effectively with the competition authorities and vice versa. To single out a few specific comments, Ofcom has said that its “relationship with the OFT is a very close one and it is a very good one” (Q 33) and Ofgem has said much the same—“it is a very good working relationship both from the John Fingleton level right the way through the organisation” (Q 111).
- 6.18. Other witnesses seem to agree with the regulators’ assessment of these relationships. Again, to single out a couple of specific remarks, David Thomas, from the Financial Ombudsman Service, spoke up for the FSA’s relationship with the OFT—“I can assure you from personal experience there is a high degree of liaison between the FSA and the OFT in its competition aspects” (Q 613)—and the Rail Freight Group claimed to “have seen evidence of good co-operation between the ORR and OFT/CC” (p 337).
- 6.19. The competition authorities were also positive in their assessment of their relationships with the sectoral regulators. Indeed, the OFT went so far as to say that the sectoral regulators helped them with their investigations—“Does that actually happen in your experience, that sectoral regulators help you in

your investigations? / Yes. We work closely with the Civil Aviation Authority, with the Financial Services Authority and we work closely with all of the regulators” (Q 246).

- 6.20. There was a recognition that the current web of relationships between the sectoral regulators and the competition authorities<sup>47</sup> is still relatively immature and there was a feeling that the relationships are improving steadily over time—“The main lesson we have taken away in the last two years—and we have had a much better relationship as I have mentioned—is that we understand each other’s respective responsibilities and we understand the skills that each organisation has that they can bring to the table, and we do not effectively compete as regulators” (Q 320).
- 6.21. So, the picture is broadly positive. There was, however, some concern expressed over overlapping inquiries and duplication of work. This point was raised particularly in respect of various recent investigations in the UK airport sector. The British Airports Authority (BAA) explained the situation clearly—“Once the OFT announced its investigation into the UK airport sector in May and then June of last year, we then had three regulators potentially about to start work on us, the CAA, the OFT and the CC” (Q 561). Such a situation is clearly inherently undesirable but BAA also went on to criticise a lack of communication between the regulators involved—“We did not perceive much interaction between them and it has meant that two reviews started to the minute on the same day” (Q 561). Manchester Airports Group supported BAA’s assessment of the situation “We certainly could see that there was perhaps less dialogue between the regulators than would have been desirable” (Q 561). It would be hard to disagree with BAA’s conclusion that the investigations could have been timetabled in a more helpful way for all concerned (Q 561).
- 6.22. The same point was also raised in relation to the FSA. The Association of British Insurers (ABI) raised the example of regulators’ co-ordination over payment protection insurance, noting that “Initially the FSA and OFT investigations were not well coordinated though this has improved in recent months” (p 373). The Association of Independent Financial Advisors (AIFA) also raised this example and had similar concerns—“FSA and OFT have jointly studied the payment protection market. This relationship has, from the perspective of the firms involved, seemed uncoordinated at times” (p 366).
- 6.23. The CAA and the FSA were not alone; similar concerns were raised in relation to other regulators, including Ofwat—“It is not clear to British Water that the Competition Commission and the Office of Fair Trading do communicate sufficiently with Ofwat for an understanding of the work of each other to fully develop” (p 508).
- 6.24. The Competition Commission also raised a different issue. The CC is a “second stage” competition authority which deals in depth with complex enquiries but only in cases referred to it by the “first stage” authority (usually the OFT, but also a sector regulator). In its written evidence, the CC expressed some concern about the lack of references to it by utility regulators. The CC said no regulatory references have been made to it since 2002 which, in the CC’s view, means it is being under-used and that the

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<sup>47</sup> See Appendix 8

important threat of a reference to the CC is becoming less credible (p 152). The CC further expressed some concern over the nature of the cases that have been brought to it—in some instances it felt that it was not receiving the meatiest cases—“there have been one or two cases which have been a little small, a little specific” (Q 258). The CC explained the reluctance of the regulators to make referrals as being related mainly to the costs of appeals, the uncertainty, the delays to decisions, the possibility of compromises between regulator and regulated being unpicked and concern that a body unfamiliar with the industry might not properly balance various “public interest” considerations. Nevertheless, the CC pointed out the importance to the regulators of there being a credible threat of a reference to the CC if they are to achieve reasonable settlements (p 152).

- 6.25. **Whilst relationships between the sectoral regulators and the competition authorities seem to be broadly sound, there is clearly a need for improved communication between the various bodies over the timing and content of their investigations of particular markets.**
- 6.26. **We also recommend that, where possible, utility regulators should look to bring more cases to the competition authorities and that the regulators should work to ensure that the cases most likely to establish useful precedents are brought to the CC.**
- 6.27. In addition to taking evidence on the state of the general relationships between the sectoral regulators and the competition authorities we looked specifically at the concurrency arrangements in place between them.
- 6.28. “Concurrency” arrangements in the British regulatory system refer to the arrangements under which decisions are made about whether competition law is applied in particular sectors by the relevant sectoral regulator or by the OFT. Many of the regulators, besides having duties to promote effective competition under their respective sector-specific legislation, have been assigned competition powers concurrent with the OFT. This can make effective use of the sector regulators’ specialist knowledge of the particular sectors they regulate, and assist in co-ordinating the use of sector-specific regulation with the exercise of general competition law. However, without some clear concurrency arrangements for deciding whether the OFT or the sector regulator will deal with particular competition issues there is likely to be uncertainty for the regulated companies and there could be inconsistencies in dealing with competition matters.
- 6.29. Of the regulators which are the subject of this inquiry, those with concurrent powers are Ofcom, Ofgem, Ofwat, ORR and the CAA (for air traffic services only). Neither the FSA nor Postcomm has concurrent powers nor does the CAA as far as airport regulation is concerned.<sup>48</sup>
- 6.30. The concurrent powers in question are: to make market investigation references under the Enterprise Act 2002 where a market appears to have anti-competitive features; to investigate possible infringements of the prohibitions in Chapters 1 and 2 of the Competition Act 1998 and Articles 81(1) and 82 of the EC Treaty in the UK (against anti-competitive

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<sup>48</sup> Concurrency is not a relevant issue for the Pensions Regulator

agreements and abuse of a dominant position); and to carry out market studies.<sup>49</sup>

- 6.31. Once it has been decided, under the concurrency arrangements, which authority will exercise the necessary functions, another authority cannot exercise those functions unless there is a formal transfer of responsibility.<sup>50</sup> When a case is brought under the Competition Act which relates to a regulated sector, the OFT formally decides whether it should undertake a case or hand it to the sector regulator. In doing so, it will take into account the sectoral knowledge of the regulator, whether the case affects more than the regulated sector, any previous contact between the parties or complainants and a regulator or with the OFT, and any recent experience in dealing with any of the undertakings or similar issues that may be involved in the proceedings. These arrangements are set out in the Competition Law Terms of Reference for the Concurrency Working Party.
- 6.32. A report in 2006 by the DTI and the Treasury<sup>51</sup> concluded that concurrency arrangements were generally working well. A Concurrency Working Party set up in 1997 acts as a "... forum in which views on current practice are exchanged" and, as far as procedures for deciding who deals with which complaints are concerned, "... the OFT generally [passes] cases over to a regulator if the complaint involves a regulated sector." The report concluded, however, that it would be beneficial to enhance existing co-operation between the OFT and sectoral regulators. It also encouraged regulators to consider whether they could be "... more proactive in using competition law, including the use of market investigation references".
- 6.33. In general, the evidence received by the Committee supported the conclusion of the DTI/Treasury report that concurrency arrangements are working satisfactorily. However, some reservations were expressed.
- 6.34. One matter which came up in evidence and has concurrency connotations is whether a sector regulator, given its involvement in the relevant market, is likely to be assiduous enough in investigating competition issues. Two entrants to the water industry in England and Wales—Albion Water and Aquavitae (UK)—both expressed doubts about Ofwat's actions. In Aquavitae's written evidence, for example, it argued that the access pricing regime in water established by Ofwat has the effect of protecting incumbents and acting as a barrier to entry (pp 490-493). Moreover, according to Aquavitae, despite adverse findings by the Competition Appeal Tribunal in relation to an appeal under the Competition Act 1998 by Albion Water regarding Ofwat's regime, Ofwat was very resistant to making changes to it (p 493).
- 6.35. Another example was provided by Energywatch which argued that when it raised a Super Complaint on behalf of energy consumers, Ofgem's solution did not "go to the heart of the problem ... Self regulatory measures were promised despite being untested and without any regulatory supervision and

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<sup>49</sup> Concurrency arrangements do not relate to merger investigations, which are the responsibility of the OFT and the CC, subject to any intervention by the Secretary of State on public interest grounds—currently national security and media plurality.

<sup>50</sup> A statutory instrument, the Competition Act 1998 (Concurrency) Regulations (SI 2004/1077) sets out concurrency working arrangements. See also 'Concurrent application to regulated industries', OFT Guidance Note 405, December 2004.

<sup>51</sup> Concurrent Competition Powers in Sectoral Regulation, May 2006.

there was no guarantee that any of the underlying problems would be resolved” (p 237).

- 6.36. As not all economic regulators have concurrent powers under competition legislation the question arises of whether there would be advantages in their being brought into line with the regulators who do have such powers.
- 6.37. Postcomm, the postal services regulator, lacks concurrent powers but there seems to be no pressure either from the regulator or from market participants for it to have them. The DTI/Treasury report on concurrency states that Postcomm feels that if it had concurrency powers it would need to carry out the same groundwork as now and would pursue cases in similar ways.<sup>52</sup> According to the OFT’s written evidence, a memorandum of understanding between it and Postcomm and “co-operative work on the ground” substitute well for formal concurrency arrangements and Postcomm itself did not suggest, in its evidence to the Committee, that it would like concurrency powers.
- 6.38. The FSA also lacks concurrent powers though it has a subsidiary duty to promote effective competition. According to the OFT’s evidence, it is committed to working closely with the FSA on competition and consumer protection matters despite the absence of formal concurrency powers (p 133). Again, neither the FSA nor financial firms suggests that the absence of concurrency is a significant problem.
- 6.39. The case of the CAA raises different issues. It has concurrent powers insofar as air traffic services are concerned, but lacks them for an important part of its functions—regulating airports. Like Postcomm, it has a memorandum of understanding and co-operates with the OFT. Written evidence from the CAA sets out the case for extending concurrency to its airport regulation functions—“combining competition law and regulation of airports in a single body to take advantage of the unique features of the airports market” (p 53). However, the CAA also points out the resource implications: joint working with the OFT might be required because the CAA may not have enough staff to cope with competition law casework. BAA, in its written evidence, does not mention concurrency as such but expresses some reservations about “disjointed” interactions between the CAA, OFT and CC, particularly since it is undergoing two references to the CC at the same time, on different timescales (one as part of a normal regulatory reference by the CAA and the other a market investigation reference by the OFT) (pp 354-355).
- 6.40. Where the sector regulators have been assigned competition powers concurrent with the OFT, these arrangements are generally working satisfactorily. However, this is not universally the case and a concern arises as to whether a regulator charged with promoting competition is the best body to review complaints under competition legislation as to the effectiveness of competition in the industry concerned (since the regulator might be perceived as having an interest in rejecting such complaints). Where regulators do not have concurrent competition powers, much of the evidence we have received suggests that the liaison between the sectoral regulators and the OFT is satisfactory and the regulators in question did not consider that the lack of concurrent powers had hampered their effectiveness. But some concern has been expressed about disjointed interactions between the sector

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<sup>52</sup> ‘Concurrent Competition Powers in Sectoral Regulation’, op cit, para 2.8

regulators and the competition authorities, and the CAA has made a case for full concurrent powers.

**6.41. We recommend the following:**

- **Concurrency arrangements should be retained.**
- **In some cases complainants perceive that a sectoral regulator is so deeply involved in regulating the industry as it stands that it pays insufficient attention to the importance of establishing and maintaining effective competition. Complainants should therefore be given the option of requesting the OFT rather than the sectoral regulator to take the lead in investigating complaints.**
- **In cases where regulators do not have concurrent powers, even though they are carrying out very similar functions to regulators which do have such powers, there is a case for giving concurrent powers.**

**What is the nature of the relationship between regulators and government departments? Are the regulators sufficiently independent from the Government?**

6.42. The question we consistently asked witnesses when considering the nature of the relationship between regulators and the Government was “are the regulators sufficiently independent?”

6.43. The regulators were all set up as different types of bodies, with different funding models, and arrangements for protecting their independence vary. The table below outlines the status of the different regulators:

**TABLE 5**  
**Status of the regulators**

<b>Name of Regulator</b>	<b>Nature of Organisation</b>
Ofcom	Public Corporation <sup>53</sup>
Postcomm	Non-ministerial government department <sup>54</sup>
Ofgem	Non-ministerial government department
Ofwat	Non-ministerial government department
ORR	Non-ministerial government department
CAA	Public Corporation
FSA	Private company, limited by guarantee
TPR	Non-departmental public body <sup>55</sup>
OFT	Non-ministerial government department
CC	Non-departmental public body

<sup>53</sup> A corporation created to perform a governmental function or to operate under government control

<sup>54</sup> Government departments in their own right, established to deliver a specific function and not funded by a sponsor department.

<sup>55</sup> A body which has a role in the process of national government, but is not a government departments or part of one, and therefore operate to an extent at arm’s length from Ministers.

- 6.44. Overall, we found that there seemed to be few problems around the issue of the independence of regulators. The regulators all believe themselves to be independent (e.g. p 14, p 153) and the regulated trust in their ability to be so (e.g. p 336). Ed Richards, of Ofcom, made an interesting point when he said that “one of the things which I think people underestimate is the extent to which the idea of independent regulation has become almost quasi-constitutional” (Q 45). The evidence we took certainly seemed to support his opinion. It was taken as read by the regulators, the regulated and the Government that the regulators are to be fully independent and that no undue influence should be put on them at any point.
- 6.45. There was widespread support, too, for the systems by which the different regulators are funded. Ministers, in particular, defended the regulators’ funding arrangements and claimed that they had no effect on independence.
- 6.46. The only potential problem witnesses raised in this area was the funding of Postcomm. Postcomm is funded by the industry it regulates which means it is funded largely by Royal Mail—and the sole Royal Mail shareholder is the Department for Business, Enterprise and Regulatory Reform (formerly the DTI). In effect then, Postcomm is funded by its sponsoring department. As the Mail Users’ Association (MUA) put it to us “Postcomm is after all, an ‘independent’ regulator that is funded by the shareholder of the very company it is principally required to regulate” (p 320).
- 6.47. The MUA and Postwatch thought there was a genuine problem here. The MUA pointed to an example of when they thought the DTI had put pressure on Postcomm—“Postcomm were reluctant to pursue Royal Mail regarding the quality of service standards that they were required to meet in the bulk service compensation scheme and we believed—and I use that word in the broadest sense—that that was pressure from the Royal Mail shareholder, the DTI” (Q 526). Postwatch noted that on this issue perception may be as important as reality—“there is a perception out there that because of the funding model and the relationship in terms of who makes the appointments, that there is a danger that Postcomm’s independence may be compromised. We have no evidence to say that it is and we do not know how we would prove it either, but I think the perception itself is quite an important issue” (Q 526).
- 6.48. **We recognise that there is a perception that Postcomm’s independence might be compromised by its method of funding. We believe that whilst in theory the funding of Postcomm by Royal Mail (and therefore effectively by the Department for Business, Enterprise and Regulatory Reform—formerly the DTI) may compromise their independence, in practice this is not the case. Moreover, as competition increases other operators in the industry will be liable to contribute to the funding of Postcomm.**
- 6.49. More generally several witnesses noted that, on occasion, the policy of a regulator and government policy might conflict. There was a feeling that whilst a degree of tension between government and regulator is healthy there needed to be clear mechanism for resolving such conflicts (p 354). This issue was raised in relation to several regulators (p 587) but was particularly raised with reference to Ofgem. Many of our witnesses felt that the economic role of the regulator was being “encroached on at the edges by non-economic considerations” (p 276). Such considerations have included issues such as

affordability, fuel poverty, security of supply and the effect that energy policy could have on climate change.

- 6.50. **Energy is now again a public policy issue and security of supply and sustainability are ever more important considerations. In this context Government will need to be careful to ensure that Ofgem is not sent mixed messages. Government must be explicit in the political decisions it makes and in the consequent guidance it issues to regulators.**
- 6.51. In the context of inquiring into the independence of regulators we also took some evidence on the complex relationship between the ORR and the DfT. The division of responsibility for the rail industry between the two bodies is undeniably complicated. The national rail infrastructure is operated and maintained by a single provider, Network Rail, which grants access to the network in return for regulated access charges. Network Rail has members rather than equity holders, is financed by debt, currently all guaranteed by government, and is required to re-invest all profits into the railway. In effect it is a public sector asset. The passenger railway network is funded by passenger fares, government subsidy to the train operators and government grants to Network Rail.
- 6.52. Within this system the ORR has responsibility for regulating Network Rail's stewardship of the national rail network. The ORR also licenses the operators of railway assets, approves agreements for access by operators to track, stations, and light maintenance depots, and enforces domestic competition law. The ORR is also the health and safety regulator for the industry. The DfT is responsible for rail strategy and for franchises, both in terms of awarding franchises and monitoring and enforcing them. Regulated fare levels are also set by the DfT. To some extent, therefore, the DfT itself is a regulator in this industry.
- 6.53. While a monopoly supplier, such as Network Rail, is not unusual, the existence of a single dominant purchaser, the extent of government subsidy and the absence of equity finance in Network Rail all influence the way the rail industry can be regulated and make for an over dependent relationship between regulator and government department.
- 6.54. In evidence to us, the ORR, whilst recognising that the system is complex, defended the current arrangements—"You can describe those arrangements in a way that is understandable, it does work ... Could it be different? Yes, it could, but what no one in the rail industry would want is a further period of change, let us get on and make the current structure work" (Q 128).
- 6.55. George Muir, from the Association of Train Operating Companies, said much the same—"The present regulatory system in the railway [industry] looks complicated and indeed is complicated but it does seem to work quite well" (Q 537), as did Paul Plummer, of Network Rail, who thought that "the regime works pretty well" (Q 537).
- 6.56. **Complexity in the relationship between the DfT and the ORR is not necessarily undesirable if the system is working. The Minister, Tom Harris MP, put in a sensible plea for "a long-standing period of settling down into the current regulatory framework" (Q 617). We believe this would be advisable and we recognise that the early signs of a productive relationship developing are promising.**

- 6.57. During our evidence session with Tom Harris MP, Gillian Merron MP and Ian Pearson MP (all then Ministers at the DfT, DTI and DEFRA), another important issue was raised—the nature of the relationships between sponsoring departments. It seems that the departments themselves do not talk to each other about regulatory issues. Ministers readily admitted the problem. Tom Harris MP explained that “ministers get too comfortable in their policy silos and deal directly and exclusively with the regulator in their own department”. He went to say that the evidence session was in fact “the first time ... where the three of [them had] got together to discuss [their] own individual regulators” (Q 643). In a later evidence session Jim Fitzpatrick MP agreed that “there [was not a] forum for ministers ... to have ... the opportunity to exchange views” (Q 698) and that that was a shame because “it would be appropriate for ministers to be able to get together to compare notes” (Q 699). Other witnesses also noted the problem. Sir John Bourn, for example, seemed to speak for many when he said that he thought that “especially at a time when all government departments are admonished to think about joined-up government, that there is more that they could do” (Q 717).
- 6.58. The only example of ministerial coordination we found was Ed Balls MP’s chairing of a ministerial group on financial inclusion and financial capability, with the aim of trying to make sure that ministers communicate well and work together in those areas.
- 6.59. **Relationships between regulators and government seem generally to be functioning well although an effective and transparent mechanism needs to be put in place for resolving potential policy conflicts so that the regulators are able to carry out their economic function without interference.**
- 6.60. **Relations between government departments on regulatory issues are in their infancy. We recommend that an inter-ministerial forum be established to require ministers to compare views and share best practice.**

#### **How will Parliament ensure the accountability of regulators?**

- 6.61. As noted in Chapter 2, the May 2004 House of Lords Constitution Committee Report on the regulatory state recommended that “a dedicated parliamentary committee should be established to scrutinise the regulatory state.” It further recommended that this “should preferably be a joint committee of both houses” and that the Committee should undertake “consistent and co-ordinated” scrutiny, focused around the regulators’ annual reports and IAs.
- 6.62. The Government’s response to the Committee’s report acknowledged that these recommendations were “for the House Authorities to take forward as they deem appropriate”.
- 6.63. The Liaison Committee of the House of Lords duly appointed this *ad hoc* Select Committee. As such, we are the child of the Constitution Committee’s report, but not the wished child. Our existence is terminated with the publication of this Report and the subsequent debate on it to be held on the floor of the House.
- 6.64. It therefore remains for us to make a recommendation on how parliamentary scrutiny of regulators should develop from here.

- 6.65. **We agree with the conclusion of many of our witnesses that “there is a crucial need for greater parliamentary oversight ... over regulation bodies” (Q 359). The question of who regulates the regulators has not been answered and will not go away. There is a need for a committee to pursue cross-sector best practice and to ensure that the recommendations of this Report are followed-through. As we emphasised in paragraph 2.18 we have examined only a part of the regulatory state. We have considered only regulators, and not regulation, and we have looked at only the economic regulators. There is a need for a wider, and continuing, review. No existing committee of either House is in a position to undertake such a continuing and over-arching review as Departmental Select Committees in the House of Commons are restricted to considering the regulators within their own sector.**
- 6.66. **We therefore recommend that a Joint Committee of both Houses be set up in line with the recommendations in Chapter 10 of the Constitution Committee’s Report.<sup>56</sup> If it proves impossible to set up such a committee we recommend that a sessional Select Committee be established in the House of Lords.**

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<sup>56</sup> See Appendix 6

## CHAPTER 7: COMPETITION AND COMPETITIVENESS

- 7.1. When sectoral regulators were first established to oversee the privatised utilities in the UK in the 1980s, the intention was that their scope should be reduced over time. They would have a continuing role in regulating “natural monopoly” parts of the utilities (such as the networks of pipes, wires and tracks) but outside these sectors regulation would be replaced by competition. Many of the ingredients of the UK’s basic model of utility regulation were contained in Stephen C Littlechild’s 1983 Report on British Telecommunications.<sup>57</sup> In his Report, Littlechild states that “Regulation is essentially a means of preventing the worst excesses of monopoly; it is not a substitute for competition. It is a means of “holding the fort” until the competition arrives”.<sup>58</sup> Sectoral regulation would reduce in scope as competition developed sufficiently in the potentially competitive parts of the utilities to protect consumers against the exercise of monopoly power. In the meantime, regulators were given a statutory duty to promote competition and thereby assist the transition from regulated monopoly to liberalised markets.
- 7.2. Over twenty years have now passed since the first utility regulators were established. It is therefore legitimate to assess the extent to which they have lived up to those initial expectations. This chapter asks whether the regulators have succeeded in facilitating competition in the sectors they regulate. Where competition has developed, have regulators de-regulated to the greatest extent possible, and will it ever be possible for them to disappear completely? Strong competition is an important driver of productivity and competitiveness, but economic regulation—whilst necessary for markets that lack effective competition—can also impose substantial costs on industry and end-consumers. This chapter therefore ends by asking whether economic regulators collectively add to the competitiveness of UK firms or detract from it.

### Have the regulators successfully promoted competition in the sectors they regulate?

- 7.3. There is a significant variation in the degree of competition that has developed in the different sectors (QQ 710–716, pp 11–12, 490–493). The variation is most striking if one compares the situation in the energy and communications sectors on the one hand, and the water sector on the other. Aquavita described the situation as follows: “In other industries that were privatised in the 1980s (telecoms, gas and electricity), markets have been opened to competition so that even the smallest customers have a choice of supplier ... In water, however, monopoly is still the norm throughout the whole range of the industry’s activities” (pp 490–491).
- 7.4. Most witnesses agreed that Ofgem and its predecessor regulators had helped to achieve a successful transition to fully competitive gas and electricity markets. Ofgem claimed that Britain had the most competitive energy market in Europe, with energy companies competing “vigorously on price, service

<sup>57</sup> Stephen C Littlechild, *Regulation of British Telecommunications’ Profitability* (London: Department of Industry, 1983).

<sup>58</sup> Stephen C Littlechild, *op. cit.*, p.7

and product range” (p 68). A similar message was received from both industry and consumers (pp 503, 515, 535, 574, 609).

- 7.5. There was also a widespread view that communications markets were highly competitive, accompanied by recognition of the role that regulators had played in facilitating that situation. Telecommunications company Orange said, “Successive Governments and regulators can take credit for the highly competitive markets that they have created” (p 589). Ofcom’s Chief Executive, Ed Richards, observed, “We have got a level of competition now in the broadband market which I think ... is probably as intense as anywhere in the world ... the level and intensity of competition has increased by a huge factor in the last 18 months” (Q 40).
- 7.6. At the other extreme, there was a consensus that competition had barely made an appearance at all in the water industry. This was a view shared by the regulator, regulated industries, potential new entrants and consumers (Q 461, pp 103, 491, 509, 612). British Water described the situation thus: “Despite various initiatives to introduce a degree of competition ... the level and intensity of competition at the level of the water and sewerage undertakers is very low, if not non-existent in practice” (pp 507-508).
- 7.7. Between these two extremes lie sectors such as post, airports and rail, where a mixed picture emerges. Competition has begun to develop in these sectors but there is still some way to go before fully effective competition is evident across the respective sectors. Sarah Chambers, Postcomm’s Chief Executive, explained the situation with respect to post, but her comment characterises the position of the other sectors in this group: “I think there is pressure from competition, even though the actual loss of market share looks very small. I am not saying we are where we want to be, and there is more [room] to go in terms of promoting really effective competition throughout this market, but I think one should not underestimate the effect of what is already there” (Q 62).
- 7.8. Financial services markets fall into a separate category. It is apparent that they are highly competitive but the regulator did not face a comparable task of facilitating the transition of a monopoly to a competitive market structure. John Tiner of the Financial Services Authority (FSA) said that, in some sectors comprising privatised utilities such as British Telecom, “there is a lot of competition now that has come about from the market structure changes in the last 20 years ... we do not have that ... financial services has always been a business that operates in the private sector, at least for as long as I can remember, and so our starting point is different” (Q 315).
- 7.9. Regulators promote competition in a range of different ways. These include unbundling potentially competitive elements in a market from natural monopoly networks, ensuring equal access to these monopoly networks for all competitors, promoting switching, enforcing licence conditions and competition law, and withdrawing burdensome regulation where possible. Ofgem explained that the “process of unbundling the potentially competitive elements of the gas and electricity supply chains from the inherently monopolistic pipes and wires networks ... ha[d] been crucial to the development in Britain of effective competition in gas and electricity supply and in services such as gas storage and metering” (p 72).
- 7.10. The CAA is an example of a regulator that promotes competition by recommending the removal of unnecessary regulation: Harry Bush, CAA

Group Director, said “We do not have a duty to promote competition ... but, through not being in, not having a lot of designated airports, effectively we have allowed competition to occur, and that is what has happened in the airports market” (Q 85). The CAA cannot claim all of the credit for this since the decision about whether or not to designate or de-designate an airport for price control purposes ultimately rests with the Secretary of State for Transport. The most that the CAA can do is to influence the Government through the advice it gives (p 52). In November 2006, the House of Commons Transport Select Committee recommended that, if the principle of designation was to be retained, the Government should consider whether designation decisions were best taken by the CAA instead of the Secretary of State.<sup>59</sup>

- 7.11. Regulators’ powers and remits clearly influence the extent to which they can and do promote competition. In addition to the CAA, Postcomm is another example of a regulator lacking the power to remove some of the obstacles to competition that it has identified. In the postal sector, the uneven imposition of VAT places Royal Mail’s competitors at a price disadvantage of about 13%, but VAT policy is a matter for HM Treasury rather than Postcomm (Q 62, Q 67). However, it is worth noting that this disadvantage is effectively limited to VAT exempt customers and to individuals—principally finance companies and charities, as all other commercial users can recover the VAT.
- 7.12. In Chapter 3, we discussed the fact that not all regulators have a primary statutory duty to promote competition. Most of the evidence we received suggested that this made less of a difference than might be imagined. In cases where there was no primary duty to promote competition, regulators often had secondary duties which required them to consider the impact of their policies and decisions on competition, or at least that they interpreted as such. For example, the FSA does not have the promotion of competition as one of its statutory objectives, but in discharging its general functions, it must have regard to the desirability of facilitating competition.<sup>60</sup>
- 7.13. When asked whether the FSA should gain a primary statutory duty to promote competition, John Tiner said that he did not think this was necessary. He thought that it was preferable to focus on making the FSA’s relationship with the existing competition authority (the OFT) work, whilst also ensuring that considerations of competition and international competitiveness were built into the FSA’s policy development process (Q 295). More enthusiasm for a new statutory objective came from the financial services industry, and particularly the ABI which thought that there was “a strong case for the Government to introduce a new objective for the FSA to promote competition” (p 374). However, some witnesses said that they did not want “yet another competition authority around” (QQ 593, 611-612). A great deal of competition already existed in the financial services sector and it was up to the OFT as the competition authority to stop anti-competitive practices.
- 7.14. **In most sectors, regulators have played an important role in helping to promote competition, but there are significant variations between the sectors. Whilst not all regulators have a primary statutory duty to**

<sup>59</sup> Transport Committee, Thirteenth Report (2005-06): The Work of the Civil Aviation Authority (HC 809), para 128

<sup>60</sup> Financial Services and Markets Act 2000, s2(3)(g)

**promote competition, the duties they do have are often framed or interpreted in such a way that they point in the same direction. In a few cases, regulators lack the necessary powers under sector-specific regulation to take measures that would stimulate competition and, as discussed in Chapter 6, do not have concurrent powers with the OFT under general competition legislation. This particularly applies to the CAA which lacks both concurrent competition powers and the power to designate or de-designate airports for price control purposes. The decision about whether or not to apply price control regulation is essentially economic rather than political and there is a strong case for transferring that power from the Secretary of State to the CAA.**

- 7.15. **We recommend that Government considers the case for transferring the power to designate or de-designate airports for price control purposes from the Secretary of State to the CAA. This matter could be addressed as part of the strategic review of the CAA that is being conducted by the Department for Transport.**<sup>61</sup>

### **Why has competition failed to develop in the water sector?**

- 7.16. Whilst there is general agreement about the low level of competition in the water sector (Q 461, p 103, p 491, p 509, p 612), the reasons why this is the case and consequent discussions about effective solutions attract substantial disagreement. In particular, there is a dispute about whether the problems lie in the legislation itself or, instead, in Ofwat's interpretation of the legislation.
- 7.17. One of the main issues concerns the access pricing rule. As a result of the Water Supply Licensing (WSL) regime introduced by the Water Act 2003 which gave the regulator a primary duty to promote competition, all water undertakers are required to develop access codes, setting out their terms, including indicative access prices, for allowing licensees access to their supply systems. The basis on which access prices have to be fixed, known as the Costs Principle, is contained in section 66E of the Water Industry Act 1991.<sup>62</sup> Under the WSL, Ofwat publishes access code guidance which water undertakers must use in framing their access codes. This guidance includes Ofwat's view on how the Costs Principle should be interpreted. Most parties, including the regulator, agree that the current method used to calculate network access charges (a retail minus approach), contained in the access code guidance, is a major constraint on competition because it produces margins that are too low to encourage new entrants. Moreover, it would leave incumbents' profit margins virtually intact if entry occurred, thus removing any competitive pressure from the undertaker. What is contested is whether it is the legislation itself or Ofwat's interpretation to the legislation that needs to change.
- 7.18. Potential entrants generally considered that the problem lay more with Ofwat's interpretation of the Costs Principle than with the legislation itself (QQ 432, 436, p 493). Ian Pearson MP said, "I have met some of the companies that want to enter into the water market, such as Albion Water and Aquavitae ... They have asked for different interpretations of the cost principle within the existing legislation, and they believe it is possible to make

<sup>61</sup> However, we recognise that the implementation of the EU Directive on Airports might make this impracticable; see paragraph 7.42.

<sup>62</sup> Inserted by section 56 and Schedule 4 of the Water Act 2003. See Appendix 7.

progress on enabling companies to switch suppliers under the current regime” (Q 618). These companies drew upon criticisms made by the Competition Appeal Tribunal (CAT) about Ofwat’s interpretation of the Costs Principle in the *Shotton*<sup>63</sup> case as evidence that the problem was chiefly about Ofwat’s interpretation of the legislation.

- 7.19. Ofwat argued that *Shotton* was a specific case, not a general case about the WSL regime, which meant that the CAT’s comments were not binding in relation to its interpretation of the Costs Principle. Ofwat’s view was that the legislation allowed for no other interpretation of the Costs Principle than the one it was making. Regina Finn, of Ofwat, told us that the WSL regime “requires a retail minus approach to be adopted in setting access prices ... in this instance it is a very specific retail minus approach that is required ... This is something in legislation that Ofwat is required to use to set access prices” (Q 161). Ofwat therefore considered that changes to primary legislation were necessary before substantial progress could be made in developing competition in the water sector.
- 7.20. A second issue related to the eligibility threshold. Under the Water Act 2003, premises that can be supplied with water by licensees are limited to those using 50 megalitres of water a year or more. Some of the evidence we gathered suggested that competition could be stimulated by lowering this threshold (Q 441, pp 103, 491). Aquavitae wrote, “The threshold is still very high ... 93 per cent of the market is still not open to competition” (p 491). Ian Pearson MP said, “I do accept there are some arguments to suggest that if you have a bigger market size then it potentially makes it more attractive for new entrants to come into the marketplace” (Q 618). On the other hand, the Minister cautioned against over-reliance on the threshold as the key to stimulating competition: “At the moment [the threshold] stands at 50 megalitres, and that enables potentially 2,200 premises to be able to switch suppliers across England and Wales. Clearly none have done so at the moment, so it is perhaps premature to conclude that changing the eligibility threshold will suddenly see competition intensify” (Q 618, Q 433). Changes to threshold would require changes to legislation. Defra has committed to review the threshold in 2008 and Ian Pearson MP recently announced that the Government would bring forward that review.<sup>64</sup>
- 7.21. In addition to the two issues raised above, we heard a number of other arguments about why competition in water had not developed. These included observations about the structure of the industry and the nature of water. Ofwat argued that the lack of competition “In part ... reflect[ed] the nature of the water supply: water is heavy and costly to distribute” (Q 162). In terms of industry structure, a number of parties pointed to the problems caused by having a series of vertically integrated regional monopolies (Q 162). We also heard arguments about the problems faced by potential entrants in having to spend considerable amounts of time and money in protracted negotiations with incumbent water companies to gain access to their pipelines (Q 437, p 491). Jeanne Golay from Water UK said that Ofwat could do more within its current statutory remit by focusing on competition

<sup>63</sup> *Albion Water v Water Services Regulation Authority (Shotton Paper)* [2006] CAT 23

<sup>64</sup> Ian Pearson MP, Speech to the Institute of Economic Affairs Annual Water Conference, 25 June 2007, <http://www.defra.gov.uk/corporate/ministers/speeches/ian-pearson/ip070625.htm> (accessed 20 July 2007)

further up the supply chain: “By focusing only on retail we have not really seen any of the proper drivers for competition” (Q 435).

- 7.22. **Whilst each of the sectors within our inquiry has distinct characteristics, we find it hard to accept that there is something specific about the nature of water itself which means that the sector can never develop effective competition. Three reasons have been advanced as to why this has not happened—the physical nature of water as a commodity; the eligibility threshold; and the access pricing rule. Whether or not the physical characteristics argument is a valid one will never be put to the test until the barriers to competition presented by the threshold and the access pricing rule have been removed. As regards the latter since virtually everyone agrees that the rule should be changed, it is very unfortunate that an impasse has been allowed to develop over what needs to be done to make the change. Ofwat maintains that legislation is required, whereas potential entrants claim, on the basis of the CAT’s general comments on the access regime, that a change in Ofwat’s interpretation of the legislation is all that is necessary. In their view, Ofwat is ignoring the competition authorities and failing to change its interpretation in a way that would make entry more attractive. The Government has so far done little or nothing to clarify the situation.**
- 7.23. **It seems to us unwise of Ofwat to claim that it need take no account of the general comments made by the CAT on its access regime. Ofwat should examine critically whether it could not find a more constructive approach to implementing the CAT’s findings.**

**Have regulators successfully de-regulated in areas where it is possible for them to do so?**

- 7.24. Regulators are often faced with decisions about when it is safe to de-regulate and allow competition to protect consumers. It is important that regulators remove sectoral regulation in areas where effective competition has developed because the costs associated with regulation can be substantial. They include not only the direct costs of running a regulator’s office (administrative costs) and costs that individuals and businesses incur to comply with the regulation (compliance costs) but also indirect costs. These are much harder to measure but include the costs associated with the distortions that regulation can cause, for example by blurring price signals, by over (or under) incentivising investment and by discouraging innovation and enterprise.
- 7.25. There is a tendency for regulators to maintain regulation for longer than is necessary because this represents the path of least resistance and/or is perceived to be the less risky option (QQ 14, 495, 786). The Mobile Broadband Group observed that regulators “Have much more to lose from taking a ‘light touch’ [approach] and then being subjected to public ordure if things go wrong than they have to gain by playing it safe and imposing regulation where it might not be necessary” (p 297). The CAA acknowledged that “there may sometimes be a tendency, which one shares on occasion oneself, to look at what might be the worst that could happen if you took the regulation away” (Q 786).
- 7.26. Regulators also faced pressures from industry and end-consumers to retain the status quo. In relation to the airports market, the CAA explained that

“for all the airlines that have got used to the system of regulation over a number of years there is a degree of safety net as comfort” (Q 786). We also acknowledge the views of the NCC: “Often the consumer interest in regulation has been seen as entirely about protection and we do not think that is what it is about ... Often it is the businesses who are the ones who are calling for more regulation because they want to stop a choice, they want to stop switching” (Q 370).

- 7.27. Martin Cave, of Warwick University, said, “I am by no means persuaded that regulators in the UK ... have been as bold as they have been, for example, in the telecommunications industry in the United States in taking a chance on de-regulation. But some progress has been made in that respect” (Q 14). In fact, we saw evidence of quite a lot of progress.
- 7.28. Where regulators had adopted a principles-based and risk-based approach to regulation this was likely to have facilitated the process of de-regulation (Q 303, p 370), but, as Ed Balls MP pointed out, principles-based regulation worked better in wholesale markets with few entities to regulate and less well in retail markets and where there were a very large numbers of firms to regulate (Q 651). John Tiner, of the FSA, said “We are quite a long way through a programme of looking at 80 per cent of our rulebook to see ... where we have imposed requirements on industry ... which are not justifiable any longer” (Q 303). Some regulators had also promoted self-regulatory and/or co-regulatory approaches in parts of the market. Peter Vass, from the Centre for the Study of Regulated Industries, explained that this could help regulators to move from “*ex ante* regulation to an *ex post* competition authority approach” and there was a case for providing regulators across the board with a duty to promote self-regulation (Q 737).
- 7.29. Ofgem was reaching the end of its Supply Licence Review and about to announce a large reduction in the rules and regulations that had been built up over the last twenty years. It described the existing regulations as “160 pages of barrier [to entry]” and said that this was being cut to about 60 pages (Q 786). The 60 remaining pages were more than had been hoped for, but were found to be necessary to protect vulnerable customers. Witnesses also drew attention to some of the regulators’ Simplification Plans.<sup>65</sup> Referring to Ofcom’s plan, Hamish MacLeod of the Mobile Broadband Group, told us, “I personally do not think they get enough public recognition of that simplification plan through the scrutiny process, or through the press” (Q 491).
- 7.30. There were many examples of regulators taking decisions that had been de-regulatory in nature. In written evidence, Ofcom submitted a regulatory log showing that its regulatory decisions had reduced regulation in a range of areas. These decisions included: lifting the retail price control on BT to reflect the development of sustainable competition; allowing the market rather than regulation to determine the best use of spectrum, and simplifying regulation by moving from annual to life-time licensing (p 13). In July 2000, the CAA advised the Government not to designate Luton airport for price-control purposes. More recently, it asked the Government to consider de-

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<sup>65</sup> A Simplification Plan is a document pulling together an organisation’s programme of Better Regulation work, showing how it will deliver on its Simplification commitments. Simplification is action that reduces regulatory burdens and includes: de-regulation, consolidation, rationalisation and the reduction of regulatory burdens.

designating Stansted airport and, on 20 November 2006, announced its decision to remove any remaining fares regulation in two stages.<sup>66</sup> In April 2002, Ofgem removed the remaining price controls for residential consumers of gas and electricity where the markets had been fully opened to competition since 1999.

- 7.31. There was a feeling that regulators could still be doing more in some areas. The RadioCentre said that “from commercial radio’s point of view ... we believe there are significant opportunities for removing whole sections of regulation that are specific to our very small industry” (Q 491). De-regulation was considered to be vital in facilitating and encouraging the investment needed to allow the radio industry to be fit for purpose in the future (Q 492). Several witnesses suggested that Ofgem should scale back its regulation of the more competitive parts of the energy market (p 220, p 228, p 232). For example, the Energy Networks Association wrote, “There should be significantly less regulation in some areas, notably where competition has been established, and “better, smarter” regulation in others, such as the setting of network price controls” (p 228).
- 7.32. **Regulators have taken important steps to de-regulate but there is still room for progress. Alternatives to classic rule-based regulation, such as risk-based and principles-based regulation, can assist sectoral regulators in moving towards an *ex-post* competition authority approach and there is a case for providing regulators across the board with a duty to promote self-regulation.**

**Will it ever be possible for sectoral regulators to disappear completely?**

- 7.33. There is, of course, a difference between slimming down the operations of regulators and phasing them out completely. It is worth drawing a distinction between competition authorities and sectoral regulators in this respect. The need for competition authorities such as the Competition Commission (CC) and the Office of Fair Trading (OFT) to monitor and enforce competition law has never seriously been doubted. As Peter Freeman, Chairman of the Competition Commission put it, “if you just had the UK market economy and no competition authorities, you would very rapidly get into difficulty because, although it is a paradox, authorities have to intervene from time to time in a measured and proportionate way in order to make the market economy work effectively” (Q 782).
- 7.34. Our focus has therefore been on sectoral regulators which in many cases were established on the presumption that they would reduce the scope of their activities over time. However, an important distinction needs to be made between sectoral regulation and sectoral regulators. All witnesses agreed that sectoral regulation would continue to be required for the natural monopoly networks that existed in many of the sectors within our remit: the pipes, wires and tracks (QQ 10, 244–245, 275, 416, 622, 690, 737, 740, 750, p 89). Stephen Glaister’s comment encapsulated this argument: “As long as there are networks involved in supplying these services—gas, water, electricity and railways—which have the characteristic of a natural monopoly there will need to be some mechanism for looking after the public interest in

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<sup>66</sup> CAA, CAA Air Fares Policy: Removing Regulation (London: CAA, 2006), [http://www.caa.co.uk/docs/589/ERG\\_EPIA\\_20061116FaresDecisionDocument.pdf](http://www.caa.co.uk/docs/589/ERG_EPIA_20061116FaresDecisionDocument.pdf) (accessed 3 July 2007), p.1

that field” (Q 10). The only rider is that, looking into the future, we should not rule out the possibility of changes in technology that may result in some networks becoming irrelevant and/or losing their natural monopoly status (QQ 713, 737). As Sir John Bourn observed, “somewhere where we have a regulator now we may find that with technology and more players in the market we do not need the regulator” (Q 713).

- 7.35. As the potentially competitive parts of a market are opened up to competition and sectoral regulation is scaled back, it may become possible for other institutions to perform the core, irreducible functions that are currently performed by the sectoral regulators. Regulation of the natural monopoly networks could be carried out by the competition authorities and the other remaining duties that some regulators have, such as health and safety regulation could be passed on (or passed back) to the most appropriate body such as the Health and Safety Executive. The need for sectoral regulators, even if not sectoral regulation, would then come to an end. John Fingleton said, “There is much non-economic work that there will be a need for ... and for the economic work there will be a need for sectoral regulation. I think the question of who does it is another question” (Q 245).
- 7.36. Several witnesses suggested that it might be possible to reach a stage where issues currently overseen by sectoral regulators moved to the competition authorities (Q 78, Q 245, Q 713, Q 805). Sarah Chambers from Postcomm said, “Genuinely we hope for, and ... are striving towards, a time when there is enough competition in this market, or enough of a threat of competition, for the market genuinely to be able to take over from us all the sort of intrusive, what we call, *ex ante* regulation ... Genuinely we believe that can happen” (Q 78). Keith Boyfield said “My ideal, though it may well be some long way off, would be to see really the competition authorities, maybe a fair trading authority, take over from all these individual sector regulators. Over the last 10 years, I think that objective goal might be more distant than if you had asked me 10 years ago, but it is still something I think we should aim for” (Q 733).
- 7.37. However, it will be apparent that in some sectors, there is a long way to go before effective competition develops, even in those parts of a market that are potentially competitive. When asked about the scope for regulatory withdrawal in the water sector, the Major Energy Users’ Council (MEUC) said, “that cannot happen at the moment because there is no competition in the water industry in the same way as there is in gas and electricity and telecoms” (Q 461). Similar comments were made with respect to post. The Mail Competition Forum (MCF) said that “in a market where there is one super-dominant operator, an increased level of regulatory protection is required to ensure that competition can develop and benefit UK mail users” (p 571).
- 7.38. A lot of the evidence we received highlighted the way in which regulators’ roles kept on expanding, taking them further away from eventual demise. This is supported by the data we received on regulators’ costs and staff numbers. Although a few regulators within our remit have reduced their individual headcount over the past three financial years, the number of staff employed by regulators collectively in the financial year 2006/07 was almost 6,246,<sup>67</sup> a 9.14 per cent increase over the comparable figure for the financial

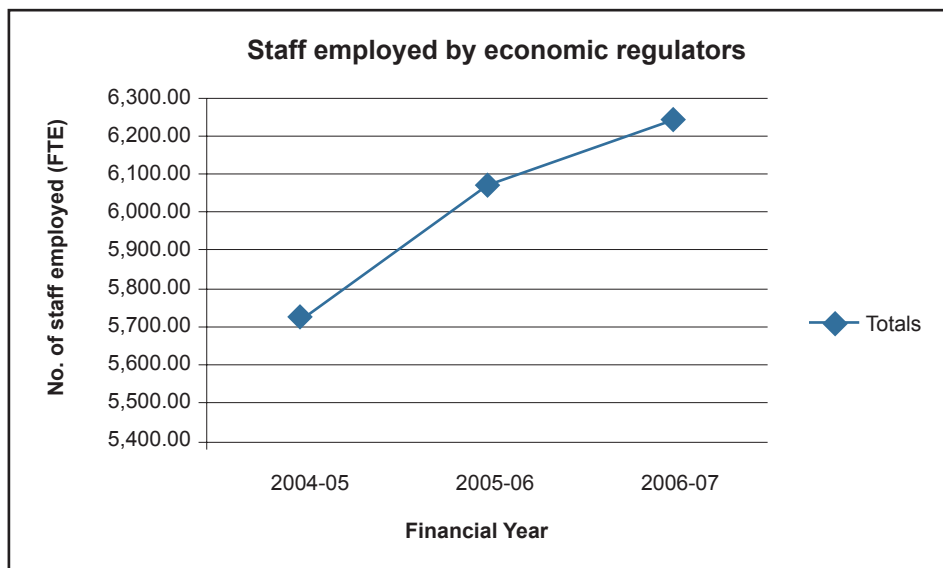
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<sup>67</sup> Full time equivalents (FTE)

year 2004/05. The overall growth in the number of staff employed by regulators is illustrated in the chart below:

**FIGURE 1**

**Staff employed by economic regulators**



- 7.39. Several witnesses commented upon the tendency for the regulators to keep looking for new things to do (Q 334, Q 485, p 296, p 459). Clive Davenport from the Federation of Small Businesses said, “when most of the regulators were formed the world was a totally different place and I feel that they have become self-perpetuating bodies, and there is a problem with that because they end up searching for something else to look at” (Q 334). The RadioCentre thought that the re-creation of a discrete radio department within Ofcom had encouraged this tendency: “the creation of a little radio department within Ofcom where the staff work exclusively on radio ... has a number of problems not least of which is that if individuals work only in one sector then their propensity to deregulate in that sector is significantly reduced because nobody wants to lobby themselves out of a job” (Q 485).
- 7.40. More often than not, however, we heard the view that the accretion of duties by regulators was caused by others—Government, Parliament and the EU—rather than regulators themselves. The Chairman of Ofcom made the following point about regulatory expansion: “the primary cause of that, I suspect, lies ... in Parliament, because it is Parliament and Government that tend to expand the roles of regulators” (Q 41). Tom Harris MP pointed out that “The widening of the remit of the ORR was a deliberate move, of course. It was not a kind of self-motivating movement that was a kind of empire-building among the regulators to improve their own remit, it was a deliberate act of Parliament to place health and safety responsibilities under the umbrella of the ORR” (Q 635). The OFT expressed a concern that “the better regulation agenda is encouraging Government to have fewer bodies doing regulation, while at the same time new regulations come from both Parliament and from Brussels” (Q 785).
- 7.41. Initiatives from the EU are having an increasing impact on the role of economic regulators. The FSA wrote, “The EU is a particularly important arena for us, given the extent to which much financial services regulation in

the UK has its basis in European legislation. We therefore work closely with the Treasury (who lead in this area) to influence the agenda and decisions of the European Commission and discussions in the European Parliament and to promote better regulation disciplines at a European level” (p 164). Ofgem explained that, “EU Directives and Regulations ... have the potential to impact increasingly on competition and regulatory policy in Britain” (p 68).

- 7.42. The CAA told us of the concerns it had in relation to the draft Airport Charges Directive. These included the effect of the draft Directive on the number of airports that it would end up regulating and the level of regulation required at those airports. Harry Bush said that if the CAA became the independent national regulatory authority for the purposes of the Directive it “could end up having responsibilities under that Directive for 20 [UK] airports ... 16 of [which it] had never interfered with before; so far from there being a sunset clause there is a huge sunrise coming, from a regulatory point of view, and one which is a bit unwelcome, to be frank” (Q 82).
- 7.43. If sectoral regulators were eventually to be phased out in favour of the competition authorities, a number of measures would seem to be required. At the UK domestic level, a mechanism would be needed to ensure that regulators were withdrawing regulation where possible and that new duties were not bestowed upon them unless there was a clear cost-benefit case for doing so. At the same time, measures would be needed to ensure that sectoral regulators were promoting competition effectively to hasten the time when *ex-ante* regulation of the potentially competitive elements of the market could be lifted. It would then be necessary to arrange for the core, irreducible roles that sectoral regulators currently perform (in particular the regulation of the natural monopoly networks) to be carried out by the competition authorities. This in turn would be likely to result in a significant expansion in the role of these authorities which would need to be managed appropriately with measures taken to ensure that access to the necessary industry expertise is retained.
- 7.44. At the EU level, UK regulators and their sponsoring Departments have limited scope for control. Harry Bush described the process that the CAA was going through in trying to influence the draft Airport Charges Directive: “It is actually trying to pull a number of different levers and ... talking as well to the European Parliament who are going to be involved in this proposed Directive. There is a whole range of things; you cannot just pull one particular lever, you have to go right across the piece and it is an extremely time consuming effort” (Q 794). Alistair Buchanan, Chief Executive of Ofgem, said “The Chairman pitches his tent regularly in Brussels; in fact a huge amount of his time allocation to Ofgem is spent in Brussels” (Q 121).
- 7.45. **It might be possible for sectoral regulators to disappear but certainly not in the immediate future. If sectoral regulators are phased out, the core, irreducible functions that they perform would have to be performed by other organisations, such as the competition authorities. If possible, it would be worth instituting measures that lead in this direction without necessarily expecting the demise of sectoral regulators to come soon.**
- 7.46. **We recommend that the proposed Select Committee on Regulators (see paras 1.29-1.30) take on the duty to ensure that the sectoral regulators it oversees are promoting competition and withdrawing from sectoral regulation wherever appropriate.**

- 7.47. **We recommend that, subject to any restrictions imposed by its statutory remit, the Competition Commission conduct a periodic review on whether effective competition exists in the markets overseen by sectoral regulators, with the aim of scaling back sectoral regulation to the greatest extent possible.**
- 7.48. **We endorse the OFT's proposal (in response to the joint report by the DTI and HM Treasury on concurrency) that it reports to the Joint Regulators' Group on an annual basis, providing an overall view about whether competition law is being applied consistently and proactively across all the sectors. The OFT could also report on the compliance of regulators with the BRE's principles of good regulation.**

**Collectively do the regulators add to the competitiveness of UK firms or detract from it?**

- 7.49. It is not part of the remit of economic regulators to promote the competitiveness of UK firms, as opposed to promoting competition. In many ways this is surprising given the importance of the sectors overseen by the regulators—utilities, infrastructure and financial services—in supporting competitiveness.
- 7.50. Recent evidence of this was provided by the Eddington Transport Study which demonstrated the crucial importance of the UK's transport networks in enabling sustained productivity and competitiveness. Tom Harris MP said, "The Eddington Report published at the end of last year made quite clear the link between good transport links and the benefits to the wider UK economy ... whatever performance improvements are made through the ORR on Network Rail, that has a knock-on effect on the train operating companies and, therefore, the UK economy" (Q 641).
- 7.51. Whilst none of the economic regulators has a primary statutory duty to promote competitiveness, there are a number of ways in which they help to foster it indirectly.
- 7.52. First, economic regulators promote competition which, in turn facilitates—but does not ensure—competitiveness. Peter Freeman, Chairman of the Competition Commission said, "In so far as we are trying to draw a distinction between competition and competitiveness, we would see them very much as pointing in the same direction. By promoting competition and effective competition policy, we hope and we expect that that will contribute to the promotion of competitiveness of firms in the UK and the UK economy" (Q 791).
- 7.53. Competition is likely to boost competitiveness in a variety of ways. One is the positive effect it has on productivity. The OFT stated that "Competition drives productivity, innovation and growth in the economy at large" (p 129). In January 2007, it published a paper highlighting the strong links between competition and productivity. The paper demonstrated that competition drives productivity via the effects it has within firms, between firms and, generally, on innovation. For example, it highlighted the way in which competition placed pressure on the managers of firms to increase internal efficiency (x-efficiency). It also highlighted the way in which "Competition

ensures that higher productivity firms increase their market share at the expense of the less productive.”<sup>68</sup>

- 7.54. These processes leave UK firms in a stronger position to compete internationally. John Fingleton told us that “in general, all of the economic evidence, starting with Porter, and so on, is that vibrant domestic competition is the best basis for international competition, and that protectionism at home leaves companies less well equipped to penetrate foreign markets” (Q 241).
- 7.55. Competition amongst firms in the utility and infrastructure sectors is also likely to raise competitiveness because it has the effect of improving service quality and putting downward pressure on prices in sectors that provide vital inputs for UK industry, thus affecting a wide range of goods and services. David Newbery, of Cambridge University, wrote that “By and large competition improves economic performance—competition lowers both costs and prices of regulated services which are an input into other sectors” (p 11).
- 7.56. The Mail Competition Forum pointed out that “In postal services, the immediate measure of the effect on the economy [of the regulator] is the savings which are made by UK businesses, charities, government and other organisations since the introduction of competition and the imposition of price controls on Royal Mail” (p 570). In fact, by raising service quality standards, competition benefits all users, not just the ones who benefit from lower prices. Sarah Chambers from Postcomm said “We think it is the combination of the threat of competition, and regulation where competition clearly does not exist ... that keeps up the quality, choice (in terms of the types of service [residential users] get, even if it is not necessarily different operators), and value for money” (Q 72).
- 7.57. Earlier in the chapter we described how some regulators had been much more successful than others in facilitating competition. If competition is a key driver of competitiveness, the suspicion arises that in some sectors, regulators may not be doing enough to boost competitiveness. We think that economic regulators should be required to facilitate the competitiveness of UK firms by promoting competition.
- 7.58. The effective regulation of infrastructure companies is also likely to bring down prices and raise the quality of service in sectors that support UK industry. The Chief Executive of Ofgem told us that, in the energy sector, “in the ten years from around 1993-94 UK industry benefited to the tune of around £8 billion compared with the German equivalent ... the UK story is one of cost-cutting on networks and getting rid of unfair contracts. The German story is unfair contracts and expensive networks” (Q 811). In the water sector, Severn Trent Water wrote that the “Achievement of efficiency savings has promoted international competitiveness by keeping down input prices for industry” (p 613).
- 7.59. In his advice to Government, Sir Rod Eddington explained that “Transport corridors are the arteries of domestic and international trade, boosting the competitiveness of imports and exports. 28 per cent of the UK’s national income is traded and, over the last 40 years, falling international transport

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<sup>68</sup> OFT, Productivity and competition: An OFT perspective on the productivity debate (London: OFT, 2007), [http://www.of.gov.uk/shared\\_of/economic\\_research/oft887.pdf](http://www.of.gov.uk/shared_of/economic_research/oft887.pdf) (accessed 5 July), pp. 5-6

costs have boosted trade, increasing the UK's economy by over 2.5 per cent".<sup>69</sup> In an October 2006 report, Oxford Economic Forecasting wrote that "[Aviation's] key contribution to the UK economy is in helping other sectors to operate more efficiently and to compete in the global economy".<sup>70</sup>

- 7.60. Gillian Merron MP said, "If we look at Sir Rod Eddington's review ... which was about the role of transport, and aviation as being part of that ... there is a very, very close link between transport and our productivity and prosperity ... If we look at international gateways and the role of places like Heathrow as the international hub ... with business that is how they want to keep it, and they want to promote it" (Q 633).
- 7.61. Although economic regulators can increase competition and competitiveness, they can also risk detracting from them, depending on the approach they take to regulation. This links in with questions about how regulators work, discussed in Chapter 4, and with questions about de-regulation that were discussed earlier in this chapter. The key here is balance. Tim Ambler and Keith Boyfield pointed out that "All markets require some rules in order to operate openly and competitively. These rules limit entry, innovation and add to administrative costs on the one side but also make the markets attractive and thereby grow ... Beyond the optimal point, the costs increasingly outweigh the benefits especially when they make the market less attractive. These are not absolutes but relative to alternative markets" (p 460). The question then is, "what is the optimal point and how do you measure it?"
- 7.62. To the Gas Forum, the fact that "a number of companies in the GB on-shore gas and electricity sector are in foreign ownership suggests that having an economic regulator does not detract from [the] UK's competitiveness. However, costs imposed by [the] burden of regulation on market participants which are higher than international levels could affect international competitiveness" (p 537).
- 7.63. The Mobile Broadband Group said that "Overall, we believe that the regulatory structures in place for the UK communications market are appropriate and fit for purpose". It pointed to the fact that "Ofcom seems to have a greater appetite for self-regulation than its peers in the EU and we support them in this ... In an era where it will be relatively easy to distribute content via the Internet to UK consumers from territories outside Ofcom's reach, we see it as vital to the interests of the UK economy that Ofcom continues to promote a responsible mix of formal and self-regulation" (p 300).
- 7.64. We did hear some concerns that the regulatory regime for financial services was too burdensome. Royal Bank of Scotland Group (RBSG) said, "The UK financial sector is generally regarded as one of the global market leaders yet the UK regulatory regime is also one of the more onerous, a situation which, unless care is taken, will only reduce the ability of UK companies to challenge international competitors and rival the market leaders" (p 602).

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<sup>69</sup> Sir Rod Eddington, *The Eddington Transport Study: The case for action: Sir Rod Eddington's advice to Government* (London: DfT, 2006), <http://www.dft.gov.uk/162259/187604/206711/executivesummary> (accessed 19 July 2007), p.5

<sup>70</sup> Oxford Economic Forecasting, *The Economic Contribution of the Aviation Industry in the UK*, (Oxford: Oxford Economic Forecasting, 2006) <http://www.oxfordeconomics.com/Free/pdfs/Aviation2006Final.pdf> (accessed 19 July 2007), p.5

According to the Association of British Insurers, “recent trends demonstrate that some companies (including re-insurers and institutional investors) are choosing to establish themselves elsewhere, such as Ireland or Bermuda. Increased regulatory burdens do have an effect on capital allocation decisions. Incrementally, such burdens are likely to drive mobile capital away from the City of London, to the detriment of the British economy overall” (p 374).

- 7.65. On the other hand, the ABI also recognised the strengths of the approach adopted by the FSA: “In general the FSA employs a sophisticated risk-based approach to regulation of financial services in the UK. In terms of capital adequacy in particular, the UK insurance industry enjoys one of the most advanced regimes in the world... In addition, research by Oxera suggests the UK’s corporate governance regime is internationally competitive” (p 374).
- 7.66. The overall picture from the evidence we have taken is that the FSA appears to have a positive rather than negative influence on international competitiveness. The FSA said, “Our approach to regulation is driven by the need to achieve our statutory objectives in a way which is proportionate and consistent with innovation and competition in the financial sector. This approach is an important and positive contributor to the UK’s position as a leading global financial centre” (p 167). A McKinsey and Company report<sup>71</sup> published in January 2007, found that senior executives considered the regulatory environment for financial services and the responsiveness of regulators to be highly important for competitiveness and considered that London outperformed New York in these respects.
- 7.67. Malcolm Williamson of the Centre for the Study of Financial Innovation explained the way in which, from a firm’s perspective, having a good regulator could provide a competitive advantage: “If you are regulated by the FSA and you are working internationally, I think it is a big advantage. I think that is because other people trust the FSA ... From that point of view, you could say that having a good regulator does help you when it comes to international competition, and that is certainly true in the financial services sector” (Q 745).
- 7.68. **Economic regulators promote competition which, in turn facilitates—but does not ensure—competitiveness. The positive effect that regulators have on competitiveness is achieved indirectly because promoting the competitiveness of UK firms does not normally form part of the regulators’ remit. Given the importance of the role played by the regulated sectors in supporting UK industry, we think it is vital that economic regulators fully consider the impact of their decisions on UK firms’ competitiveness.**
- 7.69. **We recommend that, as legislative opportunities arise, economic regulators be statutorily required to facilitate the competitiveness of UK firms by: i) promoting competition; and ii) removing regulatory burdens from firms wherever possible.**

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<sup>71</sup> McKinsey and Company, Sustaining New York’s and the US’ Global Financial Services Leadership, at [http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special\\_reports/2007/NY\\_REPORT%20FINANCIAL.pdf](http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20FINANCIAL.pdf) (accessed 6 July 2007)

## APPENDIX 1: LIST OF MEMBERS

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The members of the Committee which conducted this inquiry were:

Earl of Arran  
Lord Dubs  
Baroness Ford  
† Lord Garden  
Viscount Goschen  
Lord MacGregor of Pulham Market  
Lord McIntosh of Haringey (Chairman)  
Lord Moonie  
Lord Norton of Louth  
Baroness Prashar  
Lord Ramsbotham  
Lord Sharman

† Until 25 May 2007

Mr Graham Corbett and Ms Eileen Marshall were appointed as Specialist Advisers for the inquiry.

### Declaration of Interests

Full lists of Members' interested are recorded in the Lords Register of Interests. Details can be found at the following web address:  
<http://www.publications.parliament.uk/pa/ld/ldreg.htm>

## APPENDIX 2: LIST OF WITNESSES

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The following witnesses gave evidence; those marked \* gave oral evidence:

- Albion Water
- \* Mr Tim Ambler and Mr Keith Boyfield
- Aqua Resources Ltd
- Aquavitae (UK) Limited
- \* Association of British Insurers
- \* Association of Electricity Producers
- \* Association of Independent Financial Advisers
- Association of Investment Companies
- Association of Personal Injury Lawyers
- \* Association of Train Operating Companies
- \* BAA
- Better Regulation Commission
- British Airways
- \* British Air Transport Association
- \* British Bankers' Association
- \* British Chamber of Commerce
- British Energy
- \* British Telecommunications plc
- British Water
- Bundesrepublik Deutschland
- \* Professor Martin Cave, Warwick University
- Centrica
- \* Citizens Advice Service
- \* Civil Aviation Authority
- \* The Competition Commission
- \* Consumer Council for Water
- Credit Suisse
- \* Department for Environment, Food and Rural Affairs: Ian Pearson MP, Minister for Water Issues
- \* Department for Trade and Industry: Jim Fitzpatrick MP, Minister for Postal Services
- \* Department for Trade and Industry: Lord Truscott, a Member of the House, Minister for Energy; Mr Keith Evans, Energy Markets Unit, Regulatory Frameworks
- \* Department for Transport: Tom Harris MP, Minister for Rail
- \* Department for Transport: Gillian Merron MP, Minister for Aviation
- E.ON UK
- \* Energywatch
- \* Energy Networks Association
- \* Energy Rail Association
- \* Federation of Small Businesses

- Finance and Leasing Association
- \* Financial Ombudsman Service
- \* Financial Services Authority
- \* Financial Services Consumer Panel
- Freshfields Bruckhaus Deringer
- Fuel Poverty Advisory Group
- Gas Forum
- \* Professor Stephen Glaister, Imperial College London
- Highclere Financial Services
- \* HM Treasury: Ed Balls MP, Economic Secretary; Mr Clive Maxwell, Director, Financial Services, and Mr Will Straw, Enterprise Team
- Home Builders Federation
- IFA Defence Union
- Indepen
- \* Institute of Directors
- \* ITV plc
- \* Mr Tim Keyworth, The Regulatory Policy Institute
- London Investment Banking Association
- Mail Competition Forum
- \* Mail Users' Association
- \* Major Energy Users' Council
- \* Manchester Airports Group
- \* Mobile Broadband Group
- \* National Audit Office: Sir John Bourn, Comptroller and Auditor General; Ed Humpherson, Director of Regulation
- \* NATS
- \* National Consumer Council
- National Energy Action
- National Grid plc
- Network for Online Commerce
- \* Network Rail
- \* Professor David Newbery, Cambridge University
- Nokia
- Northern Ireland Authority for Energy Regulation
- Norwich Union
- Ofcom Consumer Panel
- \* Office of Communications
- \* Office of Fair Trading
- \* Office of Gas and Electricity Markets
- \* Office of Rail Regulation
- Orange
- Mr James Page
- \* Passenger Transport Executive Group
- \* The Pensions Regulator

- \* Postal Services Commission
- \* Postwatch
- Professor Tony Prosser, University of Bristol
- \* RadioCentre
- \* Rail Freight Group
- Regulatory Policy Institute
- Royal Bank of Scotland Group
- \* Royal Mail
- RWE npower
- ScottishPower plc
- Severn Trent Water Limited
- Mr Graham Shuttleworth, NERA Economic Consulting
- Slaughter and May
- \* Mr Jon Stern, City University
- \* TNT Post UK Limited
- TRS Independent Financial Advisers
- United Utilities plc
- \* Mr Peter Vass, University of Bath
- Mr Frank Vibert, European Policy Forum
- Virgin Atlantic Airways
- \* Water Services Regulation Authority
- \* Water UK
- Which?
- Whitechurch Network Ltd
- \* Mr Malcolm Williamson, Centre for the Study of Financial Innovation

## APPENDIX 3: CALLS FOR EVIDENCE

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### First Call for Evidence (December 2006)

The Committee has decided to conduct an inquiry into the following major UK economic regulators:

Sectoral regulators:

- Office of Gas and Electricity Markets (Ofgem)
- The Water Services Regulation Authority (Ofwat)
- Postal Services Commission (Postcomm)
- Office of Rail Regulation (ORR)
- Civil Aviation Authority—Economic Regulation Group (CAA)
- Office of Communications (Ofcom)
- Financial Services Authority (FSA)
- The Pensions Regulator

Functional regulators:

- Office of Fair Trading (OFT)
- Competition Commission (CC)

The Committee will explore the working methods of the regulators and their effectiveness; the relationship between the regulators; the public interest and the interests of consumers; the regulators' impact on competition within domestic industries and the UK economy's international competitiveness; and the regulators' use of Regulatory Impact Assessments.

The Committee look at the above economic regulators individually and also collectively, comparing working methods and highlighting best practice.

The Committee would be pleased to have your views. The Committee in particular will explore the following key issues in detail and would welcome your views on **any or all** of the following questions. **Please note that questions are not listed here in any particular order of importance.**

Written evidence must arrive by no later than Friday 9 February but would be welcome before that date.

#### *Regulators' working methods and their effectiveness*

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?

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?

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?

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?

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?

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?

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

#### *Economic regulators and the public interest*

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’?

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?

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?

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?

#### *Competition within domestic industries and the UK economy’s international competitiveness*

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

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?

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?

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?

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

### *Economic regulators' use of regulatory impact assessments*

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

- Is properly resourced and transparent;
- Produces high quality consistent analysis;
- Targets resources at areas of greatest economic risk;
- Provides genuine consultation with stakeholders;
- Requires regulators to explain why non-regulatory options have not been pursued; and
- 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)?

### **Second Call for Evidence (June 2007)**

The Committee decided to release this additional Call for Evidence to enable more evidence to be submitted on the nature of the impact the UK economic regulators make, individually and collectively, on the UK economy and UK competitiveness.

The Committee would be pleased to have your views and would welcome your views on **any or all** of the following questions. **Please note that questions are not listed here in any particular order of importance.**

Written evidence must arrive by no later than Friday 1 June but would be welcome before that date.

- To what extent can the impact of the UK economic regulators on the UK economy be quantified?
- Where regulators have promoted competition, is it possible to quantify the benefits of competition, such as lower prices and improved standards of service? Where competition is not feasible have regulators nevertheless been able to reduce prices and/or improve service standards compared with what would have occurred otherwise?
- Where competition has been introduced, have regulators deregulated the relevant markets as quickly and comprehensively as feasible to achieve the full benefits of competition?
- What estimates of the costs of economic regulation have been made or could be made?

- Does the existence of economic regulators assist the economic performance of firms in the UK and their international competitiveness or does it detract from that performance?
- Can the continued existence of economic regulators be justified on the grounds that the continuing benefits they provide exceed the costs they incur in their own operations and the costs they impose on the businesses they regulate?
- What can be done to increase the benefits and reduce the costs of economic regulation? Are there steps that could be taken that would bring greater benefits from economic regulation and/or reduce its costs? If there are such steps, should they be taken by government departments, by the regulators themselves or by others?

## APPENDIX 4: NATIONAL AUDIT OFFICE REPORT ON REGULATORS' USE OF IMPACT ASSESSMENTS

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### Summary

1. Impact assessment is a tool for assessing the need for and the impact of a proposed regulation. Used well, impact assessment can lead to a better understanding of the consequences of a regulation and thus encourage evidence-based decision making. Impact assessment also increases the transparency and accountability of policy-making because reasoning is exposed to challenge both internally and from interested stakeholders. The National Audit Office has reviewed the quality of the impact assessments produced by Government departments for the last four years.

2. In March 2007 we were invited by the House of Lords Select Committee on Regulators to review the way that impact assessment is performed by five regulators: Ofcom; Ofgem; Ofwat; Postcomm; and the Office of Rail Regulation (ORR). This report sets out each regulator's approach to impact assessment (Part One); reviews the quality of a sample of their impact assessment documents (Part Two); and considers the framework that regulators have established for developing impact assessment documents and how the process fits into their wider policy development cycle (Part Three).

### Overall conclusion

3. All five regulators have made the impact assessment process an integral part of their policy making by using it to consult iteratively with their stakeholders. There are, however, weaknesses in the quality of the impact assessment documents that some regulators are producing. To improve quality, regulators need to strengthen their analyses of costs and benefits and routinely set out how a policy's impact will be measured post-implementation.

### Key findings

#### *Regulators' approach to impact assessment*

4. Of the five regulators, only Ofcom and Ofgem have a statutory duty to carry out an impact assessment on important policy proposals. These two regulators routinely produce formal impact assessment documents as part of the policy-making process. Furthermore, only Ofgem is producing self-contained impact assessments equivalent to those produced by Government departments. Ofwat, Postcomm and ORR use consultation documents in similar circumstances, which contain much of the same information, but in some cases less detailed analysis. (Paragraphs 1.2 to 1.3 and 1.6)

5. The nature of regulators' statutory duties and their roles mean that they do not use impact assessment in the same way as Government departments. For Government departments, an analysis of costs and benefits should form the basis of their decision to implement, or amend, regulations. Regulators use such analysis to inform decisions but, ultimately, decisions are taken within their own statutory framework and not on a "net benefit" test. In addition, regulators' interventions are not always driven by identifying a market failure. On many occasions regulators' impact assessments deal with commitments already given by Government, the European Union, or are necessitated by their statutory duty. The

primary focus, therefore, is often on how the regulation should be implemented. (Paragraphs 1.4 to 1.5)

### *Quality of impact assessment documents*

6. The transparency of regulators' impact assessment documents is often impaired by fragmented structures and excessive length. Six of the ten impact assessments we reviewed had "room for improvement" in their presentation. Regulators had set out the objective of the impact assessment, the problem to be addressed and the final recommendation of the assessments. This information was, however, frequently difficult to locate. (Paragraphs 2.4 to 2.5)

7. Regulators have used consultation effectively in developing policy. We rated all ten consultation exercises as "good quality". We also found many examples of good practice including the use of focus groups, industry workshops, regional road shows, and expert panels. (Paragraph 2.7)

8. Regulators are not routinely producing good quality, proportionate analyses of costs and benefits. Two of the ten assessments had "serious defects" in their analysis, with six more having "room for improvement". Only Ofcom's two assessments contained "good quality" analysis. Regulators had all undertaken some qualitative analysis. However, two common weaknesses in the impact assessments we reviewed were a lack of meaningful comparisons between alternatives or an appropriate level of quantitative analysis. There are a number of circumstances where a regulator's quantitative analysis might create misleading certainty and in these circumstances qualitative analysis has an important role. It may not be possible to carry out quantitative analysis because estimates cannot be made robustly or sufficient data is not available. It is also possible that it would not be proportionate. However, the performance of some quantitative analysis, or at the very least an explanation of why this is not possible, would have been appropriate. (Paragraphs 2.8 to 2.10)

9. Regulators are not consistently using impact assessments to set out how they intend to measure a policy's impact post-implementation. Only two out of ten impact assessments gave firm details of how they intended to measure the success of the proposed policy. (Paragraph 2.11)

### *Use of impact assessment in the policy making process*

10. The regulators all appear to have successfully integrated the impact assessment process into their policy development. They use the impact assessment process to consult in an iterative way with stakeholders in order to re-formulate and refine policy proposals. This should allow the evidence gathered to influence decision-making. (Paragraphs 3.8 to 3.13)

11. Ofcom and Ofgem currently have guidance and training on how to produce formal impact assessments. Ofwat is revising its guidance, which was originally produced in 2001 but not used regularly. Postcomm is developing written guidance. ORR is committed to keeping its approach under continual review. (Paragraphs 3.2 to 3.7)

## **Recommendations**

(A) Whilst working within their statutory duties, regulators should ensure that important decisions are taken on the basis of proportionate, objective analysis as well as stakeholder views. If not, there is a risk that regulators may not fully understand the impacts of the proposed policy or method of implementation.

Regulators should, therefore, ensure that the principles of impact assessment are embedded in both their processes and the documents they produce.

(B) In order to improve the quality of impact assessment documents, regulators should:

- produce impact assessments that ensure that key information is easy to find, and either sign-posts or summarises additional analysis or technical information;
- ensure that impact assessments contain a proportionate analysis of costs and benefits using quantitative estimates where they can be made robustly and making clear comparisons between options; and
- set out clearly when and how they intend to measure a policy's impact.

(C) In order to ensure that the quality of their impact assessments improves, regulators should find a way of sharing good practice regularly. There is already some evidence of this occurring. Ofwat and Postcomm are developing formal, written impact assessment guidance with the cooperation of Ofcom and Ofgem respectively.

### Regulators' approach to impact assessment

1.1 This part examines the approach that the regulators take to impact assessment. We found:

- two of the five regulators, Ofgem and Ofcom, have a statutory duty to produce impact assessments on important policy proposals;
- the nature of regulators' roles and their statutory duties mean that they do not approach impact assessment in the same way as Government departments; and
- although the Government accepted a Better Regulation Task Force recommendation that all independent regulators should produce impact assessments, only the two regulators with the statutory duty are routinely performing them. All the regulators do, however, produce consultation documents which seek to achieve the same purpose and contain much of the same information as impact assessments.

#### *The requirement to produce impact assessments*

1.2 Of the five regulators we reviewed, only Ofcom and Ofgem have a statutory duty to produce impact assessments on important policy proposals. Ofcom and Ofgem are also required to publish a list of impact assessments undertaken in their annual report and a summary of decisions taken in relation to proposals where assessments were carried out. The other three regulators—ORR, Postcomm and Ofwat—do not have a statutory duty to produce impact assessments.

1.3 In October 2003, the Better Regulation Task Force published a report<sup>72</sup> recommending that all independent regulators should produce impact assessments. It specified that these should be made available for public scrutiny or if not, the regulators should explain why they decided not to produce an impact assessment. The Government accepted this recommendation in February 2004.

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<sup>72</sup> Better Regulation Task Force, *Independent Regulation*, October 2003.

### *Approach to impact assessment in the regulators*

1.4 The requirement of regulators to work within their statutory duties means that they do not necessarily use impact assessments in the same way as Government departments. The biggest difference concerns their use of cost-benefit analysis. For Government departments, an analysis of costs and benefits will usually form the basis of the decision to implement or amend regulations. For regulators, such analysis is used to inform decisions but, ultimately, they are taken within the framework of their statutory duties and not solely an analysis of costs and benefits.

1.5 The nature of the regulators' roles is also important. Regulators' interventions may be driven by identifying a market failure, the achievement of their statutory duties or may deal with commitments already given by Government or the European Union. Larger policy proposals may also be made by the body's sponsoring Government Departments, who will produce the appropriate impact assessments.<sup>73</sup> This should not, however, prevent regulators from producing their own impact assessment on how the policy should be implemented or cooperating with the relevant sponsoring department to produce one. For example, Ofwat produced a series of impact assessments on how it would implement various aspects of the Water Act 2003, working closely with DEFRA and the Welsh Assembly Government.

1.6 Only Ofcom and Ofgem, who both have a statutory duty to produce impact assessments, are regularly undertaking them. Ofgem produces self-contained, formal impact assessments—equivalent to those produced by Government departments—and uses these as part of its wider consultation process. Ofcom's impact assessment documents are incorporated into its consultation documents. The regulators have some discretion as to how to intervene and Ofwat, ORR and Postcomm all produce consultation documents which perform many of the same functions as an impact assessment, but not all. They do, however, set out the problem to be addressed, the policy options, some analysis and a summary of the comments and opinions of the stakeholders in a similar way to a formal impact assessment. Figure 1 sets out the number of formal impact assessments undertaken by each regulator in 2006-07 and 2005-06 and Figure 2 sets out the number of consultations undertaken over the period.

**FIGURE 1**

**Number of formal impact assessments undertaken in 2006/07 and 2005/06**

<b>Regulator</b>	<b>Number of impact assessments published 2006-07</b>	<b>Number of impact assessments published 2005-06</b>
Ofcom	46	40
Ofgem	13	12
Ofwat	0	3
Postcomm	0	1
ORR	0	0

**NOTES**

- Multiple impact assessments on the same subject only counted once. For example, in 2005-06 Ofwat completed six impact assessments on the implementation of the Water Act 2003.
- Ofwat, Postcomm and ORR use consultation documents to set out their assessment of the impacts of policy options.

*Source: Figures provided by the regulators*

<sup>73</sup> For example, the DfT has made policy proposals and impact assessments for: The Railways (Interoperability) Regulations 2006; Health and Safety (Enforcing Authority for railways and other guided transport systems) Regulations 2006; The Railways Act 1993 (Determination of Turnover) Order 2005.

FIGURE 2

## Number of consultations undertaken in 2006/07 and 2005/06

Regulator	Number of consultations published 2006-07	Number of consultations published 2005-06
Ofcom	63	63
Ofgem	65	80
Ofwat	12	12
Postcomm	16	22
ORR	23	22

## NOTES

1. Multiple consultations on the same subject counted once.
2. Ofwat, Postcomm and ORR use consultation documents to set out their assessment of the impacts of policy options.
3. The ORR figures do not include statutory consultations e.g. for track access applications.

*Source: Figures provided by the regulators*

1.7 Where no formal impact assessments were produced by a regulator we assessed consultation documents against our criteria as though they were formal impact assessments<sup>74</sup> acknowledging that such consultations did not set out to be impact assessments. The term “impact assessment” is used in this report to refer collectively to both types of document.

1.8 In the near future Ofwat aims to start producing impact assessments more regularly and is close to revising its guidance. Postcomm will produce impact assessments where it thinks appropriate and is developing guidance. At present, ORR uses a process of consultations which are intended to achieve the same objectives. ORR believes that this approach is more suited to its own needs and those of its stakeholders,<sup>75</sup> and has committed to keeping its consultation processes under continuous review.

### Quality of impact assessments

2.1 This part sets out the results of our analysis of a sample of impact assessments from each of the five regulators. We assessed the impact assessments against our evaluative criteria and found that the quality was mixed. Our results demonstrate that:

- there is “room for improvement” in the presentation of impact assessments which, in many instances, had fragmented structures and were overly long;

<sup>74</sup> In the case of Ofcom’s two impact assessments, and Postcomm’s impact assessment on ‘Pricing in Proportion’, we considered both consultation documents and formal impact assessment documents together.

<sup>75</sup> ORR’s approach of using consultations was supported by evidence given to the House of Lords Select Committee on Regulators by the industry (1 May 2007) and the Department for Transport (15 May 2007)

- regulators’ use of consultation in developing policy was consistently strong;
- regulators’ assessment of costs and benefits was a weakness—with room to improve the standard of analysis by providing more systematic and quantitative assessments of the impacts of different policy options; and
- there was insufficient consideration of the impact of policy changes post-implementation—with often limited coverage of the steps needed to monitor and evaluate new regulation.

### *Evaluation of impact assessments*

2.2 Our examination focused on five economic regulators: Ofcom; Postcomm; Ofgem; Ofwat; and ORR. We evaluated a sample of ten recent impact assessments, two from each regulator. Figure 3 lists the impact assessments contained in our sample and provides a brief description of each. The criteria used to assess the impact assessments is set out in Figure 4 and we have used a traffic light system to present the results. Appendix 1 provides the scores for individual impact assessments and Appendix 2 outlines further details of our methodology.

**FIGURE 3**

#### **Sample of impact assessments examined by the National Audit Office**

<b>Impact Assessment</b>	<b>Brief Description</b>
<b>ORR</b>	
Rebate Mechanisms for Investors in Large-scale Network Enhancements	Considers a proposal to create a financial mechanism that enables investors to recover some of the costs of financing a project from other parties, particularly commercial competitors, that will use it. (Note: The ORR’s Final Conclusions document was not available at the time of the initial examination. Its contents have, however, been taken into account in our assessments.)
ORR’s Sustainable Development and Environmental Duties	Considers proposals to help ORR address its statutory duty to contribute to sustainable development.
<b>Postcomm</b>	
“Pricing in Proportion”	Examines Royal Mail’s proposal to change its pricing structure from one based primarily on the weight of a mail item to another primarily based on size.
Royal Mail Price and Service Quality Review	Considers a final proposal on price and quality of service of the Royal Mail’s regulated activities.
<b>Ofcom</b>	
TV Advertising Standards for Food and Drink Products to Children	Examines whether to strengthen the rules on the television advertising of food which is high in fat, salt or sugar to children.
Amendment of Wireless Telegraphy exemption regulations	Examines a proposal to amend the Wireless Telegraphy (Exemption) Regulations 2003 to allow new types of equipment to operate on a licence-exempt basis and to amend the frequency bands and equipment which are subject to licence exemption.

<b>Ofgem</b>	
Publication of Near Real Time Data at UK sub-terminals	Examines a proposal to improve transparency in the gas market by requiring the publication of more information about the gas supplies coming onto the network.
Gas Safety Checks and Information	Considers a review of the provision of free gas safety checks to customers who can not afford to pay and of gas safety information to all customers.
<b>Ofwat</b>	
Water Undertakers' New Conditions of Appointment	Examines one aspect of a large policy proposal on the implementation of the licensing provisions of the water Act 2003—the conditions of appointment for water companies which provide water to a defined geographical area.
Setting Water and Sewerage Price Limits	Considers whether the period of time between price reviews should be changed to a longer or shorter time than the current five year cycle.
<i>Source: Information provided by the regulators</i>	

**FIGURE 4**  
**The criteria used to evaluate impact assessments**

<b>Presentation</b>
The regulators should set out a clear explanation of the problem they are seeking to address, the objectives that they wish to achieve through the introduction of a new policy proposal, and their final recommendations in light of the analysis presented. In addition, we considered whether the text was of a proportionate length and suitably structured so as to allow readers to easily access and understand it.
<b>Consultation</b>
Although the regulators are not bound by the Cabinet Office guidelines on consultation issued for government departments, we used this as a “good practice” comparison. The guidance stipulates that all new policy proposals should have written consultation which allows 12 weeks for response, and that consultation responses are published on their websites. We also considered other work undertaken by the regulators to obtain the views of stakeholders.
<b>Assessment of Costs and Benefits</b>
The regulators should supply information on the likely impacts of the policy proposal as well as identifying who would be affected. Our examination focused not just on the quantitative evidence base contained in the impact assessments, but also the qualitative evidence. This included evidence supplied by stakeholders, who may be best placed to identify the costs, if not the benefits, likely to result from any changes in regulation. Where quantitative evidence was not given, we looked to see if the reason for not providing this was given clearly for stakeholders to comment on. We also looked at the range of options that had been considered in the analysis and if the assessment took into account uncertainty in the data and calculations.
<b>Monitoring and Evaluation</b>
Detailed implementation and delivery plans should be included for the recommended option in the final impact assessment along with the proposed approach for monitoring and evaluation.
<i>Source: Information provided by the regulators</i>

2.3 Every impact assessment that we examined contained elements of good quality analysis. There was, however, “room for improvement” in all of the assessments we reviewed (Appendix 1). Figure 5 sets out the regulators’ performance against our evaluative criteria.

**FIGURE 5**  
**National Audit Office analysis of impact assessments**

	Presentation	Consultation	Costs and Benefits	Monitoring and Evaluation
Green	4	10	2	2
Amber	6	0	6	6
Red	0	0	2	2

NOTES:

1. A “green” assessment indicates good quality analysis; “amber” indicates some good assessment but room for improvement; and “red” indicates some major weaknesses in the analysis.
2. Each impact assessment has been assessed against four criteria (see Appendix 2) and this table presents the aggregate results for the ten assessments reviewed against these criteria.

*Source: National Audit Office*

#### *Presentation of impact assessments*

2.4 For the policy making process to be transparent, it is important that the analysis in an impact assessment is set out clearly, concisely and put in the appropriate context. We found that the necessary information on scope, purpose and recommendations were supplied within impact assessment documents. However, six out of ten impact assessments in our sample had “room for improvement” because key information was difficult to find.

2.5 Key information was difficult to locate within the impact assessments for a number of reasons. They were poorly structured, repetitive and it was sometimes unclear how the different documents making up the impact assessments related to each other. One of the impact assessments we reviewed, which was of interest not just to industry but also to the general public, totalled in excess of 450 pages. The fact that impact assessments were made up of multiple documents may reflect the iterative nature of the process and complexity of the issues addressed. However, impact assessments are easier to read and understand if they summarise, or at least sign-post key contextual information and analysis. See Figure 6 for an example of good practice.

2.6 In May 2007 the Better Regulation Executive introduced new guidance which seeks to encourage conciseness and greater consistency in presentation. It stipulates that information on the problem under consideration, policy objectives, the options considered and preferred option are set out in a template at the front of the report.

**FIGURE 6****Good practice example—Ofgem: Publication of Near Real Time Data at UK sub-terminals**

- There is an overview paragraph on the front page of the final impact assessment briefly setting out the problem, objectives, final recommendation and main stakeholder views.
- A “Context” section sets out how this impact assessment document fits in with the previous two iterations of the impact assessment and an “Associated Documents” section lists any other related documents which might be of interest.
- A summary table of costs and benefits is presented in the main text of the document as well as the “Summary” section at the beginning of the document.
- There is a summary at the beginning of each chapter.
- The final impact assessment is 53 pages long and can be read as a stand alone document or related to the other documents.

*Source: Information provided by the regulators*

*Consultation*

2.7 Consultation is an integral part of policy development and the impact assessment process. Stakeholders hold valuable information which aids the development of policy and is key to implementation. We found that consultation was the key strength in the use of impact assessments of the regulators. All ten were rated as being “good quality” and we found many examples of good practice. These included the use of focus groups, industry workshops, regional road shows, expert technical groups, and input from external consultants. See Figure 7 for an example of good practice.

**FIGURE 7****Good practice example—Ofcom: TV advertising of food and drink to children**

- An independent survey of existing relevant research was commissioned in 2004, and updated in 2005, before the proposal options were formed.
- Formal consultation was conducted over a three month period in spring 2006 and a 2nd one month consultation on an updated consultation document was held in late autumn 2006.
- There were 1097 responses to first consultation: 114 from a wide range of interested groups e.g. consumer bodies, advertisers, health bodies, broadcasters and children’s organisations; 655 responses from private individuals.
- An independent research consultancy was commissioned to gauge the public’s response to these proposals in a series of deliberative workshops.
- Stakeholders were invited to present their own options and to comment on the model and data used to assess the proposed policy options
- A summary of consultation responses was published alongside the regulator’s responses.
- The stakeholders’ input led to a revised model and data to analyse the impacts of the different options as well as the analysis of several new options.

*Source: National Audit Office*

### *Assessment of costs and benefits*

2.8 The fundamental objective of impact assessments is to deliver evidence-based policy-making. While it may not always be appropriate for a regulator to carry out full cost-benefit analysis, a proportionate analysis of the likely impacts of a policy is at the heart of good impact assessment. While we found two examples of good practice in Ofcom’s impact assessments, generally regulators’ assessment of costs and benefits was the most significant weakness in the impact assessments we reviewed. We found that two had “serious weaknesses” and a further six had “room for improvement”. See Figure 8 for an example of good practice.

2.9 Of the ten impact assessments we looked at, only the four assessments performed by Ofcom and Ofgem set out their analysis in a systematic way within a separate “Cost Benefit” section. The consideration of the impacts in the other six assessments was ad hoc and spread throughout the text, which made a sound comparison of the different policy options difficult. Although regulators had all undertaken some qualitative analysis in their impact assessments, the lack of quantitative analysis was another common weakness. There are a number of circumstances where a regulator will be unable to perform quantitative analysis without creating misleading certainty and in these circumstances qualitative analysis has an important role. It may not be possible to carry out quantitative analysis because estimates cannot be made robustly or sufficient data is not available. It is also possible that it would not be proportionate. However, the performance of some quantitative analysis, or at the very least an explanation of why this was not possible, would also have been appropriate.

2.10 The role of cost-benefit analysis in informing the economic regulators’ decisions differs from Government departments, as the regulators work within their statutory duties and do not take policy decisions on the basis of assessing which option offers the greatest benefit (paragraph 1.4). Cost-benefit analysis is a tool that a regulator can use to inform consultations when it is appropriate or possible to use it but, consistent with its statutory duties, a regulator’s key arbiter between options must be to balance public interest objectives. It is, though, important for regulators to undertake an objective assessment of the evidence and provide this to stakeholders to enable them to make informed judgements.

## FIGURE 8

### **Good practice example—TV advertising of food and drink to children**

- Each of the eight suggested options has been analysed.
- Detailed qualitative and quantitative data is presented in separate analysis sections.
- This includes information on the methodology for estimating the impacts of the policy options and an analysis to confirm the robustness of the economic modelling results.
- Additional research data and information on how the quantitative analysis was calculated is given in the annexes.
- A variety of groups which are likely to benefit and those likely to bear the costs are distinguished and the impacts presented in a way which allows the “winners” and “losers” of the different options to be identified.
- A range of costs and benefits is calculated for each option (i.e. a low, central and high estimate).
- A summary table of costs, benefits and efficiency of the policy options provided.

*Source: National Audit Office*

*Monitoring and evaluation*

2.11 It is important that impact assessments go further than considering the expected costs and benefits of a new policy. It should also consider how actual impacts will be monitored. Our evaluation illustrates that performance in this area was mixed. Only two impact assessments set out how they would measure the outcomes of the policy changes in detail, while another three impact assessments stated their intention to do so, providing some discussion of their criteria for success. Due to their close relationship with stakeholders, especially the industry, it may be that regulators are likely to have large amounts of informal feed-back on their policy changes. It is still important, however, to set out how they intend to collect evidence and critically evaluate outcomes from a wide-range of angles. See Figure 9 for an example of good practice.

**FIGURE 9****Good practice example—Pricing in Proportion**

- The next steps of the implementation of the proposal are set out with a time table and including a draft of the new licence conditions in an annex.
- Plans to review the actual outcome (i.e. actual prices) in 2006-07 compared to the proposed outcome (i.e. proposed prices) to ensure price neutrality.

*Source: National Audit Office*

**Use of impact assessment in the policy making process**

3.1 This part examines the extent to which regulators provide policy makers with a framework that supports evidence-based policy making. It also considers the role of impact assessments in influencing the regulators' policy development. We found that:

- Ofcom and Ofgem currently have formal guidance and training for policy teams on how to produce impact assessments. Ofwat and Postcomm are developing new written guidance; and
- the impact assessment process appears to be well integrated into policy development, and therefore offers a real opportunity to influence policy outcomes.

*The support provided to policy teams*

3.2 In order to produce good quality impact assessments, regulators need to provide policy teams with a framework that supports evidence-based policy making. In order to achieve this, regulators should develop guidance, provide training and support for teams, and establish a robust quality control process. Figure 10 summarises the support that each regulator has provided.

**FIGURE 10****Support provided to policy teams**

<b>Regulator</b>	<b>Written guidance produced</b>	<b>Formal training provided</b>	<b>Specialist support provided</b>	<b>Internal challenge process</b>
Ofcom	Yes	Yes	Yes	Yes
Ofgem	Yes	Yes	Yes	Yes

ORR	No	No	Yes	Yes
Postcomm	No	No	Yes	Yes
Ofwat	Yes <sup>1</sup>	No	Yes	Yes

## NOTE:

1. Ofwat produced guidance in 2001, which has been under review since its duties were changed in the Water Act 2003. They are now close to concluding revised guidance to take into account the new duties it was given in 2005 in relation to consumer protection and sustainability.

*Source: National Audit Office*

### *Guidance*

3.3 Ofcom and Ofgem have written guidance on how to produce impact assessments. The guidance includes information on the regulator's legal and strategic commitment to impact assessment, when an impact assessment should be produced, and the stages involved. Ofcom also has a handbook on impact assessment, mostly focusing on how to assess impacts, which was produced by Europe Economics. The remaining three regulators do not use formal written guidance. These regulators do, however, have some information on associated issues such as project management and consultation procedures. Ofwat's guidance, which was produced in 2001 and has been under review since its duties were changed in the Water Act 2003, is not regularly used. Ofwat and Postcomm are in the process of developing formal written impact assessment guidance with the cooperation of Ofcom and Ofgem respectively.

3.4 Each of the ten policy teams we interviewed was aware of Better Regulation Executive guidance. There is also an indication from policy officials that the Cabinet Office's Guidelines on consultation, at least the 12 weeks stipulation, has been taken on board, although regulators often preferred to adopt an iterative approach with several slightly shorter consultations.

### *Training*

3.5 Ofgem and Ofcom have formal training on producing impact assessments for key members of the policy development teams. Ofcom has trained some 130 people through thirteen training sessions, which are run jointly by the internal Better Regulation expert and external consultants. The other three regulators have not developed a standardised training scheme for either impact assessment or consultation. Ofwat, ORR and Postcomm seek to raise standards through a combination of on-the-job training, coaching and support. ORR believes as a smaller regulator, that, this approach offers better value for money for them than creating a standardised training course for all staff.

### *Support for policy teams*

3.6 There appears to be a sufficient level of internal and external support for policy teams conducting impact assessments. This includes access to legal teams, economists and external consultants in all five regulators. However, on the evidence of Part two, access to economists does not always appear to be leading to satisfactory attempts to analyse costs and benefits (paragraphs 2.8 to 2.10). Each of the regulators also has some form of general Better Regulation or impact assessment support, which ranges between impact assessment "champions" in

every policy team, a dedicated Better Regulation team and a single Better Regulation expert.

### *Internal challenge*

3.7 Each regulator has a different approach to scrutinising policy proposals and the accompanying impact assessments. However, all regulators do have systems that incorporate various levels of internal challenge. These include peer review within the policy team developing the impact assessment; various levels of management scrutiny; specialist scrutiny by economists; competition or legal teams; and board level challenge. At various points along this process policies will also go out for formal consultation, i.e. an external challenge or informal external opinion will be sought.

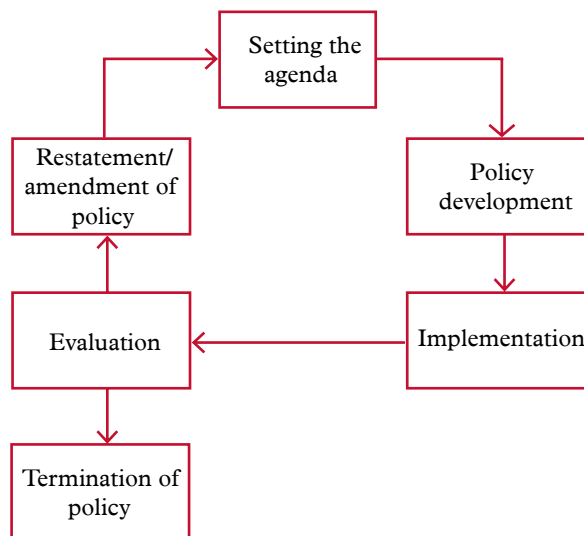
### *The role of impact assessment in the policy making process*

3.8 In order for an impact assessment to be considered successful it should influence the regulator's decision making. It is therefore not sufficient for an impact assessment to be excellent in terms of its presentation and content. The impact assessment framework aims to provide a tool for more effective decision making at various stages throughout the policy cycle (Figure 11).

**FIGURE 11**

### **The policy cycle**

The policy cycle



*Source: National Audit Office*

### *Agenda setting*

3.9 The question of whether a new regulation is required or an existing regulation is appropriate, ought to be considered at the earliest stages of the policy cycle. In our previous reviews of Government departments, the NAO has often found that impact assessments are started late in the policy cycle and rarely challenge the need for regulatory intervention.

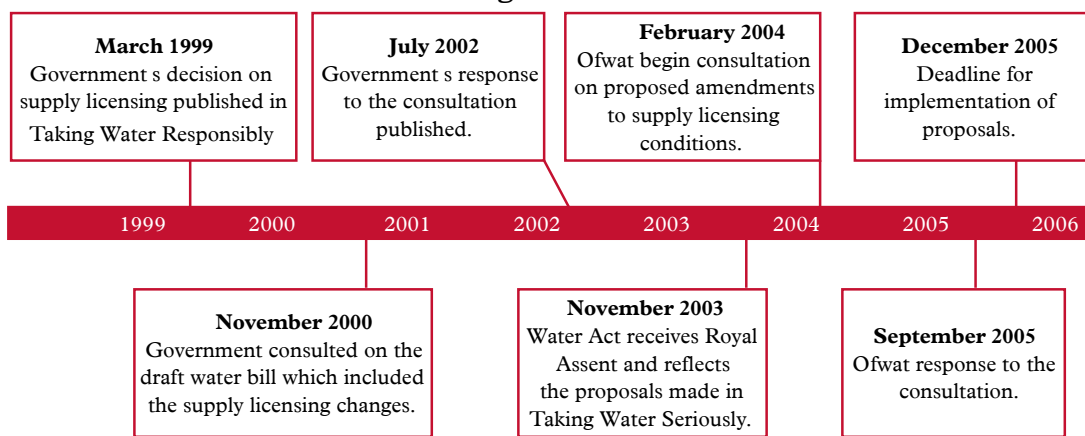
3.10 Of the ten impact assessments we reviewed in our sample, seven were on policy commitments already given either by Government, the European Union or necessitated by the statutory duty of the regulator. For example, Ofwat's proposal on Undertakers' conditions of appointment was part of a package to implement

the Water Act 2003 (Figure 12). Other policy proposals can originate from the regulators but still may be widely considered before the formal impact assessment process begins. For example, the origin of Ofgem’s proposal on “Publication of Near Real Time Data at UK sub-terminals” came from a combination of a suggestion by a stakeholder and from within Ofgem (Figure 13).

3.11 The source of policy proposals may restrict the ability of the impact assessments to satisfactorily challenge the need for regulation as the agenda setting stage can take place before they are started. However, the iterative nature of regulators’ impact assessment processes means that they are used to consider policy options and do influence the policymaking process, even if they are not challenging the need for regulation itself.

**FIGURE 12**

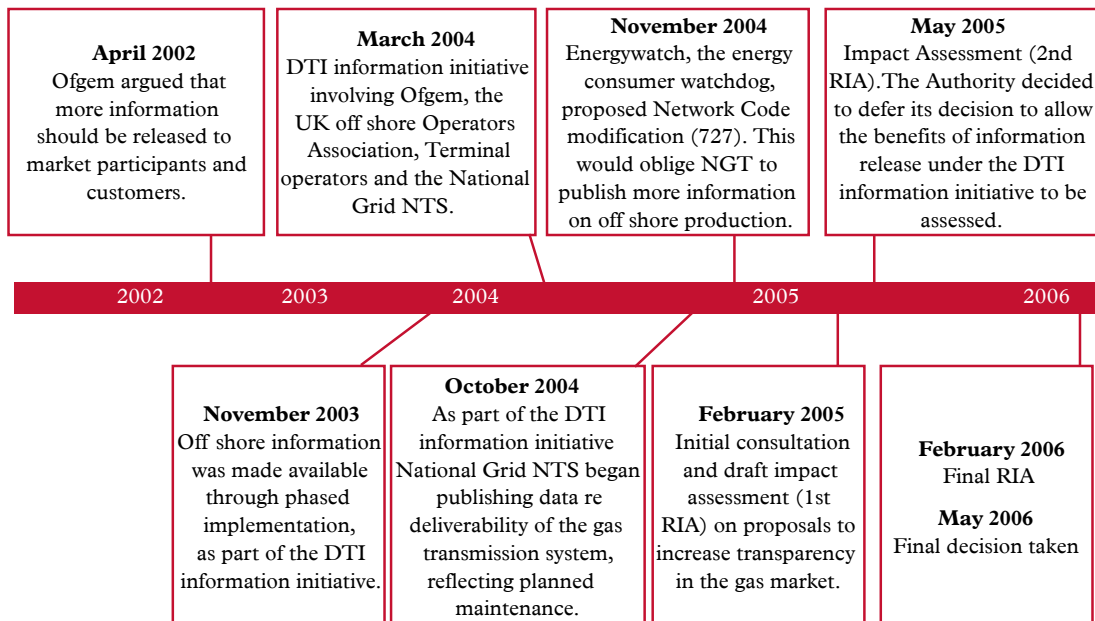
**Timeline for Ofwat’s implementation of the Water Supply licensing regulations**



Source: Ofwat

**FIGURE 13**

**Timeline for Ofgem’s proposal for offshore gas disclosure**



Source: Ofgem

*Policy development*

3.12 Consultation is an integral part of policy development and the impact assessment process. It can help to ensure that stakeholders engage with policy making and understand and accept the resulting regulations. As discussed in Part Two, our evaluation indicates that consultation is a key strength. In particular, eight of the ten impact assessments had more than one round of consultation and four had three or more rounds during the policy development stage. The iterative approach taken by regulators is encouraging because a common criticism of impact assessments is that they are seen by policy makers as a one-off event rather than a process. When combined with the apparent weight given to the stakeholder responses<sup>76</sup> this gives some encouraging indications of influence.

*Implementation and evaluation*

3.13 Evaluation completes the policy cycle and allows policy officials to ascertain the extent to which a policy's objectives have been achieved; assess the accuracy of the expected impacts; and identify any unintended or unforeseen consequences. Feedback from reviews can allow policy teams to identify where improvements can be made to optimise the benefit delivered or to reduce the regulatory burden. However, as illustrated in Part Two, this is rarely done in a systematic or proactive way. Often reviews of policies are not undertaken unless a problem is flagged up either by Government or stakeholders.

**Appendix One***Evaluation of NAO sample of impact assessments*

We assessed two impact assessments from each regulator against our evaluative criteria. This part sets out the results of our analysis for each impact assessment within our sample of ten (See figure 14). We have not attempted to form any judgement on the performance of each individual regulator on the basis of reviewing two of their impact assessments. However, the results have been used in aggregate to highlight areas where regulators are generally performing well and others where there is room for improvement (See Part Two).

Of the five regulators, only Ofcom and Ofgem routinely produce formal impact assessment documents as part of the policy-making process. Ofwat, Postcomm and ORR use consultation documents in similar circumstances, which contain much of the same information, but in some cases less detailed analysis. Where no formal impact assessments were produced by a regulator we assessed consultation documents against our criteria as though they were formal impact assessments. Ofwat told us that its consultation processes did not set out to meet all our criteria.

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<sup>76</sup> All ten impact assessments summarised not only the stakeholders' responses but also the regulator's response to these.

FIGURE 14

## Traffic light assessment of regulatory impact assessments

	Presentation	Consultation	Costs and Benefits	Monitoring and Evaluation
<b>ORR</b>				
Rebate Mechanisms for Investors in Large-scale Network Enhancements	●	●	● <sup>1</sup>	●
ORR's Sustainable Development and Environmental Duties	●	●	●	●
<b>Postcomm</b>				
"Pricing in Proportion"	●	●	●	●
Royal Mail Price and Service Quality Review	●	●	●	●
<b>Ofcom</b>				
TV Advertising Standards for Food and Drink Products to Children	●	●	●	●
Amendment of Wireless Telegraphy exemption regulations	●	●	●	●
<b>Ofgem</b>				
Publication of Near Real Time Data at UK sub-terminals	●	●	●	●
Gas Safety Checks and Information	●	●	●	●
<b>Ofwat</b>				
Water Undertakers' New Conditions of appointment	●	●	●	●
Setting Water and Sewerage Price Limits	●	●	● <sup>2</sup>	●

## NOTES

1 ORR believes strongly that the approach it took in relation to the rebate mechanism was appropriate in the circumstances given the problems in quantifying benefits ex ante. It believes that any attempt at quantification, no matter how novel the method used, would likely have led to spurious accuracy and would have potentially skewed the debate. ORR has committed to an ex-post review of costs and benefits after a year or when there is some objective evidence to review.

2 Ofwat told us that its consultation had not included quantification of costs and benefits because to do so properly would have been tantamount to doing a full price review and might not have been in consumers' interests. It agreed, however, that it would have been helpful to have explained this in the consultation.

3 A "green" assessment indicates good quality analysis; "amber" indicates some good assessment but room for improvement; and "red" indicates some major weaknesses in the analysis.

4 Each impact assessment is assessed against four criteria (see Appendix 2) and this table presents the results of the total number of individual assessments against these criteria.

Source: National Audit Office

## Appendix two

## Scope and methodology

In March 2007 we were invited by the House of Lords Select Committee on Regulators to review the way that impact assessment is performed by five regulators: Ofcom; Ofgem; ORR; Ofwat; and Postcomm. The review will form part of a major enquiry that the Committee is undertaking into the UK's major economic regulators and their collective impact on the UK economy. The Committee expect to publish its final report in early November.

We considered three key issues:-

- Are regulators producing high quality impact assessments?
- Have regulators provided their policy teams with a framework that supports evidence-based policy making?
- Are the impact assessments that regulators are producing influencing policy development?

*Evaluation of the quality of impact assessments*

We reviewed a sample of ten impact assessments, two from each regulator completed in either 2005-06 or 2006-07. One impact assessment was chosen by the regulator and one by the NAO. A list of the impact assessments is provided in Figure 3 and again in Appendix 1.

The impact assessments were reviewed using the evaluative criteria adapted from those we have developed in four years of evaluating impact assessments produced by government departments.<sup>77</sup> The questions cover four main areas of the impact assessment process and are outlined in Figure 15. Two of the criteria that we have used in the past to evaluate impact assessments produced by departments, “compliance” and “competition”, have been omitted from this study because they were thought less relevant in this new context. This is because, in general, the role of the regulators is to maintain/increase competition and so the policy proposals were in many instances entirely concerned with matters of competition by default. Similarly, the close relationship between the regulators and their often relatively few industry stakeholders, as well as the nature of many of the proposals (e.g. changes in licences for industry) mean that 100% compliance could be expected in a high number of cases.

We employed a very wide and flexible understanding of what represented an impact assessment as only one regulator, Ofgem, produced stand-alone impact assessment documents. Therefore, in all other cases consultation documents which outlined the policy problem and proposed options for the benefit of the stakeholders were evaluated. As the impact assessment/consultation process was found to be iterative it was usually necessary to include more than one document in our analysis and on several occasions three or even four documents.

*Have regulators provided their policy makers with a framework that supports evidence-based policy making?*

We examined the support in place to assist policy makers in developing high quality impact assessments, including written guidance, training, specialist support for teams and internal challenge procedures. We held semi-structured interviews with key members of staff in each of the policy teams who produced the impact assessments in our sample. We carried out unstructured interviews with Better Regulation experts at each regulator. We also reviewed the guidance provided by regulators to their policy teams.

*Are the impact assessments that regulators are producing influencing policy development?*

We examined the way that impact assessments are influencing regulator’s decision making. We held semi-structured interviews with key members of staff in each of the policy teams who produced the impact assessments in our sample. We carried out unstructured interviews with Better Regulation experts at each regulator. We also researched the source of policy proposals to establish whether they originated from prior commitments by Government, the European Union or were necessitated by the regulator’s statutory duty.

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<sup>77</sup> For the latest evaluation see: National Audit Office, Evaluation of Regulatory Impact Assessment 2006-07 HC 606 July 2007.

FIGURE 15

## Four areas covered in RIA evaluation

<b>Framework of questions for the evaluation of impact assessments</b>	
<p><b>Presentation</b></p> <ul style="list-style-type: none"> <li>• Were the objectives for the regulation clear?</li> <li>• Was the problem defined clearly?</li> <li>• Were clear recommendations made which were supported by evidence?</li> <li>• Was the RIA of a proportionate length and easy to understand?</li> </ul>	<p><b>Consultation</b></p> <ul style="list-style-type: none"> <li>• Was consultation carried out for a suitable length of time?</li> <li>• Were appropriate techniques used?</li> <li>• Were all interested stakeholders consulted?</li> <li>• Were the results of consultation used appropriately?</li> </ul>
<p><b>Costs and Benefits</b></p> <ul style="list-style-type: none"> <li>• Were all likely, realistic and relevant impacts identified as well as those who would be affected?</li> <li>• Were costs and benefits quantified, and where not, was qualitative analysis provided?</li> <li>• Did the assessment take account of uncertainty?</li> <li>• Were the costs and benefits of a range of options considered?</li> </ul>	<p><b>Monitoring and Evaluation</b></p> <ul style="list-style-type: none"> <li>• Were there details of the next steps in the process including how the policy change would be implemented?</li> <li>• Did the impact assessment contain procedures for monitoring and evaluating the extent to which the proposal meets its objectives?</li> <li>• Did the impact assessment provide a reporting timescale for evaluations?</li> </ul>
<p><i>Source: National Audit Office</i></p>	

## APPENDIX 5: REGULATORS' OPERATING COSTS

At the end of July and beginning of August 2007, in response to a request from the Select Committee on Regulators, Committee Staff gathered data on the operating costs and headcount for each of the regulators within the Committee's remit for the past three financial years. Although each regulator was asked to complete a standardised form, considerable caution should be exercised before making comparisons across the different regulators based solely on the data that they provided in this exercise. For a start, different regulators calculate and report on their costs in different ways. Secondly, the nature of the regulators and range of activities they carry out varies considerably. This makes direct comparisons problematic, even where costs are broken down by different types of regulatory activity. It is important to bear these caveats in mind when considering the information that follows.

### Total operating costs out-turn

The table below shows the total operating costs out-turn for the past three financial years for each of the regulators within the Committee's remit. The figures were provided by the regulators themselves in response to our request for information and may, in some cases, differ from the figures contained in the regulators' annual reports and/or resource accounts.

**TABLE 1**

#### Total operating costs out-turn by regulator by financial year (£000s)

Regulator	2004/05	2005/06	2006/07	% increase (decrease) 2004/05 to 2006/07
CAA <sup>1</sup>	78,169	75,860	74,551	-4.63
CC	22,800	26,388	21,617	-5.19
FSA <sup>2</sup>	241,600	256,300	263,700	9.15
Ofcom	121,555	128,986	129,420	6.47
Ofgem <sup>3</sup>	32,919	32,722	35,849	8.90
OFT <sup>4</sup>	51,678	54,845	74,526	44.21
Ofwat <sup>5</sup>	11,196	10,571	11,511	2.81
ORR	13,010	27,829	29,181	124.30
Postcomm <sup>6</sup>	9,026	9,693	8,763	-2.91
TPR <sup>7</sup>	22,599	27,434	31,607	39.86
Totals	604,552	650,628	680,725	12.60

1. The CAA's figures exclude the costs of its non-regulatory activities. These include costs associated with the CAA's subsidiary undertakings, the UK Airprox Board, meteorological services, provision of en-route air traffic services, Eurocontrol, administration of the CAA Pension Scheme, EASA transition and sub-letting activities.

2. The FSA's figures exclude taxation

3. Ofgem's figures exclude accommodation costs recharged to tenants. The deductions made are: £3,548k (2004/05), £3,923k (2005/06) and £3,659k (2006/07)

- 4. Gross operating costs
- 5. The 2004/05 figures exclude WaterVoice which was part of Ofwat until 30 September 2005.
- 6. Staff costs are included in total operating costs
- 7. Expenditure net of income from out-placed secondees and Pension Protection Fund (PPF) levy collection charges, interest received and tax on interest

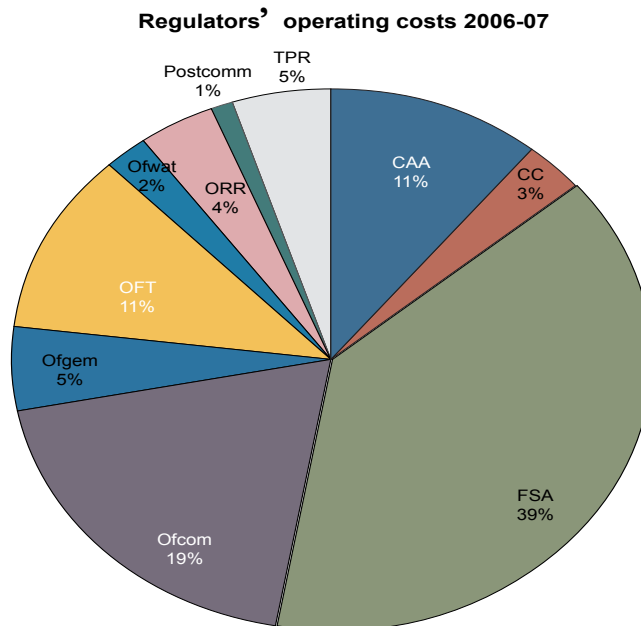
The figures for the CAA and ORR represent the costs aggregated across all of the organisation’s regulatory activities, including safety regulation. A more detailed analysis of the costs of economic regulation alone is included further on. It is worth noting that aviation safety regulation accounts for approximately 80 per cent of the CAA’s staff numbers and costs.

For the ORR, the great leap in operating costs between the financial years 2004/05 and 2006/07 is caused by the inheritance of a health and safety regulation function from the Health and Safety Executive on 1 April 2006. In line with common practice, the figures for 2005/06 (but not 2004/05) were then re-stated. In the case of the OFT, the apparently large increase in costs in 2006/07 is due to the inclusion of Consumer Direct at £19 million.

Ofgem operates under a self-imposed cost-control regime of the type imposed by the regulator on the industry. This sets a target of RPI-3 per cent cost reduction over the five years 2005/06 to 2009/10. Ofgem notes that its 2006/07 costs rose to the cost control ceiling primarily due to re-structuring costs of £1.6 million.

The contribution of each regulator to the combined total operating cost of the regulators collectively for the most recent financial year (2006/07) is illustrated in the pie-chart below:

**FIGURE 1**  
**Regulators’ operating costs 2006/07**



## Expenditure on staff

Staff costs normally form a substantial part of a regulator's total operating costs. Expenditure on staff for each of the regulators is shown in table 2. The same points made for the individual regulators in respect of their total operating costs should also be borne in mind when considering their staff costs.

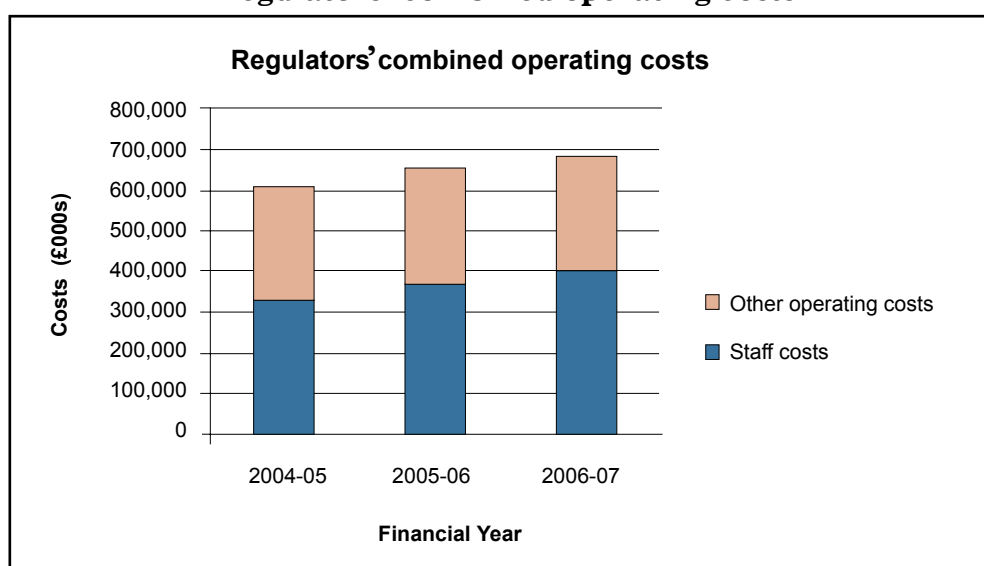
**TABLE 2**  
**Expenditure on staff by regulator by financial year (£000s)**

Regulator	2004/05	2005/06	2006/07	% increase (decrease) 2004/05 to 2006/07
CAA	42,964	43,682	43,988	2.38
CC	7,773	10,038	10,004	28.70
FSA <sup>1</sup>	153,000	175,600	186,700	22.03
Ofcom	53,900	49,841	55,748	3.43
Ofgem	16,571	16,511	18,610	12.30
OFT	30,182	32,159	34,302	13.65
Ofwat	7,033	6,896	7,191	2.25
ORR	6,627	17,068	19,127	188.62
Postcomm <sup>2</sup>	2,824	3,619	3,912	38.53
TPR	10,276	14,997	19,225	87.09
Totals	331,150	370,411	398,807	20.43

1. Including Employer's NIC and pensions costs  
2. Staff costs are included in total operating costs, and expenditure on staff includes agency staff (in accordance with FReM guidelines)

The bar chart below illustrates the combined total operating costs of all the regulators within our remit for the past three financial years, and the proportion of the total that is made up of staff costs:

**FIGURE 2**  
**Regulators' combined operating costs**



### Numbers of staff employed by regulators

When considering the cost of regulation and the scope of regulators' activities, it is useful to look at the number of staff employed by each of the regulators as well as their operating costs. The table below shows the number of staff (full time equivalents/FTE) employed by each of the regulators within our remit for the past three financial years. As before, the figures for the CAA and ORR represent the figures aggregated across all of the organisation's regulatory activities, including safety regulation.

**TABLE 3**

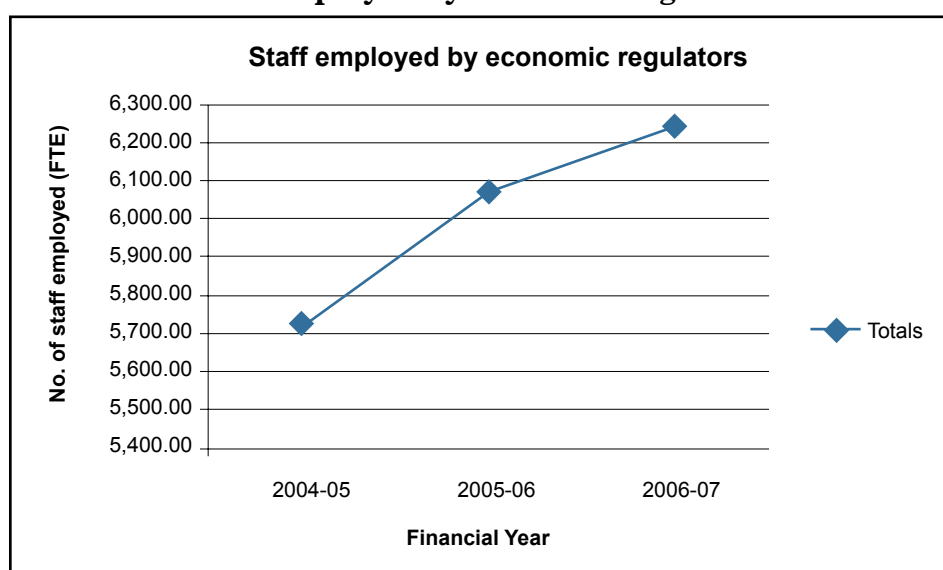
**Number of staff employed by regulator by financial year (FTE)**

Regulator	2004/05	2005/06	2006/07	% increase (decrease) 2004/05 to 2006/07
<b>CAA</b>	760.7	724.0	704.9	-7.34
<b>CC</b>	159.0	170.0	151.0	-5.03
<b>FSA</b>	2,356.0	2,610.0	2,659.0	12.86
<b>Ofcom</b>	768.0	762.0	789.0	2.73
<b>Ofgem<sup>1</sup></b>	306.0	285.0	306.0	0.00
<b>OFT</b>	717.0	696.0	683.0	-4.74
<b>Ofwat</b>	200.0	188.0	188.0	-6.00
<b>ORR</b>	128.0	298.0	379.0	196.09
<b>Postcomm</b>	48.9	56.6	60.9	24.54
<b>TPR</b>	279.0	288.0	325.0	16.49
Totals	5,722.6	6,077.6	6,245.8	9.14

1. Includes temporary agency staff. Ofgem notes that, as at September 2007, there were 285 staff in post.

The dramatic increase in the number of staff employed by the ORR is again attributable to the acquisition of a new role as a health and safety regulator. The FSA explained that the increase in its staff numbers from 2004/05 to 2005/06 is mainly the result of an extension in its regulatory scope to include mortgages and general insurance.

The line chart below illustrates the growth in the total number of staff (full time equivalents/FTE) employed collectively by the regulators within our remit. Although a few regulators have experienced a decrease in headcount over the past three financial years, the overall trend is one of growth:

**FIGURE 3****Staff employed by economic regulators****Economic regulation**

In many ways, comparison of the operating costs and headcount of the different economic regulators is more meaningful if one focuses on the sectoral economic regulators, and—where possible and relevant—the economic regulatory arms of those regulators (thus excluding health and safety regulation from combined economic and safety regulators). The table below shows the operating costs for each of the sectoral regulators for the past three financial years. In the case of the CAA and ORR, the information relates to their economic regulatory arms alone, excluding the costs associated with their wider health and/or safety roles.

**TABLE 4****Operating costs of sectoral economic regulators by financial year (£000s)**

Regulator	2004/05	2005/06	2006/07	% increase (decrease) 2004-05 to 2006-07
<b>CAA (ERG)<sup>1</sup></b>	4,717	5,268	6,494	37.67
<b>Ofcom</b>	121,555	128,986	129,420	6.47
<b>Ofgem<sup>2</sup></b>	32,919	32,722	35,849	8.90
<b>Ofwat<sup>3</sup></b>	11,196	10,571	11,511	2.81
<b>ORR<sup>4</sup></b>	13,010	14,768	12,243	-5.90
<b>Postcomm<sup>5</sup></b>	9,026	9,693	8,763	-2.91
<b>Totals</b>	192,423	202,008	204,280	6.16

1. ERG is the Economic Regulation Group of the CAA. The figures quoted are those before off-setting revenue from the sale of survey information of approximately £750k per annum.

2. Ofgem's figures exclude accommodation costs recharged to tenants. The deductions made are: £3,548k (2004/05), £3,923k (2005/06) and £3,659k (2006/07)

3. The 2004-05 figures exclude WaterVoice which was part of Ofwat until 30 September 2005.

4. In the case of the ORR, the figure for 2006/07 is not disclosed in the resource accounts and has been apportioned on the basis of information in the management accounts. The apportionment has not been specifically audited by the NAO.

5. Staff costs are included in total operating costs

The figures in table 4 suggest that the CAA has increased its operating costs by a much larger percentage than the other sectoral regulators, when comparing the financial years 2004/05 and 2006/07. These figures are likely to give a misleading impression unless one understands the reason behind the anomaly. First, the CAA's absolute cost numbers are comparatively low (the lowest of all of the regulators in the table). Second, the CAA's price control reviews are cyclical in nature and the costs shown for 2006/07 are at the peak of the regulatory cycle (with external consultancy costs making up a significant proportion of the costs in that year). The CAA told us that its costs are forecast to be lower in subsequent years.

Focusing again on the sectoral economic regulators, and the economic regulatory arms of the combined health and safety regulators, table 5 shows the figures for the expenditure on staff for each of the regulators:

**TABLE 5**

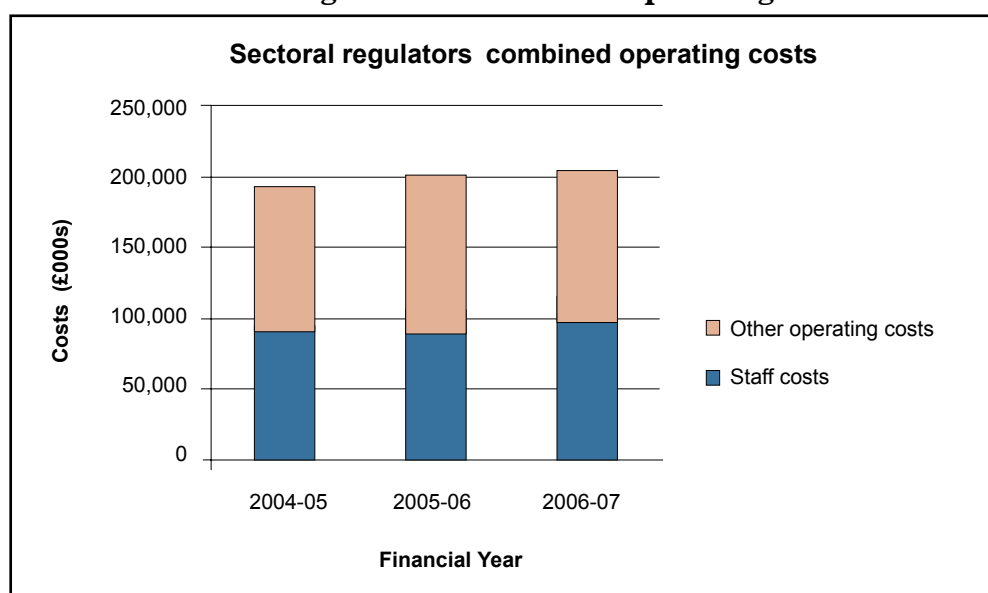
**Expenditure on staff by sectoral regulator by financial year (£000s)**

Regulator	2004/05	2005/06	2006/07	% increase (decrease) 2004/05 to 2006/07
<b>CAA (ERG)</b>	2,560	2,953	3,195	24.80
<b>Ofcom</b>	53,900	49,841	55,748	3.43
<b>Ofgem</b>	16,571	16,511	18,610	12.30
<b>Ofwat</b>	7,033	6,896	7,191	2.25
<b>ORR<sup>1</sup></b>	6,627	7,909	7,299	10.14
<b>Postcomm<sup>2</sup></b>	2,824	3,619	3,912	38.53
Totals	89,515	87,729	95,955	7.19

1. In the case of the ORR, the figure for 2006/07 is not disclosed in the resource accounts and has been apportioned on the basis of information in the management accounts. The apportionment has not been specifically audited by the NAO.

2. Staff costs are included in total operating costs, and expenditure on staff includes agency staff (in accordance with FReM guidelines)

The bar chart below illustrates the combined operating costs of the sectoral regulators for the past three financial years, and the proportion of the total that is made up of staff costs:

**FIGURE 4****Sectoral regulators' combined operating costs**

The final table shows the number of staff (full time equivalents/FTE) employed by the sectoral regulators for the past three financial years. Again, the numbers for the CAA and ORR relate to their economic regulatory arms alone. In the case of the CAA, the figures are for headquarters staff and exclude the survey field force that conducts passenger surveys at airports. Around 25-30 FTEs are employed in this activity.

**TABLE 6****Number of staff employed by sectoral regulator by financial year (FTE)**

Regulator	2004/05	2005/06	2006/07	% increase (decrease) 2004/05 to 2006/07
<b>CAA (ERG)</b>	39.5	39.3	40.1	1.52
<b>Ofcom</b>	768.0	762.0	789.0	2.73
<b>Ofgem<sup>1</sup></b>	306.0	285.0	306.0	0.00
<b>Ofwat</b>	200.0	188.0	188.0	-6.00
<b>ORR</b>	128.0	142.0	200.0	56.25
<b>Postcomm</b>	48.9	56.6	60.9	24.54
<b>Totals</b>	1,490.4	1,472.9	1,584.0	6.28

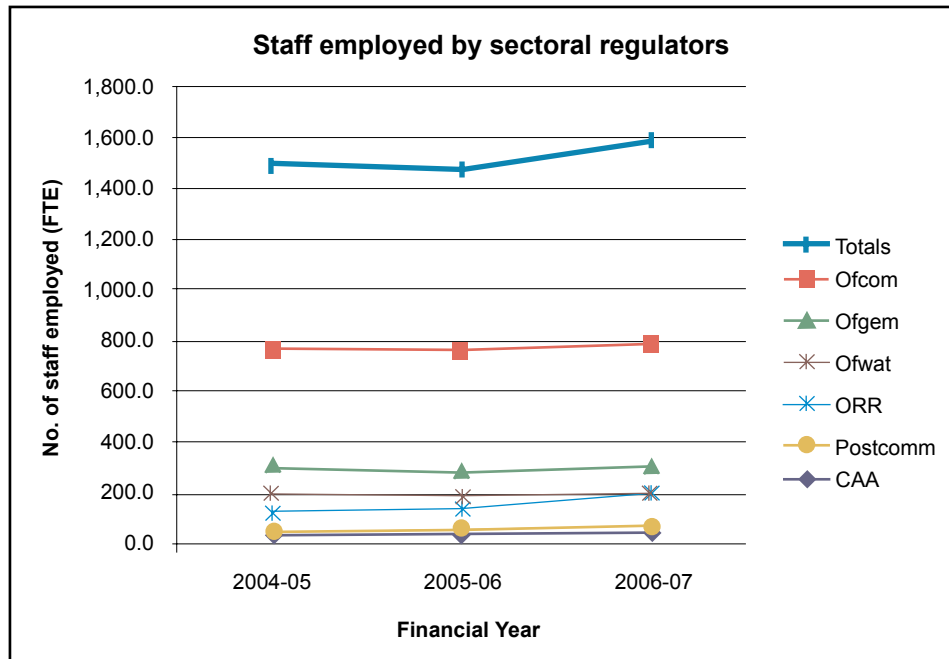
1. Includes temporary agency staff. Ofgem notes that, as at September 2007, there were 285 staff in post.

Taking the sectoral regulators together, the overall trend is a relatively small increase in headcount over the past three financial years. Some regulators have experienced zero or negative growth. Postcomm and the ORR have increased their headcount by the greatest percentage between the financial years 2004/05 and 2006/07, but—particularly in the case of Postcomm—this needs to be considered

in the context of relatively small numbers. Moreover, Postcomm points out that the underlying reason for the increase in its staff numbers is the immaturity of the postal market and the need for greater intervention by the regulator. Its current three-year plan envisages a lighter-touch regulatory regime after 2010 (after the price control) and a step decrease in headcount.

Headcount trends for the individual sectoral regulators and the combined total for the sectoral regulators are illustrated in the line chart below:

**FIGURE 5**  
**Staff employed by sectoral regulators**



## APPENDIX 6: CHAPTER 10 OF THE CONSTITUTION COMMITTEE REPORT

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Below we reproduce the recommendations made in Chapter 10 of the House of Lords Constitution Committee Report entitled ‘The Regulatory State: Ensuring its accountability’ (6th Report, Session 2003-04, HL Paper 68). The full text of the Constitution Committee’s Report can be found online at: <http://pubs1.tso.parliament.uk/pa/ld200304/ldselect/ldconst/68/68.pdf>

- A dedicated parliamentary committee should be established to scrutinise the regulatory state. [para 199]
- This should preferably be a joint committee of both Houses and should be given the necessary resources to fulfil its task effectively. [para 200]
- We see this [recommendation] as complementary to rather than as a substitute for the work of the departmental select committees of Parliament. They would continue to monitor the activities of those regulators within their respective purviews, but we recommend that they consider expanding their terms of reference to include a requirement routinely to consider and react to regulators’ annual reports, and monitor the use of resources. These activities would be in addition to the ad hoc inquiries they undertake from time to time. [para 202]
- For parliamentary scrutiny by select committees to be more consistent and co-ordinated, it should be focused around the annual report and the published RIAs, and with specific attention paid to a harmonised whole of Government view of regulation. [para 203]
- We recommend therefore that the NAO have access consistently to all regulatory bodies, including the FSA, with a view to monitoring their cost-effectiveness and budgetary control. [para 212]
- We...recommend that the annual review of Regulatory Impact Assessments by the NAO be developed. In order to maintain the strict independence of the NAO and its scrutiny role, we recommend that this should not be undertaken as an agency of the Cabinet Office. These RIAs need to be conducted retrospectively as well as in advance, to ensure that cost effectiveness is constantly under review. [para 218]

## APPENDIX 7: SECTION 66E OF THE WATER INDUSTRY ACT 1991 (AS AMENDED)

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### 66E Section 66D: costs principle

(1) The costs principle referred to in subsection (3) of section 66D above is that the charges payable by a licensed water supplier to a water undertaker, under the agreement or determination mentioned in that subsection, shall enable the undertaker to recover from the supplier—

(a) any expenses reasonably incurred in performing any duty under sections 66A to 66C above in accordance with that agreement or determination, and

(b) the appropriate amount in respect of qualifying expenses and a reasonable return on that amount,

to the extent that those sums exceed any financial benefits which the undertaker receives as a result of the supplier supplying water to the premises of relevant customers.

(2) In subsection (1) above “qualifying expenses” means expenses (whether of a capital nature or otherwise) that the water undertaker has reasonably incurred or will reasonably incur in carrying out its functions.

(3) For the purposes of subsection (1)(b) above, the appropriate amount is the amount which the water undertaker—

(a) reasonably expected to recover from relevant customers; but

(b) is unable to recover from those customers as a result of their premises being supplied with water by the licensed water supplier.

(4) Nothing in subsection (3) above shall enable a water undertaker to recover any amount—

(a) to the extent that any expenses can be reduced or avoided; or

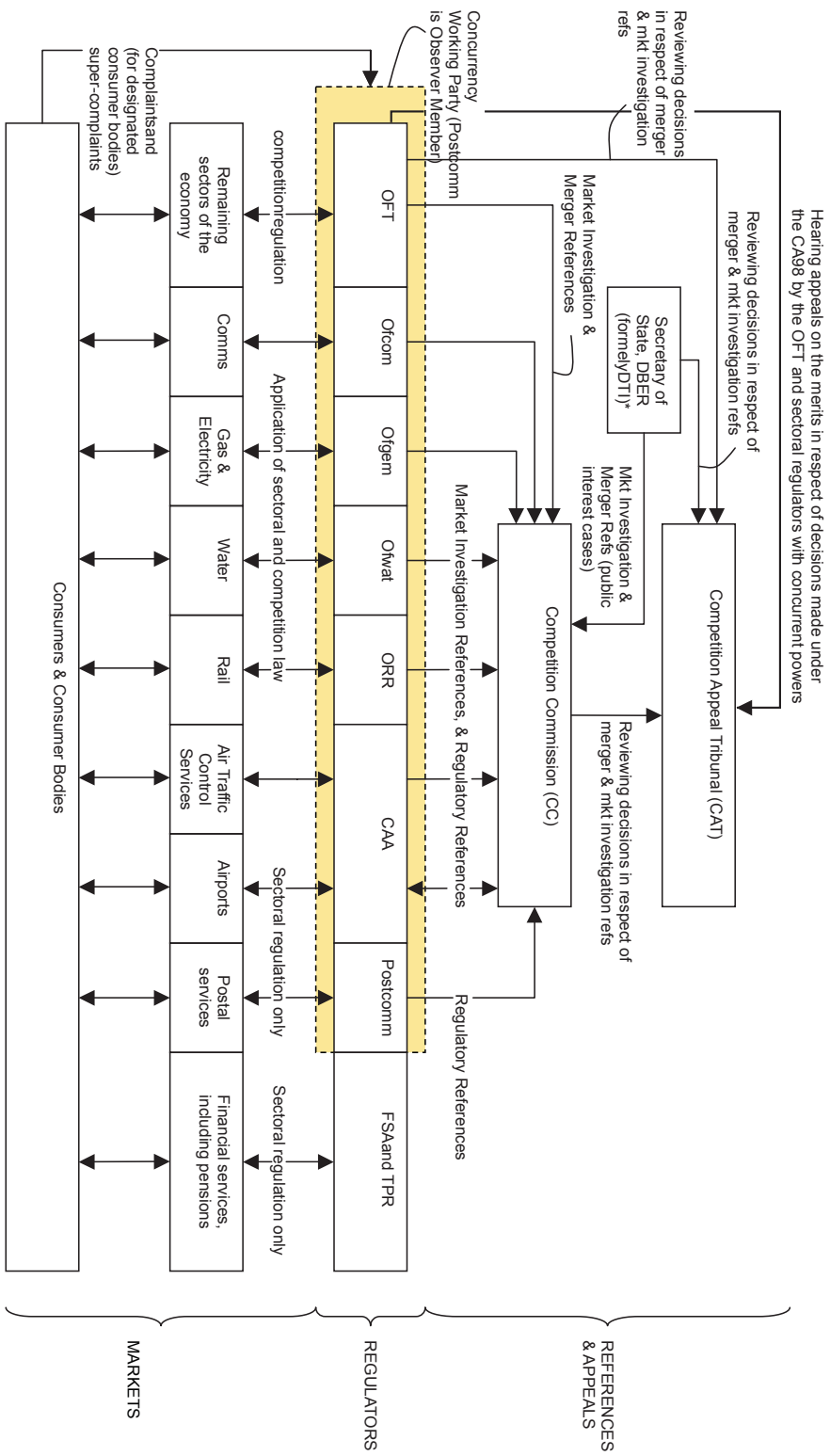
(b) to the extent that any amount is recoverable in some other way (other than from other customers of the undertaker).

(5) In this section “relevant customers” means customers to whose premises the licensed water supplier is to make any supply of water in connection with which the agreement or determination mentioned in subsection (1) above is made.

*The information above was taken from Schedule 4 of the Water Act 2003 as set out on The UK Statute Law Database at the web address below. The material featured on this website is subject to Crown copyright protection.*

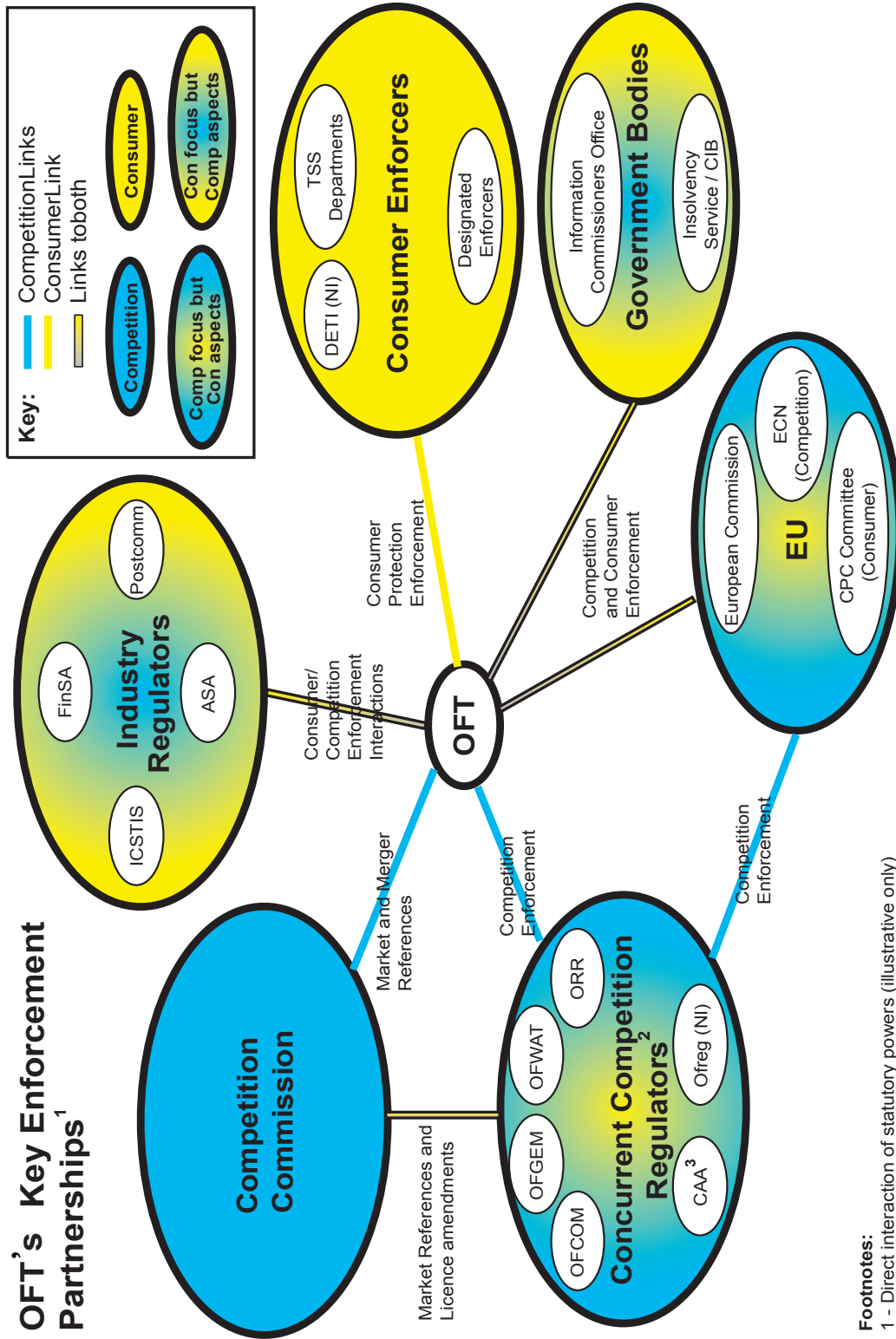
*<http://www.statutelaw.gov.uk/content.aspx?LegType=All+Legislation&title=Water+Act+2003&Year=2003&searchEnacted=0&extentMatchOnly=0&confersPower=0&blanketAmendment=0&sortAlpha=0&TYPE=QS&PageNumber=1&NavFrom=0&parentActiveTextDocId=820052&ActiveTextDocId=820222&filesize=388>*

# APPENDIX 8: SECTORAL AND COMPETITION REGULATION IN ENGLAND AND WALES—DIAGRAMS



\* Following the changes introduced by the Enterprise Act 2002, the involvement of the Secretary of State (SoS) is limited to exceptional cases. The role of the SoS in merger cases is now limited to defined public interest cases (currently, only national security), special public interest cases and newspaper mergers.

\*\* This diagram covers the main institutions based in England and Wales. EU institutions also have an important role to play in competition and sectoral regulation in England and Wales but have been excluded for the purposes of this diagram to avoid complexity compromising clarity.



**Footnotes:**  
 1 - Direct interaction of statutory powers (illustrative only)  
 2 - Also designated enforcers of consumer powers  
 3 - In respect of air traffic control services only

**APPENDIX 9: GLOSSARY**

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ABI	Association of British Insurers
AEP	Association of Electricity Producers
AIFA	Association of Independent Financial Advisors
APIL	Association of Personal Injury Lawyers
ATOC	Association of Train Operating Companies
AUC	Air Transport Users Council
BAA	BAA Ltd (formerly the British Airports Authority and BAA plc)
BBA	British Bankers' Association
BCC	British Chambers of Commerce
BRC	Better Regulation Commission
BRE	Better Regulation Executive
BRTF	Better Regulation Task Force
CAA	Civil Aviation Authority
CAT	Competition Appeal Tribunal
CC	Competition Commission
CCWater	Consumer Council for Water
CISAS	Communications and Internet Services Adjudication Scheme
Citizens Advice	Formerly the National Association of Citizens Advice Bureaux
CRI	Centre for the Study of Regulated Industries
CWP	Concurrency Working Party
DfT	Department for Transport
ENA	Energy Networks Association
Energywatch	Gas and Electricity Consumer Council
ERA	Energy Retail Association
FLA	Finance and Leasing Association
FSB	Federation of Small Businesses
FOS	Financial Ombudsman Service
FSA	Financial Services Authority
FSCP	Financial Services Consumer Panel
FSMA	Financial Services and Markets Act 2000
IA	Impact Assessment
JRG	Joint Regulators Group
LIBA	London Investment Banking Association
MBG	Mobile Broadband Group

MEUC	Major Energy Users' Council
MUA	Mail Users' Association
NAO	National Audit Office
NCC	National Consumer Council
NEA	National Energy Action
NOC	Network for Online Commerce
Ofcom	Office of Communications
Ofgas	Office of Gas Supply
Offer	Office of Electricity Regulation
Ofgem	Office of Gas and Electricity Markets
OFT	Office of Fair Trading
Oftel	Office of Telecommunications
Ofwat	Water Services Regulation Authority (formerly the Office of the Director General of Water Services)
OPRAF	Office of Passenger Rail Franchising
ORR	Office of Rail Regulation (formerly, Office of the Rail Regulator)
Otelo	Office of the Telecommunications Ombudsman
Passenger Focus	Rail Passengers Council
Postcomm	Postal Services Commission
Postwatch	Consumer Council for Postal Services
RadioCentre	Formerly the Radio Advertising Bureau (RAB) and Commercial Radio Companies Association (CRCA)
RIA	Regulatory Impact Assessment
RFG	Rail Freight Group
SRA	Strategic Rail Authority
TPR	The Pensions Regulator
Water UK	Representative body for UK water and wastewater service suppliers
Which?	Formerly the Consumers' Association
WSL	Water Supply Licensing regime, introduced by the Water Act 2003