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The Regulatory State: Ensuring its Accountability

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The Regulatory State: Ensuring its Accountability

CHAPTER 1: INTRODUCTION AND SUMMARY

1. As nationalised industries were privatised at the end of the twentieth century, industry regulators were appointed to encourage competition and to protect the consumer. Regulators are notable now not only for their number but also for their powers. These include imposing penalties, levying fines, and creating secondary legislation. Regulators have frequently been able individuals who have used their powers effectively to achieve their goals. However, their existence and the exercise of their powers have not been free of controversy. The regulatory regime is now substantial. There are significant costs of complying with regulation. The smaller the regulated body, the greater the burden. Decisions of some regulators have proved unpopular and on occasion brought them into dispute with bodies set up to represent consumer interests. Some critics query the continuing need for a state-imposed regulatory regime.

2. The existence of regulators also raises fundamental questions of accountability. They are appointed by ministers in order to achieve certain policy objectives. Ministers are accountable to Parliament, individually and collectively. Regulators are appointed in order to be at arm's length from Government in fulfilling their functions. Though created by statute and appointed by ministers, they exist essentially as independent agents.

3. Given this, the question arises as to how the performance of regulators is monitored to ensure that the public interest is properly served. To what extent are regulators accountable to the citizen? To what extent do they take into account the public interest, consumer interests, and the interests of the bodies they regulate, and how do they gauge such interests? To what extent are they answerable for their actions to Parliament? We therefore decided to inquire into the workings of Government-appointed regulators; the extent to which their activities are monitored by Parliament; their accessibility to the public and the regulated; and their responsibility to the citizen and those whom they regulate.

4. Our starting point is that regulation is a means to an end, not an end in itself. Regulation can only be in the public interest where it serves a clear purpose. We question the apparent assumption that the present level of regulation, let alone an even greater extension of quasi-Governmental powers, should remain a permanent feature of our polity. We have to resist the danger of regulatory creep. Many judge that regulatory burdens are increasing, sometimes unnecessarily. This regulatory tendency has to be checked, and the best means is effective accountability. Necessary, and cost-effective, regulation can then be properly identified; unnecessary regulation can, and should, be removed.

Context

5. Our Inquiry should be seen in the context of the very significant changes made to the machinery of Government and the institutional structures for

regulatory decision-making over recent years and decades. The most important is at the heart of our study: the establishment of the independent regulators, acting at arms-length from ministers, empowered and constrained by their own statutory authority but often responsible for issues hitherto dealt with by government departments. Traditional mechanisms of accountability may therefore have to be reinforced, or reviewed and adapted, where necessary, to the new arrangements.

6. There have also been progressive and prospective changes to the rights of the regulated in recent years, perhaps most clearly exemplified by the incorporation of the European Convention of Human Rights into UK law. This has had direct and indirect effects. Recent legislation, such as the Communications Act 2003, incorporates European Directives which pay full regard to the philosophy of appeals being made on the merits of the case, and with those appeals being heard by independent tribunals. Citizens also have higher expectations as to their rights concerning the due accountability of regulators for their decisions. We can only expect the progressive consolidation of those rights and expectations into law and judicial review procedures to continue.

7. The issue of regulation has itself been a matter of Governmental concern. Regulatory reform has been high on the agenda, now focusing on better regulation rather than simply deregulation, and improving regulatory accountability has been an integral part of that agenda. So, for example, regulatory reform orders have been introduced, and statutory duties have been extended, with codes of practice put in place, to improve the transparency of regulators' roles, responsibilities and decision-making. The question for the Committee has therefore been how effective is regulatory accountability, mindful of the on-going changes and developments, and how can it be strengthened?

Who does what and why?

8. We sought first to establish for what, and to whom, regulators are and should be accountable. We conclude that regulators should be accountable for cost-effective regulation which meets rational, well-defined objectives. This approach brings together the 'why' and 'how' issues of regulation. We take a wide view of the accountability of regulators to all interested parties, but note that in practice it will be exercised in different ways, appropriate to different circumstances.

9. We then focused on the processes by which this accountability is given effect. The three key elements we identify are:

   - the duty to explain;
   - exposure to scrutiny; and
   - the possibility of independent review.

   The last two are the means through which regulators are required to answer to public bodies for their actions. In addressing change, we have sought to distinguish between reforms which have been directed at improving the design of regulation, and reforms which are aimed at improving accountability for regulatory decisions. We have not found a conflict between independence and accountability.

Conclusions

10. Effective processes for achieving accountability are a key discipline on regulators, and are essential to maintaining both an effective regulatory framework and effective regulatory decision-making. Accountability is a control mechanism which is an integral part of the regulatory framework. Effective regulation therefore requires effective accountability. The preparation of regulatory impact assessments (RIAs) is an important discipline on regulators. Properly done it reveals whether regulators have subjected their decisions to cost-benefit analysis in order to achieve both balance and cost-effective regulation. These RIAs need to be conducted retrospectively as well as prospectively, to ensure that cost-effectiveness is constantly under review.

11. We welcome the improvements made in recent years, but more needs to be done in order to achieve a sustainable system. In particular, the Government's approach is departmentalised and insufficiently co-ordinated. This militates against accountability. It should instead be interdepartmental and fully co-ordinated. We make fifteen recommendations in this area, aimed at ensuring that the Government maintains a consistent, focused and proactive role towards achieving cost-effective regulation, where that regulation is needed.

12. There have been notable improvements in the transparency of, and hence in accountability for, the processes by which regulatory decisions are made; but efforts should be made to ensure that regulators improve access to the consumer, especially through consumer groups. The most urgent need for reform, however, is in respect of parliamentary scrutiny and independent review.

13. Improving parliamentary scrutiny is essential. It is not just a question of the answerability of regulators to Parliament, but also one of the duty of Parliament to ensure that its scrutiny is effective. As with Government, Parliament lacks the mechanism for consistent and coherent scrutiny of regulation. Scrutiny at the moment is dependent on individual committees deciding that inquiry is necessary into a particular regulator or regulatory decision. It is thus both fragmented and inconsistent. There is no means of establishing a coherent overview of the regulatory regime operating within the United Kingdom. We believe there should be.

14. We have been mindful of the need to maintain the appropriate balance between the needs of regulation in the public interest and the rights of the regulated. This is most important when considering possible reform of appeal mechanisms, on which there are contrasting views. Our view is that the power of the regulatory state needs to be matched by effective rights of appeal based on the merits of the case. The only right of appeal open to many regulated bodies is the very restricted one of judicial review. This is normally expensive, time consuming and narrow. Delays leave the regulated in a state of potentially costly uncertainty. For many, therefore, it is not a viable option. We believe that there must be a more accessible and efficient appeals mechanism.

15. Our inquiry has been a major one, and we are indebted to all of those individuals and organisations who have submitted evidence in person or in

writing.[1] The amount of evidence reflects the extent of concern about the existing regulatory state. Our overall judgement is that the increased emphasis on the accountability of regulators in recent years is to be welcomed and should be strengthened. Accountability has improved, is improving, and must continue to improve. Our Inquiry and its recommendations are directed to that end.

Recommendations

16. The recommendations have been ordered by reference to four categories: those related to the Government's and Parliament's responsibilities for the regulatory framework as a whole, and those related to the three specific elements of accountability which control the regulators, being the duty to explain, exposure to scrutiny and the possibility of independent review.

The overall regulatory framework

(1) Independent consumer bodies should be obliged by statute to engage in open meetings and conduct regular surveys of consumers. This has resource implications which should be met out of public funds. Following a review of the budgetary arrangements for each regulator, an appropriate formula should be agreed for calculating this provision and applied to each of these bodies. We believe that these changes will enhance both the accountability and the independence of the consumer bodies. (para 69)

(2) We are aware that the Government is undertaking a review of consumer bodies, supported by the National Audit Office (NAO), and recommend that the review includes an examination of the relationship between regulators and the related consumer bodies in order to introduce greater clarity in the relationship, if necessary through a statutory provision common to the regulatory regime. (para 70)

(3) We welcome the move towards more collective board structures, rather than sole regulators, as one of the principal mechanisms for improving the quality and consistency of regulatory decision-making, and urge that this should be the norm for regulatory regimes. To ensure that there is no loss of accountability we recommend that boards designate one of their number as the public face of the regulator in order not to lose engagement with the public and to perform the role of building confidence and understanding. Normally this should be the Chairman or Chief Executive. Where appropriate open meetings should be held as a means of increasing public understanding and confidence. (para 110)

(4) Government should explicitly accept overall responsibility and accountability for regulatory policy and the regulatory framework, while devolving responsibility under defined circumstances to independent regulators. (para 122)

(5) Ministers should remain responsible for appointing regulators, subject to Nolan rules, to ensure proper responsibility and accountability. (para 126)

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[1] See Volumes II and III

(6) Regulatory legislation should normally be drafted in the light of consultation with regulators to achieve clearly defined objectives. The duties imposed on regulators should be consistent with the overall remit of the regulator (for example, economic regulation). They should make clear the underlying purpose of the regulator's role (such as consumer protection). (para 130)

(7) Responsibility for environmental and social standards should normally remain with Ministers as the authority of a democratic mandate is required for decisions in these areas. (para 138)

(8) The OECD regulatory checklist should be utilised as standard for legislation, regulatory decision-making and in establishing any new regulator. (para 142)

(9) The recommendation of the Better Regulation Task Force (BRTF) that regulators should produce Regulatory Impact Assessments (RIAs) on all new major policies and initiatives has been accepted by the Government and should be applied throughout the system. We also endorse the Task Force's recommendations, among others, aimed at increasing the transparency and accountability of regulators, including open meetings and agreeing a management statement with the sponsor Department. (para 146)

(10) The BRTF should review its principles of good regulation to ensure that the principles of coherence, objectivity and rationality of approach are incorporated and signalled to the wider public. (para 148)

(11) There must be a much stronger communication of the 'whole of government' view of regulation. We recommend that the Government appoint a lead Department to be responsible for promoting effective regulation in practice, thereby co-ordinating the various roles currently played by a number of Departments, including HM Treasury, DTI, the Cabinet Office and the Office of the Prime Minister. Logically, the Cabinet Office should assume this role, possibly by expanding the remit of its RIA unit. Its responsibilities should mirror those we outline for a parliamentary committee in paragraphs 199 to 203. (para 152)

(12) There should be consistency in applying regulatory models and requirements on a like-for-like basis. (para 153)

(13) The move towards self-regulation should be encouraged and co-regulation should, where appropriate, be used as a preliminary to it. (para 157)

(14) Regulators should have a statutory duty to have regard to the principles of good regulation and effective accountability. These should include self-assessment of their compliance with the same; the design of effective consultation procedures to engage interested parties; ensuring that redress and compensation procedures are clear and accessible; and incorporating the outturn of plans in their annual reports. They should also include the publication of the following:

(a) their mission statements;

(b) codes of practice for the conduct of their regulatory office;

(c) codes of practice for consultation (including the duty to summarise and accept or rebut consultees' comments, with reasons);

(d) their forward plans;

(e) the explanations of and reasons for their decisions; and

(f) all relevant material necessary for their production before and after RIAs. (para 169)

(15) Regulators should adopt a structured approach to consultation designed to minimise the burdens on those consulted and to facilitate their engagement with either the principles or the detail as appropriate to the interests of those consulted. (para 173)

Exposure to scrutiny

(16) A dedicated parliamentary committee should be established to scrutinise the regulatory state. (para 199)

(17) This should preferably be a joint committee of both Houses and should be given the necessary resources to fulfil its task effectively. (para 200)

(18) We recommend that select committees 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)

(19) In order that parliamentary scrutiny by select committees can 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)

(20) The NAO should have access consistently to all regulatory bodies, including the Financial Services Agency (FSA), with a view to monitoring their cost-effectiveness and budgetary control. (para 212)

(21) We welcome the expansion of the role of the NAO and 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)

Independent review; improving appeals

(22) Appeals should provide an opportunity for the regulated to have their objections reviewed on the merits of the case, subject only to the condition that the appeal body should have the clear ability and power to identify and penalise appeals designed to frustrate equitable regulation. (para 230)

(23) Simplified systems of fast track appeals against regulatory decisions and arbitration should be developed for the Competition Commission

and the Competition Appeal Tribunal, and made available subject to the agreement of each of the parties concerned. (para 231)

(24) We further recommend that a Regulatory Appeals Tribunal should be set up to cover regulatory decisions that do not fall within the jurisdiction of either the Competition Commission or the Competition Appeal Tribunal. (para 232)

CHAPTER 2: REGULATORY ROLES AND ACTIVITIES: ACCOUNTABILITY FOR WHAT?

Three purposes of regulation

17. The Committee received evidence about a wide range of regulators and regulatory activities.[2] Regulation can usefully be divided into three broad categories - economic regulation aimed at controlling the abuse of monopoly power; regulation of public goods and external effects, such as environmental pollution; and social regulation.[3]

18. The role of the regulatory state is therefore about much more than regulating business decisions, important as that is. The state is concerned with promoting public goods in many areas of citizens' lives – for example, promoting charitable works, culture and civil society – whilst at the same time avoiding public bads: for example, prohibiting racial abuse, theft and speeding. Regulating such non-market conduct therefore involves changing both positive and negative types of conduct. In a general sense, both can be grouped under the heading of 'non-market conduct failures', given too little of a good thing is as much a failure as too much of a bad thing. Both command the attention of Governments to consider the right way to deal with each problem, whether by regulation or some other intervention.

19. In some circumstances, the market does not operate, the most notable example being national defence. What are known as 'missing markets' are a good example of where the Government steps in as the provider of goods and services, rather than as regulator. The Government takes responsibility for providing these types of public good, although it may still contract out to the private sector for the supply of defence goods and services. Technically, these 'pure' public goods may be classified by economists as a form of market failure, but the example illustrates that the public good is the objective of Government provision or regulation, whether caused by market or non-market failures.

20. The concept of market failure is usually more directly related to negative conducts, such as deliberate anti-competitive behaviour by a company, or external effects on third parties, such as environmental pollution, but it can encompass more positive elements, such as the need to improve consumer information about markets so that the market overall works more effectively. This often involves action to correct information asymmetries between producers and consumers, including requirements for product labelling, or as between investors and company boards, related to obligations to publish financial information.

21. Income redistribution to ensure that all citizens can afford access to essential services, or the imposition of universal service obligations on the utility and network industries (water, energy, transport and communications), are other examples of state intervention to regulate what would otherwise be unacceptable market outcomes.

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[2] See Appendix 8 for a summary of the range of witnesses by type.

[3] See, for example, standard economic texts such as Richard Lipsey and Alec Chrystal, *Economics*, 10th edition (Oxford: Oxford University Press, 2004).

A broad definition of regulation

22. Regulation is achieved by decisions intended to control or influence specific elements of the regulated activity.[4] They are implemented by the setting, monitoring and enforcement of standards designed to achieve chosen objectives. Our concern is with the accountability of regulators for those decisions and for the choice of those objectives.

23. Inspectors act as agents both of Ministers in their regulatory capacity and of independent regulators. They are accountable to the regulatory authority by which they are employed. The Office for standards in Schools (Ofsted) has the appearance of a regulator but functions as an inspectorate reporting to the Secretary of State for Education.[5] Our focus is not on inspectors but on the accountability of the regulatory authorities themselves. They are also subject to a form of inspection. The National Audit Office (NAO) can audit their accounts and report on their procedures and practices. While this provides them with an incentive to seek efficiency and best practice it does not impact on their policy decisions and is not, therefore, the subject of our enquiry.

24. The Better Regulation Task Force has provided a broad definition of regulation to accompany its five principles of good regulation. It states that "Regulation may widely be defined as any measure or intervention that seeks to change the behaviour of individuals or groups". The BRTF illustrates this definition by going on to say "it can both give people rights (eg equal opportunities) and restrict their behaviour (e.g. compulsory seat belts),"[6] in effect saying that any action by a Government body or its equivalent in carrying out certain public functions which aim to change behaviour is regulation. Publishing league tables which affect behaviour can then properly be seen as a form of regulation, and the regulators who use them should be accountable for their decision to use them. However, this type of regulatory decision can clearly be distinguished from a formal decision affecting an individual or organisation, and which requires them to take, or stop, a specific action (a binding decision).

25. A broad definition is helpful because it focuses attention on the key issue for our Inquiry, which is that regulators should be accountable for their decisions and actions, judged against the purpose for those decisions and actions (i.e. the why of regulation), and the appropriateness of those decisions (i.e. the how of regulation). This involves questions of statutory authority and the effectiveness of the particular regulatory instruments chosen. Statutory functions and the powers and duties of regulators must therefore be the starting point for addressing the accountability of regulators. As to the why of regulation, the reason for making regulatory decisions is to achieve better outcomes. The question of 'accountability for what?' can therefore be answered: accountability of regulators for achieving good regulation through effective regulatory performance in practice. How regulation is carried out is therefore a key focus for scrutiny.

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[4] The Oxford English Dictionary defines to regulate as "to control, govern or direct by rule or regulations; to subject to guidance or restrictions…to adjust…with reference to some standard or purpose".

[5] As we have noted previously, "the Education (Schools) Act 1992 had established a new schools inspection system, and made provision for the publication of school 'league tables'", *House of Lords Select Committee on the Constitution, Annual Report 2002-03, 2nd report 2003-04*, HL paper 19, p. 19, para 21.

[6] Better Regulation Task Force, *Principles of Good Regulation* (2003), p. 1, paragraph 1.

26. Regulators have made it clear in their evidence that their regulatory functions are the responsibility of Parliament, since they are created by statute, and therefore carry out only regulatory functions designed and passed into legislation by Parliament.[7] For example, Philip Fletcher, the water regulator, put it clearly and succinctly: "We are creatures of statute and work within that framework, subject to judicial review of our actions".[8]

27. The Department for Trade and Industry (DTI), which has general responsibility for co-ordinating economic regulation across Government, confirmed this basic fact, notwithstanding the different histories of the development of regulation in each sector: "Despite establishment at different times and in different ways, the regulators share a basic model: a sector specific regulator charged with a responsibility to operate under a hierarchy of statutory duties to achieve a range of public policy objectives".[9]

28. The DTI also confirmed that whilst Parliament sets the statutory framework, the statutory duties are framed in such a way as to allow necessary flexibility and discretion to independent regulators in the exercise of their functions: "The statutory objectives of the regulators are expressed as general duties. Some of these duties express matters which are to be achieved through the exercise of the regulators' functions, others identify issues or concerns which the regulator must take into account when exercising its functions. In some cases, though not all, one or more of the duties is identified as having primacy or precedence over other duties".[10]

29. As regulation starts with Parliament, the ultimate responsibility for regulation rests with Parliament. This sets regulatory accountability in a broader setting, which starts with parliamentary responsibility for establishing the right legislation and ends with effective parliamentary scrutiny of both process and outcomes, whilst at the same time recognising a hierarchy of regulation: regulatory responsibility might in some cases be devolved formally, or informally, to Government appointed regulators for executive implementation of regulation. The question of the independence of regulators, and the impact that has had on their accountability, is therefore important, and one on which the Committee received much evidence.

Accountability for effectiveness (regulatory outcomes)—the why and how of regulation

30. Accountability for effectiveness has therefore to be considered in two parts. First, what are the purposes, or outcomes, to be achieved by regulation in terms of addressing market or conduct failures (the outputs of regulation)? Secondly, how has regulation been carried out to achieve those outcomes (the inputs of regulation)? Was regulation done well or badly? If done badly, is it the fault of the specific regulator, or a systemic fault in the design of the regulatory system and the statutory powers and duties under which the individual regulator operates, for which Government and Parliament must then take responsibility? In principle, regulation should be proportionate, in

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[7] For the development of regulators and their functions, see Appendix 9. See also the annexes to the written evidence of the DTI (Vol.II pages 378-389).

[8] Vol. II p197

[9] Vol. II p372

[10] Vol. II p373. See also annex 1 of DTI submission for summary of duties of economic regulators (Vol.II pp 378-383).

that it achieves the desired outcome in the most effective and least burdensome way. In short, effective regulation is cost-effective regulation, where cost is used in a general sense. The why and how of regulation have therefore to be taken together in addressing the question, accountability for what?, so that our focus is on achieving effective regulation and the means by which accountability helps achieve that end.

31. These questions - and the burden of regulation - were at the heart of much of the evidence we received from the regulated. The UK mobile operators told us that whilst "we are one of the biggest success stories of policy and market liberalisation in this country…we are very highly regulated and therefore regulation is a very significant constraint in what we do in our commercial and competitive activities".[11] The burden of regulation came up repeatedly, including the volume of consultation. The Royal Mail told us "…sometimes there has been almost too much consultation on some issues. For example, Postcomm's powers are such that we cannot alter the terms and conditions of one of our services to even the smallest extent without their agreement unless we can show that it is for the benefit of the customer. This has resulted in delays of six, seven, eight, nine months to try and effect even the smallest change to our terms and conditions. … There has to be proportionality - more consultation for big issues where there is a real political dimension".[12] BAA told us of 'regulatory creep', which has increased the burdens: "However, the light touch approach has suffered progressive deterioration, as five-yearly reviews have expanded from 12 months to 32 month investigations, with significant duplication of effort between the CAA and the Competition Commission.... Regulation has therefore become a significant burden and distraction to all parties, including BAA's airline customers".[13]

32. The burden of regulation can particularly affect small businesses, as we were repeatedly told by firms of financial advisers: "The FSA Handbook is vast and almost incomprehensible - the only way to look at it is via the search engine on the FSA website as apparently if printed out it would stand 9 feet high!"[14] There was therefore a considerable emphasis in the evidence we received for a greater focus on deregulation. Scottish and Southern Energy plc told us "The fact that Ofgem is such a high-cost organisation, with regulatory activity seeming to increase in inverse proportion to the number of activities actually regulated, implies that it warrants detailed scrutiny and analysis of it effectiveness. This is amplified by the absence of basic standards of performance".[15] The UK mobile operators identified a lack of trust in the market, telling us that "to some extent we have to trust the market. I do not think recently there has been much trust of the market. As soon as a problem pops up someone feels that they have to go and deal with it rather than saying 'that is how competition works, when there is a problem competition deals with it'. If you always regulate all of the problems away you are never going to get rid of regulation".[16] Innogy noted that Ofgem "has made progress towards removing regulation in some areas, but would now like to

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[11] QQ1165 & 1167, Vol II p436

[12] Q643, Vol.II p234

[13] Vol.III p14, paras 3 and 4.

[14] Vol.III p180

[15] Vol.III p157

[16] Q1168, Vol.II p437

see a more concerted effort to review detailed sectoral regulation. Non-regulatory options should be examined before further regulation is introduced and, where competition is effective, Ofgem should rely on enforcement by competition law".[17]

The roles of Parliament, Ministers and independent regulators

33. The third aspect, alongside a broad definition of regulation and consideration of the effectiveness of how regulation has been carried out, is the inter-related responsibility of Parliament, ministers and independent regulators. Each plays different parts at different times - more or less independently, but is orchestrated within an overall framework for an effective regulatory state which achieves cost-effective outcomes for citizens, and operates in the public interest.

34. Parliament sets the statutory framework embodying the objectives to be achieved by regulation. It legislates, however, for that regulation, in many cases, to be carried out by independent regulators. The reason has been well summed up by the OECD: "The key benefits sought from the independent regulatory model are to shield market interventions from interference from 'captured' politicians and bureaucrats".[18]

35. Independent regulators must therefore be held accountable for their actions, but independence is not fixed in stone, and Government and Parliament retain responsibility to review regulation and ensure that the legislation remains fit for purpose. It can therefore be expected that Parliament will change the legislation from time to time. The DTI made reference to this in its evidence: "The primary means by which the regulators' role may be changed is through parliamentary amendment of the duties specified in the statutory framework. The role of regulators has been changed in this manner over time".[19]

36. The water industry regulator has provided us with a clear example, which also illustrates the relationships between various regulators. Standards of drinking water, and for discharges of used water back into the environment, are the responsibility of ministers, supported by the expert advice of the Drinking Water Inspectorate (DWI) and the Environment Agency (EA) respectively (whilst noting that the Minister's decision itself might reflect the incorporation into law of a European Directive on the subject). These two bodies advise Ministers but are not accountable in that role for the Minister's decision, which is incorporated appropriately into law. As regulators, however, they carry out functions of inspection (monitoring) and enforcement where the standards set by Ministers, and approved by Parliament, are not being met. The regulators may have discretion as to when and how they exercise their powers.

37. Once the Minister has set (or been minded to set) certain standards, the economic regulator in England and Wales (the Office of Water Services, supporting the Director General or, as now, Authority, following the Water Act 2003) is responsible for protecting customers' interests by controlling the

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[17] Vol.III p105

[18] Regulatory Policies in OECD Countries - From Interventionism to Regulatory Governance, p. 97: Reviews of Regulatory Reform (Paris: OECD, 2002).

[19] Vol.II p373

abuse of monopoly power which might otherwise be exercised by private sector water service providers. His statutory duties include customer protection, ensuring that all reasonable demands are met, and the duty to ensure that the regulated water service providers carry out their proper functions (for which they have been granted a licence) and can finance themselves. His regulatory role is independent of Ministers and set out in statute. The key regulatory decisions relate to setting maximum price controls for each water service provider for a period of years, typically five years. This decision has, however, to allow the regulated companies the financial wherewithal to maintain the quality standards set down by Ministers. Environmental and quality regulation is therefore incorporated as a constraint into economic regulation.

38. The balance between standards and affordability is debated as part of the deliberative cycle of the periodic review, involving the Department of the Environment, Food and Rural Affairs (DEFRA), Ofwat, the Electricity Association (EA) and the industry. The cycle has been formulated into an explicit timetable for submission of draft and final business plans by the regulated companies. This integrated and commendable approach developed from a challenging debate on accountability for setting quality standards and the implications for consumer bills, promoted by the original water regulator, Sir Ian Byatt.[20] His concern was whether ministers properly applied the cost-benefit test in making decisions, and took accountability for it. "… I thought it was important to start a proper debate on what I called the cost of quality where I would say 'this is what quality might cost'…Then I said: 'Of course the people who are making the decisions on the quality are the ministers so please will the ministers take notice of this and that I am making the decisions on financing of functions. So whatever the ministers decide then I will finance the functions'. I would sometimes do this in what I regard as a relatively challenging way, 'Are you sure you really want to spend the money in this way?' I would have liked to have been able to challenge the European Union rather more than I was able to do".[21]

39. The key development, therefore, was to formalise the interrelationships, and hence the accountabilities, within the regulatory framework as a whole. It showed how the regulatory framework can evolve, and particularly where regulators, being independent, thereby have the opportunity to identify and raise a problem and achieve a change in the relationship; a contribution which was noted by Sir Christopher Foster: "What Ian Byatt did in the circumstances was as good as could be expected because, at least to some extent, he institutionalised the conflicting forces".[22]

40. The consequence of this unbundling of the regulatory state has been to sharpen the accountabilities of specific regulators, Ministers and Parliament in relation to their respective roles and responsibilities, emphasising the interconnectedness of the various parties within the regulatory framework as a whole. If regulators are independent for a particular purpose, they nevertheless still fall within the overall responsibility of Government and Parliament for the regulatory system. It is independence within Government,

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[20] The Cost of Quality: A Strategic Assessment of the Prospects for Future Water Bills (Birmingham: Ofwat, 1992).

[21] Q14, Vol.II p6

[22] Q209, Vol.II p73

rather than independence of Government *per se*. The Minister of State at the DTI, Mr Stephen Timms MP, captured this when he said: "Inevitably there is an impact by regulators on a range of government concerns. I do not think the regulators exist in a vacuum outside government policy. Inevitably the decisions of regulators do impinge on government policy; there is no point trying to pretend that is not the case, it clearly is the case. The best way to handle it is for government to be explicit about what it is looking for from the regulators in those respects and for the regulators to make their decisions in that context".[23]

41. One consequence of this, as we have seen earlier from Sir Ian Byatt's evidence, is the increasing formalisation of the relationships within the regulatory framework, constraining or empowering the parties, one in relation to the other, as appropriate. The development of ministerial guidance has been referred to as a case in point in written evidence by the DTI: "In addition the Utilities Review 1998 led to the establishment of an additional process through which regulatory objectives may reflect government policy objectives. The review led to subsequent legislation introducing a duty on the energy and postal regulators to have regard to governmental guidance on social and environmental objectives … similarly water in the water bill".[24]

42. In practice, our Inquiry has concentrated on the independent economic regulators. The scope of activities of these regulators encompasses both regulatory and non-regulatory activities and their independence from Ministers brings with it additional important considerations for accountability. In any event, environmental regulation and advice to Ministers is an important aspect of utilities' economic regulation in practice, and social regulation has also played an important part in the debate on regulatory accountability and the role of ministerial guidance.

43. Evidence and requirements related to the effective accountability of these independent regulators therefore provides a model for the accountability of regulators generally.

[23] Q1097, Vol.II p392

[24] Vol.II p373

CHAPTER 3: ACCOUNTABILITY TO WHOM?

44. Before turning our attention to the processes for achieving effective accountability, we examine accountability to whom. This is because the three elements of accountability we set out in the next chapter are generic categories about the process, procedures and stages of accountability, but in their application they may vary in their incidence, and the balance between them, depending on who (or which group) the regulator is being accountable to. We start with the general view that regulators carrying out public functions wield considerable powers and must accept that these powers carry responsibilities, including the duty to explain to all interested parties, whether they are parliamentary select committees, Ministers, regulated companies, consumers or citizens. We recognise that this duty is likely to be exercised in different ways, and to different extents, for the different interested parties. It will depend on statutory and formal requirements, good practice, and an understanding of the information needs of each party. As Sir Derek Morris has said (see paragraph 74) the duty to explain is summed up for our purposes by the word "transparency".

45. Equally, the rights of the various interested parties to expose the regulator to scrutiny will vary. Parliamentary select committees have a right to summon regulators to appear before them; this is a right not normally available to the individual citizen. Differences in such rights are clearly appropriate, whilst ensuring at the minimum level that all citizens (or their representatives) have sufficient access to information to enable them to question the regulator where there is a legitimate interest. Regulatory openness, whether through replying to citizens' letters, or by holding the occasional public meeting (perhaps related to the publication of the annual report), ensures that exposure to scrutiny is available, in one way or another, to all.

46. Access to the possibility of judicial review may also be reserved to particular interested parties, although the ambit of that access is changing, and becoming wider. The range of issues which may be covered is also developing so that formal review might be extended to a challenge, not just on points of law, but on the substance of regulatory decisions.

47. In this regard, accountability of regulators to the courts should be seen not so much as a direct line of accountability, but as a means by which the direct end of accountability to affected, or aggrieved, parties is achieved. This view is qualified, of course, where the courts have the direct role of a primary regulator, rather than being the guardian for others against arbitrary regulatory decisions and activities.

The 360° view of accountability

48. Our view, therefore, is that accountability is a generic term, the precise definition of which depends on the circumstances, including the relationship between the interested party to the regulator. In practice, there are multiple accountabilities. For example, while regulated utility companies should be accountable to regulators for the proper performance of tasks assigned to them in their licence, in turn - and equally - the regulator should be accountable to them for the proper performance of the regulatory task. It should thus be possible for the companies to challenge the regulator, and for the regulator to challenge the companies, where one of the parties is not

say that list could not be improved but I do say that the commentators who say we are unaccountable and that something must be done about us are wrong in law, are wrong in fact, and are wrong in policy terms".[28]

51. The 360° view of accountability therefore provides a context and reasons for improving the accountability of regulators.

52. However, we draw a distinction between regulators exercising a duty to explain – extending to all the bodies identified in Figure 1 – and being required to respond to demands made by those who gave them their powers or control the legal application of their powers. Citizens, consumer bodies and regulated bodies lack the power to summon regulators to justify their actions. We have reflected this distinction in Figure 1. The shaded boxes comprise the bodies that exercise power directly in relation to the regulators. These are the bodies that, as we shall see, are responsible for scrutiny and formal review. Ministers determine public policy and appoint the regulators. The courts interpret and apply the law passed by Parliament. Parliament is at the apex in that it passes the law creating the regulatory bodies and is the body responsible for calling Government to account. Parliament is thus fundamental to achieving an efficient and accountable regulatory regime. A traditional view of this line of accountability is set out in Appendix 4.

Accountability as a control mechanism

53. The processes of accountability, given effect through the three elements of accountability (duty to explain, exposure to scrutiny and the possibility of independent review) are an integral part of the macro design of the regulatory system as a whole. In effect, accountability is a control mechanism through which effective regulation is maintained (and endorsed), and failing or ineffective regulation is identified and exposed, and thereby subject to remedy and improvement.

54. The purpose of accountability is to provide a system of control which helps Government achieve efficient and effective regulation. This is both positive (facilitating) and negative (constraining), and in time, both pre- and post-event. This is illustrated in Table 1.

55. The ends of regulation can therefore be combined with discussion of the means of achieving it, one element of which is the systems control element of accountability. Accountability of regulators is therefore a means to an end - effective regulation - and not an end in itself.

56. The relationships of good regulatory design, accountability as a control mechanism through the three procedural elements, and accountability for what, to whom, is set out in summary in the Table 2.

The circle of accountability

57. Who does what and why has therefore to take account of both a regulatory system and a regulatory process over time, starting with Parliament setting the statutory framework and ending with Parliament reviewing regulation in practice. This is illustrated in Figure 2.

[28] Q 597, Vol.II p219

Independent consumer bodies

58. Independent consumer bodies have been established in recent years as part of the Government's policy of strengthening the consumer's voice in regulation and to challenge the regulators.[29] They include Postwatch, Energywatch and WaterVoice. They arose from a concern that regulators, in balancing the interests of the regulated companies (and their investors) with the consumers, might hear more of the company voice and have too great a regard for their interests (albeit that there were statutory consumer committees within each utility regulator's office).

59. The policy concerns the design of the regulatory framework, and should be judged by whether or not it improves the effectiveness of regulation, and is cost-effective. Proper accountability will enable that debate to take place, and judgements to be drawn. Our primary interest, however, is with two aspects of this accountability. First, that the independent consumer bodies should be equally held accountable, as are the regulators, for their activities, given they are part of the overall design of the regulatory framework. Secondly, with the apparent policy contradiction of both the regulators and the independent consumer bodies presenting themselves as consumer champions, particularly since it is the policy of the Government to place a primary duty of consumer protection on the independent economic regulators. But we are also concerned that cost-effectiveness, clarity of roles and public understanding might be undermined, thereby damaging effective accountability. While some tension is inevitable – even desirable – there is however also a risk of damaging public confidence in regulation if relationships become adversarial, especially since both parties have been appointed by Government to carry out consumer representative functions.

60. The case for independent consumer bodies was recognised by some regulators ahead of statutory provision for their appointment. Though appointed to take into account the interests of consumers, regulators were not necessarily able to know clearly and consistently what those interests were. It was thus useful to have some input from a body representing consumers. To ensure a greater degree of independence, these bodies now exist outside rather than within the offices of the regulators.

TABLE 1

Elements of the accountability 'control system'

	Prospective	*Retrospective*
Positive (carrots)	harnessing the means of accountability to facilitate good regulatory decision-making, and to avoid the pitfalls of regulation	confidence building from either good regulatory outcomes, or learning from past failures and problems, allowing the beneficial evolution of the regulatory system
Negative (sticks)	the discipline on regulators of the threat of exposure by accountability mechanisms (avoided by good regulatory decision-making)	attributing fair blame for poor regulatory decisions (with penalties or redress as appropriate), with the incentive to avoid such blame in the future.

[29] See in particular government's review of utility regulation: *A Fair Deal for Consumers - Modernising the Framework of Utility Regulation* (London: Department of Trade & Industry, March 1998); and *Consumer Councils: The Response to the Consultation* (London: Department of Trade & Industry, April 1999).

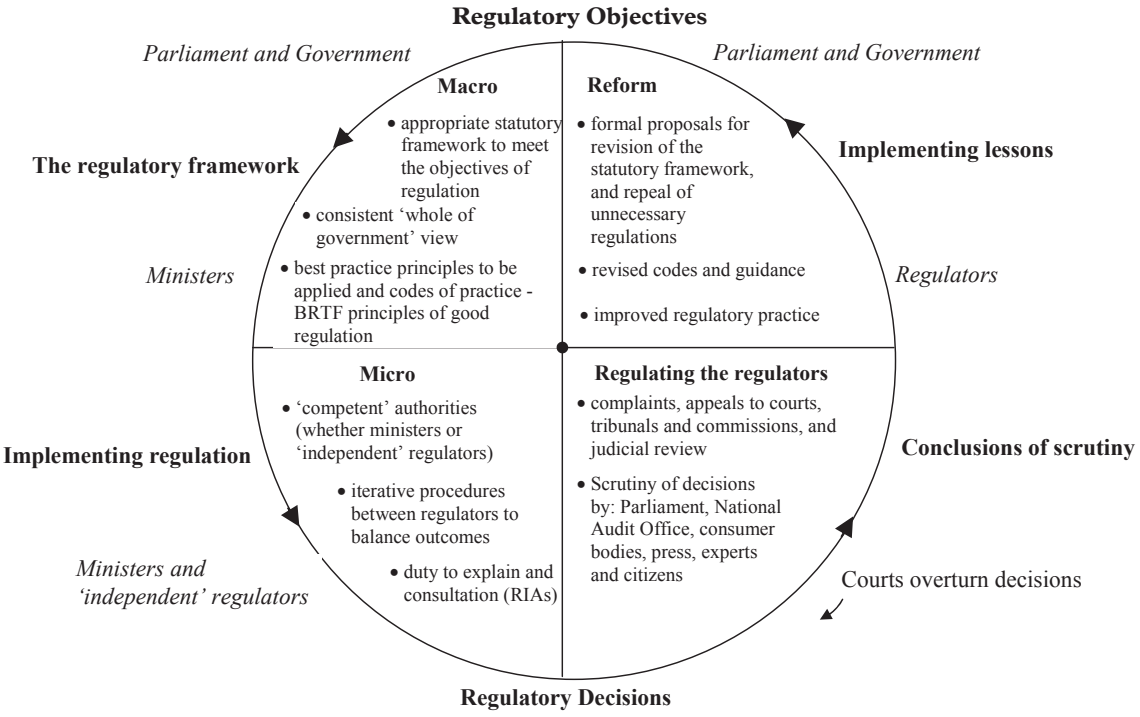
TABLE 2

Effective regulation depends on

Good regulatory design	*Control through the processes of accountability*	*Accountability for outcomes: regulatory performance*
Macro (policy) The whole of government view: - encompassed in the regulatory (legal) framework of functions, powers and duties: the division of roles and responsibilities - whether by regulatory sector, theme or hierarchy e.g. arms-length independence versus direct ministerial regulation **micro** (implementation) 'Competent' authorities	**Duty to explain** (provision of information and reasons for decisions) **exposure to scrutiny** (use of information - answerability and challenge) **the possibility of independent review** (complaints, appeals and judicial review - particularly in respect of conformance rather than performance)	**Accountability to whom:** Citizens Parliament Government Ministers Departments of State Regulators Customers Consumers Regulated companies Other interested parties.

FIGURE 2

The circle of accountability through the regulatory cycle



61. However, to what extent can the consumer bodies claim to be representative of consumers? They are not chosen directly by consumers but instead are appointed by the regulator or a minister. In their evidence to us, the officers of the different bodies explained the extent to which they relied on open meetings and surveys of consumers. Ms Deirdre Hutton, Chair of the National Consumer Council, told us that the NCC "did not represent

consumers, we are not a democratic body and representation of consumers in that sense is for those who are democratically elected". She then told us that "what we endeavour to do through qualitative and quantitative research and through policy analysis is to understand what the interests of consumers are", finally observing that "since everything we say is public, people soon let us know if they disagree". The NCC, which does not exist to cover a particular regulator, stands in a distinct position. Ms Hutton told us that the NCC does not represent consumers. Even so, when asked how she knew whether the Council was accountable, replied: "We do a lot of consultation".[30]

62. The Consumers' Association told us that it is "an independent, not-for-profit consumer organisation that is entirely independent of government and industry", and that it has "worked on behalf of consumers to achieve improvements in the quality and standards of goods and services for more than 40 years".[31]

63. Maurice Terry, the Chairman of WaterVoice, told us that openness was their way of being accessible, so that "all our committee meetings are held in public, and some of our regional committees have listening sessions, where they invite members of the public to contribute".[32]

64. The work of the independent consumer bodies in seeking to ensure that they can claim to speak authoritatively for the consumer is commendable. However, we are struck by the fact that each body is left to decide for itself what is the most appropriate mechanism for discerning the interests of consumers. There appears to be no common framework. In its response to the Better Regulation Task Force's report on independent regulators, the Government said that it "wholeheartedly agrees that there is scope for improving the performance of 'the rest' to bring them closer to 'the best'".[33] The same point we believe is appropriate in the context of the consumer bodies.

65. We were also concerned by the fact that engaging in surveys can be a significant drain on resources. The bodies are not generously resourced – they are small units, especially relative to the offices of the regulators – and are constrained in undertaking the type of consultation that they think is necessary. We believe that both problems must be addressed. There needs to be greater consistency in approach. There is little point in creating a consumer body that can match the resources of the regulator, but we recognise that consumer bodies need adequate funding.[34]

66. On our second area of concern – the clarity of the relationship between consumer bodies and the regulators – we found that the potential for conflict between bodies claiming to promote the interests of consumers was variously fulfilled. The evidence presented to us suggests that relationships can be troublesome. We were struck by the poor relationship that exists between Postcomm and Postwatch. Postwatch was critical of the lack of co-operation on the part of Postcomm, believing that it failed to be as transparent as it

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[30] Q1053, Vol.II pp364-5

[31] Vol.III p41

[32] Q344, Vol.II p121

[33] Ministerial Written Statement, Cabinet Office, Government's Response to Better Regulation Task Force Report: "Independent Regulators", 9 Feb. 2004.

[34] It should be noted however that according to *The Daily Telegraph* of 16 March 2004, quoting a report by the European Policy forum, consumer bodies in some cases employ more staff than the regulators.

should be in its dealings with Postwatch.[35] Postcomm considered that Postwatch was ill informed in its approach.[36] The extent of the poor relationship was noted by the chief executive of Royal Mail: "I think Postwatch's position is quite clear. They believe that there should only be one regulator and it should be Postwatch. The fact that we have two bodies which have some overlapping duties towards consumers has resulted in, from our perception, the two bodies almost trying to outdo each other in their degree of toughness in standing up to each other and ourselves, which I think has damaged our relationship with both of them. I have always thought it far more likely that one of our regulators would judicially review the other before we would ever judicially review either of them. I think it has been a recipe for disaster".[37]

67. The Electricity Association was equally concerned with respect to Energywatch.[38] Clare Spottiswoode also noted the inherent tensions;[39] Professor Littlechild drew attention to how difficult it was to reconcile the giving of a primary duty of consumer protection to the regulators "with the simultaneous creation of an independent consumer body whose duty is also to promote the interests of consumers".[40]

68. Poor relationships are not constant features. Ofcom, which has been established with a consumer panel, as with the FSA, appeared to have no concern about the independence of its operations.[41] Relations thus differ from sector to sector. This may reflect the personnel involved or it may reflect the different methods of appointment and structures created for each sector. The existence of poor relationships, at times verging on the adversarial, is clearly undesirable and needs addressing. A robust relationship need not necessarily equate to a poor relationship. Ms Hutton of the NCC told us that the Council had achieved change through criticising Government where necessary: "In general terms, governments of all colours have appreciated that the value of the National Consumer Council to them lies in its independence and its robustness of thought".[42] A similar relationship between independent consumer bodies and the regulators is desirable.

69. **In order to address the problems we have identified, we recommend that independent consumer bodies be obliged by statute to engage in open meetings and conduct regular surveys of consumers. This has resource implications which should be met out of public funds. Following a review of the budgetary arrangements for each regulator an appropriate formula should be agreed for calculating this provision and applied to each of these bodies. We believe that these changes will enhance both the accountability and the independence of the consumer bodies.**

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35 Q394, Vol.II p193

36 Vol.II p238, para 10

37 Q648, Vol.II p235

38 QQ521 & 523, Vol.II p 175

39 Vol.II p140, para 45

40 Vol.II p23

41 Vol.II p420, para 8.2

42 Q1081, Vol.II p370

70. **We are aware that the Government is undertaking a review of consumer bodies, supported by the National Audit Office (NAO), and recommend that the review includes an examination of the relationship between regulators and the related consumer bodies in order to introduce greater clarity in the relationship, if necessary through a statutory provision common to the regulatory regime.**

CHAPTER 4: EVIDENCE OF CONCERNS – ACCOUNTABILITY IN PRACTICE

71. Having considered accountability for what, and to whom, the next question is how that accountability is given effect in practice, and what role it can play in achieving effective outcomes from regulation. The purpose of accountability of regulators is to help secure both the effective design of the regulatory system as a whole and the effective operation of the regulatory system in its constituent parts. Effective regulation requires effective accountability. If the control mechanism of accountability fails, then effective regulation is endangered, risking arbitrary exercise of regulatory power, inequity and loss of confidence in the regulatory system. Each of the three elements of accountability has to work well in this respect, and should be critically examined in respect of the part that it plays. We have received evidence of concerns in all three areas.

72. The Committee received evidence on a number of definitions and interpretations of accountability, and it is clear that differences here affect the judgement on how effective the accountability of regulators is, or could be. The DTI's written evidence listed the mechanisms, rather than defining accountability: "Regulators' actions are subject to the following accountability mechanisms: Appeals processes; parliamentary scrutiny; Consumer representation; and transparency".[43] The Minister's oral evidence repeated these, and added in corporate governance, notably with reference to the new board structures for independent regulators, as a further mechanism.[44]

73. The Committee therefore considered the elements of the accountability process which make or break the achievement of effective accountability, elements which have been the subject of much concern in the evidence we have received.

74. The elements of accountability, which were persuasively set out in Sir Derek Morris's evidence, distinguish three stages in the processes of accountability, all three of which play an essential part in achieving not only effective accountability, but any proper accountability at all: "… I do think that there are three different and equally important levels of accountability. The first, to give it an epithet, would be transparency. People have to know what you are doing and how you have done it, and in trying to explain that and in being forced to explain there is an element of accountability … The second is more penetrating. It is not just transparency. It is actually being questioned, if you like grilled, on what you have done and how effective have you been in doing it. The decisions cannot be changed but you can be cross-questioned. There, fairly obviously, the role of the select committees is paramount . The third level is where, of course, the decisions can be changed, and that is in our case through judicial review and to the High Court".[45]

75. The elements of accountability can be summarised as:

- the duty to explain

[43] Vol.II p375, para 27

[44] Q1087, Vol.II p390

[45] Q901, Vol.II p 320

- exposure to scrutiny, and
- the possibility of independent review.

All three have to be effective if there is to be due accountability of regulators overall, and for the regulators to be challenged where appropriate and held answerable for their actions.

The duty to explain

76. The first element of the accountability process relates to the obligation on the regulator to provide information on its activities and, in particular, to explain the basis of decisions. This includes not only the decision itself, but also the thinking used to lead up to the decision, and the thinking as to why the particular decision (or regulatory instrument) was chosen, as compared with other alternatives available. The technical level, means used (media and fora), and extent of information provided (summaries or full texts) might vary between different interested parties, but we accept that the regulators have a general duty of accountability, characterised by openness or transparency in this regard, an obligation to provide information to all interested parties (or stakeholders), tailored to their locus in the regulatory scheme and the accountability procedures appropriate to that.

77. The general presumption of openness might be qualified, in particular where information available to regulators concerns personal details, or commercial confidentiality is required. Past Monopolies and Mergers Commission reports have often contained large sections of excised data, which on occasion have rendered the arguments and basis for the decisions inaccessible. We have heard from Sir Derek Morris that whilst commercial confidentiality clearly still remains an issue for the Competition Commission, he hoped that future drafting of documents would be such that the essential basis of arguments for decisions would be evident. This was the Commission's declared intention: "We tended to err on the side of protecting confidentiality and I do believe there have been some reports in the past that I will not say were incoherent but were beginning to get a little difficult to understand because of those excisions, and that is a public detriment ... (but post Enterprise Act 2002) I think that means there is going to have to be more disclosure and there will be more cases in which the tension that you have described leads to some commercially sensitive material having to appear in order that the decision can be explicable".[46] Accountability in relation to regulatory excisions of published information suggests that there should be some form of independent scrutiny, with a published confirmation of the appropriateness of the excisions.

78. A number of witnesses identified areas where progress has been made in improving accountability, especially in terms of openness. However, we have also received evidence that the regulators:

- provide insufficient information and do not give full reasons for decisions;
- provide too much unstructured information, which undermines the ability of interested parties to challenge them.

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[46] Q904, Vol.II p321

79. We have received a large volume of evidence concerning financial services regulation, particularly from Independent Financial Advisers (IFAs). Most submissions claimed that the FSA's bureaucracy is excessive, and state in general terms that the FSA is high-handed and insufficiently accountable. There were complaints about the retrospective application of rules, which raises concerns about inequitable treatment and the cost of professional indemnity insurance. We note in particular the complaints about excessive consultation and consultation on non-essential issues.

80. The evidence indicates that the burden of regulation generally is of great concern.[47] There is a clear requirement for regulators to explain their actions, so that the cost of regulation can be properly judged against the public benefits from regulation. The Electricity Association told us that: "It seems wholly inappropriate, for example, that Ofgem is under no legal duty to publish annual accounts, and that its service delivery agreement with the Treasury says nothing about the desirability of reducing the real costs of regulation."[48] The consumer watchdogs were equally concerned".[49]

81. The UK mobile operators told us that the regulator should be "justifying why he needs sector specific economic regulation … particularly where in the mobile sector we do not come from a monopoly background".[50] Northumbrian Water's view was that "If there is concern that regulators should become more accountable, then clarifying their objectives would be a good start".[51] We were also informed that "Ofgem does not provide reliable information on its key activities where its prestige is on the line; it not infrequently self-promotes itself and spins. Consequently it is not effectively self-accountable. I recommend that when Ofgem reports the success or otherwise of its activities, the reports are reviewed by an independent external party appointed by the NAO".[52]

Exposure to scrutiny

82. Our conclusion of a general duty to explain leads onto the second element of accountability, which is exposure to scrutiny; the requirement to answer questions and to provide the means through which that scrutiny can be made meaningful. In this sense, effective scrutiny is seen as a countervailing force to the power of the regulators, in that the process of scrutiny has the real power to improve outcomes, either in the short or longer term. It can take the form of consultation, where response is invited from stakeholders, or a process of inquiry initiated by a body other than the regulator. The latter may encompass requests for information from regulated bodies or a formal requirement to answer questions by a parliamentary committee.

83. The avenues by which regulators can be and are scrutinised include those shown in Table 3.

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47 Q826, Vol.II p287 (see also Q 851, Vol.II p291)

48 Vol.II p163, para 12

49 Vol.II pp148-9; Vol.II p129

50 Q1177, Vol.II p439

51 Vol.III p131, para 49 (see also para 50)

52 Vol.III p90, para 24

TABLE 3

Avenues of scrutiny

Parliamentary scrutiny - whether by debates in either House, or by select committees of either House, or by joint committees of both Houses;

Ministerial meetings with regulators - where there might be part of a regular cycle or occasioned by specific issues as they arise. This scrutiny is accompanied by the longer term power in the hands of the Minister, which is not to reappoint the regulator;

Responses to regulators' consultation documents, including participation in fora set up by the regulators to engage interested parties in the debate, including working groups, seminars and open meetings;

Specific requests to the regulator from interested parties, whether, for example, from regulated companies, consumers or investors, and covering complaints about a regulator's activities as well as other matters;

Scrutiny by representative bodies and interest groups, for example, consumer bodies, both national (such as the National Consumer Council (NCC) and the Consumers Association (CA)) and sectoral (such as Energywatch, Postwatch or WaterVoice), as well as interest groups or NGOs, such as Friends of the Earth;

Press scrutiny;

Academic and other expert commentators, such as policy institutes;

Formal reporting occasions, such as open meetings conducted to launch the annual report of the regulator or to carry out an educative purpose to widen knowledge of the regulator's functions, mission and approach.

84. We have received evidence that:

- some regulators do not consult interested parties to exchange views. There may be insufficient time for consultation, inadequate fora, or it is perceived that the consultation is simply one of form, since the decision has already been taken;

- Parliamentary select committees have not shown sufficient consistency, continuity or expertise to give full effect to their important position in the process of achieving effective accountability. The Electricity Association was particularly concerned, given the broad discretionary nature of the statutory framework for utility regulation. Their resulting conclusion: "the EA believes that the weak political accountability of regulators needs to be counter-balanced by a more effective framework of legal accountability".[53] This is an important concern, to which we shall return in later chapters.

85. As to the effectiveness of consultation, the Electricity Association was rather damning of Ofgem's record: "it would also be incorrect to say that Ofgem's consultations are particularly effective, either for the public or for licensees. With only rare exceptions, the procedures do not achieve what the courts have defined as the essence of consultation, namely the extending by a public authority, with an open and receptive mind, of an invitation to other parties to provide advice about its proposals at a formative stage, before its mind has set".[54]

86. The consumer watchdogs were equally concerned. Energywatch was dissatisfied with both the consultation - "there is considerable scope for improving the Ofgem consultation process through the provision of cost-benefit analysis and consumer impact assessments"[55] - and the response that they receive - "Quite frankly, I have not always been satisfied with the

[53] Vol.II p163, para 7

[54] Vol.II p167, para 42

[55] Vol.II p149

responses I have had. Sometimes I have had no response".[56] Postwatch was similarly critical stating that "Postcomm does not give its views or those of other consumers adequate consideration".[57]

87. However, we received warnings that the extent of scrutiny itself has to be subjected to a cost-benefit test. Postcomm told us that they " think it adds up to a pretty formidable stack of reporting back and information … there comes a point at which the degree of oversight and the number of bodies, if you add on the National Audit Office, the Better Regulation Task Force and so on, become self-defeating. I think it would be impertinent for us to judge whether we are at that point now or not. We have obviously complied with whatever obligations it is decided to put on us, but we feel we spend quite a lot of time explaining ourselves at the moment".[58]

Independent review

88. Scrutiny has the power to affect regulatory outcomes. However, it is indirect, and has to be complemented by the third element of the accountability process, which is the possibility of independent review, whereby regulatory decisions may be formally overturned or varied.

89. Independent review encompasses judicial review and a statutory appeals process. Regulators are bound by statute and must abide by any secondary legislation derived from it. They are also subject to ministerial guidance, where this is authorised by legislation. They are also bound by European Union law and, as a consequence of the Human Rights Act 1998, must exercise their powers in a manner consistent with the rights protected by the European Convention on Human Rights.

90. Regulators must also observe the principles of administrative law and must not act irrationally: that is, they must not make a decision that no reasonable regulator could have made. Therefore, in the absence of any other remedy provided by Parliament, those who are adversely affected by a regulator's decision can, if they believe the decision infringes their rights under administrative law, apply to the Administrative Court for judicial review. Judicial review is available as a residual remedy for enforcing the legal duty of regulators.

91. Unlike judicial review, which is always available as a residual remedy, a right of appeal exists against a regulatory decision only when Parliament has provided for this. Legislation is needed not only to create the right to appeal but also to establish the body to hear it, the nature of the process and the grounds on which an appeal may be brought.

92. On judicial review, there is some international consensus. The OECD summed it up thus: "the availability of judicial review of administrative decisions can be seen as the ultimate guarantor of transparency and accountability and is likely to improve the effective quality of the decisions made during administrative review".[59] Clearly judicial review is seen as a feature of effective accountability although it is, by its nature, essentially

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[56] Q493, Vol.II p159

[57] Vol.II p130, paras 17-21

[58] Q695, Vol.II, p250

[59] Regulatory Policies in OECD Countries - From Interventionism to Regulatory Governance, p. 75: OECD Reviews of Regulatory Reform (Paris: OECD, 2002).

negative and narrow. The availability of pursuing such action is important in regulation, given that a regulator both advances the case and makes the decision and, as Professor Prosser described it, is seen as "acting as prosecutor and jury on an issue".[60]

93. The value of an appeals system is generally agreed. Sir Christopher Bellamy, Chairman of the Competition Appeal Tribunal, referred us to three important features of an appeals system: "First of all, the scrutiny of the appeals system or perhaps even just the existence of an appeals system should improve the quality of decision making and I have the subjective impression that that has happened. Secondly, the existence of a system and its operation should increase confidence in the system as a whole ... Thirdly, it is a safeguard against regulatory capture, regulatory inertia or regulatory timidity which with the best will in the world may creep into any regulatory system from time to time".[61]

94. However, we have heard much evidence that traditional judicial review has not provided an effective protection, based as it is on *ultra vires* and a restricted definition of reasonableness. We have received evidence that whilst judicial review is seen as important in the context of challenging regulatory decisions, it has little role to play in challenging the merits of decisions.

95. British Energy told us that: "Judicial review to us is a sledgehammer, it creates an uphill struggle on the part of the regulated body to prove that the regulator was completely unreasonable or stark raving mad, it makes it a difficult process coming from the regulated body. If one goes back to the human rights legislation, the basic principle is that there should be some sort of appeal on the merits, rather than whether it was totally unreasonable".[62] The Electricity Association concurred.[63]

96. The consumer bodies were concerned that they had few appeal rights at all against a regulator who was overly favouring the regulated company.[64] They were particularly concerned if regulated companies should have their appeal rights improved from the current position, as this would further highlight the weakness of their own position.[65] However Postwatch did recognise that legal actions between two public bodies was not something to be encouraged.[66]

97. Nevertheless, regulators have told us of how effective a discipline fear of judicial review is on their actions and decisions. The first telecoms regulator, Sir Bryan Carsberg, told us that: "No regulator wants to have decisions overturned through judicial review. It seemed a matter of good management and prudent behaviour to consider the danger and to take steps to avoid it".[67] Professor Stephen Littlechild, the first electricity regulator, also questioned the idea that judicial review is an ineffective remedy: "I was judicially reviewed three or four times…. I won some and I lost some. Again it was a

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[60] Vol.II p52

[61] Q1032, Vol.II p358

[62] Q256, Vol.II p96

[63] Vol.II p165, paras 26 and 29

[64] Vol.II p129, para 11

[65] Q1065, Vol.II p367

[66] Q395, Vol.II p133

[67] Q195, Vol.II p 68

very thorough investigation. I think what this means is that anybody potentially adversely affected has a real, practical possibility of challenging what the regulator does, and there is evidence that parties have challenged and have won".[68]

98. We have also heard evidence that the position is changing. The development of human rights legislation is having a general impact on both the ambit of protection to aggrieved parties afforded by judicial review generally, as well as having affected the statutory position in recent legislation whereby, for example, the Communications Act 2003 incorporated a European Directive which allows appeals to an independent tribunal, and appeals on the merits of the case.[69] We have been told that this can be traced to Article 6 of the European Convention on Human Rights.[70] We have also been told that there has been a judicial reinterpretation in relation to the substance of appeals, which is being welcomed by Parliament: "There is also a move by Parliament to increase the scrutiny by the court or tribunal of the merits of the decision. The origin for this is found in the Competition Act 1998 under which the Office of Fair Trading and the sector specific regulators in their own areas are subject to an appeal broadly on the merits to a body now known as the Competition Commission Appeals Tribunal. The origin of that is that the Court of First Instance in Luxembourg, which hears appeals from the European Commission, has adopted a set of procedures which is closer to an appeal on the merits or a re-hearing than just judicial review".[71]

99. But we note that the evidence of concern can also be about not extending the right of appeal too far such that it could distort the public purposes of good regulation. Ofgem noted that "all of Ofgem's decisions are subject to some form of appeal… Ofgem believes that very careful consideration needs to be given to any proposal for change ...".[72] Philip Fletcher, the water regulator, was concerned that companies should not have the opportunity through more extensive appeal mechanisms to 'salami-slice' issues in decisions which were essentially an overall package.[73] The DTI told us that "it is not obvious that a change in the current system is necessary, or even desirable".[74]

100. If there are those who are concerned that increasing the rights of the regulated to appeal decisions might create game-playing to undermine effective public regulation, we note two countervailing influences. The Competition Appeal Tribunal has told us that the right of appeal is balanced by the right of the Tribunal to be able to strike out appeals for which there is no proper case.[75] Also, we have been told that where further rights of appeal against regulators' decisions are granted to regulated companies, then consideration should also be given to extending the rights of appeal by consumers and other interested parties against the decisions of regulators, who are meant to be protecting their interests.[76] The regulated companies

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[68] Q83, Vol.II p29

[69] Vol.II p418, para 5.2

[70] Vol.II p52

[71] Q121, Vol.II p46

[72] Vol. II pp180-181, paras 20 and 23

[73] Q590, Vol.II p208

[74] Vol.II p376, para 34

[75] Vol.II p352, para 25

[76] Vol.II p363, para 38

accept the need for a balance, as we heard from Innogy plc: "An effective appeal process is a key element in promoting regulatory accountability. Such a process should provide an important incentive to regulators to ensure good decision-making, thus reducing uncertainty and promoting greater confidence in the regulatory framework. At the same time, it should also maintain a balance between stakeholders and filter out nuisance appeals".[77]

[77] Vol.III p104, para 5

CHAPTER 5: FACTORS WHICH CAN UNDERMINE EFFECTIVE REGULATION AND ACCOUNTABILITY

101. The evidence analysed in chapter 4 shows significant concerns in all three elements of accountability. There appear to be common causes for many of these concerns. This chapter groups these together, as a precursor to examining improvements which could be made to achieve better accountability. Effective accountability and regulation can be undermined by pitfalls, poor communication to, and poor understanding by, those to whom accountability is directed, and overall incoherence in the design of regulatory roles and responsibilities:

Pitfalls

(a) presumption: regulators assume that they are there to do good and therefore have a view of what is good, which they may consider to be superior to the view of the regulated bodies. This weakens the presumption of their due accountability. Regulators can equally abuse their monopoly power, either by empire-building, imposing excessive requirements for information or regulations, or micro-management of the regulated business. Sir Bryan Carsberg told us that "There is a natural danger for regulators to over-regulate and try to solve all apparent problems…".[78] The UK mobile operators set out the arguments as they saw them: "Oftel and others, such as Offer [Office of Electricity Regulation, now merged into Ofgem] and Postcomm, were formed as the overseers of the liberalisation of markets formerly controlled by state monopolies (perhaps they should have been called 'liberators' not regulators)".[79] They then went on to say "A regulator was seen as a necessary catalyst to this transition - a means to an end not an end in itself". They accepted that Oftel had been successful but had a caveat "Oftel scores reasonably on many of the topics of your inquiry. It demonstrates independence from Government and industry. It consults widely and is fairly transparent with its processes. But, after nearly twenty years in existence, it is no nearer withdrawing from sector specific economic regulation".

(b) conflicts of interest: such as where Government retains ownership and regulation, as with Royal Mail and Rail, or where the regulators' desire to demonstrate effective independence (through demonstrably rational, disinterested regulatory decision-making) is compromised by the desire for reappointment, leading to capture by Government. One example of this danger might be an appeal by the regulated company appealing to the owner rather than the regulator for the solution to their perceived problems if they feel under too great a pressure. Postwatch was particularly concerned because "The role of the DTI in postal regulation is to say the least complex. The Department appoints the commissioners of Postcomm, the councillors of Postwatch and the chairman of the Royal Mail group … The interests of the Royal Mail Group, the UK postal industry

[78] Vol.II p61, reply to q4.

[79] Vol.II p434, paras 2.3, 3.2, 3.3

and postal users are not always (if ever) the same. It is unclear how much weight DTI gives to each interest group when reaching its decisions; conflicts of interest inevitably arise".[80] Postcomm echoed that concern, noting that, because of this, the respective roles of the Secretary of State and Postcomm had to be clearly understood and respected.[81] Postcomm drew our attention to one case of a proposed merger between Royal Mail and TNT where Postcomm had to stand their ground against the Government's shareholder interest, concluding: "In the end it did not go ahead. I think we drew a line with a firmness which will not be forgotten, which did not involve actual hostility".[82]

(c) paternalism: second-guessing consumer interests. Regulators may seek to act benignly, acting in what they see as the best interests of the regulated, without necessarily consulting in order to determine whether they are correct in their assumptions.

(d) inconsistency over time: notable in cost-benefit tests – involving assessments of probability – for regulatory decisions, such as on security of supply and safety. This has been a notable issue in both water regulation, with respect to the setting of leakage standards following the 1996 drought, and rail regulation following the Paddington rail disaster, in particular relating to the Minister's promised investment in train protection systems. So, for example, before an event a rational regulatory decision on the level of preventative maintenance could be made, but after the event the arguments on which accountability for the decision were based seem very different. Sir Howard Davies of the FSA told us that this had also been their experience in the public debate on Equitable Life.[83] Achieving consistency requires a sophisticated blend of leadership, objectivity, trust, continuity, and no-blame cultures.

(e) change for change's sake: more policies and reform are assumed to be better than less policies and continuity. This to some extent is a variation on the theme of presumption. Regulators may be prone to justify their existence by being over-active.

(f) misplaced dignity: unreasonably protecting precedents or decisions which can be shown to be flawed for reasons of maintaining the authority and dignity of regulation, rather than promoting a learning culture which develops regulation in the light of experience, and consistent with its underlying purpose.

(g) stereotyping: where this may lead to misinterpretation: for example, where profit is seen pejoratively, or an adversarial regulatory system is seen as flawed *per se*, rather than as a design feature for effective regulation.

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[80] Vol.II p130, para 15

[81] Vol.II p238, para 10

[82] Q666, Vol.II p245

[83] Q869, Vol.II p305

Poor communication and understanding

(a) lack of knowledge of the regulatory framework on the part of citizens and consumers weakens their ability to promote, or be engaged in, effective accountability. Sir Howard Davies described the implications of this, again in the context of Equitable Life: "…(the Parliamentary Ombudsman's report on Equitable Life)…referred to what she saw as a mismatch of expectations in what the public, represented by some of the people who had complained to her, expected a prudential regulator could achieve and what prudential regulation was designed to achieve, and certainly it is quite difficult to explain that we are not even aiming for a non-zero failure regime, and we do not think it would be appropriate to aim for a non-zero failure regime because to do so would only constrain financial institutions and make it impossible for them to carry out the function of taking risk that we believe is essential to financial markets…. Explaining where you are drawing that line and where you are setting that level of protection is probably the biggest single challenge we face in gaining acceptance and understanding for the nature of regulation we seek to maintain, but setting that balance is inherent in the Act".[84]

(b) lack of confidence/skill/opportunity in accessing regulatory information, participation processes or mechanisms of redress; stakeholders may not have a clear understanding of processes and how the regulator operates.

(c) lack of trust leading to a misunderstanding of regulation.

(d) the role of accountability as a control mechanism is misunderstood - a means rather than an end.

(e) obfuscation of the regulatory mission, whether by design or default and particularly where this interfaces with separation of responsibilities, such as representing consumer interests.

Incoherence

(f) inadequate separation between the three pillars of regulatory policy: economic, social and environmental. The NCC identified difficulties that can arise between Government and regulators where there is lack of clarity on respective roles. In particular they stated that "where there are social objectives in a sector, it can be unclear whose responsibility it is to set them and achieve them. Tackling fuel poverty, or extending access to financial advice, are current examples where the regulator has an important role".[85]

(g) insufficient commitment to the 'whole of Government' approach to regulatory design and implementation (unnecessary duplication, overlap or proliferation of regulatory roles and institutions; inadequate central scrutiny and/or co-ordination of review roles; inadequate application of generic models of regulation, except where sectoral differences are objectively justified) - in effect - the

[84] Q868, Vol.II p304

[85] Vol.II p362, paras 23 and 24

guardianship of effective regulation through accountability is fragmented (see also paragraph 102 below)..

(h) poor statutory design, such as excessive, or contradictory, lists of statutory duties placed on the regulators.

(i) missing principles of good regulation: objectivity, rationality and coherence.

(j) emphasis on internal board structures and accountabilities rather than external accountability of the function.

102. An example of insufficient commitment is the potential for erosion of effective accountability where regulatory structures become increasingly complex, and become disengaged from public understanding. Railways have presented us with a clear example. Rail regulation and its associated institutional structures is complex, and it seems that interested parties do not have a clear idea of who does what, and should be held accountable for what decisions. We can only observe the past and present debates on rail policy and performance, and the evidence that we have received. It underlines the danger that lack of clarity with respect to the regulatory framework will undermine regulatory accountability, and equally therefore, effective regulation. In referring to the distinctions between economic opportunities and social obligations, Sir Christopher Foster said "I hope Lord MacGregor will not mind my saying that I think, since his time, they have gone rather woefully wrong in relation to the railways. Everybody seems to be doing not the job for which they were set up but some other job". With respect to the SRA he added "It is that kind of muddle which I honestly believe the regulators should be protected from. They are then becoming quasi-political figures, and I do not honestly believe that that is a sensible job for a regulator".[86] In particular the problem arises over transparency of trade-offs by the regulatory body.[87] The evidence on confusion was reinforced by two of the Rail Regulators. Tom Winsor told us that "The distinction between the two bodies is frequently misunderstood".[88] He was clear however that regulators did not necessarily take any responsibility for rail crashes.[89] John Swift QC noted that "There has always been a difficulty in the mind of the public, and not just of the public, in knowing the precise difference between the strategic rail authority or the franchising director, as it then was, and the Rail Regulator".[90]

103. The implications of these hazards or failings is that attention has to be paid to the effectiveness of accountability mechanisms to control the regulators, and to improving the context and awareness in which interested parties can play their role in achieving effective accountability. Remedies may be provided through different means. In our remaining chapters we make various recommendations designed to alleviate or eliminate impediments to effective regulation and accountability.

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[86] Q208, Vol.II p73

[87] Q218, Vol.II p76

[88] Vol.II p211, para 4

[89] Vol.II p212, para 24

[90] Q115, Vol.II p46