BIS Department for Business Innovation & Skills

Principles for Economic Regulation

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Contents

Introduction

The importance of Economic Regulation

1. High quality and efficient economic infrastructure plays a vital role in supporting a competitive and growing economy by providing services on which all businesses and citizens depend.

2. Competitive markets are the best way in the long run to deliver these services to consumers and provide incentives to invest and improve efficiency and service quality. In certain sectors network effects and/or economies of scale create circumstances, such as natural monopolies, which, under current technological patterns, limit the prospects for effective competition. In these areas, independent economic regulation[1] will be needed over the long term to continue to provide vital consumer protections and ensure consumers' interests are promoted through efficient provision of good quality, reliable and sustainable services.

3. In the UK, economic regulation has aimed to promote effective competition where this is possible, and to provide a proxy for competition, with protection of consumers' interests at its heart, where it is not meaningful to introduce competition. Regulation has typically capped the prices that dominant companies can charge in order to promote efficiency and fairness, while providing them a return on their assets and investments. In doing so, these regulators have delivered significant benefits to consumers.

4. The regulated sectors such as telecoms, water, energy and rail face the challenge of delivering the majority of the £200bn[2] of planned infrastructure investment over the next five years. Beyond that, continued investment is critical not only for growth but also for the UK's international competitiveness.

5. Efficient delivery of this investment is vital to the long term interests of consumers who will ultimately bear the costs. Appropriate economic regulation is a critical enabler of infrastructure investment. The existing regulatory regime has facilitated significantly higher levels of investment than that delivered in the period prior to privatisation and has, at the same time, improved efficiency and competitiveness, promoted competition wherever appropriate, improved service quality for business and individual consumers and, in some sectors, enabled social and environmental goals to be met efficiently.

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[1] As detailed below, the scope of this document covers infrastructure sectors overseen by Office of Communications (Ofcom), the Postal Services Commission (Postcomm), the Office of Gas and Electricity Markets (Ofgem), the Water Services Regulatory Authority (Ofwat), the Civil Aviation Authority (CAA) and the Office of Rail Regulation (ORR).

[2] As announced in the National Infrastructure Plan, October 2010. Available here: http://www.hm-treasury.gov.uk/d/nationalinfrastructureplan251010.pdf

6. The fundamentals of the UK's system for economic regulation are sound and are not in need of major reform. The Government is committed to maintaining the strengths of the design of the system. Given the scale of the challenges for the UK's infrastructure, it is important to reinforce its key foundations and ensure it provides the right degree of clarity, certainty and consistency for the future.

Principles for Economic Regulation and Government commitments

7. The purpose of the Principles for Economic Regulation is to:

   - reaffirm the importance of, and the Government's commitment to, stable and predictable regulatory frameworks to facilitate efficient investment and sustainable growth;
   - set the framework for delivering greater clarity about the respective roles of Government, regulators and producers, and greater coherence in an increasingly complex and interlinked policy context; and
   - set out the characteristics of a successful framework for economic regulation to guide policy makers in assessing future developments.

8. In addition, the Government is setting out a series of high level commitments to ensure these Principles are enshrined in Government's policy-making on economic regulation. At a more detailed level, a targeted approach to applying the principles in individual sectors is likely to be more effective than a one-size-fits-all approach. The detailed application of the principles will therefore be for relevant Government departments to determine.

Aim and scope of the Principles and commitments

9. Stakeholders have confirmed the need for Government to set out a clearer policy and strategic context in which independent economic regulators, consumers and investors can take informed decisions, and for Government to exercise restraint when making changes to this context.

10. The Principles for Economic Regulation and the commitments are therefore focused on Government's actions. Their aim is to guide the high-level institutional design of the regulatory frameworks by Government. A key part is reinforcing the Government's role in establishing the policy direction and articulating this, together with appropriate guidance, on a periodic basis, leaving regulators to carry out their regulatory duties independently.

11. The Principles are not intended to replace the existing five principles of good regulation[3] initially defined by the Better Regulation Task Force in 1997. These continue to be relevant to how regulatory obligations are designed and enforced by regulators and Government and have a statutory basis in the duties of certain regulators.

12. The Principles for Economic Regulation are instead intended to articulate the factors that are key to the high level design of the frameworks for economic regulation, not to guide detailed application of regulators' judgement in carrying out their functions.

13. The initial scope of these Principles is the economic regulation of infrastructure sectors overseen by Office of Communications (Ofcom), the Postal Services Commission (Postcomm), the Office of Gas and Electricity Markets (Ofgem), the Water Services Regulatory Authority (Ofwat), the Civil Aviation Authority (CAA) and the Office of Rail Regulation (ORR)[4].

14. There will be, however, instances in which the Principles and the associated commitments have broader relevance to issues outside of this initial scope. This will be particularly the case for those non-infrastructure-related sectors with similar institutional arrangements, such as the regulation of qualification, examinations and assessments, or the future economic regulation of healthcare services.

[3] The principles state that any regulation should be transparent, accountable, proportionate, consistent and targeted.
[4] Some of these regulators have broader functions, for example relating to safety regulation, which are not the focus of these principles.

Chapter 1: Government's Principles for Economic Regulation

The Principles for Economic Regulation

Accountability

- *independent regulation needs to take place within a framework of duties and policies set by a democratically accountable Parliament and Government*
- *roles and responsibilities between Government and economic regulators should be allocated in such a way as to ensure that regulatory decisions are taken by the body that has the legitimacy, expertise and capability to arbitrate between the required trade-offs*
- *decision-making powers of regulators should be, within the constraints imposed by the need to preserve commercial confidentiality, exercised transparently and subject to appropriate scrutiny and challenge*

Focus

- *the role of economic regulators should be concentrated on protecting the interests of end users of infrastructure services*[5] *by ensuring the operation of well-functioning and contestable markets where appropriate or by designing a system of incentives and penalties that replicate as far as possible the outcomes of competitive markets.*
- *economic regulators should have clearly defined, articulated and prioritised statutory responsibilities focussed on outcomes rather than specified inputs or tools*
- *economic regulators should have adequate discretion to choose the tools that best achieve these outcomes*

[5] i.e. current and future consumers, and in some sectors taxpayers, who ultimately pay for the services

Predictability

- *the framework for economic regulation should provide a stable and objective environment enabling all those affected to anticipate the context for future decisions and to make long term investment decisions with confidence*
- *the framework of economic regulation should not unreasonably unravel past decisions, and should allow efficient and necessary investments to receive a reasonable return, subject to the normal risks inherent in markets*

Coherence

- *regulatory frameworks should form a logical part of the Government's broader policy context, consistent with established priorities*
- *regulatory frameworks should enable cross-sector delivery of policy goals where appropriate*

Adaptability

- *the framework of economic regulation needs capacity to evolve to respond to changing circumstances and continue to be relevant and effective over time*

Efficiency

- *policy interventions must be proportionate and cost-effective while decision making should be timely, and robust*

15. To some degree, many of these principles are already features of the regulatory frameworks. The Government wishes to build on existing good practice and find ways to systematise it through establishment of these principles.

16. Inevitably, these principles will sometimes come into conflict. For example, ensuring a system that is adaptable and fully coherent with Government policy may present a challenge to maintaining its stability and predictability. A successful regulatory framework requires an appropriate balance to be struck between the principles. The room for manoeuvre to strike this balance is, in certain cases, restricted by European Union policy which imposes requirements on the design of the frameworks of economic regulation.

Chapter 2: Applying the principles

17. This chapter sets out at a high level how the principles will apply across regulated sectors. The detailed application, however, will be most effective if tailored to reflect the differences in the characteristics and priorities of the sectors. Rather than follow a one-size-fits-all approach, the detailed application of the principles will therefore be for relevant Government Departments to determine. The process for doing so is set out below.

Division of roles and responsibilities

18. The aim of economic regulation is to create a system of incentives and penalties that aim to replicate the outcomes of competition in terms of consumer prices, quality and investment and puts the protection of consumers' interests at its heart. To achieve these objectives it is important to establish a clear division of responsibilities between the Government and economic regulators. Setting the policy direction and making politically sensitive trade-offs between objectives is likely to require democratic legitimacy and accountability and is clearly the role of Government. Government should not avoid making these difficult policy decisions or pass them to regulators to determine. By contrast, the detailed application of regulation can be carried out independently of government, and there are significant benefits to this approach in terms of the stability and predictability of regulation and the concentration of regulatory expertise.

19. It may not always be possible to draw a precise distinction between certain matters of policy and matters of regulation as the two can be closely linked. However, for the system to be effective, the responsibilities need to be as clearly articulated as possible so that consumers and regulated firms know who is responsible for what and to whom they are accountable.

Commitment 1

The Government commits to ensure that responsibilities are clearly divided between Government and regulator on the basis that high level decisions that involve political judgement are taken by Government and day-to-day regulatory decisions are undertaken by regulators.

Reaffirming the independence of regulation

20. Independent regulation has been a vital part of the UK's framework for economic regulation since the 1980s and remains central to the Government's approach.

21. Investment in infrastructure is often capital-intensive, long-term and with significant sunk costs. However, the utilities and transport sectors provide services on which every business and every citizen relies and this confers on them a high political profile.

22. Given these features, investors will price any risk of political intervention and demand higher returns for their investment or, in the most extreme cases, might even decline to invest. This is likely to be detrimental to consumers and to the economy in the long-term. Given the scale of the regulatory asset base and of the investments needed, small changes to the cost of capital can have a significant impact on the propensity to invest and on the bills consumers pay.

23. A solution to this time inconsistency problem is to design regulatory frameworks that prevent unexpected changes to the rules of the game, thus offering a credible commitment to investors. In the UK the statutory framework of independent economic regulation encapsulates a commitment by the UK Government not to intervene other than in clearly specified ways. Independence helps provide stability and consistency over time. This in turn helps to anchor market participants' expectations and increase the predictability of regulatory outcomes. The independence of regulators also protects consumers' interests by ensuring that consumers only pay for efficient investment that is required to deliver services.

24. Government needs to ensure the independence of regulation is not eroded over time.

Commitment 2

The Government will preserve the independence of economic regulators. It will ensure that:

- **regulators are legally distinct and functionally independent from any other public or private entity when carrying out their functions**
- **regulators' staff and management act independently from any market interest and do not seek or take direct instructions from any government or other public or private entity when making regulatory decisions**
- **regulators can take autonomous decisions, independently from any political body, and have separate annual budget allocations, with autonomy in the implementation of the allocated budget, and adequate human and financial resources to carry out their duties.**

The Government will continue to ensure that it does not interfere with day-to-day regulatory decision making.

The Government will ensure regulators have discretion to choose the regulatory tools to deliver their objectives.

The Government will ensure that future changes preserve the independence of regulators.

Coherent, adaptable but stable regulation

25. Economic regulation plays a significant role in establishing the terms under which investment is made. Efficient investment is an important part of promoting the long-term interests of consumers. It is important that the regulatory frameworks avoid adding undue uncertainty to the business environment.

26. To a large extent this is achieved by building a stable and transparent regulatory environment with a long track record of consistent regulatory decision making. A history of rational regulatory decisions, which can be objectively justified, creates an expectation that a narrow set of outcomes will follow a given set of circumstances. This in turn will help both investors and consumers to predict regulatory decisions. On the other hand, piecemeal, ad hoc or unanticipated changes in policy or regulatory responsibilities are likely to erode investor confidence and increase the cost of capital.

27. While there are significant benefits to economic regulation being carried out independently of Government, it needs to form a coherent part of broader public policy or its predictability can become undermined. Regulated markets and technologies change and regulatory frameworks, as well as broader policy objectives, need to be kept up to date and reflect the priorities of the day. A regulatory framework that is clearly out of date is unlikely to lead to successful or predictable outcomes. As discussed above, Government has a legitimate role to play, defining a strategic vision of the likely needs and priorities over the long term and providing a policy context for regulatory decisions in the medium and short term.

28. A balance needs to be struck between the principles of predictability, adaptability and coherence. In order to maximise the benefits from a stable regulatory system Government should offer a credible commitment to restrain itself, as strategic visions should not be changed too frequently and should be updated according to a pre-announced calendar.

29. The Government can also play an important part by ensuring it assesses the effect on investor confidence when considering changes to the regulatory frameworks.

Commitment 3

The Government therefore commits to put in place, for each regulated sector, strategy and policy statements for the individual regulators to provide context and guidance about priorities and desired outcomes.

When it sets out the policy context, the Government will use that opportunity to reaffirm the fitness for purpose of the regulators' responsibilities, pursue changes where they are required to keep the system effective and clarify the respective roles and responsibilities of regulator and Government.

The Government expects to do this no more frequently than once a Parliament.

The Government will avoid making piecemeal and ad hoc changes to the system for economic regulation outside of this process to provide stability.

Relevant departments will set out the details of how this process will operate, taking into account the differing needs of the sectors.

There may be circumstances or specific triggers that would necessitate Government action outside of this once-a-Parliament process. This will be done only on an exceptional basis, for example implementation of European legislation, as the emphasis should be on providing predictability about Government's approach.

The Government will have particular regard to the effect on investor confidence when assessing changes to the regulatory policy and regulatory frameworks. This will be addressed in the impact assessments of any proposed changes.

Reinforcing accountability

30. Accountability is vital for ensuring an effective regulatory framework that delivers the desired outcome for consumers. It plays an extremely important role in establishing the legitimacy of decision makers. While regulators are independent of Government departments, they must, of course, exercise their discretion within the limits of the law and under the supervision of the relevant bodies such as Parliament and the National Audit Office (NAO).

31. Effective accountability of a regulatory framework therefore depends on transparency, a requirement to explain decision making, exposure to scrutiny and the right to challenge decisions.

32. Open and committed consultation about proposals plays an important role in strengthening transparency. It ensures that all parties can see and understand the logic and direction of travel of a regulator's deliberations. The Government's Code of Practice on Consultation[6] emphasises the role consultation plays in informing and supporting effective policy development and delivery.

33. At the same time, publication of the reasons for regulatory decisions after the event provide clarity about their basis and rationale to help guide assessments of whether they were appropriate and proportionate judgements.

34. The design of the regulatory frameworks needs to ensure the actions of regulators can be scrutinised appropriately. In principle, scrutiny should be carried out by the body that has granted the regulator its mandate and obligations. For the most part therefore, economic regulators, whose primary remits derive from statute, should be scrutinised by Parliament. In addition, the

[6] Code of Practice on Consultation, HM Government, 2008, available at http://www.bis.gov.uk/files/file47158.pdf

department that both sponsors and has responsibility for the legislation underpinning the regulator also needs to ensure that the regulator is carrying out its functions effectively and efficiently and remains fit for purpose.

35. Finally, sponsor departments should ensure relevant parties are able to challenge decisions taken by regulators through an appropriate and proportionate mechanism to an independent third party.

Commitment 4

The Government expects regulators to follow consultation best practice in their decision making, including the use of impact assessments and the publication of the reasoning underpinning regulatory decisions.

The Government strongly encourages regulators to disclose the methods and financial models used to inform regulatory decisions, with appropriate removal of commercially confidential information.

The Government will ensure appropriate and proportionate mechanisms exist to challenge regulatory decisions to an independent third party.

Clarity and focus of regulators' objectives

36. Economic regulators are established by statute and legally bound to execute their duties. To understand their behaviour, regulated firms and other interested parties must refer to the duties and to relevant guidance. The design of regulators' duties is crucial to the conduct of both regulators and the regulated.

37. It is therefore essential that the regulator's priorities are clear. To provide clarity of objectives for the regulator and to help monitor the regulator's performance, regulators in many sectors have been given a single overarching primary duty, typically to promote the interests of consumers.

38. In a complex sector with varying objectives that can conflict, it is important that the regulator's duties strike the right balance between setting out all relevant issues and considerations and imposing statutory responsibilities of excessive complexity and scope. The Government can use periodic guidance to help focus regulators' priorities.

39. Specifying in a high degree of detail the manner in which a regulator is to achieve its objectives limits the scope of the regulator to identify or achieve the optimal outcome because those tools and inputs form, in effect, objectives in their own right. Specifying tools and inputs may also undermine the benefits associated with independent economic regulation. For these reasons, regulators' duties should be outcome-focused and avoid specifying means, tools or inputs. In certain cases the specification of regulatory approaches, such as the promotion of competition, is mandated by European legislation for the purpose of opening national markets and creating a single market.

Commitment 5

The Government will ensure that regulators' objectives are clear and appropriately prioritised (including through broader guidance) to reflect the issues that the regulators should take into account in their decisions.

The Government will take opportunities to simplify and clarify regulators' objectives where appropriate as and when the frameworks are reviewed.

The Government will not seek to add objectives, responsibilities or duties to regulators' remits without detailed consideration of the impact of the addition on the overall framework, and consideration of cross-sector impacts and even then only when it is clear that the addition is the optimal way to achieve the outcome sought.

Efficient and proportionate regulation

40. Economic regulation, as with most forms of regulation, imposes costs on regulated companies. These costs derive from the regulatory cost the regulators impose on their sectors and the administrative cost of running the regulatory institutions. Costs in these sectors tend to be passed through to end consumers. It is important that they are proportionate and outweighed by the benefits achieved for consumers. Cost minimisation might, however, not always be efficient, as lowering costs can sometimes lead to foregoing bigger benefits to consumers.

41. As organisations, regulators should be efficient and well run, maximising the benefit they can deliver with their available budgets. As regulators, their interventions and tools should deliver desired outcomes in the least burdensome way, based on the established best practice for designing regulation. This means imposing requirements only where necessary, considering alternatives to regulation and minimising the risk of unintended consequences. Competition in the market, or for the market, and consumer empowerment are usually the most efficient and effective ways of delivering benefits for consumers. Where this is not possible, regulation needs to be a cost-effective alternative.

42. The Regulatory Enforcement and Sanctions Act 2008 already requires certain regulators[7] to keep their functions under review and ensure they do not impose or maintain unnecessary burdens.

43. As well as being cost-effective, regulatory decisions need to be made in a timely manner. Infrastructure investments have long lead times. Delays to key decisions can cause uncertainty and raise the costs to industry or leave consumers unprotected. Similarly, decisions must be based on robust evidence

[7] Ofgem, Ofwat, ORR, Postcomm and OFT. Ofcom have a similar duty under the Communications Act 2003

and judgement. The framework must therefore enable regulators to make timely, authoritative decisions.

Commitment 6

The Government will apply the duties and obligations of Part IV of the RES Act to the economic regulatory functions of the CAA and Monitor[8] in upcoming legislation.

The Government will keep the effectiveness of Part IV of the Regulatory Enforcement and Sanctions (RES) Act 2008 under review.

The Government expects regulators to adopt best practice to improving their efficiency.

The Government will investigate the possibility for an independent third party to regularly assess the efficiency of regulators.

Cross-sector working

44. It is important that institutional arrangements recognise interdependencies between sectors and that the effectiveness of policies is not hindered by consideration of regulation in silos. Mechanisms already exist through the Joint Regulators' Group for regulators to share good practice and specific cross-sector research has been jointly commissioned by regulators on occasion. More could be done to consider common objectives or approaches such as price controls, promoting competition and addressing consumer impacts, including affordability. Where inconsistent approaches are likely to affect outcomes, joint working is likely to be particularly important.

45. There is also a need for Government departments to continue to consider economic regulation from a cross-sector perspective to ensure experiences from other sectors are learnt and interdependencies in policy are considered.

Commitment 7

The Government strongly encourages the Joint Regulators' Group to adopt a more systematic approach to issues of cross-sector coherence and best practice.

[8] The Independent Regulator of NHS Foundation Trusts

Detailed application in regulated sectors

46. The high level approach that the Government will adopt in applying the Principles is set out above. Their detailed application will depend on the particular circumstances of regulated sectors. Technologies and policy priorities are likely to develop at different rates in different sectors. A targeted application by sector will be more effective than a one-size-fits-all approach.

47. Relevant Government departments will therefore set out how the Principles will apply at a more detailed level through the timetable set out below as well as through the proposed reforms to the competition framework and the landscape of consumer bodies. This timetable includes the process by which the Government will articulate its policy priorities and the process for refreshing and renewing the frameworks. It enables reviews currently underway to conclude and set out how the Principles will be applied in the future.

Department	Timetable
Department of Energy and Climate Change	**Publication of the findings of the Ofgem review in Spring 2011**
Department for the Environment, Food and Rural Affairs	**Publication of the Water White Paper in Autumn 2011**
Department for Transport	**Publication of a Rail White Paper in Autumn 2011** **At the introduction of legislation early in the next session to enact the findings of the review of economic regulation of airports**
Department for Business, Innovation and Skills	**At Royal Assent for the Postal Services Bill (anticipated in Summer 2011)**
Department for Culture, Media and Sport	**As part of the review of the Communications Act commencing in Spring 2011**

Embedding the principles

48. The Government will ensure it adheres to the Principles for Economic Regulation and its published approach to implementing them.

Commitment 8
The Government will assess any proposed changes to the regulatory frameworks (either statutory changes or changes to the to the general policy direction set out in the strategy and policy statements) against the Principles

Commitment 8

for Economic Regulation and demonstrate how the changes adhere to these Principles.

The Reducing Regulation Cabinet Committee will be responsible for clearing proposed changes and policing the fulfilment of Government's commitments for the application of the Principles for Economic Regulation.

The Department for Business, Innovation and Skills, within its existing cross-sector responsibilities for Economic Regulation, will have ownership of these Principles, and will scrutinise the Government's adherence to them. It will advise the Reducing Regulation Committee accordingly, and particularly on how the interests of consumers, other end users, regulated firms and investors are being promoted.

This publication is also available on our website at http://www.bis.gov.uk

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