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Private sector

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Checks and Balances in Utility Regulation—The U.K. Experience

This Note is the third in a subseries of three by the author on the recent experience of regulating utilities in the United Kingdom. The first looks at the evolution of the price cap approach to regulation and assesses its success. The second presents a critical path for the price cap review process, which usually occurs every five years. All three are based on Richard Green and Martin Rodriguez Pardina, *Resetting Price Controls: A Manual for Regulators* (Washington, D.C.: World Bank, 1999, stock no. 14338). Contact books@worldbank.org.

A utility regulator has the task of ensuring that consumers are protected from exploitation by a monopoly supplier. This generally means that the regulator has the right to set limits on the supplier's prices or profits. Effectively, the regulator has the power to confiscate assets belonging to the company's shareholders by setting prices insufficient to cover the supplier's costs and allow a reasonable return on the capital invested. Giving this much power to a small commission (as in the United States) or a single individual (as in the United Kingdom) can be risky unless there are checks and balances on its use. In the United States, whose constitution prohibits confiscation of property, the courts have long been involved in the oversight of regulators. In the United Kingdom, which created its utility regulators from scratch in the 1980s, an alternative system was sought. This system centers on three concerns: the procedure followed by the regulator, the substance of the decisions, and the acceptability of the decisions to the public. Three main institutions have oversight roles: the Competition Commission (formerly the Monopolies and Mergers Commission), parliamentary select committees, and the courts (table 1). This Note reviews the roles of these institutions.

TABLE 1 REGULATORY CHECKS AND BALANCES IN THE UNITED KINGDOM

Checks	Competition Commission	Select committees	Judicial review	Openness and consultation
Procedure	Does not usually make a determination	Can comment	Determines whether procedure was correct	
Substance	Makes a determination if appealed to	Can comment	Determines only whether decision was unreasonable	Gives regulator more information
Acceptability	Acts as arbitrator	Can approve or disapprove		Provides explanation



The framework

Each utility regulator in the United Kingdom was established by a different act of Parliament. The act gives the sectoral ministers—the secretary of state for trade and industry (for gas, electricity, and telecommunications) and the secretary of state for the environment (for water)—the power to appoint a regulator for a fixed term; regulators can be reappointed and are subject to removal only for incompetence or misconduct.

The act also sets out the functions of the regulator and the minister, which differ from industry to industry. In general, however, the regulator is required to issue a license to companies before they can enter the industry and to monitor their compliance with the conditions in their licenses; he may also amend the licenses. The requirement to hold a license is not used as an entry barrier in market sectors that have been opened to competition, such as most telecommunications activities and electricity generation.¹ Licenses are quickly issued to suitable applicants, for a moderate administrative charge covering the costs of the regulator's organization, normally calculated on the basis of the licensee's market share.

The act obligates the regulator and the minister to exercise their functions in the way they deem best to meet the objectives it sets out. In the Electricity Act of 1989 these objectives are to ensure that all reasonable demands for electricity are satisfied, to ensure that license holders are able to finance their activities, and to promote competition in the generation and supply of electricity. Subject to these duties, the regulator and the minister should also protect the interests of consumers (with respect to the prices, continuity, and quality of services), promote efficiency and economy by companies, encourage research and development, protect the public from any dangers arising from electricity, and set standards for promoting the health and safety of industry employees. They should also take into account the environmental effects of activities relating to the electricity industry.

Most of the regulator's powers over the companies reside in the licenses. The licenses contain clauses limiting the prices that the companies can charge their customers (or their smaller, more vulnerable customers). These price control clauses typically last four or five years, after which the regulator must propose a new clause. Other clauses may prohibit the companies from discriminating among customers or require them to provide particular services.

Three main bodies are involved in the oversight of U.K. regulators: the Competition Commission, parliamentary select committees, and the courts. The legislation establishing the regulatory system also gave some responsibilities to the sectoral ministers, though these powers have rarely been used. Although as yet the system has no formal requirements for explaining regulatory decisions, the regulators have become increasingly aware of the need to do so if they are to become trusted.

The Competition Commission

When the regulator proposes a license amendment, the company may choose to accept it. But if the company believes that it is being treated unfairly, it can ask for an appeal to the Competition Commission, which took over from the Monopolies and Mergers Commission (MMC) on April 1, 1999. The United Kingdom's "competition court," the commission dates back to the Monopolies and Restrictive Practices Commission established in 1948. The commission has about thirty part-time members—from business, academia, trade unions, and the law and other professions—and a full-time staff of civil servants. A small panel of commission members with relevant expertise are appointed specifically to serve in utility inquiries. A group of four to six commission members is selected for each inquiry. Only these members are responsible for the report on the results of the inquiry, but the reports are still generally considered to be issued by the commission.

To launch an inquiry, the regulator makes a formal reference to the commission, asking it to

determine whether the license condition in question—such as a condition allowing the company’s price control to lapse or continuing with the old control for another period—might be expected “to operate against the public interest” and, if so, whether amendments to the license could prevent this. The commission normally has six months for its inquiry, although this period can be extended. It asks interested parties (including the regulator, the company, and relevant branches of government) for evidence and also solicits views more broadly. The group holds meetings with the most important parties and may visit some of the company’s facilities. After considering the evidence, the group produces a report with factual information on the company and its industry, the views of the company, the regulator, and other interested parties, and the commission’s conclusions. The report is signed by the members of the group that produced it. (Dissenting reports are possible but rare, and there have been none in price control reviews.) This report is sent to the regulator and the company and then published by the regulator (in a version that omits confidential material but notes where it has been removed).

The MMC had to rule on six price cap disputes between 1992 and 1997: British Gas (twice), Scottish Hydro-Electric, South West Water, Portsmouth Water, and Northern Ireland Electricity. It also reset the price control for the British Airports Authority (under the Airports Act of 1986 this price control is automatically referred to the commission rather than being reset by a regulator). These rulings have gradually built up some case law, for while each case is decided individually, the commission has recognized the value of developing a consistent methodology. Some commission members have served in several price control inquiries, which is also likely to add to consistency. Not wanting companies to appeal proposed license amendments, the regulators have increased the information that they release and now generally argue that they are following the “commission methodology.” If a company knows that the commission is likely to use the same methodology as the reg-

ulator, it will expect to gain little from an appeal unless the dispute relates to the data used by the regulator.

If the commission does not find that the existing situation is against the public interest, the regulator cannot change the company’s license. Thus the existing control might lapse or continue unamended. But if it finds that the condition may be expected to operate against the public interest, it will propose amendments that could remedy this,

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and the regulator is allowed to change the company’s license, taking account of the commission’s recommendations. The commission might recommend a price control nearly identical to the regulator’s initial proposals but also could recommend higher—or lower—prices (and there are precedents for both). Whether regulators had to follow these recommendations exactly was unclear for several years. But as discussed below, a recent Court of Appeal case has confirmed that the regulator’s discretion is strictly limited. The government has announced that it intends to introduce legislation to require regulators to seek final endorsement from the commission that any license modifications developed following a reference to the commission are necessary to remedy or prevent the adverse effects identified by the commission.²

The minister retains veto power over the regulator. The minister can instruct the regulator not to make a reference to the commission or not to

make a particular license amendment, but this power has never been used. Regulators publish their decisions very soon after making them. They may inform the company or the minister of what they are about to say, but there is little time for lobbying the regulators to change their mind. Thus the minister can act only after a decision is published, when the political cost of interference could be high.

Select committees

The main bodies overseeing the regulators are parliamentary select committees. A select committee consists of about ten backbench members of Parliament (that is, MPs who are members neither of the government, as ministers or in minor positions, nor of the opposition party's "shadow government"). Each committee's party balance reflects the balance of the House of Commons (so that the governing party has a majority), but the committees usually aim for unanimous reports and therefore seek consensus. They generally act in a nonpartisan manner.

There is a committee for each ministry, which can hold inquiries on any subject falling within that ministry's purview. Although the Trade and Industry Select Committee has produced the most reports on regulation, there was an Energy Committee until 1992 (when the Department of Energy was absorbed by the Department of Trade and Industry) and the Environment Committee can hold inquiries on the water industry. The committees can invite written and oral evidence and can require witnesses to appear before them. Some committee members build up great expertise in their subjects, but the committees also appoint expert advisers, often academics, to assist them in inquiries.

When a committee feels that a matter is worth investigating, the members set terms of reference for themselves and announce the inquiry so that interested parties can submit evidence. All the substantive evidence is published in the committee's reports except that submitted in confidence. The committee takes oral evidence from wit-

nesses in hearings lasting an hour or two, generally spread over several weeks. In an inquiry involving a regulated industry the witnesses might include the chief executives of some of the companies in the industry, consumer representatives, outside experts, and the regulator. The companies selected should represent a cross-section of the industry; thus an inquiry on telecommunications might hear from BT (the incumbent), Mercury (its oldest competitor), a cable company, and a new entrant in the business sector. Oral hearings are almost invariably public, and committee members sometimes try to persuade witnesses to answer a question "on the record" when they have already given the answer in written evidence but in confidence. Transcripts of the hearings are appended to the committee's report.

Select committees have no formal powers to order a regulator (or a company) to do something, but they have a great deal of influence. Their reports almost always contain recommendations, and regulators (and government departments) prepare formal responses to those that affect them. If the regulator rejects a recommendation, he must give reasons for doing so. And if the regulator accepts it, the recommendation may provide useful momentum for change.

The courts

Under English law any branch of the government can be subject to a process known as judicial review.³ If an individual or company brings a complaint about a government decision (including a decision by a regulator), the courts must determine whether proper procedures were followed in reaching that decision. Judicial review does not concern itself with the substance of the decision unless it can be shown that the decision is unreasonable given the procedures that should have been followed and the evidence presented. Thus the court would not attempt to determine, for example, whether the real rate of return to be used in the calculations for a price control should be 6.5 percent or 7 percent a year. But it might determine that 3 percent a year is unreasonable if evidence had been presented that the nearly risk-

free return on indexed British government securities was 3.5 percent a year and it was willing to hold that no reasonable person would think that a regulated company should earn less than that.

Regulators have generally been able to avoid judicial review by following sensible administrative procedures. But they have lost some cases. A housing developer that complained about the fee for connecting a new development to an electricity company's system, but paid it anyway, later asked the electricity regulator to determine the fee. The regulator had believed that he could not intervene after the event, but the court interpreted the law differently, and the regulator was required to determine the fee payable. In a case against the water regulator the High Court ruled that a regulator must take action to enforce license conditions unless this is precluded by some other legal duty.

The electricity regulator also lost a case about the price cap for Scottish Power, a vertically integrated company. The regulator had proposed allowing the company to charge its smaller customers the average cost of electricity in the wholesale market in England and Wales, and Scottish Power had accepted this proposal. But the other public electricity supplier in Scotland, Hydro Electric, appealed to the MMC, which determined that Hydro Electric should be allowed to charge the (higher) purchase price that English companies paid for the power sold to smaller customers. The regulator argued that there was no need to make the same concession in Scottish Power's price cap, since the company had accepted the lower price, but the Court of Appeal determined that this was unreasonable. The regulator and Scottish Power subsequently agreed on a more generous price cap.

The most recent case, involving Northern Ireland Electricity, is probably the most important one, because it clarified how much discretion regulators have on the substance of license amendments. In an earlier case, involving British Gas, the gas regulator had proposed substantive changes to the MMC's recommendations, and these were accepted by the company. The MMC had recom-

mended a cut in British Gas's transport prices of 21 percent in real terms, but the gas regulator imposed a 25 percent cut, to balance higher volumes than had been predicted at the time of the MMC report. The Northern Ireland Electricity case had a different outcome. In 1997 the electricity regulator for Northern Ireland proposed that he would "adjust" the MMC's recommendations for the company's revenues, reducing them from £575 million to £538 million over five years. The company took the case to court and lost on a

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rather narrow interpretation of what the MMC had said. But the Court of Appeal ruled that the regulator must follow the substantive proposals in the MMC's report, giving what had always been a presumption the force of a legal precedent. The government now plans legislation to ensure that the commission approves any license amendments that follow from its recommendations.

Openness and consultation

In the first few years of the United Kingdom's new system of regulation regulators seemed to believe that one good defense against judicial review was to release very little information about their decisions: a decision could not be judged unreasonable if nobody knew how it had been reached. In 1992, for example, BT's regulator issued a consultation paper revealing that the company's 1989 price cap had been set in the expectation that it would produce a 17 percent return on historic cost capital by the end of

the period, but this information had not been made public at the time. In the same year the electricity regulator announced a new price control for the National Grid Company in a six-page statement containing very few numbers.

The regulators recognized the disadvantages of this secrecy, however, when many people came to believe that they were not being tough enough on the companies that they regulated. The electricity distribution companies' profits rose significantly after they were privatized in

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1990, reflecting cost reductions and price controls that allowed rising prices. The Trade and Industry Select Committee twice recommended that the regulator revise these controls ahead of schedule, but he argued that such a response to unanticipated profits would damage the companies' incentives in future. In October 1993 the regulator published a consultation paper on revised price controls to apply after April 1995 with no information on their likely level. In May 1994 a letter from the regulator to the companies that was leaked suggested initial price reductions of up to 30 percent, and the companies' share prices suffered accordingly. When the regulator's formal proposals were published in August, the average reduction was only 14 percent, and the companies' share prices rose dramatically. The regulator had published little information showing how he had reached his conclusions, and there was a widespread perception that he had been far too lenient. In the end, the regulator revised the price control the following year, losing a great deal of credibility in the process.

Since then, regulators have begun to issue much more information, and to precede their final announcements with a series of informative consultation papers. The regulators often use these papers to publicize possible price controls and judge the reaction to them. They also publish information to show that their proposals are consistent with the Competition Commission's accepted methodology for the calculations underlying price controls. In the past, regulators might have been worried that this information would give companies an excuse to seek judicial review, but now that an accepted methodology exists, following it should provide a sufficient defense.

The regulators also have been willing to publish more data on the companies that might have been treated as confidential in the past. The electricity regulator, for example, has recently published the five-year business plans of the regional electricity companies.⁴ These contain the information that he will use (together with independent consultants' reports on the companies' relative efficiency) to set their price controls for the period after April 2000. The water regulator now publishes companies' "July returns" each year, which contain detailed cost data for the previous year and operating characteristics such as the length of their pipelines. These factors are used to explain the companies' costs in yardstick regulation, which predicts how far each of the companies in a group could cut its costs based on the performance of the others. The case for keeping these data confidential is much weaker for these monopolies than for competitive businesses, but their publication shows how far the regulators have come.

The regulators will be under pressure to keep moving in the direction of openness and transparency. The new Labour government announced a review of utility regulation, which led to a consultation document, followed by a set of policy proposals. One of these is that regulators should be given a legal duty to publish their reasons for key decisions. Regulators have to produce annual reports, and the government also

intends to specify the matters that these must cover.

The government also hopes to promote consistency among regulators by assigning them a legal duty to give collective (and open) consideration to matters of common interest, such as best practice for price control reviews, replacing the existing informal collaboration. In addition, because most of the regulated energy utilities are now active in both gas and electricity markets, the government will replace the separate regulators for the two industries with a single energy regulator. One person now holds both positions as a transitional measure.

The greatest change arising from the review, however, is that three-member boards will replace some of the individual regulators. The government suggests that this will increase accountability, give scope for greater continuity as new regulators are appointed, and spread the burden of regulation, but it can also be seen in the framework of checks and balances. A system of checks and balances is most important if power would otherwise be concentrated in the hands of an individual. Replacing individual regulators with boards dilutes the power of any one person. We will have to wait and see whether this leads to less use of the other parts of the system of checks and balances.

Conclusions

Judicial review is the only mechanism focused on ensuring that the right procedures are followed. Judicial review can also overrule a regulator on a substantive matter, but only if it finds that the decision is unreasonable, a tough test in English law. The main check on substantive decisions comes from the companies' ability to appeal to the Competition Commission. Select committees have no power to determine the outcome of a regulatory process, but their comments (on procedure and substance) can have a significant effect on whether the regulator's actions are acceptable to the public. The need for acceptability is summed up in the phrase "justice must be seen to be done."

People must have confidence in the regulatory system if it is to survive. That does not imply that they have to agree with every single decision, but they must believe that decisions take their interests into account. The best way of achieving acceptability is through increased openness and consultation, a strategy that may also improve the information available to the regulators—and thus the substance of their decisions.

Also see the author's "Has Price Cap Regulation of U.K. Utilities Been a Success?" (Viewpoint 132, November 1997) and "Utility Regulation—A Critical Path for Revising Price Controls" (Viewpoint 133, November 1997).

- ¹ Since December 1997, to aid the coal industry, the government has been using other powers to restrict the construction of new gas-fired stations; this is intended to be a "temporary" measure.
- ² Department of Trade and Industry, *A Fair Deal for Consumers—The Response to Consultation* (London, 1998), conclusion 7.14. The commission's decisions are already binding for the water industry, where the legal basis of the price controls is slightly different.
- ³ Scotland has its own legal system.
- ⁴ These are available from the offer Website: <http://www.open.gov.uk/offer/documents/pesbusplans.pdf>.

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