

Capture of independent sectoral regulators

Regina Finn and Simon Less

Capture is an ever present risk to the benefits of independent sectoral regulation. The primary mode of capture may shift over time. Political 'capture', or undue influence, is a key current threat.

Conventionally, 'capture' is the tendency for regulators to take decisions that are biased in favour of the interests of the industry they regulate rather than the customers or wider society on whose behalf they regulate.

The archetype is capture of appointment of the regulator him or herself. In 1887, the Interstate Commerce Commission was established to regulate prices of the US railroad "robber barons". The industry secured the appointment of a lawyer as chairman, with strong experience of railroad industry ... acquired by acting on behalf of his railroad clients. The regulator soon operated as the co-ordinator of the railroad cartel.

But even without such blatant capture, regulators commonly suffer from capture in more subtle ways.

One way is encroaching capture of a regulator's staff through sheer weight of engagement with the regulated industry. Regulatory staff have frequent contact with the industry to secure the information and deep sectoral expertise they need. It's human nature for views to tend to become 'socialised' with those whom we come frequently into contact with. As John Kay has put it: "...*Many of the people who run regulated companies are agreeable, committed individuals who are properly affronted by any suggestion that their activities do not serve the public good. Few members of the public, by contrast, ever make contact with a regulatory agency.... So even the regulator with the best intentions comes to see issues in much the same way as the corporate officers he deals with every day. You require both an abrasive personality and considerable intellectual curiosity to do the job in any other way.*"

This form of capture may act principally to influence the regulatory agenda: the set of issues that are looked at and prioritised by the regulator. It may therefore be less easy to spot than capture of the decisions themselves. Some believe that one example was Oftel's prioritisation of the issue of resale over Local Loop Unbundling and challenging the dominant telecoms operator BT. Another example may be the attention that has historically been paid to the issue of financing costs in the water sector.

How can regulators guard against this route to capture ... apart from cultivating more abrasive personalities?

Regulators need regular external review and challenge of their priorities - from strong non-executive board members, quinquennial reviews, outside advisers like Ofwat's Future Regulation Advisory Panel, and from the OFT (in future, the Competition and Markets Authority). Regulators must spend enough time engaging directly with voices other than the regulated industry, including entrants, and customers (unmediated by regulated industry).

Negotiated settlement – direct negotiation between the regulated industry and customers under regulatory oversight – is one important approach to countervailing regulatory capture, where it can be made to work in a given sector. The Civil Aviation Authority has used negotiated settlement. Both Ofwat and the Water Industry Commission for Scotland are experimenting with Customer Challenge Groups: local, independent groups including customers and customer representatives, who are playing a key role in the price reviews by challenging companies' business plans.

A third form of capture is when a sectoral regulator effectively 'captures' itself, though its own historic way of doing things.

A regulator may naturally be committed to particular regulatory processes that it has spent time and effort honing, but that commitment may outlive the usefulness of the processes. Relatedly, a regulator may become captured by a way of thinking that its historic regulatory approach nurtures. For example, a certain 'command and control' way of thinking may arise from an historic regulatory approach – like Ofwat's - of prescribing the details of standards, outputs and tariffs. These effects may be reinforced by regulatory staff simply becoming comfortable doing what they have long done.

What may have worked in a previous period is not necessarily best approach today. The world is constantly changing: more demanding customers; environmental and economic challenges; technological developments; rising commodity scarcity; increased sector maturity; opportunities for new markets; new entrants. A regulator captured by its historic approaches will tend to overlook, or even resist, a need for change in regulatory approach in response.

'Self-capture' can be reinforced by external interests vested in the historic ways of doing things. Stakeholders who wish to see a market made to deliver certain outcomes may not, for example, welcome a change of regulatory approach away from command and control. The regulated industry too may act reinforce this form of capture if the historic regulatory processes tend to protect incumbents, if the industry has learnt how to 'game' current processes, or if a culture of 'dependency' on the regulatory processes has developed.

It is hard for regulators not to suffer from some 'self-capture'. Again John Kay: *"It requires a considerable effort of imagination to visualise that any industry might be organised very differently from the way that industry is organised now."*

To combat this tendency, there is a case for regular disruptive change, to stop processes and cultures getting too entrenched. Disruptive change could focus on overhauling the overall regulatory model. Ofwat's Future Price Limits project is an example. Current market reform in the water sector is also a key disruptive change. Change could focus on

personnel, perhaps substantially slimming down a regulator between each regulatory cycle. For Ofwat, opening a London office helped refresh the organisation. Most radically, change could be institutional, replacing or merging regulators, as has happened to Offer, Ofgas, Ofel, Postcomm and others: Of course the benefits need to be weighed against the inevitable costs of institutional change

The fourth mode of ‘capture’ is through politics, in other words the undue influence of politics over the proper domain of independent regulation.

A quarter century ago, one key reason for the policy innovation of independent sectoral regulators was to secure independence from politicians. Politicians are lobbied by industry and other sectional interests and politicians feel understandable pressure to respond to this and to the short-term political imperatives of the day. Independent sectoral regulators were created to take a number of – narrow – decisions, sheltered from political pressure and volatility (within clear statutory duties). Regulators’ decisions often shape the environment for major investments in long-lived assets, and stat independence reduces the political risk premium for investors. In water, huge investment – well over £100 billion in 23 years – has been achieved at low cost.

But are some now forgetting the reasons for such independence from undue political influence? Politicians are naturally tempted to secure their objectives using tools that are available, and economic regulators can be potentially powerful tools. Over time governments have increasingly acted on this temptation.

Of course political involvement in the regulated sectors is inevitable, and appropriate. But where, and the way, politicians get involved affects the unintended costs of that involvement. John Kay: *“There needs to be ultimate political responsibility, but the wise minister will exercise it extremely sparingly, and may wish to tie him or herself to the mast to avoid the siren voices of the Today programme.”*

The way politicians have sought to achieve their – legitimate - political objectives on the environment has been the main case study in increasing political influence over sectoral regulators. Beginning with the Renewable Obligation through to the Energy Bill and Electricity Market Reform, governments have increasingly taken into their own hands the detailed specification of contracts and market outcomes, increasingly limiting the role of the market and economic regulator. Moreover, rising energy bills – as a result of higher international energy prices and government energy policies – have led to strong political pressure on the independent regulator to take action ... about something else: “improving competition” in the energy retail market. This has led to joint government / independent regulator proposals to restrict numbers of energy tariffs.

Fiscal policy, and particularly deficit reduction, is another driver of costly political influence. For example, governments have resisted the regulator’s proposals for more on-rail competition – and the potential benefits for customers and the economy – instead prioritising economic rents to the Exchequer from monopoly franchises.

There also appears to be a trend towards directly reigning in the independence of sectoral regulators’ boards. A number of board appointments have recently been for shorter terms,

and ministers have taken an increasingly hands-on role in the appointment processes of non-executive directors.

There is a risk that increasing willingness of governments to interfere in regulated sectors emboldens vested interests, who try to influence economic regulation by going around the independent regulator to government.

But it is important not to paint too gloomy a picture. Independent regulation continues to deliver benefits through providing a degree of regulatory certainty. And the Department for Business is implementing a strong new competition regulator, in the Competition and Markets Authority. Can steps be taken to maintain the benefits of independent regulation in the face of the emerging trend toward politicisation?

Of course regulators must maintain a clear-sighted focus on discharging their statutory duties, including to protect the interests of customers. But there can be immense pressure on regulators to roll with the political tide. It may be that independent regulation is an innovation that can't be sustained in the long term. Stephen Littlechild's original report did envisage economic regulation as a largely transitional phenomenon (on the road to competition). Or can we envisage a new settlement? Perhaps with a greater role for the Competition and Markets Authority, which may be more protected from undue political influence. And perhaps there is scope for a greater role for the Department of Business in relation to sectoral regulators, drawing a clearer line between independent sectoral regulation and the delivery of wider government policy objectives.

Regina Finn is Chief Executive of Ofwat.

Simon Less is a Senior Research Associate at the Regulatory Policy Institute, and a Senior Consultant to Policy Exchange.