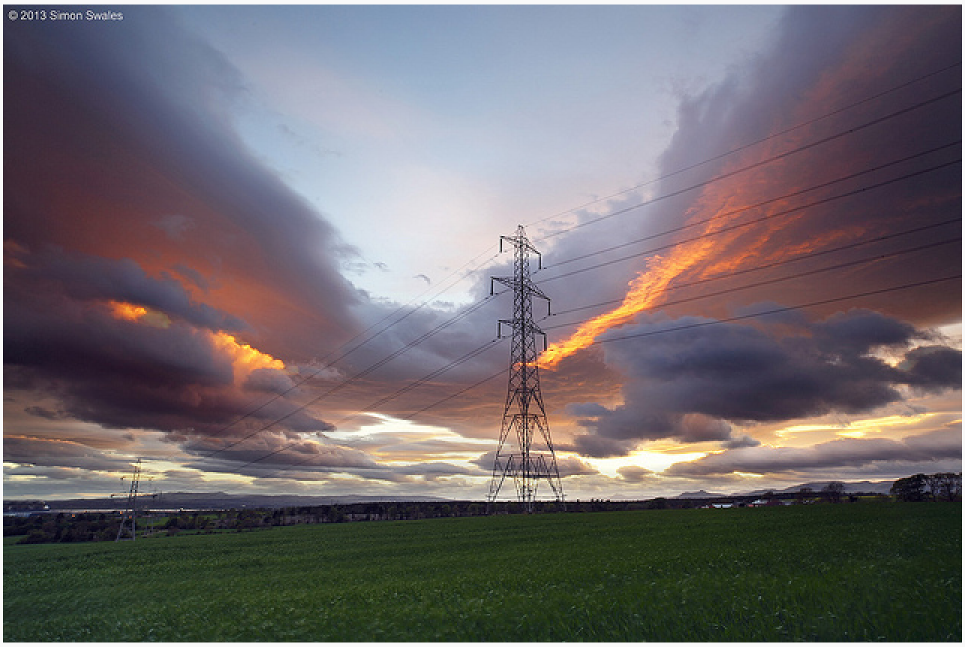
Regulators are frequently the source of castigation, but they are bound by practical realities

By Democratic Audit UK

*Ed Miliband's proposals to strengthen OfGem and OfCom – the state regulators of the energy and broadcast sectors – has put the role of democratic regulation in a market economy in the spotlight. Here **Conall Bolger** argues that regulators have a difficult role and that any discussion of alternatives to the current arrangements must take into account sectoral complexity, resources and legislation.*



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Energy bills are likely to be a focus during the general election. Coverage of the energy industry is rarely positive. In 2014 a number of suppliers were fined for mis–selling of products to customers. This type of news story may be impacting on customers; approximately one in four customers report having trust in their energy supplier. Labour has called for powers for the energy regulator Ofgem to cut bills having previously threatened to abolish the regulator if elected. The model of independent regulation of the sector is now under scrutiny. A similar model operates across other utility industries such as telecommunications and water. How these services are regulated impacts on the quality and cost of these services, thus affecting our daily lives. More broadly, regulatory policy has come under pressure with the performance of regulators during the Financial Crisis being challenged both in academia and more widely.

Sectoral regulators have a role within a democratic state of giving effect to legislative or Government policy goals. For example, if there are national pollution targets an environmental regulator might develop a body of regulations and a compliance framework to secure that goal. The regulators are often independent so that they can represent the interests of the state in an impartial manner. This procedural neutrality is expected to increase the legitimacy of the regulator.

The theoretical justification for the development of independent economic regulators originates from economic theory. Much of the energy network infrastructure was operated as a monopoly. According to economic theory, monopolies are inefficient and result in a distribution of welfare biased towards the monopolist. The regulator, in effect, acts as a proxy for market forces. Within the electricity sector, Ofgem seeks to encourage efficiency through regulation of revenues of the grid operator and maximising competitive pressures in the retail and wholesale markets. In common with other regulators, they also have a mandate to protect customers.

In practice, regulators are constrained by a number of factors. Outlined below are three: sectoral complexity; resources; and legislation.

The technical complexity of the electricity sector complicates regulation of the associated industry. There is a retail market in which electricity is sold to customers. There is also a wholesale market in which electricity generators are compensated for the power that they generate. The connection between the two markets is via the suppliers who purchase electricity from the wholesale market and sell it to customers. The price of the electricity sold to customers is set by the suppliers. The costs of that electricity include the suppliers' costs, generation costs, network infrastructure costs and the costs of transmitting the electricity amongst other items. Each of those areas involves a complex set of interacting market, system and technical issues. Attempting to regulate that setting requires a deep understanding of each of these items and the interactions between them. This complexity can be alienating to the public, potentially impacting on the legitimacy of the regulator, and limiting its effectiveness.

This issue is reflected in the oft-cited informational asymmetry between the regulator and the regulated industry. The companies in an industry will possess a greater understanding of the technical operations of the industry. In turn, the regulator depends on those being regulated to provide much of the information being used to regulate. For example, when determining a company's revenues, the regulator evaluates a submission from that company. This dependence introduces a risk of regulatory capture.

In addition to the informational asymmetry, regulators are constrained by resources. Due to the complex nature of the industry, it requires knowledgeable staff to develop and operate the regulatory framework. As the below table demonstrates, the number of staff in Ofgem is dwarfed by those in the companies regulated. The figures in the table are based on the latest accounts publicly available from a sample of companies in the industry.

Organisation	Staff	Company type
Ofgem	878	Regulator
National Grid	US (14,216)UK (9,693)	Transmission company
British Gas	28,579 (BG only)	Supply company
EDF Energy	15,150	Supply company
UK Power Networks	5,267	Distribution company
Scottish Power Energy Networks	2,910	Distribution company

This gap in resources suggests a challenge for the regulator. A further complication arises as the regulator may lose talented staff to the companies being regulated (a not unknown occurrence). Such an outcome may reinforce an informational asymmetry by granting those companies insight into the internal workings of a regulator.

The powers of staff within a regulator are statutorily defined. For example, Ofgem is governed by multiple sets of legislation that evolved over time. These statutes specify, amongst others, organisational roles and responsibilities, and the interactions with Government and other agencies. Their powers and the degree of initiative available to Ofgem is delimited by its legislation, and the ability to respond to changing circumstances can thus be restricted. While any amendment to these provisions would fall to the Government, regulatory independence from political interference is prescribed in European legislation. In addition, it could be argued that independent economic regulators provide a screen for politicians by taking unpopular difficult decisions. This issue has an implication for the legitimacy of the regulator; perceived regulatory quality is linked to independence of the regulatory authority in taking decisions.

Regulators undertake a challenging remit constrained by a number of factors including: sectoral complexity, resourcing levels, and legislation. Given these limits, it is fair to ask how effective can a regulator be in performing their role. Judging from the media coverage, energy prices (at least for certain sections of the media) demonstrate a lack of efficacy on behalf of the regulator. Clearly how the regulator undertakes its role has an effect on prices. However, within a democracy, regulators seek to do more than manage prices. They act on behalf of the state, and ultimately the populace, to ensure that the goals laid down in their formative legislation are met by the regulated industry, such as meeting customer or environmental standards. How should we be reflecting on the performance of regulators?

How to undertake regulation is a hot topic within the energy sector at the moment. Ofgem has stated its intent to undertake a model of principles-based regulation. The core idea is to move from a model of prescriptive (and detailed) regulations to one in which market participants are judged according to standards of behaviour. This debate is still very much an open one. The principles-based discussion arises out of a concern that the body of regulation may grow to be so dense that it is manageable by neither industry nor the regulator. An example from the US financial sector is the Dodd-Frank law passed in 2011 to prevent a reoccurrence of the financial crash. It runs to 848 pages and is viewed in some circles as being so complex and of such a broad scope that there are very few who have read it in its entirety.

In addition, overly complex and onerous regulations can result in high compliance costs for industry; those costs then result in higher prices for customers as companies price them in to the services that they offer. More widely, a popular perception of an impenetrable thicket of regulations can result in a perception of regulation for regulation's sake, undermining the credibility of a regulatory regime. The challenge for a principles-based regime would be the selection of the right set of principles and how they are applied in practice.

As regulation is a vehicle for putting policy into practice, then how regulation is performed is an important question for a democratic society. So the question of performance is not just about the outcomes that a regulator achieves, but the quality of both those regulations and the associated processes. The public debate, as summarised in the introduction, would benefit from further discussing how to secure a better quality of regulation. While an admittedly less dramatic narrative than the conventional one (with far fewer villains), it would be of more value to the functioning of the British state, and of more enduring worth to society.

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Note: This article gives the views of the authors, and not the position of Democratic Audit UK, nor of the London School of Economics. Please read our comments policy before commenting.

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