

**Her Majesty's Government's Response to the
House of Lords Select Committee on Regulators
Inquiry**

UK Economic Regulators

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**Pat Mc Fadden MP
Minister of State for Employment Relations and Postal
Affairs**

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House of Lords
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Dear Lord McIntosh

I am pleased to respond to the Committee on Regulators First Report, published on 13 November, on UK Economic Regulators. I apologise for the delay in responding to you.

The attached note sets out our responses to the Committee's recommendations.

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Introduction

The Government welcomes the House of Lords Select Committee on Regulators report into UK Economic Regulators. The report is a useful addition to the regulatory debate and raises important issues for both Government and the economic regulators covered by the report (Postcomm, Ofwat, Ofgem, the Civil Aviation Authority, Ofcom, the Financial Services Authority, the Office of Rail Regulation, the Pensions Regulator, the Office of Fair Trading and the Competition Commission¹).

In our response, we have looked carefully at the thrust of the overall report as well as the individual recommendations. In general, the Government is keen to make progress across the range of regulatory issues, including competition aspects and better regulation. It is with that in mind that we have approached each recommendation, as follows.

Conclusions and Recommendations

The Government's response to each of the Committee's conclusions and recommendations, as summarised in Chapter 1 of the Report, is set out below. The Committee's conclusions and recommendations are in bold text, with the Government's response following.

Regulators' statutory remits

1.1. We conclude that:

- **Independent regulators' statutory remits should be comprised of limited, clearly set out duties and that the statutes should give a clear steer to the regulators on how those duties should be prioritised.**
- **Government should be careful not to offload political policy issues onto unelected regulators. (para 3.13)**

The Government supports the need for clear statutory remits for regulators. We believe that the existing legislation which supports economic regulators largely fulfils this purpose. The regulators covered in this report have generally been set up with clear objectives and functions and there is in our experience little confusion over duties and priorities.

The Government agrees that political policy issues should not be delegated to the regulators. It is important that the clear dividing line between government and regulators should be maintained. It is helpful for regulators to be given guidance by government on issues that are matters of public policy.

¹ Throughout the report, these ten regulators will be collectively referred to by the term 'the regulators'. This is in contrast to the usual government definition of the word, which normally refers to any body which 'exerts powers over, or imposes burdens on, other organisations or individuals; by means of inspection, licensing, referral to another decision-maker (particularly with binding advice), accreditation or enforcement.'

1.2. Our evidence suggested that, on the whole, the legislation is thought to be working well and the regulators and regulated industries are satisfied with its provisions. Although it is clear that the current framework is not what would now be devised were it possible to start again it serves its purpose. We do not, therefore, recommend the drafting of a tidying up bill. However, we recommend that, as the opportunity arises, further standardisation of regulators' remits should be introduced with the aim of ensuring that they are statutorily required to follow best practice. (para 3.28)

The Government agrees that the current legislative framework works well and that a 'tidying up bill' would be unnecessary and not in the best interests of either the regulators, regulated industries, consumers or the wider public. While there are undoubtedly shared core principles regarding the protection of consumer interests, the Government does not believe that regulators would benefit from a standardisation of remits. The regulators covered by this report have been set up with specific objectives and functions and are experienced in fulfilling these. Any attempts to move towards a more standardised format could create more confusion than simplification, and would not necessarily improve the effectiveness of the regulators.

The Government also agrees that regulators should, so far as possible, follow best practice. A statutory duty to 'follow best practice' would be impracticable; hence, the Government favours the approach of identifying best practice in specific areas and statutorily embedding them when applicable. The Regulators' Compliance Code is an example of this, and we commend it to the regulators for their consideration.

Additionally, the 'Principles of Good Regulation,' as set out in Sections 2 and 21 of the Legislative and Regulatory Reform Act 2006, are a widely accepted definition of best practice in this area. The principles state that regulatory activities should be carried out in a way which is:

- Proportionate
- Accountable
- Consistent
- Transparent
- Targeted

There is a duty on certain regulators to have regard to the Regulators' Compliance Code. Additionally, some regulators (e.g. Ofwat) have duties requiring them to have regard to these principles. The Government commends the adoption of these principles by others.

1.3. It seems that most of the regulators are interpreting their remits both appropriately and effectively. As an exception to this general picture there is a question mark over whether Ofwat has explored the full extent of its remit and whether it has implemented that remit effectively. (para 3.35)

Ofwat is carrying out a review of competition in the water sector that addresses both its own approach and recommendations on changes that could improve the statutory framework. The Government welcomes this and expects Ofwat to keep those matters for which it is primarily responsible under ongoing review as the regime develops. The Government will also be carrying out its own review of the competition statutory framework in light of Ofwat's recommendations, the observations of the Committee, and in the context of the forthcoming Water Strategy which is due to be published shortly.

Working methods and value for money

1.4. We have not heard convincing criticism of how regulators approach their commitments to trim their operations and to work as cost effectively as possible. Although the operating costs of regulators have generally increased in recent years this trend can largely be attributed to significant extensions to their remits. We recommend that all regulators' operating costs be routinely kept under scrutiny by a sessional Select Committee established in line with our recommendation in paras 1.29-1.30 and by the National Audit Office (NAO). (para 4.17)

The Government agrees that the NAO should continue its valuable work of scrutinising regulators' operating costs and value for money, with the notable exceptions of the FSA and the CAA. These two regulators are not audited by the NAO, and are thus not subject to NAO scrutiny of their accounts. Consequently, there are alternative measures in place to monitor their operating costs.

Both the FSA and the CAA, in discharging their functions, must have regard to the need to use resources in the most efficient and economic way. They are also required to consult on their proposed fee structure prior to the start of each financial year.

Additionally, the FSA's board, which is required to have a majority of non-executives, publishes an annual report on the discharge of the FSA's functions. This report includes the extent to which, in its opinion, the regulatory objectives have been met, and a report from the non-executive directors on whether the FSA is using its resources in the most efficient and economic way. It is required to hold an annual public meeting to consider the report. With regard to the *ex-post* examination of its finances, the FSA is formally accountable to Parliament through the Treasury. As a company limited by guarantee, it is also subject to independent external audit. In addition, the Treasury has the statutory power to commission value-for-money reviews into the FSA, and must appoint an independent person to conduct such a study. The first such review was carried out in 2007 by the NAO. Treasury ministers are accountable to Parliament in exercising this power.

In the case of the CAA, in addition to the obligations listed above, the Authority is subject to independent external audit by auditors appointed by the Secretary of State. A copy of the auditor's report and the statement of accounts must be laid before each House of Parliament by the Secretary of

State. Additionally, the Government encourages the CAA to adopt best practice and to operate cost effectively through, for example, the Sponsorship Statement. This sets out the relationship between the Secretary of State for Transport and the CAA, and includes information on the financial conditions and other guidance relevant to the exercise of the CAA's functions, and how the CAA will be held to account for these.

The establishment of a sessional Select Committee is a matter for Parliament.

1.5. Regulators should commit to evaluating the impact of their work and monitoring the extent to which they are providing value for money. We recommend that regulators should jointly develop methodologies to quantify the impact they have in line with current best practice represented by the Office of Fair Trading and Competition Commission's methodologies. Whilst we recognise that this is an inexact science we believe that the process of trying to quantify value for money imposes a good discipline and encourages healthy self-evaluation. (para 4.25)

The Government agrees that the regulators should evaluate the impact of their work, in line with the general shift to a more outcome-focused approach to regulation in the UK. However, the Government does not wish to be prescriptive on how this should be done.

1.6. We would encourage regulators other than the Financial Services Authority (FSA) to consider risk-based regulation more explicitly, particularly as a means of using regulatory resources more efficiently. (para 4.36)

1.7. We encourage the FSA to continue its work in the area of principles-based regulation. We would also encourage other regulators to investigate the scope for replacing detailed rules by a move to a principles-based approach in their own areas of activity, and consumer bodies to monitor consistency. In doing so they could together help to identify the criteria for determining where, in the spectrum described by Ed Balls MP in Chapter 4, such an approach could usefully be employed, taking account of the possible consequences for regulatory uncertainty. (para 4.45)

The move towards a more risk-based system of regulation within the UK is at the heart of the Government's Better Regulation Agenda. A risk-based approach ensures that regulation is targeted at the highest risk areas, whilst lightening the burdens on more compliant businesses overall. The Regulators' Compliance Code, which creates a statutory duty to have regard to the principles of risk-based regulation for over forty regulators, including some functions of CAA, OFT, FSA and the Pensions Regulator, embeds this approach.

Many of the economic regulators covered by this report are playing a part in that shift. The Government is supportive of this and encourages them to

continue their efforts in this area, within the statutory boundaries set by Parliament.

The Government agrees that regulators should look carefully at the scope to move to a more principles-based approach, whilst noting that principles-based regimes work well for some sectors and some businesses and less well for others, especially small businesses who benefit from the greater clarity and certainty that comes from a more directive approach.

Regulators' use of Impact Assessments (IAs)

1.8. We agree with the recommendations of the NAO's Review of Economic Regulators' Impact Assessments (IAs) (contained in Box 1, after para 4.57). We recognise that all the regulators included within that review, and the FSA, have developed good, iterative consultation procedures. However there is room for improvement across the board in regulators' IA processes. Regulators should strengthen their cost/benefit analyses, using quantitative estimates where they can be made robustly, and should improve the presentation of their IAs with clearer sign-posting and a commitment to conciseness and clarity. All regulatory IAs should include executive summaries to make them more accessible and all should be placed in the public domain. Regulators should ensure that IAs are not used as a tool to justify policy but as a policy-making tool. (para 4.71)

1.9. Furthermore, we recommend that where they have not done so already, regulators should be required to publish their own policy documents setting out the approach they intend to take towards completing IAs. Policy teams should be supplied with written guidance and given formal training to help them to complete IAs. (para 4.72)

1.10. We recommend that:

- **Post-implementation evaluation should be conducted with greater frequency and should always be carried out where a step change in regulatory policy has been implemented.**
- **Such evaluation and monitoring should generally be carried out by the regulators themselves, but on occasion an independent body (preferably the sessional Select Committee recommended in paras 1.29-1.30, or the NAO) should monitor the quality of assessments and the objectivity shown by regulators in completing them.**
- **Post-implementation evaluation should always be made publicly available.**

The original IA makes clear that a post-implementation evaluation will be completed in cases where it is felt that a post-implementation evaluation would add value. Meaningful evaluation is not possible without clear targets and objectives. The regulator's original IA should set such targets in anticipation of a post-implementation evaluation. (para 4.76)

The Government is of the strong opinion that the Impact Assessment process strengthens policy-making, and as such is an integral part of the development of new policy.

As independent entities, regulators may exercise their professional judgment on appropriate adaptations to central Government's Impact Assessment process, in accordance with the particular needs of the industries they regulate. However, in all cases, the spirit of the Impact Assessment process should be followed.

The Government revised the Impact Assessment process last year, focussing on increasing the need for robust analysis of the costs, benefits and impacts of Government's intervention. Regulators may wish to consider these changes where they have not yet done so. The key features of the revised process include:

- a revised template to improve clarity and transparency, including new requirements to summarise both the rationale for Government intervention and evidence supporting the final proposal;
- a strengthened Ministerial declaration to bolster the quality of the analysis in Impact Assessments, supported by improved arrangements within departments;
- revised guidance for policy makers to make it easier for them to produce high quality Impact Assessments focused on the burden of the regulations they are developing; and
- increased emphasis on post-implementation review.

To improve transparency, the Government will set up a new area on the internet where summaries of published Impact Assessments will be available, together with links to departmental websites.

In addition, a Toolkit has been created to provide more detailed advice and support for policy makers in the creation of Impact Assessments, along with an online training package available at www.iatraining.berr.gov.uk that provides an overview of the Impact Assessment process and template.

The Government agrees that post-implementation evaluation is a key tool to ensure policies are having the intended effect in a proportionate way, and that it can provide good evidence for improvement where necessary. The Government's Impact Assessment template requires policy makers to commit to a date when they will review the actual costs and benefits of any new proposal and establish whether the policy has achieved the desired effects. We commend this approach to regulators.

The relationship between regulators and the regulated

1.11. We recognise the dissatisfaction of many Independent Financial Advisors (IFAs) with the work of the FSA. We welcome moves by the FSA to improve relations with the large number of smaller firms that it

regulates. The FSA must continue to cultivate these relationships. (para 5.15)

Whilst we note the comments of the Report, the Government considers this primarily a matter for the FSA as an independent regulator. The FSA will be providing their own response to the report, and we expect that they will address this issue directly.

1.12. Regulated industries recognise the need for regulators to receive timely and accurate information on their activities. The regulators should ensure that systems for providing such information work effectively. To enable the success of such systems, regulators should ensure that data requests are well co-ordinated and sent out in consistent form and should always be mindful of the burden that their information requests place on their regulated industries. Regulators should strive to keep this burden to the necessary minimum and should always explain and justify why data are required. (para 5.23)

The Government strongly agrees that regulators should ensure that the benefits of regulation justifies the costs for business, and that regulations place the minimum burden of businesses compatible with achieving their objectives. The Government supports regulators taking steps to identify unnecessary burdens and eliminating them wherever possible. There is already much good practice in this area, including the use by regulators of simplification plans and cost measurement exercises.

The Government is seeking, in the Regulatory Enforcement and Sanctions Bill currently before Parliament, to introduce a power which will allow a duty to secure that unnecessary burdens are not imposed or maintained, to be applied to regulators where appropriate.

The Government agrees that regulators should facilitate timely and accurate information provision by regulated persons, and should co-ordinate information requests where it is appropriate to do so. The Compliance Code imposes a duty on those regulators that are within its scope to consider the burdens imposed by information requests.

1.13. Industry needs reassurance that the time it invests in consultation is time well-spent and is meaningful in the decision-making process. Whilst recognising that, by and large, consultation procedures are working well, we urge regulators to continue to look at ways in which they might be improved. In particular, we recommend that wherever possible regulators allow for at least a 12 week consultation period in their forward planning to give industry a reasonable amount of time to respond to their papers. (para 5.34)

It is Government policy that the policy-making process should involve robust, transparent and genuine consultation of stakeholders. The Government

therefore strongly agrees that regulators should look for ways of making their consultation procedures more effective.

The Better Regulation Executive in the Department for Business, Enterprise and Regulatory Reform is currently undertaking a review of the consultation process, and we urge regulators to take account of this review when it is published later this year.

The protection of the consumer interest, the citizen interest, and the public interest

1.14. Regulators should normally be expected to be charged with responsibilities which reach beyond consumers to the interests of citizens or the general public. However, their duty to act outside the areas of consumer interest may, and if possible should, be circumscribed by legislation or by social and environmental guidelines issued by ministers in accordance with legislation. The interests of citizens and the general public are for Government and Parliament, and not for the regulators, to define and promote. (para 5.50)

The Government agrees that where it is appropriate, regulators should take account of interests beyond those of consumers when carrying out their functions. It is for Government and Parliament collectively to define the public interest and the specific duties which flow from it, and for regulators to decide how best to satisfy and, where appropriate, balance those duties in accordance with its statutory framework.

1.15. Different consumer representation models operate in the regulatory state and all the regulators were vociferous in justifying their particular model. However, we believe that stand alone consumer representation bodies are more transparent and more effective. (para 5.65)

The wide range of consumer representation models operating within the regulatory system reflects the different industries in which the regulators operate and the different processes of competition and consumer representation that have been followed in each. While the Government notes from the report that evidence suggests that one model is not superior to another, its preferred approach to consumer representation is set out in the Consumers, Estate Agents and Redress (CEAR) Act 2007.

This Act followed an extensive period of policy development and consultation. In July 2004, the joint DTI/HMT Economic Regulation Team published a report entitled 'Consumer Representation in the Regulated Industries'. The report contained recommendations to strengthen and streamline the current system of consumer representation and redress across the utility sectors by consolidating the existing consumer bodies. These initial recommendations were the subject of consultation in the DTI Consumer Strategy in June 2005 and again in a formal consultation on consumer representation and redress in 2006, prior to the introduction of the CEAR Act.

The Act recognised the need to strengthen consumer representation. It brings together Energywatch, Postwatch and the current National Consumer Council into a single body (currently called the new National Consumer Council.)

The new body will be a more powerful consumer advocate with the critical mass to engage effectively with Government, regulators and industry sectors, and with the benefit of being able to draw on experience and expertise from a number of sectors, as well as providing greater value for money for consumers.

The Government will consult in 2008 on the inclusion of water industry representation to the new National Consumer Council. Ministers will also consider bringing other sectors under the new Council in the longer term.

The Act provides for co-ordination between the new NCC and existing consumer functions within Ofcom and the FSA. The arrangements for consumer representation in the telecoms and financial services sectors already follow the model set out in the CEAR Act (including the provision of redress schemes for consumers).

1.16. A new landscape for consumer representation has been created by the Consumers, Estate Agents and Redress Act. We are sceptical that the proposed new arrangements will lead to improvements in consumer representation but we recognise that it is too early to judge whether our scepticism is justified. The new arrangements will need careful monitoring and this is a role that might be taken up by a sessional Select Committee (as recommended in paras 1.29-1.30). (para 5.66)

The Government believes that the Consumers, Estate Agents and Redress Act will strengthen consumer representation in key sectors. The new National Consumer Council will be established from 1 October 2008. The Government is working with industry, regulators and the existing bodies to ensure that the current consumer representative framework is maintained and wherever possible enhanced during the transition.

The Government is confident that the overall framework established by the Consumers, Estate Agents and Redress Act will provide full support to Energy and Postal Consumers.

1.17. In the energy sector, the voluntary nature of the Energy Supply Ombudsman scheme is likely to change as a result of the Consumers, Estate Agents and Redress Act and it would therefore be premature to recommend changes in this area. (para 5.73)

The Government agrees with the Committee that further changes to redress in the energy sector beyond those provided for in the Consumers, Estate Agents and Redress Act would be premature. The new arrangements should further sharpen incentives for suppliers to handle disputes effectively and compete on service quality. In the meantime, the Energy Supply Ombudsman

is an example of successful voluntary self-regulation. It has been operating for a year and has so far proved an effective model on which the forthcoming statutory arrangements can build. Ofgem's consultation on the criteria for Redress schemes in the Energy sector closed on the 12 December 2007 and the scheme will be in place by October 2008.

1.18. We recommend that the Government commission the NAO to conduct a review of the economy, efficiency and effectiveness of the Financial Ombudsman Service (FOS). The review should include consideration of the extent to which the FOS acts as a "pseudo-regulator" and the effectiveness of the working relationships between the FOS and other bodies such as the FSA and Office of Fair Trading (OFT). (para 5.74)

The recent value for money review of the FSA was carried out under powers conferred on the Treasury in section 12 of the Financial Services and Markets Act 2000 (FSMA). This enables the Treasury to appoint an independent person to conduct a review of the economy, efficiency and effectiveness with which the Authority has used its resources in discharging its functions. The National Audit Office was selected to carry out this work.

FSMA does not contain a provision which would enable the Treasury to require a similar review of the Financial Ombudsman Service (FOS).

Accountability for the FOS is through the FSA. The FSA has made a number of rules that govern the operation of the FOS. FSMA does not provide the FSA with a specific power to require that a review be undertaken of the FOS. However, the FOS board has committed itself to external scrutiny on its own initiative by way of three-yearly independent reviews. The first took place in 2004 and looked at FOS's case-handling procedures and systems. It also examined FOS's performance in terms of quality, consistency, process and value. The Rt Hon Lord Hunt of Wirral MBE is currently carrying out the second of such reviews, focusing on the openness and accessibility of the ombudsman service to its wide range of customers and stakeholders.

The FOS has liaison arrangements with both the FSA and the OFT. These are set out in published Memoranda of Understanding and on the joint website explaining how decisions with wider implications for the three parties are handled (<http://www.wider-implications.info/>).

In light of the above, the Government does not consider that it would be appropriate to request the NAO to initiate a review into the FOS.

Co-operation between regulators

1.19. We think that action is necessary to improve regulators' joint working. There needs to be more structured and formal cooperation between the regulators if it is to be meaningful. We welcome the

regulators' willingness to develop relationships between themselves to increase their effectiveness. (para 6.15)

The Government agrees that regulators should work together and co-operate more closely. We understand that the Joint Regulators Group will be issuing its own response to the report, which will be an opportunity for them to set out how they intend to do this.

Additionally, the Government notes that the Concurrency Working Party, which is already recognised as a forum for effective communication between its members (Ofcom, Ofgem, Ofwat, ORR, CAA² and the OFT, with Postcomm having observer status), has recently established a Working Group on Procedural Issues, thus increasing the opportunity for co-operation and co-ordination between CWP members.

1.20. We believe that if the Joint Regulators Group (JRG) is to prove a successful forum for the sharing of best practice, it needs to be formalised. The JRG should establish a secretariat, and suitable arrangements for leadership, to ensure greater consistency of focus and a clearer direction of effort. The JRG should publish its agendas and minutes of its meetings on a tailored JRG website online to enable interested parties to have easy access to them. Additionally, the JRG should produce an Annual Report outlining the discussions it has had over the course of the year and the details of any joint work it has undertaken. (para 6.16)

The Government acknowledges the success to date of the Joint Regulators Group (JRG) in providing a forum for best practice. We strongly encourage the group to develop this further, whilst recognising that one reason for the JRG's effectiveness is its flexibility and informal structure.

1.21. Whilst relationships between the sectoral regulators and the competition authorities seem to be broadly sound, there is clearly a need for improved communication between the various bodies over the timing and content of their investigations of particular markets. (para 6.25)

The Government agrees that good communication between sectoral regulators and the competition authorities is essential. Communication failures can place an undue burden on businesses. The Government encourages regulators to work together where appropriate to assess the combined impact of their different activities on individual businesses and to minimise duplication in the timing and content in their investigations.

1.22. We recommend that, where possible, utility regulators should look to bring more cases to the competition authorities and that the regulators should work to ensure that the cases most likely to establish

² In relation to its concurrent competition powers for air traffic services only

**useful precedents are brought to the Competition Commission (CC).
(para 6.26)**

We agree with the recommendation that utility regulators should seek to use Competition Law where it is appropriate. In 2006, the Government examined the economic regulators' use of their concurrent competition powers and published its conclusions in its report 'Concurrent Competition Powers in Sectoral Legislation'. The report identified that a distinctive feature of the concurrent regime is that it allows the economic regulators to use both sector-specific regulatory powers and general competition powers to regulate markets. Some regulators see advantages in using sectoral regulation where there is a choice between that or competition powers because it can be better targeted at a particular regulated activity; others (for example Ofcom and ORR) have used their competition powers. It is for regulators to judge when it is best to use particular powers but the Government agrees with the Committee that regulators should be encouraged to think about whether they can be more pro-active in using competition law, including market investigation references to the Competition Commission.

1.23. We recommend the following:

- **Concurrency arrangements (the arrangements under which decisions are made about whether competition law is applied in particular sectors by the relevant sectoral regulator or by the OFT) should be retained.**
- **In some cases complainants perceive that a sectoral regulator is so deeply involved in regulating the industry as it stands that it pays insufficient attention to the importance of establishing and maintaining effective competition. Complainants should therefore be given the option of requesting the OFT rather than the sectoral regulator to take the lead in investigating complaints.**
- **In cases where regulators do not have concurrent powers, even though they are carrying out very similar functions to regulators which do have such powers, there is a case for giving them concurrent powers. (para 6.41)**

The Government agrees that the concurrency regime has worked well, has provided benefits to the UK economy and to the sectors where regulators have both sector-specific and competition powers, and that existing arrangements should be retained. Recommendations to improve the operation of the concurrency regime and the joint working between regulators were made in the Government's 2006 report 'Concurrent Competition Powers in Sectoral Legislation' and have been taken forward by the regulators, including through the Joint Regulators' Group and the Concurrency Working Party reporting to it. The existing arrangements already allow complainants to state a preference as to which concurrent regulator is best placed to investigate the complaint. The decision as to which should do so is taken on a case-by-case basis after discussion between the relevant regulators.

With respect to complainants being able to request that the OFT take the lead in investigating complaints, the Government observes that they can already do so. Any request that the OFT take a case in a concurrent sector will be taken into consideration when the OFT and the relevant concurrent regulator agree who is better placed to deal with the complaint. Additionally, when conducting investigations the regulators liaise with each other and the OFT where appropriate on specific issues. Consequently, the Government see no reason to change the current arrangements.

The relationship between regulators and Government

1.24. We recognise that there is a perception that Postcomm's independence might be compromised by its method of funding. We believe that whilst in theory the funding of Postcomm by Royal Mail (and therefore effectively by the Department for Business, Enterprise and Regulatory Reform—formerly the DTI) may compromise its independence, in practice this is not the case. Moreover, as competition increases other operators in the industry will be liable to contribute to the funding of Postcomm. (para 6.48)

We welcome the Committee's finding that the current method of funding Postcomm does not compromise its independence. Government has sought to address the perception that Postcomm's independence may be compromised by its method of funding, by transferring the responsibility for postal services policy, along with sponsorship of Postcomm and Postwatch, to the Enterprise and Business Group within BERR. This took effect on 3 September 2007. This move was made in response to the NAO's report 'The Shareholder Executive and Public Sector Businesses' published on 28 February 2007, and the subsequent Public Accounts Committee examination of evidence, which highlighted concerns about the Shareholder Executive's shareholding in Royal Mail, its responsibility for BERR policy on the postal market and Post Office network, and oversight of Postcomm and Postwatch.

1.25. Energy is now again a public policy issue and security of supply and sustainability are ever more important considerations. In this context, Government will need to be careful to ensure that Ofgem is not sent mixed messages. Government must be explicit in the political decisions it makes and the consequent guidance it issues to regulators. (para 6.50)

The Government agrees with the Committee's comments. Under energy legislation, Ofgem has been given a role that clearly identifies consumer protection as its principal objective. The Government recognises that Ofgem also has an important role to play in other areas, including ensuring security of supply and helping to tackle climate change and fuel poverty, and this is why it has been given other relevant objectives. For example, in carrying out its functions, it must have regard to the interests of vulnerable consumers and ensuring security of supply.

Ofgem is also required to carry out its functions in the manner which it considers is best calculated to contribute to the achievement of sustainable development, and to have regard to statutory guidance on social and environmental matters issued by the Secretary of State. This legislative framework gives a clear mandate to Ofgem that places the emphasis on economic regulation, providing regulatory certainty to investors, while also ensuring that Ofgem is able to make an appropriate contribution, consistent with its principal objective, to meeting the Government's objectives on sustainability, security of supply and fuel poverty.

As the report points out, Ofgem's regulation of energy markets is widely regarded as successful and the Government would not want to change its objectives in a way that hampered its ability to continue to regulate effectively.

1.26. Complexity in the relationship between the Department for Transport (DfT) and the Office of Rail Regulation (ORR) is not necessarily undesirable if the system is working. The Minister, Tom Harris MP, put in a sensible plea for "a long-standing period of settling down into the current regulatory framework". We believe this would be advisable and we recognise that the early signs of a productive relationship developing are promising. (para 6.56)

We welcome the Committee's conclusion. The Government made a fundamental change to the structure of the railways through implementation of the 2004 *Future of Rail* White Paper. This set out clear boundaries between the Government and the independent regulator. We simplified the regulatory structure and reduced the number of decision-making bodies, particularly in health and safety regulation.

The rail industry faces the possibility of unprecedented growth over the coming years. A strong, stable and predictable regulatory framework will be key to providing the assurance needed by investors and users alike that it will be able to deliver, while the general guidance issued to ORR by the Secretary of State in March 2007 seeks to promote a stronger working relationship with ORR.

1.27. Relationships between regulators and government seem generally to be functioning well although an effective and transparent mechanism needs to be put in place for resolving potential policy conflicts so that the regulators are able to carry out their economic function without interference. (para 6.59)

The Government agrees that the relationship between regulators and government is functioning well. Although policy conflicts can occur, the Government is confident that resolving these disputes through existing arrangements is the most effective approach.

1.28. Relations between government departments on regulatory issues are in their infancy. We recommend that an inter-ministerial forum be

established to require ministers to compare views and share best practice. (para 6.60)

The Government agrees that there are advantages in sharing knowledge and best practice across departments on regulatory issues. It does not believe that, to do so, it is necessary to create a new formal Ministerial body in addition to those that already exist. For example, the Ministerial Panel for Regulatory Accountability (ED (PRA)), are a Cabinet Committee created to consider better regulation issues, and the network of Better Regulation Ministers drive forward the better regulation agenda in each of their departments and throughout Government more widely. These bodies already look at the sharing of best practice between their regulators.

The accountability of regulators

1.29. We agree with the conclusion of many of our witnesses that "there is a crucial need for greater parliamentary oversight ... over regulation bodies". The question of who regulates the regulators has not been answered and will not go away. There is a need for a committee to pursue cross-sector best practice and to ensure that the recommendations of this Report are implemented. As we emphasise in paragraph 2.18 we have examined only a part of the regulatory state. We have considered only regulators, and not regulation, and we have looked at only the economic regulators. There is a need for a wider, and continuing, review. No existing committee of either House is in a position to undertake such a continuing and over-arching review as Departmental Select Committees in the House of Commons are restricted to considering the regulators within their own sector. (para 6.65)

1.30. We therefore recommend that a Joint Committee of both Houses be set up in line with the recommendations in Chapter 10 of the Constitution Committee's Report on the Regulatory State (6th Report of Session 2003-04). If it proves impossible to set up such a committee we recommend that a sessional Select Committee be set up in the House of Lords. (para 6.66)

The creation of a new committee is a matter for Parliamentary consideration.

The promotion of competition by regulators

1.31. In most sectors, regulators have played an important role in helping to promote competition, but there are significant variations between the sectors. Whilst not all regulators have a primary statutory duty to promote competition, the duties they do have are often framed or interpreted in such a way that they point in the same direction. In a few cases, regulators lack the necessary powers under sector-specific regulation to take measures that would stimulate competition and, as discussed in Chapter 6, do not have concurrent powers with the OFT under general competition legislation. This particularly applies to the

Civil Aviation Authority (CAA) which lacks both concurrent competition powers and the power to designate or de-designate airports for price control purposes. The decision about whether or not to apply price control regulation is essentially economic rather than political and there is a strong case for transferring that power from the Secretary of State to the CAA. (para 7.14)

The Government notes that not all regulators covered by this report are competition regulators. In particular, the FSA and the Pensions Regulator do not set prices in the markets which they regulate, and do not have a primary duty to promote competition. The Government is of the opinion that expanding the role of these regulators to include competition enforcement powers would be undesirable. The Pensions Regulator is not an economic regulator – it regulates the pensions voluntarily provided by employers, and if an employee wishes to choose an employer-funded scheme, they must join the scheme offered by the employer. In the case of the FSA, the Government believes that an expansion of its role would be expensive, and would create additional uncertainty in what is already a highly competitive sector.

In the case of the CAA, the Competition Commission is currently carrying out its inquiry into the supply of airport services in the UK by BAA. This may have implications for the structure of the market and the framework for economic regulation of airports. It would therefore be inappropriate for Government to consider any changes to economic regulation of airport services before the conclusions of that inquiry have been reached. The Competition Commission's inquiry has a statutory end date of March 2009.

1.32. We recommend that the Government considers the case for transferring the power to designate or de-designate airports for price control purposes from the Secretary of State to the CAA. This matter could be addressed as part of the strategic review of the CAA that is being conducted by the Department for Transport. However, we recognise that the implementation of the EU Directive on Airports (discussed in Chapter 7) might make this impracticable. (para 7.15)

Sir Joseph Pilling's independent strategic review of the UK Civil Aviation Authority (CAA) will consider the structure, scope and organisation of the Civil Aviation Authority (CAA) with a view to ensuring that the UK's arrangements for aviation regulation and policy making are fit for purpose and able to meet current and future challenges. The review is due to report in 2008.

As the Pilling Review will also consider the CAA's relationship with Government, we are seeking advice on whether this issue is more appropriate to be addressed as part of this review, or whether it would be appropriate to address it after the on-going Competition Commission's inquiry into BAA has concluded. (The latter may have implications for the structure of the market and hence the framework for economic regulation of airports.)

If it is addressed as part of the Competition Commission's inquiry, DfT will consult at the appropriate time on the wider economic regulatory role of the

CAA including the way in which airport regulation operates. This will take account of, as appropriate, the provisions of any Airport Charges Directive, a draft of which is currently going through the EU legislative process.

Competition in the water sector

1.33. Whilst each of the sectors within our inquiry has distinct characteristics, we find it hard to accept that there is something specific about the nature of water itself which means that the sector can never develop effective competition. Three reasons have been advanced as to why this has not happened—the physical nature of water as a commodity; the eligibility threshold; and the access pricing rule. Whether or not the physical characteristics argument is a valid one will never be put to the test until the barriers to competition presented by the threshold and the access pricing rule have been removed. As regards the latter, since virtually everyone agrees that the rule should be changed, it is very unfortunate that an impasse has been allowed to develop over what needs to be done to make the change. Ofwat maintains that legislation is required, whereas potential entrants claim, on the basis of the Competition Appeal Tribunal's (CAT's) general comments on the access regime, that a change in Ofwat's interpretation of the legislation is all that is necessary. In their view, Ofwat is ignoring the competition authorities and failing to change its interpretation in a way that would make entry more attractive. The Government has so far done little or nothing to clarify the situation. (para 7.22)

1.34. It seems to us unwise of Ofwat to claim that it need take no account of the general comments made by the CAT on its access regime. Ofwat should examine critically whether it could not find a more constructive approach to implementing the CAT's findings. (para 7.23)

The Government notes that Ofwat does not claim that it need not take account of the CAT comments on its access regime.

Ofwat is carrying out its own review of competition in the water sector and has recommended changes to the threshold and the Cost Principle, which are both matters for Government and ultimately, Parliament. The Government will consider these recommendations in its own review of competition.

The Government believes that a retail-minus approach to access prices was intended by Parliament during the passage of the Water Bill. However, the Government will be looking at the Cost Principle as part of its forthcoming review of competition.

The CAT case in question relates to the general competition regime developed in the Competition Act 1998, not to the general Water Supply Licensing regime or the Costs Principle laid down in the Water Act 2003. In this case, the CAT did not identify any specific error or flaw in Ofwat's access codes guidance or propose an alternative interpretation of the Costs Principle in the 2003 Act as this was outside the scope of the CAT's jurisdiction.

Under the provisions of the Water Act competition regime Ofwat does not have powers to determine access prices until a dispute is referred to it. Although Ofwat has sought informally to help licensees and incumbents in resolving disputes, it is essential to have live cases to make real progress on access pricing. So far, only one case has been referred to Ofwat and it will announce its determination as soon as possible. This is a good opportunity for Ofwat to look critically at its guidance.

Regulators' attempts at de-regulation

1.35. Regulators have taken important steps to de-regulate but there is still room for progress. Alternatives to classic rule-based regulation, such as risk-based and principles-based regulation, can assist sectoral regulators in moving towards an *ex-post* competition authority approach and there is a case for providing regulators across the board with a duty to promote self-regulation. (para 7.32)

1.36. It might be possible for sectoral regulators to disappear but certainly not in the immediate future. If sectoral regulators are phased out, the core, irreducible functions that they perform would have to be performed by other organisations, such as the competition authorities. If possible, it would be worth instituting measures that lead in this direction without necessarily expecting the demise of sectoral regulators to come soon. (para 7.45)

1.37. We recommend that the sessional Select Committee proposed in paras 1.29-1.30 takes on the duty to ensure that the sectoral regulators it oversees are promoting competition and withdrawing from sectoral regulation wherever appropriate. (para 7.46)

The creation of a new sessional Select Committee is, as noted above, a matter for Parliament.

The Government strongly agrees with the Committee that risk-based and principles-based regulation often offer the best routes to achieving desired outcomes in certain sectors. The Government welcomes the move towards these approaches by the regulators covered in this report, and commends their further use.

The Government also agrees that there are policy objectives that can be achieved with little or no state intervention, and that self-regulation is particularly appropriate in relation to cultural, social and consumer protection issues. However, the Government does not believe that a statutory duty to promote self-regulation is the appropriate approach as it risks being unduly inflexible.

In addition, the Government accepts that where appropriate (due to the degree of competition, technological change or other factors) specific sectoral regulation should be removed or reduced. However, like the Committee, the

Government believes that it is unlikely that sectoral regulation can be removed completely for the foreseeable future, given the complex and technical nature of the sectors concerned.

1.38. We recommend that, subject to any restrictions imposed by its statutory remit, the Competition Commission conduct a periodic review on whether effective competition exists in the markets overseen by sectoral regulators, with the aim of scaling back sectoral regulation to the greatest extent possible. (para 7.47)

The Government recognises the merit in looking at the level of competition in sectors with the explicit aim of scaling back sectoral regulation. However, a system of periodic review would represent a significant extension of the work of the Competition Commission (CC), who currently have no powers to undertake proactive work and can only examine cases referred to it by another body. Expanding its role in this way would require Parliamentary approval.

The Government does not support changing the CC's functions in the way recommended by the Committee, as most economic regulators already have the powers to make market investigation references to the CC, and the OFT can refer any market for detailed review.

Nevertheless, the Government agrees with the overall intention of scaling back sectoral regulation where it is possible. It is the job of regulators to review levels of competition in their markets, and to identify areas where it is possible to withdraw from sectoral regulation. The Government currently conducts ad hoc reviews into levels of competition in specific sectors (e.g. the review into the Postal Services Sector). We will consider further such reviews as the evidence merits.

1.39. We endorse the OFT's proposal (in response to the joint report by the DTI and HM Treasury on concurrency) that it reports to the Joint Regulators' Group on an annual basis, providing an overall view about whether competition law is being applied consistently and pro-actively across all the sectors. The OFT could also report on the compliance of regulators with the Better Regulation Executive's (BRE's) principles of good regulation. (para 7.48)

The Government welcomes the OFT taking on the role of reporting to JRG on an annual basis to provide an overall view about whether competition law is being applied consistently across all sectors and notes that OFT reported in this role in September 2007.

The Government also notes the Committee's suggestion of an external assessment of regulators compliance with the principles of good regulation. It believes that this could be of value and is considering whether and how this might be taken forward.

The impact of regulators on the competitiveness of UK firms

1.40. Economic regulators promote competition which, in turn facilitates—but does not ensure—competitiveness. The positive effect that regulators have on competitiveness is achieved indirectly because promoting the competitiveness of UK firms does not normally form part of the regulators' remit. Given the importance of the role played by the regulated sectors in supporting UK industry, we think it is vital that economic regulators fully consider the impact of their decisions on UK firms' competitiveness. (para 7.68)

1.41. We recommend that, as legislative opportunities arise, economic regulators be statutorily required to facilitate the competitiveness of UK firms by: i) promoting competition; and ii) removing regulatory burdens from firms wherever possible. (para 7.69)

The Government supports the promotion of competition and the removal of regulatory burdens wherever possible; these activities are linked and mutually reinforcing. The report notes that the majority of the economic regulators already have a statutory duty to promote competition. We do not therefore see a need to introduce further requirements. However, the Government fully supports the need to remove unnecessary burdens wherever possible. A legislative opportunity for this presents itself at the moment, in the form of the Regulatory Enforcement and Sanctions Bill. Part 4 of the Bill includes a power to apply a duty to regulators to secure that unnecessary burdens are not imposed or maintained.