What brings the Government back in?

Comments on the notion of boundaries and independent regulation

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Does political interference reinforce the need for regulatory independence?

There are a number of reasons why governments have been brought back into the regulatory space. However, in doing so, governments have succeeded in preserving some of the boundaries that were put in place in line with the Stephen Littlechild model. This model never denied governments the ability to make strategic decisions. It, in fact, suggested that governments were required to make those strategic choices – and for regulators to work within their statutory duties.

Governmental incursions into the regulatory space since those early days of utility reform reflect a growing acceptance that regulators are one of many critical actors within the wider regulated industry network. What might at first sight be interpreted as an erosion in regulators' influence can, on second sight, be seen as a result of activities by other independent regulators. Furthermore, a closer look at those incidents where governments have intervened suggests that these were arguably in areas where regulators would have struggled to act within their existing primary duties.

Motives for intervention are transitory and set the boundaries between government and regulators

So what then prompted governments to intervene? Three particular reasons can be highlighted.

Government interventions were prompted by systematic market failure

The kind of systemic risks to the integrity of markets that were caused by the financial crisis and its aftermath were always going to be tackled by governments – and not by regulators. That governments acted should not therefore come as a surprise. Furthermore, the continued existence of many aspects of financial regulation can be explained by their continued relevance, especially in the commodity markets which are prone to boom and bust (but did not collapse in 2007). In those markets, collateral requirements have been raised. In addition, previously lightly regulated markets are now included in the same kind of regulatory requirements applicable to those highly complex markets held responsible for the financial crash.

One example of such a response is energy. European regulation is overseen by the European energy regulator ACER. This regulator receives the most comprehensive set of European energy trading data that has ever been assembled. Together with the Financial Conduct Authority and energy regulation by ACER, the centrality of independent regulation has continued to persist in energy markets.

A second market failure related motive for government intervention is price externalities. The drive towards reducing carbon emissions and the development of climate change related targets are clearly a matter for government (in the UK, the Department for Energy and Climate Change) and the European Commission. Such targets cannot be derived from the existing regulatory framework governing economic regulation. Furthermore, the sustainability-related primary duties of Ofgem are not sufficient to develop the kind of structures that are required to encourage investment to address climate change.

A third source of market failure can be generated by the type of market structure adopted at the time of privatisation. In the UK, rail is a case in point. Here, governments are always likely to intervene, especially in an industry where government becomes the key customer for rail services. Under such circumstances, it is never likely that regulators will appear independent, regardless of whether they are 'supported' by 24 separate statutory objectives.

Politicians respond to prices (when it looks like they will not go down)

The prices paid by consumers for utilities are always a political issue. Any government's performance is judged by their response to rising prices, especially in energy. The sustained super spike in international energy prices in coal and gas during 2007-09 was driven by factors that were largely outside government's control, such as Chinese economic growth, Japanese gas prices and a rise in investment in renewable generation. When prices spike, parliamentary enquiries, opposition motions and calls for investigations are never far away. In UK energy, the government did respect the regulator, despite piling on the political pressure. Given that political mood, another regulator, the Competition and Markets Authority, intervened (in 2015).

Absent in debates about prices has been a supposedly neutral, authoritative voice about market dynamics. Regulators have, as yet, failed to explain movements in prices, although this may be changing. Ofgem has developed supply market indicators that try to provide an account of market conditions, which includes the impact of government levies on price levels, such as the Energy Company Obligation in the UK that obliges large companies to deliver energy efficiency measures to domestic consumers.

The failure of industry to perform as expected prompted intervention
Finally, governments intervene when industries are seen to continuously fail. Industries generating large numbers of complaints, whether about misspelling, mis-selling or poor product quality, will witness inevitable political reaction. In such circumstances, political pressure will be applied and boundaries will be moved.

Regulatory landscape changes

Boundary changes in independent regulation are not just a product of political responses to perceptions of market and industry failures. A further source of boundary change is the wider context of regulation ('the regulatory space') – independent regulators do not operate on their own in isolated silos, but interdependently with other regulators.

Regulatory Networks and the CMA muddy the waters
One of the key changes is the regulatory space is that regulatory independence is being challenged by other independent regulators. In the UK, the Competition and Market Authority (CMA) has many of the characteristics of a lead regulator. From 20013 onwards, it has had the ability to remove a regulator's concurrency powers and take over the investigation of cases. Furthermore, it is encouraged by government to challenge other regulator's policies, if the CMA thinks that these measures are reducing competition.

A further potential source of reducing regulatory independence is the development of the UK Regulatory Network (UKRN). This network might potentially be seen as a source for the development of common solutions to common problems, for example, in setting price controls or in tackling technical issues, such as the assessment of the cost of capital.

Regulators are not independent of the power of ideas
Regulatory activities are never independent of ideas. However, responding to changing ideational fashions suggests that regulators are able to exercise their own choices. The independent regulator has at least been given technical discretion to use economic theory and econometric techniques with industry-specific problems. However, as ideas about regulation change, ideas about what and how to regulate also change. This can be seen with Ofwat's new approach to regulation that uses ideas found in transaction cost economics for price control and that places a great deal of emphasis on legitimacy as a regulatory goal. Similarly, there has been a growing interest in applying regulatory models by regulators in other jurisdictions. One critical example here is PJM and Texan energy markets which have been cited by Ofgem and the European Commission.

The legal structures are still in place and should not be dismissed

Do boundaries shift that much – and does it matter all that much? The case of UK energy prices offers an insightful example. Politicians – and government – became involved as prices were rising. This certainly led to a politicisation of regulatory decision -making; however, the solution to address rising prices was developed by the regulator, Ofgem. The adopted solution – a drastic reduction in the number of tariffs that energy companies were allowed to offer – was accompanied by a further series of measures to facilitate comparison among different energy tariffs. This response was challenged by the Competition and Markets Authority and much of Ofgem's work is likely to be unwound. Unusually for a market investigation by the CMA, remedies were designed to mediate in the relationship with the Department of Energy and Climate Change and with Ofgem. The dynamics clearly suggest that boundaries are in flux, but with the additional twist that the independence model has been re-affirmed.

Therefore, this short contribution suggests that despite powerful political reasons for intervention, the key elements of regulatory independence have remained intact. One reason for this survival is the underlying legal template. Most regulated sectors continue to be licensed and a licence provides an important legal buffer against intervention. Licence-change is a slow and relatively open process – conditions that inhibit short-term political interference.

The constraints imposed by licences are supplemented by industry agreements between licensees and monopoly networks. These agreements are mediated by a contract in the form of a code that provides for a degree of flexibility. Price control continues with innovation in energy and water methodologies. Finally, and critically, the notion of independent regulation has remained pivotal for attracting relatively cheap investment into the UK's utility infrastructure.

However, this does not mean that there has been no change. There has been a decline of confidence in the extent to which markets offer effective problem-solving capacities. There has also been a decline in the importance of the Austrian school of economics that characterised the early years of utility liberalisation in the UK.

In conclusion, it is important to move beyond the observation that boundaries between governments and regulators have changed and towards a better understanding of the driving forces behind those interventions which ultimately change the boundaries between Government and regulators.

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