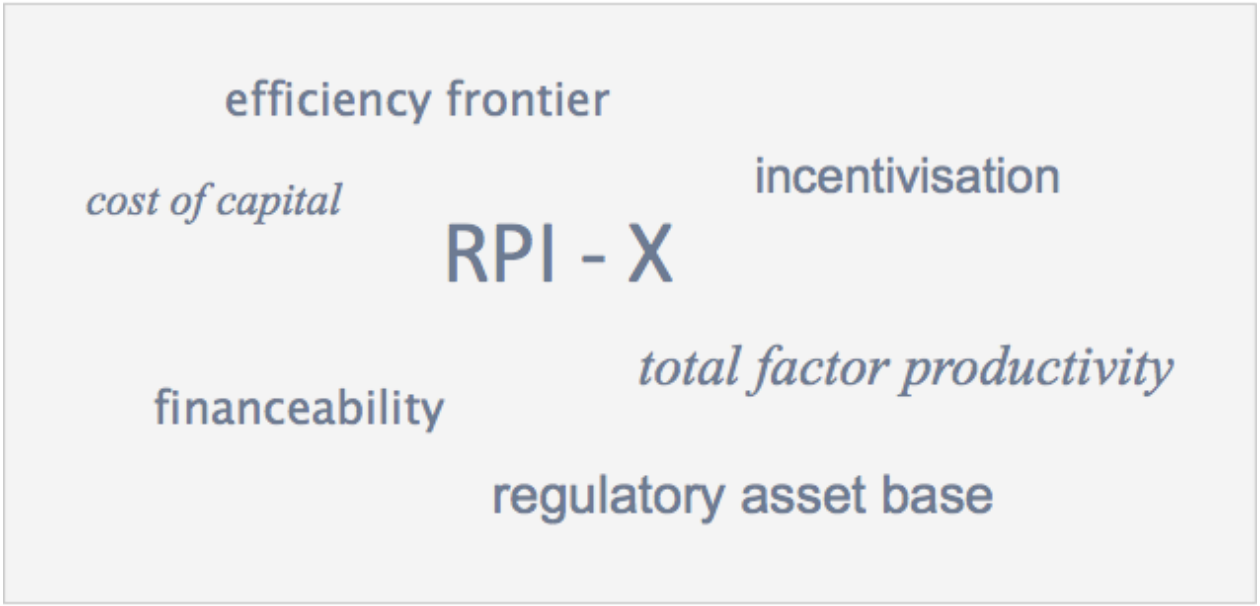
GUIDE TO ECONOMIC REGULATION



Part 1: The Statutory Framework

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Foreword

This is Part 1 in a series of booklets which aim to provide individuals working in the regulated aviation, communications, energy, rail and water sectors with an introductory guide to the principles and practices of economic regulation.

This first booklet describes the statutory framework that has been placed around the above-mentioned industries. In the pages that follow we will see how regulators get their authority and identify the tools that regulators may use. We will also draw out the checks and balances that guide and discipline a regulator's behaviours.

Note: the booklet draws on the legislation in place as at September 2023 (see annex).

1. Which firms are regulated?

We start by explaining how some sectors and some companies come to fall under the purview of an economic regulator while others do not – an important first distinction to make in any explanation of how the UK system of economic regulation works.

1.1 Overall framework

The boundaries to regulation's reach are set out in Acts of Parliament which deliberately target certain categories of firms. As a general rule, if Parliament has not explicitly said that a particular type of activity is to be regulated, a firm that is undertaking that activity does not need to worry about economic regulation. Conversely, if a firm sees that it falls under one of the headings set out below, it will need to pay attention to the arrangements that we describe in this booklet.

There are four main ways in which a company might become subject to economic regulation, as set out the grid below and in the following sub-sections.

Table 1

Appointment	Designation
Licence requirement	Market power determination

1.2 Appointment

Parliament has said that each area in England, Wales and Northern Ireland must have an appointed water undertaker and an appointed sewerage undertaker. In addition, Scottish Water has been named by Parliament as the provider of water and sewerage services in Scotland.

This creates a first distinct category of regulated firm comprising more than 20 individual companies.

Most such appointments were made by the government many years ago, but there is a process by which the geography of each appointment may be varied by the industry regulator and by which the regulator may appoint new companies to take on the responsibilities of an existing undertaker in a specified area.

1.3 Licence requirement

There are a number of sectors of the economy where Parliament has decided that it is an offence for a firm to carry on a particular activity without first obtaining a licence. Any person that does not meet this requirement shall be liable to prosecution, conviction, a fine and/or imprisonment.

The list of the activities that are proscribed in this way includes:

Generating electricity

Transmitting or distributing electricity

Supplying electricity to premises

Conveying gas through a pipeline

Supplying gas to premises

Providing a smart meter communication service

Operating a train, a station, a maintenance depot or a railway network

Providing air traffic services in a managed area

Using a water undertaker's supply system for the purposes of supplying water to premises

Introducing water into a water undertaker's supply system

Using a sewerage undertaker's sewerage system for the purpose of providing services to premises

Removing matter from a sewerage undertaker's sewerage system

A firm that wishes to engage in these activities must apply to the industry's economic regulator for a licence. This typically involves the payment of a fee and a process of vetting to establish the applicant's suitability to carry on the relevant services.

1.4 Market power determinations

Airports and telecoms companies are not 'appointed' and can offer services to customers without first having to apply for a licence. However, the relevant sectoral legislation provides for the possibility that an economic regulator may give special oversight to firms that have substantial market power.

The gateway to economic regulation in this case involves the regulator making a market power determination.

In the case of airports, the regulator must determine that: a) a firm has, or is likely to acquire, substantial market power in a market; b) competition law does not provide sufficient protection against the risk that the firm may engage in conduct that amounts to abuse of that substantial market power; and c) the benefits of regulating the firm are likely to outweigh the adverse effects.

The position is simpler in telecoms in that the regulator needs only to determine that a firm has significant market power in relation to a market.

1.5 Designation

Postal operators also do not need to obtain licences. However, the industry regulator may designate one or more postal operators to be a universal service operator. This operator is then subject to economic regulation in recognition of its special responsibilities to customers.

Another place where there is regulation via designation is the water industry. The sectoral legislation here provides for large, complex infrastructure projects to be put out to compulsory tender and for a firm that becomes responsible for delivering such a project to be designated as a licensed company.

Finally, the government has recently obtained powers that will enable it to designate new nuclear power stations for economic regulation.

1.5 Summary

A summary of the filters that are used to identify regulated companies is given in the table below, along with examples of the types of firms that are and are not caught.

Table 2

Sector	Gateway to economic regulation	Examples of regulated firms	Examples of unregulated firms
Airports	Market power determination	Heathrow Airport, Gatwick Airport	Stansted Airport, Manchester Airport and other smaller airports
Air traffic control	Licence requirements	NATS, in respect of its UK en route, Oceanic and London Approach services	Providers of tower services at airports
Energy	Licence requirements	National Grid, UK Power Networks, ScottishPower, SSE, British Gas Trading, Smart DCC	Gas storage companies, price comparison sites, pipe-laying contractors
	Designation	tbc	
Post	Designation	Royal Mail	Other postal operators

Rail	Licence requirements	Network Rail, Great Western Railway, Scotrail, Freightliner	Rolling stock leasing companies, train manufacturers, ticketing websites
Telecoms	Market power determination	BT and mobile providers in relation to specific 'bottleneck' services only	BT and mobile providers in relation to other services, BSkyB, Virgin
Water and sewerage	Appointment	Anglian Water, Thames Water, Scottish Water, Northern Ireland Water	Bottled water companies, waste management firms, pipe-laying contractors
	Licensing requirements	Castle Water, Scottish Water Business Stream, Water Plus	
	Designation	Tideway	

2. The regulators

The economic regulators in this country are:

The Civil Aviation Authority (CAA)
The Gas and Electricity Markets Authority (GEMA)
The Office of Communications (Ofcom)
The Northern Ireland Authority for Utility Regulation (NIAUR)
The Office of Rail and Road (ORR)
The Water Industry Commission for Scotland (WICS)
The Water Services Regulatory Authority (WSRA)

2.1 Legal form

Each of the above-named regulators is formally a body corporate comprising several members. Informally, these individuals may sometimes be called the regulator's "board" but, in law, the legal powers that the regulator has are vested in these persons and these persons alone.

Sectoral legislation typically specifies that the regulator must consist of a minimum number of members (see table opposite). One of these individuals must act as the Chair.

It is also commonplace, albeit not universal practice, to have rules which require there to be more non-executive members than executive members.

Table 3

Regulator	Form
CAA	At least seven but not more than sixteen members
GEMA	At least three members
Ofcom	At least three but not more than twelve members
NIAUR	At least four members
ORR	At least five members
WICS	At least four but no more than six members
WSRA	At least three members

2.2 Appointments

All Chairs and all non-executive members are appointed to a regulator's board by the government for fixed terms, following a process of open competition. The government determines the members' remuneration and allowances.

In the cases of GEMA, NIAUR, ORR and the WSRA the executive members of the board are also appointed by the government. At the CAA, Ofcom and the WIC, executive members may be internal appointments.

Once finalised, an appointment may only be terminated on grounds of incapacity or misbehaviour. This is a key factor which makes regulators independent from government, insofar as it prevents the government from getting rid of regulators because they do not like the decisions that the regulator is making (or, indeed, from threatening the regulator with dismissal if they do not act in accordance with the government's wishes). It also permits individual members to think and act independently from their colleagues.

2.3 Staff

Each regulator is permitted under law to employ staff. Indeed, given the breadth of the responsibilities that the regulators hold, it is essential that they do.

The offices supporting GEMA, NIAUR and the WSRA are known as Ofgem, the Utility Regulator and Ofwat respectively. In the cases of the other regulators, there is no formal labelling to separate the members and the staff.

Employees are normally civil servants, except for the staff at the CAA and Ofcom. When regulators employ civil servants, the government must approve both the number and the terms and conditions of the staff that the regulators employ.

2.5 Further information

Additional information about the set-up of each regulator, including biographies, organisation charts and board minutes, can be found on the regulators' websites:

www.caa.co.uk
www.ofgem.gov.uk
www.ofcom.org.uk
www.uregni.gov.uk
www.orr.gov.uk
www.wics.scot
www.ofwat.gov.uk

3. Regulatory conditions

Having explained which companies are subject to regulation and who it is that does the regulating, we now look at the contents of the regulatory toolkit.

We start with the single most important lever that regulators can use to discipline the behaviour of the firms: the ability to impose regulatory conditions.

3.1 Scope of conditions

Once a firm has passed through the filters set out in section 1, a regulator typically has very wide discretion to impose conditions on the now-regulated company.

In most sectors, Parliament has said that the regulator may introduce such conditions as appear to the regulator to be "requisite and expedient" or "necessary and expedient", having regard to its statutory duties (see section 6). This gives regulators tremendous flexibility. It means, for example, that the contents of an electricity licence can be very different from the contents of a water licence, or even within sectors that, say, the contents of a train operator's licence can differ from the contents of a railway network licence.

The regulator's freedoms are a little more constrained in the postal and telecoms sectors, in that the sectoral legislation identifies specific types of condition that the regulator may impose on a universal service postal operator and on a telecoms firm that possesses substantial market power. Even then, however, the wording tends to be quite open – for example, the permission that the regulator has to impose price controls on a universal service postal operator provides that the regulator "may make provision as to tariffs" without specifying when, where or how.

Regulatory conditions will formally sit in licences in the case of electricity, gas, rail, airports and air traffic control companies and non-undertaker water and sewerage companies. In the case of appointed water and sewerage companies, the conditions selected are formally 'conditions of appointment'. Conditions are of a more free-standing nature for postal and telecoms firms.

3.2 Modification

The flexibility that Parliament has given regulators extends, importantly, to an ability to delete, modify and update, or add conditions over time.

This power enables a regulator to respond to new circumstances and emerging issues within an industry. In the event, for example, that a regulator spots a new threat to the continuity of service, it can reword existing conditions or develop new conditions to require the regulated firm to take actions to

deal with the problem. Similarly, if old conditions are rendered obsolete by changing circumstances, the regulator is able to delete the out-of-date provisions.

The end result is that licence, or conditions of appointment, or the free-standing conditions in the postal and telecoms sectors, are living documents, which evolve and adapt over time to the circumstances of the firm and the sector.

(Note, however, the rights of appeal that the regulated firm has, as set out in section 7.)

3.3 Enforcement and financial penalties

The 'teeth' that a regulator's conditions have comes from a system of legal enforcement. If a regulated firm is not complying with conditions that have been imposed upon it, the regulator can embark down a path of ever-tougher sanctions, as follows.

1) On first becoming aware of a contravention, a regulator will give notice to this effect (a "contravention notice" or a "provisional order") to the regulated firm, warning it of the actions it will face if the breach is not remedied.

2) If the regulated firm does not or is not able to return to a position of compliance, the regulator may proceed to issue an enforcement order. This order will set out the steps that the firm must take to comply with the conditions it is required to adhere to and the steps that it must take to remedy the consequences of its breach.

(Note: in urgent cases, where there is a real risk of loss to third parties, the regulator may skip straight to step 3.)

3) If the firm does not comply with the terms of an enforcement order, the regulator may take civil proceedings in court against the regulated firm. Among other things, it may apply to the court for an injunction or an inderdict.

In most regulated sectors, a regulator may also levy a financial penalty in response to the breach of a condition and/or the failure to comply with an enforcement order. The penalty may not exceed 10% of the regulated firm's turnover and is normally paid to the government or to the regulator (NB: not customers or affected third parties).

3.4 Licence revocation, suspension of service and special administration

The most serious of cases, where a firm cannot or chooses not to comply with the terms of an enforcement order, can lead to the firm being put out of business by the regulator.

Most licences contain a provision which enable the regulator or the government to revoke the licence in the event of protracted

non-compliance. Without a licence, a firm cannot legally carry on with its business.

In the telecoms and postal sectors, the regulator is able to issue a suspension notice to an errant firm requiring it to cease all or some of its business for a period of time of the regulator's choosing.

In the water sector, the appointments referred to in section 1.2 may only be terminated with a notice period of 25 years. However, the regulator or the government may apply to the court for an appointed business that is not complying with the terms of an enforcement order to be placed in administration.

4. Price controls

Before we go any further, it is worth pausing for a moment to make clear how price controls fit into the scheme that we described in section 3.

In most industries, price controls are implemented via licence conditions (or the equivalent of licence conditions in the case of post, telecoms and water). That is to say that regulators can specify via conditions the scope, the form, the level and the duration of any control that it wishes to place on a regulated company's prices using the powers that Parliament has granted to make conditions that are "requisite and expedient". A regulator can also subsequently enforce compliance using the toolkit that we described in sections 3.3 and 3.4.

When a regulator conducts a periodic price review, it will normally work up a modification of one or more licences using the powers described in section 3.2. Note, however, that in the water industry, uniquely, the price control condition is written in such a way as to require the regulator to make periodic determinations of the maximum revenues that companies can collect from customers. Ofwat's price control decisions are therefore formally determinations by the regulator under the licence rather than licence modifications per se.

The one major exception to this set up is in the railway, where price control arrangements are written into the access agreements that Network Rail has with its train operator customers rather than Network Rail's licence. During a periodic price review, the regulator is permitted by law to reach into these access agreements and unilaterally change Network Rail's charge list. This enables ORR to make changes to the scope, form, level and duration of Network Rail's prices just like any other regulator, only via the modification of hundreds of individual access charges rather than via a global price control.

5. Regulators' other functions

Outside of the setting of regulatory conditions, there is not a one-size-fits-all design to the regulators' other functions.

We set out below some of the roles that Parliament has entrusted to individual bodies.

(NB: this is intended only as a snapshot. Readers are advised to refer to legislation for a complete account of the regulators' statutory functions.)

5.1 Enforcement of competition law

Most of the economic regulators have concurrent powers with the Competition & Markets Authority (CMA) to enforce the prohibitions in the Competition Act 1998 in the sectors that they regulate. These are:

- a prohibition on agreements between firms which prevent, distort or restrict competition
- a prohibition on the abuse of a dominant position in a market

Regulators with these concurrent powers are required by law to give priority to their competition law powers – e.g. they are not to take enforcement action under the terms of a licence if it is more appropriate for them to proceed by using the Competition Act.

5.2 Enforcement of consumer law

Most regulators also have powers under the Enterprise Act 2002 to enforce a wide body of consumer protection legislation.

Notably, this includes the Consumer Protection from Unfair Trading Regulations 2008 which contain a general prohibition on unfair commercial practices and specific prohibitions on certain types of misleading or aggressive commercial practices.

5.3 Insolvency proceedings

Regulators in the aviation, energy, rail and rail industry are able to petition the court to make a special administration order in the event that the regulator considers that a regulated company is likely to be unable to pay its debts.

If granted by the court, the purpose of such an order is to transfer to another company (or companies) as a going concern as much of the insolvent firm's business as is necessary to ensure that the regulated activities are properly carried out. This differs from normal insolvency proceedings, where the interests of the firm's creditors are accorded first priority.

5.4 Dispute resolution

Several economic regulators have statutory roles in resolving disputes that are brought to them by disgruntled customers.

Ofwat, for example, resolves disputes relating to new connections, new supply and metering.

5.5 Railway access agreements

The ORR, uniquely among regulators, is heavily involved in the access agreements that are in place between Network Rail (and other facility owners) and train operating companies. Specifically, ORR:

- must approve every single access agreement that companies in the railway enter into
- must approve all subsequent modifications to those agreements
- can issue model clauses for parties to use in their agreements
- has the power to direct an unwilling facility owner to enter into an access agreement

5.6 Functions that extend beyond economic regulation

Several of the regulators have responsibilities that go beyond pure economic regulation.

The CAA and ORR, for example, are the safety regulators for the aviation and rail sectors.

The CAA is also responsible for running the Air Travel Organisers' Licensing (ATOL) scheme of financial protection to consumers that have purchased flights and package holidays from travel companies.

Ofcom arguably has the broadest powers of all the regulators, with responsibilities that stretch well beyond economic regulation and into technical standards, security and emergency preparedness (not to mention Ofcom's roles in radio spectrum, the media and broadcasting).

6. Objective, duties and guidance

6.1 Objectives and duties

Regulators do not operate in a policy vacuum. In carrying out the functions detailed under the preceding headings, the regulators are explicitly tasked by Parliament to pursue certain objectives and have regard to certain other matters.

The list of duties varies from sector to sector but may include a mandate to:

- protect the interests of consumers
- secure that the demand for regulated services is met
- promote competition
- promote efficiency and economy on the part of regulated firms
- secure that regulated firms are able to finance their activities
- contribute to particular environmental or social policy goals

Regulators are also required to have regard to the better regulation principles of regulating in an accountable, consistent, proportionate, targeted and transparent way.

A regulator that is contemplating exercising any of the functions that we described in sections 3, 4 and 5 of this booklet must proceed in a manner that it considers is best calculated to achieve its statutory objectives. On occasion, the individual objectives can come into conflict with one another. In such instances, regulators are able to decide how to prioritise their duties with the aim of satisfying them to the greatest extent possible.

Notwithstanding the challenges that this presents, the experience during 35 years and counting of economic regulation in the UK has been that the duties that have been written into each sector's legislation have stood up well as enduring statements to regulators of the job that they are to do. Parliament has also been able to update regulators' objectives over time as society's requirements have changed, particularly in relation to environmental and social issues.

6.2 Government guidance

The other way that the government can formally convey a sense of priorities to a regulator is by issuing statutory guidance.

Again, the mechanisms by which guidance can be given differ slightly from sector to sector, but, broadly speaking, the process is that the relevant Secretary of State will table a written document in Parliament setting out his or her strategic priorities and associated regulatory objectives. The regulator is subsequently required to have regard to the

Secretary of State's stated preferences when making decisions.

Note here that guidance is not the same as a direction and "have regard to" is not the same as "must follow". The intention is not to undercut regulators' independence, but rather to ensure that regulators are informed of the government's long-term strategies and, hence, can contribute to the achievement of government policy goals when carrying out their regulatory functions.

7. Appeal rights

When setting up the statutory frameworks for economic regulation in the different sectors, Parliament decided that it is important that persons that are unhappy with a regulator's decision should, in certain circumstances, have the right to refer that decision to a third party for adjudication.

Importantly, such rights often extend beyond the right to a judicial review and allow for the third party – usually the Competition & Markets Authority (CMA) or the Competition Appeals Tribunal (CAT) – to consider the regulator's decision "on the merits".

The task of the CMA/CAT may be framed in one of two ways.

7.1 De novo review

The government's thinking during the 1980s and 1990s was that a regulated firm that is unhappy with important decisions should have the right to reject that decision outright. At that point, the regulator would have a choice: either it could go away and re-craft its decision to make it palatable to the regulated firm; or the regulator could refer to the matter to the CMA and ask for the CMA to determine how the regulator ought to proceed.

Provisions of this kind still exist today in the places listed in table 4.

Table 4

Regulator	Disputes which may be referred to the CMA for de novo review
NIAUR	Licence modifications (water) Determinations under the licence (water)
ORR	Licence modifications Access charges review decision
WIC	Licence modifications Determinations under the licence
WSRA	Modifications to conditions of appointment (Wales) Determinations under the licence

On receiving a reference from an economic regulator in relation to one of the above matters, the CMA is required by law to have regard to the same objectives and duties as the regulator. In effect, this means that the CMA is to step into the regulator's shoes and consider the issues that the regulator was considering with a fresh pair of eyes.

In the case of a disputed determination, the CMA simply makes the required determination in place of the regulator. In cases of a

disputed licence modification or a disputed railway access charges review, the regulator has to ask two specific questions of the CMA:

1) whether any matter operates, or may be expected to operate, against the public interest?

2) if it does, whether the effects adverse to the public interest can be remedied or prevented by the modification of the licence or changes to railway access charges?

The CMA's decision in a determination is binding. The CMA's report in a licence modification reference formally has the status of recommendations and it is for the regulator to decide what to do with these recommendations. Following controversies in several cases in the late 1990s, in which the regulator chose not to adhere to the CMA's findings, legislation was progressively changed to give the CMA the ability to review the regulator's response and, if necessary, veto any specific actions the regulator takes.

Ultimately, this means that the CMA is able to force its will on the parties, the mere foreknowledge of which is generally enough to bring a sense of finality to disputes at the end of the CMA's process.

7.2 Appeals

Since the 2000s, the government has tended to prefer an alternative method of opening regulators' decisions up to independent scrutiny. In the new way of doing things, a regulator may formally proceed with a decision that it wishes to make even in spite of the objections of an affected person. However, at the point of implementation, the affected person has a short window with which to lodge a notice of appeal with either the CMA or the CAT, depending on the type of decision, on the basis that the decision was "wrong".

Provisions of this kind can be found today in the places listed in tables 5 and 6.

Table 5

Regulator	Matters which may be appealed to the CMA
CAA	Licence content and subsequent modifications (airports)
	Licence modifications (air traffic control)
GEMA	Licence modifications
NIAUR	Licence modifications (electricity and gas)
WSRA	Modifications to conditions of appointment (England)

Table 6

Regulator	Matters which may be appealed to the CAT
CAA	Enforcement orders and financial penalties Market power determinations (airports) Licence revocation (airports)
Ofcom	All decisions (NB: the CAT must pass appeals involving price control matters to the CMA for determination)

This kind of appeal process differs from the old-style de novo review framework in two main ways.

First, the appellant triggers the process and is required to specify the grounds on which it opposes the regulator's decision. The job of the CMA/CAT panel is then to determine if it agrees with these complaints. This tends to make for much narrower cases, in which the appellant directs the CMA/CAT to focus on specific aspects of the regulator's thinking, like specific building blocks within a price control calculation, and ignore all other unrelated matters.

Second, the right of appeal is often available to any person that can show that they are affected by a decision. Importantly, such persons may include customers as well as the regulated firm.

If the CMA/CAT panel finds in favour of an appellant it may either quash the regulator's decision or it can remit the matter back to the regulator with a direction to make a new decision in accordance with instructions given by the CMA/CAT. In certain price control appeals, the CMA may also have powers to substitute its own decision for that of the regulator. One way of another, therefore, the parties should get the same sense of finality that we referred to earlier at the end of the appeal process.

Annex

The prevailing legislation for the regulated sectors at the time of writing, i.e. September 2023, as set out principally in:

The Office of Communications Act 2002
The Communications Act 2003
The Postal Services Act 2011
The Gas Act 1986
The Electricity Act 1989
The Utilities Act 2000
The Railways Act 1993
The Railways and Transport Safety Act 2003
The Civil Aviation Act 1982
The Civil Aviation Act 2012
The Transport Act 2000
The Water Industry Act 1991
The Water Industry (Scotland) Act 2002
The Water Services etc. (Scotland) Act 2005
The Electricity (Northern Ireland) Order 1992
The Gas (Northern Ireland) Order 1996
The Water and Sewerage Services (Northern Ireland) Order 2006
The Competition Act 1998
The Enterprise Act 2002

If you have any questions about the content of this booklet, please get in contact at:

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