

# We Deserve Better

*Replacing Failed Economic Regulators With  
Consumer Reforms, So We All Get A Better Deal  
On Our Utilities*

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### About The Author

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John is the son of two teachers and had a state-funded education (except for his MBA at Columbia University in New York, which he paid for himself). He was a latecomer to politics, after an extensive business career working for J P Morgan, McKinsey, Thompson publishing and Pearson PLC (where he was Managing Director of Longman's schoolbook publishing operations) before becoming an entrepreneur with educational software companies (Widgit and Logotron) and Credit Market Analysis (sold to Chicago Mercantile Exchange and now part of Standard & Poors). He is married to Dido Harding, who is Chief Executive of TalkTalk.

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## 1. Executive Summary

Our utility firms provide us all with the unglamorous but necessary products which we need to live in the modern world; essential things like energy (electricity and gas) and water, as well as almost-essentials like bank accounts and telephones too. Some of these firms, like the ones which provide our food, clothes and TV, produce products which we like, and rate highly (with the recent – and hopefully temporary – exception of the beef industry). But others – like energy, water, banks and broadband – make us feel ripped off and we consistently give them rock-bottom scores on everything from value for money to quality of service and overall customer satisfaction.

This isn't good enough. We all need these products every day so, when they let us down with high prices or poor service, everybody suffers. It imposes a deadweight cost which holds back our economy, slowing growth and making Britain less dynamic. And the human cost falls most heavily on vulnerable and less well-off families too.

This paper asks why these industries are performing so badly relative to other utilities which work much better. It concludes that there's nothing inherent in the products they sell, or the people who run them, which makes it inevitable that they will disappoint us so consistently and for so long. The common threads are that most of them used to be state-run bureaucracies (except for retail banks), and all of them are now heavily-regulated sectors with network (which some people call 'natural'<sup>1</sup>) monopolies embedded somewhere inside them. Apart from that, there are few similarities between water companies, telecoms firms or gas and electricity suppliers other than their unhappy customers.

And given that many of the firms in these sectors didn't exist when the state bureaucracies were privatised, their poor performance isn't caused by a shared state-run heritage from more than 25 years ago. Today's problems are down to the way they are regulated.

Unlike other parts of Britain's economy, the problematic utilities all have specialist economic regulators. These economic regulators – with familiar names like Ofgem, Ofwat and Ofcom – take a very different approach from that used for the other industries (like food or clothing) which provide day to day products successfully and have happier customers. The economic regulators use a 'Big Regulator' approach whereas the other, more successful, industries are governed with a 'Big Consumer' model instead. Given the relative performance of the sectors they manage, the Big Consumer model is clearly superior.

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<sup>1</sup> In fact there's nothing 'natural' about them at all, so this paper will use the more accurate 'network monopoly' term throughout.

The Big Regulator model is more expensive, creates slow-moving firms that are less customer-focused, takes economically inefficient and inaccurate decisions and is more prone to capture and lobbying by producers or consumer groups. It was nonetheless popular with the last Labour government (albeit for the wrong reasons) because it allows politicians to influence, interfere and intervene more readily. It also creates a culture of mutual dependence between firms and their regulator which encourages ever-greater and more detailed regulatory involvement, and which forms a habit that's hard for all sides to break.

Switching these industries onto the 'Big Consumer' model would mean introducing structural, liberalising reforms to put us consumers in the driving seat. The reforms would make it easier for us to compare competing offers clearly, and then to switch suppliers if we want. They would open more of the markets to competition, so we have more choice if we don't like our current suppliers and, by voting with our feet – or our wallets – give us the power to drive down prices, and force the utility firms to get steadily more efficient and competitive so we get better value for money. And they may also mean changing the ownership or governance of network monopolies in each sector to strip out costs and ensure that new firms trying to challenge the established utility companies have equal access and can compete on a level playing field.

Each utility market will need a different mix of reforms to put consumers in charge, depending on its starting point. ***So the Government should ask the Ministers responsible for each one to create a tailored programme of consumer reforms to reinstate the 'Big Consumer' approach as quickly as possible. And to ensure the plans are radical enough, they should be scrutinised and approved by a 'star chamber' of senior ministers in each case.***

The result should be more productive, customer-focused and competitive utility companies, happier customers and a more productive, dynamic economy. But there will be strong opposition from vested interests amongst some incumbent utility firms, plus anybody still hooked on the culture of mutual dependence which the 'Big Regulator' approach fosters in politicians, regulators, consumer groups and the firms themselves. As a result it will be important to lock in the reform programmes for each market, to prevent them from being slowed down, watered down or eroded through creeping reregulation in future. ***The Government should transfer responsibility for the competitive and potentially-competitive sections of each market from the economic regulators to the established Competition Authorities which already apply the 'Big Consumer' approach successfully in the rest of the UK's economy, the OFT and Competition Commission (soon to be merged into the Competition & Markets Authority).***

Once the reform programmes are underway, and responsibility has been transferred, the economic regulators will shrink to provide residual regulatory coverage of any unreformable network monopolies in each industry. They will also retain any other regulatory responsibilities they may have alongside their economic roles (for example, Ofcom is also the content regulator for broadcast media apart from the BBC, and the Civil Aviation Authority looks after air safety). ***Depending on the size of the remaining***

*network monopoly regulators the Government should consider whether to combine them into a single, functionally expert institution or leave them as sector specialists. And it should also consider whether the other non-economic regulatory responsibilities should remain alongside the economic sector specialists, become standalone institutions in their own right, or be merged into other similar bodies where further economies of scale and synergies may be available.*

Finally, we need to look at the bodies which represent consumers in each of the utility industries. Some of them have already been merged into Citizens Advice Bureau and Trading Standards, which should improve cross-sector comparisons and allow competition regulators to spot and eradicate examples of consumer detriment more easily. But, oddly, this entirely sensible process has left out the consumer groups for water, telecoms, transport (both trains and planes) and retail financial services. ***The Government should complete the process for them too.***

## 2. Britain's Utility Companies: The Firms We Love To Hate

### 2.1 How Big Is The Problem?

Britain's utilities – providing the unglamorous but necessary products which everybody needs to live in a modern economy – account for over a sixth of our economy and nearly two million jobs, as this table shows:

Sector <sup>2</sup>	GVA (£bn, 2011)	% UK GVA	Employees (000s)	% UK Employment
Energy (gas, electricity etc)	57	4.2%	171	0.7%
Water	10	0.7%	44	0.2%
Telecoms & post	37	2.8%	443	1.4%
Transport (rail & air)	9	0.7%	118	0.4%
Financial Services	125	9.4%	1,123	3.6%
<b>Totals</b>	<b>238</b>	<b>17.8%</b>	<b>1,899</b>	<b>6.3%</b>

But in spite of their size and importance, utilities companies represent some of the most heavily criticised and complained-about firms in Britain.

- Customer satisfaction with utilities is extremely low. In a recent official survey<sup>3</sup> of 50 different consumer sectors, the utilities accounted for 11 of the 22 least popular goods and services. Only estate agents and second hand cars ranked lower.
- Britain's water and energy utilities<sup>4</sup> cost 18% more than the OECD average
- UK railways are 20% more expensive than their European counterparts. Ticket prices are around 30% more expensive than in Europe on average per passenger kilometre and state funding is significantly higher too, with an overall 40% efficiency gap identified<sup>5</sup>.
- More than half (54%) of us don't trust gas or electricity companies to deal with us fairly. And 50% of us don't trust our banks to sell us long term products like mortgages and pensions either<sup>6</sup>.
- In the 2012 Which? customer score (a combination of satisfaction and willingness to recommend to others) survey of 20 different sectors, the utilities accounted for 3 of the bottom 4 places.

A quick scan of UK newspapers and broadcasters tells a similar tale. Coverage of the utilities is overwhelmingly negative, ranging from accusations of energy company price gouging amid stories of 'rip-off Britain'; mis-selling of financial products and 'fat cat' pay deals in banks; wastefully leaking pipes and dirty beaches for water firms; and unfair rail ticket price increases.

<sup>2</sup> Figures provided by House of Commons Library, using company reports, regulator reports & ONS data

<sup>3</sup> EU Commission 12<sup>th</sup> Consumer Markets Scoreboard, Dec 2012, UK data pg 118

<sup>4</sup> OECD. NB their figures compare prices for water, electricity, gas, other fuels & housing.

<sup>5</sup> McNulty report

<sup>6</sup> Which? consumer survey Nov 2012



Even worse, these consumer reactions contrast strongly with other, similar parts of Britain's economy, where customer satisfaction is much higher. We are, in general, a lot happier with most of the other products and services we buy every day, like food<sup>7</sup>, clothes, magazines or TV<sup>8</sup>, and with the companies that provide them, than with our utilities.

## 2.2 An Unfinished Journey

### 2.2.1 From Awful State-Run Bureaucracies.....

Extraordinarily, things used to be much worse than they are today. Most of Britain's utility companies were created after state-run bureaucratic monopolies were sold off and broken up in the 1980s and early 1990s. Many of them had been hugely unprofitable, with expensive and limited product ranges and dreadful customer service. For example, state-run British Telecom was famous for out-of-service and filthy telephone kiosks, and long waiting lists for installing phone lines; and the water boards wasted large proportions of the water they supplied due to leaking pipes, raising costs and prices for everyone. In the words of Professor Stephen Littlechild, who pioneered the 'RPI-X' price reductions<sup>9</sup> immediately after privatisation and headed the first electricity regulator, the utility sectors were '*characterised by inefficiency, excessive costs, uneconomic investments, old and outdated products, little innovation [and] little responsiveness to customer preferences*<sup>10</sup>'.

### 2.2.2 .....To The Promise Of Youth.....

For several years after privatisation, consumers steadily got a better deal. British Gas went from 100% market share to six competing suppliers, offering customers a choice of providers for the first time ever. BAA's grip on the UK's airports was steadily eroded, giving travellers to and from Britain an ever-wider choice of airlines, airports and destinations. The importance of British Telecom's telephony monopoly was steadily reduced by the growth of mobile phones, where it doesn't compete at all, and customers now have a wide range of firms chasing their broadband and landline business as well<sup>11</sup>.

And consumers didn't just get more choice and a better variety of products and services to choose from. The productivity of each sector improved dramatically too, and much of the value which was released went to consumers in the form of keener pricing, better quality products and more focused customer service – better value for money, in other words<sup>12</sup>. As Professor Littlechild points out, this explosion of competition '*provided an opportunity for others to challenge the thinking and practices of the incumbent companies. The expectation – which proved correct – was that these changed arrangements would lead to lower costs, more efficient*

<sup>7</sup> With the recent (and hopefully temporary) exception of the beef industry

<sup>8</sup> All of which are at or near the top of the same EU Consumer Markets Scoreboard that ranked utilities so poorly

<sup>9</sup> 'Retail Price Index minus x%' meant regulated prices went up by less than inflation each year.

<sup>10</sup> Littlechild, 'Regulation, Over-Regulation and Deregulation' CRI lecture at the Royal Society, Nov 2008

<sup>11</sup> Disclosure: the author's wife is CEO of one of those competitors.

<sup>12</sup> Maher & Wise 2005



*investment programmes, more innovation, and in general greater responsiveness to customers<sup>13</sup>.*

### 2.2.3 .....And A Disappointing Middle Age

But after these initial – and very substantial – gains, consumers saw much slower progress. In some markets it stalled completely. The political and regulatory regime, which had been at the forefront of liberalising the utilities markets and giving consumers undreamt-of choice and variety, introduced innovations and reforms more slowly if at all. The water industry has remained almost completely static<sup>14</sup> for 20 years, merely replacing public water boards with local private monopolies instead. Rail franchises were deliberately designed to create monopoly providers on each section of track, making consumer choice almost impossible.

Even where consumers have a broader range of companies to choose between, progress has slowed down. Energy companies have offered a huge variety of different tariffs for gas and electricity, but consumers have become suspicious rather than empowered because the small print makes reliable comparisons hard. New entrants have found it hard to win customers in retail banking, where the ‘big five’ still have more than 70% market share, or in energy where the ‘big six’ have over 95%. Only in airports, telecoms and post has the momentum been maintained: BAA has now disposed of all its airports apart from Heathrow; new parcel companies have grabbed business from Royal Mail, which is about to be sold off; and the entire mobile phone industry has grown from nothing in 20 years too.

The initial strong improvements in productivity have probably stalled as well. Reliable figures are hard to find, but very few people are arguing that consumer value for money has improved. Ofgem recently complained that energy sector productivity hadn’t improved sufficiently, and was told – rather tartly – by the firms it regulates that it had, but the benefits had been absorbed by Ofgem’s spiralling compliance and regulatory costs before they could be passed on to the customer. For whatever reason, few consumer groups, or utility customers, would argue that they are getting better value for money today than a decade ago.

## 2.3 We Can’t Go On Like This

The impact of slow progress, high prices and poor customer service isn’t just felt in large numbers of unhappy customers (although that should count as a major issue in its own right for any sensible firm’s management and staff). It has more fundamental effects too:

- While everybody suffers when the cost of day-to-day essentials like heating and water represent such poor value for money, vulnerable and less well-off families are hit hardest. Households containing people who are unemployed, sick or disabled, or pensioners will inevitably bear the brunt of the problems, feeling the practical effects of these

<sup>13</sup> Littlechild, CRI lecture Nov 2008

<sup>14</sup> Apart from in Scotland – see section 4.3 ‘Opening More of the Utility Markets to Competition’ below

shortcomings most severely. This makes a bad situation worse, by making it unfair as well.

- Britain's prospects for economic growth and commercial dynamism will be held back by high prices and poor value in fundamental products like energy, water and transportation too. This creates a very significant deadweight cost on our economy; if we could reduce Britain's overall cost of living to match the OECD average, our GDP would rise by an extra 15% over 10 years<sup>15</sup>.

Clearly, this poor level of performance isn't good enough. Our utility industries have had 25 years to make the transition from state-run bureaucracies to normal companies. By now they should be selling products that offer the same variety of choices, quality and value for money which we expect from everything else in our lives. But after an extremely promising start, which proves there's nothing inherently impossible about the challenge, they failed to complete the journey and have been disappointing their customers ever since.

## 2.4 What Went Wrong?

This section will identify the underlying causes of these problems, and then later chapters will contain proposals to put things right.

### 2.4.1 It's Not The Products

There's no inbuilt reason why utility products and services should be inherently worse than other products and services we buy every day, like food, clothes or magazines, where customer satisfaction is much higher. There's nothing intrinsically more difficult about providing a utility than these other essentials. Some may even be simpler and easier.

Equally, if something fundamental about utility products and services had changed at the same time as progress stalled, it might explain the change. But most of our utilities are still selling very similar products and services as they were 25 years ago – electricity, gas, rail travel and bank current accounts would still look pretty familiar to a time-traveller from the 1970s or '80s – and the areas where changes have been more significant, like mobile and smartphones, perform no worse (and sometimes much better) in customer satisfaction or value for money than the slow-moving ones too.

### 2.4.2 Or The People

Nor is there any necessary reason why utility companies should be less well run or organised than other industries either. They have access to the same pool of talent and training as other industries, and can motivate their staff using the same management techniques and incentives as any other firm. And there was no dramatic deterioration in the level or ability of the staff which utility companies were hiring, either before, during or after the period when progress stalled.

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<sup>15</sup> Centre For Economic & Business Research, Gresham Lecture, Jan 2013.

### 2.4.3 It's The Way They Were – And Are – Regulated

The common factor linking our poor-performing utility industries is the way they have been – and still are – regulated. Perhaps because most of them (with the exception of retail banking) started off as state-run bureaucracies before they were privatised 25 years ago, or because all of them contain at least one network monopoly, they are regulated differently, as well as more heavily, than the other, more successful sectors selling day-to-day essentials (like food or clothing). Unlike any other industries, each one has a sector-specific 'economic regulator' with a familiar name like Ofgem, Ofwat or Ofcom.

Even more significantly, these economic regulators changed the way they behaved at around the same time that progress stalled in these industries. Progressively during the Blair/Brown government, the utility sector regulators were pushed and pressured by their political masters to soften their initial, impressive liberalising zeal and switch to a more interventionist and rules-based approach which they have been using ever since. For example in the water industry Ofwat's proposals for more open markets with a broader range of consumer choice were ignored; in rail the train franchises were redesigned by John (now Lord) Prescott as local monopolies giving travellers very little choice; or in airports the Civil Aviation Authority's recommendation to end price regulation at Stansted was refused by Labour Ministers.

The result of all this extra political and bureaucratic intervention was that companies faced higher costs – which they promptly passed on to consumers in the form of higher prices – and that they started to pay more attention to pleasing regulators and politicians than customers. Unsurprisingly, their customers noticed they'd been given a back seat and got progressively less happy. The next chapter examines what went wrong in more detail.

### 3. Understanding The Regulators, And How They Changed For The Worse

#### 3.1 Who Are The Utility Regulators?

All the utilities are overseen by economic regulators that have been responsible for each sector since the state-run bureaucracies were broken up. Many have been given extra responsibilities over time – often much wider than purely economic regulation – so the current landscape looks like this:

- Ofgem’s predecessors were created after privatisation in 1986 (Gas) and 1989 (Electricity). It is also responsible for ensuring the country’s energy supplies are environmentally sustainable and secure.
- Ofwat was born in 1989 to control the local monopoly of supply in each watershed, as private sector firms took over the former Water Boards.
- The Office of the Rail Regulator (ORR)’s predecessor arrived in 1993 to regulate Railtrack (now Network Rail), the Train Operating Companies (TOCs) and Rolling Stock Operating Companies (ROSCOs). In 2004 it gained responsibility for railway health and safety too.
- The Civil Aviation Authority (CAA) was established in 1972, but effectively became an economic regulator when British Airports Authority (BAA) was privatised in 1986. It retains economic regulatory responsibility for Britain’s only significant hub airport (Heathrow), plus Stansted and Gatwick, and for all aspects of air safety including air traffic control, pilots, airlines, plane manufacturers and airports.
- Ofcom’s predecessor, Oftel, was established in 1984 when British Telecom was sold. It now covers all aspects of telecoms, including mobile and broadband. It is also the content regulator for broadcast media (TV and radio except for the BBC), and recently took responsibility for postal services too.
- The Financial Services Authority (FSA) had multiple predecessor regulators (TSA, FIMBRA, LAUTRO etc) which were set up in 1986 in the wake of Big Bang, before being merged into FSA in 2000 and now divided again into a consumer watchdog, the Financial Conduct Authority (FCA) and a systemic risk regulator, the Prudential Regulatory Authority (PRA). Uniquely amongst the economic regulators, controlling a privatised monopoly was not the reason why the FSA or its predecessors were created; they were primarily set up to prevent consumer rip-offs such as pensions mis-selling instead.



### 3.2 Three Shared Responsibilities.....

Even though the economic regulators were all created at different times, and have acquired widely different powers and responsibilities since they were created in the 1980s and '90s, they nonetheless share the same three broad areas of responsibility:

#### 3.2.1 Regulating Network Monopolies

All the economic regulators have responsibility for one or more monopolies in their sectors, where network effects give an ever-bigger advantage to the largest provider. This means smaller firms find it progressively harder and harder to compete, creating a natural tendency towards monopoly. Examples include securities exchanges and financial clearing houses, hub airports, fixed line telecoms and social networks on the web. The problem is that, if the monopoly is broken up, consumers suffer as the economies of scale are destroyed and prices rise or quality falls (or both).

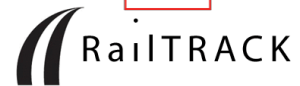
- In the energy sector, the local electricity and gas distribution grids remain network monopolies in each area.



- In water, the water and sewage pipe networks form a network monopoly in each watershed



- In air travel there are two network monopolies: Britain's only significant hub airport – Heathrow – is owned by BAA (which would argue that their monopoly is rather limited and weak, due to competition from continental hubs like Paris and Schiphol); and the air traffic control system is jointly owned by airlines, staff and Government.
- In fixed line telecoms BT Openreach owns the 'local loop' between the exchange and customer premises, which forms a network monopoly. And in mobile telecoms, call termination charges create a (smaller) opportunity for monopoly behaviour too.
- In postal services the 'last mile' of delivery to each customer's front door forms a network monopoly.
- In rail, Railtrack (now Network Rail) owns the network monopoly of the rail network.
- In High Street banking the sector became highly concentrated during the emergency bailouts and rescues of the 1998 financial crisis, so the largest firms are being forced to slim down to prevent monopoly behaviour. But the network monopolies are different: they are London's securities exchanges and the interbank payments and settlement systems, where network effects are very significant but where (broadly) equal access by member firms reduces the need for regulation. They are, as a result, a long-standing and successful example of how well-designed ownership and governance can reduce the need for economic regulation, even where a network monopoly is strong.



### 3.2.2 Regulating Potentially Competitive Businesses

Apart from the network monopolies in each industry the economic regulators also act as the Competition Authority for all the other 'normal' (ie competitive or potentially competitive) areas in their sectors too. These can be very significant indeed, and are often at least as big as – or even larger than – the network monopoly itself:

- In the energy sector, the electricity generators, gas shippers and retail energy supply companies are not network monopolies, and their combined size is bigger<sup>16</sup> than National Grid and the local electricity and gas distribution companies, which are.
- The water industry's resources (ie the rivers, reservoirs and boreholes which are the original sources of supply for all our water) are not network monopolies, and nor are water and sewage treatment facilities. It's hard to find accurate numbers because the industry is still structured like the original Water Boards, as vertically integrated companies in each watershed. But nonetheless it's clear that these potentially competitive parts of the industry are large and valuable relative to the network monopoly of water and sewage pipes systems.

<sup>16</sup> 68% of the gas value chain, 58% of electricity. Ofgem factsheet 98 'Household Energy Bills Explained Jan 2013.

- In rail the rest of the industry – the Train Operating Companies (TOCs) and Rolling Stock Operating Companies (ROSCOs) – is collectively larger than the track monopoly, represented by Network Rail.
- In banking, the revenues from the network monopolies of the securities exchanges and money transfer and payment systems are tiny compared to the rest of the sector.
- Heathrow only accounts for 1/3<sup>rd</sup> of UK air passengers.
- In telecoms BT Openreach is far smaller than the combined rest of the sector, which includes the rest of BT and every other fixed line telecoms firm as well.
- In postal services the business of sorting and shipping post is not a network monopoly, and represents a very significant part of the industry's value chain relative to the network monopoly in the last mile of delivery.

It's worth remembering that the network monopolies are often cited as the reason why the utilities sectors are different from the rest of Britain's economy, and why separate economic regulators are needed to deal with them. But it's clear from this analysis that the competitive (or potentially competitive) consumer markets in each utility sector are often larger and more economically important than the network monopolies. So even if the network monopolies need a different approach (this is considered in section 5.3 'Residual Regulation Of Network Monopolies' below) it shouldn't determine the approach that is applied to the rest of the sector. Otherwise the tail would be wagging the dog.

### 3.2.3 Regulating Other Things

Many of the utility regulators have acquired other responsibilities over time – such as CAA's oversight of air safety, or Ofcom's role as a content regulator for broadcast media – which are undoubtedly important, but which have little to do with economic regulation. These responsibilities are, accordingly, largely outside the scope of this paper, apart from the structural question of whether these different types of regulatory activity should be combined in individual sector regulators or separated out entirely. This issue is considered in more detail in section 5.4 'Restructuring Economic Regulation' below.

## 3.3 .....And Two Competing Models

It's noticeable that the competition authorities which handle the rest of Britain's economy (currently the OFT and Competition Commission, which are soon to be merged into the Competition & Markets Authority) look very different from the economic regulators which cover the utility sectors:

- They have narrower, more reactive ('ex post') legal powers than the economic regulators, which are equipped with upfront ('ex ante') powers that allow them to impose – often very detailed – conditions on firms in their industry. This casts OFT as a police force which will not investigate or intervene unless it sees evidence of anti-competitive behaviour or consumer rip-offs, whereas the economic regulators



behave like health and safety specialists inspecting factories to spot problems before they cause an accident instead.

- They are substantially smaller and cheaper than the economic regulators. In 2011 OFT cost £58 million, whereas Ofgem alone cost £62 million in the same year.
- When they find a market with weak competition or consumer rip-offs, they are more likely to introduce structural reforms rather than proposing fresh regulations instead.
- They are buttressed in some sectors by voluntary or self-imposed industry codes, covering everything from professional standards of behaviour, to advertising standards and standard items of cover in insurance contracts. Usually these schemes reduce the need for official regulation by ensuring that a particular sector's staff and products all meet a certain minimum standard, protecting customers and raising consumer confidence in an entire industry.

### 3.3.1 The 'Big Consumer' Model

The reason for these differences is that, apart from the utility sectors, the rest of Britain's economy puts consumers, rather than regulators, in the driving seat. In most markets – whether it's cars, coffee or cornflakes – all we consumers need is a basic framework of rights (e.g. preventing fraud or ensuring products are fit for purpose and safe to use), and legal redress so we can enforce them if required. Providing we are properly informed so we know what we're buying, can readily compare and understand the competing offers from different suppliers, and switch from one to another quickly and easily, we are well capable – and equipped – to take care of ourselves.

This approach can be summarised as the 'big consumer' model and, given the far higher levels of customer satisfaction with the products and services provided by companies in the other 80+% of Britain's economy apart from the utilities sectors, it clearly works pretty well. As a result, it ought to be the obvious answer for most of Britain's utility markets too. The only caveat might be the network monopolies which, although they only form part of each utility industry, may need stronger residual or long term regulation to protect consumers from being abused (see section 5.3 'Residual Regulation of Network Monopolies' below).

### 3.3.2 The 'Big Regulator' Model

In contrast, the economic regulators take a different approach. Their range of 'ex-ante' legal powers gives them a wider range of regulatory options and, as a result, they are more likely to use them instead of boosting consumer power through structural market reforms as a result. The result is that consumers take a back seat, and the regulator takes charge. This is the 'Big Regulator' model, rather than 'Big Consumer' instead.

Given the dramatically worse results which the Big Regulator approach has delivered, it's worth considering why the last Government introduced and then persevered with it, and why it is now very difficult to change. Having switched to the

Big Regulator approach, there are some powerful forces which make it very hard to go back:

- The seductive temptations of upfront ('ex ante') regulatory powers. Because it is much easier and quicker to create license conditions than to design and execute complex structural market reforms, economic regulators and politicians will always be more tempted to take the easy route than ordinary competition authorities with predominantly 'ex post' powers. And having convenient, easily-used 'ex ante' powers doesn't just substitute one type of regulatory intervention for another; it makes it much more likely that politicians and regulators will intervene more often as well.
- It creates a culture of regulatory permission-seeking amongst utility firms, because they don't want to make decisions or investments which may be unpicked by regulators afterwards; and of political complaining amongst consumers, because an economic regulator has more powers to intervene than in other industries. And the more an economic regulator intervenes in its sector, the more it makes sense for firms to get decisions pre-approved and for consumers to complain, triggering an ever-increasing spiral of demand for its services over time. This makes the 'Big Regulator' model a habit that becomes steadily harder and harder for everyone who's involved – including consumers, companies, politicians and the regulators themselves – to kick.
- Regulators don't always have the necessary legal powers to force through the kinds of structural changes which are needed to reform the markets properly. And if they do, it isn't always matched by the extremely high levels of institutional and political persistence and determination which are required to overcome the cultural obstacles described above.
- The (incorrect) assumption that, because economic regulators were originally created to control network monopolies in one part of an industry, competitive reforms are impossible in all other areas too. As an example, water companies have been awarded a single vertically-integrated license to run all the water services in each particular watershed, bundling the local pipe monopoly in with activities where normal competition could be achieved, like upstream provision.

### 3.4 Why The 'Big Regulator' Model Doesn't Work

The poor performance and dreadful consumer reactions to the utilities companies haven't just happened by chance. They are a direct result of the 'Big Regulator' model, which has some serious and fundamental inbuilt shortcomings compared to the alternative 'Big Consumer' approach.

#### 3.4.1 Regulation Costs A Lot.....

Regulation imposes very significant costs on the firms and organisations that have to comply with it. The British Chambers of Commerce Burdens Barometer put the total cost of regulation for British businesses between 1998 and 2010 at £88.3bn, using Government official figures for the impact of new laws. Specifically for the utilities, the cost of complying with Ofgem's price control reviews has soared from a one-year

process requiring 250 pages from regulated companies in 1995 to a three-year process with 2000 pages in 2005<sup>17</sup>. The burden of Ofwat's equivalent water review also increased tenfold between 2000 and 2010<sup>18</sup>.

The cost of running the economic regulators themselves has grown steadily too. For example<sup>19</sup>; in 1996 there were 2,689 people working in the telecoms sector for every Ofcom regulator, by 2010 there were just 515; in banking the figures were 1,050 staff per regulator in 1997, but only 434 by 2009; in energy there were 938 staff per regulator in 1993 and 351 by 2010.

These costs are, ultimately, fed through to consumers who end up paying for them one way or another, and they also create a permanent dead weight on British businesses, making them less nimble and entrepreneurial, and thus slowing down economic growth at a time when the country can least afford it.

### 3.4.2 ...Makes Firms Slower And Less Customer Focused....

The culture of regulatory permission-seeking which is inherent in the 'Big Regulator' approach (see section 3.3.2 'The Big Regulator Model' above) encourages utility firms to become more regulator-focused than customer-focused. It leads them to spend more time and resources on lobbying, replaces the usual direct relationships between firms and their customers with a centralised regulatory intermediary instead, and slows decision-making wherever regulatory approval needs to be negotiated too. The result is an entire industry of ponderous, slow-moving organisations which are more focused on pleasing their regulator than delighting their customers.



### 3.4.3 ...Is Usually Out Of Date.....

All regulations get out of date as disruptive technologies or new ways of working are launched which transform the industries they cover. It can take several years for regulators to understand the emerging implications of new developments in the industries they cover, and then several more to gather a sufficiently robust evidence base to underpin a case for change and undertake any necessary consultations and other scrutiny to alter the rules. At best this creates an expensive and cumbersome millstone to hold back slow-moving industries where technological change is limited. At worst, in fast-moving industries it shuts out valuable new technologies, limiting variety and creating a monoculture where consumers either miss out entirely, or only reap benefits from new products or technologies many years later once the incumbents are ready to roll them out at their own pace and cost.

<sup>17</sup> Littlechild, Regulation & Customer Engagement, Dec 2011 p3

<sup>18</sup> David Gray, Utility Week 9<sup>th</sup> Feb 2011; Tony Balance, RPI Conference, Oxford Sept 2011

<sup>19</sup> Figures provided by House of Commons Library, using company reports, regulator reports & ONS data

### 3.4.4 .....And Wrong.....

Regulations are economically inefficient compared to competition. Even the best economic regulators cannot know enough about what different groups of consumers really want, or how to deliver it for them. That knowledge is widely dispersed across hundreds – perhaps thousands – of industry suppliers and millions of customers and cannot be collected in the mind of a single entity, no matter how intelligent or well-resourced it may be. Regulators will, therefore, inevitably make mistakes which, because they apply across entire industries in markets often worth billions of pounds in sales and profits, create very high opportunity costs for utility firms and detrimental impacts on millions of consumers every year.

### 3.4.5 .....Or Even Biased

Regulations – and regulators – are prone to capture<sup>20</sup> from both producers and consumer groups because, even if an industry has top-quality regulatory and political leadership, the political process of changing regulations is always vulnerable to lobbying.

On one side, incumbent producers have plenty to lose from a disruptive challenger. They will, naturally but – from the consumer's point of view – unacceptably, tend to argue for regulations which make things easier for them and harder for challengers. This risk is, inevitably, much higher for sectors like the utilities where the level of regulation – and so the potential economic gains or losses – is higher than normal. And even where regulators are able to resist producer capture over long periods, the fact that incumbent companies still find it commercially rational to spend significant resources on political lobbyists (relative to their consumer marketing budgets) shows that the risk is always present, and where they perceive value can be gained or lost.

Equally, the rise of powerful consumer lobbying organisations has increased the risk of capture from the other side of the debate too. But consumer groups aren't immune to temptations or bias themselves; as lobbying organisations with political power, some will have wider political or other agendas which lead them to interpret consumer wishes through a particular prism. Others may only represent a particular section of deep-pocketed stakeholders who happen to be their members, leaving others to become marginalised or even discriminated against. So even though consumer groups are helpful contributors to a balanced debate, they add to the overall level of lobbying and potential for bias rather than reducing it. The fundamental problem of the Big Regulator model – that higher levels of political and regulatory intervention creates bigger opportunities for economic gains or losses from lobbying – still remains.

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<sup>20</sup> E.g. Oftel was widely criticised as having been 'captured' by BT before Ofcom was established in 2002 and 2003

## 4. An Alternative Approach: Consumer-Friendly Reforms

So the ‘Big Regulator’ approach is expensive, slow, economically inefficient and filled with errors, and vulnerable to influence by entrenched incumbents. As a result competition<sup>21</sup> authorities<sup>22</sup> and academic economists have usually concluded that competition is a far more accurate mechanism for discovering consumers’ needs<sup>23</sup>, and more efficient and effective at satisfying them cheaply too<sup>24</sup>. This approach was elegantly summarised by Professor Stephen Littlechild in his original proposals for preventing consumers from being ripped off after British Telecom was privatised.

*‘Competition is indisputably the most effective means – perhaps ultimately the only means – of protecting consumers against monopoly power. Regulation is essentially a means of preventing the worst excesses of monopoly power; it is not a substitute for competition. It is a means of holding the fort until competition arrives’<sup>25</sup>.*

The implications of this are profound. In the past, the excuse for stronger or heavier regulation has been that competition is weak in a particular sector, or that a specific market isn’t functioning perfectly. And since the real world rarely works exactly as theoretical economic models say it should, that has made it comparatively easy to justify more rules. But, it turns out, the best and most sustainable solution is to strengthen competition by introducing reforms which put consumers in charge, equipping them to make informed choices between vigorously competing suppliers, rather than attempting to impose a central solution through regulation instead. Regulation should be a last resort; not the first tool out of the box.



But if regulation is the last resort, what should we be considering instead? There are several broad families of reform which, while they will inevitably need to be applied in different proportions to each industry – the inherent variations in products, technologies, degree of existing competition and legal powers underpinning each regulator, mean applying a standardised programme would be disastrous – nonetheless provide a useful outline of the kinds of changes which could be applied to put consumers back in charge.

<sup>21</sup> Sir Derek Morris, former Chairman of the Competition Commission, ‘Dominant Firm Behaviour under UK Competition Law’, 2003

<sup>22</sup> Also Peter Freeman, another Chairman of the Competition Commission, ‘Investigating Markets and Promoting Competition: the Competition Commission’s Role in UK Competition Enforcement’ Oct 2007

<sup>23</sup> Hayek, Competition as a discovery procedure 1978.

<sup>24</sup> Kirzner, Competition & Entrepreneurship 1973

<sup>25</sup> Littlechild, The Regulation of British Telecommunications, 1983

#### 4.1 Making Complicated Products Easier To Understand

This example doesn't apply to all the utilities, but is particularly relevant to the financial services and energy sectors. As consumers, when we are faced with impenetrable small print in contracts for mortgages and endowment policies, or forests of different tariffs for gas and electricity, we become uncertain whether we're really getting what we need or want. Complexity makes comparisons harder, because it's difficult to be sure whether switching to an alternative would be better or worse. So people tend to stick with the status quo, which protects established incumbents and makes it harder for innovative new firms to show they're offering better value.

A common solution is for the industry to install a labelling system which provides a simple, clear and accurate summary of the complicated small print. This dispels the fog of uncertainty and allows consumers to compare products confidently. Current examples include the 'APR' percentage rate which allows borrowers to compare the cost of loans with different terms and structures<sup>26</sup>. Equally, Ofgem's current market reform proposals include a new Tariff Comparison rate: a 'common currency' to allow customers to compare tariffs across the market, and a new improved annual statement with all the personalised information a consumer needs to engage in the market<sup>27</sup>.



An alternative, and more fundamental, solution is for an industry to agree a minimum common set of standards or features which all suppliers will include in their products. The Advertising Standards Agency has long enforced such an industry code and, elsewhere, household insurance policies typically include common types of cover (such as flood risks<sup>28</sup>) on the same basis. Done properly, this can reassure consumers that a particular product won't have nasty surprises lurking in the small print and improve consumer confidence in an entire sector.

#### 4.2 Making It Simpler & More Convenient To Switch Suppliers

Most of us expect it to be more complex, slow and stressful to change a bank current account, or switch to a new gas, electricity or broadband supplier, than, for example, choosing a different insurer for our cars. These difficulties – whether they're real or imagined – create friction costs that make it harder for new competitors to lure customers away from the established firms, even when they're offering better value. The result is 'sticky' customers who only switch suppliers infrequently. As the graph below<sup>29</sup> shows, customers in the utility sectors are less likely to switch than those in more open

<sup>26</sup> There are calls for details of the APR calculation to be improved, but the central principle remains clear.

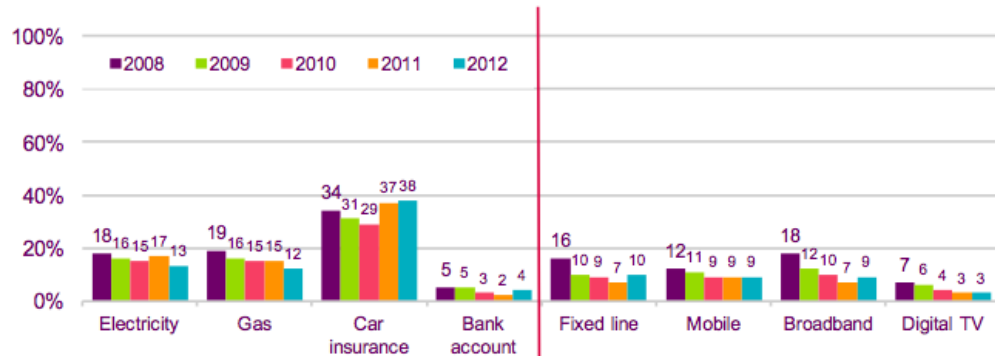
<sup>27</sup> Ofgem Retail Market Review – Updated Domestic proposals, Oct 2012 pg 8

<sup>28</sup> Although this may be about to change

<sup>29</sup> Ofcom

and competitive markets like car insurance, and the trend over the last four years is, if anything, for things to get worse.

**Figure 116 Proportion of customers who have switched communications and utilities suppliers in the last 12 months**



The answer is to improve the switching process, to remove all or most of the friction. For example, 43% of us say we would be more likely to switch our bank accounts if we could keep the same account number (and hence move all standing orders, direct debits etc with minimal fuss) , compared to 2%-5% of us who actually do so under the current system<sup>30</sup>. The Government and the Payments Council have recently announced proposals<sup>31</sup> to improve the process significantly as a result.

Simple and effective switching processes typically share some common features:

- They are free to the consumer, so incumbent firms can't make it expensive to switch to a new supplier. Long term contracts may cause problems here, because locking people in creates a legal barrier to switching, but they can also provide certainty and the possibility of locking in lower rates too.
- They are led and managed by the new supplier rather than the incumbent, since they have the greatest incentive to solve any problems which may arise during the transfer.
- They require little further effort or contact from a customer once they have decided to switch, otherwise incumbent firms will be able to make the process too time-consuming, or to persuade them to stay after all.
- They happen quickly – in a few days at most, rather than dragging on for weeks – and service isn't interrupted for the consumer during the process. Switching times for electricity customers in parts of Australia<sup>32</sup>, where the entire process takes a few days – and sometimes only hours with smart meters – are dramatically better than the UK, where things take much longer. And 56% of UK customers switching their broadband provider found the process took at least a week to complete, according to Which?<sup>33</sup>

<sup>30</sup> Which?

<sup>31</sup> Speech by Rt Hon George Osborne MP, Payments Council announcement, both Feb 2013

<sup>32</sup> Victoria and South Australia

<sup>33</sup> Which? 2012 Broadband switching survey.



If these outcomes are achieved – which can be technically demanding in some industries – then incumbent firms will have to work much harder to retain their customers, and offer better deals to prevent them from being tempted away by innovative new firms.

### 4.3 Opening More Of The Utility Markets To Competition

Most of the utility markets already offer a choice of suppliers but, in a few areas, competition remains legally limited or forbidden. The principle examples are:

- The water industry, where companies have been awarded a single vertically-integrated license to run all the water services in their area, bundling the local pipe monopoly in with activities where competition could be achieved, like upstream provision.
- Airports, where loosening price controls on the new owners of Stansted or Gatwick should allow them to compete more strongly once they aren't owned by BAA.
- Rail, where the franchise system awards a de facto monopoly over all services on a particular set of routes.

In these cases, the obvious answer is to give consumers the kind of choice of products and variety of suppliers which they take for granted elsewhere, by opening more of these markets to competition. This should force monopolists to become significantly more efficient, cutting unproductive costs which are currently weighing down Britain's economy and focusing them on delivering what consumers want instead.



As a recent example of this approach, the Scottish retail water market was unbundled in 2008, and the benefits to Scottish commercial water consumers are assessed at £138m so far, with a projected total of £300m in time. The potential benefits of extending this approach to England and Wales are estimated at £2.5bn.<sup>34</sup>

The only complication to this approach is likely to be in rail, where the rail companies will argue that their monopoly returns are necessary to reduce the level of taxpayer subsidy they receive for running their franchise services. The counter argument is that the fastest – and probably only – reliable way to remove the inefficiencies which McNulty identified, and to realise the significant cost savings which would result, is through stronger competition. The challenge would then be to modify the franchise system to ensure taxpayers and rail users capture as much as possible of the newly-released value, rather than letting it all go to shareholders of the rail firms instead.

### 4.4 Making Unfamiliar Products Less Scary

This problem is most visible in financial services, which sells things like pensions and life insurance that most of us only buy once or twice in a lifetime, and where the benefits can't be used for years. These products require people to work out what they're going to need a long time in the future, and then take a single decision for a potentially life-changing amount of money. Unlike the familiar products we buy every week in the

<sup>34</sup> Scottish Water Commission, Oxera Agenda report May 2011

supermarket, there's very little opportunity to sample different brands and learn which one is best in advance. And if we choose wrongly, we will have to live with the consequences for many years, with little time or opportunity at the end of our lives to put things right.

This combination of limited experience and high stakes makes us all less well informed and more nervous than normal about the products we're about to buy. It's a different kind of problem for competition regulators, because it isn't necessarily caused by weak competition between suppliers, but the negative effects of poor decisions – or of scams like mis-selling – are nonetheless severe.

The traditional and long-established solution is for a self-imposed industry code to guarantee professional standards of conduct from staff when they sell and explain complex, high-stakes products to their customers. Where these work well – for example in law or medicine – consumers trust that they won't be ripped off and feel they can make a safe, well-informed choice. Where they don't work well – for example in banking – customer trust and satisfaction levels are extremely low, and official regulators have to step in (usually expensively and less effectively, as the banking industry showed before 2008) to fill the void. Typically, well-designed professional schemes keep their own rules about standards of conduct up to date, because official regulators are less expert and slower (although they may also have external accreditation of the results so they don't go soft), and have a heavyweight professional body with enough teeth to discipline rule-breakers severely.

An alternative and, until recently, less efficient answer is for people to find the information they need about unfamiliar and scary products from other customers (traditionally their friends and relations) who've already bought them. This kind of anecdotal information isn't very reliable if it only comes from a small and probably unrepresentative sample of people, but internet consumer forums now provide a much larger and more reliable pool of customer feedback, and have become far more trusted and important as a result. For example, buying a holiday to an unfamiliar country used to cause problems because there was no way to know in advance whether the information and pictures in the brochure would match reality when you arrived. But now it illustrates the enormously improved consumer information provided by websites – whether they're run by travel companies, the destination itself, or by customer feedback firms like TripAdvisor – which give everyone a much better chance of finding the right product than ever before. And this improvement applies to most other sectors of our economy too; a major source of consumer problems and weak competition has been, if not solved entirely, at least dramatically reduced in size and scope.



#### 4.5 Separating Network Ownership From Control

This approach is a specialised and specific solution to the problems created by network monopolies, where well-designed ownership and governance structures have proved successful.

The reformed structures usually involve separating either ownership or control of the network from any of its users, so every user has equal access to the network and can compete on a level playing field. Securities exchanges are a good illustration, where powerful network effects give the largest incumbent exchange huge advantages in cost and trading liquidity, but where competition between banks and brokers is strong because there is equal access for all the firms offering services through it. Mutualising ownership or control of the network can deliver similar effects in some cases, and many securities exchanges were originally owned by the firms using them for precisely this reason.

These types of reform can't always provide a complete or perfect answer because, even where the network and its users are completely separated, the network's owners may still be able to ramp up prices anyway. As an example, electricity companies and their customers would be extremely concerned if National Grid could charge what it liked to transmit electricity. But with the right governance a network owner's power to increase prices can still be reduced, even if it can't be eliminated entirely; either by mutual ownership, so the users treat the network as a shared collective cost rather than a profit opportunity, although co-ordination problems between owners have led many industries outside financial services (such as energy) to conclude this has limitations; or through not-for-profit status (as distinct from public ownership), although incentives for efficiencies and cost reduction can be weak with the wrong corporate culture here; or wherever the network monopoly isn't perfect (for example securities exchanges have very strong network effects, but big firms can still decide to list their stock in New York as well as London). Because they aren't regulatory solutions, these options avoid or mitigate many of the problems described in section 3.4 'Why The 'Big Regulator Model Doesn't Work' above, and can minimise if not eliminate the need for a residual level of economic regulation as a result.

Even where residual regulation is still needed, it's still possible to mimic a competitive market in some cases if regulators make it clear they will sign off any even-handed deal the network monopoly owner can negotiate with the users. This approach has been used by, for example, CAA to encourage a deal to be reached between the airport operators and the airlines, backed by the sanction that either side can still use a full-scale regulatory appeal process if a satisfactory deal isn't struck.

#### 4.6 Implications For Each Utility Sector

These potential market reforms won't apply equally to every utility sector, of course. The different products and technologies in each industry, and varying levels of competitive reforms which have been tried in each one over the last 25 years, mean they will all start from different places. Calculating the potential economic value of each type of reform in

every utility market would probably require an entire additional policy paper for each regulated industry but, in summary, the principle opportunities in each sector will be:

- **Energy.** The proposed new Tariff Comparison mechanism, if it is as easy to understand as APR on loans, should transform customers' ability to compare competing tariffs and products quickly and transparently, so they can understand which one is best for them. A simpler and faster switching mechanism would then allow them to move to the best supplier with minimum effort or fuss. If this was done, consumers would quickly drive down prices and improve service by voting with their feet and switching to whichever electricity or gas company was offering the most competitive deals. There may also be an opportunity to add value through stronger measures to ensure cheaper, equal access for the energy firms which use the network monopolies in the gas and electricity distribution grids to supply their customers.
- **Water.** Giving consumers a free choice of who supplies their water, and who treats their sewage, and making it quick and easy to switch to another firm if they're offering a more competitive deal, should drive down prices and improve efficiency substantially. As with energy, there is also an opportunity to add value by ensuring cheaper, equal access for the water and sewage firms which use the network monopolies in the local pipe grids to supply their customers.
- **Telecoms.** Much of this industry is competitive already, so the principle remaining opportunities would come from a simpler and easier switching process to allow fixed and mobile customers to move to whichever firm was offering the most competitive deal; and from ensuring cheaper, equal access to the network monopoly in BT Openreach for the broadband companies – including the rest of BT itself – which use it to supply their customers.
- **Post.** Completing the privatisation of Royal Mail will mean consumers will always have a choice of who carries their letters and parcels, which should improve efficiency and value for money dramatically. The principle remaining challenge will be to ensure continuing cheap and equal access for competing post companies – including the rest of Royal Mail itself – to the network monopoly of the 'last mile' which will deliver their letters and parcels to customers' doors.
- **Air Travel.** With the disposal of Gatwick and Stansted by BAA, the UK's airports are competing increasingly strongly with each other. The only remaining opportunities are price regulation of Stansted and Gatwick, which could now be abolished so they can compete by cutting their prices if needed; and ensuring cheap and equal access for airlines using Heathrow.
- **Rail Travel.** The rail franchising system is deliberately designed to give Train Operating Companies (TOCs) a near-monopoly on all train services in a particular area. The exceptions (for example where local commuter services operators share tracks with high speed intercity providers, or with freight trains) show that consumers could have a choice of train operators if politicians and regulators allowed it. The fastest and most effective way to strip out the (very expensive) inefficiencies identified in the McNulty report would be to allow consumers to choose the best deal from competing TOCs for their journeys. The political decision at that stage would be whether to allow customers to keep all the

benefits – in the form of cheaper fares – or whether to retain more of it for taxpayers through lower subsidies, which would require a modification of the franchise system.

- **High Street Banking.** The biggest consumer-friendly reform in this sector is already underway; increasing competition and reducing monopoly power by selling parts of the largest High Street banks' branch network to shrink them and repair their balance sheets. After that, the major opportunities will come from rebuilding consumer trust in the products they're being offered, and staff who are offering them. This will require better and clearer labelling schemes (like APR% for interest rates) for all banking products, so consumers can compare them quickly and accurately, and be sure they're selecting the most competitive option; making it simpler and easier to switch banks (mainly by moving current accounts) so customers can put uncompetitive firms under pressure by voting with their feet; and creating a strong new professional code of behaviour for bank staff, properly enforced by a professional body with teeth, to regain customer trust that they are being given honest and fair advice. Given the sector's recent history, and the very low levels of public trust it commands at present, it will probably take many years to repair the damage. But these measures, taken together, will gradually reduce the need for expensive and less-effective box-ticking regulatory compliance (which is passed on to customers through higher charges) and allow the regulators to focus on ensuring the banking system is safe and stable instead.

## 5. How Should We Deliver Consumer Reforms?

The only way to deliver these consumer reforms, and put customers back in charge, is by transforming the way these industries are regulated. The rest of this section will lay out how to achieve this.

### 5.1 Switching To The ‘Big Consumer’ Approach

As a first step, we need to convert every economic regulator from the failed ‘Big Regulator’ model to the ‘Big Consumer’ approach instead. In summary this means they must introduce permanent, structural consumer reforms so they don’t need to rely on ‘ex ante’ regulation anymore instead.

This won’t be easy. Most of the economic regulators are long-established organisations so, inevitably, each one has its own distinct history, culture and style, not to mention legislative differences in the legal powers which underpin their work. Add the inherent variations between the products and technologies of each utility industry, plus the cumulative effects of the competitive reforms which have been introduced in some sectors over the last 25 years, and it’s clear they will all start from very different places. Applying standardised reforms would be both disastrous and ineffective, so each one will need a tailored programme to move the organisation and its staff from their various different starting points to deliver the ‘Big Consumer’ model.

***To achieve this change, the Government should task the Ministers with responsibility for each economic regulator to consider how much of the sector they cover is not a network monopoly, and then to publish a tailored programme of structural consumer reforms which will reduce the need for regulation in those areas to the same level as other, competitive sectors of Britain’s economy.***

### 5.2 Reinforcing Radicalism & Locking In Change

Even with a tailored programme for each regulator, achieving the necessary changes will probably be very difficult indeed. There will be a wide range of obstacles to overcome:

- The regulators’ corporate cultures will be deeply engrained and hard to change, and the same goes for Whitehall Departments too. Some will, inevitably, work hard to convince Ministers to water down and drag out their plans for reform.
- Depending on the decisions which are taken about the regulators’ non-competitive regulatory responsibilities, and the network monopolies they cover too, they may still retain the power – and so the temptation for their political masters – to use ex-ante regulation rather than structural consumer reforms in future.
- Many – but not all – utility firms will fear consumer reforms and resist change fiercely. All the existing monopoly owners will have a natural incentive to protect the rents they have been receiving under the current system, and others may simply fear the disruption that reforms would bring.
- Changing political priorities and, at some point in future, new Governments, make it inevitable that political backing for structural reforms will wax and wane over time, even if Ministers’ initial reform plans are bold and radical.



Taken together, these obstacles demonstrate there's a real risk that the proposed reforms won't be strong enough to deliver the necessary changes in the first place; or that they won't be carried out forcefully enough; or that they will be steadily undermined by creeping re-regulation in future. These dangers can be overcome in two ways:

***To ensure they are tough and radical enough, the initial programmes of consumer reforms should be agreed by a 'star chamber' of senior Ministers. They should review and challenge the proposals of the regulators and their sponsoring Departments, and demand improvements and changes if they don't go far enough.***

***To lock in the transformation so it becomes permanent and can't be eroded or reversed in future, responsibility for delivering each reform programme, and for ongoing economic regulation of all parts of these sectors which aren't network monopolies, should be transferred from the economic regulators to Britain's normal competition authorities (OFT and the Competition Commission, soon to be merged into CMA).***

### 5.3 Residual Regulation Of Network Monopolies

The problems and limitations of the 'Big Regulator' model apply equally strongly to network monopolies as to competitive markets, so minimising or eliminating the need for residual regulation through structural reforms should be the first priority in each utility sector. But a residual level of regulation will still be needed in some cases.

***The Government should task the Ministers responsible for each economic regulator to publish a parallel programme of structural market reforms to ensure fair and equal access for companies supplying services across the remaining network monopolies, so residual regulation of the remaining network monopolies is minimised. This could, in some industries, require fundamental and radical changes to the firms which own or run the monopolies so, as before, the reform programmes will have to be agreed by a 'star chamber' of senior Ministers, who will challenge the proposals of the regulators and their sponsoring Departments, and demand changes if they don't go far enough.***

***The Government should ensure that any remaining residual regulators retain a primary duty to promote competition through market reform wherever possible, so they only consider regulation as a last resort if structural reforms aren't possible and, even then, apply regulations which mimic or promote competition wherever possible.***

***The powers and scope of any residual regulators should comprise the smallest possible core of remaining legal powers and staff required to prevent consumer problems once the programme of structural reforms is complete. Depending on how responsibility for non-competitive regulation is divided up in future (see section 5.4 'Restructuring Non-Economic Regulation' below), the star chamber should also consider whether the remaining residual regulators of all the network monopolies in the utilities sectors ought to be combined into a single, specialist institution to minimise costs and concentrate expertise, or left as separate organisations instead.***

And finally, markets evolve as technologies and consumer behaviour change over time. The result is that, no matter where the dividing line is currently drawn between the



network monopolies and the normal competitive parts of each sector, it may well move in future. *The Government should introduce a programme of regular 5-yearly competitive reviews of the remaining network monopolies, to check whether any additional areas can be converted into competitive markets if the right structural reforms are introduced, and then transferred to become the responsibility of CMA in future too.*

#### 5.4 Restructuring Non-Economic Regulation

Once each regulator's economic responsibilities have been whittled away through market reforms as outlined above, their non-economic regulatory roles will become the most important – and costly – part of their remaining activities. As a result we will need to consider whether each one should remain as part of a separate sector regulator, or be merged into another organisation if their responsibilities could be performed more efficiently or effectively elsewhere. Again, the right answer will inevitably vary for each regulator, and will partly depend on how much residual economic regulation remains to be done in each case. There will be several different factors to consider:

- **Cost savings.** Combining all the different regulators for a particular industry under one roof could create economies of scale and cost savings by merging back office operations. But in some areas this will be limited – there will have been relatively little overlap in the CAA between air traffic control and the competition team overseeing BAA's disposal of Gatwick and Stansted, for example – and alternative potential savings overlaps may also exist with regulators doing similar jobs (eg safety, competition) in different industries instead.
- **Technical expertise.** Merging the regulators for a particular industry might improve performance by providing a single focus for specialist industry knowledge and expertise, ensuring that technically complex decisions are taken with the best available analysis of their implications. However, competition decisions typically require large teams of lawyers and economists, with relatively few in-house industry engineers. As a result, these benefits may be limited for economic regulators at least.
- **Reduced regulatory burden.** A single regulator will be able to co-ordinate its activities – like regular scheduled inspection visits or information requests – to reduce duplication and expense for the firms it is regulating. However, competition authorities do relatively little of these things – for example, the OFT tends to mount legal discovery proceedings when it is searching for evidence of anticompetitive behaviour, rather than yearly visits by a trading standards inspector – so the benefits for an economic regulator are likely to be relatively small.
- **Focus.** Merging very different types of regulatory activity into a single organisation, just because they all affect the same industry, could potentially lead to some of them becoming the 'poor relation'. As an illustration of this type of problem, the decision to split FSA into two separate banking regulators was taken because a strong focus on protecting consumers of retail financial products had meant that prudential regulation of systemic risk in the banking industry wasn't given enough weight in the run-up to the financial crisis of 2008.

Given the different responsibilities and varied histories of the economic regulators, it's unlikely that the right answer to these different questions will be the same for every utility sector. But the improvements which could be delivered, in regulatory quality and value for money, are potentially significant in each case. ***The Government should task the Ministers responsible for each economic regulator to consider the four factors described above, relative to any remaining responsibility for residual economic regulation, and to make recommendations about how best to deliver the non-competition responsibilities for the sector concerned. As before, the proposals should be agreed by a 'star chamber' of senior Ministers, who will challenge the proposals of the regulators and their sponsoring Departments, and demand changes if they are insufficiently radical.***

### 5.5 Reforming Other Utility Sector Consumer Agencies

Outside the utilities sectors, a series of changes are already underway to strengthen and improve Britain's consumer agencies. They include:

- Merging Consumer Direct (previously part of OFT) into the Citizens Advice Bureau. Both these organisations are respected and leading providers of first-call consumer advice, helping people understand their rights, how to complain if they've been sold a faulty product and how to escalate more complex problems if needed.
- Strengthening local trading standards teams (often working closely with environmental health) to provide higher quality second-call consumer advice and help, taking action against more complex examples of consumer abuse by inspecting, enforcing and, where necessary, taking offenders to court. There will also be a new, stronger national Trading Standards organisation to back up local teams and deal with larger, national examples of consumer scams as well.
- Creating a new Regulated Industries Unit, plus a National Trading Standards Board (NTSB) and a Strategic Intelligence, Prevention and Enforcement Partnership (SIPEP). These new agencies are needed to plug a gap in Britain's ability to spot sectors of the economy where entire groups of consumers are losing out or being deliberately abused ('systemic consumer detriment'). Collecting, analysing and quantifying the evidence across all sectors is essential to identify, prioritise and pursue the right cases in a thorough, systematic and determined way. It needs someone to collate intelligence from local and national trading standards teams, Citizens Advice, police forces, sector ombudsmen and independent advice providers, to identify national trends, co-ordinate enforcement responses and share best practice. The new agencies should plug this gap.

These new, more powerful bodies have also absorbed the consumer agencies which had been set up to perform the same function for some of the economically regulated industries – gas, electricity and postal services – as part of Consumer Focus.

Oddly, other economically regulated industries still have separate consumer agencies which have been omitted from these changes. The agencies covering the water, telecoms, transport (both trains and planes) and retail financial services remain untouched, creating unnecessary and expensive duplication, hampering CMA's ability to identify and solve systemic consumer detriment, and meaning that similar problems are

likely to be handled inconsistently between different sectors of the economy if nothing is done.

***The Government should merge the consumer quangos which provide first-level advice and guidance in the remaining economically regulated sectors into CAB to create a single, powerful, independent and lean consumer agency covering the entire economy. The same argument applies to second-level consumer complaints, where a single consumer Ombudsman should cover the entire economy as well, and to state investigation and enforcement where the newly-expanded Trading Standards regime should handle these sectors too.***

This will mean that, for the first time, individual citizens and consumers would have a one-stop shop where they could expect the same treatment whether they are passengers on the railways, changing their gas supplier or switching to a different broadband provider. And for the economy as a whole it would allow our first ever independent and cross-sector evaluation of systemic competition problems, so supply-side reforms can be identified and delivered wherever they're needed most.