

2010

Joint Transport Research Centre

ROUND TABLE

2-3 December 2010, Paris

21

DISCUSSION PAPERS



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**EFFECTIVE REGULATORY INSTITUTIONS:
THE REGULATOR'S ROLE IN THE POLICY
PROCESS, INCLUDING ISSUES OF
REGULATORY INDEPENDENCE**

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ORGANISATION
FOR ECONOMIC
CO-OPERATION AND
DEVELOPMENT



JOINT TRANSPORT RESEARCH CENTRE

Discussion Paper No. 2010-21

Prepared for the Round Table of 2-3 December 2010 on
“Effective Regulatory Institutions: The Regulator’s Role
in the Policy Process”

**EFFECTIVE REGULATORY INSTITUTIONS: THE REGULATOR’S ROLE IN THE POLICY
PROCESS, INCLUDING ISSUES OF REGULATORY INDEPENDENCE**

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November 2010

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London, November 2010

ABSTRACT

This paper discusses three connected aspects of regulation: (1) what makes a regulatory authority effective; (2) what is the legitimate role of a regulatory authority in the making and implementation of policy, and how that role may be regarded by others, and (3) the issue of independence of regulation from undue political intervention. It argues that regulators are usually established to carry out complex technical tasks which government is unable or unwilling to do, partly because government wishes to distance itself from responsibility for some decisions, but, having invested regulatory authorities with sometimes considerable powers which are more detailed and intrusive than any possessed by government over state-owned entities or industries, political or bureaucratic impatience or intolerance of that power sometimes takes over, and undue governmental pressure or interventions follow. These interventions come about either because of regulatory failures, or because politicians wish themselves to exercise regulatory powers which they regret having transferred to regulatory authorities. Regulatory independence from political intervention and regulatory freedom from political considerations is internationally recognised as an important facet of effective economic regulation, but despite that, it can come under such severe pressure that the system will fracture, causing severe loss of confidence in the regulatory system and in the reputation of the host government for fairness and respect for the integrity of the systems of checks and balances which has been established for the protection of investment. It argues that regulatory independence is as much about regulatory behaviour and legal status.

1. INTRODUCTION

Regulation is not a dull, technocratic process carried out by a priesthood of economists, lawyers and administrators, or at least it should not be. Its role and purpose are far more important than being a mere cipher for central government decisions affecting the regulated companies or the regulated industry. Nor should a regulatory authority be treated as the external economics consultancy for government departments, with all the key decisions being taken according to political rather than economic and public interest criteria, irrespective of the legal or constitutional status of the regulator. Although regulators will often be used by politicians as lightning conductors for political blame, that is not their primary role.

Why do I begin in these defensive, somewhat agitated terms? It is because in too many respects regulatory authorities – particularly in the transport industries, probably because of the high role of public subsidy – have been treated or regarded in exactly these ways. This does real harm to the authority and integrity of the regulatory authorities, especially when they are seen to be complacent in such treatment, sometimes even complicit in it. It harms the reputation of the state in respect of the

fairness with which investment is treated, and in terms of its reputation for respecting the integrity of the institutions of the state which are – and need to be – distant from overt (or covert) political control. Pretending an institution is independent when in reality it is not can be extremely harmful. The pretence can often do more harm than an honest acknowledgement of a lack of regulatory independence.

A great deal depends on the quality of regulatory design. Mistakes in the design of a regulatory system can be very expensive, in terms of lost opportunities, weaknesses in the system which allow or even foster behavioural abuses or malfunctions on the part of industry players, the deterrence of investment, government reputation for competence and fairness, and the sheer cost in terms of money and time in putting right the mistakes, if indeed repair is even possible. Despite these materially adverse considerations, governments go on making these design mistakes and then facing criticism and worse when things go wrong, as they undoubtedly will.

This paper discusses regulation in transport industries, and its examples are mainly (but not exclusively) drawn from railways. Railways provide perhaps the starkest instances of regulatory failure, issues about effectiveness and encroachment or assault on regulatory independence.

2. PURPOSE OF REGULATION

A broad definition of regulation is any measure or intervention which seeks to change the behaviour of individuals or groups. The purpose of regulation is to achieve better outcomes than if regulation were not present.

In its essentials, economic regulation is about protecting the weak and restraining the powerful, so as to achieve economically and politically sustainable outcomes. It is about promoting and protecting investment on the one hand, and protecting the consumer and the public interest on the other hand. Both need to be achieved.

The best regulator is undoubtedly the customer, provided the customer has an effective choice. In cases of monopoly, that choice is not present. Rail infrastructure is a monopoly, and, because of the exclusivity which is conferred on passenger rail operators either de jure or de facto, it is often the case that rail services (passenger train operations) are also monopolies.

Transport regulation – like infrastructure regulation – is necessary when the state determines that the provision of transport services cannot be left entirely to the private sector. This is because:

- (a) the transport infrastructure – in most cases – will be a monopoly, and the holder of that monopoly will have an incentive and usually a tendency to abuse that position through charging excessive prices, demanding other unreasonable terms for access to the infrastructure, and providing a poor or declining quality of service, to the detriment of the users of the system and the public interest; and

- (b) transport is a critical local, regional and national service, where the price, quality and security of supply are important to the economy and consumers.

In its broadest sense, as stated, economic regulation involves government – using legislative or administrative authority - imposing controls on business, so as to achieve behaviours or outcomes which business would not otherwise attain or provide, if allowed to make all decisions itself. It is a means to an end, not an end in itself.

What matters is the safety, availability, quality, security of supply and price of transport infrastructure and transport service operations. These are functions of the levels of capital investment, the profitability of the regulated companies, service quality in its particulars, productivity gains, expansion of basic services to new customers and functioning of new and existing markets. If the regulatory system does not achieve these objectives, it would be politically unsustainable. If it fails to support commercially viable enterprises, it will be economically unsustainable. Both masters must be served, if regulation is to achieve its objective, and getting the balance right is not straightforward or simple.

According to the World Bank, the “ultimate goal is a best-practice regulatory system – a regulatory system that transparently provides investors with credible commitments and consumers with genuine protections”¹.

3. THE ROLE OF POLITICIANS

Establishing a regulator is not – and should not be – an exercise in ministerial abdication of power and responsibility. It is generally accepted that ministers should retain responsibility for broad sector policy, including public investment, the structure of the industry, taxation, subsidies and the legislative framework. Regulators should work within that policy framework, but the framework should not be altered frequently or arbitrarily. To do so would be to destabilise the integrity of the regulatory system, raise legitimate concerns on the part of industry players, and therefore raise the cost of investment and prejudice service quality and the development of the industry.

3.1. Rail-specific complexities

The regulation of railways is usually more complex than in other industries. There are two principal reasons for this:

- (a) the industry is usually in receipt of public subsidy on a long-term basis, which raises issues of political interference and possible tensions with politicians, as well as regulatory legitimacy; it can be a magnet for political incursions onto regulatory jurisdiction or independence; and
- (b) railways transport people and goods, in a safety-critical environment, using assets which, by their nature, are more vulnerable to breakdown and consequent operational disruption.

The range of regulatory instruments in the case of railways therefore usually needs to be greater than in other network industries, such as energy, water and telecommunications. Political sensibilities and sensitivities also need to be far more acute, on the parts of regulatory authorities as well as the companies operating in the railway industry. The political acuity of railway companies is developing, infant science.

3.2. What do rail regulators do?

Overall, and depending on the industry's structure and government's existing relationship with the private sector industry participants, rail regulation usually involves all or some of the following:

- (a) safety accreditation, monitoring and enforcement;
- (b) the establishment, amendment and abolition of operating and technical standards;
- (c) licensing operators of railway assets, imposing conditions concerning the stewardship of railway assets; (note that in some systems, the regulatory authority may be supervising, monitoring and enforcing a contract between the state and the private sector, rather than a licence);
- (d) compliance monitoring and enforcement of licence (or contract) obligations;
- (e) setting the structure and maximum levels of charges for the use of railway assets (infrastructure and operations, including fares);
- (f) preventing the monopoly elements from exploiting their market power to the detriment of the public interest;
- (g) determining the terms and conditions (including price and quality standards) for access to or the use of railway facilities, including stations and maintenance facilities;
- (h) the process for timetabling and capacity consumption and allocation;
- (i) the supervision of industry-wide codes which are necessary for system integrity and co-ordination, including the establishment of those codes and their development over time;
- (j) handling appeals on industry-specific issues, such as safety and technical standards, and issues concerning mandatory changes to rolling stock or fixed railway facilities (network, stations and maintenance facilities);
- (k) sometimes acting as competition authority for the industry.

The way in which these functions are regulated varies considerably from country to country, and the regulator may perform these functions on a spectrum from an advisory role to a determination and even policy-making role².

Regulators sometimes are required to participate in the renegotiation of long-term contracts between the state and the private sector. For example, the privatisation of the London Underground involved the private sector maintaining, renewing and enhancing the infrastructure, and the public

sector running trains. This was done under a 30 year contract, with re-specification by the public sector of its requirements every 7½ years. If the public and private sector parties were unable to agree on what was to be done and how much it would cost, a specialist Arbiter had been established to determine the matter according to regulatory principles. However, he could only be brought in if the parties' negotiations had broken down³.

Elsewhere in Europe, national governments enter into multi-annual financing contracts with their railway infrastructure managers. Regulators, operating under European directives, must ensure that the infrastructure managers, if operating competently and efficiently, are fairly and adequately remunerated for the services they are required to provide. This provides them with protection against the state demanding a level of services for which it is not prepared to pay the efficient price⁴.

In Great Britain, since the passage of the Railways Act 2005, the economic regulator performs a similar role, and is constrained in the level of access charges it may set by a statement of financial restraint issued by the national treasury.

3.3. Regulatory design principles

In essence, governments need to make up their minds at the outset what they want regulatory authorities to do, and how they want them to do it. In relation to the latter consideration, the degree of independence which the regulatory authorities going to have is critical. (Independence is discussed later at point 6 “independence” *et seq.*) Once these things have been established, they should not be subject to violent, abrupt or seismic changes. That is not to say that governments may never reform regulatory systems after they have first been established. On the contrary, the quality and intensity of regulation is always a matter for legitimate political attention on the part of the legislature and the executive government. Regulators are established by government with the authority of the legislature, or directly by the legislature. It would be perverse to suggest that, in relation to institutions with such considerable power over economic and safety matters, and which are usually established to operate in perpetuity, they should never change. Regulatory authorities must always change in response to developments in the industries which they are regulating, and ideally they should change themselves, using mechanisms for change established or authorised by the institutions which established the regulators in the first place⁵.

4. REGULATORY POLICY

In its simplest form, policy is what politicians do. The Oxford English Dictionary defines policy in the following way: “A principle or course of action adopted or proposed as desirable, advantageous or expedient, especially one formerly advocated by a government, political party, etc.”

But that is too simple for our purposes. Whilst it is uncontroversial that the elected representatives of the people, through their legislature and the appointed executive government, should

make overall transport policy, that is not to say that all courses of action which are considered to be advantageous to the public should be decided upon by politicians. There are many things of importance to the citizen and the community which politicians should not do, the most conspicuous and obvious being the tasks which are allocated to the judicial branch of government. Regulators are not established merely to be the obedient instruments of politicians. For the reasons given above, they are there to do things which government is unable or unsuitable to do, and which require a degree of political detachment and distance, in order to ensure that the quality of decision-making, and the criteria according to which decisions are made, can engender confidence in those likely to be affected by those decisions.

So, the question arises, what are the boundaries of regulatory policy, and when does regulatory policy intrude into political policy? It should be recognized that the boundary line may very well move according to the political climate.

Many less intellectually able politicians and bureaucrats, and some very able ones, misunderstand (sometimes deliberately) and will not tolerate the possession of real executive power in the hands of an institution which is not controlled by central government. They may know, or have had explained to them, why it is necessary for regulatory authorities to be distant from political control, and to operate according to non-political criteria, but that does not prevent them trying to seize the levers of regulatory power, or subtly and more gradually to encroach upon regulatory jurisdiction, when a stronger or more compelling political and bureaucratic motive prevails. This issue is discussed further in the section of this paper concerning independence (see point 6 “Independence” *et seq*).

However, the question where the boundary line is placed, and how that boundary may be changed over time, is a critical one for regulatory design, and therefore political policy. For example, in the UK, it was decided by the last Labour government (1997-2010) that decisions of national and regional importance on the planning and establishment of infrastructure projects, and their approval, should be delegated to an independent infrastructure planning commission, which would operate according to clear public interest criteria set out in its enabling statute, and which would make the final decision (subject to the usual challenges on judicial review grounds of legality, rationality and procedural fairness). This commission was empowered to make decisions as sensitive as the siting of nuclear power stations, and the route of a new high-speed railway. This was regarded by many politicians, including the new Conservative-LibDem coalition government (which took office in Britain in May 2010), as a step too far. There are some decisions which are so politically sensitive that it would be intolerable for them to be taken according to non-political criteria by people who are not elected. And so the infrastructure planning commission is to become a reformed, purely advisory body, with the final decision being taken by the minister. There are some things which ministers alone should decide and take responsibility for. And that is unobjectionable, as long as the rules of the game are known and understood by those likely to be affected by them. It becomes much more problematical when the rules are changed after the game has started, especially when that change is sudden, unforeseeable and significant.

When an industry is being restructured and prepared for privatisation, it is again hardly tenable that decisions on the overall structure of the industry should be taken by anyone other than the elected government. However, after privatisation, it may very well be that further restructuring, for example the breaking up of a large, unresponsive monopolist, should be taken by regulatory authorities according to economic rather than political criteria. This is what happens in the UK. Both positions are defensible, with the hands on the levers of control being dependent upon the stage of the privatisation process.

In the case of transport, where networks can be perpetually in receipt of public subsidy, these issues can become quite acute. In the UK, in industries such as water, electricity, gas and telecommunications, none of which receives overt public subsidy, the independent economic regulator's role is to determine the condition, capacity and capability of the network in question, and the intensity of use which the network is likely to face in the following five years, and then to set the user charges for those five years according to the revenue requirements which an efficient and competent infrastructure manager will reasonably require in those circumstances. In railways, exactly the same questions have to be determined by the regulatory authority. However, in the case of railways, the infrastructure manager (Railtrack, then Network Rail) had about 40 customers, namely passenger and freight train operators. In the case of the passenger operators, they in turn had contracts with the state (franchises). The franchises were not supervised by or otherwise approved by the regulator; they were direct private law contracts between the state and the private sector franchise holders, freely entered into by a sovereign government. As well as specifying in considerable (some say excessive) detail everything the passenger train operator had to do in providing commercial services to the public, the franchises contained a financial indemnity. That indemnity was given by the government to the private sector franchise operators to protect them (the franchisees) from the uncertainty about the condition of the rail network, and against any increases in infrastructure charges which may be determined by the regulator when the condition of the network, and the efficiency of the infrastructure manager, were more fully understood and made predictable. At the time of privatisation, as is the case in so many industries around the world, during the period of public ownership the state-owned railway had been compelled for political reasons to defer maintenance and renewal, and otherwise to neglect its network. After privatisation, that was not a risk which the private sector franchisees could reasonably be expected to take, and so it was decided by the government that they would not be required to do so. Instead, legitimately, the state would take that risk. Accordingly, increases in access charges would be fully indemnified by the state. This of course meant that the decisions of the regulator would flow directly through to the national treasury. The seeds of a destructive political tension were thereby sewn (see page 17, paragraphs 3-4).

In the period 1996 to 2000, it became apparent that the condition of the British national rail network was probably much worse than had been assumed at privatisation in 1996, and that it would require considerably more money if it was to be restored to a sound and sustainable operating condition. The position was complicated by the fact that the infrastructure manager, Railtrack, was politically detested by the Labour government.

In October 2000, the regulator increased Railtrack's revenue from £10 billion to £14.8 billion, and in December 2003 increased that by a further £7.4 billion, giving a final settlement of £22.2 billion. These were, of course enormous increases, and attracted a great deal of political dissatisfaction. Politicians complained bitterly that an unelected regulator was making very significant decisions about the levels of public expenditure on the railways and, by extension, the diversion of public money away from other uses such as health, education and criminal justice. This of course misunderstood the position, because the regulator was only doing what the legislature had established him to do. The fact that the state, by private law contract, had chosen to indemnify private sector companies against the consequences of the regulator's decision did not make the regulator's jurisdiction illegitimate. But that is not how it was seen. Ignoring the fact that the financial consequences of the regulator's decisions were entirely a function of contracts voluntarily entered into by a sovereign government without any participation of the regulator, government ministers and others criticised the regulator's jurisdiction, as if it had been a function of his statutory birthright instead. And so they resolved (with the assistance of the soon-to-be appointed chairman of the Office of Rail Regulation) to cut it down, and, using primary legislation (Railways Act 2005), placed a financial cap, determined by the national treasury, on the value of the contract-based indemnities. Had it not been for the (justifiable) political timidity of

the private sector companies in question, there would have been scope for a successful challenge on the grounds that the value of their private law contracts with the state was being arbitrarily reduced without the payment of adequate compensation.

This is an illustration of political intolerance of what was perceived to be the power of the regulator to make policy as to the level and application of public subsidy in the railway industry.

If it is politically objectionable for regulatory authority to have a particular jurisdiction, whether or not it is characterised as a power to make regulatory or political policy, then at the beginning, before the assets are privatised and before citizens are invited to make investments, the decision should be taken that that jurisdiction should not be conferred. It is unsustainable, and severely damaging, for government ministers later to criticise a jurisdiction conferred with the authority of the legislature, and enhanced by the sovereign act of the same government.

Unfortunately, that is how some politicians usually behave. When things are quiet, they happily load onto regulators additional duties and functions, contentedly congratulating themselves that they have offloaded politically sensitive decisions which can conveniently be blamed on the regulators if things go wrong. But things do go wrong, whether as a result of regulatory failure or an intensity or severity of circumstances which lead the politicians simply to lunge back at the levers of control, assuming responsibility for things which have been properly delegated to the regulator.

The instinct of politicians is, of course, that they have democratic legitimacy because they, unlike anyone else, have been elected. That is undoubtedly true. However, that does not mean they should try to control and run everything, even in times of crisis.

In the UK, the legislature established the regulators, gave them their powers, and settled on them their statutory duties, which are their objectives. And so the regulators have a legislative birthright, which is the highest source of democratic legitimacy.

It could never have been expected, and nor should it have been expected, that having through the legislature created regulators, politicians would shrink back into the shadows, observing the scene from a respectful distance, offering the occasional deferential submission in regulatory consultations, and otherwise playing no part. Politicians should never completely disengage from the subject matter of what regulators do or how they do it. That would be an illegitimate abdication of the obligation of politicians to engage with regulators in an appropriate way, and to an appropriate extent, and to set overall transport policy.

The issue is the correct balance of political jurisdiction and political criteria on the one hand, and regulatory jurisdiction and regulatory criteria on the other hand. If the boundary line between the two is placed in the wrong position, it will come under possibly severe pressure, and along its fault lines it may fracture. That is what happened in the UK in 2001 in the railway industry, and the costs were very considerable. I return to the subject later in this paper, when I deal with independence (see point 6 “Independence” *et seq*).

If politicians are uncertain or uncomfortable about the scope of regulatory power, they could, when making regulatory design decisions, establish the regulatory authority at first as an advisory body, with final decisions on critical issues being reserved to ministers. Over time, and as confidence grows, the regulatory authority could be given more autonomy, and thus a sliding scale system of independent regulation could be established. The critical thing is that private sector players have confidence in the system, and in the jurisdiction, integrity and competence of the regulatory authority.

A source of significant difficulty can be the establishment of a competitor regulator.

In my time in office, I had a competitor regulator called the Strategic Rail Authority (a grave political mistake, now happily consigned to oblivion). It was created in 2001 partly to make up for the failure of Railtrack, the national rail infrastructure manager, to give leadership to the railway industry in matters of planning, but it was also meant to be ministers' iron fist in an iron glove. They were very fond of the idea of central command and control of the railway industry, which they had wished had never been privatized. Unlike the Rail Regulator, the SRA was politically controlled – the minister could tell it exactly what to do. It was supposed to be responsible for franchising passenger rail services, but over time it – and the ministers who created it – became frustrated with its statutory impotence, and decided that it should do more. And therefore the SRA, without any legal authority and with significant political (and bureaucratic) support, simply asserted a jurisdiction which it plainly did not have. This caused considerable confusion and uncertainty in the railway industry and in the public mind, and territorial encroachments into the jurisdiction of the Rail Regulator became commonplace, and often had to be publicly repelled. This was an unattractive and damaging state of affairs.

Because ministers and civil servants deliberately confused the true nature of the relative jurisdictions of the two regulatory authorities, and asserted for the SRA a jurisdiction which it did not have – one which was truly vested in the economic regulator, for example in matters of capacity allocation, stewardship and enforcement – this played into the hands of critics who wanted to pull down the pillars of the established regulatory structures. But by its sometimes aggressive behaviour and conspicuous failures, having at first been the golden hope of ministers, the SRA lost political support and operational traction, and descended into a crippled command and then a fallen empire. It was abolished in 2006, with most of its functions transferred back to the Department for Transport.

Political support for a competitor regulator, and ministers' deliberate or negligent denial of the true source of regulatory authority, did no one any good, and brought the entire system into disrepute.

Such instances of regulatory competition are not confined to Europe. In the area of anti-trust regulation in the United States, there are competing authorities which will resist the intrusions and encroachments of others rather than co-operate, even though they are all supposed to be on the same side. The chairman of the Federal Trade Commission recently described the situation in these terms: "We have an archipelago of policymakers with a very inadequate ferry service between the islands. In too many instances, when you go to visit these islands the inhabitants come out with sticks and torches and try to chase you away."

It is almost inevitable that the establishment of independent economic regulators creates or aggravates a state of infuriated impotence on the part of some people in central government who are jealous of the power of regulators, their powers of enforcement and control, to a degree of specification and detail which central government has never had. They are also intolerant when regulators proceed according to their own policies and agendas, as they interpret their statutory duties, and even communicate with their industries and the public according to their own priorities. This can be a source of considerable tension.

In Europe, the existence of European law can be a material source of protection and assistance. In Estonia the railway was privatised in 2001. Being a new member state of the European Union, the Estonian government was bound by the relevant directives concerning railway infrastructure, including the ones which provide that the infrastructure manager is entitled to be fairly compensated for the efficient and competent operation, maintenance and renewal of its network.

A change of transport minister led to a severe conflict between the Estonian government and the owners of the privatised railway. The minister declared his intention of reversing the privatisation, and used his powers over the Estonian rail regulator to secure a regulatory settlement which set access charges significantly below the irreducible minimum needed for operating the railway. This was illegal, and the infrastructure manager pursued legal action in the Estonian courts as well as international arbitration in Stockholm and Washington DC (the latter under a bilateral investment protection treaty between the United States and Estonia). One of the greatest protections was European law, which required the regulator to set access charges according to sustainable economic principles and not political ones. In 2006, proceedings were about to be commenced in the European Court of Justice for an advisory declaration as to the applicable European law (which I am confident would have been obtained on satisfactory terms) when the Estonian government made an acceptable offer to settle the litigation and instead buy out the foreign investors, and renationalise the railway by the payment of compensation⁶.

None of these dynamics is new. It is in the nature of politics and politicians that when people get power, they want to use it. If they find that power in the hands of someone else, despite their accession to high political office, they will often try to seize it or subvert it. This goes back centuries.

In 1833, President Andrew Jackson of the United States wanted the funds of the federal government to be removed from the Bank of the United States and deposited in state banks. He asked the Secretary of the Treasury, Louis McLane, to do this. However, the authority of the Bank of the United States ran until 1836, and the relevant statute provided the government funds were to be kept in it “unless the Secretary of the Treasury shall at any time otherwise order and direct”. When Treasury Secretary McLane decided against removing the funds, President Jackson removed him, and appointed William Duane as his successor. Duane also refused the President's persistent demands, explaining that under the relevant legislation Congress had conferred a discretionary power on the Secretary of the Treasury and not the President, and therefore the decision was his. After a lengthy and fervent correspondence between them, Duane refused to accede to the President's directions, and Jackson removed him too from office. Jackson then appointed Roger Taney as Secretary of the Treasury, and almost immediately, Taney made the requested order⁷.

A politician, dissatisfied by the limitations on his power imposed by the very source of that power, was determined to get his way, and ultimately did. That often happens, although the means employed to resolve the situation can be brutal, and the financial and other consequences severe.

These cases are illustrations of the wisdom of the legislature putting the policy and jurisdictional boundaries in a sustainable place, and of politicians respecting, and working with, and not against, that legislative decision.

5. EFFECTIVE REGULATION

When regulation is working well, and it is not thought to be trespassing on matters of political sensitivity, the regulators usually do not hear from the politicians.

If regulators, faced with the juggernaut of government, give into improper political pressure, and shrink back from using their powers for fear that they will be taken away from them or diminished, this would be a violation of their statutory duties as regulators, however upset that may make the politicians. However, there are ways in which regulators can mitigate or minimise that kind of political pressure through careful handling of the politicians, although this does not always work.

When regulators do a bad job, or are seen to be weak, they attract political pressure and criticism, and industry, media and public dissatisfaction and pressure, like a magnet. And it is quite a simple job to avoid this happening.

It comes down to this. The regulator should be assiduous in doing its job well, professionally, proactively, proportionately, in accordance with its legal duties, and explain to people what it is doing, and why, and the principles upon which it is operating. It should not be found asleep at the wheel, or looking the other way.

In 2008, the UK Parliamentary Commissioner for Administration – the ombudsman which investigates allegations of maladministration on the part of public authorities - published its report into the mis-regulation of the insurance company Equitable Life. Many thousands of people who lost out had a “justifiable sense of outrage” in a “decade of regulatory failure” and “serial maladministration”. According to the Ombudsman, the regulators were “passive, reactive and complacent”, their actions “largely ineffective and often inappropriate”.

In May 2006, the House of Commons Transport Select Committee criticised the Office of Rail Regulation for being “timid”, having reluctantly taken a “softly-softly approach” to Network Rail (the company which ORR is charged with regulating), appearing “meek and reluctant to use” its powers, “weak and overly cosy with the primary organisation it regulates”. Four years later, in September 2010, the House of Commons Public Accounts Committee – the most powerful committee of the legislature – added to those criticisms. It criticised the Office of Rail Regulation for being “remarkably relaxed” about the performance of Network Rail, and having an apparent “marked complacency” in its approach. These are severe and well-merited criticisms of an organisation which has been consistently failing since its establishment in July 2004. It will come as no surprise to the ORR board that the attentions of politicians are now drawn upon it, and its competence, if not its constitution, will be reformed one way or another.

With the considerable powers that regulators have comes a responsibility to use those powers fairly, proportionately, competently and professionally. It is in this respect that regulators so often get things wrong. Regulators should be seen to be on the job all the time, not simply reacting to events when they could have taken preventative action much earlier. After political intolerance of regulatory power, ineffective regulation is the second principal cause of political intervention.

6. INDEPENDENCE

The literature – UK and international – on the importance and beneficial effects of having independent economic regulation is enormous. Of course the models differ, but the message coming across - whether it be from the OECD, the World Bank, the Asian Development Bank, the Department

of the Treasury in Australia, the European Investment Bank, the ratings agencies, legislative bodies and committees, the universities, think tanks, industry participants themselves and others - is that independence in economic regulation is a very considerable strength in creating and maintaining the conditions for confident, competent and economic private investment in projects.

The OECD said, in *Regulatory Policies in OECD Countries – From Interventionism to Regulatory Governance*:

“The key benefits sought from the independent regulatory model are to shield market interventions from interference from ‘captured’ politicians and bureaucrats.”⁸

In April 2001, the World Bank published a working paper on issues and international experience in power and gas regulation in which it said:

“... the general principle for the allocation of responsibilities to Government bodies is that the functions of policy-making, ownership and regulation should be separated. This independence is essential as it is important for the regulator to make discretionary decisions solely on the basis of the facts of each case, and thus must remain out of the scope of influence of either the government or companies. Independence in decision-making is important to investors in and users of regulated facilities. It assures them that covert pressures from any quarter will not influence decisions. This is an important confidence-building factor in the regulated utility industry. ... The ... most important misunderstanding [about regulatory independence] arises from confusion about the reason for independence. Independence is not an end in itself, but a means to an end. What ultimately matters is not whether the regulatory entity is independent, but whether the government can give a credible commitment to investors and consumers. Investors, both domestic and foreign, need assurances that their investment will not disappear through direct expropriation or through many small regulatory actions that add up to de facto expropriation.”⁹

In May 2004 the House of Lords Select Committee on the Constitution (part of the UK legislature) said:

“We have received clear evidence that independence of regulators from ministers is welcomed by ministers and is seen as a vital ingredient for maintaining consistency, for ensuring that regulatory decisions are taken by ‘competent authorities’ (which accords well with current and prospective developments in the governance of the European Union), and for promoting confidence about regulation among the regulated, those investing in regulated enterprises, and the customers and citizens on whose behalf regulation is carried out.”¹⁰

Despite its actions against an independent regulator in 2001 (see page 17 - paragraphs 2-3 and 4 below), in 2003 the British Government shared that view, telling the UK House of Lords Select Committee on the Constitution that:

“the independence of economic regulators from Government -- insulating decisions from short term political factors -- is a fundamental contributor to regulatory certainty and prerequisite for continuing to attract private finance to regulated sectors”.¹¹

The independence of regulators was conferred with the authority of the legislature. In law, it can only be taken away by the legislature. But there is more to this than law. Legal independence is only half the story. It is an essential condition, but not a sufficient one.

Behavioural independence matters just as much. When I left office in 2004, I warned my successors not only of the likelihood that political pressure would be brought to bear on them some time in the future, but also of the essential need, when inappropriate demands or pressures are placed on them by politicians, not to be seen to be giving way and thus violating their statutory duties. I explained that they could lose their independence either if the legislature were to change the law, or if, by their behaviour, they showed that they were not in fact independent. Bend to that, and you will have lost your independence just as surely as if the legislature had taken it away, because people will never believe in your independent behaviour – your willingness to be independent – ever again. And once you have lost it, you will never get it back.

In summer 2001, the national railway infrastructure manager Railtrack engaged in secret and eventually unsuccessful negotiations with the UK Government for a financial rescue in the aftermath of the severely expensive operational difficulties they had experienced after the Hatfield rail crash in October 2000. That bailout proposal contemplated a four-year suspension of the regulatory regime, and more or less an open cheque-book from the Government. In my opinion, the Government was not serious about these unacceptable proposals, and instead devised an alternative plan, which involved taking back the assets of Railtrack without compensation by engineering the apparent insolvency of the company.

In order to get Railtrack into administration, it was necessary for the Government to establish to the satisfaction of the High Court that the company was insolvent. The problem was the jurisdiction of the Rail Regulator. As long as his jurisdiction was intact, the company had an alternative source of finance which could have led to the company being advanced billions of pounds of additional public money, against the will of the Treasury. This was a power which needed to be neutralised. And so, 48 hours before the Government went to court, knowing nothing about it until that point, I was informed by the Secretary of State for Transport of the Government's intention to apply for an administration order, and that if I were to intervene to improve the company's financial position, he had the authority of the Prime minister and the Chancellor to introduce emergency legislation into the legislature to take me, the independent regulator, under direct political control. Despite these threats, which I regarded as completely improper, the following day I indicated to Railtrack that I would be prepared to initiate the necessary review of their financial position, and to announce it publicly, but by then the company had given up.

The legislation had been prepared, and no amount of explaining to government the very severe consequences which such a step would have not only for investor confidence in the railway industry, but in all the other independently regulated industries, and for the Government's programme for getting private money into public projects, and the independence of the Bank of England and much else besides, would do. They were not to be moved. Railtrack therefore went quietly into that long dark night.

After that, there was a review of regulation lasting several months, from which my staff and I were excluded. It was only when government realised that they needed my co-operation to get Railtrack out of administration, which was proving both operationally and financially extremely expensive, that the dogs were called off and the spectre of primary legislation to extinguish independence in the economic regulation of the railways was removed.

Three months after I left office, in September 2004, I discussed this affair with Mr Robin Cook MP. At the time of Railtrack's collapse, he had been a Cabinet minister (Leader of the House of Commons), and so had had to defend what had been done. I put it to him that the severity of the consequences of such a threat to independent economic regulation was so great, it was hard to understand why Government would take this risk when, as Rail Regulator, I had hardly shown myself

to be a soft touch when dealing with Railtrack. He answered in this way: “Tom, in the 17th century Parliament fought a bloody civil war to gain control of public expenditure, and we were not about to give it up to you.” I thought that was a very revealing remark in relation to the mindset of ministers, careless of the constitutional implications for the sanctity of contract and the rule of law, and indeed for the Government’s reputation for fair dealing.

The political pressure at that time was, as you can see, enormous. Even after Railtrack had been effectively killed off, they were still determined to extinguish the independence of the regulator and to transfer his jurisdiction to a politically-controlled entity. In those circumstances, it was necessary for me to play the game long, and to allow the weaknesses of the political policy to be exposed over time and so ultimately disable the assault. That strategy worked, and, despite all the predictions to the contrary, the integrity and independence of economic regulation of the railways was maintained and protected until I handed over to my successors.

Regulators are often accused of being unaccountable because they are independent. This notion is misconceived. Regulators have significant amounts of accountability, far more than the accountability of the self-regulating nationalised industries which preceded them.

Regulators have statutory duties, enforceable by action for breach of statutory duty or through judicial review. They have obligations to make annual reports to the legislature, and to provide answers to written questions tabled in the legislature. Regulators can be and are called to give written and oral evidence to committees of the legislature, including the Public Accounts Committee. Regulators are answerable to the Parliamentary Commissioner for Administration in cases of allegations of maladministration, and their performance is scrutinised by the National Audit Office. They are required to give information, advice and assistance to ministers in some respects, and of course they must comply with the rules of administrative law and the rules of good public administration, including in relation to the duty to act fairly, to keep an open mind, to hear all sides before making a decision, and to take into account all relevant and no irrelevant considerations. They are bound by the rules as to the lawful exercise of powers, reasonableness and proportionality, consistency of decision-making and compliance with procedural rules.

All these things buttress the obligation to do the job properly.

The duty to explain is extremely important, one which I took very seriously. It extends to a duty to explain not only what you're doing, and why you're doing it, but the principles which inform those decisions, as well as making clear in advance the criteria and procedures which will be used for the making of the decisions, and then the publication of full written reasons for decisions afterwards.

It is a fallacy to say that regulatory independence means that regulators and ministers must never communicate. I believe that it is a violation of the regulatory birthright to adopt this policy. Of course there must be a respectful distance between the two, but ministers and regulators should engage regularly. It is very important that ministers understand what regulators are doing, and what they may do in the future, and that they play their parts in communication and information exchange. Uninterested or disinterested, unengaged ministers are a major hazard to the proper prosecution of regulatory policy, as I saw in my 2003 access charges review for the railway industry, leading up to what was then the largest financial settlement the railway industry had ever had. Getting the Secretary of State for Transport and his officials to engage with us in a timely and worthwhile manner was very difficult indeed, and it was only when the die had been cast and there was nothing much that could be done about it towards the end of the process, did we really get anything like the quality of engagement which we had needed months before.

Ministers are stakeholders in the regulatory state, just as are customers and industry participants. It is when regulators become distant from stakeholders, or are thought by stakeholders to be uninterested, that trouble begins.

As said above, regulators are the creations of the legislature, not the executive government. This is often misunderstood by commentators, and even by ministers. But, particularly in the context of behavioural independence, it is extremely damaging when this is the opinion of the regulators themselves. Regulators do themselves and their stakeholders no favours when they display a mindset such as the one I encountered in a discussion in 2008 with one of the principal economic regulators.

He had said at a conference that, because he was unelected and ministers are, he lacked democratic legitimacy. As a consequence, in his opinion, it was not only appropriate but necessary for him to defer to the will of ministers. I challenged him on this important issue. I explained that his statutory powers and duties were given to him by the legislature, and that is the highest form of democratic legitimacy anyone can have. After all, I explained, we live in a country which is subject to the rule of law. He replied, "I regard the rule of law as a scary concept." When ministers choose regulators from that mould, legal independence really does not matter.

In too many respects, some regulators have blurred the distinction between the will of the executive government and the will of the legislature. This is damaging to investor confidence.

I should not be understood to think that, having created regulatory institutions and given them their powers and duties, the legislature should never be permitted to return to the subject. Of course not. It is undoubtedly the right of the legislature, having created a regulatory structure, to review and if necessary amend the powers and duties of the regulators, since it is from the legislature those powers and duties came in the first place. There will be times when amendments are needed. There may be occasions when regulation needs to be changed significantly. It is for the legislature to do this, not ministers through bullying, intimidation or inducements. It is for ministers to make their case in the legislature, and not treat the legislature as little more than a rubber-stamp. If the legislature makes a decision to change the powers, duties or even independence of the regulator, it should do so after very careful reflection, on rational evidence-based grounds. And one of the key considerations must be the faith and confidence which investors, industry participants and others have in the integrity and operation of the regulatory system, free of undue political intervention. It is a step which the legislature should take with great caution.

Because of the importance of the decisions which regulators take, and the fact that they are required to take them without regard to inappropriate political considerations, there is an inevitable tension in the system. The possibility of conflict with politicians is built-in, and in that tension may be healthy. But it is a combustible state of affairs.

Politicians protest the independence of regulators, and react with apparent – sometimes feigned – horror at any suggestion of any dilution. But it is easier instead to take the jurisdiction of the regulator, and transfer it to ministers or another politically-controlled entity. When they have done that, in relation to the power in question, independence has been completely extinguished.

Regulators must be vigilant in relation to political pressure and encroachments on their jurisdiction. They must not be seen to be giving in to improper pressure. If the legislature decides to take away their jurisdiction or their independence, or to diminish those things, that is the right of the legislature. But it is for the legislature, not ministers to do this. Regulators should not shrink from engaging in that debate. Politicians should welcome that engagement and debate about the merits of

the proposed changes, and, in the words of Thomas Jefferson, “prefer the homage of reason to that of blindfolded fear”.

Until the legislature has made a change, regulators should adhere to their statutory remit as it stands, not as ministers may threaten to change it. Anything less is a voluntary abdication of independence and jurisdiction, and regulators should not accommodate ministers in this respect. The damage is too great.

A great deal depends on the kinds of people who are appointed to regulatory authorities. I believe that appointments should be made more distant from politicians, and that there should be a regulatory appointments commission on a statutory basis. Commissioners should be appointed by the legislature or a committee of the legislature, after nomination by ministers. Once appointed, they should apply specific, statutorily established criteria for appointment of members of regulatory authorities, and those criteria should have nothing to do with party politics or short-term political considerations.

In the UK, we also need much better scrutiny in the legislature of what regulators do. It should not be happening only when something has gone wrong, and a post mortem is needed. We need committees of the legislature which are truly expert in the issues of regulation, who can take a cross-industry view and really subject the regulators to intense, focused and substantial scrutiny. There may even be a case for the appointment of counsel to the committee to make up for the lack of forensic skills on the part of some politicians who sit on these committees.

The culture of regulation is important. Regulators should do much more to explain the principles, procedures and criteria on which they act. They need to take seriously their duties to explain and to communicate. It should be the legislature which is the primary scrutinising body for the actions or shortcomings of regulators, and it should have a different and improved role in their appointment.

In these ways, the inevitable tensions of the dynamics of the political-regulatory relationship can be constructive rather than destructive.

NOTES

1. *Handbook for Evaluating Infrastructure Regulatory Systems*, A Brown et al, World Bank, Washington DC, 2006, page 9.
2. See page 12, last paragraph.
3. The public-private partnership for the London Underground came to abrupt and unsatisfactory ends. Metronet, the company which took over two of the three parts of the London Underground infrastructure in 2002, collapsed into administration in 2007 after a ruling on its efficiency by the Arbiter. Tube Lines, the other private company, under considerable pressure from London Underground, the public sector partner, in 2010 sold its interest back to the state in the final stages of the Arbiter's periodic review of the costs of the network. Overall, the London Underground PPP was a conspicuous failure, mainly because of the over-specification and micro-managerial nature of poorly-designed over-complex contracts, the unsatisfactory procurement and contracting practices which Metronet was allowed to engage in for infrastructure services, significant uncertainties as to the jurisdiction of the Arbiter, the Arbiter's violations of established regulatory standards as to conduct and quality, and severe hostility to the privatisation on the part of the public sector partner (London Underground) whose co-operation was needed to make the contracts work. London Underground is a case in point for any municipality or national government contemplating any aspect of rail privatisation or commercialisation.
4. See page 13, last paragraph and page 14, first paragraph.
5. As for the use of a regulatory system with an in-built change regime, see *The Future of the Railway, Robert Reid Memorial Lecture*, 10 February 2004, at: <http://www.rail-reg.gov.uk/server/show/nav.37>.
6. In other countries with no established tradition of regulatory institutions operating separately from political control, or even at a distance from it, and without the protection of European law, private sector investors try to protect themselves from possible arbitrary, capricious, expropriatory or simply incompetent behaviour by regulators (as well as ministers) through the use of stabilisation provisions in their contracts with the state. These instruments are designed to give investors a degree of insulation from political or regulatory actions, and financial compensation (ideally in international tribunals) if they are affected by such interventions. Developing countries often enact investment protection laws to facilitate such mechanisms, although sometimes those laws are themselves inadequately designed.
7. The result was a political furore, with the Senate passing a resolution of censure and subsequently rejecting Taney's nomination as Treasury Secretary, the first time in American history that it had rejected a presidential nomination to the Cabinet. When, in 1835, President Jackson nominated Taney to a seat on the Supreme Court of the United States, that nomination also failed. Changes

in Senate membership finally permitted his renomination and confirmation as Chief Justice of the United States months later, an extremely unfortunate occurrence since Taney, probably more than anyone else, was responsible, as Chief Justice, for the outbreak of the American Civil War.

8. *Regulatory Policies in OECD Countries – From Interventionism to Regulatory Governance*, p 97: *Reviews of Regulatory Reform*, Organisation for Economic Co-operation and Development, Paris, 2002.
9. *Power and Gas Regulation – Issues and International Experience*, The World Bank, Washington DC, April 2001.
10. *The Regulatory State: Ensuring its Accountability*, House of Lords Select Committee on the Constitution, 6th Report of Session 2003-04, Vol I, Report, para 113.
11. *Op cit*, para 113 and Vol II, p 373, para 9.