



Briefing paper for roundtable on  
17<sup>th</sup> January 2017

Ethical regulation of monopoly  
networks

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Indepen is a management consultancy working with clients facing the challenges of regulation, deregulation, competition and restructuring. We help investors, boards and senior managers identify and assess political and regulatory risk and to develop and implement internal and external strategies to manage their exposure.

Our clients are the organisations involved in financing, constructing, managing and regulating built and natural infrastructure – water, energy, transport, land and property. We have constructive relationships with relevant government departments and agencies.

Our team combines experience of public policy, regulation, corporate finance, communication and engagement and organisational development. We complement this with input from our associates – CEOs and chairs of FTSE and privately owned companies, regulators, government ministers and academics.

The Indepen Forum provides the opportunity for investors, government and business leaders to debate, under the Chatham House Rule, issues that if mis-handled could undermine well-intentioned policy initiatives.

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# 1 Introduction

On 17 January 2017, the Scottish Government will be hosting a roundtable involving those with a close interest in the provision and regulation of utility services for customers in Scotland. The Cabinet Secretary for the Economy, Jobs and Fair Work will chair the roundtable.

Its purpose is for participants to explore the implications of the Scottish Government's commitment to the principles of ethical based regulation (EBR) and the effects of this on utility services in Scotland that are subject to economic regulation. The Scottish Government has recently published a set of principles that will guide its use of its newly devolved consumer and competition powers. The document acknowledges the benefits of EBR and the approaches advanced by Professor Christopher Hodges, and during 2017 the Scottish Government will outline how it will embed EBR into the regulatory regimes.<sup>1</sup>

There are differences between the circumstances of the utility sectors and the Scottish Government has convened this roundtable to see how its policy and commitment to EBR should allow for these differences in seeking to embed EBR and realise the associated benefits for customers in Scotland.

The water industry in Scotland has been developing approaches that are consistent with EBR and is considering how this can be extended. The sector economic regulator in Scotland, the Water Industry Commission (WICS), and the Scottish Government have asked Indepen to prepare this paper as background briefing for those attending the roundtable. The purpose of the paper is to introduce the concept and principles of EBR and pose questions about how these approaches might be applied in the context of some regulated utility services in Scotland.

Indepen will be contacting roundtable participants to explore any questions they have and the issues they might want to raise at the roundtable.

The sections of the paper are as follows.

- Consumer and competition policy of the Scottish Government
- Briefing on ethical based regulation
- Experience in water and extension to other regulated sectors
- Questions for the roundtable

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<sup>1</sup> The Scottish Government uses the phrase Ethical Based Regulation: Professor Hodges uses Ethical Business Regulation. As this paper is about the policy of the Scottish Government, it adopts the former. Both abbreviate to EBR.

## 2 Consumer and competition policy of the Scottish Government

The Scotland Act 2016 devolved to the Scottish Government powers relating to some aspects of consumer and competition policy. The Scottish Government is now in the process of developing its approach to implementing these new powers and working with interests in the UK as a whole to influence policy on relevant matters that were not devolved in the Act.

We have drawn information about the Scottish Government's policy from its response to the recommendations of the working group on the development of consumer policy<sup>2</sup> and the subsequent policy document<sup>3</sup>.

In summary, the Scottish Government's policy is to create

...confident and knowledgeable consumers in Scotland and markets that work for businesses and consumers.

The policy document states that it is vital

... that we create a system of consumer protection, competition and regulation in Scotland which is fully aligned with the needs of our citizens and businesses and which improves people's lives. We have newly devolved, although limited, consumer and competition powers and will use these to maximum effect. We will strengthen this by working closely with our stakeholders in the consumer protection landscape, both in Scotland and across the UK, to influence strongly on behalf of Scotland's consumers, in those areas which are reserved to Westminster, such as consumer protection law.

Government can't achieve positive change for consumers and business in Scotland on its own. By working closely with consumer bodies, business, ombudsmen, regulators, advice providers, local authorities and other stakeholders, we can bring about the improvements to maximise the benefits that strong consumer protection, fair competition and effective regulation can bring to Scotland's people, businesses and economy.

With respect to regulation, the Scottish Government notes that

... there is a need to strike the right balance between competition and regulation. Where required, we will ensure that regulatory initiatives recognise consumer priorities in Scotland.

We have already begun work on developing a model of consumer-focused economic regulation, building on the approach adopted in the water sector ... As highlighted by the Working Group, in the latest price review Consumer Futures Scotland, Scottish Water and the Water Industry

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<sup>2</sup> Report of the working group on consumer and competition policy for Scotland, The Scottish Government (March 2016)

<sup>3</sup> Delivering better outcomes for consumers and businesses in Scotland, The Scottish Government (December 2016)

Commission for Scotland together created the Customer Forum which put customer representation at the heart of the regulatory process. The Customer Forum negotiated a settlement on prices and service levels with Scottish Water leading to an agreement that accurately reflected customers' priorities and preferences.

The Working Group noted that the Scotland Act devolved competence for consumer advocacy in the post and energy sectors to the Scottish Parliament and proposed that, given the involvement of the Customer Forum in the price review for the water industry, the Scottish Government should work with other sector regulators to pilot approaches which allow direct input from Scottish consumers.

In developing its approach the Scottish Government notes that it is

... working closely with Professor Chris Hodges, Professor of Justice Systems at Oxford University, whose work focuses on use of collaboration and behavioural insights to create open, ethical cultures that deliver more profound and sustainable organisational change than traditional regulatory methods. We will use this thinking to develop a regulatory approach that supports businesses to treat consumers fairly, and works with them to put matters right when they go wrong, thereby building trust between consumers, regulators and businesses. This approach aligns itself well to our drive for fairness and access to justice in Scotland and will ensure the right tools will be used under the right circumstances to benefit both consumers and business, ensuring markets work efficiently.

The Scottish Government views EBR as an essential element of its approach to delivering benefits for consumers in Scotland. One of its commitments is the following.

We will develop a policy on ethical regulation to spur economic growth by increasing consumer trust and rewarding ethical businesses.

### 3 Briefing on ethical based regulation

Professor Hodges has been working with the Scottish Government, exploring how the application of EBR to the regulation of utility services could secure better customer outcomes.

EBR is about the regulation of businesses by public sector agencies. It is a behavioural approach that involves both sides of the relationship. As such it is significantly different from, and broader than, the widely-adopted principles of better regulation.

Hodges' research<sup>4</sup> leads him to conclude that the adoption of EBR principles will enable a good outcome, which he describes as ...

.... widespread trust in traders, on the basis of which a healthy, sustainable and growing economy can exist, which in turn supports employment, social stability and innovation.

This is consistent with the statements of the Scottish Government quoted in the previous section of this paper.

EBR involves primarily ethical behaviour among the regulators and the regulated, but it has important implications for all the parties involved in regulation and for stakeholders. It is an approach that can be applied in a multi-agency context. Crucial aspects are the degree of collaboration, openness and transparency on which relationships and transactions are based.

The essence of EBR is to do the right thing and speak up in sharing all relevant information in open relationships, so as to constantly learn and improve.

Potentially, it is relevant to all forms of regulation of businesses by public servants, although its application may differ according to the type of regulation and possibly by sector. Hodges has summarised the elements of EBR in a compliance and enforcement context, in the following terms<sup>5</sup>.

- 1 The regulatory system will be most effective in affecting the behaviour of individuals when it supports ethical and fair behaviour.
- 2 Businesses should demonstrate constantly evidence of their commitment to fair and ethical behaviour that will support the trust of regulators and enforcers, as well as of all levels of management and employees, customers, suppliers, investors and stakeholders.
- 3 A blame culture will inhibit learning and an ethical culture, so businesses and regulators should support an open collaborative culture.

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<sup>4</sup> Summarised in *Ethical Business Regulation: Understanding the Evidence* Christopher Hodges Professor of Justice Systems, and Fellow of Wolfson College, University of Oxford, BIS Better Regulation Delivery Office, (March 2016)

<sup>5</sup> Ibid.

- 4 Regulatory systems need to be based on collaboration if they are to support an ethical regime, as well as maximising performance, compliance and innovation.
- 5 Where there is unethical behaviour, people expect a proportionate response. This is consistent with strong sanctions for intentional wrongdoing.

## 4 Experience in water and extension to other regulated sectors

### 4.1 Experience in water in Scotland

Much of Hodges' extensive research on EBR has been in the context of regulatory compliance and enforcement, an essentially 'ex post' world. The application of EBR principles to the 'ex ante' world of economic regulation is at an early stage. In a roundtable in October, those involved in the regulation of water and waste water services in Scotland explored Hodges' ideas and identified opportunities and challenges.

While EBR had not been adopted explicitly, the roundtable concluded that there had been gains from more effective collaborative working involving Government, economic and quality regulators, customer representatives and Scottish Water. Specific issues where the approach had been beneficial over the last five or so years were identified as

- wholesale charges
- wholesale tariffs
- customer representation.

From this experience the roundtable concluded that a more explicit and wide ranging adoption of EBR could be beneficial to the water sector and its customers. On reflection, participants identified a set of conditions under which EBR could thrive.

These are all necessary conditions and are as follows.

1. Public policy and customer outcomes that are well articulated, measurable and shared
2. Roles of the organisations involved that are clear with well-defined responsibilities and relationships
3. Shared understanding of the risks and who bears them
4. Policies and arrangements that are sustainable beyond personalities and goodwill
5. Demonstrated openness and honesty about information and evidence
6. Acknowledged importance of robust challenge within the collaborative approach

The first three of these are perhaps unsurprising and would form part of any programme for more effective policy and regulation. Even so, the importance of separating the policy role of government from the responsibilities of the regulator cannot be over-stated.

The EBR flavour is expressed more distinctively in conditions 4, 5 and 6 and focuses on behaviours such as building enduring trust while respecting the different roles of organisations within the regulatory framework.

## **4.2 Other regulated sectors**

The services represented at the January workshop will be: water and waste water; energy; communications; and rail transport. The circumstances in which these services are provided in Scotland are distinctive with, for example, a high proportion of customers living in rural and island communities. The Scottish Government's competition and consumer policy will recognise the importance of this and other distinctive circumstances in the social, economic and geographic landscape of Scotland.

The utility sectors themselves differ from each other in important ways. Within a more-or-less common framework of financial, reputational and process incentives in an ex ante form of regulation, the different characteristics of the sectors lead to differences in how economic regulation works in practice. There is, though, much that is similar between the sectors and the Scottish government is looking for the adoption of approaches that will deliver consistently better outcomes for consumers in Scotland.

The Scottish Government is committed to EBR and wants to explore how this will fit with current developments in the regulated utility sectors and the scope for extending EBR to these critical sectors in Scotland.

## 5 Questions for the roundtable

Given the progress in the water sector in Scotland, it will make sense for the roundtable to discuss this and the extent to which is EBR consistent with the approaches and direction of travel in regulated sectors.

The roundtable might explore the following questions.

- Are there lessons from water that are relevant to the other sectors represented at the roundtable?
- What will need to be different in the application of EBR across the different sectors?
- What actions could the Scottish Government take if it wants to see the adoption of EBR to improve outcomes for customers in Scotland across all regulated sectors?

### 5.1 Experience in water

Relative to the other sectors represented at the workshop, the water sector in Scotland has advantages in the context of EBR. The devolution of water policy to Scotland, the fact that Scottish Water is state-owned and that the policy and regulation community in the water industry in Scotland is relatively close-knit have all been helpful in this regard. Even so, Hodges research suggests that the benefits of ethical behaviour are not limited to sectors with such propitious circumstances.

At the October roundtable, the parties involved in water policy and regulation (Scottish Government, Scottish Water, the WICS, SEPA, DWQR and CAS) considered the extent to which what had been achieved in the sector was consistent with EBR. The group went on to discuss the issues that they would need to address to make further progress.

The following table contains our assessment, as external observers, of how well the sector rates against these conditions at present. We have had regard to the situation in other sectors, including the water industry in England & Wales. Our assessment is informal and not based on extensive analysis.

Evidently, there is, as we would hope, scope for improvement against all the criteria. Even so, the water sector in Scotland has seen a significant improvement in performance, judged relative to the position in England & Wales.

Conditions	Assessment
1. Public policy and customer outcomes	Well established outcomes process in the water sector though formative in respect of consumer policy as the SG develops its approach
2. Role clarity	Well developed – though possibly dependent on personalities
3. Shared understanding of risks	Further development needed: including with respect to long term maintenance needs
4. Sustainable beyond personalities and goodwill	Requires better understanding and to be tested
5. Openness about information	Improving as collaboration develops – absence of blame culture clearly expressed, yet to be tested
6. Challenge	Acknowledged by the parties as an essential element and requires extending across all parties

The roundtable might consider the following.

- Are the criteria identified for the water sector relevant to the other sectors? Should additional criteria be considered?
- How are other sectors positioned in respect of these criteria and any others that the roundtable believes are relevant?
- What should be done in all sectors in Scotland to improve performance against these criteria?

## 5.2 Differences in application across the sectors

While the regulated utility sectors have things in common - including the essential or near essential nature of the service they provide, the presence of economic regulation and the significant extent of their externalities - there are important differences. Among other things the differences affect how they are regulated.

At a high level, some obvious relevant differences between the sectors are:

- **Policy context** – water and environment policy is devolved to the Scottish Government whereas policy for the other sectors is not: as noted above, some aspects of consumer policy generally are devolved
- **Ownership and financing of the businesses** – water in Scotland is state owned, whereas energy, and telecoms are owned by private investors and rail has a mixture of public and private ownership
- **Market structures** – each sector has a distinct structure
  - the vertically integrated regional (national in the cases of Scotland and Wales) water monopolies with limited legal (non-household) retail separation in Scotland, involving

potentially national retailers, which is shortly (April 2017) to be emulated in England but not Wales

- the energy sector has national generation, power and gas transmission networks and supply businesses with substantial but not universal integration of generation and supply; these are all separate from the regional power and gas distribution networks
- fixed line telecoms have a national wholesale:retail split and there are national, integrated network and retail service providers in mobile providing network competition with each other and the fixed network
- the national rail network, which is in the process of devolution, is fully separated from the 30-plus franchised train operators and open access operators.
- **Extent and nature of competition in the sectors** – energy and telecoms have competitive supply sectors (water in a limited way for non-household customers) and monopoly networks whereas rail has a monopoly infrastructure business, competition for the market in the form of train operator franchises and competition in the market from open access operators
- **Regulatory institutions** – energy, rail and telecoms each has its own national economic regulator (Ofgem, ORR and Ofcom respectively); water has an economic regulator in Scotland (WICS) and two quality regulators (SEPA and DWQR) while in England and Wales the equivalents are Ofwat, the EA (NRW in Wales) and DWI.
- **Regulatory relationships** - there is one Scottish Water compared with numerous regulated GB energy, telecoms and rail companies and water companies in England and Wales
- **Customer representation** – in England, CCWater is the sector specific customer representative – in all other cases, customer representation is via generic national customer entities in England (NCC) and Scotland (CAS).

**Customer satisfaction and expectations** – energy and rail have both recently experienced criticism in customer service terms, telecoms infrastructure is mooted for compulsory separation because of the allegedly poor level of service to retailers, while water is generally middling in terms of customer satisfaction, albeit a recent report from Which? identified Scotland's water industry as the most trusted utility.

In drawing on experiences in the water sector in Scotland and seeking to compare approaches in the other sectors, the key differences are likely to be the implications of

- Scottish policy context
- state owned Scottish Water v investor owned businesses in other sectors
- Scottish economic and quality regulators (WICS, SEPA and DWQR) v national economic regulators in other sectors (Ofgem, ORR, Ofcom)
- dominant monopoly in water v more or less competition in the other sectors
- relatively good customer satisfaction among Scottish Water's customers v general dissatisfaction reported among the customers of other utility services.

The roundtable might consider

- What effect might these and other relevant differences have for how EBR might be adopted?
- Whether different approaches are required in each sector?
- What are the areas where EBR thinking should be focused?

### **5.3 Actions the Scottish Government could take**

For the Scottish Government to take forward its proposals in this area, it will need to engage with national policy bodies and with companies whose markets extend beyond Scotland.

The roundtable might consider

- What specific steps could the Scottish Government take to begin and sustain the process?
- How could the bodies and sectors represented at the roundtable assist in this process?

The roundtable will provide an opportunity to begin identifying the way forward in securing the benefits of EBR for consumers of regulated utility services in Scotland.