Accountability in the regulatory State: the role of the National Audit Office in the UK

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INTRODUCTION

This paper explains the role of the National Audit Office, and its distinctive position in the process of regulatory accountability in the United Kingdom. It is structured into five parts:

- The context to the National Audit Office’s work on regulation
- The National Audit Office’s role
- The audit of economic regulators
- Outcomes from the National Audit Office’s work
- The Better Regulation agenda

CONTEXT TO THE NATIONAL AUDIT OFFICE’S WORK ON REGULATION

The UK’s Better Regulation Task Force defines regulation "as any measure or intervention that seeks to change the behaviour of individuals or groups". Typically, regulation is set out in detail in laws passed by the UK Parliament (and increasingly by UK laws which transpose European Union directives). The paper will discuss this aspect of regulatory accountability in its final section. But an important subset of regulation derives not directly from the detailed provisions of an individual law, but from the decisions, guidelines and rules established by independent regulators. The most important of these independent regulators in the UK are called economic regulators.

The economic regulators were established by Parliament in the wake of the privatisation programmes of the 1980s and 1990s, and were provided with statutory functions, duties and powers by Parliament. As economic regulators, their principal role is to control the abuse of monopoly power, though they may have other functions such as social regulation. Their duties are framed in such a way as to allow flexibility and discretion to regulators in the exercise of their functions.

The principal economic regulators are the Office of Gas and Electricity Markets (Ofgem), the Office of Communications (Ofcom), the Office of Water Services (Ofwat), the Office of the Rail Regulator (ORR) and the Postal Services Commission (Postcomm).

The relationship between the independent economic regulators and the Government is relatively clear. The Government sets the policy framework within which economic regulators operate but regulators are independent of direct Ministerial control. Independence is recognised as important and indeed one of the key benefits sought from the independent regulatory model is to shield market interventions from potentially 'captured' politicians and bureaucrats. The independence granted to economic regulators makes it possible for them to operate within a longer-term framework different from that dictated by

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1 The Government established the Better Regulation Task Force (the Task Force) in 1997. Its terms of reference are: "to advise the Government on action to ensure that regulation and its enforcement are proportionate, accountable, consistent, transparent and targeted."

3 This is an official document published by Parliament that formally sets out the Government’s response to each specific recommendation made by the Committee of Public Accounts.
shorter term political priorities.

In the UK regulatory model, however, independence is not absolute - for example regulators are appointed for a fixed term and although Ministers, in general, cannot remove regulators within this term, they have the power of appointment and reappointment. The Government can also change the legal framework within which regulators operate, by introducing new legislation subject to Parliamentary approval, although in practice this option to amend the legal framework has been used sparingly.

Furthermore, political developments such as electoral changes may mean that current priorities differ from the objectives of regulators set out in statute, which could create tensions between the regulator and Ministers. Since regulators do not operate in a vacuum, they tend to seek to minimise these tensions by maintaining open and regular discussions with Ministers and the principal Government departments.

The model then is one of constrained independence and autonomy granted by Parliament. But how are regulators held accountable to Parliament? The remainder of this paper focuses on the oversight of the economic regulators, and to a lesser extent on other independent regulators, undertaken by the National Audit Office on behalf of Parliament.

**THE NATIONAL AUDIT OFFICE’S ROLE**

This section outlines the functions of the National Audit Office and its position in the accountability of the regulatory framework.

The National Audit Office's role is to give assurance to the public and Parliament on how public bodies are carrying out their tasks, and in the process to provide a stimulus to improvements in the effectiveness with which public bodies operate.

The National Audit Office contributes to the process of accountability in two main ways:

- by undertaking the annual audit of the accounts of central government and its agencies, including regulators. This audit provides Parliament with assurance that the accounts are "true and fair" and that income and expenditure complies with Parliament's intentions;
- under Section 6 of the National Audit Act 1983, by examining the economy, efficiency and effectiveness (that is, value for money) with which audited bodies, including regulators, use their resources.

The head of the National Audit Office, the Comptroller and Auditor General, is an Officer of the House of Commons and is empowered to present reports to Parliament (and not to Ministers). The National Audit Office’s reports are normally the basis for the examinations of the Committee of Public Accounts, a committee of Members of Parliament. The Committee takes evidence on most of his reports on value for money and some reports arising from his audit of accounts.

The Committee of Public Accounts issues its own reports after taking oral evidence from the heads of the regulatory offices on the basis of the National Audit Office’s report. The Government is obliged to respond to the Committee's reports by way of a Treasury Minute.

**THE AUDIT OF ECONOMIC REGULATORS**
The National Audit Office recognises that independent regulation as a model has many strengths and in practice has brought benefits to consumers in the UK. Nevertheless this model of regulation also brings with it some risks, primarily in terms of the exercise of discretion by the regulator: how can Parliament be sure that the regulator has used its independence and discretion effectively and in the public interest?

The National Audit Office conduct value for money audits of the main UK regulators, (Ofgem, Ofcom, Ofwat, ORR and Postcomm) as well as the Office of Fair Trading (which covers competition policy and consumer protection outside these sectors).

Value for money reports on these regulators have a general focus on how far regulators have achieved their objectives for the specific markets they are responsible for. This is not because economy and efficiency are unimportant – they are not – but because the effectiveness of regulators is much more important in public interest terms. Regulators do not spend large sums of money in absolute terms—for example, Ofgem's budget is only £36 million per annum. But they take decisions which have a large impact on consumers and regulated companies, and should be held accountable for the effectiveness of such decisions. The National Audit Office therefore starts by considering how effective regulators have been in meeting their statutory duties and objectives, including a consideration of the tensions between them. For example, the report on Postcomm (National Audit Office, 2002a) highlighted the tensions between Postcomm's primary duty to ensure the provision of a universal service, and the secondary duty to promote competition, and how Postcomm could manage those tensions.

The standard template for a National Audit Office examination involves three questions:

- what is the extent and scope of independent decision-making for the regulator in question, both in terms of the legal framework and in terms of the commercial and economic context of the market regulated?
- how has the regulator resolved trade-offs and tensions between different aspects of its role, for example between the efficiency of the regulated market and equity of treatment for different groups within society? and
- given that a balanced and transparent reporting is an important element in any governance framework, how has the regulator reported its own decisions and achievements?

The reports listed in the bibliography section have in common this template as an approach to the examination of regulators.

The focus on regulators does not stop with independent economic regulators. The National Audit Office is committed to improving the way government regulates society in general, and this theme runs through most of the work undertaken by the National Audit Office across the breadth of the public sector. The National Audit Office examines the effectiveness of regulation in sectors such as home affairs and justice, health, education and the social security system. To provide two examples of this general concern for regulatory matters:

- The report on the Occupational Pensions Regulatory Authority (Opra) (National Audit Office, 2002c) included a risk analysis that showed that many important risks were receiving limited attention because of Opra's interpretation of its governing legislation while much of its effort was applied to relatively minor breaches of legislation. The report included recommendations to help Opra become a new kind of regulator, which is clearly focused on the main risks.
The report on The Gaming Board (National Audit Office, 2000b) examined the regulatory authority for casinos, bingo clubs, and gaming machine suppliers, considered how the Board could apply the principles of Better Regulation to its work. In particular, the report examined how the Board could place greater reliance on gaming companies’ own control procedures.

It is also important to recognise that the ability of the National Audit Office and Committee of Public Accounts to hold regulators to account does not apply to all regulators. The two most obvious exceptions are the regulators for airports and for financial services:

- The airports regulator, the Civil Aviation Authority, is outside the National Audit Office's remit, as it is categorised as a nationalised industry rather than a government Department.
- The Financial Services and Markets Act 2000 placed the Financial Services Authority (FSA) on a statutory footing as the regulator on behalf of Government of financial markets and services, with considerably increased powers, but made no provision for the National Audit Office to audit the Financial Services Authority or examine how it uses its resources.

OUTCOMES FROM THE NATIONAL AUDIT OFFICE’S WORK

What then is the result of the National Audit Office’s activities in holding regulators to account? This section discusses outcomes that can be discerned from the National Audit Office’s approach to accountability. It recognises that accountability should not be an end in itself but should be targeted at achieving beneficial outcomes for society.

Overall, the National Audit Office aims for the following outcomes for three separate groups:

- CONSUMERS can obtain reliable, fairly priced services and are able to navigate the complexities of the markets with confidence,

- MARKET PARTICIPANTS are free from unnecessary regulatory burdens and can invest and enter into contracts with confidence that the regulatory regime will not lurch in an unexpected direction,

- REGULATORS use their discretion and powers wisely and appropriately, being clear about trade-offs and impacts. We aim to analyse the main decisions and tensions in regulators’ functions and report to public and Parliament on results, and encourage regulators to assess their own efficiency and effectiveness and to not over-claim their achievements.

We will now go through these groups in turn. The National Audit Office’s work has brought benefits to consumers:

- The 1996 report "The work of the Directors General of Telecommunications, Gas Supply, Water Services and Electricity Regulation" (National Audit Office, 1996) considered how regulators ensure that, where companies make efficiency savings, customers benefit from these savings through lower prices or better quality. The report's
recommendations were reflected in the 1999 Periodic Review\(^4\) of water and sewerage charges, which cut the total amount paid by water customers by some £340 million in 2000-01 alone.

- Reports on gas and electricity competition pointed to significant savings (£48 a year on average in gas; £35 a year on average in electricity) that consumers could make by switching supplier (National Audit Office, 1999 and 2001a). Both reports were supplemented with a leaflet to help consumers understand how to use their choice effectively.

It has also benefited market participants:

- The reports have drawn attention to the regulatory uncertainties faced by companies operating in a regulated industry. *Pipes and Wires* (National Audit Office, 2002b) recommended that regulators should present clearly the assumptions and financial models underlying their price review decisions, and to communicate better with key stakeholders such as regulated companies. Such action should allow regulated companies to better understand the reasons behind regulators' decisions and help to tackle the perception of uncertainty amongst companies. In response, Ofwat published, in November 2002, the financial model that it will use in its next review of water and sewerage charges. This reduces the company’s cost of raising finance to fund its activities. Ofwat plans to provide more effective feedback to companies on its decisions.

- The report in January 2002 (National Audit Office, 2002a) on the opening of the postal market to competition highlighted the regulatory uncertainty caused by Postcomm's strategy of only issuing one year licences to new companies. Such licences are now issued for a minimum period of seven years, thereby reducing the risks for new companies entering the market.

The most direct outcomes the National Audit Office aims for lie in the behaviour of the regulators. This is because they are the easiest to target (the report makes a recommendations; the regulators respond). The direct outcomes available in this area fall into four categories:

- *influencing change*: where a regulator is embarking on a programme of change, the National Audit Office can have a positive influence on this process. Alternatively a report can plant the seeds that will subsequently lead to change. An example of the latter is the report on the former telecommunications regulator, Oftel (National Audit Office, 2003d). This report argued that Oftel needed to be less remote from consumers to ensure that they obtained the most from competition. The report and its subsequent Committee of Public Accounts report are helping influence Ofcom, Oftel's successor as regulator of telecommunications, as it develops its regulatory strategy for telecoms.

- *recommending change*: reports can directly recommend change. The best example is the report on Opra, the pensions regulator, which proposed that Opra adopted a risk-based approach to its regulatory work (National Audit Office, 2002c). This recommendation has been taken up subsequently by Department of Work and Pensions (the government department) and Opra itself as they develop a new regulatory regime for pensions.

- *supporting existing practice*: for reports to have an outcome, it is not always necessary

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\(^4\) Periodic Review refers to the price review: the process by which the regulator assesses and sets price limits for companies.
that they actually change the behaviour of the regulator. An important outcome could be
that the report supports existing practice where it is under criticism. The *Pipes and
Wires* report (National Audit Office, 2002b) did this: in the face of criticism from
market participants, the UK model of RPI-X price regulation was under fire. The report
looked at both the theory and evidence of RPI-X regulation, and concluded that, in spite
of the risks that it entails, it was the best available technique. Regulators have retained
this model, often quoting the report as support.

- *challenging existing practice*: even if a report concludes that existing practice is
sensible, or if the regulator rejects a report’s recommendations, there is a beneficial
outcome in the challenge provided to regulators. This is especially important where the
National Audit Office asks regulators to explain and justify the strategies they have
adopted as they interpret a series of perhaps conflicting statutory duties. The report on
Postcomm (National Audit Office, 2002a) achieved this goal: it tested the regulator’s
assumptions about the way it proposed to regulate Royal Mail.\(^5\) Feedback from
regulators suggests that simply by knowing that the National Audit Office might
conduct an examination can help to concentrate the mind of the official involved in its
preparation.

The regulators themselves have on numerous occasions pointed to the National Audit Office's role in
the scrutiny of regulatory decision-making. They have used the work of the National Audit Office to
help argue that the UK model of regulation is in fact sufficiently accountable. Through its reports, the
National Audit Office imposes a discipline on the quality of regulatory decision-making with the risk
of exposure for poor decisions, and contributes to improvements to the regulatory framework by
making recommendations for change where justified. This builds and reinforces confidence that the
system will produce more efficient and effective regulation.

And the reports benefit consumers and market participants more generally with an increasing focus on
the effective regulation of competitive markets. This has become of increasing importance, with the
introduction of competition into former monopoly markets and strengthened powers for the
competition regulators. Reports on gas and electricity competition (National Audit Office, 1999 and
2001a), and on Postcomm (National Audit Office, 2002a), examined how regulators have introduced
competition. And the National Audit Office has also examined how the Office of Fair Trading protects
consumers in competitive markets from unfair trading practices (National Audit Office, 2003a).

**THE BETTER REGULATION AGENDA**

There is a growing interest in the UK in how to move from a binary argument in which regulation is
either good or bad – and therefore to be encouraged or cut back – to a more mature debate on how to
enhance the quality of regulation. This interest reflects a disillusionment with periodic campaigns to
“cut red tape”, which rarely if ever succeed in reducing either the volume of regulation or regulatory
burdens on society, and an acceptance that public regulation of private activities is a fact of life for a
modern economy.

This interest is manifested in the widespread development and use of the tool of Regulatory Impact
Assessments (RIA). This section sets out the National Audit Office's role in analysis of Regulatory
Impact Assessments, and explains our methodology for RIA evaluations and argues that this is an
important extension to our oversight role.

\(^5\) Royal Mail is the state-owned postal company that conveys and delivers letters and packages across the United Kingdom.
Since 1997, the UK Government has encouraged an improvement in the quality of regulatory decision-making through its "Better Regulation" initiative, through the establishment of a Regulatory Impact Unit within government to promote better regulation, and a Better Regulation Task Force to provide an independent view on aspects of regulation. Regulatory Impact Assessments are widely recognised as an important tool in the evaluation of regulatory proposals.

RIAs identify the costs and benefits of a policy proposal and the risks of not acting. They are intended to inform the policy decision making process and communicate clearly the objectives, options, costs, benefits and risks of proposals to the public to increase the transparency of the process. The UK Government produces over 200 RIAs a year.

More recently, with the support of the Regulatory Impact Unit and the Task Force, the National Audit Office has been involved in evaluating the quality of the Regulatory Impact Assessments by government departments. In 2001, the National Audit Office produced a report that provided policy makers with good practice examples, and a checklist of what assessments should cover (National Audit Office, 2001b). Following this report, the National Audit Office has taken an on-going role in examining a sample of individual RIAs and reporting annually on the lessons learned to inform the development of regulatory impact assessments across the Government.

In its first annual assessment of the quality of RIAs (National Audit Office, 2004b), the National Audit Office found, perhaps unsurprisingly, a wide range of practices and approaches across Government. But from within this spectrum, the following general messages were discernible:

- RIA is now embedded within government as part of the policy-making system. All new regulations are subject to RIAs, and, in the National Audit Office’s view, departments should always produce RIAs even where it may appear to them to be unnecessary (for example, for policies which are voluntary and impose no obligations on the private or voluntary sectors of the economy).
- Within the sample, there was an insufficient degree of attention paid to the generation of alternative options, including alternatives to regulation where appropriate, and to the analysis of these options. In most cases, the RIAs did not even consider a ‘Do nothing’ option, which, in the National Audit Office’s view, is an essential starting point for counterfactual analysis of the sort required for RIAs, and allows departments to assess and demonstrate the expected net impacts of the proposals.
- By contrast, consultation was the strongest element of the sample. It seems that Cabinet Office guidance has enabled departments to improve the form, content and timing of consultations, though departments could do more to show how they have integrated consultation responses into the final version of the RIA. Under this guidance, each department is required to have a consultation co-ordinator to disseminate best practice.
- Quantifying costs and benefits remains a methodological challenge for departments. The sample contained some attempts at quantification, especially of the risks or hazards that regulation is designed to reduce, but rarely were the benefits quantified. The National Audit Office also noted that RIAs often rightly acknowledged information deficiencies, but failed to reflect the consequent uncertainties in quantified estimates of impacts. For example, there was a tendency towards excessive accuracy in quoted figures, rather than using ranges or sensitivity tests to show inherent uncertainties.
- The RIA sample did not show a strong predisposition by Government departments to consider the enforcement, sanctions or evaluation of the RIAs. In other words,
departments may be able to strengthen their consideration of how the proposed regulation will impact on behaviour over time, and how behavioural changes such as increasing non-compliance will be monitored and evaluated.

This new role is an important extension of the National Audit Office’s ability to hold the executive branch of Government accountable to Parliament. It focuses not on how independent regulators have implemented their regulatory tasks, but on the design of regulation itself. It therefore targets the technical aspects of lawmaking and aims to address the question of how well policies are conceived and designed, and whether the quality of regulatory design is sufficiently high.

**FINAL THOUGHTS**

We would like to close this paper with a speculative assertion. There is a growing interest in the UK in what is variously called regulatory quality, Better Regulation and regulatory burdens. To some extent, this interest takes on a different emphasis depending on political preferences. What is an over-burdensome regulatory approach for one commentator could for another be a reasonable and proportionate protection of society from risks. But the growing interest may reflect more than simply politics: it may reflect a wider anxiety within developed and developing economies about how ineffective regulation acts as a significant barrier to growth and development. This feeling becomes acute when society perceives regulators acting as independent experts – experts of course being particularly mistrusted in modern discourse - and with a wide degree of discretion. It may be that society fears that, so far from acting as a moderating and controlling interest on the excesses of markets, regulation itself has now got out of control.

While this assertion is difficult to support with evidence, this paper concludes that the National Audit Office's work reflects a desire to contribute to this debate and to ensure, ultimately, that the regulators use the discretion they have in the public interest.

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