1. Introduction: redefining and refining regulation

David Coen

INTRODUCTION

As European states move away from public ownership a new method of political control over public utilities is emerging. In the 1990s, member states of the European Union gradually liberalised their utility sectors and new ‘regulatory states’ emerged to govern the natural monopoly aspects (Majone 1997; Moran and Prosser 1994). However, the style of political delegation to regulatory authorities has not followed a uniform trajectory, rather institutional endowments, administrative traditions, market structure and business culture have all influenced the creation of regulatory authorities and the form of implementation (Eberlein 2000; Thatcher 2001). Although we note the variance between governments in the formal delegation of powers to national regulatory authorities, the chief focus of this book is on the post-delegation period; that is, how the regulatory regimes monitor their day-to-day objectives, and how they are redefined by institutional, business and legal interactions. We address these questions from a multiple institutional and multiple level perspective looking at how different national regulatory traditions, institutional endowments, and European Union (EU) pressures hinder or help the functioning of new regulatory markets.

Specifically, this book considers the impact of liberalisation and the introduction of new regulatory structures on three utility sectors in the UK and Germany: telecommunications, energy and rail. With regulation seeking to foster competition while at the same time protecting essential services, we investigate regulatory styles (Böllhoff), costs of ‘new’ regulatory functions (Bauer), how regulatees (firms) in the new regulatory landscapes access and influence regulatory authorities (Coen and Héritier) and, finally, the broader policy implications for this new regulatory environment (Suck and Soriano). These changes raise a number of important questions about the level of political delegation, the structure and function of regulatory authorities, as well as the impact on policy outcomes. Accordingly, this book attempts to determine how regulatory authorities emerge and evolve under different state

traditions, and assesses over time the degree to which there is potential for convergence, divergence or continued differences as regulatory functions mature.

EVOLUTION OF REGULATION: POST-DELEGATION AND POST-PRIVATISATION

Recent comparative European regulatory literature has focused on the formal institutional arrangements between the political principal and the national regulatory authorities (NRAs); be these Competition Authorities, Regulatory Agencies or Voluntary Access Agreements (Eberlien 2000; Gilardi 2002; Levi-Faur 1999; Thatcher 2003). This volume moves beyond this principal-agent (PA) discussion of delegation to explore how regulatory powers evolve and redefine their functions in a fast-changing European economic and political marketplace. In so doing, we recognise that the regulatory environment is in flux and that NRAs shirk and slip from their delegated powers (Huber and Shipan 2002).

How NRAs play the regulatory game is therefore a function of the market they are regulating, the institutional design they inherit and their institutional interests. In discussing markets, we are aware that as competition grows the need for regulation will wane, but also note the importance of institutional endowments in affecting regulatory change. In this regard attention must be directed towards the statutory objectives of the NRA and *ex ante* controls and procedures as this frames the opportunity structure for NRAs and regulatees, as well as NRAs and political principal games. In addition we believe it is correct to focus on the delegation of discretionary and *ex post* powers that emerge over time.

Creating Markets and Competition a Process of Regulatory Change

Business regulation is required because free markets can fail to deliver efficient and equitable outcomes. Monopoly abuse in retail and wholesale markets may call for the distribution process to be regulated, and discrimination across customers may lead to calls for regulation to affect the structure of prices. In the former case, regulation is undertaken to achieve efficiency, and in the latter case regulation is motivated by fairness or equity considerations (Baldwin and Cave 1999). As this volume explores, depending on the characteristics of the sector and political goals of individual countries, the emphasis of regulation will alter. As an example, attempts to encourage liberalisation and competition in the energy and telecommunications sectors, have been accompanied by regulatory measures to ensure access to

transmission, and to provide universal service coverage with geographic uniformity

Significantly, liberalisation in European utilities has resulted in business moving along a three-phase path (see Figure 1.1) from early post-privatisation monopoly (Phase 1), to a monopoly with limited competition (Phase 2), through to potentially fully competitive markets (Phase 3) (Bergman et al. 1998). However, as we will see in this volume, there is considerable diversity in the degree of competition that can be achieved across sectors and countries. Business telecommunication services are closest to the competitive stage, much of energy and residential telecoms is in the mixed period with large incumbency dominance and third party access problems, while rail networks, with the exception of freight, is still arguably a natural monopoly.

Accepting that there is a market progression through the three phases, we can also assume that regulatory intensity (creation of regulators, law-making, monitoring of business activity and court cases) alters over time and is sector assessed. In Phase 1, regulatory focus is on prevention of monopoly market power abuse, and is a period of active institution-building and rule-making, while at the same time attention is given to high levels of compliance monitoring. Nevertheless, while one would expect firms to want privatisation to succeed, this intensive regulatory period is often hindered by asymmetric information exchanges between monopoly and regulator (Coen and Hritier, this volume; Coen and Willman 2000; Parker 2004). Under these conditions regulatory costs gradually begin to increase as the number of staff required to monitor regulatory activity increases and monopoly abuse cases rise (see Bauer in Chapter 3, this volume). Regulatory activity and costs can be

Figure 1.1 Changing regulatory market

expected to peak in Phase 2 as the introduction of competition requires that the regulator monitor not only retail markets, but connection prices and competition rules. In this period, information for the regulatory authorities potentially increases as the number of actors and interests increases. However there are also potential risks associated with institutional conflicts as overlapping competencies between regulators operating at different levels and national competition authorities emerge (see Böllhoff and Soriano in Chapters 2 and 7). Finally, while this book does not directly address Phase 3 of the cycle, we can envisage competition emerging in a number of sectors and regulation becoming increasingly light handed. However, as we know from the study of institutions it is not always the case that regulatory authorities step back as the rationale for their existence diminishes, and it is possible to envisage examples of how more social or environmental regulatory functions could emerge at the expense of efficiency and competition directives (see Suck and Soriano in Chapters 6 and 7).

In sum, the emergence of competition over time means that the emphasis and style of regulation can and does change. In areas where there is clear potential for monopoly abuse or a strong incumbent firm we would expect to see continued *ex ante* regulation where market entry rules and price access are clearly defined. Gradually, as competition emerges it may be possible for a regulator to turn more to *ex post* regulation either through its own process of benchmarking or via competition authority judgements. An important question then arises as to whether a regulator that has been delegated strong *ex ante* powers would entrust these new responsibilities to competition authorities, or, vice versa, whether a strong competition authority would be willing to allow the emergence of a strong and independent regulatory body in the post-privatisation period (see Böllhoff and Coen in Chapters 2 and 4).

Regulatory Shirking, Slippage and Clawback

Just as we can observe a change in the level of regulatory activity and the nature of the market behaviour over time, it is also possible to assess the degree to which regulatory authorities deviate from the scope of the powers which were delegated to them and the opportunities for NRAs to ‘clawback’ power from their political masters. With the EU liberalisation directives in the late 1990s, member states were required to separate regulatory control and ownership of their utility industries (Coen and Thatcher 2000; Eberlien 2000; Gilardi 2002). The result in most states was the creation and delegation of powers to NRAs or the market (see Table 2.1 in Chapter 2).

Beyond the political considerations of EU legislation, principal–agent (PA) literature provides a rationale for the transfer of powers to NRAs. The benefits for political principals which are said to result from delegating

decision-making powers to regulatory authorities include the technical and market expertise of agents, the potential to shift blame for policy decisions and the ability to demonstrate a credible commitment to efficient market developments (Levy and Spiller 1996; Majone 2001). However, while benefits can accrue from delegation, risks also exist if an independent regulator chooses to follow its own preferences at the expense of the political goals it has been set (McCubbins 1985), or if the institutional structures and incentives encourage activity contrary to those envisaged by the principal (Huber and Shipan 2000).

While aware of the benefits of delegating to NRAs, this volume is more interested in exploring how regulators deviate from the political delegation (PD) over time (Figure 1.2) by utilising their formal regulatory independence and informal discretion to distance themselves from initial political objectives (shirking) and by increasing their own powers to, it is hoped, improve the regulatory environment (slippage).

In period 1 (t_0 – t_1) NRAs are faced with a monopoly and information asymmetry, and as such require political credibility and legitimacy that comes from formally delegated powers if they are to exert influence on market developments (Hall et al. 2000). Gradually, as the NRAs' technical knowledge and resources increase, they can be expected to assert their statutory goals by utilising formal court procedures and delegated powers. As such we can expect incremental changes from the PD1 as legal precedence builds up in the regulator's favour (Moran 2003). However, as Böllhoff elaborates in this

Figure 1.2 Post-delegation, emerging powers and political clawback

volume, NRAs are still under the principals' shadow, with many member states maintaining control of NRAs' budgets, director-general nominations and licensing in these early periods of market creation. While many of the formal *ex post* powers of the regulator, such as removal of a director-general, have rarely in practice been used in the EU member states (Thatcher 2005), the threat in the early periods of regulator-building is tangible and acts to deter too much independent activity. As Bauer also illustrates in this volume (Chapter 3), budgetary powers exert a strong hold over NRA activity and the potential for deviation in the early periods of regulatory development can have huge implications for the ability of the NRA to step into and manage the second phase of market regulation.

The second phase, a period of competition and monopoly (t_1 – t_2), is characterised by an increasing number of interest groups, both economic and social. As a result, information available to NRAs increases and interest groups and business are played off against one another (Coen and Willman 1998). Under such complex conditions it is not unreasonable to assume a shift from the NRAs' rigid use of *ex ante* regulation to *ex post* controls such as oversight procedures. In such conditions, business regulatees and NRAs recognise the importance of exchanging information and reputation building. National regulatory authorities, especially, use their discretion to favour those actors who have proven themselves in the regulatory process. The Coen and Héritier chapters in this volume (Chapters 4 and 5), explore how the NRAs, in creating this informational arrangement, can build a potential institutional base and political constituency which can provide them with the capacity, initially, to shirk and distance them from their political principals.

To advance the argument, Böllhoff, Coen and Héritier observe that a regulatory structure in Phase 2 is often complicated in member states with multiple authorities with overlapping competencies on the vertical (EU to national) and the horizontal level (national). This complex web of overlapping competencies has implications for business–regulator relations and for the independence of the NRAs vis-à-vis their political principals. At the national level, discontented business or NRAs can use the competition authorities and procedural courts to alter regulatory procedures (see Coen and Böllhoff, Chapters 4 and 2 respectively, in the case of telecommunications and Héritier, Chapter 5, for rail examples). At the European level, the EU can act as a political principal via European Court of Justice (ECJ) and Commission competition judgements on issues such as universal services goals (see Soriano in Chapter 7) as well as through issuing liberalisation directives.

These last points illustrate well the risks of renegotiating the political delegation. Just as an NRA may change the terms of contract or licence of firms that have failed to attain the appropriate levels of performance or provide fair connections, the courts may also rule on the openness and

transparency of a regime. In addition, political principals may renegotiate the terms of delegation (PD2). This is likely to occur if a government feels that the NRA has moved too far from its original delegation and is pursuing its own market agenda, or that the market structure has changed. If this was the case, we would expect to see the director-generals of NRAs removed, their budgets cut or their formal powers altered. While the removal of director-generals or the issuing of fines has not been observed in the energy and telecommunications sector, Böllhoff, Bauer, Coen and Suck's chapters (2, 3, 4 and 6 respectively) all observe aspects of the need for changes in the regulatory goals which are set as markets evolve. The maturing of the UK energy and telecommunications sector led to the creation of new regulatory bodies in the form of Ofcom and Ofgem. While the crisis in the privatised UK rail industry led, as Héritier has observed (Chapter 5), to complete redesign and re-politicisation of the regulatory objectives.

The second pressure for change arises as a result of political and ideological change within government. As the government's agenda changes, the emphasis of regulation alters – thus an NRA established with delegated powers to encourage competition and efficiency may be at odds with a government that now seeks an equity or 'green' agenda. How new norms can be incorporated into existing regulatory environments is the focus of Suck's chapter on sustainable and renewable energy policy (Chapter 6) and is touched upon in the energy and rail cases studies of Coen and Héritier (Chapters 4 and 5).

As noted above, the emergence of full competition in Phase 3 is not the central focus of this book. While it is perhaps too early to characterise this period, assuming the institutional lag and market development which will occur in the telecommunications, energy and rail sector, what can be said is that it is highly unlikely that NRAs will disappear over night. Moreover, their regulatory function may alter from that of market-making to that of market-correcting. Which institutions and countries are more likely to adapt their regulatory initiatives towards market-correcting aspects like renewable energy or social policies are explored in Suck's contribution (Chapter 6).

Are these Processes Converging across Europe?

In summing up the above discussion, the volume as a whole sets out to explore the pressures and constraints on regulatory evolution. The changing nature of markets and technological innovation are clearly at the forefront of many of the developments we observe in the management of markets and the style of regulation. However, institutional interests, political goals and ideologies also play a large part in how the broader liberalisation agenda is implemented and regulated.

Thus, while we can observe that regulatory intensity and political divergence from initial political delegation will increase post-privatisation and continue to rise until full competition, we cannot say that these changes will occur in a uniform or convergent way across sectors or countries. The political activism of ministries, the legacy of embedded legal traditions and administrative cultures, as well as sectoral differences, will all ensure that individual regulatory regimes will remain distinct. Therefore, while not attempting to define a European best practice for managing regulation, all the contributions in this volume illustrate how the process of refining regulation has the capacity to take on a life of its own by identifying the processes and actors that are at work.

ORGANISATION OF THE BOOK

The telecommunications, energy and rail sectors were chosen as the central case studies for this book as these industries are important for the economic performance of the European economy and provide important inputs to other sectors of the economy. Moreover, they are all industries in which important boundary shifts at different levels have occurred and are likely to occur over the next five to ten years. Thus in all these sectors industry boundaries are shifting with technological developments, market range is altering, company boundaries are shifting as cross-sector mergers become possible with deregulation, and regulatory boundaries are shifting (Thatcher 2001). Nevertheless, they are all vertically structured network industries that contain important elements of natural monopoly or essential facilities, and hence require economic regulation. In addition, they all exhibit some non-economic regulation, whether social, environmental or safety (see Suck, Chapter 6 in this volume). All have been the subject of EU-wide regulation in the form of EU directives (Eising 2000a; Schmidt 2002). However, the sectors also exhibit important contrasts in that they vary: with respect to the speed, and possible degree, with which effective competition will emerge; in technological innovation; in the balance between economic and non-economic regulation; in the balance between national and supra-national regulation; and in the acceptance by business of institutional and self-regulation.

In all the chapters we conducted high-level interviews with all the regulatory authorities at the national and European levels and with a representative cross-sample of industry, taking account of the fact that business' institutional preferences vary with size, origin and market position (see Appendix). Hence we included incumbents in energy, rail and telecommunications in the two national markets, incumbents entering a new market (whether defined by geography or by product), new entrants from outside the

EU market, and new start-ups. These differences we assumed were likely to influence their assessment of alternative regulatory systems across countries and between national regulatory options.

We took three different comparative perspectives in answering the questions outlined in the process of regulatory evolution set out above.

In Part I of the book we described and compared the regulatory regimes in the UK and Germany with their different political institutional architectures, administrative traditions and economic legacies (Wilks 1996). Particularly important are the constraints on the discretion of executive and legislatures that arise from different interrelationships between legislative, executive and judicial institutions (Levy and Spiller 1999). We take a comparative perspective with regard to the structure of the regulatory arrangements: we distinguish between multiple-authority structure and a single-authority structure at the horizontal (national regulatory regime) level and vertical level (EU interaction with national).

In exploring these levels we specifically examine how formal and informal regulatory institutional structures emerge and develop in different countries and sectors. This book assesses the creation of new regulatory authorities, and assesses what features are different in the administrative and regulatory cultures of the respective national and sector regimes. All the chapters contribute to this debate by assessing the degree to which the state has 'rolled back' from market governance in the light of liberalisation and assess the emergence of independent regulators and self-regulation. More specifically, in this part we consider the question of whether the regulator can and does evolve after the initial delegation of power. More precisely, we ask whether the regulatory discretion and independence of NRAs will continue or even increase in this period or whether we are likely to see continued political monitoring or even the re-emergence of politicisation as in the case of the UK rail and German energy sector. Secondly, if we assume change can and will occur, can we expect that similar regulatory patterns will emerge even if initial regulatory arrangements differ across sectors and countries.

In exploring the above, the contribution by Dominik Böllhoff (Chapter 2) provides a systemic and detailed description of different regulatory regimes from a comparative administrative perspective and attempts to assess the converging and diverging aspects of the respective regulatory regimes in Germany and the UK. Specifically he looks at how a number of regulatory authorities with potential overlapping competencies define their roles in a dynamic regulatory space. The chapter explores in detail the degree to which governments have defined the regulatory environment and the independence and discretion that has been delegated to regulatory authorities. The chapter also explores the degree to which ministerial interferences can still be observed in Germany and the success of UK independent regulators in

distancing themselves from government, with the notable exception of the railways. Finally, like the Coen and Héritier chapters, the Böllhoff chapter touches upon the opportunity structures of the regimes by discussing the regulatee and regulator relationships and how these interests (both institutional and economic) can, via national and European courts, define the powers and the competencies of national regulatory authorities. The overall contribution to the regulatory debate of this volume is therefore to contextualise the complex and dynamic regulatory environment in which public utilities are delivered.

Michael Bauer (Chapter 3) assesses the administrative costs of regulatory reform in the UK and Germany in light of the tensions between securing a competitive market and the continued provision of general interest services. Accepting that privatisation and liberalisation of the utility markets were introduced to improve economic efficiency, and reduce public expenditure and political intervention, this chapter attempts to assess whether there has been a visible reduction in the public burden. Specifically, Bauer finds that while privatisation has resulted in the demise of command-and-control regulation, new administrative costs have emerged in light of the re-regulation of market incentives (Majone 1997). Thus, in addition to showing the administrative burdens of different regulatory models, this chapter demonstrates the economic costs of different political and regulatory objectives, such as the provision of public goods.

Drawing on the above context David Coen and Adrienne Héritier – in Part II – analyse, the business–regulatory relationships in Germany and the UK. In particular, they look at how various institutional and regulatory arrangements provide different ‘access’ opportunities for business to influence the regulatory debate, and the degree to which it creates problems for compliance and for the implementation of regulatory rules. In taking a comparative perspective on the type of firm, they recognise that regulatory behaviour varies with business size, origin and market position. Hence, they expect access and contract compliance/implementation to vary according to the nature of the firm. For this reason they distinguish between incumbents that have a long-standing relationship with governments and those who are new market entrants. Finally, they distinguish between large firms that call upon significant resources and small and medium companies that are faced with tight budget constraints. It should, however, be emphasised that the aim of this contribution is not to try and account for the policy impact of business on actual regulatory directives or contract. Rather, the aim is to analyse how firms interact and define the regulatory regime in which they operate.

In their separate contributions Coen and Héritier explicitly focus on understanding the interactions between German and UK firms and their national regulatory institutions, and the influence of these exchanges on the

development of post-delegation regulatory structures. Both recognise that a key question in the development of European regulation is the appropriate level and style of regulation. In fact, as liberalisation leads to greater cross-border company relationships, national regulatory authorities may find it more difficult to deal effectively with inter-jurisdictional problems, and for this reason they also assess the impact of cross-country learning by business and the role of the European Commission in fixing/establishing national business–regulatory relations. However, both accept that informational asymmetry in the regulatory exchange between companies and regulators means that national authorities are better informed about local conditions, and are therefore better able to act decisively on breaches of regulatory rules. The chapters illustrate which regulatory competencies are best centralised, which are best co-ordinated at supra-national level, and which are best left to national authorities. This is of particular interest since these perspectives will often inform regulatory activity and the provision of services.

Finally, Part III describes the impact of politics and regulatory authorities on policy development. Just as the earlier chapters focus on the importance of changes in government for policy preferences, this part explores systematically how multiple levels of regulations and institutions influence the development of policy. André Suck's chapter (6) tackles the question of variance in market-correcting policy between the UK and Germany by focusing on the development of renewable energy policy. His central hypothesis is that unitary states have a better problem-solving capacity, due to less veto players, and that federal states have an inbuilt institutional barrier to reform policies (Scharpf 1988). He explains the 'better' policy outcomes in the German federal system in terms of the political-administrative cultures and the role of different policy paradigms over time. Thus he makes an argument for comparative policy analysis in EU states to be time contingent. While Suck takes a comparative study of market correcting policy, Soriano (Chapter 7) provides us with a detailed multi-level study of the role of the ECJ in the assessment of the provision of public services. By analysing how the ECJ has assessed the legality of state intervention under competition law rather than free trade rules, she demonstrates how the EU has given nation-states some discretion in how they provide public services

All these themes are, of course, interlinked. Institutional developments and costs are a function of business–regulatory relationships. Policy-outputs feed back into policy developments, which in turn influence the agenda-setting role of politicians, institutions and actors. However, as regulatory institutions and policy studies mature it is important that we understand how the regulatory processes emerge after political delegation and what factors influence redefinitions and refinements in the regulation of the European utility market.