Are Economists Kings? Economic Evidence and Discretionary Assessments at the UK Utility Regulatory Agencies

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ARE ECONOMISTS KINGS? ECONOMIC EVIDENCE AND DISCRETIONARY ASSESSMENTS AT THE UK UTILITY REGULATORY AGENCIES

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Abstract: UK sectoral regulatory authorities are hybrid communities of, among others, lawyers and economists. Since the liberalisation of essential services, expert economists enjoy broad discretionary powers in advancing the agencies’ broad statutory objectives. Yet, despite the significant societal impact of economic regulation, existing scholarship in the fields of competition law and regulation and public law has, with very few exceptions, disregarded these actors and the very essence of their work. This paper aims to address this gap in the literature by blending theoretical with empirical insights deriving from 14 semi-structured elite interviews with regulatory economists in the regulatory agencies for energy (Ofgem), telecoms (Ofcom) and water (Ofwat). It explores the increased reliance on economics in the regulatory decision-making process and the impact this has had on the authorities' decision making and discretion, when making complex trade-offs between the various goals of the regulatory enterprise. In doing so, it puts forward a theoretical framework inspired by Craig Parsons’ typology of political action so as to identify and examine the nature and scope of the constraints that inform and shape the influence of economics in the exercise of regulatory discretion. This endeavor is significant in the sense that it is the first of its kind and, in that it provides a normative framework of analysis that can be applied in other areas of regulation heavily infused with and influenced by economic evidence and analysis, such as ‘pure’ competition law enforcement by both sectoral and competition authorities.

JEL Codes: K23, K21, L51, L40, L94, L95, L96
I. Introduction

The delegation of vast discretionary powers to experts to shape and defend the legitimacy of regulatory decisions lies at the very core of the regulatory state. UK regulatory agencies in the utilities sector – i.e. Ofgem, Ofcom, and Ofwat – are no exception to this. Since the privatisation and subsequent liberalisation of essential services, such as energy supply, telecoms and water, expert economists appointed in independent regulatory agencies enjoy significant discretionary powers in advancing the agencies’ broad statutory objectives, mainly protecting consumers and promoting competition. In fact, with the exception of the neighbouring field of competition law, utilities regulation stands out amongst the various other fields of social and economic regulation in terms of the impact economics, as an external source of wisdom and authority, has had on the tools and methodologies regulators employ to inform the exercise of discretion. Indeed, economics and economic evidence emerge as the main ‘tool’ for the translation of regulatory objectives (such as the promotion of competition) to operational policies and procedures (such as access pricing) that guide regulatory judgments. The use of economics has two main features: a) it offers a logic framework for decision-making, and, ii) has a strong focus on empirical and factual evidence. Economic evidence, as used in this work, refers to the theories, methods, and tools used by the discipline of regulatory economics (mostly industrial organisation economics) with the aim to advance normative claims on matters of regulatory policy in the field of economic regulation. Economic analysis employed to understand and measure the costs and benefits of different policy options (i.e. cost–

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1 Office for Gas and Electricity Markets. Ofgem was set up by the Utilities Act in 2000. It is charged with implementing the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002, the Energy Acts of 2004, 2008, 2010, 2011 and 2013 and the relevant EU legislation as well as the administration of a number of environmental projects on behalf of the government.

2 Office for Communications. Ofcom was established by the Communications Act 2002 and operates under a number of Acts of Parliament and other statutes. It is responsible for regulating the TV and radio sectors, fixed line telecoms, mobiles, postal services and the airwaves over which wireless devices operate.

3 The Office of Water Services was established under the Water Act 1989, continuing under the Water Act 2003 until 31 March 2006. By the 2003 Water Act it was replaced from 1 April 2006 by the Water Services Regulatory Authority (WSRA). The authority is responsible for the regulation of the water and sewerage industries in England and Wales.

benefit analysis) is outside the scope of this inquiry. Turning to the ‘outputs’ of economic evidence, these may include the following: a) Economic theory; b) Economic reasoning, which refers to the economists’ methodological approach regarding which questions to ask and which indicators and evidence to examine; c) Economic techniques and tools, which refer to quantitative and qualitative techniques, such as econometrics and regression analysis; and, d) Economic data, which may refer to prices, sales, economic reports and studies.

Despite, however, the crucial role of economists within regulatory agencies in the UK and the societal impact of economic regulation, existing scholarship in the broader fields of competition law and regulation and public law has, with very few exceptions,\(^5\) disregarded these actors and the very essence of their work. Most notably, little attention has been paid to exploring how the increasing reliance of regulators on economic inputs in the neoliberal state influences or otherwise the way they perceive and exercise their discretionary powers. Has the use of economic evidence by regulators had the effect of increasing the discretion they enjoy? And relatedly, how do regulators assess the limits of their discretion and their interaction with other actors, such as the courts? Rather, the central preoccupations seem to revolve around the constitutional and institutional dimensions of regulatory action\(^6\) and the intensity of review of such action.\(^7\) Sure, there is plenty of indirect evidence from court judgments and regulatory decisions on the way economic facts and considerations feed into the decision-making process; to the process, for example, that led to the adoption of a given economic model rather than another when making discretionary trade-offs. But, still, we never really learn *directly* how those undertaking regulatory tasks actually perceive their scope of decisional freedom relative to their overall statutory mandate and the influence that economic evidence may or may not have on the reach and breadth of their discretion. The article aims to address this gap in the literature. In doing so, it blends theoretical with empirical


\(^6\) See e.g. T Prosser, *The Regulatory Enterprise: Government, Regulation, and Legitimacy* (OUP 2010).

insights deriving from 14 semi-structured elite interviews with regulatory economists working in Ofgem, Ofcom and Ofwat.

The paper explores the increased reliance on economics in the regulatory decision-making process and the impact this has had on the authorities' decision making and discretion, when making complex trade-offs between the various goals of the regulatory enterprise. The article puts forward a theoretical framework inspired by Craig Parsons’ typology of political action8 to uncover the possible constraints to the influence of economic evidence in regulatory decision-making. It thus seeks to explore the relative influence of ‘structural’,9 that is exogenous constraints (e.g. the political or economic climate), ‘institutional’,10 that is forces that affect regulators’ actions with respect to their position ‘within man-made organizations and rules’,11 and ‘ideational’12 constraints, such as the influence of epistemic communities, in the context of three rich case studies which represent diverse areas of regulatory action where economists are called upon to exercise discretionary assessments.

The argument unfolds in two parts. The first part is conceptual in nature and seeks to explore how economic evidence enters the realm of discretionary decision-making. In doing so, it offers a taxonomy of administrative discretion, that is primarily informed by the economists’ perception of their role and unpacks its interrelationship with economic evidence. The second part is operational in nature and examines the use and influence of economic evidence, particularly in the context of specific regulatory episodes that emerged during the study design as having significant importance. The findings render a stark disparity between these two levels of analysis. While on a conceptual level virtually all regulators perceived economic evidence as the main ‘tool’ for translating their broad statutory mandate to operational policies and procedures, hence allowing them to trade off between efficiency and equity goals, this perception is extremely variable between the three regulatory agencies at the operational level of analysis. The article seeks to explain this variation by drawing on Craig Parsons’ rich framework of analysis. The article concludes that the role of economics in regulatory decision-making has increased, but economists are not Kings: their influence or power is clearly constrained.

8 C Parsons, How to Map Arguments in Political Science (OUP 2007).
9 Ibid at p. 12.
10 Ibid at p. 12; 49-65.
11 Ibid at p. 12; 66-93.
12 Ibid at p.12; 94-132.
The article seeks to contribute to our understanding of how economics, as one of the primary sources of wisdom and authority in this field of economic regulation, enters the realm of regulatory discretion and transforms the way regulators (and courts) understand and conceptualise the very idea of discretion. While existing legal scholarship attempts to locate the sphere of regulatory discretion within the confines of judicial review, this study adopts an inductive and context-sensitive approach that purports to better appreciate the inner-workings of regulatory discretion, as the latter is shaped by the power relations between the hybrid communities of lawyers and economists within regulatory agencies and other actors in the regulatory space. This endeavour is significant in the sense that it is the first of its kind, and in that it provides a normative framework of analysis that can be applied in other areas of regulation heavily influenced by economic evidence and analysis, such as ‘pure’ competition law enforcement.

The article is structured as follows. Section II discusses the methodological approach taken; Section III briefly examines the institutional setting of utilities regulation in the UK; Section IV explores through the use of examples the interrelationship between economic evidence and the exercise of discretionary power and offers a taxonomy thereof; Section V explores the various constraints to the exercise of discretion and Section VI concludes.

II. Methodology

A mixed-methods approach was adopted that combined doctrinal, theoretical and empirical analysis. In order to prepare for the project’s interview stage, a review was performed of all regulatory decisions issued by Ofgem, Ofcom and Ofwat so as to gain a broad view of the input and manifestation of economic evidence employed to support a range of discretionary assessments. When such decisions had been appealed the analysis included the relevant court judgments. The regulatory decisions covered the period between the enactment of the relevant regulator’s governing statute and December 2018; i.e. since the Communications Act 2003 in the case of Ofcom, the Utilities Act 2000 in the case of Ofgem, and the Water Act 2003 in the case of the Water Services Regulatory Authority-Ofwat. The analysis conducted led to the methodological choice of focusing on three case studies, one from each regulatory agency. During the interviews, the interviewees were asked, among others, to reflect
on the influence economic evidence exerted over regulatory judgments and the reasons why it might not have been as effective in the context of these specific case studies related to their organisation. To allow for a reliable testing of the hypothesis, the case studies selection was subjected to two main constraints. First, ‘closed episodes’ were selected so as to be able to examine the use and influence of economic evidence throughout the decision-making process under examination. Second, such episodes represented relatively recent cases so as to increase the chances of locating the relevant interviewees and ensure a relatively accurate recollection of facts.

In the case of the energy regulator -Ofgem, the case study was related to the use of neoclassical/Austrian economics in introducing competition in the retail energy market and the reregulation thereof as well as the use of behavioural economics in enhancing consumer participation in the market.13 In the case of the communications regulator-Ofcom, the case study was related to the use of neoclassical economics in the termination rates disputes.14 In the case of the water regulator -Ofwat, the case study was related to the use of neoclassical economics in introducing competition to the non-residential retail market.15 Delving into these regulatory episodes allowed generating original insights on the respective positions and beliefs of economists in each episode, reinforced by their own account of the story. Because the institutional organisation of economic expertise varies greatly across the three regulatory agencies involved, the range of interviewees was balanced to involve economists in various positions within the agencies. Interviews were conducted between June 2017 and December 2017 ‘on the record’, face-to-face, and were audio recorded and transcribed. Interviewees received the interview protocol before the interviews and expressed both their written and oral consent to the interview being recorded and used to inform this research. Due consideration was given to interviewees’ requests to keep certain pieces of information off the interview record. When specifically requested,

interviews were conducted under promise of anonymity. The transcripts were manually coded. The coding aimed at identifying the regulators’ perceptions of constraints and their response to such constraints in terms of their decision-making process. Interviewees were given ample scope to self-direct their contributions within the context of a framework of prepared questions and issues for discussion deriving from the case studies. The qualitative analysis performed allowed to better contextualise the insights generated from the interviews and the breadth of the analysis allowed offsetting any possible tendency for interviewees to exert bias in their recollections. Evidence gathered via interviews was then triangulated with analysis of regulatory judgments and relevant policy reports, shedding light on the regulatory process and the various constraints on agency decision-making.

Craig Parsons typology of political action directly informs the theoretical framework adopted in this article and serves as an analytical tool for identifying the various constraints to the influence of economic evidence in discretionary assessments. This article does not claim that Parsons’ framework is the only, or even the best, way of making sense of the interrelationship between economic evidence and discretion. However, its inclusion of various macro- and micro-level factors at play in decision-making renders it well suited to the task at hand. Parsons identifies structural, institutional, ideational and psychological constraints. For methodological reasons explained below this article focuses only on the first three sources of constraints.

‘Structural’ claims, explain people’s actions ‘as a function of their position vis-à-vis exogenously given “material” structures like geography, a distribution of wealth, or a distribution of physical power’. Applied in the context at hand, they refer to exogenous constraints, such as the political or economic climate in which regulators operate as well as broader societal pressures and the way these constrain or otherwise the way they employ economics when exercising discretion.

Institutional claims also explain people’s actions with respect to their position but ‘within man-made organizations and rules (and within the “path-dependent” process implied by man-made constraints)’. For our purposes here, the more pluralistic understanding of institutions is adopted, whereby the latter are not merely

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16 Parsons (n 8) 12.
organisations that set the ‘rules of the game’. Rather, they provide operating procedures, behavioral norms and identities to those who function within them. Hence, this allows us to explore how legal factors, such as the threat of judicial review or the standard of review, and quasi-legal factors, such as organisational factors, values, and the attitudes of officials affect the way economic evidence is used in discretionary assessments.

‘Ideational’ claims also explain regulatory action based on cognitive and/or affective elements but see those as ‘created by certain historical groups of people’. For example, epistemic communities or elite beliefs may affect the type of economic evidence used, as we shall see in Section V below.

‘Psychological’ claims explain people’s actions by relying on ‘cognitive, affective, or instinctual elements that organize their thinking, but see these elements as general across human kind, as hard-wired features of “how humans think”’. Examining such constraints would require a different methodological approach than the one adopted here and are thus left outside the scope of this article. Such an approach would be based on lab experiments so to reveal the existence or otherwise of biases, such as confirmation bias, and how these affect the use of economic evidence when exercising discretion.

III. The Institutional Setting of Utilities Regulation in the UK

Before we examine the interrelationship between economic evidence and discretion it is important to provide a bird’s-eye view of the institutional setting of utility regulation in the UK so as to better appreciate the role of economists’ therein and the various constraints to their powers; most notably the institutional constraints.

Sector-specific regulatory agencies were first established following the privatisation and subsequent liberalisation of essential services in the late 1980s. They are institutionally and organisationally separated from the ordinary bureaucracy but are accountable to Parliament. All regulatory agencies are governed by corporate

20 Parsons (n 8) 12.
21 Parsons (n 8) 12.
23 See CD Foster, Privatisation, Public Ownership and the Regulation of Natural Monopoly (Blackwell 1992).
boards, which provide strategic direction to the organisations, each of which is supported by an office.\textsuperscript{24} The Board usually comprises a Chair, and executive and non-executive members. Non-executive members bring experience and expertise from a range of backgrounds including industry, social policy, environmental work and finance. The organisational structure differs radically from that conceived under the original privatisation legislation, which vested individuals (e.g. the DG for Telecommunications) rather than Boards with the task of overseeing, directing and controlling the newly privatised industries.\textsuperscript{25} For example, Ofgem operates under the direction and governance of GEMA, which makes all major decisions and sets the policy priorities of the economic regulation of the electricity and gas industries in Great Britain. The members of the Authority are appointed and reappointed by the Secretary of State for Business, Energy and Industrial Strategy in consultation with the administrations. Ofgem is headed by a Chief Executive who is further supported by a senior management team. Economists at Ofgem work on issues related to market design, monitor structural reform in wholesale and retail energy markets, produce market analysis and meet with industry representatives. Crucially, an Office for Research and Economics has been recently established headed by a Chief Economist.

Ofcom’s main decision-making body is the Board, which provides strategic direction for the organisation. Most crucially for our purposes here, the Competition Group has a prominent role over all sectors Ofcom regulates. It provides expert competition and regulatory economic analysis in relation to a diverse range of Ofcom projects that span all of the industry areas for which the authority has responsibility (e.g. regulatory policy development, market reviews, market investigations under the Enterprise Act, competition investigations, resolution of disputes between communications providers, spectrum policy, and impact assessments). The Competition Group also collaborates closely with the Chief Economist’s Team. Regarding Ofwat, the role of economists within the organization has been recently elevated with the appointment of Senior Director Analytics and Chief Economist, primarily working on price reviews.

Utility regulators are not only accountable to Parliament but also to Courts. In fact, they are subject to quite a complex institutional architecture governing appeal. Not

\textsuperscript{24} See e.g. Ofcom: \url{www.ofcom.org.uk/about/how-ofcom-is-run/}.

\textsuperscript{25} For a comprehensive account see T Prosser, \textit{Law and the Regulators} (Clarendon Press 1997); Telecommunications Act 1984, s 1.
only do appeal routes against regulatory decisions vary depending on the nature of the issue involved, but they also differ significantly for each of the regulated sectors. Furthermore, a number of appeal bodies with dissimilar expertise in regulatory matters (e.g. the specialist CMA, the specialist Competition Appeal Tribunal-CAT and generalist High Court) and entrusted with varying standards of review (e.g. judicial review, statutory review and statutory appeal) have been involved over time in scrutinising regulatory decisions.26 Contrary to the ordinary courts, the CAT’s bench combines legal and non-legal expertise in areas such as economics, business and accountancy. Crucially, the CAT enjoys both statutory review (similar to common law judicial review) and statutory appeal jurisdiction (where it engages with the factual merits of the case). The CMA enjoys broad access to epistemic competence as well as access to a pool of investigators, including Utilities Panel members. Furthermore, its in-depth inquisitorial approach allows for a better appreciation of the underlying issues in price control and licence modification cases than the CAT’s adversarial approach. Appreciating the regulatory appeals landscape is important in that it affects the incentives of the regulators and the regulated firms and the role and use of economic evidence in regulatory decision-making, as Sections IV and V will illustrate.

Having provided a brief overview of the institutional setting, we can now turn to examine how economic evidence ‘meets’ the regulators’ discretionary powers.

IV. Conceptualising the Interrelationship between Economic Evidence and Discretion

A natural starting point would be to explore how economic evidence enters the realm of discretionary decision-making. In other words, how regulatory discretion is ‘filled out’ with economic context. This will allow us to better appreciate the input of economic evidence in diverse areas in which regulators are called to exercise discretion, explored in greater detail in subsection B below, as well as the various constraints to the use of economic evidence, discussed in Section V.

26 For an analysis see Mantzari (n 7) above.
In examining the interrelationship between economic evidence and discretion, we follow a largely inductive approach that is informed by the interviewees’ own understanding of the purpose (‘why’) for which discretion was awarded in the first place and the manner in which it will be exercised (‘how’), i.e. how the regulatory agency will achieve its substantive goals and what tradeoffs should it make when multiple substantive goals interact. It will be shown that economics have added a layer to discretionary power composed of their own methodology and tools. This is not solely confined to the operationalisation of the traditional core objectives of economic regulation, such as the promotion of competition and innovation, but also applies to the broader set of non-economic objectives, such as social and environmental statutory objectives and the concomitant efficiency/equity trade-offs that regulators have increasingly been called upon to perform.²⁷ In doing so, we shall see that economics provides a logic framework of analysis in making these trade-offs, – for example equity objectives can be pursued as long as they are not too costly or have too strong negative effects of competition – thus structuring the arena of discretionary power. We shall be able to appreciate that discretion in relation to efficiency decisions is significantly more limited relative to the discretion in relation to the weight agencies need to assign to efficiency and equity, respectively.

Specifically, the interviewees understood economic evidence and analysis to inform three relatively distinct dimensions of regulatory discretion: a) the interpretation of their statutory mandate (what may be referred to as ‘interpretive discretion’); b) the way they formulate policy when ‘Parliament has expressly or impliedly left a specific policy domain undetermined’²⁸ (what may be referred to as ‘operational discretion’);²⁹ and c) the procedures and enforcement tools they choose and employ to this end (what may be referred to as ‘enforcement discretion’). This widespread input of economic evidence and analysis has allowed economists to expand their own understanding of the range of decision-making freedom open to them. As we shall see, in the case of interpretive discretion this expanded freedom is externally recognised from other actors in the regulatory space, notably the courts; but

²⁹ Ibid.
the section will also allude that it is significantly constrained in the case of operational and enforcement discretion. Section V will explore this claim in greater detail.

Before elaborating further on the three dimensions of discretion, it is first necessary to appreciate how discretion manifests itself in the statutory objectives of utilities regulator to which the next subsection turns to. Subsection B will then offer a taxonomy of the use of economic evidence in regulatory decision-making process by exploring the various ways in which economic evidence and analysis informs interpretive, operational and enforcement discretion.

A. How Discretion Manifests Itself: Scope and Implications

The source of discretion is to be found in the regulators’ governing statute. A careful reading through the statutory frameworks of Ofgem, Ofcom and Ofwat will immediately reveal that discretion manifests itself through standards, rather than narrowly construed rules; if one adheres to such distinction. Although the term ‘rules’ may be used to refer to all ‘general norm(s) mandating or guiding conduct or action in a given type of situation’, it is the narrower sense of ‘rules’, which in turn distinguishes the latter from the more flexible norms of standards and principles, that is used here.

The very fact that discretion manifests itself in the form of open-ended standards has ‘important effects on the allocation of decision-making authority’. In sharp contrast to rules, that ‘vest authority in the rule formulators rather than in those who apply the rule in particular cases at a later time’, ‘standards delegate decision-making authority to the decision-maker at the point of application’. Hence, standards contribute to the ex post formulation of the content of the law, as they allow the decision-maker to gather, process and finally incorporate into his reasoning information obtained after the promulgation of the standard. For Vermeule, rules ‘require more information and decisional competence ex ante, at the time the rule formulators decide what the content of the rule should be’, whereas ‘[s]tandards

32 Ibid 93.
33 Ibid 92.
require more information and decisional competence ex post, at the time of application’.35

Furthermore, unlike narrowly construed rules which may be overinclusive or underinclusive in their application, standards guide the exercise of discretion by encompassing an open-ended framework comprising, in our case, of various substantive regulatory objectives (economic and non-economic), which the regulator should interpret, take into account and trade-off when exercising her discretionary power. These objectives reflect both efficiency and equity considerations. For example, Ofcom’s principal statutory objective is ‘to further the interests of consumers in relevant markets, where appropriate by promoting competition’,36 but also ‘to further the interests of citizens in relation to communications matters’.37 The efficiency maximisation objective is mostly apparent in the market mechanisms governing spectrum auctioning and management, or in the need to ensure ‘the availability throughout the United Kingdom of a wide range of electronic communications services’,38 whereas equity considerations are mostly reflected in the non-economic objectives that the regulator ‘must secure’ or ‘have regard to’ in performing its duties that relate to the interests of ‘citizens’.39 Those include ‘plurality considerations’,40 and ‘the needs of persons with disabilities, of the elderly and of those on low incomes’.41

In the same vein, Ofgem’s principal statutory objective is not limited to the protection of ‘existing’ consumers, but, echoing sustainability considerations, further encompasses the protection of ‘future consumers’.42 Additionally, Ofgem ‘must have regard’ to the financeability of license holders and to the achievement of sustainable development.43 Similarly, Ofwat duties consist inter alia of promoting the interest of

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35 Vermeule (n 31) 92.
36 Communications Act 2003, ss 3 (1) (b).
37 Communications Act 2003, ss 3 (1) (a).
38 Communications Act 2003, ss 3 (2) (b).
40 Ibid, ss 58 (2B).
41 Ibid, ss 3(4) (i).
42 Gas Act 1986, s4AA(1); Electricity Act 1989, s 3A.
43 Gas Act 1986, s 4AA(2); Electricity Act 1989, s 3A2.
consumers, whenever appropriate by promoting effective competition in the provision of water and sewerage services\textsuperscript{44} and the financeability of license holders.

All three regulators, alongside their general duty to protect the interests of all consumers, they have particular responsibilities towards certain groups in society, such as the disabled or chronically sick, pensioners, individuals with low incomes and those living in rural areas.\textsuperscript{45} Promoting the interests of these groups involves a departure from the purely economic rationale for public intervention in markets summarised in the concept of ‘market failure’, in order to achieve a socially, rather than economically desirable outcome. Finally, all regulators have a duty to promote effective competition ‘where relevant /appropriate’. Naturally, this leaves considerable discretion to the regulator as to the interpretation and application of the standard to the case at issue.

There is, however, one recent exception to the legal primacy of competition. The Energy Act 2010 requires Ofgem to consider in the regulation of both electricity and gas ‘whether there is any other manner (whether or not it would promote competition…) in which the Secretary of State or the Authority [Ofgem and GEMA] … could carry out those functions which would better protect those interests [the interests of current and future consumers.]’.\textsuperscript{46} The role of competition in the electricity and gas industries has, indeed, come under considerable criticism and skepticism, rendering, as we shall see below, the energy regulator more vulnerable to structural constraints.

The following subsection will focus on how economic evidence informs the ‘ex post formulation of the content of the law’ granted by standards. It will thus attempt to open the ‘black box’ of discretionary decision-making and appreciate through the use of illustrative examples the diverse ways in which economic evidence influences the breadth of regulatory discretion vis-à-vis the statutory wording or otherwise.

\textbf{B. The Use of Economic Evidence in Discretionary Assessments: A Taxonomy}

\textsuperscript{44} Section 93(3) adding a new s 2 (2B) to the Water Industry Act 1991 as amended.
\textsuperscript{45} Water Industry Act as amended by Section 39 (2C) of the Water Act 2014.
\textsuperscript{46} Energy Act 2010, Clauses 16 (for natural gas) and 17 (for electricity).
In terms of our overarching statutory objectives of protecting the interests of existing and future consumers we have fairly wide discretion (emphasis added) in terms of how we achieve them. I do think in practice that has gone down fairly well established and well-worn routes really. We set principles that we expect companies to follow, we set price controls, clearly, we will take enforcement action if need be, there’s a set of well-understood set of tools we have to influence the market, the sector as a whole. There can be questions of balance between them, take the balance between enforcement action and compliance work (...). I think there are questions about how you get the right balance there. Equally, there are questions…we have a certain toolkit, but does that need to change if we see big changes in the sector? (Ofgem, Chief Economist)

The above quote is quite illustrative of the regulators’ own understanding of the significant leeway they enjoy in operationalising their statutory objectives, but also of the role economic logic, evidence and analysis play in structuring their discretion. It also serves to highlight the three relatively distinct dimensions of discretion that interviewees understood economic evidence to directly inform: interpretive, operational and enforcement discretion.

Of course, while these are presented here as conceptually distinct, pragmatically speaking they are very much interdependent in the larger institutional analysis of agency decision-making. For example, economic evidence and analysis employed to inform interpretive discretion as to what a ‘fair and reasonable’ price entails is impossible to cabin from enforcement discretion, as the regulatory agency’s procedural framework and rules will determine, at least in part, whether and how the agency will achieve such a goal, what tradeoffs it will be required to make and which affected interests it will consult. Similarly, the process of interpreting the statutory mandate unavoidably involves consideration of how the statutory objectives will be implemented. Despite these shortcomings, the distinction adopted reflects the interviewees’ perception of the different faces of their discretionary powers and also serves well our analytical purposes. The remainder of this section will explore,
through the use of examples, the ways in which economic evidence informs these three dimensions of discretion.

i. Economic Evidence and Interpretive Discretion

Interpretive discretion can be said to broadly refer to the leeway in determining the meaning of the agency’s statute in pursuance of its policy ends. Of course, this is closely related to agency implementation of its statutory mandate, but the process of interpretation is an unavoidable first step. We tend to think of legal interpretation as the domain of the judiciary, but much statutory interpretation is done, at least in first instance, by regulatory agencies. This is so in part because the legislature and the courts allow such an expansive role for regulators by drafting vague statutory language and by deferring to agencies’ interpretation of their governing statutes. A prime example of the influence of economic evidence on interpretive discretion relates to the interpretation of Article 13 of the Access Directive, as implemented by the Communications Act 2003 (otherwise referred to as ‘Significant Market Power conditions’). Section 88 (1) b, provides that ‘the cost recovery mechanism or pricing methodology must be designed to confer the greatest possible benefits on end-users and to achieve the other specified purposes, namely that of promoting efficiency and sustainable competition’. The interpretation of this provision is a necessary step towards the implementation of regulatory remedies. But before elaborating on the exercise of interpretive discretion, let's pause for a second to place this provision within the larger context of the so-called market review process in electronic communications to which it forms an integral part.

In meeting its principal objective to promote the interests of consumers, Ofcom has a specific statutory duty to periodically review the operation of the relevant markets in the telecoms sector so as to determine whether each of those markets is ‘effectively competitive’ and to impose regulatory remedies (price controls or quality standards) to undertakings found to enjoy a Significant Market Power (SMP), in accordance with

48 Communications Act 2003, s 88.(1)(b).
the EU framework governing electronic communications. The determination of SMP is a forward-looking equivalent of the test of dominance that is used in European competition law and enables the ex ante regulation of the sector. Such ex ante regulation is asymmetric in nature as it is imposed only on operators found to enjoy SMP and aims to prevent or remedy the abuse of dominance and create a level playing field. The determination of SMP expressly relies on economic assessments that Ofcom must perform on a case-by-case basis. Those include first, a market definition exercise often though the application of the hypothetical monopolist test, which is one way of assessing the existence of demand-side substitutability. The hypothetical monopolist test asks what products (or geographic areas) a hypothetical monopolist would need to dominate in order to be able to profitably raise prices by 5% to 10% above the competitive level – otherwise known as the SSNIP test. The likely responses by consumers to such price increase help in determining whether substitutable products exist and, if so, where the boundaries of the relevant product market should be delineated. The second step involves the determination of dominance. This is based on a case by case assessment that is not limited to market shares of the undertaking concerned, but also involves other criteria, such as the overall size of the undertaking, vertical integration, the existence of barriers to enter the market and the absence of potential competition, in accordance with the European Commission Guidelines on the issue. In identifying markets subject to ex ante regulation, Ofcom is required to take the utmost account of such recommendations and guidelines as to what product and service markets should be analyzed.

I think if you are on the telecoms side, particularly anything to do with the market review process, where there’s a very clear market definition, analysis of competition remedies, I think the economics is very heavily embedded into that and the way in which the competition group is set up. That’s what they do. If we need a


51 See e.g. EC, ‘Guidelines on market analysis and the assessment of significant market power under the EU regulatory framework for electronic communications networks and services’ [2018] C 159/1.
market, fine we go to the economists; SMP analysis we go to the economists; a network charge control, we need to get the economists to do that and even within the economists function now, we have recognized that sort of more specialized modelling role and sort of carved out specific financial economics team, which combines accounting function and people with modelling expertise (Ofcom 3).

While the determination of SMP is a strictly regulated exercise, the second stage in the process that involves the selection of the appropriate regulatory remedy to be imposed – typically price controls at the wholesale level – leaves considerable leeway to the regulator with regard to which pricing principle and pricing methodology will be adopted. Article 13 of the Access Directive, as implemented by the Communications Act 2003, plays a central role in this process. As noted above, it provides that the cost recovery mechanism or pricing methodology must be designed to confer the greatest possible benefits on end-users and to achieve the other specified purposes, namely that of promoting efficiency and sustainable competition. Of course, these are broad objectives that require interpretation before translated to regulatory action. There are choices to be made and thus discretion has to be exercised in choosing the appropriate pricing methodology. Hence, pricing methodologies embody value judgments as to which of the various objectives is to be promoted. This was echoed by an interviewee when asked to comment on the disputed ‘welfare standard’ that was adopted in the context of the termination rates appeals dispute:

Many economists would view that as being neutral, but I don’t think it is neutral; that is making a particular set of value judgments (…) some economists may disagree with me, but I don’t think it is judgment free. That involves judgement and you have to be clear what those are because they are not always appropriate. (Ofcom 4).

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53 See (n 47).
54 Communications Act 2003, s 88 (1) (b).
55 See (n 14) above.
As will be shown, economists enjoy a wide margin of discretion in choosing the most appropriate pricing methodology in light of their statutory objectives, but that also economic evidence and analysis is itself the tool for mediating between these objectives. But the final decision is of course, made by the Board, precisely because they are value judgments to be made. Nonetheless, economists are crucial in offering a framework for analysis based on facts and empirical observation which allows the ultimate decision-maker to make a reasoned choice. This institutional feature provides an important constraint to the discretion economists perceive to enjoy and allow the latter to be better exercised.

A useful example of the discretion economists enjoy in determining the most appropriate pricing methodology, but also the constraints they face comes from the 2011 market review of the wholesale mobile voice call termination.56 That is the service provided by the intended recipient’s mobile communications provider to the originating communications provider, which is necessary for mobile and fixed communications providers to connect their customers with recipients on different mobile networks. For this service, operators impose a wholesale charge known as ‘mobile termination rates’ (MTR). These have been subject to regulatory control on the basis that absent control the significant market power exercised by operators would be detrimental to competition and to consumers. Ofcom was of the view that this price control should be based on either the so-called Long Run Incremental Cost (LRIC) or LRIC+. The fundamental difference between the LRIC and the LRIC+ is that the former is intended to cover the terminating operator’s direct costs of terminating a call, whereas LRIC+ is intended to make a contribution to the terminating operators’ fixed and common costs, such as the costs that are involved with running a network. Economic theory suggests that ideally access prices should reflect the marginal costs of an efficient network operator and thus LRIC was regarded by the regulator as a better approximation of marginal costs that would result

in lowering mobile termination rates. It also had the merit of following a Recommendation of the European Commission.\textsuperscript{57}

But efficiency considerations alone could not form the basis of Ofcom’s judgment. Ofcom was, therefore, required to consider and ultimately balance the benefits and the detriments of each of these two pricing methodologies against the broad policy objectives, which further involved making a number of hypothetical assessments on the effects of the pricing methodologies on economic efficiency (allocative and dynamic) and on competition, bearing also in mind their distributional implications. For example, the interests of dynamic efficiency or the protection of vulnerable consumers – the latter being a specific social group that Ofcom has a statutory duty to protect\textsuperscript{58} – favored the adoption of LRIC+, while the interests of competition pointed towards pure LRIC. Ofcom eventually reasoned that a pure LRIC approach would confer the greatest possible benefits on consumers.

Crucially, in interpreting the statutory mandate and determining the appropriate price control standard and its proper application to the facts – a question of law – Ofcom enjoyed a large degree of interpretive freedom that is not only observed internally but was also externally recognised by the courts. The Court of Appeal afforded a large measure of discretion to Ofcom’s determinations highlighting the complexity of the economic judgment the regulator was called upon to perform that involved ‘questions of policy in a highly technical field’.\textsuperscript{59}

The regulator, Ofcom and the Competition Commission are required to make educated predictions for the future as to the effect of any price control measure to be imposed. Although decisions relating to the control of charges are of great importance to communication providers and to the general public, the exercise of seeking an appropriate solution is necessarily imprecise; when looking to the future there is unlikely to be any one right answer.\textsuperscript{60}


\textsuperscript{58} Article 8(4) of Access Directive; Article 8 of the Framework Directive.

\textsuperscript{59} In Everything Everywhere Limited v Ofcom (Mobile Call Termination) [2013] EWCA Civ 154 per Moses LJ at [35].

\textsuperscript{60} Ibid. See further, Everything Everywhere Limited v Office of Communications [2016] EWCA 2134 (Admin) (Cranston J); British Telecommunications Plc (Appellant) v Office of Communications (Respondent) & (1) Sky UK Ltd (2) TalkTalk Telecom Group Plc (Interveners) [2016] CAT 3.
The Court of Justice of the European Union (CJEU) has also highlighted the interpretive freedom national regulatory authorities (NRAs) should enjoy when operationalising pricing principles enshrined in EU legislation, such as the one prescribing ‘cost-oriented’ wholesale access prices. Indeed, in the Arcor and Mobistar preliminary rulings, the CJEU confirmed the NRAs’ broad discretion in interpreting and applying the principle of cost-orientation. It further conceded that in the absence of Community legislation, it is the task of the NRAs to define detailed rules for calculating the actual costs, which have to be taken into account. Perhaps, most crucially, the CJEU affirmed that the boundaries of their discretion are not limited to the methodology employed, but further extend to the choice of analytical cost models for establishing the costs incurred by the notified operator, as well as for other aspects of those costs and tariffs. Seen another way, the CJEU may be said to defer to the regulatory agency’s economic interpretation of the principle of cost-orientation. Those rulings epitomise what Denis Galligan referred to as the ‘central sense’ of discretion. The regulators discretion reaches its central sense as there exist both ‘significant freedom’ for the regulator in exercising his power and ‘the courts recognise this freedom’. This is not the case, however, with operational and enforcement discretion, as the next sections will allude.

ii. Economic Evidence and Operational Discretion

In contrast to interpretive discretion, operational discretion ‘is exercised independently of statutory provisions if Parliament has expressly or impliedly left a policy sub-domain undetermined’. As Eric C Ip notes, ‘while interpretive discretion might be constrained, at least in theory, by better legislative drafting technique and judicial legality review (of the procedural correctness with which legislation is

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62 See C-55/06, Arcor AG & Co. KG v Bundesrepublik Deutschland [2008] ECR I-2931, at para. 94.
63 C-438/04, Mobistar SA v Institut belge des services postaux et des télécommunications (IBPT) [2006] ECR I-6675.
64 See (n 62) at para. 150.
65 See (n 62) at para. 132 and at para. 134.
67 Ibid.
68 Ibid.
69 See Ip (n 28) 485.
construed), however, the same cannot be said of operational discretion’. Operational discretion is far more open-ended as it captures the range of choices regulators have to make as to when to intervene in the markets (what can be understood as a first-order judgment) and how to intervene in the markets (what can be understood as a second-order judgment). It includes the process of choosing the policies, strategies, standards and procedures that may suit a particular situation. Having said that, in some cases the second-order judgment may precede that of the first, as it is more useful to understand what remedies are feasible before deciding to intervene, in particular if no appropriate remedies are available.

Regarding the first-order judgment, all regulators conceded that it is economic logic deriving from the concept of market failure that informs their operational discretionary on when to intervene:

Baseline position is that there is a market failure we are intervening on, there can be other reasons for intervening, but the baseline is the market failure (Ofgem, Chief economist).

But, when regulators arrive at the second-order judgment as to how to intervene and what remedies to impose, the use of neoclassical economics has been enriched by the advent of behavioural economics, which focuses on imperfections in the demand side that allow firms to exploit market power on the supply side.

The interrelationship between behavioural economics and operational discretion is better understood in the context of the ongoing metamorphosis of the regulatory state from a model of economic regulation largely concerned with the promotion of competition, to a broader framework of market organisation, where objectives such as security of supply, sustainability and affordability have all risen in salience. As Frank Vibert observes ‘regulators have moved from creating conditions ‘sufficient’ for consumers to be able to make choices (a “satisficing” role) to a trustee role, or, to acting in the “best interest” of the consumer (a role that tries to “optimize” conditions for consumers)’. Because competition alone does not necessarily ensure that consumers will access and act upon the information needed to make sensible choices

70 Ibid.
71 For an excellent analysis see F Vibert, The New Regulatory Space: Reframing Democratic Governance (Edward Elgar 2014).
72 Ibid at pp. 55-60.
for themselves, regulators have become increasingly activist in the demand side of the market. Rather than assuming consumer rationality, they turn to the insights of behavioral economics so as to explore when and under what conditions consumers systematically depart from rationality. For instance, status quo bias explains why consumers fail to investigate alternative contracts that may be beneficial to them. This was in turn incorporated in Ofgem’s and Ofcom’s ban on automatic renewal of contracts; an exercise of operational discretion. Perhaps the most representative example relates to Ofgem’s Retail Market Review. Ofgem introduced measures aiming at the simplification of tariffs (‘simpler choices’ component). These measures included a ban on complex tariffs, a maximum limit on the tariffs offered and a simplification of cash discounts. Tariff simplification was premised on the findings of behavioural economics regarding consumers’ cognitive limits and aimed at facilitating consumer switching.

It is important not to underestimate the breadth and scope of operational discretion. Unlike the price control remedies imposed by Ofcom in the market review process, which are prescribed in great detail in the Communications Act 2003, Ofgem’s remedies in the retail energy market represent the translation of the deliberately broad statutory mandate regarding the protection of consumers into operational policies and procedures. This gives rise to a wide arena of administrative discretion, which has been given form and purpose by recourse to economic evidence and analysis. This is not a negative development: Freedom in decision-making is what allows regulators to tailor their response to different conditions and avoid making errors. However, as we shall see in Section V, this expanded arena of operational discretion has been constrained by structural and ideational factors that, in significant cases, undermine the role of economic evidence in the final decisions adopted.

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76 In particular, framing bias can be exacerbated in an environment where consumers are presented with a lot of information. This information can be purposefully presented in a confusing manner creating the problem of confusopoly. On framing biases see A Tversky and D Kahneman, ‘The Framing of Decisions and the Psychology of Choice’ (1981) Science 211. Confusopoly was first coined in S Adams, The Dilbert Future (Harper Collins 1997).
iii. Economic Evidence and Enforcement Discretion

All regulators employ a spectrum of enforcement ranging from increased monitoring to a full-blown investigation. In carrying out their enforcement actions, regulatory authorities wield vast discretionary powers, yet their statutory mandate provides little guidance as to how this discretionary power should be exercised. Accordingly, regulators are confronted with a number of very significant decisions in enforcing regulatory standards. Such decisions may not only have a serious impact on those against whom enforcement action is targeted but may also profoundly influence the overall implementation of regulatory objectives. Enforcement discretion may involve some questions of general enforcement policy – for example whether to investigate a particular segment of the market, such as standalone landline telephone services – while others are more operational in nature and may relate to specific complaints. Unlike interpretive and operational discretion, the exercise of enforcement discretion is predominantly influenced by legal and bureaucratic considerations.

A central part of enforcement powers resides, in the case of energy and water regulation only, in the licence which is granted from the regulator to companies and which allows them to operate in their respective industry. Each licence contains the terms and conditions under which a company is entitled to operate. Regulators are responsible for policing the licences and they can amend the provisions of the licence. They can also take action when industry behavior fails to meet obligations for consumers, especially those in vulnerable circumstances, and take action when companies do not observe the Standards of Conduct. Enforcement action may also include imposing financial penalties and making consumer redress orders for breaches of relevant conditions and requirements under the governing statute or consumer protection legislation. Finally, regulators also enjoy competition law powers in the sectors for which they are responsible under the concurrency regime. Economic evidence deriving from industrial organization economics mostly informs the latter exercise, i.e. the concurrent exercise of competition law powers. Whether to take enforcement action or not is not a straightforward matter for regulators, but a culmination of deliberations among lawyers and non-lawyers, including economists, regarding the desirability of triggering formal legal procedures. This is not to argue

that economic evidence does not have a role to play. On the contrary, legal considerations and economic evidence are in a constant dialectic process:

We work very closely with lawyers; they are kind of involved throughout, and a lot of the time. I mean the way we tend to operate it’s not siloed; you don’t say ‘you go away and do the economics, we go away and do the policy, you go away and do the legal analysis’. Yes, there are elements of that but it’s an integrated whole, they interplay with each other. What are we trying to achieve in policy terms? How does that fit with the economic analysis? How is that consistent with our objectives and the legal analysis? How does it apply to what we should be doing and also limits on what we might want to do? Or the test, and actually one of the key areas in the interaction between economics and law that is very important is understanding what legal condition we are doing. Is it market review with SMP conditions? What does that imply for the legal test that would need to be satisfied for us to impose? (Ofcom 4)

Economic evidence influences the regulatory authority’s decision to take enforcement action in the first place. In deciding whether to open an investigation, regulators have to assess the seriousness of the case according to the potential harm to consumers and to competition:

I think it comes down to whether you can demonstrate an effect and by that I mean can you convey to somebody that the action that one party or several parties have taken has adversely impacted generally consumers we are worried about, or some of the intermediate markets? But we need to demonstrate this as a first step. (Ofwat 3)

Because regulatory resources are scarce, economic evidence allows regulatory agencies to prioritise investigations where the alleged harm to the consumer or to competition is considered to be most serious. Economists are crucial in quantifying this harm:
We have been involved in enforcement cases. That’s two roles: one is in terms of calculating gain; say a company failed to provide good service for consumers, how much detriment resulted, my team has a role of quality assurance in the assessment of the level of detriment resulted. The second is in competition enforcement cases where my team have contributed to enforcement cases and the analysis therein (Ofgem, Chief Economist).

But this quantification of harm is then subject to scrutiny by the ‘legal frame’.\(^7\) It is the latter that will determine whether the evidence of harm marshaled in support of opening a case can meet the evidentiary requirements set by the law, i.e. the legal standard of proof. In cases relating to competition law infringements, the impact of the law is not merely procedural, but substantive: ‘what is an abuse of dominance, or refusal to supply? ‘[E]conomists may disagree about legal conditions’ (Ofwat 2), but economics need to be marshaled to support these legal conditions, i.e. the appropriate and relevant legal test for proving a competition law infringement as this is set by the case law.\(^7\) It is the influence of legal considerations in the regulators’ exercise of enforcement discretion that constrain their discretion, rendering them vulnerable to institutional constraints, as the following section will demonstrate.

This conceptual part of the analysis provided an overview of the input of economics in the regulatory decision-making process by exploring the various ways in which economic evidence and analysis informs interpretive, operational and enforcement discretion. It was shown that recourse to economic evidence is pervasive across all three regulatory agencies and that regulators enjoy significantly leeway in employing economic evidence and analysis when furthering regulatory objectives. This is particularly the case with interpretive discretion. However, the section alluded that economists are significantly constrained in the case of operational and enforcement discretion. The following section will explore the nature of these constraints by drawing on Parsons’ rich framework of analysis.

\(^7\) *BT v Ofcom* [2016] CAT 3.
V. From the Conceptual to the Operational: What Constraints to the Influence of Economic Evidence in Discretionary Assessments?

I don’t feel that we have broad latitude, when you are inside a body you feel quite hemmed in by all kinds of factors (Ofgem 1).

Economists do not operate in a vacuum. As Sections III and IV demonstrated, their decisions are made in a particular institutional setting, which reflects among others the interplay of various values, such as economic values, human rights values and norms, as well as constraints. The analysis, therefore, of the influence of economic evidence in discretionary assessments could not be complete without an understanding of how these values and constraints affect or otherwise the way economists perceive the limits of their discretion. In line with Parsons’ typology the remainder of this article explores the relative influence of structural, institutional and ideational constraints to the use and influence of economic evidence in discretionary assessments in the context of the three case studies. The findings are extremely variable between the three regulatory agencies examined. In fact, the following pattern emerges from the interviews: The greater the influence of institutional constraints, such as the threat of the decision being appealed in courts, the weaker the weight of economic evidence in the final decision reached and the more legalistic the regulator becomes in its approach, as the case of Ofcom reveals. Economic authority and wisdom while relevant, it is not always dispositive, and economists are not Kings. In contrast, when competitive markets are nascent, such as that of water, and the degree of exposure to courts and litigation has remained low, such as in the case of Ofwat, the more unconstrained economists perceive themselves in the exercise of discretion: Economists emerge as Kings. However, this regulatory reality can at any time be shattered when regulators become vulnerable to structural and ideational constraints, as the case of Ofgem paradigmatically reveals: Sound economic analysis was side-lined and the role of economic expertise within the organisation was undermined.
A. Structural Constraints

According to Parsons, structural constraints are ‘exogenous’ in nature, occupying what Keith Hawkins refers to as ‘the surround’, that is ‘the broad setting in which regulatory (or other) decision-making activity takes place’. This may involve the political or economic climate in which regulators operate and/or broader societal pressures. The ‘surround’, however, is not static or unchanging. As Hawkins underlines, ‘political and economic forces may shift, and in these circumstances the social surround of the organisation changes.’ While all regulatory agencies are exposed to structural constraints, these have been more pronounced, as we shall see, in the case of Ofgem.

Before we elaborate further on this point, it is important to appreciate the influence of such constraints on the use of economic evidence. As will be shown throughout this section, these constraints do not necessarily limit the recourse to economic evidence and analysis in the workings of regulators, but rather limit the influence of economic values. In particular, structural constraints downplay the pursuit of economic efficiency, in favour of non-economic and non-competition law values that have infused the regulatory objectives, such as that of affordability, especially when regulators exercise operational discretion. This is exacerbated by the broadening of regulatory objectives to include social and environmental objectives, which has brought regulators closer to the concerns of government, including those of redistribution. Hence, in sharp contrast to the firmly embedded in neoclassical economics ‘separability thesis’, that enables questions of economic efficiency to be separated from issues of distribution, economists working in regulatory agencies are required to grapple with both so as to claim legitimacy for their normative prescriptions. A senior manager at Ofgem emphasised the need to take more firmly into account considerations other than economic efficiency, given the nature of the regulated service:

80 Hawkins (n 78) 48-49.
81 Ibid at 49.
I am of the view that for an essential public service, like energy, which has major environmental impacts and consequences, then it is inevitable you will make complex trade-offs. I think it would be damaging to us to say we are responsible for economic efficiency and everything else is a political issue because it would mean that our roles would be very much more limited than they are at the moment. I prefer the approach where we have a degree of discretion, which enables us to take a broader role and get involved in things that do have environmental and social impacts. Actually, there’s a very few things that we do that are purely technocratic. Most things we do have distributional impacts, social, environmental, security of supply impacts (Ofgem 2).

The need to engage more closely with distributional questions, as a result of the broadening of regulatory objectives, has expanded the regulator’s arena of discretion, in the sense that their implementation requires making trade-offs between efficiency and equity. To the above one should also add the gradual decline of the ‘Littlechild model’ of economic regulation. Conveniently overlapping with the New Public Management’s (NPM) oversimplified distinction between ‘policy’ and ‘administration’ (or ‘steering’ and ‘rowing’), the ‘Littlechild model’ reserved a tightly remit to regulators to promote competition free from central government interference. 83 The influential Littlechild Report from 1983, which provided the intellectual backbone for the privatisation of British Telecommunications perceived that economic regulation would be a temporary phenomenon, to be phased out as competition increased; simply a means of ‘holding the fort’ until effective competition developed.84 But the reality showed that first, the underlying assumptions of the privatisation model were ambitious about the ability of markets with natural monopoly elements to be subjected to competition forces only, and, secondly, that there is a much greater degree of cooperation between the realm of independent regulation and the realm of central government than that envisaged under NPM.85

83 C Hood and M Jackson, Administrative Argument (Dartmouth 1991); SC Littlechild, Regulation of British Telecommunications' Profitability (London: Department of Industry, 1983).
84 Littlechild (n 83), para. 4.11.
But as an Ofcom economist explained:

Sectoral regulation has always been more deeply involved in those kinds of distributional questions, and justice questions and fairness questions than historically competition authorities, and as an economist it’s a fascinating area, because economics has little to contribute. A lot of the formal neoclassical economics is kind of trying to avoid getting into questions of fairness. What does an economist think about fairness? Most economists have nothing to say about fairness! And it is really important to understand one of these areas where understanding your limits of your specialism has to contribute, but also what it does not have to contribute. Economics and economists can really contribute to identify a framework that encompasses different perspectives and identify key trade-offs and the key issues and economics is just generally very good at that. (Ofcom 2)

Hence, economic evidence and analysis allows a more structured exercise of discretion vis-à-vis the ever-expanding statutory objectives. For example, equity objectives can be pursued as long as they are not too costly or have too strong negative effects on competition. But this broadening of statutory objectives comes at a cost, in that it renders regulators more exposed to the prevailing political and economic imperatives, undermining the role of sound economic analysis.

While Ofwat interviewees also mentioned the political environment and public acceptability, especially in relation to opening the domestic water market to competition, the analysis deriving from the interviews suggests that these structural constraints have been particularly pronounced in the workings of the energy regulator, Ofgem:

There are important and difficult constraints in terms of changing how we regulate; the way economics is involved in how we make decisions. We have high levels of formal discretion but in practice we are quite constrained (emphasis added). Some of the external
constraints include the political environment and the public acceptability (Ofgem 1).

Two plausible explanations to Ofgem’s vulnerability to their surround are offered here. First, a correlation seems to emerge between the degree of political influence observed in the workings of Ofgem and the institutional organisation of professional economic expertise within the agency. Recent evidence suggests that there was a ‘reduced involvement of economists in senior roles at Ofgem’\textsuperscript{86} that led inter alia to economically uninformed retail energy market policies against the experts’ consensus and advice.\textsuperscript{87} This was again picked up in the in-depth energy market investigation undertaken by the UK Competition and Markets Authority (CMA),\textsuperscript{88} which was, amongst others, a catalyst for institutional changes in the organisation of economic expertise within the regulatory authority including the appointment, for the first time, of a Chief economist:

I did join recently but the role was set relatively recently. The role followed the CMA investigation into the energy market, where it was felt that Ofgem had not used economic evidence as robust as it might do, economics did not have sufficient prominence in the organization and a formal office of the chief economist should be set up accordingly. There were people who had chief economist role before, but they tended to be senior people with economic background rather than people who did economics as a big part of their job. (Ofgem, Chief Economist)

The second reason has to do with the fact that energy prices and their affordability became a hotly debated political issue, and together with the prevailing economic climate presented important constraints to the monolithic pursuit of economic efficiency:

\textsuperscript{87} Ibid at 115.
You are trying to achieve economic efficiency within constraints and those constraints are set by society, by politicians, by and large security of supply, environmental constraints and limits on the degree of differential outcomes you might have, treatment of vulnerable customers, USOs, all these things. If everything was left to the market you would find that 15% of the households would not have electricity at all because they are uneconomic to supply. (…) Once something has gained this public utility status, issues of universal access justice become quite important, fairness becomes important, I think we need to recognize that we operate within that context. A while ago I think there was a belief that energy could be made to be just like any public service, but it was a period of low energy prices, before climate change became such a high profile issue, and a period of significant surplus generation capacity, and now we’ve got tighter margins, climate change is really really important, and oil and energy prices are so much higher. (Ofgem 2)

Finally, notwithstanding the crucial role of economic evidence and analysis in offering a logic framework for analysis when making trade-offs between efficiency and equity, evidence suggests that structural constraints relating to the political climate expose the limits of economists and economic evidence in areas of substantial redistribution:

There are areas of very substantial redistribution that are matters best left to government rather than the regulator because the government has the political support, the public accountability and mandate to make these decisions (Ofgem 1).

This is perhaps nowhere more apparent than in the heated political and regulatory debate surrounding the return to price cap regulation for all household energy consumers on poor value tariffs; a debate that culminated in the enactment of the UK
Domestic Gas and Electricity (Tariff Cap) Act.\textsuperscript{89} In particular, the Act puts in place a requirement on Ofgem to set an absolute price cap on standard variable (SVTs) and default tariffs;\textsuperscript{90} i.e. a rate above which no energy supplier can charge. It is estimated that this price cap will protect around 11 million households in England, Wales and Scotland, who are currently on poor value tariffs. Unlike the existing price cap that protects consumers on prepayment meters, the cap on SVTs necessitated legislative action because of its wide remit and distributional implications. The price cap will be designed and delivered by Ofgem and apply until the end of 2020, when the regulator will recommend to the government whether it should be extended on an annual basis up to 2023.\textsuperscript{91} In such a major intervention in the market, economists rightly perceive their role as presenting evidence that allows political decision-makers to take decisions on distributional issues versus actually making the decisions themselves:

> I think it would be uncomfortable if technocrats were making substantial redistribution decisions, but I do think it can be useful for us to lay out evidence based on that and provide the information to make that decision’ (Ofgem, Chief Economist).

This section explored the structural, that is exogenous, constraints to the influence of economic evidence in discretionary assessments. Such constraints do not render the use of economic evidence redundant, but rather downplay the pursuit of economic efficiency in favour of non-economic considerations such as those of affordability. This is exacerbated by the broadening of regulatory objectives, which has brought regulators closer to the concerns of government, and the concomitant decline of the ‘Littlechild model’ of economic regulation. This has led in the case of Ofgem to economic expertise, at least up to the CMA enquiry into the energy market, being ignored and sound economic analysis being sidelined. The section hypothesized on why Ofgem, amongst the other two regulatory agencies examined here, has been more vulnerable to such constraints and highlighted the outer limits


\textsuperscript{90} SVTs are the suppliers’ default tariffs charged when consumers do not choose a specific price plan. They are normally higher than fixed tariffs, which offer guaranteed prices for the duration of the supply contract. For an analysis see M Ioannidou and D Mantzari, ‘The UK Domestic Gas Electricity (Tariff Cap) Act: Re-regulating the Retail Energy Market’ (2019) 82 (3) Modern Law Review 488-507.

\textsuperscript{91} Ibid.
of the use of economic evidence in discretionary assessments that are triggered in matters of substantial redistribution.

**B. Institutional Constraints**

According to Parsons, institutional constraints differ from structural ones in the sense that they do not exist independently of the institution, but are rather forces that affect regulators’ actions with respect to their position ‘within man-made organisations and rules’.  

Institutional explanations serve as a broader organising framework from which several constraints flow, legal and quasi-legal.

Legal constraints stem first and foremost from the provisions of legislation establishing the agency’s powers and from which her interpretive, operational and enforcement discretion is derived. While, as we have seen above, economics have been crucial in operationalising discretion, the ‘legal frame’ is prominent throughout much of the economists’ work as senior economists and their teams work closely with lawyers. Economic evidence is not only integrated into legal norms and legal analysis but is also regulated by the ‘legal frame’. For example, administrative law, which requires regulatory authorities to exercise their powers lawfully, in accordance with the requirements of procedural fairness and on rational grounds, as well as its component that deals with judicial review of discretionary powers all regulate and constrain the exercise of economists’ discretion.  

As one interviewee conceded:

> The economic analysis is not the totality of it. We have to show evidence, to be rational, to be proportional, we cannot do more than can be justified by the evidence, which I think is all part of the framework that properly constrains us (Ofgem 2).

The above quote hints to considerations of both ‘thin’ and ‘thick’ legality that preoccupy economists when exercising discretion. In other words, regulators are not merely concerned with whether their discretionary assessments are authorised by the relevant law (‘thin’ legality), but also whether their overall approach to the use of economic evidence in their exercise of interpretive, operational and enforcement discretion respects and reflects broader constitutional and human rights values.

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92 Parsons (n 8) 12.

93 *Council of Civil Service Unions v Minister for the Civil Service* [1985] AC 374.
inherent in the rule of law (‘thick’ legality). This should not come as a surprise. The conferral of broad discretionary powers makes it, at times, difficult to determine whether the regulatory action is legally authorised in the narrow sense of ‘thin legality’. Therefore, a plurality of considerations and values deriving from the rule of law are likely to bear upon the requirement of legality and these considerations may well vary from case to case.

Quasi-legal constraints can be said to derive from the behaviour of other actors within the regulatory agency, most prominently the Board, and outside the regulatory agency, such as the relevant Ministry, as well as from the ‘deeper values and principles reflecting the principles and “ethos” or “shared culture” of the community that may not be expressly reflected in legal rules’. Each will be examined in turn.

i. Legal Constraints

The ‘legal frame’ carries with it its distinct ‘logic’ of what a reasonable regulatory decision entails that it imposes on economists’ discretionary assessments; something that economists find at times ‘frustrating’: ‘You think action X is economically the right thing to do, but we cannot do it essentially’ (Ofgem, Chief Economist). Hence, legal rationality may be in direct conflict with economic rationality. It is typically, legal precedent and the provisions of the legislative framework that constraint an, otherwise, ‘economically right’ approach. But this is not a one-way process: Legal interpretation is influenced by economic theories and both can change over time. Legal interpretations do also evolve in light of economic and can be challenged when deemed incorrect.

Take for example the imposition of regulatory obligations on telecommunications operators found to enjoy SMP. Economists may strongly favour a price control condition, whereby the regulator uses information about the historic costs of a service provider with SMP to impose maximum prices which it may charge for its services in the future, than the less intrusive cost orientation condition, which simply requires a reasonable relationship to be maintained between the costs of a service provider with SMP and the prices it charges for its services. But the legislative requirement of

95 See Condition HH3.1 put in place by Ofcom. On 24 June 2004, Ofcom issued its final form Leased Lines Market Review (‘the 2004 LLMR’). This was a substantial document, which included analyses of various markets and the extent of market power within them. Ofcom identified BT as having SMP in
regulatory remedies being a proportionate response to the finding of SMP may instruct otherwise.96 The same applies to the pricing methodology. For example, in Ofcom’s Determination regarding Ethernet services,97 the regulator considered that a different methodology for cost-orientation should be employed than the one used by the incumbent, British Telecom, that of Distributed Stand Alone Cost (‘DSAC’).98 In exercising her interpretive discretion, Ofcom relied on previous regulatory decisions and case law in the so-called PPC case99 and emphasised the identical wording of the cost orientation condition that applied in the latter case that rendered it consistent with her approach.100

Considerations relating to ‘thick’ legality become prominent in the workings of economists precisely because of the contested nature of economics as a source of wisdom. Recourse to economic evidence and analysis rarely lends itself to a single ‘right’ answer. Economics, as one interview conceded, ‘does not say oh well, the right answer is this, there cannot be another right answer. In almost any real-world circumstance there’s a range of possible decisions, or views.’ (Ofcom 4). Therefore, considerations relating to procedural fairness and the meaningful participation of affected interests become important in driving the overall discretionary judgment and determining the weight of economic analysis in the final decision reached. There might be ‘other considerations than the economic analysis, but we have to be clear that you have to have those other justifications or rationales if we are doing it on that basis’ (Ofgem 1). For example, adequate procedures satisfying the requirements of democratic legitimacy, therefore, structure and constrain economic analysis.101

Human rights values, as these find their expression in the European Convention of Human Rights (‘the ECHR’), also constrain the use of economic evidence, particularly when the latter engage Article 1, Protocol 1 of the ECHR, which enshrines the right to property. For example, in setting the level of the energy price

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96 See Access Directive (n 47), Recital 6.
98 See Access Directive (n 47), Recital 15.
100 See BT & Ors v Ofcom & Ors [2017] EWCA Civ 330, at para. 120.
101 See e.g. Ofcom’s approach to enforcement available at: https://www.ofcom.org.uk/consultations-and-statements/category-2/ofcoms-approach-to-enforcement.
cap, an exercise of operational discretion that unavoidably interferes with the
companies’ licences, Ofgem must strike a fair balance between the public interest,
namely the protection of certain household consumers from unjustifiably high energy
prices, and the rights of individual firms. Furthermore, Article 6 of the ECHR on
the right to a fair trial and the related underlying values of procedural fairness
influence the use of economic evidence in the exercise of enforcement discretion.
Regulators do strive to ensure that their decisions are substantively fair; that is that
they reflect some ‘substantive notion of fairness in rationally pursuing regulatory
goals’.

The economic model is a support to our decision-making, it does not
drive it entirely itself. There needs to be a good rational logic as to
why we are doing things. That’s really important as good regulatory
practice but also in making sure our decisions are robust legally
because the last place you want to be is arguing the toss over bits of
modelling code in court, which is... once you got to that stage you
probably lost (Ofgem 2).

Appeals on the merits, in particular, are a significant constraint to bad economic
analysis and can curtail the freedom economists perceive to enjoy in choosing, say,
appropriate pricing methodologies: ‘Legal review comes in to essentially everything
we do and there is a fairly substantial internal legal review’ (Ofgem, Chief
Economist). Most notably, among all utility regulatory agencies, Ofcom is the
regulator most frequently challenged in courts. On the one hand, this is due to the
shorter regulatory period set for price controls in the sector (three years versus five
years for the other two regulators); on the other hand, the multiplicity of market
players active in the sector renders almost every regulatory decision susceptible to
creating winners and losers. This in turn presents a strong incentive for companies to
challenge Ofcom’s decisions. Moreover, the majority of its decisions have been
challenged on the merits before the specialist CAT. This should not be
underestimated. The composition of the tribunal, which combines legal and non-legal

102 See further R (on the application of Infinis Plc) v Ofgem [2011] EWHC 1873 (Admin) (Infinis),
which introduced an important protection for companies in the form of a novel action for damages for
unlawful state actions in violation of Convention rights. For an analysis see Mantzari (n 7) above.
103 See Yeung (n 94) 42-43.
expertise, allows the latter to exercise its self-proclaimed ‘profound and rigorous scrutiny’ over all aspects of Ofcom’s decisions. When producing the body of economic analysis supporting the decisions, appeal on the merits is an important factor guiding the type and quality of economic evidence produced. Furthermore, appeal on the merits can be seen as a means to clarify the wide statutory remit enjoyed by Ofcom and instill greater rigour in the regulatory decision-making process.

But, Ofcom interviewees suggested that statutory appeals are being strategically deployed by market-players with deep pockets – an argument that Ofcom used to eventually get rid of the statutory appeal and relegate its decisions to a judicial review standard. In the future, the CMA and the CAT will both be required to review telecommunications appeals ‘having regard to judicial review principles’, rather than, as in the previous regime, ‘on the merits’. This may decrease in the future the quality of economic analysis within the organisation and increase the regulator’s arena of discretion.

It would be superficial to attempt to summarise the intensity of review of regulatory decisions, which has been explored in detail in previous work. But what is crucial for our purposes here is that the intensity of review does not only affect what regulatory agencies may do, but who within regulatory agencies might do it. As Adrian Vermeule illustrates, weak oversight of agency’s rationality (that is ‘reasonableness review’) empowers non-lawyers within agencies, whereas strong rationality empowers lawyers. This seems to be confirmed when comparing Ofcom – a repeat player before the specialist CAT – to Ofwat, which has so far limited, albeit of significance, exposure to appeal bodies, such as the CMA and the CAT. Against this background, an interesting pattern emerges: The greater the threat of institutional constraints, such as that of an appeal against the regulator’s decision, as in the case of Ofcom, the more legalistic the regulator becomes, which may in turn undermine sound economic analysis. Economic authority and wisdom while relevant are not

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106 Mantzari (n 7) above.

dispositive and economists are not Kings. Indeed, strong oversight of Ofcom’s decision-making by the specialised CAT has empowered lawyers at the expense of economists. Moreover, it has also embedded a high degree of ‘legal consciousness’\(^{109}\) within the group of competition economics:

> I think (the threat of appeal) does run through quite a lot of the work we do, because I know the lawyers are very alive to that threat of litigation (…) We are cautious about recognising the threat of litigation, that we do need to have a robust case for us to proceed, particularly if we are proceeding in the face of industry opposition (Ofcom 3).

All interviewees stressed the power lawyers enjoy at Ofcom during internal agency deliberations to veto policy decisions that are otherwise desirable and indeed legally supportable on the ground that they are legally incorrect. Perhaps, the most interesting account of the law’s hegemony in the workings of Ofcom is offered from a senior economist at Ofwat who had also spent significant time at Ofcom:

> Based on early impression here (at Ofwat), I think probably economics or decisions based purely on economics are more important, are given more relevance here at Ofwat than Ofcom (…). It seems to me that Ofwat is willing to take more risks, the message from the Chairman recently has been we may want to try new things, make mistakes, if you make mistakes, we accept that it is a potential outcome. Ofcom is much more conservative, it tends to rely more on precedent, simply because I think it is a big organisation and it has been more subject to appeal than others. Ofcom is a bit more conservative (Ofwat 1).

The interviewee, however, conceded that if Ofwat ‘get challenged, it may change its mind about that [i.e. relying strongly on economic analysis] (Ofwat 1). In fact, Ofwat has recently come to appreciate the threat of appeal and the impact of ongoing

controls on the way economic analysis is deployed. A case in point is the Bristol Water case,\textsuperscript{110} an appeal to the CMA against Ofwat’s price control determination. Bristol Water was concerned about the difference between its business plan and Ofwat’s final determination in relation to the appropriate level of wholesale costs required to deliver the agreed outcomes. Reducing bills to the degree proposed by Ofwat would have meant that the company would not have enough funds to invest and run its business. Bristol Water argued that the resilience duty required long-term planning to address supply challenges, and in any event, it needed to invest in a reservoir that would be invaluable in the case of a drought. At the heart of the dispute lied Ofwat’s econometric modeling. Bristol water claimed that Ofwat had relied too much on the latter and did not consider whether the reduction suggested was achievable in practice. The CMA scrutinised in great detail the econometric evidence and modeling supporting Ofwat’s decision and ultimately substituted these with its own model. It argued that Bristol Water should have been able to demonstrate that additional supplies would be needed and when they would be needed if resilience concerns were pressing. Although not frequently appealed in courts, Ofwat appears to become aware of the threat of litigation. In the words of one interviewee:

There are lots of checks and balances in terms of when we make decisions; we can be held to account. Either companies can refer our decisions in the context of cases, to the CAT for judicial review or in cases of price determination to the CMA, so we are very alert to the fact that we are not making these decisions alone, without prospect of a review. What would a reasonable person interpret our duties, or whatever particular party, there’s plenty of cases that tell you how what’s reasonable would be interpreted. We have pushed the boundaries on some of those things, certainly when we have looked at certain cost measures or how to apply cost of capital in particular cases, we have said we think that the case law is not necessarily the right starting place, given what happens in our sector is different (Ofwat 3)

\textsuperscript{110} CMA (2015), ‘Bristol Water plc price determination’.
ii. Quasi-legal constraints

Quasi-legal constraints allow us to observe the influence of actors who are both internal to the regulatory agency, such as the Board, and external, such as the relevant Ministry, on the use of economic evidence in regulatory decision-making. The role of the Board as an important source of quasi-legal constraints to the use of economic analysis is prominent in the work of all regulatory agencies. This is owing to the fact that the Board is separated from the departments conducting economic analysis leaving thus greater room for a broader set of considerations, besides the merely economic ones, to influence the final regulatory judgment. As one interviewee explained:

There’s a lot of good economics work at Ofcom, but I think the decision-makers (i.e. the Board) are a bit removed from the economics. Often what happens is that a direction is set at the very high level and then the work of the economists is more to justify the policy direction, the decision; it’s not that economics shapes the decision so much (emphasis added), it may do indirectly if the original suggestion does not prove correct, but it’s not the main driver, essentially (Ofwat 1).

A somewhat similar view was offered on Ofgem:

I think the role of the Authority, the Gas and Electricity Markets Authority, which is the ultimate decision-maker here, that body’s role is to exercise judgement. There will be evidence that we present, with suitable caveats about the quality of it, but as far as we can we will give evidence on the costs and benefits of different options. Then there is an important role for GEMA in using its judgement based on the experience of its members that goes beyond the evidence that is presented. (Ofgem, Chief Economist)

The government through its role in making appointments to regulators’ boards emerges as an important external actor. Most crucially, the relevant Ministry can
exercise influence over the exercise of regulatory discretion through issuing guidance, which signals the government’s priorities and view of how legislation should be interpreted. For instance, Ofgem operates under the Social and Environmental Guidance, which reflects among others the Government’s social and environmental energy goals with respect to fuel poverty and energy consumption. The CMA investigation in the energy market brought into greater focus the influence of the Ministry on the regulatory decisions adopted and the deployment of economic expertise. The report stated that Ofgem’s interventions in the retail energy market were based less on thorough economic analysis and more on concerns that the principals will intervene and take powers away from the regulator:

Two of Ofgem’s most important decisions in recent years (neither of which we consider to have benefited customers)\(^\text{111}\) were taken against a backdrop of DECC taking powers – or stating its readiness to take powers – to implement changes in primary legislation in the event that Ofgem did not act. We do not know how material this context was in influencing Ofgem, but the coincidence of DECC’s and Ofgem’s actions risked creating the perception of a lack of independence on the part of Ofgem.\(^\text{112}\)

Similarly, the Water Act 2014 created new powers under which the Secretary of State (i.e. the Department for Environment, Food and Rural Affairs - Defra) may publish a statement setting out strategic priorities and objectives for Ofwat to reflect in the way it regulates water services in England.\(^\text{113}\) Together with the strategic policy statement, Ofwat is required to have regard to Defra’s Social and Environmental Guidance, which seeks to provide the regulator with a steer on key environmental and social policies to which the Government expects it to contribute in carrying out its role when discharging its statutory functions.\(^\text{114}\) Crucially, compared to other regulators, Ofwat operates under more direct guidance from the

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\(^{111}\) These were the introduction of the simpler choices component of the RMR reforms in 2013 and of Standard Licence Condition 25A in 2009, prohibiting regional price discrimination.


\(^{114}\) Defra (2013), ‘Defra’s Social and Environmental Guidance to Ofwat’.
Government. As one interviewee observed: ‘there is this sort of influence of the Ministry which you have to get buying into it; they have to issue a commencement order, guidelines; that is different from the other regulators’ (Ofwat 1). Commencement orders are a form of Statutory Instrument designed to bring into force the whole or part of an Act of Parliament, which for some reason it is not desired to put into effect immediately upon Royal Assent. The gradual opening of the market to competition, deriving from the Water Act 2014, in fact depends on such commencement orders. For example, in Ofwat’s recently published 2019 price review of the sector, the regulator envisages a bilateral market in water resources in which retailers will contract directly with upstream providers of water resources, with an access charge paid to the network business (competition in the market). However, such market depends on government activation of the relevant provisions of the Water Act.115

Ofwat is slightly different from other regulators in the sense that in some areas it needs approval by the Ministry in order to do things. It got approval to open up competition at the retail level for non-households, it has not got yet approval to do that for households. There have been attempts, some cost benefit analysis done, the government is not too convinced, it has postponed the decision. It’s basically driven by government. I think if it was for us we would extend it because that would work better in the bilateral market, retailers would have a bigger share of customers with stronger incentive to go and look for resources. (Ofwat 1).

This section highlighted the role of institutional constraints to the use of economic evidence. It first discussed the relative influence of legal constraints, such as considerations of ‘thin’ and ‘thick’ legality and the way these affect the translation of economic inputs to legal outputs. It then moved on to consider quasi-legal constraints relating to the organisational constraints. Perhaps, the most striking finding relates to the impact that the threat and intensity of review has had on the use of economic evidence in Ofcom: Despite the mature state of competition in the retail telecommunications market and the dedicated competition economics teams

that exist at Ofcom, lawyers and the distinct logic of the ‘legal frame’ seem to prevail over purely economic considerations so as to minimise the threat of appeal. While the existence of the CAT provides a valuable check on the quality of economic decisions, evidence from the interviews suggests that the approach undertaken is overtly legalistic with the concomitant risk that inadvertently the goal becomes either avoiding or winning an appeal, instead of promoting the consumer’s interests. The return to a judicial review standard may render the regulator less legalistic in its approach, but it may come at the expense of sound economic analysis, which will eventually increase Ofcom’s discretionary powers.

C. Ideational Constraints

Ideational constraints refer to the influence of ideas and ‘epistemic communities’ on the workings of economists and their normative prescriptions. ‘Epistemic communities’ are ‘network[s] of professionals with recognised expertise and competence in a particular domain and an authoritative claim to policy-relevant knowledge within the domain or issue’. They are typically providers of external expertise, as opposed to the expertise that resides with the regulatory agency, and may include academics and expert consultants. Their advice and support can, at times be requested by the regulator, when for example they provide additional evidence or cooperate in modelling exercises during the decision-making process:

We’ve obviously got economic expertise within the organisation but then there is quite an important role for economics outside, particularly in academia but also in other organizations, of providing a challenge function. My role is partly that, challenging things the rest of OFGEM is doing. Inevitably you can only get so far internal challenge, and you need that external challenge. It’s always going to be quite uncomfortable, and some of the people who provide that external challenge are quite robust…but broadly it’s a good thing. Compared to other jurisdictions I’ve seen there is a greater level of external challenge, which probably gets us to better decisions more

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quickly than it’s the case in more consensual or internally focused regimes (Ofgem, Chief Economist).

An example comes from Ofgem, whose interventions in the retail energy market adopted following the Energy Supply Probe\textsuperscript{117} in 2009 attracted wide criticism from the academic community of economists at the time of their introduction\textsuperscript{118} and led to their subsequent withdrawal.

Ideational constraints may also derive from the diffusion of ideas originating in the academy to the policy arena, as the rise of behavioural economics in regulatory policymaking amply illustrates. This set of ideas has justified an increased role for Ofgem when exercising operational discretion as we saw in the previous section.

Economists and economic ideas may, however have, sometimes, conflicting impact on various policies. A notorious example concerns the access and interconnection pricing policies in telecoms. The Baumol-Willig efficient component pricing rule (ECPR), which was initially embraced and then expressly banned in the New Zealand regulatory context for its long-term damage in the telecommunications sector\textsuperscript{119} has been been one of the most hotly debated access pricing rules in the academic literature.\textsuperscript{120} The ECPR deducts from the retail price of a product the cost that an undertaking would avoid (i.e. opportunity cost) if it did not provide an upstream service. In the UK context, it was extensively discussed in the \textit{Albion}

\begin{thebibliography}{120}
\bibitem{footnote119} This legislation followed litigation in the telecommunications sector culminating in the decision of the Privy Council in \textit{Telecom Corporation of New Zealand v Clear Communications} [1994] UKPC 36, [1995] 1 NZLR 385.
\end{thebibliography}
saga, where the specialist UK CAT decided that the ECPR adopted by Ofwat was not a safe methodology to use in the case before it.

It is, arguably, the job of sociologists and political scientists to explain how economic ideas travel from epistemic communities and the academy and find their way to policymaking and why some economic theories become more prominent than others. But, what this section highlights is that the influence of ideational constraints on the use of economic evidence in regulatory decision-making is not always a straightforward exercise and that legal constraints mostly prevail, as the CAT’s judgment in the Albion water case illustrates. The application of the ECPR rule was one of the choices lying in the regulator’s arena of discretionary power. There was no legal constraint to applying the ECPR in support of Ofwat’s application of an average accounting cost methodology. Whether it promotes more or less competition is a different story. However, institutional constraints, and legal constraints, in particular, determined the final outcome. Engaging in an academic discussion on the ECPR and examining its application in different countries around the globe, the expert tribunal clearly rejected the use of the ECPR: ‘it cannot be assumed that [the incumbent’s] upstream price is reasonable…[t]he margin squeeze in question cannot be justified on the basis of an ECPR approach which is itself unsound’. Notwithstanding the value of the academic criticism advanced against the ECPR, the tribunal judged that an economic approach, which requires new entrants to be ‘super-efficient’ effectively eliminates the development of competition and is not consonant with the government’s policy goal in regulated industries.

VI. Conclusion

Ever since the liberalisation of essential services technocracy has emerged not only as a rule by experts, but also as an ethos signaling the commitment to a unanimously shared policy goal: ‘the promotion of effective competition where it is possible or to provide a proxy for competition, with protection of consumers’ interests at its heart,

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121 See Albion Main judgment (n 108) above.
122 Ibid, para. 31 and 853.
123 For an example see M Fourcade, Economists and Societies (Princeton University Press 2010).
124 The ECPR rule was banned in the New Zealand Telecommunications sector following the Clear case and it was rejected by the US Supreme Court in the Verizon case. See cases Telecom Corporation of New Zealand v Clear Communications Ltd [1995] 1 NZLR 385 and Verizon v FCC, 535 US 467 (2002).
125 See Albion Main judgment (n 108) at para. 873.
where is not meaningful to introduce competition.'\textsuperscript{126} This marks a significant shift from the ambiguous and elusive expression of ‘the promotion of the public interest.’ Professional economists have applied their discipline-specific criteria in implementing this goal. As the article illustrated, economic evidence informs a wide array of discretionary assessments and trade-offs between efficiency and equity which have been more pronounced in the last two decades due to the broadening of regulatory objectives. The complexity surrounding the use of economics in the exercise of discretion coupled with the arcane body of economically informed discretionary assessments has contributed to the latter being perceived as too ‘technical’ assessments, thus often concealing the important value judgments that they embody. Regrettably, competition law and regulation and public law scholarship have rarely engaged with the essence of the work of regulatory agencies and have by and large ignored the important role of economists therein.

It was, therefore, the author’s intention to cast light on these neglected actors and to better understand how the use of economic evidence is transforming the way regulators understand and conceptualize the very idea of discretion. This is important because, after all, traditional administrative law preoccupations on, for example, the appropriate scope of review of regulatory decisions cannot be meaningfully addressed without a deeper, context-specific understanding of how regulators actually perceive and exercise their discretionary powers. In doing so, the author drew on both the competition law and regulation scholarship (which informs the substantive rules governing economic regulation) and the administrative law scholarship (which informs the procedural rules governing this area) in the hope of blending rather than bifurcating these two fertile sources of scholarship.

The novelty of the approach adopted in the article is that it departs from the court-centric understanding of the interrelationship between economic evidence and discretion, that has dominated the literature thus far, to focus instead on the perspective of those internal to the regulatory agencies. The court-centric approach is rife with categorical, artificial, most of the times, distinctions between economic assessments (often couched as questions of fact) and value judgments (deemed as matters of regulatory policy), which the courts draw in an attempt to tame discretion

\textsuperscript{126} BIS, ‘Principles for Economic Regulation’, April 2011.
and its exercise. When delving, however, on the perspective of those exercising discretion within the regulatory agencies it became apparent that the relationship between economic evidence and discretion is much broader than the judicial paradigm allowed us to envisage.

The conceptual part of the article (Section IV) shows that recourse to economic evidence and analysis is pervasive in all three dimensions of discretion: interpretive, operational and enforcement discretion. Furthermore, the role of economic evidence and analysis has increased as it is used to inform both economic efficiency considerations and the weight agencies need to assign to efficiency and equity respectively. However, this enhanced role of economic evidence and analysis, has not had the effect of increasing the discretion agencies enjoy. On the contrary. First, against the backdrop of an ever-increasing statutory remit, economics offers a logic framework for decision-making and a strong focus on empirical and factual evidence, which structures the expanded statutory remit allowing thus discretion to be better exercised. Secondly, while economists enjoy formal discretionary powers, they are actually quite constrained, as the as the discrepancy between the conceptual and operational level of the analysis reveals. The article sought to identify, examine and critique the nature and scope of such constraints that inform and shape the influence of economics in the exercise of discretion.

The operational part of article (Section V) argued that economists are constrained by, first of all, structural factors, such as the political and economic climate, and broader societal concerns. Such constraints emanate from the need to cater for social and environmental objectives, arguably more fitted to the role of the Government. The upshot of this development is that sound economic evidence and analysis may be sidelined, as the structural (and ideational) constraints facing Ofgem revealed. Secondly, economists are also constrained by institutional factors, including the desire to produce substantively fair decisions, which may increase the quality of economic evidence especially when their decisions are challenged on the merits by the specialist Competition Appeal Tribunal. But the threat of appeal has had the effect of Ofcom becoming too legalistic in its approach, which may in turn undermine its overall statutory objective of promoting the interests of consumers. Finally, economists are

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constrained by ideational factors, such as scrutiny by the academic community, as the case of Ofgem and Ofwat revealed.

There are many benefits to understanding whether and to what extent such constraints shape the decisions of economic regulators. First, we can better explain the on-going evolution of the British regulatory state, from a project largely fuelled by a strong market ideology and the concomitant New Public Management (economic) values of efficiency and effectiveness to one concerned with the promotion of non-economic objectives and the pursuit of ‘thick’ legality. Secondly, understanding the constraints faced by economists helps us assess and possibly reform the regulatory and/or adjudicatory process. If economists operate largely unconstrained when exercising interpretive discretion, as this article posits, then perhaps a more adversarial and less inquisitorial decision-making process might be necessitated. Such as reform would subject economic facts and arguments to a more detailed scrutiny and also allow for a greater representation of affected interests. And if legal constraints, such as the threat of appeal, render the regulator legalistic and undermine the significance of economic evidence in the regulatory decision-making process, then this may invite for a reconsideration of the scope and intensity of review; provided that one adheres to the objective of economically informed regulatory decision-making.

Finally, the issues discussed in this article open up avenues for further research on the relationship between the distinct rationalities exhibited by the disciplinary communities of lawyers and economists. Does and should legal understandings of reasonableness always prevail over the economists’ understandings of rationality, as demonstrated in this article? It is, indeed, the aspiration of the author that the analysis undertaken therein will trigger a dialogue between the disciplinary communities of lawyers and economists, but also between competition law and administrative law scholars, who have tended to talk past each other despite facing common interpretive challenges.