

Approach to an Efficiency Review of Economic Regulators

Introduction

This paper proposes an approach to the evaluation of efficiency in economic regulators. It begins with a definition of “efficiency”, differentiating it from “effectiveness”. We then discuss how both efficiency and effectiveness might be measured in private and public sector environments. The difficulties of using traditional indicators for regulators are highlighted, and an alternative approach is proposed.

Effectiveness and Efficiency

“Effectiveness” is concerned with the performance of an organisation with regard to the delivery of its business objectives. In the private sector, effectiveness will be measured by shareholders (if there are any) in terms of share price and dividend yield. Company managers, while fully aware of and committed to these objectives, will have a wider perspective and consider other measures such as sales growth, profitability, and return on capital employed. Information on such metrics is widely available.

For a public sector organisation, it is less easy to quantify business objectives although it is not impossible. The Benefits Agency, for example, sets itself targets with regard to the “clearance” (turnaround time) and accuracy of income support claims. Likewise, the Passport Office measures effectiveness in terms of the time taken to process applications. Table 1 sets out some possibilities for an economic regulator.

Table 1 – Measures of Effectiveness of an Economic Regulator

Policy Objective	Possible metrics
Promoting competition	% market share of incumbent % market share of largest three firms number of players in the market number of applications for licences
Price control	Price increases relative to RPI
Promoting efficiency	Productivity of regulated companies Annual cost reductions of regulated companies (not explained by changes in sales volume) Quality of service metrics (eg. time to effect repairs)
Economic benefit	Consumer surplus created by lowering prices
Handling complaints	Time to investigate and respond to complaints

Having identified metrics against which to measure the performance of the organisation, the next step is to establish suitable targets. This is much easier for private sector organisations because they have competitors against which to compare themselves. Thus, shareholders will monitor movements in their share price against a market benchmark such as the FTSE 100 or

one or two competitors or the sector average. Managers will look at the financial performance of their competitors as well as market measures such as market share and the introduction of new products.

This is not something which can easily be replicated by economic regulators. Comparisons across sectors (Ofgem versus Oftel, for example) or across countries (the Competition Commission in the UK versus the ACCC in Australia, for example) are rendered largely meaningless because of differences in legislation and the market environment. In these circumstances, it is difficult to say whether the targets regulator set themselves are sufficiently challenging and hence whether their results represent good, bad, or indifferent performance. This leaves the question unanswered whether a regulator, with a different approach and/or different personnel, could have been more effective than the incumbent.

One possible approach to this problem is to ask stakeholders whether they consider the regulator to be effective. But this has its limitations as a methodology. Regulated companies are almost certain to say that the regulator is being too tough while consumer groups will probably say that they are not being tough enough. Such interest groups will find it difficult to provide an impartial opinion. An alternative might be to commission an independent panel of experts to review the decisions of the regulator. Provided with the same set of data as the regulator, such an independent body may come to a different conclusion but it would be difficult to interpret this result. The decisions made by regulators are based on assumptions and judgements, as would those of any other body reviewing the data. Unless several panels were set up to review the data independently of each other, in which case a majority verdict might emerge (a “Delphi” model), there would be no basis for concluding that the regulator’s decisions are any better or worse than those of the panel of experts.

This might be a valid methodology for an evaluation of a price control, although the cost would be considerable and there are still many areas on which different experts will assume different positions (e.g. cost of capital, a regulated company’s ability to make efficiency savings). But it is of very limited usefulness for all the other functions performed by a regulator. How might one judge whether the regulator has been effective in regard to the promotion of competition ? The emergence of new entrants to the market might be one measure, but how many constitute effective performance ? The number of complaints of market abuse by the incumbent could be another metric, but again how many complaints is too many ? Just one very serious complaint could be more important than a hundred minor ones.

Efficiency

Efficiency is often confused with effectiveness, and it needs to be defined with care. It is concerned with how an organisation goes about its business and is normally measured by relating a unit of output to a unit of input.

For a manufacturing company, efficiency is relatively easy to measure since both outputs (pieces or tonnes) and inputs (labour, energy, materials, capital) are measurable and the only problem is selecting the metrics which are important to the business. Some examples are set out in Table 2.

Table 2 – Efficiency Measures for Manufacturing Companies

Industry	Efficiency Measure
Cement	Kcals energy/tonne clinker kWh electricity/tonne cement
Brown goods	Labour hours/unit product
Steel	Annual tonnes of output/\$ millions of investment
Light sources	Quality defects/1,000,000 units of product
Glass bottles	Tonne silica and additives/tonne cullet
Vegetable oil	Tonne oil/tonne seeds

Efficiency measures can also be developed for service providers. Some examples are provided in Table 3.

Table 3 – Efficiency Measures for Service Providers

Sector	Efficiency Measure
Insurance	Labour hours/quote provided Labour hours/claim processed
Professional services	Support staff/professional staff Overheads/revenue
Airline	Load factor (capacity utilisation) Ticket marketing & distribution costs/revenue
Food retailing	Revenue/floorspace Revenue/number of floor staff

Some efficiency measures are better than others. Productivity (piece or tonne of output/labour hours or number of employees) might be misleading if gains have been bought at the price of reduced quality. In the case of benefit claims, for example, given the costs involved in re-work and handling complaints arising from mistakes, a productivity measure based on the number of claims handled is of limited value. A better metric is the number of accurate claims handled per labour hour. On the other hand, a metric such as kWh/tonne cement is highly potent. The cement emanating from the cement mill is regularly tested and the mill adjusted in real time to obtain a consistent specification, so the output (unlike benefit claims) is of a consistent standard. Moreover, energy is a large percentage of the operating costs of a cement plant so energy efficiency is very important for business performance.

In the case of regulators, the situation is complicated further. The outputs consist of a mix of dissimilar products – determinations, reports, consultation papers. There is no point in counting the number of “products” since their value, size, and quality varies. There is little to be gained from measuring the cost of products for the same reason. One can envisage making comparisons between the cost of price controls at the appropriate intervals (three to five years), making allowances for inflation – but the differences may reflect

variations in the thoroughness of the reviews rather than any efficiency gains/losses. The lack of a measurable output of consistent quality and specification means that traditional efficiency measures cannot easily be applied to regulators.

Another possibility might be to ask stakeholders their opinion of the efficiency of the regulators. This is of some value, but it has its limitations as a methodology. As with effectiveness, the opinions of regulated companies and consumer groups are partisan. Regulated companies will tend to say that the regulator is inefficient if they are funding the cost through their licence fees because they want to see a reduction. Consumer groups, on the other hand, are unaffected by the cost of the regulator and would rather see the regulator with more resources than less even if productivity is reduced. A second problem is that the business processes and systems deployed by the regulator are largely invisible to stakeholders, so all they have to go on is their impressions of the individuals with whom they have come into contact. Clearly, a different approach is needed to assess the efficiency of regulators.

Assessing Efficiency in an Economic Regulator

An efficient regulator would exhibit certain attributes, but what are they ? We begin this discussion with some attributes which are not necessarily good indicators of efficiency:

- Operating cost – once regulators are established, operating costs should rise as they recruit staff and beginning sizing and scoping their tasks. Thereafter, costs will stabilise but with peaks around the price controls. In principle, as the market becomes more competitive certain functions could be devolved to competition authorities, and costs should decline. In these circumstances, the regulator moves into a “care and maintenance” mode. In other cases, where competition is advanced, there will be no need for price reviews and the regulator will become redundant and cease to exist. Complaints can be handled by consumer bodies, and abuses of market position can be taken on (in the UK) by OFT or the Competition Commission. If costs are continuing to rise, however, as they generally are in UK regulators, this is not necessarily an indication of inefficiency. It may reflect the acquisition of new responsibilities by order of the Government, a one-off project (eg. NETA in the case of Ofgem), a response to unforeseen developments in the market, or a growing degree of complexity in the regulatory environment. Unpicking the cost increases that can be attributed to a widening or deepening in the scope of the regulator’s work and those which are due to inefficiencies is difficult.
- Staff numbers – regulators need a staff complement sufficient to manage their core functions but not necessarily to carry out all the activities. From this perspective, regulators should reach “steady state” after 3-4 years and handle any increases in workload thereafter (such as price reviews) by engaging consultants. In fact, regulators in the UK have tended to increase both their headcount and consultancy budget. Again, this may not necessarily be a good indicator of inefficiency for the reasons stated above. It is probably true, however, that regulators tend to keep staff numbers above an efficient level to provide “padding” given the high turnover from which most of them suffer.

There are not many “hard” indicators that are reliable and do not require interpretation which

undermines their value. What remains are mostly “soft” measures from which an impression of efficiency can be developed. In developing these measures, we need to ask ourselves the question – what would an efficiency regulator look like? Some examples of these “soft measures” are set out below.

Operating costs

1. An efficient regulator will be committed to controlling operating costs. He will therefore:
 - Make public his intention to spend no more than is necessary to effectively discharge his responsibilities and to make cost reductions when the workload allows
 - Explain and justify any budgeted increases in operating cost, particularly where they arise from new work programmes
 - Be able to document the cost of work programmes and projects so that he can demonstrate how the budget is being allocated and look for any opportunities for cost reduction
 - Be prepared to share operating cost data with stakeholders and enter into discussions about the cost of individual activities.

2. An efficient regulator will want to provide his professional staff with effective support services, but reduce their cost to a practical minimum. A regulatory office will require IT, PR, human resources, financial services and secretarial/administrative support but the more that is spent on such overheads the less will be devoted to regulatory activities given a finite budget. It is difficult to assess what might be an efficient level of support since bigger regulators will obtain scale economies and because some of these services can be outsourced. In our review of the utility regulators in the UK, we set up a “rule of thumb” that not more than 20 % of total expenditure (including capex) should be devoted to support services based on an international benchmarking exercise. At the very least, an efficient regulator will be monitoring his expenditure on support services and seeking to maintain or reduce the percentage over time.

3. An efficient regulator will want to reduce overheads to maximise the funds available for regulatory activities. Such overheads include accommodation, utilities, asset management, security/reception, internal post/courier, parking, travelling and subsistence, and entertainment. They will have to demonstrate that efforts have been made to secure competitive prices and to explore cost-effective methods of obtaining the services (eg. sharing services with other tenants, outsourcing requirements to a service provider).

Headcount and Consultants

1. An efficient regulator will want to maintain a headcount which provides sufficient resources to manage all the activities to the deadlines specified in the Business Plan, making allowance for the support of consultants. Any increases in headcount will need to be justified either by an increase in workload or a reduction in work placed with consultants.
2. Consultants should be used to provide input where the requirement is short-term, or an independent opinion is required, or because the task requires specialist knowledge it would not be sensible to maintain in-house on a permanent basis or expertise which is unavailable to the regulator and would be too expensive to acquire. It is not generally efficient to employ consultants to fill routine resource gaps given that their unit costs are at least 4 times higher.
3. An efficient regulator will want to use consultants only where they provide some real value-added and not become too dependent on their services. The focus should be on developing in-house resources. Regulators vary quite widely in their degree of dependence on consultants, and within regulators spending on consultants peaks around the price reviews. Disbursements to consultants as a percentage of total expenditure in 2000/01 was 60 % at the Office of the Regulator-General in Australia, 7 % at Ofwat (in between price reviews) and 21 % at the Office of the Rail Regulator (in the middle of a price review). It is difficult to set a suitable target because circumstances vary, but regulators should determine for themselves what they consider to be an efficient level and monitor performance against this target.
4. Where regulators are using consultants routinely for important pieces of work, they need to be managed to ensure that the assumptions, methodologies, and data they are using to arrive at their findings and recommendations are understood and signed-off by the regulator and to capture the knowledge and information they have acquired in the course of the work. This means that the regulator needs an efficacious knowledge management system.

Corporate Governance

Regulators vary quite markedly in their corporate governance – from Commissions (like Postcomm) to single person regulators (like the Office of the Rail Regulator), to management board type structures (such as Ofgem). In all cases, however, an efficient regulator will have sound systems and procedures to:

- Make decisions quickly
- Access specialist and expert advice to aid decision-making (eg. non-executive

Directors, expert advisers)

- Feed decision-makers with the reports, recommendations, and information they require for their deliberations
- Communicate decisions and directions to staff
- Ensure that the Office is compliant with public sector regulations covering accounting, procurement, employment of staff, and health & safety (eg. Audit Committee).

An efficient regulator also needs to be clear about the responsibilities of its executive and senior professional staff, their accountabilities, and reporting lines. A particular consideration is the extent to which the “executive” (the decision-makers) is involved in the “administration” (the day to day operation of the Office). Some regulators find it most efficient to make a clear distinction between the two functions, whereas others allow some degree of cross-over.

A reviewer will need to be convinced that a regulator’s system of corporate governance is workable, and strikes an appropriate balance between quick decision-making on the one hand (the strength of the single regulator model) and obtaining views from all corners and reaching a consensus among equals (the strength of the Commission model).

Corporate Planning

An efficient regulator will have good systems and procedures for:

- producing an annual Business Plan (containing programme targets and estimates of resource requirements broken down between each component of the Plan) and medium-term regulatory strategy (minimum 3 years), allowing sufficient time for consultation
- evaluating which work programmes/projects to be included in the Business Plan (for those which are not a statutory duty, some kind of cost-benefit analysis might be attempted to determine value for money)
- allocating priorities and budgets to work programmes and projects
- marrying the various Departmental plans to the Business Plan
- monitoring progress against the Business Plan
- revising the Business Plan should it be necessary to do so
- communicating the Business Plan to staff and stakeholders.

Project Management

Regulators are conceiving and managing projects which can cost a few £ thousand up to several £ millions. They can be quite complex and demanding, involving large amounts of data, sometimes with aggressive deadlines. It is important for the credibility of the regulator that these projects are well managed – they keep to deadlines and to budget, they deliver the promised results, they are intellectually rigorous, there is an audit trail, and the conclusions are defensible. This implies that regulators should have a project management system that is consistent across the Office. The main features of this would be:

- there is a project management manual
- there is a quality assurance manual
- staff are trained in the regulator's approach to project management
- a Project Initiation Document (PID), or equivalent, is written and signed-off by the appropriate individual (Chief Executive, Chairman, Regulator) before commencing work on any project
- there are arrangements for supervising and monitoring progress on projects (Project Steering Committees, Project Boards, checkpoint meetings etc)
- there is a mechanism for costing projects (this might involve just the consultancy cost, but it could also capture staff costs and other operating expenses which would require a timesheet system to be in place)
- there are procedures for recording, controlling and archiving data, reports, calculations, correspondence, e-mails, and telephone conversations
- there is a procedure for closing projects.

Performance Management

An efficient regulator will commit to a philosophy of continuous improvement and should therefore be routinely monitoring and reporting on its performance. It needs to demonstrate that it is capable of monitoring its performance, that it is interested in the results, and is willing to share them with stakeholders. Performance management could comprise:

- reviewing the delivery of the Business Plan in the Annual Report (projects/workstreams completed to deadline and budget)
- performing an activity analysis (which does not demonstrate efficiency or value for money, but records what is being accomplished) and presenting the results in the Annual Report (eg. appearances at conferences and public forums, papers delivered or sessions chaired at conferences, number of set-piece meetings with regulated businesses and end-user representatives, visits to or by other regulators, appearances on TV and radio, number of web-site hits, number of documents downloaded from the web-site). While this opens each activity to challenge, it encourages regulators to consider the business case for activities and demonstrates open government
- publishing information on the impact of the regulator's decisions and policies (which may require it to commission independent reports)
- monitoring some non-regulatory indicators and reporting performance against them in the Annual Report (eg. staff turnover, the percentage of expenditure accounted for by consultants, the percentage of budget consumed by support services)
- publishing response times to Ministerial requests, instances of non-compliance with licence conditions, and complaints (if this function is within the remit of the regulator)
- undertaking a stakeholder satisfaction survey (the key objective of such surveys is to measure the relative change in satisfaction levels over time)
- monitoring the performance of support services (probably only sensible for large regulators).

Human Resources Management

An efficient regulator will be interested in recruiting and retaining the best professionals. It will be particularly interested in reducing staff turnover to as low a figure as possible, because high turnover will result in higher recruitment and training costs, lower productivity generally, and lower effectiveness as staff move on before they can fully repay the investment in their development. An efficient regulator is therefore likely to:

- provide competitive salaries/remuneration packages
- offer attractive terms and conditions
- find innovative ways to attract bright young personnel such as graduate recruitment schemes and secondments from other regulators
- offer training and development/career planning
- have a succession plan
- have a performance appraisal scheme
- have a staff consultation mechanism.

Methodology for an Efficiency Review

We would approach an efficiency review of an economic regulator on three fronts:

- a review of business processes and systems
- benchmarking against other regulators
- an assessment of stakeholder views.

Each of these approaches has its limitations. A review of systems and processes will tell us whether the regulator is likely to go about its business efficiently, but it depends a good deal on whether these systems and processes are actually operational and effective in practice. The perceptions of stakeholders will help to answer this question as will our own observations. Benchmarking against other regulators is not altogether reliable since good comparators are hard to find either because they have different responsibilities or have organised themselves in different ways. Given this, we would ignore minor differences between regulators and focus on instances where the regulator under review is way out of line with the norm. Stakeholders are not entirely objective nor do they have sufficient information in all cases to offer an informed opinion. However, they can provide some useful insights into both the efficiency and effectiveness of the regulator provided these are cross-checked against our own information and observations.

Review of business processes and systems

This will involve interviews with both senior staff (to understand what procedures and systems have been developed and/or in progress) and junior staff (to understand how they are working in practice). We will examine internal documents which describe the business processes, and look at what is reported to stakeholders (for example, activity costs and performance). We will speak to non-Executive Directors, senior advisers, or Commissioners who are more distant from the day to day business of the regulator and can provide a more independent assessment.

Benchmarking against other regulators

We will select a suitable comparator or group of comparators and invite them to participate in a benchmarking exercise. They will be asked to provide some quantitative information as well as details on their business processes. The quantitative information will include:

- trends in total expenditure over time
- breakdown of current expenditure (eg. staff, accommodation, consultants, capex)
- % of budget spent on support services (i.e IT, HR, PR, finance)
- trends in staff numbers over time
- breakdown of staff into functions.

Stakeholder views

Stakeholders will include HM Treasury, the sponsoring government department, regulated businesses and their representative bodies, consumer groups, environmental groups, as well as consultants and advisers to the regulator. They will be canvassed for their perceptions of the ability of the regulator to carry out its duties effectively and efficiently, i.e:

- is the regulator adequately financed ?
- does it have the right number and mix of people ?
- does the regulator have effective direction and management ?
- does the regulator have the capacity to make informed, balanced decisions in good time ?
- are the business systems and procedures operating efficiently ?

Recommendations

The efficiency review will identify some areas of weakness which need to be improved. It will be important at this stage to determine priorities and focus on those areas which really matter. If the regulator is consistently late with projects, leaving stakeholders with insufficient time to make a considered contribution to the consultation process, then this is quite serious and needs to be addressed. If, on the other hand, the regulator is not collecting activity-level information then it should, if only to deflect criticism from those who might complain about the lack of it, but it not a major problem which requires urgent attention.

It is also essential to avoid putting forward recommendations which cannot be implemented. One could envisage, for example, that the day to day business of a regulator could be contracted out to a service provider with the decision-making powers remaining in the public sector. This might well improve efficiency, but politically it is probably unacceptable.

All recommendations should be rehearsed with the regulator before finalisation to check that they have a solid basis in evidence and will generate benefits commensurate with the burden of implementation.

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February 2002