

INTOSAI



*Guidelines on
Best Practice for
the Audit of
Economic
Regulation*

INTOSAI PROFESSIONAL STANDARDS COMMITTEE

PSC-SECRETARIAT

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Glossary

PART 1: INTRODUCTION

1. Following a decision taken by the XIV INCOSAI in Washington in 1992, the INTOSAI Working Group on the Audit of Privatisation was formally established by the Governing Board in May 1993 under the Chairmanship of Sir John Bourn, Head of the United Kingdom National Audit Office.
2. The membership of the Working Group comprises representatives from the SAIs of:

Albania	India
Antigua and Barbuda	Israel
Argentina	Lithuania
Australia	New Zealand
Austria	Norway
Bahamas	Oman
Chile	Paraguay
Czech Republic	Peru
Denmark	Poland
Ecuador	Russia
Egypt	Saudi Arabia
El Salvador	Turkey
Estonia	United Kingdom (Chair)
Germany	Uruguay
Hungary	Yemen
	Zambia

3. In November 1998 the XVI INCOSAI approved in Montevideo a set of forty guidelines on the audit of privatisation. Noting that privatisation by sale was not the end of the privatisation story, and that economic regulation of both privately and publicly owned businesses was a growing area of importance for governments and citizens, the XVI INCOSAI invited the Working Group to develop guidance on the audit of economic regulation too.
4. The guidelines which follow represent the Working Group's response to that remit, informed by the outcome of the survey of INTOSAI members on economic

regulation and its audit to which 67 SAIs replied, the results of which were set out in the Group's report approved at its sixth meeting, in Warsaw in October 1999 and subsequently sent to all SAIs. The guidelines can also be accessed on the Working Group's website www.nao.gov.uk/intosai/wgap/home.htm.

5. Economic regulation may be defined as the exercise by the state, either directly or indirectly, of control and influence over suppliers, whether publicly or privately owned, of services to consumers. It addresses a number of objectives, some of which are in competition with one another, for example protecting consumers from abuse by monopoly suppliers, while seeking to ensure that suppliers are able to finance the provision of essential services, such as utilities, public transport and financial services, to specified standards. In the case of competitive markets, the economic regulator's attention is focussed on securing adequacy and transparency in the provision of information by suppliers to assist consumers in making informed choices, monitoring the financial standing of suppliers and acting against anti-competitive practices. The range of business activities covered by economic regulators is vast, directly affecting the vital interests of all citizens.
6. The INTOSAI survey showed that while in the majority of countries economic regulation is mostly exercised directly by government, in a growing minority of cases it is carried out by specially constituted bodies operating at arm's length to government, some of them responsible for regulating specific industries, some operating across the economy - for example general competition regulators. Most of these are public bodies, some of which carry out functions prescribed by legislation independently of government, others reporting directly to government; some combine both of these features. A minority are private bodies, including regulators set up by the industries themselves (self regulation). Especially where businesses have been privatised with monopoly or dominant powers, privatisation has been accompanied by the creation of new regulatory bodies.
7. There is a vigorous debate as to the value of economic regulation, in particular whether it is likely to be able to represent consumer interests effectively in the face of powerful dominant suppliers, increasingly operating internationally. Developing competition is widely seen as a surer method of consumer protection, underpinned perhaps by general competition regulation. But experience suggests that, even in a competitive environment, intervention is needed in a variety of ways to protect the interests of individual consumers, especially those who are most vulnerable, as well as the interests of society as a whole. In particular, as countries develop and citizens become more affluent, the demand for services becomes more sophisticated and consumers look for higher standards of service and expect suppliers to be put under pressure to perform consistently to such standards.
8. The INTOSAI survey revealed many instances of the positive impacts of both economic regulators and SAIs on improving the provision of regulated services. These are set out in the Working Group's report. It is clear from the report that citizens are increasingly looking to SAIs to carry out authoritative examinations of the work of economic regulators and the performance of the industries they regulate, and that the reports of SAIs are leading to increased efficiencies in the supply of regulated services, to the benefit of both consumers and suppliers.

The Guidelines: Summary

9. The guidelines highlight a series of key questions that SAIs are likely to need to address when examining the efficiency and effectiveness with which economic regulators set about their tasks. In recommending these guidelines, the Working Group recognise that economic regulation is an evolving concept, practised in a variety of ways in different countries with different constitutions and at different stages of development. So the guidelines may need to be applied in the particular circumstances of different countries with appropriate modifications to take account of the state of development there. The guidelines are illustrated by examples drawn from the INTOSAI survey report, and the experiences of Working Group members. They are grouped in five sections, and the following paragraphs summarise key issues relevant to the guidelines in each section. The guidelines themselves are set out in Part 2.

Section 1: SAI Skills

10. If the SAI is to carry out well thought through performance audits, leading to worthwhile recommendations and the spread of good practice, it needs to have access to a wide variety of relevant skills and a thorough knowledge of the regulated industry. SAIs can learn much from each other's experiences, facilitated by such measures as the exchange of staff and parallel or joint audits.
- Guidelines

1. Skill requirements
2. Acquiring the skills

Section 2: The Business of Regulation

11. The SAI needs to have a clear understanding of the context of economic regulation as well as its objectives, functions and powers. It is important to evaluate how robustly the regulatory body maintains its impartiality and integrity, and competence, whether it obtains sufficient information about suppliers' operations to carry out its regulatory functions and how effective are its consultation arrangements.

Guidelines

3. The regulatory framework
4. Objectives, functions and powers
5. Impartiality and integrity
6. Technical competence
7. Information needs
8. Accountability and consultation

Section 3: The Supply of Service

12. One of the regulator's key objectives will be to secure the supply of essential services, so that access is secured for consumers, not least those who are most vulnerable. The SAI will need to examine what standards of service have been laid down and how the regulator monitors whether suppliers are meeting those standards. Complaints procedures should be put in place and effectively applied. And regulation goes wider than economics. Health and safety and environmental considerations are vital too; the SAI is well placed to examine and comment on whether these objectives are being addressed.

Guidelines

- 9. Security of supply
- 10. Consumer access
- 11. Supplying vulnerable consumers
- 12. Service standards
- 13. Dealing with consumers' complaints
- 14. Environmental issues

Section 4: The Price of Service

13. Another key objective of the regulator is to ensure that the price charged is commensurate with the quality of service on offer, and that where regulation has social objectives these are reflected in the pricing regime, including any public subsidy element. This section examines issues relating to price and other controls, and factors that need to be taken into account in considering suppliers' financing costs, including investment programmes, and measures to improve supplier efficiency, having regard to other considerations, including securing supply and environmental objectives.

Guidelines

- 15. Controlling prices
- 16. Linking price to quality
- 17. Encouraging supplier efficiency
- 18. Suppliers' financing costs
- 19. Investment

Section 5: Developing Competition

14. This final section examines key issues relating to the role of economic regulators in developing competition, including the improvements in quality of service and pricing that can result, and the steps needed to maintain competition, including combating anti-competitive practices.

Guidelines

20. Reducing monopoly and market domination
21. Promoting consumer choice
22. Combating anti-competitive practices

Conclusion

15. Since the public/private finance and concession approach is a fairly recent development, and bearing in mind that good practice in successfully implementing such projects is still evolving, the guidelines proposed should be seen as suggestions and advice, put forward in the light of experience so far. They are not laws or set procedures which every SAI should apply in their entirety to every study. Their purpose is essentially to offer guidance to ensure that an audit of such deals follows a professional and structured approach and identifies useful lessons for future deals. We believe nevertheless that many of the issues addressed are likely to remain valid and relevant, however the public/private finance and concession approach develops.
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PART 2: THE GUIDELINES

SECTION 1: SAI

SKILLS *Guideline 1*

Skill requirements

Guideline

The SAI should identify its audit responsibilities in relation to the economic regulator and, in addition to the financial audit skills needed to examine the execution of the regulator's budget, should ascertain what specialist skills it needs to carry out performance appraisals of economic regulation.

Reasons for the guideline

The SAI is frequently both the financial and performance auditor of the economic regulator.

Whether organised as part of a government ministry or as a separate body, the function of economic regulation is likely to be carried out by a comparatively small number of people, with a correspondingly small administrative budget. The audit of the execution of that budget is unlikely to give rise to particularly novel technical issues although the SAI will need to have regard to the care with which the money has been spent ([guideline 5](#)) as well as addressing such issues as compliance with legislation and internal controls.

By contrast, the regulator's actions and decisions are likely to affect all citizens, major suppliers, and possibly the economy as a whole. Both as taxpayers and as consumers of services provided by regulated suppliers, citizens are increasingly looking to the SAI to suggest ways of improving the value for money of economic

regulation and of strengthening the accountability of regulators and the responsiveness of the industries they regulate.

The SAI will need to have access to a range of specialist skills in order to address these expectations and to carry out performance audits of regulators and/or the suppliers of services whom they regulate. These skills are likely to include understanding the contractual and legal bases under which the suppliers and the regulator operate, as well as expertise in economic analysis, accounting and statistics, and in quantitative and qualitative appraisal techniques, so as to be able to evaluate the impact of regulatory decisions on suppliers and their customers. The SAI will also require knowledge of disciplines such as benchmarking, cost benefit analysis, risk analysis and attitudinal surveys.

Equipped with such skills, SAIs have undertaken audits of a range of economic regulators and the industries they regulate, often in highly specialist and technical areas. In one country for instance the SAI has carried out evaluations of the operations of state-owned banks, examining such matters as the capital, other assets, earnings and liquidity of the banks and their financial standing [*Argentina*]

Guideline 2

Acquiring the skills

Guideline

The SAI should identify and secure the core in-house skills it needs to enable it to carry out authoritative performance appraisals of economic regulation, and should supplement these skills with expert external support as necessary.

Reasons for the guideline

It would be very expensive for the SAI to try to recruit and retain in-house all the skills needed to examine all aspects of economic regulation. Yet, as consumer demand for better service grows and as privatisation takes place, the SAI is likely to find itself having to evaluate an increasing number of regulatory bodies covering a widening range of regulated services supplied to citizens. The SAI needs to decide which of the necessary skills it should develop in-house as part of its core business and which to buy-in on a case by case basis, bearing in mind that in a rapidly changing regulatory environment the skills mix needed is likely to be constantly developing, so that the SAI may need to be regularly adjusting its skills base.

The INTOSAI survey on the audit of regulation revealed that many SAIs are carrying out such performance appraisals. A number of SAIs are building teams specialising in the audit of economic regulation, supplementing their skills on an ad hoc basis with external advice on the latest developments.

SAIs are finding it helpful to exchange experiences and information with each other on audit methodologies and to exchange staff on secondments. There is scope for intensifying such exchanges of experience and staff, for instance within regional

groupings of INTOSAI or otherwise between SAIs facing similar challenges. These SAIs may wish to consider for example carrying out joint or parallel audits where similar economic regulatory issues would benefit from the application of complementary performance audit methodologies.

It may also be valuable for the SAI to seek secondments of members of its staff to regulatory bodies to obtain a better understanding of how economic regulation operates, and to acquire expertise which they can apply in subsequent performance examinations. The SAI may also wish to take staff on secondment from the regulatory bodies, so that they can gain a better understanding of the role of performance audit.

SECTION 2: THE BUSINESS OF ECONOMIC REGULATION

Guideline 3

The regulatory framework

Guideline

In order to set about performance evaluations the SAI needs to have a clear understanding of the context in which the economic regulator is operating.

Reasons for the guideline

The details of economic regulation vary between countries and between industries but they share many purposes in common, in particular: to ensure that regulated businesses supply essential services at a fair price to the public; to protect consumers against the abuse of monopoly power; to achieve social objectives; and, in pursuit of these goals, to develop competition. The SAI needs to understand the dynamics within which regulator and regulated interact with each other and with consumers in order to be in a position to examine the effect of regulation.

In many countries, regulatory functions are carried out directly by government ministries. In others there may be subsidiary regulatory commissions answerable to government [*India*]. In a growing minority of cases regulation is exercised at arm's length to government, typically by public bodies (usually boards, sometimes individuals, but also private sector companies) or by self regulation. Sometimes the regulatory function is exercised on an industry specific basis, for example bodies set up on the privatisation of monopolies supplying public services; in a minority of cases it is carried out by a general regulatory body, for example a general competition regulator. In many instances the industry concerned may be subject to regulation by a number of bodies, for example government ministries and specific or general regulators, each with powers and responsibilities that may complement each other and may overlap or compete with each other. The SAI needs to know how the activity, or inactivity, of other institutions could affect the decisions taken by the regulator and have regard to this in scoping and carrying out its audit [*Poland*].

In an industry that is being privatised - especially with monopoly powers - it is important that an appropriate regulatory structure is implemented at the time of privatisation, as it will be difficult to put matters right afterwards [*Russia*]. It is also

important to address at the point of privatisation the standards that privatised companies should be required to attain [Zambia].

Change is constantly taking place in regulated markets. Sometimes that change can be very rapid, for example in telecommunications. The SAI will need to check how the regulatory framework is coping with these developments so as not to become a drag on progress, identifying and making known examples of good practice where regulators have been flexible in responding to the challenge of market change.

Guideline 4

Objectives, functions and powers

Guideline

The SAI needs to have a clear understanding of the objectives, functions and powers of the regulator in order to examine how effectively it is addressing its tasks.

Reasons for the guideline

Regulatory objectives are most often set out in legislation but are sometimes also developed by the government or by the regulator itself. The SAI should examine the powers given to the regulatory body, to check the adequacy of the legal basis for its work. The SAI should also consider any legal or other constraints on the regulator and how these may affect the efficiency and effectiveness with which it carries out its functions. The SAI will of course also need to have a clear understanding of the regulator's decision-making process (formal and informal), information systems and internal control systems.

Regulatory bodies are typically required to pursue a number of objectives, some of which can be in competition with others; for example to ensure the supply of essential utilities such as water while protecting the consumer against monopoly abuse; and not to stifle competition and innovation in the supply of insurance and pension services while carefully monitoring the financial robustness of the suppliers of these services. In examining the regulator's functions in pursuit of these objectives the SAI should take care not to question the merits of the policy objectives which the regulator is pursuing. But the SAI needs to be clear what those objectives are so as to be able to examine the extent to which the regulator has discharged its responsibilities, and whether the current regulatory structure adequately addresses its stated objectives.

Where there are competing objectives, the SAI will need to consider whether the regulator has struck a defensible balance between, for example, economic and social objectives, or within particular objectives. For example, as regards maximising benefits to consumers, pressing for the lowest possible prices in the short term could delay the development of competition and consequent longer term benefits. It is for the regulator to decide how to cope with such competing objectives: the SAI should take care not to usurp the regulator's responsibility for

determining priorities. In one country [*United Kingdom*] the SAI examined the balance struck by four major regulatory bodies in pursuit of their statutory duties, in particular as regards protecting the interests of consumers while also enabling the suppliers to finance their regulated activities. The SAI also compared and contrasted their powers, duties and priorities and found differences between them. The regulators have subsequently worked together to adopt a more common approach on a variety of issues, ranging from consultative practices to techniques for calculating the rates of return on investment needed by suppliers of regulated services.

Guideline 5

Impartiality and integrity

Guideline

The SAI should examine what rules and procedures have been established to ensure that regulatory functions are carried out properly and honestly and that cases of alleged improper practice on the part of the regulatory body or its staff are investigated.

Reasons for the guideline

In most countries regulated industries account for a significant part of gross domestic product and they have an impact on the economic interests of millions of citizens. Consumers need to be confident that the regulatory body is capable of defending their interests in the face of dominant suppliers. And suppliers need to be confident that the regulatory body will not seek to prevent them making a fair return for a fair level of service.

To enable the regulator to operate effectively and to gain general acceptance for its work, it must be free from political pressure and resistant to influence from regulated suppliers, so that the decisions it takes are made impartially in the public interest. The SAI needs to check that the regulator has established, and operates, adequate rules and procedures to enable it to resist such pressures, from whatever source. If there are any departures from established rules and procedures, the SAI should also assess the reasons, including whether the procedures concerned need updating. One important area is whether the regulatory body has complied with rules designed to prevent conflicts of interest, such as banning staff from certain activities, including shareholdings in regulated companies, accepting substantial gifts from suppliers or engaging in activities on their own account which are linked with work for suppliers or which the regulatory body has procured under contract [*Peru*]. The SAI also needs to be aware of the risks of industry capture, resulting from pressure from powerful suppliers with significantly more resources than the regulator. There is also a converse danger that regulatory decisions intended to assist consumers, for example on price or profit controls, might put the financial viability of suppliers, and hence the supply of essential services, in question.

Regulators should keep adequate records of the reasons for their decisions, to help ensure the proper conduct of public business and for accountability. In one country

[United Kingdom] following an examination by the SAI and Parliament, a regulator improved its documentation procedures so as to keep a clearer record of the reasoning followed in reaching important decisions.

Guideline 6

Technical competence

Guideline

The SAI should examine what steps the regulator has taken to ensure that it has sufficiently competent staff, and access to expert advice, to enable it to carry out its functions with adequate knowledge of the regulated suppliers and the markets within which they operate.

Reasons for the guideline

Regulators need to keep themselves knowledgeable about the suppliers they are regulating. There are contrary risks: on the one hand, being so far detached from suppliers as to be uninformed and so to lose industry's confidence (important if regulation is to be constructive); on the other hand, being over eager to co-operate with the industry, especially with its existing members who might wish to slow down change, and discourage new entrants to the market. The provenance of the regulator and key staff is an important element in addressing these issues; recruitment from a variety of backgrounds and relevant disciplines, and regular turnover of key regulatory personnel, as well as access to respected external experts, can be important in securing both competence and independence.

The SAI should examine whether the regulatory personnel have the necessary technical skills to exercise their functions effectively and whether they are in touch with the latest technical developments affecting the sector within which they are working *[Peru]*. The SAI might also examine issues such as the mix between external consultancy and in-house expertise, and whether the regulatory staff reflect the range of disciplines, expertise and experience that the regulatory body actually needs, and how efficiently and effectively they are operating. In one country *[Poland]* the SAI found that the energy regulator had improved and updated the knowledge of its staff through a comprehensive training programme including experience from other countries. In another country *[United Kingdom]*, having regard to a recommendation of the SAI, the regulator of the telecommunications industry has sought to recruit more people with relevant industry expertise and has overhauled its training programme so as to enhance its staff's business skills.

Guideline 7

Information needs

Guideline

The SAI should establish whether the regulator is able to obtain sufficient reliable information about suppliers to enable it to carry out its functions efficiently and effectively.

Reasons for the guideline

Regulators are likely to know less about the business of the suppliers they regulate than the suppliers themselves. And they are likely to be dependent on suppliers for much of the information they need to carry out their regulatory functions. Suppliers have much closer day to day involvement with their business, and are in a position to control the information on their business that they provide to the regulator. In one country [*Poland*] the energy regulator licensed a supplier without sufficiently investigating its financial condition. Six months later the supplier went bankrupt.

This imbalance may inhibit the regulator from achieving some of its objectives. For example the regulator may seek to set a supplier's price close to its costs. The regulator has less information on the supplier's costs than the supplier itself, which has an incentive to overestimate costs in order to persuade the regulator it needs to be able to set a higher price.

The SAI should consider what measures the regulator can take to reduce this information disadvantage. This will involve reviewing the regulator's information needs, and the adequacy of the regulator's powers to require suppliers to provide information and also examining whether the regulator has agreed its information needs with suppliers (data collection is costly, and costs can be reduced if the nature of the information is agreed in advance). If the regulator wishes to compare information from several suppliers and/or over time (benchmarking), it is important that the information is collected in a standard format. The regulator also needs to be confident that any information supplied is accurate and reliable. In one country, for example, [*United Kingdom*] the water regulator requires suppliers to employ independent experts, with a legal duty to report to the regulator on the quality of the information provided by the suppliers.

More generally, the SAI will also need to examine whether the regulatory regime contains penalties and incentives to encourage the provision of accurate information. Some regulators for example have powers to impose penalties on suppliers, by fining them or imposing heavier price controls. And in some countries such powers are balanced by incentives, recognising that if a supplier believes that it will not benefit from reducing its costs it will have little incentive to let the regulator know that it has scope to do so, whereas if the benefits of cost reduction can be shared between suppliers and consumers, suppliers are more likely to co-operate ([guideline 15](#)).

Guideline 8
Accountability and consultation

Guideline

The SAI should examine what steps the regulator has taken to assist public and parliamentary scrutiny of its decisions and actions, including consultation arrangements with interested parties, having due regard to the need to protect commercial confidentiality where this can be shown to be in the public interest.

Reasons for the guideline

Whether the regulatory function is carried out within or answerable to a government ministry, or at arm's length, it is a function performed in the public interest and there is a need for the regulatory body to be accountable for its operations in order to develop its legitimacy in the eyes of the public. The SAI's reports can make a major contribution towards securing this accountability.

In many instances suppliers (but generally not consumers) have the right of appeal to the courts against the regulator's decisions. The consultation carried out by regulators, and the explanations they give for their decisions, are intended to assist public scrutiny of their actions. The greater their flexibility and judgmental discretion, the stronger the case for transparency in their decision making, to underpin public understanding. But there can be genuine problems of commercial confidentiality, for example in the financial sector where sustaining stability and confidence is a key purpose of regulation, and over rigid demands for exposure might drive the real conduct of business off the record. Nevertheless, regulators should seek to explain their actions as openly as possible. Consultation can take many different forms, including public hearings, exposure of regulators' working methods, for example covering the assessment of evidence and the rationale for decisions, and formal consultation documents. The need for adequate consultation must be balanced against the risks of making the process too cumbersome and legalistic.

The SAI should examine whether the regulatory body does all that it can to consult in advance on the issues that it must consider before making a significant decision; to explain the reasons for the decisions it has made; and to publish, so far as it is able, the financial and other information that it considers justifies the particular conclusions that it has reached. In one country [*United Kingdom*], the SAI's work has encouraged regulatory bodies to be more open and increasingly to consult interested parties.

A significant aspect of public and Parliamentary scrutiny relates to the costs and benefits associated with the particular regulatory regime. In examining this aspect, the SAI should consider to what extent, in making regulatory decisions, the regulator takes into account the likely costs and benefits, and whether the regulator periodically assesses and reports on them, for example in reports to Government and Parliament. Depending on its findings, the SAI may need to consider carrying out a cost/benefit appraisal of the regulatory arrangements under examination.

SECTION 3: THE SUPPLY OF SERVICE

Guideline 9

Security of supply

Guideline

The SAI should examine the arrangements which the regulator has put in place to ensure that suppliers provide at least the basic statutory services and that consumers are compensated if failures of supply occur.

Reasons for the guideline

The supply of such commodities as gas, water and electricity is of fundamental significance to all citizens; so are trustworthy financial and banking services and safe and reliable public transport systems. In many cases, the requirements for safety are regarded as absolute, within which suppliers have to operate and which they accept, for example, when they agree to price controls. Monitoring suppliers' performance against these safety requirements is often the responsibility of health and safety regulators, rather than the economic regulator.

The SAI should check how the economic regulator is satisfying itself that suppliers are providing the service required. This is likely to involve seeking information from both suppliers and consumers (for example through surveys) as well as from the regulator.

If the supplier fails to deliver the service required, the regulator may be able to protect the consumers' interests and to ensure that any compensation due is paid. The SAI should check whether the regulator has acted on behalf of the consumer in these areas. In one country, regulatory action has led to the provision of new services for telephones, electricity and water in rural areas (Guyana). And in another country the regulator reduced a water company's income by £40 million following serious failure by the company to maintain adequate supplies of water (United Kingdom). Regulators also need to guard against the danger that the incentives provided to companies to improve efficiency ([Guideline 17](#)) could operate in a manner contrary to consumers' interests through, for example, inadequate safety arrangements in public transport or delays in dealing with reported gas leaks.

Guideline 10

Consumer access

Guideline

The SAI should examine how the regulator has sought to secure consumer access to services and whether suppliers are prevented from discriminating unfairly between different groups of consumers.

Reasons for the guideline

It is important that consumers have reasonable access to regulated services. The regulator may need to act to prevent socially inequitable outcomes for particular groups of consumers (eg rural dwellers) or consumers being refused supply for no good reason. Regulators are frequently required to protect the interests of minority groups. In one country, for example, the regulator has secured improvements in bus services for disabled people [*Argentina*].

The convenience of consumers should also be taken into account. For instance, telephone users resent the inconvenience and expense incurred if telephone companies change their area code numbers frequently and without adequate consultation. In one country the regulator has addressed these problems by establishing a telecommunications numbering advisory group involving both the industry and consumers [*New Zealand*]. And regulators are increasingly carrying out surveys of customers to establish for example the importance they attach to particular services and how much they would be prepared to pay for improved levels of service. By such methods, regulators should be able to address more fully the demands consumers are making for better access to improved services. The SAI can play an important role in examining and publishing examples of good practice.

Guideline 11

Supplying vulnerable consumers

Guideline

The SAI should examine how the regulator monitors whether suppliers comply with their statutory duties to provide access to vulnerable groups.

Reasons for the guideline

In many countries, not least in the developing world, a high price for an essential service can act as a bar to consumers obtaining an adequate level of service. The regulator may have the powers to enforce the reduction of prices to a level which enables consumers to receive a fair level of service for the price they are asked to pay. Many regulators have begun to act on the consumer's behalf in this way. In one country the regulator has required the telephone industry to provide a special low cost scheme for those consumers who could not otherwise afford a telephone [*United Kingdom*].

Low income groups are particularly vulnerable because the cost of essential services are likely to represent a high proportion of their expenditure. Regulators are frequently given responsibility for monitoring the service supplied, and for requiring suppliers to take special measures in support of such groups. The SAI should check that any obligations placed on suppliers (including any arising out of social security legislation) are complied with. Action taken in these areas can lead to quite dramatic improvements in the way vulnerable groups are treated. For example, action taken by the regulator contributed to a reduction, from 55,000 in 1990 to 471 in 1997, in the number of people whose electricity supply was disconnected [*United Kingdom*]. The SAI can highlight situations where, although

there may be potential for vulnerable consumers to benefit from price reductions, these consumers sometimes fail to benefit as much as they should. For example, in one country, following the introduction of competition in domestic gas supply, prices fell in real terms for all consumers. The amount consumers saved varied according to the way they paid their bills. Generally consumers who pay by direct debit have benefited considerably more than those, including the poor, who use prepayment meters [*United Kingdom*].

Consumers are often not aware of their rights. This is often the case in industries such as financial services where, even though there may be a good deal of competition in the market, some groups of consumers are at a disadvantage because they do not possess or cannot acquire the specialist knowledge to make a proper appraisal of the products they are offered. In such cases, the regulator can play an important part in protecting the public from dishonest traders. The SAI will need to examine how effective such measures are proving. For example, in one country the regulator protected people from the risk of being defrauded by suspending the operations of 56 finance companies [*Thailand*].

Where the state provides subsidy to private companies for particular purposes such as reducing prices to consumers, the SAI also needs to check that the subsidy is properly applied to the intended purpose.

Guideline 12
Service standards

Guideline

The SAI should examine what the regulator has done to establish minimum standards of service for consumers, to monitor the performance of suppliers, and to secure improvements when suppliers' performance falls short of those standards.

Reasons for the guideline

Service standards are important for consumers, whether there is a competitive market or a monopoly. In a competitive market, once consumers know what quality of service ought to be provided by different suppliers, they will be able to make more informed choices between the suppliers. And where the supplier is a monopoly, service standards are important because without them the supplier may seek to reduce quality of service in order to increase profits. Standards are also important where the service is being provided by a government agency. For example, in one country targets were introduced relating to the time taken to reply to citizens' queries; this has had a positive effect [*Denmark*].

The regulator needs to guard against quality of service suffering as a result of price controls. There is often a strong link between the level of price charged and the quality of service provided. In one country the regulator has taken account of this link by setting universal service requirements and uniform prices in the postal

services [*United States*]. If the quality of service has been significantly reduced that there may be a case for the regulator seeking a corresponding reduction in prices.

Some regulators are able to penalise suppliers who have defaulted on their duty to provide services to particular standards. For example, in one country suppliers of passenger train services had to pay £24 million in penalties to the rail regulator because of poor performance [*United Kingdom*]. In cases where the supplier has undertaken to provide a better level of service, the regulator may allow a greater than expected price increase because it wants to encourage improved service standards. So in the same country passenger train service suppliers performing to a better than normal standard received extra payments of £20 million. The SAI will need to check whether incentive systems, including those which incorporate both penalties and rewards, are in practice helping suppliers achieve their performance targets.

Where competition is absent or deficient, the regulator needs to ensure that suppliers are providing services of the prescribed level and quality. In one country, as a result of regulatory monitoring, the electricity supplier was fined because of the deficiencies in the quality of service [*Brazil*].

In one country [*Poland*] the SAI found that the energy regulator only checked on suppliers' performance when it received complaints from customers; the SAI recommended that the regulator should regularly check performance. The regulator also needs to monitor suppliers' performance in order to ensure that both licence conditions and legal requirements are being observed. In another country, the vehicle regulator revoked licences, following the monitoring of performance, when it was established that the terms and regulations were not being followed by suppliers [*Philippines*].

The benchmarking of suppliers' performance can also play an important part in maintaining or improving service standards. There are excellent reasons for carrying out benchmarking, including promoting better operations, producing increased efficiency, reducing costs and quantifying potential financial savings. SAIs have often become involved in examining whether the regulator is using sufficient and appropriate comparisons between suppliers to assist in monitoring their performance. In one case the SAI recommended that the regulator should compare the insurance cover taken out by suppliers with the licence requirements, having regard also to cost [*Poland*].

Guideline 13

Dealing with consumers' complaints

Guideline

The SAI should examine whether regulators and suppliers have set up well-publicised procedures to enable consumers' complaints to be satisfactorily addressed.

Reasons for the guideline

Recipients of monopoly services have no choice of supplier. They cannot take their business elsewhere. So it is essential that their complaints are heard. The regulator should make sure that suppliers take responsibility for dealing satisfactorily with complaints, including taking all reasonable steps to resolve them. This may include fining suppliers who do not answer complaints satisfactorily. For example, in one country complaints have contributed to penalties being imposed [*Argentina*]. Consumers may also be able to seek redress through the legal system.

When an SAI uncovers problems in dealing with complaints this can often lead to improvements. Following a report by one SAI which disclosed that complaints about the telecommunications industry were handled poorly and that the number of complaints was unacceptably high, the regulator took action which helped to bring about a marked improvement in consumers' satisfaction with the way complaints were addressed [*United Kingdom*].

By investigating what kind of complaints are being received, and conducting surveys of consumer attitudes, the SAI will be able to help detect those areas on which the regulator and suppliers should concentrate in order to achieve better service. Collaboration between regulator, industry and consumers may also lead to better service. For example, in one country representatives of the consumers and suppliers take part in the activity of the regulatory body and their interests are co-ordinated. This has helped to deal with consumer complaints. [*Lithuania*]. In another country [*Poland*], the SAI recommended that power suppliers should be required to recognise customers' full legal rights (including their right to complain).

Consumer complaints procedures are necessary even where there is a competitive market. For example in one country the gas regulator included in suppliers' licences standards designed to protect domestic consumers against the abuses of doorstep selling techniques: consumers had been misled into entering into contracts through callers lying about other suppliers' terms, or through intimidation or the provision of poor or misleading information [*United Kingdom*].

Guideline 14

Environmental issues

Guideline

The SAI should examine how the economic regulator is discharging responsibilities it may have for checking that suppliers are meeting any obligations laid upon them for the protection of the environment.

Reasons for the guideline

The regulation of industries is not just about economics ; other factors need to be taken into account, including those with an impact on the environment - for example, clean water and safe food (see also [guideline 9](#)). There may be environmental objectives, such as preserving natural habitats for animals and birds, which have to be weighed against other desirable objectives, such as economic development. The economic regulator may need to take account of two types of

environmental obligations. First, governments may require all businesses to confirm to a variety of general standards for the protection of the environment, such as emission standards. Second, the economic regulator may have specific environmental responsibilities included in its objectives and duties, for example to encourage electricity suppliers to encourage energy efficiency.

In many countries economic regulators are increasingly being required to take account of such environmental considerations. For example, in one country [*Hungary*] the energy regulator has secured compliance on the part of suppliers with environmental standards which has reduced environmental damage. And in another [*Iceland*] an environmental assessment is now required before the construction of electric power stations or roads can take place. This has slowed down the speed of construction but has increased adherence to environmental standards. In another country the energy regulator has set energy savings targets for suppliers which are intended to contribute towards reducing the level of environmental pollution [*United Kingdom*].

As the external auditor of a wide range of government departments, regulators and other agencies engaged in environmental matters, the SAI is well placed to examine and report on issues requiring the co-ordinated attention of these bodies. In one country for instance, the SAI examined and reported on the arrangements for the environmental monitoring and funding to provide for the decommissioning of nuclear power stations. This study helped the various agencies and regulatory bodies concerned to clarify their respective arrangements for the on-going monitoring of the decommissioning arrangements that needed to be planned, and the funding likely to be necessary to meet the related costs [*United Kingdom*].

SECTION 4: THE PRICE OF SERVICE

Guideline 15

Controlling prices

Guideline

Where the economic regulator has responsibility for controlling the prices charged to consumers by suppliers, the SAI should examine whether the regulator has implemented a well designed and transparent pricing regime in line with the regulatory objectives.

Reasons for the guideline

Where suppliers have a monopoly or are dominant in the market, one of the methods for protecting consumers against abuse is to limit the prices that such suppliers may charge. But an effective price control regime, which protects consumers while ensuring that suppliers can finance their business, can be complex and costly. These costs can be significantly increased if the price controls are poorly designed. The SAI should examine how the regulator has sought to ensure that price controls are well thought through and are based on a thorough analysis of the key factors affecting the level of suppliers' prices. For example, SAI investigation in one country has led to prices being held, and price setting put on a

more objective basis [*Tunisia*]. Price control may also be of value where monopoly suppliers are publicly owned. In one country, for example, publicly owned power generation and electricity distribution companies are controlled by regulatory commissions answerable to government [*India*]. In another country [*Poland*] the SAI found that suppliers' charges for electricity connections varied by up to a factor of 10. The SAI recommended that the energy regulator should be empowered to control suppliers' prices.

Some regulators use a system of control in which suppliers' prices are set for a period of time, typically four or five years. The aim of this system is to give suppliers a strong incentive to reduce costs because they benefit directly from any cost savings they can make during the period covered by a price control. The regulator passes the benefit of these cost reductions on to consumers by setting lower prices for subsequent price control periods. This system may however need to be applied flexibly. For example, important elements of suppliers' costs may be outside suppliers' control where they are influenced by international energy prices, exchange rates or general inflation. In one country, for example, regulated transport fares had to be increased as a result of increases in petrol prices [*Indonesia*]. In such circumstances, the SAI should examine whether the regulator has considered alternative systems of control, such as price controls that distinguish between elements suppliers can be expected to manage and those which they cannot, or controls which focus on limiting suppliers' profit margins rather than their prices.

Even in industries in which suppliers do not have a monopoly, price controls may be in the public interest, for example to ensure that all sections of society can afford to buy a key service, such as fuel. The SAI should also examine whether the regulator has considered whether competition has become strong enough to remove the need for price controls. Other aspects which the SAI should consider include the impact of price controls on different types of consumers (eg rich and poor, urban and rural) and the potential effect of the control on competition. For example, setting price controls at very low levels might discourage potential competitors from entering the market ([guideline 20](#)).

Guideline 16

Linking price to quality

Guideline

The SAI should examine whether the regulator has sought to ensure that the price consumers are required to pay is matched by the quality of service provided.

Reasons for the guideline

Regulators need to monitor the quality of service provided by suppliers to consumers, to ensure that consumers get a level of service commensurate with price. This is especially important when regulators set suppliers' prices for a period of years to give them an incentive to cut costs ([guideline 15](#)), because the regulator needs to ascertain that suppliers' cost cutting is not at the expense of services to

consumers. Establishing a link between prices and the quality of service provided is an important way of providing an incentive to suppliers to provide a good service at the same time as they seek to cut unnecessary costs ([guideline 17](#)). And regulators can allow suppliers to charge extra for additional services. For example, in one country the water regulator allows water companies to insist that consumers with swimming pools pay for their water through a meter (as opposed to standard fixed charge) so that their bills reflect the large amount of water that such customers are likely to use [*United Kingdom*].

The SAI also needs to check whether the regulator has required suppliers to consult consumers in deciding whether or not to withhold a service on cost grounds, and to examine the methods used to establish customers' views and to seek to accommodate the range of preferences that consumers are likely to have.

Guideline 17

Encouraging supplier efficiency

Guideline

The SAI should investigate whether the regulator has sought to encourage suppliers to reduce their costs and improve their efficiency.

Reasons for the guideline

Encouraging greater efficiency by suppliers is a key responsibility of most regulators. It is important because this makes it possible to reduce prices for consumers at the same time as allowing suppliers to make reasonable profits. In one country, for example, [*Tunisia*] SAI examination has led to reductions in gas pipeline costs and in another [*Argentina*] it has led to improvements in the efficiency of the banking sector.

Price controls linked to incentives can be effective ([guideline 15](#)); the SAI needs to examine whether the regulator has sought to ensure that the price control puts monopoly or dominant suppliers under pressure to be efficient. Ideally, this pressure should be as strong a pressure as that experienced by a supplier in a competitive market. The regulator should seek to ensure that the incentive provided does not distort investment decisions. For example, if an investment is expected to reduce annual operating costs, the regulator may wish to make sure that the supplier retains enough of the saving in operating costs to pay for the investment.

The regulator needs to consider how far it is possible for the supplier to improve efficiency. This can be difficult. Suppliers may not appreciate how far it is possible for them to do so, and even if they do they may be reluctant to tell the regulator. Regulators may also be concerned not to put suppliers under too much pressure to improve efficiency for fear that to do so, for example by cutting prices, would make it difficult for the supplier to afford to maintain services ([guideline 4](#)) and could put health and safety or environmental objectives in jeopardy ([guidelines 9 and 14](#)).

Among the measures that regulators can take are

- o requiring suppliers to report the levels of their costs and activities in a standard format ([guideline 7](#)). In one country, for example, suppliers' licences provide for the regulator to issue detailed instructions for the monitoring and reporting of their costs [*United Kingdom*].
 - o understanding suppliers' businesses in sufficient detail to have a clear picture of how their costs are made up, and the scope for reductions, for example through better management, capital investment or new technology ([guideline 18](#)).
 - o benchmarking eg comparing the costs of suppliers with each other and with comparable suppliers in other countries or industries, and understanding the reasons why suppliers' costs can differ ([guideline 12](#)).
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Guideline 18

Suppliers' financing costs

Guideline

The SAI should examine whether, in setting price controls or other limits on suppliers' income, the regulator has examined the likely cost to suppliers of raising capital, including both debt and equity capital, having regard to factors such as the proportions of suppliers' balance sheets made up by different sources of finance, and taxes on profits and interest.

Reasons for the guideline

Suppliers need to be able to finance their activities if they are to provide a satisfactory service to consumers. If suppliers cannot get the finance they need, the result is likely to be a deterioration in the state of their assets, under-investment and a poor service to consumers.

Where suppliers are privately owned, or are financed by borrowing from private investors, they have to pay for this finance, through dividends paid to shareholders or interest paid on borrowings. Governments may also require suppliers to pay interest on funds provided from public sources. The SAI therefore needs to examine how in setting price controls or other limits on suppliers' income ([guideline 15](#)) the regulator has taken into account the need for suppliers to finance their activities. Issues include

- o how much finance suppliers are likely to require. The regulator may need to scrutinise suppliers' financial and investment plans for several years, both to assess the basis for these plans and whether suppliers' estimates of their likely costs are reliable ([guideline 19](#)).
- o the sources of finance available to suppliers. These could include government lending and/or subsidies, retained profits, cash flow from operations (for example from depreciation, which reduces profits but not cash flow), new investment by owners and new borrowing.

- the cost of different sources of finance, for instance, government finance, if available, compared with issuing shares.
- the supplier's financial standing. For example, borrowing may often be the least expensive source of finance for suppliers but they may not be able to borrow more if they are already heavily indebted.
- the tax treatment of profits and interest, which is likely to have an impact on the cost to suppliers of different forms of finance.

Rates of return may also require monitoring by the regulator even where there is in theory a competitive market. For example, if suppliers are enjoying abnormally high returns, this may indicate that competition is not working effectively enough to protect consumers.

Guideline 19
Investment

Guideline

The SAI should examine whether the regulator is monitoring supplier investments, checking in particular that suppliers are fulfilling any investment requirements and undertakings, and that the investment is having the desired beneficial effects for consumers.

Reasons for the guideline

Investment is an important issue for several reasons, for example:

- to protect consumers of monopoly services. A competitive market is an incentive for suppliers to undertake investment programmes in order to maintain or improve the quality of service to consumers; in monopoly conditions however this incentive is lacking because consumers cannot go elsewhere.
- it may have been a condition of privatisation that a pre-agreed level of investment should be carried out by the new owners; suppliers may also have to promise to undertake investment in return for being allowed to operate.
- the regulator may need to take action against suppliers who do not fulfil their investment promises. For example, in one country energy regulators have imposed financial penalties when investment commitments were not fulfilled [*Argentina*].
- monitoring the amount of money spend on investment is often not enough; the regulator will also want to check the effectiveness with which money has been invested. In some instances, even though an agreed level of investment has been spent, the investment may not always lead to the intended outcome for consumers.

In a number of instances regulators have been instrumental in securing investment benefits for consumers. In one country the regulator has succeeded in getting suppliers to increase the supply of water and electricity throughout the country including remote rural areas [*Guyana*]. And in another country the water regulator, following recommendations by the SAI and Parliament, set suppliers annual targets to reduce water leakage, and required suppliers with levels of service below the required levels to increase their investment to achieve these improvements [*United Kingdom*].

The SAI may need to consider whether the regulator has examined whether investment is well targeted and effective. For example, in one country, by including investment requirements as a licence condition, the rail regulator has made the rail company which operates the rail network infrastructure invest more in that network [*United Kingdom*]. In another country SAI investigation has led to improvements in the control of investment [*Argentina*].

SECTION 5: DEVELOPING COMPETITION

Guideline 20

Reducing monopoly and market domination

Guideline

Where the regulator has the objective of promoting competition in order to reduce monopoly and market domination, the SAI should examine what has been done in pursuit of that objective and with what results.

Reasons for the guideline

In a number of countries, regulators are pressing for more competition as a means of increasing consumer choice, reducing prices and improving the quality of goods and services. A competitive market contains suppliers that are continually under threat from existing competitors and potential new entrants, where a supplier that charges significantly more than its rivals or provides a poor service is likely to lose market share. For example, in one country the introduction of a competitive environment into the telecommunications and postal sectors has resulted in lower prices and better standards of service for consumers [*Malaysia*]. And more competition in the provision of ferry services between Elsinore [*Denmark*] and Helsingborg [*Sweden*] has led to a reduction in ticket prices.

By contrast, in a market in which existing suppliers expect to remain without challenge, informal understandings and expectations of prices that should be charged may develop. New entrants can counter such practices and may also provide an important source of innovation. To develop effective competition it is necessary therefore to reduce the monopoly power of the existing supplier by creating conditions that encourage potential competitors to enter the market and help them to compete with dominant suppliers.

Some parts of an industry lend themselves to competition more easily than others. The SAI needs to assess how rigorously the regulator has identified the scope to

reduce the monopoly or dominant power of a supplier. The regulator should have identified those parts of an industry which can be opened to competition and be able to justify why this has not been extended to other parts of the industry.

The SAI should also examine how the regulator has assessed the ease with which new suppliers can enter and maintain themselves in the industry to challenge the monopolist. For example, in one country the removal of barriers to market entry in the gas industry, combined with advances in technology, has resulted in around 25 new suppliers entering the market [*United Kingdom*]. And in another country the regulator has ensured that it is now easier for companies to enter the telecommunications, airline and electricity industries [*Japan*].

Guideline 21

Promoting consumer choice

Guideline

The SAI should examine what the regulator has done to assess whether consumers have the scope to change supplier, whether there is sufficient information for them to make rational decisions about which suppliers they choose, and whether there are effective arrangements for those consumers who want to change supplier.

Reasons for the guideline

When consumers are able to choose who supplies their goods and services, suppliers have an incentive to attract and retain consumers by offering prices that are lower and services that are better than their competitors. In one country, as a result of competition, private courier services have developed in the postal industry and consumers can now choose to use a service that is quicker than the government post office. Competition has also resulted in an improvement in the service provided by the government post office [*Bangladesh*].

Where the regulator has a duty to develop competition, the SAI needs to examine whether a sufficient number of companies are competing in the market to provide consumers with an effective choice of supplier. For example increased competition between airlines in one country has led to consumers being able to take advantage of lower prices for both domestic and international flights [*Ireland*].

Consumers need sufficient information to enable them to make informed choices. Where they have to deal with particularly complex information, which may result in their being misled by suppliers (for example when dealing with suppliers of financial services), it is especially important that the regulator checks that suppliers are providing such information honestly, and as transparently as possible.

Consumers are more likely to exercise their choice if the regulator has required suppliers to establish comprehensive procedures to enable consumers to change their supplier. The SAI should examine the work of the regulator in assessing the extent to which consumers are aware of what choices are on offer, their level of

knowledge about the prices and standards of service available, and consumers' perceptions of how easy it is to change supplier.

Guideline 22
Combating anti-competitive practices

Guideline

The SAI should examine whether the regulator seeks to identify and deal promptly with alleged anti-competitive practices.

Reasons for the guideline

Where suppliers are dominant there is a risk that they may act anti-competitively. So, where the regulator has the objective of promoting competition ([guideline 20](#)), the regulator also needs to be effective in countering anti-competitive practices in order to develop and maintain effective competition. Such anti-competitive practices might for example involve a supplier unfairly cross-subsidising part of its business with profits made elsewhere, or otherwise providing products or services at prices which do not cover costs.

In one country the introduction of competition has resulted in an improvement in the standard of services and, as the result of the work of the regulator in taking action against anti-competitive practices, these improved standards have been maintained [*Hungary*].

There are a number of factors the SAI needs to examine when assessing how effectively the regulator has addressed anti-competitive practices. The SAI should check whether the regulator has developed an effective system of identifying potential anti-competitive practices through the monitoring of developments in the industry, and effective complaints procedures ([guideline 13](#)). The regulator needs to take enforcement action against suppliers who breach competition legislation and to follow up systematically the effectiveness of its enforcement action. Following an investigation by the SAI in one country, the telecommunications regulator now undertakes a more rigorous analysis of the quality of the decisions taken during investigations into alleged anti-competitive practices, and has introduced more effective procedures for checking the compliance of companies with his decisions [*United Kingdom*].

Much of the work involved in identifying and dealing with anti-competitive behaviour involves complex legal, commercial and technical issues. To carry out this work effectively the regulator needs to recruit and retain staff with specialist skills, knowledge and experience that are relevant to the industry ([guideline 6](#)). And, in order to appraise the regulator's work, the SAI needs access to similar skills ([guideline 2](#)).

GLOSSARY

Term	Definition
Benchmarking	The search to find and implement good practice through comparing the performance of an organisation with that of others.
Consumers	Customers, individual and corporate, of regulated suppliers of services.
Economic regulation	The exercise by the state, either directly or indirectly, of control and influence over suppliers, whether publicly or privately owned, of services to consumers.
Gross domestic product	The total value of goods produced and services provided in a country in one year.
Market domination	Where a supplier has a major share of the market.
Monopoly	Where the market has only one supplier, enjoying the exclusive possession of the trade in that service.
Privatisation	The transfer by central or local government of a business and its assets from state to private ownership.
Rate of return	The price paid to lenders and investors for the use of their money.
Supplier	A regulated business licensed to provide a specified service to consumers.
Utility	The supply of basic services such as water to consumers.
