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The Evolution of the Firm's Regulatory Affairs Office

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In the UK in the last fifteen years, independent regulators have increasingly monitored privatised companies in utilities, transport and telecommunications: both to oversee the natural monopoly elements of service provision and to foster competition and innovation where feasible. Within these companies, a managerial function has emerged specifically to cope with relationships with regulators. Coming to terms with the role of the regulator and the demands of the various regulatory frameworks has been a central part of the process of turning public sector monopolies into public companies responsive to shareholders and customers. This article chronicles and analyses the development of the "regulation function" within firms and concludes with four recommendations for managers.

While the UK regulatory system has in recent years striven for more accountability and transparency (Hansard Society 1997 and Thatcher 1998), it is still questionable whether it has the same openness as the US regulatory system. Important issues include the degree to which the UK's institutional opacity acts as a hindrance or benefit to regulatory governance and the degree to which the regulated firm has evolved so as to participate fully in the regulation process.

The regulators' published decisions are not always a clear guide to what really occurs in the policy process. This article reports a pilot study of "regulatory directors" in firms in the water, electricity and rail sectors which explores the firms' relationship with their regulators and assesses the implications for the way regulatory affairs are managed within the firm. We also discuss the effects of the institutional environment on interactions between regulated firms and the regulator and formation of regulatory policy objectives within the firm.

One purpose of the study was to assess the degree to which firms acted as responsible actors in the UK regulatory regime. On the assumption that litigation was less generalised in the UK than in the US, we sought to understand how far business/regulatory relations developed from institutional arrangements and the informality of negotiations in the UK (Vogel 1986, Stelzer 1996, Wilks 1997). We made no prior assumptions about relations between the firms and regulator: unlike Wilks (1997), who argues that firms become 'amoral negotiators' with the regulators, we merely investigate the nature and evolution of the regulatory relationship. As the following discussion demonstrates, the flexible and somewhat closed nature of the UK regulatory environment may have given both regulators and firms an opportunity to negotiate and thus to move through iterative processes towards "win win"

regulatory solutions within a bounded regulated environment.

The UK regulatory regime has created an institutional environment that requires firms to establish sophisticated regulatory responses. This project explores how firms have evolved to deal with the regulators, how regulatory departments within companies operate, where they are located within the organisation and what is potentially the best practice when dealing with regulators. The pilot study involved interviews with members of regulatory departments in three firms within each of the three sectors mentioned above. Based on impressionistic evidence from press reports, an attempt was made in each sector to include firms with good, moderate and relatively poor regulatory records. The interviews were conducted in late 1997 and early 1998. Guarantees of confidentiality were offered and the content of the interview transcripts was referred back to interviewees for comment. No objections to content were raised.

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In all cases, respondents were asked questions not only about the current relationship with the regulator but also about the process of regulatory evolution within the firm. The bias inherent in this process, as well as that involved in single (or at best double) respondent reporting of events should be borne in mind in considering what follows. Differences emerged between sectors and, as the selection of firms would imply, between firms. However, since the purpose of the pilot was to develop general hypotheses about the regulatory relationship, we focus on characteristics of the sample as a whole.

The UK Regulatory Regime

The British approach to regulation has been to establish a regime in which the Director General of a regulatory body (Oftel, Ofwat, Ofgas, Offer, etc) negotiates directly with firms. The problem with this exclusive approach is that questions may arise about the legitimacy of a system that both excludes consumer interests and fails to afford open public debate in a clear legislative process. Institutional reformers have argued that, by being closed, the regulatory system has been denied the public credibility it requires (Thatcher 1997 and DTI 1998). How, then, can firms have a legitimate favoured position within the regulatory process without the risk of regulatory capture (ie inappropriate influence by regulated firms on the regulator) or calls for the opening up of the regulatory process? The preliminary findings of the survey show how a competitive regulatory game between firms that are monitored and encouraged by regulators can create constraints on excess rent seeking: in other words, the regulation process itself, not just the actions of the regulator, can limit the extent to which regulated firms can be inefficient or increase the prices they charge customers. Likewise, the managed regulatory environment has forced firms to adapt the way they manage their regulatory affairs if they are to be offered an active place at the regulatory table.

By allowing greater flexibility and autonomy to regulators, it is possible to envisage an environment where the normative goals of the regulator, while defined by price caps, are highly confusing to firms. Stelzer (1996) saw personalisation of the regulatory process as creating a confrontational atmosphere, described as a 'High Noon', which placed a great pressure on the business/regulator relationship - and may have resulted in second-best solutions. What is more, personalisation of the regulatory process reduced regulatory continuity since political and economic goals changed with each new director general. In such an uncertain environment, it was important that UK business consciously developed regulatory 'best practice' and clear lines of access to regulatory bodies rather than relying on the personal influence of key staff with the regulator.

While a US-style multiple-member commission of regulators might have alleviated some of the above problems, UK firms have come to recognise the potential benefits of knowing the explicit objectives of regulators. The following discussion suggests that personal contacts may actually go some way to establishing a relationship of trust and understanding between firms and regulator which may produce 'win win' outcomes for all the players. For example, while the US model of commissioners and courts encourages American businesses to be open, it also forces them to be litigious and less-inclined towards conciliatory negotiations. In Britain, firms are constrained by rivalry and the 'closed' regulatory institutions provide the opportunity to go through iterative processes until they reach a consensus with rival firms and regulators.

The opportunity for companies to negotiate with the regulators and find positive solutions has not always been taken - as the number of Monopolies and Merger Commission (MMC) referrals shows. However, as many of the firms evolve from publicly-owned industries into regulated businesses, we have observed a new form of managerial organisation which has benefited from the unique UK regulatory regime.

The Evolution of Regulatory Affairs Departments

It is possible, from the pilot study, to see three distinct stages in the evolution of the management of regulatory affairs: an "ad hoc" period; a period characterised by the emergence of a regulatory role; and the emergence of strategic regulatory management. As we shall see, each organisational arrangement had significant implications for the implementation and formation of regulatory policy in the UK.

The ad hoc approach

Initially, the firm's regulatory relationship was very much a reactive response to regulator requests while its regulatory organisation was at best arbitrary. The behavioural logic attributed to this post-privatisation period was that of empire building - with specific managers seeking out extra regulatory responsibility. As one respondent noted:

"*The company was structured on functional lines (at privatisation)...and directors took responsibility for issues that touched their competencies....There was no single co-ordination point, no one regulatory expert; rather, regulation was a shared responsibility.*"

This initial lack of regulatory accountability within the firm was somewhat surprising, considering the high degree of regulatory awareness by the CEO and officials who had dealt with the privatisation process. However, it is fair to say that the sheer scale of regulatory activity took many firms by surprise:

"*The first question was, did we have anyone who knew anything about regulation ...and did it matter?"*

"It never occurred to us to devote considerable managerial resources - at anything like the current level - to managing the regulator."

The respondents in our study describe a process of mutual accommodation of regulator and regulated firm characterised by uncertainty on the extent of the regulator's powers, the manner in which he or she chose to use them and the balance between formal and informal contact. With no clear regulatory hierarchy, the point of contact in the firm was also an issue, with several departments seeking to gain control of regulatory contact. Under such conditions, regulators were able to pick and choose information, and an air of mistrust developed between businesses and regulators. Hence, there was a concern to tell a consistent story and a concern by the regulatory department to control the telling of it.

In this environment, the experience of the privatisation process was important to the location of regulatory activity. Those who understood, so to speak, how the industry had been structured often had views on how it could be regulated. The location of regulatory activity within the firm was often an issue of personality rather than organisational design. Respondents describe clashes with the regulator over information demands, often couched in terms of the 'legitimacy' of the information request.

Among firms, the period was therefore characterised by a high level of regulatory mistrust and a tendency to out-perform price-cap regulation and procrastinate over the supply of information to regulators. This confrontational regulatory environment was not helped by the fact that newly-privatised firms were often attempting to impress the City financiers by developing aggressive business plans and impressive efficiency gains. Moreover, many of the new executives saw regulators as an old-style nationalised bureaucracy. Consequently, there was a high degree of regulatory conflict and many MMC referrals.

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The emergence of a regulatory role

The next phase was often described in terms of the emergence of a regulatory role, formalised within the organisation. This was often led, or strongly influenced, by the finance function - not least because of the rise in the regulators' demands for quantitative data on costs. Significantly, no respondents described the regulator in any of the three sectors as trying to influence the nature of regulatory management within the firm. It is entirely possible that such pressures existed, but they were not overt. Two further features are worthy of note. First, most respondents described the regulatory function as reactive and perfunctory in its co-operation with the regulator in this phase:

formalisation of structural position was associated with formalisation of responsibilities to other departments whose view of the regulator was less well-informed. In fact, it was not uncommon for there to be high levels of tension between managers who took on regulatory affairs functions and managers of strategic affairs.

In some firms, a concern emerged with balancing internal and external responsibilities. In particular, respondents remarked that this phase was associated with the role of blocking or discouraging strategic initiatives which embodied regulatory risk. The two quotations which follow are representative examples of the attitude of firms:

"There are no prizes for good behaviour - incentives to co-operate don't exist."

"We try to play the regulatory game better than competitors by being the most efficient company."

This period was therefore characterised by technical regulatory management that was by definition reactive - and was also often divisive and destructive. Moreover, the system was very dependent upon individual managers - with information flows to the regulator only as good as the managers' informal network of contacts. As a regulatory director commented:

"The key asset I have as head of regulation is a network of contacts with heads of other business groups [within the firm] - the regulatory department cannot only look out [to the regulator]."

In such a reactive period, few, if any, firms recognised the benefits of establishing regular contact with the regulators or supplying anything more than what was technically asked for. Thus, firms failed to observe potential 'regulatory opportunities' that came from maintaining close informal relationships with the regulator. That is to say, firms in this period acted as the amoral actor described by Wilks (1997). Especially, where they failed to see that blocking information flows could actually cause 'bad feelings' with regulators and, in the long run, disadvantage them vis-à-vis rivals. Firms had failed to grasp the institutional realities of being in a regulated industry.

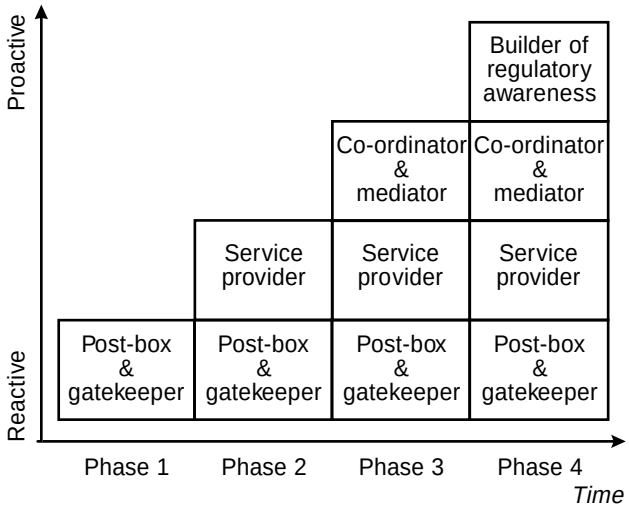
Strategic regulation

Gradually, a number of high-profile conflicts and the experience of exclusion from the regulatory discussion forced a number of firms to reassess the limitations of reactive regulatory organisation. Hence, there was a gradual realisation that a regulatory relationship could be established with the regulator and that those positions could be negotiated and exchanged for goodwill. Moreover, the takeover of some utilities by US firms helped to foster the concept of regulatory competition. Consequently, a 'bandwagon effect' was put in place: once one firm established a close working relationship with the regulator, others were forced to follow.

Under these competitive regulatory conditions, a concern emerged not only to respond effectively to the regulator but also to influence the nature of the regulatory debate by attempting to communicate and form opinions. There were attempts to assert power through informing internal and external agendas. Internally, this was reflected in a concern to import regulatory issues into the strategic planning process, not only as constraints but also as opportunities for competitive advantage. Emphasis was put on the need for regulatory issues to be considered at board level, for the regulatory head to be a senior appointment with considerable and continuous influence and for the regulatory group to have a substantial internal influence network.

*"We need to be close to the business and involved in the business planning process - there are strategic opportunities for competitive advantage within the regulatory framework."*s

The evolution of the regulatory affairs function



The Figure attempts to depict a path of development, focusing on the move from reactive to proactive behaviour by the regulatory department in the firm. There are four stages in the figure, though only three historic ones in the text above. The fourth has been inserted on the basis of respondents' views on how the regulation department might evolve in future.

Several respondents used the phrase 'regulatory awareness' to describe a pervasive understanding amongst senior managers outside the regulatory department of the constraints and opportunities existing in the regulatory domain. Its promotion was seen by several to be a key aim of the regulatory function, once again emphasising the need to consider both internal and external audiences of the firm. (We hope to use a forthcoming survey of managerial preference to explore this potential trade-off between close regulatory relationships with the regulator and the risk of 'reverse capture', ie inappropriate influence of the regulator on the firm.)

The Regulatory Lessons for Business

The British regulatory experience suggests that while firms should seek to maximise their performance, it is also important that they operate within regulatory constraints - at least until full competition can be established. This requires that they respect the legitimate role of regulators and nurture regulatory awareness throughout the firm, without overstepping the line and becoming subservient to the regulator. Balancing a conciliatory regulatory strategy with the economic incentive structure of managers requires a great deal of regulatory expertise.

What then is "best regulatory practice"? The pilot work has suggested that a successful regulatory department must provide a mix of public relations and technical representation, gate-keeping, information dissemination and strategic decision-making. These skills allow the firm to avoid regulatory conflict over excessive profits/wages and gauge when common causes can be found with the regulator. By establishing a working relationship, the firm is, in effect, discounting 'goodwill' today for improved access tomorrow. As a result, those firms that have established a regulatory affairs function have been able to select the issues to fight on more systematically and have had fewer legal conflicts.

- *A high-quality director*
  The director should have a good understanding of the regulatory environment and the core business interests of the firm. We observed that most successful regulatory managers had usually come through the company and had a high level of credibility with board members and managers. It was evident that firms benefited from regulatory directors who had a good informal network of contacts - to disseminate and collect information quickly. Problems were most common when regulatory managers were perceived to be too 'academic' and detached from the day-to-day business of firms.

- *Post box and gatekeeper*
  The primary role of the regulation department is to establish clear regulatory accountability within the firm, by monitoring what information demands are coming into the firm and what positions are going out. The most appropriate managers can be introduced to the regulator - so establishing credibility and reliable information. Regulatory departments should act as a firebreak between the CEO and regulators - providing introductions on high-level issues, but protecting the CEO from association with the day-to-day conflicts. By managing the contact, the regulation department establishes regulatory consistency, speed of information gathering, regulatory expertise throughout the company, and goodwill and trust with the regulator.
  "*The regulatory group should control all access to and communication from the regulator - it should be the one and only post box - we need to get our story straight.*"

- *Co-ordination and mediation between company stakeholders*
  In some sectors, potential conflicts between company divisions were avoided by brokering at the regulatory level. This allows for a consistent business voice and reduces the chances of the divisions being played off. Co-ordination may also just be a question of bringing together specialist teams for periods of high regulatory activity - such as in the build-up to price reviews. Significantly, in having this central point it is possible to disseminate broader regulatory issues throughout the company and, along with the gatekeeper role, act as a firebreak to misinformation from rival firms. With increased regulatory sophistication, it is possible to see the regulatory affairs departments trying to incorporate customer service information into their dealings with regulators - to gain favour.

- *Strategic planning and regulatory awareness*
  Firms have learned to avoid constant conflicts with regulators and to pick fights on issues of core importance to the business. Information that is

provided should be quick and reliable, as goodwill is an advantage in the regulatory game. It may be possible to mislead a regulator at one price review; but this will only disadvantage the firm in subsequent rounds. In establishing a relationship with the regulators, firms have placed increased informational demands on managers within the company and have had to explain the importance of regulatory issues. For this reason regulatory knowledge is being seeded across departments as firms encourage short stays by middle managers in the regulation department. The result is increasing regulatory awareness and an ability to pick up and run with new regulatory questions before the regulators.

In conclusion, it is only natural that regulators will favour those firms that appear to want to work with them and can be seen to be professional and reliable. The establishment of the above functions within a small department of specialists can therefore have huge economic consequences for a regulated firm. While many of the skills listed above are common practice in the US, they are perhaps even more important in the highly personalised and discretionary UK regulatory regime. Based on these preliminary findings of the pilot study, we hope to explore the consequences of the new regulatory relationship - based on expertise and trust - for general managerial awareness of regulations, together with its consequences for policy formation and competition between regulated firms.

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