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Regulator fees – irreconcilable objectives
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Introduction
It is government policy that regulators should seek to recover their costs from the organisations they regulate. This paper argues that this policy is unworkable in respect of small or new regulators and is capable of producing seriously perverse results.

The paper is based largely on the experience of three new regulators, the Security Industry Authority, the Gangmasters Licensing Authority and the proposed regulator for claims management activities.

Executive summary
It is government policy that regulators should cover their costs through the fees they charge, although in the case of a new regulator start-up funding is generally made available by the relevant department.

Regulated institutions have some protection from being charged excessive fees through the consultation process, the sponsor department and oversight bodies, in particular the National Audit Office, the Public Accounts Committee and Parliamentary select committees.

The arrangement works reasonably well in large sectors such as financial services and communications. The arrangements do not work well in small sectors as there is no reason why the costs of regulation divided between industry participants should result in reasonable fees.

Regulators may need to trade off standards as against viability.

There is a particular problem for new regulators, as estimating the size of the regulated population is very difficult.

The Security Industry Authority, the Gangmasters Licensing Authority and the proposed regulator for claims management activities all illustrate these problems.

The public benefit resulting from regulation should be recognised and that there should be no automatic assumption that regulators should cover their costs. Anything above 0.1% of turnover may be viewed as excessive as a regulatory charge.

For small regulators, regulatory fees should be fixed separately from regulatory budgets, with both fees and budgets being reviewed by the Better Regulation Executive.

Current policy
There are two broad types of regulator. Firstly, organisations with very wide ranging functions of which regulation is but one, where the fees may cover the direct regulatory costs but these are a small part of the total costs of the organisation. The Environment Agency and local authorities come into this category.

The second type is a specialist regulator which does little else, although there may be some public information functions. Such regulators are expected to cover their costs. When a new regulator is being established the set up costs are generally provided for out of public expenditure and are regarded as part of the costs of implementing the relevant legislation.

Safeguards
It may be argued that current policy removes any normal commercial pressure from a regulator as they can afford to operate on a cost plus basis knowing that regulated institutions have no choice but to pay whatever price is demanded.

In practice, there are some safeguards. Regulatory fees are a price like any other and the higher the price the lower the demand. If a regulator pushes up regulatory fees (and the cost of regulation generally) too high then this may cause some organisations to move out of the market or, where it is possible, to seek another regulator.

There are also some safeguards inherent in the system of public administration. These include –

- A requirement on regulators to have a public consultation on their fees and to publish regulatory impact assessments. However, it has to be said that most RIAs give little scope for real debate.
- Legislation normally provides for the sponsoring department either to approve the fees or to stipulate the fees. The government department can be expected to properly check that the regulator is running efficiently (and there is often an incentive to do so as government officials may be somewhat jealous of seemingly much higher expenditure by regulatory bodies connected to their departments).
- There is haphazard oversight by bodies such as the National Audit Office, the Public Accounts Committee and individual select committees.

Large sectors
The arrangements generally work well in large sectors of the economy with well established substantial businesses and effective trade associations. The various checks and balances tend to work with such regulators. Also, large sectors can absorb a significant regulatory cost in absolute terms, because it is likely to be small in relation to turnover.

In large sectors being regulated may be essential to trade and therefore there is a captive market with little opportunity for organisations to opt out and go into other markets. However, there is the occasional threat, for example from some financial services firms, that they will move out of London if the regulatory regime is not sufficiently benign.

Among the large sectors where regulatory fees are not a great issue are financial services, utilities, communications and legal services.

Small sectors

There are very different arguments in smaller sectors of the economy. Here, being regulated may well not be a licence to trade. A small business can have the option of moving into other businesses or even operating illegally safe in the knowledge that it may well not be caught. Regulatory fees have much more of a market effect in smaller sectors than in larger ones.

Regulation generally has a high fixed and low marginal cost. The bulk of the expenditure is in developing regulatory policy, consulting, establishing frameworks and analysis and reports. The actual work involved in dealing with individual regulated organisations is often quite small. It costs little more to regulate, say, 3,000 organisations than 1,000, and it is therefore likely that in a regulated sector with 1,000 institutions the fee could be nearly three times as high as that in a sector of 3,000 organisations. The position is different if each regulated organisation is audited annually, but this is the exception and contrary to the Hampton principles.

With the cost recovery policy, there is no reason why the resultant scale of fees should be regarded in any way as reasonable for the regulated institutions. Indeed, they may be so prohibitive as to put organisations out of business.

There is a wider policy issue here. Regulation must be seen as a public good. There is no point in doing it unless the public obtain a benefit. In some cases the State also obtains a benefit, for example through higher tax revenue. RIAs should seek to quantify this benefit and when they do so it is often a substantial multiple of the cost. To seek to recover the costs of regulation from regulated institutions almost denies this public benefit and indeed could lead to a quite perverse result. For example, a regulator may have as a side effect a substantial increase in tax revenue for which it obtains no credit. However, the regulatory fees may be so high that the regulator has to cut back on its costs, in particular monitoring and compliance, as a result of which malpractice increases and perhaps tax revenue falls.

At the extreme, the regulator may find itself in the position of having to trade off standards against viability. The imposition of what might be regarded as appropriate regulatory standards could so reduce the size of the industry that the regulator becomes unviable. In a similar way, regulators are often constrained by their financial position on how much enforcement activity they can undertake. It is not uncommon for a regulator to have to decide that it can only pursue one or two major enforcement cases a year.

Particular problems of new regulated sectors

Notwithstanding the intention to reduce the number of regulators, the reality is that a number of new regulators are created every year as there is no means of applying a general policy to specific circumstances each of which can be justified in its own right.

A newly established regulator faces a particular problem in seeking to recover costs. It is unlikely to know with any precision how many organisations will seek to be

licensed. The very purpose of licensing is to change behaviour in a sector. There may be, say, 2,000 companies in a sector but after licensing perhaps only 600 will remain. This could be regarded as a huge success for regulation in taking out the undesirable parts of the industry. However, if the regulator was banking on 2,000 licence fees and only has 500, this will present it with a financial problem. It is impossible for a newly established regulator to get it right in respect of the number of regulated institutions. This is illustrated in the case studies in the following section. The effect of this is that the fees quoted by the regulator in the run up to the introduction of regulation are liable to vary substantially and the regulator may also find itself in severe financial difficulty. This reduces its credibility with the industry it is regulating and sometimes also with the government department.

The position is complicated further because the scope of any licensing regime is determined not by the regulator but by the government department. With deregulation now being high on the agenda, a decision to narrow the scope of a licensing regime will have major effects on the financial viability of the regulator.

At the end of the day, a regulator cannot go bankrupt and the government has to bail out the regulator with financial difficulties, often with the chief executive and chairman paying the price. All of this disrupts the regulatory process, which is designed to have a public benefit far in excess of the costs of regulation.

Case studies

Gangmasters Licensing Authority

The government is in the process of introducing a statutory licensing scheme for "gangmasters" (in fact, the scheme covers employment businesses and not gangmasters but that is another issue). A Gangmasters Licensing Authority has been established to operate the licensing scheme. On 30 July 2004, Defra published a consultation paper on the establishment of the GLA. This included a regulatory impact assessment. That assessment was based on the assumption that there would be 4,000 licences. The estimated licence fee was between £585 and £750 a year.

Subsequent research indicated that the number of potential licensees would be 1,000 rather than 4,000 (and there is a view that 1,000 might be too high). When the GLA published its fee proposals in October 2005 the proposed fee was either £2,130 a year or a scale running from £660 to £32,500. The £2,130 figure is between 2.8 and 3.6 times as high as the initial estimate. Interestingly, the regulatory impact assessment makes no comment on this, and the higher regulatory costs have led to no changes in the proposed regulatory regime, which questions the point of an RIA in the first place.

At the time of writing there is an impasse. There is general agreement, including by the GLA itself, that the GLA's proposed fees are far too high. However, there is no prospect of any permanent government subsidy. The most likely option seems to be a fudge for the first year after which the issue will have to be addressed again.

The GLA also usefully illustrates the scope issue. The GLA was established on 1 April 2005 and the licensing regime is due to come into effect on 1 April 2006. As at the end of December 2005 the scope of the licensing regime has not been settled. It may cover the whole of the agriculture, horticulture and food production industries or it may cover just what goes on inside a farm, a market a small fraction of the whole of

the food industry. The narrower the scope the higher the deficit that the GLA will incur.

The Security Industry Authority

The Security Industry Authority has been established to regulate the private security industry. Its business plan published in June 2003 allowed for 100,800 door supervisors to be licensed in 2004/05; by December 2005 the number of licences issued was 37,000. The budget also allowed for 25,500 security guards to be licensed by March 2005 and 123,200 by March 2006. By December 2005, 17,300 licences had been issued. A more recent business plan (Corporate and Business Plan 2005/06-2008/09, published in June 2005) had figures for 2005/06. The plan was to issue 90,000 licences for security guards, 2,000 for vehicle immobilizers, 7,000 for CCTV and 5,000 for close protection. The actual figures as at December 2005 are 17,280, 1,116, 7 and 6.

In summary there SIA has issued fewer than half the number of licences it had planned to issue. This in turn must cause its income to be less than half budgeted. It is assumed that this has had significant financial implications for the SIA. The SIA financial year ended on 31 March 2005. The accounts for 2006 have not been published and questions on when it will be published and the financial implications of the shortfall go unanswered.

In the Corporate and Business Plan published in June 2005, the reduction in demand for licences was attributed to "unreliable base data and licensing inertia". The plan went on to say that for 2004/05: "The net effect was an 110,000 downward adjustment in licence numbers for the year and a gross income reduction of £21m. Cost savings of £8m were achieved, but £13 million additional Home Office funding was necessary." The plan did not say that the 110,000 "downward adjustment" was from a base of 129,573, that is the adjustment was by 85% of the original plan, and that the gross income reduction of £21 million was from a starting point of £24 million.

Several months on it is also clear that the number of organisations seeking licences will remain substantially below the estimates on which the new plan was based.

The plan also makes the point that "uncertainty with the Home Office approach to exemptions" (possibly the removal of some sectors from the need for licensing) "may present a serious financial risk".

It should be noted that the SIA has lost two chairmen before the end of their terms of office in the last two years. The reasons for this are not known, but at the least it is not helpful to have such instability at the top of an organisation when it clearly faces a number of major challenges.

Claims management activities

The government is proposing to regulate claims management activities. The intention is that there will be a private sector regulator. The regulatory impact assessment accompanying the Compensation Bill, published in November 2005, is based on the assumption that the regulator would regulate around 500 claims management companies and received approximately 550 complaints a year. The estimated costs–

- One-off set up costs of £0.5 million.
- Staff costs of £1 million to £1.3 million a year.
- Accommodation costs of £0.1 million to £0.3 million a year.
- Other running costs of £0.35 million to £0.5 million a year.

The total operational costs are therefore seen as being between £1.5 million and £2.1 million plus one-off set up costs of £500,000. If there are 500 licensed organisations this would lead to an annual fee of between £3,000 and £4,200.

Paragraph 70 of the explanatory note to the Bill says: "It is envisaged that the regulatory costs will be recouped from those regulated by way of a registration and annual fee. However, to deliver the regulatory mechanism before sufficient income from fees is established it is likely that government would need to provide funding to help with the start up costs. The aim will be to achieve a self-financing regime as soon as possible."

At first sight the proposed licence fee is excessive, particularly for small businesses. More importantly, it is highly likely that regulation will reduce the number of companies in the market, possibly to under 100. This would be regarded as a desirable outcome. However, the private sector regulator would be insolvent. It is unlikely that any private sector regulator would be wiling to operate on that basis, so it will be necessary for the DCA to establish a new regulator or to become the regulator itself.

Issues for consideration

It is clear that the present policy is not working for small regulators. This has been amply illustrated by the experience of the SIA. Neither the GLA nor the proposed regulator for claims management activities is capable of operating effectively if they have to cover the costs. A possible effect is that in future new regulators will have to operate within government departments as external regulators will find it difficult to obtain people willing to take on what is almost an impossible task.

Policy has to be based on the assumption that regulation results in a benefit to people other than those being regulated. Taking the three case studies –

- The SIA should remove much of the criminal element which has pervaded the private security industry.
- The GLA should reduce exploitation of workers and lead to a substantial reduction in tax evasion. The RIA on the legislation stated that it was not unreasonable for direct benefits to the Treasury to be in the order of £10 million a year.
- The regulator for claims management activities should reduce exploitation of vulnerable people, reduce the cost of compensation and lead to genuine claimants keeping more of their compensation.

In each case these benefits are a multiple of the costs of regulation, but the Treasury policy seeks to imply that the beneficiaries of regulation are the regulated organisations.

It would be sensible for general principles to be drawn up for regulatory fees, based on an analysis of current fees. The following "back of the envelope" analysis is a useful starting point –

- The Security Industry Authority has a standard fee of £190 a year. It also operates an approved contractor scheme. The proposed fee structure is an application fee between £1,000 and £3,000 and an annual fee, broadly speaking, of 0.1% of turnover.
- Fees charged by Boston Council range from £64 a year for an establishment that provides animal boarding services to £106 a year to private hire operators to a maximum of £1,043 for sex shops.
- The Commission for Social Care Inspection charges a registration fee, ranging from £518 for small homes up to £1,901 for large homes. The annual fees range from £173 for small care homes up to £864 for children's homes and £1,080 for domiciliary care agencies.
- The Financial Services Authority has a minimum fee for insurance intermediaries of £100 for a broker with commission income of £100,000, the figure thereafter increasing proportionately at the rate of £0.08 per £1,000.
- The Mortgage Code Compliance Board (now subsumed into the FSA) in its final full year charged a fee of £100 per registered person for up to 10 registered staff, decreasing to £75 per person for between 101 and 500 staff and £65 per person for over 1,000 staff.
- The Regulation of Fundraising Unit (which will regulate fundraising by charities) is planning a fee scale that runs from £30 to £1,500.
- The Gangmasters Licensing Authority is proposing to levy either a single fee of £2,130 or a scale ranging from £660 to £32,500.

A reasonable ballpark estimate is that £200 is a reasonable fee for an individual providing a non-professional service (such as a security guard), and for an organisation the fee should be around 0.1% of turnover, sharply tapering after turnover of around £20 million.

In conjunction with the BRE a regulator or government department should set fees that are reasonable in relation to other fees and take account of the public benefit. This could mean a lower fee so as to bring more people within the regulatory net if this would significantly increase the public benefit.

An appropriate budget for the regulator should be set jointly by the sponsoring department and the BRE. There is no logical reason by the regulator's fees should bear any relation to the necessary budget. However, the difference between the two should at least be substantially exceeded by the perceived public good.

Once set, the broad structure of regulatory fees should be keep unchanged for say three years with perhaps modest annual increases. After three years a major review of the both fees and budget should be carried out.