



Holding Highways England to account

Impact assessments

January 2020

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1. Introduction

- 1.1 This document sets out our initial assessment of the impacts of two proposed changes to how we hold Highways England to account in our monitoring framework and enforcement policy, *Holding Highways England to account* . These changes are:
- introducing ORR hearings as an option in our regulatory toolkit; *and*
 - removing indicative scales for fines, and instead proposing to limit fines to avoid taking money out of the business that could otherwise be spent on managing the network.
- 1.2 The impact assessments should be read alongside our consultation on the revised policy. They provide more context on how we have considered the changes proposed in the consultation version of the Holding Highways England to account policy.
- 1.3 We are consulting on these changes to gather views from our stakeholders. The conclusions in the impact assessments do not represent a final decision. We would welcome your views and additional information relevant to the options we are considering as we finalise our policy.

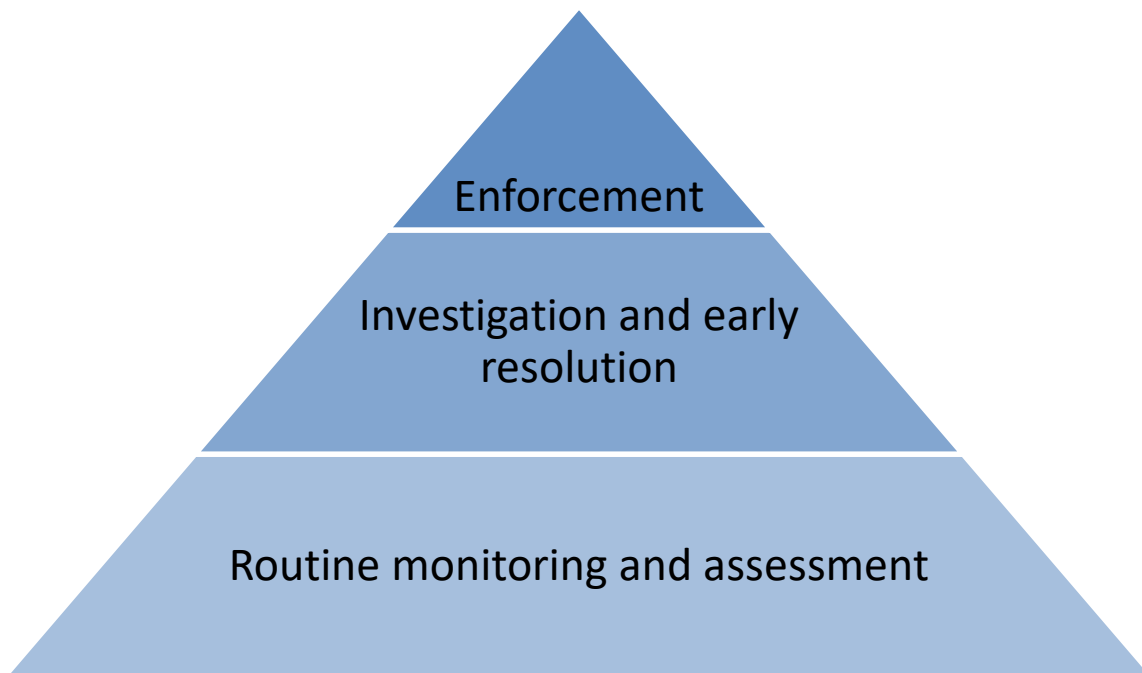
2. Policy area: ORR hearings

Objective

- 2.1 Our objective is to provide strong incentives for Highways England to take prompt action to address performance concerns, promoting early resolution and avoiding the need to escalate issues further.
- 2.2 This part of the impact assessment considers the addition of ORR hearings as a new tool in our enforcement policy, and should be read in conjunction with the draft monitoring framework and enforcement policy on which we are consulting, titled *Holding Highways England to account*.

Background

- 2.3 Highways England is a government-owned company, responsible for operating, maintaining and improving the strategic road network – the motorways and main A-roads in England. Highways England's funding and what it is required to deliver are set in five-year road investment strategies, and it operates under a Licence that sets out additional requirements.
- 2.4 As Highways Monitor, ORR holds Highways England to account for how it manages the strategic road network (SRN). We monitor Highways England's performance and efficiency and, if necessary, can take enforcement action. There are some similarities between our role and that of regulators in privatised, regulated utilities. But there are also important differences, which mainly arise from Highways England's status as a public sector body and how it is funded by taxpayers.
- 2.5 As a public sector body, Highways England has no private capital at risk and no traditional shareholders to satisfy. Therefore financial penalties or fines are less likely to be an effective deterrent or incentive for Highways England as they would for private companies. (We assess the impact of our revised policy on fines later in this document.) In this context it is important that we consider a wide range of alternative mechanisms, including options that operate through more reputational incentives.
- 2.6 In this impact assessment we consider the impacts of holding ORR hearings at different stages of our process, which is summarised below.



- 2.7 Stage 1 of our process – routine monitoring and assessment, involves assessing Highways England’s performance. As well as determining how Highways England is performing, our activities in this stage may alert us to where obligations and commitments may be at risk. Stage 2 – investigation and early resolution, is where we escalate performance concerns that are identified through our routine monitoring and assessment. Stage 3 – enforcement, would involve the use of our statutory enforcement powers. Further information about our activities in each stage is set out in our *Holding Highways England to account* policy.
- 2.8 ORR hearings could provide a useful tool to collect information and allow different parties to present their positions, and provide an incentive for Highways England to resolve issues quickly, to avoid the need for a hearing. It will be for ORR to determine the timing, scope and format of a hearing, and the parties involved, depending on the issue under consideration. We expect to publish a written record of proceedings (respecting commercial confidentiality).

Options under consideration

- 2.9 We consider two options, based around the different stages in our process when we could hold hearings. We also considered an option 0, which would not see hearings introduced. We have not included this in the table below as it would have no impact relative to the status quo, but we discuss it underneath the table. The options are assessed qualitatively against each other, and a ‘do nothing’ option of not having hearings as part of our toolkit. The options are:
- Option 1 – retaining flexibility to use hearings at any point in our process; *and*
 - Option 2 – focusing hearings in stage 2 (investigation and early resolution).

2.10 The table below summarises the key impacts of each option and the following section assesses the pros and cons of options 1 and 2 relative to the 'do nothing' option.

	Option 1	Option 2
Impact on performance (relating to the topic of the hearing)	Low-medium	Medium
	Having latitude to use hearings at any point in the process gives ORR maximum flexibility, which may create strong compliance incentives for Highways England. But this may go too far and incentivise risk-aversion.	<p>Focusing hearings in stage 2 gives appropriate emphasis to the compliance issue, and an opportunity for Highways England to resolve the issue before ORR decides whether to take statutory action.</p> <p>Retaining some flexibility to potentially use hearings in stage 3 may be a useful addition to our toolkit, particularly where we need more information to determine the appropriate enforcement action.</p>
Impact on future performance (for similar issues)	Low-medium	Medium-high
	Having the ability to use hearings at any stage in the process undermines their deterrent effect and potentially reduces their impact at later stages in the process.	Hearings may incentivise Highways England to resolve issues early. The strength of the incentive/deterrent effect is likely to reflect the prominence given to a hearing (and its related issue), which is likely to be greater for hearings in stage 2, as they are likely to be important factors when determining whether or not to take statutory action.
	Medium	High

<p>Reputational impact</p>	<p>The reputational impact of a hearing is likely to be affected by two key considerations: the prominence given to the hearing and severity of the issue. Both are likely to increase the later in the process a hearing is held. However, the impact of a hearing at the enforcement stage is moderated by the fact that other enforcement action we might take at that stage would also have a reputational impact, reducing the impact of the hearing alone.</p>	<p>The reputational impact of having a hearing predominantly in stage 2 will be more significant. As we expect to publish a written record of a hearing, stakeholders will have some visibility of the relevant non-compliance issue. If this is seen as rare and serious it will have a more significant impact on the company than if it were seen as “business as usual”.</p>
<p>Net administrative costs</p>	<p>Low-medium</p> <p>A hearing at any stage would involve costs for ORR, Highways England and any other attendees. Hearings at an earlier stage could find an early resolution and reduce the need for further action (and related costs). Later stage hearings might involve higher costs as more thorough preparation is required. As part of any decision to hold a hearing, it will be important for ORR to assess whether the potential benefits outweigh the administrative costs.</p> <p>The costs of having a hearing are unlikely to be significant.</p>	<p>Medium</p> <p>While having a hearing will always impose some costs, they are unlikely to be significant, particularly as they are most likely to be used later in stage 2 when significant evidence gathering has already taken place. Targeting them at stage 2 as part of an investigation will mean that they should be used infrequently.</p>
	<p>Medium</p>	<p>Medium-high</p>

<p>Behavioural impact</p>	<p>Highways England's management is likely to want to avoid the reputational impact of a hearing being held, so will take steps to ensure one is not needed. The size of this incentive/deterrent is linked to the size of the reputational impact. If hearings can be used at any point in our 3 stages, Highways England may see them potentially as more “business as usual” activities. This may mean their behavioural impact is lessened.</p>	<p>If appropriately targeted as being a pre-enforcement tool that is a serious issue, we expect hearings will have a strong deterrent effect and incentivise Highways England to resolve issues and engage with us fully prior to our decision on whether or not to take enforcement action.</p>
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Option 0 – do nothing

2.11 Under the ‘do nothing’ option, we would not have the option of holding "on the record" hearings into Highways England's performance as part of our regulatory toolkit. We would still be able to use our existing methods and statutory powers to require Highways England to provide us with information. And we would still have other reputational tools available to us, for example by making public comment on performance issues. As option 0 is the counterfactual, we have not assessed it in the table above.

Option 1 – retaining flexibility to use hearings at any point in the process

2.12 Being able to use hearings at any stage in the process would provide ORR with maximum flexibility. ORR would be able to bring Highways England, and potentially other stakeholders, together to gather information and try to find early solutions to a potential issue. This is most likely to be effective where other routes to gather information have not been successful.

2.13 There would be cost and resource implications for ORR, Highways England and any other attendees. It will be important for ORR to assess whether the potential benefits of a hearing at this stage outweigh the administrative costs. And those potential benefits include the early resolution of an issue that could reduce the need for further escalation, and associated costs.

2.14 In this option, we would not state our intent to focus hearings at a specific stage in the process. Because of this, it may create stronger incentives on Highways England to avoid non-compliance for the smallest of issues, which may impose additional compliance costs on the company. It may also mean that Highways England is more reluctant to be open and transparent with us for fear that a minor issue may be the subject of a hearing. While we would still need to act proportionately, Highways England may perceive that we would not be, and this may impact on our working relationship with the company.

Option 2 – focusing hearings in stage 2

2.15 Using hearings predominantly in stage 2 and potentially in stage 3 is more proportionate than option 1. Hearings are most likely to be effective where we have already identified a concern with some aspect of Highways England's performance and are failing to gain traction to resolve the issue. So the focus at this stage would likely be more on gathering information to determine whether statutory action is required, than on identifying preventative action.

2.16 As such, hearings at stage 2 would have a stronger reputational impact because it would be clear that we are investigating an issue with Highways England's performance and there is the opportunity to deal with the issue prior to the consideration of statutory enforcement action. And, in turn, hearings at this stage would create a stronger behavioural incentive or deterrent for Highways England's management to avoid the need for a hearing by finding an early resolution to the problem. This obviously does not rule out us taking statutory enforcement action following a hearing if so warranted.

2.17 A hearing at stage 2 would be before the ORR Board's decision about whether statutory enforcement action, in the form of an improvement notice or a fine, is appropriate. So it could also help ensure we can collect the relevant information that would be needed for the ORR Board to make that decision.

2.18 As hearings would be most likely to come before any decisions about escalating further to statutory enforcement action, hearings at this stage are likely to attract the largest administrative costs, due to the strong incentives for thorough preparation. However, we expect a hearing is most useful at a relatively late point in stage 2 when there will already have been significant evidence gathering. So the marginal cost of holding a hearing may not be large. We would consider the cost of a hearing when deciding whether to have one.

2.19 But this option does not rule out the use of a hearing once non-compliance has been found and the need for statutory enforcement decided upon. Although it is unlikely many situations would warrant a hearing in stage 3, this option retains flexibility to

use hearings to gather further information to determine the appropriate enforcement action in response to non-compliance.

2.20 We would make public any statutory enforcement action we take and, given the stage of the process, would likely make some public comment on the issue at the appropriate time and via the appropriate channel, even if we do not proceed with statutory enforcement action. This means there would already be a reputational impact on Highways England, which would offset the impact of holding a hearing in stage 3 and reduce the behavioural incentives it creates.

Preferred option

2.21 There are benefits to having hearings available as part of our regulatory toolkit. Hearings have costs and so we need to consider on a case-by-case basis whether the potential benefits outweigh them. Option 1, retaining flexibility to use hearings at any point in the process, has advantages, but risks creating unintended consequences that may work against us in future, for example because it changes how open Highways England is with us. Therefore option 2, focusing hearings in stage 2, is our preferred option. Hearings are most likely to be an effective way of gathering information during an investigation, and serve as an effective deterrent to ensure issues are resolved in stage 1 and do not proceed to stage 2.

2.22 While there may be few circumstances in which holding a hearing at stage 3 is appropriate, we are not ruling it out. Holding a hearing to gather further information on the appropriate enforcement action once ORR has determined there has been a significant non-compliance issue, could be beneficial. This may allow us to gain further information from stakeholders on what course of action is most likely to be effective.

3. Policy area: ORR's approach to fining Highways England

Objective

- 3.1 Our objective is to make sure that we have a credible policy on fines which supports and incentivises improved performance from Highways England in its management of the strategic road network.

Background

- 3.2 This impact assessment looks at the impact of changing our approach to levying fines on Highways England in light of the changes that will take place when the second road investment strategy (RIS2) comes into effect.
- 3.3 The 2015 Infrastructure Act gives us the power to levy fines on Highways England if it is not complying (or has not complied) with the RIS or its Licence. So fines form an important part of how we hold Highways England to account, including through a deterrent effect. We consider fines to be a last resort, and have not issued one to date. But it is important that we set out how and when this power may be used. It is also important that our approach reflects Highways England's status as a public sector body, with no private capital at risk. As such, our approach to monitoring and enforcing Highways England focuses on early resolution of issues and reputational incentives.
- 3.4 Under our current enforcement policy, which has been in place during the first road period (RP1), we set out the likely maximum amount we would fine Highways England at 1% of Highways England's average annual funding, around £25m. We set this significantly below the 10% of turnover limit that is typical in other regulated sectors to reflect Highways England's status as a public sector body.
- 3.5 However, given the increase in funding announced for the second road period (RP2), there could be a perception that we want to increase the magnitude of any fines we impose, because of the linkage between funding and fines in our policy. Without changes, our policy could create an impression we could fine Highways England £50m for the most serious instance of non-compliance. A fine of this size could significantly affect Highways England's ability to fulfil its obligations under the RIS and its Licence to operate and maintain the SRN. In turn, this could affect the credibility of our approach to fines and reduce its effectiveness in incentivising performance. Because of this, we need to change how this works in our policy.
- 3.6 The options we assess below include removing indicative fine levels and considering setting fines so that they could be paid whilst protecting the funding for Highways England's day job. How payment of a fine is funded is for Highways England to

decide, but, we consider a fine is most likely to have the desired effect if it is set at a level that does not remove funding that would otherwise be spent on operating the SRN. Before assessing those options it is helpful to set out some background on the potential links between fines and management remuneration.

- 3.7 We assume that both fines and management remuneration would be payable from Highways England's resource (or opex) budget. This is set for five-year periods as part of the road investment strategy process but with annual budgets that follow government departmental expenditure limit rules. Highways England only has limited financial flexibility and there is uncertainty about the arrangements for the second road period and beyond. In this analysis we have assumed that the company is not able to carry or transfer resource funding between years. So if it underspends its resource funding, this is returned to HM Treasury and essentially 'lost' from Highways England's budgets.
- 3.8 Highways England has discretion over its management remuneration system and how this works could change over time. Its current system includes the potential for Highways England to reduce management remuneration through its performance related pay arrangements.¹ If this were to occur, it would be likely to lead to an underspend that would be returned to HM Treasury.
- 3.9 For example, imagine Highways England is initially planning management remuneration of £Xm but decides to halve this in light of a serious incident. Remuneration decisions are typically taken late in (or after the end of) the financial year so this would likely result in an underspend of £½Xm that Highways England would be unable to carry over to the next financial year, and would return to HM Treasury. It is only if an incident (and the associated remuneration decision) happens early enough in the year that the company would be able to redirect the £½Xm to alternative/additional operations or maintenance activities.
- 3.10 In this context, if we were to levy a fine of £½Xm it would clearly not affect the funding available for operations or maintenance. Rather, it would convert the underspend (which goes to HM Treasury) into a fine (which is paid to HM Treasury) with the primary impact being reputational, rather than financial.
- 3.11 There are two potential complications to this example. First, the time taken to investigate an issue and decide to fine the company could mean that we levy a fine in the financial year after the related incident (or non-compliance, more broadly) took place. And Highways England could already have decided, the previous year, to reduce its management remuneration. In this instance, a fine could either mean that management remuneration is reduced twice in relation to the same incident, or that

¹ The company has performance related pay, which it may choose to lower in the event of ORR finding the company non-compliant and issuing a fine.

funding would be taken out of operations and maintenance (if Highways England decided not to reduce management remuneration a second time). So it would be important for us to consider decisions that Highways England had already taken regarding management remuneration when considering whether and at what level to impose a fine.

3.12 Second, Highways England could choose to fund fines (partly or wholly) by reducing management remuneration, regardless of the intent in our policy. And, again regardless of the intent in our policy, Highways England could choose not to fund a fine through reduced management remuneration. However, considering setting fines so they could be payable from management remuneration would put the onus on Highways England and protect the funding for operations and maintenance.

Options under consideration

3.13 We consider three options in this impact assessment.

- Option 0 – do nothing (maintain the current approach to fines – we have chosen to assess this in the table below because, in the absence of changes, our policy would continue to link fine levels to funding. This would mean that ‘do nothing’ would have an impact);
- Option 1 – remove the indicative scales for fines in different categories of seriousness²; *and*
- Option 2 – remove indicative scales for fines in different categories of seriousness and consider setting fines so they are capable of being paid from Highways England management remuneration.

3.14 The table below summarises the key impacts of each option and the following section assesses the pros and cons of options 1 and 2 relative to the ‘do nothing’ option.

² ORR’s current [enforcement policy](#) for Highways England sets out how these indicative scales apply.

	Option 0	Option 1	Option 2
Impact on funding available to operate and maintain the SRN	Up to Medium/high	Up to High	Low
	<p>Fines could reduce the available funding.</p> <p>The amount would depend on the severity of the issue – £5m-£50m in the most serious category (where fines might be more likely to be deemed appropriate) – and Highways England's decisions around management remuneration.</p>	<p>Fines could reduce the available funding.</p> <p>The size of fines would be considered on a case-by-case basis. There would be more uncertainty around the size of fines but we would not expect to levy fines that would risk delivery of the RIS. The impact on funding available for operations and maintenance might depend on Highways England's choices around management remuneration.</p>	<p>It would be less likely that there would be a reduction in funding to operate and maintain the SRN as we would consider setting the fine so it could be fundable from management remuneration. This would ultimately be Highways England's choice.</p>
Financial impact on HM Treasury	Up to Medium	Up to High	Low
	<p>Fines would be paid to HMT. The amount would depend on the severity of the issue.</p>	<p>Fines would be paid to HMT. The amount would be considered on a case-by-case basis.</p>	<p>Fines would be paid to HMT, with the amount set so it could be funded from Highways England management remuneration, and set on a case-by-case basis.</p>

Financial impact on Highways England management	Medium	Medium	Medium
	<p>Highways England could decide to reduce management remuneration in light of poor performance / our decision to levy a fine.</p> <p>At Highways England's discretion.</p>	<p>Highways England could decide to reduce management remuneration in light of poor performance / our decision to levy a fine, but the fines we set could be smaller or larger than the other two options without having clear principles on which to base the level of fine.</p> <p>At Highways England's discretion.</p>	<p>Where appropriate, fines would be set so they could be funded from management remuneration. In practice this is likely to have no more material impact than option 0.</p> <p>At Highways England's discretion.</p>
Financial impact on other Highways England staff	Low/Medium	Medium	Low
	<p>Highways England could decide to reduce management remuneration in light of poor performance / our decision to levy a fine. Relatively high limits on fines may mean that Highways England needs to find other sources of funding to pay and restricts remuneration to other members of staff.</p>	<p>Highways England could decide to reduce management remuneration in light of poor performance / our decision to levy a fine. No limits on fines may mean that Highways England needs to find other sources of funding to pay and restricts remuneration to other members of staff.</p>	<p>Highways England could decide to reduce management remuneration in light of poor performance / our decision to levy a fine. The impact may be lower than the other two options as we are more likely to set fines at a level that could be funded from management remuneration than the other two options.</p>

	At Highways England's discretion.	At Highways England's discretion.	At Highways England's discretion.
Reputational and behavioural impact	Medium	Up to High	Medium-High
	<p>Our powers to levy fines have a deterrent effect to incentivise Highways England to deliver the RIS and Licence. Through the company's management remuneration system, this could cascade to management and staff. But the upper limit on the size of fines could make this less effective, as the fines potentially become too large to be credible.</p>	<p>Our powers to levy fines have a deterrent effect to incentivise Highways England to deliver the RIS and Licence. Through the company's management remuneration system this could cascade to management and staff. But the open-ended nature of any fine limits could create uncertainty and a disproportionate response from Highways England. It could become risk-averse and unwilling to innovate for fear of having a fine imposed, the size of which could be unlimited.</p>	<p>Fines would be more explicitly set at a level to create a financial and reputational incentive for Highways England's management's performance and actions.</p> <p>If Highways England chose to reduce management remuneration before year-end it could reduce incentives for the rest of the year. This applies for all options but is most relevant to option 2, where fines are more closely related to management remuneration.</p> <p>Similarly, applying a fine for a preceding year may reduce incentives for the year in operation, and may not impact on those who were</p>

			<p>responsible for the issue at the time.</p> <p>There may be a small risk that this option impacts on management morale and recruitment. This applies for all options but is most relevant to option 2, where fines are more closely related to management remuneration.</p>
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Option 0 – do nothing

3.15 While this option would not involve any changes to the policy, it would result in impacts because of the way indicative fine levels are linked to Highways England’s average annual funding. While we would still have the discretion to set a fine at the appropriate level, the policy includes statements that we would not normally levy a fine exceeding £25m, 1% of Highways England’s average annual funding. In RIS2, 1% of funding would be about £50m. If we did not change this in the policy there is inconsistency, the risk of confusion, and a likelihood Highways England would consider we had increased the size of the fines we could impose. This could create inappropriate incentives or undermine the credibility of our enforcement tools.

Option 1 – remove the indicative scales for fines in different categories of seriousness

3.16 Compared to ‘do nothing’, this option reduces the perception that ORR would be likely to levy large fines (up to £50m) that would reduce the funding available to operate and maintain the SRN. In turn, this would ensure that our approach to fines remains credible and an effective deterrent to incentivise delivery of the RIS and Licence.

3.17 This option gives ORR maximum flexibility to determine the appropriate level for a fine, on a case-by-case basis. But this flexibility creates uncertainty, particularly for Highways England, around the level of fine that we might decide to impose. This could include expectations of larger fines than under our current policy or the ‘do nothing’ option.

3.18 Similarly to the 'do nothing' option it would be entirely at Highways England's discretion to decide whether any fines would be (partly or wholly) funded from management remuneration, or from funds to operate and maintain the SRN.

Option 2 – remove indicative scales for fines in different categories of seriousness and consider setting them so they are capable of being paid from Highways England management remuneration

3.19 This option maximises the likelihood that any fines would be funded from management remuneration, rather than funding to operate or maintain the SRN (although this would still ultimately remain an issue for Highways England to determine). This would avoid impacting on Highways England's ability to resource its RIS2 requirements, while maintaining fines as an appropriate and proportionate tool to incentivise the company.

3.20 This option provides more direct reputational and financial incentives for Highways England's management, as the expectation is clear that it should take responsibility for significant issues of non-compliance.

3.21 Our policy that we expect the company to consider fines when determining senior management remuneration has been our position since the first enforcement policy was introduced. Setting out an approach whereby we may set fines so that they are capable of being funded from management remuneration means that we are not unduly limited in determining the size of a fine.

3.22 There may be a small risk that this option may impact on Highways England's management morale and its ability to recruit and retain staff. However, decisions on how to fund any fine we impose are for Highways England. Our *Holding Highways England to account* policy also states that we will consider the impact of our course of action on the company before deciding whether to proceed with enforcement action. It also makes clear that we consider fines to be a last resort.

Preferred option

3.23 In the event that we did not make any changes to our policy, when RP2 starts our indicative fine levels would become inconsistent, as average annual funding for Highways England would change. Applying the percentage levels to the increased funding expected in RP2 could also create an expectation we would levy significant fines on Highways England in the event of severe non-compliance issues. This may cause Highways England to act in a strongly risk-averse manner, and result in additional costs or reduce the company's efficiency.

- 3.24 We want our rules on fines to give us flexibility to respond in the appropriate manner at all times. But we also want to ensure that we lessen the likelihood of taking money out of Highways England's funding to manage the network. If we were to remove only the indicative levels for fines (as in option 1), this could give the impression we want to retain the ability to impose almost unlimited fines. This is not the case and we want to ensure there are clearly understood principles that would underpin the level at which we set a fine.
- 3.25 Option 2 would set a clearer expectation that we would consider whether it was appropriate to set fines at a level that enables Highways England to fund them from management remuneration so as to avoid a negative impact on funding for the network. This is our preferred option.



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