

## **Business Impact Target specific issues: direct versus indirect impacts**

### **Summary and key points**

This section provides a guide to determining whether impacts on business are direct or indirect. This distinction is important because the metric for the business impact target is defined in terms of *direct* impacts on business. The guidance sets out three important steps or criteria. An impact on business is likely to be direct if:

1: The measure bans, restricts, liberalises, increases or decreases the cost of a business activity, and if the impact falls on those businesses subject to the regulation and accountable for compliance.

2: The impacts are generally immediate and unavoidable ('first round'), perhaps involving a shift in the supply and/or demand curve to a new equilibrium immediately following the measure. There are relatively few 'steps in the logic chain' between the introduction of the measure and the impact taking place. Impacts that occur subsequent to this adjustment to a new equilibrium, for example as a result of a significant reallocation of resources or innovation, are likely to be indirect. An impact resulting from the 'pass-through' of regulatory impacts, such as higher prices to consumers, is an important category of an indirect effect, where the pass-through could be viewed as a 'second round' impact.

3: The impacts are in the market being regulated (a 'partial equilibrium effect'). These impacts are sometimes sufficiently large to result in further impacts in related markets and/or the wider economy ('general equilibrium effects'). These further impacts are likely to be indirect.

The section provides examples of how these criteria have been applied by the RPC on casework, including in areas such as transport, health & safety and business finance.

### **4.1.1 Why are we interested in *direct* impacts?**

As set out in the written ministerial statement of June 2018, the metric for the business impact target (BIT) is the Equivalent Annual Net Direct Cost to Business (EANDCB). The focus on direct impacts reflects the government's objective of constraining the impositions placed by regulation on business, irrespective generally

of where the burden eventually ends up. It also reflects businesses' main concerns: the immediate and unavoidable impacts of regulation. If business impacts, for BIT purposes, were not limited to direct impacts there would also be practical problems, not least because all business impacts are eventually passed through to consumers or shareholders. It should be noted that all significant business and other impacts, whether direct or indirect, should be covered in the impact assessment and usually included in the net present value. It is only for BIT purposes that we are specifically concerned with direct impacts.

There is no clear economic definition of direct and indirect effects and there is no such distinction in the HM Treasury Green Book. It is often difficult to judge when economic impacts on business are direct or indirect and where the boundary lies between the two. The distinction is not always intuitive and in some rare instances can result in an outcome that could seem perverse. Where departments have concerns around the true impact on business being mis-represented, early engagement with the RPC could be particularly helpful. The following section provides guidance to assist departments in distinguishing between direct and indirect effects, illustrated with case studies. However, whether impacts are direct or indirect can sometimes be a matter of fine judgment and, therefore, this guidance should be treated as indicative.

#### **4.1.2 Definition, criteria and practical steps to distinguish between direct/indirect impacts**

In early 2015, the then Department for Business, Innovation and Skills (BIS) and the RPC commissioned an independent research project, which aimed to:

- set out the different definitions of direct and indirect impacts in the literature;
- present a microeconomic framework for thinking about the treatment of direct impacts within the then One-In, One-Out/One-In, Two-Out (OIOO/OITO) system; and
- develop some criteria that could be used to help officials classify direct and indirect impacts.

The research, which was undertaken by Brian Titley Consulting Ltd, was commissioned in the context of the OIOO/OITO rules that operated within the last Parliament but is also relevant to the methodology for the BIT.

This guidance builds on the findings of this research project. A summary of practical steps and criteria to distinguish between direct and indirect impacts of regulation on business is presented below.

#### **Step 1- Identify the broad type and scope of the regulatory measure**

Departments should consider whether the anticipated impacts are consistent with the type of measure being proposed. For instance, an impact is more likely to be direct if it:

- bans, restricts, liberalises, increases or decreases the cost of a particular activity; and/or
- displaces or restricts specific business activities designed to maintain or create sales, e.g. product differentiation and promotional activities.

In addition, if the impacts fall on those businesses subject to the regulation and accountable for compliance, they are more likely to be direct than impacts on businesses further down the supply chain. The two examples below illustrate impacts considered to be direct because they ban a type or aspect of a good or service.

**Banning of Inducements to Make Personal Injury Claims (RPC14-FT-MOJ-2125):**

This proposal banned lawyers from offering claimants financial inducements, or similar rewards, in return for making a claim. The objectives were to discourage weaker personal injury compensation claims from being made and to prevent claimants from being misled by offers of inducements which do not materialise in practice. The IA estimated that the policy would result in a reduction in the overall volume of claims. However, the IA asserted that the subsequent reduction in income to lawyers would be a result of behavioural change on behalf of the claimant, and therefore should be considered to be indirect.

The RPC concluded, however, that the reduced volume of claims would be a direct impact of the regulation. This is because the proposal introduces a direct ban on an activity, resulting in a loss of profit to business. The ability of lawyers to attract customers, who would have used their service in return for an inducement, has now been banned. The lost profit to solicitors from a reduction in these cases should, therefore, be considered to be a direct impact of the proposal.

**Standardised Packaging of Tobacco Products (RPC12-DH-1229):** This proposal aimed to reduce tobacco consumption by mandating the standardisation of tobacco pack colour, shape and the removal of all branding except brand name in a standardised type face. In this case, the impact of the loss of profit to manufacturers and retailers is direct primarily because it restricts economic activity from use of branding, prohibiting a form of promotional activity.

## Step 2 - Distinguish between first round and subsequent impacts

Immediate and unavoidable (first round) effects of a measure in the affected market are more likely to be direct. This could involve a shift in either the supply curve (e.g. due to a change in production costs) and/or demand curve (e.g. from removing a

restriction on purchasing a product) or a regulated change in the market price<sup>1</sup> (e.g. imposing a minimum price which moves price away from the market clearing price).

Subsequent effects in the regulated market beyond the immediate implications of the measure are likely to be indirect. These effects occur subsequent to the adjustment to a new equilibrium immediately following the measure. For example, it could be the result of:

- a significant reallocation of resources;
- product and/or process innovation by existing businesses;
- the creation of new firms/institutions; and/or
- productivity gains due to changes in business models or working practices.

***Practical application: ‘Steps in the logic chain.’***

It can sometimes be helpful to consider how many things need to happen between the regulation coming in and for the impact under consideration to take place – sometimes best thought of as the ‘number of steps in the logic chain’. Other things being equal, an impact that is dependent upon many steps in the logic chain is likely to be considered as indirect. This is not a hard and fast rule; for example, an impact that depended upon a number of steps could still be considered direct if those steps automatically followed each other.

The two examples below provide examples of this. The first is where an impact was considered to be direct because it followed automatically and was not dependent upon further action. The second is where an impact was considered to be indirect because it depended on business customers choosing to act on the information and change their behaviour.

**Proposed changes to Part L of the Building Regulations 2013 (RPC11-CLG-1130):** The policy amended the building regulations to increase energy efficiency standards. The measure imposed a cost on builders, but was beneficial to the eventual occupants of buildings because of lower heating costs. As the lower costs would be an automatic result of the more efficient buildings and not require a change in behaviour, they were considered to be direct. The policy was, therefore, considered to be ‘zero net cost’ under OITO, as the energy savings to non-domestic consumers were expected to exceed the costs to developers.

**Amendment to the Energy Act 2008 Powers to Implement and Direct the Rollout of Smart Meters (RPC10-DECC-0558):** Smart meters are a new form of gas and electricity meter that provide the customer with more information about their

<sup>1</sup> This effectively shifts part of the supply curve.

energy use. The smart meter also provides the supplier with more information, allowing for more targeted tariffs. The policy was to mandate the roll out of smart meters. If smart meters result in more efficient use of energy, this could have large benefits for business users. However, these benefits were considered to be indirect because they result only if business customers choose to act on the information and change their behaviour, rather than as a direct result of having a smart meter. The proposal gave customers more information upon which they can choose whether, or not, to act. The required behavioural change was, therefore, considered to be an indirect effect.

### **Step 3 – Identify whether the impact is a partial equilibrium or general equilibrium effect**

Departments should reflect on whether economists would consider the impact to be a partial equilibrium or general equilibrium effect. Partial equilibrium effects occur in the regulated market. General equilibrium effects are in related markets and/or the wider economy, coming from first round effects in the regulated market that are sufficiently large to result in changes in other markets. Therefore, cost, price and/or quantity effects that occur in related markets or the wider economy as a result of changes in the regulated market are second round, general equilibrium effects and, therefore, indirect and excluded from the EANDCB. The distinction here is not always exact; for example, impacts in the same market could also be general equilibrium effects. The subsequent case studies provide illustration of this, especially ‘ban on assignments.’

### ***Undertake a ‘sanity check’ – consider whether the direct impact is intuitive***

After completing the steps, it is also worth doing a sanity check on whether the outcome is intuitive. For example, can it be supported by relevant market data and/or a defensible ‘theory of change’ specifying the steps between the regulatory measure and the anticipated impacts? An example of this would be a regulatory measure that is widely agreed to be detrimental to business being assessed as having direct net benefits. This could provide *prima facie* evidence to look again at the direct/indirect classification. For example, the original submission on standardised packaging of tobacco products had a negative EANDCB on the basis that businesses would benefit directly from production costs savings in using plain packaging and that the loss from reduced sales was indirect because it resulted from consumers changing their behaviour. However, departments should not, of course, seek to define policy objectives in a way that is intended to influence the classification of the impacts into direct or indirect.

Departments should also refer to the later section (4.1.4) on ‘pass-through’ where this is applicable. In general, impacts resulting from ‘pass-through’, say to consumers, are indirect. For example, if a regulation imposes costs on business but these are recovered from consumers through higher prices, then the EANDCB should reflect the regulatory burden on business only and not the benefit to them from the price increase, which would be an indirect impact.

Finally, a practical tip suggested by a department relating to complex measures is to produce, at an early stage, a diagram mapping all significant potential costs and benefits, and considering whether each is direct or indirect and monetisable.

#### **4.1.3 Case studies of application of direct/indirect by policy area/type of economic activity**

The case study below explicitly sets out the RPC’s thinking and judgment on the direct/indirect classification of impacts, using the RPC guidance/steps. In addition, it makes use of the ‘steps in the logic chain’ approach to form a ‘spectrum’ of impacts from most direct to most indirect.

#### **Measures affecting competition authority/regulators**

##### **Special Merger Regime for Energy Networks (RPC-3239(3)-DECC)**

The proposal would enable the CMA to take account of the impact on Ofgem’s ability to compare network businesses when assessing a merger between energy network companies. The RPC opinion noted that separating the direct and indirect impacts of this proposal was not straightforward and required judgment about where to “draw the line”. However, the following treatment was concluded:

*The additional administrative costs to business* associated with the CMA’s wider remit are the most direct because they depend only upon the companies’ original decision to apply to merge.

The *efficiency savings foregone*, as a result of a merger being blocked, involve an additional step, i.e. that of the CMA taking a different decision because of the prospective loss of comparative data. The RPC’s judgment is that this cost, although closer to the boundary, is also direct.

The *loss to energy network companies from not being able to charge higher prices* involves a further step as it is additionally dependent upon Ofgem setting lower prices for energy network companies than they would otherwise have done, purely because of the continued availability of comparative data. It is, therefore, more difficult to see this effect as a direct consequence of the proposal. It was the RPC’s judgment, on the basis of the information provided in the IA, that the cost to energy network companies of not being able to charge higher prices should be



viewed as indirect.

Similarly, the pass-through of this impact to energy retail companies and, subsequently, to consumers (which will include businesses) was also be considered to be indirect.

Where a measure is expected to have a range of impacts and there is uncertainty about which of these are direct, it is good practice, especially where there is no close precedent or clear interpretation of the guidance relevant to the particular impact, to seek a **pre-submission view from the RPC through the RPC methodology sub-group (MSG)**. This is subject to the department and the RPC having time to consider the case before formal submission, but it does offer clear advantages to the department in reducing the risk of getting an IRN. As with the opinion on the case above, consideration by the MSG will also normally involve a careful setting out of the RPC's thinking and how it has arrived at its judgment. All of the following cases in this section were discussed by the MSG.

## Health and safety

### **Gas Safety (Installation and Use) Regulations (GSIUR) 1998 RPC-3948(1)**

The proposal included introducing flexibility around the timing of annual gas safety checks by allowing landlords to carry out checks up to two calendar months before the

due date, without bringing the due date forward and shortening the safety check cycle. The RPC decided on the following classification of impacts:

*Familiarisation costs* - the RPC agreed that familiarisation costs would be a direct impact.

*Programme slippage savings* - savings to landlords as a result of having to undertake gas safety checks less frequently were a direct impact. It was also agreed that the impact on letting agencies or contractors that offer gas safety checks as part of a package to private landlords would be direct.

*Logistical savings to gas engineers* - any logistical savings (reduced travel time for gas engineers travelling to and from properties) would be an indirect benefit to engineers because:

- they are not a first round effect, as they rely on a response from contractors to re-schedule their visits;
- the benefit does not accrue to the business being regulated; and
- it is an effect on a separate market (gas safety certification).

*IT costs* - since logistical savings to engineers was an indirect benefit, any related costs, such as changes to IT systems, should also be indirect.

### Business finance - ban on assignment clauses in a debtor's terms of sale.

A 'ban on assignment' is generally included in a contract, say between supermarkets and their suppliers, to prevent suppliers from sub-contracting. However, in many cases these clauses inadvertently prevented the assignment of the debt that arises under the contract, preventing the assignment of these invoices to a third party (e.g. a bank) for the purpose of accessing finance. The measure nullified this 'ban on assignment', which would mean that invoices could be used as collateral for businesses seeking finance. Seven benefits were identified by the department and considered by the MSG (see table below).

Impact	Direct or indirect	Discussion
Proposal lowers the default risk to invoice financiers, which is passed on to suppliers through a lower discount fee (interest rate).	Direct benefit to suppliers	Measure, through reducing default risk and the service cost of the loan, will directly lower the cost to existing users of invoice finance (at unchanged levels of lending). <ul style="list-style-type: none"> <li>• The measure bans a particular activity.</li> <li>• Reducing default risk appears to be a first round impact.</li> <li>• It is a partial equilibrium effect.</li> </ul>
Nullifying BoAs will reduce labour cost of invoice finances. This is reflected by levying a lower service charge on suppliers.	Direct benefit to suppliers	Arguments are similar to those above.
Profitability of invoice financiers will increase as the amount of lending increases.	Direct benefit to financier	By assuming that the measure increased lending, this involved an additional step in the logic chain and was, therefore, closer to being indirect. However, it was still considered to be a first round effect and it was an impact in the same market, i.e. the market for finance.
Lower default risk increases the amount of money advanced to suppliers for existing customers.	Indirect benefit to suppliers	This involved a further step in the logic chain because it made assumptions about how the additional finance is used, in terms of generating additional turnover and profit. These profits will also be earned in various other markets and, therefore, more of a general equilibrium effect.
Increased demand for invoiced finance from new customers.	Indirect benefit	Not possible to monetise
Reduction in refusal rates allow more firms to access finance.	Indirect benefit	Not possible to monetise
Reduction in extra collateral required.	Indirect benefit	Not possible to monetise



## Online businesses

### Universal Service Obligation (USO) (RPC-4107(2)-DCMS)

The proposal would allow individuals and businesses the right to request a broadband speed of at least 10 Mbps and places an obligation on universal service providers (USPs) to meet this request, providing they can do so within a reasonable cost threshold of £3,400 per premise. The RPC agreed the following classification of impacts on business into direct and indirect:

- Costs to the provider of faster broadband access would generally be direct because they follow directly from an obligation.
- Costs and benefits that follow from the relocation of households and business premises, in response to the measure, would be indirect.
- Time savings in undertaking existing business activities, resulting from faster broadband, are likely to be viewed as direct.
- Going further, in terms of wider 'productivity benefits', would be more indirect. This would particularly be the case where these benefits result from businesses innovating or changing their business models to take advantage of the faster broadband access.

### Business adaptation to a ban on a product

As described earlier, step 1 of the RPC guidance indicates that an impact that results from a ban or a restriction would normally be classified as direct. The example below illustrates that how a business will respond to this, for example by switching to selling other products, would normally be seen as indirect.

### RPC-4171(2)-DEFRA, 9 April 2018: Prohibiting the commercial dealing of ivory in the UK.

The Department presented two scenarios for its calculation of the EANDCB: Scenario 1 assumed no 'adaptation' and estimates a loss of profit that is constant and incurred in full over the 10-year appraisal period. Scenario 2 is where affected sectors 'adapt' and substitute the foregone profit from items containing ivory, with profit from alternative items.

The RPC considered scenario 1 to be appropriate. This was on the basis that the EANDCB was concerned with the 'impact effect' of the proposal and this was the elimination of profit from the trade in ivory that would be banned. The 'adaptation' in scenario 2, where this loss is mitigated over time as businesses adjust to selling other products, went beyond this.

The RPC considered, however, that the adaptation and associated mitigation of loss of profit could be modelled as an indirect impact providing there was sufficient reasoned argument and evidence. This should take account of a relatively inelastic supply curve for antiques, restricting the ability to substitute other antiques for ivory.

## Transport and congestion

The box below pulls together previous RPC decisions on the treatment of congestion impacts to inform treatment of a new case 'Road works: the future of lane rental'.

DfT asked the RPC's methodology sub-group for advice on classifying the savings from reduced congestion as direct or indirect in relation to its '*Road works: the future of lane rental*' (RPC-DfT-4138) case. Lane rental involves charging the promoters (e.g. utility companies or highway authorities) carrying out road works during lane rental periods for the time their works occupy the road. In doing so, the RPC reviewed its treatment of previous relevant cases:

*'Reducing congestion on local 'A' roads'* (RPC-DfT-3274(1)). This proposal required works undertaken by utility companies and local authorities on local 'A' roads to either be continued at weekends, where a worksite is in place, or removed over the weekend. The RPC opinion stated: *"It appears to be the case that congestion benefits to road-related businesses (e.g. taxis, lorries, coaches) should be classified as direct, and the benefits to other businesses (where these exist), whose employees may arrive at work earlier or have other travel savings (i.e. productivity benefits), should be classified as indirect."*

*'Proposal to authorise motor sport events on public roads'* (RPC17-DfT-3952(1)). This proposal amended the Road Traffic Act 1988 to allow local authorities to authorise, jointly with motor racing bodies, motor races on public roads. The EANDCB consisted of the increased travel time for business road users resulting from road closure.

In both these cases, the measure restricted or directed activities by businesses. In the former case, this was by requiring works to be continued at weekends or removed over the weekend; in the latter case, through closing roads to business (and other) road users. That the reduced and increased journey times, respectively, for these two cases were seen as direct impacts is consistent with step 1 of the RPC guidance. The impacts are also immediate and unavoidable effects in the 'regulated market'.

*'The Electrically Assisted Pedal Cycles (Amendment) Regulations 2015'* (RPC14-FT-DFT-2242(2), 1 April 2015)

This proposal included amending existing regulations to increase the maximum permitted electric motor power for bicycles from 200 to 250W and remove the weight limits for all types of Electrically Assisted Pedal Cycles (EAPC). The proposal was expected to increase sales of EAPCs and additional journeys by EAPCs were expected to displace journeys made by cars, vans etc.

In this case, the current restrictions are on manufacturers and sellers of EAPC and the direct benefit of the lifting of these restrictions accrues to them (through higher sales and, therefore, profit). The measure does not close or open roads/lanes. The anticipated reduction in travel times comes from additional journeys by EAPCs displacing journeys made by cars, vans etc. This was more a second round effect and the impact is in a related (car) market rather than the regulated (EAPC) market. The RPC did not consider this to be a direct impact on business and it was, therefore, ultimately excluded from the EANDCB.

*Application to 'Road works: the future of lane rental' (RPC-DfT-4138)*

On time savings from reduced congestion, case history suggested there was a spectrum from clearly direct ('local A roads' and 'motor sports') to clearly indirect ('EAPC'). The RPC viewed lane rentals as closer to the 'local A' roads case in that it impacted directly on the availability of road space. It was agreed, therefore, that the time savings from reduced congestion in the lane rentals case were direct.

On improved journey time reliability, the RPC accepted this impact as direct, noting that DfT's approach was widely accepted in transport appraisal and that the benefit was directly related to the time savings.

Surplus revenue from lane rental to local highway authorities can be used in an 'innovation fund' to reduce the negative impacts of road works. It was agreed that this would be a (very) indirect impact.

It is also worth noting that there was an additional issue of defining whether a congestion impact should be treated as an impact on business (whether direct or indirect) or on individuals. The RPC agreed to a distinction that vehicles of road-related businesses (e.g. taxis, lorries, coaches) would be an impact on business, while impacts on commuters to their normal place of work would be considered an impact on individuals. It was also determined that impacts on individuals on business trips (i.e. not travelling to their usual place of work) would be treated as business impacts. This appeared to align with HMRC rules around what constituted business activity.

### **Specific technical issues**

The case below is where the RPC considered the specific BIT treatment of the impact on business of a temporary measure being made permanent.

### **Permitted development rights for the change of use of offices, light industrial buildings, and launderettes.**

A planning application was required to change the use of existing buildings used as offices, light industry and launderettes to new homes. The proposal would classify this change of use as permitted development, which requires a lighter touch planning process. In the case of change of use from office to residential, the proposal would also make an existing temporary permitted development right permanent. This would have the effect of increasing land values and DCLG's IA had applied a land value uplift, representing the increase in the present value of the income stream from the asset. The RPC viewed that if making a measure permanent had a real material impact, then this should be allowed to score as a direct benefit to business.

#### **4.1.4 'Pass through'**

When a regulatory burden is placed on businesses they have to decide how to respond. They may increase prices, cut wages, reduce investment or reduce dividends. The EANDCB metric is an attempt to capture the burden on business of regulation. If a mechanism exists that enables some or all of this burden to be passed on to other businesses and/or consumers, this subsequent effect is generally regarded as being indirect for the purposes of the BIT. Such 'pass-through' should be excluded from the calculation of the EANDCB. The first round impact of the regulatory change, for example the compliance costs to business, is the direct impact of the regulation. The second round impact, after pass-through (such as higher prices to consumers) would be an indirect impact of the regulation. Only the direct impact should be included in the EANDCB. Without this rule, any increase in regulatory requirements on business could potentially score as zero on the basis that the cost is ultimately borne by consumers in the form of higher prices.

#### **Examples of the normal application of pass through**

##### **Reforming the regulatory framework for employment agencies and**

**employment businesses (BIS-2150):** It was expected that employment agencies would pass these costs on to their customers (i.e. organisations wanting to hire workers). The direct impact is on employment agencies; the indirect impact is on hiring organisations. Note that this had an impact on the size of the EANDCB because some of the hiring organisations were in the public sector and, therefore, not in scope of OITO/BIT.

**The future of the energy company obligation (ECO) (DECC-2105 and, more recently, BEIS-4226):** This proposal involved, during the first year, a scaling back of regulatory requirements compared to the existing ECO policy and, therefore, reduced costs to energy supply companies. The Government expected that energy companies would pass on these savings to their customers and the energy

companies appeared to have agreed to this. However, the department provided further information which explained that there was no legal requirement, or anything that had regulatory force, for energy companies to pass on these cost savings to consumers. The pass-through of business costs to consumers was, therefore, confirmed as indirect.

**Plastic carrier bags charge (DEFRA-2124(2)):** This proposal required large retailers to charge consumers five pence for each carrier bag. The policy was expected to result in a substantial reduction in the number of carrier bags that would be used. Since the existing cost of the carrier bags was, in effect, being passed on to consumers in the form of higher prices, the department's initial analysis suggested that, because retailers would pass on the savings from fewer carrier bags to consumers in the form of lower prices, this would not be a direct benefit to retailers. However, it was confirmed that the direct impact was on retailers and this was reflected in the EANDCB. Note that there was also another pass-through issue, in that retailers were expected, though not required, to pass on the net revenue from the sale of carrier bags to local good causes. However, as the latter would be voluntary and community bodies, this had no impact on the EANDCB.

### Exceptions to the normal application of pass-through

There are a very few exceptions to the rule on pass-through. As noted above, one might be where the pass-through is mandatory, (i.e. backed by regulatory force). Another possibility (see example below), is where the business experiencing the initial impact of regulation/deregulation acts only as a conduit. Following a Regulatory Framework Group discussion it was agreed that when a cost is paid by an agent on behalf of a principal, this should be considered to be a direct cost to the principal, not a cost to the agent that is passed through.

**HM Land Registry local land charges (BIS-1925):** Land charges were currently set at the local authority level. The proposal was to standardise them at a level below the current average. Most customers will be better off, but a minority will see their fees rise. These fees are normally paid by conveyancers on behalf of their clients. Initially, this was considered to be a direct cost to conveyancers that was passed on to clients (who were a mix of individuals and businesses). Following RFG discussion, it was agreed that this should be considered to be a cost to clients since they are ultimately responsible. Conveyancers were simply paying on their behalf.