JANUARY 2024

SUBMISSION TO DEPARTMENT FOR BUSINESS & TRADE

CONSULTATION ON SMARTER REGULATION PROPOSALS

ECONOMIC INSIGHT'S RESPONSE

Economic Insight is an economics consultancy, advising companies and regulators across the energy, water, telecoms, and transport sectors in the UK and abroad. This document sets out our response to the government's consultation on smarter regulation. Rather than provide question by question responses, we focus on key issues relating to:

(i) the duties and functions of the regulators (specifically the Growth Duty);

(ii) approaches to the funding of major projects; and

(iii) changing the appeals process in the water sector.

1. Regulating for growth

Proposal

"The government, led by sponsor departments, will work with regulators to conduct a thorough review of duties, with a view to rationalise duties and enable regulators to focus more on economic duties and functions."

Consultation questions

"The draft revised guidance outlines that economic growth has a number of different drivers and behaviours and describes some, but does not attempt to provide an exhaustive list. In this way, is the revised guidance clear on the Government's expectations of regulators on meeting the Growth Duty?"

"In your view what would be the best way to monitor the regulatory application of the Growth Duty? Who would best undertake this role? What would be the most effective comparative metrics to assess performance against the Growth Duty?"

We agree that regulated industries in the UK have a vital role to play in delivering economic growth, and therefore welcome the increased focus on growth within the responsibilities of the sectoral regulators (including Ofgem, Ofwat, and Ofcom, to whom the Growth Duty does not currently apply, but will do so from April 2024, under government proposals). We also welcome the proposals to consider how best sectoral regulators should balance their various duties. However, care should be taken as to the extent to which additional duties, and related guidance, are seen as a silver bullet. Indeed, as the consultation rightly points out: *"a well-protected and healthy population and environment leads to higher productivity and growth, and there is no tension between duties."* Rather, in our view, reform (and / or more appropriate interpretation) of the existing financing and customer duties should be a priority, and could achieve much of the same objectives.

Briefly, economic regulation of naturally monopolistic industries is intended (first and foremost) to protect customers from the potential harm that arises both from under-investment, and from being 'overcharged' (or provided with low quality services). The very essence of the existing financing and customer duties is, therefore, to require that regulators act in a way that best addresses those considerations. If said duties are applied appropriately, efficiently run companies should be able to:

(i) attract and retain sufficient capital to invest; and

(ii) be appropriately incentivised, such that their assets are well maintained, with high quality services delivered at an efficient cost for customers.

Yet, despite the existence of duties that should achieve the above, in practice, over the last 15 years we observe a pattern in regulated industries, that is consistently seen more broadly across UK infrastructure: under-investment; low productivity; and hence, (to some degree) outcomes that are below the desirable level. There are multiple and complex reasons for this. However, an important factor is the way in which financing duties have been increasingly interpreted and applied in a manner such that they have become a rather narrow mathematical exercise. Under the current approach, regulators largely stress test whether firms, under a hypothetical set of assumptions, are able to secure a credit rating consistent with raising debt finance. Under this approach, the answer is always likely to be 'yes', but the core purpose of financing duties has been lost.

The more fundamental question financing duties should provoke is: *"are we setting the price limits right?"* By which we mean, faced with the challenge of wishing to avoid allowing regulated companies either too much or insufficient revenues, are regulators challenging themselves equally in both directions, such that they are confident that an efficient firm is, in a more fundamental sense, financeable from a long-term perspective? If this is not the case, and if insufficient revenues are allowed, under-investment will likely follow, contributing to low productivity both within regulated sectors and more broadly, thus harming UK economic growth.

A refocus on financeability may well be a sufficient, proportionate, and effective means of delivering on growth.

With reference to the government's intention to extend the Growth Duty to Ofgem, Ofwat, and Ofcom, and the above questions regarding expectations and monitoring of regulators' actions with respect to that Growth Duty, our views are as follows:

- Taking the planned April 2024 extension of the Growth Duty as given, regulators' performance against said duty should, in part, take into account how they are interpreting and applying the existing financing duties. Most obviously, **there should be equal challenge and questioning of whether insufficient (or too high) revenues are set under price limits, when assessing financeability.**

- We are currently engaged in a programme of work to set out a 'gold standard' approach to assessing financeability, which will go to the heart of the above. Whilst we cannot pre-judge the outcome of that, issues that will likely require consideration include how financing duties might better:

  (i) guard against short-termism (when regulatory methods can struggle to distinguish between efficiencies and cuts), which can be a symptom of insufficient allowed revenues; and relatedly,

  (ii) ensure regulated industries in the UK are attractive for responsible long-term equity investors, that are able to invest their money elsewhere in the world.

- In due course, **consideration should be given as to whether financing duties themselves require further specificity,** in order to ensure the above issues are addressed (or rather, whether changes in guidance and emphasis may be sufficient).

2. Funding of major projects

Proposal

"The government strongly supports steps taken by Ofgem and Ofwat so far in considering major infrastructure projects outside of the standard price review processes. The government encourages Ofwat to take innovative approaches to project funding, where needed, and welcomes steps taken so far, such as through its Havant-Thicket reservoir approach. The government similarly encourages Ofgem to continue to take innovative approaches where appropriate."

Consultation questions

"What kind of role could regulators play to enhance the effectiveness of competition in large procurements and/or long-term design-build-operate contracts?"

We welcome the government's ambition to ensure major infrastructure projects can be delivered, as well as its support for using innovative approaches to fund these vital investments. Indeed, we have previously considered this issue for Thames Water and found there to be a case for a differential approach to funding large and complex projects.[1]

In its consultation document, the government frames the problem with funding major projects as primarily one of timescales, and specifically the short time frame of price controls. Whilst we acknowledge that this is a relevant issue, it is just one element of the problem. Rather, it is more a case of major projects having a substantively different investment risk profile, compared to the (average) projects that have been delivered under existing regulatory models. Specifically, major infrastructure projects can differ in the following dimensions:

(i) being more innovative;

(ii) spanning multiple price controls;

(iii) requiring significant capital investment;

(iv) having long construction phases, with highly uncertain timescales and costs;

(v) having higher risk profiles (both related to the long construction phases, but also within operational phases);

(vi) potentially carrying a failure risk, which may make it challenging for private investment to support them, without some form of wider support;[2] and

(vii) being associated with significant externalities that impact wider society, not just bill payers.

Major projects can be substantially different to those that have typically been funded through the standard price control processes in the past.

Thus, this calls into question whether the major investments now needed will occur at all, under existing approaches. With reference to the government's intention to consider alternative options to fund major projects, and the above question on the role of competition in procurement, our views are as follows:

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1. 'Regulatory Options for Complex Projects.' Economic Insight (2022).

2. Whereby support could mean that the contracting / delivery arrangements reduce that risk, or allocate some of the failure risk to third parties (e.g. Government); or could mean financial support in terms of said projects being partly publicly funded.

- **There is a good case for a differential regulatory approach to apply to large and complex infrastructure projects**. Without this, critical investments may not proceed; or will be sub-optimal in terms of either the mix of projects that go forward, or the time periods in which they occur. The latter is a particular concern, in the context of achieving net zero and the need to address persistently low productivity in the UK.

- Any differential approaches to funding major projects should have the following features:
  - The need for stability and simplicity, particularly in the construction phase.
  - Providing certainty over the allocation of risk across a longer period than the standard price control (at least 10 years).
  - Allow for a different risk / reward balance than in the standard price control(s).
  - Ideally allow for an approach that prices in externalities (primarily climate change).
  - Recognise that each large and complex project is unique, with its own accompanying challenges.

- **There are pros and cons associated with using competition in any alternative funding models.**
  - It is important to remember that, even where regulated incumbent companies deliver said projects, in practice they tender out most activities related to the development / construction of new assets (i.e. the benefits of said competition are already being reaped).
  - The expansion of competition, such that the actual delivery of projects is competed for at an entity level (and in some instances where incumbent entities may be *precluded* from bidding) should give pause for thought. Most obviously, the winning bidder will often be the firm that submits the least cost bid. However, least cost is not the same as value for money. The inability to determine, in advance, whether a lower priced bid is more efficient, rather than simply under-priced, is problematic. Should a third-party bidder win a contract, then fail to deliver, it is unlikely that they will be fully exposed to the consequences. Put simply, given the essential nature of the services being provided, some risk likely sits back with the incumbent and billpayers / taxpayers. Thus, there is a very real moral hazard risk associated with this path, for little obvious upside (given that, as above, competition already occurs in the supply chain with regards to construction). In addition, third-party entities may take on inefficiently high levels of debt, again knowing that they do not bear the full extent of risk priced into the contracts they have won.

  - To the extent that competition can be expanded, this is more likely to be beneficial in the design and operational phases of large and complex projects. This is because tenders in these areas can help companies identify innovative ideas, rather than merely being a vehicle to cut costs.

- **The option for sharing risk with government (on a contingent basis) is likely essential.** This is both because:

  (i) the risk may be so high that, without it, private investment would not be forthcoming in some cases; and

  (ii) because at the heart of the challenges that need to be addressed (climate change, population growth) are externalities that affect wider society, not just billpayers, both now and in the long-term.

3. Changing the appeals process in the water sector

Proposal

"The government will seek to change Ofwat's price control appeal regime from a redetermination to an energy style appeal regime and to consult on the detail of how this will be implemented."

Consultation questions

"What are the costs and benefits of moving the regime from a redetermination to an appeals standard? Do you have any evidence for this, for example from other regulated sectors or international examples of appeals regimes?"

"What risks of making this change should the government be aware of?"

We welcome the government's ambition to improve the appeals process across the regulated sectors. Whilst we agree that it is appropriate to consider whether there may be changes that could improve the approach, specifically in relation to the water industry, we have concerns that a move towards an energy style appeals-only regime is the wrong direction of travel at this time.

Our primary concern is that a migration from a redetermination approach to an appeals-only one would fail to adequately hold the regulator (Ofwat) to account for the decisions it makes. That reduction in oversight and accountability may, in turn, risk lower quality regulatory decisions in the long-run, which would be detrimental to the UK's economic growth objective. This is for the following reasons:

- **Higher threshold for revising decisions.** The evidential standard required for the CMA to effectively overrule a regulatory decision is different (and markedly higher) under an appeals regime, relative to a redetermination. Under the former, in practice the CMA tends to be limited in where it can change regulatory decisions to instances where it finds the regulator to be:

  (i) 'wrong in law'; or where

  (ii) a decision was based on an 'error of fact'.

  In contrast, under a redetermination, the CMA is able to reconsider the price control from scratch for itself. The evidential standard under appeals can be problematic, because of the inherent imprecision in the economic tools and analysis used to inform regulatory decisions. Thus, strictly finding an 'error of fact' will be a rare event, meaning that regulators will only have decisions overturned infrequently. However, even where errors are not made, it does not follow that said regulatory decisions were without fault, or could not have been improved (to the benefit of the UK economy).

- **Narrower scope fails to recognise interdependencies.** Under an appeals approach, the CMA considers specific issues brought to it by appellants, whereas (as above) under a redetermination it may consider a price control in totality. The difficulty with the narrower scope of the former is that one can only meaningfully evaluate whether a determination is consistent with regulatory duties by considering it *as a whole*. That is to say, the risk and reward balance for investors; customers; and the environment is a product of the sum of the individual parts of a price control. Thus, a narrow consideration, under appeal, of any *one* issue risks ignoring that important fact (which may result in lower quality outcomes overall). In addition, the narrower focus of appeals may, in some circumstances, encourage companies to see them as one-way bets, because they may only appeal issues under which they consider there to be a high chance of success (whereas, under a redetermination, companies are aware that the CMA may consider whichever issues it chooses, and may find against them on some).

Notwithstanding the above, we are aware that some stakeholders have raised concerns that full redeterminations can be burdensome and time-consuming. However, those concerns might be better addressed by considering whether a lighter touch approach to redeterminations could be implemented (underpinned by updated guidance). Indeed, as the CMA itself has previously stated, when making redeterminations, the authority already prioritises, based on a consideration of: *"the key elements of the price controls in light of the time and resources available."* [3] In our view, it would seem eminently feasible that some additional guidance and direction to further facilitate the prioritisation of resource would:

(a) retain the benefits of balancing interdependencies and holding the sectoral regulators to account (to ensure high quality decisions that are in the interests of the UK economy); whilst also
(b) being practical and efficient.

3. 'Summary of Final Determinations.' Competition & Markets Authority (2021).

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