



## Risk, Reward and Regulation. A Special Videoconference on Economic Regulation in the UK

At the start of 2021, The Infrastructure Forum and EPF's Regulatory Best Practice Group were examining the key issues **facing economic regulators** and the businesses affected by their decisions in **energy, water, communications and transport sectors**.

**Cathryn Ross**, Group Director of Regulation at **BT Group** and former Chief Executive of Ofwat led this work and joined a video conference on **Tuesday 26 January 2021** at which regulators, experts, advisers and market participants were able to feed in their views.

### INTRODUCTION & KEY CHALLENGES

This paper was noted to be a modest enterprise, and was not trying to undertake a state of the nation assessment of regulation.

What had been striking though, was the number of cross sectoral themes within regulation, that were worthy of being drawn together and thought about as a collective.

As a start point, the paper began by defining regulation as an attempt to align the interests of companies and investors with those of customers and wider society by means of the allocation of risk.

It then drew out some of the challenges that regulators were battling with, especially in regard to the application of some of the tried and tested regulatory tools that had helped the regulators to be highly successful over recent years.

One of the clearest challenges was that of demand uncertainty. The regulatory toolkit used in the past was based on the allocation of risk under the assumption that there would be fairly certain



demand within the sector. However, COVID-19 and the threat of climate change, had very much called this certainty into question.

When risk is allocated, it has to be remunerated and there were also questions about whether and to what extent it was reasonable to expect shareholders to bear low probability high impact risk.

A further theme drawn out in the paper centered around the link between the regulated sectors and politics. This was nothing new, as the reason the sectors were regulated was because they were politically salient. However, more recently, this salience had been increasing in line with the criticality of the sectors to meeting our biggest challenges.

Amongst all of this, there was a temptation within the political sphere to tinker with the system in order to meet these challenges. However, this brought with it costs as well as benefits.

Transparency was becoming increasingly important. Too often we were seeing a divergence between what investors thought they were bearing in terms of risk, and the level of risk that the regulator thought they should be bearing.

This was a big problem, as it meant that people had not bought the asset they thought they had with the level of protection they expected, and(or) they were not doing what the regulator assumed they should do to manage the risk that the regulator thought they were bearing.

#### QUESTION AND ANSWER SESSION

Where a regulator considered that a risk could not be managed by a company, typically they would allocate it to the customer. An example of this was general inflation risk. However, it was queried whether the time had come to lose this link with general inflation?

This idea came up every time there was a control price review. But, there was an advantage to the RPI or CPI link, as it avoided allocating the risk of general inflation to regulated companies.

Furthermore, this model was attractive to investors. It was often pension funds with inflation link liabilities that owned regulated companies, and it was having an inflation hedge through the RPI or CPI linked element of the price control that made that investment attractive. We would therefore have to think long and hard before we dismantled this.

The regulatory system had become incredibly complicated and it was agreed that the system was now suboptimal. If you could not explain the incentive properties of a price control on a few sides of paper, they would not be very effective. A streamlining of price controls would only improve their effectiveness in terms of influencing the behavior of regulated companies.

It remained important that politicians had a voice in the system. Strategic policy statements had been helpful as they provided a voice at an appropriate level in a transparent and consulted upon way, and did not cause day to day interference.

However, it was noted that these might no longer be usable, with the increasing number of political institutions and voices.

But with the increase in system wide challenges e.g. tackling climate change, we had to find a way of working together and aligning our aspirations.

Climate change was one of the most burning issues of our age and by definition it was totally systemic. It did not bare any sense to go about solving these issues in silos.

It was added that the 2005 Railways Act was described at the time as keeping ministers 'honest', but it was thought that ministers would not ever be kept 'honest' in the sense of setting a policy and sticking to it, they would always want to interfere, and strategic policy statements would not resolve this.

It was observed in the paper that three things were changing life. The decreasing certainty of demand, the politics of profit, and the increasing degree of political intervention. However, it was thought that a fourth might be added, which was the changing nature of the projects regulators had to regulate.

One participants assessment of the classic RAB model was that it worked best in a relatively steady state world, and became increasingly stretched the more that we tried to regulate the incense of very large projects relative to the existing RAB, or especially when we tried regulating new things, when an approach had to be thought up from scratch.

It was agreed that the regulatory model was sometimes stretched beyond recognition by being applied to some very new stuff. However, some of the applications of regulation to different types of projects had enabled real innovation, that had created a toolkit which could be used elsewhere, such as Thames Tideway Tunnel (TTT)

In respect of accountability, it seemed that there was a huge difference in scale between the accountability of regulated institutions, as against regulators, but the regulator could make a substantial difference to the regulatory regime.

It was thought that there was a slight David and Goliath myth in regulation, whereby the regulator was small and battling huge well-resourced corporations. In fact, regulators were actually incredibly powerful, in terms of setting the entire framework on which the industry operated.

It was extraordinary that over the last 12 months, the bar had been continually raised in terms of the understanding and awareness that we had to take action on climate change.

In this context, it was noted that it would be unacceptable if the businesses that just happened to sit within the unique group called

regulated utilities were sheltered from what everyone else was being expected to do.

Additionally, it was wondered if there was a mechanism that would allow us to come to a traditional regulatory view of how to apply the cost of reform between tax payers, customers and business itself.

This all raised a really important question about the potential for regulation to distort what was happening in different parts of the economy, by use of the regulatory toolkit to produce a more favorable to the investor allocation of risk in some sectors rather than others.

This was exemplified by Heathrow asking for a RAB adjustment due to COVID-19, because they compete with other airports that did not have the benefit of regulated charges, and this had to be a consideration for the CAA.

Regulators had to consider these things, both in terms of competition in and around the sectors that they regulated, but also how this would affect competition for globally mobile capital.

It was worrying that it was so often in the interest of companies, regulators and government to say that everything was fine at the expense of the consumer. Falling out of this, the accountability of regulators was something that was also worried about. It was therefore thought that cautiously allowing politicians to make strategic policy directions looked attractive.

This point was taken, as it would simply just make transparent the conversations that we all knew happened from time to time anyway.

However, the main worry here was that one of the benefits of regulation was its ability to take a genuinely long-term view. The more political intervention points that were created, the more this would undermine the value of regulation as the creation of a long-term framework, and if we were not careful, we would end up with an increase in the cost of capital and a pure inefficiency from political interference.

For a long time, everyone had been operating from the presumption that revenue streams would be sustainable, but this had been completely disrupted. It was therefore queried whether when we gave regulators new duties for challenges like net zero, were we also inadvertently presuming that they would have to ensure the sustainability of future revenue streams?

This was a big question. It was not thought that regulators should have a duty to preserve the future revenue streams that underwrite the cost recovery of regulated assets. However, there was a huge question regarding the treatment of revenues generated beyond regulated products and services but which benefited from regulated products and services and regulated assets.

For example, one question that this threw up was if a utility company benefitted from income streams on the basis of the data that they collect from customers usage of a regulated product or service, then how should this benefit be treated.

It was suggested that it might be time to review the principles of economic regulation, as times had moved on and we were facing a completely new set of challenges.

It was not thought that there was much of a need to update the actual principles in any review. One of the best reasons for reviewing these principles was just to get them back to center field.

Within the National Infrastructure Strategy, the piece on the National Infrastructure Bank was very important. It was striking that the NIB was pitched as providing co-investment alongside the private sector, but, if it was to add value, it could not simply displace private investment, it would have to do something new or something that the private sector would not do.

It was added that it would be good to analyse how the NIB would interface with other institutions, including the NIC, the Office for Investment, and the regulators themselves.

These discussions had been extremely rich and promising and the responses to Cathryn's work had been most encouraging. The paper would hopefully appear over the coming weeks and it was hoped that all participants would find the final document an interesting and informative read.