Sustainability *first*

Monopoly utility regulation and Government policy March 29 2023

Two years ago, in 2021, Sustainability First published our important report on policy and regulation of utilities[1]. In addition to some detailed analysis, it contained a number of explicit recommendations for policy makers and regulators. This was couched in terms of the debate about how to create utility companies with a stronger public purpose – although the analysis and recommendations had wider relevance.

The report had concrete impact, for example on the long-term approach in water regulation. Since the report we have also seen a good Government strategic policy statement in water, where we had a number of discussions with the Defra team, and (something we have been lobbying for and assisting the regulator on) a good new approach to the long term from Ofwat. And on the energy side we have witnessed a welcome new degree of within price review flexibility ('reopeners') from Ofgem and development of, and delegation to, an energy system operator.

But these welcome developments have been rather overshadowed by an exacerbated deficit in trust between companies (and to a lesser extent regulators) and the public. In water this has been driven in part by concerns around sewerage discharges, and the ensuing risk aversion in the environmental regulator has ensured the continuation of process, rather than outcome, driven approach to the water environment[2]. On the energy side, it has been reflected by a cost-of-living crisis that has focused in large part on energy costs, and significant criticism of Ofgem for being behind the curve including over specific issues such as prepayment meters[3].

With the Government's review of economic regulation underway, and with people starting to think about the next price reviews for water (PR29) and energy (RIIO3) the time seems ripe to take another look at our findings.

Our research concluded that policy makers need to give clearer signals to regulators and companies, in particular **on social and environmental issues**. While some progress has been made (e.g. the strategic policy statement from Defra), we feel this remains the case. So we continue to argue for a strategic policy statement in energy. But in many cases, as our work with Slaughter and May[4] showed, there is ample band width for regulators to change their approaches without extensive legislative changes: what is needed is the political cover/push to do so.

We continue however to support our 2021 recommendation that all three economic regulators should have new primary duties on net zero and climate resilience, in part to demonstrate cross party commitment to these issues.

[1] 25426 SF purpose for policy v8.cdr (sustainabilityfirst.org.uk)

[2] Elsewhere economic regulators have taken on board some of the case for outcome-based regulations, though improved outcome delivery incentives, but havent really touched the core regulatory model.

[3] While we are against machinery of Government changes, there is a question as to whether retail regulation has over the last 18 months been too much of a distraction within Ofgem from the core job of economic regulation of the energy networks.

[4] How far do current legal and regulatory frameworks in public utilities deliver for sustainability – and is further legislation required? (sustainabilityfirst.org.uk)

As we noted in 2021, the utility sectors and its regulation face major and interdependent challenges: net zero, climate adaptation, biodiversity, the fourth industrial revolution, and poverty (particularly relevant for energy). We said then and still strongly believe that these issues require a more multidimensional and intergenerational response than we have hitherto seen, with regulators enabling delivery of systems changes (as opposed to simply approving individual projects).

Furthermore, the new pressures on utility bills from inflation (particularly in the supply chain), increasing cost of borrowing along with the challenges mentioned above mean we now simply cannot afford an approach which fails to optimise decision making across time and to reap the efficiencies from greater outcome rather than process regulation. As set out below, an important role for Government is creating the climate for regulators to make these switches, without fearing the consequences if they take a balanced as opposed to risk averse approach.

Short termism

We noted in 2021 that these challenges and changes will not be tackled by the short-termism that frequently characterises decision making on all sides (regulators, government, customer and many companies!), nor by slavish adherence to backward looking models of 'comparative competition'. We now seriously question whether 5-year price reviews – an approach created over 30 years ago in a much less fast moving and challenging environment - alone can provide the answer. And we urge Government to consistently emphasise the need for long term decision making – which we saw and welcomed in the Defra strategic policy statement.

The challenges utilities face also require a different approach from the adversarial positioning that can dominate relationships and lead to a series of one-shot / zero-sum games.

To navigate through these fast-moving waters, and to move away from the current adversarial relationships, we are glad that Government is reviewing its approach.

A new Government approach also needs to ensure that their asks of and incentives to different regulators (including for example the Environment Agency and the HSE) are more strategically joined up. For example, Government should clarify roles and expectations so that there is collaboration to co-produce and then deliver a single agreed central/core net zero pathway and climate adaptation plan (supported by a range of common scenarios). It also means mandating more working between regulators – this could be through strengthened existing mechanisms such as the UK regulators network, but these would need a strong steer that Government expects co-operation as standard.

Where Government may not be central to the agenda (e.g. on issues other than net zero, fairness, adaptation and biodiversity), we urged policy makers in 2021 to step back and give the space for the major change which we argue is needed – and we continue to believe this is needed, though noting that the trust deficit, mentioned above, makes it harder to do. We also would urge Government to give a clear message that transparency and de-bureaucratisation are desirable outcomes: the accretion of complexity in economic regulator 'methodology statements' is in many cases in our view a rather lazy alternative to really thinking through the issues and places a barrier between regulation and those it seeks to serve. Transparency is also, in our view, an essential part of regaining public trust.

There are of course significant differences between utilities. The impact and pace of technological disruption in telecoms, for example, is far greater than for water; and net zero is an existential threat for gas while a demand increasing opportunity for electricity transmission. Within energy the issues, and indeed the long-term dimension, varies markedly between transmission and distribution and between electricity and gas – something Ofgem's early thinking on the successor to RIIO seems to underplay. More widely, telecoms is somewhat of an outlier: recommendations such as extending the proposed net zero statutory duty to Ofcom, and around culture and appointments to regulator boards[5] are relevant, but other recommendations may need a more critical examination from the standpoint of the sector.

The rationale for economic regulation arises from the existence of monopoly: something which is absent from most telecoms and retail energy. And it is important to remember that policy on water is devolved to the Scottish and in part to the Welsh Governments (and both countries have moved I some regards further than the UK Government towards better regulatory approaches) while energy and communications are mainly not devolved.

Despite these differences, all sectors face major long-term challenges – be they net zero, preparing for increased drought frequency and severity, or 5G and full fibre rollout.

Radical redesign

For regulation itself, in the wake of the net zero commitment, Covid-19 and the need for climate resilience, and with the knowledge of how PR19 and RIIO-2 have worked – along with technological developments, notably with regard to artificial intelligence, digital and green tech – what we thought in 2021 still holds true. More radical thinking and change is required – but without throwing away the elements that are shown to have worked and which have a modicum of public trust. Thirty years since the design of the current regulatory system, a fairly fundamental rethink is necessary – though we would stress that any change is not a panacea, and needs to have a very clear justification with concrete and evaluable benefits.

If the existing regulatory model is to be maintained, and in the absence of major institutional change, which we would not on balance advocate, we believe that it needs a significant overhaul in how it is applied. Our research concluded that comparative competition in monopoly activities, and the emphasis on customers rather than citizens and communities, has led to a focus on what can be measured and monetised, and backward looking and black box regulation.

This approach fails to factor in the crucial role of community and citizen engagement, and the need for a major culture shift in this regard in both regulators and companies. The monetised approach can encompass some elements of the wider social, environmental and economic outcomes that are needed for sustainable growth but it can also undermine certain goals – particularly in the social sphere. This, and wider comparative competition, need to be tempered with a move to more genuine co-invention with civil society.

Econometric models – particularly when backward looking – and detailed, prescriptive outcome/process measures have exacerbated short-termism and dampened innovation. They have also not properly assimilated outcome-based regulation - the Environment Act target on point source phosphorous reduction for waste water companies was a big step in the wrong direction here.

(While much of this is for individual regulators to implement, the Government needs in our view to be clear about what success looks like, and appoint people to regulatory boards who can think outside the box.)

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[5] We would stress as we did in 2021 that the appointments to regulator boards are a very powerful lever which is exercised by Government. Few if any economic regulator NEDs have environmental credentials for example.

Consistency

The regulatory process desperately needs a more consistent voice for the long term and regulatory processes need to be overhauled to take account of long-term issues. Intergenerational issues and pathways to net zero and adaptation cannot be conducted solely through 5- year price reviews - though again Ofwat (and the ESO/FSO) have made some welcome changes - the incentives to put difficult decisions off have time and again been shown to be simply too great. We need a fundamentally new process of 'adaptive planning', building on Ofwat's approach, but more hard-wired into the core price review, and a recognition that 'one size doesn't fit all'.

Our research showed that even in 2021 regulators had become risk averse and issues deemed softer such as engagement, governance, culture and non-competitive approaches including partnerships and collaborations, have been neglected. This is even more the case now, with Ofgem very much in the firing line, and Ofwat taking some collateral damage from the furore over sewer discharges. As stressed above, Government, with the National Audit Office, need to create space for the regulators to take some well-judged risks.

And just as we have argued that Government should back off where there is little to add, so too regulators should take those parts of company business plans which are high on sustainability content and relatively low on bill impacts out of the price review process: most specifically that part of the process which is based around comparative competition and econometrics.

Trust

In our view, change is also even more urgently needed to create what Chief Ombudsman Matt Vickers termed 'an infrastructure of trust' – between regulators and companies and between customers/ citizens and companies. The reputation of companies and regulators has taken a major dip with for example the focus on sewer discharges and bad practice on prepayment meters. That in turn has led companies and regulators to turn in on themselves, and become more risk averse, at precisely the time when then need to show humility, listening and joint working.

The energy price and cost of living crises have also highlighted that Government needs to urgently clarify how it sees the balance going forwards between the welfare system and utility company support for people in fuel and water poverty and who cannot afford to access broadband, now and in the future. The debate of who pays – bill-payers or tax-payers – cannot be ducked any longer: and we welcome apparent signals of a move from support through bills to support through general taxation. We do not think the current approach is sufficient even for the short-term impact of inflation, let alone for the fundamental impacts of climate change and net zero.

More widely, policy and regulation in utilities still needs to move from a focus primarily on consumer interests to also include citizen interests – if anything, bill increases have led to a backward move here with narrow customer interests dominating even more. All parties also need a significant reappraisal of the role of place, local democracy and communities in utilities, particularly where these are place-based anchor institutions in a local area. Where done properly, community-facing approaches such as deliberative fora, local negotiated agreements and specific decisions made by groups such as Community Interest Companies are all better and more legitimate solutions for these kinds of problem. For Government this means a stronger role for The Department for Levelling Up, Housing and Communities (DLUHC) in discussions about economic regulation.

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