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Regulation and public interest outcomes in energy and water: moving beyond compliance and towards a '*Sustainable Licence to Operate'* for a disrupted world

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The Fourth Industrial Revolution. Climate change that may exceed 1.5° warming unless 'rapid and far-reaching measures are taken.' What Michael Gove has called 'the unfrozen moment' in politics.

This evening I'll be exploring what all this means for the UK energy and water sectors and the short-term and long-term challenges that this poses for regulators and service providers.

I will then discuss what can be done about it. I'll talk about the need to re-focus on the desirable public interest outcomes that need to be delivered in the energy and water sectors.

I'll end by exploring how to shift the dial from a compliance culture to one where energy and water providers seize the initiative and start to develop a '*Sustainable* Licence to Operate' for their services.

In doing so, I'll be drawing on the work that Sustainability First has done through its New Energy and Water Public Interest Network, 'New-Pin.' This Network was set up three years ago to help build a stronger voice for long-term public interest outcomes in the sectors and to help navigate some of the difficult tensions that can exist between short and long-term interests.

The Network brought together energy and water companies, regulators, government representatives, academics and crucially a wide range of public interest groups: consumer; environmental; citizen. In many ways it was a three-year experiment in what the market research community like to call 'deliberative engagement.'

A set of 11 carefully curated discussion papers on the 'hard' public interest issues in energy and water (including affordability, resilience and trust) and the different approaches for delivering these are on our website. They're summarised in our final project report*, Looking to the long-term: hearing the public interest voice in energy and wate*r.

The New-Pin research was based on extensive bilateral interviews with key senior stakeholders and day long workshops where we systematically addressed the issues with network members. Crucially, it also included 25 Chatham House interviews with Chairs, Non-Execs, CEOs and directors in energy and water companies and regulators on corporate governance and how boards can meet the needs of customers, future consumers and wider stakeholders – including the environment.

I will also touch on Sustainability First's new Fair Futures project. This new major project is exploring how to better address the politics of fairness and the environment in the energy and water sectors and is developing the concept of a 'Sustainable License to Operate' for energy and water companies.

But first a quick word about a small but nimble player - and a giant.

The small but nimble player is Sustainability First. For those of you that don't know us, we are a very small charitable think tank with a specific interest in the energy, water and waste sectors. We have a deep expertise in consumer and regulatory policy and the demand side.

The giant is the author Charles Dickens. I wanted to bring Dickens into this evening's discussion to set the scene for what I'm about to say about disruption – and inequality (what we now politely call 'fairness') – when it comes to the most basic of essential services; water and energy. And I wanted to do this by quoting from his novel A Tale of Two Cities.

For those of you that haven't read this masterpiece, it's about the French Revolution.

A common sight around the guillotine in the revolution was women knitting. Knitting is one of the images that appears throughout the book. It is used as a symbol of how the problems, grievances and frustration of those who are 'left out' can quietly grow to a point when they cannot be contained.

I'm not saying that the UK is about to face a political revolution, but I do think this novel demonstrates the importance of trying to understand the roots and deep-seated origins of social problems. How these are multi-faceted and can build up over a long period of time. And the consequences of not being curious enough, brave or determined to address these in a timely way.

The passage I would like to quote from, features Madame Defarge, who went on to become one of the bloodiest leaders of the revolutionaries. She is being visited in her wine shop by a spy. As always, she is knitting. Knitting the names of those she will subsequently send to the guillotine into what she is making.

Not knowing this, the spy innocently comments

"You knit with great skill, Madame."

"I am accustomed to it."

"A pretty pattern too!"

"You think so?" Said Madame looking at him with a smile.

The spy then goes on to ask:

"Business seems bad?"

"Business is very bad. The people are so poor."

"Ah! the unfortunate miserable people! So oppressed too as you say"

"As you say" Mme retorted correcting him and deftly knitting an extra something into his name that boded him no good.

"Pardon me - certainly it was I who said so. But you naturally think so. Of course."

"I think?" Returned Madame in a high voice. "I and my husband have enough to do to keep this wine shop open without thinking. All we think here is how to live. That is the subject we think of and it gives us, from morning to night, enough to think about without embarrassing our heads concerning others. I think for others? No, no."

The spy was curious and wanted information. But was clearly not setting about his questioning in the right way. Nor did he attempt a sufficient relationship to understand or unravel the story that was being written into the knitting. On the streets of Paris, the early seeds of discontent were in plain sight for those able to recognise or see them.

Context, and two way relationships, are always important – particularly when you are thinking about fundamental issues such as fairness. Focusing purely on one-off transactions will not help you navigate times of seismic social and political change.

A disrupted world

So let's go back to the twenty first century and the energy and water sectors. What are the disruptions that they face? Some are already in plain sight.

The first is **technological change**.

Digitisation is causing disruption across the economy. There are clearly many benefits to this. In energy and water, it is enabling increasing targeting and personalisation. With more data companies can now tailor services to meet individual needs. Multiple experiments can more easily be run to trial and develop new approaches that better fit user requirements and are in tune with user behaviours.

Communities can use new tech to help them develop services that meet local needs and, with distributed energy, are bottom up and in their 'control' rather than top down and one size fits all. And new tech such as hydrogen in energy and fertigation in water can open up cross vector / whole system solutions that may deliver wider benefits.

All good. However, tech can also clearly have potential down sides. Digitisation can also lead to increasing cost reflectivity and the unwinding of cross subsidies that may have previously protected certain social groups. At the same time, many of the people in these groups may be seeing their livelihoods challenged by insecure and temporary jobs, zero hour contracts and increasingly by automation, robotics and AI.

Digitisation also enables differential pricing. This may adversely impact those who are unable or unwilling to shop around. Increasing tariff complexity may result and it can be difficult to assess the assumptions and basis on which the AI that drives some of these prices and offerings works. This may have limited impact if it was only one sector. However if it is experienced across essential services, it may have a cumulative negative affect.

New technologies are enabling challenger businesses to more easily enter the market. This can be great for innovation, choice and diversification. But these new businesses may not be subject to the same social and environmental obligations as existing players. For incumbents and for investors, existing assets may become stranded. And without open systems and inter-operability, different actors may not be able to fulfil their potential.

Whilst early adopters and those with the resources to buy 'enabling' kit, EVs etc may be able to benefit – those without broadband access and skills, on low incomes, in some rural areas and many living in the private rented sector may not so easily be able to take advantage of the smart world. Sticky customers may end up picking up the tab for others.

The second disruptor that I want to touch on is climate change. Its global impacts are not always as obvious but in our complex and inter-connected world are already being – albeit often indirectly - felt. Yes, the green economy can lead to new exciting jobs and some small-scale enterprise. However, the costs of adaptation and mitigation are likely to increase affordability pressures, and in some areas more than others. As demand-side measures become more prevalent, and peak / seasonal tariffs are developed, once again, those without access to smart tech may be left behind.

As we experience more extreme and unpredictable weather, shocks to the system are likely to have the greatest impact on people in vulnerable situations that don't have a financial cushion to fall back on. The 'Beast from the East' freeze/thaw impacts point the way.

Lastly, **society** itself is also going through significant **disruption** and is becoming increasingly fragmented and polarised. There is now a wide spread perception that we don't all 'play by the same rules' and that the institutions that are meant to protect and serve the people are remote, rigid, sclerotic and no longer fit for purpose. That the root causes of the 2008 Financial crisis and the EU referendum have not been sufficiently addressed.

Michael Gove himself has said that economic power has been concentrated in the hands of a few. As a result, there is increasing dissatisfaction with the political and economic 'system' and the establishment which is seen as ineffective in the face of events and corporate collapses such as the VW emissions scandal, BHS, the Panama Papers, Carillion and Grenfell. Across the economy there is a crisis of legitimacy and accountability. As we have seen, even charities (such as Oxfam) and the NHS (think Gosport hospital) are not immune.

In this febrile environment, social media is giving rise to new voices: the young, the previously unheard and those willing to take an extreme view. Shock-jockery attracts and retains audiences and sells. These new platforms and assertiveness are morphing and

evolving at the same time the energy and water sectors need to re-think communication if they are to really flex demand-side muscles in order to manage future costs.

Regulation in the eye of the storm

Taken together, these three disruptors – tech, climate and societal change - are in plain sight, blurring the boundaries between sectors on public interest duties, outcomes and freedoms and challenging institutional remits and governance.

The old divisions between consumers and citizens and what is economics and what is politics – and therefore the future role of utility regulation - are being blown apart. The neat lines that pleased the often tidy and technocratic minds of accountants, economists and engineers are melting away.

Sector specific independent economic regulation sits right in the eye of this storm. The status quo is no longer an option. In our turbulent and shifting society, five fundamental questions are now being asked of the future of regulation:

1. What does efficiency look like - *when*:

    a) the boundaries and way of framing the problem / market / sector are changing; and

    b) more social, integrated and circular business models are increasingly needed?

2. How important is optimal efficiency in *essential services* compared to a focus on relative benefits and distributional impacts?

3. What weight should be given to wider factors? Crucially, social and environmental.

4. How should risks and costs best be pooled in terms of who pays for what, when and how – national taxpayer, bill payer, specific communities or peer to peer?

5. Given the speed and pace of change, how to best use data – real time or historic - to solve emerging problems – and not stay focused on tackling yesterday's issues?

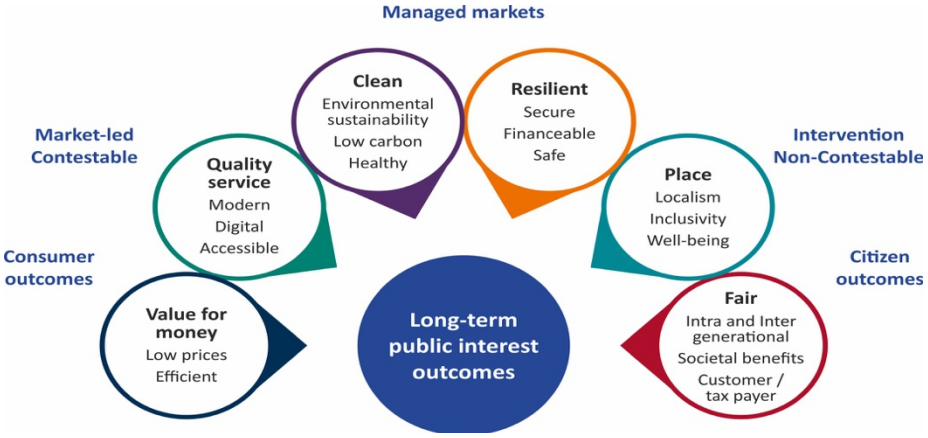
And for each of these questions: what in this new world should be the respective roles of government / the state, the devolved governments, local government, regulators, companies and consumers / citizens?

This is all clearly complex and highly political. But if we therefore brush it aside and put it in the 'too difficult' box, we run the risk of foreclosing future options and reducing the time and space for considered debate. If key actors don't speak up and explain their thinking and what they plan to do outside of the regulatory 'bubble', calls for more extreme solutions are likely to grow. Going back to Dickens, the knitting will continue to grow….

Public interest outcomes

In order to work through these difficult areas, it is vital to focus first and foremost on the outcomes that the services in question – energy and water – need to deliver. This can help provide a considered reference point and goal when times get choppy. And it can cut through technical processes that can sometimes get in the way and be seen as ends in themselves.

At this point, I want to go back to our New Energy and Water Public Interest Network, New-Pin, research. A large part of this entailed the various stakeholders *together* agreeing what the desirable long-term public interest outcomes were in the energy and water sectors and how these may be best delivered. These outcomes are illustrated in our 'public interest dashboard:'



None of this was rocket science or indeed a surprise but *together* identifying the full range of outcomes that were desirable when a longer-term perspective was taken is actually quite helpful in thinking through who should do what at this pivotal moment. And, important, where and how the role of market-led approaches - or policy and regulatory interventions - might sit in delivery of these outcomes. The process helped to flush out the full range of outcomes needed and move away from a focus purely on short term consumer prices and affordability.

'Hard' approaches for delivering public interest outcomes: markets and government and regulatory interventions

As can be seen from this diagram, New-Pin found that the citizen outcomes on the right hand side – fairness, place based well-being and long-term resilience – are unlikely to be delivered through contestable market led approaches and are likely to need interventions to address inter and intra generational distributional impacts. And there are a couple of outcomes in the middle – wider resilience and clean / low carbon outcomes (including for nature and the environment) – where a managed or mixed market approach is needed.

Our New-Pin research found that even accepting this broad categorisation, the situation still wasn't black and white, either / or. Market-led approaches in the widest possible sense (so competition *for* the market and for contestable *solutions* rather than just competition *in* the market) can potentially help deliver all outcomes – but these approaches need the right frameworks.

Incentives / funding also need to be aligned with the full range of outcomes. For example, future capital investment will take many forms – mass roll-out of small-kit, big-kit, short-run 'local' mitigations, new regional, national or 'green' infrastructure for the long-run.

Market-led approaches to deliver public interest outcomes need to reflect time-horizons which are sufficiently long-term and consistent to accommodate all these many different types of investment need. Not either or. And not necessarily always short-term, least-cost. Another example, innovation funds in RIIO need to explicitly include funding for work on customers with additional needs – something which is currently not the case.

Similarly, New-Pin found that government / regulatory interventions need long-run consistency – but on their own are unlikely to be effective unless they also have an element of inbuilt dynamism and flexibility – particularly at times of great uncertainty and change.

Understanding and acknowledging this more nuanced picture is important as it gives a signal to all parties as to what is important to measure. For example, hitherto, undue attention has been devoted to measuring switching rates in energy retail markets at the expense of keeping an eye on a wider basket of metrics to give a fuller and more coherent picture of what public interest outcomes were actually being delivered.

Even if a wider range of metrics are developed, however, these may still not ensure that the public are getting the outcomes desired. They may themselves become rigid and ossified. Or, as has sometimes been the case, lead to a culture of compliance that doesn't ask the question '*Why are we doing this*?' even if the face of unintended consequences and changing realities. And on their own, a set of metrics are unlikely to be able to address the real tensions that can sometimes exist between the different public interest outcomes and indeed between different 'publics'.

'Soft' approaches for delivering public interest outcomes: engagement and corporate governance

To address these points, the New-Pin network found that other approaches were also needed to supplement market led approaches and government and regulatory interventions: a commitment to better approaches to engagement and corporate governance.

Over the last decade much has been written about how consumer engagement can play a vital role in ensuring customer centric services. In monopolies in particular, it is clearly vital that there are mechanisms to get service providers to talk to their customers to find out about and respond to their needs. However, New-Pin found that this type of engagement –

which is often undertaken to comply with regulations – is only just scratching the surface of the role engagement can play in terms of delivering public interest outcomes.

If companies take public engagement seriously and embed it in an ongoing way within and across their businesses it can do much more. But for this to happen in a meaningful way, engaged groups need to be representative of both consumer and citizen interests, short and long-term, and to also include wider stakeholder interests including those of communities and the environment. And crucially, this engagement needs to happen early on in any decision-making process and give those engaged the opportunity and power to really help set priorities.

This type of purposeful engagement is vital to build trust and to deliver outcomes that are seen as 'fair.' After all, trust and fairness are relational concepts – they are not something that one side can opine on on their own.

Our New-Pin corporate governance research found that meaningful, structured engagement is a very different sort of activity than that which is currently carried out in many energy and water companies. Although most companies are now using engagement to drive up standards of current operational performance, too often this is limited to specific silos such as customer service departments. Engagement is rarely being used to help shape key fundamental decisions to the business, board agendas and corporate governance processes. There are some glimmers that this is starting to change but this is probably still the exception and not the rule.

Various factors are getting in the way of more radical change. Complex corporate ownership structures where key matters of strategy are reserved for the TopCo / parent company are certainly a factor. The extent to which this top level of decision makers hears the customer / future consumer / stakeholder voice from a particular geography is likely to be limited.

The TopCo may also not have any independent Non-Execs who are willing or able to provide challenge in this area. And in non-listed companies, the TopCo may well not be 'held to account' at an open AGM.

Back to Dickens, the spy and the knitting. Absent serious independent-minded and constructive challenge around the board table at the RegCo and TopCo levels, these deep-seated problems risk remaining unseen and unheard until too late.

Diversity in all its forms is crucial here - including greater *cognitive* diversity. Without a wider range of experiences, skills and backgrounds to draw on, boards can find it difficult to recognise and address knotty issues such as balancing risk and reward and ethical conduct.

This can make it difficult for them to understand what an 'acceptable' level of return for a particular activity in a particular geography actually is. Without understanding how far they are in or out of step with the wider society their company serves, boards can find it very difficult to ensure that their risk appetite is *appropriately* aligned with the long-term public interest.

Our New-Pin corporate governance research also found that building better relationships between regulatory and company boards was a challenge. Regulatory capture aside, in the absence of more constructive relationships that enable both sides to discuss common problems, there is a risk that companies fall back on a compliance approach and do not 'reclaim' strategy.

The nationalisation debate is of course catalysing energy and water companies to think more deeply about these issues.

In parallel, and in part prompted by Ofwat's *Back in Balance* work, many water companies are now starting to respond on re-balancing and '*Putting customers at the heart'*. However, change is also coming from other quarters with work on section 172 of the Companies Act and revised Corporate Governance and Stewardship Codes expected from the Financial Reporting Council this summer.

Demonstrating corporate leadership

Getting on the front foot about this rather than just reacting to the regulatory and policy decisions that emerge will be important for companies that want to deliver on public interest outcomes and be recognised for this – and at the same time evolve to embrace the disruptors of data, climate and inequality. Anticipating change is vital for those that want to show sector leadership on all of these things. This is particularly the case in the current environment where Brexit is severely limiting government bandwidth.

Given that the full impact of the disruptions outlined at the beginning of this talk has still to be felt, anticipating the profound nature of this change is vital. It has implications for corporate survival and for those service providers who wish to evolve to take advantage of the new opportunities which will arise.

Being proactive can also put companies in a better place to collaborate and partner with others – whether this is consumers, citizens, their own employees and pensioners, wider stakeholders, the supply chain, neighbouring energy and water companies, regulators or government (local / national) – to ensure the full range of public interest outcomes are delivered. Again, going back to the what I said earlier in the evening, this is about consistently '*Reading what is in the knitting'* to help influence its future shape.

Sustainability First's Fair Futures project is aiming to do just this. This project will be working with energy and water companies to help develop the concept of a 'Sustainable Licence to Operate' for the sectors. This will seek to help companies go 'above and beyond' compliance and basic CSR to really address deep within their business the politics of fairness and the environment that currently buffet them from all sides.

We plan to put out a straw-man 'Sustainable Licence to Operate' this autumn which at this initial stage will provide a 'methodology' for developing the concept. Over the next two years we will then road-test this with key stakeholder groups and against good practice from other sectors and energy and water providers in other jurisdictions.

The 'Sustainable Licence to Operate' will focus on four key 'pillars':

1. **Public service values** and how these may be embedded in company culture and reflected in statements of company philosophy and purpose. This will have implications for investors, ownership structures and company ethos and culture.

2. **Collaboration and competition.** How to make best use of assets - including physical, people, natural and data – to serve the public interest. We'll explore how this may be reflected in business models and partnerships and what the implications are for competition policy and regulatory structures.

3. **Roles and responsibilities**. We'll be asking what this means in terms of expectations around what is fair, how to work with stakeholders in this area and how this could be captured in a compact / statement of fairness.

4. **Strategic narratives** which provide a positive, coherent and honest road map of where the company and sector are going and which '*holds a mirror up'* (for example by using third party views) to demonstrate in an authentic way what consumers, citizens and wider stakeholders think of what the company does.

At the same time, we'll be looking at how the sectors can better address regulatory and political risk around fairness and the environment and to some extent at least, start to reshape company thinking around delivery of public interest outcomes. Our aim is to develop a more inclusive approach that takes account of consumer, citizen and wider stakeholder lived experience, public opinion and sentiment and the impact of media – old and new. In so doing, we want to help move away from a predominantly technocratic approach – where macro, micro and local issues are often treated in isolation- to a world where the desired outcomes better reflects the rich and dynamic interplay between the different factors and various actors that shape company risk in the water and energy sectors.

Enabling change: what does this mean for regulators and government?

For this shift to happen, both regulation and policy frameworks will also need to change. It takes two to tango and if regulation and policy stand still and don't similarly evolve, existing companies may 'dig-in' and have less of an incentive to 'step up to the plate' - and new companies and investors may be deterred from entering.

Sustainability First's Fair Futures project will be examining these issues over the coming months. Much work is going on elsewhere on the need for an overhaul of institutional governance in the sectors and for a new approach to regulation (including from Dieter Helm, Catherine Mitchell and Laura Sandys) and ownership and public purpose (including the Big Innovation Centre, the University of Greenwich and UCL). There are various views as to what future frameworks should look like.

What is clear, given the disruptions that the energy and water sectors face, is that regulatory and policy frameworks need to be flexible enough to cope with the change but also to send the right signals to both existing and new players and to investors about the overall long-term public interest goals - and consequent direction of travel.

This will necessitate getting out of the detail and focusing on the big picture. A clear view is needed as to:

1. What are common problems that span sectors (eg people in vulnerable situations being able to access services) where a more co-ordinated approach across boundaries is needed;

2. What is different between sectors (eg differences between energy and water); and

3. What is different depending on where you are in the value chain within a sector (eg differences between electricity retail, electricity networks and transmission) where a more bespoke approach may be more appropriate.

Where government policy does not provide a sufficiently clear and consistent direction of travel and time-frame, regulators need the moral courage to tell them that this is needed. If this is not forthcoming, this absence needs to be recognised in the public arena so that it doesn't fester as a problem. So that it is not 'put in the knitting' for historians to then say – why didn't they recognise and read the signs?

The extent of disruption faced by the sectors also requires an acceptance that although win wins are desirable, they aren't always possible. Sometimes difficult trade-offs need to be made, including around stranded assets and who pays for what.

In these circumstances, an ethical approach is crucial that takes into account conduct and behaviours. Principles Based Regulation should help but more thought is needed as to what this means in practice and the extent to which this is transferrable to monopoly network activities.

When these trade-offs have big price tags attached, involve systemic risks / whole system issues or deal with major future uncertainties, the importance of democratic accountability goes up. Again, this requires difficult discussions between regulators and government about the best way of addressing these things and clear and honest communication with consumers and citizens.

We still have yet to resolve the central, and post-privatisation, decades-old problem of achieving greater clarity on who should be making these decisions, and how these should be tested and who should pay for the resulting costs.

All this is complex and not new. But unless a wider, more collaborative, coherent and iterative approach can be achieved there is a real risk that in our disrupted world energy and water companies become less resilient and the demand side fails to play a strong part.

This could lead to a negative spiral where public frustration at rising costs and poor company performance leads to an increasing demand for interventions – look across to the rail sector. This further reduces flexibility, appetite for growth and innovation. In such a world, the challenge of delivering our Sustainability First desired long-term public interest outcomes is likely to rise exponentially.

Yes its difficult. But we believe 'Fair Futures' is a goal worth aiming for.

And to give Dickens the last word - let's ensure that the pattern that is being knit tells a positive tale of how cities can come together with communities across the country, consumers, citizens and companies to deliver public interest outcomes. Now that would be smart.