UK-regulated infrastructure: Current landscape and challenges

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Introduction

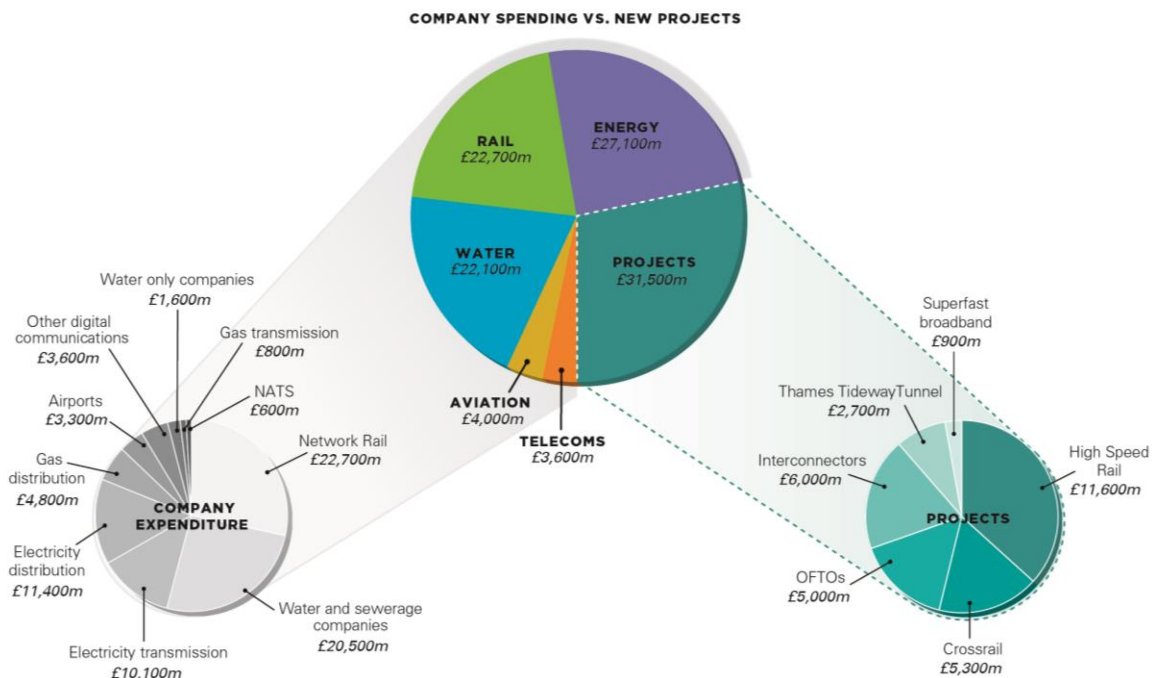
The thirty years from 1980 to 2010 represented a period of very considerable innovation in the UK's provision of infrastructure investment and the harnessing of the private sector to finance and provide essential infrastructure, which had previously been the preserve of the state. The two principal innovations were:

1. PFI – the Private Finance Initiative.
2. RAB (Regulated Asset Base) model – for financing regulated monopolies in privatised form.

The intent of this chapter is not to reprise the history of PFI or UK regulation since 1980, but to pick out a few key continued challenges lurking within the current state of UK-regulated infrastructure.

The significance of UK-regulated infrastructure can be illustrated in several ways but an important aspect relates to past and future capital investment: the RAB model has without doubt achieved a great deal in delivering hundreds of billions of capital investment since privatisation. Figure 1 illustrates the future importance of capital investment in the UK's regulated industries.

FIGURE 1: PLANNED CAPITAL EXPENDITURE IN REGULATED INFRASTRUCTURE SECTORS, 2015 TO 2020



Note: 2012/13 prices
Source: National Infrastructure Pipeline, Ofgem, KPMG analysis

It is instructive to examine these key challenges in UK-regulated infrastructure through the lens of each of its three principal stakeholders: Government; consumers and investors.

Key challenges: the Government perspective

Conflation of regulatory risk and political risk

In the minds of parties outside the UK Government and the regulatory community, one unfortunate collateral consequence of the current perceptions of heightened regulatory risk in Europe is a conflation of regulatory risk and political risk. However, it is important to recognise that much of what is being cast as regulatory risk is in fact the consequence of government or political action.

There are three recent examples of this: Gassled in Norway; the cancellation of the East-West Link in the State of Victoria, Australia and the negotiation of compensation for the contracted counterparties; and the French motorways and the refusal to allow the inflation-linked uplift to tolls and the negotiation of a 'contribution' to the French National Infrastructure Agency. Yet there is widespread perception that these projects fall under the wide umbrella of regulatory risk. Thus these assets have been cited as examples of why regulatory risk is increasing.

It would be easy, but incorrect, to dismiss the actions taken in these projects as events that could not succeed in the UK because of the rule of law, the risk of Judicial Review and so on. But the principal reason why political risk and regulatory risk have become conflated in the UK is that government and regulators have not done a particularly good job at articulating the boundaries of their respective responsibilities – it has suited both politicians (and regulators from time to time) to be imprecise about the distinction between 'policy' (for government) and 'delivery' (for regulators). It is also because the relationship between the UK Government (politicians and civil servants), regulated companies and the regulators is characterised by a surprising (given their 25+ years of shared history) lack of understanding.

Regulators are creatures of statute

The notion that politicians (advised by civil servants) decide 'policy' and regulators 'deliver' implementation of these policies is overly simplistic. Perhaps more importantly, it also encourages politicians to intervene. Political interventions appear costless, but they are not. As Professor Dieter Helm has argued,[1] regulators act independently within the law. If political leaders want to propose change – which is entirely legitimate – then such change should be made by revising the law (that is, change the role and duties of the regulators). Regulators' duties are defined by statute and regulators take them very seriously. They are periodically called to give evidence before Parliamentary Select Committees. Accountability to Parliament is a practical reality, but it does not define the practicalities of the relationship with the executive branch of government.

[1] Regulatory credibilty and the irresistible urge to meddle', 16 April 2015 at: www.dieterhelm.co.uk.

Need for much greater transparency in UK government's dealings with economic regulators

The clearest statement of the right relationship between independent regulators and Government was in the evidence of John Swift QC (the first Rail Regulator) to the House of Lords Constitution Committee in 2003: "*Independence of the regulator survives so long as and only so long as the actions of the regulator do not produce results which are at odds with what a democratic system expects. A regulator espousing the cause of independence but behaving in a manner which rattles markets, including capital markets reduces investment, raises regulatory risk and produces nothing for consumers and effectively abuses the system. One person's conduct can threaten the structure of independent regulation which thrives on causing industry to perform better than it otherwise would to the benefit of users and consumers and indeed to the State. Independence is therefore a privilege to be used with the greatest care, precisely because substantial power to control has been transferred by the State from the Executive, which, I think, remains somewhat jealous of the loss of its legacy and will look for ways of regaining it. Therefore a regulator who takes no account of Government wishes or concerns as to the future of "his" industry is acting irresponsibly.* ***Regulatory independence is not tainted by discussion or consultation with Government: rather it is enhanced through greater knowledge of the concerns of those elected to represent the public***". [2]

The Department of Business, Innovation and Skills published a document entitled '*Principles for Economic Regulation*' in April 2011. The Principles focused on Government's actions and keeping Ministers honest: "A key part is reinforcing the government's role in establishing the policy direction and articulating this, together with appropriate guidance, on a periodic basis, leaving regulators to carry out their regulatory duties independently". The Government also set down eight commitments alongside the Principles. The Principles and Commitments (see Appendix on Page 10) are hard to object to and were generally perceived as stating the obvious benefits of 'motherhood and apple pie'.

The *Principles for Economic Regulation* document has largely sunk without trace and has had no discernible impact on the subsequent action of politicians. The main reason why it has been ignored is because it does not include any requirement for transparency. As Dieter Helm argued, "tackling this incentive to manipulate outcomes is to shine a torch on what goes on". [3] Transparency does not mean therefore no contacts or discussions between regulators and government. Nor does it mean publishing every communication – emails, letters, minutes of meetings, and so on. Introducing a revised version of the *Principles for Economic Regulation* with requirements for transparency in day-to-day dealings between the Government and the UK's economic regulators would be a step forward and they would have 'teeth' if there was some form of central review or audit of departments' interactions with and requests made of their regulators, particularly looking into whether they clearly articulate the boundary between political judgements and regulatory decisions.

[2] The emphasis is that of Chris Bolt CB, the second Rail Regulator and subsequently chair of ORR from 2004 – 2009, who reiterated this statement in a paper 'The British utility regulation model: beyond competition and incentive regulation?', 31 March 2014.

[3] *Ibid* at Fn 1.

Key challenges: the consumer perspective

The current centrality of consumers' interests in UK regulation has not always been so over the past 25 years. But it is right that it should be front and centre. As Professor Stephen Littlechild stated in 1983, in the early days of UK regulation, in the context of the privatisation of British Telecom (now BT): 'Competition is indisputably the most effective means – perhaps ultimately the only means – of protecting consumers against monopoly power'.

John Penrose MP (who has just been made a Minister in the Cabinet Office in the post-2015 General Election reshuffle) made an important contribution to the debate around how consumers' interests should be promoted in his paper '*We deserve better*', published in 2013. Penrose argued for the overhaul of the bodies that represent consumers and for "the transfer of responsibility for the competitive and potentially competitive sections of each market from the economic regulators to the established Competition Authorities, which already apply the 'Big Consumer' approach successfully in the rest of the UK's economy, the OFT and the Competition Commission (now merged into the Competition and Markets Authority (CMA)".

Much is expected of the CMA and the implications of the current cases in its 'in-tray', which include the following:

- Bristol Water's challenge of the Final Determination by Ofwat.
- Centrica's challenge of the DNO (electricity Distribution Network Operator) reviews on the grounds that they were too generous and that consumers' interests have therefore been damaged.
- Ofgem's referral of the energy industry on the grounds of public confidence rather than any particular evidence of market abuse by the 'Big 6' supply companies.

These decisions by the CMA have the potential to have far-reaching consequences for the interests of consumers in UK-regulated infrastructure depending on whether the CMA takes a case-by-case approach or whether it decides to take the opportunity to set out its approach for the generality of future price control decisions by UK regulators.

Key challenges: the investor perspective

The early history of the privatisation of the UK's monopoly utilities was essentially to incentivise operating efficiency through the RPI-X formula, with a reset every five years. The idea was that managers would chase outperformance in the interests of their shareholders. Over time, however, the priority shifted to incentivising capital investment rather than operating efficiency and, by accident, the model proved effective at solving the time inconsistency problem that without regulatory involvement, network investment will tend towards the marginal cost rather than the average cost (and so act as a disincentive to capital investment).

One consequence of this is that equity investors came to appreciate the predictable accretion in the value of the 'Regulated Asset Base' (so long as the capex was incurred efficiently). The additional benefits of index-linking of the RAB gave rise to a belief that the RAB is a 'regulatory promise'. Shareholders were also the prime beneficiaries of the 'outperformance' by companies of the debt cost assumptions made by regulators, as the actual outturn costs were lower than the *ex-ante* cost assumed by regulators and with higher gearing levels that regulators assumed.

Extension of competition into regulated networks has been a mixed success

The fundamental premise underpinning independent economic regulation in the UK is that competitive markets are the best way in the long run to deliver network services to consumers and provide incentives to invest and to improve efficiency and quality for consumers.

While the extension of competition has been a success in some areas (for example, local loop unbundling in telecoms), it has not been as comprehensive and universal a solution as originally envisaged. In certain sectors natural monopolies exist that limit the prospects for effective competition, in which case independent economic regulation is necessary. Technological changes mean that these natural monopolies are not static. Perhaps this is best illustrated in the field of digital communications. Ofcom, in its forthcoming review will look at whether Openreach, the national broadband and fixed line telecoms network, should be split from BT. Open access to the natural monopoly gas and electricity high voltage transmission system of National Grid has been in place for many years, so why not in telecoms? This will be a fascinating and high profile test case of a regulator challenging whether competition can be extended further. But as Richard Price, the Chief Executive of ORR and first Chair of the UK Regulators' Network acknowledged in a speech in April 2014, the original expectation of the extension of competition in regulated sectors in the UK has not happened:

- "In water there have been challenges in extending competition – for example, in reducing the minimum inset size, and in achieving vertical separation to allow greater competition in those parts of the value chain less dependent on a monopoly network.
- In energy markets there has been dissatisfaction with the results of market liberalisation.
- In rail, the structural and financing responses to the post-Hatfield crisis have weakened incentives on the incumbent infrastructure monopolist to perform for its customers; and like the market for passenger rail services, it is prone to intervention by civil servants.
- In health – we are only starting to see the impact of a form of regulation compelling incumbent monopolists to think hard about consumer benefits first. But Monitor (the health services regulator for England) – and beyond Monitor, the competition regime – is starting to focus minds.
- Meanwhile there have been more successful, structural interventions and deregulatory moves in airports; while in communications, liberalisation and technological change have transformed the market and people's everyday experiences."

….but investors don't generally understand regulators' push to introduce 'contestability'

Regulation is not the attraction for investors per se – investors like monopolies and regulation is what comes with it. The notion of the 'regulatory promise' inherent in the RAB is widely held within the investor community but the static notion of a 'regulatory promise' RAB is at odds with attempts to

introduce competition to more areas of economic regulation. When regulators have tried to introduce 'contestability', opposition has generally been strong, which might explain why competition has not been extended into more areas such that economic regulation is obviated. It could just be that there is an obvious tension between investors liking monopolies and potential monopoly profits, and regulators trying to curb these profits.

Three examples of contestability in practice:

1. **Water.** By way of illustration, in October 2012, Ofwat announced proposals under Section 13 of the Water Industry Act to modify water companies' licences – up to 20 percent of a company's revenues could move to an alternative form of price control. The idea was that 'household retail' and 'business retail' should be "potentially contestable". Ofwat was keen to emphasise that these segments of the value chain have low capital intensity so less than 10 percent of the assets would be involved and the statutory duty to maintain financeability would continue to apply. Nonetheless, the industry and its shareholders were very strongly opposed and a compromise was reached in late January 2013.
2. **Airports.** The idea that there is a single market in aviation in the south east of England, and therefore, that Heathrow, Gatwick and Stansted should all be regulated, feels antiquated now given the fierce competition between them. Yet that viewpoint prevailed until as recently as 2007. The argument for the approach, which was changed as a result of the Competition Commission report finally published in March 2009, was that south east England's airports were in effect a network, and that cross-subsidy from Heathrow to, in particular, Stansted was therefore a good thing. Regulation was therefore necessary when they were co-owned and not competing. A lot of opposition to competition is in fact opposition to the unwinding of cross-subsidies – losers always shout louder than winners. The forced break up of BAA (British Airports Authority), which had been privatised as a monopoly and then taken private, is possibly the highest profile example of the lack of understanding surrounding the consequences of regulators' search for contestable markets, although its significance in illustrating this point has been largely lost.
3. **Electricity transmission.** Ofgem published its, little noticed, final conclusions to its ITPR (Integrated Planning & Regulation Project) on 17 March 2015. This introduces contestability to future onshore electricity transmission assets that are "new, separable and high value". So the position of National Grid as the electricity transmission operator is now open to competition. One might argue that the same publication entrenches National Grid as the System Operator, by giving them additional responsibilities. In practice, how likely is it that new entrants will succeed? The experience with offshore (as distinct from onshore) transmission – the OFTO regime – might assuage some concerns on this point and give comfort to potential new entrants. Nevertheless, the implications this policy change has for the future growth prospects of National Grid, are potentially profound.

It is this author's view that it is essential for the future of regulation in the UK to create a better understanding between investors and regulators around the dynamic of contestable markets, the risk of 'stranded' assets and what, if anything, happens to the RAB in these circumstances.

The UK Regulators Network: Objectives

The UK Regulators Network (UKRN) was formed in 2014 by the UK's economic regulators: The Civil Aviation Authority (CAA); Office of Communications (Ofcom); Office of Gas and Electricity Markets (Ofgem); Water Services Regulation Authority (Ofwat); and Office of Rail and Road (ORR) plus several others such as the Northern Ireland utility regulator, the water regulator in Scotland, the legal services board, the Financial Conduct Authority (FCA), the Payment Systems Regulator and Monitor. Membership of the UKRN cannot override or alter the statutory responsibilities of members. The UK's economic regulators have always collaborated informally and there has always been a fair amount of personal movement between regulators. There used to be something called the Joint Regulators Group too. However, the UKRN is a means of formalising this and doing things in a more joined up way.

The UKRN's objectives are as follows:

- Coherent and consistent economic regulation across sectors.
- Affordability and empowerment.
- A positive environment for efficient investment.
- Efficient regulation.
- Promotion of competition in the interests of consumers.
- Better understanding of the effectiveness of economic regulation.

The work of the UKRN mainly takes the form of a set of projects and programmes with cross-sector relevance. The priority projects are:

- Cross-sector infrastructure investment.
- Consumer engagement and switching.
- Understanding affordability across sectors.
- Cross-sector resilience.
- Exploring the benefits of economic regulation.
- Organisational development.
- Market returns and the cost of capital.
- Regulating for quality.

Creation of a single 'super regulator' is not the objective

There have been, at various stages since 1995, calls for the creation of a 'super-regulator'. John Penrose's paper calls for the government to consider exactly this. The last time it was seriously considered, government departments rejected it for fear of it becoming too powerful for politicians! Perhaps more importantly, each of the current regulators combines economic regulation with other duties in their sector such as safety (ORR & CAA), environmental issues (Ofgem and Ofwat), and public service broadcasting (Ofcom), and so they are able to take cross-sectoral views, which would be compromised in a 'super-regulator'. Short of a super merger, however, at its simplest, each regulator having a better understanding of the approaches taken in other sectors to similar issues can offer lessons: new ideas or experience of what has worked well or not, as the case may be. Consistency of approach should and can provide benefits of its own. The idiosyncratic issues specific to a single sector are best dealt with by that sector regulator rather than a 'super-regulator'.

Conclusion

Engagement can make a real difference. The recent past Chair and the current Chair of the UKRN have both made commitments to deliver on this work programme: the UKRN must show real changes in regulatory practice and real benefits to consumers. The success of the UKRN in meeting the challenges outlined in this chapter should be judged in the context of the outputs of this work programme. The cost of capital work is likely to be of most interest to investors in the sector and there is cause for optimism about what can be achieved. However, engagement needs to be two-way and not just around price reviews. Investors in the UK's regulated companies have hitherto tended to conduct their discussions with the regulators through their investee companies. The UKRN's work should now provide the basis for a more direct engagement in those areas that are of common interest to UK regulators and the investors – in private and public markets – in UK-regulated infrastructure.

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Disclaimer: This chapter is written in a personal capacity and the views expressed by the author are his own.

APPENDIX: PRINCIPLES AND COMMITMENTS FOR ECONOMIC REGULATION

Department for Business, Innovation & Skills, April 2011

The Principles

1. Accountability

- Independent regulation needs to take place within a framework of duties and policies set by a democratically accountable Parliament and Government.
- Roles and responsibilities between Government and economic regulators should be allocated in such a way as to ensure that regulatory decisions are taken by the body that has the legitimacy, expertise and capability to arbitrate between the required trade-offs.
- Decision-making powers of regulators should be, within the constraints imposed by the need to preserve commercial confidentiality, exercised transparently and subject to appropriate scrutiny and challenge.

2. Focus

- The role of economic regulators should be concentrated on protecting the interests of end users of infrastructure services by ensuring the operation of well-functioning and contestable markets where appropriate or by designing a system of incentives and penalties that replicates as far as possible the outcomes of competitive markets.
- Economic regulators should have clearly defined, articulated and prioritised statutory responsibilities focused on outcomes rather than specified inputs or tools.
- Economic regulators should have adequate discretion to choose the tools that best achieve these outcomes.

3. Predictability

- The framework for economic regulation should provide a stable and objective environment enabling all those affected to anticipate the context for future decisions and to make long-term investment decisions with confidence
- The framework of economic regulation should not unreasonably unravel past decisions, and should allow efficient and necessary investments to receive a reasonable return, subject to the normal risks inherent in markets.

4. Coherence

- Regulatory frameworks should form a logical part of the Government's broader policy context, consistent with established priorities.
- Regulatory frameworks should enable cross-sector delivery of policy goals where appropriate.

5. Adaptability

- The framework of economic regulation needs capacity to evolve to respond to changing circumstances and to continue to be relevant and effective over time.

6. Efficiency

- Policy interventions must be proportionate and cost-effective while decision making should be timely and robust.

The Commitments

Commitment 1
The Government commits to ensure that responsibilities are clearly divided between Government and regulator on the basis that high-level decisions that involve political judgement are taken by Government and day-to-day regulatory decisions are undertaken by regulators.

Commitment 2
The Government will preserve the independence of economic regulators. It will ensure that:

- Regulators are legally distinct and functionally independent from any other public or private entity when carrying out their functions.
- Regulators' staff and management act independently from any market interest and do not
- seek or take direct instructions from any government or other public or private entity when making regulatory decisions.
- Regulators can take autonomous decisions, independently from any political body, and have
- separate annual budget allocations, with autonomy in the implementation of the allocated budget, and adequate human and financial resources to carry out their duties.

The Government will continue to ensure that it does not interfere with day-to-day regulatory decision making.

The Government will ensure regulators have discretion to choose the regulatory tools to deliver their objectives.

The Government will ensure that future changes preserve the independence of regulators.

Commitment 3
The Government therefore commits to put in place, for each regulated sector, strategy and policy statements for the individual regulators to provide context and guidance about priorities and desired outcomes.

When it sets out the policy context, the Government will use that opportunity to reaffirm the fitness for purpose of the regulators' responsibilities, pursue changes where they are required to keep the system effective and clarify the respective roles and responsibilities of regulator and Government.

The Government expects to do this no more frequently than once a parliament.

The Government will avoid making piecemeal and ad hoc changes to the system for economic regulation outside of this process to provide stability.

Relevant departments will set out the details of how this process will operate, taking into account the differing needs of the sectors.

There may be circumstances or specific triggers that would necessitate Government action outside of this once-a-parliament process. This will be done only on an exceptional basis, for example implementation of European legislation, as the emphasis should be on providing predictability about the Government's approach.

The Government will have particular regard to the effect on investor confidence when assessing changes to the regulatory policy and regulatory frameworks. This will be addressed in the impact assessments of any proposed changes.

Commitment 4

The Government expects regulators to follow consultation best practice in their decision making, including the use of impact assessments and the publication of the reasoning underpinning regulatory decisions.

The Government strongly encourages regulators to disclose the methods and financial models used to inform regulatory decisions, with appropriate removal of commercially confidential information.

The Government will ensure appropriate and proportionate mechanisms exist to challenge regulatory decisions to an independent third party.

Commitment 5

The Government will ensure that regulators' objectives are clear and appropriately prioritised (including through broader guidance) to reflect the issues that the regulators should take into account in their decisions.

The Government will take opportunities to simplify and clarify regulators' objectives where appropriate as and when the frameworks are reviewed.

The Government will not seek to add objectives, responsibilities or duties to regulators' remits without detailed consideration of the impact of the addition on the overall framework, and consideration of cross-sector impacts and even then only when it is clear that the addition is the optimal way to achieve the outcome sought.

Commitment 6

The Government will apply the duties and obligations of Part IV of the RES Act to the economic regulatory functions of the CAA and Monitor in upcoming legislation.

The Government will keep the effectiveness of Part IV of the Regulatory Enforcement and Sanctions (RES) Act 2008 under review.

The Government expects regulators to adopt best practice to improving their efficiency.

The Government will investigate the possibility for an independent third party to regularly assess the efficiency of regulators.

Commitment 7

The Government strongly encourages the Joint Regulators' Group to adopt a more systematic approach to issues of cross-sector coherence and best practice.

Commitment 8

The Government will assess any proposed changes to the regulatory frameworks (either statutory changes or changes to the general policy direction set out in the strategy and policy statements) against the *Principles for Economic Regulation* and demonstrate how the changes adhere to these Principles.

The Reducing Regulation Cabinet Committee will be responsible for clearing proposed changes and policing the fulfilment of the Government's commitments for the application of the *Principles for Economic Regulation*.

The Department for Business, Innovation and Skills, within its existing cross-sector responsibilities for Economic Regulation, will have ownership of these Principles, and will scrutinise the Government's adherence to them. It will advise the Reducing Regulation Committee accordingly, and particularly on how the interests of consumers, other end users, regulated firms and investors are being promoted.