12th April 2019

Please reply to:
Sharon Darcy, Director, Sustainability First
Email: sharon.darcy@sustainabilityfirst.org.uk

Dear Sarah

Call for Evidence – National Infrastructure Commission: Future of Regulation Study

Sustainability First is a charity and think tank that works in the energy, water and waste sectors. We have significant experience of consumer and public interest issues, regulation and the demand side (see www.sustainabilityfirst.org.uk).

General comments

1. As a contribution to the National Infrastructure Commission (NIC) Future of Regulation Study, on 7th March 2019 Sustainability First published the Discussion Paper 'Circling the square: Rethinking utilities regulation for a disrupted world.' On the day of the launch, we held a joint event with Frontier Economics to explore the issues raised in the paper with key stakeholders.

2. Sustainability First's Discussion Paper concludes that utilities regulation is well overdue an overhaul, but radical change of regulatory structures may be premature. We consider that 'no' or 'low' regrets evolutionary change is urgently needed but, crucially, that this needs to be alongside the development of a high-level Vision for Regulation for the Twenty First Century and a road-map to 2030. Our paper proposes a set of criteria to assess future options for more radical change. These have a strong public-interest focus to ensure that change takes place 'with people' rather than 'being done to them'. This will be essential if future regulatory arrangements are to be accepted as 'fair', trustworthy and legitimate.

3. Our comments in this response largely focus on the energy and water sectors, where we have the greatest knowledge and expertise. For a more detailed analysis, please see our utilities regulation Discussion Paper and other Sustainability First reports referenced in this response.

Detailed comments

Future changes

Q Where has the economic regulation of water, energy or telecoms systematically failed or succeeded to: facilitate future investment needs; promote competition and innovation; and meet the needs of both current and future consumers; and what do you see as the most important improvements that could be made to the UK's system of economic regulation?

4. Sustainability First considers that economic regulation has frequently had an undue focus on price; in some areas this has led to short-termism, cumulative capital under investment, poor maintenance, and, insufficient R&D / innovation focused on the needs of consumers in vulnerable situations and future consumers. Taken together with new challenges from climate and environmental change, wider resilience and technological transformation, this calls for a **new regulatory approach.**

5. A greater **societal debate** is needed to build consensus about the **relationship between government action, regulator roles and good industry governance and practice –** particularly in terms of **who is responsible for what regarding distributional impacts**. Such a debate should help develop a fresh **social compact** as to: 1) the purpose of regulation in the Twenty First Century; and 2) how regulation can best deal with the challenges outlined above, in the process balancing the needs of current and future generations (including the needs of the environment/nature), in a 'fair' way. A social compact needs to move regulation from being a primarily negatively-framed micro-management activity focused on reducing prices and minimizing short-term detriment for the non-existent 'average' consumer to also include more positive framings around proactively maximising opportunities short, medium and long-term – for individuals, communities and the environment.

6. This change should enable regulation to develop more **iterative and agile frameworks** that encourage, enable and facilitate the delivery of a f**ull range of 'desirable' long-term public interest outcomes.** Our three-year New Energy and Water Public Interest Network ('New-Pin') deliberative engagement project identified that for the energy and water sectors these outcomes were: VFM (including efficiency); quality services (modern and digital); clean (environmentally sustainable and low carbon); resilience; place-based well-being; and fairness.[1]

Q The National Infrastructure Assessment outlined a number of changes and challenges in infrastructure to 2050. How might the scope, functions or activities of economic regulators need to adapt in light of future challenges?

7. Economic regulators need more clearly and visibly to **align their work with existing government strategies** (eg UK delivery of the UN's Sustainable Development Goals, the Industrial Strategy and the 25 Year Environment Plan – and forthcoming Environment Bill) **and the advice** of key bodies - including the Committee on Climate Change and the NIC itself. A **road-map for regulation to 2030** is needed which sets out how this can be done. This will help all sides understand how regulation can help make policy change happen and, through clearer feed-back loops, the role regulation itself can play in informing future policy development.

Q How might the increasing availability of data impact regulation in future? Can data increase the pace at which regulation responds to change, enabling innovation?

[1] See final New-Pin report: https://www.sustainabilityfirst.org.uk/images/publications/new-pin/New-Pin%20Looking%20to%20the%20long%20term%20FINAL%20report.pdf

8. Data is revolutionizing all our lives: whether as citizens; consumers; communities; or businesses. Policy makers and regulators are no exception. However, without **access to things like smart meter data** for public policy purposes, regulation runs the risk of 'flying blind' in terms of protecting consumers and dealing with environmental and social challenges.[2] Regulatory access to new sources of data can't be taken as a given. Steps need to be taken to ensure that regulators across the board are able to draw on emerging data flows and ensure that these are robust - and seen as trustworthy by all parties.

9. Regulatory **processes** also need to be adjusted to be able to benefit from the exponential increase in real time and more granular data. This is likely to hasten the move away from **rigid price controls which 'lock-in' plans over a set 5 year period**. These are often too long for keeping control of opex but too short a period for the sort of capital expenditure that's needed for climate resilience and long-term innovation. Instead, a move to more risk based, bespoke and anticipatory regulation is needed which enables greater flex in regulatory approaches so that they can adapt to new business and consumer data and socio-demographic and scientific evidence. To benefit from the insights and innovation that can arise from combining different data sources, greater collaboration between regulators is also likely to be needed (see paragraph 15).

Competition and innovation

Q How has competition impacted on investment, innovation and outcomes for consumers across energy, water and telecoms since privatisation?

10. Since privatisation, market led approaches in energy and water have helped to deliver **short-term efficiency, improvements in quality of service, clean services and short-term resilience**. However, competition has come at a cost and by its nature creates **winners and losers**. Market-led approaches also fall short when there are significant externalities, where modularisation may reduce economies of scale and scope, and, where there is a potential mismatch between asset lives and contracts.

11. Competition has therefore **struggled to deliver other more citizen-focused outcomes including long-term resilience, place-based well-being and fairness**.[3] For example, Sustainability First's Project Inspire found that innovation in services for energy customers in vulnerable situations and with additional needs was less likely to happen in the competitive retail market compared to the regulated networks.[4] These citizen-focused outcomes necessitate judgement in handling **distributional issues** and **a wider understanding of the social and environmental systems** that the energy and water sectors operate within. **Competitive pressures can lead to more fragmented approaches** which can **make systems planning, and the development of collaborations between multiple actors across systems, more challenging** (this may particularly be the case when collaborations deliver co-benefits / layer benefits).

[2] Our Public Interest Advisory Group on smart meter data is exploring this issue in more detail. See https://www.smartenergydatapiag.org.uk

[3] New-Pin op cit

[4] See https://www.sustainabilityfirst.org.uk/images/publications/inspire/Energy%20for%20All-%20Innovate%20for%20All%20(summary).pdf

12. As the low carbon transition gathers pace, it will become increasingly important to ensure that '**no one is left behind'** (particularly in the face of smart technologies and sharper more cost-reflective price signals) so that the transition is seen as 'just' and fair. Market-led approaches are value neutral and will not on their own be able to do this.

Q When has regulation been too slow to adapt to changing market circumstances and what have been the consequences for consumers and investors?

13. Regulation has a tendency to focus on addressing **yesterday's problems rather than preparing for future challenges**. To some extent, this is not surprising given how regulatory duties have traditionally been framed and the tensions that can exist between them.

14. A **reluctance to intervene in markets** and a desire to let competition 'run its course' – with the assumption that regulation should be economically 'pure' and all distributional issues be for government – has sometimes meant that regulators have permitted consumer detriment to develop before stepping in to address problems - or to flag these to policy makers. This has at times been compounded by **insufficient 'future antennae'** and a lack of curiosity (be this real or perceived) about the impacts of regulatory decisions. A **lack of willingness to learn from crises** (at least in a transparent way) has also sometimes been in evidence. These points have together contributed to an erosion of trust in the energy and water sectors - in companies, the markets themselves and regulatory processes - on the part of consumers, wider stakeholders and investors.

Regulatory consistency

Q Where could regulators work together more consistently to meet future challenges, achieve efficiencies within the regulatory system or to promote better outcomes for consumers, investors or society?

15. There is a pressing need for regulators of essential services that are key parts of the foundational economy and are vital to social, economic and environmental well-being to **proactively work together in a more consistent, collaborative and strategic way**. This is particularly important when considering cross-cutting issues such as**: vulnerability; distributional issues; resilience; and sustainability.** Detriment in these areas can be cumulative across sectors - as well as over time. Integrated responses are needed as consumers and communities do not live in regulatory silos and, as noted in the Environment Bill, environmental well-being is shaped by eco-systems that transcend boundaries – including regulatory remits and timescales. A more joined-up approach should also help send **stronger signals** to other organisations that will need to be key partners in the low carbon transition (such as sub-regional government and active communities) as to where the risks and opportunities of change may be.

16. It is perhaps worth noting that there are often no 'right' or 'wrong' approaches in many of these social and environmental areas; and regulators do recognize that they do not have a 'monopoly' of good ideas. To identify the best way forward is likely to require regulators working with others to **test, co-invent and iterate new regulatory approaches.** Making this a deliberate and open policy, rather than stopping and starting existing prescriptive

approaches as new information emerges (as has sometimes been the case in the past), may help uncover new opportunities and better outcomes.

Q What changes to the existing regulatory framework would be necessary to promote greater collaboration and regulatory consistency? Are there functions that might better be provided on a multi-utility basis without the need for wider organisational change?

17. Sustainability First considers that an overhaul of utilities regulation is urgently needed. Current regulatory arrangements were designed for an analogue age and before the full implication of climate change was known. Reform is needed to move regulation into the digital era where technological, environmental and societal disruption mean that **systems thinking** is required. Many options for radical organisational change have been put forward, including introducing negotiated settlements and systems regulation. These may in time have real merit. However, we consider that it would be premature to introduce these in advance of developing a **robust Vision for Regulation in the Twenty First Century and a road-map for utilities regulation to 2030.** This needs **to take account of the full range of long-run challenges faced** – political, economic, societal, technological, legal and environmental – not just those championed by current actors and vested interests. Addressing only one set of challenges without understanding the impacts that this may have in other areas could be detrimental to the delivery of the long-term public interest.

18. To ensure legitimacy, more radical options for change will also need to be assessed against a set of **agreed criteria.** Our Discussion Paper recommends that these be firmly 'people-centred' – and build on the government's principles for economic regulation, Greg Clark's 'Four principles' and the work of others such as Challenging Ideas. The criteria we propose include:

- public-interest outcome-focused;
- 'fair';
- transparent and accountable;
- anticipatory;
- risk-based;
- collaborative;
- agile;
- consistent; and
- enabling.

19. In due course, these will need to be tested against the environmental principles that are developed on the back of the Environment Bill.

20. In the meantime, we consider that a range of **'no' or 'low' regret steps** can be taken now to increase strategic regulatory co-operation, including:

- clearer and more transparent alignment of economic, social and environmental goals *within* regulatory decision making - and reporting on regulatory progress against a balanced scorecard/'basket' of public interest outcomes and metrics;[5]
- maintain the current basic structures of separate utility regulators - but achieve greater consistency and collaboration where appropriate via augmented *strategic* cross-regulator arrangements (possibly a collaboration duty and by giving the current UK Regulators' Network [UKRN] a greater more *strategic* and formal remit, improved resourcing and 'permanency' of leadership);
- reform of regulatory and company boards and respective governance approaches (e.g. future consumer/environmental and employee champions on boards and/or elected representatives (national / local);
- moves away from full comparative competition (something even the CMA have hinted at) towards more collaboration and co-invention;
- a clearer role for Parliament/Select Committees/All Party Groups in holding both government and regulators to account on delivery of strategic goals of utility regulation and in exploring new alternatives; and
- the adoption of more principles based/ethical approaches to regulation.

Q What is the case for or against a multi-utility regulator covering energy, digital and water?

21. Sustainability First considers that until the steps outlined in paragraphs 17-20 have been taken, it would be **premature to establish a multi-utility regulator**. A Vision for Regulation in the Twenty First Century in particular needs to address how data is dealt with in future regulatory frameworks. This has implications that go beyond the energy, water and communications sectors – and, indeed, beyond UK jurisdictional boundaries.

22. Our Discussion Paper sets out five dimensions that any future radical organizational regulatory arrangements need to take account of:

- **Sectoral structures** - Does it make sense to brigade energy, water and communications together? Might the energy and water sectors share greater commonalities with transport, or even housing, for example?
- **Functional structures** – Would it be possible to treat data or consumer issues, for example, as discrete functions to be regulated separately from other activities?
- **Geographical structures** – In the energy and water sectors, is there a case for more place-based regulation? Could this be aligned with stronger sub-regional government?
- **Independence** – If there is a move to more government or public control, what does this mean for regulation? Who has the mandate to make decisions that have significant distributional and future impacts and involve questions of judgement? What does independence really mean if government does not have the bandwidth, focus or expertise to deal with these knotty issues – or to ensure that true accountability is exercised?
- **Public voice** – If consumers, employees and / or citizens are given a more formal voice (eg through augmented consumer engagement mechanisms, future consumer representatives /

[5] See New-Pin op cit

workers / local authority leaders on boards etc), where does this leave regulators in terms of their role as 'proxy consumers'?

Policy and regulation

Q Is the traditional role of economic regulation, to mimic the outcome of a competitive market, sufficient to ensure future investment and to meet the needs of current and future consumers, and if not, how might this role need to change?

23. Sustainability First considers that in order to tackle long-term strategic social and environmental challenges, regulators need to use a wider range of tools than has been the case in the past. Economic regulators are already moving from primarily focusing on competition in the market to also including a focus of competition for the market. Considering how regulators and policy **makers co-create and enable new markets** to deal with significant social and environmental challenges is a next step.

24. Alongside this, we consider that regulators need to think how best to encourage companies, particularly those which are monopolies or where competition is imperfect, to work closely with their stakeholders to develop a **'Sustainable Licence to Operate'**. Such arrangements can help structure, formalize and 'lock-in' the purpose-led and responsible business goals and behaviours that are needed in a dynamic and disrupted world. Our Fair for the Future Project is leading work in this area. In October 2018 we published a Strawman 'Sustainable Licence to Operate.' This will clearly have implications for future regulatory actions and the shift towards more principles-based, ethical and societal-focused regulation.

Q What should be the boundary between government setting policy and strategic direction and independent regulation in these sectors? Do the existing duties and functions of regulators need to be adjusted to reflect this?

25. Sustainability First considers that greater **societal debate is needed on the respective roles and responsibilities of policy makers, regulators and companies** – particularly in terms of who is responsible for which distributional issues within and between generations.

26. We consider that there is a clear need for more explicit and consistent government guidance to regulators such as **Strategic Policy Statements** – with a non-interference pledge once this guidance is tabled. These need to give clearer guidance from government as to how different objectives should be balanced and prioritised. Thought is also needed as to how Strategic Policy Statements do not just further entrench silo-decision making - along departmental and sector lines.

Q Has there been a lack of clarity over strategic goals? What is the cause of this and what has been the impact on investment?

27. Strategic goals are not always clear. For example, it is not always obvious how social and environmental goals should be balanced (see the case study on RIIO2 in our Discussion Paper) nor how different distributional issues should be prioritised.[6]

Q Are the government's principles for economic regulation – accountability, focus, predictability, coherence, adaptability and efficiency – fit for purpose; and if not, how should they change?

28. Sustainability First considers that the above principles should be supplemented by the additional criteria set out in paragraph 18.

Q How can regulators act in the future to support public trust in the regulatory system for water, energy and telecoms?

29. To demonstrate that the regulatory system is trustworthy, regulators need to demonstrate:

- **Intent** - How does their work align with the government's Vision for Regulation in the Twenty First Century and existing government strategies and advice etc? Do regulators have an agreed vision, purpose and set of societal values for themselves? Is their purpose and intent transparent and clearly signaled to relevant internal and external stakeholders to overcome any information asymmetries?
- **Integrity** - Are regulators making decisions in a 'fair' and coherent / consistent way, thus avoiding cognitive dissonance? Do they have a transparent decision-making framework which indicates how they prioritise their work and how they balance potentially conflicting pressures?
- **Capability -** Have regulators got deep diversity in experience and skills in their executive teams and boards (including private, public and third sector experience, cognitive diversity, gender /ethnic/age diversity etc) and sufficient forward-looking antennae to spot emerging trends and challenges? Do they have the know-how and processes in place to share and embed this knowledge *across* their organisations so that all parts 'sing from the same hymn sheet'?
- **Results** – Do regulators measure and evaluate their own performance and the impact that they have on public interest outcomes? Have they created a learning culture to learn from their mistakes and those of their peers in the regulatory world and beyond? Is it clear who they are accountable to for their performance and is this accountability meaningful?

30. We would be delighted to discuss our proposals in more detail if that would be helpful.

Yours sincerely

Sharon Darcy

Director
Sustainability First

[6]See.https://www.sustainabilityfirst.org.uk/images/publications/consultations/Ofgem_HHS_Sustainability_First_response_27.03.19.pdf