



HM Treasury

Response to the Regulation Study: Strategic Investment and Public Confidence

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Introduction

The government set up the National Infrastructure Commission (NIC) in 2015, with the aim of providing impartial, expert advice on major long-term infrastructure priorities.

At Budget 2018, the Chancellor asked the NIC to undertake a study on economic regulation.¹ The aim of the study was to assess what changes might be necessary to the existing regulatory framework to facilitate future investment needs, promote greater competition and increase innovation, and meet the needs of both current and future consumers. The scope of the study was the key regulated infrastructure sectors: telecoms, energy and water.

The NIC published its report *Strategic Investment and Public Confidence* in October 2019. This document, published alongside the government's National Infrastructure Strategy, sets out the government's response to the NIC's recommendations. The government's position will be further detailed in a policy document in 2021.

The government is grateful to the NIC for their comprehensive work on this important issue and looks forward to working with the NIC as it continues further work in this area.

¹ <https://nic.org.uk/app/uploads/National-Infrastructure-Commission-Regulation-study-Terms-of-Reference.pdf>

Response to recommendations

Recommendation 1

Forward looking regulation by independent regulators remains the best approach to balancing the needs of consumers and investors, whilst incentivising efficiency. However, this should be embedded in a clearer strategic framework for the long-term investment needs of the country.

- *The government should introduce legislation by 2021 to fulfil its previous proposal that regulators have regard to endorsed recommendations from the Commission.*
- *The government should set out a long-term strategic vision for each of the regulated sectors, through strategic policy statements, within the first year of each Parliament, to support lasting plans and stable funding.*

Response: The government partially endorses this recommendation.

Whilst the government acknowledges some of the ongoing challenges with independent regulation, the government is committed to protecting the integrity of the UK system, and agrees with the NIC that forward-looking regulation by independent regulators remains the best approach to balancing the needs of investors and consumers.

The government agrees that strategic policy statements are effective at encouraging cross-sector collaboration and setting long-term objectives for the regulators that are aligned with the government's objectives and timeframes. The government has already published strategic policy statements for Ofwat and Ofcom and will ensure that clear strategic steers are provided in a timely way.

The government also recognises that there are common strategic issues across all regulators which may require overarching strategic direction. To this effect, the Government will publish a policy paper in 2021 which will consider the benefits of a cross-sectoral strategic policy statement to complement the sector specific statements.

The government does not currently intend to introduce a statutory obligation for regulators to act on endorsed recommendations from the Commission. The government will use the aforementioned paper to consider more generally the duties and obligations placed on the regulators, with the view to providing a clear and consistent direction for regulators.

This paper will also consider other policy issues and priorities building on those supported in this response, including how to inject more competition into strategic investments.

Recommendation 2

Regulatory frameworks should reflect the devolution of powers within the UK.

- *Ahead of the next price controls, regulators should put in place formal mechanisms, such as advisory committees, to ensure they have regard to the strategic vision set out by devolved administrations, where devolved and reserved powers interact.*
- *In future price controls, regulators should demonstrate how they have taken consideration of the strategic vision of metro mayors and relevant local government, within devolved powers, where this has material impacts for network investment.*
- *Regardless of specific devolved powers, regulators should engage with the views of elected representatives, alongside other sources of insight into the public's and consumers' preferences.*

Response: The specific issues in this recommendation are for regulators to consider.

The implementation of this recommendation is primarily for the regulators to consider, but the government strongly supports it in principle, recognising that more nationwide consideration of policy setting is vital to levelling up. Regulators already have some mechanisms in place to reflect the devolution of power: Ofgem has made it clear that it intends to work closely with local governments and devolved administrations in its strategic narrative 2019-2023 and decarbonisation 'Action Plan'; Ofwat already acts in accordance with the Welsh government's statement and related published documents for the determination; and Ofcom already has advisory committees and a legislative obligation to consider the roles of the devolved administrations. The government support regulators' ongoing work in this area.

Recommendation 3

Regulators' duties need to be coherent, covering price, quality, resilience and environment.

- *Ensure their decisions promote the resilience of infrastructure systems.*
- *Ensure their decisions are consistent with, and promote the achievement of, the government's legislated greenhouse gas emissions targets, currently achieving net zero greenhouse gases by 2050.*
- *Collaborate with other regulators, where relevant, to avoid contradictory regulation and promote efficient outcomes for consumers on cross-sectoral issues.*

Response: The government partially endorses this recommendation.

The government agrees with the NIC that regulator duties should be coherent covering price, quality, resilience and environment. However, the government recognises that any new duties would have complex interactions with existing statutory duties that regulators have in place and, therefore, wants to consider new duties in the round as part of the forthcoming policy paper in 2021. Specifically, the government intends to examine:

- Environment and net zero: As the first major economy to commit to reaching net zero by 2050, the government supports any mechanism that will help the UK in reaching this target. The government supports legislated climate duties where applicable and will consider this alongside existing duties to understand the most appropriate measures that will ensure regulators make the necessary contributions to achieve legislated net zero targets. The government are supportive of the work already undertaken by regulators in this regard. For instance, Ofgem already consider the impact that reducing emissions of targeted greenhouse gases from electricity and gas supplies would have on the environment, the consumer and the public interest.
- Collaboration and resilience: The government also recognises the importance of collaboration between regulators, as well as pursuing long term resilience, especially in the current economic and environmental context. The government will review how collaboration between regulators can be further improved, including the role of duties. The government welcomes the recent NIC report on resilience and will take these recommendations into account as part of further work.

Recommendation 4

The use of competition should be enhanced as the most reliable means of supporting innovation, particularly where there is rapid technological change.

- *Regulators should focus 'standard' periodic price controls on the maintenance of existing networks and marginal enhancements.*
- *Ofcom should continue to promote infrastructure competition for fibre and mobile networks.*
- *Government should introduce legislation, ahead of the next price controls, to remove any barriers to the use of competition in the provision of strategic enhancements to water and energy networks.*
- *For future price controls, Ofwat and Ofgem should separate consideration of strategic enhancements from the 'standard' periodic price control. Ofwat and Ofgem should develop tendering processes for strategic enhancements, with a clear, public justification required where tendering is not used.*
- *Government should ensure that regulators have the resources they need to carry out competitive tenders for transformational investments.*

Response: The government partially endorses this recommendation.

The government agrees with the NIC that increased use of market mechanisms and competition is the most reliable means to promote innovation and lower the cost of transformational new investments, particularly in areas where there is rapid technological change. Competition is already being used and implemented successfully in telecoms and areas of energy and water and the government encourages regulators to continue to build on their work.

However, facilitating and encouraging a broader use of competition to provide strategic enhancements could require new legislation. The government will consider as part of the forthcoming policy paper whether the government needs to remove barriers, and whether regulators need greater powers or resources, to promote more competition.

Whilst the design of price controls remains for regulators to decide, the government is supportive of moves to consider whether more major strategic investments can be removed from price control processes. This could increase the scope for new investors to enter the market and provide a wider range of opportunities for potential investors while ensuring good value for money for consumers.

Recommendation 5

Regulators should be more proactive in addressing financial risk and corporate governance, to ensure that rewards reflect performance and risks are genuinely taken by investors.

- *In future price controls, regulators should take direct account of information asymmetries in assessing the weighted average cost of capital and total expenditure allowances, 'aiming off' to ensure a fair outcome for consumers and investors.*
- *In future price controls, regulators should introduce outperformance sharing mechanisms to allow consumers to share in the benefits that equity investors achieve from high gearing, where companies have gearing levels which significantly exceed the level assumed by the regulators.*
- *For natural monopoly companies, regulators should evaluate the case for an absolute cap on gearing.*
- *For firms with a natural monopoly, regulators should ensure executive salaries are demonstrably linked to long-term performance for consumers and the public.*

Response: The specific issues in this recommendation are for regulators to consider.

The continued independence of regulators in setting effective price controls should provide a stable and predictable environment for investment to thrive whilst continuing to protect the interests of consumers.

The government recognises the importance of building public confidence in our regulatory system, and supports regulators being proactive in addressing financial risk and corporate governance issues. The government notes that regulators already have a range of tools in place to address this recommendation.

In considering these measures, regulators should seek to ensure that UK's infrastructure networks are able to attract the investment needed to drive innovation and the transformation required to meet the needs of consumers for decades to come.

Recommendation 6

Regulators should be able to prevent companies from engaging in price discrimination that does not provide an overall benefit to consumers.

- *Regulators should require companies to report annually on which groups of customers are paying more for the same service; companies should be required to publicly justify their price discrimination policies or rectify them.*
- *Regulators should be able to require companies to change their price structures where price discrimination cannot be justified by benefits to consumers.*
- *Government should introduce legislation, by 2021, to replace the current court-based enforcement of consumer law with an administrative compliance and enforcement model, subject to appropriate scrutiny by the courts.*

Response: The specific issues in this recommendation are mostly for regulators to consider.

The government is supportive of this recommendation in principle and recognises the considerable efforts regulators have already made in this area. The government has also committed to extending the default tariff cap for domestic consumers in the retail energy sector to limit the overcharging of inactive customers.

The government agrees that organisations which enforce consumer law should have the appropriate tools at their disposal to protect consumers from harm. The government has committed to introducing legislation to create civil fining powers for breaches of consumer law and is continuing to keep under review further measures to ensure consumers' rights are appropriately enforced.

Recommendation 7

Government and regulators cannot rely on a flawed assumption that market design and distributional consequences can be separated.

- *Regulators should publish an analysis of the distributional consequences for consumers and businesses of their proposals, and of the impact of possible mitigations for significant adverse effects.*
- *Regulators' boards should be given the power, by 2021, to seek explicit guidance from ministers on strategic policy direction and distributional choices, against a menu of feasible options provided by the regulator and within a fixed three-month period.*

Response: The government partially endorses this recommendation.

The government recognises that market design and distributional consequences are sometimes related and therefore supports both the overarching recommendation and the drive for greater transparency and regional impacts analysis in support of the government's levelling up objectives.

Regulators have already acted in this space by publishing impact assessments, whilst Ofgem also already takes distributional consequences into account. The government encourages regulators to consider this recommendation further to take broader action.

As outlined in the response to previous recommendations, the government is reviewing regulators' duties and strategic statements, with the view to providing more regular statements in the future. This will help to provide further clarity in this regard. However, the government does not support the creation of new mechanisms for regulators to seek government views, such as new powers for regulator boards to seek explicit guidance from ministers.

Recommendation 8

The UK Regulators Network should have a stronger role, supported by an independent chair.

- *By the end of 2020, the UK Regulators Network should appoint an independent chair.*
- *By the end of 2020, the government should review data sharing powers by regulators to ensure they can develop a 'whole customer view'.*
- *By the end of 2021, regulators, with the support of the UK Regulators Network, should develop joint data sets to enable whole customer analysis.*
- *By July 2021, the independent chair of the UK Regulators Network should publish a business plan setting out how the network will support:*
 - o *collaboration on the achievement of common goals*
 - o *coordination to avoid contradictory regulation and inefficiency*
 - o *data and knowledge sharing, including supporting the regulators to improve their data management capability*
 - o *improved performance reporting by regulators.*

Response: The specific issues in this recommendation are mostly for the UKRN to consider.

The government supports the work undertaken by the UKRN to date in respect of this recommendation and to enhance cross-sector collaboration more broadly. The decision to appoint an independent chair and the role of the chair is primarily a recommendation for the UKRN to consider.

As part of the overarching policy paper, the government will consider how to promote broader collaboration between the regulators, including through duties. This will include examining data sharing powers, with a view to considering how best to encourage regulators to develop joint data sets for 'whole customer' analysis.