25th January 2024

GIIA Response to: ***Smarter Regulation: Strengthening the economic regulation of the energy, water, and telecoms sectors.***

Introduction

The Global Infrastructure Investor Association (GIIA) is the membership body for the world's leading institutional investors in infrastructure and advisors to the sector. Collectively, our members are responsible for $1.6tn of infrastructure assets under management distributed across 70 countries and six continents. They have substantial and diverse investments in the UK, including renewable energy, water, telecoms, ports, and airports, totalling some £225 billion.

The UK faces an increasingly competitive global race for private capital and looming net zero commitments. Unable to match the significant fiscal incentive packages offered to investors in both the US and EU, the UK must instead compete for international capital on the quality of its policy and regulatory environment. There has never been a more important time to attract and drive new investment into our critical domestic infrastructure. Unlocking the untapped potential of private capital will ensure we are able to keep pace with an ever-evolving set of climate and societal expectations without further increasing the UK's public borrowing requirements.

This submission acts as a high-level position statement on behalf of the infrastructure investor community, in response to the Smarter Regulation: Strengthening the economic regulation of the energy, water, and telecoms sectors consultation. Our response comments on the proposals put forward in the consultation.

Background

The UK's regulatory prowess, historically lauded for driving substantial investments, now faces a critical juncture as the country aims to achieve its 2050 Net Zero emissions goal. Research indicates a need for £400 billion in decarbonisation spending by 2030, emphasising the pivotal role of private capital, supported by robust regulatory frameworks. However, recent shifts in economic regulation towards short-term goals pose a risk to inherently long-term infrastructure investments, neglecting the cost of inaction and introducing significant instability.

Our twice-yearly pulse survey of infrastructure investors registered a stark decline in sentiment towards investing in the UK in Q4 2022, leaving the UK as one of the most unattractive markets in Europe. Whilst this can be attributed in part to the political situation at the time, regulatory and foreign investment barriers added significant weight to the drop.

Our Q4 2023 survey showed a further deterioration in the UK's attractiveness for investment. The primary reason given by investors for their negative outlook on the UK was regulatory instability, emphasising the pressing need to address the regulatory challenges that continue to hinder the UK's investment landscape.

In a global race for capital, we cannot overstate the importance to investors of regulatory frameworks which encourage long-term growth, to ensure that the UK remains an appealing hub for investment.

To address these concerns, it is imperative that the government realigns regulatory practices with the objectives of sustainable long-term economic growth, investor confidence, and a successful transition to a low-carbon economy, ensuring adaptability to changing demands.

Chapter 1: Driving Economic Growth

As investors deeply involved in the UK's infrastructure sector, our members find that the proposed initiatives generally align well with the needs of the industry and the broader economy.

The acknowledgement of the misalignment between permitted investments and perceived necessities in sectors like water, highlighted by Ofwat's rejection of £6.7 billion in proposed spending during PR19, resonates with concerns raised by industry experts and investors. Striking a balance between challenging companies for efficiency gains and ensuring adequate long-term investment is crucial for sustained growth and innovation.

The government's commitment to expedite network connections through the Electricity Networks Connections Plan is commendable. Addressing underinvestment in network infrastructure in the energy sector is crucial, given its ripple effect on connecting new energy sources to the grid. The impact on offshore wind investments, as highlighted by RenewableUK, underscores the urgency in streamlining these processes.

The emphasis on regulatory independence while simultaneously advocating for accountability and scrutiny is a nuanced approach. The proposed independent assessment through the National Infrastructure Commission (NIC) would add a layer of transparency and credibility to the decision-making process. The NIC's role in providing an impartial view on required investment levels, as outlined in the second National Infrastructure Assessment, helps to reinforce the government's commitment to informed and strategic decision-making.

Moreover, we appreciate the government's recognition of the need to improve communication regarding the wider societal benefits of infrastructure investment. A more systematic approach by the NIC to outline benefits alongside costs aligns with our belief that the positive impact, such as community benefits, job creation, and better long-term infrastructure resilience deserve greater emphasis.

Proposal Comments

Proposal (1): A holistic assessment of infrastructure investment needs in energy networks and the water sector should be delivered. This should enhance regulatory accountability, as well as supporting decision-making approaches, respectively.

Investors strongly support the proposal for a comprehensive assessment of infrastructure investment needs in energy networks and the water sector, highlighting its potential to boost regulatory accountability and inform decision-making. Backing the call for this assessment, we recognise its pivotal role in pinpointing gaps and determining priorities for regulators. It is imperative that the assessment evaluates future needs on a long-term horizon to address the consistent short-termism currently driving the regulators' agendas.

This assessment could help equip regulators with essential insights into the current state of infrastructure, allowing for better strategic planning, resource allocation, and a proactive approach to emerging challenges.

Post-assessment, we advocate for the creation of updated Strategic Policy Statements (SPS) tailored for regulators. These statements should explicitly underscore the regulatory responsibility to foster necessary long-term investments. By aligning regulatory actions with identified infrastructure gaps and priorities, the updated SPS statements should serve as guiding documents with clear priorities, enhancing regulatory accountability.

Proposal (2): When reporting on funding decisions, Ofwat and Ofgem should include comparisons to figures outlined by other public bodies, for example the NIC and the CCC, and future figures outlined in the infrastructure needs assessment. The government welcomes Ofwat and Ofgem's greater focus on the long term in their price reviews, PR24 and RIIO3 approaches, respectively.

Members support the proposal to mandate Ofwat and Ofgem to reference figures produced by the NIC and the CCC concerning long-term investment requirements. This approach could potentially help improve regulators' accountability and ensure that their price review processes actively contribute to the delivery of long-term investments.

Proposal (3): The government strongly supports steps taken by Ofgem and Ofwat so far in considering major infrastructure projects outside of the standard price review processes. The government encourages Ofwat to take innovative approaches to project funding, where needed, and welcomes steps taken so far, such as through its Havant-Thicket reservoir approach. The government similarly encourages Ofgem to continue to take innovative approaches where appropriate.

Investors appreciate the government's proposal to require Ofgem and Ofwat to consider major infrastructure projects outside the conventional price review processes. Addressing the challenges outlined in proposals (1) and (2), the government rightly emphasises the significance of finding solutions to the long-term investment and asset management issues within regulated infrastructure. The recognition of the need for regulatory agility to provide investors with certainty regarding the recovery of long-term investments is pivotal. Major projects, encompassing large greenfield projects or substantial upgrades/refurbishments to existing infrastructure, necessitate longer-term funding models that extend beyond the confines of standard price review processes. It is essential that Ofwat and Ofgem consider long-term funding models which aren't currently catered for by the standard price review processes.

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Chapter 2: Competition

Proposal (4a): For Ofwat to work with the government to implement competition stocktake proposals. To deliver necessary legislative amendments to remove the requirement to consult in certain circumstances.

Proposal (4b): For Ofwat to explore ways to fast-track licensing for NAVs.

Proposal (4c): For Ofwat to work with the government to consider the viability of moving towards a national licensing regime for NAVs. To implement this will require legislative changes.

Proposal (5): For Ofcom to review whether existing monitoring is sufficiently capturing competition issues in the sector.

Proposal (6): In energy and water, regulators should consider introducing greater use of comparative metrics to promote greater competition on performance between companies.

The economic regulators make extensive use of comparative metrics, both to communicate performance to the public, and to benchmark performance and cost targets. Investors find that some regulators veer towards an excessive number of metrics, indeed sometimes more than companies can realistically manage towards. It is not clear to investors that a further proliferation of metrics would achieve either greater value for money or deliver better customer outcomes.

Chapter 3: Supporting Consumers

Proposal (7): The government will coordinate and work collaboratively with regulators, industry and devolved administrations to explore the creation of a single, multi-sector Priority Services Register.

Proposal (8): For the UK Regulators Network (UKRN) to convene work with regulators, industry, and the government to ensure greater consistency in how affordability support and bill changes are communicated, within and across sectors, looking at both household and business customers.

Proposal (9): The government will provide the power to Ofwat to allocate customers from an unplanned retailer exit to a new retailer/s on a mandatory basis.

Our members support the government's proposals for new measures to help ensure the protection of vulnerable consumers.

Investors express their support for Proposals 7, 8 and 9. In particular, the proposal to create a unified Priority Services Register (PSR) would be welcomed to ensure the system remains resilient and to reduce administrative burden.

Chapter 4: Duties and Functions

Proposal (10): The government, led by sponsor departments, will work with regulators to conduct a thorough review of duties, with a view to rationalise duties and enable regulators to focus more on economic duties and functions. This exercise will consider the following:

1. Which duties are still essential in today's economic landscape and whether they are fit for purpose.

2. If there are unnecessary regulatory burdens, the government should consider how best these could be streamlined or reassigned to another organisation.

3. Existing duties should be reviewed to ensure they are outcome focused and delivering their intended outcomes.

4. Considering how the duties all interact with one another, where there are trade-offs, and understand how these are impacting the sectors. To avoid continued layering, any new duties would need to be thoroughly considered between regulators and the government on how best to interpret these duties and how to deal with interactions and tensions between the multiple duties.

Investors should play a crucial role in shaping the discussion on the government's proposed review of duties and functions. In particular, our members highlight a key concern regarding the current lack of consistency in how regulators interpret and execute economic functions across different sectors. The absence of concrete economic duties in the existing Strategic Policy Statements (SPS) allows regulators to sidestep responsibilities, necessitating a more uniform approach. This consistency is seen as vital for establishing a robust regulatory framework adaptable to evolving economic landscapes, a prerequisite for fostering significant investments in the country's infrastructure.

In response to this need, investors advocate for clear and updated SPSs to guide regulators' strategic direction. The existing SPSs for Ofwat and Ofgem are rightly criticised for their broadness and lack of specific duties, hampering regulatory focus. This inadequacy has led to the SPSs falling short of their objective to set clear regulatory priorities. Investors propose that refining and regularly updating these statements will enhance clarity and contribute to more effective regulatory oversight. Additionally, they express support for the proposed creation of a "new set of core, outcome-focused duties for regulators' economic functions." If carefully crafted, this refined set of duties could provide a strong foundation for regulators to fulfil their economic responsibilities in a more targeted and effective manner.

We stress the importance of embedding long-term thinking into any new or redefined economic duties. To achieve this, members advocate for mandates that compel regulators to establish clear and measurable long-term economic objectives with a priority on investability and inter-generational fairness. This foresight is deemed essential for promoting sustained infrastructure investment, particularly in greenfield projects crucial for the country's ambitious net-zero goals. Investors suggest that utilising SPSs as a mechanism can not only integrate but also enforce this long-term focus, providing a framework for infrastructure investors committed to the development of sustainable and resilient projects over an extended time horizon. Balancing the costs for current and future generations, this approach, in our view, ensures a more strategic and future-oriented regulatory landscape.

Chapter 5: Appeals

Proposal (11a): The government should provide the CMA with the necessary powers to appoint more than three members, where considered appropriate, in a group to hear appeals.

Proposal (11b): The government should provide the CMA with the necessary powers to directly extend, when considered appropriate, a deadline in water and energy appeals, rather than needing to request an external party for the extension.

Proposal (11c): The government will explore whether to give the CMA and CAT the necessary powers to be able to recover reasonable costs from the losing party incurred by an intervener when they have acted on a 'consumer interest' basis.

Proposal (12): The government will include the recovery of the CMA costs as part of wider reforms work to code modification appeals. Reforms would be to amend code modification appeals to align with energy licence modifications to give discretion for the CMA to apportion its costs as it considers appropriate.

Proposal (13): The government will seek to change Ofwat's price control appeal regime from a redetermination to an energy style appeal regime and to consult on the detail of how this will be implemented.

Proposal (14): For Ofcom to work with both the government and industry to develop more specific guidance on what to include in decision documents to improve transparency of decisions.

Investors generally endorse the suggested reforms; however, there are significant obstacles arising from the appeals process that need to be addressed to establish a robust system for the future. Specifically, whilst the proposal (13) to transition Ofwat's price control appeal regime to a model resembling the energy sector's appeal process indicates the government's recognition of the need for reform in Ofwat's appeals process, the proposal nevertheless falls short of addressing one of the core issues for investors. A significant concern is that the cost of capital determinations, a crucial factor for investability, remains largely a matter of judgement on the regulator's part. Moving towards an energy-styled appeal regime, where appeals must substantiate a clear and objective error committed by the regulator instead of a substitution of judgement, sets an excessively high bar in this particular area, and therefore eliminates viable recourse for contesting Ofwat's WACC (Weighted Average Cost of Capital) calculations.

In addition to this, investors specifically highlight the added complexity and lack of uniformity arising from individual regulators conducting their own WACC calculations. Given the substantial similarity in the WACC calculation process across sectors, there is a compelling case for greater standardisation and centralisation of this process. To alleviate the burden on individual regulators and address the tension and complexity involved, a potential solution involves assigning the responsibility for determining WACC across different sectors to an independent body, such as the Competition and Markets Authority (CMA). Such a move would also materially reduce the investor sensitivity to the proposed change in the appeal regime for water.

The call for greater rigour in the WACC calculation process, potentially under the auspices of an independent body, could significantly enhance the appeals system in the future. Such measures have the potential to foster transparency, consistency, and fairness, ultimately strengthening investor confidence in the regulatory framework.