

The Future of Regulation



Executive Summary

The UK regulatory regime is at a crossroads. Significant investment across the regulated sectors is required in order to deliver on major long-term policy objectives, none more important than reaching net zero emissions by 2050. While there will be an important role for public investment, the scale of the challenge makes the need to mobilise greater levels of private investment more urgent than ever.

While the UK's system of economic regulation has delivered significant investment across the economy over the past few decades, there is an urgent need to update the regulatory framework so it remains fit for the greater challenges ahead. Without carefully considered action now, we risk being unable to act with the necessary urgency to achieve these long-term policy objectives. The net zero transition will require an infrastructure revolution across the economy, meaning there is no time to lose. A targeted set of reforms to the regulatory regime are needed to unlock new investment and deliver the best possible outcomes for consumers now and in the future.

The regulatory regime is a core pillar of the UK economy. Over the last three to four decades, it has overseen the transformation of utilities that deliver many of our essential services. But more recently the application of the regime has become more contentious and more burdensome, leading to sub-optimal outcomes for consumers, companies and investors alike. A new approach is needed.

Without carefully considered action now, we risk being unable to act with the necessary urgency to achieve these long-term policy objectives.

This report draws directly on the views of GIIA members – the world's leading institutional infrastructure investors – and sets out how the

regulatory regime has evolved, the challenges it faces moving forward and what reforms are required to deliver the scale of investment now needed. Getting this right will directly serve the interests of current and future consumers, as well as furthering the economic benefits that flow from infrastructure investment.

The current system of economic regulation finds its roots in the privatisation era of the 1980s. It was based on the belief that, in as much of the economy as possible, the market was best placed to ensure services were delivered efficiently and to a high quality. Economic regulators were created to correct market failures and mimic the competitive market where competition was not possible.

While the UK's system of economic regulation is often praised as an example of best practice, there have been a number of shifts more recently that have impacted the effectiveness of the regulatory regime in delivering new investment. These include:

- **Short-term regulatory focus**, specifically in the Water Services Regulation Authority (Ofwat) and the Office of Gas and Electricity Markets (Ofgem), as regulators feel obliged to interpret their statutory duties in line with the changeable political mood and / or as a result of direct political intervention. This has led to a focus on short term bill reductions at the expense of investment to achieve long-term policy objectives.
- **Greater distrust of market mechanisms and incentive regimes**, driven in part by concerns around the PFI model and previous regulatory price controls, that has been making regulation more intrusive and burdensome while weakening incentives to innovate to deliver better long-term value to consumers.
- **Less scope to drive additional efficiency in operating costs.** RPI-X has driven substantial reductions in operating costs, but companies are now heavily constrained in their ability to drive further reductions. Regulators, however, continue to look to

drive further cost reductions but now have more limited tools to do so.

- **Significantly increased service expectations**, meaning regulators face strong pressure to drive up service levels further, often without good information on the link between service levels and costs.
- **Erosion of the legitimacy of private ownership and delivery of infrastructure.** This is driven by a collective failure to communicate the successful outcomes of the mixed public-private approach in delivering infrastructure. It has in turn led to a focus on areas where the current system is not working well, rather than examples where it is driving innovation and greater levels of efficiency.

These shifts have, over time, impacted the UK's position as a destination for international infrastructure investment. They have materially increased the political and regulatory risk associated with investing in the UK. Action needs to be taken now to restore trust in the regime and drive better outcomes for

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consumers.

There are also new and urgent drivers for change. The Government's commitment to reach net zero by 2050, improve the resilience of our infrastructure to respond to emerging threats from climate change, revitalise our economy in the wake of Covid-19 and digitise the economy will require significant investment across all the regulated utilities. There is a material risk that sticking to the regulatory

status quo will fail to deliver the level of investment required, with damaging implications for the environment, the UK's competitiveness and economic security. The success of the offshore wind sector shows the potential for private investment to lead the way on net zero. We must now take steps to drive investment across all areas of the economy over the coming decades.

While reform is needed to correct course and adapt to the challenges ahead, a wholesale revocation of the current model is not. The core operation of the regulatory framework remains fit for purpose – rather, it needs to be updated to reflect the new reality. The ultimate objective should be to create a better alignment between the interests of consumers in both the short and long term, balancing the need for greater investment in new infrastructure over the next 30 years and beyond.

Drawing on GIIA members' international experience of best practice, we believe there is value in setting out a clearer set of core principles that will govern the regulatory regime going forward. This will provide clarity and certainty to those delivering new investment, while showing how consumers interests will be championed as we seek to achieve long-term policy objectives.

- **Clear division of roles and responsibilities between Government and regulators.** This would mean that the core independence of the regulators is maintained, while ensuring that policymakers are rightly allowed to set out clearly what they expect the regulators to deliver on behalf of current and future consumers.
- **Strive for intergenerational equity.** Regulation should ensure that consumers get the best possible value for money in the short-term and benefit from high-quality service delivery. But the interests of future consumers should also be protected, including through the delivery of major new capital investment to tackle long-term policy objectives, such as the net zero transition and delivery of climate resilient infrastructure.

- **Incentivise innovation over the long-term.** Regulation should be streamlined as far as possible, with efficiency incentives structured in such a way to drive innovation in service delivery and capability over multiple price control periods to support long-term objectives. This will require carefully balancing incentives to optimise outcomes, particularly if some elements of the regulatory system are less flexible.
- **Streamline regulation to reduce the burden on companies.** The regulatory frameworks in each sector have evolved to become excessively complex. Navigating them requires deep and specialist knowledge to operate. The differences in the approaches taken by different regulators are in many cases unwarranted.

Having set out these core principles, we believe there are a set of actions that could be taken to ensure the regulatory regime is able to deliver them in practice. These targeted reforms apply at the strategic, financial and structural levels:

Strategic

- **Publish an economy-wide Government Infrastructure Strategy.** As is the case in other competing jurisdictions, Government should set out a measurable plan for how it sees the UK infrastructure market developing over the next 30 years. This would provide investors with a clear view of the Government's political priorities and provide a better sense to the regulators on what they should be aiming to deliver through the regulatory price controls. To maximise certainty, the Strategy should be updated on a predictable basis, with changes limited only to what is essential. The National Infrastructure Strategy could fulfil this need provided it is sufficiently comprehensive and timely in its publication.
- **Clarify the boundary between Government and regulators.** To ensure that there is a more direct link between Government's overarching ambition for UK infrastructure, there is an opportunity to make greater use

of strategic policy guidance to ensure that regulators know how to manage and prioritise their respective duties on behalf of current and future consumers. This is particularly pressing in the energy market where no such guidance has been published. Critically, regulators should be assessed independently on their compliance with the relevant guidance. Such clarity would reinforce the independence of regulators.

- **Update regulatory duties set out in legal statute for future challenges.** Government should look to propose updates to the various regulatory duties that currently sit with each individual sectoral regulator, which will need to be voted on by Parliament. These should reflect future challenges, such as the need to deliver net zero emissions by 2050 and support regulators to make transparent trade-offs between their respective duties where necessary.

Financial

- **Remove dampened incentives to innovative.** Return to a system where incentives are highly powered to encourage investment in innovation and streamline regulation to ensure that companies are free to take measured risks that will deliver benefits to consumers. Regulators should look to rely less on prescriptive management so companies can focus on running their business and delivering innovative improvements at pace.
- **Strike a better balance between risk and reward.** Regulators should set allowed returns at a level that reflects a realistic assessment of risk, is capable of incentivising innovation and can ensure that the necessary investment is secured at pace. Where there is significant uncertainty, they should consider aiming up to reduce the risk of underinvestment at a critical moment to achieve long-term policy objectives.

- **Consider the long-term impact of regulatory decisions.** Regulators should be required to consider the long-term impact of price control determinations, beyond simply the period of that specific settlement. Regulatory impact assessments should quantify how regulatory decisions affect prices into the medium term and the delivery of long-term policy objectives, such as net zero.
- **Consider where using competition could deliver greater value.** Given the scale of some major new infrastructure investments that will be required over the coming decades, there is scope to consider more fully the role of competition. This could include promoting competition for a wide range of medium and large-scale single infrastructure projects. However, competition should only be introduced if it truly delivers better value for customers over the long-term without introducing significant additional complexity in the regulatory framework.

Structural

- **Maintain a robust appeals regime.** As the CMA changes post-Brexit to take on new responsibilities, it is important that regulatory appeals are not watered down. The current merits-based appeals mechanism is a critical part of the overall framework and should be protected as it provides significant confidence to investors of continued regulatory independence.
- **Drive consistency across regulated markets.** There is value in improving the consistency of outcomes across regulated markets as it will improve the predictability of the entire regime. A fully consistent approach to determining allowed returns across regulated sectors could be one step in ensuring this is the case, but for the avoidance of doubt we see limited value in wholesale merging of regulators. This should also not be taken to mean the same approach is used in different sectors, rather that regulators should draw from similar principles.

Clearly a number of these suggested actions require a change in approach, rather than new legislation or policy frameworks. We would therefore recommend that Government and the sectoral regulators look to use the various upcoming publications – including the National Infrastructure Strategy – to indicate a new approach, which can then be carried through in the various regulatory decision-making processes.

Taken together, these actions will allow the regulatory regime to remain fit for purpose for the greater challenges ahead. They would ensure that the country can secure the necessary private investment to deliver major new infrastructure projects right across the country, while delivering value for current and future consumers.

Background

History

The current system of economic regulation in the UK was born out of the privatisation of the utilities from the 1980s onwards. At its heart was the belief that, in as much of the economy as possible, the market was best placed to ensure services were delivered efficiently and to a high quality. Regulators, who were ultimately accountable to Parliament, were created to correct market failures and mimic the competitive market where competition was not possible through, amongst other things, regular price controls.

To regulate those parts of the market that couldn't be opened to competition, the regulators' approach was centred on the basic principle of RPI-X – a way of setting prices that incentivised greater efficiency (X) by using industry comparisons to determine efficient costs. Companies were able to retain any outperformance against the headline rate of efficiency.

This broad system of economic regulation has been a crucial driver of service improvement and infrastructure investment over the last four decades. It has been expanded to take into account a greater need for new capital investment as the privatised model has matured, but the broad focus on driving continual efficiency has been maintained. As a pioneer in the field, the UK's system of economic regulation has traditionally been viewed as an example of international best practice and has been replicated across the world.

As the demands on the regulatory framework have evolved, so too has the structure and role of the independent economic regulators. There have been institutional changes, including mergers, as well as a significant increase in the resource and capability of individual regulators. There have also been a number of changes to

their duties and responsibilities as the economy has become more complex and new long-term policy objectives have emerged. For example, in 2004/5, Ofgem, Ofwat and the Office of Rail and Road (ORR) were given a new statutory duty to “contribute to the achievement of sustainable development”.

In recent years, we have seen regulators increasingly interpret their respective duties more broadly than the specific legal requirements placed upon them. A recent example includes Ofwat setting out its ambition to create a social contract for the water sector, which aims to protect vulnerable customers. Ofgem has also set out a decarbonisation action plan for the energy sector and the Office of Communications (Ofcom) now refers to its “strategy” of promoting competition and

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investment.

These more ambitious strategic statements have been driven, at least in part, by strategic policy guidance¹ from Government that the regulators must take into account in carrying out their duties. This guidance is intended to ensure regulatory decisions align with the Government's policy agenda, setting clear direction for regulators on policy issues that must be reflected in their remit. It supplements general Government policy that the regulators must also consider as part of their usual activities.

The Department for Digital, Culture, Media and Sport (DCMS) published strategic policy guidance for Ofcom in 2019. This set priorities

¹ These documents are variously known as Statements of Strategic Priorities, Strategic Policy Statements and Strategy and Policy Statements.

that Ofcom must “have regard” to as it fulfils its functions and included “providing the UK with a world-class digital infrastructure” including gigabit-capable broadband networks and 5G.

The Department for Environment, Food and Rural Affairs (Defra) last published strategic policy guidance for Ofwat in 2017 and set two overarching priorities – securing long-term resilience and protecting customers. The Department for Energy and Climate Change (now BEIS) published the last Strategy and Policy Statement for Ofgem in draft form back in 2014 but it was never finalised.

Outcomes

Since its creation, the UK’s system of economic regulation has brought significant benefits to the economy and broader society. Many of the challenges that were experienced during public ownership – such as gold-plating – have been addressed, with the networks industries consistently outperforming the rest of the economy in productivity measures. In particular, the approach has:

- **Driven significant efficiencies.** The RPI-X model has effectively incentivised companies and investors to improve efficiency and productivity since privatisation.
- **Improved the level of service to consumers.** The predictability and stability of the regulatory regime, in part aided by a strong merits-based appeals process, has driven significant service improvements. The number and length of power cuts in local electricity networks has almost halved since 2002 and water leaks have fallen by a third since the 1990s.
- **Attracted significant private investment.** Around £150bn has been invested in water networks since privatisation – almost double pre-privatisation levels – and £45bn was invested in energy networks and generation between 2010-13 alone. This investment has delivered tangible economic benefits right across the UK and laid the groundwork for a modern, digital economy

Figure 1 summarises the outcomes that have been achieved in the UK’s main regulated sectors since privatisation.

This has led to the UK regulatory model being emulated elsewhere in the world, with countries keen to use it as a model for attracting mobile capital from international markets.

Despite the positive outcomes that the system has succeeded in delivering over time, there have also been a number of issues that have undermined its legitimacy with the public and some politicians. In particular:

- **Significant outperformance.** Due in part to underlying economic circumstances changing unexpectedly, companies have significantly outperformed their price control settlements, resulting in higher than expected returns to shareholders. However, the benefits such outperformance has delivered to customers – both in terms of better service quality and through gain sharing mechanisms – is not widely recognised.
- **Growing asymmetry of information.** As the complexity of the regulated markets has increased, while the need for additional investment in new capital projects has grown, regulators have become increasingly concerned that they are not receiving full and transparent information from regulated companies to define price controls. This has led to a lack of trust between companies – subject to burdensome price control processes – and the regulators.
- **Challenges of PFI.** The attempt to move spending for core public services off the Government’s balance sheet and bring private sector expertise into the delivery of infrastructure programmes, led to the significant growth in PFI deals, such as new schools and hospitals. This became even more important as public sector budgets were constrained: PFI enabled the costs of operation and maintenance of assets to be

Sector	Outcomes of private investment
Water	<ul style="list-style-type: none"> • Since privatisation, £150bn has been invested in the water sector in England and Wales² • Ofwat estimates annual average water bills are £110 lower than they would have been if companies had remained in the public sector³ • International comparisons of prices for water utility services in 2015 show that the UK has lower water charges than Belgium, Switzerland, Finland, Australia and the Netherlands and similar costs to France⁴ • Annual productivity growth for the water and sewerage sector has averaged 2.1% since privatisation,⁵ with a total improvement of 64% since privatisation
Telecoms	<ul style="list-style-type: none"> • The UK is one of the cheapest countries in Europe for mobile broadband and calls⁶ • Two thirds of the UK's landmass has good 4G coverage from all four operators, and this area includes 97% of the premises in the UK⁷ • Full fibre coverage grew from 3% to 10% – though from a small base – between 2017 and 2019⁸
Energy	<ul style="list-style-type: none"> • Since privatisation, almost £80bn has been invested into UK energy networks⁹ • For electricity customers, since privatisation in 1990, there has been a 50% reduction in number of customer interruptions, and a 60% reduction in length of customer interruptions¹⁰ • Network costs are now 17% lower than they were when at the time of privatisation and are projected to remain flat, and in some areas fall, into the next decade¹¹
Road and Rail	<ul style="list-style-type: none"> • Over £1bn of investment by the private sector between 2018-2019 in the rail sector¹² • Between 2006 and 2019, the private sector has invested over £9.5bn in the rail sector in 2018-19 prices¹³

² <https://www.water.org.uk/news-item/michael-roberts-response-to-labours-clear-water-report/>

³ https://www.ofwat.gov.uk/wp-content/uploads/2016/01/prs_inf_afford.pdf

⁴ <http://waterstatistics.iwa-network.org/graph/11>

⁵ <https://www.water.org.uk/wp-content/uploads/2018/11/Water-UK-Frontier-Productivity.pdf>

⁶ Mobile Broadband Prices in Europe 2018, A study prepared for the European Commission DG Communications Networks, Content & Technology by Empirica and TUV Rheinland.

⁷ <https://www.ofcom.org.uk/about-ofcom/latest/media/media-releases/2019/supercharging-investment-in-fibre-broadband>

⁸ <https://www.ofcom.org.uk/about-ofcom/latest/media/media-releases/2019/supercharging-investment-in-fibre-broadband>

<https://www.ofgem.gov.uk/consumers/energy-explained-videos-and-infographics/videos>

⁹ <https://www.ofgem.gov.uk/consumers/energy-explained-videos-and-infographics/videos>

¹⁰ <http://www.energynetworks.org/assets/files/ENA%20Response%20to%20Helm%20Report%20Final.pdf>

¹¹ <http://www.energynetworks.org/assets/files/ENA%20Response%20to%20Helm%20Report%20Final.pdf>

¹² <https://dataportal.orr.gov.uk/statistics/finance/rail-investment-and-subsidies/table-7290-private-sector-investment-in-the-rail-industry-excludes-network-rail-investment>

¹³ Ibid.

	<ul style="list-style-type: none"> The number of franchised rail journeys increased from 760m in 1995-96 to 1.74bn in 2018-19¹⁴
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shouldered by the private sector.

These issues have, to some extent, nullified the public’s perception of the benefits of the current economy regulatory model over recent years.

Challenges to the regulatory regime

Despite the UK’s system of economic regulation being praised as an example of international best practice, there have been a number of recent shifts that have impacted the effectiveness of the regulatory regime and how it is applied across each sector.

These challenges are already having short-term impacts on the outcomes that can be secured through the regulatory settlements, but more fundamentally risk our ability to deliver long-term policy objectives, such as the net zero transition and delivery of resilient infrastructure. There is a risk that taken together, they materially undermine the application of the regulatory regime in the UK and threatens the long-term investment case for the UK infrastructure sector.

Short-term regulatory focus

The consensus underpinning the model of regulators operating at arm’s length from day-to-day politics has gradually been eroded. Regulators have increasingly interpreted their duties in line with their perception of the current political mood, focusing on short-term consumer impacts rather than long-term system implications.

This is in part understandable given politicians have often been frustrated that regulators have not acted quickly enough to tackle consumer detriment. The imposition of the energy price cap is a good example of politicians taking control from what they view as ineffective regulators. This has, in turn, increased the pressure on regulators to act in accordance with the political mood of the day. This comes despite regulators themselves ardently defending their independence.

One impact of this trend has been an expansion in regulators remit and priorities. For example, Ofwat’s *Back in Balance* paper made dividend and executive pay policies a part of the price control process for the first time – enabling Ofwat to scrutinise companies’ plans and intervene to ensure they take account of how companies delivered for customers. A clear willingness to expand what the regulators are prepared to do has to some extent undermined the predictability and stability that has been at the core of the regulatory system since its

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FIGURE 1

inception.

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<https://dataportal.orr.gov.uk/statistics/usage/passenger-rail-usage/>

The CMA's provisional findings for the water price control redetermination and the Public Accounts Committee's letter to Defra calling for Government "to shift the focus of the regulatory regime away from narrow compliance requirements and price and towards encouraging more ambitious investment programmes by water companies" may have started to create more of a balance between short-term and long-term outcomes, however, the underlying risk of perceived politicisation remains. A similar challenge is observed in the aviation sector, in relation to important London airport capacity expansion. Here, the associated economic, political and legislative uncertainty have proven difficult issues for the CAA to address in the context of its existing duties, and within the existing price control framework.

Greater distrust of market mechanisms and incentive regimes

The belief that markets are best placed to ensure services are delivered efficiently and to a high quality has weakened in recent years. Distrust in market mechanisms and incentive regimes was accelerated by the 2008 financial crisis which brought about an abrupt stop to a long period of economic growth and security.

Regulators have reacted to this trend by weakening incentives. However, a corollary is that price controls in particular have become more intrusive and burdensome, leaving less scope for companies to innovate. Regulators are naturally concerned about whether investment is really needed and if companies' plans are efficient but risk going too far and removing the rate of innovation needed to reduce costs over the long-term. Regulators are effectively arguing that companies benefit from asymmetric information *but* are also substituting their own judgement for those of the companies' expert engineering teams.

Ofgem's outperformance wedge in its RII02 methodology reflects this distrust – it assumes companies use information asymmetry to outperform and attempts to counter this by making a downward adjustment of 0.25% to the allowed equity return. This is an arbitrary

solution to a problem that should be addressable.

Less scope to drive additional efficiency in operating costs

In some ways the challenges with the current application of the regulatory regime stem from the model's own successes. RPI-X has driven substantial reductions in operating costs since privatisation. Consumers have benefited but it now means companies are constrained in their ability to drive further reductions beyond economy-wide improvements in productivity – at least without significant additional investment that regulators are naturally reluctant to authorise.

While we are no doubt reaching a point where progressive efficiency will slow, there is a danger that we assume this negates the need for additional investment in new infrastructure across the regulated sectors. As we look ahead to the need to prepare for the long-term, such as the net zero transition, the need for investment is greater than ever before. While falling equity returns are clearly a necessity, we must still be able to bring forward new investment. In Germany, for example, while returns on equity have fallen similarly to the UK, large investment programmes in the energy sector to deliver climate action have been approved.

Service expectations have increased significantly

What consumers expect from their essential service providers has changed. We live in an on-demand economy where consumers want services that are fast, convenient and preferably digital. Consumers are also more alive to broader societal challenges, such as the need to tackle climate change and protect vulnerable consumers. There is also now much greater awareness of the importance not only of what companies deliver but how they deliver it, including their ESG credentials.

This trend means that regulators face growing pressure to drive up service levels in a wider range of areas. It is, however, difficult for

regulators to assess the link between service levels and costs, resulting in an increasing trend of additional regulatory burden to drive often incremental improvements. On the flipside, very little has been done to reduce the cumulative regulatory burden to reduce costs.

Erosion of the legitimacy of private ownership and operation

Events such as the collapse of Carillion; the failure of Southern Trains and Virgin East Coast; and the Grenfell tragedy in London have led to increasing scepticism around the legitimacy of private ownership and operation. There has also been greater scrutiny of utility companies' dividend and executive pay policies which have bred a perception that private providers unfairly profit from the provision of essential public services, as well as a collective failure to communicate the successful outcomes of the mixed public-private approach in delivering infrastructure. This has led to a focus on areas where the current system is not working well, rather than examples where it is driving innovation and greater levels of efficiency.

This public and political mood sits behind the Labour Party's nationalisation agenda which was first championed by Jeremy Corbyn and John McDonnell in 2017 and then quickly attracted mainstream support amongst the political left. Public ownership of rail, mail, energy and water remains official Labour Party policy – a policy that would have a negative impact for 8.5 million UK pension savers currently invested in UK infrastructure, as well as international investors. This is noted by investors as a key risk to putting their money into the UK infrastructure market.

Drivers of change

Irrespective of the broader challenges facing the regulated markets, there are a series of significant drivers of change that make some degree of reform a necessity, rather than a choice.

In its 2018 National Infrastructure Assessment, the National Infrastructure Commission set out its view of what the UK's main infrastructure

priorities should be over the next 10-30 years. At a high level, its core proposals centred around three broad drivers of change that must

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be addressed – the digitisation of our economy, the transition to net zero and improving resilience in our critical national infrastructure.

The Government is due to respond to the NIC's assessment this autumn. Since 2018, the global and local context has shifted and investment in infrastructure has become more urgent in light of Covid-19 and the need to boost the macro-economy but we believe the infrastructure priorities remain broadly as set out by the NIC:

- **Pressure to tackle climate change** has intensified and the UK's ambition has crystallised as it looks to set a global example as it prepares to host COP26 next year. The Government's target to reach net zero emissions by 2050 is a central priority across Government and at the heart of the Prime Minister's infrastructure agenda.
- **Resilience** has risen to the fore as policymakers look at how to strengthen the ability of infrastructure to withstand shocks such as major weather events and prevent related economic damage. Similarly, the pressures of real growth in sectors that act as the backbone to future economic health (e.g. aviation, rail) should be understood and properly addressed.
- **Digitisation of our economy** – specifically through the roll out of full fibre across the country – is seen as essential to the UK's ability to compete globally. The strategy for achieving this has been set out in the Government's Future Telecoms Infrastructure Review which is already being driven forward by Ofcom, DCMS and industry.

These drivers of change – particularly net zero and resilience – are urgent. A failure to act and deliver the infrastructure investment needed to support them will have damaging, long-term consequences for communities and the environment and will cause the UK to slip behind its international peers. Key to success will be mobilising £bn's in new investment across the regulated markets over the next three decades.

The way forward

The regulatory regime needs updating to meet the challenges of the future, as well as learn the lessons of the past. We urgently need to adapt the framework so that it can deliver against the three structural drivers of change – reaching net zero emissions, improving resilience and seizing the opportunities presented by digitisation. The Committee on Climate Change estimates that reaching net zero alone could cost over £50bn per year, totalling over £1tn. We also need to harness the value of infrastructure investment to drive economic growth and opportunity across the country, while supporting the post-COVID economy recovery. Failing to act now will cause the UK to fall behind others globally and prevent the UK from taking the necessary steps to avert environmental disaster. Delivering an infrastructure revolution across the economy will be critical for net zero, meaning there is no time to lose in creating a regime that can unlock the necessary investment in years ahead.

As well as preparing the regime for the challenges ahead, we need to acknowledge and address the challenges of the past. Regulators have struggled to get ahead of macroeconomic shifts and shifting political currents have bought the returns that flow to shareholders under greater scrutiny than ever before. The regulatory system needs to continue to drive greater efficiency, while also attracting new investment to deliver major new infrastructure across the economy.

It would be easy to argue that we should completely rewrite the regulatory regime. We believe, however, that the underlying model is broadly sound. Appropriately applied, it can

make sure the private sector is held to account on service quality and performance, while being continually incentivised to improve performance. It ensures that consumers get value in the short-term, but companies are also able to invest for the long-term benefit of future consumers.

It is, however, clear that the regime needs a reboot. To some extent the Government has already recognised this – as demonstrated by

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the fact that HM Treasury commissioned the NIC to undertake a study on economic regulation and has also commissioned a report into the competition and regulatory frameworks led by John Penrose MP.

One of the key objectives of any regulatory reform should be to create a regime that aligns the interests of consumers in both the short and long term. This means ensuring that we continue to drive value for money to keep bills low, but also turbocharge the investment needed now to prepare for the long-term challenges ahead. This is at the core of what the regulatory settlement was always intended to achieve but it has been increasingly challenged in recent years.

Achieving this central objective will require a number of actions across a period of time, with the approach differing to some extent between individual sectors. There are, however, a core set of principles that could be developed to guide reform. They would allow policymakers to make trade-offs, ensuring that a balance was struck between current and future consumers.

They would also allow for a greater consistency across different markets, providing consumers and businesses with a clear sense of the outcomes they should expect.

Drawing on GIIA members' international experience of investing in infrastructure in a number of different jurisdictions, we would suggest the following three core principles:

- **Clear division of roles and responsibilities between Government and regulators.** This would mean that the core independence of the regulators is maintained, while ensuring that policymakers are rightly allowed to set out clearly what they expect the regulators to deliver on behalf of current and future consumers.
- **Strive for intergenerational equity in the costs of infrastructure.** Regulation should ensure that consumers get the best possible value for money in the short-term and benefit from high-quality service delivery. But the interests of future consumers should also be protected, including through the delivery of major new capital investment to tackle long-term policy objectives, such as the net zero transition.
- **Incentivise innovation over the long-term.** Regulation should be streamlined as far as possible, with efficiency incentives structured in such a way to drive innovation in service delivery and capability over multiple price control periods to support long-term objectives. This will require carefully balancing incentives to optimise outcomes, particularly if some elements of the price control are in place longer term.

Translating these core principles into a set of definable policy and regulatory reforms that will deliver tangible change is no easy task. It will require Government to work with the regulators, companies, investors and consumer associations to ensure that a fair balance is achieved across current and future consumers.

Based on the experience of the GIIA membership, there are a number of areas

where we believe action could be taken over the course of the coming years to deliver better outcomes. The hope would be that progress could be made on each of these areas particularly ahead of the next round of energy and water price controls to ensure better long-term outcomes across the regulated markets.

Strategic

- **Economy-wide Government infrastructure plan.** As is the case in other competing jurisdictions, Government should set out a measurable plan for how it sees the UK infrastructure market developing over the next 30 years. The National Infrastructure Strategy can fulfil this role. This would provide investors with a clear view of the Government's political priorities and provide a better sense to the regulators on what they should be aiming to deliver through the regulatory price controls. The plan might be updated once a Parliament to reflect new political priorities, but the bar for change should be high so that regulators would be able to work with a consistent and stable set of priorities.
- **Clarify the boundary between Government and regulators.** To ensure that there is a more directive link between Government's overarching ambition for UK infrastructure, there is an opportunity to make greater use of strategic policy guidance to ensure that regulators know how to manage and prioritise their respective duties on behalf of current and future consumers. This is particularly pressing in the energy market. Critically, regulators should be assessed independently on their compliance with the relevant strategy policy guidance. Such clarity would better protect the independence of regulators.
- **Update regulatory duties for future challenges.** Government should look to update the various regulatory duties that currently sit with each individual sectoral regulator. These should reflect future challenges, such as the need to deliver net zero emissions by 2050 and support

regulators to make transparent trade-offs where necessary.

- **Streamlining regulation to reduce the burden on companies.** The complexity of current regulatory processes requires companies and investors to develop deep and specialist knowledge simply to operate. It also increases compliance costs. Greater consistency across regulators would reduce the level of understanding required to invest in multiple sectors. This should not, however, be taken to mean the same approach is used in different sectors, rather regulators should draw from similar principles.

Financial

- **Remove dampened incentives to innovative.** Return to a system where incentives are highly powered to encourage investment in innovation and streamline regulation to ensure that companies are free to take measured risks that will deliver benefits to consumers. Regulators should look to rely less on prescriptive management so companies can focus on running their business and delivering innovative improvements at pace.
- **Strike a better balance between risk and reward.** Regulators should set allowed returns at a level that reflects a realistic assessment of risk and can incentivise the level of innovation and investment required. Where there is significant uncertainty, they should consider aiming up to reduce the risk of underinvestment.
- **Consider the long-term impact of regulatory decisions.** Regulators should be required to consider the long-term impact of price control determinations, beyond simply the period of that specific settlement. Regulatory impact assessments should quantify how regulatory decisions affect prices into the medium term and the delivery of long-term policy objectives, such as net zero.

Structural

- **Maintain a robust appeals regime.** As the CMA changes post-Brexit to take on new responsibilities, it is important that regulatory appeals are not watered down. The current merits-based appeals mechanism is a critical part of the overall framework and should be protected as it provides significant confidence to investors of continued regulatory independence.
- **Drive consistency across regulated markets.** There is value in improving the consistency of outcomes across regulated markets as it will improve the predictability of the entire regime. A fully consistent approach to determining allowed returns across regulated sectors could be one step in ensuring this is the case, but for the avoidance of doubt we see limited value in wholesale merging of regulators. This should also not be taken to mean the same approach is used in different sectors, rather that regulators should draw from similar principles.
- **Consider where using competition could deliver greater value.** Given the scale of some major new infrastructure investments that will be required over the coming decades, there is scope to consider more fully the role of competition. This could include promoting competition for a wide range of medium and large-scale single infrastructure projects. However, competition should only be introduced if it truly delivers better value for customers over the long-term without introducing significant additional complexity in the regulatory framework.

There may, over time, become more of a case for radical reform. This may be part of wider structural reform that will be required to institutionalise structures across the regulated markets to deliver long-term policy objectives, such as net zero. More major reform would have to balance carefully the additional value generated, with the risk that it undermines investor confidence and drove up the cost of deploying capital in the UK infrastructure

market. While structural change will no doubt be required, it should not delay the more practical steps that can be made in the nearer term.

Conclusion

We are at a critical juncture. Significant investment across the regulated sectors is required in order to deliver net zero, strengthen the country's resilience to future challenges and digitise our economy. The current model of economic regulation has delivered positive outcomes, but its recent application has raised

questions over its effectiveness, particularly its ability to attract the necessary level of investment. Without decisive action, the UK will struggle to achieve its long term objectives.

We believe that with a clear set of guiding principles, supported by a set of concrete actions, the regulatory regime can continue to be fit for purpose to meet the unprecedented challenges ahead. With the right approach regulators can act in a way that means the UK secures the right levels of private investment to deliver major new infrastructure projects right across the country, while meeting the needs of current and future consumers at the best value.



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