



## THE FUTURE OF REGULATION

Our response to the National Infrastructure Commission's call for evidence

## INTRODUCTION

Economic Insight is delighted to provide this brief response to the “The future of regulation study” call for evidence published by the National Infrastructure Commission (NIC).<sup>1</sup> Economic Insight is advising several companies involved in both the PR19 and RII0-2 price control processes.

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<sup>1</sup> [View the NIC Report](#)



Economic  
regulation has  
a major impact  
on infrastructure  
investment in  
the UK

The study and its call for evidence is timely: all water companies have recently received the first round of feedback from Ofwat on their 2020-25 business plans as part of the 2019 price review and Ofgem is continuing to engage with energy companies on its approach to RIIO-2.

Economic regulators have significant influence over the level, type and timing of infrastructure investment through the allowances and incentives they set. To illustrate the scale of the impact economic regulation has on investment, Ofwat has recently published its first round of feedback on water companies' 2020-25 business plans.<sup>2</sup> Amongst other things, Ofwat's work contains important data on the size of the investments planned by water companies between 2020 and 2025.<sup>3</sup>



The data shows that water companies have proposed capital enhancement investments of over £15 billion between 2020-25, representing a 60% increase on historic expenditure of around £9 billion.



The data also shows that Ofwat considers that a lower of expenditure is required at around £11 billion – a difference of £4 billion (or 30%).

Of course, differences between companies and the regulator are not unusual, but this simple comparison illustrates that the approach to economic regulation really matters for investment.

In this response, we highlight two growing features of economic regulation that together will have a significant impact on investment and innovation, and are therefore highly relevant to the call for evidence.



The first feature is the use of incentives to encourage specific outcomes or outputs identified by regulators and/or regulated companies.



The second feature is the use of caps to limit the returns regulated companies can make.

<sup>2</sup> This is called the "initial assessment of plans" or IAP.

<sup>3</sup> View [Ofwat PR19 initial assessment of plans document](#)



# The impact of incentive design on investment and innovation

Both Ofwat and Ofgem use incentives to encourage regulated companies to deliver the outcomes that customers want.<sup>4</sup> Companies face financial penalties for missing their targets and can earn financial rewards for exceeding them. Therefore, the level at which the targets are set affects the financial performance of the companies and, critically, the level, type and timing of infrastructure investments they make.<sup>5</sup>

To ensure that the right level of infrastructure investment takes place in the future, outcomes targets must be set in a manner that properly reflects the costs and benefits of meeting them. To help illustrate what we mean by this, we continue the example from the water sector.

Last year, the NIC recommended that water companies should aim to halve leakage by 2050 in order to help reduce the growing risk of future water shortages.<sup>6</sup> Concerns over water shortages have been echoed by other stakeholders, most recently the Environment Agency (EA).<sup>7</sup> Analysis by both agencies suggest that prevention is better than cure.



The NIC's analysis in 2018 suggests that the costs of investing in resilience (£21 billion) are significantly less than the costs of an extreme drought (£40 billion).<sup>8</sup>



The EA's analysis in 2016 suggests that a severe drought would cost each household affected more than £100, whereas the cost per household of greatly reducing the risk was only £4 a year.<sup>9</sup>

Consistent with these aspirations, Ofwat set companies an ambitious leakage reduction target of 15% by 2020 and most companies' business plans show that they intend to hit (or in some cases exceed) Ofwat's target.

Inevitably, hitting these targets comes at a cost to support the investment needed to reduce leakage. The capital enhancement expenditure included in companies' business plans for addressing the supply-demand balance adds up to around £1.9 billion between 2015-2020.

<sup>4</sup> Ofgem calls the incentives "output delivery incentives" and Ofwat calls the incentive "outcome delivery incentives", both use the acronym "ODI".  
<sup>5</sup> For example, Ofwat has set an indicative return on regulatory equity (RoRE) range for outcome delivery incentives of +/-1% to +/-3%.  
 See [Ofwat Delivering Water 2020: Our methodology for the 2019 price review](#)  
<sup>6</sup> See [NIC Natural Infrastructure Assessment document](#)  
<sup>7</sup> See speech notes "[Escaping the Jaws of death: ensuring enough water in 2050](#)"  
<sup>8</sup> Ibid.  
<sup>9</sup> See speech notes "[Escaping the Jaws of death: ensuring enough water in 2050](#)"

Ofwat's assessment is that £1.9 billion is too much and is allowing just over half at around £1.1 billion – a difference of £0.8 billion (accounting for around 20% of the £4 billion gap noted above).<sup>10</sup> Much of the difference in view is accounted for by the fact that Ofwat considers that a 15% leakage reduction is achievable without any increase in expenditure over historic levels, whereas companies disagree.

For the purpose of this response, it is not necessary to decide whether Ofwat or the companies are “right”. It is simply enough to note that neither the target nor the ambition for hitting it has dwindled, but there is new evidence on how much it will cost to hit it in the companies' business plans.

This feature of economic regulation raises several questions that the NIC should consider answering as part of its study:



Should government or its agents commit or signal such targets prior to the process of fully evaluating their feasibility and cost?



To what extent should economic regulators be able to deviate from such targets once their feasibility and cost have been fully evaluated? Similarly, to what extent should government or its agents be able to revisit targets once a full evaluation has taken place?



To what extent should economic regulators be able to interpret government's views regarding the appropriate balance between keeping prices low today and delivering on such targets tomorrow?

Our view is that there is a need to better join up the setting of outcomes targets with the costs and benefits of meeting them. One way of achieving this is to ensure that price review processes do not set targets in advance of a full evaluation of the feasibility and cost of meeting them – and this may require changes in the way that government and economic regulators interact and/or the order in which things are done. Another way is to ensure that the cost baselines set by regulators are consistent with the targets that companies are set.

<sup>10</sup> [View Ofwat assessment data](#)



The impact  
of capping  
outperformance  
on investment  
and innovation

Ofgem considers that regulated energy companies have systematically outperformed its assumptions when setting the price controls. It therefore stated that it planned to “*limit the potential for outperformance caused by factors outside of a company’s control, or that is due to flaws in the underlying budget/output target-setting process*”.<sup>11</sup>

This year, Ofgem consulted on introducing various return adjustment mechanism’s – predictable ex ante rules – that would limit the extent of out or underperformance achievable by companies.<sup>12</sup> Similar concerns and adjustments exist in the water sector. For example, last year, Ofwat decided to increase Severn Trent’s outcome delivery incentive performance targets once it had exceeded its original target.<sup>13</sup>

The practical challenge is that it is difficult to distinguish between outperformance caused by companies innovating, versus outperformance caused by flaws in the price control process. Accordingly, economic regulators face the challenge of balancing two risks: the risk of customers overpaying for utility services versus the risk of stunting company incentives to invest in cost-reducing innovations. Implementing measures that increase the certainty of “fair returns” may come at the expense of promoting innovative (and so riskier) investments.

Again, this feature of economic regulation raises several questions that the NIC should consider answering as part of its study:



Is there a common and coherent view across the economic regulators on what the right balance is between these risks and is this consistent with the government’s objectives with regards to promoting investment and innovation?



How is the right balance achieved via the implementation of economic regulation? To what extent does the design and implementation of the price controls contribute to meeting the objectives?

Our view is that there is a need to better understand the impact of capping the returns on investment and innovation activity. This could involve undertaking cross-sector or cross-country studies, for example comparing countries with rate-of-return regulation versus countries with price-cap regulation. Early consideration of how to measure the success or otherwise of the return adjustment mechanisms also seems important. Finally, we must avoid the “clawback” of outperformance after it arises – such an approach both dulls incentives and increases regulatory risk to the detriment of customers.

<sup>11</sup> See [Ofgem RIIO-2 Framework Decision report](#)

<sup>12</sup> See [Ofgem RIIO-2 methodology](#)

<sup>13</sup> See [Ofwat Final determination of In-period ODIs for 2018 report](#)

## NEXT STEPS

We hope that the observations set out in this brief response are helpful. We would be delighted to discuss any of them with the NIC as its study progresses.

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