

6 INDUSTRY COMMENT

PINPOINTING PRIORITIES TO IMPROVE REGULATION

Frontier Economics on behalf of UKWIR has sifted through options for future work on the regulatory framework and identified three front-runners.

In September 2020, UKWIR commissioned Frontier Economics to explore its regulatory focussed 'Big Question', which asks: "How do we ensure that the regulatory framework incentivises efficient delivery of the right outcomes for customers and the environment?". The objectives of this project are to identify the priorities of UKWIR's members for increasing the effectiveness of economic regulation in the water industry, and based on this, to define future work on

specific aspects of economic regulation. UKWIR's Big Question on this topic is wide-ranging, as it covers all aspects of economic regulation across all the jurisdictions in which its water company members operate (England, Wales, Scotland, Northern Ireland and the Republic of Ireland). This makes it challenging to address for a number of reasons: the regulatory approaches differ across the jurisdictions; individual components

of these regulatory approaches can be complex; and there are various ways in which the individual components overlap and interact within each overall regulatory approach.

To address this challenge, and to help identify UKWIR members' priority areas for improvement, Frontier Economics broke the Big Question down by developing an overview of components that typically make up an overall regulatory methodology, which is shown in Figure 1. This illustrative overview includes three levels: the form of a price control (e.g. whether a Regulatory Capital Value is used or not); the roles of various players; and more detailed building blocks which are often used to form the core of a regulatory approach.

To identify UKWIR members' views and priorities on how economic regulation in the water industry could be improved in future, Frontier Economics took this overview and held virtual interviews with individual water companies, asking the following questions.

What are your top three strategic priorities for the future of economic regulation in the sector?

What are the key interactions between different components of economic regulation that need to be addressed?

We are very grateful for the level of interest and engagement that we received from all water companies that took part in the interviews. This enabled us to identify interesting discussion topics for the workshops that we held and which we were confident the industry would find helpful.

Priority topics

Based on the findings from these interviews, Frontier Economics identified six priority topics for the industry to consider further. These topics were then discussed at six virtual workshops, where existing issues were explored and potential options for future work on these topics were identified. All UKWIR member companies were invited to attend the workshops.

The six topics are summarised in Figure 2 and further detail on the workshop discussions is provided below.

The role of the customer. There was general agreement that customers should be engaged, where it is possible to conduct meaningful research and where the insights can be used to genuinely inform business plans and regulatory decisions. In terms of options for the future, evolutionary changes (e.g. incorporating national research as well as company-led research) were generally favoured, although there was some support for more revolutionary shifts (such as moving to a negotiated settlement, where this is not currently used).

Long-term issues. There was overall consensus that long-term incentives (including explicit mechanisms and more implicit incentives) are important. In particular, it was noted that if there is an insufficient emphasis on the longer term, then this risks affecting performance lev-

FIGURE 2: TOP PRIORITIES FOR IMPROVING ECONOMIC REGULATION



els for future generations and some environmental outcomes. Potential future options to increase the balance on the longer term included: introducing more risk-based cost assessment; setting service quality targets over a longer time period; and setting more genuinely high-level outcomes rather than measures being more output focused in practice.

Optimal investment in achieving environmental outcomes. There was general agreement that there are potential barriers to investing in nature-based solutions (see p10). A range of options to address this were discussed, including more explicit measurement of natural capital (e.g. as a subcomponent of the RCV) and amending investment appraisal guidance to more effectively capture environmental benefits.

Government role and light-touch regulation. There was general agreement to maintain the status quo in terms of how economic regulation and government policy interact in each jurisdiction. In particular to maintain the government's role in setting the broader policy architecture, and the economic regulator's role in

developing detailed regulatory methodologies to achieve those high-level policies. An interesting discussion was had on the merits of returning to light-touch regulation (i.e. the original form of RPI-X regulation). On balance, there was some interest in simplifying the regulatory framework but not to any great extent. It was also noted that the sometimes complex mechanisms have been introduced for a reason, and simplifying these mechanisms risks leading to more unfair outcomes for companies and/or customers.

Integration of cost assessment and service quality. The group recognised that this topic has been considered many times before by companies and regulators, so even though it remains a priority for some, it may not represent good value in terms of carrying out

further work. One potential option for improvement is sequencing elements of price control decisions. This may be pragmatic and increase focus on each area when it is considered, but may not be a credible approach if more information comes to light as the review goes on, meaning that changes are made to earlier decisions.

Balancing risk and reward. It was agreed that, despite implementation challenges, the use of a regulatory risk and reward measure remains valuable. The common view was therefore that future work should look to improve the current measures of risk, to ensure they better articulate risk, and also to develop guidance to support companies and regulators to carry out these calculations more consistently.

We are very grateful to all the

water companies who took part in these workshops, and recognise the significant time commitment they invested in the project. This level of engagement and discussion enabled us to identify future work that UKWIR members can take forward in 2021.

Future work options

Any future work that is commissioned by UKWIR needs to deliver best value for its members. Therefore the short list of options for future work from these six areas should take account of UKWIR members' priorities, work that has been carried out in the past and is ongoing, and also where there is scope to influence the shape of future regulatory policy.

At a discussion forum held on 18 January 2021, UKWIR and Frontier Economics gathered views and priorities from key stakeholders (such as economic regulators, environmental regulators, government departments, and consumer bodies) to ensure the proposed way forward reflects their views as well.

Based on all of this, this project has identified three key areas for future work:

- Long-term incentives and investments.
- Customer and stakeholder engagement.
- Regulatory risk and reward measures.

UKWIR and its members will now look to commission future work on the priorities that were identified. This work will provide detailed assessment of options improvement, which will inform decision making for the next set of price controls in UKWIR members' jurisdictions.

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FIGURE 1: OVERVIEW OF ECONOMIC REGULATION IN WATER

