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Resisting marshmallows: the BEIS strategy for economic regulation

February 2022

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Governments are to economic regulators like children are to marshmallows: they know they'll get the best results if they leave them well alone, but find it hard to resist the sugar-rush of intervention.

This is the tension implicitly recognised in the BEIS paper on the future of Economic Regulation published on Monday. The paper is the start of the process of reforming the fundamental basis of economic regulation in the UK following leaving the EU. The reforms will affect all regulated firms, their investors, and their customers. The paper correctly identifies a number of tensions and imperfections in the current regime of economic regulation for industries such as telecoms, water, and energy. It also makes broad commitments for reform to try to remedy these concerns.

A number of these reforms, such as increased consistency in the calculation of the cost of capital, are relatively technical and likely have no regrets. Others, such as clearer mechanisms for central government setting regulators a "strategic direction", are more nuanced and will have many devils in their detail.

This note outlines the points in the BEIS paper that will be of most interest to regulated firms, and some of the tensions and challenges that the paper raises. It concludes with some thoughts on how regulated firms, and their investors, might want to engage with the process to minimise risk and, perhaps, unlock new opportunities.

Summary of BEIS paper

The BEIS paper opens with a recognition of the importance that long-term policy stability has had in delivering £450bn of private sector investment in regulated industries since privatisation. Building on recommendations from the National Infrastructure Commission and the content of the National Infrastructure Strategy, and mindful of both the challenges of our 2050 Net Zero commitments and the increased regulatory flexibility afforded by leaving the EU, the paper proposes four areas of reform to ensure the UK remains "a prime global destination for investment into utilities sectors for the long-term benefit of consumers." These are:

- **Increased coherence of duties across economic regulators**, with a suggestion that the number of duties will be simplified. The proposed duties cover price/quality, resilience, and environmental impact/carbon footprint.
- **Increased consistency and transparency of the "strategic leadership" of economic regulators by central government**, potentially through the (not too regular) publication of guidance letters. Kwasi Kwarteng, the Secretary of State for BEIS, published a general letter to all economic regulators on the same day as the BEIS paper. It ran to a modest 1900 words and called for roughly equal balancing of the objectives of growth, fairness, and sustainability.
- **Promoting transparency and consistency between regulators**, in addition to the work of the existing UK Regulators Network. The paper focuses on increasing the consistency of some shared areas of technical regulation, such as establishment of the cost of capital, and on the complex and divergent mechanisms for appeal of regulatory decisions.
- **Promotion of greater competition in strategic investment**, in particular by asking regulators to try to increase the scope for competitive bidding for the delivery

of investment rather than assuming that incumbents will invest and be compensated under the traditional model of a regulated return on investment. The paper cites historical successes with Thames Tideway and Ofgem and BEIS's work on off-shore wind and system operation.

Tensions

The paper is a great start. It clearly identifies a number of the challenges that currently exist in economic regulation, and begins a process to address these.

However, when scratched, the paper highlights three tensions within economic regulation that will need to be addressed as any future reforms are implemented.

> The sugar rush of ordering regulators to change focus and redirect resources is hugely appealing for governments, but risks muddling objectives and undermining independence and consistency.

The eating of marshmallows (or, the importance of time-consistency in policy)

The paper implicitly recognises the risk of short-term government actions undermining the long-term policy stability required to encourage investment. Examples of such actions might be the 1997 windfall tax on utilities, the energy price cap, or the way that Ofcom has delivered the government objective of faster rollout of fibre to the premises at the expense of legacy copper customers and, potentially, the long-term credibility of the price-control system.

However, the paper also recognises the importance of governments being able to steer and influence economic regulators to ensure democratic accountability of powerful technocrats making decisions that affect the lives and futures of all citizens of the country.

The paper suggests sensible reforms to mitigate this tension in the future, focussed around a clearer and more consistent relationship between government and the economic regulators. In particular, it is important that the concept of a strategic steer is not used as a cover for what in practice may be more of a tactical diktat. BEIS is leading by example in this regard, with its 1900 word all-regulator strategic letter less than one third of the length of DCMS's 2019 "Statement of Strategic Priorities" to Ofcom.

An alternative to "strategic steers" may be to slightly reverse the flow of control such that regulators are required to publish and consult on annual or multi-year plans that show how they are delivering against wider policy objectives, with government, and perhaps the National Audit Office, responding to those plans through normal channels of consultation.

Reducing the number of marshmallow given to each regulator (or, the difficulty of balancing multiple objectives)

Too many duties can paralyse decision-making and risk not satisfying any stakeholder. Different duties between regulators risk inconsistency in how to tackle cross-sectoral challenges. Most effective organisations typically have a single or very few duties, but considerable leeway on how they deliver them. The recommendation of the paper to reduce the number of duties, and make them more consistent, is welcome.

However, it appears that regulators will continue to have multiple competing duties under the new reforms. Price, quality, resilience, environmental protection, and carbon output are all mentioned in the BEIS paper. The strategic guidance from the Secretary of State further mentions distributional concerns of fairness amongst consumers, particularly those considered vulnerable.

Such a plethora of duties, some of which are clearly mutually exclusive, risks uncertainty for market participants, inefficiency for regulators, and a lack of clarity and democratic accountability between regulators and government in how trade-offs are made.

While strategic guidance from government may help, BEIS could consider additional mechanisms for solving the problem of competing regulatory objectives. One solution might be to remove objectives relating to distributional concerns but require regulators to make detailed distributional impact assessments that government can then take into account in their own, broader, distributional policies.

Having just one really big marshmallow (or, biting the "one regulator" bullet)

The paper is right to comment that there is considerable inconsistency in both the process and substance of the way economic regulators operate, and that much of this inconsistency may not be justified by differences in the industries which they serve. The proposals for greater consistency have to be welcomed. Similar attempts to increase consistency can be observed in initiatives such as the Digital Regulation Cooperation Forum.

But the paper does not take this argument to its logical conclusion: why not simply have one economic regulator focused on regulating prices and returns across multiple industries? Non-economic licence conditions, such as consumer protection or online safety or environmental damage, could continue to be operated by sectoral oversight bodies. Competition enforcement could be consolidated in the CMA, replacing the current web of concurrency.

> The government's recent paper on economic regulation recognises the tensions between regulator independence and accountability, and the challenges in balancing competing stakeholder objectives.

While a significant change with its own challenges, such a model could also have significant benefits:

- Consistency in shared calculations and policies would be ensured on a structural basis.
- Many firms invest in multiple regulated markets, and a single consistent regulator would reduce risk and costs of investment.
- Separating economic regulation from non-economic regulation would simplify the difficult job of regulators balancing multiple objectives across multiple tools, reduce the risk of sectoral regulatory capture, and reduce the chance of implicit and untransparent cross-subsidisation or trade-offs in the regulatory compact (such as allowing a firm an easy ride in one space in return for concessions in another).

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For regulated firms and their investors: so what?

The BEIS paper should be welcomed, and the proposed reforms are almost all sensible. However, there is significant devil in the detail. Detail that will become clearer when a more detailed consultation on the future of regulation is published later in the year.

Government, the regulators, regulated firms, and their investors want a regulatory regime that is efficient and consistent. The most constructive role regulated firms can play in the further development of the regime is in highlighting areas of uncertainty that should be reduced, and linking that uncertainty to the investment, business decisions and costs seen in the normal course of business. Engaging now with the BEIS team can help shape early thinking on the future of economic regulation, and may be sensible for firms with strong opinions on what should, or should not, change.

Once the objectives and duties of the regulators become clearer over the next few months, regulated entities could consider how closely their own objectives align or deviate from those of the regulator and whether any divergence might cause unnecessary friction. An assessment of how their own business models and culture align with regulatory objectives may uncover opportunities for optimisation. Optimisation that could reduce operational complexity, mitigate regulatory risk, increase commercial agility, and ultimately deliver for both consumers and investors.

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