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Agenda

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Legitimacy and renationalisation: where next for utility regulation?

UK regulated utilities are facing the tightest scrutiny that they have experienced in years. A tit-for-tat battle between the two main political parties in proposing changes to address public concerns has culminated in the Labour Party proposing renationalisation and the Conservative Party greater regulatory supervision. So what is the regulatory outlook for customers, companies and their investors in the context of the renationalisation agenda and other recent developments?

UK utilities companies are facing tight scrutiny, with declining confidence in some quarters that regulatory oversight of privately owned companies is delivering good-quality services at fair prices. Concerns that companies are excessively profitable are commonplace in media reports and opinion pieces; financing structures and shareholder dividends too are under the spotlight.[1]

The blame has not been borne by the companies alone. In 2015, the National Audit Office published a heavily critical review of Ofwat, the economic regulator of the water industry in England and Wales, which concluded that the regulator had allowed companies to make large windfall gains from factors outside their control between 2010 and 2015.[2] The Office of Rail and Road (ORR) fared no better in write-ups from the Public Accounts Committee and Dame Colette Bowe's inquiry. These followed Network Rail's admission that it would be unable to deliver the CP5 enhancements programme within the funding envelope.[3] Finally, the Helm Review recommended a significantly reduced role for the energy regulator for Great Britain, Ofgem, in regulating energy networks.[4]

In short, the utilities *and* their regulators have an image problem.

For the Labour Party, under the leadership of Jeremy Corbyn and Shadow Chancellor John McDonnell, the solution to this problem is renationalisation. The party outlined its intention to bring water, energy and rail companies back under public control, and to reverse the more recent privatisation of Royal Mail, in its 2017 election manifesto. More recently, in February 2018, the party held a conference on Alternative Models of Ownership, sending a clear message to stakeholders—renationalisation of utilities remains high on the party's list of priorities.

Survey evidence suggests that it is a popular policy with the public. A YouGov survey undertaken in the run-up to the last election found that the majority of respondents believed energy companies (53% of respondents), water and railway companies (c. 60%), and Royal Mail (65%) should be owned and managed by the public sector.[5]

Regulators and industry participants were aware of negative public perceptions long before the Labour Party's policy announcement, and the concept of 'legitimacy' has become a much-used part of the regulatory lexicon. However, with nationalisation now a 'credible threat', the pressure is greater than ever for regulators to show that they are delivering against their duties and securing good outcomes for consumers, and that they have a handle on the companies they regulate. Meanwhile, in contrast to the Labour Party, the position of the incumbent Conservative government is that confidence can be restored through greater regulatory scrutiny.

Regardless of whether widespread renationalisation is a realistic short-term proposition, the fact that the outcomes delivered by privately owned utilities are being so openly questioned in the political arena is likely to have a knock-on effect on the behaviour of companies, and on the next round of price reviews and beyond. For companies and shareholders, the implications could be far-reaching.

Tighter controls on governance and financing structures

Current pressures

Of particular concern to shareholders will be the threat of greater regulatory intervention in companies' management and financial arrangements. Take the water sector. In January 2018, the Secretary of State for Environment, Food and Rural Affairs, Michael Gove, wrote to Jonson Cox, Chairman of Ofwat, outlining some familiar bugbears—off-shore financial arrangements, securitisation, high leverage, high levels of executive pay, and high dividend payments.[6]

Gove's letter concluded by asking Ofwat to investigate whether and how these behaviours should be tackled, and hinted that Ofwat may be given stronger powers to do this. Roll forward to 1 March 2018, and the intent has become clearer, with both Gove and Cox providing speeches at the Water Industry City Conference that did not shy away from further intervention.[7]

Renationalisation is something that the current government does not want to see but, as highlighted by Gove, 'Unless we see change, the pressure for renationalisation will only grow'.[8] Gove highlighted the complexity of some company financing structures and the use of off-shore tax havens, and went as far as naming individual companies. He also (albeit indirectly) questioned levels of executive pay, naming individual CEOs. Gove expressed further concerns as to whether highly leveraged companies would be in a position to absorb financial shocks, given the erosion of the equity 'buffer zone'.[9]

Cox has since picked up the baton, putting forward a wide range of governance and regulatory changes to address legitimacy concerns in the sector. These include:

- the prospect of 'significant scrutiny' at the next price review for companies that do not satisfy financial resilience criteria, and that have an 'aggressive' financing structure that departs significantly from Ofwat's notional assumptions on gearing;
- the suggestion that companies adopt a 'progressive dividend policy' that follows best practice in the sector, with the 'gateway' to any dividend payout being that the company must be delivering on its promises to customers;
- that the majority of board directors should be separate from investor-owners, and that board–investor relations should be transparent.

Ofwat refers to the above as 'Tier 1' activities—which it is currently working on—and is also considering a set of 'Tier 2' activities, including a licence duty to place customers and society at the heart of business; licence conditions relating to financial resilience for all companies (e.g. a requirement to achieve an investment-grade credit rating, and cash lock-up provisions in the event of poor financial performance); and a simpler process for agreeing such licence changes.

Taking stock

The issue of leverage is not a new area of focus. Debates around optimal gearing levels have rolled on for two decades—and Oxera has actively contributed to this debate.[10] Ofwat introduced a set of principles on 'Board leadership, transparency and governance' more than four years ago, going beyond the existing conditions in the network licences.[11] A number of regulators have introduced new reporting arrangements (e.g. Ofgem's RIIO accounts), board assurance of business plans, and requirements around financial resilience (e.g. the Civil Aviation Authority's (CAA) requirement that airports produce annual sufficiency of resources statements covering the forthcoming 24 months). The latter is evidently an area of particular interest as regulators seek to ensure companies are able to withstand shocks.

There may be even more radical requirements to come—customer representation on boards, gearing caps, requirements to maintain minimum cash balances, restrictions on executive pay, and mandatory equity injections. Ofwat is not alone here—the CAA, for one, is considering similar measures for Heathrow Airport.[12] The UK air traffic control services provider, NATS, is already subject to a gearing cap (of 65%).

Ofwat has indicated that it will provide an update on its plans in early April 2018. The outcome will be of relevance to shareholders across regulated sectors.

In the meantime, some companies have decided not to wait—Anglian Water became the first company to set out a package of measures intended to address the concerns raised by Michael Gove and Ofwat, including a reduction in dividends and gearing, and changes to its financial structure and board composition.[13]

Tougher price settlements

Ex ante allowed revenues

An obvious response of regulators to political and public pressure of the kind described above is to set tougher price controls and performance targets. A number of levers are available to the regulators to do this.

- **Lower allowed returns**. At the last round of price reviews, the going rate for the (real, vanilla) WACC was well below 5%. Early indications are that the allowed rates of return will be even lower this time around. Ofwat's WACC estimate of 2.4% (real, RPI-based) is 133bp lower than its PR14 estimate, while the CAA has presented an initial range of 3.0–3.9% for Heathrow (with a wider range of 2.8–4.6% if the third runway goes ahead). The conclusion? Forget 5%—regulators are looking at figures of 4% and below.

- **More challenging efficiency assessments**. A second route to lower prices is to require companies to deliver larger or faster efficiency improvements. There is already some evidence that this is happening. Ofwat's PR19 methodology includes a number of changes to its cost assessment approach that are likely to result in companies facing a tougher efficiency challenge.[14] The ORR last year consulted on ways in which it can drive improvements in Network Rail's renewals efficiency in CP6.[15] While Ofgem and the CAA have yet to provide much detail on their cost assessment approaches, they may be inclined to follow suit, particularly in the context of large investment programmes (and, hence, growing cost bases).
- **Higher total expenditure (TOTEX) capitalisation rates**. Under the TOTEX approach, Ofwat and Ofgem have another tool at their disposal to reduce prices in the short term. Increasing the proportion of spend that is added to the regulatory asset base and returned over multiple years ('slow money') would have the effect of bringing down prices in this period. Of course, this is no more than a short-term fix and would be offset by higher prices in future periods, making it a temptation that should be resisted absent strong grounds to do so.
- **Tougher performance targets**. As well as clamping down on prices, regulators might seek to set more challenging performance targets that companies would need to meet in order to achieve the baseline return.

Overall, companies should expect lower rates of return and greater efficiency challenge. This is particularly important in the context of large capital programmes, which will put upward pressure on charges absent offsetting efficiencies and lower returns.

Ex post outperformance-sharing

As well as getting tough on the forecast costs and returns baked into price settlements, regulators might look to limit the extent to which companies can benefit from outperforming these targets. In particular, the message coming out of regulators is that they want to take additional steps to reduce the scope for companies to benefit from factors deemed to be outside their control or from 'gaming' regulatory forecasts. As Ofgem has noted, this is at the heart of the concept of legitimacy:

> Stakeholders are more likely to view high returns as legitimate or fair when they are the product of efficiency or innovation. They are less likely to view them as legitimate or fair when they are perceived to be the result of companies exploiting the information asymmetry or windfall gains due to economic conditions differing from original forecasts.[16]

For Ofwat, this is critical following the National Audit Office's finding that companies made net gains of at least £800m between 2010 and 2015 as a result of falling borrowing costs and the corporate tax rate.[17] Ofgem has similarly recognised that all network companies are currently forecasting significant TOTEX underspend, as well as outturn returns above the baseline rate of return for current control periods.[18]

Regulators might take several approaches (or companies may propose them themselves) to rebalance risks.

- **Cost-sharing incentive rates**. Ofwat and Ofgem both prescribe TOTEX incentive rates—i.e. the proportion of any cost saving that is shared with customers. Ofgem is exploring the possibility of 'sculpting' incentives—i.e. linking the sharing rate to the company's financial performance, such that there is greater sharing with customers as company returns increase.[19] The CAA has signalled that it intends to explore caps and collars on incentive payments, sliding scales, and/or sharing factors for the H7 review.[20] In all of these systems, there may be a requirement of greater sharing with customers.
- **Indexation and automatic pass-through mechanisms**. Ofwat is following Ofgem's lead by indexing the cost of new debt (albeit with a slightly different approach), and the CAA is consulting on whether to do the same. PR19 will also feature a mechanism to pass through changes in tax rates. Companies might consider whether to propose their own sharing mechanisms to cover a wider range of cost items. South West Water's WaterShare mechanism, which identifies factors outside of management control and allows for bill reductions or reinvestment where the company benefits in these areas, may well become the industry standard.
- **Re-openers or ex post claw-backs at the discretion of the regulator**. While regulators have typically been reluctant to claw back outperformance after the event for fear of undermining incentives, this remains an option. For example, the Commission for Aviation Regulation in Ireland reopened Dublin Airport's control in 2016/17 to take account of significant volume outperformance.[21] (Even if regulators are loath to claw back profits, the government might do so. Many will remember the windfall taxes imposed on privatised utilities in the late 1990s.)
- **Anchored returns**. Ofgem has discussed the possibility of anchoring ex post returns to the cost of equity that is captured in the ex ante WACC settlement.[22] This would involve setting a target range for the cost of equity ex ante and then making ex post

adjustments to ensure that companies' actual returns fell within this range. Better-performing companies would still be allowed to earn higher returns than poorly performing companies, but the realised returns would be anchored to ex ante expectations.

- **Profit cap and floor**. Regulators could set explicit caps and floors on the distribution of returns, such that the company would not be allowed to earn more than the cap. This could be a 'soft' cap, allowing companies to earn more where they are able to prove to the regulator that the higher returns are due to positive management actions or innovation.

Naturally, any such mechanism runs the risk of diluting incentives and/or creating additional, unforeseen distortions to behaviour. Consequently, careful thought will be needed as to how sharing/uncertainty mechanisms are designed and implemented. However, the overall direction of travel is clear—companies should expect greater scrutiny of outturn returns, as well as lower baseline returns.

It may therefore be in companies' long-term interests to be proactive in this area, identifying factors that are outside the control of management and putting in place arrangements to pass through any benefits that arise from these factors. Given that a key element of legitimacy is perception of fairness, mechanisms to prevent windfall gains (if well designed and effectively explained) to regulated firms could do much to restore confidence in the regulatory model.

Greater protection of vulnerable customers

A final area of increasing regulatory attention is how companies treat vulnerable customers. The requirements on companies will be both price- (i.e. increasing use of social tariffs) and service-related (i.e. additional customer support), and there will necessarily be implications for customer engagement and data collection. This may be led by regulators (such as Ofgem's introduction and extension of the safeguard tariff for users of pre-payment meters) or by the companies themselves (as envisaged by Ofwat).

This is an interesting development, not least because it inherently requires a departure from textbook economics. The ability to make social trade-offs is the latest addition to the regulator's required skill-set.

Concluding thoughts

The next round of price reviews will take place in the shadow of renationalisation. The Gove and Cox speeches are statements of intent, and all companies will need to assess their current governance and financing arrangements. Clearly, the status quo is not an option, in particular for the highly geared companies.

Companies should expect to receive a tough time in terms of both base price settlements and their ability to increase returns by outperforming these settlements. As ever, the companies that do best will anticipate their regulators' and consumers' positions, and will produce business plans that directly address them.

Best practice would indicate that any policy and regulatory decisions should be led by the evidence. In this respect, it is important to ask the right questions before developing potential solutions. Is it policy, ownership, industry structure, governance, financing or regulation that is driving the problem? In terms of potential remedies, should a common approach be applied across the particular industry, or is it not a case of one-size-fits-all?

Companies (and regulators) have a fight on their hands to regain credibility with the public and their political masters—if neither side heeds the warning of renationalisation and works towards a more sustainable regulatory outcome, time could be up for the utilities model as we know it.

[1] For example, see *Financial Times* (2017), 'Thames Water: the murky structure of a utility company', 4 May.

[2] National Audit Office (2015), 'The economic regulation of the water sector', 14 October.

[3] Department for Transport (2015), 'Report of the Bowe Review into the planning of Network Rail's Enhancements Programme 2014-2019', presented to Parliament by the Secretary of State for Transport by Command of Her Majesty, November; Network Rail (2016), 'Report from Sir Peter Hendy to the Secretary of State for Transport on the replanning of Network Rail's Investment Programme', January; Shaw, N. (2016), 'The future shape and financing of Network Rail. The recommendations', March.

[4] Helm, D. (2017), 'Cost of Energy Review', 25 October.

[5] YouGov (2017), 'Nationalisation vs privatisation: the public view', 19 March.

[6] Defra (2017), 'Letter 1: from the Secretary of State to the Chair of Ofwat', 31 January.

[7] Gove, M. (2018), 'A water industry that works for everyone', speech at Water UK City Conference; 1 March; Ofwat (2018), 'Jonson Cox speech at Water Industry City Conference, 1 March 2018', 1 March.

[8] Gove, M. (2018), 'A water industry that works for everyone', speech at Water UK City Conference; 1 March.

[9] Gove, M. (2018), 'A water industry that works for everyone', speech at Water UK City Conference; 1 March.

[10] For example, see Oxera (2002), 'The Capital Structure of Water Companies', report for Ofwat, 11 October, http://bit.ly/2Gj8f7G.

[11] Ofwat (2014), 'Board leadership, transparency and governance—principles', January.

[12] Civil Aviation Authority (2017), 'Economic regulation of capacity expansion at Heathrow: policy update and consultation', December, CAP 1610, Appendix F.

[13] Anglian Water (2018), 'Anglian Water announces Board and shareholder commitments to improve transparency, show that public interest is at the heart of the business, increase investment and reduce dividends', 15 March, http://bit.ly/2DPcbHV.

[14] Oxera (2017), 'It's a tough one: Ofwat's PR19 methodology', *Agenda*, September, http://bit.ly/2pA6Pfn.

[15] Office of Rail and Road (2017), 'Improving Network Rail's renewals efficiency: a consultation', July.

[16] Ofgem (2017), 'Open letter on the RIIO-2 Framework', 12 July, p. 7.

[17] National Audit Office (2015), 'The economic regulation of the water sector', 14 October, p. 10, para. 18.

[18] Ofgem (2017), 'Open letter on the RIIO-2 Framework', 12 July.

[19] Ofgem (2018), 'RIIO-2 Framework Consultation—Our approach to setting price controls for GB gas and electricity networks', March.

[20] Civil Aviation Authority (2017), 'Consultation on core elements of the regulatory framework to support capacity expansion at Heathrow', CAP 1541, p. 32.

[21] Commission for Aviation Regulation (2017), 'Decision on the Interim Review of the 2014 Determination of Airport Charges at Dublin Airport Related to the North Runway', Commission Paper 4/2017, 28 April.

[22] Ofgem (2018), 'RIIO-2 Framework Consultation—Our approach to setting price controls for GB gas and electricity networks', March.