Sustainability first

Contact: Zoe.mcleod@sustainabilityfirst.org.uk
23 August 2023

Email: betterregulation@beis.gov.uk

Dear Department for Business and Trade,

Re Smarter Regulation: Consultation on extending the Growth Duty to the economic regulators, Ofgem, Ofwat and Ofcom

Sustainability First is an independent charity and think tank focused on promoting practical solutions to deliver fair and sustainable energy and water sectors. We work extensively with regulators Ofgem and Ofwat, energy and water companies, and civil society and consumer groups.

We welcome the opportunity to respond to this consultation and also direct DBT to our related expert viewpoint by Sustainability First Associate and former Treasury macro-economist Martin Hurst - How the utilities sector could play into the growth agenda.

Key messages:

- We agree with the need to secure significant investment in essential service infrastructure and how important water, energy and telecoms are for Britain PLC to thrive. However, it's important that regulators drive the 'right kind of growth'.
- We do not support the Deregulation Act 2015 Growth Duty being extended to the economic regulators of Ofwat and Ofgem in its current format. In practice, Ofgem and Ofwat already support growth in many of the ways outlined in current Duty and associated guidance.
- Simply creating another 'must-do' Duty isn't going to be helpful unless DBT provides further guidance on how trade-offs should be made between different primary and secondary duties. This is especially the case as the Strategic Priorities for Ofwat[1] and the draft strategy and policy statement for energy[2] are largely silent on trade-offs.
- There is a risk that despite its intentions, the Duty has unintended negative consequences; further strengthening the interests of industry at the expense of consumers, wider societal and environmental needs. This at a time when there is low trust in regulators, a biodiversity and climate crisis, and the opposite is needed. If anything, DBT needs to support culture change within these regulators to become more consumer centric in particular[3]. Given how it may be interpreted, rather than strengthen growth, the Duty could in practice further undermine public trust in the water and energy sectors, in competition, and in turn then investor confidence with the wider knock-on negative effects to the economy.
- Any new Growth Duty should be updated to focus on delivering 'sustainable growth' with guidance acknowledging both the direct and indirect ways in which water, telecoms, energy and regulators support a prosperous economy, and the interplay between growth, a thriving environment and healthy stable society. This includes building legitimacy and trust and the social licence to operate.

---

[1] https://www.gov.uk/government/publications/strategic-policy-statement-to-ofwat-incorporating-social-and-environmental-guidance/february-2022-the-governments-strategic-priorities-for-ofwat
[2] https://www.gov.uk/government/consultations/strategy-and-policy-statement-for-energy-policy-in-great-britain
[3] https://www.sustainabilityfirst.org.uk/publications-expert-viewpoints/423-why-the-failing-energy-sector-is-a-lesson-for-all-regulators

- Promoting a thriving environment must be explicitly acknowledged as positive for growth (not just the transition to net zero energy). In the guidance, more could be made of the growth potential of environmental protection and enhancement and net zero, as creating advantage for the UK in what will be key growth industries of the future and as 'attractors for business and younger skilled employees.' There is an argument for regulators to enable more training in green skills and climate adaptation.
- Importantly, new guidance should reflect the need for best value decision-making, not just focus on efficiency and lowest cost. That means taking into account the impact of decisions on wider society and environment. The six capitals may be a useful model to use in regulators annual reporting, capturing among other areas, intellectual, manufacturing, human, social, environmental capital alongside financial capital. We would also like DBT to encourage purpose-led sustainable businesses.
- The conclusion of the National Infrastructure Commission[4] is that the duties of the regulators need to be coherent to ensure stable and predictable regulation over the long term. Ideally DBT would review Ofgem, Ofwat and Ofcom's duties in the round, and not adopt a piecemeal approach as proposed here.
- Finally, we need an intelligent and informed debate about the role of regulation in utilities, where it is needed (for example, for market operation, consumer and environmental protection, and certainty for investors and exporters) and the areas where deregulation could genuinely help.

<u>Answers to questions</u>

1. Do you agree that Ofcom, Ofgem and Ofwat should be included in the scope of the Growth Duty specified in the Deregulation Act 2015?

No, not in its current form.

We recognise the need to secure significant investment in essential service infrastructure and how important water, energy and telecoms are for Britain PLC to thrive.

In practice however, Ofgem and Ofwat already support growth in many of the ways outlined in the proposed Growth Duty's guidance.

Simply creating another 'must-do' Duty isn't going to be helpful unless DBT provides guidance on how trade-offs should be made between different primary and secondary duties. This is especially the case as the Strategic Priorities for Ofwat and the draft strategy and policy statement for energy are largely silent on trade-offs.

If DBT introduces a Growth Duty it is important that it, and the associated guidance is updated to promote the 'right kind of growth' in the energy, water and telecoms sectors. We would prefer to see a 'sustainable growth' duty with a clear focus on the long-term. This would be consistent with regulators wider social and environmental primary and secondary duties.

In practice, we have concerns that implementing a Growth Duty in its current form could have unintended negative consequences. Ofgem has in practice struggled to find the right balance between consumer and business interests, competition, and affordability. Indeed, the House of Commons BEIS Select Committee's report on Energy pricing and the future of the Energy Market for example, talks of the 'permissive culture' toward business encouraged by 'the body politic' in Ofgem. It criticised the Government for prioritising 'competition over effective market regulation',

[4] https://nic.org.uk/app/uploads/NIC-Strategic-Investment-Public-Confidence-October-2019.pdf

leading to the collapse of the energy supply market; and Ofgem for repeatedly failing (over many years) to effectively protect consumers, including those in vulnerable situations[5].

Water companies appeals to the Competition and Markets Authority (CMA) for a redetermination following Ofwat's 2019 price review and the recent furore over raw sewage in our rivers and seas highlight Ofwat's comparable struggles to make legitimate and transparent trade-offs between affordability, long-term resilience and environmental interests. As the Environmental Audit Committee report 'Water Quality in Rivers' concluded, Ofwat has "hitherto focused on security of water supply and on keeping bills down with insufficient emphasis on facilitating the investment necessary to ensure that the sewerage system in England is fit for the 21st century". However, it highlights that the right kind of investment (not just building infrastructure) is needed with a strong focus on "cross-catchment collaboration with farmers and drainage authorities… to restore rivers to good ecological health, protect biodiversity and adapt to a changing climate".[6]

In the absence of guidance in the strategic policy statements on how regulators should make trade-offs, a Growth Duty risks being seen as a de-facto steer, further strengthening the interests of industry at the expense of consumers and environment just at a time when the opposite is desperately needed.

Trust in regulators has taken a battering. Both Ofwat and Ofgem are already perceived as too close and sympathetic to industry interests by many[7]. If anything, DBT needs to support culture change within these regulators to become more consumer and environmentally (not just net zero) centric[8]. There is a risk that the Growth Duty will have the opposite impact further undermining public trust in the sectors, competition and in turn investor confidence.

In addition, if the Growth Duty was extended with the current guidance, it risks undermining more progressive growth-related policies at regulators, and whole-system initiatives. In particular, the welcome promotion of purpose-led water companies[9] and workforce resilience and a focus on best value as opposed to lowest cost[10], which are helping to drive more sustainable growth in the public interest.

Ideally DBT would review Ofgem, Ofwat and Ofcom's duties in the round, and not adopt a piecemeal approach which could further add complexity and confusion. There is merit in streamlining regulatory duties and in this context we are not convinced a separate Growth Duty would be a priority.

2. What additional guidance would be beneficial to support effective implementation of the Growth Duty?

As noted, if a Growth Duty is introduced DBT needs to encourage 'the right kind of growth'. The Growth Duty should be updated to focus on 'sustainable growth' (capturing economic, social and environmental value) with a stronger focus on the longer-term.

---

[5] https://committees.parliament.uk/publications/23255/documents/169712/default/ p.4
[6] https://committees.parliament.uk/publications/8460/documents/88412/default/ p.6
[7] Illustrated by recent media coverage e.g. https://www.telegraph.co.uk/news/2022/09/03/water-watchdogs-independence-question-revolving-door-polluting/
[8] https://www.sustainabilityfirst.org.uk/publications-expert-viewpoints/423-why-the-failing-energy-sector-is-a-lesson-for-all-regulators
[9] https://www.ofwat.gov.uk/wp-content/uploads/2020/12/Ofwat-Response-to-Public-value-discussion-document.pdf
[10] The energy network companies are developing a common approach to measure social return on investment moving away from lowest cost to best value decision making, considering wider environmental and social benefits of investment.

Guidance should acknowledge the direct and indirect ways in which regulators – energy, water and telecoms can support short and longer-term growth. For example, one of the most important ways in which regulators support growth is by ensuring resilience of supply – enabling other businesses and the wider economy to operate reliably and safely.

A well-regulated system doesn't just deliver efficient outputs from its inputs and thus drive economic growth and productivity, it supports the environment, communities and wider society to thrive. This includes building legitimacy and trust and the social licence to operate. Guidance should reflect this and the need for best value, not just efficiency and lowest cost. That means taking into account the impact of decisions on wider society and environment.

The six capitals may be a useful model to use for regulators to demonstrate effective use of customers money, the value of investment and impact on short and longer-term growth[11]. Any regulatory annual performance report should provide a more holistic picture of growth and include not just the views of business by civil society groups who also have an interest in a thriving economy.

Promoting a thriving environment must be explicitly acknowledged as positive for growth (not just the transition to net zero energy). As the Dasgupta Review reports, 'Our unsustainable engagement with Nature is endangering the prosperity of current and future generations. Our economies, livelihoods and well-being all depend on our most precious asset: Nature'.[12]

Regulatory bodies such as Ofwat and Ofgem can and do contribute to growth through protecting and enhancing nature, helping to deliver energy security, carbon reduction, and increased resilience to the impacts and economic costs of extreme weather such as flooding, drought, and wildfires. There is clear evidence that lack of air pollution, clean water, and an attractive and accessible natural environment is a major attractor to many foreign businesses. Equally, if we are looking to attract internationally mobile younger skilled workers, the environmental reputation of a country and/or company or region is important.

Before it was abolished, the South-East Regional Development Agency identified access to the natural environment as one of the key attractors to the region, to be built on and nurtured for its economic returns: a number of the LEPs (Local Enterprise Partnerships) have more recently come to similar conclusions. Finally, access to open spaces has been shown to be a powerful tool in preserving mental and physical health – and thereby reducing ever growing pressures on the NHS and increasing labour market participation. Guidance should require regulators to think about whole-systems cross sector growth.

The Secretary of State for Environment, Food and Rural Affairs' July 2023 letter reportedly asking 'companies to explore the opportunities to phase non-statutory commitments including net zero to future price controls where appropriate' highlights the tensions between necessary investments to secure both environmental and sector resilience, and costs to customers. It also reflects a lack of understanding that cutting back on essential environmental improvements will undermine both environmental and economic resilience, and ultimately increase costs to consumers undermining growth. Wildlife and Countryside Link wrote to the Secretary of State to share this concern, and to highlight that alternative approaches such as greater and more effective use of nature-based solutions would in fact deliver 'more for less' with customer funds[13].

---

[11] https://www.integratedreporting.org/what-the-tool-for-better-reporting/get-to-grips-with-the-six-capitals/

[12] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/962785/The_Economics_of_Biodiversity_The_Dasgupta_Review_Full_Report.pdf

[13] https://www.wcl.org.uk/docs/WCL_Letter_Secretary_of_State_PR24_Ambition_10_08_2023.pdf

We agree that the current regulatory system has generated significant investment. But as the National Infrastructure Commission concluded the system was not set up to provide strategic direction for investment to tackle issues such as achieving net zero greenhouse gas emissions by 2050, tackling the biodiversity crisis, transitioning to full fibre digital networks, and managing the increasing risks of floods and drought. Nor as has been noted, does it always protect consumers where the market is not working in their favour. The system must be strengthened and updated, and public and political confidence in it must be improved.

Re investment, guidance should have a strong focus on facilitating strategic investment; meeting the country's long-term needs, and investment decisions reflecting the priorities of the whole of the UK. This is especially important given the high levels of investment required in future will ultimately be recovered from consumers. It is important that consumers have confidence that money is being well spent. Public confidence in the system must be improved to enable long-term certainty for investors and promote investment.

Regulators also need to recognise that investment per se may not automatically promote growth, especially in our uncertain times. The challenge currently is not investment but rather delivery with supply chain blockages and lack of appropriately trained and skilled workforce. Thus, rather than stimulating growth, the wrong focus could increase inflation, which coupled with the risk premium associated with possible increased borrowing and debt, could send jitters into the market. Any hit to sterling will of course exacerbate this. And it also likely to lead to higher interest rates, which on top of the risk premium, further increases the government (and business) cost of borrowing and servicing debt.

The guidance should have a section on promoting British skills and training. The utility industry grows many of its own skills, but it can do more, and should work with government to invest in the building blocks: including further education and continuing support for apprenticeships.

The guidance should also cover sustainable investment. There have also been concerns raised about high debt to equity ratios ("gearing levels") in natural monopoly companies. There are benefits to having high gearing levels, especially when debt is cheap; the debt can finance investment that benefits consumers, without significant increases in bills. However, high gearing levels increase the risk of company failure, and this risk falls in part to consumers. Remuneration levels should be linked to performance; supporting growth through fair prices and social capital.

To build public confidence, we agree with the National Infrastructure Commission that there needs to be a better balance between risk and reward between investors and consumers; improvements in how markets work for consumers, ensuring regulation acts fairly and improved coordination of regulators. It is unclear how a Growth Duty would contribute to this outcome.

Ofwat has taken some much welcome steps in recent years to promote purpose-lead sustainable water companies, greater financial and workforce resilience (including a focus on diversity and skills) which in turn also support growth. These kinds of initiatives should be encouraged in other regulators, recognising that sustainable corporations are often more financially profitable, resilient, while also being better for the environment and society.

Lastly, while we support regulators steps to promote innovation which drives service improvements and benefits for consumers, society, and the environment we ward against 'innovation for innovation's sake'. We would welcome a stronger focus on measuring the short and longer-term value regulators innovation funds/initiatives deliver in practice, so as to improve their efficiency and maximise value for money for customers who ultimately fund them.

3. **How would you envisage a regulator's actions changing as a result of a growth duty? Please outline any benefits you can foresee.**

Without knowing the detail of any updated guidance, it is hard to know how it would work and the interplay with the respective strategic policy statements.

As noted, simply creating another 'must-do' isn't going to be helpful unless DBT provides further guidance on how trade-offs should be made.

Ofgem and Ofwat already support growth in many of the ways outlined in the current Growth Duty guidance as currently defined. Ofgem for example is already committed to more flexible decision making; since the retail market collapse has a renewed its focus on ensuring new market entrants are resilient; already supports businesses to innovate; has the sandbox to help remove regulatory barriers to innovation and encourage new kinds of business models; and has arguably been relatively quick to respond to geopolitical events such as the war in Ukraine and the Covid-pandemic.

Expenditure on energy and water resilience is being prioritised which is probably a good thing economically - though how best to do this is open to debate, and the timing needs to avoid exacerbating supply side constraints which would further drive-up input prices.

That said, the Duty could potentially increase transparency, and perhaps the quality and speed of compliance advice and support (assuming it is also supported with additional resources).

In RIIO-2 there was strong stakeholder support for some gas network companies to be allocated funding in the price control to have a role in installing energy efficiency measures in homes (given their regional footprints, expertise and ability to go door to door, the environmental, social and economic benefits), but this was rejected by the regulator as inappropriate for energy customers to pay for. Given the potential for investment in insulation to create new jobs and support local economies maybe a Growth Duty would have led to a different decision. Though Ofgem's new net zero duty may also have the same effect.

There are lots of questions to be answered however. In its current form the Duty could potentially shift 'who pays' from industry to customers. For example, if there is a growth duty, it is feasible that rather than water and energy connections being paid for wholly or partly by developers or generators, the full costs could legitimately be socialised onto customers' bills. Good for developers, not so much for affordability or arguably fairness.

It could make it harder for water companies to have an independent advocacy role against inappropriate housing developments, as they have now. This activity is often strongly supported by the communities' water companies serve. Could it result in Ofwat effectively supporting inappropriate developments in the interests of growth, despite the potential negative environment, social and resilience implications?

We also query how a Growth Duty would interplay with the planning system in energy and what that would mean – this seems something of a political minefield for an independent economic regulator. Also, if a Growth Duty could be used to justify a requirement for higher compensation payments to businesses as a result of supply interruptions, given the impact on their economic performance? It might lead to stronger protections generally for micro-businesses and non-household customers.

If a 'sustainable growth' duty was introduced with the guidance, as we propose in question 2, it has the potential to shift regulatory thinking from a focus on lowest-cost to best value; with a better balance between short and longer-term investment; it could support purpose-led more sustainable energy, water and telecoms companies, win-win investment for growth, the environment and wider society.

There is significant scope for the sectors to make more of the growth potential of environmental protection and net zero energy transition, as creating advantage for the UK in what will be key growth industries of the future and as attractors for business and younger skilled employees. For example, nature and catchment-based solutions that offer cost-effective approaches to tackling environmental and social challenges whilst providing multiple benefits for nature and society are routinely excluded from water company business plans, due to failures to fully consider natural capital in the Price Review process. Though Ofwat's requirement that companies consider 'best value' as opposed to simply 'least cost', as mentioned, is a welcome step in the right direction, focus remains overwhelmingly on upfront financial cost.

4. **How do you foresee the Growth Duty interacting with existing statutory duties? Please provide examples.**

As per question one. We have concerns that (despite its intentions) in practice the duty as proposed would further undermine consumer and environmental interests at a time when these aspects of regulation desperately need to be strengthened. This in turn would further undermine public confidence in the sectors, and in competition, with knock-on effects for growth and investment.

There is a risk of further confusion. As the government's Economic Regulation Policy Paper[14] outlines, existing duties are complex, and adding in a new duty will not necessarily increase transparency or predictability of the current framework or provide greater certainty to regulators or stakeholders.

There are some tensions. For example, the current guidance talks about minimising regulation and appropriate recognition for self-regulatory and third-party assurance. This at a time when light-touch and self-regulation are being widely criticised for failing to protect customers, including those in vulnerable situations and have been held responsible for the pollution of our rivers and seas.

Ideally DBT would review Ofgem, Ofwat and Ofcom's duties in the round as part of a streamlining exercise, and not adopt a piecemeal approach as proposed here.

5. **Is there any evidence that this will add significant costs to regulators or business? If so, why and what would those costs be?**

We are not best placed to answer this question.

6. **Are there alternative or additional means by which we could improve growth outcomes in these regulated sectors?**

In addition to those areas outlined above in question 2, DBT could improve collaboration between the regulators and in particular require Ofwat, Ofcom and Ofgem to better reflect the interdependencies between sectors and develop whole system cross sector approaches. For example, when setting supply interruption outcome delivery incentives, and compensation standards, Ofgem primarily considers the lost value of an electricity supply interruption to end

[14] https://www.gov.uk/government/publications/economic-regulation-policy/economic-regulation-policy-paper-accessible-webpage-html

electricity customers, with less emphasis on the wider impact on water, telecoms, transport or wider business and society.

Similarly, the cost to the consumer and the knock-on effect on the wider economy (time lost) is too often not factored into regulatory decision making when setting appropriate levels of service. For example, the cost of a customer waiting in for half a day for a home appointment with a utility company (especially for someone who is self-employed or paid by the hour), or the cost of waiting on the phone on hold to customers is often time lost not only to the individual but to the economy.

As noted rather than extending the Growth Duty to Ofgem, Ofwat and Ofcom, we would welcome DBT reviewing the regulatory duties in the round with a view to potentially streamlining them and developing guidance on how regulators can make trade-offs.

There is likely more merit in a duty on resilience than a growth duty. We would also support a new 'thriving environment duty' to conserve, enhance and restore the natural environment in line with the Government's pledge to halt the decline in species populations by 2030 and to reverse this decline by 2042[15]. Both of these would support sustainable economic prosperity and growth.

Yours faithfully

Zoe McLeod
Associate Director, Sustainability First
CC David Murray, Executive Director Sustainability First
Martin Hurst, Sustainability First

[15] https://www.gov.uk/government/news/new-legally-binding-environment-targets-set-out