Purposeful Regulation and CMA Appeals

The last year has seen a significant amount of CMA activity in the water and energy sectors. This Viewpoint explores the differences in the appeals regime in these sectors, the basis for the recent appeals and their implications for purposeful regulation. To address the challenges of net zero and to facilitate the purposeful agenda, the appeals regime needs reform. To help reduce the focus on legal processes, and increase transparency and trust, this paper makes three suggestions for how the regime could be improved in terms of: cost of capital; social and environmental initiatives; and major investments and efficiency.

Introduction

Sustainability First recently published a major report as part of its Fair for the Future project looking at how regulation needs to change to support the purposeful business agenda. The report consciously did not explore the CMA appeals regime for price controls although it stressed the need for a less confrontational approach to regulation to give companies the space to progress wider social and environmental goals. The fact that four water companies appealed the PR19 price control decision and that all eight of the energy networks involved have appealed the latest RIIO2 decision does however raise questions about the appeals regime which this Viewpoint seeks to explore.

Appeals Regime Today

The first important point to note is that the price control appeals regimes in water and energy are very different.

In water the CMA are effectively carrying out a re-determination. They are not choosing between the positions of the company and regulator but are forming their own view on what the price control should look like and how to balance Ofwat's different regulatory duties. They look at the price control as a package although they will tend to prioritise areas that are in contention. The process is open – third parties can and do engage and there is a formal consultation on their draft decision.

In contrast the energy appeals regime is much more like a judicial process. The companies identify specific elements of the decision where they consider that Ofgem was wrong – where there was an error of law, fact or application of their duties. The CMA are then effectively deciding between the company and Ofgem view. The process is much less transparent and there is only limited scope for third parties to qualify to intervene.

The telecoms model is similar to energy. Appeals go first to the Competition Appeal Tribunal but price control decisions are then referred on to the CMA under a similar model to energy.

The PR19 Water Appeals

In the PR19 price control Four water companies appealed against the Ofwat decision with particular concerns raised about the cost of capital, the need for more strategic investment and assumptions around cost efficiency. The CMA ended up supporting the companies on a number of these issues with their final decision landing somewhere between what Ofwat originally proposed and what the companies were seeking.

The PR19 CMA decision made clear that this was very much about the CMA's judgment as to the balance to be struck between customer interests in short term bill reductions and their long-term interests in resilience, along with the need for financeability of the companies.

The CMA came out firmly in favour of more strategic investment to address environmental issues, to cope with demand growth and to deal with climate change. At one level this is the agenda that Sustainability First has been arguing for and where we have highlighted the risks of this being down-played in the face of short-term political pressures around bill reductions. On this basis the CMA decision – reflecting perhaps a more independent and less political perspective - is to be welcomed. However, there are real concerns about the bill impacts, in particular in a post Covid world, and this

question of the balance to be struck between competing duties is not a technocratic one but needs to be taken in the context of a much wider public policy debate informed by in-depth consumer and stakeholder engagement. It is not clear why the CMA is better equipped than Ofwat to make that judgment about the appropriate balance.

The appeals took a year to run and will have been a significant distraction for Ofwat and the companies through that period. The costs were significant – amounting to £26m across the four companies in external costs alone and a further £6m for the CMA / Ofwat's costs. For the companies the investment will have been worth it but it highlights the difficulty in ensuring that the consumer voice is heard over the well-resourced petitioning of the companies.

The fact that the whole framework is up for grabs as a part of the process creates significant uncertainty – and there is the potential for the decision to leave the companies in a worse position than when they went in (as happened with Northern Ireland Electricity in 2014 when they had this same appeals regime). This should act as something of a check on the number of appeals, even if it did not this time round.

Energy Appeals in Practice

The RIIO ED1 decision was the first time the new energy appeals regime had been used (apart from in Northern Ireland) and was the point at which people seemingly woke up to the implications of what is sometimes called a "cherry picking" appeal. Companies are free to pick the issues on which they consider they have the strongest arguments and they cannot end up worse off than when they went in. It is a one-way bet.

That said the bar for proving the regulator "wrong" is a high one. In ED1 Ofgem won on 7 out of 8 grounds and, as in water, there is a cost in terms of management time and effort in making an appeal.

The other notable feature in energy is that third parties can also appeal and in ED1 Centrica appealed (supported by Citizens Advice) arguing that the price control was too generous. This was another wake-up call for the companies who found that the settlement they were happy with could be unwound without them having a chance to argue for more if they had not already lodged an appeal.

Given these features it always seemed inevitable that there would be a significant number of appeals at RIIO2. The "full house" that we have seen should be taken as a reflection of the nature of the appeals regime (and the encouragement provided by the CMA's PR19 Provisional Decision on the cost of equity) – not necessarily a sign that Ofgem got things badly wrong.

The end result is a regime that is stacked in the companies' favour. While consumer bodies (and suppliers) can appeal as they did in ED1 they don't have the direct financial incentive or the deep pockets required to do so. Professor George Yarrow did a lot of work looking at a very similar regime in Australia and reached the clear conclusion that it was not in consumers' interests.

Ofgem have sought to create more balance by setting out arrangements by which they can re-open price controls if there are linkages with other areas of the price control where they consider, following a CMA decision, that action is required to bring the package back into balance. However, this has met with some push-back from the CMA who want to see Ofgem articulating those inter-linkages as part of the appeal process itself.

Finally, while the RIIO2 process has put a strong emphasis on enhanced consumer and stakeholder engagement this is worryingly absent from the CMA process, particularly in energy. In principle it is possible that the Ofgem Challenge Group could attempt to intervene but the company Consumer Engagement Groups and User Groups are unlikely to contribute given the focus of the appeals on finance and cost efficiency arguments. However, these decisions remain ones with significant implications for consumers and it is important the consumer voice is heard. Transparency is also important for giving legitimacy to the process in what is a politically sensitive area.

How Does this Sit with Purposeful Regulation?

Reviewing the themes and recommendations from our report "Regulation for the future: The implications of public purpose for policy and regulation in utilities", there are a number of elements that stand out as being of direct relevance in thinking about appeals:

- The Report highlights the need to move to a less confrontational model of regulation to support a purposeful agenda. Appeals are inherently confrontational. Some of the energy networks are trying to maintain good relations with Ofgem, including by positioning them as "technical appeals". However, my experience is that it is hard to avoid appeals becoming confrontational in practice - and in particular with counsel involved (for whom a legitimate part of the process is to try to undermine the credibility of the other party).

- Sustainability First has highlighted the important role of Strategic Policy Statements for some time. While the argument has been made that regulators anyway have a good understanding of government's priorities, it is worth remembering that these documents also provide a framing for any appeal and with the CMA more remote from government they are of particular relevance.

- The Report argues that the regulators have significant discretion and that they are not constrained in their ability to support the purposeful agenda by their duties. The CMA are bound by the same duties, although in the case of energy they are limited in the decisions they can reach (in effect choosing between the position of the company or Ofgem).

- The Report endorses the focus given by regulators to consumer and stakeholder engagement which is central to a purposeful agenda. Any appeals process should surely include the consumer voice routinely as an input to the deliberations. Even in the water appeals where the Consumer Challenge Groups did have a chance to input, their views did not appear to be given much weight.

What Would be a Better Approach?

There seems to be a growing consensus that that the appeal arrangements are ripe for review – and the need to address net zero and climate change, and the wider purposeful agenda only add to that argument.

While it might be possible to come up with incremental improvements that could be made through changes to the CMA Rules (around transparency, for example) or a process that takes the best of the water and energy regimes, there are arguments for looking more fundamentally at the regime in the context of how we would want to see regulation operate. We make three suggestions that we believe would merit more serious investigation:

1. **Cost of capital** - our regulation Report highlighted the valuable work done by the joint regulators network to establish a common approach on the cost of capital. However, one problem with this has always been that the CMA has refused to participate because of its appeal role. There clearly would be value in a process that looks to establish a common cross-sector framework for the cost of capital and takes this out of the price control process (which would in turn help make that less confrontational). At a Utility Week investor conference there was strong support, from Scottish Power and others, for a Cost of Capital Commission looking across sectors. The investors' concern was that the cost of capital had become politicised with regulators competing to be the toughest. A less confrontational "Commission" model – perhaps with HMT involvement – could be a good solution that would not just benefit investors. Regulators could still make adjustments in relation to sector specific factors but within a pre-agreed framework.

2. **Social and environmental initiatives** - our Report highlighted the potential for regulators to make more use of negotiated settlement in these areas – making use of the company

challenge groups who have scrutinised and witnessed first hand the engagement the companies have done – to form a view as to whether elements of spend are properly justified as meeting consumer needs and wants.

Professor Littlechild in evidence to the CMA on PR19 advocated a move to negotiated settlement as an alternative to the current process. We are less convinced that this would work where cost efficiency and financial arguments (eg on cost of capital) are at play. However, it could have a role around particular social and environmental outputs (with more limited financial implications) where those on the ground will have a better sense of what is needed than any central regulator or appeals body could.

3. **Major investments and efficiency considerations** – In these core price control areas, our Report argues that a less confrontational regulatory approach is needed with more decisions on major projects taken outside the 5-yearly cycle. For appeals on these elements (whether in the main price control or one-offs) a CMA "hybrid" model could work - one that is more investigatory and less adversarial, more transparent and inclusive, with upside and downside risks for the companies and a high bar for over-turning regulatory discretion. But drawing on developments in other aspects of civil law there would also seem to be a strong case for exploring pre-action protocols which require parties, before commencing proceedings, to try to settle the dispute and to consider a form of Alternative Dispute Resolution to assist with settlement. In its RIIO2 proposals Ofgem tried to include a pre-action step but procedurally it could not be made to work within the existing legal framework where companies have a set time after the Ofgem decision in which to lodge an appeal.

In his 'Power to the People' **paper** on the future of the consumer and competition regime, John Penrose proposed that regulatory appeals should move from the CMA to the Competition Appeals Tribunal. This is based on Lord Tyrie's earlier recommendation in his letter to the Secretary of State and is not discussed in any depth. Lord Tyrie's rationale was essentially that it would enable the CMA to focus more effectively on the wider remit he was seeking for it in relation to consumer protection. It is far from clear that the CAT is better placed than the CMA to take these crucial public policy decisions and indeed both Penrose and Tyrie are critical of the drawn-out processes of the CAT.

"What is needed is if anything a less legalistic process with more focus on skills around engagement and communication to help build trust in the outcomes in a sensitive area of public policy. However, what we would all agree on is that reform is needed."

The water re-determination model has been in place since privatisation. The new energy appeals were introduced in 2011 to comply with legal requirements under the EU Third Energy Package but without much thought to the wider implications. BEIS did initiate a review in 2013 looking at streamlining regulatory and competition appeals[1], but it never went anywhere. Now is the time to revisit the earlier thinking, updated to take account of the new challenges of net zero and the purposeful agenda, as part of the Treasury's wider review of Regulation.

"The CMA appeals process needs to support and strengthen the regulatory framework, not undermine it. It cannot be ignored in thinking about the wider regulatory framework."

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1 https://www.gov.uk/government/consultations/regulatory-and-competition-appeals-options-for-reform