INDUSTRY COMMENT

A LOOK AT SUPERVISORY REGULATION

Annabelle Ong explores how a supervisory approach in water could work in practice.

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In addition to the creation of a new super regulator, the Cunliffe review has introduced a supervisory approach, which is a fundamental shift in the approach to regulating the water sector.

While the supervisory approach presents an exciting opportunity to improve regulation of the sector to the benefit of all stakeholders, there is a risk in adopting an approach that was designed for financial regulation without adapting it appropriately to the water sector. We provide initial thoughts and ideas on a series of questions that need to be considered in detail to design a supervisory approach for the water sector:

- *What are the benefits that the supervisory approach needs to deliver to be successful? What are the key risks?*
- *How can the approach work in practice?*
- *What are the design choices?*
- *What is different in water compared to financial services?*

Benefits and risks

The supervisory approach offers a practical remedy to sector challenges by building trust between regulators and companies, increasing delivery of infrastructure by providing appropriate flexibility, and preventing a "doom spiral" for companies. Complementing benchmarking with the supervisory approach can better reflect company-specific circumstances, and help move beyond the "notional company" philosophy of regulation, helping set efficiency targets that are achievable for the actual company. The latter represents a profound shift in regulation, but it risks inconsistency across companies and requires broad technical expertise to ensure the supervisory approach has a full "whole of company" view.

A third point is tackling information asymmetry: companies know more about their costs, risks and performance than regulators. Benchmarking and incentives have limitations, particularly in distinguishing inefficiency from risk or external factors, making supervision a valuable complementary tool.

To date, regulators have set a high hurdle for accepting company-specific factors as drivers of performance differences. This has likely led to overestimating the size of the gap that can be attributed to inefficiency, and unachievable targets. A successful supervisory approach could lead to regulatory decisions that are closer to the "true split" between efficiency and company-specific circumstances (which is unobservable). This would benefit all stakeholders as targets would become truly stretching but achievable for all companies. However, there are two key risks:

- *The supervisory approach could lead to overestimating the role of company-specific factors – this could be a result of regulatory capture.*
- *The supervisory approach may not shift the dial – this could happen for various reasons, for example the supervisory team may find the benchmarking evidence more compelling than engagement with companies.*

A successful supervisory approach needs to be designed to deliver consistent outcomes that are closer to the true split than benchmarking alone. This applies both at the time of setting allowances and during the price control delivery.

How can the approach work in practice?

Drawing on supervisory approaches in financial services, we have developed a high-level approach in Figure 2. In phase 1, the regulator's benchmarking team undertakes a consistent quantitative assessment providing a view of the company's current and forward-looking performance across all relevant areas. At a minimum, this would include performance around costs, delivery, outcomes and finance.

The forward-looking analysis also needs to include a risk assessment. This would test how the metrics could change under a set of standardised events.

All of the information and data in Phase 1 would then be aggregated into automated risk scores that could be categorised from 1 to 5 – where 1 is a high performer and 5 represents serious concerns.

In Phase 2, the supervisory teams would receive the quantitative analysis and engage with the company on a forward look and drivers of performance (including how key performance drivers will evolve and any factors/context missing from the analysis), and governance and processes (including the governance arrangements and process in place to improve performance and take appropriate action).

The supervisory teams would effectively conduct qualitative benchmarking of the company. At the end of this phase, the supervisory team would combine the Phase 1 risk scores with its own judgement to reach a final categorisation. The supervisory manual would prescribe engagement between the supervisory team and the company for each category.

FIGURE 1: BENEFIT OF SUPERVISORY APPROACH

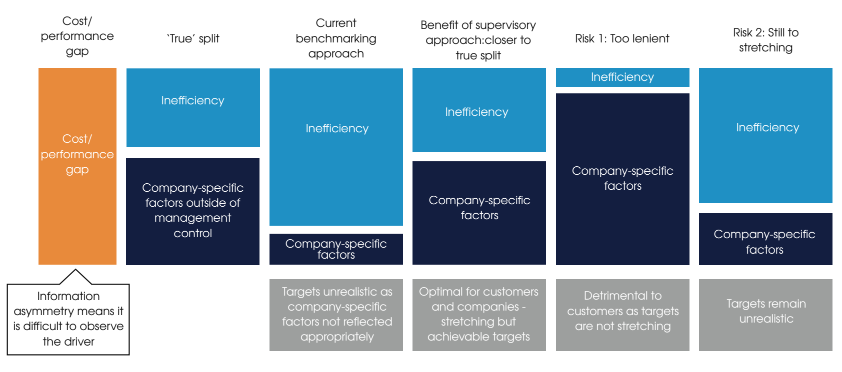
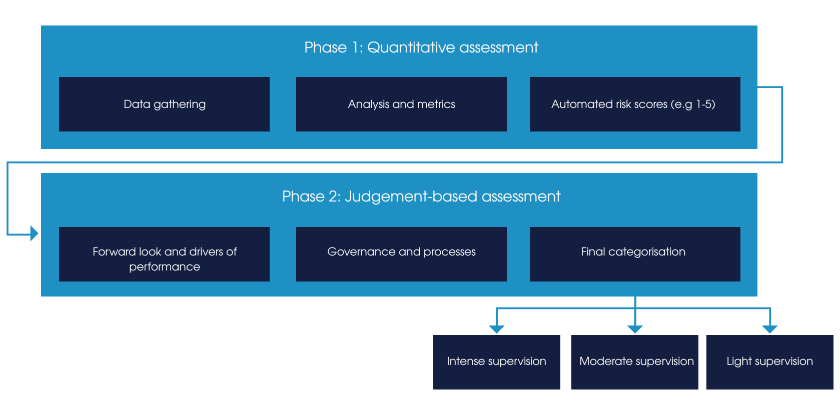


FIGURE 2: HOW COULD A SUPERVISORY APPROACH WORK IN PRACTICE?



Design choices

Putting this framework into practice requires further high-level design choices summarised in Figure 3. These will have implications for the regulatory burden and effectiveness of the supervisory approach (and for the resource requirements). For each design choice, we provide our early view of the optimal system (in orange) based on our expert judgement and the Cunliffe review – this is intended to be a starter for discussion and not a final view.

The key choices are:

- **Team size and skills requirement**. *A light touch approach could put more emphasis on Phase 1 discussed above whereas a resource-intensive approach could add more value to the judgement-based Phase 2. The Cunliffe review is clear that teams will require a diverse skillset, including engineers, environmental experts, financial experts and regulation economists so the approach is likely to be towards the resource intensive side.*
- **Engagement type**. *This could be bespoke to companies or be standardised. The high-level approach described above would be in the middle with standardised data analysis and bespoke engagement on the basis of the data. This is aligned with the Cunliffe review references to a risk categorisation system similar to that employed in the financial sector, such that the nature of the engagement will depend on the risk level assigned to each company.*
- **Supervisory framework**. *The Cunliffe review clearly specifies an outcome focused approach aligned with the approach described above. This contrasts with an approach where supervisory teams check if companies adhere to the right principles.*
- **Risk orientation**. *A fully uniform approach would not be appropriate to identify and address emerging risks and circumstances. The categorisation described above would allow for the prioritisation of larger risks, while ensuring that the resources are being deployed in the most sensible manner – the Cunliffe review supports this approach.*
- **Frequency of data collection and Phase 1 and 2 analysis.** *This could range from real-time data on one extreme to annual data on the other (which is the current frequency of data collection through Annual Performance Reports). While an annual process may be sensible for the final categorisation, a more frequent re-assessment of the quantitative risks is required for the supervisory approach to deliver pre-emptive action. Quarterly data collection should be able to indicate trends and any changes that would require addressing promptly.*
- **Relationship**. *It is important that there will be specific teams assigned to regions, or companies, to understand companies' specific circumstances. However, dedicated measures are needed to avoid regulatory capture, as discussed by the review. An additional measure could be the oversight from a central team on top of the dedicated supervisory teams to minimise the risk of regulatory capture.*
- **Accountability**. *The Cunliffe review recommends changes to governance including a new regime for senior accountability. Senior manager regimes from other sectors are also quoted. Accordingly, we think there will be links between the new senior accountability regime and the supervisory approach, with senior managers being assigned specific business areas or risks and actions for which they will be responsible.*

What is different in water?

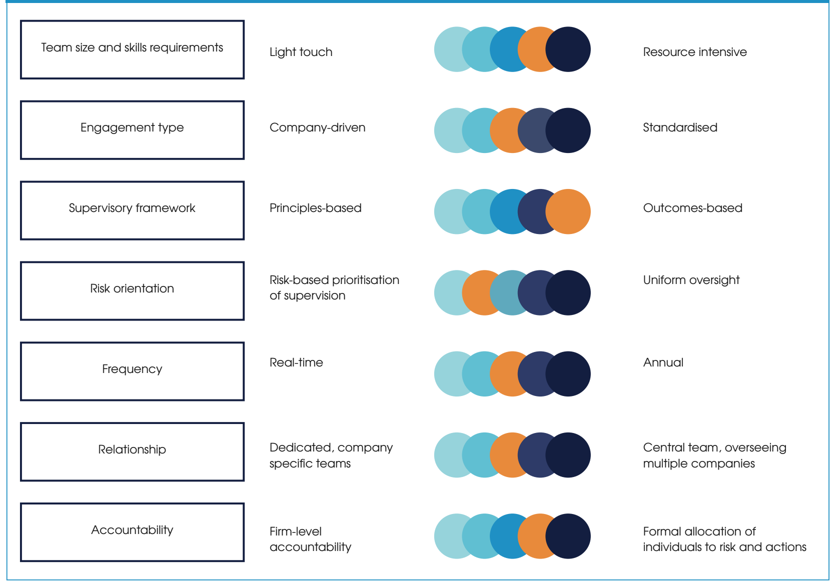
Any approach to supervisory regulation in water needs to be mindful of the following key differences to financial services:

- *In the water sector, the regulator sets the cost allowances, performance targets and returns – the supervisory team may therefore interpret any underperformance against the targets that it set itself as a management issue rather than external circumstances. While this is helpful to avoid regulatory capture, it increases the risk that the supervisory approach only adds value at the setting of the price control but not throughout the period. We discuss the role of the supervisory team in determining cost allowances and outcomes on p10-11.*
- *The mix of skills required is wide – as discussed above, a wide range of engineering, asset management, operational and financial skills is needed to successfully implement a supervisory approach.*
- *The number of companies is small – this could increase the risk of regulatory capture as water is a "small world" with a limited pool of individuals.*

Next steps

This paper has provided an early view. Substantial further work is needed to develop the approach in detail. This includes clarity on what success looks like, and how to design an approach that works both at and during the price control and balances regulatory intervention with letting companies get on with delivery.

FIGURE 3: KEY HIGH-LEVEL DESIGN CHOICES



Source for all charts: Frontier

INDUSTRY COMMENT *continued*

IS THIS THE END OF ODIs AS WE KNOW THEM?

Anna Northall looks at prospects for the outcomes regime.

One of Sir Jon Cunliffe's recommendations is to rationalise the overall number of outcomes performance commitments and to dampen the financial incentives on them. We have considered the rationale for keeping the current outcomes framework and provided our initial thoughts on how the approach could evolve to meet the Cunliffe recommendations.

Should we keep the current framework?

Ofwat introduced an outcomes-focused approach at PR14 following the Gray review, in which it was suggested that companies should be given more ownership and flexibility to find better solutions. The outcomes approach was intended to encourage companies to focus more on what customers want, and allow companies more freedom to innovate.

Are the principles that underpinned the recommendations of the Gray review still valid? In principle we do not disagree with the findings of the Gray review but the context around the water industry has changed since then. Delivery is a higher priority as the enhancement programme has grown substantially and there is less trust between companies, society and regulators. The policy focus has shifted to one of turnaround and trust building.

Within this changed world, should we keep the current outcomes approach and dampen incentives as suggested in the Cunliffe review? A useful thought experiment is to consider what gaps would arise if we removed the outcomes framework altogether, and adopted other related recommendations in the Cunliffe review. Without the outcomes framework there would still be a range of regulatory mechanisms holding companies to account, as summarised in Figure 4. The blue boxes illustrate mechanisms with a potential financial impact on companies. The grey box covering the supervisory approach would be reputational in impact.

Overall there are already a lot of mechanisms to hold companies to account. However, without the outcomes framework there would be a lack of incentives for: innovation or for strong performance; and for poor performance in service areas that are not covered by Guaranteed Service Standard payments, or potential enforcement fines. More generally, removing the outcomes framework that companies have had in place for three price controls would add uncertainty to the regulatory regime. We also know that company boards have placed a lot of focus on (financial) Outcome Delivery Incentives (ODIs), and removing the financial incentives would likely reduce this focus in future.

FIGURE 4: GAP IN REGULATORY MECHANISMS WITHOUT OUTCOMES FRAMEWORK IN A POST CUNLIFFE WORLD

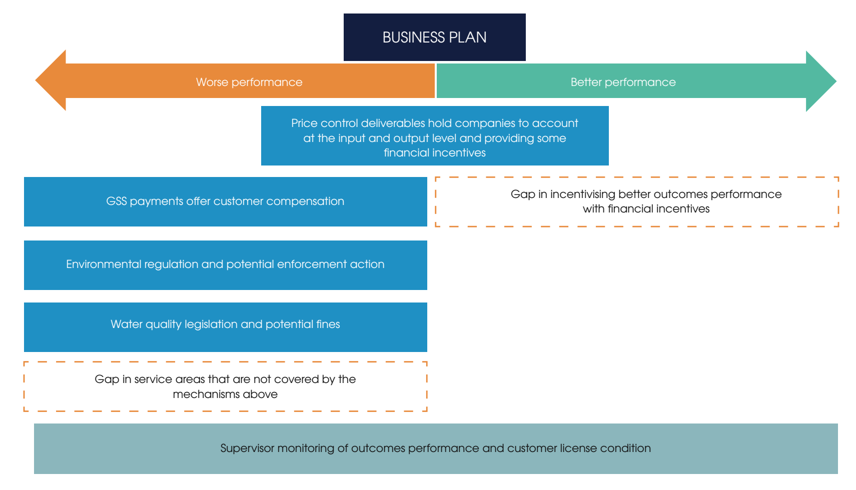


FIGURE 5: INITIAL THOUGHTS ON HOW TO IMPLEMENT THE RECOMMENDATIONS

Implementation

We have considered how to implement the recommendations in the Cunliffe review on the outcomes framework, in a way which is consistent with the wider regulatory mechanisms and other recommendations in the review. Our initial thoughts are illustrated in Figure 5, with our proposed adaptations to the existing outcomes framework in dark blue.

In this approach, the supervisory team would monitor outcomes performance across a suite of service areas. The supervisory team could do deep dives into company performance when it dips below a certain level to understand what is causing the poor performance, and develop a mandatory turnaround plan with the company, with the potential for financial implications.

In addition, there would be the potential for financial rewards in two areas. First, innovation in areas where the industry is a long way off long-term goals and customers value improvements significantly (e.g. leakage). Companies that demonstrate innovation in these service areas would receive financial rewards. Second, the supervisory team could also provide small rewards for companies that deliver comparatively strong performance across a basket of performance commitments. These awards could be lump sum and potentially given ex-post on the basis of comparative performance or assessing how companies performed relative to the external environment they were faced with.

Questions for debate

The issues that we think need to be debated are as follows:

- *How would management teams and boards react to measures that are no longer ODIs but part of supervisory monitoring? What impact would this have on decisions made by companies?*
- *Would customers receive sufficient protection from price control deliverables and GSS payments?*
- *How strong is the case for incentivising innovation and what can we learn from the impact of ODIs on innovation in the past?*

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PCDS, QAA, COSTS MODELLING AND MORE

Frontier Economics is publishing a series of papers on the Cunliffe Review to support the industry with shaping the way forward. We have included summaries below and our full set of papers can be found here: https://www.frontier-economics.com/uk/en/hot-topics/collection-i21852-cunliffe-review/#:~:text=The%20Cunliffe%20review%20was%20published,systems%3B%20legislation%3B%20and%20regulation.

1. Will it be possible to increase accountability for investment through more PCDs while increasing flexibility and avoiding excessive regulatory burden? *We think expanding Price Control Deliverables (PCDs) indiscriminately across base costs risks stifling innovation and creating perverse incentives. To avoid this our initial ideas include: linking planned PCDs to long-term asset maintenance strategies, allowing swap-ins/swap-out flexibility across both activities and time, and recognising the need for differentiated approaches across diverse types of capital maintenance. A well-designed supervisory approach should create checks and balances in the system that will help avoid incentives for companies to misuse the flexibility that this allows.*

2. Was the QAA really the problem? *In our view, the QAA was a legitimate tool to address information asymmetry between companies and Ofwat. Over time however it anchored companies towards certain pre-determined policy positions, which may have led to companies telling Ofwat what it wanted to hear, not what it needed to hear. Removing the QAA risks reducing incentives for truth-telling and, alongside a supervisory regime, increases the danger of regulatory capture. We suggest reframing business plan incentives to align with the new supervisory model. A stronger regime would incentivise companies to prepare credible plans that demonstrate how risk and reward are balanced. Supervisors and regulators will need a deeper understanding of company risk and risk management to judge ambition and credibility effectively.*

3. How do we set costs and outcomes with a supervisory approach? *A successful combination of a supervisory approach and benchmarking should enable the regulator to develop costs and performance targets that better reflect the true split between inefficiency and company-specific factors. We have developed three options for setting costs in future: separate assessments with mechanistic weighting; a sequential approach where the supervisory team sets final allowances taking benchmarking into account; and the supervisory team adjusting the benchmarking outputs. We have also identified options for setting performance targets. While there are advantages to introducing the supervisory approach, such as an opportunity to set cost allowances and performance targets more consistently, there are also potential implementation issues which the industry needs to address together.*

4. Cost modelling under the supervisory approach – the end of totex? *Cost modelling is a critical tool for regulators to set efficient costs. While the Cunliffe review recognised the importance of benchmarking modelling, it described Ofwat's models as 'one-size-fits-all'. In this paper we consider how cost modelling needs to evolve to provide better insight into company cost efficiency and to enable meaningful engagement between companies and their supervisory teams. We explore operating costs, capital maintenance costs, and enhancement costs in turn – looking at where existing modelling approaches can be improved, for example by modelling costs at a more granular level to drill down into the causes of cost variances, and where new approaches are needed, specifically for setting capital maintenance allowances.*

5. Setting a minimum capital requirement for the water sector. *The topic of financial resilience is not a new one in the water sector, but the ability for the regulator to directly set capital requirements directly would be new. There are many questions about how a minimum capital requirement could work in practice. We look at how the requirement could be expressed, what research could inform the debate and how this recommendation overlaps with the wider supervisory approach.*

We find that the recommendation is relatively open-ended, leaving discretion for the regulator in taking these proposals forward. It will be important that requirements take account of changes to the regulatory regime, particularly if they result if a 'lower risk profile'. Companies should be ready to engage on their specific, forward-looking financial resilience risks.

6. Setting returns on regulated infrastructure. *The review proposes that the Competition and Markets Authority plays a major role in setting the Weighted Average Cost of Capital (WACC) allowance, setting market parameters directly, and providing guidance on sector-specific parameters. Unsurprisingly, this has important implications beyond the water sector.*

We review the case for centralising WACC setting, exploring the motivation for the recommendation, opportunities, risks and issues to be addressed. While WACC consistency matters, it is not clear that a central body model is best solution or if the CMA is the body best suited to such a role, particularly given the complexity it could create regarding the scope of appeals. We explore ways in which consistency could be improved without overhauling the existing roles and responsibilities of different parties in the sector.

7. RCV run-off and the PAYG ratio. *The review encourages the regulator to review the approach to Regulatory Capital Value (RCV) run-off. This is linked to wider considerations about asset conditions and expected asset lives. The recommendation is only clear up to a point, calling on the run-off rate to be "more closely" aligned to economic depreciation of assets.*

We explore how approaches to RCV run-off in the sector have evolved over time, the context for why that has happened, and how the regulator could do things differently in future. We find that the regulator will need to strike a balance between backward-looking cost recovery and forward-looking cashflows, and that the supervisory approach does not mean a wholesale move back to the pre-PR14 approach is required.