The Regulation Forum

The Fair Bet Concept: A Way to Boost Investment in Regulated Infrastructure?

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Introduction

The term ‘fair bet’ is now often used in economic regulation, especially in connection with questions of investability and financeability. It is intuitively appealing: the concept of a bet is commonly understood and it is hard to argue against fairness. But where did the term come from? And what does it actually mean? How does its meaning or form vary according to context? What is necessary for a ‘fair bet’? And how can regulators, companies and investors make practical use of the idea?

This note provides a summary of the thoughts of a group convened by The Regulation Forum to discuss the ‘fair bet’ and provide insight into an ongoing review of economic regulation being conducted by the Department for Business and Trade. The group comprised people with a wide range of experience across different sectors, in different roles in companies, regulators and as advisers, and from different disciplines including lawyers and economists.

The breadth, depth and richness of the thinking is a credit to the group. Responsibility for any errors, omissions and infelicities rests with the author.

The genesis of the fair bet

The origins of the ‘fair bet’ lie in telecoms regulation. It was conceived to solve a specific problem, namely how to remove regulatory risk as a blocker to the decision that BT, the owner of (100% equity investor in) regulated incumbent network provider Openreach, was faced with in whether to make a substantial investment to upgrade its ‘final mile’ telecoms network to replace twisted copper pairs with a full fibre final mile.

Full fibre broadband had been a key public policy objective for the Government since 2017 [ref: Matt Hancock speech ‘Building a full fibre Britain’, Broadband Stakeholder Group conference, 2 November 2017]. The Government had weighed up the pros and cons of ‘competition in the market’ and ‘competition for the market’ as the commercial model for local fibre networks, and had concluded in favour of 'competition for the market', which it believed would drive a faster roll out [ref: DCMS Future Telecoms Infrastructure Review, 2018]. This choice of model, alongside potential for competition from different technologies, such as satellite and wifi mesh, meant that BT's investment decision was not without considerable downside risk. Commercially, then, BT needed to see the potential for significant upside should its investment be successful; the available upside needed to be sufficient, set against the downside, to allow BT to expect a return on its investment that was at least equal to its cost of capital. Without this, the investment would not be commercially rational. However, if that upside were realised it would quite possibly be because the potential for competition, either from other fibre providers or different technologies, had not fully materialised. In which case, Ofcom could diagnose Openreach as having significant market power and introduce regulation that would limit what Openreach could charge and strip away returns in excess of what Ofcom would at that point assess as being the cost of capital of a firm with significant market power.

Regulatory risk as the binding constraint

BT was prepared to take the commercial risk, and the construction and execution risk, associated with full fibre roll out, because these were risks it could understand and manage. It was not, however, prepared to take the regulatory risk associated with future regulatory decisions by Ofcom that could strip away legitimately expected upside returns.

Ofcom's answer to this was to enshrine in its regulation the concept of the 'fair bet'. Ofcom stated explicitly that it would not intervene retrospectively to strip away the upside returns that BT could reasonably have expected at the time it made its investment decision. Indeed, Ofcom repeatedly made this statement, in terms, in policy documents, in speeches from different people across the organisation and specifically to BT in many discussions and in writing.

Ofcom also gave life to the 'fair bet' in its Wholesale Fixed Telecoms Market Access Review 2020 (WFTMR). Ofcom decided that it would not regulate the prices of Openreach's wholesale full fibre local access product for at least two consecutive price review periods (i.e. 10 years). Ofcom's framework provided no downside protection for BT; BT was left to bear the commercial risk of the investment both in respect of whether customers would take up the new product and of how competition in the market would develop. But the potential upside in BT's investment appraisal would remain in play for a decade.

Ofcom did retain measures to protect customers both at the wholesale and retail levels. In particular, it retained controls on some of Openreach's super-fast local access products, which it considered had the effect of 'anchoring' the price Openreach would be able to charge for full fibre connections (because the older, slower product would in the same market as the newer, faster product at least for a time). It also retained obligations on Openreach to ensure its pricing was 'fair, reasonable and non-discriminatory'.

Regulators tend to be slow to do anything that could be seen as 'fettering their discretion' and Ofcom clearly took a risk in adopting this position. But it was supported in doing so by the Government, whose Statement of Strategic Priorities for telecommunications, issued to Ofcom in 2019, set out a clear objective in favour of investment in full fibre broadband, and a clear preference in favour of that investment over lower wholesale local access charges.

Operational expectations and reciprocal commitments

Both Government and Ofcom also made clear their expectations that, once BT had made its investment decision on the basis of the 'fair bet', the result would indeed be an extensive full fibre roll out programme. They were clear with BT and Openreach that the roll out needed to be rapid but also a 'balanced build', so that Openreach would not cherry pick the more commercially advantageous areas. Openreach was required to report regularly on build and take-up and these reports were subject to significant scrutiny and discussion. Government, for its part, undertook a programme of 'barrier busting' aimed at removing blockers to roll out by all the network providers, such as wayleaves and planning.

While not leaving Openreach and BT a free hand, Ofcom's decision in the WFTMR, and its clearly stated policy on the 'fair bet', allowed BT to take the view that it did not need to factor the risk that upside returns would be regulated away into its investment appraisal. This in turn enabled BT to give the green light to £15bn of investment, which, alongside investment from other network providers, means that almost 7 in 10 homes in the UK have access to full fibre broadband [ref: Ofcom Connected Nations Report, December 2024].

The evolution of the 'fair bet'

The 'fair bet' undoubtedly had its genesis in a very specific set of circumstances, namely the need for the regulatory environment to enable massive investment in a new technology with considerable risks in relation to demand and competition in order to achieve a clearly stated public policy goal. Indeed, the specific manifestation of the 'fair bet' in Ofcom's WFTMR, in particular the regulator's choice to 'forebear' from regulating the price of a product and to rely instead on 'anchor pricing' and 'FRAND' obligations to protect customers, was only possible because of the degree of competition in the market. However, the term has been widely adopted in other sectors subject to economic regulation, where both public policy goals and the underlying economics are very different.

In its broadest sense, the term ‘fair bet’ is used to describe a situation in which regulatory regimes successfully and sustainably align the interests of investors and the interests of customers. In such a situation, investors accept that they enjoy the privilege of a high degree of stability and the protections of regulation on the basis of a regulatory asset base, in return for which they provide capital at relatively low cost and accept their role as stewards of long term public interest businesses. Similarly, regulators accept that investors do need to earn returns, which if they are to be low (and thereby reduce pressure ultimately on consumer bills) require sensible real world limits on the extent of downside risk to which investors are exposed.

From principle to practice in RAB-based sectors

More specifically, in highly monopolistic sectors with RAB-based regulation, the ‘fair bet’ can be used to describe the relationship between the risk allocated by regulation to a regulated firm and the WACC set by the regulator. This risk may be inherent in the industry, for example in relation to real input price inflation, or it may be created by the regulatory regime itself, for example through financial incentives and cost and performance targets, or it may be legal, for example in respect of compliance obligations where non-compliance could lead to financial penalties and unfunded remediation costs. The scale of exposure and the distribution of that exposure, will have an impact on the WACC, the greater the scale of exposure and the more the distribution is skewed to the downside the higher the WACC will need to be to provide a reasonable return for the risk investors are bearing. Where the balance of risk and return is perceived to be out of kilter, the regime will be seen as not being a ‘fair bet’ for investors.

Figure 1: Potential components of the ‘fair bet’

As both a former non-executive director of Ofcom, and the Chairman of Openreach, in addition to chairing a number of other businesses in regulated and non-regulated sectors, Mike McTighe offers a unique perspective on the ‘fair bet’:

The ‘fair bet’ concept is often used to refer to the balance of risk and reward struck through the penalty and incentive regime, where “stretching but achievable” targets are also frequently referred to, but in my view a “fair bet” is broader than that and would encompass, for example:

- the setting of legal compliance obligations by reference to what companies can (and will be funded to) actually achieve;
- awarding companies realistic expenditure allowances and removing the current over reliance on econometric models and benchmarking where those models have low predictive power, where companies are different and therefore can’t be regulated as if they are the same, and where (as with the water sector) the work and risk profile that companies now face is without historic precedent;

- a sensible (low) number of realistic and achievable performance targets and symmetrical incentives, to avoid a skew to the down side, that do not overlap in their application and are capped at proportionate levels to avoid the penalties becoming overpowered;
- removal of double jeopardy, between different performance targets and between performance targets and enforcement action for breach of law/regulation;
- meaningful in-period re-openers to address in close to real time the consequences of unexpected events;
- a broader recognition of the impact of external factors such as supply chain constraints;
- a viable appeal or redetermination process to allow companies to efficiently challenge regulatory decision making;
- a risk reflective WACC;
- a turnaround regime that supports companies in operational and/or financial difficulties;
- appropriate statutory limitations on the risk of class action type third party claims / liability for failure to deliver the regulated service (i.e. enforcement should be principally through the regulatory regime); and
- regulating for reality, with the regulator having the skills and time to understand the individual companies they regulate and not becoming blinkered by a notional company theoretical paradigm.

Sector-wide vs company-specific considerations

Economic regulation UK-style rests on the allocation of risk to regulated companies in order to provide those companies with incentives to improve, in terms of efficiency, physical performance and resilience; in this way it seeks to align the interests of customers with those of investors. Economic regulators tend therefore to take the view that companies and their investors should bear risk associated with cost efficiency, performance and resilience, at least to some extent. Typically regulators will set targets in each of these dimensions, with financial pain for companies who do not meet those targets and gain for those who exceed them and in doing so reveal information about what is possible, which the regulator will factor into its future decisions.

The extent to which such regulatory frameworks deliver a ‘fair bet’ is therefore a function of whether those targets are set at achievable levels and whether the incentives around those targets are reasonable in scale and symmetrical, as well as the extent to which any material skew in the expected outturn of those incentives is taken into account in the regulatory WACC. It is easy to see how in this context – especially where regulatory targets are set sector-wide - a regulator might achieve a ‘fair bet’ on average, at a sector-wide level, but not at an individual company level.

Simplistically, it could be argued that where a regulator is interested in financeability, and because it is *companies* that raise capital rather than sectors, regulators should care about whether they have created a 'fair bet' at the company level, rather than simply at the sector level. This does not necessarily mean that the regulator must adjust its framework so as to ensure that every company, based on its individual circumstances, is exposed to the same balance of risk and return. Within any sector-wide regulatory regime, some companies will be performing better than others and those who are performing less well need to be exposed to the downside risk from the performance so they may be spurred to improve. Recall that, in applying the 'fair bet' to BT's investment in full fibre, Ofcom did not provide protection against downside risk.

However, if the allocation of risk is to be used as an effective incentive, it must be allocated to those who are able to manage that risk. Otherwise, the allocation of that risk creates an inefficient premium on financing costs that will ultimately affect customers either as its remuneration flows through to customer bills or because it is *not* remunerated such that private capital does not flow and investment cannot be made. In this sense, the regulatory regime does need to provide a 'fair bet' for *all* companies; it must be possible for even the poorer performing companies, over a reasonable period of time, to take steps to improve their performance and achieve a risk-reward balance that is commensurate with the regulatory WACC.

There is a debate taking place at the moment, especially in the water sector, about how companies that have persistently performed poorly within the regulatory regime should be treated.

Special administration or a turnaround regime

As it stands, in energy and water, the regime contains provisions for 'special administration'. In 'special administration', Government appoints a special administrator whose primary role is to keep the assets in operation in service of the customer, while attempting to find new owners for the business. Essentially, in such a situation the risk of persistent poor performance within the regulatory regime, which has been allocated ultimately to the owners of the businesses, has crystallised and the businesses' existing shareholders have substantially lost their investment. However, in special administration, the characteristics of the company that created such persistent poor performance may endure.

This would be the case, for example, if those characteristics relate not simply to poor management of the company or downside risk within particular commercial contracts having crystallised but to long term degradation of the asset base or to other factors that cause the company to be an outlier within the sector. The company will still need to (be perceived by investors to) represent a 'fair bet' if new owners are to be found to take the company out of special administration, such that any of the more systemic factors that contributed to its entry into special administration are addressed by the regulatory regime.

The Independent Water Commission, chaired by Sir Jon Cunliffe, in its recent report proposed a new tool within the regulatory regime, namely the creation of a 'turnaround regime' into which persistently poor performing companies could be placed, short of special administration. The turnaround regime would allow regulatory adaptations to be made such that these companies could be seen as a 'fair bet' by investors, who would then be able to contribute the private capital needed to support the investment needed to transform their performance.

In the spirit of the 'fair bet' there would be a price for entry into such a regime. This might involve some commitment to recapitalisation, not to take dividends from the company during its time in the turnaround regime, to undertake activity to remedy the main problems faced by the company, and to be subject to enhanced monitoring and oversight, which could be done by an independent expert third party. The whole regime could be given effect in a legally binding way (e.g. via undertakings), such that if the company and its investors do not deliver the improvements to efficiency, performance and resilience that are expected, the regulator has the ability to amend or suspend the turnaround arrangements. Again, this echoes the original 'fair bet' in respect of full fibre broadband with regulatory easements in return for investment that will deliver improvements for customers, all with appropriate oversight.

Company-wide vs project-specific considerations

As set out, the original concept of the 'fair bet' had its genesis in the need to create the regulatory conditions that would support full fibre broadband roll out, i.e. one very specific, very large, project. In more monopolistic RAB-based regimes, regulators have historically focussed on regulated businesses as single corporate entities, with a single cost of capital, reflecting the fact that finance has typically been raised by that corporate entity to cover its portfolio of activities. As discussed above, this has tended to mean in RAB-based sectors that the 'fair bet' has been characterised by a reasonable balance of risk and return within the regulatory regime to which the regulated business is subject as a whole. Implicit in these regimes has been the idea that the portfolios of the regulated entities would be dominated by 'business as usual' monopolistic activities, such that the combination of inherently low levels of commercial risk and regulatory predictability (principally via the RAB) would provide access to private capital at low cost.

However, in many of these traditionally monopolistic RAB-based regimes, the portfolios of the regulated entities are changing. In energy the demands of electrification and decarbonisation require transformational investment in the grid and local distribution networks. In gas, future use of hydrogen – even if only for industrial use, rather than home heating - would require transformational levels of investment. In water, the investment needed to secure the resilience of drinking water and waste water treatment and drainage in the face of climate change and population growth is huge, and layering on to this demands for a step change in environmental protection adds further pressure.

It cannot be assumed that the regulatory tool kit deployed in the traditional way, will create the conditions for investment of this nature and at this scale to attract the private capital it will require.

In energy, Ofgem has recognised this. It is regulating so-called 'strategic infrastructure', i.e. large scale connections required to enable renewables such as offshore wind to be connected to the grid, on the basis of different licences with a different regulatory regime applying to the relevant entities. Under this regime, Ofgem has the ability to choose more or less competition for the market, and to set specific incentives for delivery of projects. National Grid has created a National Grid Strategic Infrastructure business unit that is a separate entity to National Grid Electricity Transmission, reflecting the distinct nature of the risks managed in this part of its portfolio. In respect of gas, Ofgem has said that it will regulate transportation of hydrogen using a separate price control and a separate RAB from transportation of methane. The 'hydrogen transportation business model' is yet to emerge but Ofgem's approach gives it the ability to create a regime that will deliver a 'fair bet' that will attract investors into a market that could potentially have quite different market characteristics to traditional methane transportation.

In water, the scale of the 'enhancements' each water and sewerage company will deliver in the current price control period (AMP8) is typically between 3 and 5 times the size in the previous control period. This enhancement spend is typically capex, aimed at improving outcomes delivered for customers and the environment beyond those in the previous period, and costs need to be financed on the basis that they will be recovered via depreciation of the RAB (in water the Regulatory Capital Value or RCV) over time. Delivery of the projects involves design, build, often contract management and sometimes complexity associated with land acquisition, planning and outage management.

As this type of activity grows within each water company the risk profile of the sector increases. Ofwat recognised this in reducing its notional gearing at PR24 from its historic 60% to 55%. But it has continued to regulate water companies using a single regulatory framework and a single WACC. In principle, this approach can work provided that the WACC is adjusted to reflect the change in risk *and* provided the capex programme of the company is understood at the time of the price review. If the WACC does not adequately reflect the changed risk mix in the company's portfolio, a company faced, it would be rational for a company – to the extent it could – to curtail capex in the period. Even if the WACC did adequately reflect the risk mix in the portfolio at the time of the price review, if a company was faced with the option of undertaking a substantial additional capital project within the price control period it could well be rational for it to decline to do so because the whole company regulatory WACC would be less than the incremental financing cost of the project, given its risk.

Lessons from Tideway

So far in water the only project-specific regulatory framework has been that in relation to the Thames Tideway Tunnel. Reflecting the same ‘fair bet’ principles as applied to full fibre broadband, a key enabler of the Tideway project was the creation not only of a distinct regulatory framework but also one that would be stable and predictable. Ofwat’s decision to provide upfront clarity on the framework it would apply and how it would apply it was key in providing potential investors with the confidence they could bid for the project knowing they did not have to factor in regulatory risk. Government’s decision to provide a support package that essentially socialised the extreme long tail of downside risk within the project (relating for example to some very low probability but very high impact scenarios associated with the tunnelling process) was also key to providing investors with confidence that those risks they were being asked to bear were risks they could reasonably manage. Because Tideway was subject to a competitive process, and because the regulatory framework and government support package had been clearly set out as part of that process, the WACCs that were bid in to the competition by definition reflected the regulatory and policy regime that applied to the project – the process itself created a ‘fair bet’.

Conclusions and notes on operationalisation

While the ‘fair bet’ as originally conceived had a very specific meaning in a very particular context, in its broader sense it has become widely adopted as a shorthand for an effective regulatory compact between the regulator (on behalf of customers) and companies and their investors, in which the needs – if not the desires - of all are met.

In this broader sense, a ‘fair bet’ has a number of key characteristics. It requires that the regulatory regime affords the opportunity to earn upside returns that are sufficient to attract capital in the face of downside risk. Where products and services are regulated it requires that the regulator do so using a regulatory WACC that reflects the balance of risk and return allocated to companies and investors through the regime. A ‘fair bet’ is not a one way bet – the regulated firm remains exposed to downside risk, but there is a measure of protection from regulatory risk.

A ‘fair bet’ can be achieved in different ways. In the original telecoms context, it was achieved through Ofcom’s forbearance from price control regulation for a period (with lighter touch customer protection in place). For the Thames Tideway Tunnel it was achieved through the use of a Government support package, a clear and predictable regulatory regime and a process of competing the WACC. It can be achieved in more traditional price controlled sectors by means of a reasonable allocation of upside and downside risk through targets and incentives and a WACC that reflects this.

However, a ‘fair bet’ is to be achieved, it is clear that its fairness or otherwise will be in the eye of the beholder. In order to be effective in unlocking private capital to finance investment, investors must be persuaded not only that the bet is indeed fair, but also that the regulator will make good on the expectations they have created over time. Investor perceptions are intrinsically linked with the perceptions of other key stakeholders. The bet set up by the regulator needs to be seen as fair by customers, because if it is not the pressure on the regulator, from politicians but also from NGOs, to make changes to it will be great and the bet as constructed will not survive. Where there is a degree of competition in the market, the bet also needs to be seen as fair by the regulated firm’s competitors. If it is not, the regulator’s actions may well be subject to challenge using competition law, and again risk being unwound.

Investors, then, should be under no illusion that a fair bet will be an easy ride. Customer protection (and perhaps also protection of competition) will be part of the package of any ‘fair bet’. And they should also expect to be held to account by the regulator for delivering on their side of the bargain, i.e. substantial investment delivering using private capital at lower cost than would otherwise be the case. Monitoring and reporting will also be an important part of the package, with transparency and delivery tracking key in maintaining the trust on which the sustainability of the ‘fair bet’ will depend. An independent expert monitor, as suggested by the Independent Water Commission in relation to its proposed ‘turnaround regime’, could be a helpful additional element for both sides.

Whether the ‘fair bet’ is applied at a sector-wide level, a company-wide level or on a project-specific basis will depend on the nature of the investment problem to which it is part of the solution. It will also likely reflect regulatory traditions and the appetite of regulators to depart from those traditions, which will take account of a panoply of factors. It is worth noting, however, that new technology is making it much easier to deploy granular, data-driven approaches to the calculation of financing costs on the basis of a given risk profile. Large data sets can be created containing risks and financing costs from projects globally and artificial intelligence and machine learning can be applied to better understand what is and is not an investable combination of risk and return, and indeed what the financing cost benefit of different approaches to risk reduction could be. What took BT, working with consultants, several years to do in order to understand what a ‘fair bet’ on full fibre broadband would look like, can now be done in a matter of weeks.

The ‘fair bet’ then, has evolved over time both conceptually and practically. Its essence, though, remains compelling. Experience also suggests that, when deployed effectively, it is a powerful means of enabling efficient access to private capital. Given the scale of infrastructure investment required in the UK in coming decades, then, and the regulated nature of much of the infrastructure sector, the ‘fair bet’ is likely to remain an important part of the tool kit, and one worthy of continued examination and innovation.

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