

Expanding the role of consumers
in regulatory determinations?

Or

Reducing the role of regulators
in consumer determinations?

Stephen Littlechild

ACCC Conference, Brisbane

26 July 2018

Introduction

- Development of customer engagement in regulation very welcome
- But still further to go
- Here is a summary of (my) thinking over last 50 years, taking snapshots at 10 (or more recently 5) yearly intervals
- With some suggestions for the future
- Focus mainly on UK - others here know more about Australia
- Focus mainly on water rather than energy networks –
 - water happening now in UK
 - & also illustrates two different approaches.

1968 Problem & solution

- Problem: (for economists) Nationalised industries
 - Inefficient pricing (price not equal to marginal cost)
 - Inefficient investment
- Solution (for economists):
 - Marginal cost pricing
 - Optimal investment rules

1978 Problem & solution?

- Problem: Nationalised industries
 - Not efficient hence high prices
 - Not innovative
 - Not customer sensitive
- Solution:
 - Financial targets
 - Introduce competition where feasible

1988 Problem & better solution

- Problem: Nationalised industries still nationalised
 - Still not efficient hence high prices
 - Still not innovative
 - Still not customer sensitive
- Solution:
 - Privatisation, made possible by
 - Regulation: RPI-X to incentivize efficiency & innovation, while also protecting customers (NOT US regulation!)
 - Restructuring
 - Competition

1998 Problem solved?

- Privatisation with RPI-X incentive regulation in place
- Efficiency clearly increasing
- Customer sensitive? Well, quality and reliability improving
- Innovation? Not much, but is this relevant for energy & water networks?
- With these achievements, is there really a problem?

1998 Actually, several other problems

- Price control reviews getting more complex & longer (1 → 3+ yrs)
 - Excessive time & cost & risk to companies
- Regulatory decisions undermining company responsibility for business plans
- But did regulators know customer preferences?
- Regulation → uniformity → less variety, innovation & learning
- Consumer groups often made valuable inputs
- But review process increased company/customer group tensions
- Public concern about excess profits
- Do customers trust companies ... or regulators?
- Solution? There must be a better way of setting prices ... But what is it? Do other regulators do it any better?

2008 How other regulators do it?

- Negotiated settlements
 - US: Federal Power Commission gas pipelines 1960s
 - US: FERC transmission lines 1990s+
 - Florida: Consumer Advocate electricity & telecoms 1990s+
 - Canada: National Energy Board pipelines 1997+
- Argentina: Public Contest Method transmission lines 1990s
- UK Civil Aviation Authority constructive engagement at major airports 2005+
- Australia: Hunter Valley Access Undertaking rail track 2009

2008 A new solution?

- In these examples, regulatory decision-making is supplemented or superceded by negotiation, engagement & settlement
 - Between companies, customers & other interest groups
 - Interested parties select themselves
- All parties prefer this outcome where achieved
- Regulator does not have to make all the decisions, doesn't need "all" the information relevant to parties
- The process of price setting can be decentralised
- Transactions costs not a problem in these cases
- We (at least I) never thought of this in 1978 or 1988 or 1998

2013 The new solution implemented in E&W

- UK regulators accept there are problems
 - “regulatory burden has increased massively ...major cultural change needed on both sides” (Ofwat)
- Solution: customer engagement to inform company plans & regulatory decisions
 - Customer Challenge Groups chosen by companies to report to Ofwat
- Also fast-tracking process for those companies with soundly-based customer-supported business plans
- Note Ofgem & Ofwat did not envisage negotiated settlements
 - Ofgem: such a process would not reflect views of future customers
 - Ofwat: such a process would be too onerous
- Also many other changes aimed to increase regulatory effectiveness
 - E.g RII, totex, restructuring, outcome-based, retail choice (business customers)
 - Ofwat: 522 performance commitments, 838 Outcome Delivery Incentives

Key changes for PR14

Goodbye Ofwat setting companies' plans

Hello company ownership of business plans

Goodbye outputs for regulators

Hello outcomes for customers

Goodbye capex bias

Hello totex

Goodbye regulation of integrated business

Hello wholesale/retail split

Goodbye forced one-stop-shop

Hello choice for business customers

Outcomes – summary of approach

Companies submitted their business plans in December 2013. We applied 18 risk-based review tests to their outcomes, performance commitments and Outcome Delivery Incentives (ODIs) on issues such as:

- the **quality of their customer engagement**
- whether the commitments were set at the **economic level**
- whether the financial incentives **reflected costs and/or willingness to pay**

171	Outcomes
522	Performance commitments
316	Financial ODIs
206	Reputational ODIs
144	Penalty-only ODIs
172	Reward and penalty ODIs

2013 Initial experience in E&W - mixed

- Company plans better reflected customer views
- Companies & customer representatives were supportive, often enthusiastic
- Ofwat & Ofgem praised process and outcomes
- But remit of CCGs unclear & changed over time
 - to challenge/negotiate/agree/endorse business plans? or just advise Ofwat?
- Were all CCGs independent and capable of challenging companies?
- Late announcements by Ofwat (eg cost of capital) & its later criticism of many companies' opex projections left CCGs unsighted/undermined?
- So customer groups supported most company plans, but regulators rejected most
- Hence very few companies fast-tracked
 - Transmission 2/4, Distribution 1/6, Water 2/19 companies
- Some CCGs & Cos disappointed – could discourage future customer engagement?

2013 A different solution in Scotland

- Water Industry Commission Scotland (WICS), Scottish Water (SW) & Consumer Focus Scotland jointly created the Customer Forum
- Remit: research programme to ascertain & represent customer views to company & to regulator
- Detailed programme of work, with expert advice
- Enthusiastic & effective participation by all (as in E&W)
 - Including pushback on company research
 - Deeper understanding customer preferences
 - Input into development of draft business plans
- So far, not dissimilar to Ofwat's approach

2013 Initial experience in Scotland – success?

- In mid-process, WICS asked Customer Forum to seek to agree a Business Plan with Scottish Water
- Should be consistent with WICS Guidance Notes
 - About 25 Notes issued including opex, capex, finance, environmental
 - These indicated area of acceptability to WICS (& Scottish Govt)
- Parties did reach agreement on a Business Plan
- WICS price determination was consistent with it
- Claimed better outcome for customers than WICS alone
 - New customer service measures
 - Additional nominal price cap +1.6% for 3yrs for additional certainty (within overall real price cap CPI-1.75% for 6yrs)
- Approach seen as v successful
 - Has inspired similar trials in Australia

Comparing approaches in E&W and Scotland

- Customer Forum seemed more successful than Consumer Challenge Groups?
 - Scottish regulatory process mostly clearer about roles, and more timely provision of information
 - Continual interaction between Company, Regulator and Forum during process
 - Regulator proposed and accepted plan negotiated by customer group
- But how dependent on special factors?
 - Scottish Water owned by Scottish Government
 - Single company, no comparators (except in E&W), easier to interact with
 - Close community in Scotland, tradition of working together
 - Personalities (strong leaders at WICS, SW and Customer Forum who wanted to cooperate)
- Also 1st Customer Forum gave credit to announced greater regulatory flexibility in future
 - WICS proposed to undertake a rolling investment review every 3 years
 - And WICS undertaking to set out tramlines to monitor company performance
 - Price adjustment or profit sharing if unexpected performance
 - These gave assurance to parties to commit to agreement
- Is Customer Forum approach feasible elsewhere? Particularly in conditions of E& W?
- Could Ofwat/CCG approach (with better planning) be as successful as Forum approach?

2018 WICS reaffirms policy in Scotland

- March 2017 WICS appointed Second Customer Forum, with same approach
 - Govt support: wants enhanced voice for customers on levels of charges & service priorities
- New issues are being identified:
 - Does resilience justify a backup supply – why now & not earlier?
 - How to finance future investment (Govt borrowing or retained earnings)?
 - What if water quality now relates to lead in poorer housing, no longer in water networks?
- And multilateral dialogue emerging: CF now has seat at table (with WICS, ScotWater, Govt, Environment Agencies) - more tradeoffs available
- Scot Govt long-term stability: objectives same 2015-21, 2021-27, 2027-33
- This gives Customer Forum greater flexibility to pursue customer objectives
 - CF taking longer term perspective: 10-20 yrs rather than 6 yrs
 - CF able to consider (eg) 3 year pricing periods instead of 6 yrs, within Govt policy
 - Ongoing CF role in implementation & monitoring price control obligations on SW
- Customer engagement evolving in Scotland - more integral & more influential
- Potentially moving to power-sharing with economic & environmental regulators?

2018 Ofwat reaffirms policy in E&W

- Policy to build on customer engagement & innovate
 - To view customers as active participants
 - To facilitate more collaboration between CCGs
 - To be clearer – earlier - on Ofwat’s expectations
 - To put more focus on customers in vulnerable circumstances
 - To use more comparative information about company performance
 - To publish early indications of WACC and Rate of Return ranges
 - To put more emphasis on innovation, including in customer engagement
- Ofwat envisages greater number of companies being fast-tracked
- But note that CCGs’ reports are still just one input into Ofwat decisions:
 - Ofwat would not expect CCGs to challenge company costs
 - Nor expect CCGs to endorse a company’s overall plan
- So Ofwat’s policy is as before, *not* moving to the Customer Forum approach

But many questions remain in E&W

- The price control review process is prescriptive & mechanistic
 - 108 data tables in business plan, 3000 pages of Ofwat guidance
- Key decisions still reserved to Ofwat, with CCG views as one input
- Ofwat's dilemma: how far can it delegate responsibility to CCGs?
 - Can it maintain consistency, comparability, manageability of process?
 - What is CCG legitimacy if chosen by the companies?
 - How far do CCGs really represent real customers?
- Wider concerns about the price control framework
 - Is customer engagement fundamentally changing company attitudes?
 - Are the long-term incentives to innovate sufficiently plausible to companies?
 - There are still public concerns about excess profits and wasting water
 - Which is not conducive to trust in water companies – or in regulation
 - YouGov poll 2017: 53% wanted to nationalize the energy cos, 59% water cos
- Customer engagement in E&W marking time? One of many inputs into centralized & controversial regulatory decision process? To review later?

Scorecard of UK utility regulation

	1978 - 1988 Nationalised industries	1998 Privatisation + 10 years	2008 Privatisation +20 years		2018 Scotland +30 yrs	2018 E&W +30 yrs
Efficiency	Red	Green	Green		Green	Green
Innovation/uniformity	Red	Orange	Orange		Orange	Orange
Customer sensitivity	Red	Red	Red		Orange	Orange
Review process	Grey	Yellow	Red		Yellow	Red
Conflict/trust	Yellow	Red	Orange		Yellow	Orange

Green	A
Yellow	B
Orange	C
Red	F
Grey	N/A

What have we learned in UK over 40 years?

- Network regulation is effective in increasing efficiency & quality
- But is also time-consuming, costly, restrictive & socially divisive
- Are chosen customer groups capable of negotiating with network cos?
- Yes, within limits, especially when one Govt company is involved
- But if regulator has many price controls for private cos? Unclear
- In contrast, overseas, actual customers often negotiate effectively
- If we want to expand role of consumers in regulatory determinations
- We need also to reduce role of regulators in consumer determinations

How are views of consumers best represented?

- Don't limit consumer representatives
 - Don't limit them to parties chosen by company and/or regulator
 - Don't limit them to advising regulator on company behavior
 - Let actual customers negotiate with companies, and possibly reach settlements
- Consider relaxing some premises of early incentive regulation
 - Eg RPI-X, uniform controls over simultaneous 5 year periods
 - Extend role of customers to engaging on type and duration of price controls
 - Let them negotiate with alternative service providers – to enable real competition
- Reduce duration of review, say 3 years down to 1 year
 - This would attract more informed actual customers eg from major users
- But does there need to be a regular price control review at all?
 - Why not only if case made out – US regulation had merits after all

Don't worry, there is still a role for regulators

- Regulators should provide comparative information & inputs before and during a price control review process
- And retain duty to approve any settlement, to adjudicate on dissenting views, and to substitute their own judgement if not persuaded by the parties' settlement
- But going forward let process evolve in response to what parties need
- And enable actual consumers to negotiate more effectively with their companies and with other interested parties
- Regulators: Ask not what your consumers can do for you, Ask what you can do for your consumers.