

Regulation and Customer Engagement

STEPHEN LITTLECHILD^a

ABSTRACT

The utility regulation framework developed in the UK in the 1980s, and widely adopted internationally, was intended to improve on the restrictive, inefficient and burdensome regulatory approach in the US. But the UK regulatory process has itself now become increasingly burdensome. Meanwhile, utilities and customer groups in the US and Canada have developed methods of negotiating and settling regulatory issues that more directly reflect the interests of customers, often embody incentive price caps as in the UK, and avoid unduly burdensome regulatory processes. There is now scope for UK regulators to learn from overseas. This paper summarises these developments. It then examines how three UK utility regulators—of airports, water and energy—are responding to them by developing new forms of customer engagement. The CAA has moved firmly in this direction for airports, while Ofwat and Ofgem have nominally rejected it for water and energy, but seek to secure many of the benefits of the approach via less committed processes. There is scope for governments to encourage a regulatory approach that offers the prospect of better outcomes for customers and a less onerous process for all concerned.

DOI: 00.0000/ISSN2160-5882/E-ISSN2160-5890/EEEP-Vol1-No1-6

Keywords: Negotiated settlements, Constructive engagement, Customer engagement, Regulation

✎ 1. OWNERSHIP, COMPETITION AND REGULATION ✎

The regulatory framework developed in the UK in the 1980s, and widely adopted internationally, was intended to improve on the restrictive, inefficient and burdensome US regulatory approach. Over subsequent years, UK utility regulation has a number of achievements to its credit. Privatisation, the promotion of competition and the imaginative use of incentive price caps have generally led to greater efficiency, price reductions and improved quality of service. However, the regulatory process has become increasingly burdensome and there are growing doubts as to how well it protects customers.

Meanwhile, utilities and customer groups in the US and Canada, encouraged by some regulators, have developed methods of negotiating and settling regulatory issues that more directly reflect the interests of customers, often embody incentive price caps as in the UK, and avoid unduly burdensome regulatory processes. There is now scope for UK regulators to learn from overseas. This paper summarises these developments. It then examines how regulators of the UK airport, water and energy sectors are responding to them by developing new forms of customer engagement.

^a Emeritus Professor, University of Birmingham, and Fellow, Judge Business School, University of Cambridge, Trumpington Street, Cambridge CB2 1AG. E-mail: sclittlechild@tanworth.mercianet.co.uk. Tel. 01564 74 2502. Formerly Director General of Electricity Supply 1989–98.

Copyright © 2011 by the International Association for Energy Economics

✎ 2. THE US REGULATORY FRAMEWORK ✎

When the UK began to privatise its previously-nationalised utilities, it looked at how the US regulated its privately owned utilities. US regulators took a “cost of service” approach. They allowed price increases that provided a “just and reasonable return” on investment that was “used and useful” and “prudently incurred”. The regulator could step in at any time to seek price reductions whenever a company seemed to be making excessive profits.

All this might seem reasonable. However, closer examination by economists suggested several reservations.

First, this was too much like a ‘cost-plus’ arrangement. There was little incentive for utilities to reduce costs if the regulator could immediately ask for the resulting savings to be passed on to customers. If the allowed rate of return exceeded the company’s cost of capital, there was an incentive to ‘gold-plate’ or ‘pad the rate base’. Also, in setting prices the US framework looked only at actual expenses in a ‘test year’. The regulator typically did not make judgements about the scope for future efficiency improvements or the need for future capital expenditure. This seemed a serious limitation at a time when increasing the efficiency of the hitherto nationalised industries was a key aim of policy in the UK.¹

Second, in many industries like airlines, telecoms and energy, US regulators enforced barriers to entry that maintained a monopoly and prevented competition. Customers were denied the protection that competition could provide against inefficient production techniques and misinvestment, against excessive prices and lack of innovation, and against regulators that might be unable or unwilling to act in the interests of customers.

Third, the US legal framework and litigation process seemed unduly bureaucratic and legalistic. Rate cases could take years to resolve, in some cases many years. This was time-consuming, expensive, inflexible and not conducive to the rapid modernisation that was needed in the UK.

✎ 3. THE UK REGULATORY FRAMEWORK ✎

In 1982, the Secretary of State for Industry, Patrick Jenkin, had the task to privatise British Telecom. He needed to reassure investors and customers so as to attract very considerable new investment into this rapidly changing sector. He was also conscious of the limitations of US regulation. He wanted something more flexible and evolutionary. He specified that British Telecom should be regulated ‘with a light rein’. (Littlechild 1983, para 14.9) For present purposes, the UK regulatory framework that was designed to meet this aim had three main elements.

First, the regulator was not only to allow competition, but indeed to promote it wherever possible. This would give customers choice and stimulate companies to greater efficiency and innovation. Second, where competition was not possible or not economic, an RPI-X incentive price cap was a simpler and more effective form of regulation than US rate of return control.

1. Joskow and Schmalensee (1986) pointed out that, in practice, the US regulatory system was not as inefficient as sometimes suggested. For example, “regulatory lag” in adjusting prices meant that the actual rate of return might be above or below the cost of capital for periods of time, and this lag also provided (inadvertently) some incentive to increase efficiency. Also, many states introduced incentive regulation schemes by the mid-1980s, although most of these were subsequent to our consideration of utility regulation in the UK in 1982.

Set for a fixed-term, it offered a greater incentive for the company to become more efficient and reduce its costs. Requiring prices not to exceed the rate of inflation less an 'X factor' provided assurance to customers and company alike. As efficiency improved, customers would benefit from further price reductions over successive price control periods. The price cap was simple to explain, and hopefully would be simple to set. The third element was the ability of the regulator and utility simply to agree a modification to the licence conditions (e.g a new price control) without the need for formal and adversarial legal proceedings. The regulator had the ability to refer the issue to the Monopolies and Mergers Commission (later the Competition Commission) if the utility declined to accept a modification proposed by the regulator.

✎ 4. UK REGULATION IN PRACTICE ✎

In the event, with a few exceptions, the novel UK policy turned out remarkably well throughout the privatised and regulated industries: telecoms, airports, gas, water, electricity and rail. The regulators have generally promoted competition both actively and effectively. This has been less marked in the water sector, but there is some scepticism about the scope for competition there, and Ofwat has been faced with an unenthusiastic series of ministers.

The record on removing price controls as competition develops has been mixed. Offer, Ofgas and Ofgem removed the controls on domestic gas and electricity prices within at most four years of opening those markets. In contrast, Ofel (later Ofcom) took some 22 years to remove the initial RPI-X price control on BT's retail prices. International comparisons (at least in electricity) suggest that those countries that have maintained price controls have thereby discouraged competition. The low point in the record must be the Government's overruling of the recommendation of the Civil Aviation Authority (CAA) to remove Stansted Airport's price control, on the grounds that the Airport might have market power in future.

RPI-X price controls have generally provided very effective incentives. Operating costs have significantly reduced, and efficiency has improved. There has been very substantial capital expenditure. Prices are generally lower, or at least lower than they would have been in the absence of these changes. Quality of service is higher. There has been innovation in techniques and in products.

Yet the UK approach, for all its advantages and potential flexibility, seems to have limitations in terms of process. The price control review process is especially and increasingly burdensome. Initially it took about a year, now it takes about three years, to set a five year control. The total length of regulatory documents issued during the price control review of the electricity distribution companies increased from about 250 pages when I did the first review in 1995, to about 500 pages in 2000, to about 2000 pages in 2005. A colleague has estimated that the length may have been about 3–4000 pages in 2010 – at least a twelve-fold increase. Similarly, the volume of annual information required by Ofwat increased tenfold between 2000 and 2010.²

2. David Gray giving evidence to the All Party Parliamentary Water Group, *Utility Week*, 9 February 2011. Severn Trent Water alone submitted over 2000 pages. The annual "June return" required 67 tables with 1200 lines of data and (until 2011) nearly 900 pages of commentary. Tony Balance, Severn Trent Water, presentation on Simplicity versus complexity to RPI Conference, Oxford, 13 September 2011. Obviously page numbers are a limited indicator, and it is true that there is now increased repetition and pressure for transparency, which may not imply increased content or complexity. Nonetheless, they do suggest an increased burden.

The regulatory process is also intrusive and often a cause of conflict between companies, customers and regulators within each industry. All parties are invited to give their views – indeed, the process encourages the parties to lobby the regulator rather than to talk to each other—but some question how far the regulator listens. Regulators are increasingly specifying or approving quality of service standards and investment programmes on the basis of limited knowledge about customer preferences. The pressure for regulatory uniformity limits the ability to tailor regulation to particular circumstances. There is less innovation, less learning from experience, than one would expect in a competitive market.

Indeed, the burden of the typical UK approach is now so great that it rivals the burden of the US approach in the 1970s that the UK sought to avoid. If we had been able to foresee present UK regulation in action, we might have been equally keen to avoid it.

✎ 5. ALTERNATIVE APPROACHES ✎

Why has UK regulation run into such problems? The initial RPI-X regimes put a cap on the prices that the companies could charge, but left efficiency improvements and investment and innovation to the companies themselves. In resetting these price controls, however, regulators have increasingly sought to ascertain and specify in advance what levels and kinds of efficiency improvements, investment programmes and innovation could or should take place. Partly this is to continue to be able to deliver real price reductions, in the face of tougher counter-arguments from the companies. Partly it is to avoid the embarrassment of setting targets that in hindsight seem to be too easily met.³

But how can regulators know what companies can achieve, and what customers want? Regulators are coming to realise that there is more to competition than setting price equal to cost. In order to specify the desired outcomes, regulators have gradually taken upon themselves the discovery and coordination process traditionally undertaken by the competitive market. This is proving to be an increasingly challenging task.

Are there different and better ways of regulating? Since stepping down as UK electricity regulator, I have been exploring how regulation actually works in other jurisdictions, not least in the US and Canada. As in the UK, there has been greater focus on competition than in the past, and also (as noted) greater use of incentive schemes. Although the formal regulatory framework has not changed much, in many jurisdictions the parties have nonetheless found ways to reduce or avoid the previous regulatory burden. Moreover, utilities and customers have secured outcomes that they themselves perceive as better than what the formal regulatory process would have delivered.

The key to this development has been the active involvement of the users and customers themselves, and/or their representatives, in negotiations with the regulated utility. The regulatory body no longer sees its role as taking all the decisions itself. Rather, its role is to facilitate discussion, negotiation and if possible agreement among the interested parties.

Briefly, the normal process is that a utility will request a rate increase, and the regulatory commission will respond by setting a schedule for a hearing process in front of an Administrative Law Judge (ALJ). This provides for discovery (the provision of information in reply to

3. It is true that UK regulators have chosen, or have been required, to play an increasing role with respect to other issues such as environmental policy and fuel poverty. However, these have hitherto impacted on the generation and retail businesses rather than on the distribution price controls discussed here.

questions), the submission of evidence and counter-evidence, the hearing itself, and then a recommendation from the ALJ which is then approved or modified by the regulatory commission. Many types of parties participate, including the electric or gas utility, users such oil and gas producers, shippers and marketers, generating stations and retailers, large final customers, representatives of smaller customers, and other regulatory Commissions.

What is increasingly happening, however, is that, before the initial evidence is due, all these parties get together to negotiate an agreed rate increase, which the regulatory commission will approve unless it sees reason not to. Regulatory staff play a more or less active role in facilitating these negotiations (see below). There are regulatory procedures for dealing with non-unanimous and partial agreements and objections. The price control determination reverts to the standard regulatory process in the event that the parties fail to agree.

The ability of customers to call on the regulator, if necessary, to determine the price (and other terms) in effect removes the utility's ability to exercise monopoly power over its customers. The focus of the negotiations is therefore on discovering and providing what customers want at an acceptable price. The regulator thereby facilitates the market discovery process, even in the absence of competition. This obviates or reduces the need for the regulator itself to engage in a burdensome discovery process.

⌘ 6. NEGOTIATED SETTLEMENTS IN THE US AND CANADA ⌘

In the US, negotiated settlements were pioneered by the Federal Power Commission (FPC). Following a Supreme Court decision that extended regulatory jurisdiction from 157 natural gas companies to 4365 independent producers, the FPC was suddenly faced with thousands of pipeline rate cases. In 1960 it was estimated that, even with tripled staff, the FPC would take at least 82 years to deal with the 3200 rate applications then filed.

As a means of coping with this backlog, the FPC encouraged settlements between the pipelines and their users. The FPC's successor body, the Federal Energy Regulatory Commission (FERC), continued this policy. By 1980 settlements were reached in approximately two-thirds of all electric rate cases there, and in 1986 in over 70% of gas pipeline rate cases. Presently, no less than 90% of the rate cases at FERC are settled by the participants rather than determined by the Commission through the conventional litigation process.

There have been similar developments in some other parts of the US and in Canada. (Doucet and Littlechild 2006, Littlechild 2008a,b) The regulatory commissions have varied in their stance: some have been sceptical but most have been more sympathetic. The Florida Public Service Commission (FPSC) has accepted and indeed encouraged settlements. (Littlechild 2009a,b) Negotiations there have generally been led by the Office of Public Counsel, whose duty is to protect the interests of customers. In Canada, too, the National Energy Board (NEB) has explicitly encouraged the parties to settle. (Doucet and Littlechild 2009) To minimise repetitive and burdensome debates on the allowed rate of return, the NEB initially set out annually how it would determine the cost of capital in the event that a rate change was referred to it. In practice this seems to have facilitated negotiations and agreement on one of the most difficult issues facing the parties.

In both these jurisdictions (Florida and Canada), settlement discussions have generally taken place independently of the regulatory commission (FPSC or NEB). In contrast, FERC Trial Staff (who are distinct from FERC Commissioners and Advisory Staff) play an active role in facilitating negotiation and settlement. (Littlechild 2011) When a pipeline files for a

new tariff, Trial Staff analyse it and after 3 months they propose a first settlement offer. Essentially, this indicates the argument that Trial Staff would make if the case went to litigation. It includes, for example, an indication of the costs and return on equity that Trial Staff deem reasonable.

Trial Staff then lead discussions among the interested parties with a view to finding a mutually acceptable tariff. In recent years, agreement in principle has been reached in a median time of 2 ½ months after Trial Staff's first settlement offer, just before testimony would otherwise need to have been filed. Typically it takes a further 2 ½ months for the parties to finalise the wording of the settlement and to obtain the judge's certification that it is uncontested. It then takes about 3 months for FERC formally to approve it. This stands in contrast to litigated rate cases that typically take several years to conclude.

✎ 7. DIFFERENCES IN PROCESS AND OUTCOME ✎

Although the formal regulatory framework in the US may be as burdensome as it ever was, the parties have found a more effective way of operating within this framework. User groups and utilities have negotiated settlements of rates, and often other relevant issues such as investment and quality of service. The parties generally focus on the main features of the control, including the 'bottom line', without having to agree in detail each input into the calculation. In particular, the parties typically do not spend undue time on detailed econometric comparisons of costs. This is partly because the 'test year' tends to focus on facts rather than estimates, but also because an agreed outcome does not need to have mountains of evidence to support it. In consequence, the negotiations are less time-consuming, less costly and less uncertain than litigation.

The agreed outcomes have been more flexible, more innovative and more closely tailored to the needs of particular users and customers than the previously litigated outcomes determined by US regulators. They have been the means of introducing significant price reductions, a series of fixed-term efficiency incentive programmes, and many other features over the last two decades. These settlements have thus introduced variants of the RPI-X incentive price caps that characterise UK regulation, and that improve on traditional US rate of return control.

The durations of the agreed price controls are often shorter than in the UK, typically 3 to 5 years but sometimes 1 or 2 years. This reduces risk for both sets of parties. In other respects, risks are often shared rather than put on one party. For example, in face of uncertainty about the level of future demand, parties might agree to share variations in revenue about an agreed projection.

Prices and capital expenditure programmes are usually specified explicitly. It is not usual to agree 'tariff baskets' giving a utility the flexibility to rebalance its charges at its own discretion. Revenue is typically not allowed for capital expenditure until it is actually spent and the equipment operational. Revenue is not agreed for a conjectured future expenditure programme regardless of whether the capital is actually invested, nor have I seen 'menu regulation' or comparable devices.

In consequence, negotiated prices or price caps are generally simpler than in the UK. Agreement documents are also simpler: there are seldom any formulae. For recent gas pipeline settlements at FERC, the settlement document ranges from 4 pages to 79 pages (the latter being exceptional): the median length is about a dozen pages. Accompanying documentation

to explain and relate the settlement to FERC regulatory processes, and to set out the agreed tariff sheets and contractual terms, might be twice as long again.

In addition, the development of settlement processes has generally been associated with improvements in information provision and understanding within the industries, and better relationships between utilities and customers. In sum, the parties find that both the process and the substance of these negotiated settlements better meet their needs than do the approach and solutions determined by the regulatory commissions.

8. THE CAA'S CONSTRUCTIVE ENGAGEMENT

How have UK regulators responded to the growing concerns about burdensome regulatory processes, to questions whether the process delivers the outcomes that customers really want, and to the negotiated settlements approach that has developed in the US and elsewhere? We note the policies of the UK airport and water regulators before examining the policy of the UK energy regulator.

The Civil Aviation Authority (CAA), which regulates UK airports, is making increasingly significant moves in the direction of negotiated settlements, although perhaps not consciously copying the US approach. There was growing dissatisfaction with airport price control processes, including on the part of the regulatory body itself. In 2005, the CAA invited the airports and airlines to take forward some of the work usually carried out by the regulator, under a process of "constructive engagement". (CAA 2005) The specified work included traffic forecasts, quality of service requirements, and investment programmes. The CAA would retain responsibility for assessing operating costs, cost of capital and the final price control on airport landing charges. The CAA would ensure that the interests of passengers and future airlines were safeguarded, and would retain final responsibility for decisions. "But if an agreement can be better reached by the parties, the regulator is likely to have a preference for it."

The CAA considers that the outcome was generally satisfactory at Heathrow and Gatwick. Several broad agreements were reached. There was also an improvement in consultation and regulatory discourse. (Bush 2007)

The Competition Commission (2007) was more critical, as was former British Airways Authority (BAA) executive Mike Toms (2008), though the CAA was also critical of BAA's own planning procedures. The CAA was particularly concerned about significant increases in BAA's capex programme during its inquiry, about information and resource asymmetries between airports and airlines, and about the absence of a dispute resolution or arbitration procedure at each stage. Nevertheless, the Commission saw substantial merits in the constructive engagement process, noted that the airlines did too, and concluded that constructive engagement should be an ongoing process. When the Commission was faced with the task of recommending a price control for Stansted, it decided to resurrect the constructive engagement approach. With the controversial issue of a new runway by now deferred until a later planning period, the parties were able to reach agreement.

The CAA then adopted what it called a "customer consultation approach" in setting the price controls for national air traffic services (NATS). (CAA 2008) The new process reflected learning from the experience with the airport price control reviews. For example, the process specified more explicitly what was expected of the parties, including the process of interaction and the obligations and timetable for providing information.⁴ The consultation process was

4. A referee emphasises the need for information systems and transparency that were lacking at BAA initially. The referee goes on to suggest that "what the UK regulators deliberately avoided was the collection and publication of systematic detailed

managed by a Customer Consultation Working Group (CCWG). It incorporated some new elements, notably in accommodating the interests of many smaller users. This customer consultation approach proceeded smoothly and on time to a successful conclusion.

Most stakeholders then indicated that they would like the process for the next airport price control process to build upon the NATS process. None suggested a reversion to the previous price control review process. (CAA 2010, paras 3.6, 3.7) Given the uncertainty surrounding the Government's new legislation on economic regulation, the CAA invited the parties to negotiate a one-year extension of the previous controls. Heathrow agreed with its airlines a cap for its capital expenditure programme; Gatwick negotiated with its airlines a more comprehensive and radical settlement, involving a tightening of the price cap from RPI + 2 to RPI-0.5, in exchange for a new set of capital expenditure triggers. (CAA 2011 p. 6)

CAA and the parties are now exploring a more enhanced negotiated settlements approach for the 2013–18 price control period. Already, some new ideas are emerging. For example, there has been a proposal that the airlines and airport set up joint working groups on operating cost and the design of incentives, with a gain-share basis for operating savings found by joint action.

✎ 9. REGULATION IN THE UK WATER SECTOR ✎

Regulation in the UK water sector has been extensively reviewed. Most recently, Gray (2011b) “found a clear consensus that the burden imposed on the companies by the regulatory regime is excessive and needs to be reduced”. (p. 6) On the specific issue of customer involvement, a number of stakeholders and reviewers, including Walker (2009) and Cave (2010) as well as Gray, have recommended introducing more formal constructive engagement, or at least have been sympathetic to that.

Ofwat's own view has evolved over time. (Ofwat 2010, 2011a,b) In April 2011 it declared that “Customer engagement is essential to achieve the right outcomes at the right time and at the right price”. (Ofwat 2011) It explained at some length that “engagement means understanding what customers want and responding to that in plans and ongoing delivery”, and that “good engagement with customers can legitimise the price setting process” by influencing companies' plans, helping them to demonstrate that they have delivered value for money, ensuring that the price limits represent a price and service package that customers and society want and are willing to pay for, and much more.

All this is what one would associate with negotiated settlements and constructive engagement. Yet Ofwat then explicitly rejected these approaches, because “the process is onerous and requires substantial commitment from any customer or negotiator”. (p. 18) This is puzzling, since these approaches have been adopted elsewhere precisely because they are less onerous than the conventional approach. And Ofwat's expectation of customers' commitment in its own proposed process is nothing if not substantial.

Ofwat explains that “The monopoly nature of the water and sewerage sectors and the vertical integration of existing wholesalers and retailers mean it would not add sufficient challenge to justify the bureaucratic burden needed.” (Ofwat 2011b p. 10) This may reflect

accounting information on regulated companies which does form an important basis for negotiation. Arguably the US had got this right.”

the view that a large proportion of end-customer bills is determined by factors over which customers can have relatively little or no influence.⁵ Whether the situation in water is different from that in other industries where negotiated settlements are used is debateable. Customers there find that the opportunity to grant (e.g.) an additional basis point on the cost of capital is rather effective in securing their objectives, and justifies their involvement in the process.

In the meantime Ofwat's proposed approach "includes more structured opportunities for customer experts and representatives and other key stakeholders to challenge the companies' engagement processes and the way they reflect the results in business plans". Ofwat will take account of this customer engagement in formulating its own challenge to the companies. But quite what it takes – in terms of engagement process or outcome—to gain Ofwat's acceptance remains somewhat vague.

As to the formal rejection of negotiated settlements, Ofwat indicates that "we may revisit this conclusion in time". Gray (2011b) noted Ofwat's decision, but also commented: "The general trend in economic regulation is clearly towards a greater degree of stakeholder engagement and potentially towards negotiated settlements overseen by the regulator rather than the conventional price control process." (p. 85) Whether Ofwat accepts – and is seen to accept—a company's business plan where there has been good engagement and customers support the plan will be critical to the success of this approach. If this happens, the price control determination process in the UK water sector will in fact have moved towards a form of negotiated settlement adapted to the UK water context.

Gray strongly advocated the retention of CCWater (the Consumer Council for Water). This organisation has a statutory role to represent the interests of water and sewerage customers, and in doing so to have regard to the interests of specified sets of vulnerable customers. It has played an active and constructive role in previous price control reviews, not least by encouraging a Quadripartite Working Group process. The judgement that "the trend towards constructive engagement/negotiated settlements seems likely to continue and CCWater is well placed to do this" (Gray 2011a, slide 11) is spot on.

Meanwhile, progress is being made elsewhere in the UK water sector. The Water Industry Commission for Scotland (WICS) is basing its forthcoming price control review on a process of customer negotiation with Scottish Water. (Sutherland 2010, WICS 2011) This approach is currently being implemented by establishing a Customer Forum, with the active involvement of Consumer Focus Scotland and WaterWatch Scotland on behalf of customers, together with Scottish Water, the Drinking Water Quality Regulator (DWQR), the Scottish Environmental Protection Agency (SEPA) and officials from the Scottish Government.

✎ 10. OFGEM'S RPI-X@20 REVIEW ✎

The UK airport regulator has thus moved decisively to constructive engagement and on towards negotiated settlements; the UK water regulator is proceeding more cautiously. Where does the UK energy regulator stand?

During the fifth distribution price control review, Ofgem created a Consumer Challenge Group with expertise in the interests of present and future consumers. The Group challenged

5. Notably capital charges largely driven by sunk investment and the cost of capital, operating and maintenance costs that are a function of the installed network and exogenous input prices, and incremental legal obligations in respect of water quality and abstractions from or discharges to the environment.

both Ofgem and the companies, albeit acting as individuals not as representatives of their own organisations. Ofgem and the Group found this process helpful. (Ofgem 2010a) Suppliers too were offered similar access (as network customers), though only one (Centrica) took this up, and the companies were rather dismissive. (Smith 2010)

Ofgem has noted the achievements of the traditional UK regulatory approach but has also acknowledged some of the problems. Its RPI-X@20 Review picked up on some of the points made by commentators (e.g. Pollitt 2008) and extensively explored alternative approaches. (Buchanan 2005, 2008a,b) It accepted the case for an 'enhanced engagement' model, whereby customers, users and networks would engage in more discussion, and stakeholders would be given greater opportunities to influence Ofgem and network company decision-making. (Ofgem 2010b) But it was anxious not to be prescriptive, and companies would be encouraged to engage with stakeholders in a wide variety of ways, including on the development of their business plans. (Ofgem 2010c)

Ofgem concluded against adopting negotiated settlement or constructive engagement. Its basic reason was that customer groups would be unwilling or unable adequately to reflect the interests of present and future customers.

We do not think it is appropriate to delegate responsibility for agreement of network regulatory decisions to consumer representatives, network users or other parties. We have concerns that the interests of these parties are not sufficiently aligned, with those of final consumers (existing and future), to delegate primary responsibility to them to agree regulatory decisions. It is also not clear which body would be able to represent the interests of future consumers. While consumer representatives may be better placed to perform this role, we recognise that it is extremely difficult to develop a sufficiently full understanding of the diversity of consumer needs and interests to represent the entire consumer view accurately to make trade-offs between, what may be, competing views from different groups of customers. As such, consumer representatives may not be able to add value in assuming responsibility for agreement of regulatory decisions over and above the role that we currently play. We also have concerns regarding their current access to resources, the current levels of expertise of all but a very small number of individual consumer representatives and their appetite to engage in this way. (Ofgem 2009, para 5.2)

The view that residential and other small customers would not be adequately represented in a negotiated settlement or constructive engagement process is probably the biggest single obstacle to its adoption in the energy (and water) sectors. How valid is that argument?

In the US, customers are represented by many organisations. Many US states, though by no means all, have also established an independent consumer advocate, with an express role to represent customers' interests before the regulatory body. (Holburn and Vanden Bergh 2006) The situation is similar in the UK. For example, the Energy Intensive Users Group, the Major Energy Users Council and the Utility Consumers Consortium are supported by many energy-using companies. Chambers of Commerce represent smaller businesses in many contexts. Consumer Focus has a statutory function to represent the views of consumers on consumer matters to regulatory bodies like Ofgem. The organisation Which? campaigns actively on consumer matters, not least energy. The Public Utilities Access Forum is an informal association of organisations concerned with the provision of services to customers in vulnerable circumstances. Ofgem has worked actively with Citizens Advice on the Energy Best Deal scheme (Ofgem 2011 p. 50).

Would such bodies be properly able to represent customers in a negotiation? Access to expertise and resources is of course important. At FERC, Trial Staff provide an important

Regulation and Customer Engagement

II

input in proposing a first offer as a reasonable basis for settlement, and in being on hand to explain to all parties, not least the customers and their representatives, the issues and calculations involved. In some North American jurisdictions, the regulator can authorise financial support for smaller participants to enable them to contribute to the regulatory and settlement process.

Is there the “appetite of customer representatives to engage”? Hitherto, UK price control processes have not been conducive to customer engagement in this way. Why should companies and customers spend time negotiating settlements if the regulatory body would ignore the outcomes? And it is understandable that customer representatives might be apprehensive about taking on the magnitude of the present regulatory task. But surely there would be an appetite to engage under more suitable conditions. With appropriate encouragement and access to expertise and information, and an understanding that arrangements negotiated with utilities would be respected, customer representatives could be as keen to engage in the UK energy sector as they have been elsewhere.

Suppose that, in the event, certain types of customers were not well represented in the negotiations. Other regulators have certainly been alert to the need to protect those not at the negotiating table, including future market participants, but this has not proved an obstacle to encouraging customer negotiations. Thus, before approving negotiated settlements, US regulatory bodies have to assure themselves that the proposed rates are just and reasonable, and not unduly discriminatory or preferential. The negotiating parties therefore bear this in mind – and, if necessary, regulatory staff will bring this to their attention. Similarly, the CAA has been willing to modify the outcome of negotiations if necessary to protect the interests of those not present in the negotiations.⁶

It is true that the Gas and Electricity Acts now give Ofgem a principal objective “to protect the interests of existing and future consumers”. However, the statutes qualify this in various respects. “The interests of such consumers are their interests taken as a whole, including their interests in the reduction of greenhouse gases and in the security of the supply of gas and electricity to them.” Ofgem must have regard to “the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas”, as well as to “the need to secure that licence holders are able to finance the activities which are the subject of obligations on them” and “the need to contribute to the achievement of sustainable development”. It must “promote efficiency and economy” on the part of licensees. It must “secure a diverse and viable long-term energy supply, and . . . have regard to the effect on the environment.” In addition, it must have regard to “certain statutory guidance on social and environmental matters issued by the Secretary of State”.

Given this multitude of obligations on Ofgem, not to mention the political and media pressures to which any regulatory body is necessarily subject, is such a regulatory body *better* able to understand and represent the interests of present and future customers than the bodies that actually represent present customers? Experience in jurisdictions where negotiated settlements are common suggests that customers themselves do not accept this. Nor did the UK Competition Commission in the case of airports and airlines.⁷ Discouraging the use of ne-

6. The CAA has consistently emphasised that it would be minded to adopt agreed outcomes “subject to the CAA’s consideration of the extent to which the results from any customer consultation reflected the interests of passengers, cargo shippers and airlines not directly represented in such consultation”. (CAA 2008, paras 5.48, 5.49) On this basis, the CAA introduced a positive incentive for BAA to improve quality of service, beyond what the airlines considered necessary for their own purposes.

7. “We took the view that the airport’s airline customers are generally in a much better position than the regulator, the CAA, to suggest what development is needed at the airport, even recognising that these interests might, on occasion, diverge from the interests of future airlines and passengers, whose interests should also be represented. We considered whether the interests of

gotiated settlements therefore limits the extent to which customers can act to seek the outcomes they themselves prefer. It removes a protection, which has developed in the US, against the 'regulator knows best' philosophy. It seems likely to lead to more investment and expenditure, and higher prices, than customers themselves would be willing to choose. It remains to be seen whether Ofgem's proposed 'enhanced engagement' model can provide the same degree of protection for customers as negotiated settlements do.

A further development may nonetheless facilitate the development of settlements. Ofgem (2010) emphasised that "transparent provisions to allow third parties to challenge our price control determinations are an integral element of enhanced engagement". (p. 18) If the possibility of third party appeal led to enhanced bargaining power for customer groups, it could shift the price control process towards negotiations between companies and customers. (Littlechild 2009c, Smith 2010)

For its part, the Government has now reviewed Ofgem. In response to a concern about undue bureaucracy and regulatory burden, the Government initially mentioned the scope for learning from regulatory experience overseas. (DECC 2010) Surprisingly, given this context, it did not mention negotiated settlements, and there is no reference to this approach in its final report. (DECC 2011b) However, in implementing the EU Third Package requirements, the Government has proposed that the National Consumer Council (assuming Consumer Focus is abolished) should have the right to appeal a licence modification decision (such as a new price control) to the Competition Commission. (DECC 2011a) It will be interesting to see if this does indeed shift the focus of energy price control negotiations.

11. CONCLUSIONS

UK utility regulation, based on competition and the RPI-X incentive price cap, was designed to operate 'with a light rein', certainly with a lighter rein than utility regulation in the US. In many respects UK regulation has delivered excellent results. However, it no longer operates 'with a light rein': it is just as heavy-handed, if not heavier-handed, than US regulation was.

Meanwhile, regulators, utilities, customer groups and other interested parties in the US have discovered a practical way around the legal bureaucracy. Utilities are encouraged to negotiate their proposals with market participants. The aim is to understand the products and investment programmes required by customers, and the costs of delivering the required goods and services, with a view to agreeing prices instead of requiring an expensive, time-consuming and uncertain regulatory procedure. The regulator stands by to determine the outcome if the parties fail to agree, and this is a factor that encourages rational discussion and agreement.

There have been similar developments elsewhere. The Canadian energy sector has been mentioned. Argentina requires all major transmission expansions to be decided upon by users. (Littlechild and Skerk 2008) Australia and some states in Germany have effectively moved towards negotiated settlements between airports and airlines. (Littlechild 2011c,d) A recent regulatory determination of a rail access undertaking in Australia also contained a significant element of negotiated settlement. (Bordignon and Littlechild 2011)

With negotiated settlements, the burden of the process is generally lower than with regulatory determinations. The settlements are simpler, and the outcomes more closely reflect

potential new airlines at the airport or passengers might deviate from the interests of current airlines in these decisions, but we found no reason to believe that they did." (Competition Commission 2008 paras 23, 24).

the needs of customers themselves. The scope for innovation is greater because there is no longer the same pressure for regulatory uniformity from one utility to another. Settlements allow different approaches to be tried.

With these alternative approaches, the regulator facilitates rather than replaces the market discovery process. If we had been aware of this idea in the early 1980s, I suspect we would have considered it an attractive way forward. Admittedly there was a need at that time to demonstrate a tangible form of regulation, and also the requisite customer bodies were not then in existence. But with the benefit of experience here and overseas, and the emergence of customer bodies, we can now see the possibility of a more enlightened and effective form of utility regulation, better able to identify and protect the interests of customers, and operating with a lighter rein than the present one has turned out to have.

In the UK, the CAA has moved firmly in this direction. The airlines—relatively small in number, well-informed and adequately resourced—have come to support the approach in determining airport landing charges. Ofwat and Ofgem have nominally rejected the approach for the moment, while seeking to secure many of the benefits of the approach via less committed processes for customer engagement. In both sectors, water and energy, it is possible that the process will move towards a version of negotiated settlements. A major concern in these sectors is the representation of a large number of small and residential customers. By the same token, a major challenge for the regulators going forward is to ensure and demonstrate that such customers can be adequately represented.

Governments in the UK and elsewhere have the ability to encourage or discourage this potential next step in the development of utility regulation. For example, the Alberta Energy and Utilities Board Act 1995 (s132) provides that “*the Board must recognize or establish rules, practices and procedures that facilitate negotiated settlement*”. This would be a useful encouragement for a regulatory approach that offers the prospect of better outcomes for customers and a less onerous process for all concerned.

✎ ACKNOWLEDGMENTS ✎

An earlier version of this paper appeared as Littlechild (2011b). I am grateful to the Adam Smith Institute for permission to work from that paper, and to several colleagues and three referees for helpful comments and suggestions.

References

- Bordignon, S. and S. Littlechild (2111). “The Hunter Valley Access Undertaking: elements of a negotiated settlement”, forthcoming.
- Buchanan, Alistair (2005). “Facing up to the Better Regulation Challenge”, Speech to the Institute of Economic Affairs, London, 29 November.
- Buchanan, Alistair (2008a). “Ofgem’s ‘RPI at 20’ Project”, speech at SBGI, 6 March.
- Buchanan, Alistair (2008b). “Is RPI-X still fit for purpose after 20 Years?”, Beesley Lectures on Regulation, Series XVIII, London, 2 October.
- Bush, Harry (2007). *Some Issues in Airport Regulation*, presentation at Hertford Seminars in Regulation, 11 May.
- Cave, Martin (2010). *Independent review of competition and innovation in water markets*, April.
- CAA (2005). “Airport regulation: the process for constructive engagement”, May.
- CAA (2008). “CP3 Price control review for NERL – CAA consultation”, October.

- CAA (2010). "Airport Regulation: Lessons learnt from Q5 Price Control Process and Improvements for Q6", Consultation, October.
- CAA (2011). "Extending the current price regulation at Heathrow and Gatwick airports, The CAA's Decision", March.
- Competition Commission (2007). *BAA Ltd. (Heathrow and Gatwick Quinquennial Review, Final Report)*, published 3 October.
- Competition Commission (2008). *Stansted Airport Q5 price control review, Final Report*, published 4 November.
- Department of Energy and Climate Change (DECC) (2010). *Ofgem Review: Call for Evidence, A Government Response*, December.
- Department of Energy and Climate Change (DECC) (2011a). Final Impact Assessment for Proposals for Implementation of the EU's Third Energy Market Package (Overarching IA), 14 January, updated July.
- Department of Energy and Climate Change (DECC) (2011b). *Ofgem Review Final Report*, July.
- Doucet, Joseph and S.C. Littlechild (2006). "Negotiated settlements: The development of legal and economic thinking", *Utilities Policy*, 14(4), December, 266–277. <http://dx.doi.org/10.1016/j.jup.2006.09.001>.
- Doucet, Joseph and S.C. Littlechild (2009). "Negotiated settlements and the National Energy Board in Canada", *Energy Policy*, 37, November, 4633–4644. <http://dx.doi.org/10.1016/j.enpol.2009.06.018>.
- Gray, David (2011a). "Review of Ofwat and CCWater", Presentation by David Gray and Review Team, Department for Environment, Food and Rural Affairs, 20 January.
- Gray, David (2011b). Review of Ofwat and customer representation in the water sector, Defra.
- Holburn, Guy L.F. and Richard G. Vanden Bergh (2006). "Consumer capture of regulatory institutions: The creation of public utility consumer advocates in the United States", *Public Choice*, 126: 45–73.
- Joskow, Paul and Richard Schmalensee (1986). "Incentive Regulation for Electric Utilities", *Yale Journal on Regulation*, 4 (1), Fall, 1–49.
- Littlechild, S.C. (1983). Regulation of British Telecommunications' Profitability, Report to the Secretary of State, London: Department of Industry, February.
- Littlechild, S.C. (2008a). "Some alternative approaches to utility regulation", *Economic Affairs*, 28(3), September, 32–37. <http://dx.doi.org/10.1111/j.1468-0270.2008.00841.x>.
- Littlechild, S.C. (2008b). "Some applied economics of utility regulation", *Energy Journal*, Special Issue #2, September, 43–62.
- Littlechild, S.C. (2009a). "Stipulated settlements, the consumer advocate and utility regulation in Florida", *Journal of Regulatory Economics*, 35(1), February, 96–109. <http://dx.doi.org/10.1007/s11149-008-9071-2>.
- Littlechild, S.C. (2009b). "The bird in hand: stipulated settlements in Florida electricity regulation", *Utilities Policy*, 17(3–4), September–December, 276–287. <http://dx.doi.org/10.1016/j.jup.2008.09.001>.
- Littlechild, S.C. (2009c). "Consumer involvement, ex post regulation and customer appeal mechanisms", Ofgem RPI-X@20 Web Forum, 29 November.
- Littlechild, S.C. (2011a). "The process of negotiating settlements at FERC", EPRG Working Paper 1105, University of Cambridge, 9 December 2010, revised version 17 May 2011.
- Littlechild, S.C. (2011b). "Regulation, customer protection and customer engagement", in Butler, Eamonn (ed.) (2011) *Reflections on Regulation: Experience and the future*, Adam Smith Institute, London.
- Littlechild, S.C. (2011c). "Australian airport regulation: exploring the frontier", *Journal of Air Transport Management*, forthcoming.
- Littlechild, S.C. (2011d). "German airport regulation: framework agreements, civil law and the EU Directive", *Journal of Air Transport Management*, forthcoming.
- Littlechild S.C. and C.J. Skerk (2008). "Transmission expansion in Argentina 1: The origins of policy", *Energy Economics*, 30(4), July, 1367–1384. <http://dx.doi.org/10.1016/j.eneco.2007.12.003>.
- Ofgem (2009). "Regulating energy networks for the future: RPI-X@20. Delivering outcomes: Consumer engagement in the regulatory process", October.
- Ofgem (2010a). "Consumer First: The Ofgem Consumer Challenge Group", March.
- Ofgem (2010b). "RIIO: a new way to regulate energy networks, Final decision", October.
- Ofgem (2010c). "Handbook for implementing the RIIO model", 4 October.
- Ofgem (2011). 'Ways of working': Ofgem's response to issues raised in the Ofgem review, Annex A to DECC (2011b).
- Ofwat (2010). "Involving customers in the price-setting process – a discussion paper", October.
- Ofwat (2011a). "Involving customers in decisions about water and sewerage services", April.
- Ofwat (2011b). "Involving customers in price-setting: Ofwat's customer engagement policy statement", 11 August.

Regulation and Customer Engagement

15

- Pollitt, Michael G. (2008). "The future of electricity (and gas) regulation in a low-carbon policy world", *The Energy Journal*, 29 (Special Issue 2), 63–94.
- Smith, Steve (2010). "RPI-X@20", Beesley Lecture, at www.RPIEurope.org
- Sutherland, Alan (2010). "The outcomes of the WICS review into regulatory methodology", presentation, London, 13 October.
- Toms, Mike (2008). "Airports regulation: a case of destructive engagement?" Beesley Lectures on Regulation, Series XVIII, 9 October 2008.
- Walker, Anna (2009). *Independent review of charging and metering for water and sewerage services*, December.
- Water Industry Commission for Scotland (2011). Ofwat's consultation on Involving customers in decisions about water and sewerage services: Response from the Water Industry Commission for Scotland, 24 May.