

Negotiated Settlement and Consumer Engagement

UK Experience and lessons for Australia

ECA Research Report No. 2



Energy
Consumers
Australia

Version History

Version	Date	Comments
1	5 April 2016	
2	2 May 2016	Final edit

This paper is the work of David Havyatt, Senior Economist, CEO Office, Energy Consumers Australia. ECA is publishing this research paper for information and discussion and it does not represent a concluded advocacy position of ECA.

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Negotiated Settlement and Consumer Engagement: UK experience and lessons for Australia

Introduction

Stephen Littlechild, the original developer of the CPI-X approach to incentive regulation (Littlechild 1983), has over the last decade encouraged UK regulators to consider the possibility of a negotiated settlement model of economic regulation (Doucet and Littlechild 2006, Littlechild 2008, 2010, 2011).

A number of regulators in the UK have utilised versions of consumer engagement as a part of their economic regulation process. Bush and Earwaker (2015) provide a very useful overview of many of these efforts with a particular focus on water.

The most significant of all these has been the regulation of Scottish Water by the Water Industry Commission for Scotland. Three reports provide a comprehensive review of the Customer Forum that was the centrepiece of this work (Littlechild 2014, CFWS 2015 and Bush and Earwaker 2015).

Interest in the role of consumer engagement in regulation has spread to Australia (Biggar 2011, Mountain 2013, ENA 2014, Henley 2015 and SACOSS 2015).

Following a rule change request from the Australian Energy Regulator (AER), the National Electricity Rules were amended by the Australian Energy Markets Commission (AEMC) which creates an obligation on the AER to consider the extent to which capex and opex forecast “includes expenditure to address the concerns of any electricity consumers to the extent those concerns have been identified by the DNSP in the course of its engagement with electricity consumers.” The rule also includes a requirement for the DNSP to report on its consumer engagement.

The AER’s Better Regulation program introduced a suite of changes in response to these rule changes. This included guidelines on networks’ consumer engagement as part of revenue proposals (AER 2014).

To develop Energy Consumers Australia’s understanding of the UK situation the author interviewed a number of participants and analysts in the UK on a study trip in February 2016. These interviews were particularly helpful in understanding the processes, especially in

Scottish Water. The available written reports are very thorough, but the interviews provided the opportunity to test conclusions reached from the reports.¹

The author also benefitted from additional analysis of the UK situation (Lodge 2016, Heims and Lodge 2016) and presentations conducted by Frontier Economics in Sydney on the implementation of RIIO-ED1 by Ofgem. (Huggins 2016, Wilson 2016).

The paper commences with a discussion of the field of negotiated settlement and consumer engagement as concepts and identifies why they have become of such interest to regulators in the UK and Australia.

This is followed by a specific focus on the Customer Forum for Water in Scotland as the case of Scottish Water is a stand-out example. Then differing approaches by Ofwat, Ofgem and the Civil Aviation Authority (CAA) are discussed.

The paper concludes with an attempt to position consumer engagement within a framework of economic regulation and includes recommendations for regulators.

Concepts of ‘negotiated settlement’ and ‘consumer engagement’

The proposition that certain network industries are “natural monopolies” and that such monopolies need to be subject to “economic regulation” is a relatively uncontroversial position. In the USA there has been a long history of these network firms being privately owned. In the UK and Australia there was a similarly long history of these firms being regulated through Government ownership.

US practice revolved around a process of tariff filing that is known as “rate of return” regulation. Regulatory engagement only occurs when a firm seeks to vary a price, each of which is filed separately. The regulator applies an acceptable rate of return as the criterion for accepting or rejecting such filings (Beeley and Littlechild 1989). Spulber (1989:270) characterised US rate hearings as a bargaining process between consumers and the regulated firm, writing:

Given rate hearings as a forum for negotiation between consumers and firms, the regulatory commission performs the important function of establishing rules for the negotiation game and mechanisms.

Settlement procedures were first adopted by the Federal Power Commission in 1949, but were actively fostered in the 1960s as a way to deal with a case backlog. There are many reasons

why negotiated settlement was adopted by firms, but among these was the benefit from keeping out of the regulatory processes as it effectively avoided scrutiny. Firms were, in effect, trading short term profit decline (by agreeing a lower specific price) for greater profit in the long term (by avoiding scrutiny). Doucet and Littlechild (2006) concluded that:

Negotiated settlements are thus an important and influential aspect of modern utility regulation, but are under-appreciated by economists. They deserve further research. In addition, understanding how settlements are different from litigated outcomes will shed light on the nature and effects of regulation itself. Policy on developing and reforming regulatory frameworks would also seem to benefit from greater scope, and more fruitful conditions, for the development of such settlements.

When the British Government moved away from the public ownership of network industries, UK authorities turned their minds to the appropriate form of economic regulation. Beginning with the regulation of British Telecom, UK regulators chose to implement a different form of price control regulation known as “RPI-X”. Beesley and Littlechild (1989) compare this British form of regulation with US style rate of return regulation. This comparison predates Littlechild’s later investigation of the role of negotiated settlements in the US.

RPI-X fundamentally differs from US style rate of return by explicitly creating incentives for the regulated firm to implement x-efficiency programs. It also varies in two other significant ways. The first is that it is a regularly reset control on the firm, rather than only occurring when the firm wants to vary prices. The second is that the mechanism of regulation controls firm revenue (or a subset of revenue), not individual prices.

The original form of RPI-X (also known as CPI-X) was created to regulate newly privatised vertically integrated monopolies. As Beesley and Littlechild (1989:455) succinctly described:

The key features of this price control are that, for a prescribed period of four to five years, the company can make any changes it wishes to prices, provided that the average price of a specified basket of its goods and services does not increase faster than RPI-X, where RPI is the Retail Price Index (i.e. the rate of inflation) and X is a number specified by the government. At the end of the specified period, the level of X is reset by the regulator, and the process is repeated.

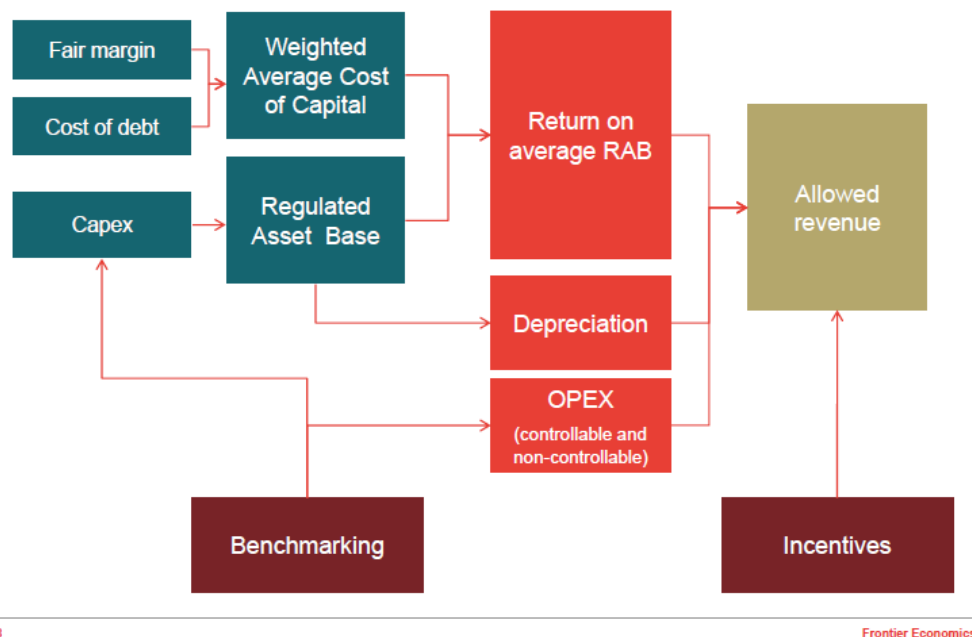
“X” was to be set at a level to reflect expected productivity improvement. An important feature was that were the firm to improve productivity by more than X the firm would be able to retain these savings as profit.² Hence it also came to be referred to as *incentive regulation*.

RPI-X regulation encountered difficulties as the process of determining the value for X became more significant. In electricity regulation in particular, when Stephen Littlechild was the

regulator, this challenge resulted in the institution of what in Australia is best known as the “building block” approach, but is still referred to in the UK as RPI-X.

The building block approach has been neatly summarised by Huggins (2016:8) in the figure below.

The historical elements of GB regulation



Having been responsible for both the original RPI-X and the building block approach, as mentioned in the opening, Stephen Littlechild has become an advocate of negotiated settlement approaches as adopted in the US. He has described this progression in the following terms (2011):

UK utility regulation, based on competition and the RPI-X incentive price cap, was designed to protect customers and 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, but it has become transformed into ‘heavy handed regulation’, just as heavy if not heavier than in the US.

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 discuss 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.

With negotiated settlements, the regulatory burden is generally lower. The outcomes more closely reflect 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 would allow different approaches to be tried.

Aside from this efficiency in regulatory process argument, Littlechild (2010) has also identified the value of “negotiated settlement” in better representing regulatory intent. Claiming that “If regulation is supposed to replicate (some would say ‘mimic’) or at least reflect the results of competition, then it is necessary to ask what competition is supposed to do.” He concludes that one of the functions of competitive markets is to be a mechanism for communicating consumer preference.

While Littlechild had been discussing the prospect of negotiated settlement since 2006, the UK Civil Aviation Authority had been pursuing a similar concept called “constructive engagement” since 2005 (Bush 2006, Bush and Earwaker 2015).³ When Littlechild in 2008 published his *Constructive engagement and negotiated settlements – a prospect in the England and Wales water sector?* He was not only aware of Bush’s work in aviation, but was also in conversation with Alan Sutherland at the Water Industry Commission for Scotland.

We have already encountered an array of terms, including “negotiated settlement” and “constructive engagement” in the UK literature, and “customer engagement” and “consumer engagement” in other regulatory literature. While negotiated settlement and constructive engagement both have domain specific application that include notions of how the regulator is directly involved, both are subclasses of the more generic activity “consumer engagement.” “Consumer” is chosen in preference to “customer” to be inclusive of cases where the network industry is structurally separated from retail and hence to identify that we are talking about engagement with end-users not just the people who directly pay the network.

This paper uses the term “consumer engagement” to be inclusive of all these models

By “engagement” we include any case where the regulated firm has a structured process to identify consumer preferences as part of the process of making a regulatory submission.

While Littlechild began this journey promoting “negotiated settlement” he now believes that he has previously over-stated the case for such settlement to be a substitute for regulatory determinations. The cases in North America are for negotiated settlement as an adjunct to regulatory decision making, not a substitute for it.⁴

Scottish Water

Both Ofwat and Ofgem have included consumer engagement as specific elements in most recent revenue determination processes, but the Strategic Review of Charges 2015-2020 for Scottish Water is the case where consumer engagement has had the most influential impact in a UK regulatory process.

The CEO of the Water Industry Commission for Scotland (WICS), Alan Sutherland, had been discussing the opportunities of consumer engagement with Stephen Littlechild. He credits Littlechild with the thinking that led to the specific implementation in the Scottish Water case (Sutherland 2012).⁵

As we will see this engagement was particularly successful, however, the regulatory circumstance in Scotland is somewhat different. Firstly, Scottish Water is still Government owned and certain parameters for Scottish Water are determined by the Government rather than the regulator. Unlike the case of Ofwat and Ofgem, WICS is regulating only one entity. Notwithstanding these unique factors, WICS had been using benchmarking against English water utilities as a means of driving greater efficiency from Scottish Water.

There were three reasons why WICS was looking to change its regulatory approach:

- With Scottish Water's improved efficiency, benchmarking against English utilities would no longer drive efficiency improvement;
- It felt uncomfortable with Scottish Water's previous use of customer consultation but felt unable to challenge it; and
- It wanted something in the process to legitimise household bills in the eyes of Scottish Water's customers.

In addition, WICS had a concern about how to discharge its statutory role to determine "the lowest reasonable overall cost." WICS concluded that "reasonable" had to reflect the views and preferences of consumers.

Drawing on the work of Littlechild (cited above) WICS decided that consumer engagement was the only way forward. In September 2011 the Customer Forum for Water in Scotland was created with three aims:

- To work with Scottish Water on a program of customer research;
- In the light of this research to understand and represent customer priorities to Scottish Water and WICS; and

- To secure the most appropriate outcome for customers in the Strategic Review of Charges.

In October 2012 the Customer Forum was asked to agree a Business Plan with Scottish Water, consistent with Ministerial Objectives and with guidance notes from WICS. In January 2014 this agreement on the Business Plan was reached, and in March 2014 WICS made a Draft Determination consistent with that plan (all of this section thus far from Littlechild 2014).

That the agreed Business Plan was the basis for the Draft Determination is a strong recommendation for the processes adopted in this case.

Two specific outcomes are important to note. The first is that the Forum successfully dealt with a proposition from Scottish Water to increase reliability by interconnecting more water systems. The conclusion was that customers were not prepared to pay as much for this as Scottish Water originally planned to spend.

The second was the inclusion in the Business Plan of two new measures on Scottish Water; a Customer Experience Measure and the High Esteem Test. In addition Scottish Water set higher targets for its Overall Performance Assessment (WICS 2014:80-81).

There are a number of dimensions against which these processes can be analysed: constitution, mandate, support, engagement and commitment.

Constitution of the Forum

Having identified the need to increase consumer input in the regulatory processes, the first option for WICS was simply to engage the existing consumer advocacy body, Consumer Focus Scotland (CFS), but Alan Sutherland formed the view that CFS was not up to the task. It seems this view was in part driven by the representativeness of CFS and in part by the turbulence that was then occurring across the UK in support for consumer advocacy.⁶

However, CFS did play a significant role in the Forum. The Customer Forum for Water in Scotland was created under a cooperation agreement between WICS, CFS and Scottish Water. Finance was provided by WICS, while CFS provided administrative support. All parties agreed to support the work of the Forum and members were to be appointed jointly (CFWS 2011).

A total of eight members were appointed, including the Chair Peter Peacock. Two members represented independent retailers, the remainder were chosen for their specific expertise. This included a market researcher, a consumer law specialist, an environmental lawyer, a former senior bureaucrat who had become a CFS volunteer and a former water industry executive. The chair was a highly respected former Minister with extensive experience across different

levels of government, as well as the volunteer and business sectors (Littlechild 2014:8-9 and CFWS 2015:51).

The *Legacy Report* (CFWS 2015:11) identified this diversified expertise as a strength, creating the right environment for productive conversations. It also identified as a strength that members participated in a personal capacity and not as 'stakeholders' representing an organisation or a group of customers. In considering how to maximise success in the future the *Legacy Report* argued against including "institutional stakeholders" noting "the Forum represents the interests of all end-users but is not a sample of the customer base, so it does not have to reflect its composition." It also notes that specific needs of end-users are already represented through other channels and cites the example of environmental issues being represented through the Scottish Environment Protection Agency.⁷

Mandate

Under the original agreement of September 2011 the Forum was given very clear instructions on its role. This was to work with Scottish Water on its customer research, to understand and present customer priorities to Scottish Water and to secure the most appropriate outcome for consumers in the SRC.

As Littlechild (2014) reports, in the process of fulfilling these objectives, the agreement implied that the work of the Forum would be just another input to WICS determination process. At the working level there was an emphasis on trying to reach some kind of negotiated outcome with Scottish Water.

This latter view was formalised in October 2012 when WICS asked the Forum to seek to reach agreement with Scottish Water on its Business Plan (Sutherland 2012).

This revised mandate contained its own uncertainties, in particular, could WICS delegate its decision making to the Customer Forum. WICS used a form of words that said it would be "mindful to accept" an agreed plan. It also required both the Forum and Scottish Water to give a detailed report on why they could not agree if that was the outcome.

Apart from this clarity WICS did not just give the Forum and Scottish Water an unmarked field and no rules of play. Over the course of the Review WICS issued 22 Notes to the parties indicating its expectations. These included its "financial tramlines"; a set of financial parameters within which it expected Scottish Water to stay. In addition the Minister as part of the Scottish regulatory system specified a range of matters, including price structures.

The Forum worked because of, rather than in spite of, its unusual existence. It was an *ad hoc* body with no statutory role that was given a clear mandate by WICS with the agreement of Scottish Water, CFS and the Government.

Support

The Forum in its *Legacy Report* identified that it felt well supported by both WICS and Scottish Water. Timing of the establishment of the Forum created one issue arising from Scottish Water having commissioned research prior to the Forum's creation. Forum members felt "that the company had not probed willingness-to-pay issues well enough, and was drawing unwarranted conclusions about investment priorities."

Scottish Water was disappointed with this outcome as other stakeholders had agreed with the approach. The Forum commissioned its own research to explore affordability and willingness-to-pay issues. The research revealed the limited extent of customers' knowledge about how much they pay for water and hence the limitations on customer participation in evaluating the investment program (Littlechild 2014). In the final agreement the Forum reported "Customer Forum and Scottish Water formally agreed what that research was telling us about customer priorities for investment and customer service" (CFWS P2014:75).⁸

The significant role that Scottish Water played in the success of the Forum has not been mentioned yet, apart from acknowledging that they were a party to the initial agreement. CFWS Chair Peter Peacock thought the approach from Scottish Water was another reason for success. In particular he noted the importance of Scottish Water's strategic goal of "being Scotland's most valued and trusted business, one we can all be proud of." In addition, Duncan Millican CEO of Scottish Water was perceived to be keen to change the culture of his organisation in support of goal, and this was supported by the Customer Forum.⁹

Throughout the process the Forum was well supported on methods of approach by both Stephen Littlechild and Harry Bush (WICS 2014:74).

Engagement

A body such as the Forum can only succeed through active participation of members. Formal engagement was strong between the Forum and Scottish Water. Scottish Water managers were perceived to have benefitted greatly from the need to explain their proposals clearly to a panel of expert lay people. In doing so they identified some of their own usually unstated assumptions (CFWS 2015:8). This particularly occurred through the presentation of eight detailed Service Improvement Reports. Engagement on the customer research has already been discussed.

Similarly WICS was closely engaged, including through the provision of guidance notes.

Two other features outside the formal meetings stand-out. The first was an extensive process of regular consultation between the principle players at WICS, Scottish Water, the Forum, CFS, and the Scottish Executive. A key factor in this was the choice of Forum Chair, as the *Legacy Report* states “the Forum members have pointed out that the role adopted by any Chairman in such a process is an important factor in how that process is likely to work.” The second was the creation of the Engagement Committee of the Forum. This smaller group was able to actively engage in negotiation with Scottish Water towards the end of the process. This governance tool had been instituted in the initial agreement and proved to be most useful at the end.

Commitment

Having made an initial commitment to the Forum all the institutions maintained that commitment. At times both the Board of WICS and Government were uncertain whether the Forum was being tasked with issues that were their own concern (see below), but commitment remained.

The *Legacy Report* also suggests that part of the success might have been due to national characteristics, writing “The Forum was the product of a partnership and was therefore very much attuned to the culture of cooperation that prevails in Scotland and goes a long way to building productive consensus” (CFWS2015:10). Whether this is correctly described as a part of national Scottish character, it certainly was a personal trait of both the CEO of WICS and the Chair of the Forum.

Other issues

The above discussion highlights what worked well for the Customer Forum. There are two outcomes that were avoided that could have made the process less successful; failure to reach agreement or an agreement that saw a significant increase in prices.¹⁰

Both of these outcomes would have been able to be well managed had they occurred through the process that WICS established to guide the Forum’s deliberations.

The guidance notes provided clear upper and lower bounds for most parameters. The CEO of WICS was confident that if there had not been agreement these guidelines would have provided the basis for a fairly easy decision for the regulator to choose the option that best met consumer interests.¹¹

In discussion with Harry Bush the author suggested the prospect of “baseball arbitration” as once contemplated in an Australian negotiate/arbitrate context in a Productivity Commission

draft report (PC 2001). This is also called “pendulum arbitration” and is simply a case where if two parties cannot agree the arbiter can only choose one of the parties’ final offer, not something in between. The concept is that parties have an incentive to make their genuine best offer rather than an ambit claim. Even in the context of an already narrowed scope for disagreement, explicit provision for this kind of arbitration on items not agreed on should be a consideration if a negotiated outcome is sought.

There was no risk of a significant price increase in the Scottish Water case. However, had there been WICS would prefer to have had the agreed outcome of the Customer Forum than not.

The one outstanding issue is why the regulator itself couldn’t fulfil the role being performed by the Customer Forum. Why couldn’t WICS do what the Forum did? Alan Sutherland’s response was that the “day job” of being a regulator involves you in so much detail that you have immediately distanced yourself from the customer. That is, there is a specific benefit of a group of lay people looking at the evidence.

As noted above Government also asked itself whether the Forum was substituting for their role in representing consumers. That there is an element of truth in this is reflected in how appropriate Peter Peacock was as Chair of the Forum. But politics isn’t what it used to be. Right up to the early eighties Government ownership still worked as a regulatory model, politicians did balance consumer interests in managing utilities. With the advent of the “cartel parties” as the dominant political form this changed.¹² Parties used the resources of the State for political ends – and utilities were subject to

instructions to keep prices low for electoral reasons, or subject to demands for high dividends to fund promises, or often both.

Other approaches

The Civil Aviation Authority (CAA) has been using “constructive engagement” in setting airport access charges since 2005. Both Ofwat (for water in Wales and England) and Ofgem included consumer engagement as part of their most recent regulatory processes (PR14 and RIIO-ED1 respectively). Bush and Earwaker (2015) provide some analysis of each of these approaches.

Civil Aviation Authority

The CAA is instructive as the customers of the airports are primarily airlines and not end-users. Constructive engagement has been successfully used to reconcile differences between airport owners and airlines over the last decade. The determination of “competition by

substitute” between airports means that only the two big international airports (Heathrow and Gatwick) are still subject to regulation.

In the airline case certain items were excluded from the process to allow meaningful engagement where customers could contribute. The level of operating efficiency, the cost of capital and commercial revenues were excluded. The outcome of engagement was not agreement as such, but there was consensus around the most important elements of the airport business plan.

In discussion with the CAA it was identified that there is a specific difference of opinion between the majority of airlines and the most cut price operators. There is also an identified need for more research of end-user interests.¹³

Ofwat

Both Ofwat and Ofgem confront a more challenging circumstance, with 18 and 14 concurrent reviews of regulated businesses respectively.

For PR14 Ofwat (2011) announced that as consumers are “at the heart of the price-setting process” when Ofwat next set prices it would “expect companies to take responsibility for engaging with their customers.” Ofwat said they would not be prescriptive, but then outlined a three tiered approach of:

- **Direct local engagement** on local priorities and issues that could have a significant impact on the service customers receive or those that affect the local community;
- **A company customer challenge group** to ensure that the company’s business plan reflects a sound understanding and reasonable balance of customers’ views; and
- **A sector-wide customer advisory panel** established by Ofwat to inform and challenge it on a number of key sector-wide assumptions, such as the cost of capital, and provisions for pensions.

The individual Customer Challenge Groups (CCG) differed from the Customer Forum for Water in Scotland in a number of ways. Firstly membership did include existing water advocates, with the Consumer Council for Water (CCWater) providing a number of chairs. This was the intention of Ofwat (2011:4). The Environment Agency and the Drinking Water Inspectorate also participated in CCGs directly.

The low level of guidance on the role of the CCGs and the presence of a number of chairs from CCWater resulted in a number of CCGs adopting a very wide brief and seeking to comment on issues of cost of capital and efficiency which Ofwat was reserving to itself. (Bush and Earwaker 2015:9).

A number of CCGs had reached agreement with the water utility on their business plan, but this agreement had little value. Ofwat only determined cost of capital and efficiency for firms after the CCGs completed their work. This meant that the evaluation of trade-offs by CCGs between quality and price were based on incorrect assessments of price.

The use of the word “challenge” in the title of the firm level engagement bodies was taken literally by some advocates. For example, CCWater (2015:5) wrote in its review of PR1 “CCGs are a step forward in giving stakeholders a platform for challenging company business plans.” The CEO of CCWater emphasised the word “challenge” in discussion and saw the CCGs as a way to combat the utilities hiding efficiency opportunities from the regulator.¹⁴ This was a very different framing to the climate of trust developed between Scottish Water and the CFWS.

While the Scottish process had emphasised the value of skilled laymen, CCWater in its review (2015:5) also noted “CCG membership through PR14 was representative of a wide range of interests, but some CCG members with non-water industry backgrounds struggled at times to cope with the complexity of the subjects under discussion, and the time commitment over a long period.” Advocate fatigue through a two year process was also highlighted by the CEO of CCWater.

A challenging issue that emerged in the Ofwat case is how to pay the independent chairs for future reviews (Bush and Earwaker 2015:17). There is a concern that directly funding participation by the regulated firm presents a perception of capture. In PR14 they were funded and provided by CCWater. In Scotland the entire Forum was funded by WICS through funds administered by CFS.

Ofgem

Ofgem for RIIO-ED1 took a different approach. One of Ofgem’s motivations was that companies had seemed more focussed on the regulator than on the customer. (Wilson 2016: 3). The language in the RIIO Handbook (Ofgem 2010:15) sounded similar to Ofwat, saying:

Network companies should proactively engage with consumers of their network services and wider stakeholders, as highlighted in Figure 8 above. We expect this engagement to take place on an ongoing basis, not just as part of the price control review. While we do not want to be prescriptive about how network companies engage with their stakeholders, Table 1 provides an illustration of the type of issues on which network companies should engage in the context of the price control review and what engagement might involve. It also explains how the framework is designed to provide network companies with a strong incentive to engage effectively on an ongoing basis.

However, more emphasis was placed on the quality of engagement through its inclusion as one of the indicators for placing a business plan on the “fast track” for regulatory approval. As it transpired the fast track process only rewarded one company, and it is generally agreed they were over-rewarded (Huggins 2016).¹⁵

There has been no formal review of the actual consumer engagement experience in RIIO-ED1 and Ofgem has not decided whether to conduct one.¹⁶ Given the significant use made of engagement in fast-tracking, and the value of analysis of the water case by Bush and Earwaker (2015) it would be a valuable exercise.

Lessons for Australia

Requirements for network businesses to include consumer engagement in their regulatory proposals were introduced as part of the AER’s Better Regulation reform package. The AER’s intention was clear (AER 2014:17):

Our consumer engagement guideline sets out how we expect energy network businesses to engage with their consumers. Businesses should demonstrate a commitment to ongoing and genuine consumer engagement to provide services that better align with consumers’ long term interests.

Like Ofgem, the AER has given little guidance on how network businesses should conduct their consumer engagement. Unlike Ofgem there is no explicit benefit for a network business to aspire to a high standard of engagement.

Consumer engagement has now featured in both the last round of distribution business revenue determinations and the more recent Tariff Structure Statement proposals. Like Ofgem, the AER has no intention to undertake a review of the consumer engagement to date.¹⁷

The AER’s Consumer Challenge Panel (CCP) wrote twice to the AER in 2014 outlining the CCP’s concern about the quality of network business engagement. (CCP 2014a, 2014b). The author is unaware of what response the CCP received from the AER.

The Energy Networks Association is attempting to assist its members by commissioning the CSIRO to develop a Consumer Engagement Handbook. The effectiveness of the handbook will depend on the extent to which it addresses the concerns identified by the CCP and the extent to which it is adopted by members.

The general conclusions reached by a comparison of the experiences is that:

- Consumer engagement does benefit from being non-statutory activity that is able to work to an outcome rather than a process.
- There are aspects of revenue determinations that need to be determined by regulators not negotiation; that includes cost of capital and the determination of efficiency.
- Consumer engagement is a suite of activities and the function of a “Consumer Forum” is to use the information provided by all these channels to assess the effectiveness of the company’s response. The selection of members of the forum needs to follow the Scottish Water approach rather than the Ofwat approach.
- The regulator needs to be explicit on how the contribution that the “Consumer Forum” will be used in the determination process.
- As stated by the Consumer Challenge Panel (CCP 2014b) network businesses need to “adopt a ‘continuous improvement’ attitude to consumer engagement.”

The regulatory task is expressed differently in different jurisdictions. WICS had a statutory remit to determine “the lowest reasonable overall cost.” The AER is required to promote economic efficiency for the long term interests of consumers. No matter how it is expressed, the objective is always that consumers pay no more than they need to for the services they want.

Regulators can determine cost of capital and efficiency benchmarks, but in the end only consumers can determine what they want to pay for. Consumer engagement is a process for bringing that to the forefront of the regulatory process.

Littlechild (2014) has referred to consumer engagement as a “change of regulatory approach.” Heims and Lodge (2016) question the claim that it really is transformative innovation in regulation.

The reality is a bit of both. Consumer engagement is an essential characteristic in economic regulation but in the adoption of econocrat models of price setting it got lost. In the previous regulatory arrangement in the UK and Australia the consumer interest was delivered by government. In the move to corporatisation and privatisation that function of Government was lost and not replaced in the network businesses.

To be effective as part of economic regulation, regulators need to be clear in how the outcomes of engagement will be used in regulatory decision making. However, the lessons from Scottish Water do provide useful lessons for businesses in constructing their own consumer engagement processes.

¹ Meetings were held with Professor Stephen Littlechild (proponent of negotiated settlement), Tony Smith CEO Consumer Council for Water (on Ofwat's process) Alan Sutherland (CEO Water Industry Commission for Scotland) Peter Peacock (Chair Scottish Water Customer Forum) Harry Bush (First Economics – author of study on Ofwat's scheme for UKWIR) Maxine Frerk (Ofgem) Richard Moriarty (Civil Aviation Authority) Professor Martin Lodge (LSE) Roger Darlington (Essential Services Action Network) Chris Alexander (Citizens Advice) Andy Manning (British Gas) and Audrey Gallacher (EnergyUK). The author is extremely grateful to all these people who made their time available, and in particular Stephen Littlechild for initial introductions and identifying some of the available literature.

² The 'Littlechild Report' is a slim 42 page document of which Trove lists only one copy in Australia at the Australian Parliamentary Library. It seems to have escaped digitisation. Useful discussions can be found in Stern 2003 and Beesley and Littlechild 1989.

³ It appears that neither Littlechild nor Bush were influenced by the other in their initial development of thinking about new techniques in economic regulation. This was certainly the opinion of Richard Moriarty in interview with the author in Feb 2016.

⁴ Discussion with author Feb 2016.

⁵ Discussion with author Feb 2016.

⁶ Discussion with author Feb 2016. Consumer Focus Scotland became Consumer Futures on 1 April 2013 before moving into Citizens Advice Scotland on 1 April 2014.

⁷ In discussion CFWS chair Peter Peacock was more forceful, saying the Forum would have been 'hopeless if we had church, union or homeless advocates's members of the Forum.

⁸ The unified view was published as *Listening to our Customers* Scottish Water 2012

⁹ Conversation with Peter Peacock Feb 2016. See <http://www.scottishwater.co.uk/strategic-projections> for an example of Scottish Water's statement of this goal. Similarly the company LinkedIn page states "It's our ambition to be Scotland's most valued and trusted business as we work to put our customers at the heart of everything we do." <https://www.linkedin.com/company/scottish-water>. The view on culture was made in the *Legacy Report* (CFWS:13,18) see also CFWS:8 for the Scottish Water vision.

¹⁰ The issue with an outcome of significantly higher prices would be the extent to which it was reasonable for a regulator to simply accept the agreed business plan.

¹¹ Alan Sutherland discussion with author Feb 2016

¹² In politics, a cartel party or cartel political party is a party which uses the resources of the state to maintain its position within the political system. Richard S Katz and Peter Mair, *Changing Models of Party Organization and Party Democracy: the emergence of the cartel party*, *Party Politics*, Vol. 1, No. 1, p 5-31 (1995)

¹³ Discussion with Richard Moriarty Feb 2016.

¹⁴ Discussion with Tony Smith Feb 2016.

¹⁵ Also discussion with Andy Manning Feb 2016.

¹⁶ Discussion with Maxine Frerk Feb 2016.

¹⁷ Discussion with Chris Pattas January 2016.

Glossary

AER	Australian Energy Regulator
CCP	Consumer Consultation Panel (of the AER)
CCWater	Consumer Council for Water (England and Wales)
CFS	Consumer Focus Scotland
CFWS	Customer Forum for Water in Scotland
SACOSS	South Australian Council for Social Services
SRC	Strategic Review of Charges
WICS	Water Industry Commission of Scotland

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