

**Customer engagement methodologies in water
price setting: experience in England and Wales and
Scotland, and possible application to Victoria**

A paper for the Essential Services Commission of Victoria

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Executive Summary

The Essential Services Commission (ESC) has asked us to describe customer engagement methodologies in setting water prices, with particular emphasis on experience in England and Wales and Scotland, and to provide some initial ideas on how customer engagement in economic regulation of water companies in Victoria might be strengthened.

In particular, the ESC asked us to consider how the pricing approach may accommodate a greater role for customers in shaping the price submissions prepared by water companies. This may have a number of benefits, including improvements to the quality of price submissions, providing greater assurance to customers that their water company is attuned to their needs and acting in their interest, and the possibility to apply a more light-handed form of price regulation.

This paper is divided into two parts: Part A provides information on customer engagement in water and electricity regulation particularly in Great Britain. Part B focuses on customer engagement in water regulation in Victoria and sets out some ideas on how this might be strengthened. This Executive Summary draws on the material in Part B.

The relevant Victorian legislation does not promote active customer engagement as part of the regulatory process but neither does it preclude it. However, the Statement of Obligations (issued by the Minister for Water to the water companies) obliges the companies to consult with customers to develop their price submissions. The ESC Act also requires the ESC to develop a charter of consultative practice to guide its own consultations.

Customer groups told us that they had observed that the ESC has placed progressively greater importance on customer engagement.

The Water Industry Regulatory Order, while reinforcing the statutory obligations in legislation, provides the ESC with wide discretion in how to fulfil its obligations. In

some respects the ESC's guidance to water companies on customer consultation is similar to the guidance and instructions adopted by Ofwat and Ofgem in Great Britain.

Some water companies in Victoria seem to have been more proactive in their engagement with customers on regulatory matters. In many cases, the engagement of water companies with customers is undertaken as part of broader "stakeholder" consultation and directed at broader strategic and operational issues, rather than prices, quality of supply and water company efficiency.

If greater customer participation is desired, then more resources will be needed to achieve this. We estimate average annual spending by customer advocates on Victorian water regulatory issues, of \$150k to \$250k per year, spread amongst several groups. The active advocates are particularly focussed on the interests of low income households. It will also be helpful to widen representation to ensure participation of groups representing - or with knowledge of - the interests of industry, commerce, agriculture and other residential customers.

One way to strengthen customer engagement would be through a "customer advocates' advice centre" whose main function would be to collect and disseminate information on water prices, industry assets, expenditures, service outcomes and profits, and to maintain digests of relevant regulatory and policy developments. It might provide or procure research on specific issues in response to requests from customer advocates and on its own initiative. The centre would not itself advocate, but would focus on providing technical assistance to customer advocates to strengthen their ability to engage with the water companies on substantive issues.

We suggest that a particular focus in the development of customer advocacy should be to ensure that customers are themselves able to report to the ESC on how the water companies have consulted with them and the extent to which the companies have taken account of their concerns. This is preferable to relying on the companies' accounts of such consultation, or advice of a "Customer Challenge Panel". Indeed strengthening the participation of customer advocacy groups is likely to encourage the companies to engage with these groups.

Consideration also needs to be given to how the ESC might engage with customers, not just in hearing customers' views, but also possibly in providing the ESC's views to customers of the companies' relative efficiency and the issues that the ESC would wish customer groups to focus on. In the propose-respond regulatory model adopted in Victoria, there might be some concern that such advice and engagement would fetter the ESC's discretion. But in the active customer engagement models in North America and most recently in Scotland, regulatory staff have briefed customer advocates on their views of the relevant issues and this has helped to focus customer engagement without fettering regulatory discretion.

Finally, the ESC may wish to consider going further, to the possibility of customers negotiating with water companies, with final acceptance (or rejection) of any settlements by the ESC. The paper briefly outlines the range of possibilities, the scope and processes of such engagement, how customers might be represented and the role of the ESC in facilitating and co-ordinating such negotiation.

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1 Introduction

Customers and their representatives have long had a role in the process of setting utility prices, but in recent years this role has increased. There has been a significant step forward in customer engagement in the process of setting water prices both in England and Wales, and in Scotland. In Victoria, there has also been progressively greater emphasis on customer engagement in regulatory processes.

The Essential Services Commission (ESC) has asked us to describe customer engagement methodologies in setting water prices, with particular emphasis on experience in England and Wales and Scotland, and to provide some initial ideas on how customer engagement in economic regulation of water companies in Victoria might be strengthened.

Part A of this report focuses on experience abroad. Part B examines the situation in Victoria and, taking account of the experience elsewhere, develops some initial ideas on how customer engagement in the regulation of water companies in Victoria may be strengthened.

PART A: International experience

Stephen Littlechild

1 Introduction

Customers and their representatives have long had a role in the process of setting utility prices, but in recent years this role has increased. There has been a significant step forward in customer engagement in the process of setting water prices both in England and Wales, and in Scotland. This Part is set out in six sections as described in the rest of this introduction.

Section 2 summarises the earlier examples of customer engagement (in North America and at the Civil Aviation Authority in England) that preceded the more recently developments in water and energy in Great Britain. It also describes how the idea that customer engagement could have a greater role to play in future began to disseminate.

Section 3 explains the approach developed and adopted by Ofgem in its most recent decisions. This indicates the broader aim of the revised process and also the defined (and limited) role that customer engagement played in that process. It notes the interaction between customer engagement and “fast-tracking”. Some similar features (such as customer engagement and fast-tracking) were incorporated in the Ofwat price setting process.

Section 4 sets out in more detail the new customer engagement process designed and carried out by Ofwat in setting water prices. It includes detail on the responsibilities of the Customer Challenge Groups. It also provides some initial comments on the outcome.

Section 5 is a preliminary assessment of the Ofgem and Ofwat price-setting reviews. It also comments on the interaction between fast-tracking process and customer engagement.

Section 6 describes the Customer Forum approach adopted in Scotland. It provides some discussion of the process and some initial comments on the outcome.

Section 7 draws comparisons between the approaches in Scotland and in England and Wales. It considers in particular the challenges of assessing efficient costs in a sector where there are many participants. And it considers whether the fast-tracking and customer engagement processes could be enhanced by separating them more, and/or by feeding more and earlier comparative information to customers and companies.

2 Previous examples of customer engagement

2.1 Negotiated settlements in the U.S. and Canada

In North America, the typical process is for a utility to file for a price increase as and when it considers it needs one. There is a process of requesting information and filing testimony, prior to a hearing with cross-examination of witnesses. Then an administrative law judge decides whether to recommend a rate increase and of what amount. The regulatory commission then decides whether to approve, modify or reject this recommendation

In some jurisdictions in the US and Canada, user groups and utilities have taken the initiative in trying to negotiate a settlement to present to the regulatory body. When a utility files for a rate increase, the parties will typically begin negotiations after the written statements have been presented and cross-examined but before the formal hearings begin. The rate cases and hence the settlements usually cover pricing. They may – but often do not – also cover investment and other issues. Typically the settlements are accepted by the regulator, obviating the need for a formal hearing and regulatory decision other than to adopt the terms of the settlement.

This has been the normal approach for some years at the Federal Energy Regulatory Commission (FERC), at least for straightforward issues.¹ Gas pipelines and a wide range of interested parties typically negotiate a variety of issues including cost of service and rate design. The interested parties (called intervenors) include ratepayers (direct and indirect customers including local natural gas distribution companies, industrial, electric and commercial gas users, and gas marketing companies) and non-ratepayers (including state public utility commissions, competing pipelines and potential customers).

¹ Zhongmin Wang “Settling utility rate cases: an alternative ratemaking procedure”, *Journal of Regulatory Economics*, 26 (2), September 2004, 141-163. Joseph Doucet and Stephen Littlechild, “Negotiated settlements: the development of legal and economic thinking”, *Utilities Policy* 14, December 2006, 266-277

The process is more flexible and innovative than traditional litigation. The settlements typically include rate moratoria and/or must-file provisions (not available to the regulatory commission), thereby providing efficiency incentives coupled with the ability to reassess the issues after a specified period of years.

In recent years, FERC staff have taken an active role in facilitating settlements.² Once a request for a rate increase is filed, staff will respond in three months with their own analysis of the case. Staff will then encourage the utility and its customers to get round the table and hammer out a deal, typically somewhere within the utility's proposed rate increase and the Staff view.

In Florida, the Office of Public Counsel (the state-established customer advocate) took the lead in negotiating settlements (often called stipulations) on behalf of customers, often in conjunction with user groups.³ At that time the settlements typically provided one-off refunds or rate reductions and rate freezes for a specified period of years. Several four-year settlements were repeated. Provisions have also included approval of new generation plant. Settlements effectively replaced traditional rate of return regulation. Later there were earnings sharing schemes with profits caps. These in turn were replaced by 'revenue-sharing incentive plans': agreements that fix prices for specified periods of time with stronger and more enforceable revenue-sharing arrangements in the event of (e.g.) unexpected demand increases.

At the Canadian National Energy Board (NEB) participants have included all eight oil and gas pipelines plus relevant producers, shippers and customers.⁴ Settlements have been used to determine prices, operating and capital cost projections, return on equity, service quality improvements and information requirements. Settlements were the vehicle by which multi-year incentive agreements developed rapidly for all pipelines.

² S C Littlechild, "The process of negotiating settlements at FERC", *Energy Policy*, 50, November 2012: 174-191.

³ S C Littlechild, "Stipulated settlements, the customer advocate and utility regulation in Florida", *Journal of Regulatory Economics* 35(1), February 2009, 96-109. S C Littlechild, "The bird in hand: stipulated settlements in Florida electricity regulation", *Utilities Policy*, 17 (3-4), September - December 2009, 276-287.

⁴ J Doucet and S C Littlechild. "Negotiated settlements and the National Energy Board in Canada", *Energy Policy*, 37 (11), November 2009, 4633-4644.

In addition, from 1996 to 2001 parties settled about one quarter of the 120 electricity and gas rate cases at the Alberta Energy and Utilities Board. Some of these settlements have been quite innovative: for example, a regulated rate option to encourage efficient purchasing and pricing by an electricity utility as the market opened to competition.

Certain qualifications are important, however. First, compared to UK price control reviews, at least, North American rate cases are typically relatively simple. They look at actual costs in a recent test year. They do not look ahead for five or more years, considering what investment programme would be appropriate and how far an efficient company could reduce its costs. The main question at issue is usually the cost of capital.

Second, in order to reduce the time taken by hearings, the National Energy Board in Canada decided to publish the formula it would use to calculate the cost of capital. This enabled the parties to resolve the most important issue that divided them, and to focus on other subsidiary issues where there were gains from discussion and mutual accommodation.

Third, the customers and users involved in these North American settlements are by now well familiar with the processes and issues. They are adept at participating in a litigated process and in a negotiated settlement.

In the UK, and no doubt in Australia, things are rather different.

2.2 Constructive engagement at the Civil Aviation Authority (CAA) (Great Britain)

The CAA appraised the 2004 airport price control review at some length and had several concerns about the confrontational nature of the previous process and the fact that the CAA was forced to make many of the key investment and operational decisions, which it felt it was not well placed to do. Looking forward, airlines wanted more focus on (airline) customers, mainstream consultation and a real input into decisions. Airports wanted greater consensus on plans, more structured information on

airline requirements and more recognition of realities. The CAA wanted improved information and inputs, less intrusion on commercial issues, a more focussed role and better decisions.

In May 2005 the CAA proposed that “some of the work usually carried out by the regulator will instead be taken forward by the airports and their airline customers through a process of ‘constructive engagement’”.⁵ These were (primarily) the traffic forecasts to be used in setting the controls, the investment programmes at each airport and the desired quality of service parameters. “In this way, the normal business of commercial airport/airline interaction should be reinforced by the regulatory process, rather than interrupted by it.”

The key responsibilities that the CAA would retain included analysis of market power and opex efficiencies, addition of past investment costs to the RAB, proportion of future capex to be recovered in the next price control period, assessing the cost of capital, determining any price profile adjustment, establishing a revenue requirement (including allowance for non-regulated revenue), assessing options for the structure of the control, and developing proposals for financial incentives.

The CAA gave some general guidance on working arrangements and set a timetable. It also responded to concerns about how “the interests of passengers and small, new entrant (or future) airlines would be safeguarded in negotiations between airports and airlines”. It would be looking to see explanation and evidence on how the agreements took account of these interests, and to that end set out some general guiding principles and basic questions that would be considered in looking at whether the agreements met the CAA’s statutory objectives. Importantly, the CAA committed to respecting the agreements that were made.

“Final decisions and responsibility in a legal sense will continue to rest with the regulator. But if an agreement can be better reached by the parties, the regulator is likely to have a preference for it, provided the regulator is satisfied that the

⁵ Airport regulation: the process for constructive engagement, CAA, May 2005.

agreement meets user interests overall and is consistent with its statutory obligations.”⁶

No change in the statutory framework was involved.

Appraising the situation in May 2007, the CAA considered that the outcome so far had generally been satisfactory, indeed better than expected, at least at Heathrow and Gatwick. (The approach had reached impasse at Stansted and was still ongoing at Manchester.) Achievements included agreement on base capex, treatment of non-regulatory charges, the broad scope for capex efficiency, and traffic evolution at Gatwick. There was also an improvement in consultation and ‘the quality of regulatory discourse’.

The Competition Commission saw substantial merits in the process, and noted that the airlines did too.⁷ It had some concerns about the process of consultation, and was particularly concerned about the significant increase in BAA’s capex programme during the course of its inquiry. However, it concluded that constructive engagement should be a continuous process, not confined to the periods approaching a quinquennial review. It recommended that the CAA specify and monitor the process more closely. In a subsequent report, the Commission indicated that it envisaged a greater role for such processes rather than a return to traditional regulation.

The CAA was encouraged to use the approach again in determining the price control for air traffic control (NATS), where it worked well. The CAA proposed the process again for the most recent airport price control review, and invited the parties to engage on a wider range of issues, including operating cost. Circumstances were somewhat problematic because in parallel there was a new process for determining whether an airport should be regulated, and there was some fear at Stansted and Gatwick that an agreement between the airport and airline would indicate that there was no need for

⁶ Airport Regulation: Looking to the future, learning from the past, CAA, May 2004, para 37, p. xii.

⁷ BAA Ltd. (Heathrow and Gatwick Quinquennial Review, Final Report), Competition Commission, 3 October 2007.

regulation. Nevertheless, progress was made on capital expenditure, traffic forecasts and service quality at most airports, although there was no agreement on opex efficiency or on cost of capital.

2.3 Sowing the seed

When I finished my term as GB electricity regulator in December 1998, I spent some time examining how regulation was conducted around the world. My feeling was that there ought to be better ways of setting prices than we had found in the UK. I was intrigued by the Public Contest method used to determine transmission investments in Argentina, whereby transmission expansions were only made if the beneficiaries voted in their favour. The proposed expansion was then put out to competitive tender to determine the price and who would construct and operate it. Contrary to expectations, this method had worked well.⁸

Negotiated settlements as practised in North America also seemed to have several advantages, as just explained. From 2002 onwards, in various conference and seminar presentations, I began to urge other regulators to take note of these possibilities.⁹ I wrote about these approaches in academic publications.¹⁰ These various presentations

⁸ S C Littlechild and Carlos J Skerk, "Transmission Expansion in Argentina 4: a review of performance", *Energy Economics* 30(4) July 2008, 1462-1490, and other articles in the same issue.

⁹ E.g. "Electricity Regulation and Deregulation", Conference on Wholesale Markets for Electricity, University of Toulouse, 22 Nov 2002. "Customer Participation in Regulation: stipulated settlements, the customer advocate and utility regulation in Florida", Market Design 2003 Conference, Stockholm, 17 June 2003. "Stipulations, settlements and customer representatives in public utility regulation: evidence from the Florida Public Service Commission", ISNIE Annual Conference, Budapest, 10-13 September 2003. "Beyond Regulation", Beesley Lecture series XV, 4 October 2005, reprinted in Colin Robinson (ed.) *Utility Regulation and Competitive Markets*, Cheltenham: Edward Elgar, May 2007. "Foreword: The market versus regulation", in Fereidoon P Sioshansi and Wolfgang Pfaffenburger (eds.) *Electricity Market Reform: An International Perspective*, Elsevier, April 2006, xvii-xxix. "Negotiated settlements: a role for American practice in UK policy". Hertford College, Oxford. 23 February 2007. "Negotiated settlements - a role for American practice in UK regulation?" Faculty of Laws, University College London, 24 May 2007. *Regulation, over-regulation and deregulation*, CRI Occasional Lecture 22, London, 24 November 2008, published by Centre for Study of Regulated Industries, University of Bath.

¹⁰ S C Littlechild, "Some alternative approaches to utility regulation", *Economic Affairs*, 28(3), September 2008, 32-37. S C Littlechild, "Some applied economics of electricity regulation: A paper in honour of David Newbery", *The Energy Journal*, Special Issue #2, September 2008, 43-62.

drew on early drafts of the papers that I subsequently published in academic journals, as referenced above. I also wrote simple explanations in the popular utility press.¹¹

By 2008 the regulatory bodies were taking an interest. In April the All Party Parliamentary Water Group (APPWG) said that it “would like to explore these approaches in the UK and the possibility of a potential role for CCWater [the Customer Council for Water] in representing customer interests in this way”.¹² I responded with a paper that examined recent and ongoing experience with price control reviews in the England and Wales water sector, particularly with the Quadripartite Working Groups set up by CCWater.¹³ I briefly reviewed CAA experience with constructive engagement and some experience with negotiated settlements in the US and Canada, and then explored possible ways of applying and encouraging this approach in the water sector.

UK energy and water regulators began to note the possibility of exploring such approaches. For example, Alistair Buchanan, CEO of Ofgem, mentioned my work on settlements when launching Ofgem’s reappraisal of RPI-X regulation.¹⁴ We explored it in another conference later that year.¹⁵

S C Littlechild, “Regulation, over-regulation and some alternative approaches”, *European Review of Energy Markets*, 9, October 2009, 153-159. S C Littlechild, “Planning, competition and cooperation: the scope for negotiated settlements”, in Dipak Basu (ed.), *Advances in Development Economics*, World Scientific Publishing Co. Pte. Ltd, 2009, 119-124. S C Littlechild, Regulation and customer engagement, *Economics of Energy and Environmental Policy*, 1 (1), December 2011.

¹¹ “Let’s Talk”, *Utility Week*, 2 May 2008, 20-21. “Let’s make a deal ...”, *Utility Week*, 14 November 2008, pp. 18-19.

¹² *The Future of the UK Water Sector*, April 2008, pp. 38-40.

¹³ S C Littlechild, “Constructive engagement and negotiated settlements – a prospect in the England and Wales water sector?” 29 August 2008, published on the EPRG (Energy Policy Research Group) website, University of Cambridge.

¹⁴ Alistair Buchanan, “Ofgem’s RPI@20 Project”, SBGI conference 6 March 2008.

¹⁵ Alistair Buchanan, “Is RPI-X still fit for purpose after 20 years?”, IEA Beesley Lecture 2 October 2008. In my Comments when chairing the Lecture I asked whether there would be any point in moving to negotiated settlements if we already have RPI-X incentive regulation in the UK. “My answer is Yes because it would bring at least three additional benefits. 1) A greater involvement of users and customers in the decision on what the investment programme should be and what quality of service is preferred. 2) A greater variety of price controls and regulatory arrangements, which is conducive to more innovation. 3) Better understanding and relationships between the companies and their users and customers, instead of the regulator acting as piggy in the middle.”

In retrospect, a further important milestone was the SGBI conference held in London on 5 March 2009 on the theme *After RPI-X: What Next?* Speakers and attendees included the CEOs of Ofgem, Ofwat and WICS and senior figures in UK regulatory bodies and regulated companies. The focus was on learning from North American and CAA experience, and exploring the possibilities for customer engagement in UK regulation.¹⁶

2.4 Regulators becoming pro-active

The ball was now rolling. Ofgem commissioned Nigel Cornwall and me to write a Report for Ofgem's forthcoming transmission price control review,¹⁷ and invited me to contribute to the debate on the role of customers in the evolving energy sector appeal process.¹⁸ Customer engagement was firmly embedded as one (albeit limited) element of Ofgem's evolving RIIO approach to succeed RPI-X regulation, explained in more detail in the next section.

Ofwat and the water sector generally were also developing thinking on a new approach to price control reviews. As in the energy sector, customer engagement was to form a key part of the new approach. In July 2009 the customer body CCWater asked me to set

¹⁶ Speakers on customer engagement, who also participated in discussion at the dinner preceding the conference, included Nick Fincham (CAA) on "Negotiation in UK airports price regulation", Kenneth Bateman (NEB) on "Negotiated settlements in Canada", Scott Thomson (Terasen Gas, Canada) on "Negotiated settlements from the perspective of a local distribution company", Jack Shreve (former Public Counsel - or Customer Advocate - in Florida) on "Regulation without regulators: delivering equity for all", and Tony Ballance (Severn Trent) on "Could constructive engagement work for the water sector?" I chaired the dinner discussion and at the end of the conference gave some final remarks on Key issues and conclusions.

¹⁷ *Potential scope for user participation in the GB energy regulatory framework, with particular reference to the next Transmission Price Control Review*, (with Nigel Cornwall), Report to Ofgem, 28 March 2009 (56 pp), at

<http://www.ofgem.gov.uk/Networks/rpix20/publications/CD/Documents1/User%20participation%20Ofgem%2028%20March%202009%20-%20final.pdf> and at

http://www.cornwallenergy.com/cms/data/files/pdf/Services/Reports/report_to_ofgem_sc.nc.pdf

¹⁸ Customer involvement, ex post regulation and customer appeal mechanisms, Ofgem RPI-X@20 Web Forum, 29 November 2009.

[http://www.ofgem.gov.uk/Networks/rpix20/forum/rocag/Documents1/Customer%20involvement%20ex%20post%20%20customer%20appeal%2029%20Nov%202009%20\(2\)%20\(2\).pdf](http://www.ofgem.gov.uk/Networks/rpix20/forum/rocag/Documents1/Customer%20involvement%20ex%20post%20%20customer%20appeal%2029%20Nov%202009%20(2)%20(2).pdf)

out some thoughts.¹⁹ In May 2010 Ofwat asked me for a paper.²⁰ In September Catherine Waddams and I gave a briefing for Ofwat and the industry. Successive Ofwat publications explored the possibilities, and David Gray's review of water regulation endorsed customer engagement.²¹ As explained in Section 3, Ofwat incorporated customer engagement in its latest price control review in a significant way.

Finally, but not least, the Water Industry Commission for Scotland (WICS) embodied customer engagement even more explicitly in its own approach to setting water prices in Scotland. WICS had been interested in the approach since my articles in 2008, and WICS and Scottish Water participated actively in the SGBI conference in March 2009. Both came to the view that customer engagement was the way forward. I helped to brief them in 2010, and from time to time advised on the project as it subsequently developed.

The purpose of this section has been to indicate that it takes time to develop the interest and thinking for a new regulatory approach – in this case about ten years overall in the UK energy and water sectors, but only about five years in water once there was active regulatory interest. Getting “buy-in” from all participants is important, as is tailoring the approach to the particular conditions and regulatory framework of each industry. In the water sector, for example, customer bodies and some individual water companies were publishing their own thoughts and suggestions for the way ahead, in parallel with the regulatory bodies.

Of course, customer engagement was not the only focus of a changed approach: it was part of a broader attempt to build on and develop a largely successful regulatory

¹⁹ S C Littlechild, “Greater customer involvement in regulation of the E&W water sector”, paper for CCWater, 21 July 2009.

²⁰ S C Littlechild, *A customer consultation process for the water and sewerage sectors: A paper for Ofwat*, 20 May 2010.

²¹ C.f. *Involving customers in the price-setting process – a discussion paper*, Ofwat, 22 October 2010; *Involving customers in decisions about water and sewerage services*, Ofwat, April 2011; David Gray, *Review of Ofwat and customer representation in the water sector*, Defra, July 2011, esp. p 83; *Involving customers in price setting – Ofwat's customer engagement policy statement*, Ofwat, 11 August 2011; *Involving customers in price setting – Ofwat's customer engagement policy – further information*, Ofwat, 20 Apr 2012; *Setting price controls for 2015-20 – framework and approach A consultation*, s 2.2.2 The role of CCGs, Ofwat, January 2013.

regime. The aim now was to find a more efficient and more innovative way of regulating for a rapidly changing future, and to do so in a way that enabled customers to play a more significant role in the process.

3 The RIIO approach in energy regulation

3.1 The need for change

This section seeks to explain why Ofgem considered that the previous RPI-X approach had run its course, and why it chose the new approach called RIIO. This will be useful in considering how to approach customer engagement in the Victoria water sector, for two reasons. First, it explains how customer engagement was embedded in a larger programme of reform, which influenced both the design and implementation of customer engagement. Second, the approach that Ofwat took in determining water prices was similar in several ways to the approach that Ofgem took – in contrast to the approach that WICS took to determining water prices in Scotland, which relied heavily on customer engagement but for the most part stuck with the RPI-X approach and did not embody the RIIO ideas.

Ofgem’s RPI@20 project was launched in March 2008. After an intensive review, with much interaction with stakeholders, it culminated in October 2010.²² The following brief summary will rely heavily on a lecture given the next month by Steve Smith, Senior Partner at Ofgem responsible for the RPI-X@20 Review and in charge of network regulation at Ofgem from 2008 to 2010.²³

The RPI-X approach had been successful, delivering nearly 30% reductions in network revenues, improved reliability and customer service, and substantial new investment in capacity. But it had weaknesses.

First was the time and effort involved in a review process. (Steve Smith said “close to two years”, but perhaps about double that taking into account the time to implement and assess one review and prepare for the next.) This seemed disproportionate when

²² Regulating energy networks for the future: RPI-X@20 decision document, Ofgem, 4 Oct 2010.

²³ “RPI-X@20”, Beesley Lecture, London, 4 Nov 2010. A slightly later account is by Dr Cloda Jenkins, sometime head of the same Review team, “RIIO Economics: Examining the economics underlying Ofgem’s new regulatory framework”, Florence School of Regulation Working paper, June 2011.

many efficiency gains had been captured and several network companies were demonstrating excellent operating performance. Yet all companies had to go through the same long price control process. This diverted senior management attention from running the company and did not provide sensible incentives for companies to put in realistic business plans. It also meant that companies focused on Ofgem and paid limited attention to their customers.

The second weakness related to innovation. There was significant innovation in operating efficiency and in company balance sheets, lowering the cost of capital. But not much innovation in network operation and design, and in the way network capacity was sold and priced. These aspects would become more important in future, with the need to design and operate low carbon networks. Many different scenarios could be envisaged, ranging from big networks to smaller, more local and more flexible networks.

3.2 RIIO

Ofgem's aim was that energy networks would play a full role in the delivery of a sustainable energy sector.

To achieve this, network companies will need to focus on long term value for money, they will need to be more innovative, seek to identify options and be flexible (to deal with uncertainty), work with suppliers, producers and customers to identify the best delivery solutions and understand and respond to the needs of their customers. (p 15)

The chosen approach was called RIIO, standing for Revenue, Incentives, Innovation and Outputs.

Revenue would reflect the RPI-X approach, with an allowance based on current building blocks including Regulatory Asset Value (RAV). But the length of control would increase from 5 to 8 years with a mid-period review.

Incentives would continue to incorporate the existing RPI-X incentives for outperformance. But there would be a new emphasis on making sure that these

incentives represent good value for customers. The challenge would be to calibrate the incentives correctly.

Outputs would reflect what networks were required to deliver in return for the right to collect revenue. These outputs would be informed by enhanced engagement with customers using the network. The challenge would be to produce a credible set of outputs. I return shortly to the role of customers here.

The next proposal was fast-tracking.

a company with a good track record on efficiency, service and delivery that submits a well-evidence business plan with a clear set of outputs and demonstrate good engagement and ongoing efficiency and deliver could be “fast tracked”. Fast track might mean concluding the control in 6 months rather than the current 18 months. That creates a carrot by rewarding good management and good behaviour by giving talented management an extra 12 months to focus on the business and customers and not the regulator relative to their peers. And it provides a stick by making the process more onerous for companies with poor track records and poor business plans. (p 20)

Another new proposal was a greater role for third parties in the delivery of new capacity on the networks, if it seemed that they could deliver new capacity faster or more cheaply than the incumbent. (This was recently illustrated in the latest transmission price control review, when Ofgem proposed to put out to tender all projects with a value of over £100m.)

Another element was innovation funding.

Here we are proposing a time-limited, ex ante fund that will be designed to encourage and reward innovation in the way networks are designed and operated and they way network capacity is priced and sold. This will build on the £500m Low Carbon Network Fund introduced for the electricity network companies but will cover all of the networks and will be open to all parties – not just the network companies. ... This fund will invite bids annually and award funding based on published criteria with a Panel of experts – comprising

economists, engineers, customer representatives and commercial expertise – making recommendations to Ofgem on who to fund. It is designed to replicate the incentives that companies operating in competitive markets have – through the patent system and the rewards that being first to market brings – for companies that are regulated. (p 21)

The final element was financeability, where Ofgem sought to provide more clarity and predictability on how it would assess the situation. It would continue to set allowed returns on a WACC approach, but it would also use Return on Regulated Equity (RORE) to calibrate returns and incentives. That is, all the various incentives would be calibrated on a common basis, both to inform debate about risk and return, and also to take some of the pressure off the cost of capital parameter.

3.3 Customer engagement

Customer engagement had an explicit role, but admittedly it was a limited one.

“Enhanced engagement will require companies to engage more effectively with their customers and a wider range of interested parties. But GEMA will remain the decision maker. Ofgem have rejected the model advocated by some of constructive engagement and the more radical variant of allowing customers and the company to propose a deal and the regulator only stepping in if they can’t. This is born of one concern and one practical reality. The concern is how you ensure that all customers are represented effectively. Business customers – especially large business customers – have well organised and resourced associations who could participate on their behalf. Smaller business customers and domestic customers do not. So how do you ensure that in any process these customers’ interests are properly represented? ...The practical concern is that we asked the various customer representatives covering both domestic and industrial whether they would want this sort of process and they told us no. (pp 17-18)

However, third parties including customer groups now had an enhanced opportunity to request a price control reference to the Competition Commission (now the Competition and Markets Authority or CMA). This could encourage networks to engage more thoroughly with their customers.

Ofgem indicated in a little more detail the approach to stakeholder engagement that Ofgem itself intended to take, and that it expected the network companies to take. See for example Table 1 from the RIIO Handbook.²⁴ Ofgem evidently left considerable discretion with the network companies, and with itself.

Table 1: Overview of the key elements of network company engagement

What issues might network companies need to engage in?

- ♣ the early development of their business plans at Stage 1;
- ♣ business plans at Stage 2;
- ♣ revised business plans at Stage 3;
- ♣ engagement should cover all aspects of the business plan; and
- ♣ potential areas of engagement include, but are not limited to:
 - electricity transmission: the volume of generation likely to connect to a network now and in the future;
 - electricity distribution: the level of reliability customers expect and their willingness to pay;
 - gas transmission: expected changes in required capacity now and in the future; and
 - gas distribution: potential rate of biogas deployment.

How might network companies engage with stakeholders?

- ♣ we will not prescribe how companies should engage;
- ♣ network companies should take decisions about how best to understand and respond to the needs of their customers; and

²⁴ *Handbook for implementing the RIIO model*, Ofgem, 4 October 2010, Table 1 p 16.

♣ network companies may wish to explore a range of techniques, providing accessible information to facilitate this, including public versions of their proposed business plans.

How will we assess network company engagement?

♣ credibility of engagement: we will consider the range of stakeholders whose views had been sought, the information provided to stakeholders and the form engagement took; and

♣ impact of engagement: network companies should clearly set out how they had used the views expressed through engagement. Where they had not made use of stakeholder views, they will need to provide robust reasons for this.

What incentives are there for network companies to engage effectively?

♣ if they engage effectively they may face less scrutiny under proportionate treatment;

♣ the primary output related to customer satisfaction relates to the experiences of a range of users of network services providing incentives to deliver a service and level/quality of engagement aligned with their expectations;

♣ we could enhance reputational incentives, publishing best performance examples of network company engagement; and

♣ if there was evidence of insufficient engagement, we could seek to place a licence obligation on the companies requiring that they demonstrate thorough and ongoing engagement – enforcement action could then be taken for breaching the condition.

3.4 The meaning of success

How would success of the new framework be measured?

- First, if successful companies achieved fast-track status, with that becoming the norm over time.
- “The second would be a form of constructive engagement where companies engage seriously with their customers and other interested parties and do not focus exclusively on Ofgem as the regulator. And who knows, this might even

lead to more realistic discussion on cost of capital and make this a less contentious part of the settlement.” (p 24)

- Third, more innovation in the way networks are designed and operated, and the commercial arrangements for buying capacity (and recognising that innovation means that some significant failures would have to be accepted).
- Finally, “a much faster closing of the gap between the best and worst performing companies in each sector because the incentives will be sharper)” (p 24)

If all this happened, the main beneficiaries would be customers, with more responsive networks offering excellent service and managing the costs and uncertainties of tackling climate change. “But the companies and their shareholders also stand to gain - by being able to earn the suitable rewards for delivering on their outputs and higher rewards for delivering higher efficiency, innovation and improved customer service.” (p 25)

3.5 RIIO in practice: transmission and gas distribution

The RIIO approach was first implemented in the Transmission Price Control Review (RIIO-T1). In October 2011 Ofgem decided that none of the four company business plans was suitable for fast-tracking at that time, but that two of the four companies could resolve the outstanding issues within the timescale of the review and the other two could not. Having received revised business plans, Ofgem in January 2012 fast-tracked the two companies. In both cases Ofgem welcomed the improved customer engagement but expected more.²⁵ But it would seem that customer engagement played a relatively small part in the overall decision.

To encourage transmission operators (TOs) to be more responsive to changing stakeholder needs, Ofgem put in place a stakeholder engagement scheme, which as yet is in its early stages. The scheme provides an annual reward of up to 0.5% of annual

²⁵ “While both companies have made considerable strides forward over the last year, there is inevitably more that they could do.” *RIIO-T1: Decision on fast-tracking for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd*, Ofgem 23 Jan 2012, p 5.

allowed revenues per TO. The allocation of this reward is based on an assessment of TO activities by a panel of independent experts, which is chaired by Ofgem.²⁶

The RIIO approach was next used in the Gas Distribution Price Control Review, where there were eight gas distribution networks owned by four different companies. The Final Proposals in December 2012 discuss the various RIIO categories and concepts, but there is virtually no reference to customer engagement.²⁷

3.6 RIIO in practice: electricity distribution

The third and most recent use of the RIIO approach was in the Electricity Distribution Price Control Review. There are 14 electricity distribution network operators (DNOs), owned by four different companies. In February 2014 Ofgem decided to fast-track the four networks owned by Western Power Distribution (WPD), and not to fast-track the other ten networks owned by three other operators.²⁸ In explaining its decision, Ofgem said that “WPD’s stakeholder engagement has clearly informed its business plan. It plans to build on its strong post performance, especially in customer service and reliability. In terms of customer interruptions, it sets itself more challenging, and binding, targets than those we specified. It also has a comprehensive strategy for how it can help address the needs of vulnerable customers.” (p 3)

Again, customer engagement does not seem to have been the critical factor in identifying the network to fast-track. It is not clear that the other network operators had worse records in this respect. They did not argue that Ofgem had not appreciated their customer engagement processes.²⁹ It seems that Ofgem’s main reason for not fast-

²⁶ *Report on the RIIO-T1 Stakeholder Engagement Scheme 2013-14 – Transmission Operators*, Ofgem, 10 December 2014. The first year was on a trial basis with no financial reward. The panel concluded that all four TOs passed the minimum requirements whereas in the previous year only one had done so.

²⁷ *RIIO-GD1: Final proposals – Overview*, Ofgem Reference 168/12, 17 December 2012.

²⁸ *Decision to fast-track Western Power Distribution*, Ofgem, 28 February 2014.

²⁹ “In their responses, slow-tracked DNOs expressed their disappointment at not being fast-tracked. Several highlight concerns over parts of our assessment. Most of the issues raised are disagreements over our cost assessment approach.” (p 2)

tracking other companies was their insufficiently challenging assumptions about future cost reductions (and hence price reductions to customers).

This became clear when Ofgem issued draft determinations for the other five network operators in November 2014, embodying significant further cost reductions.³⁰

Our decision results in a reduction in allowed revenues of around 4.7% on average over the RIIO-ED1 period relative to the current price control DPCR5). ...Following RIIO weighting (interpolation) of company and Ofgem forecasts, we have reduced companies' allowed total expenditure by £1.3bn over RIIO-ED1 from their forecasts....In our comparative assessment we judge DNOs could reduce their forecast expenditures by more than £700m. We have also updated our forecast of the movement in DNO costs relative to the RPI measure of inflation. This gives a figure £728m lower than forecasts in the DNOs' plans...Finally, we don't believe that the DNOs have sufficiently considered the potential savings they can make to the cost of running their networks by adopting smart grid solutions. It is important that customers receive adequate returns on their investment in innovation trials and the roll-out of smart meters. We have reviewed the new evidence provided following draft determinations. The DNOs have included over £476m smart and innovative solutions in their plans. We think they can save a further £322m. (pp 4-5)

³⁰ RIIO-ED1 Final determinations for the slow-track electricity distribution companies, Overview, Ofgem, 28 November 2014.

4 Customer engagement in water

4.1 Background

The water sector in England and Wales currently comprises 32 private companies. 10 regional companies provide both water and wastewater [sewerage] services. 8 regional companies provide water services only. These 18 companies have regional monopolies fixed at privatisation. (There are also 5 local companies providing either water or sewerage or both, and 8 water supply licensees offer water services to large use customers.)

Ofwat sets price controls for the 18 regional water and wastewater companies, for five years at a time. Previous reviews were completed in 1994, 1999, 2004 and 2009. In the last of these, setting price limits for 2010-2015, Ofwat “adopted broadly the same approach as in previous price reviews. However, this time there was greater focus on setting price limits within the context of the long-term future of the water and sewerage sectors”.³¹

In November 2009, immediately after setting these prices, Ofwat “started a wide-ranging and in-depth review of our regulation to see if it was fit for purpose”. In doing so, Ofwat needed to take into consideration at least four other reports into aspects of the water sector (the Pitt, Cave, Walker and Gray reviews).

4.2 Ofwat’s planned customer engagement

In August 2011 Ofwat published its statement on customer engagement.³² Its key messages were as follows.

³¹ Price review 2009, www.ofwat.gov.uk

³² *Involving customers in price setting – Ofwat’s customer engagement policy statement*. Ofwat, 19 August 2011, p 2

Ofwat customer engagement policy: Key messages

- *Water customers are at the heart of the price-setting process – they need to know that the bills they pay are fair and legitimate.*
- *We expect the companies to take responsibility for engaging more with their customers. We will not prescribe how they do this, but will provide high-level guidance and expect the companies to use good practice.*
- *We understand that the issues that shape the companies' business plans are varied – customers' views can inform and influence some of these more directly than others.*
- *We wish to see a three-tiered approach that will enable customers to engage with and influence all parts of their companies' business plans.*
 - o *Through direct engagement with their water company on issues including local services and tariffs*
 - o *Through challenging the shape of the overall plan and the way the companies meet their legal obligations (for example on drinking water quality and the environment)*
 - o *Through influencing and informing our decisions.*
- *We want our approach to engagement to provide*
 - o *greater customer focus,*
 - o *more incentives on the companies to innovate and*
 - o *more efficient use of water resources.*
- *Customer engagement will be an important factor in determining whether we will accept the companies' business plans. How much evidence of customer support we need, and how detailed our scrutiny of plans is, will be proportionate to the scale of changes to bills and services that an individual company is seeking. Customer acceptability is a key factor in our decisions.*

In April 2012 Ofwat published further guidance on customer engagement.³³ It explained the responsibilities of each company's Customer Challenge Group (CCG). It also noted explicitly that the CCGs were not responsible for agreeing the company's business plan or prices, nor for seeking a negotiated settlement. Ofwat would take the final decisions on business plans and price limits.

³³ Involving customers in price setting – Ofwat's customer engagement policy: further information, IN 12/05, April 2012

Who does what

Each company is responsible for:

- *direct engagement with its customers, with challenge provided by the CCG;*
- *effective working of its CCG, including membership, providing accurate and accessible information and a timely work programme; and*
- *submitting a well-evidenced business plan to us.*

Each CCG is responsible for:

- *testing that the company has adequately understood and addressed its customers' priorities and needs;*
- *challenging whether the plan will deliver the right outcomes and levels of service at a price customers are willing to pay;*
- *assuring us on how well the company has engaged with its customers and highlighting any concerns; and*
- *reviewing how well the company delivers its plan and challenging its response to any service failure.*

The CCG does not agree the company's business plan or prices on behalf of customers.

We [Ofwat] are responsible for:

- *providing information on our regulatory assumptions, the price review methodology and sector-wide information; and*
- *making decisions on each company's business plan and price limits.*

Direct engagement

Each company must engage directly with its customers to understand their views, not just through customer representatives. We have not prescribed how the companies should do this. Instead we have left it to each company to find an approach that works best for it and its customers.

We expect that each company will use a wide range of information from its customers (for example from any complaints they make) and where necessary carry out any robust

new customer research needed to understand its customers' priorities for services and views on bills. This will help it shape its plans to reflect the needs of current and future customers. We will look for evidence that each company's business plan reflects its customers' views when we make our decisions on price limits.

Customer challenge groups

We have not prescribed how these groups are set up or run. Each company is able to decide the membership, timings and work programme to best reflect local circumstances and priorities. We have asked that the group's chairman be independent of the company. Each group will:

- review the company's engagement process and emerging evidence;*
- confirm the outcomes that the company will deliver for customers and challenge the phasing, scope and scale of work required to deliver them, together with the balance of risk incorporated into the company's plan; and*
- advise us on the effectiveness of the company's engagement and the resulting acceptability to customers of its business plan and bill impacts.*

This does not mean reaching a negotiated settlement (where the company and customer representatives agree on the price, cost and service package). Instead the CCG is responsible for challenging the business plan if it does not think the company has properly sought or reflected its customers' views.

We will hold each company to account for understanding and responding to its customers' views in its business plans. Our scrutiny of plans will be informed by the CCG's assurance on how well the company has done this.

4.3 Other Ofwat price control modifications, notably totex

Shortly afterwards, in May 2012, Ofwat provided a statement of principles for the next price control review.³⁴ There was a need to plan for the long term, to be flexible enough to innovate, to find new ways of meeting customers' needs and to manage a more changeable environment. Customer legitimacy was crucial. And regulation needed to change. The main proposed changes were more targeted price controls, focused incentives and reduced regulation where unnecessary; a risk-based approach to compliance to focus and reduce regulation; more effective incentives; giving companies ownership of and accountability for delivery of what customers want and need; flexibility and responsiveness of regulation; and transparency and predictability.

Ofwat also decided to move to a totex approach, which it explained as follows (para 6.2.1).

While we were reviewing our price setting tools, many stakeholders told us that the way we treat capex and opex separately has become complex and burdensome. We have also heard that our approach may create perverse incentives, ranging from a bias towards capex to a rigid, technical and inflexible approach from companies that are driven by the detailed mechanisms we use. Others have perceived that our overall approach may encourage 'gaming' or 'padding' of business plans by companies that may consider it in their interest to inflate costs in their original submission.

So, we have consulted on – and propose to change – our approach. Within our wholesale control, we intend to move to an approach that:

- treats capex and opex together (a totex approach), to equalise the incentives between the two; and*
- uses a menu approach similar to that used for capex in the last price review (the CIS).*

This would allow companies more choice in the level of risk they want to take and the accompanying potential for outperformance. It would also create a better incentive for

³⁴ *Future Price Limits – statement of principles, Ofwat, 14 May 2012*

companies to reveal true investment needs in their business plans, thus reducing the incentive to game the process.

4.4 Ofwat's 2015-2010 price control review: fast-tracking

Ofwat's price control review timetable provided for the 18 companies to prepare business plans subject to challenge from their CCGs during the period August to November 2013. In December the companies submitted their business plans to Ofwat. In March 2014 Ofwat announced the results of its initial examination.

All water and wastewater companies in England and Wales have worked hard to engage with their customers and to take ownership of their plans. While the business plans of other companies demonstrated areas of strength, against our necessarily high bar, only South West Water and Affinity Water have pre-qualified for enhanced status – we are confident their plans will deliver the best possible outcome for customers.³⁵

Ofwat was particularly complimentary about customer engagement.

All water and wastewater companies have worked hard to take ownership of their plans. We have seen a real change in approach, which will benefit customers. It is clear that companies have engaged actively with customers, and have sought to reflect that engagement in formulating customer-focused plans. The customer challenge groups (CCGs) have made a significant and important contribution to this step change.(p 3)

Ofwat's explanation of why it fast-tracked South West Water indicates that customer engagement played an important part, but was by no means the only or main consideration.

South West Water's business plan met our expectations of a high-quality plan across the plan.

³⁵ *Setting price controls for 2015-20 – pre-qualification decisions, Ofwat, March 2014, p 1*

One of the reasons South West's plan stood out from most other companies was the strong focus on engagement and balancing the need to keep customers' bills affordable while also investing in the environment and service improvements.

South West Water demonstrated in its business plan how successive rounds of engagement fed into further engagement and its plan. After finding that less than two-thirds of its customers found its initial proposals acceptable, the company reduced its proposed average bill at the end of the period by £31. It did this by scaling back investment in areas such as the duplication of strategic water mains, sewer separation and smart metering and challenging itself further on efficiency. The company also has a comprehensive range of schemes in place to support customers who would still find its proposals difficult to afford, including a social tariff it put in place in 2013-14.

The focus on affordability and efficiency, through the use of new technology, partnership working and innovative approaches, is also evident in other areas of the company's plan.

South West Water is also proposing to deliver its proposed improvements to its retail service at no additional cost to its customers and absorb cost increases through efficiency savings.

Finally, the company's plan also stood out because of a desire to build legitimacy with its customers. The company partly demonstrated this through its engagement with customers, but also through its approach to measuring and sharing performance over 2015-20.

South West Water's business plan contains a Board pledge to share the benefits of success fairly between customers and investors. In line with this it is proposing an independently monitored and transparent performance sharing framework called 'WaterShare'. This framework would involve the company publishing a scorecard on an

*annual basis that summarises its performance and would allow for the sharing of net gains with customers in a timely manner.*³⁶

4.5 The other companies

Two companies (Northumbrian Water and Dŵr Cymru) opted to quickly revise their business plans in the light of Ofwat's initial decision. They received a draft determination in April 2014. Again Ofwat praised the role of the CCGs, but again made modifications.

Both companies have submitted plans that deliver the outcomes that their customers want and can afford. This has occurred because of a combination of greater Board involvement, the challenge provided by the customer challenge groups (CCGs) and targeted regulatory incentives. For these reasons, and because the development of the plans has been led by companies' individual Boards, we are also seeing more divergence about what the companies will deliver for customers than in the past.

The risk-based review has been instrumental in improving the quality of business plans by shining a light on aspects of the December 2013 plans that required further development. Similarly, there are also important changes in the revised plans – most notably around the weighted average cost of capital – as the companies have sought to take into account our risk and reward guidance.

While there have been a number of positive changes to the business plans, in a small number of instances we have had to intervene to protect customers. The targeted and proportionate interventions for Northumbrian Water and Dŵr Cymru are designed to ensure that companies are only rewarded for delivering for their customers. We expect

³⁶ Prequalification decisions – conference call 10 March 2014, Speech by Sonia Brown, Ofwat, pp 2-3

that the two companies could address our concerns in some areas and as such the final position for their customers will not be known until the final determinations.³⁷

The remaining 14 companies took a little longer to revise their business plans. Ofwat issued draft determinations for them in August 2014. Again Ofwat paid tribute to the customer engagement process. It also noted that the main differences between the determinations and these business plans related to assumptions about costs.

Even after our interventions, for a number of companies our draft determinations are largely unchanged from their business plan proposals. Overall, we are allowing 96% of the revenues set out in company business plans. This reflects the work that companies have done in engaging with customers, working with their CCGs, and challenging themselves before the submission of their plans to us.

Although there are a number of factors that drive differences in revenue allowance, our interventions on wholesale water and wastewater costs are a key driver of the difference between draft determination revenue and company plans. Around 80% of the value of interventions relate to wholesale costs.³⁸

Ofwat issued final determinations for the remaining companies in December 2014.

³⁷ *Setting price controls for 2015-20 – draft price control determination notice, Ofwat May 2014, p 1*

³⁸ *Setting price controls for 2015-20 – draft price control determination notice, Ofwat, August 2014, p 6*

5 Assessing the Ofgem and Ofwat reviews and customer engagement

5.1 The new price control approaches and some challenges

Neither Ofgem nor Ofwat has yet issued any formal assessment of the recent price control reviews in the energy network and water sectors. Indeed, it would be premature to do so since both sets of regulatory determinations are presently under appeal by two companies and a major customer. We have yet to see what the Competition and Markets Authority (CMA) thinks of the way the regulators handled the new price setting processes.

My general impression, from comments of participants and observers in companies and regulatory bodies, is that on the whole both review processes were considered to be aiming in the right direction and to be broadly successful. As ever, both reviews were very demanding in terms of time, information and intellectual argument – despite regulatory intentions to reduce regulatory burden. Almost all companies accepted the regulatory determinations, and the regulators too appear satisfied with the results.

Ofgem said that *“The potential to be fast-tracked inspired all DNOs to raise their game. Their plans contained expenditures more than £2bn lower than DNOs’ previous forecasts.”*³⁹ Reportedly, there have been significant changes for the better in company behaviour. In addition, the focus on totex instead of opex and capex separately led to new ways of looking at and comparing alternatives. There was more innovation and more cost-efficient outcomes are believed to have been identified.

At the same time, there were some concerns about the complexity of the processes, the statistical and econometric techniques used, and the calibration methods. There was some doubt whether the regulatory comparisons were accurate, and some challenge to particular regulatory calculations. Once the more detailed slow-track examinations took

³⁹ *Decision to fast-track WPD* p 2.

place, some questioned whether the companies chosen to be fast-tracked were indeed ahead of the others. Since the terms promised to the fast-tracked companies would in fact be paid for by their customers, who would face higher prices than they otherwise might have done, some questioned whether the outcomes were entirely in the interests of customers.

These issues emerge in the ongoing appeals to the CMA. Northern Power Grid has appealed against Ofgem's determination.⁴⁰ Interestingly, *"The Appellants welcome the shift from RPI-X to RIIO and believe that [Ofgem's] principles of proportionate assessment ... form a sound and improved basis for regulation."* However, *"the appeal concerns several important errors which GEMA made in operating this price control."* These errors related to the calculation of smart grid benefits which impacted on the efficiency savings assumed to be available, the calculation of the real price effects (network cost movements relative to RPI), and regional labour cost adjustments. These errors mean that Northern Power Grid's proposed revenue is too low.

British Gas has also appealed against Ofgem's slow-track determinations, from the opposite perspective. Again, British Gas comments that "BGT fully supports the principles underlying the RIIO framework; and broadly agrees with the strategic proposals for implementing the framework to the electricity distributors". (para 1.11)⁴¹ However, it argues that Ofgem has made a series of errors such that "the Price Controls are likely to earn even relatively poorly performing DNOs returns well in excess of their cost of capital". These errors relate to an inappropriate mechanism to return double-recovered revenues from the previous price control period, inappropriate incentive targets, an unwarranted ex post change to information quality incentives, unwarranted transitional arrangements for the change in asset life policy, an unwarranted change in the cost of debt indexation, and certain procedural defects (insufficient explanation of Ofgem's reasoning).

⁴⁰ Energy price control appeal: Northern Powergrid, Notice of appeal, filed on CMA website 2 March 2015

⁴¹ Energy price control appeal: British Gas trading, Notice of Appeal, filed on CMA website 2 March 2015

Third, Bristol Water challenges Ofwat's calculation of its reasonable costs and questions the robustness of Ofwat's models.⁴² It argues the case for proceeding with a reservoir investment that Ofwat did not accept. It says that Ofwat has underestimated its cost of capital, and inappropriately penalised it with respect to certain services.

5.2 The customer engagement process and possible modifications

From the present perspective, the main question is how well the customer engagement processes worked. The answer seems to be that the focus on outputs or outcomes and on customer engagement worked very well in both sectors. The participants - companies and customer representatives - were very keen, they devoted considerable time and effort to this aspect, and they worked together well. Company business plans were more responsive to customer needs.

However, customer engagement did not seem to be at the centre of either price control review process. It seems to have been very helpful and welcome in both cases, but it does not seem to have been critical in determining which companies were fast-tracked, or in setting prices.

There will no doubt be further consideration of the fast-tracking approach, its relationship to customer engagement, and the future extent of customer engagement. On the one hand, the incentive to be fast-tracked must have encouraged companies to engage more constructively with their customer groups. But over the longer term some more difficult questions arise. Put simply, if only one company out of six is fast-tracked (albeit representing 4 networks out of 14), will that dissuade companies from seeking a fast-track position in future? If customer representatives engage enthusiastically with companies, and give their support to a business plan that is drawn up and modified to reflect their preferences, and then the regulator rejects most of those business plans,

⁴² Bristol Water plc price determination, Bristol Water response to Ofwat's reply to its statement of case, filed on CMA website 16 April 2015

will the customer representatives be inclined to engage another time? Will they see any point in it?

In mitigation, it might be said that, in assessing companies' revised plans, the regulators reportedly sought to preserve the approach and projects supported by customers, so their effort was not wasted. And customers were presumably better off as a result of the modifications required by the regulators. For example, Ofgem said "We set a high hurdle for fast-tracking, which only WPD cleared. The other DNOs' plans showed areas of strength, but all had scope for improvement.... We expect the revised plans to show improved value for customers." (p 2)

The customer engagement element of the price control review seems to have been a success and it would be unfortunate to lose it. It would therefore seem worth giving thought to the relationship between the process for assessing the companies' assumptions about future costs and efficiency, and the process whereby customers and companies engage on outputs and customer preferences. Some thoughts on this follow the description of customer engagement in the Scottish water sector.

6 Scottish water ⁴³

6.1 Creation of the Customer Forum

As in other sectors, the parties in the Scottish water sector were interested in an alternative approach to setting prices because they were conscious of the cost and confrontational nature of the traditional price control process, and the limited representation therein of the views of customers. In September 2011 the main parties involved – the Water Industry Commission for Scotland (WICS), Scottish Water and Customer Focus Scotland (CFS, part of the National Customer Council) – formally signed a Cooperation Agreement that created a Customer Forum. The chairman was to be jointly nominated by the parties, CFS was to nominate “5 persons with a strong customer-focused reputation” and WICS would seek nominations for two members from the largest water retailers and one from the Scottish Council of Development and Industry. The Customer Forum’s remit was to work with Scottish Water on a programme of research to ascertain the views of customers, to represent those views in the course of the price control process, and to seek to secure the most appropriate outcome for customers.

A year later, when the Scottish Government initiated the Strategic Review of Charges, WICS asked the Customer Forum to seek to agree a Business Plan for delivery by Scottish Water in 2015-2020 (subsequently extended to 2021). WICS specified that “*Such a Business Plan should be fully consistent with Ministerial Objectives and with the views and ranges that the Commission will set out in notes and papers over the period to early 2014, unless there are demonstrable reasons for going outside those ranges to the benefit of customers.*”⁴⁴

⁴³ The material in this section is taken from S C Littlechild “RPI-X, competition as a rivalrous discovery process, and customer engagement”, *Utilities Policy*, Vol 31, Dec 2014, 152-161. A more detailed study of the Customer Forum is Stephen Littlechild, “The Customer Forum: customer engagement in the Scottish water sector”, *Utilities Policy*, Vol 31, Dec 2014, pp 206-218.

⁴⁴ Letter from Alan Sutherland, Chief Executive of WICS, to Peter Peacock, Chair of Customer Forum 15 October 2012, reproduced in *Draft Determination*, Appendix 3.

As in England and Wales, the commitment and enthusiasm of all the parties for the customer engagement process was quite remarkable. The Customer Forum gelled and operated very effectively. Scottish Water responded. The parties did reach agreement on a Business Plan, and on 20 March 2014 the regulator WICS formally proposed a price control consistent with it.⁴⁵ Further detail of this story has been given elsewhere.⁴⁶ Nevertheless, certain observations may be helpful here, with respect to regulatory inputs into the process and what was achieved.

6.2 Regulatory guidance

In order to facilitate and guide the customer engagement and negotiation process, and to assist in discharging its own statutory responsibilities with respect to setting a price control, WICS issued a series of Commission Notes indicating what it would be minded to find feasible and acceptable. These did not determine the final outcome but they did indicate the space within which negotiation could fruitfully take place. Since they were aimed at the Customer Forum rather than regulatory specialists within the company, the Notes were couched in more approachable and less technical language than conventional price control statements.

WICS provided preliminary views in autumn 2012 and further comments on Scottish Water's Business Plan in winter 2013/4. For example,

Scottish Water completed its business plan and the Commission commented on this in detail. The Commission determined the ranges it expected the Customer Forum to keep within when reaching agreement on service improvements with Scottish Water. These decisions included: the appropriate levels of operating costs; inflation rates for costs; the financial parameters used in the tramlines; the size of the capital programme; the level of capital maintenance; assumptions on growth; and maintaining a benchmark with the OPA. (*WICS Draft Determination* p 11)

⁴⁵ The Strategic Review of Charges 2015-21, Draft Determination, WICS, 20 March 2014.

⁴⁶ Stephen Littlechild, "The Customer Forum: customer engagement in the Scottish water sector", *Utilities Policy*, Vol 31, Dec 2014, pp 206-218

It is often asked whether there is asymmetry of knowledge and bargaining power under customer engagement arrangements. These regulatory Notes went a long way to alleviating that. For example, the Forum was able to rely on WICS advice as to acceptable levels of future efficiency improvement.

The "tramlines" referred to here were established by WICS with respect to Scottish Water's financial performance during the forthcoming price control period.⁴⁷ If Scottish Water's performance runs - or looks likely to run - outside these tramlines, the parties will discuss how it should be brought back on course. For example, if the company appears likely to make excessive profits, there will be a discussion as to how those profits might be used - to reduce borrowing, to increase investment or quality of supply, to reduce prices, etc. Similarly, if performance is below a specified level, there will be discussion of options such as an increase in government funding, a reduction in the capital investment programme, an increase in customer charges, etc.

Formally, it is for Scottish Government to take many of these decisions. However, it was hoped that the tramlines, with their potential sharing arrangement, would provide assurance to all parties including Scottish Government. They could also reduce any concerns about possible downside risks of agreeing a Business Plan that could form the basis for a price control.

6.3 Outcomes of the Customer Forum process

The Customer Forum process, with the active cooperation of Scottish Water, has led to a more thorough investigation and understanding of customer preferences, certainly more than would otherwise have taken place as part of a conventional price control review.

⁴⁷ They were described as "An innovative approach that allows all stakeholders to have confidence that Scottish Water's financial performance is consistent with its price determination and that the industry is in a financially sustainable position for the longer term." *Draft Determination* fn 4, p 10. The financial tramlines are expressed in terms of three cash-based financial ratios: cash interest cover, funds flow and gearing.

The process has changed Scottish Water's approach in a number of significant respects. For example, the company has been forced to think through more thoroughly what investments and improvements it is proposing and why. This in turn has influenced the kinds of projects it has focused on – with greater emphasis on avoiding sewer flooding, for example. Scottish Water, like the regulator WICS, has become aware of the need to explain its thinking in a simpler, less technical and clearer way so that customers can better understand the significance for them. This applies particularly to its Business Plan. The company has become more sensitive to the needs of customers in the context of present difficult economic circumstances. As a result it has become more open to a price control settlement involving a lower rate of price increase than it might otherwise have considered appropriate.

Several participants have suggested that the negotiated outcome was better than could have been achieved via a conventional price control process: more open discussion could take place without the regulator, and the outcome was not limited to what the regulator could prove was reasonable in the face of company resistance. Importantly, too, Scottish Water believed that earlier and mutual agreement would allow the company to plan and operate more efficiently than would otherwise have been the case. In the view of the participants, such factors have enabled a better deal for customers in terms of both price and quality of service.

The negotiations led to – or at least facilitated – some innovative variants on the traditional price control. The Customer Forum argued that a price control related to CPI was more relevant to customers than one related to RPI. It also argued that customers needed some reassurance on actual prices for the first three years rather than a commitment relative to an inflation index. The parties agreed that it would make more sense to fold into the agreement the final year of the present price control rather than have a price increase followed by a decrease. This followed policy and experience south of the border.⁴⁸

⁴⁸ On 31 October 2013 the Ofwat chairman wrote to water companies noting the social and political concerns about water prices, urging that business plans embody price reductions over 2015-19, and pointing out that it was for companies to choose whether to implement price

The agreement negotiated between the Customer Forum and Scottish Water reflected these considerations.

Taking into account Scottish Water's decision to limit the increase in household prices in 2014-15 to 1.6%, the Customer Forum and Scottish Water agreed that Scottish Water's revised business plan would assume nominal price increases for household customers of 1.6% per year for 2015-18; an overall cap on household charges of CPI-1.75% for the regulatory period 2015-21; and increases in wholesale charges of CPI-0.3% per year for 2015-21.⁴⁹

The WICS *Draft Determination* in effect accepted and implemented this agreement.

Negotiated settlements in the US and Canada, which involve customers, are typically in money terms, often holding prices constant for a specified period, albeit typically shorter than a five or six year UK price control. Bringing the Customer Forum into the price control negotiation process thus seems to have had a very useful outcome for customers in terms of the form as well as the level of the control. One would hope that the involvement of retailers in other water and energy network price control processes would have a similar effect.

The form of the agreement between Scottish Water and the Customer Forum is interesting. It is not expressed as a typical price control document. Rather, it reads like a typical commercial contract. It does not spend time explaining and defending why particular options have been chosen. Instead, it focuses on saying what has been agreed, and precisely what each party is to do and when. It is intended to be operational from day one, to deliver what the parties have agreed, and to be capable of monitoring and enforcement. It also has a strong emphasis on agreed areas of future

increase entitlements in January 2014 for the final year of the present price control. Two water companies proposed to bring forward reductions in bills to smooth changes in bills over six years rather than five, and others indicated that they were not taking up their allowed increases in 2014/15. "Ofwat is aware that other companies are considering whether to take their full allowed increase in prices in 2014/15." Water companies submit business plans to Ofwat, PN 11/13, 2 December 2013.

⁴⁹ *Draft Determination* p 17.

action, characterised by commitments and statements of intent to work together. It thus provides for developing over time the relationship that has been established with the initial engagement process.

7 Learning lessons from experience of customer engagement

7.1 Is Scotland inherently different?

There is surely much to learn from the ongoing experience of all these reviews. Could experience in Scotland have implications for price control reviews in sectors with many companies, such as the energy and water sectors in England and Wales? And is it possible to design and implement a process where customer engagement is successful for all or most companies rather than for only one or two?

Admittedly the Scottish water sector has certain distinctive features. Scottish Water is the only wholesale water company in Scotland (though there is competition at the retail level for business users), it is government-owned, and Scotland is a relatively tight-knit community with a well-developed sense of community and shared values. These factors may well have been conducive to the success of the project.

However, I am minded to think they were helpful but not an essential prerequisite. The parallel experience with customer engagement in the England and Wales electricity and water sectors suggests that the enthusiasm of companies and customers to engage and negotiate successfully on business plans transcends market structure, ownership and cultural homogeneity.

7.2 Comparisons between the approaches of Ofgem and Ofwat, and WICS

There were numerous differences between the approaches of the three regulatory bodies, but consider the following five. First, in England and Wales the regulators invited companies to engage with customers, and indicated that they would take customer views of that engagement into account in assessing the case for fast-tracking a company. In Scotland the regulator went further: it asked the company and customers

to try to agree a business plan. Formally, the Scottish regulator reserved the right not to accept or to modify any such agreed business plan, but increasingly the expectation at working level was that an agreed business plan would form the basis of the price control, and parties participated with that expectation.

Second, in England and Wales the regulators left the choice of customer representatives and mode of operation largely to the companies. In Scotland the regulator was an active participant in the choice of those representatives and in specifying their terms of reference and working timetable.

Third, during the process in Scotland the regulator issued nearly two dozen guidance Notes, on cost of capital and efficiency improvements and on many other topics. These gave the parties a clear idea of the space within which they could negotiate fruitfully, with realistic prospect of acceptance of the agreement by the regulator. There was no comparable advance guidance in England and Wales. Indications of what the regulators there regarded as acceptable, particularly on cost of capital and efficiency improvement, did not emerge until near the end of the process or even after business plans had been submitted.

Fourth, the regulator in Scotland, in one of those Notes, initiated the concept of financial tramlines, which did not obtain in England and Wales. These facilitated successful negotiation in the sense that either party would be less concerned about conceding too much if any adverse consequences could be addressed later.

Fifth, throughout the process, the Scottish regulator played an active role in facilitating successful negotiation between the parties. Indeed, some of the guidance Notes addressed issues that had first arisen in the course of those negotiations.

The obvious question is: could and should the regulatory process in a sector with many companies more closely mirror the regulatory process adopted in Scotland? In most respects my feeling is that there would be advantage in giving serious consideration to this, while recognising that it may not be as feasible to give individual regulatory attention to, say, a dozen companies as it is to a single one. However, one feature of the process needs further thought, namely the method for assessing costs in a multi-company sector.

7.3 Assessing cost of capital and efficient operating costs

UK experience as a whole suggests that customer representatives do not at present have the experience, time and resources to make informed judgements on technical issues such as cost of capital and scope for future efficiency improvements. Nor do the regulatory bodies presently feel comfortable in delegating such judgements to customer representatives. In considering a practicable scheme, therefore, one must for the moment assume that the regulatory body will decide what is acceptable in terms of cost of capital and efficiency improvements for each company.

How should the regulator do that? How and when should it communicate its views to the participants?

As regards cost of capital, subject to one important qualification it would seem possible for the regulator to form and communicate a view on this to the companies and customer representatives. This cost of capital would presumably be the same for all companies, with possible slight modification for size or type of business. The qualification is that some companies that took on more aggressive commitments to reduce cost might thereby incur greater risk and justify a higher cost of capital, and analogously for those who made a lesser commitment to efficiency improvement. The challenge would thus be to indicate the regulator's thinking on the "norm" while at the same time leaving scope for company and customer representatives to discuss and agree something more tailored to their own circumstances and preferences (including as to the sharing of efficiency improvements).

As regards the scope for increasing efficiency, the Scottish water regulator took the view that Scottish Water was now among the more efficient companies, and the main requirement was essentially to maintain that position. The English regulators, on the other hand, are faced with a much broader range of operating efficiencies. They have traditionally seen comparative benchmarking – and requiring the laggard companies to match the performance of the leaders - as a critical element of the price control process. In the past, they have also gone further, and sought to prescribe or predict what the leaders might achieve in future.

This time, the regulators have used the lure of fast-tracking to try to persuade the leaders to reveal what they could achieve in future. In seeking fast-tracking, all companies have "bid" their business plans and it appears that the regulator has accepted only the most aggressive bid (in terms of operating costs) in each category. In fairness, competitive tendering works like that, and it might be argued that such a bidding process for fast-tracking enables the regulator to obtain the advantages of competition *for* the market.⁵⁰ Other companies can then be asked to match the performance offered by the winning bidder.

Whether this approach would work a second time is unclear. If a company does not submit the winning bid, its bid has no effect on the outcome. Any business plan it has agreed with its customers will be set aside because its assumed costs are not low enough. If it does submit the winning bid, its agreed business plan will presumably be the basis for the price control, but its efficiency target will be tougher, and its revenues lower, than they otherwise would have been. A company might well conclude that it would be better to wait for another company to make the running (though one cannot rule out the competitive spirit of chief executives wanting to be seen to be the best!).

7.4 Possible future directions

Are we then faced with two possible directions for the future? One possibility might be for the regulator to feed into the customer engagement process more detailed advice as to whether each company's efficiency assumptions would be acceptable to the regulator. This advice could be separate from – and perhaps in some respect run ahead of – the customer engagement process. One possibility for doing this might run along the lines of the Customer Forum process in Scotland. It has to be admitted, however, that that process is probably easier in the case of one regulated company than in the case of half a dozen companies, let alone 18 such companies.

⁵⁰ Harold Demsetz, "Why regulate utilities?" *Journal of Law and Economics*, 11, April 1968, 55-66.

The other possibility might be for the regulator to feed back comparative information about company efficiency proposals to the customer representatives, and then let them decide – or at least advise – whether their company should or should not be fast-tracked. Maybe even the customer representatives could be armed with greater consultancy advice on this issue. Here, of course, a question arises about the ability and enthusiasm of the customer representatives with respect to making and judging cost comparisons. To date, they have not wished to take this responsibility. However, arming them with comparative information might enable them to prod recalcitrant companies a little more effectively. No company likes to be seen as the least competent or most grudging. I have suggested elsewhere that one might even conceive of a competitive process in setting price controls.⁵¹

⁵¹ S C Littlechild “RPI-X, competition as a rivalrous discovery process, and customer engagement”, *Utilities Policy*, Vol 31, Dec 2014, 152-161

PART B: Customer engagement in Victoria

Stephen Littlechild & Bruce Mountain

1 Introduction

Part B considers customer engagement in the economic regulation of water companies in Victoria, drawing on the lessons and ideas in the previous section and prior consideration of related issues in Australia^{52,53,54,55}.

The first sub-section examines the relevant parts of the law (the Essential Services Commission Act and the Water Industry Act), regulatory orders (the Water Industry Regulatory Order) and ESC guidance (pursuant to the WIRO) in respect of the customer involvement in water regulation. The second subsection describes customer advocates' perspectives on how they have been involved in the economic regulation of

⁵² S C Littlechild, Australian airport regulation, Ofgem RPI-X@20 Web Forum, 29 November 2009.

[http://www.ofgem.gov.uk/Networks/rpix20/forum/for/Documents1/Australian%20airport%20regulation%2029%20Nov%2009%20\(2\).pdf](http://www.ofgem.gov.uk/Networks/rpix20/forum/for/Documents1/Australian%20airport%20regulation%2029%20Nov%2009%20(2).pdf) Stephen Littlechild and Stephen Bordignon, "The Hunter Valley Access Undertaking: elements of a negotiated settlement", *Transport Policy* 24, 2012, 179-187.

⁵³ S C Littlechild, Australian airport regulation, Ofgem RPI-X@20 Web Forum, 29 November 2009.

[http://www.ofgem.gov.uk/Networks/rpix20/forum/for/Documents1/Australian%20airport%20regulation%2029%20Nov%2009%20\(2\).pdf](http://www.ofgem.gov.uk/Networks/rpix20/forum/for/Documents1/Australian%20airport%20regulation%2029%20Nov%2009%20(2).pdf)

⁵⁴ S C Littlechild, Scope for customer involvement in transmission planning decisions in Australia, Annex (pp. 46-61, submitted 21 October 2006) to Planning and Governance Arrangements for the National Transmission Grid, Firecone Ventures Pty Ltd, Appendix to *Energy Reform: the way forward for Australia*, Energy Reform Implementation Group (ERIG), 2 May 2007. S C Littlechild, "Substitutes and complements for traditional economic regulation of monopoly infrastructure", presentation at ACCC regulatory conference, Gold Coast, July 2009. S C Littlechild, RPI-X Regulation: Ofgem's RPI-X@20 Review and the Scope for More Customer Involvement, *Network* (ACCC publication for Utility Regulators Forum), Issue 34, December 2009, 1-10.

<http://www.accc.gov.au/content/item.phtml?itemId=906637&nodeId=817271ec150e20c393e64992dc519edb&fn=Network%20December%202009.pdf>

⁵⁵ Mountain, B. R. 2013. "A summary of evidence and thinking on negotiated settlements in the regulation of energy network service providers". <http://cmeaustralia.com.au/public-reports/>

the water sector to-date, and develops some initial ideas on how customer engagement can be strengthened.

2 Current arrangements for customer engagement

2.1 Essential Services Commission Act

The Essential Services Commission Act establishes the ESC and its authority in the economic regulation of Victorian water companies.

The ESC became the independent economic regulator for Victoria's water and sewerage services in 2004. It made price control decisions in 2005 for metropolitan and regional water businesses, 2006 for rural water businesses, 2008 for regional and rural water businesses and Melbourne Water's drainage and sewerage, 2009 for metropolitan retail businesses and Melbourne Water, 2013 for metropolitan water companies (3 year decisions for Goulburn-Murray Water and Melbourne Water) and five year decisions for the other companies. A four year decision for Goulburn-Murray Water, and a five year decision on Melbourne Water are currently underway.

The Essential Services Commission Act instructs that in its price determinations, the Commission is required to have regard to:

- the particular circumstances of the regulated industry;
- the efficient costs of producing or supplying regulated goods or services and of complying with relevant legislation and relevant health, safety, environmental and social legislation applying to the regulated industry;
- the return on assets in the regulated industry;
- any relevant interstate and international benchmarks for prices, costs and return on assets in comparable industries;
- any other factors that the Commission considers relevant.

The Commission is also required to ensure that the expected costs that customers are charged do not exceed their expected benefits; and that trade-offs between costs and service standards are taken into account.

Beyond these specific requirements, the Commission is authorised to *“regulate a prescribed price for prescribed goods and services in any manner the Commission considers appropriate”*.

The Act does not envisage any particular role for customers in economic regulation, indeed it does not oblige the ESC to consult with customers in setting prices, although it does not preclude consultation or customer involvement. However, the Statement of Obligations (issued by the Minister for Water to the water companies) obliges the companies to consult with customers to develop their price submissions. The ESC Act also requires the ESC to develop a charter of consultative practice to guide its own consultations.

2.2 Water Industry Act

The Water Industry Act establishes the water industry as a regulated industry, and authorises the Governor in Council to make, amend or revoke the Water Industry Regulatory Order (WIRO). The WIRO “may” specify which goods or services provided by the regulated water industry are to be regulated by the Commission. The WIRO “may” require the Commission to adopt a specified approach, principle or methodology in regulating prices and fix regulatory asset values; specify matters relating to quality and performance standards of a health, environmental or technical nature in respect of which the Commission may not exercise any function or power. Likewise the Water Industry Regulatory Order may include restrictions on the way that the ESC designs and implements regulation. Like the ESC Act the Water Industry Act does not place any obligation on the ESC to consult with customers (or otherwise involve them in the process). However it does not preclude such involvement or consultation.

2.3 Water Industry Regulatory Order

The WIRO was revised in 2014. The revised WIRO establishes a regulatory process whereby the water companies propose prices (or revenues) and the Essential Services Commission then decides whether to accept their proposals. This approach is sometimes known as a “propose-respond” approach (the company proposes and the regulator responds to their proposal). The WIRO requires the ESC to set guidelines for

the “nature and scope of matters” it requires water companies to address in their proposals. The Commission can then decide to accept the companies’ proposals or, if it decides to reject them, decide itself what should be the “*maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated*”.

The WIRO requires the Commission to make decisions that promote efficient production and consumption and the financial viability of the water industry. It repeats the issues in the Essential Services Commission Act (section 33) that the Commission is required to have regard to in making its decision (efficient costs, health safety social and environmental obligations, the return on assets, national and international benchmarks for prices costs and return on assets) and requires the Commission to ensure that benefits exceed costs and that trade-offs between service quality and prices are taken into account.

The WIRO has some specific instructions in respect of the prices that the ESC determines, it requires that the prices should be easy for customers to understand, should provide signals about the efficient costs, avoid price shocks where possible and take into account the interests of customers, including low income and vulnerable customers. The WIRO also requires the ESC to explain to the companies how it expects the water companies to consult with customers.

2.4 ESC guidance

In its 2013 guidance to Yarra Valley Water (YVW) in the preparation for YVW’s 2014 to 2018 price control, the Commission described the customer consultation that it expected YVW (and the other water companies) to undertake. YVW described these as four deliverables:

- Deliverable 1: Consult with the community during the preparation of the draft Water Plan, and on the draft Water Plan itself when it is complete
- Deliverable 2: Set out in the final Water Plan customers’ preferences and the steps the business took to understand customers’ views in preparing the Water Plan with a particular focus on proposed prices and drivers; key investments; trade-off decisions and tariff options.

- Deliverable 3: Demonstrate how the business’s long and short term strategy reflects customers’ views about tariffs and services
- Deliverable 4: Set out how YVW used the results of surveys on customers’ preferences in cost-benefit analysis of major projects

We understand that in response to these requirements YVW undertook willingness to pay studies; ran a number of “deliberative” forums, constituted a community advisory group and met bilaterally with special interest groups. Several customer groups have commended this consultation⁵⁶. The most visible outcome from this engagement was YVW’s decision to slightly increase expenditure to fund water efficiency programs.

In Melbourne Water’s price control, which is currently under way, the ESC’s guidance (pursuant to the WIRO) has numerous references to customer consultation and involvement. The guidance is that Melbourne Water must consult with customers during the development of its price submission but the manner in which Melbourne Water consults will be for it to determine so that it is “effective”, “fit-for-purpose” and “meaningful”. Melbourne Water is also required to consult on all aspects of its price submission with water retail businesses (other than for Melbourne Water’s waterways and drainage services).

The guidance also provides numerous specific requirements:

- Melbourne Water must consult with residential and non-residential customers on matters where they will have a particular interest. This includes waterways and drainage services and prices, and the time profile for the recovery of its desalination security payments.
- Melbourne Water’s price submission must demonstrate that it has consulted with customers and other interested parties, and provide information on how their views have been addressed in its submission.

⁵⁶ Joint letter to Professor Graham Samuel, Independent Reviewer, 16 June 2014, Customer Action Law Centre, Customer Utility Advocacy Centre, Victorian Council of Social Services.

- Melbourne Water’s price submission must (for each proposed service outcome), identify whether it reflects a government obligation, or a customer need (demonstrated via cost benefit analysis, evidence of customer willingness to pay, or similar).
- Where the proposed service outcome reflects a customer need, Melbourne Water is required to explain:
 - 1) how consultation with customers (including water retail businesses for Melbourne Water’s water and sewerage services, and residential and non- residential customers for waterways and drainage services) has informed the proposed service outcomes.
 - 2) provide evidence of customer willingness to pay for that standard of service (for example, via a willingness to pay study or similar evidence), and
 - 3) identify any proposed changes to service outcomes from the third regulatory period and provide justification for the changes.
 - 4) provide a description of how Melbourne Water consulted with customers, and a summary of the views received from customers, and
 - 5) describe how the views received from customers were taken into account in determining the time profile for recovering the desalination security payments.

For price changes of more than 10 per cent for any tariff in any year, Melbourne Water is required to describe the relationship between the cost of service provision and the proposed price; explain how customers were consulted and what they said in response.

2.5 Customer advocacy

We reviewed customer advocates submissions to the Independent Review and ESC regulatory processes and met with customer advocates to understand their views.

Four customer advocacy / public interest / social services groups, the Customer Action Law Centre (CALC), Customer Utility Action Centre (CUAC), the Victoria Council for Social Services (VCOSS), St Vincent de Paul Society and Kildonan Uniting Care are the

most active customer groups. The Australian Industry Group, presenting commercial and industrial customers, has also participated on behalf of commercial and industrial customers at various times. All of these groups tend to be focussed mainly on the metropolitan water companies.

A customer advocate described the customer engagement of rural and regional water companies as generally much broader than economic regulation and generally focussed on other issues. Their proximity to their customers was described as resulting in “folksy and organic” consultation often focussed on political and operational issues (“keeping the playing fields green during the middle of the drought”) rather than the parameters (prices, expenditure, service outcomes etc.) that would be the focus of attention in setting economic regulations.

None of the customer advocacy groups have staff dedicated only to the water sector. Their participation in economic regulation – primarily with metropolitan companies – takes the form of written and sometimes oral submissions on draft ESC decisions or in response to inquiries or other consultations.

CALC, VCOSS and CUAC have at times pooled their resources in developing joint responses. They are focussed mainly on hardship and direct their advocacy efforts towards the Commissioners. They are adept at using the media to draw attention to issues and have successfully brought about significant changes (for example Melbourne Water’s early recovery of desalination charges) in this way.

The customer advocates we spoke to, commended the Commission’s increasing interest in customer engagement in economic regulation, for example in their submission to the Independent Review⁵⁷:

“ ... the Commission has developed experience and expertise in customer consultations, and this has improved with each water pricing review. The Commission has taken positive steps to increase the amount, quality, and scope of consultative processes with customer advocates – as

⁵⁷ Ibid

well as promoting customer consultation by water businesses ... The Commission has also created the expectation that water businesses consult with their customers about customer preferences when preparing pricing proposals. This has also improved with each water plan process, particularly for metropolitan water businesses."

None of the customer advocacy groups have access to technical assistance and as far as we know they have not ever commissioned expert engineering, economic or accountancy advice in the course of their water customer advocacy work. They do not consider that they have the expertise to assess the efficiency of the water companies. For example in their submission to the Independent Review, CUAC, CALC and SACOSS commended the Commission for reducing the water company expenditure charged to customers by \$1bn below the amount sought by the companies but then expressed concern about the lack of transparency of the water company expenditure and hence their concern that lower expenditure might be associated with lower quality of supply.

On the basis of answers to our questions, we estimate the average annual total expenditure on customer engagement in water regulation (by the customer advocates) is around \$150k - \$250k.

All the customer groups we spoke to recognised the effort that Yarra Valley Water had made in engaging with customers. They were less complementary of the engagement by other companies, likening it in some cases to a process of gathering "yes-men around the table to have a sandwich".

Some also drew a distinction between "stakeholder" consultation through the water companies' consultative councils, which was often focussed on wider "strategic" issues, and consultation on more technical and narrow economic regulatory issues. The perception we were left with was that stakeholder consultation through the companies' councils was invariably far more focussed on wider strategic issues than on the specific issues relevant to economic regulation.

Some said that water companies had invited them to workshops focussed on regulation and that in response they had encouraged the industry to co-ordinate their activities because they did not have the resources to respond to all of the invitations.

All of the groups we spoke to said that resource constraints meant they had limited ability to critique the technical information put before them or actually engage in the technical content of issues. This meant that consultation sometimes reduced to “tick-a-box” rather than substantive engagement.

3 Ideas to strengthen customer involvement in economic regulation

The main points from the previous section are summarised as follows:

- The legislative arrangements in Victoria do not specifically envisage a role for customer involvement in economic regulation. But the Commission has sought to encourage the companies in its customer engagement. In its guidance to water companies in the development of their regulatory proposals has set increasingly precise requirements on the consultation that it expect water companies to undertake before and after regulatory proposals have been submitted.
- Some companies have been more enthusiastic in responding to the Commission's encouragement than others.
- There are several long-established customer advocacy organisations that get involved in the economic regulation of water. These organisations are also typically focussed, primarily, on the interests of low income households.
- The customer advocates are extremely resource constrained and have limited ability to engage in the technical and intellectual detail of a price control.

The ESC has asked us to consider ways in which customer engagement might be strengthened. The rest of this section sets out ideas for further discussion.

3.1 Customer advocacy resources

If customers are to be more seriously engaged in the development of economic regulation they will need to be appropriately resourced. Widening representation to also include those representing - or familiar with the concerns of - industrial and commercial customers and other residential customers would be valuable.

Consideration might also be given to the establishment of a "customer advocate advisory centre" as a way to strengthen the technical assistance available to customer

advocates. Such a centre may have a small permanent staff and be responsible for compiling and publishing information that customer advocates are likely to find useful. This could include information on prices, tariffs, regulated revenues, water company expenditure, industry profits, regulated asset values, quality of supply and service information. The centre might also be able to provide or procure research on relevant regulatory issues.

We envisage that such an advisory centre would be focussed only on providing such technical assistance rather than itself representing customer interests to companies, regulators and other parties.

The funding for such an advisory centre – and indeed funding to strengthen the customer groups themselves – may come from the ESC, the industry via a levy or from Government or perhaps some combination of all three.

Of course we would expect that costs incurred in engaging with customers such as through deliberative forums and willingness to pay studies would be funded by the companies. And customers may advise the companies on what sort of research it would find useful.

3.2 Is the propose-respond model an impediment to customer engagement?

The Water Industry Regulatory Order (WIRO) establishes a regulatory process whereby the water companies propose prices (or revenues) and the Essential Services Commission then decides whether to accept their proposal. This approach is sometimes known as a “propose-respond” approach (the company proposes and the regulator responds to their proposal).

It might be suggested that this propose-respond approach is an impediment to customer engagement. However, the Commission’s approach involves a relatively high level of interaction with the water companies before a proposal is lodged. In the guidance it provides before proposals are lodged, the ESC specifies the sort of

information that it requires and, as described, sets out clear requirements in respect of customer engagement.

It would not seem inconsistent with this process that a water company, having received Commission guidance, could engage with customer advocates in drawing up its proposal before lodging it with the ESC, and present it as a proposal supported (if that is the case) by its customers.

Through the legislation and regulatory orders the ESC has to have regard to specific factors and needs to make its decision in the light of them. It would therefore be prudent for the ESC to inform the company and customer advocates of such factors, so that they can bear them in mind when drawing up a proposal. Ultimately, however, while a company might agree its proposal with its customers, this would not bind the ESC's decision.

3.3 Would a “customer challenge panel” be helpful?

The Australian Energy Regulator has formed a “Customer Challenge Panel” which it has involved in the regulatory determinations currently under way.

The CCP has two specific functions:

- To act as a “critical friend” to the AER, based on the Panel's view of customers' interests;
- To advise the AER on its view of how the companies have consulted with customers.

The AER appoints members of the CCP. Members are allocated to sub-panels of 3-5 members. Each sub-panel is focussed on the determinations for the distributors in one state (in the case of New South Wales it also included the distributor in the Australian Capital Territory). Annual budgets of the sub-panel are around \$100k.

A number of customer groups involved in regulatory processes currently underway have expressed their appreciation for the efforts of the CCP in the technical assistance

that they have provided to the customer advocates. The sub-panels that have been involved in decision that have reached final or draft stage have generally been critical of the way that the companies consulted with customers. The companies have in all cases disputed the CCP's assessments.

Ofwat and Ofgem had both made use of Customer Challenge Panels. As far as we know, these panels have not generally been critical of the way that companies consulted with customers, nor have the companies generally disputed the advice given by the panels.

It is not obvious that a challenge panel is needed in order to develop customer engagement in the ESC context. If technical assistance for customer advocates is to be strengthened it would seem better to do this directly as we have proposed above rather than as a spin-off from a CCP whose main task is to advise the regulator, and who might therefore be faced with a conflict of interest.

In addition, it would be preferable for customer advocates to report directly to the ESC about how they feel that they have been consulted and about the extent to which companies responded to their concerns, than for these views to be filtered through another advisory body.

3.4 How should the ESC engage with customer groups?

In the previous sections describing customer engagement in Great Britain, we drew particular attention to the relationship between the process for assessing the companies' assumptions about future costs and efficiency, and the process whereby customers and companies engage on outputs and customer preferences.

Should ESC staff advise customer advocates on staff views about the companies' costs and efficiency so that the customer advocates might consider this in their dealings with the companies?

As we described in the earlier sections, in negotiated settlements at FERC in North America, the regulator's staff engaged with companies and customers to provide staff's

assessment of the companies' proposals. Something similar occurred with the Customer Forum approach in Scotland, where the regulator WICS issued Guidance Papers on various relevant issues including efficiency assumptions. We also noted that this was not the approach adopted by Ofwat and Ofgem, who had both preferred to leave it to the companies and customers to work together. Both Ofgem and Ofwat did however seek out customers' views on the companies' proposals, rather than leave it to the companies to report on their engagement with customers and how customers' views were taken into account.

Staff involvement by FERC and WICS seems to have facilitated settlements and a business plan, respectively, that the regulators could accept as the basis for a price control. This was not the case in the England and Wales water and energy sectors, where the business plans of most companies were initially rejected, even though they were supported by customers. With hindsight, the experience by Ofwat and Ofgem suggests that, if the latter outcome is to be avoided, the provision of more information by the regulator, to customer representatives and/or to companies, would have been helpful. This may be particularly valuable, for example, in sharing the regulator's views on the companies' relative efficiency, if relative efficiency is a critical element of the regulator's assessment of a company's proposal.

Customer groups might obtain technical assistance through the proposed "customer advocate advisory centre" rather than - or as well as - from ESC staff.

Clarity from the ESC on what it is seeking from customer groups will be valuable in deciding how the ESC should interact and support those groups.

3.5 Should the companies be incentivised to engage with customers?

We described earlier the "fast-track" and related financial incentives that Ofgem had developed to encourage companies to put in realistic business plans and, in particular, to consult with customers and to develop proposals that responded to their wishes. However, we also noted that the decision to "fast track" the regulatory processes for

some of the companies depended on several other factors in addition to the quality of their engagement with customers.

Significant financial incentives to promote customer engagement are likely to result in greater effort to secure customer support. However if the customer advocates are not adequately equipped to engage in such consultation and drive a suitably hard bargain, then such financial incentives may not be in the interests of customers.

In our consultation with customer advocates and some companies we got the sense that water companies, though all government-owned, had a very different sense of what government ownership meant for the stance that they should take with respect to financial returns. Rural and hybrid companies are explicitly not for profit and the metropolitan companies may place a different level of importance on financial returns than the delivery of other objectives.

We understand that Victoria's water companies scrutinise their performance using the ESC's annual performance reports. These reports could be an important part of an incentive to motivate companies to find and meet their customers' needs. Success in such comparative assessments might be rewarded through fast-track regulatory assessments and enhanced reputations.

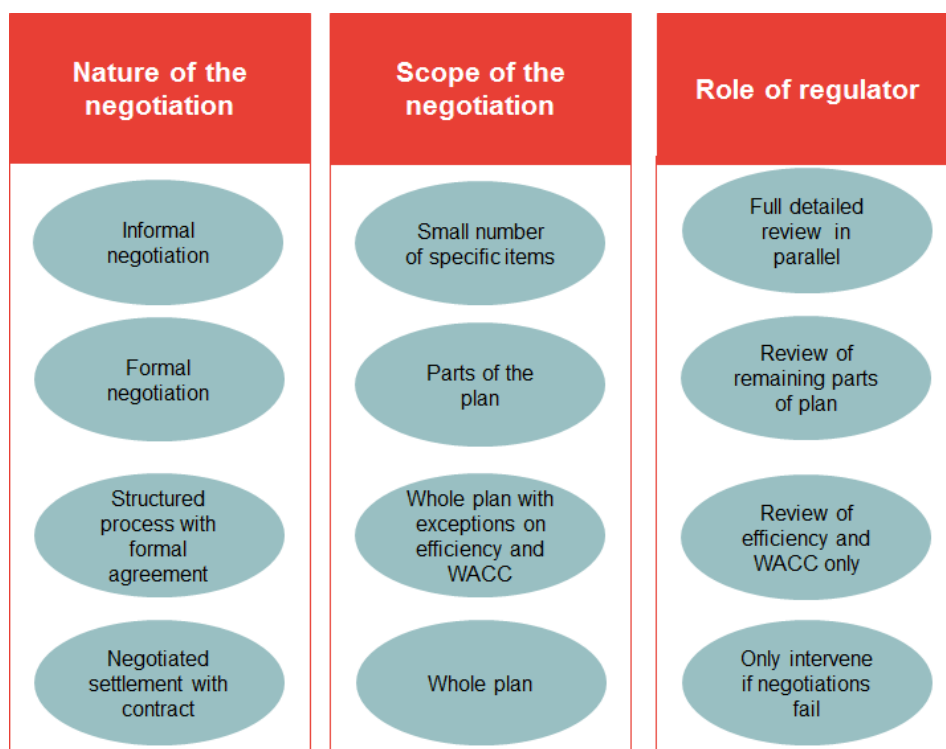
3.6 Direct negotiations between customer representatives and companies?

A logical aim for more active customer engagement is that companies and their customers might thereby agree on parts or all of the expenditure that the companies intend to incur, as well as on specified outputs and quality of service targets.

The Victorian water sector is a diverse sector with companies of very different scale and scope, and evidently different attitudes to customer engagement. The appropriate arrangements for direct negotiation, if at all, may differ significantly from one company to another.

Customer engagement and negotiation can take many forms. The scope might vary from informal discussion and agreement between customers and water companies on a few items, to structured negotiation and “settlement” of the whole decision – in this case, of the whole proposal to be submitted by the water company.

Similarly, the scope of the regulator’s work might range from conducting the full regulatory review in parallel with whatever negotiation might be occurring between the company and its customers, to intervention only if negotiations fail. This potential variety is illustrated in the figure below, taken from a recent report commissioned by Wessex Water in England, to promote what they call direct negotiations, between companies and customers, in water regulation in England.



Source: Frontier Economics, July 2015. *The potential for direct negotiations for price setting in the water sector in England and Wales*. A report prepared for Wessex Water, July 2015.

Issues that need to be considered in deciding whether, and if so how, to pursue such customer engagement or negotiation include:

1. The scope of the matters that should be negotiated and the process for negotiation

2. How customers are to be represented and equipped
3. The ESC's role in establishing arrangements and overseeing implementation

The rest of this section presents initial thoughts on these.

Scope and processes

We noted earlier that in the Scottish water sector, the regulator continued to set the cost of capital rather than leave this to be negotiated. Likewise we would expect that in Victoria as in Scotland, statutory obligations on safety and quality would not be negotiable. Customers groups may however be invited to negotiate on alternative ways in which the standards could be met. In addition, there is the possibility of going beyond the quality of service standards, of improving service in other ways and how competing priorities might be decided.

It might be advantageous to start with a more limited scope for customer engagement and potential settlement – such as service targets, tariff structures and possibly aspects of specific major projects. Given the absence of previous experience of this approach, and the possible reservations on the part of companies, customer groups and regulator, narrowing the scope of negotiation may enhance the prospect of agreement between companies and customer groups of a kind that is acceptable to the regulator.

A meaningful negotiation must be about both benefits and attendant costs. In their discussions, customers and water companies need to consider the additional costs that would be passed on to customers if service levels were improved in different ways, or if particular investments were or were not taken forward.

The negotiation process also needs to be established. We would envisage that the ESC would need to take the lead in establishing the process, at least in the establishment phase. However, it will be important that the ESC consult with the parties to the negotiation in developing the process to be followed.

How are customers to be represented and equipped?

We noted earlier the participation of customer advocates often with a focus on the interests of low-income water users and the absence of active representation of other water users. Thought will need to be given to how the range of customer interests are to be represented or taken into account and how different customer representatives will be coordinated and decisions made. Arrangements for the legal form of the customer entity, membership, responsibilities, voting rights and so on would need to be established. The Scottish Water Forum, with an independent chairman and the members appointed jointly by the regulator, the company and the main customer body, with a specified remit and process, provides one model that might be studied further.

We noted earlier the currently low level of technical expertise available to customer representatives. Indeed many customer groups suggested to us that, while attracted to the idea of negotiated settlement, they were reticent about pursuing this since they did not feel sufficiently skilled or adequately resourced to negotiate with the water companies.

Resources will be needed to fund the operation of a customer forum and in ensuring technical assistance to the forum so that it can feel able to hold its ground in negotiation.

ESC staff may also provide some of this technical assistance (subject to concerns described earlier). Notwithstanding support from the ESC, we expect that customer groups would also wish to have access to technical assistance that they are able to direct.

We would also envisage that part of the process of engagement may involve deliberative forums, juries, willingness to pay studies and similar approaches that would involve engagement with customers and not just customer representative groups. While such engagement would undoubtedly be valuable further thought needs to be given to how such broad-based engagement might form part of a negotiated settlement.

The ESC's role

The experience of negotiated settlements and customer engagement in Scotland, Florida, Alberta and federally in the United States points to the importance of the role to be played by regulators in setting up the arrangements, structuring and managing processes and providing customers with technical assistance. To implement negotiated settlements in Victoria, we would expect that the ESC would need to take the lead in:

- Facilitating the establishment of a customer forum;
- Establishing the scope and process for negotiation (as discussed above);
- Ensuring that customer participation in the negotiation is funded;
- Providing technical assistance (or ensuring its provision by others) to the customer forum;
- Explaining how it would treat settlements presented to it (and what it would do if settlement is not achieved).

The ESC has a statutory obligation to have regard to various issues in deciding its economic controls. If direct negotiation is to be pursued there would need to be recognition that what is agreed would be taken seriously by the ESC and only rejected if it is clear that acceptance by the ESC would be contrary to the ESC's statutory obligations.