

Involving consumers in the economic regulation of water: the UK approaches

Stephen Littlechild

SACOSS Adelaide

18 August 2015

Outline

- Evolution of UK price controls
- Negotiated settlements in US & Canada
- Constructive engagement at CAA
- Ofgem and RIIO
- Customer engagement at Ofwat
- Customer Forum in Scottish water sector
- Possible implications for E&W
- Conclusions

First CPI-X price cap 1983

- Background: needed to reassure customers & investors to privatise British Telecom
- Perceived US approach (rate of return)
 - Cost-plus costly & not conducive to efficiency
- RPI-X tangible benefits to customers, reassured investors, incentive to efficiency
- Setting X? seemed easier than US regulation
- Transitional for BT – but then adopted for “permanent” network controls

Setting price controls in practice

- Establishing efficient opex v difficult
 - Benchmarks very sensitive to assumptions
- Ditto capex – what future demand?
 - What do customers want & prepared to pay for?
- Time & cost 1 yr for 5 yr control – now 3-4 yrs, disproportionate
- Confrontational. Uniform v innovation
- Piggy in middle: cos v customers: blame
- Benefits in price, efficiency, inv, quality
- But ... is there a better way?

How do others do it?

- Is US regulation in practice cost-plus?
 - Price control hearings indeed v costly
 - Companies prefer not to apply for price increase
 - Regulators prefer not to apply for price decrease
- Settlements –parties & regulators prefer
 - Concerns better addressed, quicker, less risk
 - Better information & relationships
- Fixed periods avoided reopening, better incentives, controlled timing of review
 - Sharing arrangements explored
 - Increasingly, agreeing further settlements

Could we do it here?

- US & Canada price controls simpler
 - Based on costs in present/recent test year – not a five year look ahead, no efficiency improvement
 - Investment projects assessed separately
 - Cost of capital is main single issue, decided frequently (cases don't run in parallel), precedent established (and in NEB Canada formula was set)
- In UK may need means for regulator to indicate views on opex, capex, cost of cap

CAA airport regulation

- CAA appraised airport price control process
 - Confrontational, CAA had to make decisions
 - Airlines wanted more input, airports wanted more consensus & better info about customer requirements, CAA wanted better decisions
- 2005 constructive engagement
 - Airports & airlines to agree traffic forecasts, capex & quality of service standards
 - CAA to accept these & determine other parameters eg cost of capital, efficient opex

Outcome at CAA

- Initially widespread scepticism
- Generally satisfactory outcome
 - except broke down at Stansted
 - But later worked there too
- Improved information exchange
- Better quality of regulatory discourse
- Competition Commission approved but suggested more structured by CAA
- Later used successfully in other areas

Ofgem RPI-X@20 review

- 2008 Ofgem RPI-X@20 review network regIn
- Achievements of RPI-X
 - Efficiency, 30% lower network prices, 30% greater reliability, more investment, rewards shareholders
- Weaknesses
 - Reviews are time-consuming, costly, complex
 - Innovation good but narrow (opex efficiency, finance)
 - Not good in network design, operation & pricing – latter will be more important in future (low carbon techs)
 - No incentive for good business plans: same process
 - Companies focus on Ofgem instead of customers

RIO on customer engagement

- Focus on what customers get (capacity, reliability) not what cos spend & investment
- Fast track for well-evidenced business plans with good engagement: 6 v 18 mos
- Output focus & Customer engagement – parties were keen & it worked well
 - Business plans more responsive to customer needs
 - Changed company behaviour
- But only few fast-tracked: 2/4, 0/4, 1/6

Ofwat & customer engagement

- Ofwat, too, concerned about several aspects of price control review process
 - Regulators setting co business plans
 - Minimal role for views of customers
- New incentive: companies engaging with customers to get support for business plans could get enhanced status (fast-track)
- Companies keen & competed for this status
- Customer Challenge Group at each company

Key changes for PR14

Goodbye Ofwat setting companies' plans

Hello company ownership of business plans

Goodbye outputs for regulators

Hello outcomes for customers

Goodbye capex bias

Hello totex

Goodbye regulation of integrated business

Hello wholesale/retail split

Goodbye forced one-stop-shop

Hello choice for business customers

Outcomes – summary of approach

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

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

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

We are also reflecting on the lessons we will take forward

We did not set prescriptive guidance on how customer engagement should be undertaken – some companies and CCGs **enjoyed the flexibility but others found it challenging**

Sometimes translated into a very **wide remit for CCGs**, for example some delving more deeply into engineering and finance matters

We **changed our expectations about the CCG role through the process**. We asked companies to use the CCGs at the end to look again at PCs and ODIs – went beyond the challenge and assurance that we had originally envisaged



Photo © Highways Agency

A limitation?

- Customer engagement went very well
 - Good challenge to large/incremental projects
 - Business plans geared to meet customer preferences
 - changed co behaviour
- But only 2 cos given enhanced status
 - Customer engagement necessary but not sufficient
 - Others' commitments not set at economic level
- Regulators used process to provoke/assess maximum feasible cost reductions?
- So Ofwat again set most price controls

How to evaluate outcome?

- Does this matter?
 - Mirrors competition – winner takes all?
 - Or will this discourage future engagement?
- Is there a way to get benefits of competing business plans without discouraging customer engagement?
- Consider experience Scottish water sector
- Then return to England & Wales

Customer Forum

- Water Industry Commission Scotland (WICS)
 - concern at adversarial price control process, efficiency not key
 - “lowest overall reasonable cost” –customer judgement?
- WICS, Scottish Water & Consumer Focus Scotland jointly created Customer Forum
 - SW public owned, consistent with new mission
- Remit: research programme to ascertain & represent customer views in review process
 - 9 members: 5 persons “strong customer focussed reputation”, 1 chamber of commerce, 2 retailers, Chair former politician
- Detailed programme of work set out
 - Access to expert advice – former water CEO

Working

- Enthusiastic & effective participation by all
 - Including pushback on company research
 - Deeper understanding customer preferences
 - Input into development of draft business plans
- Then WICS asked Forum to seek to agree Business Plan with Scottish Water, consistent with WICS Guidance Notes
 - About 25 Guidance Notes, on various issues including opex, capex, finance, environmental
 - Indicated area of acceptability to WICS
 - 2 way interaction – WICS responded to Forum & Co

Outcome

- **WICS: tramlines re future SW performance**
 - Adjustment/sharing if unexpected performance
 - Gave assurance to parties
 - And led to focus on monitoring over next period
- **Reached agreement on Business Plan**
- **WICS price determination consistent with it**
- **Changed Scottish Water approach**
 - thinking, projects, explanation, more sensitive to customer needs, more open to lower price settlement
- **Better outcome for customers, including**
 - New customer service measures
 - Nominal price cap 1.6%~3yrs within CPI-1.75%~6yrs

Next steps in E&W?

- Does experience in Scotland have implications for England and Wales?
- Could regulators feed in earlier information about acceptable costs?
 - Maybe fast-tracking on costs earlier and separate from customer engagement?
- Is it feasible for regulator to interact with 12/18 separate cos & customer groups?

Alternative approach

- Ofwat feeds comparative info to customers
 - And any other appropriate guidance
 - And enables access to technical advice
- Let each customer group decide what are acceptable costs given what others offer
- Each see what others accept or reject
- Ofwat accepts or rejects agreed terms
- Evolving recognition of “going market price”
- Market process in setting price controls?
 - With innovation, variety, learning from experience
 - Would customer groups like menu regulation, totex?

Conclusion

- UK regulators looking for light-handed customer-oriented way to set price controls
- Ofwat & WICS have tried different forms of customer engagement in water sector
- Achievements but still big regulatory input
- Is single buyer regulatory model needed?
- Can customer groups decide what price controls are acceptable? A competitive market process in setting price controls?
- Regulatory role to promote such competition