

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

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# 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



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# 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