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Agenda

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Rules of engagement: involving customers in UK regulatory settlements

There is a growing body of opinion in the UK that sectoral regulators should involve consumers more fully in their price control reviews, with a view to improving both the effectiveness and the legitimacy of their decisions. While the objectives of consumer engagement are fairly uncontroversial, less attention has been paid to the precise institutional arrangements that are necessary to deliver them, or the possible repercussions on the regulators' independence. Peter Bucks, Oxera Associate, explores some of these difficulties

It is generally accepted that the main purpose of economic regulation in the UK is the protection of consumer interests. The principal sectoral economic regulators (Ofgem, Ofwat, the ORR, Ofcom/Postcomm, and, putatively, the CAA) have explicit duties to this effect. With differing degrees of emphasis, these duties all reflect a presumption that giving consumers the scope to choose among competing suppliers is the best way to protect their interests, but not all segments of public utility supply markets can be contestable. Moreover, markets require constant surveillance to ensure that they remain competitive. Regulation will still be required in order to prevent market failure, in particular to restrict monopoly rents and to ensure that externalities (especially public policy objectives) are adequately reflected in supply and consumption choices, and that appropriate investment is made in the renewal and enhancement of capacity.

Against this background, there is a growing body of opinion that, more than 25 years after incentive-based regulation was first introduced in UK public utility sectors, the limits of pure RPI – X regulation have been reached, and that more needs to be done to ensure that consumers have a say in the choices that must be made by public utility service providers and their regulators. In this article, I describe some of the current thinking on how consumers can be enabled to engage more fully in the processes through which choices are made in regulated market segments, and ask whether the current model of sectoral economic regulation in the UK might need to change for such an approach to be fully effective.

Background

Liberalisation of the UK public utility markets (telecommunications, water/wastewater, gas and electricity, airports, mainline railways and postal services) in the 1980s and 1990s, accompanied by the restructuring and total or partial privatisation of formerly state-owned, vertically integrated monopoly suppliers, gave rise to a need for new forms of economic regulation. The dominant model adopted was ex ante incentive-based regulation (or 'RPI – X' for short), applied by newly established sector-specific statutory authorities, and sitting alongside the traditional ex post approach to economy-wide regulation of private sector competition. The new sectoral regulators were set up as administrative agencies of government, independent of legislative and political processes and accountable to Parliament. They were given wide powers and a number of explicit duties, in particular to protect the interests of consumers and to ensure that providers are able to (and do) discharge the duties placed on them. This style of regulation may be described as purposive and determinative—the regulator uses its powers to intervene in markets with a view to securing specific objectives founded in its duties.

Although some changes have been made to the governance model, with a view to strengthening accountability, the sectoral regulators continue to have wide discretion in the interpretation of their duties and the exercise of their powers. This has given rise to a number of criticisms. In this article, I focus on the argument that regulators—especially Ofgem and Ofwat, although they are not alone in this respect—

have failed to respond adequately to the considerable differentiation of consumer expectations and behaviours, assuming an unrealistic degree of homogeneity and economic rationality—in short, that they take a one-size-fits-all approach in which there is no effective role for the consumer voice. According to those who make this argument, regulatory decisions may, as a result, lack legitimacy in the eyes of consumers, and there is a risk of sub-optimal outcomes.

Responses

So how should the regulators respond? Various remedies have been suggested, and some implemented, from the use of improved market research techniques (for example, Ofwat's use of deliberative research at the water periodic review in 2009) to appointing regulatory advisory panels of consumer representatives (Ofgem and the ORR have recently done this); changing the composition of regulatory boards to include members with specialist expertise in consumer affairs (the Gas and Electricity Markets Authority (GEMA) now includes two non-executive members from consumer backgrounds); changing regulators' duties to give more priority to interests judged to merit a greater level of protection (for example the introduction, in GEMA's principal objective, of specific reference to the consumer interest in decarbonisation and security of supply[1]); increased oversight and strengthened appeal mechanisms (for example, the debate about third-party appeals of regulatory determinations); and the erection of structures to give consumers (or their advocates) a formal role in the regulatory process (for example, the CAA's experiments with constructive engagement, or the negotiated settlement process advocated by Professor Stephen Littlechild[2]).

Whether any of these or similar approaches will prove effective in furthering the regulators' objective to protect consumers' interests is moot—indeed, what is meant by 'consumers' interests' is itself moot. It is generally considered by the regulators that it means the interests of all present and future consumers of the relevant supply, in their capacity as such. The supply should thus be of such quantity and quality, and on such terms and conditions, as may be expected to enhance the welfare of the generality of consumers, and this should be sustainable over the long term. From this follows the emphasis placed on ensuring that supplies are economic and efficient, and on non-discrimination (both between members of the same generation and between generations).

It can be readily seen that this construction leaves many questions unanswered. What about the interests of infrastructure users—energy and water supply licensees, airlines, or train operating companies—which may not always be aligned with those of the end-consumer? What about the differentiated interests of different groups of end-consumer, reflecting their geographic, demographic, socioeconomic, physiological and ethnocultural differences? Should the specific duties held by most regulators to have regard to the interests of particular groups of disadvantaged consumer (such as those who are chronically sick, disabled, living in rural areas, on a low income, etc) be taken to imply that people outside these groups can be lumped together as 'typical' consumers, or should regard similarly be had to other relevant differentiating factors not specifically mentioned in the statute? Is it only the private interests of consumers that are to be protected, or are their interests as taxpayers and members of particular communities or society at large also to be taken into account? How are consumers' interests to be identified and assessed? How are they to be traded off, lying as they do in different and sometimes conflicting areas—for example, in relation to availability and access, price and quality, complaint-handling and redress, and protection from risk? Perhaps the most difficult question is this: what weight should be given to the differing values placed by different consumers on the benefits provided, not only on the benefits that consumers can internalise, but also (especially) on external benefits, such as cleaner rivers and bathing waters, better connectivity between communities, lower carbon emissions, and so forth?

It is perhaps in this last respect that more effective consumer participation in the process leading to a regulatory settlement may have its greatest potential. A regulatory settlement comprises a compact between regulator and provider in which the provider must deliver a range of specified outputs, and, in return, is entitled to charge its customers at a level that will enable it, assuming reasonable efficiency, to recover the associated costs (including an appropriate return to capital providers). Some of the outputs are externally determined (for example, by government); others are those judged necessary or desirable by the regulator to meet consumer demand (in some or all of its many facets). In reaching such judgements, regulators in the UK have typically relied on a combination of stated-preference survey results and expert advice.

This is an intrusive and time-consuming process, dominated by debate between the provider and regulator, in which users and consumers have a minimal role and, consequently, little sense of 'buy-in'. A process which enabled consumers (or their representatives) to participate actively in determining the outputs for which a regulatory settlement is to provide would, it is argued, have a better prospect of achieving satisfactory outcomes for consumers and providers alike. Experience of negotiated settlements in North America and Australia tends to bear this out.[3]

The process of constructive engagement adopted by the CAA to enable airline users and regulated airport operators to reach agreement (if possible) on a number of the elements of the price control review—including, notably, most of the output requirements—has generally been considered a worthwhile innovation, while recognising the scope for further improvement in the associated processes.[4]

Important questions remain unanswered—in particular, how the regulator can ensure that the interests of end-consumers (especially future consumers), new entrants and participants in related markets, and society at large (in terms of environmental and social policy objectives, for example) are to be adequately protected in a negotiated-settlement process. Recent developments, however, have seen other UK regulators take initial steps towards greater consumer engagement. For example, in its final decision document following its review of energy network regulation, RPI–X@20, Ofgem promises enhanced engagement in future price control reviews, by which 'stakeholders will be given greater opportunities to influence Ofgem and network company decision-making.'[5] Ofwat, too, is carrying out a project as part of its Future Price Limits programme to review how more effective consumer engagement might be structured as part of future price reviews,[6] and (as noted earlier) Ofgem and the ORR have appointed expert consumer panels to advise on a range of regulatory decisions.

A word of caution seems called for at this stage. It is not difficult to see how present intermediate customers (of network services, for example) and large users might be engaged—as the CAA's process has demonstrated—but it is much more difficult to see how even present consumers in the mass market (never mind future ones) are to be engaged effectively in the absence of significant institutional reform. In the US model, the process leading to a regulatory settlement is based on the litigation model, in which the provider makes application for a new 'rate' (tariff), which is then tried in (quasi-)judicial proceedings. The provider, regulator, customers and other interested parties act as interveners in these proceedings. In some US states a public office has been established to act as consumer advocate. This office generally leads the case for the consumer in 'rate' cases. Where the public service provider and interested parties (including the consumer advocate) reach a negotiated settlement, the regulator may endorse it, in which case the proceedings are concluded without trial. Where the parties are unable to agree, the case proceeds to trial, at the conclusion of which a recommended basis for determination is put forward which the regulator then implements with or without modification. The important point to note is that this form of regulatory process in effect arbitrates among the competing claims of all interested parties, casting the regulator in a different role from that traditionally played by UK regulators. In particular, the regulator represents the wider public interest and makes the final decision (as in the UK), while the consumer is separately represented (unlike in the UK). In this model, consumers and/or their representative have a formal role and an effective voice, independent of the regulator. In the absence of something similar, it may be that the best that should be hoped for from greater consumer engagement is improved information flows.

Could the procedure in the UK be improved?

It is not, in my view, realistic to expect that the UK model of purposive, determinative regulation can assimilate the functions of consumer representation and advocacy without a loss of independence and, with it, efficacy. Let it not be forgotten that UK utility regulation has been very effective in securing substantial improvements in the quality and reliability of supply, major cost reductions, and a huge programme of investment in renewal and expansion of infrastructure capacity. I would argue that the critical success factors have been the regulators' vision and drive. There has been clarity of purpose, and a strong focus on the rigorous assessment of costs and benefits (social as well as private, in the long as well as the short run).

These priorities have not changed. Indeed, if anything, there is today a greater and more urgent need to foster infrastructure investment and to bear down on the associated costs. It is at least arguable, therefore, that the need is greater than ever for regulators to have the independence and discretion to choose and then stick to a course, whatever the state of the political and media 'weather'—ie, to be purposeful as well as purposive. That is not to say that they should not be sensitive to stakeholder concerns—on the contrary, regulators cannot hope to retain their independence if they act in ignorance or disregard of their stakeholders' views. But it is to argue that it may not be tenable to expect a purposive or determinative regulator to take on responsibilities for consumer representation, let alone advocacy.

If independence is to have meaning, regulators must be in a position to assess and weigh the competing claims of different stakeholders, including both consumers and providers, in the long as well as the short run. Inevitably, they will be perceived by some stakeholders to give insufficient weight to those stakeholders' interests. But those stakeholders must expect to make their case on objective grounds. It would be wrong to give them the power to hold the regulator hostage on the grounds that it was failing to

discharge a putative duty to represent their particular interests.

It is therefore to be hoped that, in reviewing the current institutional arrangements, government will recognise the vital role that an independent consumer representative plays in ensuring that regulatory decisions are as well informed as possible about consumers—including their needs and expectations, the drivers of their behaviour, and their experiences as customers—without compromising the independence of the regulator. Such a consumer representative, if appropriately resourced and skilled, could play an effective participative role in regulatory determinations, facilitating resolution of the trade-offs that the regulator is bound to make in the public interest, and ensuring that the consumer voice is heard, without compromising the regulator's independence.

Peter Bucks

[1] Energy Act 2010, Chapter 27.
[2] See, for example, Littlechild, S.C. (2008), 'Some Alternative Approaches to Utility Regulation', *Economic Affairs*, **28**:3, September, pp. 32–7.
[3] See Littlechild (2008), op. cit. See also Littlechild, S.C. (2009), 'Stipulations, the Consumer Advocate and Utility Regulation in Florida', *Journal of Regulatory Economics* **35**:1, pp. 96–109, February; and Doucet, J. and Littlechild, S.C. (2009), 'Negotiated Settlements and the National Energy Board in Canada', *Energy Policy*, **37**:11, October, pp. 4633–44.
[4] See, for example, Toms, M. (2007), 'Airport Regulation: Keeping Up with an Industry at Full Throttle?', *Agenda*, January.
[5] See Ofgem (2010), 'RIIO: A New Way to Regulate Energy Networks', October, p. 26.
[6] See http://www.ofwat.gov.uk/future/monopolies/fpl/customer.