

Agenda

Advancing economics in business

The CAPEX factor—part 2: giving stakeholders a voice

In the March 2016 issue of *Agenda*, ‘The CAPEX factor—part 1’ considered ways in which regulators might deal with uncertainty when determining capital allowances at periodic reviews. In this second article we consider another recent trend in regulation—the enlarged role of customers and other stakeholders in the regulatory process—and its implications for the regulation of CAPEX

‘Customer engagement’ has become something of a regulatory buzzword in recent years in the UK. In some contexts, regulators have begun to open up markets in order to generate engagement through customer choice (for example, in business water retail). For the core networks, where competition and choice are either infeasible or undesirable, the emphasis has been on encouraging companies to proactively engage with customers, intermediate users and/or wider society, and to use this engagement to inform business decision-making.

This trend has been particularly noticeable in the energy and water sectors. Ofgem, the energy regulator for Great Britain, and Ofwat, the economic regulator of the water industry in England and Wales, have required companies to undertake enhanced customer engagement as part of the business-planning process, albeit using different terminologies.¹ The rewards for companies that can provide evidence of strong customer engagement are reduced regulatory scrutiny of the business plan and, potentially, being ‘fast-tracked’ through the periodic review.

Ofwat has stated that this engagement should be a function of ‘business as usual’, influencing how water companies make day-to-day decisions, rather than a five-yearly exercise to appease the regulator. In 2015 it stated that:²

It is essential that companies understand what their customers want, and that customers have trust and confidence that this will be reflected in the decisions that companies take on an ongoing basis, rather than just at the five-yearly price reviews.

It is imperative that the relationship between companies and their customers should not be one in which customers are seen as passive receivers of services, but one in which there is a continuing dialogue, in which

customers are genuinely engaged and empowered and become part of how the sector delivers...The relationship between companies and their customers should be at the heart of everything.

In its May 2016 Water 2020 decision document, which sets out its vision for the next price review (PR19), Ofwat reiterated this principle:³

Customer engagement is not a one-off exercise restricted to a specific time period in the run-up to the price reviews. It is a continuous process of learning and responding...Continuous engagement means being open to gaining customer views and feedback across channels, interactions and platforms, and can be driven by customers rather than necessarily being solicited by the companies.

Customer engagement is not confined to the energy and water sectors, and neither is it a new concept. Regulated UK airports have followed a formal ‘constructive engagement’ process with airlines (involving consultation and discussion around the capital programme) for the last decade. In recent years, engagement has evolved, and has become even more central to the regulatory process.

- First, the CAA has allowed Gatwick Airport to move to a new, commitments-based regulatory regime, under which the airport has established a minimum set of service standards and commitments for all airlines, but is able to enter into bilateral contracts (with bespoke price, service, and investment conditions) with individual airlines. The rationale for this approach is that commercial negotiations between the airport operator and airlines should deliver more targeted investment and better outcomes for end-users than traditional price-cap regulation.⁴ (Similar frameworks are used

elsewhere in Europe—for example, the levels of charges, investment and service quality at Copenhagen Airport are determined through multilateral negotiations between the airport and its airlines.)

- Second, in 2015 the CAA announced the formation of a Consumer Challenge Board (CCB) for Heathrow Airport.⁵ The CCB will play a purely advisory role, primarily focused on the development of a consumer-focused outcomes framework—i.e. determining what outcomes consumers want airports to deliver and how these outcomes should be incentivised—and providing the CAA with a view on the overall quality of Heathrow’s customer engagement, and the extent to which this engagement is reflected in the business plan. This is similar to the assurance role played by Customer Challenge Groups (CCGs) in the England and Wales water sector, and the advisory role of the Consumer Challenge Group (also CCG) in energy—although there are differences in the detail.
- Finally, the CAA’s stated aim is for any new runways for the London area to be financed through commercial agreements between the airport and incumbent airlines rather than through general price controls.⁶ This would involve the airport and airlines agreeing the efficient level of cost for the project and the appropriate level of sharing should the outturn cost vary from this level.

However, this move towards more and better-targeted customer engagement has not been pursued in all sectors. In the GB rail sector, for example, the definition of outputs and capital schemes has continued to be driven by the UK government as part of the High-Level Output Specification process, and there has been limited input from either wholesale customers (passenger train and freight operating companies) or end-users (rail passengers).

This has not gone unnoticed by stakeholders, with recent government-commissioned reviews of GB rail planning and funding (known as the Bowe and Shaw Reviews) concluding that users should play a far greater role in the planning of enhancements. For example, the Bowe Review recommended that:

considerably more is done to ensure that user priorities, in particular those of passengers, are considered at an early phase of the planning process, not just in determining what enhancements are delivered, but in *how* they are delivered by Network Rail⁷

The Shaw Report similarly states that:

customers and end users should be far more involved in planning and delivering enhancements in the future. Where they are contributing funding, their role and degree of influence should reflect this.⁸

While customer engagement covers a wide range of issues, a key component is its interaction with the regulation of capital

(and, indeed, overall) expenditure. Important issues include the role that customers might play at different stages of the project life cycle; which customers might need to be represented; and how their differing views can be taken into account. These issues are explored below.

What role can customers play with regard to investment?

Customer engagement could potentially feed into any of the following parts of the investment life cycle.

- *Determining the overall outcomes that network investment should help to deliver.* This has been the focus of the outcomes-based framework introduced in the England and Wales water sector, which has involved companies engaging with stakeholders to understand what outcomes customers and wider society want water companies to deliver. This provides the framework within which companies can then make investment decisions. As noted, CCGs/CCBs play an important role in reviewing the quality of customer engagement undertaken, and in challenging companies to present robust business plans.
- *Identifying specific areas where investment is needed, and (co-)creating solutions.* Users may be able to play a role in identifying parts of the network where investment is needed. For example, Highways England’s route strategies work has included asking motorists and local transport authorities to identify issues at the route level. Taking this a step further, there may be scope for customers to be actively involved in co-creating investment solutions with companies, or at least in road-testing solutions put forward by the company—and indeed Ofwat proposed this in its May 2016 Water 2020 decision paper.⁹ In a total expenditure (TOTEX) world, this could include testing whether an investment solution is needed at all, or whether alternative operational solutions could deliver the same, or better, outcomes at lower cost.
- *Appraising and prioritising schemes.* Customer research can play an important role in the investment appraisal process and, where there is a funding constraint, in helping to prioritise different investment options. Willingness-to-pay (WTP) surveys have been widely used in the water sector to inform investment decisions, as well as to set outcome-delivery incentive rewards and penalties. For future control periods, Ofwat is challenging companies to develop their understanding of WTP by implementing an array of methods rather than just the traditional stated-preference surveys. This includes using revealed-preference WTP techniques, employing economic experiments, and applying behavioural economics insights to the design and interpretation of customer engagement.¹⁰ The development of these methods

has been placed in the companies' court. What is important to note is that some methods will help to derive WTP estimates; some will be a way of testing the effectiveness of demand-side interventions; and some will do both.

- *Determining the level of cost to be recovered.* Where customers are well informed and have sufficient technical understanding of the regulated company's asset and cost base, it may be possible for the level of cost recovery to be determined through direct negotiations between the company and its users. As noted above, the CAA has proposed this approach for dealing with the costs of new runway capacity in the south-east of England.
- *Providing oversight of delivery.* Finally, customers may be able to help monitor whether companies are delivering on their investment (and related performance) commitments within the control period. For example, the recent review of Network Rail's financing and structure recommended that delivery of enhancements should be overseen by route boards that include representatives of passengers, train operating companies and freight shippers.¹¹

There are, of course, factors that will determine the exact role of customer engagement in each sector. These include the number of customers and how informed they are about the assets and the need for investment, the degree of bargaining power that intermediate users have, and whether the interests of all 'users' (broadly defined) are aligned.

Which customers should be involved, and how can different opinions be traded off?

There is a wide range of parties that may wish to engage with a regulated company in relation to potential investments, and there will almost certainly not be unanimous agreement on what the company should do. As such, the outcome of any customer engagement exercise will inevitably require trade-offs to be made.

First, there is a question of how to balance the views of **intermediate users versus end-users**. If CAPEX is agreed between the company and intermediate customers (such as airlines, train operating companies or energy suppliers), there is a risk that insufficient attention will be given to the preferences of end-users. This is important, as wholesale customers (such as airlines) may have different preferences and WTP for investment-led improvements relative to end-users (their passengers).¹² This issue was highlighted in 2015 in an independent inquiry into system failure suffered by NATS, the UK air traffic control provider.¹³ The inquiry found that the reliance on consultation between NATS and airlines to validate the capital programme did not adequately take account of the congestion costs

faced by passengers, and thus led to a suboptimal level of investment. The inquiry panel recommended that the economic regulator of the sector (the CAA) take on a more active role, and develop its internal capability, in scrutinising NATS's future CAPEX plans.¹⁴

Interestingly, as discussed above, the CAA has since announced the formation of a CCB for Heathrow Airport's Q7 price review. This seems like a natural extension of the constructive engagement model and, if nothing else, should provide a useful cross-check for the outcome of the airline discussions. More generally, the challenge for regulators and companies is to understand where the interests of intermediate users and end-users are misaligned, and to ensure that sufficient emphasis is placed on both when making investment decisions.

Second, there may be **different sub-groups of users** who have different preferences, receive different levels of benefit from an investment, and/or have different WTP (e.g. household versus non-household customers, business passengers versus leisure passengers, and low-cost airlines versus full-service carriers). A key element of the engagement process is likely to involve understanding these various needs and preferences, and then determining which to prioritise. Having a clear national policy and long-term vision for the sector will help with this process, and statutory duties or licence conditions (for example, to protect vulnerable customers) are likely to weigh heavily when companies and regulators are considering these trade-offs.

One possible outcome of such an exercise is a push for differentiated charging. For example, a company might identify an investment that benefits one, or a proportion, of its downstream users, but not all. The downstream users that would benefit from the investment might be willing to pay for it, but those that don't might not. Regulatory frameworks may need to exhibit sufficient flexibility to allow the company to undertake the investment and recover its costs from only those customers that benefit.

A third consideration is how to balance the interests of **current and future customers**. Again, these will not necessarily be aligned, meaning that companies and regulators will need to ensure that sufficient attention is given to intergenerational equity issues. One risk is that current users might push for less investment today, thereby lowering today's bills but potentially passing on a higher investment requirement to future generations. There may also need to be consideration of how to prevent engagement between the company and existing users from creating barriers to entry for future intermediate users. Airlines currently serving an airport will not necessarily argue for more airport capacity if this also means more intense competition from future entrants.¹⁵ Notably, EU regulations require a proportion of slots for newly created capacity to be offered to new entrants.

A further point is worth noting. We have referred here to customer engagement—in reality, engagement might need

to include **stakeholders** that are not direct customers, such as environmental groups, local and national government, and local communities. This is perhaps an obvious point, but infrastructure investments can have huge impacts on third parties that need to be taken into account in the planning and decision-making process. This is recognised in the water sector, for example—while customers want a reliable drinking water supply and to be free of sewage odour issues (direct customer benefits), it is also necessary to protect the water environment through water conservation and to ensure clean rivers and beaches (wider societal benefits).

Engaging with customers on the latter issues is important, and will also require the right mixture of WTP methods. The Environment Agency will continue to have a key role in ensuring that mandatory outcomes for water abstraction and wastewater treatment are delivered, but customers and communities (e.g. landowners) may have more involvement in *how* these outcomes are delivered.

Conclusions

This article has provided a brief overview of how customer engagement can feed into investment decision-making by regulated companies, which customers might be involved, and how trade-offs can be made. This is a wide-ranging topic and this article is by no means exhaustive in covering

the potential questions and issues involved. However, a number of conclusions can be drawn.

- In regulated sectors where customer engagement currently plays a limited role in planning and the regulatory process, companies and regulators could examine whether there would be benefits from greater stakeholder involvement.
- To effect real change, engagement should be seen as a continuous process, rather than an input into the periodic review process every five or eight years. This means factoring customers into day-to-day decision-making processes and, in the context of investment decisions, into every stage of the project life cycle.
- Relying exclusively on engagement with intermediate users to determine the capital programme will not necessarily lead to inclusive investment decision-making. End-users are increasingly being given a say, but they will need to be presented with information in a clear and non-technical way.
- Companies will need to be transparent in how they engage with different stakeholders and make trade-offs between them.

This article follows on from Oxera (2016), 'The CAPEX factor—part 1: dealing with uncertainty in setting CAPEX allowances', *Agenda*, March, <http://www.oxera.com/Latest-Thinking/Agenda/2016/The-CAPEX-factor%E2%80%94part-1-dealing-with-uncertainty-i.aspx>.

¹ Ofwat refers to the engagement process as 'customer engagement', whereas Ofgem refers to 'stakeholder engagement'. The UK Civil Aviation Authority (CAA) refers to 'constructive engagement', and the Scottish water regulator (the Water Industry Commission for Scotland) refers to 'customer involvement'.

² Ofwat (2015), 'Towards Water 2020 – policy issues: customer engagement and outcomes', July, p. 2.

³ Ofwat (2016), 'Water 2020: our regulatory approach for water and wastewater services in England and Wales', decision document, May, p. 33.

⁴ Civil Aviation Authority (2013), 'Economic regulation at Gatwick from April 2014: final proposals', CAP1102, October.

⁵ Civil Aviation Authority (2016), 'Decision on the Terms of Reference for the H7 Consumer Challenge Board', CAP 1449, September.

⁶ 'We therefore expect some or all of the capex required for new runway capacity could be underpinned by commercial arrangements between airport operators and airlines. To the extent that such structures are used, fewer charges will be based on a fixed standard tariff structure.' Civil Aviation Authority (2015), 'Economic regulation of new runway capacity', March, p. 47, para. B8.

⁷ Department for Transport (2015), 'Report of the Bowe Review into the planning of Network Rail's Enhancements Programme 2014-2019', Cm 9147, November, p. 7, para. 1.11.

⁸ The Shaw Report (2016), 'The future shape and financing of Network Rail: The recommendations', March, p. 84, para. R5.12.

⁹ See Ofwat (2016), 'Water 2020: our regulatory approach for water and wastewater services in England and Wales', decision document, May, pp. 32–33 and p. 4.

¹⁰ See Ofwat (2016), 'Water 2020: our regulatory approach for water and wastewater services in England and Wales', decision document, May, pp. 32–33.

¹¹ The Shaw Report (2016), 'The future shape and financing of Network Rail: The recommendations', March.

¹² For example, see Oxera (2015), 'Buyer power in a regulatory context: myth or reality? (revisited)', *Agenda*, April, <http://www.oxera.com/Latest-Thinking/Agenda/2015/Buyer-power-in-a-regulatory-context-myth-or-reality.aspx>. This was originally published in November 2012, and the article is based on Oxera (2012), 'Buyer power and its role in regulated transport sectors', Report prepared for the NMA, March, <http://www.oxera.com/Latest-Thinking/Publications/Reports/2012/Buyer-power-and-its-role-in-regulated-transport-se.aspx>.

¹³ Independent Enquiry Panel (2015), 'NATS System Failure 12 December 2014 – Final Report', Independent Enquiry, 13 May.

¹⁴ Independent Enquiry Panel (2015), 'NATS System Failure 12 December 2014 – Final Report', Independent Enquiry, 13 May, R27, p. 65.

¹⁵ See Oxera (2015), 'Buyer power in a regulatory context: myth or reality? (revisited)', *Agenda*, April, <http://www.oxera.com/Latest-Thinking/Agenda/2015/Buyer-power-in-a-regulatory-context-myth-or-reality.aspx>.