Competition and Markets Authority
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Submission to the CMA on Ofwat price determinations

From Stephen Littlechild[1]

The CMA has invited comments on the appeals of four water companies against Ofwat's price control determinations.

I have not followed the recent water sector price control process, and have no opinion to offer on the stances taken by the various parties such as Ofwat, the water companies, the Customer Challenge Groups (CCGs), the Consumer Council for Water (CCWater) and others. Rather, my concern is that the regulatory processes for setting water (and energy network) price controls have gradually gone awry. In the awful modern jargon, they need "resetting". Realistically, this CMA panel is the only entity that can jump-start the process of rethinking, so the present appeals are an opportunity to do so that should not be passed up.

I write as a former government adviser who in 1983 recommended the RPI-X form of incentive regulation for British Telecom (BT) and who in 1986 advised that that approach would be more suitable for the privatised water companies than rate of return regulation. As electricity regulator from 1989-98 I had to set rather a lot of these wretched price controls. I have since come to the view that there is a better process for setting them, based on the concept of negotiated settlement, an approach that was unknown to me at the time. I also write as a former member of the Monopolies and Mergers Commission (1983-89) who believes that this CMA panel can and should play a critical role here, to enable a beneficial rethinking of the method of regulatory price setting in the England and Wales water sector, with implications for this aspect of regulation of the UK energy network sector too.

This submission is not an academic paper or a pitch for one of the interested parties. Rather, it is an explanation, based partly on personal experience and partly on understanding of other regulatory approaches, of why, in my view, it is important for this CMA panel to seriously consider introducing an innovative approach for these appeals, even though the appeal process has already started. I apologise for not realising earlier the possibility of making this submission.

1. The initial RPI-X price caps

In 1982, after some initial relatively small privatisations, the Government proposed to privatise BT, the first nationalised industry to be privatised. The Department of Industry argued that BT was a monopoly therefore needed regulation, and the obvious precedent was rate of return regulation of profit as used in the US. Professor Alan Walters, economic adviser to the Prime Minister, objected

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that such regulation was legalistic and costly, and that its cost-plus "gold-plating" nature provided no incentive to greater efficiency, which was a central objective of the UK privatisation programme.

I was asked to adjudicate. I knew from previous study of US regulation that it was indeed legalistic and costly, and a few rate cases could go on for years. I was not convinced by Professor Walters' own alternative proposal, but I was attracted to a proposal previously made by BT itself, in another context, to limit its prices to RPI-2%. It seemed to me that this would provide a significant incentive to efficiency. And it would not be legalistic, costly or time-consuming to set. How difficult could it be to set one number, which was a political as much as an economic decision? (In the event, it turned out to be a little more difficult than I thought.) I therefore recommended RPI-X as the basis of a temporary price control for BT rather than a permanent rate of return (profit) control, until sufficient competition emerged to render price control no longer necessary. The Government accepted and implemented this proposal.

In 1986, the Government proposed to privatise the water sector and asked me what kind of price control would be suitable there, where it was assumed that competition would not be viable, hence price control would be permanent. I advised that, while RPI-X was not designed for that, it seemed better than US rate of return control. It was duly implemented, and similarly for British Gas.

In 1988 I advised the Government on the privatisation of the electricity sector. My focus was on increasing competition in the generation and retail sectors, so that permanent regulation would not be needed there. I accepted the need for regulation of the distribution and transmission networks, and the RPI –X price cap approach still seemed best.

2. Experience of implementing price caps and two ensuing concerns

In 1989 I was appointed as the first electricity regulator. The initial price caps were set by the Government at privatisation. By 1992 it fell to me to reset the transmission price cap, then in 1995 the distribution price caps, then in 1996 yet another transmission price cap, and throughout some temporary supply price caps, then to start another round of distribution price cap setting in 1998.

The processes were interesting, innovative, challenging, at times stressful, and not without their hiccups. I hope that, on the whole, we protected customers because we were able to pass on the benefits of some significant efficiency improvements made by the companies, and encourage more such improvements. But two things particularly concerned me.

One concern was the straight-jacket that I found myself having to impose on some of the companies and, by implication, their customers. In order to bring some order into the process, and to facilitate comparisons between companies, I had set out a framework and methodology that would be followed by all companies. But sometimes a company would say to me: what about doing this or that, which would be beneficial to customers as well as to the company? And I found myself replying: It sounds interesting but I'm afraid I can't let you do that unless I require all the companies to do it. Maybe I was wrong to say that, but I don't sense that subsequent energy network and water price control processes have encouraged or even allowed different companies to explore different ideas for the price control. It just seemed too difficult, and too undermining of the attempt to get sound comparative data and to make well-balanced proposals as between one company and another.

Were there better ways of doing things? Surely. Were lessons learned over time? Yes, and changes were made, with varying degrees of success. But was the regulatory process geared to finding such better ways? No. Not unreasonably, it was geared to doing what the regulator at the time thought most

appropriate, most effective, most convenient. This included being geared to getting better data so as to set better (generally tougher) controls. A different regulator might see and do things differently next time. But I don't think there was ever a time at which a regulator said "Let a thousand flowers bloom, and see which works best". That didn't seem defensible. But the question that I shall pose shortly is whether there is a way to get the benefits of learning from different ways of doing things, while properly protecting the interests of customers.

The second concern that I had from my own period as electricity regulator was the time that it took to complete each price control process. I don't recall precisely how long it took to complete the first transmission price control with one company (National Grid), but I think just a matter of months. When it came to the 14 distribution network companies, it took about a year. I was mortified. How could I have taken up a whole year of the top management time of 14 companies, to implement a price control whose form had been chosen because it was "light-handed" and superior to the potentially time-consuming US rate of return approach? Much of the intended point of the RPI-X approach was precisely that it would *not* take a year to set. But I consoled myself with the thought that at least I would not bother these companies for the next four years. One year of negotiation for four years of freedom from regulatory intervention seemed to me a defensible line to take, if pressed.

What happened after that? Alas, the time taken for these price control reviews has steadily increased, in both water and energy networks. From one year, to two years, to three years, to more. My understanding is that, with the possibility of appeals to the competition authority, and with the process for taking stock and considering the lessons learned after each review, and the process for considering what approach to take before the next review, the whole process for setting a five year price control often takes about five years. One review no longer finishes than the next one starts. Indeed I am told that the first steps of the next water price control review have already been taken, before the present one is complete. I am also told of colleagues who have left the sector, having led a price control review, precisely because they could not stand to start another one. There should be more to life than arguing about price controls.

Surely this is awful. It is a quite indefensible use of so much time and resources of the regulatory bodies, of the management teams of the companies involved, and of the CCGs and of other participants in the price control processes. In 1983, the Secretary of State requested "regulation with a light hand". That is what subsequent UK regulation has claimed to stand for. Today that is a hollow claim. This is now arguably one of the most heavy-handed regulatory regimes anywhere in the world.

Indeed, it is worse in this respect than the apparently heavy-handed US regulation that it was intended to replace. A concern about US regulation that Alan Walters and I had back in the 1980s was that, although most US rate cases were dealt with routinely within a year or so, occasionally some cases could drag on for two or three years. And now we have a situation where, for *all* UK regulated water and energy network companies, the price setting process routinely takes about five years, is indeed an ongoing never-ending process. It is like purgatory - "a place or state of temporary suffering or misery" - except that it is no longer temporary: it is a place or state of permanent suffering or misery.

And yet regulators remain optimistic. Press Release from Utility Regulator Sisyphus: "I am pleased to announce today that I have finally rolled this price control boulder to the top of the hill."

3. Excess profits and politicisation?

Another concern gradually became apparent over time. The privatised companies often seemed to be making excess profits (or paying fat-cat salaries or whatever) – was this a result of lax regulation? We

early regulators said, in effect, "Not at all, we accept that there are excessive profits but that was the fault of the Government in setting the initial price controls, we shall do better when we reset them." And as noted, we did tighten price controls to reflect improved efficiency.

But somehow companies continued to make what some said were excessive profits. Instead of regulators and companies being praised for enabling continued increases in efficiency (and in quality of service) for the subsequent benefit of customers, regulators were blamed for setting too lax price controls. Indeed, some say that there has been no productivity growth – in effect, the main purpose of this type of price control has not been achieved. Regulators were widely urged to be tougher. And are now being told that their naivety is so systematic that they should deliberately "aim down" in setting price controls – in effect, think of a credible number for future efficient costs then halve it.

What are the positions in all this of the various consumer groups and other parties? In general, they have little interest in explaining, defending or supporting the regulatory position. In various ways they were asked for their support and advice on certain important but limited issues and in general they seem to have contributed well, both in water and in energy networks. But the critical decisions on the form, duration and level of the price controls were retained by the regulators. Advice from the various consumer groups may or may not have been heeded. Consumer groups and others thus have no particular ownership of the process or the outcome.

Nor, for that matter, do the companies. Some may do well, others badly, as a result of a particular control. But why should they support a process imposed on them, albeit with some consultation?

So the regulators are left exposed, and they are increasingly being told how to regulate. Despite their many achievements for customers, the concepts of regulation and perhaps even of privatisation are called into question.

None of this is the fault of any individual UK regulator, all of whom seem to me to have been able and conscientious. The present price control process is what the statutory duties and political and other pressures have led UK regulators, over time, to perceive as the most appropriate approach to take in both the water and energy sectors. All we regulators bear some responsibility, including myself. (I would only plead, as did the economist George Stigler: "It must be my chief and meager defense that I am not the worst sinner in the congregation". And I have since tried to make amends.) But we have to accept that what the price control process has gradually evolved into looks more like regulatory failure than regulatory success. So is there a better alternative, one that involves a less burdensome process, that would better discover and protect the interests of customers, and that would help to give all the parties involved some ownership in the process?

This was the question I asked myself when I finished my term as UK electricity regulator in 1998. It seemed to me that there were broadly two alternative possible modifications. One was that the duration or form of the price cap could be modified – for example, a shorter price control period so that there was less scope for forecast errors in future costs, or an explicit within-period provision for sharing efficiency gains with customers, although both modifications might run the risk of reducing the scope or incentive for efficiency improvements. The other possible modification might be some different process for setting the control, but I didn't then know what that might be.

4. Negotiated settlements in the US

So I set out to find what other countries were doing in the way of regulation, and whether they were doing it better. In particular, I looked at the US. Was it really as bad as I and others had perceived it?

The answer turned out to be Not Everywhere: there were intriguing examples of where the cost and bureaucracy and lack of efficiency incentives had been by-passed, and everyone seemed satisfied with the outcome.

I discovered that, in some places such as the Federal Power Commission in the early 1960s, and later at its successor body the Federal Energy Regulatory Commission, and at some state utility regulatory commissions such as in Florida and Texas in the mid 1980s and afterwards, the problems traditionally associated with US regulation had driven the regulators and the parties involved – principally companies, customer bodies and large industrial consumers - to find a way around those traditional problems. They did that by encouraging the parties themselves, rather than the regulators, to find mutually acceptable ways forward.

In the US generally, rates were (and often still are) not set for a specific period of time. Rather, they were set until such time as they were perceived to be too high or too low, in which case either the regulatory commission or the company would initiate a process to review and reset them. In the places mentioned, there were several occasions on which customer representative bodies calculated that a regulated company was now earning excess profits, and these bodies indicated that they would and could argue for the regulatory commission to open a new rate case. But instead of proceeding down the cumbersome, time-consuming, costly and uncertain regulatory route, and leaving the matter to the regulatory commission, they had negotiated with the company, come to an agreed settlement, often in the form of a fixed price for, say, three years, and proposed that to the regulatory commission. The commission had typically agreed that the proposed settlement would be an acceptable outcome: this avoided the burden of a complete rate case, with the possibility of appeals against the regulatory commission's decision.

Over time, it gradually became apparent that this route was much more efficient than the conventional rate case: it took months rather than years. It eased the burden on the regulator. The agreement provided the efficiency incentive of a fixed price instead of a profit limit. And it left both the customers and the company feeling satisfied because they had negotiated an outcome that was mutually acceptable and preferable to the regulatory alternative – an alternative that was costly in terms of time and resources, and uncertain in terms of outcome.

The process did not always work smoothly or completely – sometimes a company and the various customers or customer representatives were not able to reach agreement, or only a partial settlement or a non-unanimous settlement. And occasionally the regulatory commission did not feel able to accept the negotiated settlement in its entirety, though they usually tried to accept it subject to small modifications. But in the jurisdictions mentioned, as well as some others, it gradually became the norm to at least explore a negotiated settlement before committing to a full rate case. Indeed, I understand that in Texas the regulatory commission now requests that the parties seek to reach a negotiated settlement before petitioning for a new rate case to be opened.

For the avoidance of doubt, as my legal adviser would frequently advise me to say, this does not involve the regulatory body abandoning its statutory duties with reference to price controls. Negotiated settlements or other similar approaches do not remove any regulatory duty to set or approve such controls, nor do they modify the criteria that the regulatory body must or may use, or transfer these duties to any other body or group. Rather, they open up a wider range of processes that can be used in order to bring different and potentially more acceptable and indeed more attractive options to the attention of the regulatory body, options that this body might find preferable to the outcome of what has become a routine but unduly time-consuming and costly price control process.

From this perspective, it is not the job of the regulator to take all the decisions itself. Rather, it is to "hold the ring", to facilitate negotiation and if possible agreement between companies and customers and other interested parties. Of course, the regulator must protect the interests of customers more directly if it appears that the process is not working in customers' interests, and it must satisfy itself that any proposed settlement is in the interests of customers, and consistent with the regulator's many statutory obligations. But the regulator would not start out with the assumption that it would determine all the price control parameters itself.

5. Subsequent developments

After discovering negotiated settlements in the US, I looked more widely and discovered that something not unlike this approach had been subsequently and successfully adopted in many other countries and contexts – in the setting of oil pipeline charges in Canada, electricity transmission charges in Argentina, and some railroad charges in Australia. Moreover, closer to home, Harry Bush at the UK Civil Aviation Authority introduced in 2004 what could be seen as a variant of this approach – which he called constructive engagement - in the regulation of airport landing charges.

So from about the mid-2000s to the mid- 2010s I wrote papers described all these developments. At the same time I urged the other UK regulatory bodies, including Ofgem and Ofwat and the Water Industry Commission for Scotland (WICS), to explore the possibility of doing something similar. The most responsive was WICS, under the leadership of Alan Sutherland, which set up a Customer Forum to negotiate with Scottish Water, subject to guidance notes from WICS. The Customer Forum and Scottish Water were able to reach agreement on a future price control, and WICS accepted that. As I understand it, the process was and is widely regarded as very successful, and is to be repeated shortly for the resetting of the next water price control in Scotland.

I have not followed in detail the recent approaches of Ofwat and Ofgem. They did indeed respond to some extent. They secured the creation of a Customer Challenge Group for each company, to challenge the companies on matters related to customers, so that company plans (and their own regulatory decisions) would better reflect the views of customers. This happened, to a greater or lesser extent, and seems to have been worth doing.

However, these regulatory bodies retained ultimate decision-making on the form and detail of the price controls: they regarded the CCGs as providing useful chivvying of the regulated companies, and useful information for the regulators themselves to take into account when it was convenient to do so. But there was no role or encouragement for the CCGs or other parties to negotiate with the companies to try to find some mutually acceptable form or level of price control that might be proposed to the regulator. The regulatory bodies retained their monopolies on price control decision-making: they alone would decide the nature and duration of the price controls, reflecting their own views of what was in the interests of customers.

6. Assessing the options

There thus seem to be three main regulatory approaches available for the regulation of water (and energy network) companies:

- First, the conventional US approach to regulated industries: a rate case sets a rate for a particular utility that applies until such time as the regulator thinks it is too high or the company thinks it is too low, at which point there follows a generally costly legal rate case of uncertain duration and outcome;

- Second, the conventional UK approach to regulated industries as now applied to water and energy utilities: the regulator reviews all the companies in the sector in parallel, according to criteria that it specifies, enlists the assistance of CCGs, compares the companies against each other and sets the same kind of price control for the same period of time, basically one size fits all, albeit with company-specific assumptions about (e.g.) scope for efficiency improvement;
- Third, the more customer-oriented approach applied in some North American jurisdictions, to some Australian railroads and water companies, to UK airports by the CAA, and to the Scottish water sector, whereby the regulator facilitates a negotiation between interested parties and the company, possibly indicating some guidelines, and if agreement can be reached between these parties the regulator is minded to endorse this, or build it into the price control, and if agreement is not reached then the regulator itself determines the price control.

I am not aware that anyone is arguing for adopting the traditional US approach. Whatever merits it might have, an agreed aim in the UK, at privatisation and thereafter, has been to find a better approach that was more conducive to efficiency improvement.

The conventional UK approach, now enhanced with CCGs, has significant merits and achievements. But it has become increasingly costly, time-consuming and confrontational. It is a process that, in the view of four water companies today, seems to have failed. More generally, it cannot be sensible for regulators and companies to spend almost full time setting and resetting price controls.

This leaves the third approach, which has now been applied in many different ways in a variety of different settings and in different sectors and countries. I have not kept up with the most recent developments but, as far as I know, it has proved successful in all these cases, and there have been some very innovative and exciting developments in some of the Australian water sectors. I am not aware of significant failures or complaints about this sort of approach. On the contrary it has been supported by all the parties involved, not least the regulatory bodies. In all these cases, I believe the present intentions are to continue along the same or similar lines.

Is it not time to consider developing and applying an appropriate variant of this third approach, which has proved successful internationally, and in the Scottish water sector in particular, to the rest of the UK water (and potentially energy network) sectors? If so, how is this to be taken forward?

7. The way ahead

As yet, the decision to use some form of negotiated settlement (or constructive engagement) is not one that the England and Wales water and energy network regulators themselves have felt able to make. On the contrary, they have considered the option and rejected it, while incorporating a significant but different role for CCGs. It is not a decision that Government or the CMA could or should make for these regulators: Government can modify the statutory regulatory framework and the CMA can make suggestions, but neither is really in a position to tell regulators in any detail how to regulate.

In contrast, this particular CMA panel is in a position to devise and use an appropriate form of negotiated settlement to assist it in discharging its present duty to re-determine the disputed final determinations. And that would have important implications because it would provide insights that would otherwise be unavailable to inform the design of future price control processes.

Specifically, I believe that it would be open to this CMA panel to invite each of the four companies and interested parties, notably the corresponding CCGs and CCWater but the other parties as well, to

enter discussions (separate sets of discussions for each company of course) with a view to reaching some agreement as to the nature and detail of the price control to recommend for that company. If an agreement is reached, it would be put to the CMA for endorsement or, if it were not complete, for incorporation as part of the CMA's whole determination. Or, if the CMA panel considered it more appropriate, it could incorporate a modified version of the agreement in its determination. Or, conceivably, the CMA could reject the agreement and determine the price control in the conventional way.

Would the CMA panel be neglecting its duties and responsibilities if it decided to invite the companies and other parties to see if they could reach agreement on all or some aspects of the nature and levels of these price controls, when the role of the CMA is apparently to take precisely those decisions itself? No, because the CMA panel is not handing over these decisions: the question is rather how best the panel might arrive at its own decisions, and whether inviting the active participation of the interested parties would be helpful. I appreciate that an individual panel member might have been looking forward to exercising his or her judgement on the particular numbers in each case. But my submission is that there is a greater judgement to be exercised here, as to how to facilitate the constructive engagement of the parties at this stage and what weight to put on any recommendations that emerge. Moreover, there is also a greater good to be sought, which is the potential improvement of the whole regulatory process, to lessen the need for such appeals in future.

In introducing its own constructive engagement approach in 2004, the CAA explained that it would be looking to see explanation and evidence on how the agreements took account of the interests of customers and others, 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. It said, "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 agreement meets user interests overall and is consistent with its statutory obligations." Essentially the same argument could be made by the CMA panel.

So the purpose of the proposed approach is at least fourfold. First, to enable the CMA panel to make more informed decisions about the disputed price controls, that better reflect the concerns and expectations and preferences of the parties involved. Second, to enable the parties to propose new or different elements in the price controls that would better achieve the same ends. Third, to engender a more constructive relationship between the parties, and for that matter between the parties and the regulator, that will be conducive to better achieving their mutual aims and discharging their responsibi lities over time. And fourth, to provide further information and experience that can help to inform future regulatory decisions on the form and nature of the future price control processes.

8. Scope of negotiations

If the CMA panel believes that any particular feature of a price control should either be included or not included, the panel should say so up front, so that the parties can take this into account.

So, for example, if the panel considered that any discussion and potential agreement should be limited to the specific price control parameters determined by Ofwat (such as R and K numbers) for the next five years, it should say so in advance. But I would argue the case for giving the parties the option to consider additional or different parameters or elements, because that could facilitate their coming to

agreement. If it is seen as a zero-sum game, whatever one party gains, another loses. But if some new options are available, there is the potential to find a win-win situation.

How much latitude should the companies and parties be given in their negotiations? To take a perhaps radical example, should the CMA panel constrain the duration of the control to five years, in order to maintain comparability with the accepted price controls on the other water companies? This is for the panel to decide, but I would argue against imposing such a constraint ex initio. Five years has been a regulatory imposed construct, which has been convenient in some respects but problematic in others. We need to discover what durations of control customer groups and companies themselves think are most convenient. They may have no problems with five years. But if it is easier to get agreement for three years, say, we need to know that.

Similarly as regards the form of the control and any associated conditions: should they be specified or limited? Again I would suggest flexibility. For example, if a five year duration at a given price path would be mutually acceptable if there were a specified re-opener clause in the price control, with provision for a mid-term review of certain items, or if there were provisions or undertakings regarding particular investments, we need to know that too.

Different companies and customer groups will place different values and levels of importance on different aspects of service, and may set different targets, perhaps inconsistent from one company to another. Does this matter and should it be prevented? No. We have heard what Ofwat has said about these things. What we now need to discover is more about what different customers and companies think, to find out what they value most highly, what kind of tradeoffs they prefer to make, what kind of new ideas they have for resolving these issues, and where and how consensus can be achieved, so that all parties can support an agreed way forward.

Particular kinds of variation in the nature of the price control might seem to the CMA panel to be too problematic to consider, and if so it should say so. But I would urge the panel not to be too constricting in advance. The panel will no doubt consider carefully what kinds of parameters and variations to allow or disallow, bearing in mind the convenience of the process and future regulation, and the interests of the parties, and then indicate its decision in its initial invitation to interested parties. However, the taking of such decisions on behalf of the parties, rather than letting the parties themselves take or participate in these decisions, is precisely the nature of the problem here. So I would urge the panel to ask the parties themselves, at an early stage, whether they think that it would be helpful to restrict the scope of subsequent discussions in certain ways, or preferable to leave more options on the table. And perhaps not make that decision too soon, before the parties have a chance to explore these issues.

9. More questions and answers

It might be argued that the present proposal would surely not provide a sufficient or full test of the negotiated settlement approach because it is introduced at the last stage of a process that was not designed for negotiated settlement, where the regulatory body has already made its views known, and where only four of the companies are involved. All these are true. But they also constitute advantages. It means that a test of the proposed approach can be carried out in a much shorter time, with much relevant data already available, and involving only a few of the companies and CCGs. It is therefore a more economic and less risky way of getting some insights into how the approach could work on a full-scale basis, and how the process could be facilitated.

Will the CCGs and CCWater and other parties have the expertise to understand and negotiate these issues? Since they have been working on these issues throughout the price control review process they will be much more familiar with the issues than the average customer – or, for that matter, than the average CMA panel member. They have the benefit of Ofwat's views. If there are specific areas of expertise where they need advice, they would be able to hire such advice.

Are the CCGs the proper representatives of customers? Or is CCWater, or Citizens Advice? They all have strengths and limitations. There is no prospect of creating a perfect body to represent customers, and nor is that necessary. They are what we have. Between them they have, in different ways, participated to date with a view to the interests of customers, and will continue to do so. It is for the CMA panel to decide whether the interests of customers would be best served by endorsing, modifying or rejecting any agreed recommendation these parties make.

Have the CCGs been captured by their companies, or for that matter by the regulator Ofwat? If they all rolled over and accepted without further modification the proposals of the companies or the regulator, the panel might be tempted to draw that conclusion. But my belief is that this won't happen, for three reasons. First, because the CCGs seem to have been very conscientious in discharging their duties, and they now have the additional benefit of seeing Ofwat's final determination and hearing its arguments, and they will need to be persuaded (for example) why these companies can't meet Ofwat's efficiency targets when other companies can. Second, because CCWater and Citizens Advice are separate entities from the CCGs and have a record of defending strongly, in different ways, the interests of customers: that is their raison d'etre. Third, because such rolling over doesn't typically happen in other cases where this approach is used. Indeed, some companies have said that the customer groups have been able to extract better terms from the company, not least because the process involves the development of trust and 'give and take' to work in partnership, not only at this moment but into the future too. Similarly, Alan Sutherland at WICS has said that a well-managed company will "go much further for their customers than they will for the regulator".

Should all interested parties be invited and allowed to participate in the process if they wish to do so? Yes, although in practice not all will wish to be active, and some may wish simply to record their view that if a particular concern is addressed in a particular way, then they would be supportive of whatever other provisions the other parties might agree on. Any subsequent settlement does not need to be unanimous, though it is more persuasive if it is. Nor does it need to cover all the items at issue if it is not possible to get agreement on them all.

Would the CCGs and CCWater, in particular, be able to work together and with the company to achieve an agreed settlement? There is a CCWater member on each CCG, so they are certainly able to work together in that context. Of course they have different objectives and concerns and priorities. But does that mean they could not work together and find a common position in a negotiation with a company? If so, again we need to know that sooner rather than later. And try to understand why that is a problem in the England and Wales water sector but not in Scotland, and not in a variety of other sectors in many other countries. So I don't believe that their inability to work together would be a problem.

But would the companies and the CCGs and CCWater agree to participate in this process? I don't know, but it's very important to discover the answers to this question, and that can only be done by offering these parties the opportunity to participate. My present expectations would be Yes, for the following reasons.

I see no downside for the companies: better to negotiate a deal they can accept than run the risk of a determination they might regard as harmful.

It is possible that a particular CCG, or CCWater, might say (or it might be said of them): But we weren't set up to do this. We are not prepared for it. We are not constituted in the appropriate way for that sort of role. We do not literally "represent customers" though we try to protect their interests. It would not be appropriate for us to take this on at this late stage. We could be interested in participating if we were starting a new price control process and we were appropriately constituted and prepared, but as it is we could not be properly effective, so the normal procedure should take place.

This would be an understandable position, but I would respond as follows. We do not live in an ideal world, we are where we are. The question is not whether you would be willing to engage in this way at the start of a new price control process, with appropriate membership and preparation. At the moment, no one is interested in asking you that question. Rather, what the CMA panel might be prepared to ask you, is whether you would be prepared to assist them at this final and critical stage of the present price control process? Whether you would be prepared to give them the benefit of your views and experience, not merely in giving evidence to them, but in negotiating with the company to try to find a mutually acceptable way forward for this present price control? Whether you would be prepared to try to bring about an outcome that you think would protect customers or secure other objectives that you consider important, and that would enable you and others to learn from this experience so as to provide valuable information in designing future price control processes?

Similarly, suppose it were said by these or other parties: Well, we would have been willing to participate if this possibility had been offered at the beginning of the CMA reference. But now the reference has already been running for two months, a timetable has been set that did not include this possibility, parties have begun to submit their evidence and initial meetings have been held. It is too late to start now. In response, I would ask: is that everyone's view? Do all the companies and interested parties think that? I suggest the panel ask the parties to exchange views amongst themselves on whether they think it could be helpful to get together to discuss the possibilities and prospects. Do they see potential merit in at least an initial discussion to identify the key issues where they do or do not differ and whether there is any scope for compromise and agreement between them, perhaps on some issues if not on all? Is there any assurance or commitment or something else that, for example, the company could offer to reassure any of the parties about their particular concerns? Is there some modification to (e.g.) the proposed K factor that would be acceptable to some or all parties that would be preferable to the uncertainty of what the CMA panel might come up with?

Of course the situation is not ideal, but it is what it is. My point would be the same as before: the relevant question is whether, despite all the various limitations, the parties would be prepared to try to assist the CMA panel to bring about an outcome that secured the objectives they considered important, and that would provide valuable information in designing future price control processes?

Could a process of this be fitted into the CMA timetable? Yes, quite simply because if the CMA panel and the parties want to do it, they will find time to do it. There is another nine months before the statutory deadline. Where there's a will there's a way.

Are there other legal considerations and details to be taken into account that may impact on the proposed process? Probably. But the CMA panel and CMA staff are not short of experienced lawyers who can use their wisdom and best judgement to facilitate the process.

Is there a role for Ofwat in this process? Ofwat, along with the companies, CCGs, CCWater and other parties, has put a great deal of thought and effort into this price control review, and I express no opinion on the merits of its final proposals. But the ball is now in the CMA's court, and if the CMA panel decides to go ahead with a negotiated settlement approach of some kind, then I hope that Ofwat would accept this and provide constructive input, with an intention to see what can be learned from the outcome of this approach. Whether, and if so how, to modify the process for setting future price controls would be a matter for Ofwat to consider in due course.

10. Conclusion

The argument in this submission is that some version of a negotiated settlement approach would provide valuable assistance to the CMA panel in determining the present appeals, and could also be a critical contribution to developing a much-needed revised approach to setting price controls. This panel has a unique opportunity. I hope the panel has the imagination and courage to seize it.

11. Further information and advice

Attached is a short publication from 2015 that gives a little more detail about some of the developments mentioned above. ("Involving customers in water regulation", *Cayman Financial Review*, 22 April 2015)

A number of people have great experience in implementing varieties of negotiated settlements in the UK. These include Harry Bush, who developed constructive engagement at the CAA, followed by Richard Moriarty also at the CAA, and Alan Sutherland who set up the Customer Forum at WICS. I hope the CMA panel will invite the views of these and other people who are experienced on this issue.

12. References

A very good review (again as of 2015) of the situation and prospects for a more active customer role in the England and Wales water sector (including an account of constructive engagement in the UK airport sector) is:

Harry Bush and John Earwaker, *The Future Role of Customer and Stakeholder Engagement in the Water Industry*, a report for UK Water Industry Research, 2015.

The following are some of my own earlier articles on varieties of negotiated settlement:

Negotiated settlements: the development of legal and economic thinking (with Joseph Doucet), *Utilities Policy* 14, December 2006: 266-277.

Constructive engagement and negotiated settlements – a prospect in the England and Wales water sector? Response to the All Party Parliamentary Water Group, 29 August 2008, at http://www.eprg.group.cam.ac.uk/wp-content/uploads/2008/11/negotiatedsettlementsew29aug08.pdf

Stipulated settlements, the consumer advocate and utility regulation in Florida, *Journal of Regulatory Economics* 35(1), February 2009: 96-109.

The bird in hand: stipulated settlements in Florida electricity regulation, *Utilities Policy,*17 (3-4), September – December 2009: 276-287.

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.

Negotiated settlements and the National Energy Board in Canada (with Joseph Doucet), *Energy Policy*, 37 (11), November 2009: 4633-4644.

Regulation and customer engagement, *Economics of Energy and Environmental Policy*, 1 (1), December 2011.

The Hunter Valley Access Undertaking: elements of a negotiated settlement (with Stephen Bordignon), *Transport Policy* 24, 2012: 179-187.

Australian airport regulation: exploring the frontier, *Journal of Air Transport Management,* 21, July 2012: 50-62.

German airport regulation: framework agreements, civil law and the EU Directive, *Journal of Air Transport Management*, 21, July 2012: 63-75.

The process of negotiating settlements at FERC, *Energy Policy*, 50, November 2012: 174-191.

The Customer Forum: customer engagement in the Scottish water sector, *Utilities Policy* 31, Dec 2014: 206-218.

Involving customers in water regulation

TOPIC: Regulation/Compliance
By: Stephen Littlechild
April 22, 2015

Change seems to be afoot in the Cayman water sector. There has been discussion about a revised form of regulation of Cayman Water Company. One proposal involves a rate cap adjustment mechanism (RCAM) and other models have been suggested. Another proposal is to sell off or lease the Cayman Water Authority, leaving its regulatory function with the government. It is all rather reminiscent of the 1989 water privatization in the U.K.

The purpose of this article is not to take sides on any of the proposals just mentioned, but rather to throw another hat into the ring. This hat is consistent with any of the methods of price regulation under discussion, and with public or private ownership. It is an approach that is gaining favor in several countries across the world, in utility sectors generally, including water.

The essence of this approach is the greater involvement of customers in regulation. The regulated company and customer representatives discuss, negotiate and, where possible, agree on certain proposals to put to the regulator. These proposals may relate to investment, quality of service, prices, profits, the company's business plan as a whole – whatever is of mutual concern.

The discussions may be informed by regulatory precedent or regulatory guidance – for example, on cost of capital and efficiency. Ultimately it is for the regulator to decide whether to accept any proposals put forward, so there is no loss of regulatory control. But the focus of regulation is changed: the regulator facilitates discussion and agreement between market participants, rather than taking all the decisions itself.

What benefits does this bring? Greater mutual understanding and satisfaction, because regulation is geared more closely to the preferences of the customers and the needs of the business.

Taken in historical and international context, I sense a continually evolving and developing customer role in utility regulation generally. The rest of this article looks briefly at the past, the present and the future, so that

Cayman can consider whether this approach might have a useful role to play in the regulation of the water sector there.

The past

In the early 1960s, the Federal Power Commission (FPC), faced with a sudden and enormous new caseload, invited gas pipelines and their customers to negotiate and agree on pipeline tariffs. Many indeed did so, which reduced cost, delay and uncertainty. Subsequently, the FPC's successor body the Federal Energy Regulatory Commission (FERC) has actively encouraged settlements between gas and electricity transmission networks and their users.

From the mid-1980s onwards, the Public Counsel in Florida negotiated many settlements with telecom and electric utilities as a means of securing quicker, more substantial and more certain price cuts for customers than the Florida Public Utilities Commission was likely to offer. Utilities and customers both found attractive the certainty of fixed-price fixed-period agreements.

Since the mid-1990s, the National Energy Board in Canada has facilitated settlements between oil and gas pipelines and their customers. At one time it set out the formula it would use for calculating cost of capital, thereby removing the main barrier to productive and successful negotiation between the parties.

In all these industries, settlements brought better deals for customers. The agreements better reflected what the customers themselves wanted rather than what regulators thought they wanted or ought to have. In the process of negotiation, all parties came to better understand the needs and preferences of other parties. Relationships improved and trust began to be established. In general, this brought the prospect of ever more fruitful negotiation in future.

In the U.K., utility regulation did not begin until 1984, with the privatization of British Telecom. U.K. regulators have always listened to what customers have to say, but regulators have generally felt that it was their duty to make all the decisions themselves. Amongst other things, this has led to an ever-increasing burden of price control reviews, throughout the U.K.-regulated utility sector generally.

The Civil Aviation Authority (CAA) was the first U.K. regulator to propose a greater role for users. In 2004, conscious of the problems of the previous price control review, it proposed what it called constructive engagement. It invited each price controlled airport and its airline customers to try to agree some central parameters of the price control review, notably traffic forecasts, capital investment and quality of service. The CAA would determine the remaining parameters such as operating cost efficiency and cost of capital, and set the price control. There was widespread skepticism among the parties, but the process worked at Heathrow and Gatwick. Once the heavily-disputed new runway at Stansted was taken off the table, constructive engagement worked at Stansted too.

The present

So much for the past, what has been happening recently? The CAA has successfully used constructive engagement and related approaches in other contexts, including in setting rates for national air traffic control and in its latest

airport price control review. Ofgem, the Office of Gas and Electricity Markets, has involved customer groups in setting price controls for gas and electricity transmission and distribution networks. Regulated companies that get the support of their customers for their business plans have been eligible for "fast-tracking" through the price control reviews.

Ofwat, the Water Services Regulation Authority, has allowed a greater role for customer challenge groups in setting price controls for companies in the water sector in England and Wales. WICS, the Water Industry Commission for Scotland, has gone furthest.

Together with Scottish Water and Consumer Focus Scotland it set up a Customer Forum. The functions of the Forum were to research customer priorities and to represent the interests of customers to Scottish Water and to WICS; to seek the most appropriate outcome for customers in the strategic review of charges; and, later, to seek to agree on a business plan with Scottish Water.

I had some limited involvement in the WICS process, but mostly my position has been as observer on the sidelines, rather than as a participant. I am impressed with several features common to all these customer processes. There has been a remarkable degree of enthusiasm and commitment by all parties involved, not least the companies and their customer groups.

There has been substantial learning about the preferences of customers, and exploration of alternative means of meeting these preferences. Companies have demonstrated willingness to change and to innovate in order to satisfy customers. Business plans have been modified in many respects. The extent of ultimate agreement between companies and customer groups has been notable. In all these respects, the new customer engagement processes have been more successful than might have been expected at the outset. Regulators themselves have testified to this.

Yet the regulators have had significant reservations about other aspects of the latest price control reviews, particularly about the options offered by most companies. While encouraging companies and customers to engage, and in different degrees to negotiate over business plans, the regulators have emphasized that the final decisions about price controls remain for themselves. In a sense, agreement between companies and customers is a necessary but not sufficient condition for a business plan to obtain regulatory approval.

Regulation still plays a central role. Although the CAA acknowledged that agreement between Stansted and its airlines was a justification for no longer regulating Stansted, at the other airports it set central parameters of Heathrow's price control and indicated what kind of price undertaking it would accepted from Gatwick in lieu of a price control. In the water and energy sectors, many business plans proposed by companies and supported by customers have not been approved. Ofwat and Ofgem fast-tracked only a handful of company business plans and required significant revisions to the business plans of other companies. In contrast WICS accepted the business plan negotiated by Scottish Water and the Customer Forum as the basis of the price control.

The future

Why did the CAA determine or require changes in the price controls of Heathrow and Gatwick? Why did Ofwat and Ofgem not accept business plans supported by customer groups? Primarily because company plans embodied

what the regulator regarded as too high costs of capital and projected operating costs. It is of course the duty of the regulators to be satisfied on such matters. But it would be unfortunate if this jeopardized an increasing role for customer engagement, by leading companies and customers to conclude that negotiation and agreement were not worthwhile.

What then might be done to facilitate customer engagement that would meet the requirements of the regulators too? I have written elsewhere about the successful experience in Scotland. Two aspects of the policy adopted by WICS seem to have been helpful. First, through the price control review process, WICS issued a series of guidance notes exploring the issues and indicating its own view.

This included on cost of capital and operating costs. Increasingly, these guidance notes identified a range of parameters within which Scottish Water and the Customer Forum could fruitfully negotiate, with the prospect that an agreed business plan would indeed provide the basis on which WICS could and would set a price control. Second, WICS suggested that, in the event of outcomes varying significantly from the agreed upon business plan, the parties would together consider remedial action, including the sharing of any unexpected gains and losses. This gave the parties more confidence in committing themselves to agreement, and encouragement to work together over time.

The success of the approach in Scotland may – or may not – have been facilitated by the fact that Scottish Water is a monopoly and publicly owned supplier. Nevertheless, whether and how far such approaches would be effective and appropriate in the England and Wales water and energy sectors deserves careful consideration. Would it not be possible for regulators in England and Wales to indicate their views on cost of capital, future operating costs and other significant issues before or during, rather than after, the process of customer engagement with companies?

It might be argued that the cost of capital and efficient operating costs will depend upon the precise nature of the business plan to which companies and customer groups agree. But could not regulators give guidance on some basic issues and leave the detailed adjustments to companies and customer groups?

This may result in some inconsistencies, less neatness than the regulator would like. But the competitive market is full of inconsistencies. And neatness, as I know from setting some 50 price controls, is a regulatory artificiality imposed upon a diversity of efficient cost projections that are embarrassingly inconsistent.

If we wish to discover new ways of reducing costs and of improving quality of service, and of finding what works best for customers, we must allow companies and their customers to explore and adopt new and different approaches. Over time, companies and customers and regulators will learn from these different experiences. U.K. regulators have been moving in this direction, with good results.

The next round of price control reviews will provide the opportunity to go further. I would be surprised if there were not scope to involve customers in water regulation in Cayman too.