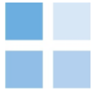

CONSUMERS' RIGHT TO APPEAL REGULATORY DECISIONS

REPORT TO CENTRICA

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EXECUTIVE SUMMARY

In recent years there have been attempts by other UK regulators to engage more closely with consumers (or their representatives) as part of the regulatory process. This has manifested itself in Constructive Engagement for London's three designated airports, consumer surveys and an expanded role for the Consumer Council for Water (CCWater) in Ofwat's regulatory process, and ongoing engagement with consumers on the part of Ofcom. The introduction, and arguably success, of rights to appeal against modifications to Ofgem's Energy Codes and to the Competition Appeals Tribunal (CAT) against Ofcom's decisions, and the decision of the Competition Commission to advocate extending the rights of appeal with regard to airport licence modifications have put the issue of broader rights to appeal front-and-centre of the debate that is currently taking place as part of Ofgem's RPI-X@20 review.

This report examines whether greater consumer involvement in Ofgem's regulatory process is needed and, if so, what is the best approach to engaging with consumers, given the nature of the industries in which Ofgem operates.

Is closer engagement with consumers needed?

Broadly Ofgem's current approach to engaging with consumers during price control reviews can be described as "Consult and Explain". In other words consumers have an opportunity to respond to Ofgem's consultations and Ofgem will generally explain how it has taken account of consumers' views in its decisions, but there is limited further redress available to consumers if they are dissatisfied with how Ofgem has taken account of their views.

A natural consequence of the process as currently specified is that Ofgem is required to focus a large proportion of its time and resources on responding to/ exploring network company submissions. Many efforts have been made to pay more attention to the needs of customers but this does not alter the fundamental point that price controls boil down to a bilateral negotiation between the networks and Ofgem, and that, particularly at the end of a review process, focus is increasingly on "cutting a deal" with the networks.

All this has taken place within the context of a fairly clear primary duty to further the interests of customers. If this duty is diluted through establishing multiple duties then there is a risk that conflicts between the duties could lead to the role of customers being down-played.

What are the options for greater consumer involvement?

The various ways in which consumers' views may be taken into account as part of the regulatory process may be divided into two groups: *ex ante* and *ex post*. The former includes:

- constructive engagement, as utilised by the CAA;
- consumer surveys, as utilised by Ofwat;

- ongoing engagement with consumers, as utilised by Ofcom; and
- negotiated settlements, as practiced in the US.

The latter includes:

- pendulum arbitration, as practiced in Guatemala's communications sector; and
- extending the right to appeal to consumers, as is the case with regard to the Energy Codes.

In our view the *ex ante* approaches may be a complement to an *ex post* approach. The history of UK regulation suggests that while *ex ante* approaches are helpful, they do not necessarily lead to a culture change, given that the regulator still knows that it is only the regulated company that can reject its proposals. Therefore, while it is appropriate to consider in more detail *ex ante* options, we would not necessarily see them as a substitute for *ex post* options but rather a complement.

What are the pros and cons of consumer appeals?

The Competition Commission expressed the view in its market investigation of BAA's airports that, in order for the appeals system to best achieve accountability, the right to appeal must be available to those with material interest with regard to the regulator's duties. However, there needs to be a mechanism which helps determine who constitutes a materially affected stakeholder and who does not.

We think there are two general approaches that can be used:

- the law for wider consumer appeals could include a set of definitions of parties that are considered to be materially affected by Ofgem's determinations; or
- the appeal body or some other nominated independent body could be given the right to determine whether a party is materially affected subject to a set of pre-determined criteria.

There is a range of stakeholders who could have the right to appeal, including final consumers, their representative bodies and suppliers..Each of the stakeholders can bring their own perspectives and issues to bear on the process and thus there would be merit in engaging with each of the stakeholders, although it is clear that each would also have different ability to engage (owing to resourcing, appetite to engage etc) Support for the provision of a broad definition of customer was provided by the Competition Commission which has argued that since airlines pay the airport charges and it is their passengers who are ultimately affected by licence modifications, they are well placed to pursue customers' needs and should be granted the right of appeal.[1]

It is primarily this issue of bringing customers and the regulated companies closer together which is identified as a major benefit of granting customers the right of appeal. Granting customers the right of appeal ought to move the price control process away from the existing bilateral negotiation between the regulated companies and the regulator

[1] Competition Commission (2009) 'BAA airports market investigation', p. 280.

to a situation where customers are involved in the determination from an earlier date and in a more substantive manner. Further, we believe that this would lead to a more robust regulatory process which should lead to more sustainable decisions. Finally, any actual appeal that is triggered ought to lead to improved decision making in the future.[2]

The main concern that critics of wider rights of appeal have voiced regards the potential for trivial or vindictive appeals to be raised, potentially by parties intending to delay the implementation of decisions that they do not like. Indeed, the Irish airports experience demonstrates that an unfettered right to appeal may not be appropriate. However, designing appropriate checks and balances so that customers gain a realistic right to appeal without unduly burdening the regulatory process ought to be achievable, as evident by the experience of CAT appeals and the Energy Codes.

A related point to the above issue of frivolous appeals is how Ofgem may be affected by an expansion of the rights to appeal. It has been argued that the right to appeal would be abused to such an extent that in effect two price control reviews will take place – the first, by Ofgem, would not be taken seriously by any of the stakeholders, with all the attention focused on the second review by the Competition Commission instead. The perception is, therefore, that Ofgem will effectively be reduced to the role of mediator. As we note above, however, so long as there are mechanisms in place to discourage trivial or vexatious appeals, the right to appeal will only be used appropriately and with due consideration.

Some of the companies that Ofgem regulates have argued that extending the rights to appeal would increase regulatory uncertainty and should, therefore, be accompanied by a higher cost of capital allowance. However, not only is there little reason to suspect that the companies would be subject to greater regulatory uncertainty as long as the necessary steps are taken to prevent frivolous appeals, there is also an argument that regulatory uncertainty would, in fact, be reduced if wider rights to appeal are used to arrive at better regulatory determinations. The desire to avoid appeals of its determinations should lead Ofgem to engage more actively with consumers and to take on board their views. Further, a culture change might be seen among those companies that currently view customers as more of a hindrance to their operations rather than the key stakeholder that they are. This, in turn, should result in better, more robust and ultimately more acceptable determinations for all stakeholders.

Profit maximisation in competitive markets is a function of meeting consumer needs and the same holds true for the faux-competitive markets which Ofgem regulates. With the right to appeal extended to consumers, investors should be able to take heart from the fact that Ofgem is taking on board a range of stakeholder views and, therefore, that its determinations would be less likely to require interim adjustments or significant changes from one control period to the next. Hence, while we think that there is a strong case for not raising the cost of capital allowance in response to widening the rights to appeal, we feel that an equally compelling argument could be made for lowering the allowance.

[2] There is almost a fear of being seen to have failed if a regulatory decision is taken to appeal rather than viewing this as a natural part of the regulatory learning process.

Lastly, the grounds on which appeals are made, and the discussions that follow, would be indicative of the main concerns of stakeholders (including the companies themselves). It is reasonable to expect that Ofgem would "learn from its mistakes" and that over time its decisions would be sounder, its consultation more inclusive and, ultimately, the outcomes more in line with Ofgem's statutory duties.

Conclusions

While we consider that frivolous appeals are undesirable, we also consider that the current situation where no network company has appealed a price control proposal from Ofgem for over ten years (two full price control cycles) is undesirable. We believe that consumer appeals are an effective way to improve Ofgem's ability to meet its statutory duties without necessitating a comprehensive overhaul of the regulatory framework. This issue becomes even more crucial with the proposed changes to Ofgem's primary duties. We, therefore, advocate that Ofgem should undertake consultation into how a wider appeals mechanism might be implemented as well as strengthening the *ex ante* role of consumers.

1. INTRODUCTION

This report has been produced by CEPA for Centrica as part of Ofgem's RPI-X@20 review to facilitate discussion on the issue of greater involvement of consumers in Ofgem's regulatory process and, specifically, the right of consumers to appeal some aspects of Ofgem's decisions.

For the purposes of this report we have used a relatively broad definition of consumers to include not just potentially final consumers, but also their representative bodies, such as trade associations, and intermediaries between network companies and final consumers, such as shippers and suppliers. This is an issue that has been discussed as part of the consumer working group of RPI-X@20. We do not consider that the arguments we set out are materially affected by the precise definition of consumers that is used.

Currently only licence holders have the ability to trigger an appeal against a proposed licence change by Ofgem – although in principle the Secretary of State could also request an appeal, a power no Secretary of State has ever used.[3] In both electricity and gas the rejection of a proposed modification to a licence condition by the licence holder gives Ofgem a choice between withdrawing the modification proposal or referring the issue to the Competition Commission as the effective appeal body. For the purposes of this report we have focused primarily on the potential right of appeal for consumers' regarding licence condition changes to implement new price control arrangements, as these are generally the most significant changes that are made to licence conditions, and price control regulation is the focus of Ofgem's RPI-X@20 review. We acknowledge that the balance of arguments may be different with regard to other types of licence modifications.[4]

In recent years there have been attempts by other UK regulators to engage more closely with consumers (or their representatives) as part of the regulatory process. This has manifested itself in Constructive Engagement for London's three designated airports, consumer surveys and an expanded role for the Consumer Council for Water (CCWater) in Ofwat's regulatory process, and ongoing engagement with consumers on the part of Ofcom. The introduction, and arguably success, of rights to appeal against modifications to Ofgem's Energy Codes and to the Competition Appeals Tribunal (CAT) against Ofcom's decisions, and the decision of the Competition Commission to advocate extending the rights of appeal with regard to airport licence modifications have put the issue of broader rights to appeal front-and-centre of the debate that is currently taking place as part of Ofgem's RPI-X@20 review.

This report examines whether greater consumer involvement in Ofgem's regulatory process is needed and, if so, what is the best approach to engaging with consumers, given

[3] The fact that this power currently exists is insufficient in our view to protect consumers. The fact that the power has never been used suggests that either the instrument is too blunt or that a significant change in structure is needed to place the Secretary of State in a position where s/he felt able to use that power.

[4] Of course, in some other areas, like code modifications, certain types of consumers already have the right of appeal, something discussed later in this report.

the nature of the industries in which Ofgem operates. The report is structured as follows:

- Section 2 considers whether Ofgem's statutory duties may be better served by increasing consumer involvement;
- Section 3 then outlines a range of options that afford consumers a more involved role in the regulatory process;
- Section 4 discusses the right of consumers to appeal in detail; and
- Section 5 concludes.

2. IS MORE CONSUMER INVOLVEMENT NEEDED?

2.1. Introduction

In this section we set out how Ofgem currently engages with consumers during price control reviews, and consider how Ofgem's statutory duty with regard to the interests of current and future consumers may affect consideration of these issues.

2.2. Ofgem's current level of consumer engagement

The central issue here is how to achieve the best outcomes with regard to Ofgem's statutory duties and whether a higher degree of consumer engagement is conducive to achieving this objective. It has been argued that that firms that operate in competitive markets answer only to shareholders and that, if the aim of regulation is to make firms that operate in naturally monopolistic markets proxy the behaviour of competitive firms, regulatory regimes should focus on the question of profit maximisation. However, while the ultimate goal of competitive firms is profit maximisation, this is not necessarily achieved simply by trying to satisfy shareholders' wants. The views of consumers, as well as other interested parties, often play a crucial role in businesses' decision-making process, for example through market research. Indeed, in a competitive market companies are only able to profit maximise by meeting their consumers' needs.

Some have argued that the essence of energy regulation in the UK is that Ofgem's role is to represent the public interest, which includes but is not exclusive to consumers' views. Holders of this view think that Ofgem should develop its proposals in each price review with reference to the public interest, with the regulated companies then having the choice of accepting the proposals or appealing against them if they are seen to be unreasonable. In reality, however, a natural consequence of the process as currently specified is that Ofgem is required to focus a large proportion of it time and resources on responding to/ exploring network submissions. Many efforts have been made to pay more attention to the needs of customers (see Box 1) but this does not alter the fundamental point that price controls boil down to a bilateral negotiation between the networks and Ofgem, and that, particularly at the end of a review process, focus is increasingly on "cutting a deal" with the networks.

Box 1: Ofgem's current approach to consumer engagement
In 2007, Ofgem launched Consumer First, a strategy to enhance its understanding of consumers, which is designed to ultimately lead to "a qualitative improvement to decision making." Part of the impetus for Consumer First came from Ofgem undertaking some benchmarking work to review its practices; this identified a need to strengthen its research capacity. It is also in part a response to the not-unrelated issue of the recent changes in consumer representation arrangements in the energy sector.
There has been some criticism of Ofgem that it previously relied too much on other organisations, principally energywatch, to interact with individual consumers, which has contributed to an insufficient understanding of consumer behaviour. Ofgem has been described to us as being "frightened of consumers" and "completely at arm's length from consumers".
Examples of research already undertaken under the programme, as listed in Ofgem's 2007/08

Annual Report, include:

- customers' willingness to pay for quality of service improvements;
- customers' views of suppliers' complaint-handling processes;
- debt and disconnection;
- green tariffs; and
- behaviour of vulnerable consumers when switching suppliers

More recently, as part of its probe into the energy market, Ofgem conducted a survey among domestic energy customers to investigate their attitudes and behaviour in respect of Great Britain's energy supply market and help to establish the extent to which the market is "working" for consumers. The study examined awareness, participation in switching, experience of the process, satisfaction with switching and intentions to switch again and barriers to future switching. Because of a particular interest in switching behaviour amongst prepayment meter customers, their numbers were boosted to ensure a robust sample size. In addition, Ofgem conducted three qualitative studies looking at experiences of consumers with the energy markets: one with groups of vulnerable consumers; a second with mainstream domestic consumers; and a third with small businesses.

In some of its other areas of operation, Ofgem affords consumers (defined broadly for this purpose) a more active role. For example, intermediaries have a major in determining investment with regard to connections in electricity and entry capacity auctions in gas.

Consumer involvement during DPCR5 has involved a number of levels, including:

- Consumer First research into consumers' willingness to pay for a range of improvements (cleaner energy, fewer interruptions, etc.);
- establishing a Consumer Challenge Group consisting of expert consumer representatives;
- holding focus groups, including some specifically targeted at understanding the expectations, experiences and priorities of the worst-served customers; and
- requiring all DNOs to undertake stakeholder consultation in order to inform their business plans.

Broadly Ofgem's current approach to engaging with consumers during price control reviews can be described as "Consult and Explain". In other words consumers have an opportunity to respond to Ofgem's consultations and Ofgem will generally explain how it has taken account of consumers' views in its decisions, but there is limited further redress available to consumers if they are dissatisfied with how Ofgem has taken account of their views.

Some would argue that the consultation process, coupled with the possibility of Judicial Review and the Secretary of State's ability to block a licence modification, all act as checks to ensure that the public interest is met. In reality, however, neither Judicial Reviews nor interventions by the Secretary of State have figured substantially. In particular, it is apparent that the Secretary of State is not resourced or focused on the details of price controls to be able to make an informed view on issues raised. With little room for consumers' voices to be heard compared to the regulated companies, there is a strong case for including a mechanism which specifically makes consumers' needs a central part of the regulatory process. In the next section we discuss the specific options for this.

2.3. Present versus future consumers

Ofgem's statutory duty is to protect the interests of customers, present and future, wherever appropriate by promoting effective competition. This is important because, as some commentators have argued, the interests of present consumers and those of future consumers do not necessarily align. Hence, it is important that the views of future consumers will be explicitly taken into account as part of the regulatory regime.

While some debate and uncertainty exist with regard to what are the interests of future consumers, and who is best placed to represent these interests, these in themselves are not sufficient reasons to avoid incorporating existing and future consumers' consideration into the regulatory process. In doing so, it would be useful to stick to the topics which are most clearly defined and generally accepted, such as the drive towards greater reliance on renewable energy sources and ensuring that development is compatible with environmental sustainability. While the specific views of future consumers are, by definition, unknown at present, if we assume that in general consumers desire lower prices and better quality, we can see that increasing the investment in and reliance on renewable sources is clearly compatible with these desires. This is because:

- investing in renewable energy now allows for an accumulation of knowledge, which would lead to better quality service (such as fewer interruptions to the electricity supply) over time;
- developing the use of renewable energy sources opens up the possibility of economies of scale, which would lower prices for consumers; and
- shifting the reliance for energy from fossil fuels to renewable sources lowers the chance of rapid price increases as has been witnessed in the crude oil market during 2007-2008, again protecting consumers from sudden increases in prices.

It is also arguable that if anybody is well placed to represent future consumers' views it is current consumers.[5] At its simplest level future consumers will be family members and friends of current consumers. The Competition Commission, in its investigation of BAA, noted that even if the interests of current and future consumers were different, the regulated company should at the very least engage in dialogue with current consumers and take their interests into consideration.[6]

The issues raised above would become even more important should the change to Ofgem's primary duties that was raised in the white paper be enacted. More balancing of duties means that Ofgem will increasingly need to juggle customer interests with security of supply and low carbon objectives, and these may conflict. This argues for a clearer separate voice for customers in the process.

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[5] This is especially true if we include shippers in the definition of consumers since they will want to ensure that prices and quality are of a level that future consumers desire.
[6] Competition Commission (2009) 'BAA airports market investigation', p. A10(8)-3.

3. What are the options for greater consumer involvement?

3.1. Introduction

The various ways in which consumers' views may be taken into account as part of the regulatory process may be divided into two groups: *ex ante* and *ex post*. We discuss a number of options under each of these headings below.

3.2. *Ex-ante* options

This category refers to processes by which consumers or their representatives take an active part in the regulatory process in the lead up to determinations. Hence, when the regulator sets its final determinations, these already take into account the views of consumers. Below we discuss three examples of proactive consumer engagement that have recently been utilised by UK regulators and a fourth that has been proposed based on overseas experience:

- constructive engagement, as utilised by the CAA;
- consumer surveys, as utilised by Ofwat;
- ongoing engagement with consumers, as utilised by Ofcom; and
- negotiated settlements, as practiced in the US.

3.2.1. Constructive engagement

In constructive engagement, the consumers or their representatives take an active part in discussions in which certain elements of the regulatory process are determined (for example, elements of capex). The regulator normally oversees the process without necessarily getting involved, although it may act as a mediator between the regulated company/ companies and consumers if needed. Naturally, constructive engagement lends itself to regulatory processes where consumers are already knowledgeable about the main issues that affect the regulated company, and where consumers can be defined and grouped easily (for example, geographically). These conditions make the aviation sector an obvious candidate for constructive engagement, given the resources and knowledge of airlines.

In the UK, constructive engagement was introduced by the CAA in its latest price reviews of the three major London airports. Box 2 below describes the different experiences of constructive engagement in Heathrow and Gatwick to that of Stansted. The key observation to make from the experience of constructive engagement in the UK is that, in order to be truly effective it needs to be framed by a strong set of guidelines from the regulator and possibly enforcement to ensure information flows from the companies to consumers to facilitate effective engagement. The regulator needs to clearly specify the topics that will be discussed as part of constructive engagement and, in its role as mediator, ensure that discussions stick to the prescribed topics. The regulator

also needs to clearly set out whether the outcomes of constructive engagement would be accepted unaltered into the final determinations, or whether they will simply be proposals for the regulator to consider when making its final determinations.

Box 2: Constructive Engagement in the UK aviation sector

Constructive Engagement (CE) between airport operator BAA and its consumer airlines with regard to capex plans as well as setting service standards was introduced by airport regulator CAA in 2004.

Ahead of its fifth price review (Q5) of the three major London airports, the CAA set up CE between BAA and its customer airlines at each individual airport. At Heathrow and Gatwick, where capacity constraints made it in the interest of both sides to see capex increase, CE was seen as an improvement over the previous consultation process, although some areas of disparity between stakeholders persisted, as evident by the delays to Heathrow East Terminal. At Stansted, where low-cost airlines dominate, while BAA would have liked to embark on major capex projects, the process of CE never got off the ground and was terminated by the CAA in December 2005.

The stand-off at Stansted resulted in each side placing the blame with the other; BAA claimed that it had made considerable effort to engage in CE with the airlines but was frustrated by their preconditions, while airlines, in turn, argued that the information provided to them by BAA was insufficient to effectively engage in consultation. The impasse mainly originated from the fact that BAA provided airlines with a Capital Investment Programme (CIP), while the latter deemed this insufficient and sought a full business plan.

The Competition Commission's inquiry of the Stansted price review sided with the airlines on this matter, arguing that BAA showed a "lack of responsiveness to the interest of airlines and passengers that we would not expect to see in a business competing in a well-functioning market". In particular, the Competition Commission highlighted several aspects of the current CE format which it deemed to exclude genuine two-way dialogue between BAA and airlines and which it argued hampered the process not only at Stansted, but also at Heathrow and Gatwick. These factors include:

- BAA's considerable advantage owing to asymmetrical information;
- the scope for BAA to take advantage of airlines' different requirements and potential to play airlines off against each other;
- BAA's ability to control the timing of the release of information; and
- the absence of a dispute resolution procedure.

The Competition Commission recommended that CE could be improved by making better provisions and clarifications with regard to the information that is to be provided as part of the process and the process itself, including appointing an independent facilitator (which could but does not have to be the CAA).

For its part, the CAA argued that CE was never meant to determine all facets of airport operations, but rather to provide inputs to the price control process with regard to items which were not zero-sum, such as the cost of capital, or which relied on commercially confidential data, such as airports' retail revenue. The failure of CE at Stansted led to the CAA using its own projections in setting up building blocks of the revenue requirement. The CAA also outlined in detail the information BAA must present to airlines at various stages of capex projects, although the demand for a business plan remains conspicuous by its absence.

Sources: Competition Commission (2008) 'BAA airports market investigation: initial findings report'.

Civil Aviation Authority (2008) 'Stansted Airport: CAA price control proposals'.

3.2.2. Ofwat's approach in PR09

Ofwat's statutory objective to protect the interests of consumers was established under the Water Act 2003 and the regulator appears to take its obligation seriously and has made concrete steps to securing more structured consumer involvement in the regulatory process. Additionally, CCWater has become the focal point for consumer involvement in the water and sewerage industry. They were established as an independent statutory consumer body under the Water Act 2003 to replace WaterVoice, the previous consumer watchdog, who were both funded and appointed by Ofwat. Separating the consumer watchdog from the regulator gave CCWater a better position to stand up to regulatory decisions in support of the consumer agenda.

CCWater stress the need to identify consumer priorities but realise that needs are neither static nor uniform. This is evident in their strong research programme, focussed to identify actual priorities. CCWater tries to maintain active engagement with Ofwat and have increased their involvement in the current price review from previous years. It is difficult to say whether CCWater actively represent all consumers, but they appear to be trying to do so. Whether CCWater have been successful or not will be revealed in their effectiveness to deliver consumers what they want over 2010-15.

As we noted above, Ofwat has regularly attempted to give consumers a platform to make their views heard. During PR99, each water undertaker was required to conduct consumer surveys to inform their business plan submissions. However, the variety of methodologies used to assess consumer priorities were so diffuse that it was difficult to establish useful lessons. In response to this, a national survey was commissioned to assess priorities as part of PR04. Since then, Ofwat has further stepped up its efforts to increase consumer involvement. They have aimed to do this in a more structured manner such that information gathered can be put to use more effectively than before.

Ofwat set out its formal PR09 consumer consultation process in its price review methodology paper. This process has now concluded. It included three main phases of consumer research, each feeding into key stages of the review and Ofwat's final decisions. This process is summarised in Box 3. The evidence collected in each of these stages, feeds into Ofwat's decisions and is also used to inform policy decisions of non-economic regulators (such as the Drinking Water Inspectorate). The exact manner in which Ofwat will use this information is unclear and has been questioned by some of the companies. Ofwat have certainly put consumers at "the heart" of the review process, but final decisions are still made by companies and Ofwat, not consumers or CCWater. Therefore, although much research and analysis has focussed on consumers, it remains to be seen whether the industry becomes more responsive to consumer needs or not.

In addition, Ofwat plan to use a revised Overall Performance Assessment (OPA) incentive as one way to integrate consumer involvement into the ongoing regulatory process. The OPA is an incentive scheme based on a composite measure of service outputs, the level of which determines allowed prices. CCWater has been involved in revising the OPA to include more responsive consumer measures. The new OPA has two new elements:

Box 3: Ofwat's approach to consumer engagement in PR09

Consumer research to inform PR'09 has followed a three stage approach:

- **Stage 1 – company-led research:** Each company, with input from CCWater, conducts research to inform and develop 25-year Strategic Direction Statements designed to ensure that long-term planning for an environmentally sustainable water industry is based on an understanding of what consumers really value.
- **Stage 2 – joint stakeholder deliberative research:** CCWater leads a joint regional deliberative consumer research project. This has three stages: discussion groups to produce a picture of beliefs and attitudes; self-guided deliberation in the everyday context; and deliberative workshops. The results were published in the spring of 2008, allowing each company to use them to develop draft business plan proposals.
- **Stage 3 – joint stakeholder quantitative research:** Once companies have submitted their draft business plans, Ofwat carried out quantitative research working with other stakeholders to explore consumers' views on the value for money, acceptability and affordability of their company's draft business plans.

- a consumer experience survey of actual interactions and propensity to switch or recommend their supplier; and
- a quantitative measure of contact and complaint volumes designed to pick up on when they are not meeting consumers' expectations.

The existing OPA specification already includes reliability and response times in its weighted basket, but does not include the quality of interactions. The introduction of 'consumer experience measures' based upon what consumers say is important to them should prove to be an improvement. This should enhance responsiveness to consumers by adding incentives that firms would have to deal with under competition, and incentivise firms to improve actual customer satisfaction.

3.2.3. Ongoing engagement

While the two approaches above require specific involvement of consumers or their representatives as part of the price review process, an alternative approach would be for the regulator to ensure that it is up-to-date with consumers' views by engaging with them on an ongoing basis. Such an approach would allow the regulator to become the authority on consumers' views and would, therefore, be more in line with the underlying approach of RPI-X regulation as argued by some commentators.

As we note in Box 1, while Ofgem has attempted to take better account of consumers with its Consumer First initiative, the general feeling is that Great Britain's energy regulator may be able to do more to ascertain the views of consumers. In the UK, it is generally acknowledged that Ofcom has the most comprehensive process of involving consumers in its regulatory decision-making process. The process adopted by Ofcom, which involves ongoing interaction with consumers through surveys and other forms of research, is described in detail in Box 4.

It is perhaps not surprising that Ofcom leads regulators in consumer interaction, since the type of sectors and activities which it covers are ones in which consumers are better able to judge quality and value for money than they are able to do, for example, with

regard to Ofgem's areas of operation. Nevertheless, a strong argument can still be made for Ofgem to devote more resources to understanding and monitoring consumers' views.

Box 4: Ofcom's approach to ongoing consumer engagement

Ofcom is something of a leader in this area with two main instruments for consumer engagement. These are:

- Consumer Interest Toolkit; and
- Consumer Experience Report

Consumer Interest Toolkit

During 2004 and 2005 the Communications Consumer Panel worked with the National Audit Office and PricewaterhouseCoopers (PwC) to develop a methodology for auditing the way in which Ofcom takes consumer interests into account in its regulatory decision making. In February 2006, the Panel published "Capturing the consumer interest – a toolkit for regulators and Government". The report included a consumer interest toolkit (the Toolkit) comprising 31 questions that could be asked of a regulator to help determine if consumer interests are being considered appropriately.

The Toolkit is based on three elements of policy development:

- identifying consumer interests;
- demonstrating consumer interests; and
- communicating consumer interests

The Toolkit has been designed in such a way that it can be used as either an internal or an external assessment tool, and it is sufficiently generic to be equally applicable to other regulators.

Consumer Experience Report

Ofcom produces an annual report entitled The Consumer Experience, which lists the full results of its research programme aimed at measuring how well consumers have fared over the year in relation to telecoms, the internet and broadcasting. Data sources for the 2008 report included:

- communications tracking survey;
- consumer decision-making survey;
- consumer concerns research;
- Ofcom visual impairment research; and
- Ofcom learning disabilities research.

Alongside the research report is a policy evaluation. Ofcom's website explains its purpose:

"The policy evaluation examines the research data and uses it to assess the impact of our regulatory policies and activities. This evidence will help us make sure that we have the right priorities and that our actions are securing positive outcomes for citizens and consumers. It provides an opportunity to consider the effect of our policy work and market developments on all consumer groups – in particular older people, children, disabled consumers and consumers on low-incomes"

Ofcom invites stakeholders to submit their views on both the research report and the policy evaluation

3.2.4. Negotiated settlements

The conflict between what consumers want and what the regulated companies are willing to give is at the core of the difficulties faced by Ofgem and other regulators under the current regime. For some time now, Stephen Littlechild has been advocating a system of negotiated settlements that operates in a number of areas in the United States as a way of resolving this fundamental conflict (see Box 5).

Negotiated settlements are agreed between consumers (or their representatives) and each individual company (or a body that represents several companies) and require the approval of the relevant regulatory/ competition authority. In the US, it has been argued that this approach has led to significant reductions in the prices consumers pay. In return for agreeing to charge lower prices, the companies have usually been granted concessions in other areas. In the context of the companies Ofgem regulates, negotiated settlements could potentially be used to agree on fixed prices, which consumers' desire but which network companies have been reluctant to accept.

While Littlechild has argued that negotiated settlements can be (and have been) used to agree on quality of service or environmental parameters rather than simply prices, for this to be done effectively, the remit and statutory status of Ofgem would need to change so as to give the regulator powers to enforce settlements to be compatible with the public interest, which includes ensuring that current actions are in line with the probable needs of future consumers.

Additionally, settlements would have to be structured in such a way that, on the one hand enough stability and predictability are built into the contract, while on the other hand there is sufficient flexibility. The former can be done by including a minimum time period for which the settlements hold, while the latter may be achieved by including a maximum length for the settlements, as well as re-openers for exception circumstances. It is not clear whether such clauses have been used to date in settlements in the US.

Box 5: The use of stipulated settlements in electricity regulation in Florida
Since the mid-1980s, regulation of electricity prices in Florida has increasingly been determined by stipulated settlement between a utility and a particular consumer group, thus moving away from the prior approach of litigation. Littlechild (2007) shows that, in the ten years to 1985, electricity prices were determined through litigation in all 20 cases that involved Florida's four major electricity companies. In the following ten-year period, 17 out of the 20 cases that occurred were settled through litigation, with the remaining three being settled by stipulation. Over the ten years to 2005, however, nine out of the 10 cases which occurred were settled by stipulation, with only one being settled through litigation. Under the litigation system, Florida state's regulatory body, the Florida Public Service Commission (FPSC), would open a case either based on its own determination or following a request by either the utility itself or by a body representing consumers. Following an investigation/hearing, the FPSC would make its decision, which held the same status as that pronounced for a court of law. The rise in stipulated settlements has been facilitated by the Office of Public Council (OPC), which is a body set up in 1974 to represent the citizens of Florida in matters involving utilities. Stipulations must also be approved by the FPSC. Stipulations have resulted in an array of measures to lower prices faced by consumers, such as price reductions, price freezes and refunds, while never resulting in a price increase. Littlechild (2007) calculates the savings to consumers that resulted for stipulated settlements during the

period 1986-2006 at over UD$3 billion and notes that all of these benefits were either greater or occurred earlier than had those settled through litigation. Indeed, Littlechild argues that around 75 per cent of the reductions would not have occurred at all had the case been settled by the FPSC alone.

It is important to note, however, that the catalyst for the increased reliance of stipulated settlements is not the fact that they provide the same outcome at a lower cost, but rather that they allow for a different outcome than would have been the case under litigation, and that is the main reason that utilities have agreed to price cuts of the magnitude described above. Stipulations on occasion have included clauses that specified a period for which further price reductions could not be requested, or included a provision for the withdrawal of a separate claim against the utility.

Stipulations have also resulted in a shift of the regulatory approach itself, with a move away from the classic "building blocks" approach in which an allowed return on equity (ROE) was used in order to determine prices, and towards a system in which the ROE has little role, although deviations from a particular ROE were occasionally used as re-openers. Furthermore, the increased use of stipulated settlements has seen a move away from the FPSC's favoured earnings sharing schemes toward revenue sharing, which Littlechild claims is easier to enforce and removes utilities' incentive to artificially increase their costs in order to drive down earnings. The risk that the above shift it the regulatory approach would encourage cost-cutting by utilities were, in some settlements, countered by the introduction of service standard controls.

The main concern with regard to stipulated settlements which were facilitated by the OPC is the fact that large industrial users are likely to benefit from them more than residential consumers. However, Littlechild (2007) suggests that smaller electricity users were also better off as long as the stipulation resulted in an overall reduction in prices of more than 10 per cent, which he argues has often been the case. Overall, the use of stipulations is seen to have brought about a more flexible approach to utility regulation.

Sources: Littlechild, S. (2007) 'The bird in hand: stipulated settlements and electricity regulation in Florida', Electricity Policy Research Group Working Papers, No. EPRG 0705.

Littlechild, S. (2006) 'Stipulations, the Consumer Advocate and utility regulation in Florida', Electricity Policy Research Group Working Papers, No. EPRG 0615.

3.3. *Ex-post* options

Where consumers or their representatives are not involved in the process leading up to the regulator's determinations (and even where they are in some cases), there is an argument for them to have some *ex post* say on matters that affect them. In this section we review the options of pendulum arbitration and consumer appeals.

3.3.1. Pendulum arbitration

Pendulum arbitration (sometimes known as Final Offer Arbitration or FOA) is a process in which an arbiter accepts (usually in full) one of the offers made by the parties to a negotiation process if no settlement is agreed upon within the time allotted for negotiations. The process is most commonly used in labour disputes, where collective bargaining is absent or has failed. However, since reforms in 1996 it has also been the approach to regulating Guatemala's telecommunications industry (see Box 6).

The thinking behind pendulum arbitration is that the parties to negotiation aim to minimise the "loss" they incur by compromising on some of their positions. Given the choice between potentially having the other party's proposals accepted in full or compromising to reach an agreeable middle point, it is assumed that both parties will

prefer the latter. Additionally, should negotiations fail and the arbiter forced to make a decision, it is expected that both parties will make reasonable proposals in order to stand a better chance of having theirs accepted.

Box 6: Pendulum arbitration in Guatemala's telecommunications sector
In 1996, Guatemala's Congress approved the General Telecommunications Law, which created the Superintendencia de Telecomunicaciones (SIT), a semi-autonomous regulatory body that operates under the Ministry of Communications, Transportation and Public Works, and that is responsible for, amongst other things, issuing licences and regulating the telecommunications sector. The General Communications Law also introduced pendulum arbitration as a mechanism for resolving disputes while avoiding protracted litigation. While the law itself has been praised, the SIT has struggled to carry out its activities to the full extent initially prescribed due to inadequate resources as well as pressure from both public and private sector bodies. Additionally, the regulator has noted that the legal framework does not provide it with sufficient power to ensure that firms comply with its rulings.
Source: Bisher, J. (2000) 'Telecommunications in Guatemala: do opportunities outweigh obstacles?', Prepared for University of Maryland University College Graduate School of Management and Technology, accessed on 23 September 2009 at http://webspace.webring.com/people/wj/jamie.bisher@ngc.com/guate_telecom_r1.pdf.

As can be seen from the above box, pendulum arbitration is seen as something of a "worst case scenario" approach, to be adopted when more progressive approaches fail. We note several issues with pendulum arbitration that make it less desirable than the alternatives:

- Pendulum arbitration does not facilitate or encourage dialogue between the parties, thus not leading to easier negotiations over time.
- Network utilities failing to invest the necessary amount in their infrastructure is considered a more undesirable outcome than consumers paying excessively. Hence, the arbiter is more likely to accept the utility's proposals. This could lead to a situation in which the utility makes no concessions during the negotiation stage, knowing that it is likely to be granted what it asks for if the process reaches arbitration.

3.3.2. Consumer appeals

With the exception of the communications sector, currently in the UK only the regulated companies can cause an appeal of a price review by refusing to accept a licence modification associated with the new determination.[7] In principle, the Secretary of State could cause something similar since it has the right to block a licence modification on behalf of customers. This need not lead to an appeal – in theory the regulator and company could propose an alternative determination without going to appeal – but has never been tested since no Secretary of State has so objected. In other countries the right of appeal is not limited to the regulated companies. For example, in Ireland customers also have the right to appeal regulatory decisions. This has been taken to

[7] Technically it is the regulator that appeals the refusal of the company to accept the determination to the Competition Commission rather than the company appealing directly to the Competition Commission.

extremes in the airport sector, where one airline has appealed a significant number of regulatory decisions – especially relating to price reviews.

Partly because of the precedent set by the Energy Codes (see Box 7) and partly because of the appeals mechanism to the Competition Appeals Tribunal (CAT) regarding Ofcom's determinations (see Box 8 on page 24) is considered successful and seen as the industry standard, the question of consumer appeals has gathered a lot of attention as part of the RPI-X@20 review. Hence, for the remainder of this document we focus on consumer appeals.

If we accept that the main objective of the regulatory regime should be to apply the best approach to achieving Ofgem's statutory duties, then the question becomes whether wider rights to appeal would create a set of incentives (within which companies maximise their profits) that better represent the balance of stakeholders' interests as prescribed by the Utilities Act 2000 than the current arrangements do. It is our view that the current regime has pushed the balance too far in favour of the regulated companies and, hence, it has been more than ten years since an appeal has been made to the Competition Commission against one of Ofgem's determinations. In the next section we consider in detail some of the arguments in favour and against wider rights of appeal.[8]

Box 7: Appeals against Ofgem's modifications of the Energy Codes

Industry codes are effectively the rules by which participants in the gas and electricity industry operate together. The appeals process is concerned with the codes that have the most commercial significance.

Where Ofgem rejects a majority recommendation on a particular modification by a code panel the Competition Commission has the power to:

- quash decisions by Ofgem;
- approve modification decisions;
- direct that recommended modifications rejected by Ofgem have effect; or
- remit decisions to Ofgem for reconsideration and redetermination in line with the Competition Commission's directions.

An appeal will normally take 12 weeks (exceptionally a maximum of 14 weeks) from the date of Ofgem's decision.

Legal framework

The right of appeal was provided for in Sections 173–177 and Schedule 22 of the Energy Act 2004, following a consultation by the Department of Trade and Industry (DTI, now BERR). The grounds upon which appeals can be made are set out in Section 175 of the Energy Act 2004. The Competition Commission may allow an appeal only if it is satisfied that the decision appealed against was wrong on one or more of the following grounds that:

- Ofgem failed to have proper regard for carrying out of its principal objectives and the performance of its duties under the relevant sections of the Gas Act 1986 and 1989 Act;
- Ofgem failed to have proper regard to the purposes for which the relevant condition has effect;

[8] It is worth noting that while consumer appeals are classified as an *ex post* solution, for this to be a tenable approach – and any appeal to stand up to Competition Commission scrutiny – customers will need to have been proactively engaged throughout the process.

- Ofgem failed to give the appropriate weight to one or more of the above matters or purposes;
- the decision was based wholly or partly on an error of fact;
- the decision was wrong in law.

Codes covered

The right of appeal applies to three codes in each of the gas and electricity industries. Broadly speaking, appeals can be made where Ofgem rejects a majority recommendation on a particular modification by a code panel.

The codes to which the right of appeal apply are, in electricity:

- The Balancing and Settlement Code;
- The Connection and Use of System Code; and
- The Master Registration Agreement (MRA),

in modification cases where Ofgem has the final right of approval.

In gas the codes covered are:

- the Unified Network Code (UNC);
- The Network Code;
- The Supply Point Administration Agreement (SPAA);

again, in modification cases where Ofgem has the final right of approval (some minor changes to the SPAA and MRA do not need Ofgem approval).

Certain decisions by Ofgem cannot be appealed, such as where the delay caused by an appeal might have a material adverse effect on the security of supply.

Source: The Energy Act 2004, Sections 173 to 177, accessed on 2 October 2009 at http://www.competition-commission.org.uk.

Competition Commission (2005) ' The Energy Code Modification Rules'.

There are, however, two types of appeal that could be made. The Competition Commission in its March 2009 final decision with respect to BAA discuss two types of appeal that could be made to them:

- investigations – the existing type of appeal which involves the Competition Commission reviewing the facts of the case; and
- adjudicative – in which the Competition Commission assesses specific issues raised by an appellant as to whether a regulator's statutory duties have been met by a determination (rather than the wholesale review involved in an investigation).

Both types of appeal can be useful. The latter type is driven by the appellants specific appeal and so should be more targeted and possibly easier to determine the merits of a case prior to undertaking a full review. However, that does not mean it is not possible to design appropriate safeguards for investigative appeals.

3.4. **Summary**

We have outlined in this section a range of ways in which consumers can be involved in the regulatory process associated with price control reviews. In our view the *ex ante*

approaches may be a complement to an *ex post* approach. In our view the history of UK regulation suggests that while *ex ante* approaches are helpful, they do not necessarily lead to a culture change, given that the regulator still knows that it is only the regulated company that can reject its proposals. Therefore, while it is appropriate to consider in more detail *ex ante* options, we would not necessarily see them as a substitute for *ex post* options.

4. WHAT ARE THE PROS AND CONS OF CONSUMER APPEALS?

4.1. Introduction

In this section we discuss a number of the issues that have been raised for and against extending consumers' rights to appeal against Ofgem's decisions. Below we examine in turn each of the following:

- difficulties associated with deciding who holds the right to appeal;
- fear that these could lead to frivolous or trivial appeals (and potential safeguards that could address these concerns);
- how Ofgem's statute and role may be affected;
- the impact on risk faced by the companies (and the consequent impact on the cost of capital) and the strength of the regulatory process; and
- whether consumer appeals can help frame the regulatory debate by setting precedents.

4.2. Benefits expected from granting the right to appeal to consumer

There are three likely benefits that we believe would arise from granting consumers the right to appeal. These are:

- changing the existing balance in the price control process so that it moves away from the existing negotiated settlement between Ofgem and the regulated companies to one where consumers are fundamentally involved in the process from an early date. This would mean closer, earlier and deeper involvement in the regulatory process;
- improving the robustness of the regulatory process and consequently decisions; and
- providing opportunities for appeals that would help inform future decision making.

The regulatory process was established in such a way as to provide for learning through the appeals process. This seems to have been forgotten and appeals now seem to be viewed as a failure of the regulatory regime rather than an opportunity for difficult issues to be discussed and lessons learned for future determinations. Broadening the scope of who has the right to appeal would potentially bring back this original situation.

4.3. Who has the right to appeal?

As noted above, the question of better outcomes from Ofgem's regulatory process extends beyond merely consumers to also include the environment, future consumers and other topics that are deemed to be "in the public interest". As such, the question of rights to appeal applies not only to consumers or their representatives, but also to bodies

that represent other stakeholders. It can be argued that stakeholders can include "end customers" which include:

- actual end customers (existing/future);
- consumer representatives (e.g. customer focus);
- network users (e.g. suppliers – discussed in more detail below); and
- independent networks;

The Competition Commission expressed the view that, in order for the appeals system to best achieve accountability, the right to appeal must be available to those with material interest with regard to the regulator's duties.[9] However, there needs to be a mechanism which helps determine who constitutes a materially affected stakeholder and who does not.

We think there are two general approaches that can be used:

- the law for wider consumer appeals could include a set of definitions of parties that are considered to be materially affected by Ofgem's determinations; or
- the appeal body or some other nominated independent body could be given the right to determine whether a party is materially affected subject to a set of pre-determined criteria.

As noted above, there is a potential range of stakeholders who could have the right to appeal. Each of the stakeholders can bring their own perspectives and issues to bear on the process and thus there would be merit in engaging with each of the stakeholders, although it is clear that each would also have different ability to engage (owing to resourcing, appetite to engage, etc). Support for the provision of a broad definition of customer was provided by the Competition Commission which has argued that since airlines pay the airport charges and it is their passengers who are ultimately affected by licence modifications, they are well placed to pursue customers' needs and should be granted the right of appeal.[10]

We recognise that too broad a set of stakeholders having rights to appeal could have drawbacks with regard to frivolous appeals (discussed below), but some of the mechanisms discussed below would effectively discourage many parties from appealing unless they had a clear case.

4.4. Frivolous appeals

The main concern that critics of wider rights of appeal have voiced regards the potential for trivial or vindictive appeals to be raised, potentially by parties intending to delay the implementation of decisions that they do not like. Indeed, the Irish airports experience demonstrates that an unfettered right to appeal may not be appropriate. However, designing appropriate checks and balances so that customers gain a realistic right to

[9] Competition Commission (2009) 'BAA airports market investigation', p. 279.
[10] Competition Commission (2009) 'BAA airports market investigation', p. 280.

appeal without unduly burdening the regulatory process ought to be achievable, as evident by the experience of CAT appeals and the Energy Codes.

Several factors may impact on the decision of stakeholders to launch an appeal, including:

- Initial hurdles – the fact that there is often an initial stage of establishing the right to appeal at which vexatious or incomplete appeals can be stopped. For example, one of the appeals to the Competition Commission against Ofgem's code modification was refused leave to appeal on the grounds of failing to meet the stated requirements of material interest, complete application, etc. Having clear rules by which appeals are initially judged and, consequently, grounds for refusing appeals creates a credible hurdle.[11]
- External costs – if the cost of the appeal, and the cost of other parties, falls on the appellant if the appeal is unsuccessful then this is likely to influence their decision about making an appeal where they face little chance of winning. The Independent Panel report seemed to imply that the costs of appeal to the CAT were sufficient to influence decisions about whether to appeal.[12]
- Time commitment – a major cost for appellants is the time taken for senior management to be involved in the appeal process, and this can have a much greater impact on a company than any external cost associated with an appeal since the management are not available to undertake their day-to-day roles and responsibilities for a significant time period.
- Reputation risk – Management teams often put their careers on the line when they decide whether or not to appeal a decision. A perceived "loss" could be very costly on a personal level, which is a powerful barrier.

If these hurdles were still felt to be insufficient to stop vexatious or frivolous appeals, then in addition it could be proposed that price decisions would be implemented from the time initially set, rather than waiting for any appeal to be completed. This obviously would not be appropriate for appeals against some licence amendments, but it could stop appeals which were just seeking to delay to a price increase. Obviously, any change to the determination would then have to be implemented on a net present value-neutral manner but, provided the appeal is completed within six months, the time under which the new pricing regime had been implemented is likely to be limited – especially since there is normally some time allowed at the end of a price review for appeals to be heard prior to the implementation of the determination.

Furthermore, the nature of the appeal is likely to have an impact on how often these are sought. As the Competition Commission notes, investigations are lengthy, complex processes which tend to place a significant burden on the company and there awarding costs is fraught with difficulties. In comparison, adjudicative appeals assess the merits of

[11] Ibid.

[12] Department for Transport (2009) 'Report of the independent panel on airport regulation', accessed on 2 October 2009 at http://www.dft.gov.uk.

the regulator's decision against its duties, with reference to the specific points raised by the appellant. Such appeals can be subject to an initial stage in which the relevance of the appeal is checked and frivolous appeals are rejected. Additionally, the nature of adjudicative appeals lends itself to recognition of "winners" and "losers" and, hence, to award of costs.[13]

In Box 8 we describe the process by which appeals to the CAT against Ofcom's decisions are filed and reviewed. The experience in this area has shown that sensible rules ensure that only serious appeals are submitted.

Box 8: Rules for appealing Ofcom's decisions to the CAT

Scope

Article 4 of the EU Framework Directive on 'a common regulatory framework for electronic communications networks and services' introduced a right to appeal, requiring that parties subject to a decision by a national regulator relating to electronic networks, services or rights of use of spectrum should have the right to appeal to an independent party.

In the UK, Section 192 of the Communications Act 2003 introduced an appeal mechanism to meet these requirements. As such, any party affected by a range of regulatory decisions (such as the revocation of a licence or price control matters) taken by Ofcom (or the Secretary of State) can receive a full appeal before the Competition Appeal Tribunal (CAT). The Act established the CAT in place of the appeal tribunal of the Competition Commission, and is funded and supported by the UK Competition Service.

Appeals can be made on a range of decisions made by Ofcom, the Secretary of State or another decision maker under the Communications Act 2003, or the Wireless Telegraphy Acts (1949 & 1998). Certain decisions are not subject to appeal. These decisions either have no immediate effect as they require a further act or decision to come into effect or cover matters outside the scope of the EU Communications Directives.

Process

Appeals before the CAT are relatively straightforward and efficient. However they can be expensive to pursue. An appeal can be made by submitting a notice of appeal to the CAT and may be sought on the grounds of either:

- an error of fact; and/or
- an error of law.

To be accepted, the notice of appeal must include details of what decision is being made and the grounds for appeal, but must be submitted within a defined timeframe (a notice of appeal must be received within two months of the appealing party being notified of the disputed decision). The CAT makes decisions based on the merits of the case and the grounds set out in the notice of appeal. This gives the CAT relatively wide-ranging jurisdiction to investigate the appeal and assess the decisions compared to a judicial review. The CAT must subsequently communicate any directions regarding what they consider to be the most appropriate action to be taken by Ofcom or any other relevant decision maker.

Further appeals

CAT rulings may be appealed on a point of law at the Court of Appeal or the Court of Session in Scotland.

[13] Competition Commission (2009) 'BAA airports market investigation', p. 278.

Costs

The CAT has discretion over whether to award legal cost orders against Ofcom. Recent cases have shown that they are unlikely to be awarded costs unless it is clear that Ofcom acted unreasonably or in bad faith. Costs were not awarded in a recent case despite Ofcom's determination (which was overturned) being found to be "seriously flawed."

Appeals in practice

Of the 109 appeals seen by the CAT at the time of writing, 29 were against Ofcom decisions. It is not possible to say how many appealable decisions have been made and therefore how acceptable Ofcom's decisions have been in general. Nonetheless, this seems to be a manageable number over six years. The appeals against Ofcom have largely been with regard to access issues (such as termination charges) or the labelling of significant market power, rather than specific price control decisions. Appeals to date have shown that Ofcom must be confident with its decisions in these areas and, in particular, that it should be prepared to face appeals from companies that believe they are victims of anticompetitive practices by other companies that were permitted by Ofcom.

Sources: European Commission (2002) 'Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services'.

Ofcom (2007) 'Wireless Telegraphy Act licensing policy manual: a practical user guide to licensing policy'.

Competition Appeals Tribunal (2003) 'The Competition Appeal Tribunal Rules', Statutory Instrument 2003 No. 1372.

Berwin, S. J. (2008) 'Standard of review by the Competition Appeal Tribunal', *The Legal 500*, accessed on 23 September 2009 at http://www.legal500.com/developments/5984.

4.5. What will be the impact on Ofgem?

A related point to the above issue of frivolous appeals is how Ofgem may be affected by an expansion of the rights to appeal. It has been argued that the right to appeal would be abused to such an extent that in effect two price control reviews will take place – the first, by Ofgem, would not be taken seriously by any of the stakeholders, with all of the attention focused on the second review by the Competition Commission instead. The perception is, therefore, that Ofgem will effectively be reduced to the role of mediator. As we note above, however, so long as there are mechanisms in place to discourage trivial or vexatious appeals, the right to abuse will only be used appropriately and with due consideration.

One option for ensuring that appeals are more targeted and to avoid a marginalisation of Ofgem is to narrow the grounds for appeal only to a set of specific issues by which each stakeholder is considered to be materially impacted. This will help prevent attempts to "throw out the baby with the bath water". However, the right to appeal Ofgem's entire determination should still exist, but be subject to a much stricter evaluation of materiality – similarly to the way the full "shipwreck clause" in Ofwat's price control requires a higher materiality threshold to be passed than the event-specific IDOK.

We also do not believe that adjudicative appeals only are appropriate, although they clearly have a role to play. Investigative appeals are important to ensure that the robustness of a regulator's arguments can be tested. One solution could be to allow appellants to decide what type of appeal they would like – with a consequent risk in terms of the costs, time etc noted above differing as to whether an investigative or adjudicative appeal is sought. However, no matter what type of appeal is sought we do not believe that this weakens Ofgem's role.

4.6. Better determinations / removing regulatory risk

Some of the companies that Ofgem regulates have argued that extending the rights to appeal would increase regulatory uncertainty and should, therefore, be accompanied by a higher cost of capital allowance.[14] However, not only is there little reason to suspect that the companies would be subject to greater regulatory uncertainty as long as the necessary steps are taken to prevent frivolous appeals, there is also an argument that regulatory uncertainty would, in fact, be reduced if wider rights to appeal are used to arrive at better regulatory determinations. This is, we believe, appropriate to both substantive and process related risks.

The desire to avoid appeals of its determinations should lead Ofgem to engage more actively with consumers and to take on board their views. This, in turn, should result in better, more robust and ultimately more acceptable determinations for all stakeholders. As mentioned above, profit maximisation in competitive markets is a function of meeting consumer needs, and the same holds true for the faux-competitive markets which Ofgem regulates. With the right to appeal extended to consumers, investors should be able to take heart from the fact that Ofgem is taking on board a range of stakeholder views and, therefore, that its determinations would be less likely to require interim adjustments or significant changes from one control period to the next. Hence, while we think that there is a strong case for not raising the cost of capital allowance in response to widening the rights to appeal, we feel that an equally compelling argument could be made for lowering the allowance.

4.7. Framing future regulatory discussion

Should appeals be made against Ofgem's decisions and heard by the competition Commission, these could help frame the discussion for Ofgem (and potentially other UK regulators') future price control reviews. This is particularly true with regard to targeted, rather than general, appeals.

The grounds on which appeals are made, and the discussions that follow, would be indicative of the main concerns of stakeholders (including the companies themselves). It is reasonable to expect that Ofgem would "learn from its mistakes" and that over time its decisions would be sounder, its consultation more inclusive and, ultimately, the outcomes more in line with Ofgem's statutory duties.

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[14] Whether the higher risk is linked to uncertainty about the substance of a decision or the fact that there is greater overall regulatory risk arising from the extension of the process is not clear.

While we consider that frivolous appeals are undesirable (and the risk of these can be mitigated relatively easily – for example through a CAT-type "leave to appeal" mechanism), we also consider that the current situation where no network company has appealed a price control proposal from Ofgem for over ten years (two full price control cycles) is undesirable. Major changes to the regulatory regime have occurred over this period, including the introduction of the Information Quality Incentive, Investment incentives building from gas entry capacity auctions, major environmental incentive schemes, etc, and yet none of these mechanisms have been considered at any stage by the Competition Commission.

5. CONCLUSION

There seems to be a move towards a general consensus in regulated industries in the UK that closer engagement with consumers is a necessary element of better regulation. In this report we have highlighted the current situation regarding consumer participation in Ofgem's price control review processes. We noted the general deficiencies which are present in Ofgem's current approach and have considered a range of options that could improve consumer involvement and help achieve Ofgem's statutory duties.

We categorised our options into two groups: *ex ante* and *ex post*. These are not mutually exclusive and could in fact be complementary. However, we noted that, in general, there are complications in implementing an *ex ante* approach to consumer engagement in the industries in which Ofgem operates due to the nature of these industries. Most notably, because the products/ services of these industries are not consumed for themselves, but rather are consumed in order to facilitate the consumption/ use of something else, consumers find it hard to judge the quality and value for money of the product/ service that they receive. However, that is not to say that greater use of *ex ante* approaches should not be consider, but they are unlikely to be enough by themselves.

This leaves *ex post* engagement as the more appropriate approach. We presented a detailed discussion of the case for and against extending the right to appeal against Ofgem's decisions to consumers (and potentially other stakeholders). Experience with regard to Energy Codes and in the communications sector, as well as the competition Commission's desire to see the right of appeal extended, have build a compelling case for those who are materially impacted by regulatory decisions to have the right to appeal. We noted that by setting sensible hurdles to the appeals process, many of which atre relatively simple to introduce, the risk of frivolous appeals could be avoided. We also noted that experience in the UK, with regard to appeals against modifications to Ofgem's Energy Codes and appeals to the CAT against Ofcom's decisions, shows that the power to appeal has generally been exercised responsibly.

We argued that, as long as the necessary checks are in place, Ofgem's role would not be marginalised and regulatory risk would not increase, and may, in fact, decrease owing to better outcomes from the regulatory process. All in all, we believe that consumer appeals are an effective way to improve Ofgem's ability to meet its statutory duties without necessitating an overhaul of the regulatory framework. This issue becomes even more crucial with the proposed changes to Ofgem's primary duties. We, therefore, advocate that Ofgem should undertake consultation into how a wider appeals mechanism might be implemented.