

RPI-x@20 Consumer Working Group Paper

1 Introduction

This paper examines the current regulatory environment for consumers and the issues faced by the regime in engaging consumers and their representatives in the price control process. It does not make any recommendations, as the issues raised within the paper require more detailed examination and debate than that available to working group members in order to explore in the required depth. In addition, although there has been agreement in a number of areas, it has not been possible to gain consensus across the working group on some fundamental points and this necessarily constrains the ability to reach agreed outcomes. It should therefore be regarded as a useful starting point upon which to build and develop some of the emerging themes and arguments.

A paper developed by John France on Appeal Mechanisms for the workgroup will be published separately as it could not be agreed by all members.

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Defining Consumers

Definitions of consumer vary, but generally describe an individual or entity that purchases goods or services. In the energy context, this definition holds true and as for other sectors, the goods and services purchased will differ depending on the needs, priorities and activities of particular consumers. It follows therefore, that the concept of a typical consumer would be a false construct in any market-place including that of energy.

From an energy network perspective, consumers of goods and services fall into a number of categories:

- a. Domestic consumers
- b. Small and Medium Enterprise non-domestic consumers
- c. Large non-domestic consumers
- d. Energy Traders
- e. Gas Shippers
- f. Energy suppliers
- g. Storage Operators
- h. Liquified Natural Gas Operators
- i. Gas Producers
- j. Generators
- k. Other downstream networks
- l. Connection Providers
- m. Metering services businesses
- n. National and Local Government and Statutory undertakings

This is a very diverse (and not exhaustive) list of consumer categories all of which can be further sub-divided into different segments. For instance, domestic consumers will include; those on high incomes as well as the fuel poor and vulnerable. They may also receive different types of service such as; emergency services, connections and meter-works as well as being affected by asset replacement or reinforcement activity. Each individual consumer will value different services in different ways and those values will also change for an individual depending on their circumstances at a given point in time. For the purposes of this report, “consumer” is used in its widest sense to include all categories outlined above.

This diversity makes it very difficult to define what consumers actually want, particularly in the absence of competitive alternatives, where choice is limited or non-existent. Thus we also place reliance on “representative” bodies either statutory, voluntary or trade associations to act as a focus and proxy for consumer views. Although imperfect (and recognising that consumer bodies still have to decide how to balance the conflicting preferences of those they represent), this is probably the most practical means of filtering and counter-balance the breadth of consumer opinion.

The question is how much weight should be accorded to the opinions expressed by organisations that represent the views of customers and to what extent this should influence price control outcomes.

1.1 Network interaction with consumers

Just as consumers are not a homogenous group, the energy networks are diverse in terms of their size, market position and energy delivered. The product is either gas or electricity and the networks are Transmission, Distribution or Independent Distribution (Independent Gas Transporters and Independent Distribution network operators).

These characteristics mean that different network operators interact with different consumer categories.

1.1.1 Transmission

Transmission companies have very little interaction with domestic and SME non-domestic consumers, other than where new transmission engineering work is being carried out in a particular locality. The direct consumers of Transmission services are normally gas shippers, generators, direct entry connected customers and large non-domestic consumers. In some respects Distribution network operators could also be considered as consumers of Transmission services.

Being larger, well resourced commercial organisations with longer term investment horizons, there is arguably more scope for these consumers to influence the outcome of a Transmission price control. Nevertheless the same diversity of views, driven by commercial imperatives is unlikely to provide adequate clarity to underpin efficient investment decisions.

1.1.2 Distribution

Distribution companies tend to have more impact on domestic and SME non-domestic consumers than transmission networks, both through their activities and relative costs (distribution costs being typically 15 – 20% of a domestic consumers energy bill). Consumers experience distribution services through the reliable delivery of energy into

homes or through emergency call centres and work associated with emergency, repair and replacement activity, together with provision of connections and metering services. In some cases Suppliers act as an intermediary between distribution networks and customers by facilitating information flows and contracting for services such as meterworks and connections on behalf of consumers.

The scale in terms of population and diversity of the consumer base for distribution networks makes it very difficult to obtain any consensus on clear investment signals. Hence reliance on “representative” organisations or focus groups to provide input on behalf of consumers. The question of how these groups balance competing demands and interests in order to develop a viewpoint that reflects the spectrum of opinion is unclear and might depend on the issue being faced.

1.1.3 Independent distribution operators

Independent distribution operators although licensed are not directly price controlled (the relative price control restricts transportation revenue) and therefore have some limited flexibility to offer more services. Similarly to distribution networks, their main inter-action is with domestic and SME non-domestic consumers. As they are not directly price controlled, investment is driven by network growth.

1.2 Consumer involvement in current price controls

A typical price control review will be carried out over 18 – 24 months during which Ofgem will review evidence relating to both the historic and forecast costs and operation of the network business. Much of this evidence is sourced from the networks, particularly with regard to historic, current and forecast data. At regular intervals during the price control review public consultation documents are published outlining Ofgem’s views and seeking responses from interested parties. These responses are used to inform the next phase of the review ultimately leading to the Final Proposals which concludes the process if the licensee accepts the proposals.

Direct consumer involvement in this process is generally restricted to industry consumers such as suppliers and representatives of trade associations and domestic consumer representative bodies such as Consumer Focus and the Fuel Poor Advisory Group. There is no particular bar to individual consumers participating in the consultation process, but in general there is limited interest. In addition to those already mentioned the network businesses and Ofgem typically engage consumers directly through surveys and focus groups, which are used to gain insights into customer perceptions of service and cost and willingness to pay for enhancements. Since the purpose of the surveys is usually to find out what customers value and how much they are willing to pay for it, this work is usually utilised for customer related incentives and performance standard development rather than the core price control building blocks of capex, opex and WACC.

This model of consumer involvement has evolved over the years since Ofgem’s primary duties were amended by the Utilities Act in 2002 with increasing levels of consumer engagement. Recently as part of the Consumer First programme, Ofgem has appointed a Consumer First Panel and Consumer Challenge Group. The former consists of one hundred members of the public and meets three times a year to discuss consumer energy issues and the latter of six consumer experts who challenge the Gas and Electricity Markets Authority on policy issues, including those arising during price control reviews.

In all cases Ofgem will take into account the views expressed by these fora in coming to a particular decision, but ultimately will decide on an appropriate course of action taking into account a number of factors consistent with its statutory duties. The influence of these bodies is unclear and whether they could or should be utilised or expanded to form a more powerful voice could be explored further.

1.3 Post Price Control engagement

Following implementation of a price control, formal consumer engagement has tended to follow a well established continuous process. Networks continue to provide transmission and distribution services and inter-act with domestic and non-domestic consumers largely through provision of energy delivery and replacement, emergency, connections and metering activities. At an industry level the inter-action is generally commercial and revolves around regulated contracts such as the Uniform Network Code and Connection and Use of System Code and the supply point administration and invoicing arrangements. In general these arrangements work effectively and ensure that networks respond to customer requirements consistent with their respective licences.

On occasions where this doesn't happen or consumers and their representatives raise particular concerns these are dealt with through a variety of routes. Individual concerns or complaints are either dealt with directly by networks or to the extent they don't do so adequately, issues can be raised through various channels. These include Consumer Direct, Consumer Focus, the Energy Ombudsman and in certain cases such as connection pricing, through Ofgem determination. Industry consumer issues are more likely to be managed through established commercial channels or within the various regulated Code Agreements outlined above.

More significant issues affecting consumers can be dealt with by formal Ofgem investigations such as those relating to electricity connections and gas metering competition. Others, depending in severity and timing, can be rolled into the following price control.

In addition to the ongoing inter-action and dialogue with consumers, networks are required to gather and publish information about their businesses such as pricing information and business plans as well as performance metrics.

During the course of the gas distribution price control, gas networks are required to carry out quarterly consumer surveys following planned work, emergency and connections activity. The results of these surveys are published to enable the public and other interested parties to assess consumer opinions of the service provided. Furthermore, all networks are required to submit and have published their performance against regulated standards of service. Failure to achieve standards of service could lead to enforcement action by Ofgem. Networks are also required to submit detailed cost and revenue data on an annual basis, which again is published by Ofgem for public scrutiny and is used to provide evidence for subsequent price control reviews.

This level of dialogue and provision of information provides consumers with the opportunity to scrutinise network activity and performance in great detail; arguably far more than competitive businesses in either the energy market or other sectors. The extent to which this information would be of help to domestic and non-domestic consumers in shaping their views on what they want from networks in the future is unclear. It can however, provide

useful insights for representative bodies and industry consumers such as suppliers, shippers, generators and others who have the resources and capability to use it.

1.4 Current Appeal Mechanisms

During a typical price control review participants and interested parties can express views and provide responses to the consultation papers published by Ofgem during the course of the review. At the end of the process, Ofgem publish what is termed, final proposals that describe the basis of the future price control, including an assessment of costs, incentives, revenues and services to be provided to consumers. While the final proposals articulate the outcome of the review they do not have any formal status in themselves. This aspect of the price control resides with the accompanying licence modification proposals which only the licensee (or licensees in the case of collective elements of the licence) can object to.

Where a network company refuses to accept a price control determination, it is able to cause an appeal of a price review by refusing to accept a licence modification associated with the new determination¹. This appeal will re-examine the entire price control package and may vary its terms and relevant licence conditions giving such effect. Such appeals have been relatively rare in relation to price controls, although British Gas plc triggered references to the Monopolies and Mergers Commission (the Competition Commission's predecessor) in 1993 and 1997. There is no formal right of appeal for other parties such as consumers or industry participants such as energy suppliers or their representatives.

The only other form of power over price control licence modifications rests with the Secretary of State in the event that he/she requires amendments to be made. This particular power has not been exercised since the respective gas and electricity privatisations were enacted.

¹ Although, strictly speaking, it is the regulator that appeals the refusal of the company to accept the determination to the Competition Commission.

2 Consumer involvement in price controls

This section sets out views of the group on a number of issues that may impact the willingness / propensity of consumers to actively engage in price controls.

2.1 Complexities of market structure

In the UK, domestic and non-domestic customers select the energy supplier of their choice and are billed by them for the energy used. A component of the unit price of the energy covers the distribution and transmission of the energy. The customer has no effective choice over which companies undertake the distribution or transmission of their energy, and typically has no active interest or involvement in price control processes.

The relationship between supplier and distributor is very different compared with many industries providing a consumer service in the UK. The payment of the distribution or transmission company is made by the supplier, but the consumer deals directly with the distribution company for emergency, interruption and new connections (and can pay the distributor directly for new and altered electricity and gas connection work).

2.2 Transparency

Following Ofgem's retail probe work, from April 2010, suppliers will be required to include a range of elements on domestic bills (including tariff name, a consumption comparison with same period for previous year, and a projected cost for the following year). A breakdown of network components is not one of these requirements; however some suppliers (e.g. British Gas) provide this on a voluntary basis.

However, despite the efforts of some suppliers to give their customers a breakdown of the main components of the energy bill, it is unlikely that the typical consumer will understand the components attributable to distribution or transmission, what this income funds or how the prices are reviewed and controlled.

In the interests of informing consumers of the costs of distribution, transmission and environmental initiatives, suppliers could look to provide such a breakdown on consumer bills in future.

2.3 Level of understanding and knowledge of stakeholders

Most domestic and small business consumers are unlikely to understand the electricity and gas distribution or transmission arrangements, the relationship between the distributor and supplier or how the distribution price controls are established and reviewed. Unlike the UK Water industry, the price control determines allowable revenue rather than distribution prices making price control more difficult for the lay person to understand.

Historically, (and potentially due to the legally binding nature of price reviews), price control documentation has tended to be complex and lacked "plain English" summaries, that could be understood by a layman. In the past this might have contributed to difficulties engaging

consumer groups in some of the key debates of price controls². This is something that could be rectified by Ofgem or networks to explain the impact of a price review, although would have to remain factual and balanced in order to serve a useful purpose.

2.4 Increasing energy prices and network costs

Since privatisation energy and network costs have fallen substantially, although more recently, domestic and small business consumers have faced increasing energy bills and this has been reflected in recent media articles. The underlying cause of these recent increases has tended to be attributed to increasing commodity prices. Increases that have resulted from higher capital expenditure necessary to invest in sustainable long-term distribution and transmission networks have typically not received similar levels of media attention other than at the point at which Ofgem announces its final proposals. As a consequence, it is possible that consumers may not have seen a clear need to engage actively in price control settlements.

2.5 Low carbon agenda v. affordability

This causes an apparent conflict between the affordability of energy and the investment in long-term sustainability and low-carbon distribution and supply in which the consumer has little effective say or involvement. Indeed it is highly likely that faced with higher network costs to support the government's climate change commitments, some consumers will be unwilling to pay. This particular issue will be more critical for consumers in a recession and if the outlook for wholesale energy costs is rising. In that sense there is a legitimate question as to whether **today's consumers** are best placed to make long-term investment decisions on behalf of **future citizens**.

2.6 Security of supply

Consumer interest in distribution or transmission of energy is very low and is generally only awakened when supplies are interrupted, or when there is a threat of interruption (although increased interest may also be triggered by price rises). At such times security of supply becomes a key issue as consumers realise that many gas and other heating systems rely on a supply of the fuel and an electricity supply to function.

2.7 Role of Ofgem as a consumer representative

In conducting the regular review of price controls, Ofgem has a responsibility for balancing the needs of the distribution and transmission companies with the needs of consumers and other network users. To undertake this responsibility, Ofgem has increasingly required such companies to publish strategic plans and has consulted with consumers and their representatives, the latest example of this being the consultation in 2008 in preparation for the electricity distribution review, DPCR5. It is therefore possible that customers have felt less need to engage in price control reviews, given a perception that Ofgem would ensure their rights were protected.

However, Ofgem also needs to balance its primary duty to protect the interests of existing and future consumers with other secondary duties. In addition, the increasing focus on sustainability, as part of the Energy Act 2008, may make it more challenging for Ofgem to

² Although the most recent price control publications by Ofgem – Initial Proposals for the electricity distribution price control – do seem to represent a movement towards a suite of documents that comprise an overall (plain English) summary document, with more technical appendices.

focus on its primary duty to current and future consumers – particularly if it is assigned new primary duties relating to security of supply and carbon emissions reductions. This may signal an even greater need to include the voice of the consumer in price control settlements.

2.8 Consumer interest – their willingness to engage

It is unlikely that many individual consumers or representatives of such consumers have sufficient knowledge of either the process or the issues to contribute significantly to the review process. In contrast, networks, Ofgem and suppliers employ specialist and experienced teams to deal with price controls and regulatory matters.

Some attendees of the Working Group believe that energy suppliers do not have a remit to represent the consumer view in this process, suggesting there to be a misalignment between short-term commercial objectives of suppliers and the longer-term investment needs of networks. This is not to say that suppliers do not have a legitimate interest in influencing price control outcomes, but these attendees thought it would be wrong to characterise the objectives of suppliers and consumers as being the same and therefore suppliers representing an adequate proxy for consumers.

However other attendees noted that network charges are an increasingly important area of supplier cost. As such, these attendees believed that the level of network charges – and uncertainty around the future levels of these charges – mean suppliers have a material interest in the outcome of price control reviews. While suppliers recognise the need for investment in networks, they also place a high importance on ensuring that network charges do not increase any more than is necessary, and that uncertainty and volatility in these charges is minimised.

2.9 Who is a representative consumer? – special interest lobbying

Currently the general residential or business community does not have sufficient interest, knowledge or resource to lobby during a price control review. There are bodies which do purport to represent various classes of consumer and local government agencies who are involved in regional development. These groups inevitably focus on the issues pertinent to their members or representative interests. For instance, Regional Development Agencies will seek investment to support local growth plans or the Fuel Poverty Advisory Group will lobby on behalf of the fuel poor. It is Ofgem's role to balance the legitimate views and expectations of these groups with those of the wider consumer base in devising price control proposals. If consumer representatives were given more influence in price controls, this balance would need to be carefully managed to avoid undue weight being given to one group over others.

Given the long-term nature of investments made by network operators, there is a great danger that such influence could produce stop-start investment policies leading to inefficient investment and security of supply degradation.

The Consumer Working Group believes that Ofgem could continue to take the role in balancing the views of the various parties that engage on the price control to ensure that any special interest lobbying is balanced with a view of the longer-term consumer needs of cost effective and reliable distribution and transmission. However, without stronger and

experienced consumer representation from consumer bodies it will be difficult to incorporate their needs in price controls.

3 Alternative approaches

3.1 Introduction

In previous sections, we set out a number of potential difficulties in engaging customers on the price control review process. This section sets out potential solutions to some of these potential difficulties, including:

- a summary of **characteristics** of a better process of customer engagement;
- an overview of **generic models for customer engagement**;
- a description of “**who**” could act as customer representative; and
- a discussion of **safeguards** that may need to be included in a new model for customer engagement.

3.2 Characteristics of a better process

In the previous chapter, we set out a number of perceived difficulties with engaging with customers, some of which may apply (in varying degrees) to price control processes currently conducted by Ofgem. In this section, we set out a number of characteristics which could be viewed as being “desirable” in a price control process, with particular regard to encouraging involvement of customers.

- **Inclusivity.** It is important that, to the greatest extent possible, the process accounts for diversity in the views of customer, and ensures that the views of no customer segment is unduly discounted. In addition, the process should also try to ensure that barriers to customer engagement are minimised (e.g. through preparing price control documentation that customers can engage with relatively easily).
- **Minimising complexity.** Complexity of price control processes and price control mechanisms tend to act as a barrier to customer engagement. This is because complexity, by its nature increases the level of time and resources that are a “prerequisite” to engagement. A price control process that is relatively less “complex” could therefore be viewed as being more likely to encourage customer engagement. While minimising complexity could be viewed as being aspirational (as incentive-based regulation by its nature involves a degree of complexity), complexity can be reduced by increasing the use of “top down” indicators of the implications of proposals.
- **Improving transparency.** Engagement can also be promoted through improvements in the transparency of price control processes. This could include the publication of more easily accessible price control documentation, as well as the wider use of other ways of engaging with stakeholders (e.g. workshops, seminars and roadshows). Networks and suppliers could also be viewed as having a role in improving transparency. For example, suppliers could continue to improve the transparency of way in which energy bills are communicated to end customers, and networks could continue to improve the way in which anticipated changes to network charges are communicated to stakeholders.
- **Clarity of role of the regulator.** Customer engagement may be promoted by a wider understanding that Ofgem is increasingly required to balance its duties to protect the interests of current and future customers with other (sometimes conflicting) duties. This may be particularly relevant following the anticipated addition of new primary duties relating to security of supply and emissions reductions. – c

3.3 Generic models for customer engagement

Numerous questions have been raised in the context of potential models of customer engagement. These include:

- extent and nature of information provision (including timing)
- definition of which customer representatives should be involved
- role for government
- potential need for a consumer panel in the price control, and
- role of a right of appeal (with or without a formal consumer panel)

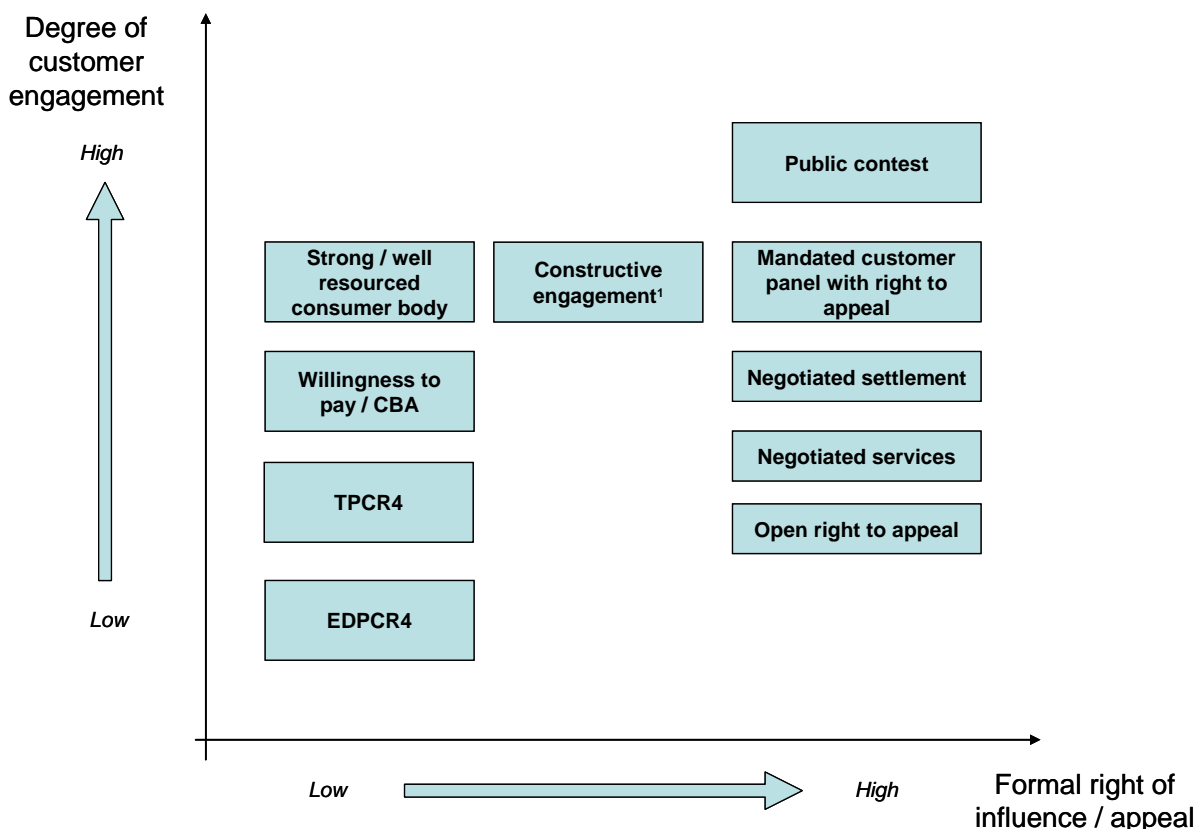
Potential models for promoting customer engagement are diverse, and may differ in suitability depending upon:

- nature of network (i.e. T or D) and consequent “type” of customer
- scope of core issue / concern (e.g. single large investment)
- energy type

Nevertheless, we need some structure to set out the set of “solutions” that could be followed in engaging with customers. Two key defining characteristics seem to be:

- degree of customer engagement each model induces; and
- extent to which customers have a formal right of influence (e.g. right to sanction a set of investment / right to appeal change to a licence condition).

These are illustrated below:



¹Degree of customer engagement in this model critically depends on definition of “customer” (e.g. can airlines be viewed as a customer representative?)

Note that this does not show all of the potential “solutions” – but some of the key models debated to date. A more detailed analysis of models used in other industries/countries are included in section 4 of this paper.

3.3.1 Lower engagement / lower level of formal rights models

Current models (i.e. DPCR4 / TPCR4 – to varying degrees) are effectively “consult and explain.” Consumers’ rights are protected by an independent regulator, which will consult consumers, and provide explanations for decisions. As such, customers have relatively limited direct involvement in the process, and tend to have a limited level of engagement.

Other models in this category (with increased level of consumer engagement, though still a low formal right of appeal) would be models using Willingness to Pay surveys and use of evidence from these in cost benefit analysis (CBA) as an option. Ofwat is an example of a regulator that has made this work well. A further option (with higher level of engagement) would be a model with a strong / fully resourced consumer body. .

3.3.2 Higher engagement / higher level of formal rights models

Numerous models with higher levels of formal customer influence exist. One example is “Public Contest”, which places customers at the heart of some key decisions – but application of such models tends to be specific and limited. This model has been used in Argentina in the context of transmission investment (with projects being voted on by users, with the regulator being required to accept the outcome of such votes).

Other general methods of increasing formal right of influence include “negotiated settlement” (agreements binding on parties, but not mandatory for adoption by regulators). However, again these tend to be focused on *specific* issues (with scope defined by the regulator).

The constructive engagement model (e.g. UK airport price control reviews) is an additional example, which may have a broader scope (defined by the regulator). However, models that rely on negotiation / engagement tend to require a small group of customers that have relatively well aligned objectives.

3.4 Who is a customer representative?

The definition of who is a customer representative is clearly critical when seeking to increase the level of customer engagement in the regulatory framework.

Empowering energy consumers is not straightforward. There are more than 20 million premises in Great Britain connected to the electricity network and 17 million connected to the gas network. It would therefore be a challenge to secure the direct participation of so many people in the regulatory process.

One alternative would be to follow arrangements under the Enterprise Act 2002 whereby a ‘designated consumer body’ can make a ‘super complaint’ to the Office of Fair Trading (OFT) could be adapted to define a body that could exercise powers of veto or appeal on behalf of consumers.

However, focusing power of engagement with a single body does have a downside when the diversity of consumer interests is recognised. This issue becomes especially complex when the balance of interests between existing and future consumers needs to be struck. Whilst it is possible to see how a representative body might look after existing consumers, it is less clear how it would do the same with respect to future consumers.

There are a number of relevant precedents regarding the engagement of customers, including:

- in telecoms, “a person affected by” an Ofcom decision can bring an appeal to the Competition Appeals Tribunal (CAT). The CAT is then required to refer appeals related to price control conditions to the Competition Commission for determination. In practice this means that all customers are able to appeal regulatory decisions to an independent third party;
- in energy, Energy Act 2004 allows for a “consumer group” to challenge some of Ofgem’s modifications to designated industry codes;
- in airports, constructive engagement was used in the airport price control review, with CAA suggesting stakeholders (including airlines) focused on a narrow range of issues (rather those covered in a broad control).

The Competition Commission (CC) recently published some views on the definition of “customer” in the context of increased engagement in regulatory controls³ In this document, the CC says:

- the effectiveness of the appeal system in providing accountability will be directly affected by the breadth of the class of people with standing to appeal; and
- in considering who should have standing to appeal, the CC believes the starting place should be that a system of appeals provides accountability (i.e. giving all parties that have a material interest at stake the right to defend that interest).

The CC’s views are necessarily confined to the regulation of the airports sector and the working group did not consider the extent to which the premises upon which the CC made its recommendations in relation to airports would apply in the energy networks sector.⁴

With respect to airlines, the CC states that the interests of the airport, of airlines and of passengers are all aligned, and it suggests all these classes of party should have rights of appeal (given they all have a material interest). The CC also says that, as well as airlines having standing to appeal, passengers should be able to appeal but only through the medium of designated passenger groups.

Importantly (and in response to CAA concerns that if airlines are allowed a right of appeal they will only exercise this to protect their interests), the CC believes it correct that a party will exercise that right of appeal where it thinks its interests are at stake (and where the benefits of an appeal seem to outweigh the disadvantages). However, the appeal will involve the application of the regulator’s duty to the facts of the case – therefore “the ability of an airline to pursue its interests through an appeal will be limited by the nature of the regulator’s duty”.

³ BAA airports market investigation, Competition Commission, March 2009

⁴ This issue is considered in detail in the paper *Consumers, Stakeholders and Appeal Mechanisms in the Regulation of Energy Networks* by John France which appears on the Ofgem RPI-X@20 web forum.

3.5 Safeguards

One potential criticism raised with regard to increased customer involvement, and the granting of a right of appeal to price control determinations is that this may make CC references more common and make the CC, rather than the sectoral regulator, effectively the real regulator of the system.

The CC recognised this with respect to airports and discussed (without reaching definitive conclusions) the pros and cons of a number of possible “safeguards”, including:

- restrictions on who is able to make appeals; and
- restrictions on the nature of appeals.

3.5.1 Who can make appeals?

Although discussed more fully above, it is important to note that in defining who is a “customer representative”, a safeguard may already be built into the appeals process. For example, in the recent BAA decision, by restricting appeals to only airlines and designated passenger groups, this mitigates the risk of ad hoc appeals by individual passengers. The market structures and dynamics in energy are somewhat different and therefore qualifying appellants would need to be considered accordingly.

3.5.2 Nature of appeals

A further safeguard could be set in place in the nature of appeals made by customer representatives.

At present, in the event that a network does not agree with a regulator, and an appeal is lodged, the CC is required to review the **whole** price control (within a six to nine month window). This is an intensive process, and involves verification of all decisions made in the control.

An alternative approach would be to require appellants to lodge “adjudicative” appeals. In such a model, the CC would assess the merits of a regulator’s decision – but only in so far as this is expressed / lodged by the party making the appeal. The CC would therefore assess the appeal only on the basis of the evidence lodged by the parties. This would tend to narrow the scope of the appeal, reducing time and cost.

An “adjudicative” appeal might in some circumstances make it possible to identify “winners” and “losers” from appeals (and therefore allow clearer cost allocation). This could act as a further safeguard on the raising of appeals that have little validity (and therefore less chance of success). The major downside of adjudicative appeals such as these however is that a “narrow” appeal (e.g. on cost of capital) may be meaningless unless it takes account of other regulatory decisions (e.g. on treatment of pension costs, investment, opex etc.)⁵

One final potential safeguard would be a requirement to raise an appeal with an independent third party to review its validity **before** escalation to the CC. Appeals that seemingly had little validity would then be unlikely to trigger a full review of a price control decision. In this regard, the model in the telecoms sector could be viewed as being a relevant precedent (as appeals must go to the CAT before they are escalated to the CC).

⁵ The issues are treated more fully in the paper *Consumers, Stakeholders and Appeal Mechanisms in the Regulation of Energy Networks* referred to above.

4 Alternatives

4.1 Introduction

As part of its discussions on the RPI-X@20 review, the Consumer Working Group has considered alternative approaches to consumer engagement, referring to examples both from overseas and from other regulated industries within the UK. Discussions have been broadly based around Consumer Focus's 'Rating Regulators' paper⁶ and the Littlechild & Cornwall paper commissioned by Ofgem⁷.

4.2 Alternative approaches to consumer engagement

The Littlechild Cornwall paper commissioned by Ofgem considers four potential models of consumer regulation in the context of electricity transmission price control review: the public contest method; the constructive engagement approach; negotiated settlement; and negotiated services. Brief references have been made to these approaches in section 3 of this paper; further explanation of each is provided below:

4.2.1 Argentine Public Contest method

The Public Contest method is used for transmission expansions in Argentina. Under this approach, transmission users (i.e. customers) vote on potential transmission expansions. If they vote in favour of expansion, the construction, operation and maintenance are put out to competitive tender. The voting element of this approach helps to ensure that investment programmes don't exceed the level that customers would actually be willing to pay for; the tendering process helps to ensure lower construction costs.

One of the benefits of this approach cited by Littlechild & Cornwall is the fact that it gives users of the network direct involvement in determining capital expenditure plans. However, its appropriateness to the GB market is questionable. The approach was developed in Argentina at a time when a regulatory framework was first being put in place and there was widespread distrust of both the Transmission Company and regulation. The same conditions do not apply in the GB market.

4.2.2 CAA constructive engagement method

The constructive engagement model is used by the Civil Aviation Authority in the UK for airport price control reviews. This approach hinges on direct engagement and negotiation between airports and airlines (with airlines acting as the de facto representative of consumers). Under this approach, there are 3 key chunks of elements: one portion is discussed and agreed by airlines and airports (traffic forecasts, quality of service standards and capex programmes); another portion is jointly decided by the regulator and certain interested parties (opex and benchmarking); the third chunk of elements is the sole responsibility of the regulator – although subject to consultation (cost of capital, scope and form of price control, incentives and financing issues). From the outset, the regulator sets its

⁶ Rating Regulators, Consumer Focus, February 2009 [Publications & Reports - Consumer Focus](#)

⁷ User participation in the GB energy regulatory framework, Littlechild & Cornwall (2009)

<http://www.ofgem.gov.uk/Networks/rpix20/publications/CD/Documents1/User%20participation%20Ofgem%2028%20March%202009%20-%20final.pdf>

expectations for the negotiation process, its scope and timing. The regulator reserves the right to intervene with a more traditional price control process if the constructive engagement method looks unlikely to lead to a successful outcome.

The Littlechild & Cornwall analysis of this model suggests it could be translated to the world of electricity transmission with relative ease and likely success, offering ‘the prospect of fruitful discussion on a number of elements of the transmission price control review, without committing the parties to attempt agreement on all elements’. However, some members of the Consumer Working Group questioned how analogous airports are with distribution and transmission companies. In the airport model, a consumer has the freedom to choose an alternative airport or an alternative mode of transport if they deem the costs passed on to them to be unacceptable. In the energy field, while consumers have the ability to switch energy suppliers, they have no choice in their provider of distribution and transmission services.

4.2.3 US and Canadian negotiated settlement approach

The negotiated settlement approach is used in various regulatory contexts in North America. Energy utilities and interested parties (eg network users and customer representatives) negotiate in order to come to an agreement on a price control. Whatever is agreed is then adopted by the regulator. The negotiation is carried out using a litigated approach – if either the regulator or the regulated utility feels that allowed rates, tariffs or prices are no longer reasonable, they can request a hearing. The hearing will take place unless the interested parties can propose and agree an alternative approach that can then be agreed by the regulator (in which case there is no need for the hearing). In some instances the regulator can choose to intervene and suggest modified outcomes to reflect the interests of parties not taking part in negotiations (eg possible future competitors). Consumer representation can be provided through a number of official consumer representatives.

Littlechild & Cornwall’s report claims that this approach has resulted in efficiency improvements which ‘have yielded significant price reductions along with higher profits’. Moreover, the negotiated settlement model might have the added benefit of better reflecting the preferences of both companies and customers.

4.2.4 Australian negotiated services

The negotiated services approach is used for regulating electricity transmission and distribution services in Australia. The negotiation applies to specific services on offer by the regulated entity, and gives consumers the chance to express their preferences for these services. The desired effect of the negotiation is that it results in a solution that better matches the requirements and preferences of consumers. If no agreement can be reached between interested parties there may be scope for the regulator to intervene in the role of arbitrator. This approach is best suited to bespoke services or services where the consumer has a choice between different levels of certain services.

The negotiated services approach is a relatively new one, so there is little evidence available by which to assess its success.

4.3 Best practice in consumer engagement

In addition to assessing the approaches to regulation summarised above, the group also investigated whether there are any examples of best practice in consumer engagement used

by other GB regulators that could also be applied by Ofgem in the context of price controls. Discussions were based largely around the findings of Consumer Focus's recent 'Rating Regulators' paper. The group identified some potential for lessons to be learnt from the approach used by Ofwat in its price control mechanism as well as some more generic examples of best practice from other regulators that could be adopted by Ofgem.

4.3.1 Ofwat approach to consumer engagement: consumer research to inform 2009 Price Review

Ofwat has designed a three stage consumer consultation process to inform its 2009 price review work, working in partnership with the Consumer Council for Water (CCWater), Defra, Drinking water Inspectorate, Environment Agency, Natural England, Water UK and the Welsh Assembly Government:

Stage 1: 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: CCWater leads a joint regional deliberative consumer research project. This has 3 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 Spring 2008, allowing each company to use them to develop draft business plan proposals.

Stage 3: 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.

The aim of this approach was to ensure that companies are more responsive to their customers and that water bills following the 2009 settlement are based on what consumers are willing to pay.

4.3.2 Ofwat approach to consumer engagement: Incentives

In the absence of competition, Ofwat relies heavily on an incentives framework to achieve its objectives. The monopoly nature of the water sector means that Ofwat regulates prices in a more significant way than regulators in other sectors.

a) Price Setting Process

The principal incentive mechanisms are built into the price setting process. Ofwat bases the price limits water companies can charge on an estimate of the costs an efficient company should incur in delivering required services. Currently, if a company can deliver these services at lower cost, it can retain the benefit for a period. In addition, at a price review where a company has no legitimate excuse for failing to deliver an output, Ofwat will make a financial adjustment to remove all benefit from the associated price limit allowance. Ofwat will also consider the nature of the undelivered output when deciding on additional measures, which would include a requirement to deliver at shareholder expense or a financial penalty.

b) Overall Performance Assessment

A second incentive mechanism used by Ofwat is the Overall Performance Assessment (OPA) framework. This is used by Ofwat to measure each company's performance against a range of service categories, including leakage and security of water supplies. The overall score for a company feeds into the prices it can charge. A revised framework is being developed by Ofwat (in association with CCWater and an industry-nominated working group) to develop a revised model to include new 'customer experience measures' related to what consumers say is important to them.

Proposals for the revised OPA framework are based around a series of steps that a service provider should go through, from essential services right through to more innovative and personalised services that will generate increased consumer satisfaction and loyalty. The latter qualitative measures represent the standards of service that companies would normally need to meet to win customers in competitive markets.

Two new consumer experience measures are proposed:

- A consumer experience survey – to measure how a consumer feels about a specific, actual interaction with their water company from first contact to resolution of an issue. Will also seek views on the consumer's propensity to switch or recommend their existing supplier if given the choice and to benchmark against other sectors.
- Quantitative measure – a composite model focusing on contact and complaint volumes, attaching more weight to contacts/complaints which are not dealt with effectively by companies. It seeks to expose where a company is not meeting its consumers' expectations.

The model has been designed so that the measures are automatically recalibrated by consumers as their expectations change in order to create a continuous incentive on companies to deliver the service levels that consumers want.

4.3.3 Consumer engagement – best practice across UK regulators

As well as potential for lessons to be learnt from the approach used by Ofwat in its price control mechanism there are some more generic examples of best practice from other regulators that could be adopted by Ofgem. The most significant (and potentially easiest to achieve in the context of the regulatory framework for electricity networks) are engaging consumers through transparency and through the use of customer focused language. Transparency can be achieved through initiatives such as holding public meetings, rotating the venue for board meetings around the country and providing free dial in facilities. Consumer focused language is important not only on websites and in pamphlets aimed at the public, but also in corporate documents and consultations (so that potential respondents aren't put off by technical language).

5 Conclusions

5.1 Introduction

Rather than proposing a straw man model of an alternative approach to customer engagement in the RPI-X process, the Consumer Working Group has concentrated on identifying some of the benefits and shortcomings in consumer engagement that exist under the current RPI-X arrangements. The Consumer Working Group has suggested some areas for further consideration and high level characteristics of a “better” approach to consumer engagement that it believes should be fed into subsequent stages of the RPI-X@20 review process.

5.2 Key areas for further consideration

5.2.1 Defining Customers

When considering energy networks, there is a long and diverse list of customers. These customers will vary in terms of their requirements, their knowledge, their willingness to engage in the process and their interests/motivations. There is no single blueprint for a ‘model’ customer. The Consumer Working Group also noted that some customer groups will require more help or representation than others (for example the fuel poor or vulnerable).

5.2.2 Complexity of relationships

In the UK, the consumer selects their energy supplier of choice and is billed by them for the energy used. Included in this bill are charges for the distribution and transmission of the energy. The consumer has no choice over which companies provide their distribution and transmission of energy. In addition, the Consumer Working Group noted that unless consumers come into direct contact with networks through for example, emergency works, they tend to view the energy relationship through their supplier, and often (as a consequence) have little awareness of the distinction between their supplier and distributor.

5.2.3 Stakeholder knowledge

The Consumer Working Group noted that most domestic and small business consumers are unlikely to understand the electricity and gas transmission or distribution arrangements, the relationship between the distributor and supplier or how the network price controls are established and reviewed. Further investigation into whether customers need to be fully informed, or just their representatives, may be beneficial.

5.2.4 Today’s consumer v tomorrow’s consumer

The GB transmission and distribution infrastructure require significant investment to make them capable of meeting the government’s climate change commitments. Inevitably, a significant proportion of these investment costs will be passed through to the consumer. Consideration should be made for what proportion of these costs is paid by today’s consumer, and what proportion is passed through to tomorrow’s consumer. In the context of consumer engagement, the Consumer Working Group raised the issue of whether today’s consumers are best placed to make long-term investment decisions on behalf of future consumers.

5.2.5 Right to appeal

The Consumer Working Group members had mixed views on whether an ideal model of consumer engagement would include a right to appeal, what form an appeals process might take and who would be eligible to raise such appeals.

Some attendees considered assigning a right of appeal to customers **unnecessary**, given customers (along with all stakeholders) already enjoy the right to participate fully in price consultation processes and have a regulator that has a primary Duty to protect the rights of customers. In addition, some members also considered it only appropriate to give a direct power of appeal to the person whose property rights are constrained by the licence (i.e. network licence holders) and that referrals to the Competition Commission would be likely to be more common (or even the norm) with any extension of the right of appeal. It was also noted that customer interests were also protected by rights of “veto” to proposed licence changes, exercisable by the Secretary of State. A concern was also raised that Ofgem’s role in price controls would change significantly if other parties were to be given rights of appeal or veto (becoming more of a mediator than a regulatory decision-maker).

In contrast, other attendees considered there **would** be merit in introducing a right of appeal, as it seemed appropriate for all parties who have a material interest in the outcome of price control settlements – not just licence holders – to be able to contest price control proposals. It was also noted by some working group members that Ofgem is required to balance a range of (increasingly diverse) set of Duties. Some also considered that introducing a right of appeal would be a relatively simple way of elevating the importance of customer views in the price control process (and therefore that there was a compelling case for a separate voice for end customers in the process). To the extent that an extended right of appeal increased the engagement of customers in the price control process, these attendees considered this would help to inform and strengthen Ofgem’s decision making (rather than in any way devaluing it). Some members also observed that there was no established or clear process by which customers could readily engage the Secretary of State in the outcomes of the price control process. In addition, those attendees that supported the concept of extending the right of appeal considered that “frivolous” appeals to the Competition Commission could be avoided so long as sufficient safeguards were put in place.

5.3 Key characteristics of a “better” approach to consumer engagement

Finally, the Consumer Working Group has identified a number of key characteristics that it believes should form part of Ofgem’s approach to consumer engagement in the price control review process.

The chosen approach to consumer engagement should:

- Provide a clear process for users in all customer segments to provide formal input
- Ensure that the process does not exclude the views of any customer group
- Promote simplicity in both the types of controls used and in the communication of control mechanisms to customers
- Promote transparency in explaining charging implications
- Provide a transparent explanation of drivers of changes to charges.