CONSUMERS, STAKEHOLDERS AND APPEAL MECHANISMS IN THE REGULATION OF ENERGY NETWORKS

A contribution to Ofgem's RPI-X@20 Project

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ABSTRACT

This paper was originally prepared for discussion at Ofgem's RPI-X@20 Consumers Working Group.

It attempts to consider from first principles some important issues that arise in relation to any proposals that would introduce new powers of appeal or veto for stakeholders that do not currently enjoy such rights with respect to the price control reviews of the energy networks businesses.

The most important of the conclusions reached in the paper are that:

(i) conferring new rights of veto or appeal on classes of stakeholder that do not currently enjoy such rights would greatly diminish both the role of Ofgem and the salience of environmental considerations within the price control review process; and

(ii) the interests of suppliers and customers are not aligned and there is no case for conferring rights of veto or appeal on suppliers.

INTRODUCTION

1 This paper offers some thoughts for consideration on the issues referred to Ofgem's Consumers Working Group that is contributing to the RPI-X@20 project. In particular it considers whether the interests of stakeholders can be better incorporated into the regulatory process by giving certain categories of stakeholders rights of veto or appeal within the price control review process.

THE SCHEME OF THE PAPER

2 The paper begins by demonstrating that the British system of regulation is based on the twin assumptions that the regulated firms will seek to profit maximise to the benefit of their shareholders and that the interests of other stakeholders are concentrated upon the regulator and reflected in its principal objective and general duties. The paper then goes on to show why the public interest is advanced by a regulatory regime that is respectful of property rights and why it was logical for the regime to accord the licensee a right of veto over proposed licence modifications but to promote the interests of other stakeholders by a range of procedural safeguards and a right of veto given to the Secretary of State. The paper then demonstrates that the interests of consumers are distinct from, and are not ordinarily aligned with, the interests of suppliers. It also shows how giving new rights of veto to consumers or suppliers will make it less likely that environmental considerations will feature strongly in price control reviews. The paper explores the likely consequences of granting rights of veto or appeal to stakeholders that currently do not enjoy such rights and shows how this would both diminish the role of Ofgem and make the Competition Commission (CC) the forum in which network price controls would usually be determined. The paper explores the difference between policy reforms that are aimed at giving consumers a bigger voice in price control reviews (essentially an informational improvement to the current regime) and reforms that would give consumers real power at such reviews. Finally, the paper considers very briefly an alternative means of empowering customers (in conjunction with a system of pendulum regulation) that merits further exploration but is not thoroughly examined in this paper.

3 Specifically, it asks how, if more emphasis is to be placed on the validation by customers or suppliers (rather than the regulator) of the investments planned by the network business, the views and interests of other stakeholders could be taken into account in such a process? Who should be given standing in such a process and how should their rights be enshrined? Who should represent the interests of end users in the exercise of any veto or right of appeal or in any form of negotiation, or constructive engagement? At what point in the process and under what constraints should the various regulators enter the process or the veto or appeal right be exercisable? All these matters are considered below.

APPEAL MECHANISMS – SOME OBSERVATIONS FROM HISTORY

4 Ofgem is considering whether consumers or users should be given a formal role in the price control review process and, if so, whether this should take the form of a right of appeal or a veto with respect to price control review proposals that may be proposed by Ofgem.

5 Before examining the merits of any alterations to the present arrangements it is worth rehearsing why there is no formal, directly exercisable, consumer or user right of appeal or veto in those arrangements.

6 This begins with an understanding of what a licence is. In economic and indeed in legal terms, a licence is an interference with the property rights of the person that owns or operates the assets and conducts the business that can be carried on because of that ownership or control. The interference that takes the form of the licence is justified on public policy grounds because, without the constraints imposed in the licence, it is supposed – and with good reason – that the monopoly characteristics of the assets would enable the owner of the assets to extract monopoly rents to the disadvantage of society.

7 Understood thus, the licence is *not* a contract that sets out the terms and conditions on which one party provides a service to another. (In the network sector that function is performed by contracts such as the use of system agreement that is entered into between a network operator and a supplier.)

8 When the regime was conceived it was well understood that the licence was not akin to a contract between two parties of equivalent status, with competing interests that needed to be arbitrated by the regulator. Rather it was a different kind of legal instrument that constrained the behaviour of one person – the property holder – for the benefit of society.[1]

9 This brings us to another important principle upon which the energy network regulatory regime has been founded. The regime aims to secure the public interest by creating a body – namely Ofgem – whose purpose is to do just that.

10 The price control conditions of the licence have a special significance because they interfere with the property owner's right to charge what he might charge if he were left unconstrained by the licence.

[1] In passing we should note that the regimes typically require network operators to offer to enter into agreements for the use of their property and that within the regulatory frameworks that govern those agreements there are indeed rights of appeal in the sense that disputes between the parties can be referred for determination to the regulator.

11 Since the price control conditions of the licence amount to a special constraint on the use that a person may make of his property it was regarded as logical that any interference with such a right should be made by a body that was not self-interested but whose remit was to pursue the public interest. This was logical because it was the public interest, and *only* the public interest, that justified the interference with the property rights of the owner of the asset.

12 The public interest is encapsulated in the duties imposed on the regulator. Pre-eminent among these is the principal objective to 'protect the interests of consumers' but the public interest is not synonymous with the interests of particular customers or even customers as a whole. Still less is it the same as the interests of suppliers; but we shall come to that later.

13 The statute provides that, in exercising its functions, the Gas and Electricity Markets Authority (the Authority) must balance competing interests, objectives and preferences.

14 This is rather important. The body equipped with the power, indeed the duty, to interfere with one person's property rights is enjoined to do so in the manner best calculated to further the principal objective referred to above having regard to:

(a) the need to secure that all reasonable demands for electricity are met; and

(b) the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under the relevant statutes; and

(c) the need to contribute to the achievement of sustainable development.

15 Proposing a change to the property rights of a licence holder (in the form of a modification to the price controls set out in the licence) is an activity that is one of the 'functions' (in legal terms) of the Authority. In formulating and making such proposals the Authority is required not only to have considered the 'principal objective', the need to meet all reasonable demands for electricity, the need to contribute to the achievement of sustainable development and the need to secure that licence holders can finance their functions, but also it must have regard to the interests of:

(a) individuals who are disabled or chronically sick;

(b) individuals of pensionable age;

(c) individuals with low incomes; and

(d) individuals residing in rural areas.

16 Moreover, subject to these, the Authority must carry out its functions in the manner which it considers is best calculated:

(a) to protect the public from dangers arising from the generation, transmission, distribution or supply of electricity; and

(b) to secure a diverse and viable long-term energy supply,

17 In addition to this set of considerations, the Authority must have regard to the effect on the environment of activities connected with the generation, transmission, distribution or supply of electricity.

18 This array of objectives, duties and matters to which the Authority must have regard may be taken to be a statement of the factors and considerations that, for all practical purposes, define the public interest.

19 It is clear that the legal framework within which the regulator interferes with one person's property rights has been conceived on the basis that the regulator is not the *representative* of a particular interest, or set of interests, but the disinterested and powerful servant of the public interest as encapsulated in the principal objective and the general duties set out in statute.

20 If we understand the licence properly – as an interference in a person's property rights that is justified by, and only by, the public interest - we should not be surprised that the person whose property is being interfered with enjoys a measure of protection against adverse changes to the prevailing price controls and that this person alone has been given the power to give notice of the disapplication of those controls and thereby force the regulator to make proposals for a new control. The right of the owner of the property to contest in another forum (i.e. at the CC) any price control changes (or the continuation of the existing controls in respect of which a disapplication notice has been served) was regarded as an essential component of a regime that allowed a limited interference with property rights where this was in the public interest.

21 By the combination of, firstly, the right to force a CC reference where a regulator proposed a modification that the licensee regarded as unfair and, secondly, an elegant disapplication mechanism that a licensee could operate if it considered an existing price control to be too onerous, the designers of the regime effectively created a system where a regulator would be required to pursue the public interest, but the deleterious effects of any misdirection or disproportionality on the part of the regulator were effectively balanced by conferring upon the property owner certain protective rights.

22 This sounds very grand and highly principled, and so it is. But respect for property rights also performs a functional role in securing the public interest. Without secure

property rights incentives are harmed. In the extreme, investors would not invest the sums necessary to secure the continuing provision of the service. Short of that extreme, investors will demand a higher return if they are to risk their capital. The protection that the regime gives to the property holder in the form of constraints on the ability to make licence modifications without the property owner's consent did not arise by accident. It was conceived to be an essential part of the regulatory regime whose purpose was to secure the public interest.

23 If the public interest could be better served by denying these rights to the property owner, the only objection to a regulatory regime that gave the regulator an unfettered power to direct the licence holder 'to do thus and so' would be the moral objection to the taking of other people's property. It would be very easy to draft a licence for such a regime. There would be one condition in the licence and that would be a short one. It might read:

> 'The licensee shall do as it is instructed to do by the Gas and Electricity Markets Authority from time to time.'

24 This *reductio ad absurdum* usefully reminds us why the regime has been designed to strike a balance between, on the one hand, the powers of the regulator to interfere and, on the other, the rights of the licensee to resist interference that is injurious to him. Secure property rights in network assets are beneficial to consumers and to the wider public interest.

25 In Britain we are apt to forget that respect for property rights is fundamental to a good regulatory system. Perhaps this is because the very success of the RPI-X regime has enabled us to avoid the litigation that characterises the approach in the USA. Much of the case law of regulation in the USA proceeds from the takings clause of the Fifth Amendment to the Constitution that commands: 'Nor shall private property be taken for public use, without just compensation.'[2] This gives property rights a more prominent place in the regulatory discourse in the USA than they have in Britain. Nevertheless, they remain fundamental to good regulatory practice here just as much as in the USA.

THE ABSENCE OF DIRECT RIGHTS OF APPEAL FOR PARTIES OTHER THAN THE LICENSEE

26 The absence of any corresponding, directly acting, right of appeal or veto being conferred upon customers (or other industry participants) is not an oversight. It is the logical consequence of the design of the regime. Customers and suppliers do not *own* the property that is the subject of the interference that is represented by the licence.

[2] See J. Gregory Sidak and Daniel F. Spulber, *Regulatory Takings and the Regulatory Contract: The Competitive Transformation of Network Industries in the United States* (1998) p1.

Their right to do as they please with their belongings is not being constrained by the licence. It is not therefore surprising that the power to say 'yes' or 'no' (in the first instance) to a change to the licence was regarded by the designers of the regime as a power that needed to be conferred only on those whose property rights were being interfered with in the public interest.

27 Now it may be objected that anyone who depends upon a monopoly service may still have vital interests that can be harmed if that service is poor or is priced at a level that is harmful to that person's interests. Why did the designers of the regime not consider that the potential adverse effects of an ill-considered price control merited the confirming of a power of veto exercisable by those who are dependent on the monopoly network?

28 The answer lies not only in the fact that the parallel between the dependent customer, or user, and the owner of the property is not an exact one, but also in the fact that the regime secures the interests of those who depend upon the network by a different route.

29 That route is pre-eminently the creation of a body whose remit is now reflected in its principal objective and its other duties. As we have seen, not all of these are the same as the consumers' interests. For example the consumer, acting in his capacity as such[3], may be uninterested in the environmental consequences of a particular course of action, preferring instead cheaper electricity. The Authority must certainly have regard to such a preference (if it exists), but it must balance that by the other considerations that are set out in the statute and that go to make up the public interest. In other words the regulator is enjoined to identify, take into account, and promote the interests of the consumer but, in pursuing this principal objective, other interests must also be balanced. If it fails to do its duty it can be challenged through the legal processes of judicial review that are there to deal with public bodies that fail to do as the law requires.

30 The designers of the regime did not disregard the interests of consumers. Indeed, it gave them pride of place in the overall scheme, but it promoted their interests not by establishing a symmetry of rights between the licensee on the one hand and the consumer on the other, but by recognising that the interests of licence holders and consumers are subtly, but profoundly, different.

31 One of the differences between consumers, suppliers and the distribution licence holders is that the distribution licence is an instrument that can create obligations on the part of no person other than the distribution licence holder. No supplier, consumer or

[3] This qualification is important because it is not denied that as *individuals* consumers may be very interested in environmental matters. However, it is in their capacity as *consumers* that any rights of appeal or veto would be exercisable.

even regulator can be required to do, or refrain from doing, anything by the terms and conditions of a licence that is held by someone else. The distribution licence attaches to the assets and makes requirements only of the person who owns or operates those assets. Unlike a contract, it is not an instrument that applies obligations, or constrains the behaviour, of two or more parties. It is therefore unsurprising that direct rights of appeal and veto have been given only to the party on whom the licence places direct burdens.

32 However, although only the holders of licences are given direct powers to veto changes to the special conditions of their licences, it would be quite wrong to suppose that the regime was designed with no regard to the possibility that a regulator might be persuaded to propose changes to a network operator's licence that would be injurious to the consumers' or, indeed, to the public interest.

33 The first safeguard against such an undesirable outcome is that, before any modification may be made to any person's licence, the Authority must give public notice of its intention to make the modification, allow time for 'representations or objections' to be made, and 'consider any representations or objections which are duly made and not withdrawn.'

34 Ofgem's current practice with respect to changes to the price control conditions of the licence goes rather further than is required by this duty. It consults with all persons who may be affected by a change to the price controls as it develops its thinking. That their influence can be significant is demonstrated by the similarity of the views put forward by Ofgem in the recent initial proposals for electricity distribution with the recommendations put forward by Centrica and by CEPA (acting on behalf of Centrica).

35 It is also worth remembering that the supplier's financial interests are also protected by the general duties that must guide the Authority. The supplier holds a supply licence and the Authority must exercise its functions with respect to any modification of the price controls in *distributors*' licences having regard to the need to secure that *supply* licence holders are able to finance their activities. This duty does not apply only in respect of the licensee whose licence is being modified, but in respect of all classes of licensee who may be affected by that modification.

36 A safeguard against agency capture – the prospect that the regulator would be unduly influenced by the regulatee – was built into the privatisation statutes. The Gas Act 1986 and the Electricity Act 1989 each followed the precedent of the Telecommunication Act 1984 by making provision for the Secretary of State to order that an agreed licence modification should not be implemented without first being endorsed by the CC.

37 This was a pragmatic solution to what was hoped, and probably was shown by events, to be a largely theoretical problem. However, it should be seen for what it is, namely a long stop just in case a regulator went native. It was not an attempt to confer direct powers of appeal on consumers or their representatives. To our knowledge it has never been formally used.

38 None of the above is intended to suggest that it would not be possible to conceive of different regulatory arrangements that might be founded upon different regulatory principles and assumptions. However, it is to suggest that the regime was properly thought through so that it would achieve its purpose.

39 Moreover, since the regulation of privately owned monopolies has been designed around the assumption that property rights should be interfered with only when, and to the extent, necessary to secure the public interest, it would be no small matter to introduce another layer of competing rights into a process that has been designed on subtly different premises. We have had twenty years of price regulation in which an exercisable right of appeal has been given only to the licence holder. The cost of capital that regulators observe from market data must be assumed to reflect all the relevant risks, including the risk attaching to future price control settlements. Unless we also assume that the market has priced in the risk of a change to the regulatory regime, does it not follow that any change in the balance of risk that would arise from conferring new rights of veto on parties other than the licensee would end up being reflected in a higher cost of capital? If so why is it assumed that the overall impact of such a change would improve the position of customers? Put simply, interfering with network operators' property rights by giving a power of veto or appeal to consumers or others could certainly be done, but it would come at a price in terms of the investors' perception of risk.

WHO MIGHT BE GIVEN RIGHTS OF VETO?

40 Once it is decided that rights of veto or appeal should be given to parties that do not currently enjoy such rights the rather important decision has to be made as to who should be included in this group.

41 The outcomes will be different depending on who is chosen and the choice needs to be made with this in mind.

42 Under the present arrangements a disinterested body puts proposals to a licensee and that licensee, we must presume, considers what is in its best interests and decides whether to accept or reject the proposal.

43 We should presume that any additional groups that are given a right of veto or appeal will be similarly guided by their identification of their own interests.

44 This matters because a process that grants rights to those with duties to serve particular interests (such as the interests of shareholders or even consumers) cannot be expected to balance other interests (such as the environment) when they are exercising their newly granted rights.

45 Unless rights of veto or appeal are to be given to campaign groups like Friends of the Earth or Friends of the Lake District, the consequence of granting rights of appeal to parties that do not have a public-interest remit is that the priorities that are not their priorities will feature less in the outcomes than is the case under present arrangements.

46 In particular, we note that the interests of consumers, *qua* consumers, and the interests of suppliers are not necessarily aligned with, and may well be in opposition to, the interests of the environment. This is considered further below.

47 In short, giving more weight in the process to consumers or suppliers means giving less weight to someone else: that someone else is not just the licensee, but it is also those interests that are currently weighed by Ofgem when it prepares its proposals to put to the licensee but that would not enjoy a power of veto under revised arrangements. A regime that gave new rights to certain interests would find it harder to reflect the abstract interests – the externalities - that cannot easily be given status in the process.

48 For the purposes of our exploration of these issues we shall proceed now on the assumption that the designers of the original regime were misguided and that, notwithstanding the above, the public interest would be better served by the creation of a directly acting power of veto or right of appeal. The question we now consider is on whom would it be appropriate, or indeed possible, to confer such rights?

Consumers

49 If we take our guidance from the 'principal objective' referred to above, and we disregard other considerations, any changes to the regime should be focussed upon improving its ability to protect the interests of consumers.

50 Empowering 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 be a challenge to secure the direct participation of so many people in the regulatory process. Once it is accepted that it would be undesirable or impractical to give any *individual* the power to force a CC reference – for within the current arrangements that is what a meaningful veto or right of appeal amounts to – it follows that some kind of representative or surrogacy arrangement is required.

51 Arrangements under the Enterprise Act 2002 whereby a 'designated consumer body' can make a 'super complaint' to the Office of Fair Training (OFT) could be adapted to define a body that could exercise powers of veto or appeal on behalf of consumers.[4]

52 However, once it is decided that a body shall be given such a power, it would need to develop its own expertise and establish its own means of determining what is in the interests of those whose interests it is required to service. This is not straightforward.

53 The substance, as opposed to the price-consequences, of price control reviews is necessarily complex. A sensible appraisal of a set of proposals requires more than a glance at the resulting price change. Whatever body is equipped with this power would need the resources to discharge its new responsibility.

54 Consideration would also have to be given to the creation of a downside risk, otherwise there might be a tendency to use the power unnecessarily.

55 In its report on the supply of airport services by BAA,[5] the CC acknowledged the disadvantages of a system that might generate too many appeals. It concluded that this might be addressed if 'winners' and 'losers' could be identified by the CC and the losers would be required to pay the costs of the inquiry. The CC observed that this is more practical if the CC's role is 'adjudicative' rather than 'investigative' because it is easier to identify a clear 'winner' in the adjudicative appeal.[6] However, this is far from simple. If more than one entity exercised its right of appeal the CC might find itself having to determine appeals on several different matters within the overall settlement. Its decision on one narrowly defined issue raised by one appellant (i.e. the calibration of a particular incentive mechanism) might reasonably have a consequential effect on its decision on another matter raised by another appellant (e.g. the cost of capital). Since a price control is a package of measures the reasonableness of which has to be judged in the round it is not clear that even an adjudicative appeal would enable the CC to identify the 'winners' and the 'losers' so that costs could be awarded in favour of one and against the other.

56 Moreover, introducing such a downside risk is not straightforward for a body that has no shareholders, such as Consumer Focus, and that therefore suffers only reputational damage as a result of any ill-advised decisions on its part.

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[4] The obvious body to perform such a task would be the National Consumer Council (known as Consumer Focus), but this is not to disparage the many other 'designated consumer bodies' named under that statute such as the Campaign for Real Ale (CAMRA).

[5] CC *BAA airports market investigation: A report on the supply of airport services by BAA in the UK, 19 March 2009* (hereafter referred to as *CC airports*).

[6] *Ibid.*, paragraph 10.311. An adjudicative role would require the CC to rule only on the specific issue that is disputed by the appellant. This is narrower than the investigative role that is the CC's traditional function when it receives a reference following a licensee's refusal to agree to a price control modification proposed by a regulator.

57 An alternative safeguard against too numerous or vexatious appeals considered by the CC is the introduction of a permission stage to an investigation that would consider whether there is sufficient merit in the dispute to allow it to proceed to a full inquiry. The CC considered that it was 'not easy' to include this safeguard.[7] Such a mechanism might rule out the frivolous and vexatious appeals, but the increase in the number of referrals is more likely to arise from the entirely reasonable perception that an appellant has legitimate interests that it wishes to defend at the CC. Unless appeals are to be permitted only on procedural rather than substantive grounds, it will always be possible for such an appellant to make a reasonable case in favour of allowing its appeal to proceed. It therefore follows that, in the absence of any serious downside risk, CC references will become much more common, perhaps even the norm.

58 But there is another problem with the exercise of a consumer veto by a representative body. It is incorrect to speak of consumers as if their interests were singular. We know from opinion research that consumers' preferences vary significantly and, to some extent, predictably. For example, poorer customers tend to be more price-sensitive, whereas wealthier customers are prepared to pay more, especially for environmental benefits. Customers in different parts of Great Britain express markedly different price preferences. Yet, at some point a network must deliver the same standard of service to all who are served by that part of the network. The opportunity for individuals to express their own preferences in the form of the price-v-quality or price-v-environmental benefit trade-offs that are routinely presented by competitive markets simply cannot arise with respect to a network. Whoever has the job of 'representing' consumers must not only find out what the consumers think but develop its own means to balance their widely differing preferences.

59 This issue becomes especially complex when the balance of interests between existing and future consumers needs to be struck. The statute has recently been rearranged so that the duty to protect the interests of future consumers is more prominent. 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. At the very least it would be a particularly difficult balance to strike; indeed it looks rather like the kind of balance that can be struck only by a disinterested public-interest body (such as Ofgem).

Suppliers

60 It has been proposed that, either instead of, or in addition to, a veto or right of appeal directly exercisable by consumers or their representatives, such a right could be conferred upon suppliers.

61 The argument takes two forms.

[7] *Ibid*., paragraph 10.310.

62 Sometimes the argument is made that suppliers' interests are aligned with those of consumers and, since suppliers may be presumed to have the expertise and the resources necessary to participate directly in the regulatory processes, it would make sense to give the suppliers a right of veto or appeal.

63 The alternative form of this argument is that the supplier is the person who receives the bill for use of system and therefore it is the supplier who has the most direct and most legitimate interest in the outcome of a price control review of the network companies.

64 We consider both of these claims below.

65 First let us consider whether the interests of suppliers are aligned with those of the end user.

66 Let us suppose that a supplier was equipped with a power of veto and that it used that power to constrain the prices charged by a distributor. Who would benefit from such an action? The answer is that that would depend upon the characteristics of the supply market. That market has its critics, but for the purposes of the argument let us be optimistic and assume that the reduction would be passed on to the extent, and in the timescales, that the market determines. Eventually the consumer would get all the benefit that is properly his because if the supplier tried to keep the benefit the customer would be free to choose another supplier.

67 Let us now consider the case where the network owner contends that an increase in price is necessary to fund an investment programme. The interests of the supplier would certainly be served by resisting this price rise and preventing it from taking place. Now it is not at all obvious that the consumer would truly benefit if that resistance were to be influential or successful. Perhaps the investment is necessary to ensure the continued uninterrupted supply of energy to the premises. Perhaps it is necessary to meet an environmental commitment for which the consumer is willing to pay. But a supplier that uses its influence to resist such a change suffers not at all from the exercise of that power even if the result is harmful to the end user.

68 This point was nicely illustrated in the discussions at the working group. When asked by a distribution representative whether it was possible to envisage circumstances where a particular supplier would exercise its influence in favour of more network investment, the supplier representative said 'no that's your job.' This candid recognition that that supplier would always argue for lower costs without regard for the

interests of the end user is a clear demonstration that the interests of the customer and those of the supplier are not aligned, although sometimes they may coincide.[8]

69 Significantly, an important constraint is missing. The consumer cannot choose a supplier that promises him a quality of service (in this regard) that is better aligned with his own interests because, whoever his supplier is, his quality of service and the network component of the price of that service will remain the same.

70 Even if we assume a perfectly competitive supply market, it does not follow that the supplier is incentivised to promote the interests of the customer with respect to network services. To give suppliers a right of veto or appeal would therefore give power to one whose interests are not aligned with those of the consumer. In this respect it would amount to conferring power without responsibility.

71 The foregoing analysis shows that the presence of a competitive *supply* market would not ensure that the interests of customers and suppliers were aligned with respect to distribution services. There is a further reason why it is surprising that Ofgem might be contemplating giving suppliers such a role. In October 2008 Ofgem concluded its Supply Probe and indicated that it was to take action 'to strengthen competitive pressure on the Big 6 suppliers'. Ofgem found that competitive pressures on suppliers 'may not be sufficient' to protect prepayment customers and that there was evidence that 'many small business consumers are unaware of their contract terms … and that this is being used by suppliers to lock in their small business customers.' Ofgem's chief executive said that whole categories of customers were being 'woefully served by energy suppliers.'[9] In order to protect customers from abuse Ofgem introduced a new non-discrimination requirement. Ofgem also had reason to be concerned with suppliers' treatment of their customers when it fined Npower £1.8m for the misselling of energy contracts to customers. This history makes it even more surprising that Ofgem might suppose that suppliers would be effective representatives or champions of the interests of the customer with respect to network services. If Ofgem is so dissatisfied with the behaviour of suppliers in areas of their businesses where they compete with one another, why might it suppose that suppliers will be good at looking after customers' interests in those areas in which there can be no competition (which is the position with regard to the network component of the overall package)?

72 But what of the argument that suppliers receive and pay for the service of transmission and distribution and that this alone is sufficient to give them a legitimacy in terms of

[8] At a subsequent meeting at which a version of this paper was received and very briefly discussed, the supplier representative clarified his position saying that he meant that, whilst it was the job of the distributor to argue for high investment, the supplier would exercise his influence to ensure value for money (rather than lower investment). Readers may make their own judgement as to whether the supplier is incentivised to perform this benign role.

[9] Ofgem, *Energy Supply Probe*, 6 October 2008.

the exercise of a veto or power of appeal? For example it has been pointed out that when a distributor puts its prices up the supplier must suffer a margin squeeze or pass the price rise on to its customers. In one supplier's case it has been observed that 24 per cent of household customers and 70 per cent of industrial commercial and business customers enjoy fixed-price contracts. This prevents the supplier from passing on changes in distribution or transmission prices, at least for a while.

73 Although no regulation or law compelled the supplier to offer such terms and the supplier presumably chose to offer those terms because it was prepared to enter the contract on that basis, the argument is not utterly without merit. Suppliers' interests can be adversely affected by price changes and particularly by price increases that are different from those that the market was expecting. However, if that is an argument for anything, it is an argument for longer notice periods or greater transparency with respect to price changes. It is not an argument in favour of an ability to influence the magnitude or the sign of those price changes.

74 This merits a little further exposition. What is it about the commercial arrangements that we have put in place that appears to have two such contradictory properties whereby the person who is the first recipient of a price change (the supplier) is not the person that truly benefits from the supply of the service in the sense that it matters to him whether the service is good or bad, reliable or patchy? Why is the supplier so exposed to changes in the price of a service the benefit of which is felt by his customers?

75 It can be shown that the issue arises because of the 'supplier hub' principle. In order to make life simple for the end user, in particular to ensure that he receives a single bill, the commercial arrangements were set up so that, instead of distributors billing the end customer directly for use of system, that bill is sent to the supplier who offers the end customer a bundled product. This followed the principle established at privatisation that use of system charges should be paid directly by suppliers and therefore only indirectly by end customers. Since the charges for any particular premises were to be the same irrespective of the identity of the supplier, it was not thought to be significant that these would be paid by the supplier in the first instance, for the assumption was that a competitive market would soon render this component of the bill as a pass-through. It may not have been expected that suppliers would deliberately take positions that gave themselves exposure to such charges but, if it had been, no doubt that would have been regarded as entirely a matter of choice for each supplier.

76 It is worth pausing to consider why the arrangements for conveying energy to premises are dissimilar to the arrangements for the transportation of products in other sectors. Different approaches apply in different sectors, but let us consider a product that is provided in a competitive market where the product has to be delivered by a specialist

transporter to the consumer's premises. Furniture would be a good example. The retailer may arrange with a delivery company to transport the goods. If the retailer strikes a good bargain that balances correctly the consumers' preference and price sensitivity his business will prosper. If on the other hand he tries to retain too much of a margin on the delivery element of the final product, or offers an unreliable service or a service that is available only at inconvenient times, consumers will buy their furniture elsewhere.

77 It takes only a moment's consideration to realise that the monopoly characteristics of networks mean that the supply market, even if it were fully competitive, could not work to protect the end consumer with respect to the transmission or distribution components of the bundled product. The supplier has an interest in competing where he can distinguish himself from his competitors. Where he cannot, he has no commercial interest in the welfare of the end user.

78 The problem that is now perceived by suppliers arises because network prices are rising. In the past, when price control reviews could be expected to produce price reductions, suppliers were able to enjoy the benefit of those reductions, which contributed to their margins until they were competed away. Unfortunately the reverse is true in a period of rising network prices.

79 Another way of seeing this is to regard the supplier hub principle as a fiction on which contractual agreements have been built. This is demonstrated by the fact that, if the bill for use of system were sent directly to the consumer, the supplier would have no interest in the outcome of a price control review. The suppliers' problem (or opportunity when prices are falling) arises because the commercial arrangements have been set up on the assumption that the supplier is more like an agent for the collection from end users of the use of system component of the charge. Inadvertently, this has given suppliers an exposure to variations (especially upward variations) in such charges and a pecuniary interest in the outcome of price control reviews where the suppliers' interests are real but are quite distinct from those of their customers.

80 To the extent that the case for a supplier veto is based on the claim that the supplier is the recipient of the bill from the distributor, one might observe that customers receive *their* bills from suppliers. Suppliers have not suggested that customers should enjoy power over the content of the supply licence. Certainly, the extent of competition differs between the supply and distribution markets, but since regulation is assumed to make up for the absence of a competitive market in distribution, the analogy remains a valid one. Is the case for a supplier veto over the distribution licence qualitatively different from the case for a customer veto over the supply licence?

SOME POSSIBLE CONSEQUENCES OF GRANTING RIGHTS OF VETO OR APPEAL

81 The essential difference between the present arrangements and those in which parties other than the licensee are given a right of appeal is that the regulator would have to satisfy not only the licensee, but also all the other parties to whom such rights have been granted before a modification to the price controls could be made by agreement.

82 It is obvious that this makes references to the CC much more likely if only because it is harder to reach agreement amongst many people than it is between only two. The greater the number, and the greater the diversity, of the interests of the parties to whom such rights are given, the more pronounced this tendency will be.

83 Granting such rights to parties other than the licensee will significantly change the role of the regulator at a price control review. Instead of conducting a review that is essentially a bilateral process in the sense that it is focussed on delivering a set of proposals targeted at the licensee that the licensee can accept or reject (where the tendency has been for licensees to accept), the regulator will instead conduct a review where the end product is a set of proposals that, if they are to become effective, must receive the approval not only of the licensee but of all the other parties that have to be satisfied.

84 For these reasons Ofgem's role will become mediative rather than decisive because all parties will know that any of the other parties can force the matter to the CC. This would change Ofgem's behaviour, giving it more of an honest-broker role between the parties than the leadership role that it now has. Its review would be exploratory and it would rapidly be confined to facilitating multilateral discussions between the parties that had rights of veto or appeal. It would explore whether there was any basis for an agreement between the parties. In this respect the process might become less adversarial but it is not clear that it would have much prospect of finding common ground.

85 Under such arrangements, with CC references becoming much more common, perhaps even the norm, the real consequence might well be not that everything would remain more or less the same (albeit that a new group of people would be given rights of appeal or veto in the same way that licensees have such rights within the existing arrangements) but that, effectively, no one has a meaningful right of appeal because everyone would know that Ofgem's review was merely a preliminary skirmish, or an exploration of the points at issue, before the inevitable review took place at the CC. There would be only one real review – the one at the CC. Whether you think this would be a good or a bad thing depends on how well you think Ofgem does its job under the present arrangements.

86 The CC acknowledged this problem when it considered the supply of airport services by BAA.[10] It considered the risk that conferring rights of appeal on airlines and passengers would make the CC 'effectively the regulator of the system'.[11] The point has previously been considered in a more limited way when the Energy Code Modification appeal system was created under the Energy Act 2004. In that case the Government had wished to promote accountability 'while avoiding the creation of a second tier regulator'.[12] In the airports market investigation the CC does not appear to offer a definitive solution to the problem that it has identified but hints that giving the CC an 'adjudicative' rather than an 'investigative' role in response to an appeal may help avoid this unwanted consequence:

> 'We see the question of whether the CC becomes a second-tier regulator as one that turns more on the nature of our procedure and the decision that we can take than on who has standing to appeal.'[13]

87 If any person or group of persons were to be granted rights of veto or appeal consideration would also need to be given to the point in the process at which such a right might be exercisable. The properties of the mechanism might be different if, for example, the Authority were required to have secured the agreement of those who were to be given the new right of veto or appeal *before* it made final proposals to the licensee, compared with the situation that would arise if the proposals were to be offered simultaneously to the licensee and to the newly empowered parties, or if the regulator had to present a deal that had already been agreed with the licensee to the newly empowered parties for their final approval. In the case of airports the CC has recommended that this right should be exercisable after the regulator has taken its final decision, but is silent as to whether this right should be simultaneously exercisable by the licensee and the other possible appellants.[14] It is well known in game theory that the order in which players take their turn can significantly influence the outcome.

88 By way of example, let us consider the incentives that would operate if the regulator made its final proposals at the same time to all entities that were endowed with a power of veto. Let us also suppose that each party had to declare its use or non-use of its veto in a sealed bid to the regulator and that all such bids were revealed at the same moment. A licensee that believed that at least one other party was likely to exercise a veto would be well advised to exercise a veto itself because otherwise the CC would represent a purely downside risk. This is because the CC would be unlikely to reach a decision that was more generous to the licensee than the proposal from the regulator that the licensee

[10] *CC airports.*
[11] *Ibid*., paragraph 10.325.
[12] *Ibid*., paragraph 10.327.
[13] *Ibid*., paragraph 10.327. For the difference between an 'adjudicative' and an 'investigative' role see above paragraph 55.
[14] *Ibid*., paragraph 10.303.

had already signalled it would accept. Once a licensee forms the view that *someone* will force a reference to the CC, the licensee will wish to improve its chances at the CC by leaving itself the option to argue that, contrary to the case made by the other appellant (or appellants), the regulator's proposals are too tough. The same calculation in reverse could be expected to push the other potential appellants to exercise their vetoes and so preserve their negotiating position at the CC.

89 Although it may be possible to introduce a downside risk for the licensee (in terms of bearing the costs of the inquiry), this might still be insufficient to outweigh the adverse consequences of contesting the appellant's case at the CC having already signalled that the regulator's proposals are acceptable.

90 It may be possible to imagine a different calculus or to create different incentives from different arrangements, but the key point is that conferring rights of appeal on parties that do not currently enjoy such rights requires careful thought because it cannot be assumed that everything else will remain the same. A static analysis will not do.

PRECEDENTS FROM OTHER SECTORS

91 In this note we have concentrated on the procedures that presently govern the modification of the special conditions of the energy networks' licences. During one of our meetings an observation was made that appeal mechanisms were increasingly common in regulated industries. However, a quick check reveals that the following sectors have arrangements in which the regulatory regime gives consumers (or other parties) no direct formal power of veto or appeal:

- electricity distribution (Great Britain)
- electricity transmission (Great Britain)
- gas transmission (Great Britain)
- gas distribution (Great Britain)
- electricity distribution (Northern Ireland)
- electricity transmission (Northern Ireland)
- gas distribution and transmission (Northern Ireland)
- air traffic control
- postal services
- water and sewerage (England and Wales)
- water and sewerage (Scotland)
- water and sewerage (Northern Ireland)
- railways (i.e. Network Rail).

92 We note, however, that it is possible under the Energy Act 2004 for a consumer group to challenge some of Ofgem's modifications to designated industry codes.

93 There are two jurisdictions where the arrangements merit further comment. These are telecommunications and airports. Airports have been considered briefly above and are considered in more detail below. Telecommunications is considered briefly below.

94 Telecommunications firms do not have licences as such; rather Ofcom has the ability under the Communications Act 2003 to impose certain types of free-standing conditions on certain types of operator. Uniquely in the regulated sectors the appeals body is the Competition Appeals Tribunal (CAT), and consistent with general competition law 'a person affected by' an Ofcom decision can bring an appeal to the CAT. The CAT is required to refer appeals related to price control conditions to the CC for determination. In practice this means that customers can appeal, and have appealed, Ofcom's decisions to an independent third party. The practicalities of this may merit further investigation as the idea sounds quite interesting.

95 The CC has recently opined in favour of introducing a right of appeal exercisable by airlines and passenger representatives with respect to proposed modifications to the price controls and service quality conditions of the licences that it proposes should be granted to certain airports.[15]

96 It is worth considering the reasons advanced by the CC in support of these conclusions, examining the differences between airports and energy networks and asking how far these differences would diminish the salience of the arguments if they were to be applied in relation to energy networks.

97 Our starting point should be the CC's observation that:

> '…the CAA [i.e. the regulatory body for airports] has not paid sufficient attention to the legitimate interests of airlines, and that airlines operating in a competitive environment are normally best placed to judge the interests of their customers, present and future. The ability of airlines to articulate the interests of their passengers is particularly important given the diffuse and diverse nature of the passenger base.' [16]

98 Proceeding from this assumption the CC concludes that:

> 'In relation to airport charges and to the level of service and quality of airport services, the interests of the airport, of airlines and of passengers are all engaged. Presumptively, these classes of persons should all have rights of appeal.'[17]

[15] CC *airports.*
[16] *Ibid*., paragraph 10.294.
[17] *Ibid*., paragraph 10.314.

99 The CC is a body that considers issues deeply and, although its recommendations with respect to airports have neither binding nor persuasive authority in relation to energy networks, it would be foolish, as well as disrespectful, to dismiss the notion that its conclusions in one sector might be applicable, *mutatis mutandis*, in another.

100 Applying the CC's reasoning and recommendations to the electricity networks sector, the airport is analogous to the network, the airline is analogous to the supplier or generator that uses the network, and the passenger is analogous to the owner or occupier of the premises that uses or generates the electricity.

101 But how valid is this analogy when important characteristics of the two markets are brought into the analysis?

102 The CC was alert to the possibility that at times the interests of airlines and passengers would diverge. In proposing that the regulator should recognise the 'reasonable interests and expectations of airlines', the CC observed:

> 'this does not mean that the interests [of airlines] should be pursued where they are contrary to the promotion of competition or the interests of users. On the contrary, *it is because we consider the interests of airlines and passengers to coincide to a great degree that we think it is proper to consider the interests of airlines in their own right.* At the point at which those interests diverge, the interests of airlines will cease to be a matter of legitimate concern for the regulator.[18]

103 The recommendations of the CC with respect to airports are clearly predicated upon its view that the interests of passengers and airlines are substantially aligned. This paper has suggested that the interests of energy consumers are not aligned with the interests of suppliers. If that contention is correct, the relevance of the CC's recommendations with respect to airports to the situation in energy networks becomes highly questionable.

104 It is therefore worth considering in more detail why the CC concluded that the interests of passengers and airlines were well-aligned. What specific features of the airports market gave the CC grounds for this conclusion? Do these assumptions hold in the energy networks sector?

105 It was shown above that the reality is that, although suppliers are the initial recipients of the bill for the transmission and distribution of energy to the end user, the supplier is not in any meaningful sense the recipient of the services for which the charges are made. The CC observed something very different in the case of airports:

[18] *Ibid*., paragraph 10.296, emphasis added.

> '…the services that are provided by an airport to an airline are not in toto the subject of further "on-supply" by the airline to the passenger. An airport provides a bundle of services to an airline. The airline then makes use of that bundle of services to supply a different bundle of services to consumers. Airlines are themselves final consumers in relation to many of the services provided by airports.'[19]

106 In energy the services provided by the network pursuant to a use of system agreement are provided entirely to the benefit (or disbenefit) of the end user rather than the supplier. They are not repackaged to complement the final supply offering. One fundamental of the CC's analysis of the airport market therefore clearly does not apply to energy networks. This raises doubts about the reality and the legitimacy of the suppliers' interest in the network charges.

107 Furthermore, the CC observed that:

> '…many of the services that are provided to airlines by airports are unusually heterogeneous. This means not only that different airports supply different services to airlines as consumers, but that the services provided by each airport to airlines will differ according to the requirements of those airlines: these differences can be expected to increase in a more competitive market for airport services.'[20]

108 Again the contrast with energy networks is clear. Networks differ very little in the services that they provide in return for regulated income. The same industry contract applies across all fourteen DNOs. All suppliers and all distributors are parties to the same agreement (the price of the service being effectively determined by each DNO's price control conditions in its licence). The CC's observation on heterogeneity therefore does not hold in the case of energy networks.

109 It was shown above that the competitive energy market works on the assumption that the network service is a universal service that is available to all on the same terms and that does not change when a consumer chooses a different supplier. No serious proposals have been advanced to change this fundamental of the commercial arrangements. This therefore distinguishes energy networks from the position that the CC said prevails in the case of airports and it casts further doubt on the validity of the analogy. If passengers do not like the experience (including the price that they pay in their air fares for that experience) at a particular airport, they may use a different airport or, in some cases, a different mode of transport altogether. The service provided by the airport therefore affects the competitive position of the airline.

[19] *Ibid*., paragraph 10.288.
[20] *Ibid*., paragraph 10.289.

110 The same is not true of an energy network. Whether the end user experiences a good or a poor service from the distributor, or even whether the price of the service that he pays in his energy bill is high or low, makes no difference whatsoever to the competitive position of the supplier because the end user cannot affect his network-related experience by changing the one thing that he can change, namely his supplier. This distinction between airports and networks is rather important when the alignment of interests and the legitimacy of potential appellants is being considered.

111 Moreover, the CC identified two consequential difficulties that arose from this complexity in the case of airlines. The first is that 'it is difficult to give effect to service level agreements between airport and airline… because the quality of service delivered by an airport affects the airline's competitive position.[21]

112 The second is that 'it is difficult for a regulator to assess the necessary measure of capital investment at an airport where elements of each capital project may need to be tailored to the different requirements of a number of airlines.'[22] These complexities do not arise with respect to energy distribution networks and the objection that a supplier veto is needed because a regulator is ill-placed to determine such matters that touch the suppliers' legitimate interests has no force.

113 Finally, the CC founded its recommendations on an adverse view of the performance of the airports regulator (the CAA).[23] The CC has not had cause to criticise Ofgem's regulation of energy networks and the case in favour of diminishing Ofgem's role by transferring power to suppliers and making the CC the forum in which the price controls would most often be determined cannot be inferred from the reasoning or the recommendations set out in *CC airports*.

POWER OR INFLUENCE – A RIGHT TO DECIDE OR A RIGHT TO BE HEARD?

114 It is possible to become unrealistic about what can be expected from direct engagement with consumers. If the regulatory regime is to be redesigned the architects of the new order need to make a choice. Consumers can be protected by the conscientious discharge of its duties by a regulatory body that is equipped to balance all the conflicting priorities to secure the best outcome that is possible for consumers. That is broadly the model we have today and there is general agreement that, provided its limitations are understood, there is value in trying to ascertain the preferences of consumers as one input to the judgements that a regulator must make. In this sense the changes would be directed towards improving the *information* that the regulator uses at a price control review.

[21] *Ibid*., paragraph 10.290.
[22] *Ibid*., paragraph 10.290.
[23] See e.g. *ibid*., paragraph 10.294.

115 The alternative, and more radical, model would give a more real power to consumers (or, more accurately, to their representatives). This would raise significant issues of governance and legitimacy but it could be done. Under this model consumer representatives would be empowered to reach agreements with network operators, which the regulator would either endorse or reject. The corollary of this would be that the consumer representatives would need expert advice to enable them to negotiate effectively on behalf of consumers. However, we should be realistic about this. Whatever merits it has in terms of facilitating deals that are mutually advantageous for consumers and network providers, we should not expect any benefit to arise from any idea that such a process could avoid considering the complex issues that currently arise in price control reviews.

116 This is because both sides would know that their alternative to any agreement would be a regulatory review conducted by Ofgem or by the CC. Each side, assuming it behaved rationally, would assess any prospective agreement by reference to its prospects through the alternative, conventional, regulatory route. Thus, the factors that would determine the normal (regulated) outcome would feature in each side's assessment of its position and, very probably, in the negotiation itself.

117 In short, truly empowered consumer bodies would need expertise and resources.

118 The first alternative, which is no more than a more deliberate attempt to ascertain customers' preferences, needs little change to present arrangements and resources. Regulators and network operators would continue, from time to time, to try to ascertain the preferences of consumers whilst recognising that this assigns the customers a very different and much more limited role.

119 An important distinction between these two approaches is that the current approach requires only that the *preferences* of consumers are *taken into account* in reaching regulatory decisions. It does not require that consumers should become acquainted with technical, financial or regulatory issues or even that they should participate in the discussions of these matters. By contrast, the more radical option where consumers, through a representative body, are empowered to conclude agreements with network companies requires that the representatives of consumers in that process become expert in these technical, regulatory or financial issues.

120 There is a pleasing irony in the fact that Stephen Littlechild, who told us all in the 1980s how bad the American system of regulation was, is now enthusing about the merits of an alternative form of North American regulation, namely 'negotiated settlements' where, initially at least, the regulator takes a back seat and the utility negotiates a settlement with the representatives of customers. If agreement can be reached between the negotiating parties and the regulator endorses the deal, the

negotiated settlement, according to Littlechild, brings benefits in terms of lower prices and a better alignment of the outcome with customers' preferences.

121 The stakeholder engagement process required at DPCR5 avoided any prescription as to who should count as a legitimate stakeholder and what weight should be given to the views of different parties. This is an important question that needs some consideration if the stakeholder engagement model is to be enhanced to have the characteristics of US-style negotiated settlements. The problem here is a variant on one described above, namely that, if the negotiated settlement is to have the beneficial characteristics of a normal negotiation between a firm and an informed customer, it is not *stakeholders* in general who must be represented in the process, but *customers* acting in their capacity as such. But if the stakeholder group is to be narrowed to include only those who end up paying the bill (and receiving the service), the negotiated settlement will not reflect any of the interests that are external to those of the network business and the customer who is represented in the negotiations.

122 This is all very obvious, but it is also rather important. The RPI-X@20 project is coming at a time when the public policy priorities require the interests of one particular, but very abstract, stakeholder to be taken into account. That stakeholder is not the customer but the environment. A negotiated settlement between a network business and a group of customers can be expected to deliver an outcome that takes into account the environmental priority only if the negotiating parties choose, or are required to secure, an environmental objective. It would seem odd that, at a time when the Secretary of State has consulted on changing the social and environmental guidance given to the Gas and Electricity Markets Authority to promote environmental concerns further up the regulator's agenda,[24] for a regulator to be contemplating a form of regulatory process that would tend to exclude the environment from the negotiated settlement process.

123 One of the merits of the present arrangements (at least in legal terms) is that the interests of competing stakeholders are captured and weighted in the principal objective and the general duties of the Authority. It makes sense that a public interest body should be given the job of reconciling these interests. Conversely, it would seem to be an odd way to fulfil this remit to introduce a process that, in its simplest form, is designed to exclude these interests.

124 Is it possible to enlarge the negotiated settlement process to include other stakeholders so that environmental objectives could be represented in the process? Perhaps it is. If the stakeholders with standing could be defined, the regulator might be prepared to endorse a negotiated settlement that had been agreed by all, or even by only some,

[24] BERR, *Social and Environmental Guidance to the Gas and Electricity Markets Authority: A Consultation Document*, June 2008.

stakeholders. Provision could even be made for deals between the network company and the represented customers (or some of them) to be put to the regulator for approval. The regulator might give, or withhold, its approval having regard to its own statutory remit, which would no doubt include environmental duties and objectives. Any stakeholder that was aggrieved by the regulator's endorsement of a negotiated settlement (with or without dissenters) might then issue a legal challenge to the regulator's endorsement. The basis of the challenge would be that the regulator should not have endorsed the negotiated settlement because that endorsement was inconsistent with the regulator's remit to take due account of environmental objectives. So it is not impossible to introduce a wider stakeholder group to a negotiated settlement process. Indeed, this occurs in some US jurisdictions. The evolving regulatory decisions and judicial reviews would begin to establish the weight to be given to the various interests. Over time such decisions and legal judgements would begin to influence the next negotiation between the network company and the representatives of the customers.

125 But the question has to be asked, is it likely to improve things? Once we introduce other stakeholders into the process, the benefits of a negotiation between two informed parties where the regulator takes a back seat become complicated by the introduction of other competing interests.

126 Experience of negotiated settlements in the USA may well be positive, but, we suggest, not for the reasons outlined by Stephen Littlechild.[25] The negotiations do not avoid the arcane regulatory issues. On the contrary, the represented parties argue about all the usual things and often the largest proportion of the seats at the table are taken by the 'staffers' of the regulatory body. If the settlements that emerge are preferable for both customers and companies this is probably because the alternative is a litigated settlement with the regulatory body acting quasi-judicially and imposing a judgement from the process of testimony and cross-examination within the inflexible context of a judicial constrained process. *That* process may be very respectful of property rights and due process but it tends not to be conducive to a sensible dialogue about the optimum solution. In the USA the counter-factual to the negotiated settlement is the litigated settlement. In the UK the alternative to the negotiated settlement is the continuation of the present form of the RPI-X price control review. The benefits of the negotiated settlement in the UK may therefore be rather less than they are in the jurisdictions studied by Littlechild.

[25] See especially 'The Bird in the Hand: stipulated settlements and electricity regulation in Florida', February 2007; 'Constructive engagement and negotiated settlements – a prospect in the England and Wales water sector? August 2008; and Stephen Littlechild and Joseph Doucet 'Negotiated Settlements and the National Energy Board in Canada', 23 November 2006.

AN ALTERNATIVE FORM OF CONSUMER EMPOWERMENT

127 One of the problems that confront a regulator is that it can never know as much about the investment needs of the network as the licence holder does. However, the system of RPI-X regulation rewards a network business if it spends less than the regulator assumed when the price control was set. What is now known as the IQI was introduced at DPCR4, and then adopted in gas distribution and water, to incentivise companies to reveal their best view of capital investment needs in the forthcoming period. Another approach to this issue is the system known as baseball arbitration or pendulum arbitration.

128 This technique was often discussed during the industrial relations disputes of the 1970s but it has also been used in setting network access prices in Guatemala and has been recommended for use in Chile.

129 The essential features of the mechanism are as follows. The parties to the negotiation must be defined. Once this is settled they are given a maximum period of, say, four months in order to negotiate an acceptable settlement. If they are unable to agree, prices and presumably quality of service issues may be determined by a third party on the basis of pendulum arbitration. Under these arrangements the arbitrator must choose *between* the two final offers presented by the parties to the dispute. The arbitrator may not propose, or determine, anything else. It is said that such a regime limits the parties' posturing incentives and provides them with an incentive for truthful revelation. More accurately, it has been said that it is in each party's interest to make an offer that is marginally fairer than the opponent's expected offer, giving a strong incentive both to make reasonable offers and to reach a negotiated agreement.

130 Stephen Littlechild has observed that the advantages of negotiated settlements are diminished if the regulator is permitted to cherry-pick the bits of an agreed settlement that it likes and to supplement or replace these with its own preferences where it disagrees with the freely negotiated outcome. He believes that the regulator should be required to adopt or reject the negotiated settlement in its entirety. Pendulum arbitration would take this principle further. It could be applied where the parties cannot agree.

131 Limiting the arbitrator’s role to choosing between the competing views of the parties would probably require a change to the primary legislation. Moreover, for pendulum arbitration to work effectively, *all* levels of the appeal process must be similarly constrained. Otherwise the posturing incentives are still present.

132 The existing institutions could be adapted to use this form of regulation. For example, the network company and Ofgem could be the parties to the initial negotiation. If they

failed to agree the CC could be the body that is required to choose between the packages offered by the two parties.

133 It would be premature to advocate this method of regulation since it is clear that a number of issues arise that would need further careful consideration. In particular it is not clear from the foregoing analysis how the mechanism deals with the situation where both sets of proposals are deficient, but in different ways. For example, the regulator's cost of capital assessment might be too low to attract investment, but the licensee's investment plans might be overstated. Nevertheless, the RPI-X@20 project might seek to discover how such problems have been overcome in the regimes in which it has been tried.

CONCLUSIONS

134 In summary, therefore, we conclude that:

- RPI-X regulation is founded on the principle that the firm will look after its own interests and that other interests must be weighed and balanced by the regulator that is guided by its principal objective and its general duties;
- the public interest is encapsulated by the principal objective and the general duties. It is not the same thing as the interests of consumers, although these are pre-eminent among the various factors;
- the public interest and the consumer interest are served by well entrenched property rights;
- the privatisation regimes gave a direct power of veto to the person whose property rights were being constrained by the licence;
- other peoples' interests were protected by other aspects of the regime, including rights of veto exercisable by the Secretary of State;
- giving rights of appeal or veto to some stakeholders but not others will reduce the influence of the non-empowered stakeholders;
- it is hard to give status to the environmental stakeholder in appeal mechanisms;
- Ofgem's role would change significantly if other parties were to be given rights of appeal or veto. It would become more of a mediator than a regulatory decision-maker;
- CC referrals would be likely to be more common (or even the norm) with the probability of such referrals being greater the more parties are given rights of veto;

- a right of appeal conferred upon customers would require representation and governance arrangements;
- whoever represented customers would need to find a way to resolve the conflicting priorities of different customer groups;
- the interests of suppliers are not aligned with those of customers, though they may sometimes coincide;
- suppliers are exposed to changes in network prices. In the past their margins have been swelled by reductions in charges until these have been competed away;
- in an era of rising network prices, suppliers' margins are reduced until the market (or the contracts) allow price rises to flow through;
- the supplier hub principle (rather that the reality of who benefits from the network service) is the design feature that exposes the supplier to pricing risks from network charges;
- the supplier is commercially indifferent to the experience of the end user with respect to network services;
- the recommendations of the CC with respect to airports are based on a number of premises that do not apply in the case of energy networks;
- there is an important distinction between giving consumers 'a right to decide' and a 'right to be heard'. The right to decide implies greater resources and expertise;
- negotiated settlements may bring benefits in the USA but the counterfactual (litigated settlements) differs from the alternative in the UK; and
- alternative mechanisms (e.g. pendulum arbitration) that could operate in conjunction with rights for consumers merit attention.