



CONSUMER INVOLVEMENT IN BILLION-POUND ENERGY AND WATER SECTOR PRICE CONTROLS - A THINK PIECE

ABSTRACT

The process of setting price controls for natural monopolies in energy and water sectors in Britain has come a long way in the last three decades. It started with Stephen Littlechild's economics-based formulae of RPI-X (with focus on efficiency) and evolved to where we are today with outputs and incentives based regulation, with a popular mantra "monopoly companies must deliver outputs that meet the needs of consumers". Are consumers really involved and how? How does it matter? - therein lies the core of this think piece, with some views on what next.

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Why now?

There are plenty of reasons why this think piece is topical. Both energy and water regulators (Ofwat¹ and Ofgem) have either recently settled price controls or are in the process of settling one (PR19² and RIIO-2³). They are inevitably going to turn their minds to the framework for next set of controls (PR24 and RIIO-3) and will no doubt seek to learn lessons from PR19 and RIIO-2. Ofwat have already made a start on this process for PR24⁴.

In both sectors, the companies subjected to price controls can appeal the regulator's final decision to the Competition and Markets Authority (CMA). In the water sector, the CMA is currently presiding over appeals from four water companies with provisional decision expected in September 2020⁵ and no doubt once the energy regulator concludes its price control decision for RIIO-2, there will be appeals to CMA again.

I therefore hope this think piece will help sector regulators (Ofwat and Ofgem), the CMA, Government, utilities⁶ and anyone else involved in price controls decisions and contribute to price control related thinking now and for the future. This piece contains my personal reflections as someone who led Ofgem's design of enhanced stakeholder engagement for RIIO-2⁷. I was also involved in parallel in PR19, as I sat on the South East Water's Customer Challenge Group⁸.

How did we get to where we are today?

The context and history, as always, are important.

Privatisation of utilities and creation of regulators started from mid-1980s across many European countries and it originated in Britain. As widely quoted in regulatory literature, this expansion⁹ in part happened due to declining confidence in the

¹ Ofwat is the regulator for water companies in England and Wales. Water Industry Commission for Scotland (WICs) is the regulator for water company in Scotland. This think piece is on the regulatory regime of Ofwat.

² In December 2019, Ofwat decided on a five year package of £51 billion for water companies in England and Wales ([here](#)), which will apply from 2020-2025, under its price control framework called Price Review 19 (PR19).

³ In July 2020, Ofgem published its draft decision for consultation on a five year package of £25 billion for gas and electricity Transmission and Gas Distribution companies ([here](#)) under its framework of price controls called RIIO-2. Ofgem's final decision is expected in December 2020 and it will apply from 2021-2026. Ofgem has also commenced the process of settling the price control for electricity Distribution companies.

⁴ Ofwat have said "We are now considering what our approach to customer engagement should be for PR24. To inform this work, we will be publishing a consultation later this year and are keen to hear a wide range of views. If you have any ideas you'd like to share about this work now then please email us at PR24@ofwat.gov.uk" ([here](#))

⁵ Anglian Water, Bristol Water, Northumbrian Water and Yorkshire Water have challenged Ofwat's decision. The CMA's process is described [here](#) and is expected to conclude in December 2020. The timetable for the process can be found [here](#).

⁶ In this paper, the terms "utilities" and "companies" is used interchangeably.

⁷ I left Ofgem in January 2020 (after six years in their RIIO division), to join the Bar Standards Board as their Head of Policy and Research.

⁸ [South East Water Customer Challenge Group for PR19](#).

⁹ Majone, G. 1994. 'The rise of the regulatory state in Europe', *West European Politics* 17 (3): 77-101.

Consumer involvement in billion-pound energy and water sector price controls - a think piece

government run institutions such as water, gas, electricity and telecoms. Privatisation was also considered the most appropriate option to reduce public debt and secure investment in ailing infrastructure. The utilities were thus privatised, and regulators were created to oversee the privatised utilities^{10,11}.

Regulation of privatised utilities was deemed a complex activity, which required experts to solve the problem - the problem of market failure (in particular, natural monopoly). Ex ante price controls were seen as a solution. These privatised companies needed money to run the business and the regulator decided how much it would be, importantly to provide the services as cheaply (efficiently) as possible to the consumers of the companies. RPI-X pioneered by Stephen Littlechild¹² was used as a formula by the regulators in case of natural monopolies to settle the money upfront (usually for a 5-year period).

What is interesting here, even though Stephen Littlechild envisaged price controls of natural monopolies to eventually wither away to be replaced by negotiation of deals between consumers and companies with regulators having a role in periphery^{13,14}, the legacy of consumer involvement in price controls has remained debatable. Put simply, at the time of privatisation in 1980s, the key objective of the British Government (which translated into the objective and then duties for regulators) was to achieve efficiency in the operation of the monopoly utilities, with benefits passed on to consumers in the form of lower bills. Consequently, the regulatory frameworks were primarily aimed at sweating the assets to cut the costs of running these companies and making efficiencies. Regulators who set the price controls were considered proxy for the consumers of goods services provided by these utilities. Comparison between the companies was a key tool to identify and drive efficiencies. Therefore even if any regional demands from the consumers of these companies came forward to the regulator through a company, it was difficult for them to accept

¹⁰ "Regulatory agencies were set up in the 1980s and early 1990s. Partly because it was realised that in many cases privatization would only mean the replacement of public by private monopolies unless the newly privatised companies were subjected to public regulation of profits, prices, and entry and service conditions. Hence the rise of a new breed of regulatory agencies, the regulatory offices: Office of Telecommunications (1984), Office of Gas Supply (1986), Office of Water Services (1989), Office of Electricity Regulation (1990)." Majone, G. 1994. 'The rise of the regulatory state in Europe', *West European Politics* 17 (3): 77–101.

¹¹ For example, British Gas post privatisation in 1986 was a monopoly, vertically integrated, and therefore its customers and consumers did not have a choice on the provider of gas. "British Gas is a vertically-integrated utility owned by over 2 million shareholders with a market capitalization of £14 billion, placing it among the top ten UK firms and making it one of the largest and most financially powerful energy companies in the world." (Stoppard, 1993). To, therefore, protect the interest of these consumers and customers, the government at the time of privatisation established the economic regulator of gas Ofgas (Office of Gas Supply)

¹² "Recognising that competition in all areas of utility activity is impossible, the RPI-X mechanism is designed to act as the next best alternative by mirroring the benefits of market forces." Prosser, T. 1999. 'Theorising utility regulation', *Modern Law Review* 62 (2): 196–217.

¹³ Or price controls replaced by increased competition (for example in case of electricity generation or retail and BT).

¹⁴ Stephen Littlechild in his very recent submission (May 2020) to the CMA on water sector price control appeals, which can be found [here](#), continues to argue for negotiated settlement model and is encouraging CMA to also apply it for price control appeals. From about the mid-2000s to the mid- 2010s he wrote several papers on this topic and urged UK regulatory bodies, including Ofgem and Ofwat and the Water Industry Commission for Scotland (WICS), to explore the possibility of doing something similar.

those differences in proposals unless they applied them to all companies¹⁵ especially given information asymmetry^{16,17} problem inherent in the process. Concepts such as "direct consumer involvement in price control decisions" or "outcomes desired by end consumer" or "consumer engagement" were therefore not at the forefront of anyone's mind.

What resulted in the shift in thinking?

The call for changes to regulatory objectives in Britain emerged in the latter part of 1990s, about RPI-X framework not being fit for purpose anymore^{18,19}. Government and regulators were being challenged to think differently about the price control frameworks partly due to changes in the structure of the privatised companies²⁰ and partly due to changing government agenda.

In 1997, when Labour Party came to power in Britain, it was a chance for them to think differently, given the pressures and challenges of the privatised models that were coming to the fore. Although the then Labour party was strongly opposed to the

¹⁵ "One concern was the straight-jacket that I found myself having to impose on some of the companies and, by implication, their customers. In order to bring some order into the process, and to facilitate comparisons between companies, I had set out a framework and methodology that would be followed by all companies. But sometimes a company would say to me: what about doing this or that, which would be beneficial to customers as well as to the company? And I found myself replying: It sounds interesting but I'm afraid I can't let you do that unless I require all the companies to do it." Stephen Littlechild, former electricity regulator, in his submission to the CMA PR19 redeterminations [here](#).

¹⁶ In Contract Theory of economics, information asymmetry suggests that sellers of goods (i.e. monopoly utilities in case of price controls process) may possess more information than buyers of the goods (regulators and consumers in price control process), skewing the price of the goods in favour of the sellers (utilities) of the goods. In the context of price controls for example "systematic outperformance may also indicate that companies have been set budgets and targets that were easier to outperform than anticipated. This may arise because the presence of information asymmetry, between the regulator and regulated companies, can create incentives for companies to act strategically, for example by misrepresenting information, such as overstating costs" - C. Decker (2015), *Modern Economic Regulation, An introduction to theory and practise*, page 86, section 4.4.

¹⁷ Companies' informational advantage in utility regulation has been widely acknowledged in the academic literature, especially in the case of ex ante price regulation regimes. This is explained by Joskow [here](#) and also in a recent paper published by the UK Regulators Network (UKRN) on cost of capital [here](#).

¹⁸ For example, Prosser argued "across utility regulation it has proved impossible to separate economic approaches to regulation from the broader political and social framework. This can be illustrated vividly from the case of price control." Prosser, T. 1999. 'Theorising utility regulation', *Modern Law Review* 62 (2): 196–217.

¹⁹ In 2004, helm said "RPI – X is a deceptively simple rule, and that, while it lent itself well to the assets sweating agenda of the 1980s and 1990s, it is less well suited to the new demands of the new century, with investment, security of supply and environmental concerns to the fore. Other instruments might be better suited to the new purposes, albeit with a strong bias towards using market-based mechanisms where possible." <http://www.dieterhelm.co.uk/home/about/>.

²⁰ An example of structural change is the case of the gas sector. When gas was first privatised in 1986, it was a vertically integrated industry and the entire value chain from production of gas to supplying it to the homes of people was a natural monopoly owned and operated by British Gas. Until 1997, the regulator Ofgas set the price controls for the entire business of British Gas, using RPI-X formula. However, in 1997, the business was separated into different parts owned and operated by different private entities. There was different type of regulation for these parts too, for example for Transmission and Distribution of gas pipes price controls continued to apply because this part of the value chain remained natural monopoly, whereas supply of gas to households and on-households was open to competition and regulator Ofgas retreated gradually from this market. Source: Ofgem, 2009, *History of Energy Network Regulation*, [here](#).

idea of privatised utilities, they did not support the idea of re-nationalisation, in contrast to today²¹. Instead, changes were recommended to make the regime tougher against the background of media noises of privatised utilities gaming regulators in price controls to earn excessive profits. There was also emphasis on the social consequences of utility operations and an intention to incorporate social responsibility into utility regulation.

As a result, the statutory duties of Ofgem and Ofwat were replaced (using utilities Act 2000 for Ofgem and Water Act 2003 for Ofwat²²) with a primary or principal duty to exercise their functions in the manner they consider best calculated to protect the interests of consumers, to which other duties would be secondary.

This new thinking of including social objectives in the role of regulation stemmed from the argument that if regulation was to be accepted in the long run and provide a stable framework for the regulated utilities then it must be fair and seen to be fair by all those who have connection or stake in the utilities. This thinking was seen as an alternative to earlier model of price controls, where primary relationship was between the regulated business and the regulator as its ruler, proxy for consumers and the objective was efficiency.

Amongst the essential utility providers in Britain, it was the energy regulator Ofgem that rose to the occasion and undertook a review of the RPI-X framework in 2008 (after Stephen Littlechild's RPI-X had been in use for 20 years²³) under the leadership of David Gray, Alistair Buchanan and Hannah Nixon, aptly supported by Cloda Jenkins and my late colleague and friend Iain Morgan. Stephen Littlechild (amongst others Ofgem consulted for this review) wrote a paper²⁴ for this review on scope for more consumer involvement in energy networks. The key challenge for Ofgem according to Littlechild, was "how to involve consumers in the regulatory processes? How to improve company focus on consumers? How to obtain legitimacy of its decisions?".

Ofgem eventually settled on a new regulatory framework called RIIO (**R**evue equals **I**ncentives plus **I**nnovation plus **O**utputs)²⁵ to replace RPI-X in the energy sector, with a key tenant of this model being stakeholder engagement²⁶. Under this new framework, the network companies were required to inform and design their business plans through engagement with stakeholders. The engagement with stakeholders would inform the outputs the companies need to deliver and how much

²¹ Labour Party Manifesto for 2019 elections in Britain can be found [here](#), page 7, "We will bring rail, mail, water and energy into public ownership to end the great privatisation rip-off and save you money on your fares and bills."

²² [Utilities Act 2000](#) and [Water Act 2003](#). Ofgem's duties can be found [here](#). Ofwat's duties can be found [here](#).

²³ Ofgem's RPI-X@20 review paper can be found [here](#).

²⁴ Littlechild, S, 2009, RPI-X Regulation: Ofgem's RPI-X@20 Review and the Scope for More Customer Involvement, Ofgem.

²⁵ [RIIO: A new way of regulating energy networks](#)

²⁶ In its final decision on the RPI-X@20 project Ofgem also set out the primary benefits stakeholder engagement as: - Improved legitimacy of the process; Ensuring outcomes are aligned with the needs of consumers; Assisting with meeting the emerging challenges especially around the transition to a sustainable energy system.

consumers would be willing to pay for them. These business plans were then submitted to Ofgem for approval.

Stakeholders under this new framework were defined as individuals, organisations or communities that are impacted by the activities of the network companies. This includes existing and future consumers. The regulator was no longer considered a proxy for consumers or the sole consumer of the goods and services produced by the energy companies. Regulator was no longer telling utilities what to deliver for consumers, but instead utilities would be telling the regulator what their consumers wanted and how much their consumers were willing to pay for it by engaging with their stakeholders. The RIIO handbook²⁷ set out practical steps involved in operating the new framework for example principles of engagement, temporary incentives (notably rewards) such as stakeholder engagement incentive²⁸ (SEI) to change the behaviour of the companies to engage with stakeholders and understand their needs and priorities (something a company would naturally do under competitive pressures to avoid going bankrupt).

RIIO-1 and PR14 price controls

The RIIO model was implemented for the first time in 2013 as RIIO-1.

It is important to note that under the RIIO model, Ofgem still remained the final decision maker on monies needed by the companies to run their business. Price controls remained ex ante. The need for regulatory experts still remained to supervise, collect relevant data, enforce, monitor the outputs and agree the financial parameters within which utilities must operate and make final decisions on funding of the businesses. Although the energy model started to make the role of stakeholders (including consumers of today and tomorrow) prominent, it was still miles apart from Littlechild vision of negotiated settlements.

In water sector in England and Wales, the regulator Ofwat decided to follow in Ofgem's footsteps for price review 2014 (PR14) with the focus shifting to regulating the outputs produced by the water companies. It was deemed that water customers should have more say in what these outputs should be, the prices and services they receive from regulated companies for these outputs. Ofwat said ²⁹ *"PR14 represented a fundamental change to how we, and the sector, carried out price reviews. The rationale for this change was that companies' plans for delivering water and wastewater services should be driven by what their customers, the environment and society want, now and in the future. This is critical to our vision of promoting a sector that focuses on delivering what the customer wants, with the regulator setting the underlying framework instead of being the companies' focus."*

Notably, both regulators left the stakeholder engagement for business plans in PR14 and RIIO-1 to the companies, the rationale being that companies should know their stakeholder preferences and needs like any company in a competitive market would do. Recognising the information asymmetry issues and limitation of regulatory

²⁷ [RIIO Handbook](#).

²⁸ Stakeholder Engagement Incentive (SEI) guidance from Ofgem can be found [here](#).

²⁹ Ofwat quote from its PR14 lessons learnt publication can be found [here](#).

budget to address them, Ofwat took an additional step to require companies to set up Customer Challenge Groups (CCGs) consisting of consumers and other regulators to challenge the quality of stakeholder engagement being undertaken by the company and the extent to which it is reflected in the company's business plans. Ofwat provided high level guidance³⁰ to the water companies on their expectations, whereas Ofgem published nine principles of effective engagement it expected energy companies to be mindful. Ofgem subsequently evaluated all business plans in RIIO-1 based on five criteria: process, outputs, resources (costs), resources (finance) and uncertainty and risk. The criterion on process included how stakeholder engagement was undertaken and how this engagement impacted areas of business plans.

To facilitate their own engagement with stakeholders during price control process, both regulators introduced additional forums, aside from usual consultation process – Ofwat introduced customer advisory panel, which they set up for themselves as critical friends to inform and challenge Ofwat on a number of key sector-wide assumptions, such as the cost of capital and provisions for pensions. Likewise, Ofgem had three forums to engage with consumers, Price Control Review Forum, Consumer Challenge Group and Consumer First Panel³¹.

Both regulators undertook lessons learnt from PR14³² and RIIO-1³³ and confirmed the behaviours of the utilities has changed positively. The revised regulatory frameworks have improved the importance of stakeholder engagement in planning for company business day to day and longer term. But more needs to be done. The independent report³⁴ commissioned by Ofgem to learn lessons from RIIO-1 went as far as saying “*now that stakeholder engagement has been trialled in RIIO-1, it is reasonable for Ofgem to apply (stronger) penalties for insufficient/inadequate stakeholder engagement in RIIO-2.*”

Fast forward to today – where is stakeholder engagement in price controls today for PR19 and RIIO-2?

PR19 and RIIO-2 price controls are the latest rounds of controls to be implemented by the water and energy regulators. These price controls are being settled against the background of sustained criticism of previous controls (PR14 and RIIO-1), where utilities were seen to have successfully gamed the regulators to earn super normal profits under the new outputs and consumer focussed frameworks³⁵.

³⁰ Ofwat guidance in PR14 on customer engagement can be found [here](#).

³¹ Maxine Ferk, ex- Ofgem Senior Director undertook a lessons learnt in 2017 of Ofgem forums established for RIIO-1 and her paper can be found [here](#).

³² Lessons learnt for PR14 by Ofwat can be found [here](#)

³³ Lessons learnt from RIIO-2 can be found [here](#). Ofgem commissioned independent review of RIIO framework and RIIO-1 through CEPA and consulted on RIIO-2 framework subsequently. All documents are available (including CEPA report) on this link.

³⁴ [Review of RIIO Framework and RIIO-1 performance](#), CEPA, para 3.1.2, page 45.

³⁵ It is important to note here that price controls is a repeat game. With each round of price control, the information asymmetry problem is expected to reduce, with regulators changing their framework for the future to take account of new revealed information and any lessons learnt. Unless there are structural changes to the entire system as explained in this paper, which results in wholesale change to regulatory approach.

Citizens Advice in 2017 issued a report called “missing billions” claiming that their research found under RIIO-1, energy consumers were overpaying for energy networks by £7.5billion over the course of the current eight-year price control set by Ofgem. The Financial Times in 2018 ran the headline “*Privatisation currently has a bad reputation in Britain, only some of it is underserved. Companies, regulators and politicians involved need to win back the public’s trust by conducting themselves with regard to fact and analysis rather than ideology alone.*”

However, as can be seen from history, this criticism of the regulatory framework and utilities earning super normal profits and public discontent is not new. What was new this time was Labour Party calling for the utilities to be re-nationalised and surveys showing growing support in the public for re-nationalisation. “*A recent poll by Legatum Institute found that 83 percent of respondents favoured re-nationalising the water industry that Margaret Thatcher, the then Prime Minister, sold in 1989. For energy and railways, 77 percent and 76 percent.*” (Financial Times, 2018). The threat of re-nationalisation leading up to 2019 general elections was taken so seriously by the water industry, that they commissioned a report from Social Market Foundation (a think tank) published in February 2018³⁶, that estimated the cost of re-nationalisation to be £90billion for taxpayers.

Both Ofwat and Ofgem responded to the criticism this time by (amongst many other things):

1. reviewing their price control frameworks again (decision was made to still proceed with outputs and incentives-based framework with focus on consumers).
2. maintaining that stakeholder engagement should be central to good business plans and companies can do better than PR14 and RIIO-1.
3. requiring water, gas and electricity network companies to set up *independently chaired* challenge groups³⁷ to strengthen the voice of consumers and to help legitimatise the decisions taken by the regulators. This was meant to be achieved through these groups challenging the business plans prepared by companies before they are submitted for the regulators for approval. The groups would provide an independent report to the regulator. Ofgem went a step further by establishing a UK wide challenge group who would consider all the company business plans comparatively (this ensured Ofgem had independent views both at regional and country wide levels) and to challenge Ofgem’s own policies. Ofgem also set up a mechanism of Open Hearings to hear areas of disputes between the companies and the challenge groups.

Crucially again, both regulators left the direct stakeholder engagement to the companies as they did in the previous price controls (with independently chaired groups providing views on quality of it). For example, Ofgem said explicitly in its guidance to the companies that they will not prescribe which stakeholders a

³⁶ [The cost of nationalising water industry in England](#), February 2018, Social Market Foundation.

³⁷ Ofwat groups were called “Customer Challenge Group (CCGs)”. Ofgem groups were called Customer Engagement Groups for Distribution, User Groups for Transmission and UK wider RIIO-2 challenge group. The role of challenge groups in water sector can be found [here](#) and role of energy groups and types can be found [here](#).

company should engage with, nor the format or frequency used for engagement. The responsibility for engagement sits with the companies³⁸. This implied that role of the challenge groups was important to provide assurance to the regulators on the quality of the engagement and should the regulator decide to ignore or override either the company and/or the group's views, the onus is on the regulator to explain clearly why. This made it more important that the regulator explains early on in the process to all involved, what it considers to be best practice and the criteria it will apply when assessing stakeholder engagement the companies, whether to accept, disregard or override it.

In the past regulators have used "decision in the round"³⁹ rationale to override views in business plan submitted by the companies. It is important to note the CMA's latest position on "decision in the round". CMA said⁴⁰ *"We note that there have been previous submissions that a regulatory decision should be considered in the round.....the overall price control set by a regulator is the combination of a number of individual decisions, and we do not accept that it can be beyond the CMA's powers to review these individual decisions, on the basis that they need to be considered "in the round" with decisions that are otherwise unconnected parts of the regulatory settlement."* Simply put, this reiterates the importance of regulators being clear and transparent on every individual decision they take in a price control and how they are interlinked. Arguably they may not be able to disregard evidence provided by stakeholder engagement using this rationale.

[More on new *independently Chaired* challenge group model for PR19 and RIIO-2](#)

For PR19, Ofwat reviewed the model it had for challenge groups in PR14 and made changes to improve its legitimacy, whereas Ofgem introduced the challenge group model (called enhanced stakeholder engagement) for the first time in energy sector and it was seen as a major innovation to its price control framework. The guidance from Ofgem on enhanced stakeholder engagement stated that the vision in energy sector was for the challenge groups (with experts and not consumers like in water sector) to challenge the companies on behalf of consumers of today and tomorrow on the entirety of the business plans. Ofgem would then use Open Hearings process to focus on areas of disagreement and contention between the companies and the groups, before making its final decision. Open Hearings for RIIO-2 had to be cancelled due Covid -19, however, Ofgem has another opportunity to apply this concept of hearings through the Electricity Distribution Price Control process, which has just commenced with publication of a framework⁴¹.

Both Ofgem and Ofwat made it clear that the challenge groups were not a replacement for stakeholder engagement expected of the companies, these groups

³⁸ Ofgem enhanced stakeholder engagement guidance can be found [here](#).

³⁹ The regulatory rationale means, decisions in the price control are interlinked. Therefore, altering one part of the price control could have a knock-on impact on the other parts of the price control, implying cheery picking individual errors by companies appealing the regulator's decision should not be permissible.

⁴⁰ CMA response to Ofgem, 30 October 2019 can be found [here](#) with the aim to provide clarification on appeals process for RIIO-2.

⁴¹ RIIO- ED2 price control framework can be found [here](#).

were not expected to endorse the business plans of the companies and they were not decision-making bodies.

It is important to note that whilst the groups in the water sector primarily focussed on challenging the water companies' quality of stakeholder engagement, the groups in energy were designed to focus on all aspects of the business plans (excluding finance, which was in the remit of their country wide group only).

When designing the system for the energy sector⁴², I was keen that the remit of challenge groups included challenging all aspects of the business plans of the companies. This is because stakeholder engagement is only part of the story (as I would describe it, stakeholder engagement is 1/3 of the picture with the other 2/3 comprises of expenditure and financing). The recent Citizen Advice's submission to the CMA on water company appeals on Ofwat's PR19 decision adds weight to why it is important to consider the business plans in entirety. Citizens Advice said⁴³ *"Research and engagement with consumers have been vital and valuable parts of PR19. The consumer evidence collected by companies, where this has been done well can help to identify people's needs, shape the outputs of the price control and justify specific programmes of investment or service delivery. But it is much harder for this evidence to say what the return and cost of that investment should be. We were concerned with the way some companies used consumer evidence in their appeal submissions in arguments around the fairness of returns."*

To challenge the thinking of the energy utilities effectively, it was essential therefore the groups were given the complete picture on the plans and not just on quality stakeholder engagement. This was ultimately to avoid the same information asymmetry issues for the groups as faced by the regulators that could lead to gaming of the process⁴⁴. I wrote the guidance on this new model for the energy sector, which contains further details and rationale for this and can be found [here](#). The three key objectives for introducing this model were:

1. Raising the bar for engagement and quality of business plans.
2. Support Ofgem's business plan assessment.
3. Enable more flexible regulation – reflecting regional differences.

To crystallise this vision in energy sector, it was also important to have the right mix of individuals on these groups – individuals who can understand price control settings and can challenge the thinking of the utilities from their own deep work experience in either the energy sector or comparative areas, which direct consumers may not be able to. Ofgem reached this conclusion of having "experts" on these groups (and not direct consumers or regulators like in the Ofwat PR19 model⁴⁵) by also undertaking their own consumer research at the start of RIIO-2. I commissioned

⁴² Lessons were learnt from the Ofwat model, Water Industry Commission model of negotiated settlement, Civil Aviation Authority model of constructive engagement

⁴³ Citizen Advice Submission to Competition and Markets Authority on PR19 appeals can be found [here](#)

⁴⁴ In the last section of this paper I have explained what else should be done to ensure the information asymmetry for the groups is minimised in the process.

⁴⁵ The PR19 Customer Challenge Group I sit on is Chaired by Zoe McLeod. Zoe took the decision to include independent experts on her group aside from consumers and regulators mandated by Ofwat.

this research⁴⁶ to understand how consumers would like to be involved in the price controls and the results pointed to use of “experts”.

Aside from responding to the legitimacy concerns, which had arisen from the criticism of the previous controls (PR14 and RIIO-1), these independent groups were seen as an important “additional” regulatory tool to combat the inherent information asymmetry problem around the business plans. The regulator normally would set the framework for a price control and then leave it to the companies to develop their business plan, not getting involved in the development of the plans. Now regulators had independently Chaired experts working in close quarters but at an arm’s length from the companies on these business plans costing billions to energy and water consumers. These groups therefore are not only a source of independent assurance on the business plans but also an opportunity to better reflect local context, priorities, expectations and needs (which for example due to information asymmetry problem was not possible in RIIO-1 as Ofgem confessed in its lessons learnt exercise).

Ofgem also saw the independent groups and their reports as an alternative source of information for the CMA to use if/when Ofgem’s decision is appealed by the companies to the CMA. In the absence of these independent challenge groups, CMA will only have two views – that of the regulator or the company, making CMA face the same issues as the regulator with information asymmetry.

It was important for these challenge groups in both sectors to receive views from both the company and the regulator, but also important they were independent from the company and the regulator to arrive at their own conclusion using the information they gathered and their expertise. Both Ofwat and Ofgem issued detailed governance guidelines to ensure independence (in particular, in relation to the Chair).

Speaking academically, Stephen Littlechild said on negotiated settlements⁴⁷ *“the role of the regulator is to “hold the ring”, to facilitate negotiation and if possible, agreement between companies and customers and other interested parties. Of course, the regulator must protect the interests of customers more directly if it appears that the process is not working in customers’ interests, and it must satisfy itself that any proposed settlement is in the interests of customers, and consistent with the regulator’s many statutory obligations.”* Ofgem’s RIIO-2 framework on stakeholder engagement may be the closest price controls in energy⁴⁸ have come to Stephen Littlechild’s vision of negotiated settlement using experts, without Ofgem abandoning its regulatory duties. Ofgem stopped short of stating “Ofgem will not

⁴⁶ Ofgem research on involving consumers in price controls can be found [here](#).

⁴⁷ Stephen Littlechild response to CMA on water company appeals to PR19 can be found [here](#).

⁴⁸ The water regulator in Scotland (Water Industry Commission for Scotland - WICS) set up a Customer Forum to negotiate with Scottish Water, subject to guidance notes from WICS for its Strategic Review of Charges 2015-2021. Similarly, The Civil Aviation Authority (CAA) also used this approach (called constructive engagement) in 2004 to settle price control for Heathrow. Constructive engagement required the regulated airport to consult with airlines and the air traffic control service provider in developing its plans for the next price control period. The airlines and airport were expected to engage directly on all areas relating to the regulatory building blocks to identify areas of joint agreement, or indeed where they do not agree. Passengers were not directly represented, as the approach assumes that airlines adequately represent passengers’ views.

expect to determine all price control parameters itself”, as it would have done so in case of negotiated settlements model prescribed by Littlechild.

Decisions by Ofwat and Ofgem on PR19 and RIIO-2

Ofwat made its decision on PR19 in December 2019⁴⁹. Whilst it made little reference to how it used the reports of the challenge groups to reach its decision on quality of stakeholder engagement, it is clear that Ofwat have scrutinised the stakeholder engagement of each water company and taken effort to explain where they agree with the company and where they disagree (and why). Ofwat also published various documents, independent researches and held workshops to facilitate discussions, to give an early indication to the companies ahead of PR19 what Ofwat considered to be best practice in stakeholder engagement (although some would argue it was not enough and early enough). Ofwat in its PR19 decision also differentiated between the business plans in totality using a rating mechanism (A-D) in 9 categories, of which stakeholder engagement was one and categorising business plans as a whole into exceptional, fast track, slow track and significant scrutiny. Subsequently, four water companies appealed Ofwat’s final decision to the CMA⁵⁰. Ofwat in its submission to CMA⁵¹ have said *“We expected Customer Challenge Groups (CCGs) to provide independent challenge to companies and independent assurance to us on the quality of a company’s customer engagement and the degree to which this is reflected in its business plan. As we explained in our ‘Introduction to the CMA’, we did not expect CCGs to endorse a company’s overall business plan, nor did we expect them to act as a substitute for the views of customers. We are currently considering the future role of CCGs (or equivalent) for PR24, including how to better promote the independence of CCGs from companies.”* Reading between the lines, Ofwat seems to be raising concerns over the independence of the challenge groups in PR19 process.

Ofgem published draft decisions in July 2020 for three price controls in RIIO-2⁵², using its new challenge group model (enhanced stakeholder engagement). Ofgem said *“As part of our work leading to Draft Determinations, we have reviewed the groups’ reports and responses to the stakeholder call for evidence. The groups’ reports and stakeholder feedback were useful in casting light on the key issues in the company Business Plans. We have also facilitated a dialogue between the RIIO-2 Challenge (national) Group and the Customer Engagement Groups/User (regional) Groups to explore areas of difference between the groups on their perspectives on the plans. Our Draft Determinations have been informed by relevant considerations, including (but not limited to) the enhanced stakeholder engagement process as a whole.”* Unlike Ofwat, Ofgem have steered clear from commenting on quality of stakeholder engagement undertaken by the companies and have not differentiated between the plans (like it did in RIIO-1 through fast tracking mechanism for best plan by a company⁵³). They did have penalty and rewards on overall quality of the

⁴⁹ PR19 decision from Ofwat can be found [here](#).

⁵⁰ Anglian Water, Bristol Water, Northumbrian Water and Yorkshire Water have challenged Ofwat’s approach.

⁵¹ Ofwat’s submission to CMA can be found [here](#).

⁵² Ofgem’s draft determinations published in July 2020 can be found [here](#).

⁵³ For example, in RIIO-ED1 Western Power Distribution’s (WPD) Business Plan was fast tracked. Ofgem said *“We think WPD’s business plans are, overall, of sufficiently high standard that it is in the interest of consumers*

business plan based on a pre-defined criterion, however the draft decision didn't do much to differentiate between the plans on that basis, except for a notable penalty on National Grid in Transmission sector. Ofgem also did not explain what it considers to be good, like Ofwat did, instead it provided guidance on what business plans should cover⁵⁴. Ofgem was updating its guidance on business plans till two months before the business plans were due to be submitted to Ofgem.

So, what next?

If like me, you have been involved in the price control world for a while and in different sectors, you will not be surprised to hear that when involved in this process you always have an eye out for the next round of controls. This is simply because price controls are a repeat game, where lessons are always learnt from the previous round to improve the next round.

So, no doubt once the dust settles on the CMA appeal process for the four water companies, Ofwat and water companies will embark on the journey to review the framework for next price control, Price Review 2024 (PR24). Ofwat has started the process already to review the challenge group model.

Ofgem will make final decisions on three sets of price control (Electricity and Gas Transmission and Gas Distribution sectors) before 2020 ends, then the CMA appeals stage related to this will commence. It will in parallel also repeat the process for Electricity Distribution sector for RIIO-2. Ofgem should be learning lessons for Electricity Distribution sector from both Ofwat and its own controls for Electricity and Gas Transmission and Gas Distribution sectors and it will be thinking about RIIO-3 as well.

Given both sectors are still in the process of their price controls being settled, I have focussed the remainder of this paper on lessons that can be clearly learnt from what has happened already drawing from my own experience of being involved in both PR19 and RIIO-2.

PR24 and RIIO-3 will commence from 2025 onwards. Assuming Labour Party's plan to renationalise utilities doesn't materialise, regulatory objectives remain unchanged and price controls continue to apply for natural monopolies, the primary duty of regulators to act in the interest of consumers of their respective sectors will remain and engaging with stakeholders to demonstrate compliance with this primary regulatory duty is here to stay, especially in the current challenging times of Covid-19 and on the road to net zero.

With this context and history in mind, regulators must be clear upfront on what do they mean by stakeholder engagement and role they expect it to play, recognising engagement has a cost and if done appropriately it should not be a stop/start exercise. Stakeholder engagement can be also done by both company and the regulator. Learning lessons from the history and other sectors as explained in this

for us to accept them in full (subject to a cost of equity change, described below)." Ofgem's decision can be found [here](#).

⁵⁴ Ofgem's business plan guidance can be found [here](#).

think piece including various approaches that have been tried before will be important. The following three fundamental questions must be answered upfront:

1. **How should consumers be involved in price control processes?**
2. **What should be the role of stakeholder engagement in price controls** - both on an ongoing basis and for the purposes of price control settlement.
3. **Who should take the lead on research for consumer needs?** There are various options to consider here – a) companies are responsible for undertaking research as was the case with water sector in PR19 with independent views on the quality of the research sought from the Customer Challenge Group and ultimately then it is up to the regulator to accept it. The regulator should define upfront what it considers to be good practice and acceptable, including criteria for assessment b) regulator undertakes research - this is something Ofwat did in PR04 and PR09 for example by undertaking its own research on consumer needs and willingness to pay c) combination of options a and option b.

Having introduced the independent challenge group for PR19 and RIIO-2 to strengthen the voice of consumers in the price control process, how should Ofwat and Ofgem decide whether to continue with the challenge group model for next set of price controls⁵⁵? Two aspects need to be considered together to answer this question, which are as follows:

1. What is the **problem** the regulator is trying to solve and is this the only effective solution for solving it? It is clear from PR19 and RIIO-2, these groups were established to address legitimacy of regulatory decisions with consumers and help address information asymmetry issues. Do these problems remain for PR24 and RIIO-3? If yes, are there any other tools to address these problems?
2. **Lessons learnt**- how well has this system worked in PR19, RIIO-2? Have the objectives of the process been met? It is important for the regulators to undertake a combination of lessons learnt and evaluation exercise to understand the impact of these groups. In my role at Ofgem, I was encouraging all the challenge groups to capture their impact (where possible in £s – both benefits and costs). The impact should also capture non-quantifiable elements such as the impact the groups have had on changing the culture of the companies. It is also worth looking outside Britain to learn lessons, for example, recently Australian Energy Regulator commissioned an independent review from KPMG to understand the impact their Consumer Challenge Panel (CCP) programme is having⁵⁶.

If the regulators do decide to continue with this model for PR24 and RIIO-3, from my experience of participating in the process for PR19 and designing the process for RIIO-2, there are **some key practical points** for regulators, companies and others

⁵⁵ It is worth keeping in mind that the role of the groups could be broadly divided into “role during the price control process” and “role after the price control process – ongoing role”. This paper is addressing the former. Ofgem for example is currently consulting on the ongoing role of the groups.

⁵⁶ More on the Australian Model and its review can be found [here](#).

involved to consider to ensure success. This is by no means a complete list but a starter for ten to consider.

1. **Early start (timetable, timetable, timetable):** This is the most important practical element of the entire process. It is important that the regulator signals its intention to keep the challenge group model as soon as possible. This would enable the groups to set up from the start of the business planning process (and/or the companies can continue, revive, review the existing challenge groups from PR19, RIIO-2). Groups coming in late in the business planning process will face an information disadvantage from the start because it takes time for the groups to settle, be inducted and start to make effective contributions. It is important for both the company and the regulator to be aware, that including the challenge groups in the price control process expands the timetable and requires for example the regulator to complete its tasks (most importantly settle the framework) as early as possible and for the companies to build information sharing iterations with the groups into their workplan.
2. **Framework “boundaries”:** For the process to work successfully, it is important for the regulator to settle the framework (i.e. boundaries) as early as possible to allow the groups and companies to work “within the boundaries” and resist the urge of tinkering with the framework repeatedly. Simply put, if the regulator keeps intervening, it defeats the purpose of the whole engagement process, whereby the focus of the companies should be on the needs of the stakeholders when designing the plan and not focussing on the regulator repeatedly intervening with changes to boundaries. Regulator must have faith in its process and step back for it to play out, unless it has a strong case for intervention, the criteria for which it should define upfront.
3. **Role, scope, responsibilities:** Alongside signalling the continuation of the challenge groups and settling the framework, it is important for the regulator to explain the role, remit and responsibilities of all parties involved in the process. This would ensure the right membership, with appropriate capability central to the success of these groups, is recruited at the outset, with clarity on the size of task, objectives and the level of time commitment needed from the members of the groups.
4. **Incentives/consequences** It is important also for all parties, especially the companies, to be clear on the reward/penalty of the challenge group process being implemented at the outset, acknowledging the industry structure is such that an incentive will be needed for the system to not be besieged by the same information asymmetry issue as faced by the regulator.
5. **Business plan visibility for the groups:** The groups must review complete business plans (and at least a few times). This needs to be built into the timetable (linking back to point 1) by both the companies and the regulator, otherwise the process will fail because of information asymmetry issues.
6. **Governance:** The theory of regulatory capture⁵⁷ now extends to these groups as well, which could defeat their legitimacy and that of the process. To avoid capture by either the companies or the regulator, governance of these groups

⁵⁷ The theory of regulatory capture is an economic theory that says regulatory agencies may come to be dominated by the industries or interests they are charged with regulating. The result is that an agency, charged with acting in the public interest, instead acts in ways that benefit the industry it is supposed to be regulating.

is important. There are a few questions to consider here. Should the Chairs be jointly selected by the company and the regulator? Should the group report to Non-Executive on the Board? Should the non-Executive in case of the company be shareholder to align the interest of investor and consumers? Should the regulator attend the meetings of the group with the company from time to time?

7. **Alternative views:** To avoid capture of the groups, it is important for the groups to hear alternative views – not just of the companies or just of the regulators. It is therefore essential for both companies and regulators to build this information sharing process in their work programmes, what and how they will share the information with the groups (without compromising their independence). As an example, challenge group would benefit from information, which compares performance of all companies (i.e. benchmarking data both historical and forward looking) to efficiently challenge the company business plans. This information should be provided by both companies and the regulators. This would mean for example the regulator would need to be ready with the data and benchmarking models in advance. This would not be an issue if the regulator is focussed on building its knowledge bank through price controls to avoid information asymmetry (something that was envisaged for example through RIIO energy framework).
8. **Reports by the groups:** regulators need to be clear at the outset where they would particularly like to hear views from the groups on the business plans (at the same time as they settle on the framework for the price control), which should then be reflected in the reports from the groups. For example, if a regulator decides to rely on the consumer research of the companies, then this would be an area that would benefit from scrutiny of the groups.
9. **Interaction between the groups and regulator post final business plan:** It is impossible to summarise everything in an independent report and the nuances are inevitably lost in the written report that seeks to summarise the work that has taken place over number years. It is important that the lines of communication between the regulators and the groups remain open following the submission of the final plans, whilst the regulator is deliberating on the plans, with a view to make decision.
10. **Regulatory capability:** This process does not mean the regulator can operate on slim capability without experts (unless, arguably, a complete negotiated settlement model is implemented). As it stands, it does however allow the regulators to focus on areas of disagreements should it chose to do so. Regulator does need capability/expertise in-house to not only set out what good looks like to the industry as part of the framework but also understand final plans when submitted to Ofgem to ensure consumer interest is not undermined. Regulator needs to be prepared to also step in, in case for example it considers the research undertaken by the companies not in the interest of consumers, to then undertake its own analysis (the timetable should allow for this).

As for RIIO-2 and PR19, the jury is still out on these price controls including whether these price controls are really consumer focussed or are they reverting to RPI-X or US style rate of return controls with stakeholder engagement on fringes. As is always the case, these questions will be no doubt also tackled in due course with benefit of hindsight.

Consumer involvement in billion-pound energy and water sector price controls - a think piece

For now, at least on the face of it and as examined in this piece, consumers are involved (directly and indirectly) in these billion-pound price controls of natural monopolies like never before. Could more be done? Always. Could it be done better? Always.

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