Customer engagement: A new regulatory approach?

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Customer engagement

• What’s all the fuss about?
  – Don’t we already consult with customers when making regulatory decisions?
  – Don’t customers have many opportunities to get involved in developing policies, changing the Rules (AEMC), or appealing regulatory decisions (at the Tribunal)?

• Prof Littlechild has been arguing for a larger role for customer engagement and negotiated settlements for some time…
  – But should we take his word for it?
  – Aren’t we doing enough already?
Customer engagement

• Key points of this talk:
  – Customer engagement is not more of the same but a new way of approaching utility regulation…
  – Customer engagement is consistent with and flows out of the view of regulation as a long-term contract.
  – Customer engagement offers promise for better regulatory outcomes, swifter regulatory decisions, clarity of regulatory roles, and more constructive and less litigious industry relationships.
  – There are genuine concerns and issues to be addressed, but it is worth taking these issues forward…
The TCE approach to utility regulation

- What is the intellectual foundation for customer engagement?
  – The neoclassical textbook model of utility regulation with its focus on deadweight loss provides relatively weak grounds for involving customers directly in regulatory processes…

- There is an alternative way of thinking about utility regulation that is founded in transaction cost economics.

- This approach focuses on the need for **sunk investments by customers** of the service provider…

For example, a coal mine must make a sunk investment in reliance on continuing access to a coal railway; an aluminium smelter must make a sunk investment in reliance on continuing access to the electricity transmission network; small businesses and residences make a sunk investment in electrical equipment in reliance on access to the distribution network.
The TCE approach to utility regulation

- The trouble is that without some sort of protection, these investments are subject to the threat of **hold-up**…
  - The risk that the monopoly service provider will raise its charges after the customer has made a sunk investment.

- The service provider and the customers recognise that they need some sort of protection for these sunk investments – a **governance mechanism** to protect and thereby promote these investments.

- Classically there are two possible governance mechanisms: **vertical integration** and **long-term contracts**…
The TCE approach to utility regulation

- Vertical integration and long-term contracts are common between private firms.
- But where the number of customers is large, we often need to rely on public arrangements...
  
- Public utility regulation is a form of **publicly-administered long-term contract** between the customers and the monopoly service provider.
The TCE approach to utility regulation

- In the regulatory contract, the regulator plays the role of the dispute resolution mechanism.
  - The dispute resolution mechanism allows the contract the flexibility to adapt to changing circumstances over time.

- The central task of administering and adapting the regulatory contract over time is played by customers negotiating directly with the service provider (with the right to seek a ruling from the regulator).

The role of the regulator is primarily as a backstop - to resolve disputes (together with facilitating the negotiations, information exchange, and so on).
How is this different?

• How is this different to what we currently do?
  – At present the vast bulk of the interaction in regulatory processes is between the regulator and the regulated firms…
  – There is a little interaction between customers and the regulator and (almost) none at all between the customers and the regulated firm…

• In this alternative the vast bulk of the interaction is between the customers and the regulated firms.
What’s the benefit?

• There is a potential for better regulatory outcomes, swifter, less litigious regulatory processes, more constructive relationships, and a clearer role for the regulator.

• The parties know their own needs, desires, and constraints better than the regulator; they have local knowledge of their environment and can negotiate or tailor arrangements which suit them.

• Specifically this might include:
  – Better trade-offs between investment and higher prices or between better service quality or capacity and higher prices; Selection of investment projects
  – Better tailoring of services to match needs of customers; Profiling of price changes and tariff structures that better meet the desires of customers;
  – Greater innovation in the design of regulatory arrangements.

  – In principle the parties can agree on outcomes that the regulator is not legally able to impose…
What’s the benefit?

- Furthermore, there is the potential for swifter, less litigious regulatory processes, with less politicisation.
- Under current approaches, customers with limited influence in the regulatory process have an incentive to use political and media processes to make their concerns heard.
  - They have no incentive to make hard trade-offs and take responsibility for the outcomes. This makes for a litigious and contentious relationship with the service provider.
- In principle there is scope for better understanding of constraints and trade-offs, more responsibility by customers in accepting trade-offs, faster regulatory processes and lower regulatory-overhead costs…
What’s the benefit?

- Finally, there is scope for clarification of the role of the regulator and the role of appeals.
- Under the current arrangements the regulator is often tempted to (or even expected to) “take the side of the customer” in the regulatory negotiation.
  - The regulator must second-guess customer needs and desires.
  - The Tribunal may see itself as the first neutral decision-maker.
- Under the alternative approach the regulator would play a neutral advisory role – appeals could be limited to judicial review(?)
What’s the evidence?

• If we look around the world we find quite a lot of examples of utility regulation operating in this way:
  – With customers represented in utility proceedings by customer representative bodies…
  – The regulator taking the role of the dispute resolution authority…
  – And customers and service providers directly negotiating regulatory outcomes, perhaps facilitated by the regulator…
Customer representation in the US

- The US has a long history with customer representation in utility proceedings – mostly stemming from the 1970s.
- The majority of states in the US have funded authorities tasked with representing consumers in utility regulatory proceedings.
  - In 12 states the state attorneys general provide utility consumer advocate representation.
  - In 29 other states there some kind of office of the consumer advocate (also known as a consumer counsel, or public counsel).
  - Some of these may be located within the regulator itself (e.g., CA DRA).

"That office was created with the realization that the citizens of the state cannot adequately represent themselves in utility matters, and that the rate-setting function of the Commission is best performed when those who will pay utility rates are represented in an adversary proceeding by counsel at least as skilled as counsel for the utility company." (Florida Supreme Court)
Customer representation in the US

- The national body is the National Association of State Utility Consumer Advocates…
- Some states also have private member-funded customer representation bodies such as the Illinois Citizens’ Utility Board.

From the website of the CUB: Scope of work
When a utility seeks a rate increase or a change in service, it must win approval from the ICC. The utility usually presents the commission with detailed testimony from numerous experts to back up its request. CUB’s job is to present the same kind of evidence and make persuasive legal arguments—but from the consumers’ point of view.

CUB challenges utility rate increases, fights for rate reductions and refunds of overcharges, and appeals unfair regulatory decisions in the courts. CUB also promotes tougher consumer protection laws in the state legislature, where rules governing the utilities are written, and publishes consumer, education materials. CUB also is working to ensure that the introduction of competition into the utility industry will provide real benefits for real people, and not just added headaches and hassles.
Dispute resolution by regulators

- Many regulators overseas have an explicit dispute resolution role and often require negotiation or mediation prior to submission.
  - In the rail sector in Canada, shippers involved in tariff disputes with railway companies can seek Final Offer Arbitration from the regulator. The Canadian Transportation Agency also has the power to carry out mediation and arbitration and offers a facilitation service.

Germany, in relation to non-price energy and telecommunications disputes, parties are encouraged to seek a pre-lodgement ‘mediation’ with the relevant Ruling Chamber. The mediation process is more streamlined than the formal process, with brief submissions (usually around ten pages) and the Ruling Chamber typically reaching a decision within three weeks. In addition, details of the proceedings are not put into the public domain. While the decision is non-binding, it sets out the Ruling Chamber’s thinking as to how it would address the matter if a formal application is made. The FNA reports a high willingness among parties to participate in this pre-lodgement process.
Prof Littlechild has provided many examples of customers entering directly into negotiated settlements with service providers and the resulting benefits:

He points to many benefits:

- FERC gas pipeline rate cases: In addition to swifter regulatory proceedings, the parties were able to agree on innovative solutions that were not open to the regulator to impose, such as rate freezes that provided security to customers for a period of years and incentives to pipeline companies.

- Florida OPC: The Office of the Public Counsel has negotiated settlements with utilities in 30% of earnings reviews over the last 25 years. "Customer achieved significantly bigger and earlier benefits than they otherwise would have done on accounting provisions.

- Canadian Oil and Gas Pipelines: These Canadian settlements have introduced many features going beyond previous regulation. These include, for example, multi-year incentive arrangements that have increased efficiency and benefited companies and users; innovative provisions to improve quality of service; agreed terms for pipeline expansions; agreements on the provision of information and arrangements for monitoring; and agreed remedial actions in a few instances where performance has been inadequate. In short, negotiated settlements have done all that regulation does, and more. But they have done it by agreement, and by focusing on the issues and outcomes that the parties themselves find most important. Some pipelines are now on their third five-year settlement.
Customer engagement in the UK

• Since May 2004 the CAA (UK airport regulator) has pursued a strategy of “Constructive Engagement”. The stated objectives at the outset were:
  – “to empower users and airports to take more ownership of the regulatory process;
  – to place more responsibility on designated airports to demonstrate that their plans reflect their current and future users’ preferred combinations of outputs and service levels under various budget options;
  – to focus the CAA’s contribution on underpinning, rather than supplanting, airport/airline strategic interactions; and
  – to make the regulatory process complementary to normal commercial interactions (rather than a potential distortion of them)”
Mike Toms, former BAA executive, reports that Constructive Engagement has had some success…

But he also notes some concerns:

• Both sides need to be committed to co-operate and to be appropriately represented.
• There is a need to address the disparity in interest between the parties.
• The process gives precedence to views of existing customers.
• The process provides no vehicle for the views of passengers to be taken into account…

At Heathrow and Gatwick Airports broad agreement has been reached on traffic forecasts; a shared high-level vision of the future of the airports has been created; and progress has been made towards achieving a mutually satisfactory service quality regime. At Gatwick a broad consensus has also been established on the capital programme. Significantly, at both airports there has been agreement on the levels of construction cost to be applied to capital projects. This had been unlocked by an agreement with the airports to pay the costs of airlines to appoint expert consultants.
Customer engagement in Australia

• The ACCC also has some experience with negotiated settlements (as Stephen will discuss).

• ARTC is required to lodge an Access Undertaking for access to its Hunter Valley coal rail network.
  – The ACCC rejected the first two undertaking submitted by ARTC, in March 2010, and December 2010.
  – ARTC submitted a third undertaking in April 2011.

• During April and May 2011 ARTC negotiated with the NSWMC (the representative body of the coal miners) and reached an agreement.
  – The ACCC accepted the revised undertaking in June 2011.
  – The revised undertaking allowed ARTC a higher cost of capital in return for addressing specific concerns of the coal miners.
What are the objections?

- There are a number of possible objections:
- “The customer groups that exist are under-funded, lack expertise, or are not fully representative.”
- “Customer groups can’t be trusted to not pursue short-term objectives over long-term, or to use the process as a delaying tactic.”
- “We can’t be sure that all interests will be represented around the table.”
What are the objections?

- Ofgem considered negotiated settlements in its RPI-X@20 review but was largely dismissive…

5.2 We do not think it is appropriate to delegate responsibility for agreement of network regulatory decisions to consumer representatives, network users or other parties. We have concerns that the interests of these parties are not sufficiently aligned, with those of final consumers (existing and future), to delegate primary responsibility to them to agree regulatory decisions. It is also not clear which body would be able to represent the interests of future consumers. While consumer representatives may be better placed to perform this role, we recognise that it is extremely difficult to develop a sufficiently full understanding of the diversity of consumer needs and interests to represent the entire consumer view accurately to make trade-offs between, what may be, competing views from different groups of customers. As such, consumer representatives may not be able to add value in assuming responsibility for agreement of regulatory decisions over and above the role that we currently play. We also have concerns regarding their current access to resources, the current levels of expertise of all but a very small number of individual consumer representatives and their appetite to engage in this way.
What are the objections?

• In response, Littlechild simply notes that the experience shows that when given the opportunity “customer representatives do successfully negotiate settlements with utilities, and so so successfully”.

• Furthermore, when given the opportunity, customer groups will, he suggests, develop to match the responsibility provided…

The main condition for improved decision-making is that the customer groups should be given greater responsibility. Faced with the costs of their decisions for customers, they can be expected to act as responsibly as regulatory bodies, to negotiate more flexibly, and to make choices with a more informed knowledge and understanding of the needs and preferences of customers. The development of such a practice should lead to more defensible decisions and greater innovation and learning in the sphere of regulation.
What are the outstanding issues?

• There remain several significant outstanding questions:

  1. How can we best encourage effective, representative, knowledgeable, pragmatic customer representative bodies?

     – Should we establish funding arrangements for customer representative bodies and, if so, what arrangements?

        • Should there be a single, funded customer representative (such as an Office of the Consumer Advocate)?
        • Should there be multiple customer representative bodies from which customers can choose to direct a levy on their utility bill?
        • Should there be a contestable pool of funds to which customer representative groups can apply (such as the National Electricity Consumers Advocacy Panel)?

     – How should these customer groups be governed?
2. What should be the role of the regulator?
   - Should the regulator narrow the range of issues to be decided by direct negotiation? Should the regulator decide certain issues in advance, or on request? For example, should the regulator make a determination in advance on, say, the cost of capital?
   - Should the regulator continue to collect and disseminate information – if so, what information is most likely to facilitate agreement? What role should the regulator have in verifying or auditing information provided?
   - What role should the regulator have in approving the final agreement? Should it be required to accept that agreement? What powers should the regulator have to vary that agreement?
What are the outstanding issues?

3. What form should the negotiation take?
   - Should the negotiations be chaired or facilitated directly by the regulator? Or is it best left to another party?
   - Should all decisions require unanimity or is some sort of super-majority sufficient?
   - How should we deal with confidentiality issues?

4. What are the legal obstacles?
   - Do we currently have the legal authority to engage with customers in this way – is there a need to change the statutes or rules?
   - Should there be an explicit obligation on a regulatory body to encourage negotiated settlements where appropriate?
What are the outstanding issues?

5. Is this approach better suited to some industries than others?

Is it more likely to work where customers are:
- Few
- Stable
- Highly motivated (monopoly service a large component of expenditure)
- Homogeneous

And less likely to work where customers are:
- Numerous
- Transient
- Little motivated (monopoly service a small component of expenditure)
- Heterogenous (leading to conflicts between customers)

Airports? Gas pipelines? Electricity distribution?
A possible model

During each regulatory reset a series of steps would be carried out:

- The service provider would submit its proposal, for consideration by the customer representative bodies.

- The parties (in conjunction with the regulator) would agree on a timetable for negotiation setting out what information must be provided by when, the stages in the negotiation, what decisions must be reached at each stage, and the steps to be taken in the event of failure to reach agreement.

- The regulator would facilitate negotiation by auditing and verifying information provided, enforcing the timetable, clarifying legal requirements (such as safety obligations), and clarifying its likely views.

- After a period of time, as set out in the timetable, remaining unresolved issues would go before the regulator for a draft decision.

- The parties would then have another opportunity to negotiate, again facilitated by the regulator.

- Finally, after a further period of time (as set out in the timetable) any remaining outstanding issues would be resolved in the final decision by the regulator.
What steps could be taken?

• What are the next steps in progressing these ideas?
  – Identification of which industries/sectors show the most promise;
  – Discussion with customer groups and service providers to establish a work programme;
  – Clarification of the legal position – what exactly can we do within the scope of the existing legislation or Rules?
  – Pilot programmes of direct negotiation between customers and service providers in specific areas
    • perhaps in the setting of WACC parameters or in the revision of the AER’s Service Target Performance Incentive Scheme
  – Consideration of funding options – how can we best foster representative, knowledgeable representative bodies?
  – What else?
Conclusions

• If utility regulation is a form of long-term contract, it makes sense that the primary parties engaged in the establishment and on-going administration of that contract are the customers and the service provider themselves.

• Giving customers a central role in negotiating with the service provider would be a material change in the way we do regulation and a change in the role of the regulator.

• There is the promise of better regulatory outcomes, greater innovation, and faster, less litigious regulatory process.

• However there remain concerns. It is not clear that adequate consumer advocacy bodies exist or will rise to the challenge. It is not clear how the negotiations should be structured.

• Yet it seems that there is sufficient promise here to make this approach work exploring further…