



The potential for direct negotiations for price setting in the water sector in England and Wales

A REPORT PREPARED FOR WESSEX WATER

July 2015

The potential for direct negotiations for price setting in the water sector in England and Wales

Foreword from Wessex Water	i
Executive Summary	1
1 Introduction	7
1.1 <i>Background and objective</i>	7
1.2 <i>Report outline</i>	8
2 Rationale for direct negotiations	9
2.1 <i>What is the relevant regulatory context?</i>	9
2.2 <i>What is direct negotiation?</i>	10
2.3 <i>What is the rationale for direct negotiations?</i>	12
2.4 <i>How can customers still be protected?</i>	13
3 Experience from other sectors and countries	15
3.1 <i>Overview of common themes</i>	15
3.2 <i>Summary of experience</i>	16
3.3 <i>Key lessons learned</i>	22
4 Benefits and risks	24
4.1 <i>Overview of benefits and risks</i>	24
4.2 <i>Legitimacy</i>	25
4.3 <i>Regulatory burden</i>	27
4.4 <i>Innovation and flexibility</i>	27
4.5 <i>Uncertainty and transparency</i>	28
4.6 <i>Benefits and risks for different parties</i>	28
4.7 <i>Implications</i>	29
5 Framework for direct negotiation in the water sector in England and Wales	30

5.1	Overview	30
5.2	Who negotiates on behalf of customers?	31
5.3	What is the scope of the negotiation?	35
5.4	What is Ofwat's role?	36
5.5	What is the role of the other regulators?	38
5.6	How does this approach relate to market reform and wider regulatory methodology?.....	39
6	Conclusion and summary	42
	Annexe 1: Detail on experience in other sectors and countries	43
	Annexe 2: References	57

The potential for direct negotiations for price setting in the water sector in England and Wales

Figure 1. Difference between traditional approach and direct negotiation	2
Figure 2. Overview of risks and benefits	4
Figure 3. Difference between traditional approach and direct negotiation	11
Figure 4. Types of direct negotiations	12
Figure 5. Incentives that drive direct negotiations	14
Figure 6. Role of airports, airline and CAA under constructive engagement	18
Figure 7. Overview of risks and benefits	24
Figure 8. Scope of the negotiation	36
Figure 9. Overview of process set out by WICS at the start of the price control	45
Figure 10. Roles under constructive engagement	48



A Foreword from Wessex Water

It is now more than 25 years since the water industry was privatised in England and Wales. At that time there was a legacy of underinvestment in the sector. Since then, the RPI-X model of regulation has delivered improved and more efficient services to the environment and customers, investing more than £120bn without recourse to the public purse. This is a significant success story.

It is well understood that the challenges faced by the water sector of population growth, climate change, tightening environmental standards and changing customer expectations are likely to require further significant investment. While to date the sector has retained the support of the bill paying customers on which it relies, this has been the result of a willingness to adapt and improve the regulatory framework over time – in particular so that through each price determination the views and requirements of consumers and bill payers have become progressively more central to their outcome.

As we look to meet the challenges ahead we are clear that as a sector we should consider making further changes to the framework if customer support is to be retained. Wessex Water has long held the view that placing customers at the heart of the price review process is essential for a sustainable outcome. This comes from an understanding that we are a long-term business, delivering essential services to long-term customers with long-term investors underpinning that delivery – put simply, in the long run investors prosper if customers are receiving the services they want at a price they are willing and able to pay.

While at the most recent price review (PR14) the level of engagement from water companies with customers was unprecedented, this was in the context of a methodology which was understood essentially to be confrontational in nature. By this we mean that ultimately companies were assumed always to act in favour of the interests of investors while it was the economic regulator's job to ultimately represent customers' interests in a zero sum game.

Our hypothesis is that moving to a methodology where there is greater scope for direct negotiation between customers and the company can achieve a better outcome for both customers and investors than one in which an external view is imposed. Using the analogy above, we move from a zero sum game to a win-win outcome. A framework which explicitly facilitates and validates such an

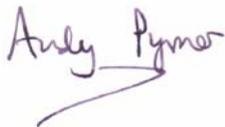
agreement will change the nature of the conversation companies will have with their customers and may enable the industry to take the next step in truly delivering on customers' priorities at PR19 and beyond.

We commissioned this report from Frontier Economics to understand more fully where direct negotiation approaches had been used in other similar sectors and the range of approaches taken. We also wanted to identify whether there were common themes that determined the success or otherwise of direct negotiation, and to understand how these might be applicable to the water sector in England and Wales.

Frontier Economics' report shows that there may be significant benefits to customers from the greater use of direct negotiation with companies in future price controls, but that there are also risks. The design of the process is crucial to achieving these benefits alongside a clear understanding that all parties are committed to standing by the process itself.

We start from a good place. Ofwat's requirement for Customer Challenge Groups at PR14 and the AMP6 Reporting and Assurance framework mean that companies are already well-used to engaging with and being held to account on an ongoing basis by customers and their representatives.

While the additional steps required will still be challenging we think the potential benefits of a greater use of direct negotiation are considerable. By collaboratively considering these issues in detail now, we have an opportunity to place customers firmly at the centre of the sector and to give them a direct say in the services and bills they receive.

A handwritten signature in purple ink that reads "Andy Pymer". The signature is written in a cursive style and includes a long horizontal stroke at the bottom.

Andy Pymer
Director of Regulation & Customer Service

Executive Summary

Background and objective

Following the completion of PR14, Ofwat has commenced “*Water 2020*”, a programme of work that will determine how the water industry in England and Wales will be regulated at PR19. Ofwat’s methodology to regulating has evolved significantly over time with an increasing focus on customer and stakeholder involvement. While the initial price controls were focussed on delivering investments and efficiency gains, from the mid-2000s the methodology started to reflect customers’ view more and more. At PR14, the trend towards greater customer involvement continued, as Ofwat required companies to undertake extensive engagement with customers and stakeholders through Customer Challenge Groups who were required to publish their own views on the extent to which the company had reflected customers’ views in their proposals.

Ofwat has also recently published its vision for the water sector which centres around building “*trust and confidence*” in water. Going forward, Ofwat has also indicated that it would like the water sector to behave in a way that is consistent with:

- *“Improved incentives to manage business over longer term with on-going, dynamic and responsive relationship with customers;*
- *Strong incentives for monopolies to act in customer interest (e.g. concept of enhanced companies)⁴.*

In the context of the evolution of the price control methodology, Water 2020 and Ofwat’s vision, Wessex Water has identified direct negotiations between customers and companies as one of the methods that can contribute to achieving Ofwat’s vision and objectives. As a result, Wessex has asked us to research how direct negotiations between customers and the company could be applied to the water sector in England and Wales. In this report we:

- provide an overview of the rationale and concept of direct negotiations;
- describe the experience with direct negotiations in other sectors and countries and to identify lessons learned;
- identify potential risks and benefits of direct negotiation between customers and companies; and

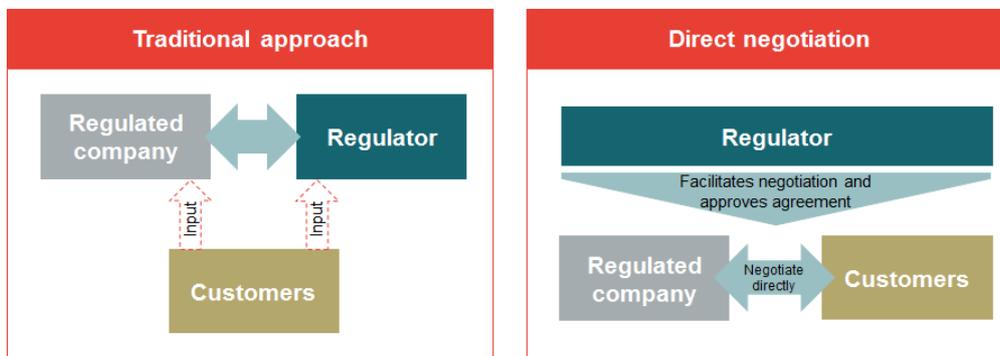
¹ Ofwat, 2015, Introduction to Water 2020, Available http://www.ofwat.gov.uk/pricereview/water2020/prs_pre20150602wukwater2020.pdf

- set out a framework for direct negotiations that identifies the challenges in the England and Wales water sector.

What is direct negotiation?

The traditional approach to regulation implies that customers provide inputs to both the regulated company and the regulator that feed into the final determination. Direct negotiation is a method of regulation that requires the regulated company to negotiate an agreement directly with customers covering some or all of the committed price and service levels. The role of the regulator is to facilitate the negotiation and to approve the final agreement. **Figure 1** illustrates this concept.

Figure 1. Difference between traditional approach and direct negotiation



What are the key lessons learned from other sectors and countries?

Based on the evidence of using direct negotiations in different regulated sectors and countries, we can identify a set of key lessons learned that should be reflected in the future approach in England and Wales:

- **A regulator that actively facilitates agreement appears to be the most successful approach** – pro-active regulators that work with companies and customers appear to have the best track record such as FERC in the US, ACCC in Australia or WICS in Scotland. This implies that Ofwat would have to play an important role in facilitating agreement.
- **Information asymmetry can be a substantial issue** – to ensure that bargaining power is not biased towards the company as it holds most of the information, the regulator needs to consider carefully what type of information companies need to share with their customers. This also ensures that customers are able to make informed judgements.

Executive Summary

- **Process and timing is important** – a successful negotiation needs clear and realistic timeframes and a well-designed process so the regulator needs to clearly set out responsibilities, expectations and timings at the start of the price control. Customers can be further protected where it is clear that the process does not simply end with the final agreement, in particular where there is a clear expectation of future negotiations which will be set within the context of company delivery.
- **Customers need sufficient resources, skills and expertise** – to ensure legitimacy of the process customers need sufficient resources, skills and expertise to negotiate. The regulator needs to consider how it can address the potential imbalance in resource availability between customers and the companies.

What are the key benefits and risks?

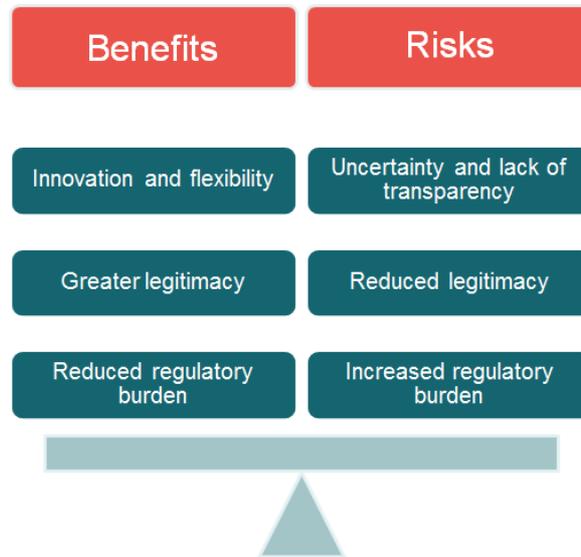
Figure 2 provides an overview of the broad categories of benefits and risks of direct negotiations. The benefits include:

- more scope for innovation and flexibility with respect to the type of agreements that may better reflect local circumstances,
- greater legitimacy as customers can provide more direct input; and
- reduced regulatory burden by focussing the price setting process on the big questions.

The risks include:

- uncertainty over the outcome of the process and a potential lack of transparency,
- reduced legitimacy if the customer representatives do not appropriately represent the diversity of customer interests; and
- potentially increased regulatory burden if the process ends up duplicating the regulators' activities.

This overview highlights that the benefits and risks largely fall in the same categories and therefore the design of the process is crucial for the success of direct negotiations.

Figure 2. Overview of risks and benefits

How can customers still be protected?

Given that one of Ofwat's primary duties is to protect consumers it is clear that there must be sufficient confidence that the design of the process will not allow the monopoly businesses to exploit their market power. In a regulated sector, customers' bargaining power in direct negotiations are based on:

- A process where there is a clear ex ante expectation that in the event of non-agreement the outcome of an Ofwat determination will, all other things being equal, be worse for the company reputationally, procedurally (and perhaps financially), but at the same time is not necessarily a better outcome for customers.
- A process where there is a clear ex ante expectation that the negotiation process will be repeated, and where future negotiations will take place within the context of company delivery of the previous agreements.
- A process where the scope of the negotiation is set so that Ofwat retains direct responsibility for the areas where customers may not have the resources or information to negotiate effectively.

We suggest that careful design of these elements would help develop confidence in the outcome of the direct negotiation as they enhance the negotiating power of the customer representatives.

A framework for direct negotiation in the water sector in England and Wales

We have identified the key questions that need to be addressed to implement a framework of direct negotiation in the water sector in England and Wales and have identified the range of options that could be considered for each question:

- **Who negotiates on behalf of customers?** It is important to ensure that those negotiating on behalf of customers are truly representative of the various customer groups and have sufficient resources, expertise and skills. There are various options for the composition of the group representing customers that need to be considered and most of them require a trade-off between simplicity of the process and direct representation of different customer groups and stakeholders. CCWater could fulfil a co-ordinating role regardless of the approach taken.
- **What is the scope of the negotiation?** The scope of the negotiation can vary substantially with the most common options implying that i) part of the plan, ii) the whole plan except for the cost of capital and efficiency or iii) the whole plan is negotiated. Initially, the scope of the negotiation may be more limited but this could evolve over time so that lessons learned from earlier negotiations can be reflected.
- **What is Ofwat's role?** Ofwat's role would depend on the scope of the negotiation but lessons learned from regulatory precedent suggest that an active regulator is a key factor in ensuring successful negotiation. Ofwat therefore would need to have a mindset of facilitating agreement and take responsibility for setting out the process, timelines, information requirements and expectations. Ofwat would need to provide customer representatives and companies with sufficient confidence that the outcomes of any direct negotiations will be tested against a set of known and objective criteria and only over-ruled in specific and clearly understood circumstances. It is important that customer representatives expect that their inputs will be viewed as valid and legitimate as the negotiation otherwise becomes ineffective. Likewise for the negotiation to be successful and open companies will need to have a high ex ante expectation that the negotiated agreement will hold "in the round" rather than being subject to later amendment by Ofwat.
- **What is the role of the other regulators?** It will be important to set out the role played by other regulators, such as the Drinking Water Inspectorate (DWI), The Environment Agency (EA) and the Health & Safety Executive (HSE) in the context of a direct negotiation process. While the DWI and EA have to date played active roles in water company stakeholder

engagement through Customer Challenge Groups it is unlikely that they would consider it appropriate to explicitly negotiate with others on statutory requirements any more than would an organisation such as HSE on health and safety regulations. One could therefore take the view that the statutory process could be independent from the negotiation process.

While there appears to be no regulatory precedent for other regulators to be part of a negotiation, in principle two additional options can be considered that involve these regulators either being part of the negotiation or providing an assessment of the plans at specific points in time. Advantages and disadvantages apply to any of these approaches.

- **How does this approach relate to market reform and the regulatory methodology?** We would expect that direct negotiation would take place in the context of the building blocks approach. We would also expect that retail market reform implies that in the medium-term retailers would be well-placed to represent non-household customers in the negotiation but are unlikely to do so in the short-term. In contrast, it is not clear whether upstream competition would have a significant impact as this depends on the reform arrangements that emerge from the Water 2020 process.

Conclusion

Overall, we have found that direct negotiations could make a significant contribution to achieving Ofwat's vision of "trust and confidence in water", particularly the outcome from a well-designed direct negotiation process would have a strong positive impact on the legitimacy of the price control.

In addition, direct negotiation could facilitate more tailored, customer focused outcomes and solutions and more innovation in price.

In the long-run, direct negotiations that are facilitated by a pro-active regulator within a well-designed process can provide benefits for companies, customers and the regulator. In the context of Ofwat's desire to *"improve incentives to manage business over longer term with on-going, dynamic and responsive relationship with customers"*², direct negotiations appear to be a useful tool to ensure that companies are focussing on building effective, long-term relationships with customers.

² Ofwat, 2015, Introduction to Water 2020, Available http://www.ofwat.gov.uk/pricereview/water2020/prs_pre20150602wukwater2020.pdf

1 Introduction

1.1 Background and objective

Following the completion of PR14, Ofwat has commenced “Water 2020”, a programme of work that will determine how the water industry in England and Wales will be regulated at PR19. As part of Water 2020, Ofwat will consider a range of topics including:

- how markets can be developed to introduce competition in parts of the value chain;
- how economic regulation should evolve in PR19; and
- how markets and regulation can work together to deliver outcomes for customers and the wider society to support its “trust and confidence” strategy.

Ofwat intends to publish an Issues Paper on Water 2020 in July that will discuss the challenges to the sector and issues to be addressed followed by a consultation paper in December that sets out its proposed approach to competition and regulation. The Issues Paper is likely to provide at least some high level direction on what Ofwat considers to be within the scope for investigation for PR19.

One of the aspects of PR19 that Ofwat is considering is the role of customer engagement. Among other objectives, Ofwat would like the water sector to behave in a way that is consistent with:

- “Improved incentives to manage business over longer term with on-going, dynamic and responsive relationship with customers; and
- Strong incentives for monopolies to act in customer interest (e.g. concept of enhanced companies)³.”

Ofwat has also recently published its vision for the water sector which centres around building trust and confidence in water. Ofwat would like water companies and stakeholders to work together with Ofwat to build trust and confidence among customers, investors and within society.

In the context of Ofwat’s vision and the Water 2020 programme, Wessex Water has identified direct negotiations between customers and companies as one of the methods that can contribute towards building trust and confidence. As a result, Wessex has asked us to research how direct negotiations between customers and the company could be used to contribute to achieving Ofwat’s overall vision.

³ Ofwat, 2015, Introduction to Water 2020, Available http://www.ofwat.gov.uk/pricereview/water2020/prs_pre20150602wukwater2020.pdf

The objectives of this project are:

- to provide an overview of the rationale and concept of direct negotiations;
- to describe the experience with direct negotiations in other sectors and countries and to identify lessons learned;
- identify potential risks and benefits of direct negotiation between customers and companies; and
- to set out a framework for direct negotiations that identifies the challenges in the England and Wales water sector.

1.2 Report outline

This report is structured as follows:

- Section 2 provides an overview of the rationale and definition of how direct negotiations work and how they fit in with the wider regulatory methodology;
- Section 3 sets out the experience with direct negotiations in other sectors and countries;
- Section 4 discusses the benefits and risks associated with direct negotiations; and
- Section 5 provides an overview of the potential framework for direct negotiations in England and Wales.

Annexe 1 provides more detail on the experience in different sectors and countries. Annexe 2 provides a list of references.

2 Rationale for direct negotiations

2.1 What is the relevant regulatory context?

Water and sewerage companies in England and Wales are natural monopolies and are therefore subject to economic regulation to prevent companies from exploiting their market power. Specifically, one of Ofwat's primary duties is to protect consumers. Following privatisation in the late 1980s, the water sector in England and Wales has been subject to a RAB based price control form of economic regulation.

The price control methodology has evolved from a simple price cap approach focussing on efficiency and delivery of statutory requirements in the 1990s to greater emphasis on cost incentives, cost benefit analysis in the 2000s. The evolution of the regulatory methodology can also be characterised by an increasing focus on customer and stakeholder involvement. While the initial price controls were focussed on delivering investments and efficiency gains, from the mid-2000s the methodology started to reflect customers' view more and more. As part of PR09 companies undertook extensive willingness-to-pay studies to inform cost benefit analyses. At PR14, the trend towards greater customer involvement continued and intensified, as Ofwat required companies to engage with customers and stakeholders so that business plans are focused on them rather than the regulator. Engagement during PR14 was based on three main components:

- Research on customer priorities, valuations of different service elements and trade-offs;
- Engagement with Customer Challenge Groups (CCG) on the business plan; and
- Additional engagement with stakeholders on specific issues such as the NEP, drinking water quality targets, etc.

Companies were required to engage with CCGs on all parts of the business plan and initial business plans were accompanied by CCG reports that provided an independent assessment of companies' customer and stakeholder engagements to Ofwat. The new process meant that companies considered carefully what customers truly value and listened to both customers and stakeholders in developing their plans.

The trend towards involving customers more in the price setting process is aligned with Ofwat's vision of building trust and confidence in the sector. A potential logical extension of the PR14 methodology may therefore be to introduce direct negotiation with customers.

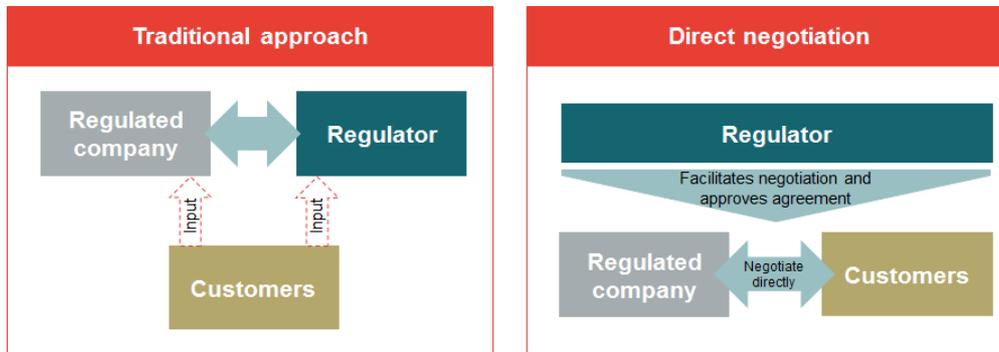
While PR14 had the strong focus on customers, the interactions between companies, customers and Ofwat were set up in a form that focussed more on the perceived competing objectives of the stakeholders rather than the development of common ground. Companies had to consult with CCGs but at the outset it was not clear to what extent Ofwat would agree with customers' views. In fact, there are a number of areas that customer representatives and companies agreed on that Ofwat changed such as performance commitments and rewards. Even the determination of the "enhanced" companies cannot be viewed as an outcome of direct negotiations between customers and the companies as Ofwat required a number of changes to their business plans as indicated in its risk and reward guidance. Companies therefore viewed CCGs as critical stakeholders rather than partners in a direct negotiation.

The potential for direct negotiation at PR19 and beyond needs to be considered in the context of the established regulatory methodology. This leads to a number of implications. First, we should assume that direct negotiation would be facilitated within a RAB based regulatory framework that uses building blocks to determine prices. Direct negotiation would therefore change the nature of the interaction between customers, the regulator and the company but not the building blocks of the price control. Second, we need to be mindful of the existing relationship between customers, companies and Ofwat. At PR14 Ofwat did not put in place a process where it could effectively leave decisions to companies and customers. Therefore, any new approach that encourages direct negotiations between companies and customers may require steps from Ofwat that establishes trust in the approach on all sides. Companies and customers would need to trust that the process has evolved sufficiently from PR14 so that direct negotiations are not just supported by Ofwat but viewed as a key component of its method for delivering its duties. It is important to be aware of the context from PR14 when considering the framework for direct negotiations.

2.2 What is direct negotiation?

Direct negotiation is a method of regulation that requires the regulated company to negotiate an agreement directly with customers. The role of the regulator is to facilitate the negotiation and to approve the final agreement. **Figure 3** illustrates that under a traditional approach customers provide inputs to both the regulated company and the regulator that feeds into the final determination. With direct negotiation the regulators' role is to facilitate negotiation and agreement between the regulated company and customers as they negotiate directly. The main interaction is therefore between the company and customers.

Rationale for direct negotiations

Figure 3. Difference between traditional approach and direct negotiation

Direct negotiation or negotiated settlement?

Negotiated settlement is a term that is commonly used to describe a method of regulation that requires the regulated company to negotiate an agreement directly with customers that covers all aspects of the price control. The final agreement therefore generally covers the overall price-quality trade-off and while there may be inputs from the regulator in the final agreement, it is largely driven by the content agreed between customers and the company.

In contrast, for the purposes of this report, we have used the term “direct negotiation” which describes a method that also involves customers and companies negotiating but the negotiations can be focused on parts of the price control and therefore do not imply that they have to result in an overarching agreement or settlement.

There are various types of direct negotiations as the nature and scope of the agreement and the role of the regulator can vary (illustrated in **Figure 4**) below. The nature of the negotiation can range from informal and unstructured to formal processes with specified outcomes and milestones. The scope of the negotiation can also vary from covering a small number of specific items of the plan to the whole business plan. The regulator’s role can range from conducting a full detailed review in parallel to intervening only if negotiations fail. Direct negotiations between customers and the company can therefore take various forms and do not always have to cover a full negotiated settlement that covers the whole plan.

Rationale for direct negotiations

Figure 4. Types of direct negotiations

Nature of the negotiation	Scope of the negotiation	Role of regulator
Informal negotiation	Small number of specific items	Full detailed review in parallel
Formal negotiation	Parts of the plan	Review of remaining parts of plan
Structured process with formal agreement	Whole plan with exceptions on efficiency and WACC	Review of efficiency and WACC only
Negotiated settlement with contract	Whole plan	Only intervene if negotiations fail

2.3 What is the rationale for direct negotiations?

The reasons why direct negotiations are used in a number of sectors around the world can generally be summarised as follows:

- **Increase legitimacy** – customers know their preferences better than the regulator and direct negotiations ensure that outcomes are more focussed on what customers want.
- **Increase innovation and flexibility** – direct negotiation enables local decision making and therefore supports decentralisation instead of a one-size-fits-all agreement. It provides the opportunities for more innovative agreements with local solutions.
- **Make it easier for customers to engage** – economic regulation can become an “abstract” process that is driven by lots of technical terms and theory so direct negotiation can be a way of making it easier for customers to engage with the process.
- **Change dynamics of price control** - the relationship between the regulated company and the regulator can become adversarial, in contrast the

Rationale for direct negotiations

relationship between companies and their customers may have a more positive dynamic.

- **Reduced regulatory burden** – direct negotiation between customers and companies implies that there is greater focus on things that matter most such as trade-offs between price and quality in terms of the overall package. This reduces time and costs involving in price setting.

Overall, the rationale for direct negotiation depends strongly on the available alternative. For example, in some sectors and countries the alternatives are lengthy legal proceedings which provide a strong rationale for negotiated settlement.

2.4 How can customers still be protected?

One of the key question that arises when considering direct negotiation as part of the approach for regulating monopolies is to what extent customers are still protected from the abuse of market power. Direct negotiation between customers and a pure monopolist would not lead to a desirable outcome as customers do not have any alternative supply option.

However, if the negotiation is facilitated by the regulator, customers are not in a “take-it-or-leave-it” position as their outside option is a determination by the regulator. Customers’ bargaining power therefore stems from the back-up option which is a determination by the regulator. To facilitate agreement, the back-up determination by the regulator cannot be expected to be clearly more favourable to customers as this would mean that they have little incentive to engage seriously with the process. The regulator needs to carefully describe an option that is clearly worse for the company but not clearly better for customers. This would create an appropriate incentive for the company to come to a reasonable agreement with customers. **Figure 5** illustrates these points.

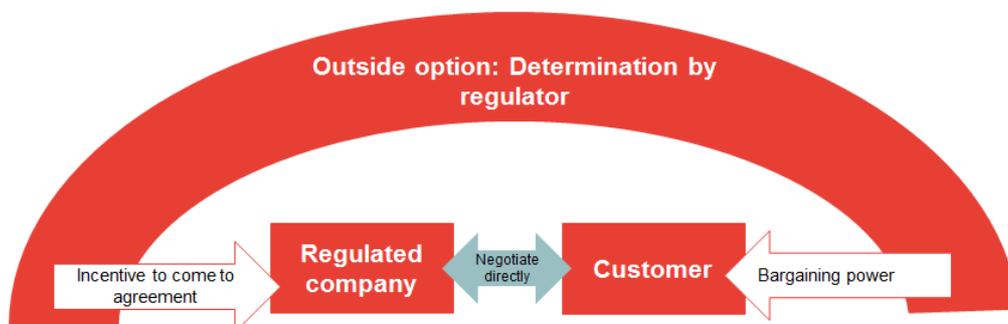
Customers’ bargaining position would also be strengthened by a framework that emphasised a repeated negotiation process. In the water sector, there is little change in the (household) customer base over time so the same parties are likely to negotiate on an ongoing basis. In a “repeated game”, participants take into account how their actions impact on future actions of others. A repeated direct negotiation would therefore imply that customers and companies can focus on long-run outcomes (provided that both parties do not change significantly over time⁴).

⁴ This is important as, for example, a new set of customers may not be aware of all the outcomes of past negotiations.

Customers can also negotiate the type of monitoring they consider appropriate and ensure that the company is held accountable to delivering outcomes agreed in the negotiation. Past performance will be an important factor in determining trust between the negotiating parties so it is in the long-run interest of companies to establish a trusting relationship.

While it might be considered a disadvantage in the England and Wales water sectors that there are 19 separate companies (at least compared to the Scottish experience), the multitude of companies can be used to increase customers' bargaining power. This is because companies' management will have strong reputational incentives to be seen to be able to reach an agreement with their customer representatives, and customers representatives can use information published from other agreements in their own negotiations.

Figure 5. Incentives that drive direct negotiations



While this highlights the importance of clearly specifying the outside option, it also demonstrates that the role of the regulator is crucial as the success of the direct negotiation depends on the regulator setting up a process that provides customers with bargaining power and incentivises the company to come to an agreement. Direct negotiations can therefore provide sufficient protection for customers from market power exploitation if they are set up properly.

Rationale for direct negotiations

3 Experience from other sectors and countries

3.1 Overview of common themes

We have reviewed experience with direct negotiations in other countries and sectors that are subject to some form of economic regulation. Our review has covered a wide range of different types of processes and agreements. We can identify a number of common themes that are relevant to the water sector in England and Wales:

- **Direct negotiations are usually applied where large customers exist** – with the exception of the energy sector in Florida and the water sector in Scotland, direct negotiations are generally applied in markets where the customers can be represented by large companies such as airlines, coal producers, pipeline users, etc. In Florida customers are represented by the Office of Public Counsel, elected to negotiate on behalf of customers. In Scotland the Customer Forum represented customers in the negotiation but the process was somewhat simpler as there is only one publicly owned company. There is therefore limited direct regulatory precedent of direct negotiations when there are many small customers.
- **There are various forms of direct negotiations** – the approaches range from negotiated settlement (i.e. direct negotiation of the full contract) to engaging with customers on a limited number of issues to develop a report that details areas of agreement and disagreement. Different approaches work in different sectors and often approaches evolve over time.
- **A regulator that actively facilitates agreement appears to be the most successful approach** – pro-active regulators that work with companies and customers appear to have the best track record such as FERC in the US, ACCC in Australia or WICS in Scotland. In contrast, early experience with the constructive engagement process in the UK airports sector was less positive. This implies that Ofwat would have to play an important role in facilitating agreement.
- **Incentives are crucial for success** – Direct negotiations have generally been successful when there are strong incentives on both sides to come to an agreement. This is generally the case if the alternative approach is perceived to lead to inferior outcomes and there are strong reputational incentives. This implies that the incentives for companies and customers in England and Wales would have to be considered carefully in the design of the process.

3.2 Summary of experience

We have reviewed experience with direct negotiations in a range of sectors and countries. Annexe 1 provides a more detailed description of the experience. This section provides an overview of the following aspects for each case study:

- How do direct negotiations work?
- Why were they introduced?
- What is the role of the regulator?
- What are the key lessons learned?

3.2.1 Experience from the water sector in Scotland

Direct negotiations between customer representatives and Scottish Water (SW) were used to establish the determination at the last price control. The original intention was that customers (represented by the Customer Forum) and SW agree on specific parts of the business plan so the scope focused on enhancement expenditure and discretionary service level improvements and therefore excluded items such as WACC, financing assumptions, efficiency and base expenditure but the final agreement went further than expected⁵. The rationale for introducing direct negotiations was to provide customers with more opportunity to engage with the price setting process. The Customer Forum consisted of a small number of individuals with substantial relevant professional experience. The Regulator, the Water Industry Commission Scotland (WICS), set out a clear process and timeline for negotiation that also included key points in time for government policy guidance and input from stakeholders. The process also set out the responsibility of the different parties.

The role of the regulator was to set out the process, responsibilities and timelines and monitor progress. WICS provided information in a timely way and in a way that customers could understand. This came in the form of more than twenty guidance notes on key topics such as efficiency. WICS set out upper and lower bound scenarios on financing and efficiency assumptions and encouraged all parties to work together⁶. In practice, WICS pro-actively facilitated agreement. WICS also approved the final agreement. The key lessons learned are⁷:

- The success of the process can be attributed to:

⁵ Littlechild (2014)

⁶ For example, refer to <http://www.watercommission.co.uk/UserFiles/Documents/CustomerForumNote1.pdf>, for operating expenditure assessment

⁷ Littlechild (2014)

Experience from other sectors and countries

- the strong support of all interested parties and substantial reputational incentives on all sides to make it a success;
 - the pro-active role taken by WICS;
 - the public ownership of SW, even though this may not be a prerequisite for success it changes some of the dynamics.
- Potential improvements that have been suggested for the future include:
 - setting up the Customer Forum earlier to members can familiarise themselves with the sector;
 - the legitimacy of the Forum has been questioned by some so the Forum constitution and membership could be adapted to increase independence from SW. For example, this could include greater representation of all customer groups.

3.2.2 Experience from the airports sector in the UK

Direct negotiations between airports and airlines were first introduced as a regulatory tool during Q4 (2004-2009) as a process called “constructive engagement”. In the context of deregulation, these have now evolved to full commercial negotiations at Stansted and commercial negotiations with back-stop regulation at Gatwick. Nevertheless, we consider the evidence from the earlier days of constructive engagement most relevant as full commercial negotiations only apply in the context of limited market power which is not likely to be the case for water companies in England and Wales⁸.

Constructive engagement was introduced as the airlines indicated that the regulatory process had moved too far towards “abstract” economics with inaccessible language and content. They felt alienated from the process and could not influence strategic direction⁹. So the CAA considered a range of reform options and concluded that there is a strong case for airport-airline engagement at the start of price reviews to help deliver better business plans and more informed regulation.

The process of constructive engagement envisaged that airports and airlines directly engage on a number of topics and if they come to an agreement this would feed directly into the price control. **Figure 6** illustrates the split of topics between the airport, airlines and the regulator.

The role of the regulator initially was to set the framework, set the agenda and the terms of constructive engagement and undertake its own cost assessment.

⁸ At least not for the network part of the business.

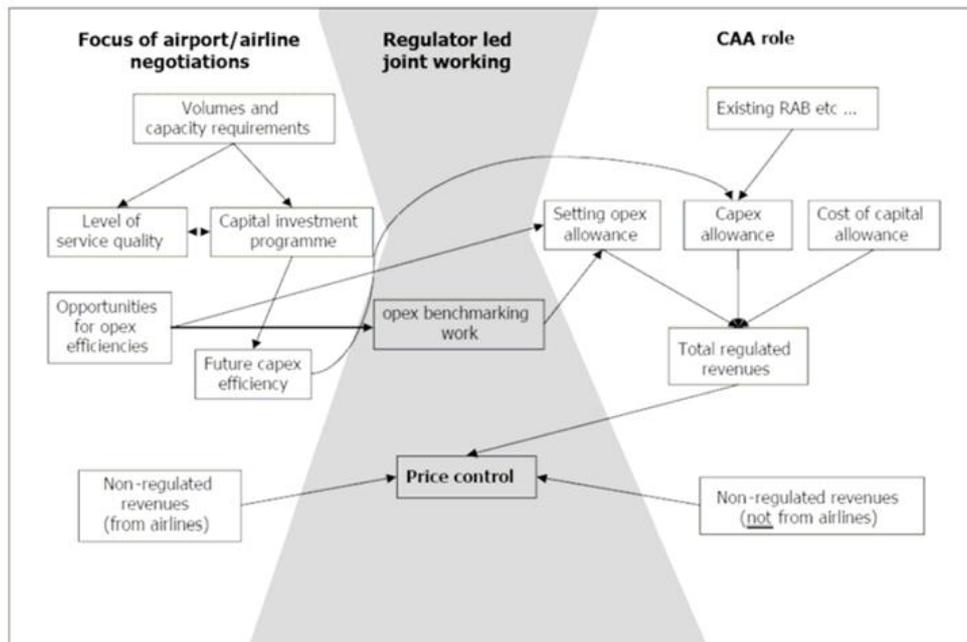
⁹ CAA (2009)

The CAA also took the lead on the cost of capital and regulatory finance. This was due to the “zero sum” nature of the debate, the CAA saw no prospect of constructive engagement delivering any agreement in this area and did not expect any negotiation on these topics to reveal additional insight which might be gained over and above the evidence which the parties would submit anyway to the CAA’s own regulatory consultations.

The key lessons learned from the process are that the process can fail because of:

- mistrust due to information asymmetries that are not addressed by clear information requirements;
- too many diverging opinions between customer groups (different airlines);
- diverging opinions between regulated company and customers over a range of underlying assumptions;
- passive approach by the regulator; and
- perceived and/ or real lack of flexibility and willingness to cooperate on all sides.

Figure 6. Role of airports, airline and CAA under constructive engagement



Source: CAA (2009)

Experience from other sectors and countries

3.2.3 Experience from the energy sector in the US and Canada

Negotiated settlements are reasonably common in the US and Canada in the energy sector¹⁰. The approaches differ slightly:

- **US Energy sector:** Companies propose price increases, the regulator (the Federal Energy Regulatory Commission) prepares an initial assessment followed by a period of negotiation between customers and the company, the final agreements are then submitted to the relevant courts.
- **Specific case for Florida:** Company negotiates with the Office of Public Counsel that represents consumers independently of the regulatory commission.
- **Canada:** the National Energy Board (NEB) facilitates settlements by making generic cost of capital decisions and setting criteria for an acceptable settlement process. Companies and customers negotiate on this basis. This approach is mainly used for oil and gas pipelines so customers include large companies such as producers, shippers and large industrialists.

The rationale for introducing negotiated settlement stems from the counterfactual process which takes a lot of time and is costly. Negotiated settlement is therefore seen as a complement to the conventional process of litigation. In addition, the FERC introduced settlements to assist with a backlog of cases.

The key lessons learned from the process in North America are:

- the process is more likely to be successful if both parties have incentives to agree – in North America the counterfactual process is time-consuming and costly;
- there are mixed views on whether negotiated settlements are merely a means of procedural streamlining or whether they reach more innovative and creative solutions – assessment of the success therefore always depends on the counterfactual;
- the process is more likely to be successful if customers can be represented adequately – a good example is the Office of Public Counsel in Florida that is an independent body that represents customers.

¹⁰ Doucet and Littlechild (2006 and 2009)

3.2.4 Experience from the air traffic navigation sector in the UK

The air traffic navigation sector uses direct negotiations to facilitate the price setting process but not all aspects of the price control are negotiated directly and the CAA does not expect the provider (NERL) to agree the full business plan with its customers. The overall process is therefore closer to the approach adopted by Ofwat at PR14. The CAA requires NERL to establish a customer consultation working group (CCWG) with an independent chair and expects the CCWG and NERL to exchange views on a list of topics around the price control. NERL then needs to facilitate a process that ends in a report to the CAA that outlines areas of agreement and disagreement. The CAA uses this report as an input to its determination. The CAA's role is to set out the timetable, process, principles and expectations. The CAA then undertakes its own assessment of the business plan and develops projections for opex and WACC.

There is limited documentation available on the rationale for the process but the CAA had introduced a similar approach to airports. The key lessons learned are:

- expectations need to be set out in advance to avoid disappointment;
- resource availability may differ substantially between the regulated company (lots of resources available as the process is important for bottom line) and customers (limited resources available as this is only one input cost item);
- information asymmetry can be a problem – the airlines criticised that the mandate was only partially fulfilled because of the lack of time and detailed information from NERL and the absence of results of any CAA studies;
- the CCWG nevertheless had the view that the process had improved mutual understanding and alignment on issues of importance to their businesses.

3.2.5 Experience from the telecoms sector in the UK

There is limited experience with direct negotiations in the telecoms sector in the UK but Ofcom has established OTA2 which is an independent organisation to oversee cooperation between Openreach and its customers to deal with strategic issues affecting the rollout and performance of Openreach's products. OTA2 is independent from the regulator and can be used by the industry to reach agreement on a range of defined "in-scope" products. The idea is that OTA2 can facilitate agreement between Openreach and its customers quickly so that Formal Dispute Proceedings can be avoided. Ofcom provides support and advice to OTA2 and defines the issues that OTA2 deals with.

Experience from other sectors and countries

3.2.6 Experience from the rail and airports sectors in Australia

Negotiated settlements are encouraged by regulators in Australia as they are seen as more effective ways of determining prices. In the airports case, the regulatory regime is based on price monitoring and relying on ex post competition law to prevent any abuse of market power. Negotiations differ between rail and airports:

- Rail sector: for the Hunter Valley coal line, the track provider (ARTC) negotiates with customers (coal producers, etc) directly to reach an agreement that is then presented to the regulator (ACCC) as an undertaking. The ACCC is actively involved in this process and facilitates consensus where necessary.
- Airport sector: direct negotiation between airports and airlines without any involvement by the regulator. The ACCC monitors price movements and changes in quality of service but has no direct power to set prices. The price monitoring reports are viewed as providing comparative information to feed into the negotiation.

The role of the ACCC therefore differs substantially. While it plays an active role in the rail sector (with respect to the Hunter Valley rail line), it has no active role in the setting of airport charges.

The key lessons learned from Australia are¹¹:

- it can be difficult to tell whether the outcomes of negotiations protect customers sufficiently – for example, it is not clear whether the absence of any major competition cases in airports signal success;
- it is also difficult to use negotiating parties' views to judge success - the views of different parties are aligned with their own interests so airlines view the process as one-sided and dysfunctional whereas airports have a different view; and
- a pro-active role of the regulator is seen as helpful (in the rail sector) – the negotiating parties seem to agree that the regulator can facilitate agreement by structuring discussions, clarifying issues, taking initial decisions and insisting that parties keep negotiating.

¹¹ Bordignon and Littlechild (2012)

3.3 Key lessons learned

Based on the evidence of using direct negotiations in different sectors and countries, we can identify a set of key lessons learned that should be reflected in the future approach in England and Wales:

- **Active role of the regulator** – the regulator needs to play an active role in facilitating agreement.
- **Information asymmetry can be a substantial issue** – to ensure that bargaining power is not biased towards the company as it holds most of the information, the regulator needs to consider carefully what type of information companies need to share with their customers. This also ensures that customers are able to make informed judgements.
- **Process and timing is important** – a successful negotiation needs clear and realistic timeframes and a well-designed process so the regulator needs to clearly set out responsibilities, expectations and timings at the start of the price control.
- **Customers need sufficient resources, skills and expertise** – to ensure legitimacy of the process customers need sufficient resources, skills and expertise to negotiate. The regulator needs to consider how it can address the potential imbalance in resource availability between customers and the companies.
- **Process and timing is important** – setting clear and realistic timeframes and process at the start of the price control is essential.
- **Assessing success may be difficult** – it is not always easy to tell whether the process has been a success. Views from negotiating parties may differ and may not provide a good indication of success. The regulator therefore needs to consider up front how success may be defined. Littlechild (2010) suggests that the regulator should focus on developing a sound process rather than focussing on the outcomes. This would suggest that success can be judged by the extent to which well-designed negotiation process has been followed as opposed to the outcomes. Similarly, success could be defined as reaching a particular stage of the negotiation that may only be available for companies that have demonstrated high quality engagement at the start of the price control process.
- **There is regulatory precedent for direct negotiation in the context of a large number of relatively small customers** – in these cases the

Experience from other sectors and countries

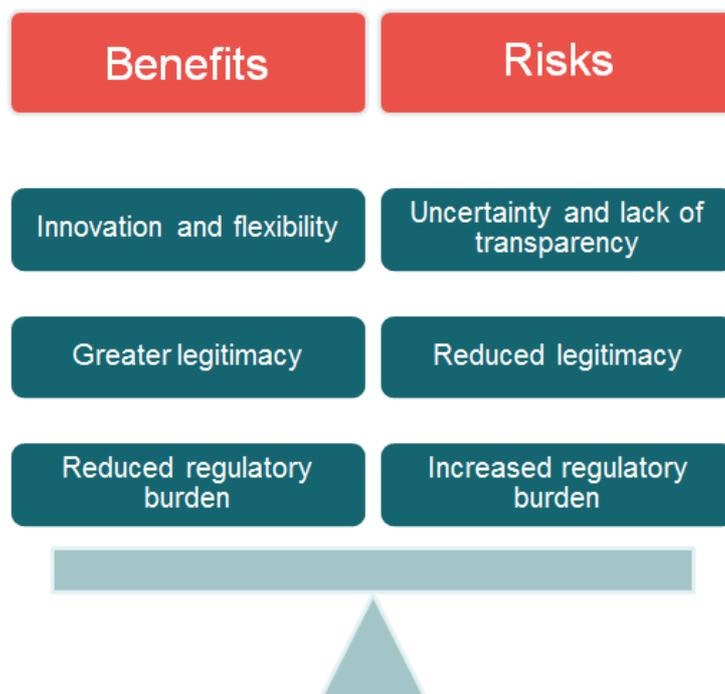
composition of the customer representation is even more important as they need to reflect the views of a large range of customers.

4 Benefits and risks

4.1 Overview of benefits and risks

Figure 7 provides an overview of the broad categories of benefits and risks of direct negotiations. The benefits include more scope for innovation and flexibility with respect to the type of agreements, greater legitimacy as customers can provide direct input and reduced regulatory burden by focussing the price setting process on the big questions. The risks include uncertainty over the outcome of the process and a lack of transparency, reduced legitimacy if the customer representatives do not represent the diversity of customer interests and potentially increased regulatory burden if the process ends up duplicating the regulators' activities. The brief overview highlights that the benefits and risks largely fall in the same categories and therefore the design of the regulatory process is crucial for the success of direct negotiations.

Figure 7. Overview of risks and benefits



Before we discuss the benefits in risks in more detail, we need to point out that the available evidence needs to be interpreted with caution as the size of the benefits and risks depends strongly on the counterfactual (i.e. how would prices

Benefits and risks

be set in the absence of direct negotiations) and the specific legal, regulatory and policy context. There are three types of evidence that we have considered:

- **Views of participating parties** – while these are subjective views they are clearly relevant and particularly useful when considered in the context of whether parties would prefer to go back to “traditional” approaches for setting prices.
- **Quantified benefits and risks** – these are often based on simple metrics that are focussed on the price setting process rather than the outcome. Examples include the time and costs it takes to set prices.
- **Conceptual benefits and risks** – while these are based on theory and often describe the opportunity or potential for the process to general benefits, they still need to be considered to develop a full picture of the benefits and risks.

4.2 Legitimacy

Why legitimacy matters

Political legitimacy can be defined as the popular acceptance of an authority or governing regime. This form of legitimacy is also important in the water sector as it implies that customers and stakeholders generally accept the regulatory regime and its outcomes. Increased legitimacy is desirable for a number of reasons.

- First, legitimacy is closely related to the concepts of “trust and confidence” that describe Ofwat’s vision for the water sector. This implies that greater legitimacy would contribute significantly to achieving Ofwat’s vision.
- Second, in monopolistic markets economic regulation creates incentives for greater efficiency. As these incentives are created by the regulator, the regulated company naturally focuses on delivering against the outcomes set by the regulator (even though these can be developed with input from customers). In contrast, companies in a competitive market are focussed on customers and continually finding better ways of serving their needs. In a traditional model of regulation, the customer focus of a competitive market is not easily replicated. Greater legitimacy of the regulatory process is desirable as it means that companies are more focused on customers so that outcomes are more similar to those we would expect in a competitive market.
- Third, legitimacy is important for companies as it has a direct impact on regulatory and political risk. Customers cannot express their views by

switching suppliers in a monopolistic market but public opinion influences the way sectors are regulated. Legitimacy an important objective for companies as it ensures stability with respect to the regulatory approach. This also provides benefits to the regulator as a stable regulatory regime is more likely to deliver long-term benefits for customers.

The impact of direct negotiations on legitimacy

Introducing direct negotiations has the potential to substantially improve legitimacy of the price setting process as the negotiation allows customers to express directly and clearly what they care about rather than having to rely on the regulator. Over time, the process also has the potential to lead to much better relationships between all parties as direct negotiations between customers and companies require parties to identify common ground and establish long-term relationships as the negotiation is repeated in the future. Direct negotiations with customers change the dynamic of the price control as companies will focus on meeting customers' needs rather than the regulators'. We would expect companies to approach these negotiations in a different way than engaging with the regulator as the overall incentives are fundamentally different. Companies have better incentives to build a positive relationship with customers compared to the regulator as there are a range of complex interactions between companies and customers. For example, demand management, bad debt and customers informing the company on network issues all illustrate that an effective two-way relationship between companies and customers can have significant positive impacts for both parties as the company can improve performance and customers can benefit from lower bills.

Direct negotiations may also increase legitimacy as customers and companies can make local decisions that reflect what they care about rather than being subject to a one-size-fits-all approach by the regulator. This supports decentralisation of decision making.

However, there are also a number of risks associated with direct negotiation that could reduce legitimacy.

- First, negotiators may not represent customers adequately as they may not represent the diversity of customers and may not trade-off customer views in a representative way. In particular, the representation of future customers is a challenge and there is some evidence that current customers negotiate at the expense of future customers. The legitimacy of the customer representatives therefore has a direct impact on the legitimacy of the overall process.
- Second, customers may not have the expertise, resources or ability to negotiate effectively. This has a direct impact on the legitimacy of the final agreement.

Benefits and risks

- Third, the regulator could intervene and undermine legitimacy of the agreement. This may be because the regulator does not consider customers to be sufficiently protected. Lastly, depending on how the process is designed, the company may be able to exploit information asymmetry and therefore skew the outcome. This could also undermine the credibility and legitimacy of the final agreement.

Overall, the key to maximising the potential benefits and minimising the risks is a well-designed process that considers each of these points up front. For example, careful consideration of who negotiates on behalf of customers and ensuring sufficient resources and expertise is important to reduce the risk of undermining legitimacy.

4.3 Regulatory burden

Direct negotiations provide the opportunity to reduce regulatory burden and there are a number of examples where the process requires fewer resources and less time than compared to the alternatives. The main reason is that customers and the company are more likely to focus on the most important trade-offs in the business plan. This also means that the negotiation is likely to be more productive. In the long-run, regulatory burden may also be lower as direct negotiation with customers may lead to fewer changes in the detailed methodology. Introduction of new regulatory mechanisms that require data and expertise may be less frequent as customers will want to engage in a simpler form of negotiation.

However, depending on the design of the process, the regulatory burden may be increased as customer representatives may be running a process in parallel to the regulator so effectively duplicating rather than replacing some of its function. Similarly, negotiation will require representation from a diverse set of customers which may increase the regulatory burden.

Overall, the experience from other sectors has shown that the regulatory burden may increase in the short-run as the initial design and set up of direct negotiations require the regulator to consider this carefully. A pro-active regulator is an important success factor which requires appropriate resources. In the long-run, the regulatory burden is likely to be lower as the regulators' role is to facilitate agreement rather than assessing the details of all business plans.

4.4 Innovation and flexibility

Direct negotiations provide the opportunity to increase innovation and flexibility with respect to the type of agreements. Customers and companies can develop innovative agreements that solve local problems and may not be applicable across England and Wales. For example, agreements could contain longer-term

elements or include specific mechanisms for some categories of expenditure (e.g. an evolving NEP programme) or innovative sharing arrangements (e.g. South West Water's Water Share).

4.5 Uncertainty and transparency

In contrast, direct negotiations could also lead to greater uncertainty for all parties as the outcome of the process is uncertain and it is not clear to what extent customers will be able to stick to agreements if the circumstances imply that the company benefits from substantial outperformance. Customers may wish to re-negotiate agreements more frequently than regulators would.

There may also be a lack of transparency as the level of information that is publicly available may be substantially lower than a regulator's price control. Agreements from direct negotiations may also not reflect stakeholders' interests as much as the negotiation will have to focus on customer representatives rather than stakeholders.

4.6 Benefits and risks for different parties

The benefits and risks discussed above can also be categorised by the relevant party:

- **Customers** – benefits include greater influence on the final outcome, views are represented directly and it is much easier to influence the company and develop local, innovative solutions. Key risks include the possibility that some customers may not be represented, lack of skills and information asymmetry that could lead to an outcome that favours the company.
- **Company** – for the company the benefits include the opportunity to build productive relationships, greater legitimacy of the outcomes, greater ability to tailor solutions to local needs, potential to reduce the regulatory burden and engage in more meaningful negotiations. The key risks include greater uncertainty on outcome, process and whether customers will want to reopen negotiations and the potential for greater regulatory burden if the company has to “upskill” customers.
- **Regulator** – for the regulator the potential benefits include a more focussed role and potentially reduced regulatory burden, greater legitimacy of the final agreement, more scope for innovation and flexibility and therefore meeting the principles of good regulation in a better way. The main risk is that the regulator is not in control of the outcome and there is too little information to judge whether the settlement is in the interest of customers. In addition,

Benefits and risks

there is also the risk that both customers and companies see the process as a failure if no agreement is reached.

4.7 Implications

Considering the benefits and risks from direct negotiations, it is clear that the design of the process for negotiating is of crucial importance to make sure that:

- diverse group of customers are represented and representatives have sufficient resources and expertise;
- there is scope for localised solutions;
- there is clarity around how stakeholder views are reflected;
- the process is designed to enable companies and customers to focus on big questions without duplicating efforts between customers and the regulator; and
- the agreements are sufficiently transparent, and
- the issue of information asymmetry amongst the negotiating parties is addressed appropriately.

5 Framework for direct negotiation in the water sector in England and Wales

5.1 Overview

In order to provide a framework for direct negotiation in the water sector in England and Wales, this section sets out the key questions that need to be addressed and the options for how direct negotiations could be implemented. We have drawn on the lessons learned from other sectors and countries but consider how these can be applied in the context of the specific regulatory context of the water sector in England and Wales. We therefore attempt to develop a framework for a sector that is characterised by:

- private ownership¹² and companies with varying sizes ranging from Dee Valley Water serving a population of c. 260,000 to Thames Water serving a population of c.15 million;
- specific regulators for drinking water quality and the environment;
- a price control approach based on building blocks and a clearly defined RAB; and
- changing market structure with competition in non-household retail from 2017 and the potential for further competition in the upstream part of the value chain.

It is important to keep in mind the regulatory context when considering how to best implement a regulatory approach that involves direct negotiations between customers and companies. To provide a framework that is specific for England and Wales, this section therefore discusses:

- Who negotiates on behalf of customers?
- What is the scope of the negotiation?
- What is Ofwat's role?
- What is the role of the other regulators and stakeholders?
- How does this approach relate to market reform and CMA appeals?

¹² Welsh Water has a mutual structure (a company limited by guarantee). The remainder of the industry is under private ownership.

5.2 Who negotiates on behalf of customers?

One of the key benefits of direct negotiation is greater legitimacy as customers can provide direct inputs to the price control. Another key benefit is the scope for innovation and flexibility, companies and customers can negotiate local solutions to local problems. In order to achieve and maximise the potential for these benefits, it is therefore important to ensure that the customer representatives credibly represent a diverse customer group and have the skills to negotiate effectively. There are a number of key questions to consider:

- Who represents customers?
- How do customer representatives know what customers want?
- How can we ensure that customer representatives have sufficient resources, expertise and skills?
- How can we ensure that customers face appropriate incentives?
- Should the customer representation be on a local or national level?
- What is the role of stakeholders?

We discuss each of these in turn.

Who represents customers?

This is an important question as the benefits of the process of direct negotiation depend strongly on the legitimacy and credibility of the customer group. Regulatory precedent provides a spectrum of options ranging from a small number of high powered individuals with relevant expertise (Scottish Water) to authorities established with the sole purpose of negotiating on behalf of customers (Office of Public Counsel in Florida).

The trade-off is between individual groups that are represented separately and one consumer body that represents all customers and draws on input from individual groups. The advantage of a single body is that the process is likely to be simpler and the body needs to internalise any disagreement between customers. But the risk is that trade-offs between customer preferences are not transparent so not all customers may be represented effectively. In contrast, individual representation of customer groups may provide greater legitimacy as the diverse customer base can be represented more transparently but bears the risk of creating an ineffective process (similar to diverging airlines' views that affected the success of the negotiation). This also relates to the question of how and whether stakeholders and interest groups should be represented. While some stakeholders such as the Citizens' Advice Bureau may be well-placed to represent specific customer groups in direct negotiations, other special interest groups

(such as environmental groups) may be better placed to provide input to the customer representatives if they represent a small group of customers.

If a single body was chosen, CC Water appears to be well-placed to represent customers in the industry. Similarly, even if there is direct representation of multiple customer groups, CC Water could potentially coordinate the overall group and draw on national resources and expertise that local representatives may not have access to. In the context of retail market opening, it would also appear sensible for non-household retailers to be represented, at least in the medium-term.

In addition, it is important that Ofwat considers specifically the question of how future customers could be represented. This is to ensure that current customers do not negotiate agreements at the expense of future customers.

Existing Customer Challenge Groups (CCGs) that were set up during PR14 (and are continuing to be used during AMP6) were not intended to negotiate directly on behalf of customers. And there are a number of issues that would need to be addressed if CCGs were to take up the role of representing customers in direct negotiations. For example, the level of resources, skills and expertise and the time commitment required for direct negotiation is likely to be very different from the role of the challenge group in PR14. Nevertheless, with a different composition and set up, the CCG model could be evolved to represent customers in direct negotiations.

How do customer representatives know what customers want?

Customer representatives need to be able to cover a wider range of customer views. For example, customer preferences are likely to differ depending on whether a customer is:

- small or large (e.g. large chemical plant versus hairdresser);
- part of different socio-economic groups (e.g. this could affect both willingness to pay for water services in general and specific valuations of environmental aspects);
- part of a special interest group (e.g. surfers and swimmers that care about clean beaches); and
- using water in different ways (e.g. large garden versus flat).

While there are a number of organisations that represent different interest groups, it is important for the customer representatives that negotiate with water companies directly to be able to represent all customers. In principle, there are three different approaches:

- It could be argued that customer representatives have sufficient reputational incentives to engage with a wide range of customers so that they design their

Framework for direct negotiation in the water sector in England and Wales

own research programme. The benefit is that this process is not prescriptive and allows for flexibility. However, the drawback is that customer representatives may focus on particular groups.

- Ofwat could determine a “minimum” engagement programme to ensure that customer representatives are well-informed. This provides greater certainty that all customer views are taken into account but it is not clear that Ofwat would be in a better position to design the programme than customer representatives. In addition, companies should be encouraged to interact directly with their customers rather than engaging with customers via the customer representatives.
- Similar to PR14, customers could have a role in defining customer research undertaken by companies so that both parties can draw on the same evidence base. This requires lower resources and less duplication of research but requires the role of the company and customers in setting up the research to be defined clearly.

These options are not mutually exclusive and companies and customer representatives both need to undertake ongoing research to be well-informed. For the purposes of the negotiation, a joint research programme that is undertaken in advance of the negotiation is likely to be most effective. Such a programme would be an efficient use of resources, ensure that there are no information asymmetries with regard to customer insights and still leaves room for interpretation on both sides. This implies that customers and companies do not have to agree on the interpretation of the research but would have access to the same research. It is important to avoid a situation where information on customer views represents bargaining power. A joint research programme would ensure that this is not the case.

How can we ensure that customer representatives have sufficient resources, expertise and skills?

It is important that customer representatives have “sufficient” resources, expertise and skills. A balance needs to be struck between balancing legitimacy and regulatory burden as the objective is not to duplicate Ofwat’s skills. The appropriate level of resources and expertise therefore needs to be specified up front. In principle, there are different ways of achieving this:

- customer representatives could be chosen based on a set of criteria that includes specific skills and expertise in this area;
- Ofwat could set up a panel of independent advisers that customer representatives can draw on;
- customer representatives could receive direct funding to develop;

- customer representatives could receive direct funding to commission external advice; and
- customer representatives could employ their own staff with expertise in the relevant areas.

In order to maintain independence, funding would ideally be provided by Ofwat but could be provided via a specific contribution made by companies.

How can we ensure that customers and companies face appropriate incentives?

A successful direct negotiation depends strongly on the incentives of all parties to come to an agreement. Regulatory precedent suggests that a process of direct negotiation does not automatically create reputational incentives to agree as, for example, experience in the airport sector has shown that airlines may not be faced with strong incentives to agree whereas the success in Scotland has demonstrated the opposite. Customer representatives need to have sufficient incentives to engage seriously but also be able to “walk away”.

In order to achieve this, Ofwat needs to clearly specify what happens in the case of a failed negotiation. If customers suspect that they are clearly better off with an Ofwat determination, they are not likely to engage seriously. If customers expect a determination by Ofwat to be less reflective of their interest, they may not have sufficient bargaining power to leave the negotiation. Ofwat therefore would have to strike a balance between these two scenarios. There are a range of options that can be considered to achieve this:

- **Full or partial review** – in the case of failed negotiations, Ofwat could still require a report that details areas of agreement and disagreement and use these as inputs to the determination. This would ensure that Ofwat’s determination still reflects customers’ views.
- **Specific penalty** – Ofwat could put a lump sum penalty on companies where negotiations fail. This would imply that customers may not be better off but the company is clearly worse off. There would also be a negative reputational impact from failed negotiations for the company.

Should the customer representation be on a local or national level?

Another key question is to consider whether customer representation should be based on a national organisation (or multiple organisations) or be selected at the local level. There could be variations around this as customer representation could be provided by a national organisation with local branches (where the local staff can draw on a pool of national experts) or local representatives include some national organisations.

Framework for direct negotiation in the water sector in England and Wales

On the one hand, a national body would ensure consistency which is important to ensure legitimacy. A national body would also have the advantage of having greater bargaining power as it can use agreements reached with some companies to leverage negotiations with other companies. On the other hand, a national body may not reflect local preferences to the same extent as local organisations. The advantages and disadvantages would have to be weighed up carefully to select the best approach.

5.3 What is the scope of the negotiation?

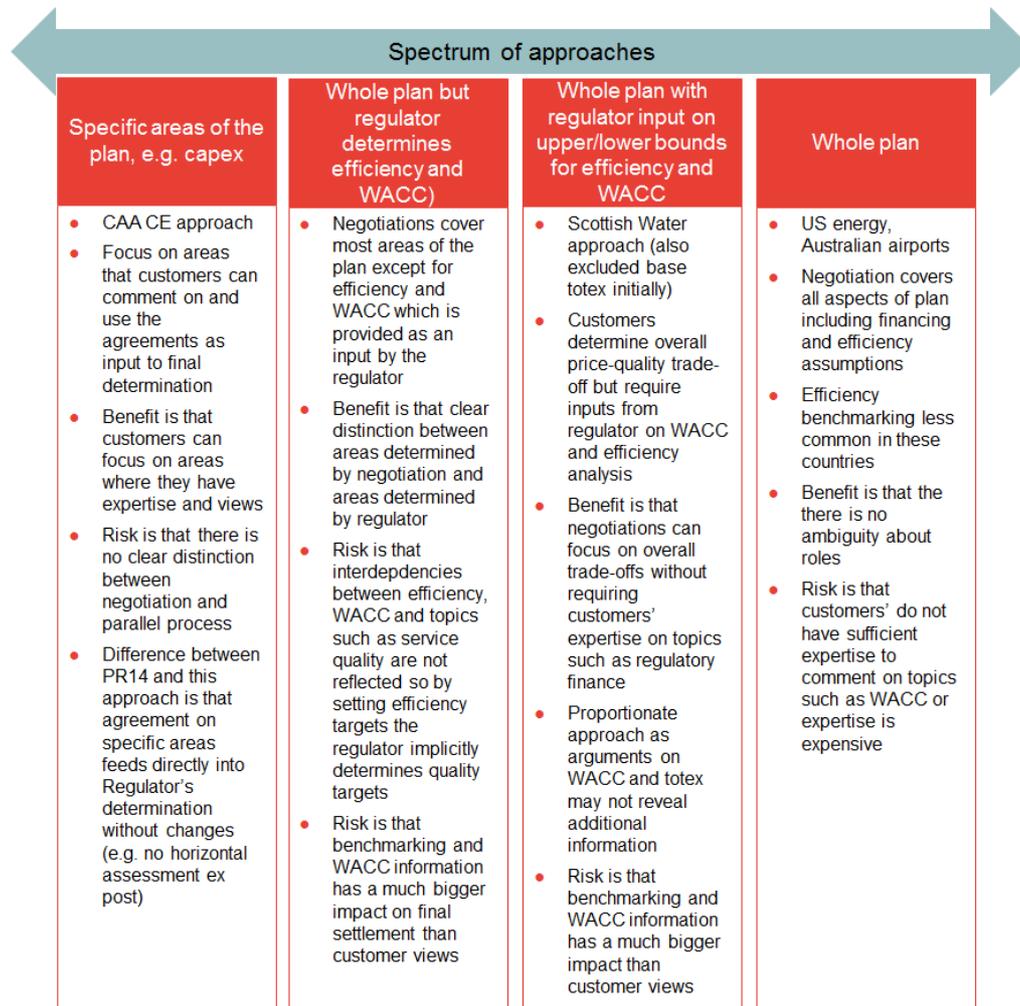
The scope of the negotiation can vary in two different ways:

- **What is included?** Figure 8 shows that the scope of the negotiation can vary substantially with the most common options implying that part of the plan, the whole plan except for WACC and efficiency or the whole plan is negotiated.
- **What is the outcome of the negotiation?** The expectation could either be that the parties come to an agreement (e.g. early days of constructive engagement in airports sector) or that the parties identify areas of agreement and disagreement (e.g. air traffic navigation and similar to PR14).

Considering the regulatory context of the water sector in England and Wales, an evolutionary approach could be applied. For example, at PR19 companies and customers could directly negotiate parts of the plan. At PR24, lessons from the PR19 negotiation could be applied and a more comprehensive negotiation envisaged.

The most common elements that are excluded from the negotiation are the cost of capital and the efficiency assessment. This is because negotiations on the cost of capital are often viewed as a zero sum game and the efficiency assessment requires substantial expertise and resources. There are two different approaches to this. Customer representatives can still negotiate with companies on these issues if the upper and lower bounds have been set out by the regulator (as was the case in Scotland). Alternatively, the regulator can set the efficiency targets and cost of capital independent of the negotiation. This raises questions around the interdependencies between different elements of the price control (e.g. costs and quality).

Regardless of the scope of the negotiation, it is important that the process allows for sufficient time so that the parties can engage on the issues that are within scope. This is an important lesson from PR14, as it takes time for customer representatives to develop their expertise on specific topic areas and the legitimacy of the process will depend partly on having sufficient time to engage properly.

Figure 8. Scope of the negotiation

5.4 What is Ofwat's role?

Ofwat's role would clearly depend on the scope of the negotiation. In general, lessons learned from regulatory precedent suggest that an active regulator is a key factor in ensuring successful negotiation. Ofwat therefore would need to have a mindset of facilitating agreement and take responsibility for the following:

- Before the negotiation starts:
 - clearly setting out processes and the timetable;
 - specifying information requirements to avoid companies exploiting information asymmetry;
 - make comparative information available in a timely way;

Framework for direct negotiation in the water sector in England and Wales

- ensure that other information (e.g. WACC, efficiency modelling) is also available in a timeline way if it is not part of the negotiation;
 - set out expectations and outputs (e.g. what would the final agreement or report cover);
 - try to calibrate the incentives for both parties so that successful agreement can be reached; and
 - set out what “success” would look like.
- During the negotiation:
 - monitor progress and encourage parties to continue negotiations, address arising concerns (e.g. on provision of information, etc) but do not try to take decisions;
 - provide additional information if necessary;
 - make sure that “back up” option is sufficiently developed in parallel so that timetable can be met if negotiation fails.
- Once an agreement is reached:
 - assess the agreement against a pre-determined set of criteria;
 - refrain from over-ruling customer views as this would undermine long-term credibility of the process.
- If no agreement can be reached:
 - implement “back up” option as soon as possible and as set out before the process (deviations may undermine credibility of Ofwat’s processes for the next price control).

Littlechild (2010) suggests that regulators should design a process that is sufficiently robust that they will judge the outcome on the basis of the process. As discussed above, this would imply that the success of the process is judged by whether the process has been followed rather than focussing on the outcome. The regulatory would therefore focus on designing a robust process instead of developing an alternative price determination. This mindset is also important so that customers and companies trust the negotiation. Based on the experience of PR14, Ofwat would need to provide customer representatives with sufficient confidence that the outcomes of any direct negotiations will be tested against a set of criteria but only over-ruled in exceptional circumstances. This is to address a legacy issue created in PR14 where Ofwat asked CCGs to provide their assessment of business plans and customer views but later on over-ruled CCG’s views in particular with respect to rewards and performance commitments. It is

important that customer representative expect that their inputs will be viewed as valid and legitimate as the negotiation otherwise becomes ineffective.

One of the most important roles for Ofwat is to describe information requirements. While a hands-off approach may be more appropriate in the long-run as it allows for greater flexibility and innovation, in the early days of direct negotiation the party with the relevant information holds substantial bargaining power. As a result, Ofwat would need to specify the type of information and the timing for companies.

5.5 What is the role of the other regulators?

It will be important to set out the role played by other regulators, such as the Drinking Water Inspectorate (DWI), The Environment Agency (EA) and the Health & Safety Executive (HSE) in the context of a direct negotiation process.

While the DWI and EA have to date played active roles in water company stakeholder engagement through Customer Challenge Groups it is unlikely that they would consider it appropriate to explicitly negotiate with others on statutory requirements any more than would an organisation such as HSE would on health and safety regulations. One could therefore take the view that the statutory process could be independent from the negotiation process.

In contrast, other environmental stakeholders such as the environmental non-governmental organisations (e.g. WWF) could be considered to represent the views of a group of customers and seek to influence business plans to reflect these views as part of the negotiation process.

There is no regulatory precedent for other statutory regulators to be part of a negotiation between customers and companies and there are many relevant regulators in other sectors that could have played this role (e.g. safety regulators in transport sector). This is likely to be the case because these regulators set statutory requirements (that are often measured in binary terms) and therefore do not negotiate with the companies, customers or the regulator.

In principle, there are three options.

- First, one view could therefore be to consider the DWI's, EA's and HSE's requirements as a separate topic that does not have to be aligned with the price control cycle and business plan.
- Second, given their water specific responsibilities there may be benefits from the DWI and EA having a direct seat at the negotiating table as the final agreement would clearly reflect the regulators' requirements. The advantage is also that the EA and DWI influence how statutory requirements are reflected in plans and represent those requirements directly so it is easier for customers to engage with the parts of the plan where trade-offs are required.

However, the drawback is that there may be a greater risk of a failed negotiation 1. due to the complexity by involving more parties and 2. as the regulators may be more experienced than the customer representatives, this could influence the outcomes.

- Third, another approach would be for other regulators to provide an assessment of whether business plans meet statutory requirements at specific points in time using an agreed format. Final agreements would not be valid unless the regulators confirm that the plan meets statutory requirements but the process of negotiation does not directly involve them. The advantage of this approach is that it separates statutory compliance from negotiating a price-quality trade-off between customers and companies. In this case, the customer representatives would have to have sufficient expertise and understanding to engage with the statutory obligations that companies have to fulfil. The disadvantage is therefore that this may create greater resource requirements for the customer representatives to engage on these issues effectively, and the regulators themselves may be unwilling to commit in public that a particular forward looking business plan is compliant with regulations.

In any case, it is important to set out in advance how the company and customers should interact with other statutory regulators such as the DWI, the HSE and the EA.

5.6 How does this approach relate to market reform and wider regulatory methodology?

How direct negotiations relate to wider regulatory methodology

The process of direct negotiation has to fit into a wider regulatory framework that is characterised by a building block approach with a well-established RAB. We therefore need to consider how the two approaches would interact.

It is reasonable to expect that the building block approach would remain in place so customers and the company would negotiate some or all of the key decisions that Ofwat needs to make. One approach is to leave the fundamentals of the methodology unchanged (and develop specific items further) and to provide customer representatives with appropriate training or resources to engage with companies on complex matters. This seems to be most appropriate if customers and companies negotiate on specific parts of the plan. For example, Ofwat could develop a revised methodology for performance commitments and outcome delivery incentives and ask companies and customers to negotiate these directly.

However, if the scope of the negotiation was to include the whole plan (or the whole plan with some exceptions), there may be a question around whether the

regulatory methodology can be simplified. For example, the menu approach is a relatively complex mechanism that could be simplified if customers were negotiating directly. Another approach is therefore to consider which parts of the methodology could be simplified to enable more constructive negotiations. These parts could then be modified or simplified. Overall, this approach makes sense if customers and companies negotiate large parts of the plan as one of the benefits of direct negotiation is that it allows the negotiation to focus on the big picture, the overall price-quality trade-off rather than focussing on specific regulatory mechanisms.

There are also interactions with other parts of the regulatory methodology such as the length of the price control, the risk reward balance and uncertainty mechanisms. A longer price control implies that there is greater scope of under- or outperformance and therefore may require greater consideration of sharing risk between customers and the company. Direct negotiations could be a valuable tool for informing the type of sharing mechanisms that are most effective in sharing risk. This is also an area where direct negotiation could facilitate innovation (an example from engagement at PR14 is South West Water's Water Share mechanism).

How direct negotiations relate to market reform

Retail market reform raises a number of questions around how direct negotiations would work. The key question is whether non-household retailers would represent customer views and should therefore be part of the negotiation. In the short-term it is difficult to see how non-household retailers can negotiate with the wholesaler effectively, particularly if they are part of one vertically integrated company. However, in the medium-term we would expect the market dynamics to evolve in a way that retailers would be well-placed to represent non-household customers. The question may therefore be a matter of timing and a transitional arrangement could be used to ensure that non-household customers are represented appropriately at all points in time.

In contrast, it is not clear whether upstream competition would have a significant impact as this depends on the type of market Ofwat envisages. In a single buyer market, it is still the wholesaler who would negotiate with customers or retailers. The customers would require assurances that resources and treatment are sourced at least costs. In a market structure where retailers source their water directly from resource providers but retailers and wholesalers for household customers are still vertically integrated (and there is no household retail competition), negotiations between customers and the vertically integrated company are still likely to be most appropriate. Overall, the process of direct negotiation can be applied in any market structure as the underlying principle is for the monopoly network provider to negotiate with its customers.

Framework for direct negotiation in the water sector in England and Wales

How direct negotiations relate to CMA appeals

In the context of well-established appeals processes, it is also important to clarify how the process of direct negotiation would relate to CMA appeals. The role of the CMA is determined by legislation so the question is how the CMA's decision making could impact on the process of direct negotiation. There are a number of potential impacts:

- **Confidence in the process** – under the current structure companies can appeal the determination even if it was the result of a negotiated agreement. If the CMA did not consider the outcomes from a direct negotiation between customers and companies as valid, this could undermine the future negotiations. However, this is a risk for any change to the regulatory methodology. The view of the CMA is therefore likely to depend on how robust the negotiation process is.
- **Asymmetric right of appeal** – while companies can appeal Ofwat's decision, customers in the water sector currently do not have the right to appeal. This can create an imbalance as companies' have a back-stop option if they do not agree with Ofwat's decision whereas customers do not have this option. The impact of this asymmetry may be that companies have less incentive to come to an agreement with customers than customers.

The role of the CMA process could be reviewed in legislation once any new approach to direct negotiation is properly established. This could include giving customers the right to appeal and /or limiting the scope of appeal to issues that are not part of the direct negotiation (these changes would mirror the evolution in the energy sector where CMA appeals now focus on specific issues and third parties have the right of appeal).

6 Conclusion and summary

We have presented the rationale for direct negotiations, reviewed regulatory precedent and set out a framework for direct negotiations in England and Wales. While there is a lot of detail that would need to be developed further, we can conclude that:

- **There are potentially substantial benefits from direct negotiations** – the key benefits include greater legitimacy, reduced regulatory burden and more scope for innovation and flexibility.
- **There are also risks associated with direct negotiations that a well-designed process could minimise** – the key risks are reduced certainty and transparency and the potential for increasing the regulatory burden. These can be addressed by designing a robust process.
- **A pro-active regulator is an important factor for success** – a successful process needs a pro-active regulator that carefully considers the design of the process. Regulatory precedent shows that it is important for the regulatory to set out a clear timetable, process and expectations. The regulator also needs to consider carefully and specify clearly how it will approach the price determination if negotiations fail.
- **There are a number of detailed design questions that need to be considered further** – questions around who is best placed to represent customers, what should be in the scope of the negotiation and how this approach relates to the overall regulatory methodology need further investigation as they are important for the success of the negotiation.

Overall, we have found that direct negotiations could make a significant contribution to achieving Ofwat’s vision of “trust and confidence in water”, particularly as the outcome from a well-designed direct negotiation process would have a strong positive impact on the legitimacy of the price control.

In the long-run, direct negotiations that are facilitated by a pro-active regulator that is focussed on a well-designed process can provide benefits for companies, customers and the regulator. In the context of Ofwat’s desire to “*improve incentives to manage business over longer term with on-going, dynamic and responsive relationship with customers*”¹³, direct negotiations appear to be a useful tool to ensure that companies are focussing on building effective, long-term relationships with customers.

¹³ Ofwat, 2015, Introduction to Water 2020, Available http://www.ofwat.gov.uk/pricereview/water2020/prs_pre20150602wukwater2020.pdf

Annexe 1: Detail on experience in other sectors and countries

Water sector in Scotland

Why were direct negotiations introduced in the first place?

There were a number of reasons why a process of direct negotiation was introduced in Scotland:

- The complex, technical and data-intensive process made it difficult for customers to access the information they needed to understand fully the choices to be made (similar to issues raised by airlines in aviation).
- Customer contact is focused on consulting on draft decisions, rather than presenting options early in the process and involving customers in decisions so they had limited opportunity to have a big impact.
- Scottish Water's business plan focused on economic and quality regulators, rather than being based on detailed discussions with customers of the potential trade-offs resulting from quantitative and qualitative analysis of customers' priorities.

As a result, the Scottish regulator WICS established the Customer Forum to negotiate directly with Scottish Water.

What was the role of the regulator? What did the customers decide on?

WICS played an active role in facilitating agreement. At the start of the process it set out clear timelines, responsibilities and sequencing of decisions (see **Figure 9** below). WICS set out that it would assess:

- whether the outcomes are sufficiently well defined and can be monitored objectively and whether the plan;
- value for money (in other words, the strengths and weaknesses of the plan);
- areas where there may be scope for customers to decide on trade-offs; and
- quantified price impacts of different approaches included (or omitted) from the business plan.

WICS also set out that it would determine prices in a way that is similar to previous determinations if no agreement could be reached. Specifically, it highlighted the “back up” option may involve:

- more detailed scrutiny;
- reviewing Scottish Water’s business planning processes, the planning options that have been considered, their cost estimates and the trade-offs that are proposed between cost and service to customers; and
- price limits would then be based on the results of WICS’ analysis and any expert scrutiny.

In the end the agreement went further than expected as the process was viewed to be constructive and successful.

WICS published a series of short notes that provide information on key topics. The notes enabled customers to understand the key issues and covered areas such as:

- **costs:** Operating expenditure, Base expenditure, efficient use of capital investment expenditure;
- **quality:** levels of service measurement, levels of service performance, assessing SW’s overall service performance, measuring customer satisfaction; and
- **finance:** Financial tramlines¹⁴, initial prospects for prices, financial strength and closing cash, financial assumptions.

Another example is the “ready reckoner” that helps customers assess how investment affects bill levels. This information contributed to the final agreement covering a greater scope than expected.

The responsibility of the Customer Forum was to:

- identify and understand from quantitative and qualitative research (with Scottish Water) customers’ priorities; and
- seek to get the best outcome for customers (as a whole) based on those priorities and preferences within the broad policy framework agreed by the Scottish Government.

¹⁴ Financial tramlines set the levels of financial strength measured by cash-based financial ratios at which Scottish Water would have to begin discussions with customers and the Scottish Government on how to share out- or underperformance.

Figure 9. Overview of process set out by WICS at the start of the price control



Annexe 1: Detail on experience in other sectors and countries

Members of the Customer Forum were appointed jointly by Scottish water, the Commission and CFS with an independent chair nominated jointly. Members were appointed as follows:

- CFS suggested 5 person with strong customer focussed reputation;
- 2 other members from the two water services providers and/or sewerage providers with the largest market shares (the retailers); and
- one member from the Scottish Council of Development and Industry.

The Customer Forum had an initial budget of £175,000 paid by the regulator but the members all had relevant skills and expertise as it included, for example:

- former Minister in the Scottish Executive and MSP for the Highlands and Island;
- Finance Director of Business Stream and a Chartered Accountant;
- lecturer in law specialising in water and environmental law at the HIP-HELP Centre for Water Law, Policy and Science at the University of Dundee.
- director of Osprey Water Services, Anglian Water's retail arm;
- previous Head of Corporate Services at the Scottish Executive, Board Member of Citizens Advice Scotland, a member of the Scottish Health Council and a director of the RSNO; and
- a fellow of the Chartered Institute of Marketing.

The Customer Forum was therefore a relatively small group of highly experienced professionals that negotiated on behalf of customers.

What are the key lessons learned?

The process was a success due to:

- the strong support of all the interested parties, especially WICS, Scottish Water, CFS and Scottish Government, was surely critical. All wanted this project to work;
- WICS proactive role, for example, the notes it provided and the financial tramlines were very effective in informing customers. WICS encouraged agreement and led the design of the Cooperation Agreement;
- public ownership was seen to be helpful but not necessarily seen as prerequisite for success.

The following areas for future improvement have been identified:

Annexe 1: Detail on experience in other sectors and countries

- the Forum could be set up earlier so members can gain a more thorough understanding of the sector (and input to SW's research programme);
- forum constitution and membership could be seen as more independent of regulated company as legitimacy of Forum questioned by some. Greater representation of all customer groups could be considered in the future; and
- forum would have benefitted from more resources (particularly early in the process).

Airport sector in UK

UK Airports - Background to constructive engagement

In this section we set out the experience in the UK airports sector on the development of constructive engagement (CE). This is split into the following three sections:

- Why was CE introduced in the first place?
- What was the role of the regulator, and what did the customers decide on?; and
- Have the approaches been successful and what are the key lessons learned?

We discuss these points in turn below.

Why was CE introduced in the first place?¹⁵

The Civil Aviation Authority (CAA) regulates airports in the UK. For control periods Q1, Q2 and Q3, the CAA used a relatively straightforward RPI-X formula to set prices. However, in the review process for the Q4 price control (which ran from 2003-2008) the CAA considered introducing new incentive mechanisms. This included many concepts that were new to many industry stakeholders. In response to this, there was a general consensus among airlines that the regulatory process had moved too far towards 'abstract economics' with inaccessible language and content. Many stakeholders felt that this technical barrier prevented them from engaging in the process and influencing the strategic direction of the price control.

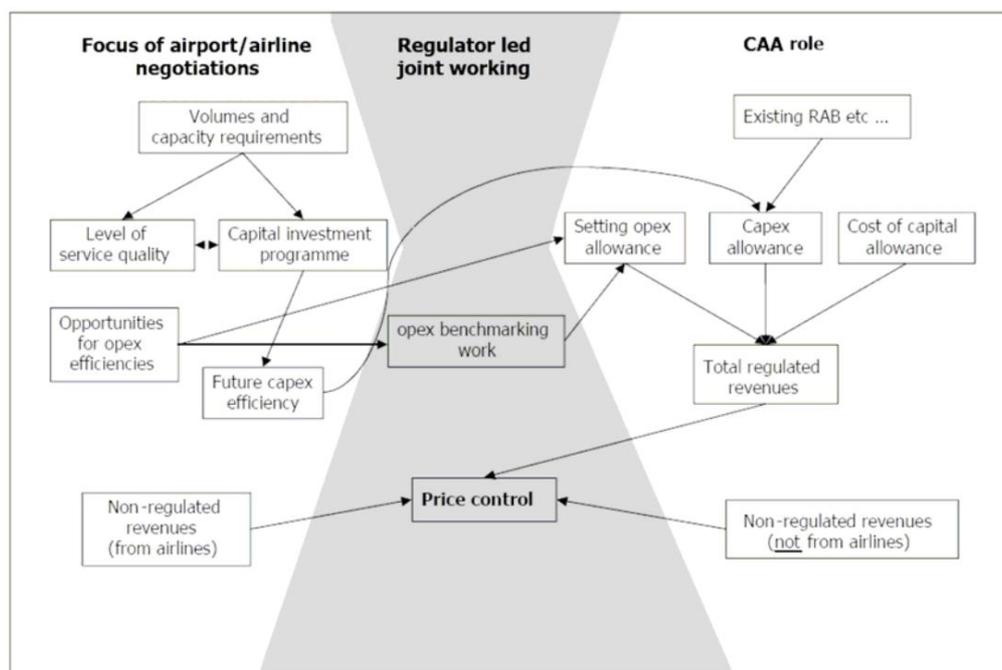
¹⁵ For further information see paragraphs 7-23: Reforming the framework for the economic regulation of UK airports The Civil Aviation Authority's response to the Department for Transport's consultation Supporting Paper I – Constructive Engagement May 2009. <https://www.caa.co.uk/docs/5/ergdocs/20090522FworkEcRegSPI.pdf>

The CAA recognised these concerns. To ‘clear the air’ and move on from Q4, it assessed ways of bringing airlines back into the process. It concluded that there was a strong case for airport-airline engagement at the start of price reviews. This would help deliver better developed business plans and ultimately better informed regulation. This gave rise to constructive engagement.

*What was the role of the regulator? And what did the customers decide on?*¹⁶

Figure 10 below provides an overview from the CAA, illustrating the roles of the regulator, the airport, and the airlines in CE.

Figure 10. Roles under constructive engagement



Source: The CAA. Reforming the framework for the economic regulation of UK airports The Civil Aviation Authority's response to the Department for Transport's consultation Supporting Paper I – Constructive Engagement May 2009. <https://www.caa.co.uk/docs/5/ergdocs/20090522FworkEcReqSPI.pdf>

The CAA was clear that it was still ultimately responsible for making the final decisions. It wished for there to be agreement between airports and airlines on the key variables feeding into the price determination. However, it would reach a decision with or without a consensus. And it could choose to ignore any consensus if it felt that it was not in the interest of passengers and potential new entrants.

¹⁶ For further information see paragraphs 24-36 in the report referenced above.

It saw its role as setting the framework, the agenda for CE and the terms of engagement, and then reaching final decisions based on the outputs from CE as well as its own assessment of costs. It recognised that it would only be worth proceeding with CE where there was a realistic prospect of some substantive agreements being reached between the airport and the airlines.

However, the CAA still took the lead on the cost of capital and regulatory finance policy. This was because it considered that any discussions between the airport and the airlines on the cost of capital would be unlikely to ever reach a consensus. It also felt that it held a comparative advantage in deciding the cost of capital and that no additional insight could be gained over and above the evidence which the parties would submit anyway to the CAA's own regulatory consultations.

Have the approaches been successful? And what are the key lessons learned?¹⁷

CE had mixed success across the different UK airports where it was introduced. Ultimately it failed at Stansted. The CAA believed that there were simply too many differences in opinion between the airport and the airlines. For example, the airport wanted a second runway, and the airlines did not. As a result, communication between the parties broke down, and this meant that CE was basically abandoned there.

At Heathrow and Gatwick there were more positive messages. The airlines and the airports reached a consensus on many aspects. As a result, the CAA incorporated large parts of the airports' and airlines' proposals. This would have implied less work for the regulator, less intervention, and an outcome close to that which the airports and airlines had agreed on.

CE attracted criticism. However, the CAA felt that because CE was new to the control process it was an obvious focal point for criticism. It therefore believes that the criticisms need to be considered in that light.¹⁸ Airlines raised the following points:

- information flow from airports to airlines was often deemed too little too late;

¹⁷ For further information see paragraphs 50-93 in the report referenced above.

¹⁸ The Q5 price control reviews at each of BAA's designated airports were unusually contentious. There was a range of factors, mainly external to economic regulation which meant that the Q5 reviews would always have been challenging, whatever approach the CAA adopted. It is therefore unsurprising that the process and outcome of the Q5 reviews have attracted criticism in general. Given that the CAA had introduced the innovation of CE, though, it was perhaps inevitable that CE would itself become the focus of much of this criticism from the parties, and more broadly. The survey of such criticism should be considered in that context

- the airports would often present its own preferred solution rather than explore jointly with the airlines a range of potential options;
- significant changes to the scope and costs of capital and service plans in the latter stages of the price review gave rise to suspicions among some airlines that airports were ‘gaming’ the process, by deliberately holding back information until the last moment and thereby reducing the ability of the airlines to scrutinise it effectively; and
- some airlines expressed frustration with the lack of engagement by the CAA in the CE process, and argued that the CAA should have been stricter in its oversight and discipline of airports’ behaviour, and should have stepped in sooner to resolve emerging differences on substantive and process issues.

The CAA itself recognised that CE was a learning process for all involved. It highlighted the importance of establishing trust. It said that a good degree of trust was established at many airports, overcoming some long-held suspicions on the part of airlines about the airport operators’ motives and capabilities. It also noted that by contrast, the absence of such flexibility on all sides at Stansted was the main reason why CE failed to establish itself there.

It also commented that disagreements between the parties can be just as valuable as an input into regulatory decision-making as agreement, and in some cases might be said to be more valuable, in that it exposed more clearly differing views which might have been hidden within a consensus.

Energy sector in US and Canada

In the US and Canadian utilities markets, negotiated settlements are frequently used in place of litigation:

- in the US, the Federal Energy Regulatory Commission (FERC) uses negotiated settlements for gas pipeline and electricity transmission rate cases;
- in Canada, the National Energy Board (NEB) uses negotiated settlements in oil and gas pipelines markets; and
- in Florida, the consumer advocate (the Public Counsel) negotiates settlements with utility companies.

Why were negotiated settlements introduced in the first place?

Negotiated settlements have a long established history in North America.

- They began being actively used by FERC in the 1960s as a means of “resolving its backlog of cases” (Krieger, 1995). Today, 90% of gas pipeline and electricity transmission rate cases are determined by settlement rather than litigation. (Littlechild, 2010).
- In Canada, the NEB began to explore the use of negotiated settlements in the early 1980s. Reforms were a way to meet the need for “reasonably expeditious treatment of applications” (Priddle, 1999) and were in line with wider changes in federal government policy designed to free up commodity markets and increase open access to pipelines.
- In Florida in the 1970s utility rates were increasing and negotiated settlements were seen as a way to give greater representation to consumers (Chakravotry, 2014).

What was the role of the regulator? What did the customers decide on?

The level of involvement of the regulator differs significantly in these cases. FERC takes a very active role, while in Florida and Canada “such settlements seem to be negotiated largely or entirely independently of the regulatory commission” (Littlechild, 2010).

- In the US, after a gas pipeline proposes a rate change, FERC spend 3 months analysing the proposal and come up with a First Settlement Offer. There is then a period of about 3 months before testimony has to be submitted, during which time the pipeline and other interested parties negotiate. Staff at FERC will lead Settlement Conferences where various offers and counter-offers will be proposed and discussed. In many cases,

agreement in principle is reached by the end of the second Settlement Conference at which stage the pipeline and the parties jointly file a motion to suspend the procedural schedule. Where settlement is not achieved, the case reverts to a FERC hearing per the procedural schedule (Littlechild, 2010).

- In Canada, the scope for using settlements is wide and has extended to determining prices, operating and capital cost projections, service quality improvements and risk-sharing investments among other things. The NEB's approach to negotiated settlements is much less active than FERC's. The NEB's 1988 guidelines on negotiated settlement note that: "The Board's role as an independent adjudicator must not be impinged by being a party to the negotiations" (NEB, 1988). Furthermore, in its Revisions to the Settlement Procedure in 1994, the Board affirmed that: "Should the settlement not be opposed by any party, the Board would normally be able to conclude that the resultant tolls are just and reasonable and a public hearing would not be required". As such Doucet and Littlechild (2009) view the "primary role of the Board...is to enable well-informed market participants... to negotiate satisfactorily on something like equal terms with the oil and gas pipelines."
- In Florida, the Office of the Public Counsel is duty-bound "to represent the general public of Florida" and is accountable to the Florida legislature. It negotiates with utility companies on behalf of consumers during negotiated settlements. The Regulator, the FPSC, does not get involved in these negotiations but does approve the final decision (Littlechild, 2007).

What are the key lessons learned?

Evidence from the US and Canadian experience suggests that negotiated settlements can be a successful alternative to the traditional regulatory process.

- Littlechild (2010) argues that there are two key characteristics of FERC's approach to negotiated settlements, which makes it successful.
 - staff indicate their thinking on key parameters early on, which forms the basis for informed discussion. In particular, the proposed rate change and FERC's First Settlement Offer create bands for structuring subsequent discussions by making clear the outside options to parties.
 - FERC aims to bring the parties into agreement, not to impose a preconceived settlement on them.

Doucet and Littlechild (2009) argue that two similar mechanisms are behind the success of negotiated settlement in Canada:

- In 1994, the NEB introduced the Generic Cost of Capital mechanism, which established an automatic means to adjust the return on equity. Roland

Annexe 1: Detail on experience in other sectors and countries

Priddle, former chair of the NEB, argued that this was an “important building block for subsequent gas pipeline settlements” (Doucet and Littlechild, 2009). This reduces the scope for opposing parties to harbour divergent expectations about likely outcomes of hearings, which focuses negotiations on mutually beneficial decisions of “the additional value the utility can offer to merit additional revenue” (Doucet and Littlechild, 2009).

- Also NEB judges settlements by the process rather than outcome, which helps to facilitate more innovative solutions.

However, there is some evidence emerging from Florida which gives reason to be cautious when designing negotiated settlements frameworks. Chakravorty (2014), finds that the “consumer advocates agree to settlements primarily to secure substantial immediate rate reductions”. As such one needs to be cautious to ensure that future consumers and wider concerns are represented in settlement negotiations. In particular, Chakravorty (2014) finds that: “the shorter and more uncertain their tenure, the more likely that [consumer] advocates will want to secure present observable gains in exchange for future losses”.

Air traffic navigation in the UK

Why were direct negotiations introduced in the first place?

As the CAA implemented a similar approach for airports, the rationale was to make NERL more customer focussed. However, in contrast to the airport sector, the CAA expectations of the process were modest. The CAA expected the parties to agree on an independent chair or co-chairs of the process, respect process rules, and complete the process with a joint report to the CAA on the areas of agreement and disagreement between the parties. The CAA did not expect NERL and airspace users to agree the business plan as it considered this unrealistic given the different commercial perspectives on each side. However, the CAA did expect NERL to use its best endeavours to understand airspace users’ priorities and ensure these are taken into account in its business plan.

What was the role of the regulator? What did the customers decide on?

The CAA proposed a step-in/step-out role but this would be restricted to secure procedural fairness rather than on outcomes where it cannot fetter its discretion at this stage of the process. The CAA required NERL to submit a draft business plan. Following this, the CAA reviewed those areas of the business plan where NERL and its airspace users have a significant divergence of views. The CAA developed its own in-depth analysis of NERL’s projections for operational efficiency and its weighted average cost of capital (WACC). The CAA would then use the minutes from the engagement and the final report as inputs.

NERL had to establish a Customer Consultation Working Group (CCWG). The negotiation was intended to cover:

Annexe 1: Detail on experience in other sectors and countries

- NERL's proposed plans for meeting airspace users' needs in RP2, in terms of the KPAs under the Performance Regulation: safety, environment, capacity and cost-efficiency;
- the key components of NERL's business plan including traffic projections, its capital plan, operating costs, and financing costs etc;
- the steps that NERL is taking to improve its cost-efficiency in RP2 and beyond;
- NERL's programmes (including costs and benefits) required to deliver the Future Airspace Strategy (FAS);
- NERL's ambitions and plans for delivering improved outcomes for users through its relationship with the IAA ANSP and the UK-Ireland FAB;
- the use of incentive mechanisms to encourage NERL's performance;
- the priorities of airspace users in relation to certain trade-offs relating to strategic choices NERL could make regarding cost and service quality; and
- airspace users' requirements for Oceanic services

The CAA envisaged NERL holding a series of plenary meetings and workshops to elicit customers' views.

What are the key lessons learned?

The key lessons learned are:

- expectations need to be set out in advance to avoid disappointment;
- resource availability may differ substantially between the regulated company (lots of resources available as the process is important for bottom line) and customers (limited resources available as this is only one input cost item);
- information asymmetry can be a problem – the airlines criticised that the mandate was only partially fulfilled because of the lack of time and detailed information from NERL and the absence of results of any CAA studies; and
- the CCWG nevertheless had the view that the process had improved mutual understanding and alignment on issues of importance to their businesses.

Annexe 1: Detail on experience in other sectors and countries

Airport and rail sector in Australia

Why were direct negotiations introduced in the first place?

For the Hunter Valley rail track, the ACCC saw direct negotiation as the most effective way to resolve a number of issues between the rail track provider and its customers. For airports, the government chose a “light handed” approach on the basis of its market power assessment. The rationale for price monitoring (and therefore direct negotiations instead of price determinations) is that the government thought that the threat of reintroducing regulation would put sufficient constraint on prices. This is combined with price monitoring which will identify any misconduct. As a result the ACCC does not have a direct role in determining prices but rather has to monitor annual price movements.

What was the role of the regulator? What did the customers decide on?

In the airports sector, the regulator only provides price monitoring so airlines and airports negotiate contracts without any specific requirement or process. The ACCC publishes comparative information on prices to inform negotiations but does not take a view on whether these are justified (e.g. their latest report says that profits are increasing despite service levels not increasing). Airlines can take legal action (under the national third party access regime) and if their access claim is successful, they can seek arbitration should they be concerned about the negotiated outcomes but to date none of the airlines have taken such action.

For the Hunter Valley rail track, the ACCC staff encouraged the parties to negotiate. This was not with a view to achieving a negotiated outcome that the ACCC could then endorse. Nor was it standard ACCC policy or practice. Rather, direct negotiation between the parties was seen as a more effective way to resolve some of the differing views of the parties in this case. The ACCC adopted a flexible approach. For example, ACCC was willing to extend its timetable on at least two occasions, in order to facilitate discussion. ACCC staff also played a pro-active role, acting where necessary as mediator and seeking to build consensus. It appears that the settlement led to different terms and to a higher rate of return than would otherwise have been allowed.

According to a review of the outcomes: *“Experience here is thus consistent with experience elsewhere, that customers are often willing to pay a little more than the regulator deems appropriate, in order to secure a service better tailored to their needs than the regulator would otherwise specify. In short, both sets of parties secured a better outcome than they would have done with a regulatory decision.”*¹⁹

¹⁹ Bodington & Littlechild, 2012

What are the key lessons learned?

In the airport sector it is difficult to tell whether the current approach is a success. Airlines are concerned about airports exploiting market power but there is divergence in views and it is difficult to assess what would happen with economic regulation. In a review of the approach, the Productivity Commission found that “There is considerable scope to improve commercial negotiation — particularly with regard to contract formation — as it has not yet achieved the level of maturity envisaged with the lifting of price regulation nearly a decade ago²⁰”. At the same time there appears to be little appetite to change the process as there is not strong evidence either way.

In the case of the Hunter Valley rail track, there are mixed views. For example, the ARTC was content with the ACCC’s role whereas coal producers say ACCC was very risk averse, and not sufficiently pro-active in getting the parties to the table and stimulating negotiations. As a result the process was unduly prolonged.

Both sets of parties have urged that the ACCC be more willing to recognise particular industry circumstances and risks, and less concerned about maintaining uniformity between industries via precedent. A review of the approach has also concluded that *“A willingness by customers and users to accept a slightly higher rate of return for desired services seems to work wonders in facilitating negotiations. An early recognition of this seems helpful”*²¹.

The Hunter Valley rail track negotiations have shown that a proactive role for the regulatory body can be helpful. This is not simply to allow or encourage negotiations but also can include structuring the discussions, clarifying the issues, taking initial decisions on the less critical ones, insisting that the parties get round the negotiating table, giving a lead on what is or is not likely to be acceptable, and taking a firm line where necessary with the regulated entity.

²⁰ Productivity Commission, 2012

²¹ Bordignon & Littlechild, 2012

Annexe 2: References

- Bordignon, S and S C Littlechild (2012). “The Hunter Valley Access Undertaking: elements of a negotiated settlement”. Available at: <http://www.econ.cam.ac.uk/dae/repec/cam/pdf/cwpe1218.pdf>
- CAA, (2009). “Reforming the framework for the economic regulation of UK airports”. Available at: <https://www.caa.co.uk/docs/5/ergdocs/20090522FworkEcRegSPL.pdf>
- Chakravorty, S (2014). “A Study of the Negotiated-Settlement Practice in Regulation: Some Evidence from Florida”. Available at: http://warrington.ufl.edu/centers/purc/purcdocs/papers/1419_Chakravorty_A%20Study%20of%20the%20Negotiated-Settlement%20Practice%20in%20Regulation%20Some%20Evidence%20from%20Florida.pdf
- CME, (2013). “A summary of evidence and thinking on negotiated settlements in the regulation of energy network service providers”. Available at: <http://cmeaustralia.com.au/wp-content/uploads/2013/09/Mountain-2013-evidence-and-thinking-on-negotiated-settlements-.pdf>
- Coppack M, Jackson F and Tallack J, (2014). “Involving consumers in the development of regulatory policy”. Available at: <http://www.ukrn.org.uk/wp-content/uploads/2014/07/Involving-consumers-in-the-development-of-policy.pdf>
- Doucet, J and S C Littlechild (2006a). “Negotiated settlements: the development of economic and legal thinking”. Available at: http://www.cepe.ethz.ch/news/news/Negotiated_Settlements_1_Development_of_thinking_17_Feb_06..pdf
- Doucet, J and S C Littlechild (2006b). “Negotiated settlements and the National Energy Board in Canada”. Available at: <http://www.eprg.group.cam.ac.uk/wp-content/uploads/2008/11/eprg0629.pdf>
- Doucet, J and S C Littlechild (2009). “Negotiated settlements and the National Energy Board in Canada”. Available at: <https://www.ofgem.gov.uk/ofgem-publications/52137/5.pdf>
- easyJet (2014). “Draft policy for the economics regulation of new runway capacity”. Available at:

<http://www.caa.co.uk/docs/78/easyJet%20response%20to%20CAA%20consultation%20on%20capacity%20financing%20non-confidential.pdf>

- Fellows GK (2012). “Negotiated settlements: Long-term profits and costs”. Available at: <http://www.policyschool.ucalgary.ca/sites/default/files/research/g-kent-may012-3.pdf>
- Independent Pricing and Regulatory Tribunal (2012). “Customer engagement on prices for monopoly services.” Available at: <http://www.ipart.nsw.gov.au/Home/Industries/Research/Reviews/CustomerEngagement/CustomerEngagementonPricesforMonopolyServices2011/10Aug2012-ReleaseFinalReport/FinalReport-Customerengagementonpricesformonopolyservices-August2012>
- Littlechild, S (2007). “Negotiated settlements: a role for American practice in UK policy?” Available at: <https://www.ofgem.gov.uk/ofgem-publications/52136/4a.pdf>
- Littlechild, S and Cornwall N, (2009). “Potential scope for user participation in the GB energy regulatory framework, with particular reference to the net Transmission Price Control Review”. Available at: <https://www.ofgem.gov.uk/ofgem-publications/52036/user-participation-ofgem-28-march-2009-final.pdf>
- Littlechild, S (2010). “The process of negotiating settlements at FERC”. Available at: http://www.ofwat.gov.uk/publications/commissioned/rpt_com_1010fplferc.pdf
- Littlechild, S (2012). “Electricity and gas experience with constructive engagement / negotiated settlements around the world and their applicability to the UK”. Available at: <https://www.ofgem.gov.uk/ofgem-publications/52776/december-workshop-stephen-littlechild-judge-business-school.pdf>
- Littlechild, S (2014). “RPI-X, competition as a rivalrous discovery process, and customer engagement”. Available at: <http://www.eprg.group.cam.ac.uk/rpi-x-competition-as-a-rivalrous-discovery-process-and-customer-engagement/>
- Littlechild, S (2014), The Customer Forum: customer engagement in the Scottish water sector. Available at:

Annexe 2: References

http://www.rpieurope.org/Publications/Studies_New_Series/Studies_NS_4_2_Littlechild_July_2014.pdf

- Littlechild, S (2010). “A customer consultation process for the water and sewerage sectors”. Available at:
http://www.ofwat.gov.uk/publications/commissioned/rpt_com_1010fplconsult.pdf
- Mountain, B (2013). “The potential scope for negotiated settlements in the regulation of electricity and gas networks in Australia”. Available at:
http://a2se.org.au/files/Bruce_Mountain.pdf
- Stern, J (2014). “The British regulation model: it’s recent history and future prospects”. Available at:
http://www.city.ac.uk/_data/assets/pdf_file/0003/236370/CCRP-JS-Paper-WP-23.pdf
- Storey, D (2008). “The Future of Energy Regulation in Britain”. Available at:
<https://www.ofgem.gov.uk/ofgem-publications/52085/daniel-storey-presentation.pdf>
- Water industry commission for Scotland (2014). “The Strategic Review of Charges 2015-21. Draft determination”. Available at:
http://www.watercommission.co.uk/UserFiles/Documents/Draft_determination_2015-21.pdf
- Water industry commission for Scotland (2011). “The impact of new improvements on water and sewerage bills: a ready-reckoner”. Available at:
[http://www.watercommission.co.uk/UserFiles/Documents/ReadyReckoner%20\(7\).pdf](http://www.watercommission.co.uk/UserFiles/Documents/ReadyReckoner%20(7).pdf)
- Water industry commission for Scotland (2014). “The Strategic Review of Charges 2015-21. Innovation and choice”. Available at:
<http://www.watercommission.co.uk/UserFiles/Documents/scr%20innovation%20and%20change%20proof%204.pdf>

Frontier Economics Limited in Europe is a member of the Frontier Economics network, which consists of separate companies based in Europe (Brussels, Cologne, London & Madrid) and Australia (Melbourne & Sydney). The companies are independently owned, and legal commitments entered into by any one company do not impose any obligations on other companies in the network. All views expressed in this document are the views of Frontier Economics Limited.

FRONTIER ECONOMICS EUROPE

BRUSSELS | COLOGNE | LONDON | MADRID

Frontier Economics Ltd 71 High Holborn London WC1V 6DA

Tel. +44 (0)20 7031 7000 Fax. +44 (0)20 7031 7001 www.frontier-economics.com