

Regulators and consumer engagement

Richard Moriarty

We are all customer focused now ...

A consistent theme of regulation over the past decade or so has been how regulatory authorities encourage their regulated communities to be more customer focused. I'll use the word customer here as shorthand to mean the end user, as different regulatory regimes have different terms for the end user: consumer, customer, the public, client, passenger, patient, tenant, etc. This policy direction has in some sectors been supported by legislative changes to give regulators a primary duty towards the customer (as is the case with the recent Aviation Act 2012).

Regulators have been particularly keen to ensure their regulated communities understand the needs of customers and develop services that meet those needs. Although much of the focus has been on the field of economic regulation (e.g. water, energy, and aviation), this trend has also been evident in other forms of regulation such as professional conduct regulation (e.g. legal services and healthcare) and prudential regulation (e.g. financial services and social housing).

Often with similar strategies ...

Customer engagement is quite a broad canvas. In the main, regulators view active and assertive customers as key to the health and vibrancy of the market they regulate. Regulators have adopted a fairly similar approach. They have developed 'demand side' interventions usually under the banner of 'empowering customers through better information' about their rights, service providers and the market. They have also sought 'supply side' interventions aimed at encouraging regulated companies and professionals to take more interest in the views and needs of their customers. Finally, regulators now routinely undertake customer research themselves and many have customer panels and similar bodies to advise them on policy development – some of these panels are statutory bodies (e.g. legal services, communications) and some non-statutory (e.g. aviation).

I will focus on one aspect that has received a lot of attention lately – what I called the 'supply side' interventions or in plain English how regulators go about encouraging those that they regulate to be more responsive to their customers.

Regulators sometimes have different motivations for customer engagement

It is worth reflecting on the reasons regulators have given to support this type of intervention.

- In some cases there is a classic monopoly or market failure rationale. Although expressed with more diplomacy, the regulator thinks that the companies with a monopoly position cannot be trusted to understand and serve consumer interests well (e.g. water and energy network businesses). But the regulator is also conscious that it itself is also a poor proxy or substitute for local customer preferences. So it imposes a governance framework for how the monopoly business should engage with its customers.
- Some regulators have also seen greater customer engagement by regulated companies and professionals as a way of reducing the role for direct regulatory intervention by making Boards of companies much more accountable (e.g. social housing and water). Regulators in these sectors have observed that those they regulate spend a disproportionate amount of their time managing their relationship with their regulator compared to managing the relationship with their customers. The regulator in effect is attempting to encourage a cultural change.
- Outside the sphere of economic regulation, there are other regulators that have pursued greater customer engagement as a supply side intervention. The motivation often being that even if the regulated companies or professionals are generally active in an open market, they may not always have the right incentives to sufficiently protect or promote customers' interests (e.g. certain financial services) or where there are significant asymmetric information barriers or personal consequences that cannot be addressed with regulatory remedies after the event (e.g. legal services and healthcare).

There is broad support for customer engagement to continue

Within the context of economic regulation, the general feeling of most stakeholders that I have spoken to, or read about, is that the move towards greater customer engagement is very welcome and it has delivered value.

During the recent Ofwat price review of the English and Welsh water companies, I worked with one such company and know from my first-hand experience how our business plan priorities were shaped by an intense process of customer and community engagement. Our balance of investment priorities between reducing leakage, investing in new water sources, and the ultimate cost to bill payers would have been different had we not engaged our customers in the way we did. It would have also been very different had we had a more traditional regulator-led settlement driven by Ofwat focusing on the outputs it thought our company should have delivered to our customers.

An important point here is that by forcing us to reflect on our customer priorities, Ofwat subtly enabled our Board to focus outwards towards our customers and communities and therefore own *our* business plan; and so it did not feel the plan was somehow imposed upon us by Ofwat as had been the case in the past. This was a small but hugely psychologically important point.

Inevitably with such a new regulatory process there have been lessons learnt. The view, however, of many regulated companies and consumer bodies is that they would like to extend the process of customer engagement even further for the next round of periodic price reviews. This undoubtedly raises the question of how such processes should be designed in future reviews.

Six observations to help shape future customer engagement processes

I would like to offer six practical observations or recommendations based on my experience of seeing how the process works across various sectors, both from the point of view of being the regulator and the point of view of working for a regulated company. I should stress that I have also been greatly influenced by a recent report written for UKWIR by Harry Bush and John Earwaker (2015), which examined in quite some depth the lessons learnt from the last Ofwat periodic price review.

1 – Be clear upfront what role you want customer engagement to play in the regulatory process

First, and perhaps most importantly, the regulator has to be clear right at the start about the ‘weight’ it wants to place on customer engagement in its periodic review process. This is important to manage expectations of market participants and also guide the skill set and behavioural characteristics required by the regulator in the course of the process.

The Bush and Earwaker (2015) review for UKWIR presented three options the regulator could adopt in differentiating each option according to the weight the regulator wished to place on the outcome of the customer engagement process. A complementary way of describing the choice set facing the regulator is to think of there being a spectrum of possibilities for how it treats customer engagement.

- At one end of the spectrum (the ‘shallow end’) the regulator can view customer engagement as a consultation exercise, e.g. in requiring companies to consult their customers in formulating their business plans – perhaps this is best characterised as the traditional approach. Many regulatory standards or licence conditions obligate companies to consult with their customers. Customers’ views are just one input the regulator takes into account before it calculates the price determination, and often after quite detailed and technical analysis.
- Moving along the spectrum, the regulator could place a greater weight on customer engagement by requiring companies to gain assurance or sign off from a consumer panel/group or a similar body. Under this approach, the regulator can rely on the assurance provided by the consumer panel/group rather than have to undertake its own intrusive investigations about customer preferences at the local level. This approach was perhaps best exemplified by Ofwat in its recent periodic price review for water companies in England and Wales. Water companies were required to gain assurance from independent consumer challenge groups (CCGs).

- At the other end of the spectrum (the ‘deep end’) the regulator could view itself as a facilitator of a negotiated settlement between the company and its customers – this is something that the water regulator in Scotland has done in its recent review of Scottish Water’s charges. It requires the regulator to be pre-disposed to accept the outcome of the process and how to ensure fair play between the regulated company and the consumer panel/group where the former may have significant market power and access to information and resources not available to the latter. This approach also requires a degree of trust and confidence among the principal parties involved. Stephen Littlechild (2014) has written extensively about how this approach could be a superior alternative to how UK regulators have traditionally undertaken price reviews.

II – the regulator should clarify its expectations about how customer engagement should be conducted and the roles and responsibilities of the parties involved

Having decided upon the weight it wants to place on customer engagement, the regulator can help the process by being clear what type of governance process it expects and the roles and responsibilities of the key players. Some regulators have tended to be specific and have required purpose built bodies to be established, such as the aforementioned customer challenge groups that Ofwat mandated or the constructive engagement groups that the CAA established. Experience has taught us that being clear on the practicalities really does matter and the regulator communicating its expectations greatly helps. Having clear objectives, terms of reference, timetables, and so forth is critical to success and momentum as is making sure the group has the right governance, members, resources and information to do the job effectively. Participants also need to know what it is in scope and out of scope and any important legal or policy ‘boundaries’ that should set the context for the discussions.

I would make the following observation on consumer panels, which I appreciate is from my own experience so others may take a different view. I have found that they yield most value when their role is to provide *assurance* that proper account has been taken of customer views rather than to *represent* customer views themselves. This is a subtle but important distinction. If panels are supposed to represent customers, then there is a real question of how they gain ‘legitimacy’. There is no such thing as *the* customer as customers tend to be a very heterogeneous group. What about ‘difficult to engage’ customers? How are the customers of the future to be represented?

III – the regulator should be clear on its role in the customer engagement process especially in relation to information provision

The regulator will have to adopt a different mode of working if it is facilitating a negotiated settlement than if it is determining the outcome; the former requires careful thought about what and when information is provided as well as skills in shuttle diplomacy.

With the exception of the example for Scottish Water mentioned earlier, most regulators tend to sequence their reviews with the customer engagement process taking

place before the regulator determines some key parameters. I have some sympathy with the argument that the customer engagement process could be strengthened by the regulator making some information available earlier in its process to guide participant expectations, especially if the regulator has access to comparative or benchmark data that the customer group would not have access to. This also helps guide the outcome of the customer engagement discussions to a place that is within the tolerance range of the regulator.

IV – incentive mechanisms may have a role to play

The regulator should consider whether there is a role for incentives to reward/punish companies in how seriously they take customer engagement. I appreciate this is tricky territory because what regulators want to see is that there is a genuine culture of properly taking into account customer views, not that the company only does it to tick a box for its regulator.

Incentive mechanisms may in certain circumstances help. These do not need only to be financial incentives. I am quite attracted in some sectors to the power of reputational incentives. I have found that many CEOs of regulated companies like being at the top of their regulator's 'league tables', even if they have little idea what that league table actually is! Process incentives can also be used. Offering a company a lighter touch regulatory review (or fast tracking) as a result of it being good at customer engagement is a win-win that could be considered. This does, however, raise the question of how the regulator judges a company is good at customer engagement, which is not something that usually gets taught on economic regulation training courses.

V – the process needs to be mindful not to frustrate the potential for innovation and competition

The regulatory design for customer engagement should be very conscious not to close in or frustrate the space for innovation within the regulated sector especially if the sector has competitive elements. Competition is not static. The dynamic process of rivalry and innovation that characterises a good competitive process cannot be replicated by a planned discussion between a company and its customers at a particular point in time. It is very difficult today to forecast innovation of the future and the process of discovery and trial and error that will lead to it. I am mindful of the quote often ascribed to Henry Ford: 'If I had listened too much to my customers at the start I would have invented a faster horse!'

VI – there is no playbook: experiment!

My final point is that we need to bear in mind that there is no standard model or blueprint for how regulators should design customer engagement processes, unlike for other aspects of price review, such as in calculating the Regulatory Asset Base or the cost of capital. So there is inevitably a process of regulators feeling their way on how best to conduct customer engagement. Each will need to experiment and learn. The price for enduring success in the long term is a tolerance of failure every now and then.

References

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Richard Moriarty is Deputy Chief Executive and Consumers and Markets Director at the Civil Aviation Authority. Until early 2016, he was CEO of the Legal Services Board.