

# **Innovation through customer engagement and negotiated settlements in water regulation**

## **Towards a transformed regulatory state?**

**Eva Heims and Martin Lodge**

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## **Abstract**

Across economic sectors, contemporary regulation is said to be characterised by two essential dimensions, the centrality of regulatory agencies in price-setting, and the use of the RPI-X formula to incentivise regulated companies. These dimensions have also come to play important roles in the regulation of water. This paper considers one major shift in the regulatory approach to the governance of water, namely, the move towards customer engagement in price-setting in England and Wales, as well as Scotland. By drawing on original interviews and documentary analyses, the paper demonstrates that this delegation of regulatory responsibilities to customer bodies can be explained by policy disappointment and policy entrepreneurs. It also questions whether these developments represent a transformation of the regulatory orthodoxy of the past three decades. The paper finds that despite appearances of customer engagement processes, regulators continued to play a pivotal role in price-setting in both jurisdictions.

## Introduction

The age of the regulatory state was said to be characterised by a combination of privatised provision of public services, contractualised agreements and oversight by quasi-autonomous regulatory agencies. These arrangements were supposed to establish a ‘logic of discipline’ (Roberts 2010) in order to remove short term interests from regulatory decision making (otherwise known as the need to establish ‘credible commitment’), and procedural instruments were to hinder regulatory capture, while potential problems associated with populism and participation were designed away through means of ‘deck-stacking’ (Majone 1994, 1997; Laughlin and Scott 1997, Gilardi 2002). This age of the regulatory state was further characterised by particular incentive-based instruments, most prominently, the periodically set ‘price cap’ (RPI-X).

Much has been said about the rise of regulatory agencies as a common feature across OECD and non-OECD states (Jordana et al. 2011), the institutional diversity in regulatory arrangements (Lodge and Stirton 2006), tensions and paradoxes of the regulatory state (Moran 2003; Black 2007; Lodge 2008) in general, and in utility regulation in particular (Helm and Tindall 2009; Lodge and Stern 2014). One further central theme has also been the question of legitimacy and accountability, given also the international and cross-sectoral criticisms of existing regulatory arrangements (Majone 1999; Scott 2000; Black 2008; Lodge and Stirton 2010).

In light of widespread concern with regulatory arrangements, especially in utility regulation, surprisingly little attention has been paid to distinct procedural innovations that have been identified as potentially transforming the regulatory state. This paper focuses on one such innovation: customer engagement in economic regulation as practised in UK water regulation. Customer engagement has been a policy theme that has been gaining increasing traction across regulated sectors, involving water, airports, and energy in particular, and has gained considerable attention in the world of practice (CAA 2005; Littlechild 2008, 2014; UKWIR 2015). Such engagement goes beyond the traditional channels of customer representation and consultation and requires regulated companies to engage directly with customers’ views, affecting, for example, the price companies will be able to charge. Such a process might be seen as a variant to ‘negotiated settlements’ in which key regulatory decisions are taken through direct negotiations between customer bodies and regulated firms, rather than by expert regulators.<sup>1</sup> Such forms of engagement, therefore, could be argued to directly contradict the core orthodoxies of the regulatory state with its emphasis on reduced administrative discretion, predictability and disciplined regulatory expertise. In addition, it could be said to represent a novel type of approach towards enhancing

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<sup>1</sup> As examples of negotiated settlements in utilities regulation in the US and Canada show, these arrangements may lack any formal arrangement between negotiated partners other than the agreement the involved parties come to at the end (see Doucet and Littlechild 2009; Littlechild 2009b).

participation in the rate setting process, thereby addressing wider legitimacy and accountability concerns.

The rise of consumer engagement-type processes across utility sectors, therefore, offers scope to explore sources of innovation (the introduction of customer engagement processes) and their potentially transformative impact on the regulatory state more generally. This paper's focus on water in UK economic regulation represents a critical case due to the trend setting quality of UK utilities regulation from an international perspective (see Alexande 2014; Gassner and Pushak 2014; Mirrlees-Black 2014). Water regulation in the UK represents one utility sector where the movement towards customer engagement has been particularly pronounced. There has also been considerable variety in the ways in which this shift has been implemented – in Scotland, on the one hand, and England and Wales on the other. Should, regardless of the institutional diversity, common patterns across the different UK jurisdictions be found, then there is a stronger case for the argument that customer engagement processes amount to a 'transformation' of the regulatory state more broadly.

The rest of this paper proceeds as follows. Firstly, it sets out the analytical framework to assess different motives for the introduction of customer engagement processes and different orders of change associated with regulatory innovation. The second part offers a brief chronology of the customer engagement processes in the two regions of the UK. The paper then considers the motives for this interest in customer engagement, before assessing the order of change.

The evidence base rests on documentary analysis as well as 24 interview transcripts and a series of 19 interviews with 25 key participants (both conducted on the basis of informed consent and abiding by the Chatham House rule, i.e. non-attributability and confidentiality). Interviewees were selected due to their direct or institutional participation in the different regulatory experiences. The interviews were conducted by the authors at the conclusion of the Scottish, English and Welsh experience. The transcripts documented conversations conducted by a consultant – Stephen Littlechild – at different stages of the Scottish process (the findings are presented in Littlechild 2014). Again, these involved participants directly engaged in the Scottish processes. Access to this material was granted with the consent of the interviewees; original interviewees were contacted by a former secondee to the Customer Forum process and only those interview transcripts where consent had been granted were transferred to the authors of this paper. Overall, these interviews provide insights from key participants at different stages of the Scottish process as well as *ex post* perspectives from both Scottish and English/Welsh participants.

### **Assessing dynamics and orders of change in the regulatory state**

While customer engagement processes in UK economic regulation were widely seen as innovative departures from existing arrangements, such processes are hardly a

novel concept in other spheres of public policy. Ideas about customer engagement range from those that emphasise consumer rights and representation, stakeholder engagement with government and regulators (through consultative processes or the existence of particular committees), to fora encouraging citizen participation and deliberation, such as in the siting of large industrial facilities or the licensing of new technologies. Debates about introducing stakeholder understandings into the theory and practice of utility regulation have also been a recurring feature in the (legal) literature (Prosser 1999, 2005). It thus might be claimed that utility regulation as practised in UK was catching up with regulatory experiences in other sectors and jurisdictions that had already moved towards engagement processes and away from ‘command and control’. The wider literature on engagement processes draws on a range of strains.

One distinct strain of literature draws on ‘bottom-up’ implementation by emphasising processes in which involved parties develop problem-solving approaches in conjunction with local level officials. Similarly, the early 1970s saw the rise of ‘alternative law making processes’ in which citizens supported, if not developed local planning processes. Such developments enjoyed particular prominence in local governance processes (Bressers et al. 2011; Chapman and Lowndes 2014; Dickinson and Sullivan 2014; Elgin 2015).<sup>2</sup>

A second strain in the literature on consumer engagement has focused on ‘alternative rule making’. The US 1990 Alternative Rulemaking Act generated considerable interest in the literature (under the ‘reg neg’ label, drawing on the wider interest in alternative dispute systems). One of the key attractions of negotiated settlements or rule making was the potential reduction in transaction costs, the enhanced legitimacy of decisions, and the reduced likelihood of court challenges (Susskind and McMahon 1985). Empirical studies, however, cast doubt on these supposed advantages of ‘reg neg’ (Coglianese 1997). Others suggested that ‘reg neg’ mostly supported consensual rather than optimal outcomes (Rose-Ackerman 1994).

A third strain in the literature stresses the importance of regulatory agencies and other state actors in engaging and incorporating local actors in their decision making. According to ideas of ‘democratic experimentalism’, local actors directly engage over policy decisions within frameworks set by administrative agencies. Such processes allow for decentralised and legitimate decision making and are said to achieve higher problem solving capacity than ‘command and control’ and hierarchical decision making. Ideas about governance representing a form of ‘experimentalism’ have emerged in a variety of contexts, such as EU governance, health & safety and environmental regulation (see Dorf and Sabel 1998; Lobel 2004; Sabel and Simon 2011). Elsewhere, there has been increasing interest in the utilisation of non-state actors in relation to responsive regulatory strategies, especially in enforcement (Gunningham et al. 1998).

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<sup>2</sup> More recently, this idea has witnessed further interest, in the German-speaking world as part of ‘Bürgergutachten’, namely guided processes in which randomly selected citizens deliberate over particular projects, <<http://www.buergergutachten.com/uebersicht/>>

Fourthly, there is literature that has focused on direct engagement processes and negotiated settlements in North American utility regulation (Doucet and Littlechild 2009; Littlechild 2008, 2009). It is this strain in particular that influenced the debates in UK utility regulation, largely due to the entrepreneurship of Stephen Littlechild. There appears to have been no direct utilisation or even awareness of the other strains among the key participants.

The first three strains of literature in particular would suggest that the regulatory state as defined earlier has moved towards a more ‘participatory’ era – and that either our conception of the regulatory state is outdated or that it reflects on the ‘outdated’ practices of UK economic regulation. However, the literature on economic regulation continues to emphasise the themes of econocratic, ‘high discipline’ and low discretion regulation. In other words, should we observe a transformation in the regulated sectors discussed in this paper, then it could be argued that this transformation brings economic regulation closer to the kind of regulatory processes experienced in other sectors.

For customer engagement processes to challenge and transform existing orthodoxies of the regulatory state, especially in the context of UK utility regulation, requires the presence of two conditions: firstly, that the observed changes are driven by similar causes and, secondly, that the observed innovations alter rather than reinforce existing logics. If it can be argued that there is a common motive for moving towards customer engagement in price reviews across the two jurisdictions under scrutiny, then there are grounds to suspect more than just ad hoc adaptation within the existing broad parameters of the regulatory state. To explore potential common sources for regulatory innovation, this paper draws on four explanatory approaches: disappointment effects, changing interest constellations, ideational change and, finally, policy entrepreneurship (Hood 1994; Black 2005).

The paper focuses on different levels of change and the extent to which they can be associated with transformative regulatory innovation. If it can be established that the types of changes related to the introduction of customer engagement in the UK, even in their diverse application, amount to a reformulation of existing arrangements – for example, a move towards a less synoptic and ‘disciplined’, but more negotiated state – then there is scope to point to a transformative change.

Turning to approaches which explain innovation, firstly, *disappointment effects* emerge over time rather than as a response to one-off policy fiascos (Hood and Peters 2004). Accordingly, repeated attempts to trial particular problem-solving approaches in light of considerable side effects leads to growing disillusionment. Over time, this pent-up disappointment establishes the ground for a shift to another policy approach. Accordingly, we would expect innovation in the regulatory state to emerge as a result of repeated failures or disappointment effects.



Secondly, the search for a different approach might not only reflect the declining support with existing frameworks, but also the growing availability of alternative ideas and approaches (Blyth 2013). Such *ideas*-related arguments suggest that change reflects shifts in intellectual fashions. For example, views about the role of competition in regulated industries influence wider approaches towards the regulated incumbent; similarly, views about the ‘rationality’ of individual consumers are likely to influence views as to the role of consumer representation in regulation. As noted in the wider ‘politics of ideas’ literature, policy is embedded within an intellectual climate that advocates particular approaches rather than others, which highlights some elements of evidence rather than others. The growing appeal of alternative policy approaches that embed particular ideas hence facilitate change in policy settings and instruments (Hall 1989, 1993). Accordingly, we would expect innovation to reflect wider ideational shifts in approaches towards regulation, especially in terms of the value of participation in regulatory decision making.

Thirdly, arguments stressing the role of *interest constellations* highlight the importance of economic rents (Peltzman 1989). Supporters of existing arrangements are unlikely to insist on their continuation should this incur more costs than benefits. Such changes in the underlying costs and benefits of regulatory agencies may also have wider implications for involved interests. For example, the emergence of less stringently regulated substitutes may trigger regulatory change (Hammond and Knott 1988) as regulated parties demand a ‘level playing field’. Accordingly, innovation reflects changes to the underlying costs and benefits of regulated actors.

Fourthly, arguments pointing to *policy entrepreneurship* can be linked to two sub-strands in the literature. One is the claim that policy entrepreneurs are advancing their proposals continuously, waiting for the ‘policy windows’ to open and to place their pet proposals on the agenda (Kingdon 1984). Such policy windows open at times when politics, national moods and problems coincide. In other words, we would expect to observe both the presence of particular entrepreneurs and the presence of the conditions of such ‘windows’ in order to suggest that policy entrepreneurs drive regulatory innovation. Another approach in the literature points to entrepreneurship by regulatory agencies. Those agencies associated with a degree of autonomy, i.e. where their political environment granted discretion to shape their own jurisdiction, are therefore seen to innovate, in part to further advance their autonomy (see Carpenter 2001).

These approaches should not be viewed as mutually exclusive or fully exhaustive. However, each of these approaches accentuates certain mechanisms and has wider implications for the study of innovation in the regulatory state: For example, disappointment-related accounts point to largely endogenous processes of change, whereas the wider ideational climate or the presence of policy entrepreneurs points to the importance of exogenous factors in regulatory innovation.

Turning next to innovation and the potential overall transformative impact of customer engagement, it remains notoriously difficult to define ‘innovation’ as a

distinct form of change. The same holds for ‘transformation’. Regulatory innovation has previously been likened to novel solutions that are used to solve old or new problems (Black 2005: 4). It remains a perennial question as to whether something needs to be entirely ‘new’ to count as innovation or whether it only needs to be new to a particular setting. Indeed, innovation might emerge as a result of combining two unrelated, but not necessarily novel approaches.

In short, innovation is the repeat adoption of novel ways of doing things; an innovation becomes a transformation if it represents a departure from existing standard operating procedures or objectives. Even small scale adaptations might amount, over time, to considerable innovation. Moreover, change is likely to generate outcomes that deviate considerably from initial intentions as actors exploit new opportunities, the wider environment changes, or different approaches interact in unpredictable ways (Teubner 1998). In other words, transformation emerges as a result of intended and unintended consequences.

What kind of innovation, then, is required to qualify as ‘transformation’? Black’s use of the Hall three-way categorisation of orders of change allows us to consider to what extent the different UK experiences with customer engagement might be regarded as an innovation in light of the wider logic of the regulatory state. We can distinguish between three orders of change – ‘paradigms’, policy frameworks, and policy settings’.<sup>3</sup> Policy paradigms are interpretive views of the world based on models of cause-and-effect relationships which are taken for granted in a policy community in a given period of time. Policy frameworks are specific institutional and organisational solutions in place to achieve policy goals, and policy settings refer to the specific tools and instruments that are used to fulfil policy objectives. Regulatory innovation can occur at all three orders. Wider transformative outcomes emerge, then, as a result of innovative alterations rather than changes in the paradigm order of policy trickling downwards in order to ensure consistency. Table 1 provides an overview of these orders of change and shows how each level of change relates to the key characteristics of the regulatory state, as defined earlier. In addition, Table 1 also identifies the kind of observable change that would qualify as innovation and, indeed, transformation at a particular order of policy.

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<sup>3</sup> This conceptualisation is not normative in that innovation is not inherently seen as ‘good’; its intention can be malevolent, and it can lead to unintended consequences and be unsuccessful.

**Table 1:** Orders of policy and the regulatory state

Order	Regulatory state	Type of change required to qualify as transformation
Paradigm	Efficiency as key consideration and justification	Move away towards other policy values (security of supply/fairness); for example, negotiated settlements based on values other than efficiency and conducted without intervention by a regulator.
Policy framework	Regulatory agency jurisdiction and direction, emphasis on 'non-majoritarian' character of decision-making, enforcement standards and information-gathering approaches	Sidelining or realigning of agencies' roles and jurisdiction, change in decision-making approaches regarding standards, information-gathering and enforcement. For example, negotiated settlements based efficiency consideration but without direct intervention by the regulator.
Policy setting	Setting of RPI-X after price review	Change in methodologies of calculation (such as the weighted average cost of capital (WACC))

### Customer engagement, the Customer Forum and Customer Challenge Groups

As noted, it was particularly the fourth strand of literature, advocacy and papers by Stephen Littlechild on US state-level utility regulation, that was put forward to advance customer engagement processes in England and Wales, and in Scotland. This section sets out the chronology of the two jurisdictions' customer engagement processes, which built on existing customer representation in water and wider customer-rights advocacy more generally.

Turning to Scotland first, the Customer Forum was created through a tripartite agreement including the economic regulator (WICS), the consumer representation body responsible for this sector (at that time, Consumer Focus Scotland), and the publicly owned incumbent, Scottish Water. The Customer Forum was to represent customers' preferences during the 2014 price review (see Cooperation Agreement,

Article 2.1).<sup>4</sup> WICS nominated two water industry representatives and one representative with a wider industry interest to the Forum. Consumer Focus Scotland nominated five members with a ‘strong customer-focused reputation’ (as stated in the initial Agreement (Schedule 1, 1.1.2)). Peter Peacock, whose background in Scottish local government and as member of the Scottish Parliament and minister in the Scottish government was to prove critical for guiding the process, was recruited as chair of the Forum. Table 2 outlines the chronology of the process.

**Table 2:** Chronology – Customer engagement in Scotland

September 2011	Customer Forum established through tri-partite Cooperation Agreement
October 2011	First meeting of the Customer Forum, followed by monthly meetings thereafter
15 October 2012	Letter from WICS extending the remit of the Forum
October 2012 -January 2014	WICS Notes 1-22 published
February 2014	Minute of Agreement (agreement on Business Plan between Scottish Water and the Customer Forum)
March 2014	WICS Draft Determination published
April 2014	WICS initial deadline for agreement on Business Plan between Scottish Water and Customer Forum

The Customer Forum’s involvement in the regulatory process expanded considerably after its creation. During the process, the Customer Forum evolved into a de facto negotiating partner of Scottish Water in agreeing its business plan during the price review. The involved actors developed a clear understanding of this arrangement as the process went on, and the WICS Chief Executive confirmed this formerly in a letter to the Chair of the Customer Forum on 15 October 2012 by inviting him to ‘to seek to agree by April 2014 a Business Plan for delivery by Scottish Water in 2015–20 [*Note: subsequently changed to 2021*]. Such a Business Plan should be fully consistent with Ministerial Objectives and with the views and ranges that the Commission will set out in notes and papers over the period to early 2014’ (WICS 2014: 70f). From October 2012 onwards, WICS supplied the Customer Forum members with 22 ‘notes’ (usually of around 2–4 pages) that included technical background information and provided advice to the Forum on proposals by Scottish

<sup>4</sup> See Cooperation Agreement, Article 2.1  
<http://www.watercommission.co.uk/UserFiles/Documents/11102011%20-%20Cooperation%20agreement%20WICS%20SW%20CF.pdf> Accessed 23 April 2016.

Water. WICS expected the agreement between the Customer Forum and Scottish Water to be fully in line with these notes unless there were ‘demonstrable reasons’ for not doing so.

Furthermore, while the process involved regular sessions between the Customer Forum members and Scottish Water, the process was supported by frequent bilateral and trilateral discussions between three key individuals, namely, the Chief Executive of WICS, the Chief Executive of Scottish Water, and the Chair of the Customer Forum.

Participants of the Scottish processes agreed that the Customer Forum played a highly effective role in challenging Scottish Water and in influencing the final business plan (also Littlechild 2014; Customer Forum 2015). Three areas were commonly identified in which the Forum was said to have been particularly influential: firstly, the language and framing of the business plan was said to have changed from highly technical to being more readily understandable to a lay audience. Secondly, Scottish Water switched its use of the Retail Price Index (RPI) to the Consumer Price Index (CPI) which was seen as more meaningful to customers but also reflected related moves in the UK. Lastly, participants – including Scottish Water – suggested that the agreed price cap of CPI-1.8 over the period 2015–2021 had gone beyond all expectations, and, most of all, had been tougher than WICS had regarded as feasible at the outset of the process. Given this outcome, and despite some earlier concerns about statutory responsibilities within the water regulator, WICS accepted the entirety of the negotiated business plan in its Draft Determination.

**Table 3:** Chronology – Customer engagement in England and Wales

August 2011	Ofwat publishes policy statement on customer engagement (introduction of the Customer Challenge Group concept)
January-November 2012	Formation and first meetings of Customer Challenge Groups (CCGs) in each company
February 2012	Customer Advisory Panel established
January 2012-November 2013	CCGs challenge their companies in respect to their customer research and business plan
December 2013	CCGs submit their report on their companies’ customer engagement and its reflection in the business plan to Ofwat Water companies submit business plans to Ofwat
April 2014	Ofwat publishes result of risk-based review including decisions on enhanced status and satisfaction with customer engagement of each company
August 2014	Ofwat’s Draft Determinations published
December 2014	Ofwat’s Final Determinations published

The water sector in England and Wales witnessed a different kind of customer engagement process and were not granted the same remit as the Customer Forum in Scotland (see Table 3 for chronology). The responsible (economic) regulator, Ofwat, created a customer advice panel for considering questions relating to its overall price review methodology, while also requiring each water company to set up a ‘customer challenge group’ (CCG) for the Price Review 2014. These groups built on so-called ‘Quadripartite Groups’ that had brought together regulators, company and the consumer body during the Price Review 2009. The customer challenge groups were situated at the company level, and were tasked to verify whether companies’ business plans were adequately informed by high quality customer research (Ofwat 2011, 2012). Other regulators were also directly involved in the customer challenge groups.

Ofwat provided direction to companies at the beginning of the process, especially in relation to the composition and remit of CCGs (one aspect being to encourage firms to seek challenge group chairpersons from outside the existing customer representation universe). Once groups had been set up, Ofwat did not provide detailed or bespoke guidance to the different challenge groups. One reason for this was that the groups were to be ‘owned’ by their company rather than the regulator. Another justification was that individual engagement processes could have been stifled by too much direction being given by the regulator: Ofwat argued that companies tended to be too attentive to the regulator to the detriment of their customers. Moreover, detailed company-specific guidance comparable to WICS Notes would have required a large resource commitment on the part of Ofwat in the context of 18 water companies in England and Wales. Finally, the differences in remit (to Scotland) were justified by highlighting the mostly private ownership structure in England and Wales (based on interview material).

As a result, the CCGs varied considerably in their organisational structures and their members. While some water companies put their CCGs on a highly formalised footing (including timetables and deadlines), others allowed their CCG processes to develop in a less structured way. There were also considerable differences in the agendas that different CCGs pursued (straying into the territory occupied by Ofwat) and in the recruitment of chairpersons. It had been Ofwat’s (implicit) intention to sideline existing customer representatives, i.e. CCWater, by emphasising the importance of ‘independent’ chairs, i.e. independent from the firm, politics, regulators *and* customer advocacy groups (based on interview material). Nevertheless, some companies chose to appoint their chair from CCWater, others recruited ‘independent’ chairpersons for their group. In contrast to Scotland, CCGs included members from the other regulators (the Environment Agency and the Drinking Water Inspectorate) as mandated by Ofwat. More generally, membership varied across different groups, although CCGs usually consisted of a mix of private business representatives and owners, local authorities and charities. Many CCGs also included paid consultants at various points throughout the process (for an account of these differences, see CCWater 2014; UKWIR 2015).

Ofwat's decentralisation approach to customer engagement – and the subsequent variations in which water companies organised their CCGs – had the effect that the CCGs focused on different issues in their reports on companies' business plans. Many CCGs perceived themselves to have had crucial impacts on their company's business plan, including the lowering of prices through further efficiencies. However, Ofwat disputed the strength of the evidence of satisfactory customer engagement in 9 of 18 of the initial risk-based reviews of business plans and CCG reports (see, for example, Ofwat 2014b: 13f). Ofwat's subsequent request for Business Plans to show more clearly how they had been informed by customers' views resulted in frustration on the part of CCGs and water companies due to the perception that a lot of time and effort had been spent 'for nothing' during the CCG process. Ofwat, however, concluded that not all CCGs had the necessary independence (from firms) and expert capacity to challenge companies (interview material). Although all involved actors evaluated the process as having succeeded in forcing companies to consider their responsiveness to their customers, no one suggested that it was a resounding success.

Overall, the move towards customer engagement with the regulated firm can be regarded as more than a mere symbolic gesture as considerable effort was expended and the experience signified a major departure from earlier experiences in both jurisdictions. At the same time, there was a marked difference for the Scottish model not only in the institutional arrangements governing the process and the extent to which price-setting powers were de facto delegated to a customer body, but also the perceived impact the groups had on the outcome. While WICS was supposedly surprised by the extent to which the Customer Forum was able to challenge Scottish Water on price, Ofwat largely perceived the CCGs as not having been 'tough enough' on their companies. WICS played a central orchestrating role, establishing the central parameters within the early stages of the process. Ofwat was criticised for establishing too few parameters and not guiding the process sufficiently. This emerged clearly from all interviews (also see CCWater 2014; Ofwat 2014a; UKWIR 2015).

### **Why more customer engagement?**

The emergence of customer engagement, not just in water, can be seen as a result of widespread *disappointment* with existing technologies of economic regulation, most of all the price review process and the manner in which the use of the RPI-X methodology had developed, which resulted in tediously complex and long price review processes. A sense of exhaustion with an existing approach was shared across both jurisdictions of interest here and reflected a broader consensus in the UK economic regulation community. Interviewees (in both jurisdictions) argued that the price review process had become extremely complex and lengthy, leading regulator and regulated to be pre-occupied with gaming each other. Companies were accused of focusing on and being responsive to regulators rather than customers.

In the Scottish case, disappointment with the regulator-led RPI-X model for price reviews was further enhanced by large disagreements about the ‘right’ price cap between Scottish Water, WICS and the customer body. This was partially the result from the perceived gaming on the part of Scottish Water during the same round of price reviews, and the resulting confrontational nature of the process (for example, see Hobson 2005). The difficulties during the 2004 price review culminated in the departure of the then chair of Scottish Water due to disagreements with the Scottish Executive over the speed of delivery of water quality and environmental standards. Given the feeling that Scottish Water’s efficiency and performance had increased significantly after the 2009 price review process, it was felt that the ‘old model’ would not be able to challenge Scottish Water sufficiently during the next price review, precisely because the previous price review processes had been very successful in rendering Scottish Water a much more specific company. Disappointment was hence a result not only of the model’s unintended consequences and undesirable effects, but also a consequence of its very success in incentivising Scottish Water to improve its performance. Scottish Water was said to have witnessed a period of significant performance improvement following its creation in 2002 by merging three water authorities. It was argued that the RPI-X formula, and benchmarking with English companies, had achieved considerable efficiency gains, but that this approach had reached a dead end, partly because of the ability of different parties to game the system, partly because of the adversarial relationship between regulator and company, and partly because of the actual performance improvements (for example, cf. Sutherland 2011). In addition, WICS considered that the production of a highly technical, seven-volume draft determination in previous price reviews impeded the engagement of customer representation bodies and the general public. WICS hence saw the idea of customer engagement as an attractive way of changing the challenges on Scottish Water, thereby overcoming the sense of ‘exhaustion’ with previous approaches:

The scale of Scottish Water’s improvement means we can no longer rely on benchmarking comparisons – the gaps are just too small to draw definitive conclusions. ... We are moving to the Cold War End Game – a case of trust but verify. This explains our change to the role of the Reporter.

(Sutherland 2011)

In the case of England and Wales, the perception of dissatisfaction with the performance of water companies was driven by the regulatory view that the methodology used in price reviews was not stretching companies and that companies were not sufficiently attempting to innovate and to ‘aim higher’ in their performance than regulatory standards demanded of them (for example, see Ofwat 2013: 3ff). A review of Ofwat’s practices (Gray Review) also pointed out the need for businesses to take ownership of their decisions, while clearly allocating responsibility to Ofwat in encouraging this behaviour:



The more Ofwat demands, the more the companies want to provide, in order to ensure Ofwat accepts their business plans. [...] The end-result is a loss of “ownership” of business plans by companies.

(Defra 2011: 27)

Ofwat saw customer engagement as a means of providing a different kind of challenge to companies as it would require them not only to fulfil regulatory requirements but also to reflect customers’ views in their business plans. This was seen as a means of encouraging innovation at the level of the regulated firm. Other changes to the price review methodology were designed to allow for more flexibility in companies’ business plans and regulatory decision making in order to avoid the type of regulatory box ticking referred to above (Ofwat 2013).

In many ways, enhanced customer engagement in England and Wales was introduced as a means to break this established dynamic between the regulator and the water companies. Other than in Scotland, however, the disappointment with the established model was not just a result of internal considerations of the regulator, but also had an external dimension driven by the Gray Review. Furthermore, the rise of customer engagement was also a response to frustration with existing customer representation arrangements, especially as Ofwat saw CCWater as being too close to firms and lacking interest in sustained engagement with regulatory decision making. In short, innovation in terms of introducing different types of customer engagement processes into water regulation did reflect a widely shared sense that existing methodologies and arrangements had worn out or had been worn down.

However, disappointment alone cannot explain why particular forms of customer engagement processes emerged in England and Wales on the one hand, and Scotland on the other. These initiatives were the result of distinct *policy entrepreneurship*. In the case of Scotland, a number of entrepreneurs can be distinguished. The apparent success of the Customer Forum process was a result of a strong commitment on the part of the chief executives of WICS and Scottish Water, as well as the chair of the Customer Forum. At the outset and throughout the process, a key role was played by Stephen Littlechild. In his papers (for example, Doucet and Littlechild 2006, 2009; Littlechild 2008, 2009, 2009c), Littlechild had praised the flexibility customer engagement and negotiated settlements could bring to price reviews, whilst also relieving the regulator of the ‘burden’ of having to represent what the customers wanted. He also emphasised that such processes had resulted in an improvement of relationships between customers, companies and regulators. A negotiated settlement would also have the potential to trigger a more serious effort by the company to meet regulatory demands as these would effectively be the result of ownership of the agreement. Littlechild’s advocacy and papers introduced the (then) Chairman of WICS (Sir Ian Byatt) to ideas about negotiated settlements.<sup>5</sup> The suggestion of a particular solution by a policy entrepreneur (customer engagement as advocated by

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<sup>5</sup> Interviewees thought this happened in 2008 or 2009.

Stephen Littlechild) coincided with the identification of a problem and search for a solution on the part of WICS in 2010 (cf. WICS 2013a). As a ‘policy entrepreneur’, Littlechild put the idea for a ‘new way of doing things’ onto the agenda.

According to interviewees, there was no initial consensus on the establishment of such a body among the three key parties but it emerged as a solution which provided all three parties with sufficient reassurances. At the time of initial discussions about the creation of the Forum, Scottish Water had already begun its internal strategy of prioritising the idea of ‘listening to the customer’ in order to attain the goal of becoming ‘Scotland’s most valued and trusted company’ (Scottish Water 2009: 2) – an idea that also received political support from the Scottish nationalist government which subsequently also sought to back the Customer Forum approach as exportable to other jurisdictions. Therefore, the idea of a Customer Forum conveniently overlapped with the company’s own public relations strategy, which was seen as reinforcing the company’s acceptance of a change in regulatory approach. Moreover, in contrast to the incumbent consumer advocate organisation at the time – Waterwatch – the organisation that took over in 2011 (Consumer Focus Scotland) had a clear commitment to the concept of the Customer Forum.

The degree to which decision making was delegated to the customer body in the Scottish case can, however, only be understood as a result of the entrepreneurship by the chief executive of WICS (cf. Carpenter 2001). WICS’ chief executive enjoyed considerable autonomy to drive innovation as a result of several factors: WICS had built a reputation of ‘getting the job’ done in terms of overseeing large efficiency gains by Scottish Water. This operational improvement occurred under the helm of the same chairperson throughout its existence. This degree of granted autonomy was under challenge only once, namely when the membership of the WICS board changed and incoming Commissioners displayed scepticism about the degree of delegation of regulatory competencies to the Customer Forum (interview material). Furthermore, WICS benefitted from the relatively circumscribed and consensus-driven political environment of Scotland. Additionally, it regulated one publicly owned firm; as a result, its main consideration was to ensure support from the Scottish government rather than from private investors.

This represented a marked difference to the English and Welsh context in which private investors had to be reassured about the new customer engagement model by Ofwat and their companies. Similarly to Scotland, company support for ‘more’ customer engagement was also present in England and Wales. Here, however, the argument was made that the regulator, rather than firms, had not taken customers’ priorities seriously enough (Defra 2011). Once regulators had assured companies and investors that customer engagement processes were unlikely to pose an unpredictable regulatory risk, resistance of the regulated companies to customer engagement was unlikely.

In contrast to the Scottish case, however, Ofwat’s leadership decided that a similar degree of discretion and institutional design as in Scotland was not feasible in the

context of diverse ownership patterns across 18 companies in England and Wales. Instead, Ofwat relied on the predecessor model of the CCGs (the quadripartite groups, as noted above). It also had a (less positive) perception of the companies' performance. Furthermore, the political context of England and Wales posed further constraints. The introduction of CCGs is attributable to Ofwat's leadership being keen on tackling the 'box ticking' of regulated companies by taking them 'outside their comfort zone' (based on interview material). Customer engagement processes were seen as one aspect of this strategy even though initially this view was not shared across Ofwat (interview material).

Emphasising the role of bureaucratic and policy entrepreneurs also suggests that consumer engagement seems to have become an *idea* whose time had come. Customer engagement processes had been trialled across a number of UK sectors before, especially in airport regulation. While the actual results of these processes were seen as mixed, there was continued enthusiasm for 'more' customer engagement, backed by the view that the issue of 'affordability' of utility prices had high political salience. (Indeed, during the 2014 general election major parties committed to energy prices remaining 'as low as possible' or be 'frozen'.) Customer engagement offered a common language that appealed to multiple (possibly contradictory) motives. For those interested in reducing regulatory oversight, customer engagement offered one way to shift the attention of regulated companies away from regulators and towards 'consumers'. For others, customer engagement justified changes in the way engagement with consumer representatives was organised.

In the wider context, there had been considerable cuts to consumer representation bodies in the UK due to the political commitment to cutting public expenditure that emerged after the 2010 general election. Moreover, in the area of regulated utilities, regulators were dissatisfied with existing consumer representation bodies due to being seen as ill-equipped in offering informed input into price reviews and other regulatory decisions. Calling for customer representation at the company level was therefore an ideal way for regulators in the UK to reduce the role of other means of consumer representation. For others, especially companies, customer engagement offered a way to find sources of information so as to reduce political pressure regarding their legitimacy and business model. Finally, there was little evidence to point to changing *interest constellations*. Change in terms of innovation of the role in which regulated firms engaged with customer groups did not emerge from wider changes in the environment of regulated firms that had depleted or threatened their economic rents.

In sum, the rise of customer engagement emerged as a product of multiple sources, nevertheless revealing some joint concerns. In England and Wales as well as Scotland, customer engagement reflected successful policy as well as bureaucratic entrepreneurship by certain actors. The perceived disappointment and exhaustion with existing regulatory approaches and experiences on part of regulators gave rise to the search for 'new' ideas, and the advocacy of customer engagement processes offered a useful 'solution'. Disappointment with the previous approach was closely tied to

disappointment with key arrangements of the regulatory state (such as the role of the regulator in price reviews) in both jurisdictions. This was partially a result of the very success of these models in incentivising firms to the extent that regulators felt a novel approach was needed to surpass these already achieved successes. It was also partially fuelled by the perception that price reviews had become excessively long, complex and adversarial. The move towards enhanced customer engagement added novel aspects to existing arrangements; whether this degree of innovative practice points to a potential transformative change is considered in the next section.

### **Transformation in the regulatory state?**

As noted, customer engagement in UK water regulation represented a considerable departure from previous price reviews. In the Scottish case, participants hailed the experience as ‘innovative’ – less enthusiasm was expressed in the case of England and Wales (Littlechild 2014; Ockenden 2014; Customer Forum 2015). Nevertheless, in both cases, customer engagement processes were seen as significant and indicative of a future, albeit undetermined way of regulating. What, then, might be considered as transformative about customer engagement across the three levels of regulatory change identified earlier? The following concentrates on changes at the second and third order. i.e. paradigm and policy framework level.

At the level of *paradigm*, either process led to fundamental departures in the way in which economic regulation was understood. In the Scottish case, the substantive grounds of the negotiation – the company’s business plan – and the eventual agreement might be characterised as having features of a negotiated settlement. However, these negotiations continued to be shaped by the traditional concerns that characterise the ‘orthodox’ regulatory state: the Customer Forum may have changed Scottish Water’s and the regulator’s ways of communicating, but these changes did take place within the broad context of regulatory concern with efficiency. Furthermore, the Customer Forum process was designed to ensure ‘credible commitment’. The initial agreement, informal commitments, the close inter-personal connections among key participants, and the so-called ‘tramlines’ that featured in the concluding agreement were all geared towards granting Scottish Water (and its ‘owner’, the Scottish government) a degree of reassurance.<sup>6</sup> These issues played less of a role in the case of Ofwat, where credible commitment was signalled by limiting the scope of discretion from the outset, and by maintaining its strong ex-post control function.

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<sup>6</sup> The ‘tramlines’ were agreed performance indicators. Should indicators move beyond particular parameters, then there was the possibility to revise the agreed commitments. The monitoring of these performance indicators was to be conducted by the (successor to the) Customer Forum.

**Table 4:** Overview of drivers and extent of change

	<b>Scotland</b>	<b>England and Wales</b>
<b>Drivers of change</b>	Internally driven disappointment with old model (gaming and relationship with regulatee);  Policy entrepreneurship of key individuals	Internally and externally driven disappointment with old model (lack of ownership of business plans);  Incremental development of previous engagement model
<b>Extent of innovation</b>	Tri-partite agreement Quasi negotiated settlement BUT  Regulator’s intervention through guidance Notes	Initial withdrawal on part of regulator BUT  Ex-post intervention of regulator

Focusing on the level of *policy framework* offers arguably more scope to suggest that the Customer Forum and the CCGs were innovative *and* transformative. It established consumer representation type processes within regulated firms, used different methodologies and altered the role of regulators. Both English and Scottish strategies reflected an innovation by establishing a direct relationship between customer representatives and regulated company. In Scotland, the direct negotiations meant that the regulator, WICS, no longer directly (at least formally) engaged with the water company. Furthermore, the Scottish Customer Form did not make use of the RPI-X methodologies to determine the kind of water charges that could be imposed on Scottish Water. Instead, the focus was on ‘what the customer wants’, thereby questioning Scottish Water’s business approach rather than engaging in methodological battles over complex calculations and assumptions.

Moreover, the direct engagement process also challenged a further policy framework aspect of the regulatory state, namely, its emphasis on codification. The Scottish experience in particular was characterised by very close and informal relationships between the chair of the Customer Forum, the chief executive of WICS and the chief executive of Scottish Water (somewhat akin to the tradition of ‘club government’ that used to characterise British regulation, see Moran 2003). Equally, the ‘drift’ towards more extensive powers was facilitated by means of a letter rather than any changes in statutory basis although, arguably, the continued existence of formal provisions presented the water utility with safeguards against too far-reaching discretionary activities by the Customer Forum. Similarly, the CCG process enabled the formulation of business plans that were primarily based on customers’ preferences, rather than the regulator’s thinking. And equally, whether this was the case and was verified by CCGs in the first instance, rather than the economic regulator. Companies had to consider how to respond effectively to customers’ preferences and were also

held to account to demonstrate their responsiveness by the CCGs. As a result, justifiability of any measure in front of CCGs became a benchmark for companies' positions.

Furthermore, customer engagement processes amounted to an *altered* role of the regulators during the price review as WICS still played a central role in the process and its technical expertise was required to support the work of the Customer Forum. The various notes issued by WICS to assist the Customer Forum were based on the conclusions the regulator had come to on the basis of technical modelling (for example, see WICS 2012: 2). The notes hence provided the Customer Forum with bespoke and focused advice and contextual information. In doing so, WICS not only explained technically complex regulatory issues to the 'lay' Customer Forum, but also provided very clear directions to the Forum as to which demands it 'may wish to' place on Scottish Water in the succinct conclusions of its notes, as exemplified in the following excerpt:

Growth is an area where the Customer Forum should focus its attention. There is scope to increase the estimate of the level of growth in new household connections. At the same time, the proposed revenue profile expected from the non-household sector may be too optimistic.

(WICS 2013b: 5)

In other words, far from removing the regulator from the process, WICS maintained a central role in this process by supporting the Customer Forum. While it is difficult to measure the exact influence of the WICS guidance notes, they provided an explicit 'corridor' within which negotiations could take place since WICS had clearly stated that it expected the agreement between Customer Forum and Scottish Water to reflect them.

In contrast to the ongoing central backstage role played by WICS, Ofwat relied on the different customer challenge groups' deliberations. The provision of direct advice to each challenge group would have proven too resource-intensive for Ofwat and would have confused jurisdictions as the regulator would have provided information to groups that were formally established by and within the regulated companies. It was also feared that this would lead to potential accusations of bias and asymmetric attention across companies (interview material). While Ofwat's strategy was supposed to encourage diversity in the way customer groups engaged with companies, the absence of focused guidance was a crucial factor in the relative lack of 'success' of the CCGs since CCGs reportedly found it difficult to challenge their companies in the absence of more focused expert guidance from Ofwat (CCWater 2014; Ofwat 2014a; 2015: 21; UKWIR, 2015; this is also very clearly reflected in the interview material). This lack of bespoke advice was compounded by an infrequent information exchange across customer challenge groups, even though membership in some cases overlapped. Apart from the final meeting of Ofwat's customer advice group, there was no interaction between Ofwat's own and the companies' consumer engagement

groups. Overall, the evaluation of business plans without technical expertise or expert guidance was perceived as problematic by participants.

Ofwat nevertheless continued to play a central role in the final determination of the price review process, not least because it did not accept 9 out of 18 of the CCGs' initial interpretations of their companies' business plans in its risk-based reviews. This variation across CCGs can at least in part be attributed to whether the chair of a given CCG was regarded by Ofwat as sufficiently independent from the water company and CCWater, and to the extent to which the water company had formalised its CCG process (CCWater 2014). Overall, however, the lack of necessary expert capacity and independence from their companies was a key reason for Ofwat to intervene with customer engagement issues in its risk-based reviews. The extent of *ex post* criticism highlights the continuing centrality of regulatory agencies and their thinking in existing customer engagement processes in the English and Welsh case.

In conclusion, is there evidence of 'transformation'? Neither of the two processes altered the fundamental regulatory framework in any formal sense – procedural innovations occurred within the set statutory provisions. Nor did either of the two processes fundamentally reduce the role of the regulator: both regulatory bodies continued to play central roles, WICS played a central orchestrating role throughout, Ofwat especially at the *ex post* stage. Individual policy settings did change, such as the move from RPI to CPI in Scotland, and companies were said to have become more responsive to customer rather than regulatory requirements. Both processes were a response to extensive disappointment with existing approaches and were said to have encouraged regulated companies to engage more responsively with consumer issues. They represented innovation in *altering* the role of regulatory bodies and drawing in customer representatives directly into the regulatory process rather than limiting them to complaints handling and policy advocacy, for example through the submission of responses to consultations. However, the underlying principles of the regulatory state were not transformed.

The continued centrality of the regulators means that we should not be surprised if enhanced customer engagement processes turn out to have similar consequences as more regulator-led price review models. These would include gaming and adversarial relationships, ironically, exactly the side effects that regulators are trying to escape and a worry identified by Ofwat in relation to providing more guidance to Customer Challenge Groups (see Ofwat 2015: 21). Finally, the transformative potential of the customer engagement process might also be worn down rather quickly. It is uncertain whether a process that was put in place to challenge regulated companies differently will be able to do just that if it were to be used for a second time. Indeed, participants in England suggested that they would prove less enthusiastic if Ofwat continued to prove so reluctant in delegating competencies. Overall, while the observed patterns do not suggest paradigm changes, consumer engagement in water regulation did generate a degree of innovation at the policy-setting level with potentially wider transformative implications at the level of policy framework, namely, in the form of an altered role for regulatory agencies.

## Conclusion

The British regulatory state has, for some, proven successful, for others, the drive for ever ‘deeper’ synoptic control that denies informality and discretion sits uneasily with political processes (Lodge and Stern 2014; Moran 2003). For others, again, there are fundamental legitimacy concerns involving the growing significance of regulators. The rise of customer engagement in economic regulation, especially in water, challenges all three of these views. Firstly, it highlights a shared dissatisfaction with and exhaustion of one of the key instruments of the ‘orthodoxy’, namely incentive-based price capping. These frustrations did not result from outright failure or scandal, but emerged endogenously from within the wider regulatory community due to a concern with the growing costs and complexities of regulating utilities and the sense of widespread gaming.

Secondly, customer engagement reflects an instrument that appears far from the kind of regulatory technique associated with the regulatory state as it seemingly replaces econocratic expertise with varying forms of customer representation. However, the two cases of customer engagement provide a different picture, in which customer engagement co-exists with continued use of econocratic expertise. Indeed, the continued orchestration of that expertise throughout the Scottish Customer Forum experience offered one key ingredient to this perceived success story. In contrast, Ofwat could not offer similar bespoke and informal backstage support to its regulated companies. Customer engagement represented an innovation in that it altered the role of, and demands on regulators, and challenged regulated companies to engage differently to legitimise their business model, even if the implications of such innovations remained and remain ill-understood. Furthermore, customer engagement introduced its own side effects, such as concerns as to whether or how such processes trade-off short term price pressures with long term investment requirements, or issues as to the legitimacy and resourcefulness of the customer representatives themselves.

Thirdly, regardless of the interest in the literature on ‘neg reg’ and democratic experimentalism that note the increasing inclusion of local actors and other stakeholders in regulatory practices, the move towards customer engagement raises issues about the legitimacy of the regulatory state more generally that require further attention. The issue arises as customer engagement shifts attention from the traditional focus on regulators and customer representative bodies to direct negotiations involving sets of representatives and the regulated firms, orchestrated in one way or another by regulators.

In sum, customer engagement processes do challenge the orthodoxies of the regulatory state, but, as yet, it has not transformed the regulatory state, most of all, because regulatory agencies remain central in the process of customer engagement. This, however, does not imply mean that the observed changes reflect a reassertion of existing orthodoxies as the observed patterns suggest a complexification of regulatory



arrangements. Traditional concerns, whether it is about credible commitment, the calculation of regulated asset bases and other efficiency measures remain central. Other concerns, such as legitimisation, greater interest in customer responsiveness, and the importance of negotiation have assumed growing significance. In this respect, utility regulation seems to have inadvertently moved towards the kind of advocacy of ‘experimentalism’ that characterises other regulatory domains. In turn, this paper highlights the constraints in which such experimentalism can take place.

At one level, the increase in complexity suggests that innovation occurs at the policy-setting level that then trickle up to the policy framework level. This might not offer the same kind of dramatic systemic shocks that challenge policy paradigms. Nevertheless, it carries the potential for more widespread change in that existing institutional arrangements drift, are subverted or encounter ‘layering’ by additional objectives or procedures. At another level, consumer engagement adds to complexity in regulation. While consumer engagement may have avoided some of the traditional conflicts between economic regulators and the companies they regulate, the overall cost, in terms of hours invested, papers written, and discussions held, was nevertheless considerable. In fact, given that consumer engagement alters rather than reduces the role of economic regulators, the growing importance of mediation and ‘boundary spanning’ points to the increasingly complex role that regulators are expected to play. More generally, the observed complexification suggests an increased blurring of roles and responsibilities.

Finally, adding consumer engagement to the regulatory process raises further questions that centrally affect the role of the individual citizen in the relationship between state and market. While it may be seen to increase the legitimacy of regulated public services in the short run, whether such processes are effective in areas of entrenched conflict or where there are trade-offs between short and long term objectives, remains questionable (cf. the empirical results of Fremeth et al. 2014). In other words, by engaging customer representatives with the regulated firm directly, customer engagement processes offered a new layer of debates about the legitimacy of regulating.

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