Proposed rule changes: preliminary observations

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Inevitable biases require checks and balances

- Reiteration of points made in ACCC paper (Yarrow, 2011).
- There are two monopolies, not one; each with its own 'biases'.
- The Regulator is part of the system, not a *deus ex machina.*
- Biases of regulators?
  - Political influences: 'Prices are increasing, something must be done, this is something, therefore we should do this.' Economic logic: overall price movements are likely to be poor signals of defects in rules, since such movements are a function of many factors.
  - Bureaucratic influences: power, control, meddling.
  - Capture.
- Biases vary depending upon the historical context. Political influences tend to increase in periods of rate shock.
- Good regulatory systems recognise these things, and are designed to mitigate biases (achieve balanced outcomes).

“Aiming off”

- Good regulatory systems tend to ‘aim off’ a little: expected rate of return = cost of capital plus a little.
- Various reasons:
  - Klevorick, *The “Optimal” Fair Rate of Return*, Bell Journal, 1971.
  - Asymmetric effects (type I and type II ‘errors’): the costs of getting it wrong can be much greater if efficient companies are unable to achieve a rate of return that covers their capital costs.
  - Bargaining effects: a participant in an agreement, bargain or compact who is always held ‘just at the margin of participation’ can be expected to be more opportunistic – there is nothing to lose.
  - Discovery and development: for similar reasons, a positive stake in the pie (= the total gains from trade) is good for encouraging contributions from regulated companies that increase the size of the pie (and thereby also benefit consumers, who will take most of the pie in effective regimes).

Propose/respond

- Given previous comments, there is nothing inherently wrong with propose/respond for opex and capex forecasts.
- Has obvious advantages in that it avoids a conflict over 'who owns the plans' – a conflict about the distribution of power which is rarely beneficial for economic performance and the long term interests of consumers.
- May be particularly helpful in the presence of public ownership, since conflicts over power tend to be greatest in public systems.
- It can be problematic if any resulting bias becomes disproportionate to other biases in the system (or if, although small, it is one of several, correlated biases that are collectively disproportionate).
- Evaluation of this is a matter of evidence.
- Disappointing paucity of evidence in a system whose legitimacy partly depends on its expertise in addressing complex issues.

Evaluation based on the little evidence that was available

- Suppose NSP forecast bias is large.
- Would then expect strong challenge from AER to proposals, and replacement of excessive expenditure plans with the AER's own forecasts.
- This is what the system is designed to do.
- Hard to square lack of AER action with substantial problems claimed to be associated with propose/respond.
- Could still be part of a 'collective' bias problem – 'mony a mickle maks a muckle' – but then great care is needed to look at matters as a whole, with the aim of restoring balance and of avoiding simple reversal of the aggregate bias.

Best available evidence?

- Best available evidence I came across was Littlechild and Mountain.
- Suggests that there may be problems that lead to unduly high prices, and suggests potential sources of such problems. Ends with questions not answers.
- Best available evidence was, therefore, still relatively remote from the question at hand: does propose/respond lead to a disproportionate upward bias in expenditure forecasts, and hence in rates/prices?
  - Evidence suggests upward NSW rate movements compared with GB both before and after 2006 reforms. No immediate correlation with the reforms themselves.
  - Victoria rates falling relative to GB, pointing to factors correlated with ownership arrangements, not to propose/respond.
- View? If there is a problem (not established on evidence presented), best suggestion in the submissions to date is that of Victoria DPI (issues to do with financial/ownership supervision of publicly owned NSPs).

Further points

- GB moving a little closer to propose/respond in the recent RIIO reforms (see 2011 ACCC paper again).
- Fast tracking (less regulatory supervision) in response to well developed business plans, including customer/consumer engagement in the development of plans.
- Part of a general (still modest, still slow) shift in UK regulation toward a less intrusive style that comes with many labels: ‘risk-based regulation’, ‘earned recognition’, ‘earned discretion’.
- See also the general importation into GB (from the EU) of notions of ‘proportionality’ [including in appeals, which may also be relevant to rules issues].
- Propose/respond implicitly incorporates notions of proportionality.

Capex incentives

- There is clearly a significant probability that efficient capex will exceed an unbiased forecast. To automatically disallow a fixed fraction of any excess (as proposed by the AER) therefore appears arbitrary and inappropriate.
- However, the fact that any inefficiently incurred expenditure can automatically be rolled in the RAB at the end of an investment period does indicate a weakness in the system of supervision and incentives, and that there is scope for improvement.
- My experience is that capex incentives only have prospect of success if (a) developed on a negotiated basis or the NSP has some choice (i.e. some degree of control) and (b) they are intended to have expected NPV > 0.
- Can reasonably be asymmetric (in a mathematical sense) if expected NPV > 0. ‘Balanced’ may be a better word than ‘symmetric’ to capture the notion that there should be benefits for investors, as well as consumers.

Capex incentives (cont.)

- Reasons for a negotiated/agreed approach:
  - Complexity: really easy to get it wrong and create unintended consequences.
  - Unlikely to get it right first time, so parameters will need to be adjusted. Similarly, parameters will be affected by changing circumstances.
  - Incentives will be damped by the resulting volatility in parameters unless there is buy-in from companies.
  - More fundamentally, incentive schemes can be a source of regulatory opportunism and regulatory uncertainty if not negotiated.

Ex post assessment

- I don’t share the widespread resistance (in Australia) to the introduction of <u>any</u> *ex post* element in capex assessments.
- The reality is that past performance will always, one way or another, affect regulatory attitudes going forward. If a regulated business is egregiously inefficient in its investment, more or less any regulator will seek ways and means of taking something back (cf the old saying of English Chancery judges: ‘dirty dogs don’t win’).
- The Australian system, with the AEMC as guardian of the rules, is better placed than others to incorporate *ex post* assessment in an explicit, limited and controlled way.
- GB regulation has *ex post* aspects, but they have been used sparingly and have not posed any serious problems. There has been no material threat to property rights, as reflected in highly favourable costs of capital in GB.