

Regulatory Certainty Through Committing To Explicit Rules – What, Why and How?

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Abstract

A primary aim of regulation is to create an environment in which investment can take place so that both the level and quality of services provided to consumers can be improved (or maintained). Yet, regulatory systems where a high degree of discretion is vested with the regulatory agency may actually work against this aim – investors fear arbitrary decisions that could expropriate value and consequently they either do not invest or require a higher rate of return than would otherwise be the case to compensate for this risk.

There are ways in which the credibility and commitment within the regulatory regime can be strengthened to overcome this perceived problem. This paper focuses on one specific set of actions that can be taken – the establishment of guidelines or rules by which a regulator can commit to future actions. There are different levels of commitment possible with a trade-off inasmuch as the greater the commitment the lower the flexibility in the regime – examples of the different forms of guideline and rules are provided to illustrate the various approaches. Given this trade-off, the decision about when different levels of commitment should be employed is an important one. These circumstances are also investigated in this paper.

This paper is based on aspects of the Tariff Adjustment Rules: Guidelines for Regulators, prepared by Chris Shugart and Ian Alexander, available to download from the PPIAF website (accessed July 2008):

http://www.ppiaf.org/index.php?option=com_content&task=view&id=224&Itemid=214&sub_action=activities&action=show_project_details&project_id=253&post_action=sector&post_action_val=water%20and%20sanitation

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1. INTRODUCTION

The Fifth Annual Conference of the African Forum for Utility Regulation (AFUR) had as a central issue “REGULATORY NON-DISCRIMINATION, PROMOTION OF COMPETITION AND PROTECTION OF INVESTORS”. Central to this theme is the issue of regulatory commitment and rules. This is because rules:

- ensure that all operators and customers are treated equally;
- can facilitate a level playing field for competition; and
- reduces discretion and the associated risk for investors.

Now, across Africa and more generally around the world, there is a concern that insufficient regulatory commitment exists and this is reflected in high-level regimes with significant regulatory discretion. This lack of commitment consequently leads to either:

- lower levels of investment; or
- a higher cost of finance than would otherwise be the case.

This theme is one that was discussed in great detail in AFUR’s Fourth Annual Conference – see especially the keynote address by Professor Eberhard.ⁱ

One approach to strengthening regulatory commitment is to establish rules that limit the regulator’s discretion. There are various forms that these rules can take and evaluating the various forms and when they might be used is the primary aim of this paper. The paper is structured as follows:

- Section 2 briefly sets out why we might want to introduce reduced discretion rules;
- Section 3 investigates the various options for rules to reduce discretion and provides examples from around the world;
- Section 4 then reviews the relevance of the options; and
- Section 5 concludes.

There is, however, often a concern that reducing regulatory discretion can also reduce the independence of the regulator. This need not be the case. When a regulator has discretion there are likely to be stakeholders with significant reason to try to influence the regulator in the way in which that discretion is implemented. Under a reduced discretion rule based system the regulator’s effective independence could be strengthened since stakeholders have less potential to influence decisions and so less reason to try and mitigate the regulator’s independence. In addition, the accountability of the regulator may be improved under a system of reduced discretion rules because the exact decision-making process of the regulator is set out.

2. REDUCED DISCRETION RULES – WHY DO WE NEED THEM?

The regulation of utilities generally has three main goals, including:

- protecting consumers from potential abuse where a firm has significant market power;
- encouraging investment by protecting investors from arbitrary action by government; and

- promoting economic efficiency.

In this paper, we are particularly focusing on the second of these – the need for regulatory rules that are conducive to investment. Utility investments tend to be large and long-term and the assets created are generally immobile. Large upfront costs need to be offset by a stream of future payments that are derived from the prices paid for utility services.

However, the pricing of utilities is often a political decision and raising utility prices is considered to be politically difficult, even where this rise is economically justifiable. The prospect of not being able to recover investment costs restricts the flow of private sector investment. In the long run, limited or highly priced investment will lead to an increase in tariffs and will reduce the benefits available to consumers.ⁱⁱ

It is in this context that reduced discretion rules or other forms of regulatory commitment should be considered. Reduced discretion rules provide a legal commitment on the part of the regulator as to how they will act when they make regulatory decisions. The phrase ‘reduced discretion’ refers to the fact that the regulator is constrained in its decision making powers to follow the rules that it has set out.

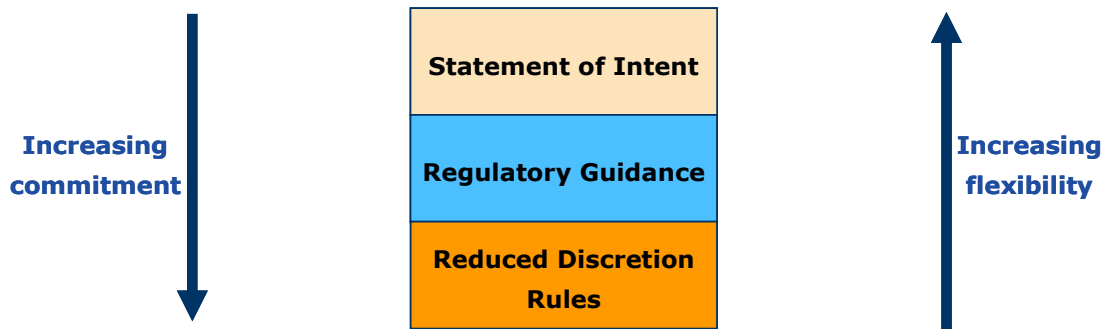
Essentially, investment in utilities can be encouraged where regulators commit, through a set of legally binding rules, to a level of pricing that allows investors to recover their costs. Where the legal and institutional environment is strong, it may not be necessary to resort to legally binding rules to encourage investment and the more light-touch approaches of a statement of intent or regulatory guidance may suffice as commitment devices. These different approaches are discussed below.

3. OPTIONS FOR CREATING COMMITMENT THROUGH EXPLICIT RULES

In Section 2, we established the need for a regulatory commitment device to ensure the flow of investment in utilities. This section sets out three options for increasing the level of regulatory commitment. The first commitment device, and the lightest touch approach, is the ‘Statement of Intent’. This approach provides some increase in commitment but also retains a reasonable level of flexibility for the regulator. The second approach we examine is that of ‘Regulatory Guidance’. This involves a higher level of commitment than a statement of intent but also a consequent lower level of flexibility as compared to the statement of intent approach. At the higher end of the commitment scale is the reduced discretion rules approach. This option significantly reduces the flexibility of the regulator but as a consequence it may provide a more convincing commitment device for investors.

Figure 3.1 demonstrates the trade-off between commitment and flexibility of the three approaches.

Figure 3.1: Options for creating commitment



3.1 Statement of intent

A Statement of Intent sets out the broad principles for how a regulator intends to approach the investment-pricing decision. It may provide some comfort to investors because it provides some insight into the regulatory approach to be taken, however, the level of commitment is limited because a Statement of Intent is not binding on the regulator – except inasmuch as it may be enshrined in primary legislation.

A Statement of Intent will generally be enshrined in:

- primary legislation, ie the law establishing the regulator;
- a general mission statement or slightly more detailed policy statement; or
- a letter or input to a privatization process.

As noted above, the latter two types of documents provide no form of legal commitment by the regulator and therefore although the regulator may be minded to follow the stated principles at the time they are developed, there is no legal obligation to do so.

An example of a Statement of Intent is contained in the mission statement of the National Energy Regulator of South Africa (NERSA) as set out in Box 3.1. This is a very broad statement that the regulator will act in accordance with existing laws and will apply ‘international best practice’.

Box 3.1 – The NERSA mission statement

To regulate the energy industry in accordance with government laws, policies, standards and international best practices in support of sustainable development.

Source: NERSA website, accessed May 25th 2008

Of course, even if this statement was legally binding on the regulator it still provides a significant degree of discretion – for example, exactly what constitutes international best practice may be open to interpretation.

3.2 Regulatory guidance

Regulatory Guidance can be described as a ‘medium’ level of commitment – somewhere in between a statement of intent and reduced discretion rules. A regulator is not legally bound to follow an approach outlined in regulatory guidance, however, the level of commitment is higher than that of a statement of intent because the regulator goes beyond broad principles and sets out the regulator’s expected behaviour in more detail. It can be argued that by setting out a more detailed approach the regulator creates an expectation of how it will act in the future. Consequently if it fails to follow this approach it may be possible to seek some form of redress, but that is likely to depend on the degree to which an expectation could legitimately be formed.

Regulatory guidance can be set out in a number of ways, including:

- general philosophy;
- basic methodologies; and/or
- a statement of how an approach is likely to be implemented (process).

There are also a number of ways in which regulatory guidance can arise. Box 3.2 sets out the regulatory guidance that was issued by the UK Civil Aviation Authority (CAA), the economic regulator for major airports in the UK, as part of a recent determination of charges at Heathrow and Gatwick airports.

Box 3.2 – The CAA regulatory guidance

At the recent CAA determination of Heathrow and Gatwick charges, the CAA provided an Annex, titled ‘Regulatory Policy Statement’. This policy statement was an update of a document issued by the CAA in 2003. The second section of the document provides a forward looking statement about Q5 (the fifth five-year price control period from April 1st 2008 to March 31st 2013) and beyond.

The statement covers key issues such as:

- the allowed rate of return;
- the development of future capacity; and
- the mid-term review of investment.

In relation to the cost of capital, the CAA stated that it would expect future assessments, including of the cost of equity, to strike an appropriate balance between reflecting changing circumstances and maintaining regulatory consistency so as to deliver investment required to meet users’ needs.

It also proposed that a mid-term review of capital expenditure be undertaken. The proposed scope for this review (subject to consultation early in Q5) is:

- development and application of cost benchmarks to the Q5 capital investment plan and, prospectively, to the initial development of capital plans for Q6 and beyond;
- application and evolution of risk allowances for projects;
- progress in management of certain risks at airport investment portfolio rather than

- individual project level, and implications for setting future risk allowances;
- BAA’s consultation performance against its revised agreement on information disclosure and consultation (Annex G to this decision document); and
- at Heathrow, consultation on, and efficient delivery of, preliminary capital expenditure associated with the expansion of airport capacity via mixed mode operations and/or a third runway.

The CAA anticipates consulting on the scope of the review in summer 2009, and then conducting the review between April and December 2010.

Source: Annex E, Economic Regulation of Heathrow and Gatwick Airports 2008-2013 – CAA decision, March 2008

Regulatory guidance may also arise as part of a consultation process. For example, the Independent Pricing and Regulatory Tribunal (IPART) the multi-sector regulatory agency in New South Wales (Australia) included regulatory guidance in a letter to the CEOs of distribution companies. This guidance indicated how it would assess prudence when thinking about investment decisions. Further details of the guidance issued in contained in Box 3.3.

Box 3.3 – The IPART guidance

In 2001 through a letter to the CEOs of distribution companies, IPART provided guidance on how it would assess prudence when thinking about investment decisions. Specifically, it would expect investment decisions to be consistent with good industry practice, including:

- Current and projected capacity;
- Current conditions of assets and renewal requirements;
- Alternatives of contracting for support through demand management and distributed generation (taking into account emerging trends in technology and costs);
- Current safety standards for the distribution network and accepted planning standards;
- Current and foreseeable policies in regard to factors such as environmental requirements and contestability;
- Current demand and reasonable projections for demand; and
- Analysis of the risks attached to the above elements.

Source: Tribunal Guidance on Prudence Test for Capital Expenditure by Electricity Distributors, IPART, 2001

3.3 Reduced discretion rules

Reduced discretion rules provide the highest form of commitment and the regulator is legally bound to follow the process outlined in the rules. Such rules may involve a well-defined commitment to:

- a specific methodology;
- a source of data; and
- a process for handling disagreements.

Reduced discretion rules are binding on the regulator and the certainty they provide for investors means that they are increasingly being considered in both emerging and developing countries.

The New Zealand Competition Commission intends to introduce reduced discretion rules for calculating the inputs that feed into the determination of the appropriate regulatory prices. The Cabinet Economic Development Committee recommended the introduction of reduced discretion rules, which they refer to as “input methodologies”, on the basis that while flexibility will be reduced, this risk is outweighed by the significant increase in business certainty. Box 3.4 provides some further discussion of the New Zealand input methodologies approach.

Box 3.4 – New Zealand input methodologies

The Cabinet Economic Development Committee in New Zealand recommended that input methodologies be set out in binding rules at the start of inquiries and any set or re-set of price/quality paths. Relevant input methodologies include calculating the weighted average cost of capital (WACC), valuing assets, allocating common costs and preparing regulatory accounts. The purpose of setting these input methodologies upfront is to give greater certainty, transparency and predictability to businesses (including businesses not subject to regulation) and their customers.

The Cabinet committee recommended that the Commerce Commission should set methodologies for determining the following matters:

- cost of capital;
- valuation of assets (including depreciation);
- allocation of common costs, including between businesses, customer classes and geographic areas;
- treatment of taxation;
- preparation of regulatory accounts;
- regulatory specifications (where applicable), including:
 - duration of regulatory period
 - excluded costs
 - circumstances for re-considering terms during the regulatory period
 - processes for re-setting terms and conditions;
- requirements for a proposal under ‘default / customised price-quality path’ (where applicable); and
- pricing principles.

Source: Review of Parts 4 and 4a of the Commerce Act, Office of the Minister of Commerce and Office of the Minister of Energy, 2007

In Pakistan, reduced discretion rules in the electricity sector took the form of setting an “up-front tariff” for generation such that regulatory assessment of an investment proposal was only required if the proposed tariff was above the up-front level. Where proposed tariffs fell below this level, no regulatory assessment was considered to be necessary. Box 3.5 discusses the up-front tariff in Pakistan in more detail.

Box 3.5 – The Pakistan up-front tariff

In order to encourage investment in power projects in Pakistan, the National Electric Power Regulatory Authority (NEPRA) was required by the Federal Government to set up-front tariffs for power projects such that proposals where tariffs would fall below the up-front level would not be subject to regulatory assessment. Prior to this requirement all independent power projects required regulatory approval for their proposed tariffs.

This approach arose due to government concern about the lack of new independent power producer plants. The electricity regulator was identified as contributing to this problem because investors were concerned that tariff decisions took too long and were hard to forecast. Up-front or benchmark tariffs were seen as a solution to this problem.

Source: Indicative Tariff for Coal Based Power Plants, National Electric Power Regulatory Authority (NEPRA), 2008; author's notes.

4. ASSESSING THE OPTIONS

4.1 Trade-off between flexibility and commitment

The choice between high and low/reduced discretion rules involves a trade-off between flexibility and commitment. High discretion rules have three key advantages:

- the detailed nature of low-discretion rules may result in the wrong decision being taken where circumstances are not as expected (for example, as a result of changes in technology or market conditions), high-discretion rules allow the regulator flexibility to respond to these types of situation;
- high discretion rules allow the decision maker to consider basic policy objectives when making a decision and to tailor the response to the particular situation; and
- high discretion rules are likely to involve lower set-up costs.ⁱⁱⁱ

However, the loss of flexibility inherent in reduced discretion rules comes at the benefit of a higher level of commitment by the regulator to behave in a certain way. Well-defined rules, if they are credible, can reduce the risks as perceived by investors and therefore can lead to a lower cost of capital. Hence there is a trade-off between reducing the risk of unpredictable government actions (and therefore the cost of capital) and maintaining the flexibility to adapt to current circumstances.^{iv}

Further, some of the inflexibility in reduced discretion rules may be mitigated through a greater focus on process and dispute resolution rules rather than pre-defined answers/figures.^v

4.2 Ability to enshrine the rules

Where a competent, independent regulatory organisation exists or in the case that there are established legal precedents that provide adequate constraints to the exercise of discretion, it may be the case that high-discretion rules provide the appropriate environment for investors.

In the case that these precedents and institutions are missing or if the independence of the regulatory body is subject to political intervention then reduced discretion rules may be the more appropriate choice.^{vi} In these circumstances, low/reduced discretion rules will:

- make the outcomes of regulatory decisions more predictable;
- reduce the risk of decisions that are inconsistent or arbitrary; and
- enable regulatory decisions to be made more quickly and using fewer resources.^{vii}

The decision to use a low discretion approach requires up-front resources to establish the guidance or reduced discretion rules. In addition, some credible method for enforcing reduced discretion rules is needed.

4.3 Ability to limit gaming

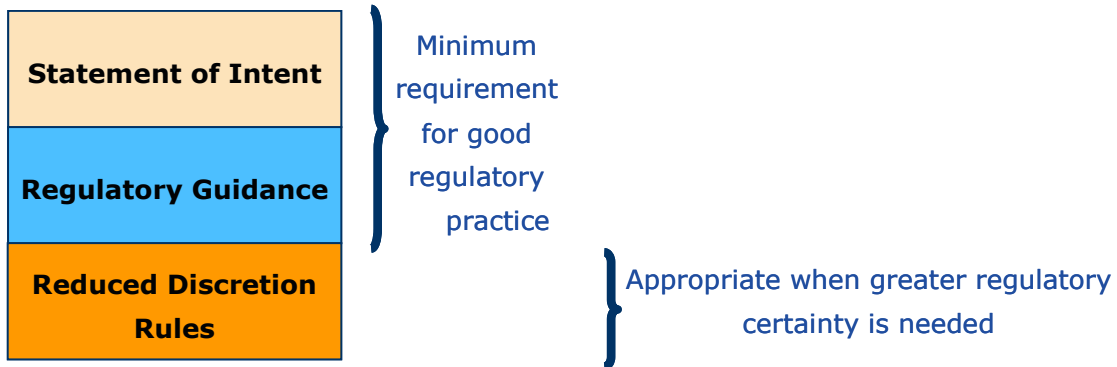
Reduced discretion rules also need to be considered in terms of the options for gaming that they may provide. In Pakistan one of the commissioners at the electricity regulatory agency provided a minority view that up-front tariffs should not be provided since they created an opportunity for gaming. This opportunity was based around investors knowing that the regulator would not be able to push tariffs below the benchmark figure and so it could be worth proposing a higher value. The worst situation that could arise would be that they receive the up-front tariff, but there is a possibility that a higher tariff will be accepted by the regulator. So, even if it is not needed a higher tariff may be worth requesting.

This concern about gaming clearly ignores the problem of the time taken by the regulator to reach its decision. However, provided the up-front tariff is seen as a credible lowest value this would not necessarily stop the investor from raising the finance needed for construction and then spending part of the construction period presenting their case for a higher tariff.

5. SUMMARY AND NEXT STEPS

When a lack of regulatory credibility or commitment is a concern, an appropriate regulatory response is to provide greater commitment. Different levels of commitment can be provided as shown in figure 4.1. The choice of the level of regulatory commitment to provide will depend on the specific circumstances faced in the country or sector. However, it is good regulatory practice to provide some form of statement of intent and also regulatory guidance. The real question is whether it is necessary to go beyond this and provide reduced discretion rules.

Figure 4.1: When to use the different approaches



ⁱ Eberhard, A. (2007) “The Independence and Accountability of Africa’s Infrastructure Regulators: Re-Assessing Regulatory Design and Performance”, Keynote Address, 4th AFUR Annual Conference, [Link](#)

ⁱⁱ Smith, W (1997) “Utility regulators - the Independence Debate” Public Policy for the Private Sector, [Link](#)

ⁱⁱⁱ Ehrhardt, D. et al (2007) “Economic Regulation of Urban Water and Sanitation Services: Some Practical Lessons” Water Sector Board Discussion Paper Series, Paper No. 9, April 2007, [Link](#)

^{iv} Smith, W (1997) “Utility regulators - the Independence Debate” Public Policy for the Private Sector, [Link](#)

^v See for example Alexander, I. (2007) <insert ref to AFUR conference paper>

^{vi} Ehrhardt, D. et al (2007) “Economic Regulation of Urban Water and Sanitation Services: Some Practical Lessons” Water Sector Board Discussion Paper Series, Paper No. 9, April 2007, [Link](#)

^{vii} Ehrhardt, D. et al (2007) “Economic Regulation of Urban Water and Sanitation Services: Some Practical Lessons” Water Sector Board Discussion Paper Series, Paper No. 9, April 2007, [Link](#)