Bulletin

Water
→ Energy
Transport
Financial services
Telecoms
Media
Competition policy
→ Policy analysis and design
→ Regulation
Strategy
Contract design and evaluation
Dispute support services
Market design and auctions

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Once bitten, twice shy

WHY RETROSPECTIVE ACTION UNDERMINES INCENTIVE REGULATION

A recent judgment by the Australian Competition Tribunal leaves it open to the Australian Energy Regulator (AER) to consider whether it would be in the long-term interests of consumers of electricity for it to make adjustments to the revenues that networks may earn in future to account for supposed windfall gains in the past. This bulletin explains why the long-term interests of consumers would be served best by preserving the incentives that networks face to pursue efficiencies, and by restraint on the AER's part.

It seems an obvious idea to most of us: if someone makes you a promise, and then reneges, you are unlikely to believe them when they make promises in future.

George H.W. Bush (the elder one) learned this the hard way. When he was given the Republican nomination in the run-up to the 1988 US general election, Bush made this foolhardy pledge: "*Read my lips: no new taxes.*" The commitment to not raise taxes was a key issue on which Bush ran, and one that many agree contributed to his victory that year. However, once in power, Bush was unable to make good his promise. Faced with a ballooning deficit, and a Democrat-controlled Congress that stymied spending cuts, the President was forced to approve tax hikes in 1990. Condemnation was swift. One news outlet carried the headline: "*Read my lips: I*

lied." In 1992, when Bush sought re-election, his U-turn on taxes was lampooned to great effect by the Democrat nominee, Bill Clinton, and even by his fellow Republican candidates. Clinton went on to win the race, and Bush's broken promise was thought to be a deciding factor in his defeat.

The moral of the story? Going back on your word changes others' views about your credibility.

CHOICES

The Australian Energy Regulator (AER) is at a crossroads. It must decide whether it will keep a promise made implicitly (and, in some cases, explicitly) by all economic regulators that operate systems of incentive regulation: *to never regulate retrospectively*. The outcome of that decision will send a strong and lasting signal to the industry regulated by the AER about the credibility of its commitments, which, in turn, is likely to influence how the industry will behave in future.

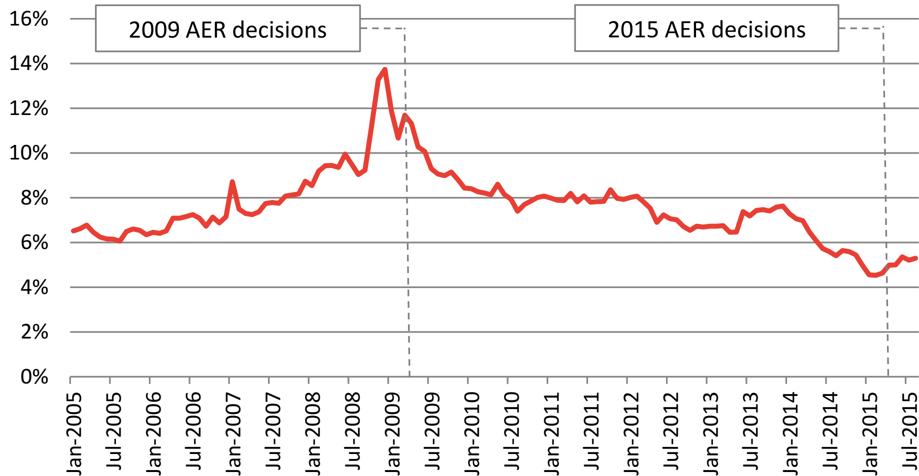
Ill-gotten gains?

In 2015, the AER published decisions on the revenues that several regulated energy networks would be permitted to earn over the next two to four years. In those decisions, the AER changed the way it determined the return on debt allowance used to calculate the networks' regulated revenues. During a review of its rate of return methodology in 2013, the AER was persuaded that the approach it had been using needed to change because it produced allowances that could not be matched by any business that managed its debt in an efficient and prudent way. Through consultations, it identified a new approach that would resolve this problem.

But, there was a snag. With hindsight, the AER realised that when it last set network revenues in 2009, corporate bond yields had spiked (see Figure 1) due to the global financial crisis (GFC). The AER's old approach had locked these high rates in as the return on debt allowances. But, the AER posited that the *actual* cost of debt faced by networks would be significantly lower if they had raised nearly all of their debt before the GFC, when interest rates were low. The AER concluded that the actual debt management strategy followed by the businesses meant that they had been 'in the money' during the last regulatory period.

Importantly, there was no contention that anyone did anything wrong during the previous regulatory period: the businesses managed their debt portfolios prudently and the AER set the regulatory allowance precisely as the National Electricity Rules required. The issue is that the AER now (with the benefit of hindsight) considers that the proper application of the previous Rules turned out to be too generous.

Figure 1: Yields on Australian BBB-rated corporate bonds



Source: Reserve Bank of Australia

It is important to note that the AER's conclusion that the regulatory allowance exceeded the true cost of debt was not based on any analysis of whether businesses actually did benefit under the previous Rules. Indeed, there have been arguments about whether the regulatory allowance actually *did* exceed the true cost. For example, a business that raised its debt at the same time that the regulatory allowance was set would simply receive an allowed return in line with its actual costs. Similarly, businesses that had their regulatory allowance set after the peak of the GFC, and which needed to raise debt during the GFC, may have incurred actual costs in excess of the regulatory allowance. In addition, the AER did not consider whether its approach may have under-compensated businesses in earlier regulatory periods. Rather, the AER's starting premise was that its proper application of the then Rules to the previous regulatory period resulted in over-compensation.

The AER reasoned that if it were to continue with its old approach, in all likelihood there would be future periods in which the networks would be 'out of the money' (i.e., the regulatory allowance would be locked in *below* the networks' actual costs) and, eventually, the wins and losses would even out. However, the new approach would produce allowances that would be in line with the efficient cost of debt, rather than below it. Indeed, this is precisely why the new approach was adopted — it provides a much better match between the regulatory allowance and the efficient cost of debt.

Thus, immediate adoption of the new approach would result in all future regulatory allowances matching properly the efficient cost of debt, and the problems of the old approach would be fixed henceforth. However, the AER argued that we should not have fair and appropriate allowances from today forward, but rather that we should have some degree of deliberate under-compensation to balance out the over-compensation that resulted from applying properly the old Rules in the

previous regulatory period. The solution hit upon by the AER was to transition gradually, over 10 years, to its new approach, rather than adopt it immediately. The effect of the transition was to set the return on debt allowance below the cost of debt that would be faced by a business that had adopted a debt management strategy that the AER itself said was efficient. The idea was that by forcing the networks to under-recover their costs for a period of time, the alleged windfall gain from the previous regulatory period would be eroded.

'See you in court'

Understandably, the networks baulked at what they considered to be a deliberate attempt by the AER to "clawback" past allowances. Four businesses challenged the AER's debt transition through merits review applications to the Australian Competition Tribunal (the Tribunal). The Tribunal found that the AER had erred in its return on debt decisions, and instructed the AER to remake these, but for reasons that were not related directly to the alleged windfall gains.[1] However, the Tribunal noted in its judgment that if the change in the AER's approach caused some "carry forward windfall" gain that results in consumers "paying a second time" for the GFC, the National Electricity Law (NEL) may entitle the AER to "make some adjustment" when considering any transition between approaches.

Under the s.16(1)(d) of the NEL, if the AER is making a regulatory decision, and is faced with two or more decisions that will or are likely to contribute to the achievement of the *national electricity objective*, the AER must make the decision that the AER is satisfied will or is likely to contribute to the achievement of the national electricity objective to the greatest degree. The national electricity objective specified in the NEL:

> *is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity.*

The Tribunal's decision means that when the AER remakes the return on debt determinations, it must decide, first, if its change of approach has in fact created a windfall gain to the networks. The AER has expressed this view consistently, and there is no reason to suppose that it has changed its position on this question.

Secondly, the AER must decide whether making an adjustment to allowances for windfall gains would promote the long-term interests of consumers. When tackling that question, the AER should consider what impact an 'after the fact' adjustment on revenues would have on the incentive properties of its regulatory regime.

In this regard, the context of the AER's proposal is important. The AER considers that it applied properly the old Rules in the previous regulatory period. Now, with

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[1] The Tribunal found that the AER had used the wrong benchmark when determining the efficient return on debt.

hindsight, the AER considers that the previous Rules were too generous, and it proposes to redress this via under-compensation over the forthcoming regulatory period. This is tantamount to a retrospective, unilateral Rule change. There are two problems with this. First, under the Australian regulatory framework, there is a deliberate separation of functions so that the regulator is not also the rule-maker. But the AER's proposal has the effect of undoing the Rules that were put in place by the Australian Energy Markets Commission. Second, even if the AER does have the power to rewrite the Rules (which it does not) retrospective changes to the Rules risk undermining the incentive regulation system administered by the AER, as we explain below.

THE BASICS OF INCENTIVE REGULATION

Under a system of *incentive regulation*, the regulator determines the revenues that businesses are allowed to earn over the next regulatory period in line with its best, forward-looking assessment of the businesses' efficient costs over that period. Crucially, the regulator does so using the information available, and according to the regulatory rules prevailing, *at that time*. Once the regulator has set the revenue allowances, the businesses have an incentive to strive to generate efficiencies. If they succeed in spending less than the efficient benchmark assumed by the regulator, the businesses (and their shareholders) may keep these savings for a time.

Incentive regulation provides monopolies with financial rewards for finding and realising efficiencies that they would otherwise have no reason to pursue. The short-term rewards that the businesses gain from making such savings are ultimately translated into long-term benefits to consumers. This is because by making savings, the businesses reveal to the regulator the true scope for efficiencies. In subsequent periods, the regulator can use this revealed information to set a more challenging benchmark, thereby passing on savings permanently to customers.[2]

Incentive regulation is more beneficial to consumers than the main alternative system, *rate-of-return regulation*, whereby businesses are allowed to recover their actual costs. Because the actual costs incurred by the business are simply 'passed-through' into prices, under rate-of-return regulation, businesses have little or no incentive to become more efficient over time.

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2 Some regulatory regimes also provide for explicit, immediate sharing of savings between businesses and consumers, whereby a proportion of any efficiencies generated are passed on to customers within the regulatory period in which they are generated.

COMMITMENTS UNDERPINNING INCENTIVE REGULATION

In order for businesses to respond well to such incentives, it is critical that the regulator commit credibly to not making adjustments retrospectively that remove (and distribute to consumers) past outperformance by the businesses. Indeed, *the* most important commitment a regulator can make under an incentive-based system is a promise to not use hindsight to adjust the revenues that businesses are allowed to earn in future.

Unless businesses are permitted to keep the benefits of outperformance relative to the benchmark that the regulator determines, they are unlikely to strive to beat such benchmarks in future. This is because the businesses will always be wary that the financial benefits from efficiencies made could be removed retrospectively.

If businesses believe that the regulator either will, or may, take retrospective action to clawback past outperformance, what would be their incentive to engage in the painful and costly struggle of squeezing out efficiencies? The rational response by businesses would be to do just enough to match the cost allowances determined by the regulator, but no more. This could eventually result in the regime collapsing to a system akin to rate of return regulation. A weakening of incentives in this way would ultimately be to the detriment of consumers, because they would not benefit from regulated businesses striving constantly to generate efficiencies.

Whilst the commitment to not regulate retrospectively is implicit within any well-functioning incentive regulation regime, some regulators make this commitment explicit. When Great Britain's energy sector regulator, Ofgem, refreshed its regulatory framework in 2010, it said:[3]

> *Network company decisions will be influenced by their perceptions of the credibility of the regulatory framework. The RIIO model is designed to provide certainty and transparency about how the framework will work in the future. As part of this, we will seek to avoid any retrospective/ex post adjustments to the package agreed in final proposals and licence modifications as this could undermine regulatory commitment.*

Ofgem has remained true to its word. It is not enough for a regulator to say that it will refrain from using hindsight. In order for such a commitment to be credible, its words must be matched by its actions.

LET BYGONES BE BYGONES

So, what should the AER do when it remakes its return on debt decisions? Should it apply adjustments to future revenues to mitigate supposed windfall gains?

The key consideration should be whether doing so would promote the "long term interests of consumers of electricity". One of the ways in which consumers'

[3] Ofgem, Handbook for implementing the RIIO model, 4 October 2010, p.29.

interests are furthered in the long-term is by networks becoming more efficient over time, thereby allowing the AER to share those efficiencies with consumers. So, the AER should consider whether an adjustment to future revenues would enhance or degrade such incentives.

At this juncture, it is important to recognise three facts:

1. The process of regulation involves repeated interaction between the regulator and the regulated. Specifically, the networks' future behaviour is modified by what the AER does today because those actions reveal some information about how the AER is likely to behave in future.
2. Actions speak louder than words. The AER may vow a certain approach, but if its actions contradict that commitment, its promises will not be viewed as credible.
3. The AER cannot force networks to become more efficient than a benchmark it sets. It can only induce outperformance through the promise of reward. But in order for such incentives to work, the AER's promises must be credible and not hollow.

With this in mind, the AER ought to recognise that regardless of whether it agrees or not, networks perceive adjustments to future revenues as a clawback.

In its 2015 decisions, the AER denied that its debt transition was a clawback. Rather, argued the AER, the transition was to "account for accumulated differences between the return on debt estimate and the actual return on debt." This really is a distinction without a difference.

The facts (which the AER does not dispute) are these:

1. In 2009, the AER set return on debt allowances using its old approach in accordance with the Rules that applied at the time.
2. The debt management strategy employed by a number of networks (which the AER agrees is an efficient debt management approach) meant that some networks were able to raise debt more cheaply than the AER's allowances. In other words, they outperformed.

The AER considers this to be a windfall gain (unless it were to continue with its old approach). From the viewpoint of the businesses regulated by the AER, why is this a windfall gain any more than a network beating the expenditure allowances set by the AER by, say, finding more efficient ways of running its operations?[4] If the AER can decide after the fact that its return on debt allowances had been 'too high,' what is to prevent the AER arriving at a similar conclusion about any other type of allowance? The uncertainty of such a possibility would hang over the networks like the Sword of Damocles.

Therein lies the rub: In such a world, why would a rational business strive to do more than the regulator asks in *any* area if there is a chance that the regulator might confect a reason in future to remove the rewards of outperformance?

CONCLUSION

The effectiveness of incentive regulation depends on the credibility of commitments made by the regulator. The most important commitment a regulator can make under an incentive-based system is a promise to never use hindsight to adjust the revenues that businesses are allowed to earn in future. The AER now has the opportunity, when it re-makes its decisions, to send a strong signal that it will always set returns for every regulatory period based on its best estimate of efficient costs for that regulatory period.

Irrespective of what the AER says on the matter, an adjustment based on the AER's view that its proper application of the previous Rules led to overly generous allowances in a previous regulatory period would always be regarded by networks as an attempt to clawback past allowances. It would be difficult for networks to trust that the AER would not, in future, do the same thing in other areas, should it decide that the networks have outperformed more than expected, or if allowances were, with the advantage of hindsight, judged to be 'too generous'. The AER now has the opportunity to demonstrate that, like other regulators such as Ofgem, it will not venture onto the slippery slope of ex post adjustments in relation to outcomes from prior regulatory periods.

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4 The AER might argue that any outperformance that occurred was not due to good management but due to luck (i.e., corporate bond yields just happened to be high at the time it made its last determinations). Such an argument would be false for two reasons. First, the debt management strategy followed by a number of the networks at the time the AER made those determinations is precisely the strategy that the AER describes now as efficient. Second, the outperformance was not due to luck; it was due to a method of setting allowances that locked in prevailing rates.

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