Session 4: Developing Countries Experience and Outlook

Getting the framework right

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Introduction

A little learning is a dangerous thing;
drink deep, or taste not the Pierian spring:
there shallow draughts intoxicate the brain,
and drinking largely sobers us again.

Alexander Pope (1709)

In this session I want to consider:

1. When has regulation broken-down or when have problems been identified?
2. What has been the reason for failure? And
3. What lessons can be drawn for the implementation of regulation?

Examples of regulatory "failure" and their causes

Three examples of regulatory failure in developing countries…

South Africa

Airport regulation based on a single-till system wide approach.

Massive investment across several airports in the late '00s stressed the system to breaking point.

Regime has subsequently been updated.

Colombia

Electricity distribution and transmission based on CPI-X regulation.

To date low levels of investment.

Approach to calculating WACC and valuing assets inconsistent with FCM principles.

Peru

Lima Airport regulated based on a single-till long-term RPI-X control.

Contract requires investment to meet specified service standards.

Faster than expected passenger growth is leading to stress on the system……

But problems are not only in developing/transitional economies….

The Netherlands

Energy regulation applies efficiency adjustments to total costs – so effectively revaluing the existing asset base at each periodic review.

Effectively breaches FCM since the WACC is not adjusted for this "stranding" risk.

Reasons for "failure"

In each case the approach that has been adopted has tended to be a partial adoption rather than a whole approach….

Regulatory philosophy

Underlying UK regimes is the concept of FCM – embodied in the rolling-forward of the asset base which then allows a focus on WACC

Picking and choosing aspects of the regulatory regime can break this philosophy

Approach and process

When setting prices there is a consideration of the efficient costs that a company would incur. These costs are then the ones recovered. The link between costs, recovery period and customer acceptance is key to ensuring legitimacy….

Why does this matter?

- In the first case the risk of stranding means that a higher WACC (or some other mitigation mechanism such as additional depreciation charges) is necessary to encourage investment.
- In the latter, the link between costs, revenues and financeability is key to a sustainable industry.

Lessons

Incentive regulation is appropriate in developing and transitional countries

But getting it right is not always easy (not just a developing and transitional country problem) especially as circumstances change

A willingness to periodically test whether the regime is fit for purpose is important – regulation is an evolutionary process!

When establishing or updating regimes it is important to understand the whole regime and the underlying philosophy/objectives of other regulatory regimes so that lessons drawn are appropriate and complete

Does not mean you have to copy regimes, of course they can be adapted, but mitigating perverse incentives or unintended consequences is important if the regime is to deliver what it is intended to….

So regulators need to drink deep from the Pierian spring to ensure that they are sober in their regime design!

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