REGULATORY TREATMENT OF RISK: MANAGEMENT AND ALLOCATION

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Ashley C. Brown
Executive Director, Harvard Electricity Policy Group
Harvard Kennedy School
Harvard University
Symmetry is Critical

A. Allocation of Risks Must Be Reflected in Rate Of Return Allowed
   a. Level of Risk Drives the Cost of Capital
      i. Higher Risk Requires Higher Allowed Rate of Return
      ii. Lower Risk Means Lower Rate of Return

B. Asymmetrical Scenarios to Be Avoided:
   a. Privatization of Risk / Socialization of Gain
   b. Socialization of Gain / Privatization of Risk
Principles for Allocating Risks: Consciousness of Incentives and Effects

A. Allocate Risks to Those Best Able to Manage/Absorb Them
   a. Incentivizes Performance
   b. Heightens Awareness of Risks
   c. Aligns Incentives with Performance Expectations
   d. Overall Fairness to Management and Consumers

B. Risk Allocation Affects Cost and Quality of service
Classification of Risks

A. Fully Manageable by Company
B. Partially Manageable by Company
C. Uncontrollable Risks
Fully Manageable Risks

A. Examples (Not Complete List):
   a. Construction Risks
   b. Routine Operations and Management Risks
   c. Compliance Risks

B. Principles:
   a. Fully Allocated to Company
   b. Internalized into Rate of Return
Uncontrollable Risks

A. Examples (Not Complete List):
   a. Inflation
   b. Taxation
   c. Recession
   d. Other Macroeconomic Risks

B. Principles
   a. Fully Socializable
   b. Full or Partial Allocation to Company is Very Expensive
Partially Manageable Risks

Most Complex Risks to Allocate

A. Examples (Not Complete List)
   a. Currency Risks
   b. Environmental Risks
   c. Liability Risks (e.g. Accidents)
   d. Country Risk

B. Principles
   a. What Share of Risk is Manageable?
   b. Who is Best Positioned to Manage the Risk?
   c. How Expensive is Risk Management (e.g. Hedging, Insurance)
Other Relevant Principles:

A. Balance Between Risk Adversity and Risk Assumption

B. All Risk Allocations Have Inevitable Cost and Rate Implications
Conclusions

A. Risk Management Closely Linked to Cost of Capital
B. Allocating Risk Has Impact on Incentives and Overall Productivity
C. Symmetry is Essential