

REGULATORY TREATMENT OF RISK: MANAGEMENT AND ALLOCATION

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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