The Fine Line Between Regulatory Independence And Protection Of Investor Rights

A ROLE FOR PARETO EFFICIENCY?

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Agenda

1. Stability vs Adaptability
2. Pareto Efficiency
    I. Concept
    II. Application to Policy Decisions
3. Conclusions

Stability VS Adaptability

To encourage investment, it can be attractive for states to give long-term commitments:

- Energy infrastructure often long lived
- Capital intensive/Large up-front investments
- Benefit: Stability for investors
  - Lower risk = lower return = lower end-user prices

The best interest of the system may require regulatory changes:

- Provided not just politically driven
- Benefit: Adapt appropriately to changing conditions

Q: Can these competing interests be reconciled?

Pareto Efficiency

Pareto was an engineer and economist who studied “efficient” resource allocation

- Efficiency means gains to “winners” exceed losses to “losers”

“Pareto Improvement” is a change in which:

- At least one party is better off
- No party is worse off

Hence, efficient change must allow compensation

- “Winners” compensate “losers”

Example: Efficient Breach

A signed contract for delivery of widgets to B

- Contract worth 100 to A, 20 to B

C urgently requires widgets

- Willing to pay 130 to A;
- A cannot satisfy both parties.

What should A do?

Efficient Breach Example (continued)

	#1: Original Contract	#2: A Breaks Contract		#3: A Breaks Contract, fully compensates B	
	Value	Value	Change	Value	Change
A	100	130	+30	110	+10
B	20	0	-20	20	0
Total:	**120**	**130**	**+10**	**130**	**+10**

Breach beneficial to society overall

A incentivised to change

Example: Inefficient Breach

What if C can only offer 105 to A?

	#1: Original Contract	#2: A Breaks Contract		#3: A Breaks Contract, pays compensation to B	
	Value	Value	Change	Value	Change
A	100	105	+5	85	-15
B	20	0	-20	20	0
Total:	**120**	**105**	**-15**	**105**	**-15**

Breach **not** beneficial to society overall

A incentivised to change only when compensation not paid

Pareto Efficiency and Regulation

Same principles apply to regulatory intervention

- Regulators will find it attractive to “breach contract” if it represents gain to system as a whole

Payment of compensation does not make any <u>efficient</u> policy change unattractive

- If change represents net gain, benefits must be sufficient to compensate losers

Compensation only disincentivises <u>inefficient</u> policy choices

Arbitration (I)

Arbitration explores original commitments

- What was risk allocation at outset, e.g.:
  - Which party bore technology risk
  - Which party bore price risk
- Often: were such commitments reasonable?

Not necessary to measure efficiency of breach for damages *quantification*

- Only whether changes were “fair and equitable” for investor
- Damages measure what would have happened to investor absent any breach
  - Not any impact on consumers

Arbitration (II)

A state “losing” an arbitration may still be an efficient outcome

- If damages are less than consumers would have suffered without the breach
- For example: State pays $20 million but saves consumers $50 million

Nevertheless, repeated breaches regulatory commitments leading to arbitration will not be efficient:

- May lead investors to lose trust in regulatory system;
- Hence, require higher returns to invest;
- Worse outcome for consumers in the long run

Conclusions

States often argue sovereignty means *all* regulatory changes must be permissible

- But state sovereignty includes ability to make commitments
- Failing to compensate = ignoring prior commitments
- So actually undermines sovereignty

Requirement for compensation does not necessarily mean regulator acted inappropriately or in bad faith

- Not a fine, but recognition of earlier commitment

As long as compensation is not punitive, all future efficient policies remain attractive

- Only inefficient choices unattractive

Q: Can competing interests be reconciled?

- **A:** Yes: and compensation (in some form) is key

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Serena has over 30 years of experience in providing energy sector advice and nearly 20 years as an expert at Brattle.

Serena has testified in numerous gas contract arbitrations since 2003, and more broadly: billing system problems, electricity contracts, market manipulation, failure to respect regulatory guarantees/ due process in relation to energy networks, expropriation of district heating assets, warranty violations and insurance claims for power stations

She has provided advice on the value and regulation of gas pipelines, gas storage, power stations, district heating and electricity networks.

Serena has worked extensively with EU energy regulators. She has advised on the design of trading arrangements (GB, the Netherlands, Belgium), network access (EU, GB, Greece), transportation tariffs (GB, Ukraine) market monitoring, quality of supply obligations (GB, Germany, Australia) and price controls and incentives (GB, Germany, Australia).