

Regulation Resources

IP3's Infrastructure Regulation Information Series – May 2009

Regulation in the Downturn: Importance of Regulatory Design and Enforcement In Our World Economy

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About the Author



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Abstract

This article describes the importance of regulatory design and enforcement in our current world economy. As the economies of many countries continue to decline, the importance of regulation rises. There is a close relationship between the need for regulation and the need for return to economic growth. Investors are averse to risk these days. Regulators can clarify risk for uncertain investors, and hasten the return to prosperity that characterized much of the last decade. Clear, predictable outcomes from the regulatory process will contribute to the return of investment capital in emerging markets. Infrastructure projects require a long-term view. Regulators should take care in these challenging times not to make expedient short-term decisions that will jeopardize long-term economic growth.

Introduction

One of the most important functions performed by successful regulatory commissions is the quantification of risk for investors. There are investors who seek high-risk projects with the potential for high rewards. There are also investors who seek lower risk projects with a greater chance of success and lower rewards. Neither type of investor will support a project whose risks cannot be quantified.

There are many risks associated with large infrastructure projects. Some, such as country risk, cannot be affected by actions in the regulatory arena. But some of them can be. When regulators clearly describe their policies in a transparent way, when outcomes from the regulatory process are predictable, then there is a greater chance that investors will be able to finance the project at returns that are affordable for customers.

Key Points

Global Crisis

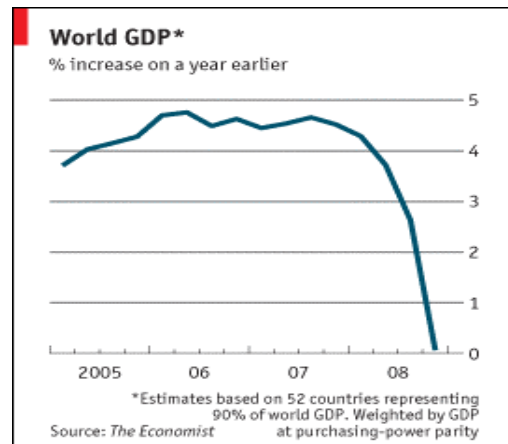
The current global economic downturn means less investment capital for large infrastructure projects, in the USA and elsewhere around the world. Michael G. Morris, American Electric Power (AEP) chairman, president and chief executive officer stated on the company's website that:

*'It's anticipated that the economy will remain soft in 2009, and we expect that our sales for 2009 will be about the same as 2008. We're uncertain when the economy will return to the more robust growth we have seen in recent years. Because of that uncertainty, we are managing our cash flow, have tightened controls on spending, and have reduced our capital expenditures budget for 2009 by \$750 million, a reduction of more than 20 percent.'*¹

How long will the global recession last?

Standard & Poor's Rating Services believes that the recession, "will last through this year and into 2010", characterized by a decline in investment capital and lowered demand for services worldwide. Because there is less credit available, there will be less investment capital. For those able to access the credit markets, the cost of credit has increased.

The chart to the right shows estimated decline in world GDP 2005-2008². Wealth has been lost at a dramatic pace, making investors highly risk averse. The loss of value in many investments, combined with tightened credit, makes it very difficult to attract private investment for large infrastructure projects.



Solutions?

As global capital available for infrastructure investment declines and almost disappears, the need for strong signals from regulators increases. Regulatory commissions are in a unique position to signal investors that risks are fully predictable, within the markets they control. By creating a regulatory process with highly predictable outcomes, regulatory commissions may contribute to a return to prosperity and increased investment.

How do regulators obtain predictable outcomes? There are two simple ways. First, keep the process transparent. Investors want to be able to see how evidence is treated and how decisions are reached. They want to know that regulators make their decisions based on evidence in a case, not based on political influence.

Second, follow your own Rules. Unbelievably, many regulatory commissions go to the trouble to adopt sound, transparent Rules, and then ignore the Rules themselves. Expect your staff and stakeholders to follow your Rules.

Potential for Legislative/Policy Changes: High

During a recession, governments are seeking ways to improve their economies. Much new legislation is being discussed. The role of the regulators in this process is to offer good information on a timely basis. Here is an example of regulatory involvement in the legislative

¹ Michael G. Morris, AEP Chairman, quoted on AEP Website, www.aep.com, November 9, 2008.

² www.economist.com

process from the new USA Federal Energy Regulatory Commission Chairman, quoted from the FERC website:³

“In his first press event since being tapped by President Obama on January 23 to head up the commission, Wellinghoff said he expects FERC to be heavily involved in formulation of either a comprehensive energy bill or a series of bills meant to address obstacles to increasing renewable wind, solar and geothermal energy, and other matters that fall within FERC’s purview”.

The same is true for telecommunications policy, and policies for ports, transport, natural gas, water, and wastewater. As policy is being reformulated, regulators should be prepared, with facts, to offer input to the policy debate. For example, at the April 21, 2009 meeting of the International Telecommunications Union in Lisbon, Portugal, the union held a High-Level Strategic Dialogue that brought together leaders from government and industry to address the problems facing vendors, operators, and governments. The event sought to formulate proactive strategies to help the ICT sector weather the storm, as well as leveraging the power of ICTs to accelerate economic recovery in other sectors⁴. By joining in the debate, regulators can assure that their important perspective is heard.

Conclusions and Summary

Yes, we are in a critical economic state now, where regulators need to be aware of the heightened need for clarity and predictability. Regulators need to participate in policy dialogues that will set important legislation for regulated industries.

Finally, regulators want to be sure that they do not take short-term steps that will prevent them from fully participating in the recovery when it comes. There may be a temptation to make short-term decisions to reduce the short-term impact of the current economic downturn. Yet, regulation is designed to provide stability for the long term. Infrastructure projects are long-term projects. Regulators need to take care not to jeopardize the long term for temporary, short-term gains that may prove harmful during the inevitable recovery.

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³ www.ferc.gov

⁴ www.itu.int