The Ports Regulator   20 March 2017
The Marine
Suite 1101
22 Dorothy Nyembe Street
Durban
4001

Att: Mr. Mahesh Fakir
Cc: Mr Chris Lotter

Dear Sir

COMMENTS ON THE PORTS REGULATORS' DRAFT REGULATORY MANUAL

INTRODUCTION

1.   SAASOA notes the Regulator's request for the comments on the Regulator's proposed tariff methodology, the regulatory manual for the tariff year 2018/19-2020/21.

2.   In these comments:

   a. We reiterate our support for the use of a price-capping approach instead of the Revenue Requirement approach;

   b. We lament the fact that increasingly, due to the inherent deficiencies of the approach, the Authority's revenue requirement is increasingly determined not with reference to objective criteria but largely at the discretion of the Regulator;

   c. We welcome the introduction of an efficiency measure but point out that it is not clear from the manual how precisely this will impact on the Revenue Requirement;

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d. We note two unexplained changes in the methodology and request clarification.

e. We contend that it is no longer acceptable for the Regulator to simply assume an asset beta of 0.5 and that a lower estimate of beta must be adopted.

PRICE CAPPING APPROACH

3. It is apparent from the draft methodology that the Regulator intends persisting with the Revenue Requirement approach for the foreseeable future.

4. In our comments on the previous methodology, we pointed out that there are compelling reasons why a price capping approach should be adopted.

5. Although it is apparent from the draft methodology that the Regulator is trying to encourage efficiency, it is clear that:

   a. The methodology is becoming increasing complicated and requires the Regulator to make a number of value judgments;

   b. There is no clear indication that the methodology is capable of removing the perverse incentives for the Regulator to keep on increasing CAPEX and operating costs.

   c. While the efficiency incentive may promote increased volumes, it is not clear that it will do so at lower prices.

6. We therefore repeat the contents of our previous year's submission in full below:

7. The Regulator's core methodology is based on the Revenue Requirement (RR) approach.

8. In our view, the primary objective in regulating a monopoly is not to prevent - at least in the short run - the monopoly from earning an economic (or supernormal) profit.

9.   The objective in regulating a monopoly should be to ensure that consumer surplus (that is, the difference between aggregate willingness to pay in respect of the quantity of services supplied, and the actual revenue earned in respect of the said quantity) is maximised to the extent that is possible. Our members are, arguably, the primary consumers of the Port Authority's services. Other things being equal, consumer surplus is increased when price levels drop and the quantity of a particular good or service supplied increases.

10.   In essence, the revenue requirement approach, as implemented by the regulator, is in the nature of Rate of Return regulation (this is acknowledged by the Regulator). Rate of return regulation aims at ensuring that a monopoly is able to earn sufficient revenue to cover its economic costs, but no more.[1] The goal is to ensure that the monopoly does not earn an economic or supernormal profit.

11.   The alternative approach to rate of return regulation, is the so-called price capping method. Under the price capping method, the monopoly's prices are limited to a specific rate of increase, typically entailing a specific percentage reduction in real terms. Under the price capping approach, the monopoly is limited in the use of its pricing power. However, subject to the price constraints imposed by the price cap, the monopoly is free to make an economic profit. This can be done by increasing the quantity of services delivered at lower real prices as well as by reducing costs. At the same time, the monopoly is not guaranteed the recovery of its costs (including the cost of capital). That is to say, the monopoly may make an economic loss.

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[1] Sometimes the approach is relaxed to create incentives for the monopoly to reduce costs.

12. The approach adopted by the Regulator, at least superficially, has elements of the price capping approach, notwithstanding that it is self-described in the manual as a rate-of-return approach.

13. Having determined the Revenue Requirement, the Regulator uses that as a "building block" in determining a specific price increase applicable to various categories of tariff in the Port Authority's tariff book.

14. To the Regulator's credit, the price increase caps imposed by the Regulator have in the past two years resulted in a reduction in real average tariffs. This is crucial, because as the Regulator's comparisons of the Authority's tariffs with overseas ports' tariffs have demonstrated, the tariffs charged to users of South African ports tend to be significantly higher than the global average measured in US dollars (based on the sample measured by the Regulator).[2]

15. However, in our view, the manner in which the Regulator has implemented the combination of the Revenue Requirement approach and the setting of a specific price increase for tariffs loses out on the benefits of the conventional price capping approach. These benefits are that the monopoly being regulated under such an approach, subject to the price constraints, nonetheless has an opportunity and thus a strong incentive to earn a supernormal profit by (1) optimising the cost of producing the services it provides (an incentive towards increased efficiency on the supply-side), and (2) having improved supply-side efficiency, by considering further price reductions with a view to increasing the demand for (and consequent supply of) services which are price elastic (an incentive to increase consumer surplus).

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[2] Global Pricing Comparator Study (GPCS), Tariff sample date: 1 April 2015, p27

16. The problem with the approach implemented by the Regulator lies in the application of the clawback. The clawback is aimed, in part, at ensuring that the Ports Authority cannot earn (or at least retain) an economic profit by earning more than the revenue requirement. However, if a forecast of the volume of usage of service is based on a particular assumption as to the tariff for a service, it follows that a reduction in that tariff could lead to a significantly higher demand for that service and the earning of additional revenue if demand for the service is relatively price-elastic. This is a good outcome for users of the service (consumer surplus increases), notwithstanding that it will permit economic profit to be earned (an over-recovery).

17. The application of a clawback means that notwithstanding that the Regulator's decision is expressed in the form of a price cap, the regulatory method is best described as a rate of return approach.

18. We appreciate that there are good reasons for the Regulator to follow a rate of return approach. The Port Authority performs a strategic function. It is also forms part of a problematic parastatal with a number of loss-making divisions. It is therefore highly desirable for the Regulator to ensure that the Ports Authority always recovers its economic costs. However, as the Regulator has acknowledged in the present regulatory manual, it has become increasingly important for it to ensure, in applying the Revenue Requirement approach, that these costs are not overstated, and are closely monitored.

19. We cannot but speculate that the present approach of determining the actual tariffs could be modified with a view to accelerating the increase in consumer surplus.

20. In our view, the incentives created by the present regulatory system for the Port Authority to (1) increase the volume of services provided, (2) to increase its cost efficiencies, and (3) to lower its prices at a faster rate than has been the case, are relatively weak.

21. In particular, we are of the view that the Regulator should permit the Port Authority stronger incentives to reduce prices and increase output of services than are in place under the present system. We acknowledge that there may considerable difficulty in implementing such incentives, because of the Regulator's lack of perfect information concerning both the structure of demand for the Port Authority's services, as well as of the Port Authority's cost structure.

22. However, we propose the adoption of or at least the consideration of an approach similar to that embodied in the following simple rule aimed at ensuring that consumer surplus is progressively increased, and which does not rely on the Regulator having perfect knowledge of the port authorities demand and cost structures. Our proposal is along the lines of Vogelsang and Finsinger (1979).[3]

23. The rule is as follows:

The set of prices charged by a monopoly for its services (or goods) in period t must be such that when these prices are applied to the quantity of services or goods sold in period t-1, the aggregate revenue must be no greater than (i.e. less than or equal to) the observed cost of producing the quantity of services (or goods) produced in period t-1, or mathematically:

$$\sum p_{it} \cdot q_{it-1} \leq C(q_{1t-1}, \ldots, q_{it-1}, \ldots, q_{nt-1}),$$

Where p_{it} is the price of good or service i in period t, q_{it-1} is the quantity of good or service i sold in period t-1 and C(.) is the cost function of producing quantities of the various goods and services. The cost function is assumed to be fixed.

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[3] Vogelsang and Finsinger (1979) A Regulatory Adjustment Process for Optimal Pricing by Multi-Product Monopoly Firms, Bell Journal of Economics, 10:157-171.

24. The operation of the rule can be illustrated with a simple example. Suppose a monopoly manufactures and sells widgets, for which demand is relatively price elastic. The monopoly's cost function is linear and as follows: it has fixed costs of R250 000 and variable costs of R25 per widget manufactured (i.e. $C(q) = 250000 + 25q$).

25. In period 1, the monopoly is unregulated and sells 10000 widgets at a profit-maximising price of R100 each. It therefore has revenue of R1m. Its costs for period 1 comprise R250 000 in variable costs and R250 000 in fixed costs (which include the cost of capital), with the result that it earns an economic profit of R500 000.

26. On imposition of the rule by a regulator in period 2, the monopoly must choose a price p_2 such that $p_2 \times q_1 \leq C(q_1)$, or in this case, $p_2 \times 10000 < 500000$. In other words, the monopoly is forced to drop its price to R50 per widget or less. If the monopoly decides to sell only 10000 widgets, it cannot make an economic, because its revenues will be less than or equal to the cost of producing 10000 widgets. The monopoly, assuming it is rational and profit-maximising, will therefore elect to produce more widgets at the lower price.

27. In period 2, therefore, the monopoly produces 20000 widgets at a price of R50. Its revenue is once again R1m. Its costs are R750 000 (R250000 + 20000 x R25) and its economic profit is R250000.

28. The monopoly has <u>still made an economic profit</u> **(**though the effect of regulation has been to reduce this). However, the price of widgets has been halved and the quantity sold doubled. Consumers of widgets have benefited immensely from regulation.[4]

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[4] For instance, the consumers <u>who were prepared to pay</u> R 1000000 for 10000 widgets can now acquire the same quantity for R500000. Other consumers can now purchase widgets at prices they are willing to pay.

29.   By contrast, if the monopoly were subject to a rule which deprived it of an any economic profit (through the application of a claw back mechanism), it would have no incentive to do anything other than produce 10000 widgets at R50 per widget. Although consumers would benefit from a significant reduction in price, consumer surplus would not increase as much, due to the small quantity of good sold. This demonstrates that the earning of an economic profit by a monopoly is not necessarily a bad thing, at least in the short-run, provided that the effect of regulation is to promote significant increases in consumer surplus.

30.   In period 3, the rule is imposed again. Now the monopoly is subject to the following constraint:

$$p_3 \times 20000 \leq R750000$$

31.   This means that $p_3 \leq R37.50$.

32.   Suppose the monopoly can sell 30000 widgets at a price of R37.50. It will earn revenue of R1 125 000 and have costs of R1 000 000 (R250000 + 30000 x R25).

33.   The monopoly therefore once again earns an economic profit. However, this is much reduced at R125 000 (down from the pre-regulation R500000). Consumer surplus is increased because consumers can now purchase 30000 units at the lower price of R37.50.

34.   As the process is repeated, the monopolist reduces prices and produces more until there is no further incentive to do so (it can no longer earn an economic profit by doing so). At this point: (1) the monopolist earns zero economic profit; (2) no further gains in consumer surplus can be obtained.

35. The rule embodies a dynamic price capping approach aimed (1) at maximising possible consumer surplus while (2) in the long-run, ensuring that the monopolist does not earn an economic profit. Moreover, it does not require the regulator concerned to have knowledge of the structure of demand, nor of the monopolist's cost structure. The monopolist, acting in accordance with the rule, takes decisions that increase consumer surplus so long as it is able to earn an economic profit thereby.

36. How can this rule be related to the Revenue Requirement methodology? The Revenue Requirement is simply a method of calculating the economic cost of forecast production (because revenue must equal economic cost). It follows that the same methodology can be used to measure the economic cost of delivering the quantity of services provided in the previous period of observation.

37. Thus, one way in which the Regulator could impose a price cap would to specify that:

$$\sum p_{it}.q_{it-1} \leq RR_{t-1}$$

38. Or, if it is apparent that there is change in the parameters that determine economic cost:

$$\sum p_{it}.q_{it-1} \leq RR_{\underline{t}}(q_{1t-1}, \ldots, q_{it-1}, \ldots, q_{nt-1})$$

Where RR_t is a cost function used to determine the cost of producing the q_{it-1} in period t.

39. We do not necessarily say that this precise rule should be adopted. However, we have raised the possibility of using such a rule in order to show that that the operation of the clawback rule and strict enforcement of zero economic profit is removing incentives for the Ports Authority to take actions that increase consumer surplus.

40. We have also raised the possibility of using such a rule to demonstrate that there are, in our view, potentially superior alternatives to the present approach of capping tariff increases in order to enforce a cap on revenue.

41. We also point out that the adoption of such a rule would, to some extent, encourage the Port Authority to increase cost efficiencies, because this too would allow it to temporarily earn an economic profit. This incentive is weakened somewhat by the fact that lowering costs would render the constraint imposed in the subsequent period more onerous (an example of the so-called "ratchet" effect).

42. A simpler version of the rule would be simply for the Regulator (using the Revenue Requirement calculation as a guide or by calculating a target Revenue Requirement for a forecast level of services) to specify a reduction in the Port Authority's tariffs by a specified percentage in real terms.

43. This is an example of the RPI-X price capping methodology, where RPI refers to Retail Price Index (the South African equivalent is CPI) and X refers to an offset, with X typically greater than RPI (or CPI).

44. Within the constraint imposed by this rule, it would be possible for the Port Authority to explore possibilities for increasing economic profit by lowering prices and increasing the quantity of services with price-elastic demand as well as reducing costs. In lowering prices and increasing the quantity of services provided, the Port Authority would increase consumer surplus.

45. The Regulator's present approach of stipulating a general percentage would be consistent with use of an RPI-X rule if there were no clawback, that is, if the Regulator did not seek to

enforce the Revenue Requirement as a constraint. In our view, the Revenue Requirement should be a tool used by the Regulator (a "building block", to use its own language) in imposing a price cap; it should not be a constraint in its own right.

46. Although there may be moral objections to the Port Authority being able to earn economic profits in the short run, and to be able to retain that economic profit, the simple fact is that, as far as the users are concerned, provided that the quantity of services supplied increases, and the tariffs charged for those services decreases, then consumer surplus increases and we benefit.

47. We now turn to our further comments.

INCREASING SCOPE FOR DISCRETION ON THE PART OF THE REGULATOR

48. It has become apparent that the methodology increasingly calls for the Regulator to make value judgments. This is not unexpected; this is precisely the function of the Regulator.

49. While much of the Regulator's work has focused on ensuring that best practice methods are used in determining the objective components of the revenue requirement calculation, in order to ensure that the Authority is not allowed to earn a supernormal profit in consequence of mismeasurement, the Regulator has more recently developed its version of the revenue requirement methodology in order to focus on the way in which the Authority runs its business. This development is entirely justified, indeed laudable. It is cold comfort to know that a monopoly cannot earn a supernormal profit if that monopoly is nonetheless poorly run, reducing the consumer surplus available to users.

50. To this end, the Regulator indicates that:

a. The Authority's CAPEX plans will require the Regulator's approval, and that the Regulator will take into account the Authority's ability to implement projects, its recent CAPEX implementation record, as well as the "appropriateness" of the CAPEX plan.

b. The Authority must provide a detailed and complete motivation for each of the expenses it applies for inclusion in operating costs; in other words, the Regulator will decide which operating cost items are justified.

c. It will select the performance indicators, in consultation with port users and the Authority, for inclusion in the efficiency gain incentive (WEGO) that will be included as part of the Revenue Requirement.

51. This is apart from the longstanding discretion held by the Regulator to build up the reserve of revenue in the ETIMC and disburse revenue therefrom in order to cushion shocks arising from various factors.

52. Increasingly, therefore, the Regulator is obliged to make decisions that impact on the Authority's strategy directly, and not merely indirectly through a price mechanism. That is, when deciding how much revenue the Authority is permitted to earn, the Regulator must also ensure that the Authority is managed in a particular way with particular strategic objectives. These sorts of decisions are of the type ordinarily taken by a board of directors with reference to information supplied by the market.

53. However, when these decisions are taken by the Regulator, they are (or form part of) administrative action, and must be taken in a procedurally fair manner. In keeping with the principle of audi alteram partem, affected persons (which would include port users) must be afforded a reasonable opportunity to make representations concerning these decisions.

54. These decisions are also susceptible to administrative review by affected persons, including the Authority.

55. In order to give effect to audi alteram partem, it is essential that the tariff methodology explain the criteria to be applied by the Regulator in making these discretionary decisions and that tariff applications contain sufficient data for affected persons to be able to comment on these decisions (or components of the overall tariff decision).

56. This has all been necessitated by the retention of the Revenue Requirement approach. The advantages of replacing most if not all of these discretionary decisions with the market signals permitted by the price capping approach is yet another reason why we submit that approach should be followed.

THE EFFICIENCY INCENTIVE

57. The efficiency incentive proposed by the Regulator is aimed at increasing the Authority's operating efficiency. Clearly this desirable. The Revenue Requirement approach, in its basic form, does not promote operating efficiency.

58. However, it is not clear from the draft regulatory manual precisely how this efficiency incentive will work. The concept of an Efficiency Gain Index is clear enough. However, the regulatory manual fails to define the variable Re_{t-1}.

59. It is also not clear that this incentive will necessarily promote operating efficiency, in the sense of increasing the quantity of service supplied per unit of cost, or that it will promote lower prices. Assuming a positive value for EG is achieved, other things being equal, the measure itself will tend to increase the revenue allowed to the Authority (directly in the form of the incentive, and perhaps indirectly through an increase in the asset base and / or operating costs entailed in achieving the performance target); This increase in revenue would need to be

more than offset by an increase in the quantity of services provided in consequence of the incentive in order for price per unit of service to fall.

60.   With the utmost respect, the Regulatory Manual needs to deal with the methodology for determining the incentive in considerably greater detail.

TWO UNEXPLAINED CHANGES IN THE METHOLOGY

61.   We point out that in comparison with the 2015/16 – 2017/18 manual,

a.   Capital work in progress (CWIPy) in the $RAB_{c,y}$ equation is now inflated at CPI, whereas previously it was not. Given that one would assume that the final CWIPy is an end-of-year figure, it is not clear why it should be inflated. No explanation for this change is given.

b.   Tax allowance is no longer on the list of variables to be estimated for claw-back. No explanation is given for this omission, which seems to be an error.

THE CAPM BETA

62.   In our submission for the previous year, we stated the following regarding the use of the CAPM model in conjunction with an asset beta of 0.5:

"…[w]e accept that the use of an asset (unlevered) beta estimate represents an acceptable compromise between use of a standard, relatively well understood asset pricing model and more complex models.

However, we submit that if the Regulator intends to continue implementing the CAPM model using an assumed asset beta, its decision to use an asset beta estimate of 0.5 needs to be revisited. It is submitted that this beta estimate overstates the true asset beta of an enterprise that is largely insulated from market risk by virtue of its monopoly

pricing power, not to mention further revenue smoothing mechanisms such as the clawback and ETIMC included in the tariff methodology.

Accordingly, in our view, the asset beta estimate should be closer to zero (0) than to 0,5. We acknowledge, however, that there would be more justification for an asset beta of 0.5 (or higher) if the clawback mechanism were removed and the Authority could either earn an economic profit or sustain an economic loss."

63.   We stand by these submissions. We note that the Authority has acknowledged that the beta estimate is probably excessive, but are disappointed that the draft methodology has not attempted to address the issue directly.

64.   To this end, we present the results of a quick exercise we have performed in estimating the Authority's beta. We determine a form of accounting beta[5] using five years' worth of observations, from the 2011/12 financial year to the 2015/16 financial year.

65.   We have attempted to calculate the Authority's actual return on capital using the actual (annual financial statement ("AFS")) revenue it reports as earning, together with its actual or reported expenses, when explaining its proposed clawback calculation in its annual tariff application. One caveat is that is not clear to us whether these actual AFS revenues include provision for ETIMC and clawback. We exclude clawback and ETIMC from consideration in working back to determine the actual return on capital ("ROC").

66.   If it is assumed that the reported RAB is a fair market valuation of the assets earning the capital (which assumption is implicit in the Revenue Requirement approach), then we obtain the following estimates of the actual rate of return on capital:

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[5] It is not an accounting beta in the strict sense because the Authority's rate of return is calculated with reference to the best estimate of the fair market value of its assets and not the book value of assets.

FIGURE 1:

	2011/12	2012/13	2013/14	2014/15	2015/16
RAB	47 379,00	57 779,00	58 701,00	63 858,00	66 573,00
AFS REVENUE	7 985,00	8 329,00	9 850,00	10 592,00	11 144,00
REPORTED OPEX	2 774,00	3 109,00	3 662,00	3 912,00	4 362,00
REPORTED DEPR	937,00	1 472,00	1 562,00	1 675,00	1 789,00
ACTUAL ROC + TAX	4 274,00	3 748,00	4 626,00	5 005,00	4 993,00
TAX RATE	0,28	0,28	0,28	0,28	0,28
ACTUAL ROC	3 077,28	2 698,56	3 330,72	3 603,60	3 594,96
ACTUAL ROC / RAB (RATE OF RETURN)	**6,50**	**4,67**	**5,67**	**5,64**	**5,40**
SOURCE	*TA 2013/14 p35,43-44*	*TA 2014/15 p36*	*TA 2015/16 p37*	*TA 2016/17 p42-43*	*TA 2017/18 p44-45*

67. In order to facilitate comparison with the market rate of return, we add back inflation using the Fisher equation. The inflation value used is CPI for the 12 months up to 31 March of the particular financial year (Transnet's year end is 31 March), obtained from the South African Reserve Bank's KBP7127A time series. This yields nominal rates of return as follows:

FIGURE 2:

	2011/12	2012/13	2013/14	2014/15	2015/16
ACTUAL ROC / RAB (RATE OF RETURN)	6,50	4,67	5,67	5,64	5,40
INFLATION RATE 12MTHS TO 31 MARCH					
PER SARB KBP7127A	4,90	5,30	5,60	5,70	5,80
NOMINAL RATE OF RETURN:					

(1+nr)=(1+rr) x (1+inf) - 1	11,71	10,22	11,59	11,66	11,51

68. The mean return on assets for the Authority is 11,34%, with a very small standard deviation of 0,63%.

69. In order to determine the annual return for the "market", which we proxy as the All Share Index, we simply add the percentage change in value in the All Share Index over the 12 months preceding 31 March of the year in question to the dividend yield:

FIGURE 3:

	2011/12	2012/13	2013/14	2014/15	2015/16
ALL SHARE INDEX: MARCH (T-1)	32 204,06	33 554,21	39 860,84	47 770,92	52 181,95
ALL SHARE INDEX: MARCH (T)	33 554,21	39 860,84	47 770,92	52 181,95	52 250,28
RATE OF CAPITAL RETURN	4,19	18,80	19,84	9,23	0,13
DIVIDEND YIELD - MARCH (T)	2,95	2,88	2,81	2,92	2,87
MARKET RETURN	7,14	21,68	22,65	12,15	3,00

70. The mean market return is 13,33% with a standard deviation of 8,7%.

71. We can then estimate the CAPM beta for the Authority by ordinary least squares regression using a simple market model: $r_{Auth,t} = \alpha + \beta\, r_{Market,t} + e_t$. This yields the following regression out (using Microsoft Excel):

FIGURE 4:

SUMMARY OUTPUT

Regression Statistics	
Multiple R	0,522666665
R Square	0,273180443
Adjusted R Square	0,030907257
Standard Error	0,62203711
Observations	5

ANOVA

	df	SS	MS	F	Significance F
Regression	1	0,436291593	0,436291593	1,127571928	0,366201333
Residual	3	1,160790497	0,386930166		
Total	4	1,59708209			

	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%
Intercept	11,84591717	0,551522701	21,47856678	0,000220839	10,09072579	13,60110856
X Variable 1	-0,037949569	0,035738368	-1,061871898	0,366201333	-0,151685006	0,075785869

72.   The regression reports a beta estimate of -0,0379. As can be seen from the t-statistic of -1,06 and associated p-value of 0,366, we cannot reject the null hypothesis that the true value of beta is zero.

73.   The precision of the estimate is low, because of the small number of observations. Of greater interest therefore is the 95% confidence interval which can be interpreted as follows: we can predict with 95% confidence that the true value of beta lies between -0,152 and 0,076.

74.   As we have pointed out, this regression is the result of a simple exercise using the limited data reported in the Authority's tariff applications concerning its actual results. However, we see no reason why this type of analysis cannot be employed with a view to estimating the Authority's beta.

75. If we accept, for the Authority's benefit, that the beta should be <u>the upper limit</u> of the 95% confidence interval, 0,076, this is still considerably below the assumed asset beta of 0.5. A low beta of 0,076 or rounded up to one decimal place, 0,1 is certainly not unexpected even leaving aside the role of the clawback and ETIMC, given that the fundamental objective of the Revenue Requirement approach is to set prices to ensure that the Authority earns an acceptable profit, no more and no less. Even allowing for unexpected shocks in volume, it is difficult to conceive of [probable] circumstances in which the Authority could deviate significantly from its projected, regulated return on capital.

76. We therefore suggest that the Regulator conduct an empirical analysis along the lines set out above to determine the Authority's CAPM beta. However, we do not believe that such analysis would yield materially different results. In the circumstances we propose an asset beta of 0,1 for the Authority.

CONCLUSION

77. In these comments, we have once again called on the Regulator to adopt a genuine price-capping approach, rather than the present approach of determining a revenue limit and capping prices in conjunction with a clawback mechanism to enforce that limit.

78. We believe a genuine price-capping approach would be more likely to encourage the Authority to lower prices and costs and increase consumer surplus, because it would have an incentive to do so in order to earn an economic profit. It would also reduce the need for the Regulator to intervene actively in the Authority's strategy. It is implicit in the draft methodology that the Regulator will be obliged to exercise its discretion in a number of matters that directly impact on the Authority's strategy.

79. To the extent that the Regulator resolves to persist with the present methodology, we have also expressed our concern regarding the continued practice of assuming that the Authority has an asset beta of 0,5. We believe an asset beta of about 0,1 is more appropriate, not only intuitively, but because it can be supported by empirical analysis.

80. We also have pointed out that the regulatory manual needs to contain considerably more detail on those matters in which the Regulator exercises a discretion. In particular, considerably more information on the efficiency incentive needs to be incorporated into the manual. At present, it is not clear how the incentive mechanism will work and nor what its eventual impact on price and volume is likely to be.

Prepared by Advocate Andrew Christison

Kind regards

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