

# REGULATORY TREATMENT OF RISK: MANAGEMENT AND ALLOCATION

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**Regulatory Conference**

BRASILIA, DF, BRAZIL

June 18, 2018

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# Symmetry is Critical

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- 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

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## 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

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

# Fully Manageable Risks

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## 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

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## 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

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## 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:

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- A. Balance Between Risk Adversity and Risk Assumption
- B. All Risk Allocations Have Inevitable Cost and Rate Implications



# Conclusions

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