Managing the threat of regulatory capture under the European Energy Union

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Outline

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- Maxim 1: the promotion of shared meaning
- Maxim 2: putting each party in its adversary’s role
- Maxim 3: the use of cost-benefit analysis
- “Clean Energy for all Europeans” legislative package
Background

- European Energy Union ("EEU"), the strategy for energy market without internal frontiers throughout European Union ("EU")

- If design or implementation of legal instruments for transboundary regulation of EU energy industry is imprudently in the grip of regulatory capture (i.e. the sly substitution of public for private interests), then efficiency or equity of outcomes is likely harmed

- Risk of imprudent regulation leading to wasteful or unfair distribution of gains or burdens over time or across locations (e.g. distortion of investment signals for electric power generation or transmission capacity at appropriate scale, location, timing, or technology)
Objective & approach

• How to alleviate exposure to regulatory capture under EEU?

• Build a framework for managing risks of regulatory capture in context of European energy industry

• Drawing on law & economics, we investigate propensities for inefficiency or inequity arising from regulatory capture in transboundary energy industries
  - Develop three maxims to mitigate risks of regulatory capture
  - Test maxims against potential distortions in operation or expansion decisions in EU electric power industry, with reference to legislative package “Clean Energy for all Europeans” adopted in June 2019
Our foundational idea

• Concept of efficient, effective, & equitable regulation in transboundary setting affirmed as meaningful exchange amongst adversarial parties to the proceeding

• Regulation is process-bound mechanism of discovering information, in much the same way that market tends to be characterised as a process

• Analytical tools of law & economics yield three maxims for mitigating peril of regulatory capture in transboundary energy industries
  ▪ Promotion of shared meaning in regulatory process
  ▪ Indifference of parties given their respective claims, if each was in its adversary’s role
  ▪ Use of cost-benefit analysis as a basis for transboundary compensation (given winners & losers across participating states), or provision of non-arbitrary justification in the absence of cost-benefit analysis
Winners & losers

• Winners could have compensated losers under Kaldor-Hicks efficiency, but actually have compensated them under Pareto efficiency (thus satisfying Pareto criterion of no harm)

• Distinction between actual (under Pareto efficiency) & possible (under Kaldor-Hicks efficiency) compensation is a function of practicality
  ▪ How to realise a move from possible to actual compensation?
  ▪ Yet if Pareto efficiency not satisfied, government rarely makes arrangements for winners to subsidise losers
  ▪ In the absence of such subsidisation, value judgements involving inter-personal comparisons have to be made

• Possible compensation under Kaldor-Hicks efficiency is at heart of cost-benefit analysis (i.e. project is undertaken if benefits exceed costs), but how to do so is seldom specified in detail
A sophisticated regulatory process provides a trusted broker-dealer service

- Prudence refers to “reasonable manager standard” under which regulator determines if reasonable manager, given information that was or could have been available at the time, had made decision in good faith

- Yet standard of prudence refers to reasonableness rather than market efficiency
  - Markets are obviously not always & everywhere efficient
  - Managers of unregulated firms sometimes make inefficient decisions
  - Reasonableness standard is probably not too different to market standard

- Prudent regulator recognises potential for asymmetric information increasing regulatory “decision costs”
  - Search for findings of fact
  - Acquisition of supportive evidence
  - Procurement of counter-evidence contesting utility’s claims
Regulatory capture, a private interest conquering the public interest

- Under economic theory of regulation, regulators maximise their utilities
  - In the presence of information asymmetries or transaction costs, interest groups with low organisation costs can impose burdens on those with high organisation costs
  - To the extent regulated industry continuously has lower organisation costs than consumer or other interest groups, ongoing threat of regulatory capture

- Regulatory capture amplifies inclination for manipulation or lack of transparency in regulatory proceedings
  - Settlement process during ratemaking proceedings perverted into a spectacle
  - In complex rate cases, “many investments can be deemed sufficient, prudent, and acceptable” reportedly because “all aspects” susceptible to manipulation
  - If PUC, without judicial oversight, can grant a wide range of utility requests, regulation is “the very definition of arbitrary and capricious”
Regulatory capture in a transboundary setting (e.g. EU)

- Investments in interconnection capacity, notwithstanding increase in net benefits overall, tend to bring about winners & losers

- Managing threat of regulatory capture depends on how size, ownership, jurisdictional, or spatial distribution of assets affects cost of politically organising for frustration of public good

- From viewpoint of social welfare, transboundary regulator can rightly claim that countries are individually & collectively better off with transmission investments
  - In areas where prices fall (rise), consumers (generators) gain but generators (consumers) suffer
  - If generators have lower cost of politically organising than consumers, support for transmission investments could be different across jurisdictions
Maxim 1: the promotion of shared meaning

- Price discovery is central to regulatory process in multi-level jurisdictional settings

- Vigorous involvement by federal regulators of customers or their representatives in negotiations with utilities yields outcomes perceived by all parties as superior to what formal regulatory process would have delivered
  - Negotiations focus on discovery & satisfaction of customer wants at acceptable price
  - Role of regulator is to encourage conversations & ideally, agreement, rather than to make decisions itself

- Regulatory process bears witness, as it were, to naturally emerging arrangement in which discovery of price occurs during sincere dialogue
In other words, the avoidance of boilerplate or senseless text in a pseudo-contract

- Empty show of perverted ratemaking settlement sounds disconcertingly reminiscent of various practices threatening efficient or equitable outcomes in legal proceedings, such as pseudo-contract

- In pseudo-contract, boilerplate text (e.g. lengthy but mostly unread terms & conditions in online transaction) does not reflect shared meaning (i.e. a communal significance most consistent with cooperative deployment of language to contract) amongst parties

- But it is unthinkingly added to a contract & thus could hardly be deemed a genuine contractual provision
Meaningful transboundary regulation

- Imbued with normative pursuit of social welfare maximisation for all participating states & spatial or temporal equity for all participating national societies

- Encourage a sense of shared meaning amongst multiple jurisdictions in a regulatory process for transboundary energy industries

- Regulation thus becomes meaningful exchange amongst adversarial parties
  - Honest conversation, a real prospect for proper prudence review of various interests represented in regulatory procedure
  - A bona fide journey towards an understanding of each other’s valuations
  - Shared meaning aligned with collaborative use of words to reach accord
  - Purposeful articulations, a persistent quest for contract, rather than mere form-filling
Maxim 2: putting each party in its adversary’s role

• Five justices of contract law: justice of equal exchange, justice of the wager (i.e. symmetrical solutions to risk allocation), justice of the term that “fits” the parties or the situation, justice as the deserved return, justice as the advantage not taken

• The third justice, of the term that “fits,” pertains to appropriate distribution of responsibilities or contributions of parties as a matter of fairness (rather than equality)

• Enables an inference most consistent with reasonable expectations of parties, what they must have meant or what situation calls for, in the context of their agreement (rather than a judicial imposition on an essentially private matter)

• If transactional justice prevails, then reasonable & conscientious parties, acting in self-interest, would accept terms of contract & be bound by it, even if they did not know their roles
Bearable levels of transactional injustice, such as unconscionable disparities of value, lopsided gambles, unsuitable epilogues, opportunism, or coercion

• Parties are exchanging meaningful communications in accordance with their particular milieu (rather than a judge’s view) in order to contract

• Indifference of party to prospect of being assigned its adversary’s role indicates whether or not agreement is optimised to bring efficient & equitable outcomes
  ▪ Additional reductions in transactional injustice, up to its complete removal, are unlikely worthwhile
  ▪ A court “should usually tolerate” contractual imperfections because it cannot correct “most imperfections in private transactions”

• Regulator, a trusted broker-dealer prudently managing imperfections of an international regulatory framework, is to demonstrate that treaty, customary law, or conciliation is approaching perfection (further decreases of transactional injustice are not worthwhile)
Indifference test implied by justice of the term that “fits” consistent with test for prudence under “reasonable manager standard”

• If a party is indifferent to being assigned its adversary’s role, then agreement is likely optimal, best available outcome given constraints, signifying a tolerable level of contractual imperfection or transactional injustice.

• Similarly, for a reasonable manager, prudence is inferred from reasonableness, suggesting a tolerable level of inefficiency, unlikely far from market standard.
  ▪ If a party happens to pass, as it were, an indifference (a prudence) test, regulator would have served public interest.
  ▪ Uneconomic to entirely eradicate all instances of transactional injustice (market imperfection).

• Under meaningful regulation, it is judicious & practical to impute optimised provisions which reasonable parties would have accepted if they had engaged in most efficient form of cooperation & diligent price discovery, whilst comfortably in “each other’s shoes”.
Maxim 3: the use of cost-benefit analysis

- The diagnostic devices of Pareto and Kaldor-Hicks efficiency emphasise availability of leftover surplus &amp; respectively, reality or possibility of its redistribution

- What matters is practicality of moving from possible to actual compensation

- Presence of losers *per se* does not justify dismissal of efficiency-enhancing policy, but utterly aggrieved losers could organise themselves politically to block enactment of efficiency-enhancing policy

- If not all losers are compensated, then prospects for efficiency-enhancing policy depend on number of particular losers to be compensated & amount of compensation they require
The need for side payments

• A cynical view: regulator simply has to compensate specific subset of losers who are politically organised enough to ruin chances for efficiency-enhancing policy

• Yet prudent regulator, as trusted broker-dealer, cannot avoid making value judgements inadvertently affecting spatial or temporal matters of equity

• If losers are unavoidably created due to imprecision in compensation, then other elements of regulatory compact, across multitude of mutual obligations, rights, or benefits, may serve as additional levers

• Such an expansion in set of “choice variables” of optimisation process may include side payments, such as money or perhaps compromises on other issues, in order to ensure that states benefit enough to accept regulation
Cost-benefit analysis remains crucial to the control of capricious regulation

- Mitigating the peril of regulatory capture in transboundary energy industries through the use of cost-benefit analysis as a basis for compensation across jurisdictions

- Quantitative cost-benefit analysis is “best available method for assessing the effects of regulation on social welfare,” even though its outcome should not be sole metric for social welfare

- Strong need for non-arbitrary justification in the absence of a cost-benefit analysis, especially if adjudication on monetary or non-monetary side payments is imminent as a consequence of imprecision in loser compensation

- The right to judicial protection & corresponding effective judicial review are crucial to the control of regulatory capture
“Clean Energy for all Europeans” legislative package in May 2019 directly concerns design of integrated EU electricity market

• Liberalising rules on unbundling, third-party access, & independent national regulation of transmission & distribution system operators

• EU-wide target of 34% contribution of renewable energy in final gross energy consumption
  ▪ MSs to limit financial support to national renewable sources
  ▪ If MS decides to support producers in other MSs, then Commission shall provide information & analysis (e.g. data on costs & benefits of cooperation)

• Regulatory framework for transboundary electricity flows & trading
Could ACER become the model of a transboundary regulator under the clean energy package?

- Decentralised organisational architecture to oversee integrated market (i.e. independent MS regulators with exclusive competence to regulate domestic operations cooperate through ACER at EU level)

- Role of ACER in the energy market has been enhanced
  - ACER is decentralised EU agency, but not endowed with status of regulatory agency with full decision-making powers
  - Decisions & recommendations adopted by director, but in most instances with approval of board of regulators that brings together representatives of national authorities

- 2019 reform granted ACER additional but limited competences in areas where fragmented national decisions of cross-border relevance could lead to problems (e.g. regulatory oversight of future “Regional Coordination Centers,” review of bidding zones, or drafting technical codes for interconnected electricity grid)
Harmonising potentially fragmented national decisions with cross-border implications

• ACER functionally (if not organizationally) on course to be a genuine transboundary regulator pursuing an independent assessment of overall social welfare

• How to deploy its additional competences for harmonising potentially fragmented national decisions with cross-border implications

• ACER would have to design & implement highly granular side-payments, either monetary or non-monetary inducements, in order to help along the search for cooperative equilibrium

• Of course, ACER itself as sectoral regulator cannot be tasked with carrying out such side-payments
Challenges for ACER: the first maxim

• Promotion of shared meaning in regulatory process demands substantive & procedural reforms not only in operations of national regulators & ACER, but also in relationships between them

• Shared meaning established through normative pursuit of social welfare maximization

• Increasingly market-oriented approach of clean energy package, such as cross-border trade of electric power, rationalisation of subsidies, or active participation of consumers, all of which affect efficiency or equity

• ACER cannot engage in mere box-ticking spectacle or just hope that national regulators will naturally “break out of the self-sufficiency mind-set”
Challenges for ACER: the second maxim

- A proposal to streamline procedures to allow direct approval by ACER (rather than separate approvals by all national regulators) provides unique opportunity to lift, as it were, “veil of ignorance” possibly hindering parties from seeing situation from each other’s viewpoint.

- ACER has to demonstrate to all national regulators that its approval is as perfect as it can be relative to each of their respective claims.

- ACER is procedurally hosting transparent debate in which common language, the analytical tool for social welfare maximisation, is used by all parties.

- Judicial oversight requiring sound reasons for limited use or non-use of cost-benefit analysis serves as another defense against danger of regulatory capture.
Challenges for ACER: the third maxim

• If ACER is to contend successfully with risk of regulatory capture, it has to simultaneously manage propensity for information asymmetry & subject its decisions to judicial review

• Maintain trust of all national regulators not only as collaborators in quest for truth, but also as ultimate guardians of its legitimacy

• Flow of appropriate information & support from multiple stakeholders, especially private actors

• Participation of private actors in regulatory proceedings should not harm integrity of regulatory regime