Conference on Regulatory Reform

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1.1 Introduction

Thank you for inviting me to speak at this important conference.

I will be talking today about regulation and its influence on utilities’ costs, prices and efficiency.

What do we mean by ‘regulation’?

Before I start, I would like to clarify what I mean by ‘regulation’. In the context of supervising the monopoly services of electricity, water and public transport providers, ‘regulation’ refers to the rules and institutions for the setting of prices and service standards.

As such, it includes government standards or policies that prescribe certain types or levels of services, such as the quality of water services, train services or electricity supply. It also includes laws aimed at preventing or minimising harm to the community or the environment from production.

It includes the rules that economic regulators, such as IPART, follow in setting prices and monitoring performance.

It also includes government policies that control choices on methods of utilities’ service delivery, often to achieve certain policy ends. For example, the requirement on Sydney Water to obtain water from recycled sources and a desalination plant, aimed at helping to secure water supply.

‘Regulation’, therefore, is not confined to requirements put in place by law, but refers to any compulsory obligation on businesses that affects the type, scope and cost of goods and services they produce.

This potentially opens up a wide field of issues. Today, I will focus on a topic that may be of interest to you - the contribution of regulation to recent price and service outcomes - and also captures some of the key issues facing IPART as economic regulator.
A major theme of this speech is the extent to which prices and outcomes in respect of monopoly services have been affected by government decisions affecting regulated agencies’ costs, and the imposition of restrictions on economic regulators’ discretion to determine efficient prices.

Regulatory and policy decisions have been a major contributor to recent price increases, especially for water and electricity. Understandably, rising prices have caused significant public - and political – concern about the affordability of essential services.

Traditionally, economic regulators have been in charge of setting or overseeing costs and service levels of monopoly service providers. Their role is to match as closely as possible the price and quality offered by the providers with that likely to be offered to customers in a competitive market.

The primary tools of regulators are close vetting of proposed expenditure and what this is to deliver, and independent monitoring of the utilities’ performance. Through pricing controls, regulators create incentives for utilities to improve their efficiency, and through tariff structures, we seek to design prices in a way that will promote the best use of resources.

To the extent that decisions on service levels, which drive expenditure, are made by the government rather than by the regulated utility or an independent regulator, there is clearly reliance on government to make those decisions in a way that results in the delivery of services at the levels and prices customers want (or can bear).

This is where regulatory due diligence comes in. Rigorous quantitative and qualitative evaluation frameworks, including cost-benefit analysis, provide a solid foundation to identify, promote and progress policies to improve people’s well-being.

But we have observed with some concern, particularly in recent years, that regulatory decisions affecting service levels and prices have not always been made following careful design and rigorous, transparent appraisal of their impacts.

In addition, we have some concerns about policy settings that limit the role and ability of economic regulators to assess expenditure and determine efficient prices.

In my talk today I will outline some examples of the impact of regulatory decisions on utilities’ costs, prices and efficiency. I will then comment on the importance of pre- and post- evaluations of regulation, given these impacts, with some practical lessons from our own experience.

I will conclude with some observations about IPART’s role versus others’ in overseeing the services and prices of monopoly utilities, and some of the steps we are taking to promote more efficient and affordable supply of electricity, water and transport services.
1.2 The impact of regulation on utilities’ costs, prices and efficiency

In NSW, IPART sets prices for electricity, water and public transport services, but plays a relatively limited role in setting standards of service.

Our biggest role in relation to services standards is in advising the NSW water minister on operating license conditions we consider should apply to suppliers of water and sewerage services. These include the metropolitan providers Hunter Water and Sydney Water, and bulk water suppliers Sydney Catchment Authority and State Water.

For the most part, operating licence conditions are aimed at ensuring that utilities meet standards for water security, reliability, quality, and the minimisation of environmental damage.

Some of the standards which the licences require be met are, in fact, developed by other parties, such as the Department of Health in relation to water quality and safety, the environmental regulator in relation to the environmental impact of sewerage systems, and the relevant policy agency in relation to water security targets.

Historically, we have sought to ensure that utilities comply with, and manage risks associated with achieving, requirements thought necessary to meet the community or government’s expectations in relation to the supply of water and sewerage services.

For energy and transport, IPART sets maximum prices for electricity and transport services, but the government principally determines, with the advice of relevant policy agencies, the standards with which utilities must comply in delivering them.

For example:

- The NSW Government sets electricity reliability and security standards.
- The Government also specifies, for public transport services, requirements in relation to the frequency and location of services, their timeliness, passenger safety and comfort.
- It also often decides how these requirements should be met, for example, the number and type of train carriages or buses that should be in service and the routes they should follow.

Given that such requirements have a significant impact on the scope, quality, and means of providing services it is not surprising that they are a significant driver of service providers’ costs.

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1 The minister makes the final decision on the terms of licenses and may accept or reject our advice.
In recent years, the regulatory and policy decisions of governments – both state and federal - have been amongst the most significant drivers of electricity and water providers’ costs and price increases. These include, but are not limited to:

- changes to electricity licence conditions
- the cost of administering various greenhouse gas reduction schemes
- the rules that governments have set for the determination of electricity prices, and
- the cost of complying with government policies to secure water supply and standards for water quality and environmental protection, particularly as the population has grown.

I will briefly describe their impacts below.

**Electricity licence conditions**

In 2005, in response to a number of outages across NSW, the government introduced a new licence condition in relation to the reliability and security of electricity distribution networks. ²

The condition specified minimum and average reliability requirements, planning requirements to ensure interruption times of specified duration in the event of unplanned outages, and various customer service obligations.

The condition has required network operators to modify their networks to raise levels of service to the new mandatory levels, and have permanently increased their costs because they must maintain services at these levels in the future.

Between 2006/07 to 2013/14, network operators are anticipated to incur capital expenditure of at least $2.79 billion to comply with the condition.³ These costs, as approved by the Australian Energy Regulator (AER), are directly passed through to prices.

To put this in context:

- Network costs currently comprise an average 50% of a typical residential customer’s bill.⁴
- The 3 NSW network operators will spend around $14 billion over 2009/10 to 2013/14 on capital - almost 70% more than the $8.2 billion spent in the previous 5 years - so this proportion is expected to rise.

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² The condition was revised in 2007, mainly to change the compliance date for some requirements from 2009 to 2014.

³ Between 2005/06 and 2008/09, the reliability standards led to an increase in the 3 distributors’ expenditure of $1.45 billion. For the period 2009/10 to 2013/14, the AER indicated that distributors are likely to spend at least $1.34 billion to meet the standards. *New South Wales draft distribution determination 2009-10 to 2013-14*, 21 November 2008.

An average of 9.3% of capital expenditure in the 5 years to 2013/14 is related to reliability and quality of service enhancements.\(^5\)

The new licence condition imposed the most costs on Country Energy, reflecting the ‘reach’ of its network across most of non-metropolitan NSW (Figure 1.1).

**Figure 1.1  Country Energy’s actual and proposed capex by category ($m, 2008/09)**

![Chart showing actual and proposed capital expenditure by category](source)


**Cost of ‘green’ schemes**

The cost of complying with the Federal Government’s renewable energy target (RET) schemes and the NSW Government’s energy efficiency and greenhouse gas reduction schemes is around $2.26 per MWh out of total average energy purchase costs of $77 per MWh in 2010/11 (3%).

Energy purchase costs comprise around 40% of retailers’ total costs, and are passed onto customers.

The cost of complying with green schemes is anticipated to rise to an average of $8.80 per MWh in 2012/13 out of total average energy purchase costs of $83.30 per MWh – 10.5%.

The rise is mainly due to recent changes to the RET scheme that split this scheme into 2 parts – effectively 1 scheme that continues the RET policy for large-scale renewable energy projects and a new scheme to encourage take-up of small-scale renewable energy projects.

Of particular note are cost increases due to the small scale renewable energy scheme. Costs are anticipated to be high because:

- obligations are uncapped, and
- strong demand will be driven by the generous up-front and bonus credits offered under the scheme, as well as other federal and state government incentives to install small-scale renewable energy, including NSW’s Solar Bonus Scheme, and federal and state rebates for solar hot water.

The policy changes to the RET scheme will add significantly to price increases from 1 July 2011.

**Rules for setting electricity prices**

**Network charges**

Rising network costs have been, and are anticipated to be, by far the biggest driver of electricity prices over the next few years.6

One of the drivers of higher network costs is more stringent licence conditions, as I have outlined. Other cost drivers include investment to meet growing demand and to replace/maintain ageing assets.

To an extent, costs associated with ensuring continuing electricity supply and their impact on prices are unavoidable. But it is important that decisions driving expenditure are made prudently. Prudent expenditure decisions ultimately bear fruit by increasing the capacity of businesses to deliver services, and/or to create value. I will touch on this further shortly.

Apart from cost drivers, we have concerns that rules for the setting of electricity network prices bias regulatory decisions in favour of higher prices.

Network charges are set by the Australian Energy Regulator in accordance with the National Electricity Rules. The National Electricity Rules are set by the Australian Energy Market Commission.

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6 In IPART’s determination of prices for the period 2010/11 to 2012/13, we estimated price increases of between 20% and 42% for the 3 standard retailers. An average of 80% of the increase was due to increases in network charges set by the Australian Energy Regulator. IPART, Review of regulated retail tariffs and charges for electricity 2010-2013, March 2010, p 6.
In our view:

- The National Electricity Rules place an inappropriate burden of proof on the AER before it can limit spending proposals from network businesses.

  In effect, the AER must accept a spending proposal unless it can prove that the proposal does not reflect the reasonable efficient costs of the business. The AER can only amend a proposal to the extent necessary to make it compliant with the National Electricity Rules. The AER thus has a substantial evidentiary burden if challenging a proposal, and limited discretion to judge what the efficient costs of a business might be.

  We consider these rules create risks of bias toward higher, rather than lower, prices, and outcomes favouring the interests of the monopoly businesses rather than ones that balance customers’ interests and efficient overall outcomes.

- The Rules also inappropriately allow all capital expenditure, once incurred, to be included in the businesses’ regulated asset bases.

  Expenditure may be prudently or imprudently incurred. Once spent, however, this expenditure is added to the base on which businesses earn a return in future years. And this, of course, is passed through to electricity prices.

  We consider that customers should only pay for returns on expenditure that is prudently incurred.

- Further, the appeals process appears to be unbalanced, and so provides a ‘one way bet’ for the network businesses.

  In effect, businesses can ‘cherry-pick’ aspects of the AER’s determination to achieve more favourable outcomes. There is no requirement on the appeal body, the Australian Competition Tribunal, to consider the merits of the appeal in the context the AER’s whole determination or on final outcomes.

  The risks from failure are low – the businesses will generally end up in a neutral position rather than worse-off. But the impact on prices of these selective appeals can be significant.

  In NSW, the network businesses appealed an aspect of how regulated returns are calculated – specifically, the averaging period for the risk-free rate. The result was approval of an additional $1.6 billion in allowed revenue – out of a total $18.9 billion overall.

These features of the National Electricity Rules do not contribute to efficient outcomes and appear to favour the interests of the monopoly businesses.

We have, therefore, recommended that the Australian Energy Market Commission immediately review how the AER regulates network prices in Australia.
Government policies on water

Turning to water.

Over the past 2 years (2008/09 and 2009/10), the bills for average residential customers of Sydney Water have increased by 26.5%. The bills for customers of Hunter Water went up by 18.3% in 2009/10.

The main drivers of price increases were the costs of complying with mandatory standards for water security, quality and environmental protection, and the need to construct certain infrastructure to meet the state government’s water policy goals.

This includes, for Sydney Water, the costs of the desalination plant and 2 large water recycling schemes at Rosehill-Camellia and Western Sydney.

These decisions have contributed to declines in the measured productivity of metropolitan water suppliers, as the significant increases in ‘inputs’, or resources used to deliver services, have not been matched by commensurate increases in outputs.

Another policy decision affecting water prices in metropolitan areas is that made in December 2008 to set developer charges for water and sewerage infrastructure to zero. Development costs are now passed on to all water users through higher prices.

This decision was made in response to concerns about high development costs and housing affordability. However, developer charges provide signals regarding the costs of urban development and the true relative costs of providing such infrastructure.

The setting of developer charges at zero means that new developments in high cost areas are subsidised by existing customers of Sydney Water and Hunter Water.
Public transport

Finally, I will briefly comment on public transport.

Prices have not increased at the same rate for public transport customers, partly because costs are shared with taxpayers through the Budget – recognising the benefits that the use of public transport provides to the community as a whole through the reduction of congestion and air pollution.

IPART has identified significant scope for efficiency gains while maintaining or increasing levels of service, particularly by CityRail, buses and ferries. However, these services are substantially subject to state government control and direction, and reforms that would realise these efficiencies are subject to government decision.

1.3 Implications for policy development and economic regulation

These are some examples of the impact that regulation, including policy decisions, can have on monopoly providers’ costs, prices and efficiency. It will not surprise you that we consider rigorous and transparent evaluations of policies affecting service levels and costs to be extremely important.

The significant role that governments play in determining the costs and standards of monopoly services also raises particular considerations and challenges for IPART as economic regulator, particularly in relation to promoting improved efficiency in the utilities, and fair and efficient outcomes overall.

I will consider each of these issues in turn.

Importance of pre- and post- evaluations of regulation

Regulatory requirements should generate (and continue to generate) a net benefit over time.

I would summarise the key aspects of regulatory due diligence as:

1. defining the problem accurately
2. determining the best way to fix the problem, and
3. checking regularly that the problem still exists and the policy response remains appropriate – and removing or amending the policy if necessary.

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7 For example, in IPART’s 2008 review, we found scope for at least an 18% reduction in CityRail’s operating costs per annum by making efficiency savings of around $454m in real terms, while maintaining or improving service standards. IPART’s 2009 fare review for Sydney Buses found that Sydney Buses could deliver up to $41.2m in efficiency savings annually by 2013/14, under current labour constraints.
Given the difficulty of ‘unwinding’ requirements for capital-intensive businesses, rigorous pre-decision analysis for the electricity, water and transport businesses that IPART regulates is particularly important.

Where the government makes decisions on service levels or means of delivering them, rather than the regulated entity, there is clearly less scope for IPART as the economic regulator to question the prudence of these and to limit or not allow expenditure.

It is, therefore, important that regulatory decisions be made following thorough consideration of options for achieving policy aims, consultation with stakeholders and rigorous cost-benefit analysis.

**Tillegra Dam and electricity licence conditions**

The examples of Tillegra Dam and changes to electricity licence conditions provide useful case studies on these points.

In 2008, the NSW Government directed Hunter Water to construct Tillegra Dam as a way of securing water supply for the Hunter Region. At the same time, it directed IPART to include in Hunter Water’s prices the efficient costs that it would incur to construct the dam. The cost of the dam was estimated at $477 million.

Under the terms of the direction to IPART, we were not permitted to review, as we would do for other expenditure, the prudence of Tillegra dam – for example whether it was necessary, and whether there were more cost-effective ways of securing water supply for the region.

The proposed dam was highly controversial and debated extensively in the community because of its likely costs and potential environmental impact.

Due to its nature and significance, the Tillegra Dam proposal was required to undergo environmental and technical review by the planning department.

The proposal fell at this last hurdle, and the government announced in November 2010 that the dam would not be constructed. IPART has since released a determination announcing refunds and revised prices for Hunter Water customers.

The Tillegra Dam case contrasts with the outcome of the new electricity licence condition.

Both Tillegra Dam and licence conditions were mandatory policy requirements of the government.

We understand that the government made decisions to proceed with both following limited evaluation of their costs and benefits.
The impacts of the policies on costs, prices and the community were not fully known until they were being implemented. Unlike Tillegra Dam, however, the more stringent electricity licence standards were not subject to a phase of external review, therefore transparent scrutiny and community input. They were implemented upon the decision of the minister.

As indicated earlier, the standards have had a significant impact on electricity prices.

The government has considered ways of limiting the price impacts, but it is hard to completely reverse decisions that have such a profound impact on network planning and delivery.

**Regulatory good practice – some practical considerations**

It is critically important that decision-makers make their best efforts to define policy problems as precisely as possible and consider all feasible options for tackling them - informed by their costs and benefits - before making their final decisions.

Following good regulatory practice is challenging. There needs to be the will to undertake analyses properly. A common challenge is measuring problems, costs and benefits.

Some practical lessons from our experience as economic regulator and independent advisor to government include the following.

**A clear understanding of goals is extremely important**

A clear understanding of “ends” – the goals or objectives of regulatory decisions - is extremely important.

In relation to increased electricity reliability standards, more stringent standards to reduce the risk of service interruptions might have seemed a worthy object.

But taking the question of “ends” a step further, have more stringent standards materially advanced people’s well-being? The risk of service interruptions may have diminished, but does this matter much to customers?

Certainly, more stringent standards have created significant costs for electricity customers, and they might consider themselves to be, on the whole, worse off.

Of course, the question as to “ends” could be taken further. Using the example of electricity network reliability again, are all customers’ needs the same? If businesses need a higher standard of reliability than, say, most residential customers, should this invite consideration of options other than network augmentation?

In this case, policy directions may have been better informed by the community’s views on whether or how much it is willing to pay for such service enhancements.
The approach of South Australia’s economic regulator, ESCOSA, provides an interesting contrast to NSW.

ESCOSA is responsible for determining customer service, reliability and quality standards, as well as electricity prices. In 2003 and again in 2010, ESCOSA commissioned a survey of customers’ satisfaction with service standards and their willingness to pay for service enhancements.

Amongst the findings of the surveys, both times, was that around 85% of customers were satisfied with their existing levels of service. ESCOSA decided not to change service standards for the current 2010-15 price control period as a result of the most recent customer survey.

It is worth remembering that regulation is supposed to be a proxy for competitive market mechanisms that would otherwise resolve the question of what customers want and how much they are prepared to pay.

Regulators, whether government agencies or independent bodies such as IPART, need some way of knowing that services are a reflection of what customers want.

Regulators would expect companies to take steps to determine what customers want and for this to be part of their business decisions. Customer engagement is therefore important for both regulated businesses and for regulators.

We see merit in there being an obligation on the relevant decision-maker (be they the utility, environmental regulator, service standard regulator, or economic regulator) to consult with their customers (or community for environmental standards) before changing mandatory standards or submitting pricing proposals.

For our part, we are currently looking at how customers’ preferences can play a greater role in driving changes to service levels for the entities we regulate.

Our first step is a study of the extent and means of customer engagement in support of pricing proposals undertaken either voluntarily or at the request of the regulator; and the extent and form of research undertaken on customers’ willingness to pay for capital expenditure, service standards and pricing.

This study is looking at practice both in Australia and overseas. We hope to release it in June this year.

**Important, too, is an understanding of the means to achieve goals**

As important as understanding goals is an understanding of the “means” for achieving these goals. On this, we need practical evidence and input:

- What works?
- What are the risks?
- What are the feasible options?
Public consultation on policy directions and design is almost always invaluable.

The input of stakeholders allows policy makers to obtain a more thorough understanding of policy problems, and the cost, benefits and impacts of change. This helps to develop practical options for change and strategies to manage risk, so build acceptance, if not support, for proposed reforms.

Further, public consultation provides decision-makers with an opportunity to gauge the likely community responses to different policy options, helping it to anticipate and better respond to these responses. This is especially relevant where the policy issues involved are complex or contentious.

**Need for better measures of progress**

Good quantitative analysis will help to identify the best reform options once objectives are clear. But we need to ensure that our metrics – what we use to measure progress – are robust.

Along with many regulators, we recognise the need for better measures of progress (outputs/outcomes). Statistical indicators affect judgements about the current state of affairs and what society and individuals value and, therefore, what the appropriate policy responses are.

A challenge is to ensure that we collect the right indicators, and ensure these indicators are well understood and communicated. But investing in better measures of progress will not produce better outcomes if customers or the community do not understand them.

IPART is currently reviewing, in consultation with stakeholders, indicators for water and sewerage services. Our aim is:
- to better inform customers about the level and quality of services being provided
- to improve the rigour of our advice to the minister on operating licence conditions that should be applied to the water utilities, and
- to incorporate better measures of service delivery into our reviews of proposed expenditure by the utilities, and their performance.
Role of IPART versus other ‘regulators’ and implications for promoting efficiency

I will now turn to some of the implications of current institutional settings for our role as economic regulator, in particular the promotion of efficient and equitable outcomes.

As indicated earlier, in NSW many of the decisions on changes to service levels for energy, transport and water are made by government (ministers and agencies) rather than IPART. In large part, this may be because many of the businesses are government-owned, and are commonly seen to provide ‘essential’ services. They are, therefore, more affected by government policies and changing standards.

But these decisions can directly and significantly influence service providers’ costs, prices and productivity.

What does this mean for promoting improvements in utilities’ efficiency?

The traditional economic regulatory problem is getting the operator’s and owner’s interests to align. Hence the main incentives in pricing mechanisms are based on the maximisation of profit – if the utility improves efficiency it gets to keep a share or all of the gain from doing so.

In our experience, improving efficiency in order to maximise profit is only one objective and driver of performance in government businesses, and may not be necessarily the most important.

Government ownership of the major utilities also alters the dynamics of standard and other policy setting. For example:

▼ Their expenditure may be driven by non-financial goals or pressures, for example, political goals, budget constraints.

▼ Capital expenditure proposals may be subject to other tiers of review, such as Cabinet. Proposals that facilitate the policy goals of government may assume mandatory force, for example, through the issuing of a direction to the business to undertake the project. This occurred with Tillegra Dam and the desalination plant for Sydney.

▼ The process for setting standards and other policy requirements affecting services is different, in practice, to setting requirements for private firms:
  - Utilities may be less inclined or able to resist more stringent standards and, in some cases, have helped develop and promote them.
  - There tends to be less transparent scrutiny of proposed policy changes when the directly affected parties are mostly regulated government businesses. Regulated businesses may also be less inclined to ‘push back’ on proposals because costs associated with binding directions will be recovered through higher prices.
Some implications for our role as regulator include that:

▼ To the extent there is monopoly rent, it may be captured within the utilities through excessive costs rather than monopoly profits.

Hence, there may need to be greater focus on testing the efficiency of costs, and accountability for outcomes, and less emphasis on complex financial efficiency incentives.

A key question for IPART is that of how the regulatory process can ensure better information is provided earlier and alternative solutions debated so that we can have more confidence in the solution provided and it has the community’s support.

▼ In relation to ex-post reviews of outcomes, it is hard to unwind regulatory decisions and, of course, bad decisions leading to (economic) loss cannot be recovered. In this case, our role may be to determine who bears the loss.

However, more in-depth ex-post reviews may help inform judgements in future about the capacity for efficiency improvements and thus lead to the setting of more robust targets.

▼ Improving governance of the utilities may be the primary means for improving efficiency.

Ultimately, the government, as owner of the major energy, water and transport businesses, has the most control and influence over the businesses’ behaviour.

The incentives to improve cost-efficiency that are embedded in IPART’s price controls are only effective to the extent that they align with the incentives that the government gives to the businesses’ management. At present, there is not strong alignment.

**Steps we are taking to promote efficient and fair outcomes**

**IPART’s pricing and licensing decisions**

In line with the implications set out above, IPART is seeking to more closely scrutinise proposed expenditure and service providers’ actual performance.

Our work on developing better measures of performance for the water utilities is one step in this direction. Amongst other things, we are seeking to develop a smaller number of the most important indicators which are likely to promote better accountability and give better assurance for the community.

As indicated previously, we are also:

▼ seeking to ensure that our advice to government on operating licence conditions for water utilities meets standards for good regulatory practice, and

▼ in price setting, looking at how customers’ preferences can play a greater role in driving changes to service levels.
Encouraging good policy making by government

When IPART was established in 1992, policy makers considered that the establishment of an independent regulator would be important for ‘de-politicising’ price setting, and thereby improving fairness and efficiency.

It is probably fair to say that this function remains important.

Where the government makes policy decisions, we are seeking to promote better policy making by making government decisions affecting costs and prices transparent, and encouraging stronger government and service provider accountability through the independent monitoring of performance.

IPART is also seeking to promote more equitable outcomes, including by advising the government on policies to assist customers who are adversely affected by rising prices.

We have recently developed an impact assessment model. This model contains the best set of consumer data in NSW, and is able to provide a greater understanding of the impact of utility price rises and Government customer assistance programs on different groups in the community. As such, we are seeking to facilitate better-informed decisions about how to make government customer assistance programs more effective.

Finally, we have made a number of recommendations to the government in relation to the governance arrangements for government-owned utilities, including the institution of stronger monitoring and incentives to improve the efficiency of their performance.

Concluding remarks

I have outlined some of the impacts of regulation on utilities’ prices and efficiency, the challenges these raise and steps we are taking to promote more efficient and affordable electricity, water and transport services in NSW.

I hope that these remarks have been useful. Thank you for the opportunity to present to you today.