



ROLE OF REGULATORY PROCESS IN ENERGY SECTOR REFORMS

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Independent regulator

- **Energy regulation – why?**
- **Energy regulation – how?**
- **Independent regulator – why?**

What is regulation?

- **Government has 3 functions: tax, spend and regulate**
- **regulation is Government intervention**
 - **direct: primary and secondary legislation**
 - **indirect: telephone calls, friendly advice, personal favors, etc.**
- **economic regulation is a (bad) substitute of competition**

Objectives of regulation (why?)

- **protection of customers**
- **ensuring the financial viability of the companies**
- **promotion of competition**
- **collection and dissemination of information**

How to regulate?

- **No regulation**
- **Self-regulation**
- **Command and control**
- **Independent regulation**

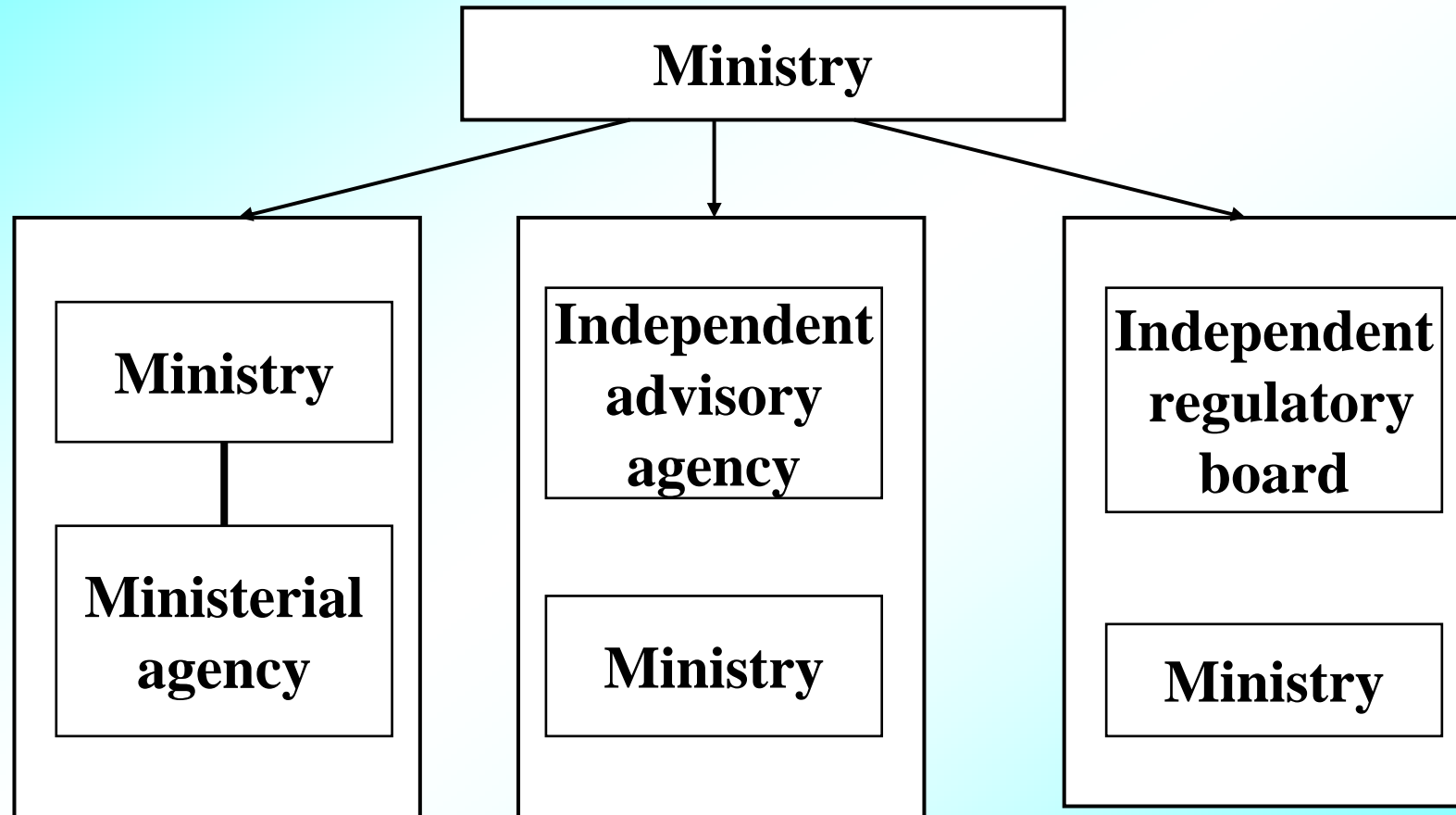
Old style regulation (command and control)

- **energy companies - state owned monopolies**
- **Government approves minor operating decisions**
- **sectorial ministry is an owner and a regulator**
- **state owned enterprise is protected from competition but may be not allowed to cover all its costs**
- **subsidies and cross-subsidies are allowed and politically supported**

Need for a new type regulation

- **emerges with an introduction of a private capital**
- **investors want to secure themselves from the Government intervention**
- **increases with the liberalization of the sector (unbundling, introduction of competition)**
- **regulation of the liberalized, privatized sector require new tools and approaches**

The regulator vs. the Ministry (1)



The regulator vs. the Ministry (2)

	Ministry	Indep. regulator	Compet. authority	Judicial system
Specialised knowledge	high	high	low	very low
Risks of capture	depends	depends	low	very low
Speed in decision making	high	high	low	very low
Trustworthiness	depends	high	low	high

New versus old type regulation

- **old type regulation was performed, in general, through**
 - **setting prices and technical standards,**
 - **using ownership as a control mechanism**
- **it was unclear, non-transparent, unpredictable**
- **the goal of a new type regulation is**
 - **to encourage competition (where it is possible)**
 - **to regulate monopolies by using clear, transparent rules and mechanisms**

Need for an independent regulator

- **to protect investors from unacceptable risks**
- **to protect consumers from the monopoly power abuse**
- **to give to all the market players clear, transparent stable rules of the game**

Why to protect investors?

- **utilities are heavily capital intensive and have very long-life assets**
- **investments are large and immobile, with long pay-back periods**
- **investors require clear rules of the game**
- **distrust of the investors reduces credibility of the country and increases the cost of capital**

Some pitfalls for regulatory bodies

Europe is unfamiliar with the need for institutions to constrain opportunism and to protect investors in the energy sector, for several understandable reasons:

- There is a history of public ownership**
- The basis for incentive regulation is unfamiliar**
- There is no explicit constitutional protection of investments**

Main principle for price regulation

The regulator should set *regulated rates* or tariffs for the regulated companies so that the regulated rates allow the companies to earn a revenue that covers the “*justified costs*” of their operation, that is the costs that are *necessary* and *unavoidable* to provide the regulated service at a *predefined level of quality*

Distorted prices – regulatory tasks

PRICE DISTORTIONS

- **Above-efficient market prices**
 - Monopoly pricing
 - Few players exercising their market power
- **Below-efficient market prices**
 - Subsidised industries
- **Non-internalised external costs (free pollution)**

GETTING THE PRICES RIGHT (MIMIC THE MARKET)

- Monopoly price regulation
- Market price caps (?)
- (Merger control and antitrust)
- Removing direct and indirect price subsidies
- Renewables pricing
- (Creation of emission rights / green certificates markets)
- (Environmental taxation)

Major threats for regulatory independence

- In case of monopoly regulation: the direct conflict is more with profit oriented companies
 - capture
- In case of depressed prices: the direct conflict is more with politics
 - politically influenced / modified prices
- Insufficient resources - low quality decisions
 - lack of enforcement
 - lack of information

Challenges of the present

- Price regulation in various market models
- Promotion of competition in liberalised energy markets
- Promotion of trans-national market integration and regulatory cooperation

**We will discuss these issues
further**