



# Regulation as it Affects Privatization and Encourages Utility Efficiency

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## Our Perspective

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A few fundamentals...

A coherent, stable and predictable regulatory framework for a utility is vital for the success of a privatization process.

Although there are examples in which a privatization transaction occurred even with an undeveloped regulatory framework, the post-privatization experience is where the weaknesses in the regulatory framework often materialize and cause the greatest difficulty.

## Our Perspective

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Given that the government is actively considering privatization, this presentation indicates the critical components of regulation that are needed to both:

- ✓ Support the objective of successful privatization process measured not just by the transaction being consummated, but by the post-privatization experience as well
- ✓ Enhance the efficiency of utility services and service quality, to ensure that supply is of sufficient quality and reliability to support economic and social development, that is reasonable in terms of costs of supply, and aligns with other governmental objectives (e.g., environment).

Our perspective is based on having served as both an operator for state-owned utilities and transaction advisor for utility privatizations ...

# Regulatory Needs to Support the Privatization Process

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## #1 - Institutional Makeup:

- ✓ An enabling law(s) for regulation of the sector that establishes:
  - The authorities of the regulator
  - At least the basics for quasi-independent regulation (e.g., financing scheme promoting independence in decision-making)
  - The delineation of responsibilities between the policy making and regulatory functions.
- ✓ The legal framework is not subject to frequent amendment, i.e., is relatively stable.
- ✓ The regulatory institution has a track record of at least a few years to provide some degree of comfort in how the regulator functions.
- ✓ The regulator is seen as being trained and competent in the practice of regulation.

# Regulatory Needs to Support the Privatization Process

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## #2 - Transparency:

- ✓ Clearly defined procedures in areas including:
  - Evidentiary gathering and documenting the decision-making process (more like a court judgment, less like a decree)
  - Stakeholder participation and contribution to the regulatory deliberations
  - Hearing process and public participation
- ✓ Decision-making that is seen as being:
  - Based on the evidence presented
  - Coherent chart of accounts – audited by the regulator – as the basis for cost and tariff reviews
  - No apparent government, or other undue stakeholder, interference in the decision-making process.

## Regulatory Needs to Support the Privatization Process

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### #3 – Regulator ‘Practicality’:

- ✓ The regulator should recognize the complexity of certain reform processes, not making unreasonable demands of the utility
- ✓ No involvement in utility operational matters other than through regulatory audit, tariff and other related cost reviews
- ✓ The regulator should be seen as being realistic – e.g., avoiding introducing a complicated tariff structure that the metering infrastructure cannot support.

## Regulatory Needs to Support the Privatization Process

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### #4 – Tariff Principles:

- ✓ The basis for establishing tariffs should be seen by the potential investor as:
  - Transparent and relatively simple
  - Economically efficient
  - Cost reflective
  - Stable/predictable path towards full cost recovery
  - Equitable for customers
  - Promote electricity system expansion.
- ✓ The tariff system should also reflect cost recovery for various components of the revenue requirement that are out of the control of the utility, e.g., exchange rate changes, impact of legal amendments.
- ✓ No significant use of the tariff system for addressing social protection.

# Regulatory Needs to Support the Privatization Process

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## #5 – Tariff Structure:

- ✓ “Cost-Plus” Pricing: This approach relies on the concept that the costs which a monopolist prudently incurs in providing services to consumers should be allowed to be recovered in tariffs, together with a “fair” profit level.
- ✓ “Benchmark” Regulation: In some (generally rare) instances, it may be reasonable to set prices for services on the basis of observable (market-based) prices for the same services in an equivalent market. This approach reduces the regulatory burden associated with detailed “cost-plus” pricing.
  - This approach was used to regulate generation prices in Scotland in the early 1990s, benchmarked to the market in England & Wales
- ✓ “Incentive” Regulation: Today, increasing numbers of regulators are adding elements of incentives -- usually schemes to allow some sharing of the benefit of cost or performance improvements between consumers and the regulated entity. These incentive arrangements are usually linked together with cost-plus or benchmark regulation.

## Regulatory Needs to Support the Privatization Process

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### #5 – Tariff Structure (cont.):

In recent years, a variety of different approaches have been developed aimed at providing better incentives for good performance by regulated entities, approaches that may be useful to consider during privatization such as:

- ✓ Performance Target Reward / Penalty Schemes: Identify (controllable) measurable technical parameters and negotiate systems of financial rewards or penalties for performance better or poorer than target levels.
  - This approach is used to provide incentives for the minimization of transmission system losses and ancillary services costs in England.
  - Such schemes usually require sufficient “baseline” experience in order to negotiate reasonable target levels.
- ✓ “Price Caps” or “Revenue Caps”: As an alternative / adjunct to “cost plus” approaches, these techniques essentially freeze a forward path of average prices (or total revenues), allowing regulated entities profit-enhancing incentives to develop and implement operational efficiencies.

## Regulatory Needs to Support the Privatization Process

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### #6 – Market and Trading Rules:

- ✓ The basis for the commercial trading arrangements in the sector must be clear. This includes:
  - Sector structure
  - Contractual arrangements
  - Power purchasing arrangements
  - Franchise requirements and extent of exclusivity
  - Recognition of ancillary services
  - Market monitoring to prevent abuse
  - Planning regime in place
- ✓ The market and trading rules should be seen as being relatively stable, with amendments made only after a broad and open consultative process with all stakeholders.

## Regulatory Needs to Support the Privatization Process

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### #7 – Regulatory Participation in the Process:

- ✓ The regulator should participate in the privatization process, or at a minimum, be consulted throughout.
  - Although this seems obvious, it has sometimes been ignored and this can cause concern for the potential investor and increase perceived risks.
- ✓ The regulator must be seen as balancing the interests of the potential investor and consumer. Too heavy of an emphasis on the consumer – or worst still, strongly populist statements – will increase the perceived risks of ownership, likely countered by additional investor demands and reduced value for the government and public at large from the privatization process.

## What you Want to Avoid...

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*Yes, this is a single privatization contract, in 59 volumes... key regulatory procedures and principles had to be defined contractually given weaknesses in the regulatory framework and regulatory institution...*