

***Regulatory Performance vs.
Independence –
The European Experience***

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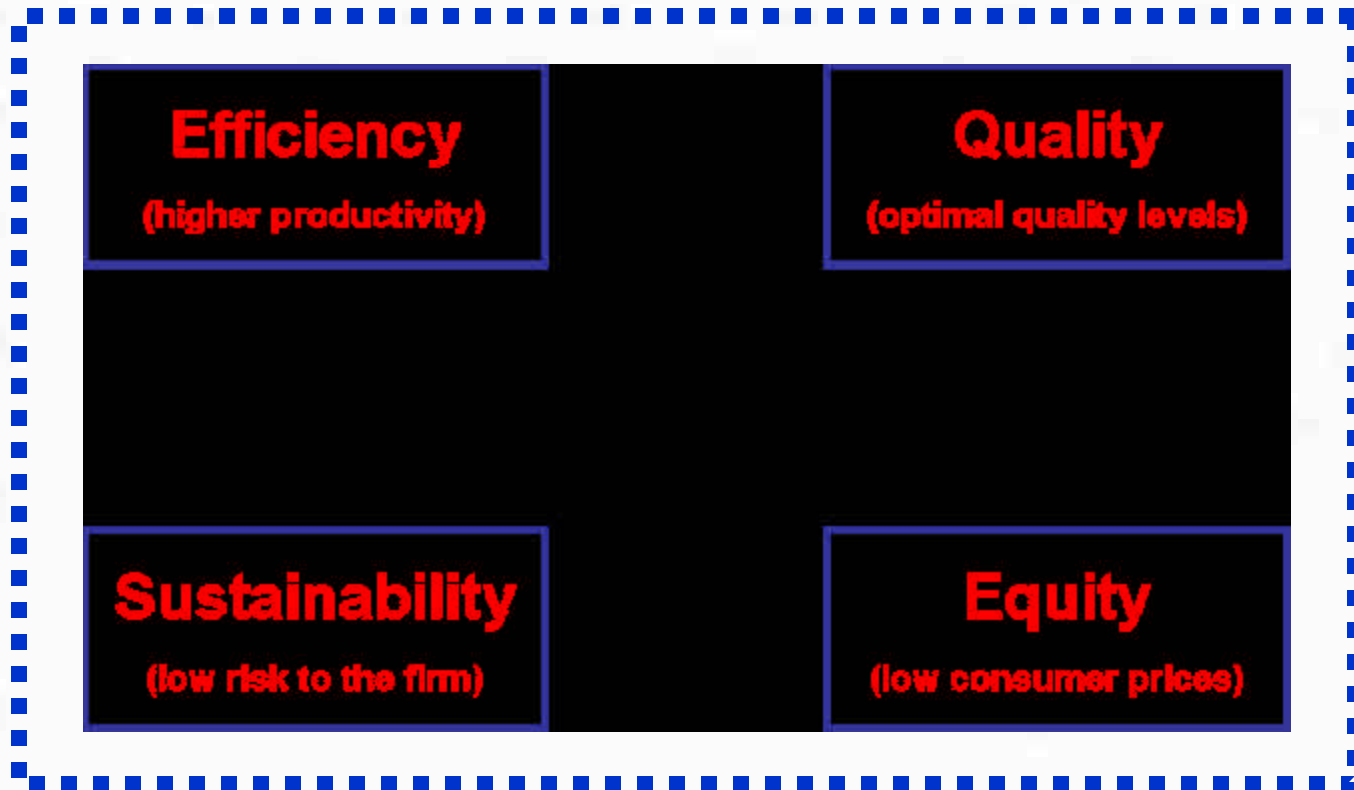
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Overview

1. Regulatory Objectives
2. Independence vs. Performance
3. Case Studies
 - the Netherlands
 - Slovenia
4. Conclusions

Conflicting Objectives



Constraints: Political, Legal, Environment, etc.

Independence vs. Performance

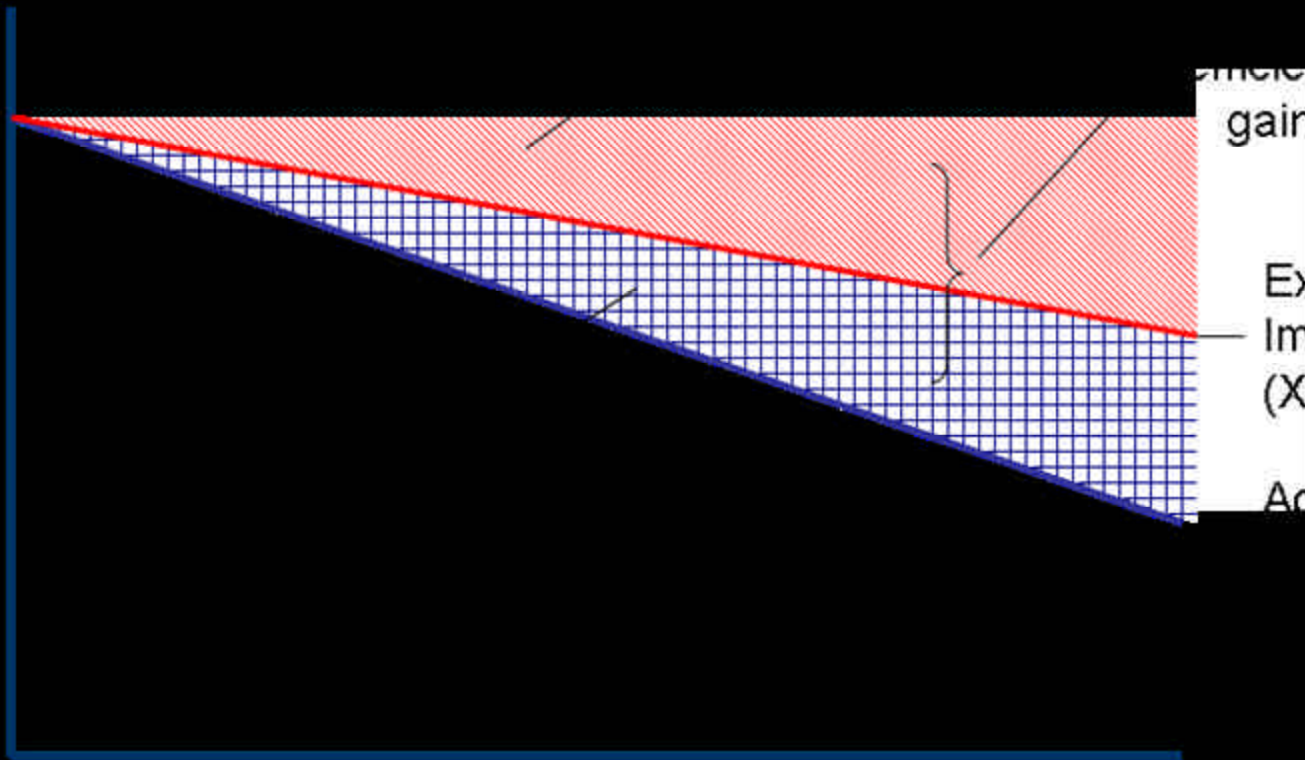
- Independence
 - Carefully weighting objectives and interests
 - Detached from short-term political concerns
 - But taking into account long-term political and other constraints
- Performance
 - Credibility: Fair and just in its decisions
 - Expertise: High level of expertise and deep insight into the complexities involved
- High regulatory performance is a necessary (but insufficient) condition to maintain independence
- Lack of expertise can lead to loss of credibility and consequently, loss of independence

Price-Cap Regulation

- Becoming default approach to set network monopoly prices
- Provides much stronger efficiency incentives than rate-of-return regulation
- Principle: Unlinking prices from costs produces incentives to operate more efficiently
- Concept is simple, but implementation is complex

Price Cap Regulation – Principle

$$P_t = (1 + CPI - X_t) P_{t-1}$$



Price Cap Regulation – Complexities

| Determinant | Choices and Issues |
|---------------------------------|--|
| Regulatory Strategy | Singular Caps, Related Caps, Yardstick Competition |
| Price Cap Form | Price-Caps, Revenue-Caps, Sliding Scales |
| Demand Forecast | Volume dependent or independent caps |
| Operations and Maintenance Cost | Benchmarking Technique: Ratios, DEA, COLS, SFA, Reference Models |
| Assets Valuation | Historic costs, replacement costs, recoverable costs |
| Return on Assets | Risk assesment, WACC, CAPM |
| Depreciation | Straight line, accelerated |
| Investments | Inflated projections, efficiency assessment, quality |
| Network Losses | Incentives for quantities or price |
| Inflation Indicator | General Inflation Index (CPI or RPI), industry-specific indexes |
| Regulatory Period | Annual review, 3-5 years, efficiency transfers to consumers |
| Benefit Sharing | Readjusting the price-zero, efficiency carry-overs |
| Quality Problems | Minimum standards, incentive schemes, quality indicators and measurement |

Case Study: The Netherlands



The Dutch Price Cap

- 2000: Primary price-cap decision for electricity networks
 - Very high X-factors (DEA benchmarking model)
 - Critique on methodology and (benchmark) data
- 2001: First revision
 - Adjustment of methodology
 - Use of improved data
- 2002: Second revision
 - Further improvement of data
- 2003: Settled with the industry

Independence Problems

- Political critique on DTE's performance
 - Many and fierce legal battles with the industry
 - Frequent revision of its decisions
 - Led to question DTE's credibility
- Effects on DTE's independence
 - More operational influence by the Ministry
 - Important policy issues shifted to the Ministry

Case Study: Slovenia



Slovenian Price Cap Approach (1)

- Price Cap approach: Based on remuneration of (efficient) costs
 - Including a reasonable return on investment
- Historically: under-returns on investment
- Price Cap led to increase in prices of average 15% per year

Slovenian Price Cap Approach (2)

- Price Cap was based on fixed demand predictions
- Demand growth in excess of expectations led to substantial “windfall” profits
- Accession to EU: Reduction of inflation important political issue
- Inflation strongly driven by electricity prices

Independence Problems

- Political critique on AERS's performance
 - Not responsive to macro-economic effects of its decisions
 - Hesitation to claw back windfall profits
- Effects on AERS's independence
 - Revision of the Energy Act
 - Replacement of the Director and reduction of powers
 - Establishment of Regulatory Council: Politically controlled

Conclusions

- Political ammunition to attack independence
 - Netherlands: Wrong use of benchmarking analysis
 - Slovenia: Little flexibility towards macro-economic objectives
- Main points of this presentation
 - Performance fuels Independence
 - Performance requires Expertise
- When implementing price caps, these experiences provide valuable lessons to Caribbean regulators



*Thank you
for your kind attention!*

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