

REGULATION AND ELECTRIC RESTRUCTURING POLICY NOTE:

FOLLOWUP TO MOSCOW VISIT OF JULY 12-15,2005

AND WORKSHOP OF JULY 14, 2004

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I. INTRODUCTION AND BACKGROUND

In January 2004, a World Bank (WB) mission, including both WB staffers and two outside consultants, visited Moscow to review the proposal of RAO-UES, the state-owned electric utility, to restructure the Russian power sector in ways that would promote competition and render the sector more efficient. The objective of the WB mission was to produce two Policy Notes, one on market design, and the other on regulation. After extensive review of documents and meetings with a broad array of critical players in the market, as well as interaction with Russian counterparts, the Policy Notes were written in June 2004. Those papers, based on the submissions of the two outside consultants (Larry Ruff for market design and Ashley Brown for regulation), were distributed within the Russian power sector.¹

Since the publication of those reports, the nature of the sector reforms being proposed has been somewhat revised. Moreover, a series of institutional changes in the regulatory regime occurred after the January, 2004 mission to Moscow, but prior to the issuance of the report. In light of those changes and in a desire to exchange ideas, the WB, in

¹ The report based on Ruff's findings is entitled, "Structural and Design Issues in the Russian Electricity Reforms." The other, based on Brown's findings, is called, "Policy Perspective and Analysis of the Regulatory Regime in the Restructured Russian Power Sector."

cooperation with both the Russian Government and RAO-UES decided to conduct a workshop in Moscow on July 14, 2005 to facilitate and enable such an exchange.

As a result of that workshop and informal conversations enabled by it, a Policy Note Update would be appropriate. As in the case of the 2004 Policy Notes, there will be two papers. This one will address regulatory issues, while the other one, based on findings by Larry Ruff, will look at market structure and design issues.

II. UPDATED POLICY NOTE ON RUSSIAN ELECTRICITY REGULATION

The RAO-UES proposals for restructuring the electricity market in Russia have undergone considerable change since the 2004 report was issued. The substance of the changes is addressed in the companion policy update prepared by Dr. Larry Ruff. *What is particularly striking about the evolution of policy is the almost complete asymmetry between the effort that has gone into the evolution of the market design versus the virtual absence of any action, discussion or thought on developing a regulatory system appropriate for the new market.* This asymmetry, if continued, based on precedents in other countries around the world, is potentially very problematic and requires attention.

Experience around the world has, perhaps without exception, been that the failure to have an adequate electricity regulatory framework in place either before implementing market reforms, or at least contemporaneous with market reforms leads to serious, if not catastrophic, results. *Should the asymmetry between market design and regulatory evolution continue, Russia runs the very serious risk of joining such places as Brazil, India, Indonesia, Pakistan, and even California in having electricity supply crises or severe loss of investor and consumer confidence (or both) brought on or exacerbated by the failure to keep pace on regulatory reform.*

The regulatory situation in Russia in 2005 is not appreciably different from what was described in the Policy Note of 2004. Accordingly, the policy notes (as numbered in the 2004 paper) are set forth below in italics. Following each category of notes, where appropriate, updates will be noted. In many cases, however, because the regulatory situation has remained largely unchanged for the past year, no updates are required.

OVERVIEW OF THE PROPOSED REGULATORY REGIME

2. 1 Policy Observation

It is of great importance to review all of these arrangements and institutions to make certain that they interact harmoniously, coherently, and comprehensively, or that the regulatory design be reduced in its complexity (e.g. merging functions and/or institutions, clear decisional hierarchy established) in order to facilitate consistent, coherent, and

carefully calibrated decision-making. It is not at all certain, even in the context of the recent restructuring, that the current alignment of agencies and responsibilities will be fully functional as currently configured. If, as foreshadowed, substantial changes in the regulatory regime may be required, it would be better to implement the changes earlier rather than later. If, however, practical considerations mean that this is not achievable a clear transition timetable should be established. It must be noted in that regard, however, that post-reform changes can prove quite problematic. Vested interests can become quite invested in the status quo and resist changes that others may believe to be in the public interest. The ability to make second generation reforms cannot be taken for granted.

UPDATE

There has been some change in the institutional arrangements since 2004, that could reduce the complexity of the regulatory system. Some authority may have become more centralized for two reasons. The first is that regional Governors will no longer be elected, but rather appointed by Moscow, so presumably they and their appointees to the REC's will be more accountable to central authority than they may have been in the past. While that may allow for more coherent decision-making, as will be discussed below, it may come at a cost in terms of reduced independence. The second reason is that MEDT, as was noted in the 2004 paper, has acquired more authority over FTS, and perhaps FAS as well, than it had over their predecessors, the nominally independent FEC² and MAP.³ In addition, the FTS mandate seems largely confined to tariff setting, so it is possible that FAS' primacy in regard to competition issues is now better established. Those observations, however, may turn out to be more speculative than real, as there is simply not yet sufficient experience to prove anything.

The fact remains that a bewildering complexity of decision-makers exists in regulation. None of the changes referenced reduced the number of agencies with a jurisdictional place on regulation. FTS may have replaced FEC, but there is still the national electricity regulator. Moreover, the FAS, regional REC's, MEDT, and FTAS (formerly SESA) not only still exist, but play basically the same role they did before. In short, the complex allocation of regulatory responsibilities have possibly been simplified, but this is not clearly the case. Even if it has been simplified, compromised independence may be the cost.

Finally, none of the changes that did occur appear to have been done in response to the proposed changes to the market structure for the sector. As noted above, regulatory reform appears to be on a completely different, and largely unrelated, track to market reform.

² The creation of FTS and termination of FEC occurred after the January, 2004 visit of the consultants to Moscow, but before the completion of the report, so the change was noted in the Policy Notes, but given its newness at the time, it was not clear how the situation would play out..

³ FAS, like FTS, is a new agency created to supplant its predecessor, MAP.

3. REGULATORY INDEPENDENCE

3.1 Policy Observation

ATS is neither completely independent of the Government, nor lacking in ties to the private economic and financial interests of market participants. While those interests may well diverge or even conflict from time to time, that is a weak foundation for assuring that ATS will possess the level of independence required for a market administrator to effectively and credibly carry out its responsibilities.

UPDATE

While the FTS's predecessor, FEC, as noted in last year's report had at least nominal independence of the government,⁴ FTS appears to have considerably less. While the 2004 Policy Notes stated that MEDT had veto power over the agency, a Ministry representative at the July 2005 Workshop denied its existences. He did, however acknowledge that the Ministry did have two seats on the Board of FTS. No controversy exists regarding the fact the MEDT's inflation targets are, to understate the point, influential in the tariff setting process.

In regard to the connections between market participants and FTS, no additional information surfaced that would justify any updates to the 2004 paper.

3.2 Policy Observation

Best international practice suggests that final authority over regulatory matters be vested in agencies that possess adequate independence from government and from private interests with significant stakes in regulatory outcomes. It does not appear that the Russian regulatory agencies possess that requisite level of independence.

UPDATE

No change, beyond that already noted in 3.1.

3.3 Policy Observation

Competition regulators should possess full independence in assessing and monitoring the market, in taking actions to enforce and enhance competition, and to remedy problems associated with market power, market failure, market design flaws, and abusive behavior. The key point is to make certain that the competition regulators are able to carry out their obligations free from politics and free from undue interference or lobbying by private economic interests. That does not appear to be the current circumstance in Russia.

⁴ Many interviewees made comments suggesting that in practice the agency's independence was more theoretical than real both in regard to the government and to certain market participants. While the author made no judgment as to the veracity of such claims, it is notable that they were fairly widely held.

UPDATE

No change in the principles enunciated, although the nature of regulatory oversight may change because of the changes in the proposed market design, as noted in Larry Ruff's companion update.

3.4 Policy Observation

The fact that all but one of the FTS Commissioners are appointed by the Government rather than by the President, that MEDT has the power to direct the use of its preferred methodologies, to impose price caps and to rescind FTS decisions is inconsistent with best international practice regarding the independence of regulatory agencies. To the extent that price caps for particular customer classes or limitations on pricing methodologies are necessary they should, as far as possible, be specified at the outset, in the framework within which the regulator operates rather than subsequently imposed by the Government.

UPDATE

No change

3.5 Policy Observation

The context within which REC Boards are appointed and do business – often without fixed, staggered, terms, with communications between RECs and regional governments be made generally on a non-transparent basis, and without a single board, entirely composed of persons fully independent of any particular special interests – is out of step with best international practice.

UPDATE

The policy note does not warrant updating, but the fact that Governors are now to be appointed by Moscow authorities rather than freely elected may even further diminish the independence of the REC's. Given that no in depth inquiries were made on the subject while in Russia, that observation is more in the nature of an intuitive judgment than a scientific observation.

3.6 Policy Observation

FTS and FAS should not be represented on the ATS board as it may compromise the effective regulatory oversight of the market administrator. The fact that ATS has a governing board composed of directors linked to market participants and/or the government is a potential source of problems and should be monitored carefully.

UPDATE

No change

4. LEGAL POWERS OF THE REGULATORY AGENCIES

4.1 Policy Observation

The fact that regulatory agencies derive their authority from a delegation of powers by the government, rather than directly by law is inconsistent with best international practice and seriously compromises regulatory independence. The authority of MEDT to rescind regulatory decisions and to mandate specific methodologies and guidelines, rather than doing so in more permanent instruments such as law or concession documents is similarly out of step with best international practice.

UPDATE

No change

4.2 Policy Observation

The ability of private companies to require regulatory agencies to treat as confidential any information they provide to the agencies is contrary to best international regulatory practice on transparency.

UPDATE

No change

4.3 Policy Observation

The FTS lacks sufficient remedial powers to address violations in ways that are proportionate to the offenses. Examples of such remedial powers include, but are not limited to assessing penalties, refunds to consumers, specific orders to perform, escrowing of funds to be used for specified purposes only, and suspension or revocation of licenses.

UPDATE

No change

5. REGULATORY DECISION-MAKING PROCESSES

5.1 Policy Observation

Credible regulatory decision-making requires a formal, highly transparent, decision making process with ample opportunity for public participation. MEDT and FAS should adopt and publish clear decision-making processes so that all parties will know how the process will work and how they may access and participate in it. The failure to do so can be quite harmful to the regulatory regime in terms of credibility, consumer and investor confidence, and substantive outcomes.

UPDATE

No change

5.2 Policy Observation

The decision-making processes of all of the regulatory agencies should be conducted with a view toward making them more transparent, more user friendly, and more informative. While recognizing the need to ensure that regulatory processes reflect the specific circumstances in a country, the following measures are key elements in assuring transparency:

- 1. All decisions should be written. They should be in a format that includes a description of the matter at hand, a history of the proceedings/review, a description of the positions taken by the various parties and of the information offered in support of those positions, an analysis of the arguments and information offered, an analysis of the policy, factual, and legal issues, and finally, a clear statement of the board's conclusions and decision. All dissenting and/or concurring opinions should also be in writing.*
- 2. Submissions and other material such as consultant reports or research commissioned by the stakeholders or the regulator should be on the public record¹⁷ and properly tested and evaluated during the course of the proceedings/review. As part of the consideration and evaluation of this information stakeholders should have access to the information in order to have the opportunity to provide effective and meaningful input.*
- 3. All communications between regulators (including individual board members) and the Government and/or commercial entities on pending or prospectively pending regulatory matters should be transparent and made part of the public record.*

UPDATE

No change

6. RELATIONSHIPS AMONG REGULATORY AGENCIES

6.1 Policy Observation

The level of diffusion in regulatory authority has within it enormous potential for sending confused, incoherent, and even contradictory signals to market participants. Some means of preventing that outcome needs to be put in place. That might come from establishing the preeminence of one of the agencies, by some joint action by the agencies, or by some other means. For an embryonic market, however, the potential for conflicting regulatory signals should cause very significant concerns, and this problem should not be allowed to fester.

UPDATE

The principle should remain unchanged, but note that the increased clout of MEDT in regulatory matters may actually be a step in the direction of a more coordinated approach, although certainly not in the manner proposed in the 2004 Policy Note. The key notion in that paper was better coordination should be achieved among independent regulatory agencies, not by vesting Ministries with greater powers.

6.2 Policy Observation

The relationship between the RECs, FTS, and FAS is still another example of the diffusion of regulatory authority and lack of clarity in regulations that needs careful

attention in order to avoid confusing, incoherent, and even contradictory signals and policies.

UPDATE

No change other than what is noted in the previous update.

7. ROLE OF REGULATORS IN MARKET DEVELOPMENT

7.1 Policy Observation

Any failure to have FAS, FTS and the RECs fully engaged in the restructuring process could enhance the probability that future regulatory decisions will be inconsistent with the intentions and goals of the designers of the markets and could cause confusion and incoherence in the evolution of the market.

UPDATE

No change in the principles, but the lack of parallelism and symmetry on the paths of market design and regulatory development, as noted above, adds even further emphasis to the points made in 2004.

7.2 Policy Observation

The regulatory agencies' responsibilities for investment in the market, on both the supply and demand side, are a conflict of interest for a regulatory agency and should be assigned to another entity for which market participation poses no conflict of interest.

UPDATE

No change

8. PROMOTING AND MAINTAINING COMPETITION

8.1 Policy Observation

The regulatory responsibilities for promoting, maintaining, and monitoring competition in generating markets are highly diffused among regulatory agencies. The coordination of market monitoring and the promotion and maintenance of competition among the agencies may prove to be difficult. It is essential that policies and procedures be carefully coordinated and calibrated, that responsibilities of relevant agencies be clearly defined, and that the relevant IT technology be deployed before implementation of the new market, and that requisite information be shared among agencies once the technology is deployed.

UPDATE

No change

8.2 Policy Observation

It is not at all clear that FAS, as currently constituted, has the experience, technical capability, and resources to carry out its heavy responsibility to promote, maintain, and

monitor the competitiveness of generating markets. It should seek the assistance of international experts, experienced in competitive electricity markets to assist in the task of capacity building, putting appropriate systems in place, and promulgating clear, enforceable standards on market power and proper functioning of competitive generation markets. It is also recommended that thought be given to retaining an independent consultant on an ongoing basis to provide publicly available, periodic (e.g., quarterly) reports to the regulators on the state of the market, with particular focus on behavioral, institutional, and systemic problems in the market's overall competitiveness and efficiency.

UPDATE

No change.

9. TARIFF SETTING

9.1 Policy Observation

FAS, FTS, and other relevant institutions need to launch an immediate effort to build the capacity, human, technological, and otherwise, to be able to effectively monitor the grid for regulatory purposes, to develop appropriate allocation of costs for new interconnections, for overseeing transmission planning, for determining how best to optimize system enhancements (e.g., new transmission wires, FACS technology, better controls, strategically located generation, and demand-side/load-control measures), and to perform other necessary regulatory tasks associated with the grid. Second, a clear understanding regarding the allocation of regulatory responsibilities needs to be in place to avoid future bureaucratic quarreling and market confusion.

UPDATE

No change in the principles, but note that the proposed new market design calls for the regulator to allocate capacity to load serving entities through vesting contracts of limited duration. That will be a complex and sophisticated task to add to FTS's other responsibilities. FTS will obviously have to make sure that it possesses the capability of performing this new mission in a very effective manner.

9.2 Policy Observation

Generators will need to know when they will be subject to tariffed rates, as opposed to selling output at market based rates. At present, there is no way for them to acquire that information. Accordingly, FAS should, at its earliest opportunity, publish what criteria might cause a plant to be subjected to tariffs, how often that status will be reviewed, and under what circumstances. FTS should also publish the methodology for setting tariffs. These actions should be taken before the market is implemented.

UPDATE

No change, other than to note the proposed vesting contracts may reduce any urgency in FAS and FTS to move forward on these points. Ultimately, however, if market reforms evolve as envisioned, they will have to be carried out.

9.3 Policy Observation

There needs to be an open and public debate on what methodology should be used to establish tariffs for distributors, for ATS, and for the system operator. MEDT and FTS should publish a preferred proposal for tariff methodology for distribution companies, for ATS, and for the system operator. International consultants with experience with distribution, market administrator, and system operator tariffs might be employed to assist the formulation. Comments and analysis on the proposal should be sought and fully considered. The methodology should be fully and publicly articulated before the new model is implemented.

UPDATE

No change

9.4 Policy Observation

As is the case with tariffs for monopoly services, a public debate about PLR obligations is needed. It is recommended that a proposal for the specific responsibilities, risks, and incentives for PLR's be published and put out for public comment and analysis. Once again, the engagement of an international consultant with specific experience with PLR issues might be useful. PLR's are entitled to know ex ante what risks they are being asked to bear, so it is recommended that the regulators fully articulate the criteria to be applied in passing through costs before the market is implemented.

UPDATE

The amount of retail competition is now being contemplated is unclear, at least during the life of the envisioned vesting contracts. To the extent, however, that at least some end users will be able to select suppliers, the principles remain unchanged.

9.5 Policy Observation

Once again, the initiation of a public debate is important. It would be very helpful to publish a plan for the gradual phasing out of subsidies in order to solicit public comment and analysis and to stimulate a national, public education campaign to acquaint all consumers with the plans and assist them to cope with the consequences that will inevitably affect many of them.²⁶ The necessity to fund some of the needs financed by cross-subsidies (e.g. subsidies to low income households) should be made an explicit part of the public debate.

UPDATE

No change

10. ACCOUNTING AND INFORMATION ISSUES

10.1 Policy Observation

The lack of power for Russian regulators to mandate specific accounting for regulatory purposes is inconsistent with very basic powers typically provided to regulatory agencies in other countries. Those powers are essential for market transparency and to guard against improper cost allocations that can distort and do harm to competitive markets. It is also very problematic that regulators lack adequate resources to hire and retain a regular auditing staff to examine the books and records of regulated entities.

UPDATE

No change

10.2 Policy Observation

The lack of information flow needed for both regulation and effective market operations caused by inadequate metering is a critical shortcoming.

UPDATE

No change

11. APPELLATE PROCESSES

11.1 Policy Observation

The Government's power to exercise ex ante and ex post control over regulatory decisions is inconsistent with best international practice in regard to both regulatory independence and regulatory accountability. Indeed, the government's ability to exercise ex post, appellate review of regulatory appeals is out of step with more commonly accepted international norms.

UPDATE

No change

11.2 Policy Observation

While international practice varies, the Russian situation where precedent need not be followed, and where the courts in general possess no specific expertise in infrastructure regulation, it might be more appropriate to establish a single, specialized appellate tribunal to hear regulatory appeals.

UPDATE

No change

11.3 Policy Observation

Good regulatory practice suggests that the decision of the agency should be presumed to be valid until adjudged otherwise by the appellate forum. The only circumstance where

the implementation of a decision should be delayed is upon successful application by an appealing party to either the regulatory agency itself or the appellate forum for an order to delay implementation. Such an order should be granted only under the very limited circumstances where the order will do irreparable harm to the applicant during the appellate process and where the applicant can demonstrate a high probability of success in the appeal.

UPDATE

No change

11.4 Policy Observation

Best practice suggests that appellate bodies should only reverse a decision of a regulatory agency if it finds that the agency has exceeded its legal authority, violated the law in some fashion, failed to follow the correct procedures, or has acted arbitrarily, unreasonably, or against the manifest weight of the evidence presented to it. Should an appellate body find it necessary to reverse an agency decision, rather than fashioning its own remedy, it should remand the case to the agency to remedy the deficiency in a way that is consistent with the appellate decision. While at least some of these principles appear to be followed in practice, it does not appear to be codified, and thereby assured.

UPDATE

No change

12. ETHICS

12.1 Policy Observation

There is, at present, no appropriate Code of Ethics for all regulatory officials. Best international practice suggests that one should be written and adopted. Subjects to be regulated by such a code include prohibitions on conflicts of interest, acceptance of gratuities, and leaving regulation to accept employment serving a private interest on the same matter. Other possible subjects include financial disclosure of holdings by regulatory officials, rules regarding communications with companies having business before the agency or traders in the securities of such firms, and any other matters that are deemed relevant and important in the context of international experience, and Russian circumstances.

UPDATE

No change

13. REGULATORY RESOURCES: HUMAN AND FINANCIAL

13.1 Policy Observation

The human resources which will be required for the multiple regulatory functions in the preparation for and implementation of the new model are simply inadequate at present. FTS, FAS, and the RECs should assess their human resources requirements and make

these known to the government. In addition to all other tasks, particular attention should be directed to the need for comprehensive public relations, outreach, and education.

UPDATE

No change

13.2 Policy Observation

The compensation packages for regulatory personnel are inadequate for the recruitment and retention of fully trained, technically competent, professional staff. It is specifically recommended that the remediation of this problem be examined in tandem with the ethics issues flowing from them, so that some of the rationale for higher salaries is linked to restrictions on the job mobility and investment opportunities of regulatory personnel.

UPDATE

No change

13.3 Policy Observation

The current practice of funding regulatory activities out of general treasury funds is inconsistent with best international practice of funding regulation through a dedicated fee imposed on electricity tariffs. The current practice leaves the door wide open to political retaliation against regulators through budgetary actions, to cross-subsidies to rate payers from taxpayers and vice versa, and to destabilization of regulatory activities.

UPDATE

No change

CONCLUSION

The July 2005 mission to Russia was largely limited to preparing for and conducting the workshop, so the policy updates are based on those activities rather any extensive new round of inquiries. Nonetheless, the contrast between the effort being put into designing the new market versus the lack of any similar effort in regard to regulation is both striking and worrisome. Market and regulatory reform are irretrievably linked and that fact seems to have gone largely, although not universally, unnoticed in official circles. While the policy notes enunciated in the 2004 paper remain largely relevant and not in need of any substantial revision, the lack of progress on them must be noted with considerable concern.