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**USAID Privatization Project:
The Russian Electric Power Sector**

**DEFINING A REGULATORY FRAMEWORK
FOR THE RUSSIAN ELECTRIC POWER SECTOR**

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**for the Consideration of
Working Group B on Legislation & Regulation**

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FORWARD

In 1992 and 1993, the government of Russia embarked on a systemwide privatization of the Russian electric power sector. The privatization plan called for the transformation of state-owned electric power generation and distribution enterprises into private joint stock companies. It also resulted in the creation of a new company, RAO EES Rossii ("RAO EES"), as the central management entity for the unified electric power system providing central dispatch and transmission for Russia's national power network.

In conjunction with this privatization program, the Russian electric power community is focused on two principal tasks: (1) selecting an appropriate market structure to develop the Russian electric power industry; and (2) preparing a legal and regulatory framework, including comprehensive legislation, to establish a legal background against which the power industry can function and develop.

In December of 1993, the U.S. Agency for International Development initiated a joint Russian-American working group project with RAO EES and the Ministry of Fuel & Energy (the "MFE") to assist with these two important tasks. The project has involved the work of a number of experts from both countries and five discrete working groups. These groups are: Group A: Market Structure and Pricing, Group B: Regulation and Legislation, Group C: Securities and Finance, Group D: Investment Promotion and Group E: Training. In the first half of 1994, Working Group A on Market Structure and Pricing developed a basic market model which was initially introduced at the RAO EES Privatization Conference held in Moscow on April 21, 1994. This model has been further developed through Working Group A and B joint discussions and at the RAO EES conference held on November 8 & 9, 1994.

The purpose of this report is to define and discuss a regulatory framework that may be implemented with the market models being considered by Group A. It is also intended to serve as a source of issues for discussion and consideration by Working Group B participants. Section I of this report articulates regulatory goals. Section II addresses several key elements for the implementation of an effective regulatory system. Section III summarizes proposed features of the Russian power sector market structure under consideration by Working Group A. Sections IV and V propose a system of regulatory bodies and discrete functions to be delegated to such bodies. Finally, Section VI of this report recommends the use of a "transition period," during which the implementation of comprehensive reform can begin.

SECTION I

GOALS OF REGULATION

A. Universal Goals

Working Group B participants have proposed several important universal goals for the effective regulation of electric power in any country. Electric power regulation in any country should:

- (1) protect the rights of electric power consumers;
- (2) ensure the reliability and safety of the electric power sector;
- (3) minimize bureaucracy and the cost of regulation;
- (4) promote the efficient operation of the electric power sector; and
- (5) provide for the development of sufficient capacity to meet the demands of electric power consumers.

B. Specific Goals

Working Group B has also developed a set of specific goals for the implementation of power sector regulation in Russia. Electric power regulation in Russia should:

- (1) preserve the benefits of the Russian power sector's current operation as a unified complex;
- (2) maintain retail electricity tariffs at socially acceptable levels;
- (3) distribute equitably the benefits of the existing Russian power sector;
- (4) encourage private investment in the Russian power sector; and
- (5) increase reliance on competition as a market regulating force.

SECTION II

KEY ELEMENTS OF A RUSSIAN REGULATORY SYSTEM

Working Group B has identified certain elements that will be instrumental in the achievement of the aforementioned goals and the implementation of Working Group A's market model. Set forth below are six specific recommendations that will be essential components of new legislation for the Russian electric power sector.

A. Use Appropriate Existing Regulatory Bodies

As has been noted earlier by Working Group B participants, a regulatory framework for the Russian electric power sector has already begun to take shape. In 1992, the Council of Ministers created a Federal Energy Commission (the "FEC") to regulate wholesale power transactions. Subsequently, regional energy commissions (the "RECs") for 74 separate geographically defined regions were created. Each REC is responsible for regulating retail power transactions in its region. To the extent that these and other existing regulatory bodies can fulfill the objectives of Working Group B's proposed structure, we recommend their use in lieu of creating new and redundant agencies.

These existing bodies, however, were created pursuant to Russian government "acts" rather than Russian congressional law. To make them permanent organizations and to enhance their legitimacy, the existence and authority of the FEC and RECs should be confirmed by appropriate legislative acts. Additionally, in order to handle the proposed regulatory functions, their jurisdictions need to be broadened and their powers expanded.

B. Establish Clear Division of Regulatory Responsibility between Federal and Regional Authorities

The Russian power sector should be principally regulated by the FEC, which should be responsible for the development of a wholesale power market and for regulating certain monopoly aspects of transmission and distribution. RECs, on the other hand, should be empowered to regulate rates on the retail market and address regional concerns. This division of authority between federal and regional bodies takes into account the relative advantages of regulation at both levels. Dividing up regulatory responsibility for regulation along coherent, practical lines would serve to promote the efficient operation of the power sector.

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The nature of the electric power sector dictates that some aspects of the industry be addressed on a systemwide basis. Examples of such aspects include power pooling arrangements, the wholesale power market, interregional power transmission and the import and export of power from the Russian Federation. The FEC is the only viable means of addressing such multi-regional issues.

The existence of the FEC also makes sense for Russia from a practical standpoint. There are still insufficient resources at the disposal of Federation Subject governments to regulate wholesale or retail power markets without the guidance and support of the FEC. Furthermore, a system built on independent regional commissions presents the danger of inconsistent regulatory policy development between regions and the potential for inconsistent application of standards and enforcement mechanisms.

RECs, on the other hand, are uniquely situated to regulate rates on the retail market. One of the specific goals for the Russian power sector is to distribute the benefits of regulation evenly. Since the retail energy consumers within one region are likely to be similarly situated, RECs would be able to establish fair regional tariffs. RECs are best situated to address specific consumer protection issues because of their proximity to consumers and their direct contact with electricity retailers.

There should also be substantial harmonization of FEC and REC rate-making procedures. This will ensure that consistent regulatory policy is applied in different regions around Russia. It will also prevent distortion of the national electricity market due to regional political battles over rate-making.

The Constitution of the Russian Federation grants the federal government exclusive jurisdiction over all "Federal Power Systems." However, this term is not clearly defined in the Constitution. We recommend that this term be legislatively defined to include specific facilities, transactions and all other activities by electric power sector participants that affect the "national interest" of Russia. Additionally, the FEC should be granted the power to determine what is in the Russian "national interest" based on established criteria. Determination that an activity falls within the purview of Russia's national interest should be reviewable by Russia's Constitutional Court only.

C. Eliminate the Possibility of Overlapping Jurisdictions

Many federal regulatory functions need not be performed by the FEC. There are, for example, various existing Russian government bodies that are competent to assume regulatory responsibilities. We believe that the Ministry of Environmental Protection (the "MEP") is best suited to regulate environmental matters and the Federal Securities Commission (the "FSC") or the Ministry of Finance (the "MOF") should regulate securities

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transactions as they would in other Russian industries. Allocating regulatory responsibilities to other governmental entities serves the purposes of lessening the central regulator's overall regulatory burden, preventing redundancy and avoiding the possibility of inconsistent results. Federal government agencies that can assist in various aspects of regulation include:

- MFE - energy policy;
- Ministry of the Economy (the "MOE") - economic planning;
- MEP - environmental matters;
- MOF - securities transactions;
- State Antimonopoly Committee (the "SAC") - concentration of market power; and
- State Property Committee (the "SPC") - privatization.

D. Insulate Regulators from the Political Process

The independence of the FEC and RECs is essential to the achievement of several of the goals stated above. For example, the commissions will need to make difficult tariff decisions to ensure that different groups of consumers are fairly treated. In addition, the commissions must have the institutional will to enforce licensing requirements if they are assigned such responsibilities.

Furthermore, a viable long-term electric power industry, in which investors can earn a fair rate of return on capital, requires effective and consistent rate regulation. The commissions will be responsible for balancing the interests of consumers and power sector service providers. Effective regulation can only occur if the committees are insulated from undue political pressure so that a rational balance can be struck between the desirability of low prices and the need for fair returns on invested capital.

Prerequisites for such autonomy are: (1) appropriate legislative acts setting forth the powers, responsibilities and authority of the FEC and RECs; (2) fixed terms for commission members with protection against geographic reassignment or other retribution for unpopular decisions; (3) authorization for the commissions to establish their own budgets; and (4) authorization for commissions to hire, fire and promote their own staffs.

E. Regulators Should be Accountable

Autonomy does not mean that the regulators are above the law and divorced from other organs of the Russian Federation government. There must be accountability and effective oversight of the FEC and RECs. First, the authority of the FEC and RECs should be precisely defined and limited by legislation. The responsibilities of these regulatory bodies, therefore, should be changed only through legislative amendment. Second, the budgets of RECs should be reviewed by the Russian government and the budget of the FEC should be reviewed by the Russian Congress. Third, financial accounts of the FEC and RECs should be audited by the MOF. These three measures would help to prevent the burgeoning of an unwieldy regulatory bureaucracy, one of the regulatory goals stated above.

Finally, the basis for the FEC's and RECs' decisions should be detailed in writing and subject to judicial challenge. This measure should ensure that the authority of the commissions is checked by judicial scrutiny.

F. Electric Power Laws and Regulations Should Be Transparent

In order for regulation to be effective, it is important that it be perceived by the Russian public as fair and appropriate. One of the above-stated goals for the Russian power sector is the protection of consumer rights. Consumers must first understand their rights in order to exercise them. To this end, the proposed legal framework should include rules that are accessible and easily understood. Also, the purpose of the regulations should be apparent to the untrained reader. Important rules and regulatory decisions should be published in national and appropriate regional media.

Where possible, the public should be given some forum for participation. It is not a tradition in Russia for the public to have an opportunity to comment on proposed regulations or rulemaking. Developing an appropriate public forum will be one of the most difficult regulatory challenges.

SECTION III

SUMMARY OF PROPOSED MARKET STRUCTURE FOR RUSSIAN POWER SECTOR

Although variations on the power sector's market structure are still under consideration, Working Group A proposed several important revisions to the existing structure. Before detailing proposed regulatory functions and structures, it is useful to identify the various market entities envisioned by Group A.

Similar to all major power markets around the world, the Russian market is comprised of three principal categories of entities: generators, distributors and transmission entities. Group A has considered a model that contemplates a number of independent generation companies, one central dispatch and transmission company, and various distribution entities. The specific nature of the entities that make up each of these groups is outlined below.

A. Generation

Generators will be privately-held entities licensed to produce electric power. They will be able to enter into long-term contracts for the sale of power to a wholesale market pool administered by RAO EES. Group A, for now, has left open the possibility of direct sales to distributors and consumers at a later date.

B. Transmission and Dispatch

Transmission and dispatch will be accomplished through the existing entity RAO EES or a similar single-entity structure. RAO EES, a privatized joint-stock corporation, currently owns and operates all high voltage transmission and central dispatch assets within the Russian Federation. One proposal is to allow RAO EES to operate the entire transmission and dispatch system under license.

Although RAO EES currently owns both generation and distribution entities, Group A has proposed that RAO EES divest itself of its ownership of distribution entities over the long run. RAO EES could retain ownership of certain generation facilities so long as the profits of such facilities are regulated.

C. Distribution

Regional distribution companies called "A/O Energos" will distribute power within each of 74 existing regions. A/O Energos will have the right to purchase power on the wholesale market under license and resell such power to consumers. A/O Energos will also have the responsibility to provide power to all customers in their defined regions. This entails the ownership, operation and maintenance of regional distribution systems. Ultimately, some consumers may purchase power directly from the wholesale market. A/O Energos may also choose to contract with licensed electric power resellers to provide service to certain customers or certain areas.

The 74 existing A/O Energos, like RAO EES, have already been privatized and operate as independent regional distributors. Currently, RAO EES has a controlling interest in most of the regional A/O Energos.

SECTION IV

REGULATORY FUNCTIONS

The creation of a comprehensive regulatory structure for the Russian electric power sector requires the consideration of certain fundamental regulatory functions. Working Group B has identified the following key regulatory functions:

- planning;
- licensing;
- rate regulation;
- financial and securities regulation;
- environmental and land use regulation;
- data collection and dissemination;
- safety and reliability;
- labor relations;
- enforcement; and
- dispute resolution.

In this Section, we recommend how each of these functions should be performed.

A. Planning

In a market-oriented economy, planning is conducted by market participants. The Group A model would create markets for the generation and distribution of electricity. Therefore, the decisions of individual generators and distributors within a regulated industry will replace a great deal of the planning that was previously necessary. However, even after implementation of a new market structure, regulation must insure that important planning functions are carried out by appropriate entities.

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1. **The MFE, in consultation with the MOE, should be responsible for the development of a systemwide energy and economic policy and a strategy for its implementation.**

The MFE is well prepared to produce a systemwide policy and strategy since it currently performs this function. Furthermore, its ministerial status affords it the broad vision that is necessary to weigh competing policy concerns. The MFE also has closer ties with the federal administration, a link that will help the MFE integrate its strategy into cross-sector economic efforts. In particular, the MFE should consult with the MOE in its formulation of systemwide policies and implementation strategies to ensure that they fit into the government budget and strategic economic plan.

2. **RAO EES should be required to prepare an investment and resource plan for the Federal Power System.**

Under a proposed market structure, RAO EES would be responsible for the continued operation of its facilities and the expansion of such facilities when needed. Therefore, under a new regulatory structure, RAO EES should have primary responsibility for the preparation of Russia's investment and resource plan for the transmission of electric power within the Federal Power System. This plan should be reviewed by the FEC to ensure that proper resources have been committed to the planning process.

3. **A/O Energos should be required to submit forecasts and energy plans to RECs for review.**

Although distribution will be performed by a large number of independent A/O Energos, oversight of planning is essential to meet energy needs. Since A/O Energos are entrusted with the responsibility of providing service to the retail customers in their regions, they must plan and acquire the resources necessary to satisfy their customers' needs. Each year, therefore, each A/O Energo should prepare a five-year demand forecast, a ten-year demand forecast and an energy plan. RECs should in turn review and approve these forecasts and plans. Based on these materials, RAO EES should prepare and submit coordinated plans to the FEC for approval.

This process would achieve two purposes. First, RECs would be able to monitor the A/O Energos' plans to satisfy their service obligations. Second, regulatory approval of investment plans would provide additional assurance to regulated entities that they will recover expenditures made consistent with such approved plans, thereby encouraging investment.

4. **The FEC should not be responsible for the approval of government plans for arranging new generation and transmission resources.**

Publicly financed generation and transmission facilities may be necessary as a last resort if private investment does not provide for adequate electric power resources. Ultimately, each market participant, and in particular the A/O Energos, should be responsible for arranging new generation and transmission resources. In the near term, however, this responsibility may continue to be performed by the Russian government since other entities lack the financial resources necessary to undertake such projects.

The FEC should not be responsible for approving government-financed projects. This function should be performed by the MOE, which is already in charge of Russia's long term economic development. We understand the MOE's tasks to include analyzing sources of financing for the power sector based on various studies and proposals prepared by Russian organizations. However, because of its unique position in the market and its understanding of needed investments, RAO EES should be delegated the function of preparing initial case studies and proposals of investment projects for submission to the MOE. This would be a continuation of a function that RAO EES now performs.

5. **Investment projects at the regional level should be promoted by Federation Subject governments.**

Federation Subject governments should also play an active role in the promotion of power generation and the improvement of other power sector facilities. These governments are keenly aware of the present system's deficiencies and are positioned well to encourage regional investment. They should also provide the regional support necessary for the development of power projects.

B. Licensing

New electric power legislation should establish a licensing regime under which each electric power sector participant (except non-power generating consumers) would receive a license to engage in a specified commercial activity. The following specific recommendations address the issuance and content of such licenses.

1. **The FEC should issue licenses for generators, RAO EES and A/O Energos.**

The FEC should license the generation, transmission and distribution of electric power since these electric power sector functions demand consistent interregional

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treatment. The FEC is best prepared to create a consistent procedure by which licenses are issued and to ensure that there is a "level playing field" for entry into the market. Specific licenses should be designed for each of these specific functions.

Generation licenses should obligate their holders to participate in power pooling arrangements under the management of RAO EES and to dispatch electric power according to rules established by RAO EES. These licenses should also require that holders comply with specific technical and safety requirements. By forcing generators to periodically renew their licenses, the FEC can help to ensure the continued coordination and safety of these electric power generation facilities.

The FEC should issue the RAO EES transmission license since RAO EES will operate in all regions of the Federation. The RAO EES transmission license should grant an exclusive transmission and dispatch franchise to RAO EES. In return, RAO EES should be required to provide transmission service to all participants of the electric power sector. This license should allow RAO EES to provide nationwide, integrated dispatch and transmission service. RAO EES' license should have an unlimited term since RAO EES will be a regulated monopoly and since no competitors will exist to provide comparable service.

Distribution licenses issued to A/O Energos should allow for the provision of services in defined geographic "service territories" for a fixed period of years. In addition to the right to provide service, licenses should also give holders the right to request the condemnation of land. For the foreseeable future, service territories should be drawn along the geographic lines of service being provided by the 74 A/O Energos. These service territories are useful because they are of reasonable size and take advantage of existing consumer relationships.

Each distribution license should essentially serve as a contract, pursuant to which the A/O Energos are given an exclusive service territory in return for assuming an obligation to serve all customers within that territory. Fixed terms should require such licenses to be periodically renewed and the performance of the license-holder assessed. At the distribution level, renewals may occur on a competitive basis according to the judgment of the FEC. With regard to the licensing of A/O Energos, however, RECs should be required to approve licensees.

2. Licenses to buy electric power from A/O Energos and resell it to consumers should be issued by RECs.

RECs are closer to retail customers, so it is appropriate that they should monitor the resale of energy by third parties under contract with A/O Energos. This arrangement would also help encourage competition within the distribution sector since it

would impose less of a burden on resellers to apply to RECs for a license than to a central authority. Resale licenses should be renewable periodically.

3. The effectiveness of licenses should be conditioned on certain duties.

Licenses need to define clearly the licensee's duties. Some duties are important enough that they should be statutory prerequisites to the issuance of licenses, including:

- the obligation to serve all non-delinquent customers on a non-discriminatory basis;
- the maintenance of economic and efficient service (including, for RAO EES, merit dispatch and the development of operating and pricing rules for transactions within a national power pool);
- modernization of facilities;
- compliance with all Russian Federation laws;
- compliance with federal and regional regulations, including performance standards, reporting requirements, standardized accounting rules, and codes of conduct;
- limitations as to certain business activities;
- the development and maintenance of cost-reflective tariffs that encourage efficiency and ensure the financial viability of the regulated entities; and
- the duty to submit to appropriate dispute resolution forums.

Licensing procedures and the approval process should be equitable for all market participants.

4. Licenses should not be required for small generation or "inside the fence" industrial facilities.

Companies that produce power for their own consumption and that do not sell power to other entities should have little effect on the wholesale power market. There is little need to license the production of power by consumers when such power never reaches

the wholesale market. Likewise, small generation facilities do not have a sufficiently significant impact on the market for power in Russia to justify the expense necessary to regulate such facilities.

5. The renewal of licenses should be conditioned on certain standards of service quality.

Participants should be forced to uphold certain minimum levels of service quality. The denial of renewal applications should be an important tool for the enforcement of performance rules. Performance standards, however, should be attainable under the applicable rate regime given the overall state of the industry.

C. Rate Regulation

Rate regulation will play an important role in the development of Russia's electric power sector at both the wholesale and retail levels. At the wholesale level, regulations should facilitate the development of an efficient, reliable and cost-based wholesale power market. They should also be designed to promote competition and be flexible enough to be modified as the wholesale market develops.

As in the wholesale market, retail rate regulation should provide for efficient use of assets and the sale of power at economical costs. At both levels, rate regulation should be transparent and easy for the public and the electric power industry to understand.

In recommending changes to the Russian system, one should keep in mind the overall objectives of rate regulation. These include: (1) permitting sellers to recover their costs of providing service, including a sufficient profit margin to finance capital improvements and new construction; (2) protecting consumers against excessive prices; (3) encouraging efficiency by making regulated companies' profitability depend on their ability to control costs; and (4) encouraging efficiency by setting rates that send price signals regarding the relative availability of power. Ultimately, electric power rates should reflect the costs of providing service. It should be noted, however, that a cost-based rate regime will result in regional differences in electric power tariffs. Such rates are also likely to differ by time, customer class and type of electric service.

1. The current rate-making procedure should be revised to prevent improper political influence.

Despite the existence of one central federal regulator, today's system for establishing rates involves substantial work by other Russian government bodies. While in theory the FEC has responsibility for establishing pricing rules, the Russian State Committee

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on Pricing and the MOE still perform rate calculations. As a result, rate-making is the subject of considerable political oversight. In order to attract private investors to the Russian market, the current decision-making structure needs to be revised to eliminate this political influence. In addition, economic regulation in Russia should be made substantially more transparent.

2. The FEC should perform rate-making for the following electric power transactions:

- wholesale power purchases from generating companies;
- wholesale power sales to A/O Energos;
- RAO EES transmission and dispatch services;
- direct power sales to ultimate consumers from the wholesale market;
and
- power pool pricing.

3. Each REC should perform rate-making for the following electric power transactions:

- power sales by A/O Energos and resellers to captive retail customers;
and
- "low voltage" transmission services provided at the regional level.

4. All market participants should be required to use a uniform system of accounting in order to ensure fair rate-making.

One of the cornerstones of successful rate-making is the establishment of a uniform system of accounting to be used by all market participants. Rate-making bodies should initially establish uniform accounting rules to be used for all cost calculations at the wholesale and retail level. Such procedures should be used by RAO EES for general accounting activities as well as for the preparation of wholesale price data to be reviewed by the FEC.

5. In the retail market, RECs should use the cost-of-service method to set tariffs.

In the retail market, RECs should be primarily responsible for the approval of tariffs. There are essentially two possible models for rate-making at the retail level: cost-of-service and indexation.

Under the cost-of-service model, the regulatory process begins with a request by the selling firm to an REC for approval of electric power rates. The REC would first review an A/O Energo's operating expenses and decide which expenses are allowable. The REC would then determine the "rate base." This is done by ascertaining the net amount of capital investment the A/O Energo has made. Capital investment includes tangible property such as plant and equipment as well as intangible property such as working capital and leases.

There are alternatives for valuing capital investment. Plants and equipment, for example, can be valued at their original cost. Considering the inflationary trends in Russia, however, replacement cost values should be used.

This cost information would then be used to determine an A/O Energo's "cost-of-service" (the amount of money it needs to cover its variable and fixed costs including a fair rate of return on investment). This computation would be made on the basis of the costs and sales of an A/O Energo in some "test period." That is, some historical or projected period should be selected and the revenues required to cover the expected costs of the A/O Energo in such period determined.

The final step is rate setting. The cost-of-service to be recovered should be divided among the different classes of service or customers and converted into unit prices (e.g., rubles per kilowatt hour). When the rate for each class of service is multiplied by the expected sales and totaled, the total expected revenue should equal the cost-of-service. These rates should remain in effect until the next rate calculation.

Rates should not be so low as to be confiscatory. Since there is no constitutional or judicial precedent in Russia to ensure that rates are not confiscatory, the proposed regulation should contain some basic criteria that RECs must apply in order to prevent a confiscatory result.

Alternatively, under the indexation model, an A/O Energo's rates could be set using a formula involving changes in prices other than the A/O Energo's costs. Indexed regulation specifically involves an initial determination of the base price an A/O Energo will charge when regulation begins. The regulator then permits the regulated firm to adjust that base price periodically in accordance with some pre-approved index (e.g., consumer price

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index). In England, for example, rates are adjusted using the UK Retail Price Index. If such a system is used, however, adjustments must be made for productivity improvements and for any significant cost-increasing investment, such as a new transmission line or substation. Various other adjustments to reflect changes in an A/O Energo's situation can be built into an index, but complexity increases substantially with every adjustment.

There are two distinct disadvantages to the indexation model which may make it impractical for the Russian power market. The first is the lack of any stable index upon which regulators can rely. The second is an inability to establish accurately a true base price. Given the constantly changing economy in Russia, there is as of yet no reliable index upon which a pricing system can rely. Additionally, the economics of most companies in Russia fluctuate in the course of a very short time frame and in ways that can not be reflected in any simple price-adjustment formula. Therefore, under an indexation model there would be a need for numerous periodic reviews of the regulated firm's costs and revenues to insure that equity investors are recovering some but not excessive profit. This means that even with indexed regulation, something like the type of investigation required by the cost-of-service rate regulation would need to take place. Additionally, prices used as "base prices" for electric power must be viewed by the Russian public as economically acceptable. This is vitally important for attracting private investment in A/O Energos.

Retail pricing in Russia is the subject of growing debate. Russia is still making a transition from a subsidized power market to one in which prices accurately reflect costs. Given the lack of any reliable index and the irregularity of costs, the indexation method of rate-making is likely to produce results that are unacceptable to both regulators and power consumers.

6. The FEC should regulate rates for power pools and capacity contracts.

The FEC should also regulate rates for the dispatch of electricity through power pooling arrangements. Generators should be paid for energy and capacity separately. Generators should receive payments for energy when dispatched at the highest bid price in each hour of dispatch. Assuming any "old plants" are still in existence during the final stage, they should continue to receive cost-based payments.

Capacity payments should be made by RAO EES as provided in individual contracts. All capacity contracts should include RAO EES as a signing party and should include the price for transmission on the national grid. The FEC should regulate this price to allow RAO EES to earn a fair profit.

D. Financial and Securities Regulation

An important function of the regulatory system is monitoring the financial and securities activities of power sector participants. Four important regulatory considerations should be addressed: (i) issuance and sale of securities; (ii) investments in non-core businesses (e.g., not related to the electric power supply business); (iii) business combinations such as mergers and acquisitions involving A/O Energos; and (iv) transactions with affiliates and over-leveraging.

1. The MOF and the FSC should retain primary regulatory responsibility over the issuance and circulation of securities.

The MOF currently regulates the securities transactions of all Russian corporations, including those within the power sector. The MOF has already instituted regulations that govern the issuance and sale of securities. For example, MOF approval must be obtained for sales of over 15% of a corporation's outstanding shares. In addition, approval must be obtained in order to acquire over 50% of a corporation's outstanding shares.

The FSC has recently been created and will eventually assume some of the MOF's current functions. Together, the MOF and the FSC should remain the principal regulators of securities issued by power sector participants.

2. The licensing procedure should be used to regulate investments in non-core businesses.

One could argue that there is no special need for involving the FEC in the securities transactions of private electric power companies. Securities regulation for all Russian businesses is currently being administered by the Russian MOF and the FSC as described above.

However, further review of investments in non-core businesses is justified since existing regulation would not protect captive consumers. Consumer interests in the power sector differ greatly from those in other sectors that the MOF and the FSC are prepared to regulate. For example, an A/O Energo that decides to speculate in timber probably would not run afoul of Russian securities laws. However, such an A/O Energo's non-core investment could, in certain circumstances, hurt consumers by threatening its own financial health. The increased costs of a financially unsound A/O Energo could easily translate into higher retail electricity rates.

The licensing process affords an excellent opportunity to monitor closely non-core investments. Licenses issued to RAO EES and the A/O Energos should narrowly

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describe the business activities in which they may engage. These entities would be able to expand into other businesses or make non-core investments only by amending their licenses in accordance with conditions determined appropriate to protect consumers interests.

3. Business combinations that are not technical violations of antimonopoly laws should be closely regulated.

Questions of market domination currently fall within the regulatory domain of the Antimonopoly Committee. Granting separate authority to approve financing transactions, it can be argued, would be unnecessarily duplicative and burdensome and would have the effect of discouraging investment. Nonetheless, business combinations and alliances could affect the power market in subtle ways that would not be evident to outside regulators. Moreover, since the power sector actually functions as a number of licensed monopolies, it would be difficult for the Antimonopoly Committee to apply the same standards that it employs in its regulation of other sectors.

Therefore, the FEC should have the power to approve business combinations that could potentially threaten consumer rights even though they do not technically violate existing antimonopoly statutes. Such power should be reviewable by the Supreme Court.

4. The FEC should monitor transactions with affiliates and over-leveraging.

Through its licensing role, the FEC can closely monitor transactions with affiliates. Transactions with affiliates should be regulated since they give electric sector participants opportunities to distort costs, and therefore, market prices through transfer pricing. The FEC can control this practice by requiring that licensees disclose such transactions and their terms during the licensing process.

Over-leveraging can threaten power consumers by allowing fiscal irresponsibility. The FEC can set maximum debt levels for electric sector participants to guard against such abuses.

E. Environmental and Land Use Regulation

An increasingly important and pervasive issue for all industries in Russia is that of environmental damage.

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1. **The FEC should not be directly involved in environmental regulation of the electric power sector.**

The FEC should not be directly involved in environmental regulation. The MEP is already responsible for addressing the environmental issues that arise in the electric power sector. If the FEC were to get involved, it would need to develop environmental expertise, duplicating the efforts of the MEP. Additionally, combining responsibility for economic regulation and environmental regulation would create an internal conflict between the goal of keeping electric rates low and the goal of protecting the environment. It would be prudent, however, to require that the MEP consult with the MFE as environmental policies are developed for the power sector. The MFE can assist the MEP to design regulations that are realistic given the financial health of the power sector.

Unlike the regulation of business combinations and new business ventures, environmental compliance does not directly affect power consumers. The costs of environmental damage are borne by the population generally or by inhabitants of specific regions. The FEC is not the proper authority to protect the interests of such groups.

To ensure the electric power industry's compliance with environmental regulation, the licenses issued to RAO EES, A/O Energos and generators should include a condition requiring compliance with MEP environmental regulations. The MEP should be authorized to request the assessment of fines and license revocation for failure to comply with environmental regulations.

2. **Approval of power generation sites and transmission lines for the power grid should be the responsibility of Federation Subject governments, subject to the power of eminent domain.**

Permission to build specific generation facilities is a subject separate and apart from licensing of commercial activity. A new regulatory framework must require permits for locating power stations and high voltage transmission lines. As a general matter, the FEC should not become involved in regulation of the land use and water resources. Authorizing the use of land resources for electric power generation or distribution is appropriately handled by regional governments given the regional impact of such authorizations on both the environment and population.

At the same time, however, the law must preserve the FEC's right, in specific situations, to override the decisions of regional Federation authorities. The use of land for power grid transmission lines, for example, should be subject to federal regulation. In the case of nuclear power projects, permission-granting authority should be retained exclusively by the Russian Federation regulatory bodies which oversee the nuclear industry.

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The FEC should also have the authority over hydroelectric power projects as they impact the interests of several regions.

The FEC should only reverse decisions made by Federation Subject governments and authorize construction of power plants or transmission facilities if it concludes that such facilities are necessary to the "national interest." This determination can be made only after balancing all the competing uses of the land and evaluating the opinions and recommendations of all interested parties, particularly the provincial and governmental authorities who would otherwise have been responsible for licensing land use. Having obtained the FEC's authorization, investors need assurance that they can obtain the necessary land. Therefore, the authorization obtained should entail a limited right of eminent domain.

F. Data Collection and Dissemination

- 1. The FEC and RECs should be repositories of information that may be useful to market participants and the public.**

The FEC and RECs should record information useful to industry participants and the public. All licensees should be required to submit considerable information in the course of their business. The FEC should be principally responsible for determining the type and form of information that needs to be collected from the industry and making such information available to the public. The FEC should harmonize such forms and procedures to be used by RECs, although RECs should be responsible for collecting information in each service territory.

All information (other than that which is commercially sensitive or proprietary) should be made publicly available. The FEC and each REC should maintain well-organized libraries, where the public would be permitted to conduct information searches. Such libraries should be open at times that are convenient to the general public.

- 2. Periodic reports should be issued on the power sector.**

The FEC, RAO EES and the MFE are the government entities best suited to assess the adequacy of private sector investment in power resources, the development of competition, and the health of the industry. The FEC should prepare periodic reports for the Russian government regarding the status of the electric power sector utilizing information received in the planning, licensing and rate-making processes. An evaluation of the competitiveness of the industry, barriers to market entry and related recommendations should be included in these reports.

These reports should be prepared by means of a process that solicits opinion and comment from all concerned parties, including the regulated entities, industrial customers and the regional Federation governments. Recommendations for reforming the electric power sector should be made available for public comment before being formally submitted to the Russian government.

G. Safety and Reliability

An important aspect of regulation is to ensure that electric power facilities are constructed and operated pursuant to certain minimum safety and reliability criteria that will prevent accidents and hazards to citizens and property. Safety and reliability criteria should also apply to consumers, especially large industrial consumers. Appropriate regulatory bodies should be responsible for the establishment and enforcement of safety and reliability criteria.

- 1. The MFE should be responsible for the development and approval of industry safety and reliability standards for completed electric power sector facilities.**

In the past, power plant construction was conducted by state enterprises pursuant to standards established by the government bodies to which they were subordinate and by certain other key organizations. There was not then, nor is there now, any licensing or permitting of construction firms in the power industry.

The proposed industry structure entails the engineering and construction of power generating and distribution facilities by private contractors, both foreign and domestic. Therefore, the MFE should develop industry safety and reliability standards for completed facilities. By setting standards for completed facilities, the MFE will ensure that planning and construction of facilities is also performed in a safe and reliable fashion.

- 2. The MFE should be responsible for the safety and reliability of operators and consumers.**

With respect to plant operation, safety standards are currently addressed by two organizations. These are the "State Energy Supervision of the Russian Federation," which is currently within the MFE, and the "State Inspection for Operation of Electric Power Plants," which is currently within RAO EES. The State Energy Supervision establishes safety and technical operating standards including criteria for frequency and voltage use and efficiency by consumers. The State Inspection establishes safety and technical criteria for power supplying organizations.

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We recommend that the functions currently being conducted by these two organizations be combined into one body and that such body be within the MFE.

3. The MFE should establish uniform safety and reliability standards for the consumption of electric power.

Although it would be impracticable to license all electricity consumers, a regulatory regime should recognize the safety and reliability concerns that exist at the level of electricity consumption.

H. Labor Relations

Another function that should be addressed by the regulatory structure is the approval of trade union agreements with power sector labor unions and the regulation of minimum wage standards. Currently, tariff agreements for the power sector are executed by RAO EES, the MFE and the power sector trade union. As a result of such agreements, the minimum wage for power sector employees is substantially higher than the minimum wage for the general population. Currently, RAO EES represents power companies in these agreements pursuant to its corporate charter. In the future, following divestment of A/O Energo assets, each power company will need to execute trade union agreements on its own.

We recommend that the MFE continue its regulatory role as a party to such agreements. The Ministry of Atomic Energy (the "MAE") should approve trade union agreements for workers in the nuclear industry.

I. Enforcement

Power sector participants should be required to comply with their service obligations as defined by their licenses. The day-to-day performance of the A/O Energos should be monitored by RECs. The FEC should be involved in the enforcement of service obligations of RAO EES and power generators.

1. RECs should retain responsibility for monitoring the day-to-day retail service of the A/O Energos.

RECs should monitor service quality and investigate consumer complaints regarding A/O Energos. RECs should be empowered to issue fines and to take other actions to enforce service quality standards. Where a particular violation requires license revocation, RECs should be authorized to recommend revocation to the FEC. Upon receipt of such recommendation, the FEC should institute a speedy review proceeding. Such proceedings

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should include standards of review that place the burden on the market participant to show cause why revocation is not warranted.

Enforcement actions should be taken by the FEC only upon an adequate evidentiary record. This would require that (1) RECs submit periodic reports on the performance of the A/O Energos; (2) consumers be able to challenge REC's failure to address service complaints adequately by taking an appeal to the FEC; and (3) enforcement actions be effected by written decisions after the appropriate parties have had an adequate opportunity to address allegations regarding inadequate service.

The specifics of procedures for reports, investigations and enforcement actions can be developed by both the FEC and RECs in consultation with each other. It is understood that there may be circumstances in each region that warrant regional variations in service. Differences between regions may result in separate rules being prepared by RECs. On the other hand, the FEC should, to the extent possible, require the harmonization of service obligations to prevent extreme disparities among service territories.

2. The FEC should hear complaints relating to RAO EES and generators and be able to issue fines to redress misconduct.

The FEC should have exclusive administrative jurisdiction over RAO EES and generators. Enforcement action should be taken against these entities only after adequate evidence is compiled and a hearing is conducted, giving RAO EES or the generator a fair opportunity to respond. Enforcement actions should include fines, divestiture of assets and revocation of licenses.

J. Dispute Resolution

One of the most important tasks of a regulatory framework is the resolution of certain disputes. Because of their role in regulating and monitoring electric power industry transactions, the FEC and RECs may be best qualified to resolve disputes between power sector participants, especially as they pertain to conflicts over such matters as rate-making and service obligations. At the same time, it must be recognized that the Russian Constitution has granted ultimate authority for dispute resolution to the Russian courts. However, the courts should allow the FEC to conduct "administrative" proceedings regarding issues that are unique to the regulatory domain of that agency.

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1. The FEC should have original jurisdiction and appellate review in certain disputes between market participants.

The FEC should have original and appellate jurisdiction over certain disputes within the power sector. The jurisdiction of such agency should be administrative in nature; i.e. it should cover disputes between specific participants involving issues that are not within the exclusive province of the Russian court system. In general, such agency should be the forum of first review for disputes between:

- an REC and a consumer;
- an REC and an A/O Energo;
- two A/O Energos;
- two RECs;
- RAO EES and a generation company or A/O Energo;
- a generation company and an A/O Energo over wholesale transactions (when and if allowed); and
- two generators.

The FEC should have appellate jurisdiction over REC decisions. The law should require that all electric power market participants submit to the jurisdiction of the FEC for administrative proceedings. A similar condition should be included in the license of each market participant.

2. Administrative decisions should be reviewable by the Russian Arbitration Court.

Ultimately, decisions by administrative courts should be reviewable by the Russian Arbitration Court. The Russian Constitution guarantees all legal entities the right to challenge decisions of government bodies in Russian courts. This right of judicial review cannot be waived or rescinded by the government.

It has been suggested that a special appeals panel be created to review decisions. The use of a special panel is problematic. First, creating such a panel could interfere with the right of judicial review. Second, establishing a new independent body with plenary powers could substantially undermine the credibility of the FEC. Since the Russian courts will retain the ultimate power to review decisions, the resolution of disputes is likely

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to be lengthened to such an extent that justice may not be served by the time a final decision is reached. Even now the delay in decisions alone is problematic for the industry.

On the other hand, the existing arbitration courts in Russia may not have sufficient expertise to review detailed rate-making decisions. Therefore, appeals of administrative decisions should be taken according to a two-tier system. First, the Russian arbitration courts should remain the primary body to review administrative decisions as is required by the Constitution. To strengthen the Arbitration Court's ability to review power sector cases, however, the Arbitration Court should appoint specific judges to specialize in these types of cases. These judges would receive training and background in electric power industry issues. They could also consult with experts in the course of rendering opinions.

Second, an independent three-person appeals panel, comprised of two senior government officials and one supreme court judge, should be created to review appeals of cases involving rate determinations. This panel would have a very narrow subject matter jurisdiction, leaving all other cases to be reviewed by the Arbitration Court. The panel would be subject to very strict time limitations and would be limited to review of the rate-making calculations and procedures used in formulating the rates in question. Decisions would be made by majority vote of the panel.

3. RECs should have initial jurisdiction in disputes between consumers and A/O Energos.

RECs should perform one very basic dispute resolution function. They should review disputes between consumers and A/O Energos as well as between two A/O Energos located in their jurisdiction. RECs should have no appellate review function.

SECTION V

STRUCTURE OF REGULATORY BODIES

A revised market structure will make new and different demands on Russia's system of energy regulation. A successful strategy for reform of the Russian electric power sector can work with existing regulatory bodies. These existing bodies, however, must be prepared to perform the regulatory functions assigned to them under an advanced market structure.

To meet the regulatory goals set forth in this paper, existing regulatory bodies should be made internally efficient. Efficient internal organization will translate into lower regulatory costs and quick, effective performance of regulatory functions. The internal structure of regulatory bodies also affects the ability of such bodies to work together within an overall system of regulation. The following recommendations should assist the Federation in the design of internally efficient and well integrated regulatory agencies.

A. Federal Energy Commission

The changes recommended below would create a smaller, multi-member commission made up at least partially of technical experts. The Chairman of the revised FEC would have significant powers of delegation and the ability to shape an enlarged professional staff. The FEC structure proposed here also would require the annual submission of a budget and the preparation of materials that keep the Russian public informed of FEC actions. These changes would transform the FEC into a less political, more capable regulatory agency.

1. **The FEC should be structured as a multi-member commission.**

There are two alternative structures for the design of a regulatory body: a single administrator or a multi-member commission. A single administrator is generally considered more efficient than a multi-member commission. A single administrator has greater control over staff and is able to render decisions more quickly. On the other hand, a multi-member commission is considered less susceptible to improper influence and political interference. Furthermore, a multi-member commission can offer greater depth and breadth of experience.

Regulation of the electric power sector involves a number of difficult technical, engineering and economic issues. A multi-member commission, if properly structured, can bring together the diverse set of specialties required for informed decisions.

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A multi-member commission makes it possible for experts from various fields to interact and contribute.

Today the FEC is a multi-member commission. We recommend continuation of this approach. However, for reasons discussed below, some changes to the size and composition of the existing commission should be considered.

2. The size of the current FEC should be reduced.

A large FEC allows representation from a broad cross-section of interest groups and expertise. On the other hand, an overly large FEC would prove unwieldy and experience bottlenecks in decision-making. The existing FEC is comprised of twenty members. We believe this size may be too large. After careful consideration of commissions of different sizes, we recommend a seven member commission.

Seven members is a logical size for a number of reasons. First, a smaller commission would substantially increase the FEC's efficiency and rate of decision-making. At the same time, a group of seven is large enough to allow representation by different interest groups. Second, a smaller commission would enhance each member's ability to contribute. The large size of the current FEC means that the responsibility of existing members is extremely defuse, if not perfunctory. A smaller group would facilitate meaningful dialogue among members that would not be possible in a large group.

3. The FEC should be partially composed of experts from important technical fields.

Currently, the FEC appears to be structured along the lines of political interest groups rather than functional expertise. While it is certainly important that different interest groups are represented on the FEC, there should be a requirement that certain defined areas of technical expertise be represented as well. The five most important areas of expertise are: economics, law, finance/accounting, engineering and management.

4. FEC members should be appointed by the Prime Minister.

Inasmuch as the FEC would be created under federal law, its members should be appointed by a senior official of the federal government. The most appropriate official for this is the Prime Minister. Of course, all members will need to meet the minimum qualifications specified by statute.

- 5. Members of the FEC should be appointed for a fixed term of years and such terms should be staggered.**

Members of the FEC should be appointed for a period of five years and should have staggered terms. Thus, at least one new member should be appointed or an incumbent reappointed every year. It is recommended that the first members have different terms of service, so as to permit such staggering. Members should be appointed for a fixed term and should work on a full-time basis.

It is recommended that each member be eligible to serve no more than two five-year terms. Members appointed initially will be able to serve their first term plus one additional five year term. This serves the important purpose of precluding the creation of permanent alliances and influence by interest groups. For instance, the limitation to two terms would discourage individuals from viewing employment as a member as one's primary career. Also, a periodic influx of new management would be healthy for the FEC.

- 6. Members should be removed from the FEC only for cause and only after judicial due process.**

Currently, members of the FEC can be recalled at any time for any reason. We recommend that members be recalled or reassigned to other positions only upon their malfeasance or mental illness. Moreover, removal should only occur according to a legislatively defined judicial process.

The process of removal should function as follows: if the Prime Minister believes a member is either guilty of malfeasance or mentally ill, he should be required to serve that member with a charge sheet outlining the charges warranting the member's removal. The member should then be able to reply to the charges in writing within a fixed period of time. If charges are denied, the Prime Minister should appoint an Arbitration Court judge to hear the charges. This judge should be empowered to hold a hearing where both sides are given an opportunity to present their respective positions. The judge should then prepare a report rendering a verdict to be submitted to the Prime Minister. Only after this process has been completed should a member be removed by the Prime Minister. Furthermore, the removal process should be subject to the appellate review of the Supreme Court.

- 7. The FEC Chairman should be appointed by the Prime Minister and given powers of delegation and appointment.**

The Prime Minister should designate one member of the FEC as Chairman and Chief Executive. A chairmanship would assure timely decisions and protect against an excessively powerful staff.

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The remaining six members should report to the Chairman. The Chairman should have the authority to delegate decisions to any individual member, whose decision would stand as a decision by the commission. However, delegated decisions should not include rate determinations and determinations regarding franchise requirements. These decisions should be decided by several members sitting as a body. In addition, decisions by individual members through the exercise of delegated authority should be appealable to the full commission. Finally, the Chairman should have the authority to hire and fire staff.

8. Each member should be assigned oversight responsibility for specific regulatory tasks.

Each member should be assigned a priority task by the Chairman -- e.g., tariff reform, performance standards, service franchises and accounting standards. In these areas, we would expect staff to report to and work directly with individual members. The priority tasks should be rotated among members at defined intervals in order to broaden members' expertise and experience. Details as to how responsibilities will be assigned and rotated should be established by the FEC.

9. Each FEC member should meet certain minimum professional qualifications.

Members of the FEC should be highly qualified professionals. The electric power law should specify minimum qualifications for members to ensure professionalism. We recommend, for example, the following basic requirements:

- at least ten years (fifteen for the Chairman) of relevant experience in management, government or business;
- an advanced degree in the member's area of expertise;
- at least five years' practical experience in the member's area of expertise;
- relevant work experience in Russia; and
- a clean personal record, reflecting professional integrity and honesty.

10. Legislation should provide for a permanent FEC professional staff.

One of the principal changes that should be made to the FEC is the creation of a larger professional FEC staff. The staff of the FEC today is almost non-existent. The FEC will require a highly qualified and professional staff with special backgrounds and areas of expertise. We envision a staff of 100 to 200 workers with a 30-person professional staff

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for each of the FEC's functional departments. These professionals should be supported by a capable support staff to perform necessary functions such as accounting, human resources, library, secretarial, and other administrative functions.

The FEC should have the sole authority to hire and dismiss its technical and support staff. This function should be exercised by the Chairman, to whom the staff would report. Although it is assumed that the staff would be comprised of permanent employees, the FEC should function like a private sector organization, without the usual government-type restrictions on hiring and dismissal. Thus, the Chairman should be able to dismiss staff for non-performance, low levels of output, malfeasance, doubts about integrity and honesty or interpersonal problems that hinder working relationships. The Chairman should be the final decision-maker on hiring and firing staff although consultations should be held with the other members to obtain their opinions.

Compensation is a critical issue as it applies to members and professional staff. Today, members of the FEC are not compensated. In order for the proposed structure to work effectively, compensation must be provided. Additionally, compensation must be substantial enough to attract the appropriate talent and expertise needed to run the FEC. The members, in particular, should be paid a salary that insulates them from financial pressures and incentives from various interest groups. The professional staff should be paid compensation that is commensurate with their capability and expertise.

11. Legislation should prohibit conflicts of interest.

FEC members and staff should be prohibited from owning any interest whatsoever in entities engaged in the generation, transmission or distribution of electric power or the provision of intermediary services within the electric power sector. This prohibition should also apply to ownership of any parent or subsidiary companies of organizations participating in the electric power industry. FEC members and staff should not receive compensation from any source other than the FEC. This restriction will help to ensure that members and staff are not receiving kickbacks disguised as compensation.

12. The FEC should be divided into departments along functional lines representing different key professions.

When selecting an internal structure, the FEC should be organized around the three different aspects of its operation. These are: (a) regulatory functions; (b) the entities to be regulated; and (c) staff characteristics. One of these aspects should be used to structure the primary departments of the FEC. Next, one of the two remaining characteristics should be used to structure the major subdivisions of the departments. Finally, the remaining aspect of the FEC's operation should be used to structure further sub-departments.

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Which internal organization is most desirable depends in large part on what aspects of the FEC should be initially emphasized. For example, an organization concerned with procedure should structure first along functional lines. Conversely, an organization concerned about the entities it regulates should be structured around the entities it regulates.

In the near term, the FEC will have a need to build an organization that delineates responsibility along functional lines. We recommend that the FEC be divided into departments along functional lines such as "standards" and "rate-making," with the different professions represented on the staff split among the departments.

All staff officers should report to the Chairman. However, the members should not merely have decision-making responsibilities, but should take an active role in the day-to-day activities of the FEC. The members' ongoing responsibilities in the areas assigned by the Chairman will probably lead them to operate by means of task forces put together from the different offices or by coordinating the flow of advisory and decision documents among staff departments and offices. The development of internal staff reporting and management mechanisms is best determined by the FEC itself.

13. FEC decisions should be made by a legislative-type process according to voting procedures adopted by the FEC.

FEC decisions should be made by a legislative-type process. Under a legislative-type process, the FEC would gather information from interested parties, staff, panels of experts convened by the commission and other sources that the commission can subpoena to testify. This recommendation reflects the limited staffing resources that the FEC would have and the benefits of avoiding delays associated with formal adjudicatory proceedings (i.e., proceedings in which a judicial officer takes testimony offered by interested parties). A legislative-type proceeding would enable the FEC to use a variety of resources as it sees fit.

The FEC must develop administrative procedures for making decisions. Although certain decisions can be delegated to individual members or even staff, all important decisions should require formal deliberation among the several members acting as a single body. Such decision-making would require applications and other filings by regulated companies to be submitted on written forms devised by the FEC. Similarly, public comment typically should be in written form, although oral comments could be requested in certain circumstances.

The decision making process should include a time limit for making decisions -- three months for rate determinations and sixty days for all other matters. Further, the decision making process can include provisions for open meetings, with minutes made available to all interested parties.

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Decisions by the FEC should be made according to a voting procedure established by the FEC. All members should be required to vote on all matters submitted for formal consideration, and the vote of each member should be recorded for the public record. This procedure should allow individual members to dissent. If unable to physically attend meetings, members should be allowed to vote by proxy or by submitting a written communication to the Chairman. As a general rule, six members should be present or represented by proxy for a quorum on major issues such as a rate determination, review of investment and resource acquisition plans, and promulgation of rules and regulations. On less crucial matters, five members should constitute a quorum.

14. The FEC should prepare its own budget and sustain itself on user fees.

In order to ensure its proper functioning, the FEC should receive an adequate budget allocation from the Russian Federation. To preserve the independence of the FEC, it is critical that the FEC budget not be subject to manipulation by different interest groups.

On an annual basis, in keeping with the regular Russian government budget cycle, the FEC should draw up its own budget. The FEC should combine its budget with the budgets it receives from RECs and submit a combined budget to the MOE for inclusion in the government's budget for submission to the Congress. The Congress would then pass the budget outright or refer it back to the FEC for revision. If after multiple revisions, the Congress and the FEC are unable to arrive at a negotiated budget, then the positions of each should be submitted to the Prime Minister for decision.

The FEC budget should be substantially funded by user fees assessed against regulated companies. Such user fees should be levied on the basis of kilowatt/hour sales on the wholesale or retail market. Other revenue sources could be filing fees paid by companies regulated by the FEC, fines and confiscations, and interest and profits from administration of the commission's own funds.

If the FEC collects levies and fines in excess of its budget during a fiscal year, such excess funds should be paid over to the government so that there is no incentive for the FEC to abuse its enforcement authority. If the FEC finds its allocated budget insufficient to provide for its functions, it may be given the authority to collect additional license fees up to a maximum of 15% of its annual budget. However, a strong justification for such additional fees should be submitted to the MOE. Congress should have the authority to decide on the reasonableness of the increase after the fact. If Congress finds the budgetary increase unacceptable, it should then have the option of subtracting the same amount from the following year's budget.

15. The FEC should be required to publish opinions and certain other documents to keep the public informed of its actions.

The FEC should be required to issue decisions and opinions in written form, setting forth their technical and legal basis. These decisions and opinions should be published and made available to the public. This requirement should help ensure that the FEC's actions are supported by legitimate, well-reasoned arguments.

In addition, the FEC should prepare several types of documentation, including:

- an annual report describing activities and indicating the trends for the following year; and
- a "State of the Industry" Report.

Finally, the FEC library should develop and maintain a computerized database of the publications on-hand or readily available from other sources. The public should have access to all materials collected by the FEC, including investment and resource acquisition programs and the contracts and reports of regulated companies.

16. The FEC should institute measures to ensure public participation in its function.

One of the FEC's primary goals should be to protect the interests of power consumers. The FEC should institute, when practicable, measures to ensure there is adequate participation by the public in rate hearings, complaints against industry participants, and other issues of concern to the general public. Notice of requests for regulatory action should be published in a widely-read newspaper or other widely-circulated document. Such notice should be given sufficiently far in advance to allow time for interested parties to formulate meaningful comments.

B. Regional Energy Commissions

Currently, the 74 RECs correspond to 74 regional distribution companies. With certain exceptions, the internal structure of RECs should be the same as the FEC structure proposed above. The following is a list of those aspects of RECs' recommended structure that might differ from that of the FEC.

1. The members of RECs should be nominated by regional governments.

Given RECs' crucial role in serving regional interests, regional government authorities should have a substantial role in appointing REC members. Moreover, RECs should ultimately be supported by legislation at the regional level.

Initially, however, RECs may continue to be empowered by federal legislation. Therefore, while REC members could be nominated by regional government authorities, the final appointment of members should be made by a federally-authorized person or persons. The regional governments, for example, would nominate alternative candidates for seats on REC boards. A federal agency such as the FEC would then appoint members from candidates nominated by the regional governments. If nominations are not made within a limited period of time, the FEC or its Chairman would then be able to make appointments. As regions develop their own legislation, new procedures for member selection would be instituted.

2. Members of each REC should be residents of the region served by such REC.

REC members should represent interest groups that are regional in character and should be responsive to the service area that they regulate. Therefore, we recommend that there be a legal residency requirement for REC members.

Additionally, REC members should represent a cross-section of each region's industry. The existing RECs already reflect such an approach. We recommend standardization of REC membership composition requirements so that the same types of interest groups are represented in each region. Further, there should be some control over the member selection process so that an appropriate political balance is maintained.

3. The professional staff of each department within RECs should be composed of approximately 10 persons.

Legislation should limit the number of professional staff in order to restrict the natural growth of bureaucracy. An average staff of 10 persons in each department should be sufficient to handle the tasks assigned to RECs. In certain regions (e.g., Moscow), where the degree of regulatory activity is high, a larger number of staff may be considered.

4. REC budgets should be submitted to the FEC for approval before inclusion in the government budget.

Initially, budget responsibility for RECs should be shared by the federal and regional governments. RECs should prepare budgets, but the FEC should review and

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approve such budgets. The FEC is best situated to do this because it is familiar with REC functions and their approximate costs. The alternative of having every REC submit a budget to the MOF would unnecessarily burden the MOF and lead to inconsistent budgetary oversight. Eventually, as each region develops its own legislative basis for regulation, budgetary responsibility should be shifted to the regions.

SECTION VI

TRANSITION PERIOD

The success of any effort to restructure the Russian power sector will depend on the design of a workable transition program. A transition program should provide for the creation of an interim body to assist in the implementation of changes. In addition, the timing of regulatory changes and the authority of each regulatory agency during the transition period should be set forth in detail. The following recommendations should help ensure a successful transition period.

A. Transition Measures Committee

1. **A Transition Measures Committee (the "TMC") should be created to oversee the transition to a new power sector and regulatory structure.**

A TMC should be created by a Presidential Order to referee the power sector's transition to the proposed power sector structure. The TMC should not be a regulatory body, but rather a temporary organization with interim powers.

The TMC's primary function should be to monitor the progress of market reform. The Presidential Order should set forth the criteria against which progress is measured, but should also allow some flexibility as the passing of time will necessitate the need to change criteria. The TMC should be authorized to make recommendations to the FEC and other regulatory bodies based on established periodic review periods. Such recommendations may include suggested changes in pricing methodology, service code establishment and enforcement, privatization, reformation of the FEC and REC structures and definition of service territories and zones. These recommendations should eventually serve as specific proposals for new electric power legislation.

B. Power Sector Regulation during the Transition Period

1. **During the transition period, RAO EES should assist in the creation of the wholesale market.**

In the initial phase of the transition period, RAO EES should be responsible for negotiating power purchase contracts with all generators. RAO EES also should coordinate the purchase of electric power (capacity and energy) from generation companies and arrange for the sale of that power to A/O Energos under a unified pool tariff.

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Generators should be required to provide all of their power to RAO EES and A/O Energos should be required to purchase power under the pool tariffs.

In the final stage of the transition, power generated from nuclear power generators, RAO EES corporatised generation subsidiaries, privatized independent generators and foreign generators should be sold on the emerging wholesale market. These sale transactions should be administered and dispatched by RAO EES or another central dispatch organization on the basis of actual costs. The generators with the lowest actual variable costs should be dispatched first. The dispatch regime should be based on cost criteria compiled by the generators and collected by RAO EES on a monthly basis. The FEC should review this process and institute a uniform system of accounts to be used by all generators and RAO EES.

2. During the transition period, the FEC should oversee RAO EES' purchase of power from generators.

The FEC should have substantial oversight responsibilities over wholesale transactions and their pricing. An effective power pool operation and pricing rules will be needed to ensure merit dispatch of generation and an efficient and reliable supply of power. The FEC should also review all contracts entered into between RAO EES and generators.

Tariffs for wholesale power purchases should be calculated by RAO EES based on the monthly cost data collected from generators and should be reviewed and approved by the FEC. If dispatched, a generator should be paid its actual costs. This will include both variable and fixed costs. The FEC should allow all generators to receive a price for energy and capacity sufficient to recover costs and earn a fair profit. A distinction, however, should be made between plants in existence on the date of the new law (and built with public funds) and newly built or substantially rebuilt facilities. New generators should be allowed to recover an unregulated profit. Existing generators should be allowed to recover a regulated profit margin. This profit margin could be tied to any number of market factors. It could, for example, be tied to a fixed percentage that would be sufficient to allow generators to raise money from investors.

The FEC should conduct advance prudence reviews for all new generators and determine what new generation is needed and what new plant construction or plant refurbishing should be allowed to be conducted. The definition of "new generator" could, for example, include any plant or facility that has received investments, following the electric power law's effective date, in an amount that exceeds 20 percent of the total value of the plant's or facility's assets on the date the prudence review is made.

3. During the transition period, the FEC should approve all purchases of power by A/O Energos from RAO EES.

Wholesale power should be purchased by A/O Energos at prices that reflect the average cost of generation in the national power pool. These rates should be prepared by RAO EES and approved by the FEC. First, RAO EES should calculate one combined "weighted average" pool input price (the "PIP") for the wholesale market. This price should be the average price paid to all generators in the pool, weighted according to the proportion of energy dispatched from each generator in the pool.

Second, the PIP should be combined with RAO EES' transmission and dispatch costs to form one Uniform Power Pool Tariff rate (the "UPPT"). There could be one UPPT for the entire wholesale market. In the alternative, UPPTs could be created for various regions. One proposal is to establish seven UPPTs designed around the seven existing regional dispatch centers. In either case, the FEC should have exclusive authority to approve the UPPTs.

Additionally, the UPPTs could have a "time of day" structure that distinguishes between "peak" and "off-peak" hours. Under this structure, there should be two UPPT prices available to purchasers, depending on the time of day: an "off-peak price" that applies in the evening hours when customer demand is low and a "peak price" applying during the busiest hours of the day in periods of high customer demand (which reflects the increase in costs of generation during times of high demand). Additionally, the UPPT price may contain a two-part tariff. One part would contain an energy charge to cover variable costs (kwh) and the other part would contain a capacity charge to cover fixed costs (kw).

4. During the transition period, RECs should regulate rates on the retail market.

In the retail market, rate regulation during the transition should be very similar to rate regulation thereafter. In both cases, RECs should be primarily responsible for retail rate approval. However, during the transition period, the calculation parameters will need to be adjusted as alternative power sources become available.

5. The SPC should monitor the process of privatization and exercise its voting authority within state-owned enterprises.

The SPC already has statutory control over the privatization of state enterprises in Russia. One instrument of control that the SPC exercises over enterprises that are in the process of being privatized is the right to vote shares held by the Russian government. The SPC's right to vote the government's shares in RAO EES should be used

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to monitor and encourage RAO EES's divestiture of certain holdings pursuant to the Group A working model.

6. The TMC should assist the SPC in monitoring the progress of privatization.

The TMC should assist the SPC in the process of transforming ownership of power sector entities. Once the privatization has taken place, the TMC should assist new entities in their transition into the restructured industry. On a macroeconomic level, the TMC should play a key role in the timing of the institution of the new regulatory system, helping to bring new structures and functions "on line" as soon as they become practicable in the changing industry.