

Romania: Natural Gas Sector Restructuring – Principles for a New Regulatory Regime

1.1 SECTOR RESTRUCTURING AND THE REDESIGN OF REGULATORY POLICY

The Government of Romania (GOR) has decided to restructure its natural gas sector. As part of this process the government has decided to (1) revise the legal/ institutional framework governing the sector and to establish a regulatory authority, (2) unbundle the natural gas industry, (3) examine the pros/cons of commercialising the industry and (4) restructure the nation's natural gas tariff structure.

1.1.1 Restructuring

There are several critical components to sector restructuring including (1) a change in the existing industry structure, (2) a change in ownership, (3) a change in regulatory oversight, and (4) the introduction of competition. Likewise in introducing sector restructuring, a Government may have one or more broad objectives: (1) to increase efficiency, (2) to raise revenue by divesting full or partial ownership, or (3) to promote public participation in the sector.

Before meaningful sector restructuring can occur there are a number of key policy ingredients and critical issues that must be addressed: What does the government want to accomplish?

- Enhance sector coordination and planning
- Broaden access to capital
- Improve technical and operational performance
- Introduce competition
- Improve enterprises' financial viability
- Improve effective regulation
- Permit private participation/ownership

1.1.2 Regulatory Change

Regulation of privately-owned businesses should, in an ideal world, be limited to activities that cannot be disciplined through market competition owing to a variety of market deficiencies, including "externalities" that are not reflected in the costs (such as pollution) and the ability of market participants to exclude or control competitors. Most countries that have gone through the process of establishing effective regulatory institutions have found that it is better to maximize the role of competition and contracts in disciplining the operation of the electricity market using regulation only when these other elements have failed. Currently, meaningful competition does not exist in Romania's natural gas market. In addition, many of the laws and institutions needed for an efficient, private gas sector are embryonic or not yet fully developed. Consequently, a regulatory structure needs to be put into place to oversee the transformation of the sector, to

insure that those aspects of the gas industry not subject to competition are not allowed to infringe in a manner inconsistent with the public interest and to ensure the coordinated, reliable and adequate supply of natural gas.

There are a number of issues that need to be addressed in determining the proper oversight functions of a regulatory institution. There are several elements of Romania's natural gas sector that may never be subject to effective competition. These include transmission, and distribution, and the use of land resources that are vital for the expansion of natural gas throughout the country. In addition, there are elements that may not be subject to competition for many years, such as natural gas planning, procurement and marketing (e.g. supplying gas to the nation's fledgling commercial and retail markets). These elements of the gas network will require regulation until the proven presence of competitive market pressures.

There are a variety of possible regulatory structures from comprehensive regulation requiring the Gas Regulatory Authority (RA) to monitor the day to day activities of the regulated entities to light-handed regulatory techniques that structure financial incentives to induce efficient management, acceptable prices, and provisions for the non discriminatory provision of natural gas. As a general rule, Nexant believes the Regulatory Authority should minimize the burdens of regulation in terms of both the scope of regulatory activity and the interference with the management of the regulated entities. However, it is up to the Government of Romania to design a Regulatory Authority that is most appropriate to its needs.

1.1.3 Regulatory Principles

The Team's recommendations will centre on the degree to which the Draft Bill includes a number of regulatory principles that have proved very successful in other countries.

- (1) **Independence:** the Regulatory Authority should be able to make decisions without approval from higher political authority. Rules governing the appointment of members of the Authority should prevent their "capture" by special interest groups. The Authority should have its own source of funding.
- (2) **Efficiency:** Regulatory approaches should create incentives for efficiency and innovation while promoting competition whenever possible.
- (3) **Financial Viability:** The methodology for setting and adjusting natural gas tariffs should take into account the cost of efficiently operated services that meet sector standards and goals so as to promote financial viability and attract justifiable capital investment
- (4) **Transparency:** Regulatory goals and processes should be specified clearly in the Laws and Regulations governing the sector. All regulatory decisions should be published along with clearly articulated explanations and justifications and should follow agreed upon procedures.

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- (5) **Fairness:** While promoting economic efficiency, regulatory decisions should strike a balance among all stakeholders including consumers, service providers, investors and the Government.
 - (6) **Balance Between Discretion and Stability:** the Regulatory Authority should have sufficient flexibility to allow it to respond to changing circumstances without creating excessive uncertainty for investors, consumers or service providers.
 - (7) **Cost-effectiveness of Regulation:** The Regulatory Authority should be a lean organization with a core staff of professionals that relies on outsourcing of specialized functions.
 - (8) **Expertise:** The members of the Authority and its staff should have sufficient economic and technical expertise to promote the credibility and consistency of regulatory decision-making.
 - (9) **Accountability:** Well publicized and accessible appeals mechanisms should provide appropriate checks and balances to ensure the Regulatory Authority operates in accord with its mandate. It is important that courts be capable of determining the merits of appeals cases so that the Regulatory Authority will not be vulnerable to unwarranted appeals that undermine its credibility.
 - (10) **Continuity:** Consumers and utilities should be able to expect continuity in the regulated tariffs and standards from one review period to another.
 - (11) **Simplicity:** Both large and small customers should be able to understand the basis of charges, the configuration of rate classes, conditions of service and other regulated factors.

In the past two decades, it has become clear that many large and small state-owned corporations throughout the world in the natural gas as well as in the electricity, water and telecommunications sectors have not been operated on a commercial basis and have not generated sufficient financial resources required to maintain and upgrade their basic infrastructure. Tariffs are often not adequate to recover costs, do not promote efficient operation, and are subject to political interference. The lack of investment in new assets and inadequate maintenance of old and aging assets over the years have led to a progressive decline in operational efficiency, increasingly unreliable service and only limited extensions to new customers. These problems have become particularly acute as a result of other financial and economic pressures plaguing emerging-market economies in the past two decades. To address these problems, governments have begun to develop and implement strategies to restructure their utility sectors, in many cases with an emphasis on introducing private sector participation (PSP). I regret to say that while Romania has made important strides in “unbundling” its natural gas sector, it has lagged far behind in introducing PSP.

In dealing with these problems in the natural gas sector, many governments are attempting whole-scale sector restructuring to introduce competition in those parts of the sector where it is most practicable. Some Governments are “unbundling” their historically vertically integrated

utilities into separate generation, transmission, and distribution companies. Competition through “common carriage” (or, third-party access) is also being attempted, although this form of competition is mostly limited to a handful of OECD countries.

In services that remain monopoly services, such as transmission and distribution of natural gas, electricity and water, a strong and effective regulatory framework plays a critical role in the utility sector reform process, especially when introducing PSP. Monopolies if left alone will tend to have profit maximization goals and thus the incentive to charge high prices and or shirk on quality of service. Regulation, as a substitute for competition, can help provide the consumers protection from potential monopoly abuse. This is especially true in countries such as Romania where retail prices have been held for a long time below the real cost of providing service and a rapid escalation in prices at a time of real wages rising slowly or falling makes raising gas prices politically difficult. Furthermore, where the provision of service has been poor, experience from around the world demonstrates the need to raise service and to extend service before raising retail prices for the consumer.

In addition, the need to invest in new plant and equipment requires an assurance of timely and adequate cost recovery, including attractive profit levels in order for operators and investors to devote capital for the utility enterprise. For a private investor to lend or invest in a utility he must be assured that a legally enforceable, transparent regulatory process exists, free from government and political interference. Good regulation can help remove the uncertainty for the private operator, and that will in the long run help lower the cost of capital, improve operating efficiencies and lower customer tariffs. In addition, given proper authority, performance based regulation can be designed to provide incentives to service providers to operate and invest efficiently.

A government may regulate transparently, for example through a regulatory body that is established pursuant to a government decree or by a legislative act with its powers, duties and responsibilities clearly defined. It may also “regulate” through informal, case-by-case contracts between ministries and the managers of the enterprises. Nexant believes that the former approach is preferable, and this is the approach we would recommend might be considered by the Government of Romania as it moves its regulatory process forward.

Independence: The Regulatory Authority should be able to make decisions without undue interference from Government authorities. Statutory powers and rules governing the process of appointment of members of the Regulatory Authority should assure its independence, and prevent their “capture” by special interest groups. The Regulatory Authority should have its own source of funding, such as an assessment on licensee services.

Transparency: Regulatory goals and processes should be specified clearly in the law and regulations. All regulatory decisions should be published along with clearly articulated explanations and justifications and should follow established procedures.

Accountability: A well-established and publicised public input process and accessible appeals mechanisms should provide appropriate checks and balances to ensure that the Regulatory Authority operates in accord with its mandate. It is important that the courts or other adjudicative bodies respected by the nation's citizens be capable of determining the merits of appeals cases so that the Regulatory Authority will not be subjected to unwarranted litigation that undermines its credibility while insuring that it does not exceed its authority.

Consistency/Stability: Regulatory decisions should be consistent with its statutory goals and purposes and applied consistently in order to send clear signals on policy and principles. This will reduce regulatory uncertainty and ensure that when change in regulatory methodology/practice is required as a result of a major shift in circumstances, this can be done in a manner that is predictable and acceptable to all parties.

Nexant believes that "best practice principles" should be tempered with practical considerations, public understanding and gradualism, rather than adhered to blindly. For example, even though regulatory independence is often considered a fundamental precept to effective regulation, we believe that independence is only important to the extent that it helps achieve consistency, transparency and accountability. Furthermore, complete regulatory independence is often not feasible nor always desirable in certain cultural contexts. However, even in a democratic society, a regulatory body should be held to some degree of public and, therefore, political accountability and scrutiny.

1.1.4 Functions

The Regulatory Authority must be assigned the requisite authority in its enabling legislation or other legal foundation to conduct basic regulatory functions. While the breadth and depth of regulatory responsibilities vary considerably throughout the world, there are four functions that are central to effective regulation:

- **Licensing:** Issuing, and monitoring and enforcing compliance with licenses;
- **Pricing:** Reviewing tariff proposals and establishing tariffs;
- **Service & Quality Standards:** Specifying and enforcing standards; and
- **Sector Expansion:** Reviewing capital investment plans.

The Regulatory Authority should be assigned these responsibilities by statute and they should be unambiguous; the statute should include clear substantive and procedural guidelines for conducting the tasks.

1.1.5 Procedures

An independent regulator should establish and consistently apply a set of procedures for conducting its responsibilities. There are a few basic principles that should guide the development of these procedures. Interference with management of the regulated companies, and the procedural requirements placed on the companies, should be minimized to the greatest extent

possible. Standards for decision-making should be stated clearly and publicly disclosed; the process of applying the standards should be transparent.

Interaction of the RA with other Sector Institutions: Are there adequate provisions for the RA's requests for information, including the format and type of data required, the process for handling inquiries and complaints, the guidelines for public hearings and the collection, analysis, and dissemination of information for regulatory purposes?

Enforcement: Does the RA have the requisite rights and powers to issue orders and decrees, and the authority to direct regulated entities to comply with its findings?

Resolution of Disputes: Are there adequate procedures for the RA to resolve two kinds of disputes: those in which a customer has an unresolved complaint against a utility and those that arise between or among different electric service providers?

Tariff Review Procedures: The enabling statute of the RA should grant the RA the ability to review the tariff schedules of each regulated entity to insure that the tariff schedules they are using are commensurate with government policy.

Other critical questions include:

- What is the process for approving development and expansion programs?
- What accounting standards are used and how can incentive regulation be developed/implemented?
- What financial reporting is required?
- Are there clear and specific guidelines for regulating private sector participation?
- Are tariff review methodologies and tariff setting approaches in place and or sufficient?
- What powers do the regulatory agencies have to enforce performance measurements?
- Are environmental and safety regulations sufficient and enforceable?
- What are the obligations of energy suppliers?

Finally, it is also very important that all key stakeholders have an appropriate understanding of both the de jure and de facto situation i.e., the difference between the laws regulations as written and actual practice, interpretation and enforcement.

Reform is never easy or quick but if done well regulation can be a vital ingredient in the reform process. Regulation can play a critical role in helping to effect the requisite institutional reforms/changes needed to facilitate the introduction of private sector participation in Romania. However there are many pitfalls on the way to establishing an effective regulatory institution and many other institutional actors who often view the new RA as a threat to their established positions. Critical corollary issues include:

- The mandate of any RA includes implementing regulatory functions, i.e., goes beyond policy making and setting sector guidelines;
- The statutory role of the RA may conflict with policy-making or other regulatory functions of the Government;
- The RA's mandate and functions are not clearly specified or are incomplete in its enabling legislation.
- The RA's operations and administrative structure/procedures are subject to outside interference;
- The RA is required to interact with numerous Government agencies; and
- Terms of existing contracts, and/or legislation grant overlapping powers and functions to more than one government entity (i.e., the Ministry of Electricity, Cabinet, other Ministries and the RA).

In addition, it is vital that the RA interact with other governmental institutions and laws which while not directly under the purview of the RA are of critical importance to the evolution of the sector. These laws/ regulations include:

- Competition or anti-trust legislation;
- Relevant laws dealing with concessions, licensing and/or privatisation;
- Existing PPA's and other contractual arrangements if any exist;
- Existing licenses for concessions
- Relevant laws dealing with foreign investment;
- Relevant environmental and natural resources laws;
- Labour and/or civil service laws;
- Laws that deal with consumer protection; and
- Laws that deal with the process for appeal, judicial review, etc.

1.2 CONSIDERING FEASIBLE OPTIONS

Nexant will consider several feasible options for the development of the natural gas sector regulatory process, including establishment of a set of processes and procedures that govern the operations, powers, and duties of the RA and its regulated activities for (e.g. rate-making procedures, public hearing process etc). These would not specify the standards for the technical provision of natural gas service which would be specified in the Licenses. Licenses to the greatest extent possible should be standardized. However there may be differing licenses for different functional activities, e.g. distribution, transmission, wellhead drilling, etc.

This option is consistent with the emerging trend in the development of legal and regulatory frameworks in developing countries.