Mitigating regulatory risk for private investors in the electricity sector in Africa

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Overview

- Experience of private participation and regulation in the electricity sector in Africa
- Regulatory risk for investors
- Mitigating risk through regulatory design
  - Regulation by agency / Independent regulator
  - Regulation by contract
  - Contracting-out regulatory functions
  - Advisory regulators
  - Regional Regulators
- Mitigating risk through accountability and capacity building
  - Mandated periodic and public reviews of regulators
  - Building the demand-side for regulatory transparency and participation
  - Capacity building
- Redress mechanisms for regulatory failure
  - Arbitration
  - Political risk insurance
  - Partial risk guarantees for regulatory systems
Private participation in power projects

13 countries
25 projects

Source: PPI database
Private management control of power sector

80% of sector under private management
Some (>10%) private sector management
Electricity regulators* in Africa

*Regulators generally outside Ministry but may, or may not, have final tariff-setting authority
African Forum of Utility Regulators

“AFUR recommends that the following key principles form part of an initial framework for utility regulation in Africa:

- Minimum regulation necessary to achieve policy and sector objectives;
- Adherence to transparent decision-making and due process requirements;
- **Independent or autonomous regulation where possible**;
- **Accountability** towards government, **investors** and end-users
- Non-discrimination when not in conflict with policy prerogatives of government;
- **Protection of investors** against physical and regulatory expropriation; and
- Promotion of competition by limiting anti-competitive behaviour.”

A Framework for Utility Regulation in Africa 2003
Regulatory worries for investors

Arbitrary or inconsistent decision-making

- **Limits to regulatory independence**
  - Some regulators only advise the Minister who makes final tariff decision
  - Tariff setting often highly politicized
  - Members of regulator boards are frequently replaced
  - Gap between “law” and “practice”

- **Institutional fragility**
  - Most regulators only a few years old

- **Lack of capacity**

- **Regulatory contracts under stress**
  - Renegotiation of concession contracts
  - Pressure on IPP / PPAs
  - Confusion of authority between regulators and contracts
Defining regulatory risk for investors

Potential **loss of regulated revenues** resulting from **arbitrary changes** to an agreed or pre-specified **legal framework** governing the regulation of infrastructure investments

i.e. arbitrary changes in law, regulations, licences or contracts

involving tariff-setting regimes, formulae or parameters, or various performance requirements including investment obligations, quality and extent of service, environmental and safety performance, etc **that have financial implications**
First approach: mitigate regulatory risk through regulatory design

1. Regulation by agency / independent regulator
2. Regulation by contract
3. Regulatory functions contracted-out to 3rd parties
4. Strong advisory regulators
5. Regional regulators

Select from menu of options to create transitional or hybrid model
1. Regulation by agency / independent regulator

No government entity other than a court or pre-designated arbitrator can overrule regulator’s decision

Legal protection
- Regulator protected from dismissal without due cause

Institutional independence
- Regulatory institution outside ministry

Managerial independence
- Regulator has control over professional staff

Financial independence
- Earmarked, secure, adequate source of funding

Not all regulators in Africa are independent
Rethinking the classic independent regulator model

THEN
“A requirement of all power lending will be explicit movement toward the establishment of a legal framework and regulatory processes satisfactory to the Bank…………this requires countries to set up transparent regulatory processes that are clearly independent …..”

NOW
“. a credible regulatory system requires more than a formally independent regulatory entity……other transitional arrangements may need to be established…. including limiting the amount of discretion that regulatory bodies have in setting prices and key parameters..”

The WB’s Role in the Electric Power Sector
World Bank Policy Paper 1993

Public and private sector roles in the supply of electricity services
Operational Guidance for World Bank Group Staff 2004
2. Regulation embedded in contract

A regulatory regime, including multi-year tariff-setting systems (for 1st period), pre-specified in one or more legal instrument or contract

- Sometimes approximates the French concession or affermage model without the Conseil d’Etat
- Mostly within context of private sector participation but regulatory contracts also possible for state-owned utilities
- Key issues are base-line data; efficiency targets; cost pass-through; new investment; foreign exchange adjustment; triggering events; dispute resolution

Three variants:
1. Key contract provisions self-administered
2. Regulator administers contract
3. Regulatory contract makes provision for contracting-out

Bakovic, Tenenbaum and Woolf 2003
3. Regulatory functions contracted-out to 3rd parties

The use of external contractors either by regulatory agencies or as stipulated in a regulatory contract to perform or assist with certain regulatory functions

- Considered when challenges or problems regarding regulator’s independence, competence/capacity, or legitimacy or where regulatory contracts require additional support.
- Strategic decisions needed around core competency and cost-benefits and extent of contracting out.
- Potential benefits: increase in regulatory competence, enhanced credibility
- Can be politically sensitive and requires sound contract management

Two broad variants:
1. Consulting support for regulators or regulatory contract
2. Advisory regulators

Tremolet, Shukla & Venton / Bertolini 2004
4. Advisory regulators

1. Regulator may only have an advisory function
2. An expert advisory panel may be contracted

- **Weak advisory regulator**
  - Advice is confidential
  - No obligation on Minister to explain rejection or modification of recommendations
  - Little or no public consultation
  - No separate earmarked budget

- **Strong advisory regulator**
  - Regulator’s advice must be public
  - Ministerial policy directives to regulator must be public
  - Regulator has public consultations
  - If Minister fails to respond within specified time, recommendations adopted
  - Minister must explain publicly rejection or modification of recommendations
  - Separate, earmarked funding
  - Pre-scheduled, periodic regulatory assessments
  - Role could be specified in primary or secondary legislation

Brown, Stern & Tenenbaum 2005
5. Regional regulators

• **In principle**........
  – Certain decisions on pricing and interconnection of regional networks could be contracted-out to a regional regulator.

• **In practice**........
  – Governments and regulators are unwilling to cede “sovereignty”
    AFUR & RERA have not made this choice?

• **Regional institutions face huge challenges in terms of political commitment, institution building and resources**
Regulatory design options

1. Regulation by agency
   Independent Regulator
   Regulator administers contract

2. Regulation embedded in contract
   Regulatory contract hires external contractors

3. Regulatory functions contracted-out to 3rd parties
   Regulator contracts out support

4. Advisory
   Regional regulators

5. Regional regulators
Regulatory context and design choices

High

Strong advisory regulators

Independent regulator contracting-out if cost-effective

Country X

Regulatory contracts

limit regulatory discretion

Regulatory contracts

with contracting-out

Low

Institutional and human resource capacity

High
Further actions for mitigating regulatory risk

• Build capacity
  – Need massive and ongoing commitment to training
• Mandatory reviews of regulatory performance
• Building the demand-side for regulatory transparency and competence
A third approach: redress mechanisms for regulatory failure

• Arbitration clauses in regulatory contracts

• Bilateral Investment Treaties

• Political Risk Insurance

• Partial Risk Guarantees
Partial risk guarantees for regulatory systems

- First WB regulation PRG (anywhere in world) - Uganda Elec
- For loss of regulated revenues from a guaranteed event
  - Non-compliance by regulator of pre-agreed tariff framework
  - If bulk price not fully passed-through
  - If tariff adjustment is not timely (45 days)
  - If GOU electricity bills are not paid (60 days)
  - If termination payments are not made
- Provisional PRG payments made pending dispute resolution
  - Liquidity of utility facilitated
  - Described as “deal-clinching” by investor
- Regulation PRG considered for Lesotho LEC concession
  - also adopted in Romania
Mitigating regulatory risk: conclusion

• An effective regulatory system needs credible regulatory substance and robust regulatory governance.
• Enhancing regulatory substance implies improving the quality and sustainability of decisions.
• Regulatory governance structures and processes should constrain arbitrary administrative action.
  – Key question: how much regulatory discretion?
• Success of a regulatory system depends on compatibility with country’s regulatory commitment and institutional and human resource endowment.
• Select from a menu of regulatory options to create hybrid model that suits country.
• Build capacity and mandate reviews of regulatory performance.
• If necessary – employ additional risk-mitigation measures such as partial risk guarantees.
The Management Programme in Infrastructure Reform & Regulation (MIR) is an emerging centre of excellence and expertise in Africa. It is committed to enhancing knowledge and capacity to manage the reform and regulation of the electricity, gas, telecommunications, water and transport industries in support of sustainable development.

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