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Response to TIPS presentation on "**Review of Regulators' Orientation and Performance: Electricity**"

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Presented by Grové Steyn
Meridian Economics
grove.steyn@meridianeconomics.co.za

New style vs Old Style Regulation

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- Old Style Regulation
  - From within line ministry
  - Relatively opaque
  - E.g. : Airport's Regulatory Committee in Dept. Transport.
- New Style Regulation
  - Separate regulatory entity
  - Circumscribed independence and decision making authority, with concomitant accountability
  - E.g: NERSA (Electricity, Gas and Petroleum storage and pipelines, ICASA, Ports Regulator)

Two Dimensions of Regulation

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- Regulatory Governance (how)
  - Independence and accountability of the regulator
  - Relationship with policy makers
  - Decision making processes (formal and informal)
  - Transparency; predictability; accessibility
- Regulatory Substance (what)
  - Tariff levels and structures
  - Cost pass-through (or not)
  - Services standards
  - Consumer complaints
  - New investments
  - Network access
  - Social obligations
  - Reporting requirements

Scope of evaluation

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An important conclusion of the handbook is that any evaluation of a regulatory system will be seriously incomplete if the evaluation is limited to regulatory governance or regulatory substance alone. Any serious evaluation of regulatory effectiveness needs to look at both dimensions.

Brown et al (2006, p.21)

– Brown, A. C., Stern, J., Tanenbaum, B., & Gencer, D. (2006). Handbook for evaluating infrastructure regulatory systems. Washington DC: The World Bank.

What should economic regulators do?

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- Economic regulation as second best alternative to competitive markets and competition enforcement.
- Typical economic regulation functions cover:
  - Market access
  - Access to and use of common network infrastructure
  - Tariffs and prices
  - Minimum service levels and standards
  - Adjudication of disputes
  - Etc.
- Regulators are not Economic Development agencies or Government Departments, but (should) have very specific and focused mandates related to the points listed above.

Basic insights (1)

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- Economic regulation is part of a broader institutional framework that governs sector behaviour and impacts on performance
  - Aspects of the governance framework includes
    - Government and State as:
      - Policy makers
      - Regulators
      - Share holders
      - (Project promoters)
    - Other providers of capital
    - Consumers and other stakeholders (labour, etc.)
    - Competitors
  - Influence through formal and informal means
  - Analytical implications
    - The impact of regulation needs to be understood in the context of these other governance drivers
    - It can be difficult to isolate the role of regulation in explaining sector performance (e.g. “the impact of regulation on SOE performance”)

Basic insights (2)

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- Potential conflicts of interest created by the multiple roles of the State
- Conflicts of interest in sector governance is resolved by separating key powers and functions
  - Separating roles improves the ability of the State to meet stated policy objectives
  - Hence the need for regulatory independence and the adoption of “new style” economic regulation
- The choice of new style economic regulation presupposes the rule of law
  - Access to functioning courts, etc.
  - Legislation must be coherently drafted
  - Legislation and regulatory mandate must reflect policy
  - Effective regulatory accountability
  - Realistic expectation that all parties (including government and the regulator) will play by, and be bound by the rules
  - Stakeholders must not
    - perceive a risk of being penalised for using system (e.g. appealing, etc.)
    - consider it more practical/attractive to do deals outside of the system

Objectives of the TIPS study:

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Objectives

- Effective performance of economic regulators crucial for economic growth and development
- Regulatory Entity Capacity Building Project by Centre for Competition, Regulation and Economic Development of University of Johannesburg (UJ), partnership with Economic Development Department (EDD)
- Aims to build capacity of regulators through design and implementation of a series of capacity building measures to support economic regulators in South Africa:
  - review of performance of economic regulators to identify constraints impacting performance
  - design and implement knowledge capacity building programme in response to identified needs through Short Learning Programmes (SLPs)
- TIPS contracted to look at electricity, renewable energy and ports

Questions for the TIPS study:

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Key questions for the TIPS electricity industry review

- How effective has economic regulation in the ESI been in relation to NERSA's mandate?
- To what extent is regulation in the electricity sector contributing to, or in conflict with, other economic development mandates aimed at sustainable development and growth?

Study design

- Important to identify the problems and analyse the causes carefully before solutions are attempted.
- This ensures that the one generates appropriate solutions.

Assessing the performance of regulators

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- In the final analysis, the performance of regulators should be measured in terms of their contribution (or not) to industry outcomes.
  - Lower costs and prices
  - Improved service (access, reliability, quality, service levels, etc.)
  - Long term sustainability
  - Environmental impact
  - Etc.
- Then zoom in on regulatory governance and substance
  - We need to look at the **quality** of NERSA' decisions i.t.o. process (governance) and substance
  - We need to look missed opportunities (what they have not done) as well as actions that were taken.
- Apply the Pareto principle
  - Focus on the 20% of problems that make 80% of the difference.

What does the objective pre-suppose: "Regulatory Entities Capacity Building Project"

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- Is this the focus because the funders / researchers are of the view that regulatory outcomes are not adequate or satisfactorily; and
- That regulatory capacity is assumed to be the cause?
- There are other important causes of regulatory performance problems.
  - cf Steyn(2012).

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Thank You

Successes with SOE regulation to date

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- Greater transparency and more informed public debate about infrastructure economic issues.
  - Licence and tariff hearings conducted by some regulators have greatly increased the available public information about SOE performance and infrastructure policy questions.
  - This has highlighted the fact that there is a trade-offs to be made between capital expenditure on large infrastructure investment decisions and tariff levels.
- Regulators have at times probably also contributed to more rational outcomes in cases of highly politicised tariff decisions
  - Compare Eskom tariff decisions to the recent SANRAL toll debacle
- At times regulators have provided a check on inappropriate behaviour by senior officials and ministers.

Problems with economic regulation of SOE performance in South Africa

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- Regulatory frameworks are developed on an *ad hoc* basis and are often inconsistent
- Regulatory decisions are sometimes unpredictable, arbitrary or of poor quality
- Tariff increases are often unavoidably high, but still insufficient
- Regulators are unable to review new market entry and new capital projects effectively
- Regulators are unable to protect consumers against poorly executed SOE projects and cost overruns
- Regulators are often not effective in preventing monopoly abuse

Issues with the impact of regulation on SOE performance (1)

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SOE performance area	SOE Performance problem	Possible examples	Regulatory role
Affordable and cost reflective tariffs	- Tariffs that are "too high" but paradoxically not cost reflective - Tariffs reflect market power	- Eskom; - Transnet Pipelines; - ACSA; - Telkom.	- Regulators do not have adequate oversight of cost drivers (see below); - Popular and political pressure constrain regulators setting cost reflective tariffs - Regulatory capacity
Price path	- Unpredictable price paths	- Eskom; - Transnet Pipelines; - ACSA.	- Incomplete regulatory and policy frameworks; - Inexperienced or under resourced regulators - Inappropriate regulatory methodologies (WUC not in RAB)

Issues with the impact of regulation on SOE performance (2)

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SOE performance area	SOE Performance problem	Possible examples	Regulatory role
Capital project selection	- Inefficient project selection (timing, sizing and complexity, technology (incl. fuel), location - Unfunded mandates and informal (or semi-formal) political pressure	- NMPP - KSIA? - Kusile?	- Either no powers to regulate market entry; or - Are effectively bypassed in decisions btwn Govt. and SOE.
Capital project execution	- Large cost overruns	- NMPP - KSIA - Medupi - Kusile?	- Inherent difficulty in monopoly sectors with locating sufficient investment risk on SOEs and their managers

Issues with the impact of regulation on SOE performance (3)

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SOE performance area	Performance problem	Possible examples	Regulatory role
Financing capacity and costs	- Loss of debt capacity; - Reduction in credit ratings; - Increasing cost of debt finance	Large risk for: - ACSA - Eskom - Transnet	See the issues listed above
Service standards and quality	- Interrupted service; - Delays in service provision; - Quality problems	- Municipal electricity distributors - Eskom	- Limited regulatory capacity and resources; - Limited regulatory leverage: require sufficient capital and maintenance investment.

The problem causes (1)

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- Governmental
  - Ministers and senior officials often undermine the separation of powers established for the effective functioning of policy formulation, SOE regulation and corporate governance
  - The finalisation of policy and regulatory frameworks is often subject to inordinate delays
  - Policy makers often misunderstand the role for, and strategies to achieve market based competition to deliver desired policy outcomes
  - Fundamental policy contradictions are often left unresolved
  - The mandates and objectives given to SOEs are often too broad leading to loss of focus, more political interference, and weakened regulatory incentives

The problem causes (2)

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- Regulatory
  - Regulatory accountability is limited
  - Regulatory independence and capacity is compromised by the nature of appointments
  - Regulators do not have proper control of the secretariat supporting them
  - Regulators are often under resourced
  - Regulators generally fail or are unable to implement modern performance and talent management practices
  - Regulatory methodologies are inconsistent and subject to frequent change
- Other
  - South Africa suffers from a dearth of teaching and research capacity in the field of regulatory and infrastructure economics

Recommendations - What Government should do:

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- Separate the roles of: Policy formulation, Regulation, Shareholding, Project promotion & Operations
- Establish a comprehensive national infrastructure decision framework to provide alignment and independent review of SOE related infrastructure investment decisions (see following slide)
- Improve regulatory accountability (see following slide)
- Improve regulatory independence (see following slide)
- Appoint specialists as regulators
- Standardise regulatory methodologies
- Establish a national legislative framework for economic regulation to implement that outlined above
- Support applied research and teaching in economic regulation

A comprehensive national infrastructure decision framework

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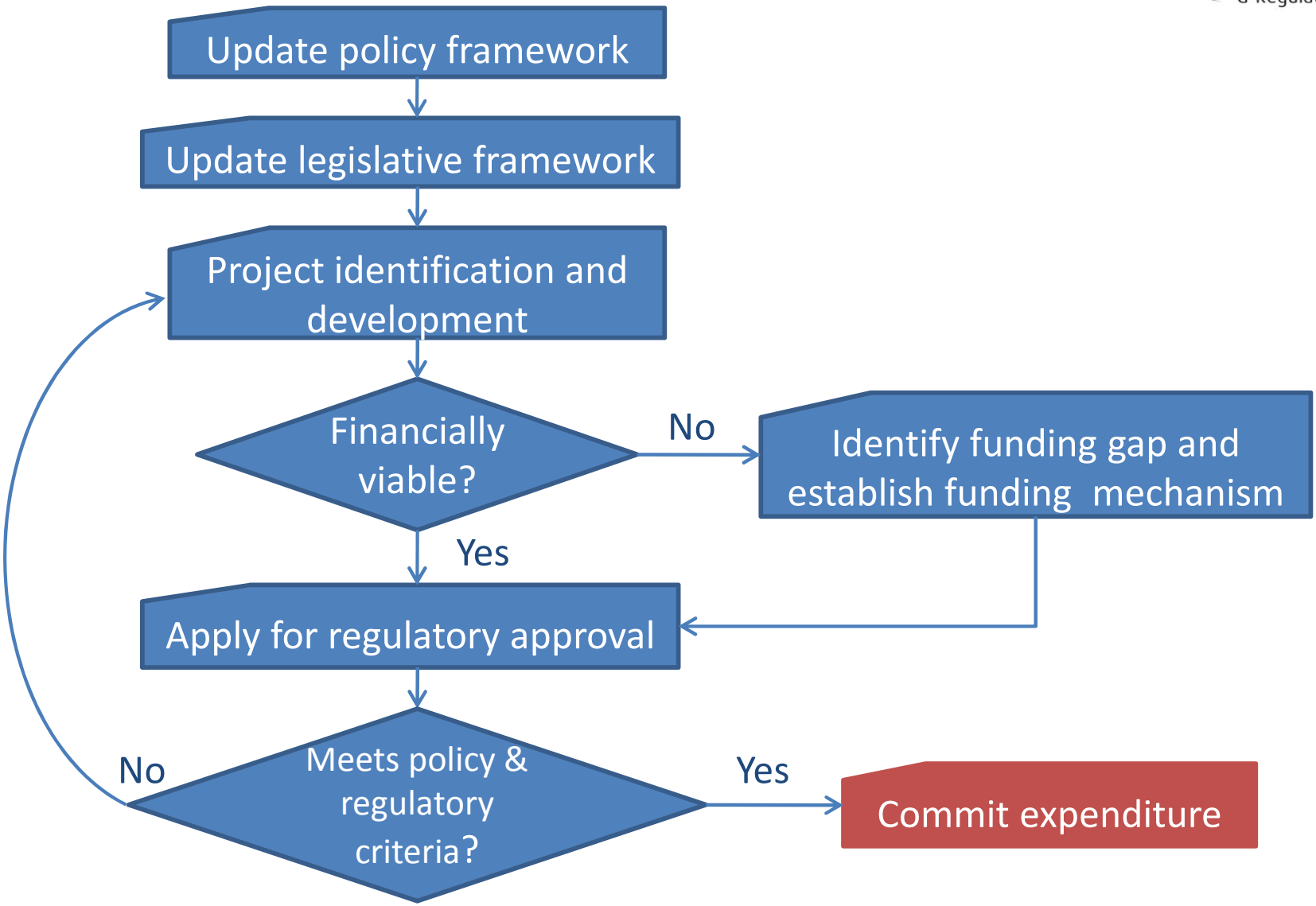

Improving regulatory accountability

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- Regulators should be required to:
  - Conduct meetings in public and give proper notice
  - Provide comprehensive written reasons for their decisions
- Government should commission expert regulatory reviews every 3 -5 years
- A multi-sectoral regulatory appeals tribunal should be established

Improving regulatory independence

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- The regulator appointments
  - Process should NOT be managed by policy / line departments
  - Process should be managed by a non-sectoral department and the appointment made by this minister.
- All regulators should be able to appoint their own personnel, including the CEO
- Regulators need adequate funding, from sources that are not controlled by the line department

Recommendations - What Regulators should do:

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- Implement the requirements of regulatory accountability
- Implement modern performance and talent management practices
- Work with regulators in other sectors and Government to standardise the main elements of tariff setting methodology
- Promote research into and the teaching of regulatory economics at universities

Recommendations - What SOEs should do:

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- Adopt risk averse practices with respect to capital project planning, selection, and procurement
- Practice regulatory and public accountability – including full disclosure of, and early regulatory application for approval of planned capital projects
- Adhere to the requirements of financial viability for new projects
- Advocate for a balanced scope of responsibilities, to ensure adequate focus to deliver on their core mandate

Conclusions

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- South Africa is pursuing infrastructure led growth
  - Once in a generation opportunity
  - Getting infrastructure wrong is all to easy
- Infrastructure development dominated by the public sector
- Appropriate design of governance and regulatory frameworks can contribute significantly to improving infrastructure outcomes.

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Thank You