4th Workshop of EASTERN PARTNERSHIP
ENERGY REGULATORY BODIES - *Chisinau 2015*

# HOW TO MANAGE TRANSITIONS IN TARIFF REGULATION:

## Case Study of Croatia as a new EU Member State


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- Some lessons learned

# Croatian Energy Regulatory Agency

- **Est'd in 2001/2 by Croatian Parliament**
  - element of the National Energy Sector Reform (EU horizon)
- **Reg. Council ⇨ Reg. Agency : major development stages**
  - evolving organisational form
  - sequence of regulatory priorities (licensing → tariffs → markets)
  - relevance roughly in parallel with EU energy packages
  - growing scope and responsibilities
- **Q4 2012 – New Act on Energy Activities ("HERA law")**
  - part of the EU accession process
  - **frame for independent energy regulation**
  - context of liberalisation/market opening
- **1 July 2013 – EU regulatory body**
  - expanding horizon (EC, CEER, ACER)
  - managing transition

# Managing (regulatory) transition

## 3 TARGETS:

„parallel and moving”

- **„Sins of the fathers”**
  - „communal” heritage, ownership, social concerns
- **EU environment: market opening transition**
  - adopting and adapting, constraints and concerns
- **Rapidly changing energy and regulatory scene**
  - evolving regulation(s) for a changing supply/demand paradigm

## 2 PILLARS:

- **Independence**
- **Capacity / Competence**

# Energy regulatory developments

**Three stages in life of a regulatory agency:**

- **Licensing stage (2001-03)**
  (starting on the road to an open energy market)
- **Tariffing stage (2004-07)**
- **EU adjustments and Market opening stage**

1. formal → real market opening
2. removing obstacles: conditions for effective market functioning
3. reviewing systems in place
4. **UPGRADING TARIFF METHODOLOGIES**
5. reviewing market model

# Electricity and gas regulation – two stories

**Croatian electricity and gas scenes:**

**different histories – different structures**

- **Electricity – national champion (HEP-Group)**
  - TSO (*HOPS*) – ITO certification on-going
  - DSO (also under PSO of universal and last-resort supply services)
  - network regulation: essentialy **cost plus (RoR) methodology**
- **Gas – diversified structure:**
  - TSO (*PLINACRO*) – OU certification on-going
  - **revenue cap tariff model (capacity-based)**
  - 36 DSOs – (former LDCs) – communal utility history
  - **revenue cap tariff model (commodity-based)**

# Example: Croatian gas sector

- **Empirical sequence of stages in the market opening of Croatian natural gas sector:**

| | |
|---|---|
| 1. formal (legal) market opening | 2007 / 2008 (full) |
| 2. creating conditions for effective market functioning | 2011/12 |
| (e.g. removing price caps in segments of gas supply) | 2012 |
| 3. enter new players | 2011/12 |
| 4. incumbent provides (some) resistance | 2012/13 |
| 5. monitoring and fine-tuning operational rules | 2013 |
| 6. market research/review | 2014 → |
| ⇨ measures to improve efficiency and/or remove barriers | |

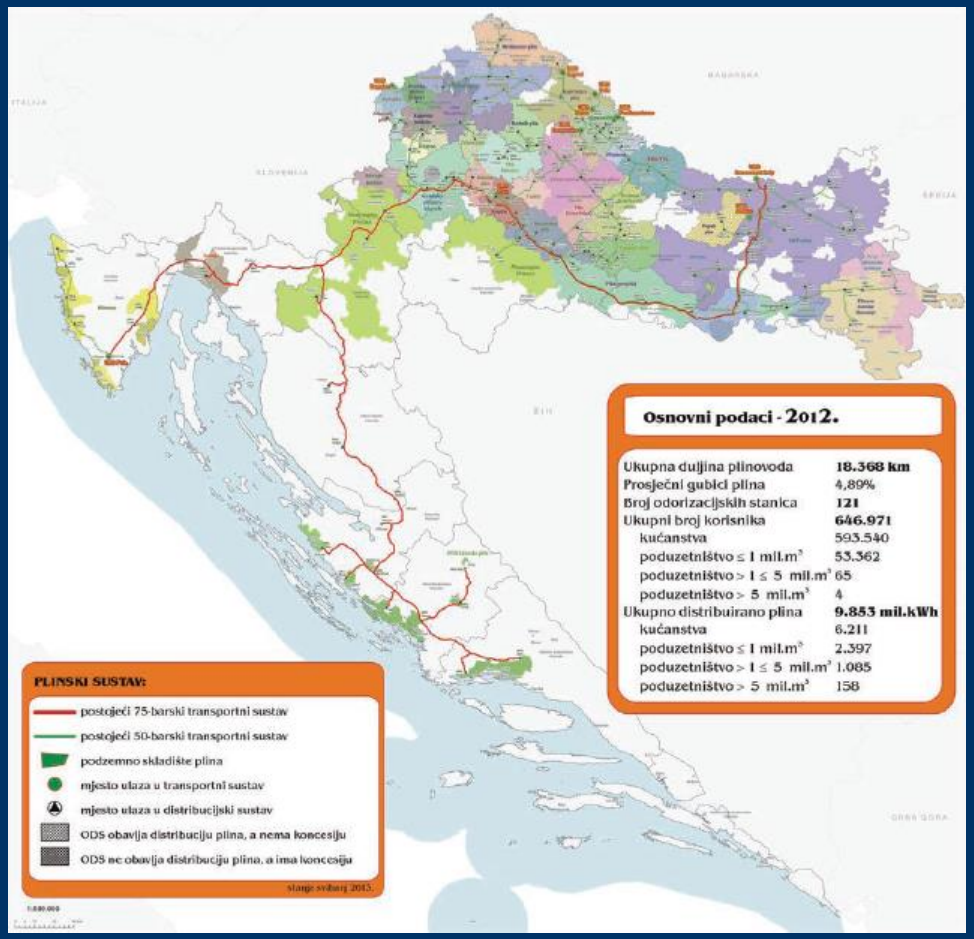
# Croatian gas DSO tariff overhaul

## "Fine-tuning" the Croatian gas distribution sector

Tariff adjustment round based on new methodology for gas distribution:

**(effective 1-Jan-2014)**

- **recession environment**
- **declining gas sales**
- **payment issues**



# Challenges for gas distribution tariffing

**Distribution remains the vital element of every gas system !**

**CHALLENGES:**

- Tariffing as traditional (and permanent) regulatory role
- Improve/upgrade methodological basis
- Provide incentives (certainty) for grid investments
- Declining gas sales – loss of revenue
- Changing gas consumption patterns
- New roles/expectations – interface with customers

# DSO Tariff Methodology Overhaul 2013

## REASONING

- **Consistent methodological basis of gas infrastructure regulation**
  - Upgrade to incentive-based tariffing
  - Follow-up on TSO methodology upgrade (initiated by introducing entry-exit model)
- **Review existing DSO tariff level/distribution**
- **Review the position of INVESTORS IN DISTRIBUTION GRIDS**
  - Difficulties related to existing cost-plus methodology – in particular to the **one-year regulatory period**
  - Particular position of GREENFIELD investors

# DSO Tariff Methodology (II)

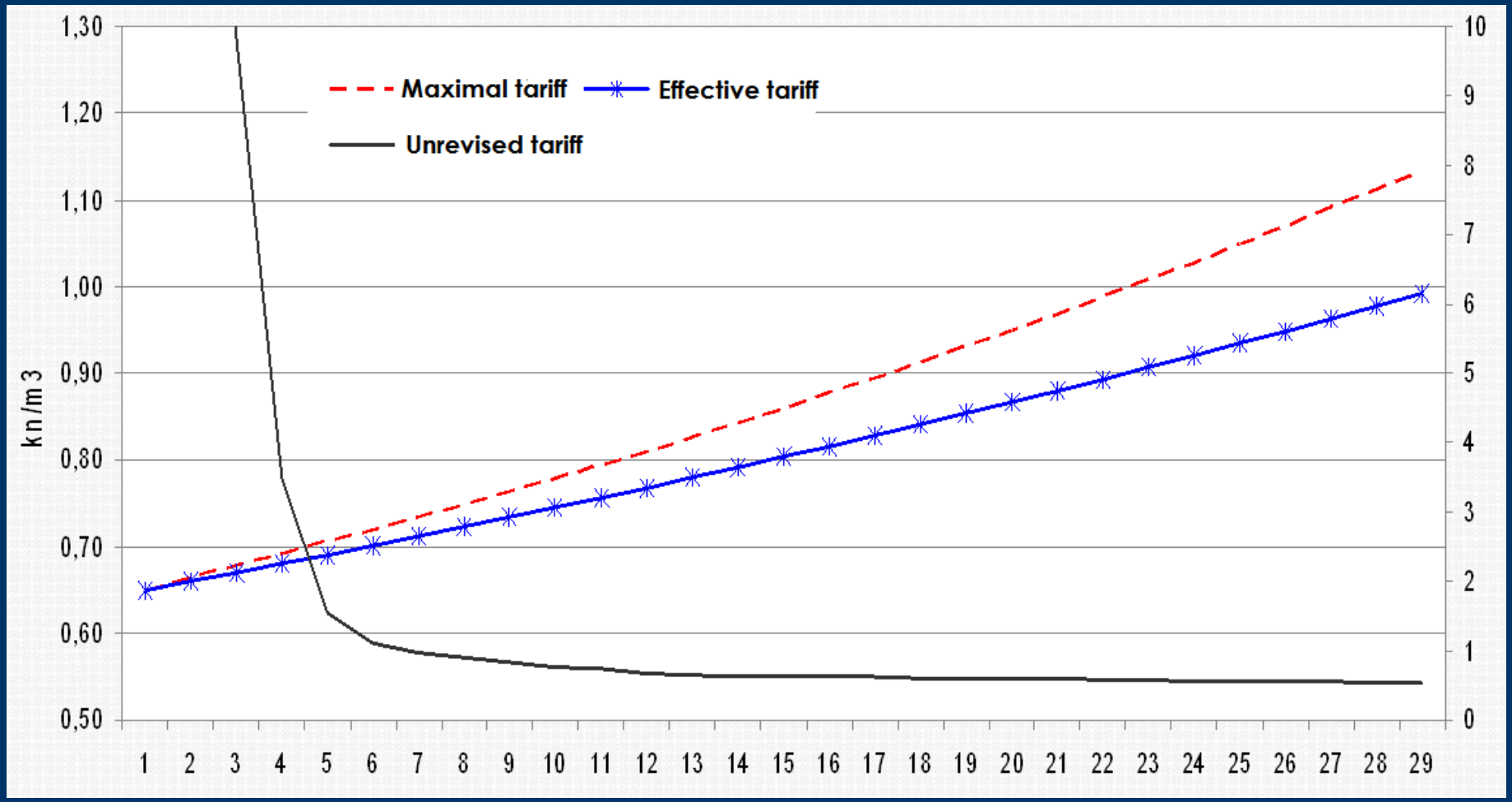
- **Incentive regulation principle → Maximum allowed revenue method (*Revenue cap*)**
- **Incentivizing through *Efficiency factor* (X) and a *Profit sharing mechanism***
- **Benchmarking the efficiency**
  - initially simplified benchmarking for base OPEX
  - full benchmarking for subsequent regulatory periods
- **Pre-determined parameters**
  - unjustifiable costs, max. depreciation rates, nominal pre-tax WAAC
- **Investment plan approval**
  - a process „within" the tariff approval procedure

# Regulatory account

- **Significant greenfield investments in gas distribution grids or major reconstructions:**
  - steep growth of the regulated asset base
  - initially low gas volumes (small number of customers)

  **→ result in uncompetitively high grid tariffs**
- **Unsustainable greenfield distribution projects**
  - unless (?) requesting exemption from regulation
- **Imperative to prolong the regulatory period**
  - Redesigning the basic tariff methodology
  - Providing a special option for qualified grid investments

# Regulatory account – tariff dynamics

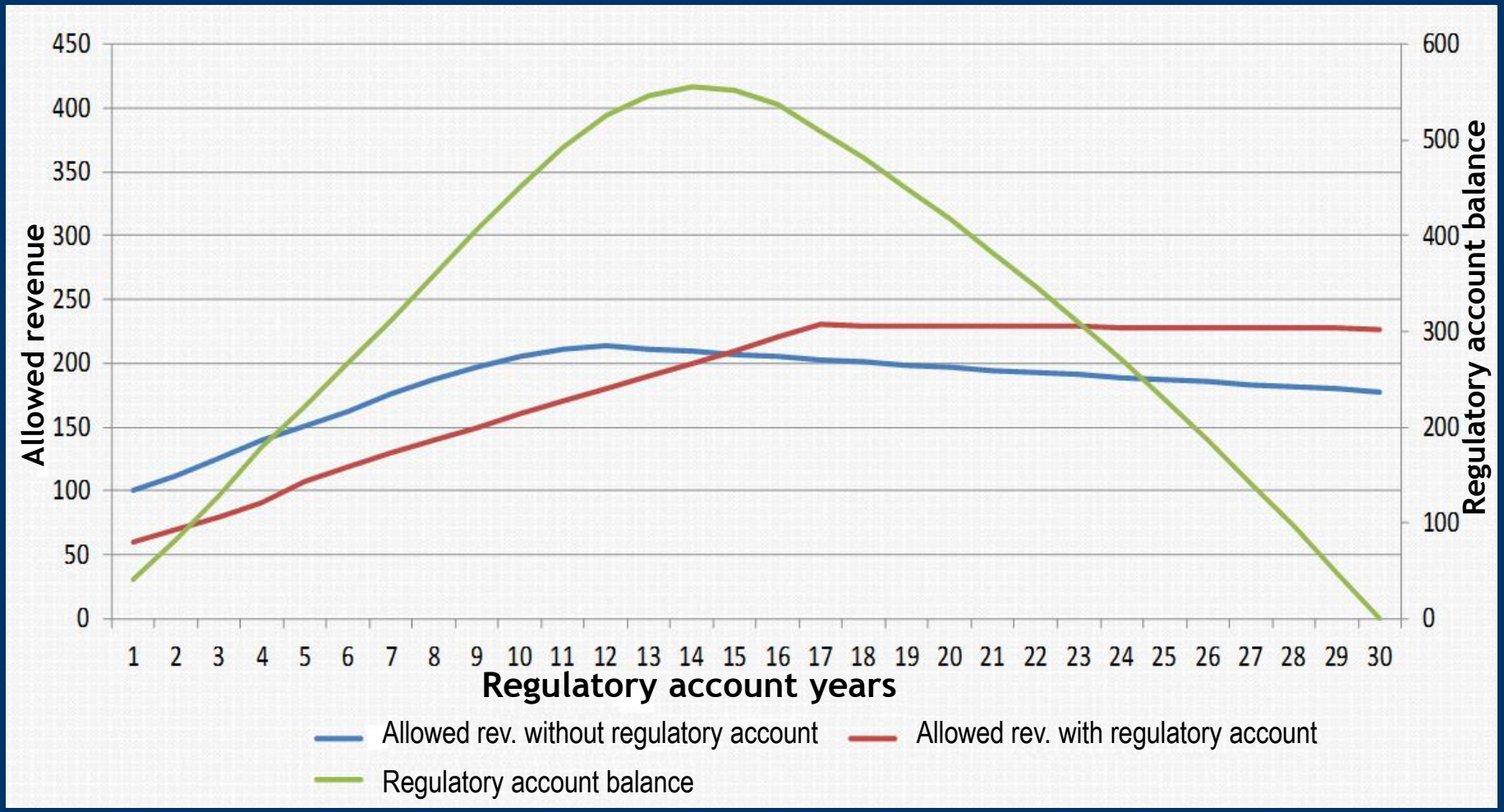


# Regulatory account (II)

- **REGULATORY ACCOUNT as an optional model**
  - steep growth of the regulated asset base
  - initially low gas volumes (small number of customers)

  **→ result in uncompetitively high grid tariffs**
- **RA enables the investor DSO to recoup the allowed revenues of first years in the later project years**
- **Longer regulatory periods with interim revisions**
- **NPVs of allowed revenues remain the same for options with or without RA – but are realized with different dynamics**

# Regulatory account – allowed revenue



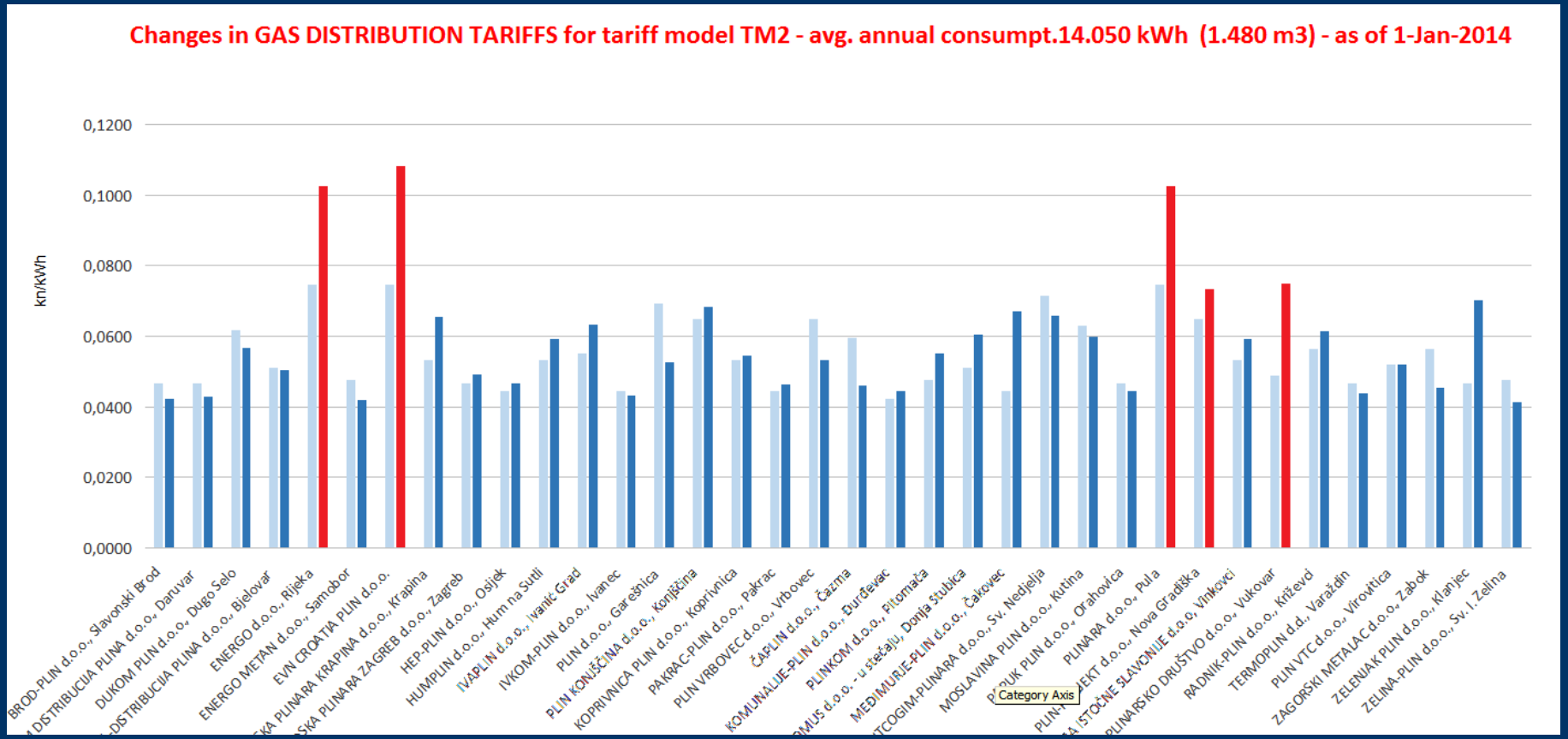
# OBJECTIVES of gas distribution tariff corrections as of 1-Jan-2014

- **Aligning tariff levels with the new gas distribution tariff methodology from Q4-2013**
- **Gas distribution level a neglected area when it comes to investment**
  - Almost 40% of Croatian DSOs in red numbers in 2012
  - Consolidation of gas distribution to maintain security of supply
- **Enable sustainable investments in gas distribution systems (grids) and system reconstruction**
  - Challenge to differentiate among the gas grid investment environments

# RESULT

- **Individual tariffs respond to actual situations in distribution areas** (23 increases of average tariffs, 14 decreases and 1 unchanged tariff)
- **Decrease of the fixed tariff component (→ monthly charge) for all household categories**
- **Increase of the overall average distribution tariff for 6,3%**
  - mainly due to tariff increases on new gas distribution areas (→ **regulatory account**)

# 1st year effect on DSO tariffs after the change of methodology



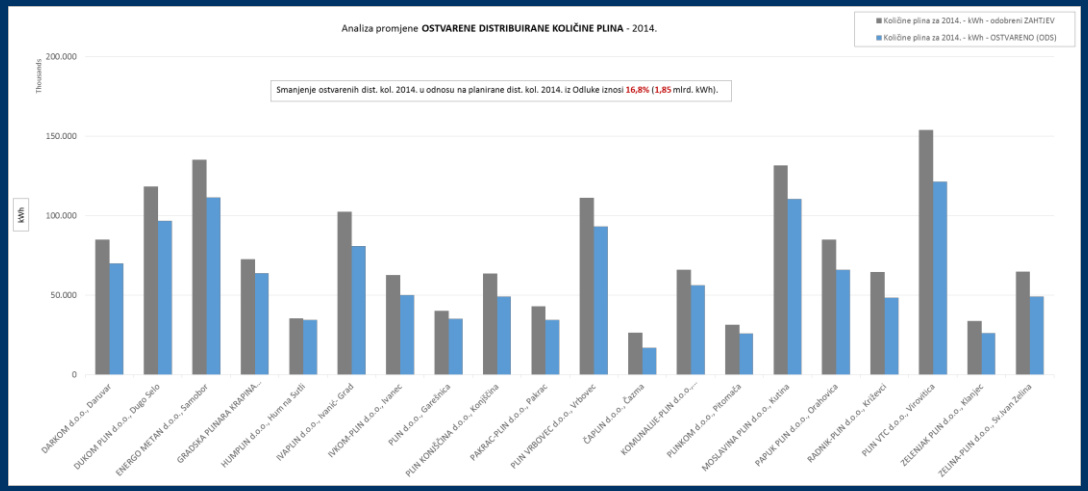
# Gas distribution tariff transition

## OUTCOME:

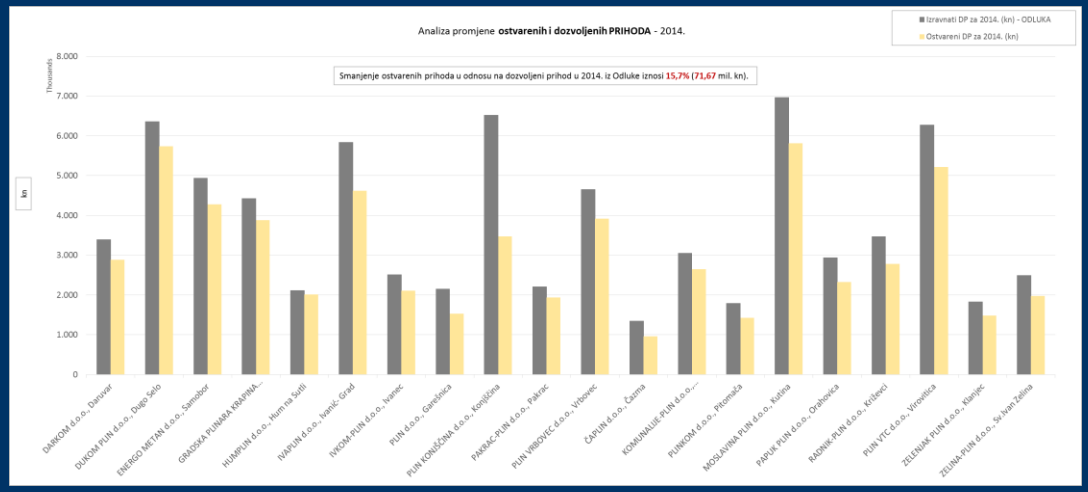
- Objective and methodologically consistent calculated tariffs for regulated price components
- Longer regulatory period adding to robustness of DSO business plans
- Introduced option of REGULATORY ACCOUNT (used by 5 DSOs) – as a tariff model supporting investments in new distribution grid
- Confirmed 3-yr investment and reconstruction plans (as a part of DSO rate cases) – for all 36 DSOs
- Increased number of tariff categories – in order to better reflect group-specific cost distribution

# YET ... after the first year

- Market circumstances can change




declining demand in 2014




falling revenues in 2014

# THEREFORE:

- Crucialy important to monitor the market for effects and effectiveness
- Shrinking market and/or decreasing demand may influence the assumptions
- Should be ready to make changes/revisions – remaing as TRANSPARENT as possible
- Engage customers and stakeholders

# OVERALL LESSONS LEARNED

- Tariffing remains a permanent core competence of the energy regulator
- Tariff methodology changes go hand-in-hand with market opening steps (→ interlinking objectives)
- Plan, design and announce well ahead
- Insist on open, transparent and well-in-advance communication
- Know your market (and monitor it!) ... as well as your market players

# Next steps for energy regulation in Croatia

- Test the EU-harmonized (regulation) frame for effectiveness
- Broaden the strategic planning horizon – get on board the on-going and the expected future changes
- Improve the market model(s) and related frame - based on experiences gained
- Maintain and keep upgrading the traditional features
- Improve communication and engage energy consumers
- Keep promoting the role of an independent regulator ... yet

***Quis custodiet ipsos custodes ?***

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**THANK YOU**

**FOR YOUR ATTENTION !**

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