

“THE GREATEST CHALLENGES AHEAD LIE IN THE MANY TECHNICAL DETAILS THAT WILL NEED TO BE RESOLVED TO BRING SUCH A SUBSTANTIAL REFORM TO A SUCCESSFUL CONCLUSION. TIME WILL TELL WHETHER THE GOVERNMENT WILL MAINTAIN ITS RESOLVE TO COMPLETE THE REFORM.”



While encouraged by progress to date in Russia’s energy sector, Claude Mandil, Executive Director, IEA, says that the key to the success of competitive markets will be strong, well resourced, well informed, well-trained and truly independent regulators

What should be the priorities to achieve further investment into Russia’s electricity sector and the creation of efficient electricity markets?

The IEA’s World Energy Investment Outlook 2003 estimated Russia’s total electricity sector investment requirements at around \$380b to 2030, representing an average of around 1.9 per cent of Russian GDP per year over the period. The investment requirement is likely to be relatively evenly split between generation and network assets. We see the majority of this investment required well after 2010, which provides a window of opportunity for implementing electricity reforms before supply-demand balances become tight across the market.

However, concerns have emerged about the ability of Russian electricity markets to attract the necessary capital, particularly while policy and regulatory uncertainty remains during the transitional period. Clearly, regulatory certainty – especially in relation to clarifying wholesale market rules, supported by ongoing consistent government commitment and leadership – will help create an environment that can attract private investment. This is a key point we discuss in our recently published book, *Russian Electricity Reform: Challenges and Opportunities*

(IEA, 2005) where we examine the capacity mechanism and investment guarantee mechanism which has been proposed to address this concern. We believe this is a sensible way forward during the transition period. However, international experience regarding their effectiveness is mixed, with some being criticised for providing poor investment signals and being prone to manipulation. A poorly designed capacity mechanism may crowd out efficient private investment and entrench a form of central planning that is not compatible with efficient market operation and development.

Turning to transmission investment, electricity reform can be expected to create new patterns of transmission network use, possibly leading to new congestion which may seriously undermine efficient operation and development of electricity markets over time. Appropriately timed, sized and located transmission investment will be required to address this challenge. Cost-reflective tariffs are a necessary pre-condition for successful introduction of market reforms. Considerable progress has been made to make tariffs more cost-reflective and to remove cross subsidies. However, tariff levels remain relatively low by international standards and compared to the returns that are likely to be

needed to attract new investment. The World Bank estimates that wholesale electricity tariffs need to be in the range of \$25-30/MWh to cover long run marginal costs, which implies increasing wholesale prices a further 40% above the current regulated levels.

A mechanism will be needed to allow customer choice while the remaining cross-subsidies are being unwound. We understand that the Government and UES are developing a proposal to address this issue based on the use of regulated bilateral contracts which would provide a mechanism for gradually reducing cross-subsidies while increasing the proportion of electricity purchased through the competitive market. However, there is a risk that progress toward tariff rebalancing could be stalled. To address this, the Government could set clear milestones for completing this process, to help provide impetus to see the process through to completion.

Another area of concern is the fact that the Russian Government will retain control over the nuclear and hydroelectric generators (around 25 % capacity). Ongoing government control, especially of strategic assets like the hydro facilities, could create pressure for government intervention, which may prove difficult to resist particularly as excess capacity is absorbed and higher wholesale

prices begin to emerge. It is very important for the Government to resist such pressure. Even the perception that the Government may intervene may promote uncertainty, add regulatory risk, and discourage efficient and timely investment.

After the market reforms in the electricity sector, do you anticipate that concentration of ownership will present a significant danger healthy competition?

At present it is proposed to create up to 26 wholesale generation companies and territorial generation companies that would be capable of competing with each other across the wholesale market. The analysis we undertook and present in the IEA's book on the Russian electricity reform process (IEA, 2005) suggests that the proposal could deliver considerable diversity of ownership and a highly competitive wholesale market structure. However, network congestion could be expected to split the market on occasion – especially when supply-demand balances tighten during periods of peak demand. Our analysis suggests that structural diversity may deteriorate considerably when this happens – and market power could become an issue.

Further unbundling to create more generating companies at a regional level could help address these concerns, however, that may not prove feasible due to pressure from existing minority owners, or in the context of creating enterprises capable of raising competitively-priced capital for new investment.

Competition could also be promoted through interregional trade, facilitated by a relatively strong transmission network linking major centres of generation and load (probably the best option forward at present).

International experience suggests a strong trend toward rationalisation and concentration of ownership in wholesale and retail markets following initial restructuring and opening of electricity markets and the Russian electricity sector is likely to experience similar trends. Effective competition supervision will be required to avoid undue concentration and market power.

Russia's reform proposals do not currently include independent regulatory institutions. Will this lead to abuse by vested interests and dominant players in the market?

I am glad you asked this question, as it allows

me to emphasise a key point we develop in our recently published book, "Russian Electricity Reform: Challenges and Opportunities" (IEA, 2005) and to elaborate further on your prior question. Independent regulatory institutions are not proposed under the current reforms. While there may be good reason for this approach while the market structure, rules and regulatory regime are being created and established, it could (at the very least) create concerns among market participants about conflict of interest resulting from the Government being the rule maker, regulator and a substantial market participant.

Such perceptions will need to be actively managed to build confidence in the objectivity and integrity of the regulatory arrangements. Consideration could be given to reviewing issues of regulatory independence and resourcing, with a view to establishing more independent regulators once the transition is complete. Key to the success of competitive markets in electricity and eventually other parts of Russia's energy sector will be strong, well resourced, well informed, well-trained and truly independent regulators that can rise to the challenge of establishing access to network and other monopoly products and services on fair and reasonable terms for all market players.

The IEA is concerned about the lack of resources and independence of the regulatory bodies in Russia – especially with respect to the Federal Anti-Monopoly Service and the Federal Tariff Service – given the critical role these bodies will need to play to ensure against market power abuses in the face of powerful vested interests and dominant players such as Gazprom.

Do you think that the public protests in winter 2004/5 over the planned monetarisation of social benefits, was a sign that sensitive reform of the electricity sector is likely to meet with public disapproval, and must be handled delicately?

The IEA has been following the evolution of this important electricity reform process in Russia since it moved into its active phase in Spring 2003. While we are heartened by the progress and the Government's newly reaffirmed commitment to the electricity reform process in late 2004, we fully recognise how important and difficult it will be to bring the public along with such major changes.

The IEA commends the Russian Government's plan to use this period to gradually raise regulated end-user tariffs to levels con-

sistent with the delivered price of electricity sourced through the competitive wholesale and retail market. Such rebalancing would allow customer choice to be extended progressively through the life of the vesting arrangements and ultimately to all users at the end of the vesting contract period if desired. This plan to rebalance tariffs appears measured and sensible, but it needs to be progressed and this – as in every country – has the potential to create some tension. The recent public backlash in Russia that you mention, against monetisation of certain public services demonstrates the importance of getting this balance right.

We consider the greatest challenges lie ahead in the many technical details that will need to be resolved to bring such a substantial reform to a successful conclusion. Time will tell whether the Government will maintain its resolve to complete the reform. Although the proposal is likely to extend the transitional period, it has the potential to provide greater stability, certainty and public acceptance to the implementation process, which would help to enhance the likelihood of the reform being fully and successfully implemented.

Do you believe that potential investors in the electricity markets will be put off by uncertainty surrounding government policy and the form of future regulation?

The implementation strategy is built around parallel development and implementation of industry restructuring, market design and regulatory reform in three stages to 2010. The strategy is very ambitious, and if achieved on schedule would represent a considerable achievement and compare favourably with best practice reform processes to date. But, the parallel process creates the potential for cascading delays. International investors may well be put off by this uncertainty and by the delays which have already occurred.

As you know, progress on market design and regulatory reform slowed in 2004, with the restructuring of government activities, delaying implementation of some key elements by at least 12 months. These delays, combined with the June 2004 decision to suspend Government decisions relating to structural reforms until 2005, created uncertainty for the corporate restructure and affected the timing for industry restructuring. Delays are common in such complex and sensitive reform processes. As in the many IEA member countries having taken steps in electric-