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CPFL ENERGIA

Financial Regulation of the Electricity Distributors: Necessity and Feasibility

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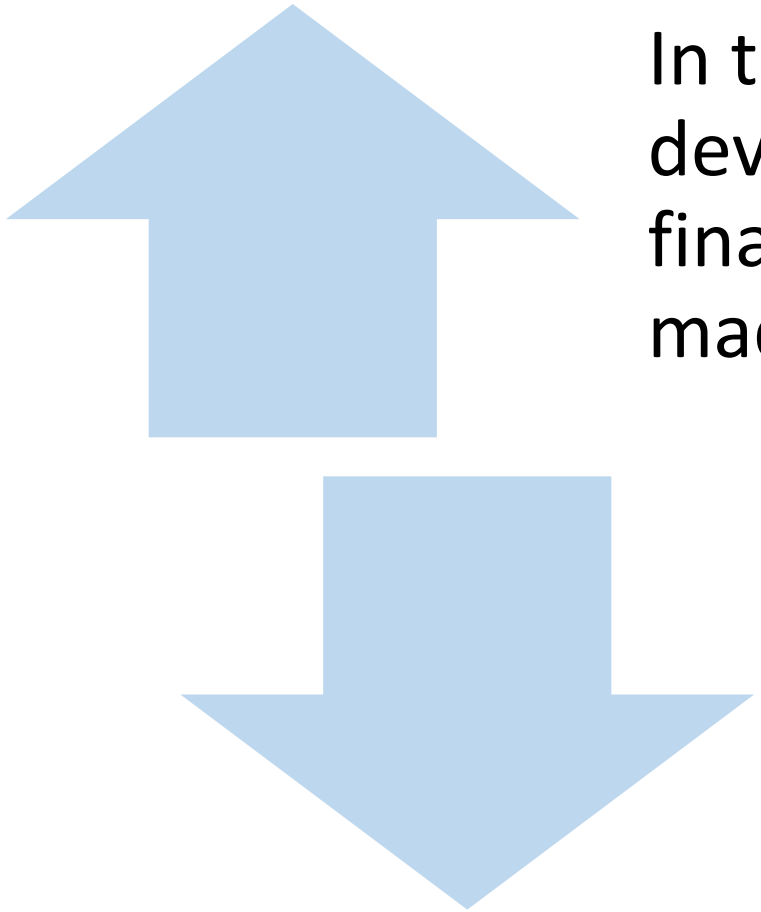
Introduction

- This paper was developed under the framework of the **Sustainability Indicators of the Brazilian Electricity Distributors** project, being developed with CPFL ENERGIA and supported by the ANEEL's R&D Program.

Introduction



In the last few years, efforts to develop methodologies in financial regulation have been made.

Similar to the criteria, parameters and rules applied to regulate the electric utilities finances in Canada, England and Brazil.

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Introduction

- That is a new issue in the electricity sector and it is Brazil in an improvement stage;
- It is important to search and analyze similar policies already implemented worldwide.

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Introduction

With the comparison we can observe the strengths and weaknesses of this recent subject.

We can also characterize the need and feasibility of the reform's implementation, that is the object of this article.

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Introduction

The paper is divided in two main parts:

- The **need** for financial supervision in Distribution utilities that is more evident where Performance based regulation is adopted.
- The **feasibility** of this policy, by showing the main points of the current status of financial regulation in **England**, **Canada** and **Brazil.**

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Methodology

- Literature review **and** research on governmental regulation on financial sustainability of electric Distribution utilities.

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Paper Framework

- The paper exposes the increasing financial risk stemming from the **regulatory reforms** that have occurred in several countries with the transition from a “safe” model in terms of profitability and costs (cost-of service regulation), where financial risk was largely borne by customers, to another in which the companies can incur in financial loss in a regulated environment.

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Types of Regulation

Cost of Service

- Compensates the **full cost** and include a rate of remuneration;
- Lack **efficiency** Stimulus**.**

Price-cap

- Establishes **limits** to the average price of the firm;
- **Verify** the economic and financial balance.

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Risks

- In the cost of service regulation companies have a low risk: operational and capital costs are both covered;
- In price-cap regulation, inefficient companies may not recover operational and capital costs, leading to financial losses;
- In price-cap regulation, some costs that are considered as not manageable may be passed through to consumers, but this do not contemplate **mismanagement and inefficiency**.

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Case Study

- In this paper, three main recent cases of financial regulation of electricity distributors were analyzed: that of the Ontario Energy Board, the British Office of Gas and Electric Markets (OFGEM), and the Brazilian Electricity Regulatory Agency (ANEEL).

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OFGEM

- Policy purpose
  - Primary objective is to protect the interests of the existing and future consumers;
  - Designed to manage the risks and to prevent the impacts of deteriorating financial health of the companies to consumers;
  - The regulation aims to avoid company deterioration so that the utility can maintain quality of service.

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OFGEM

Guidance procedures to respond to the deteriorating financial health of a utility

Details on financial health evaluation – Annual or more frequent **reports requirement** to evaluate the company resources

Warning Signs: Constraints on the operation, including provisions for cash lock-up; provision for reopening/revising price controls; apply to court to place an administration regime in case of insolvency.

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OEB (Ontario Energy Board)

- The performance based approach aims to encourage distributors to operate effectively, continually seeking ways to improve their productivity and performance and, better relate with their costumers, through benchmark performance evaluation on services/processes.
- Four indexes in OEB performance monitoring, but this paper focused only in the financial performance index.
- The OEB Performance Based Regulation sets **indicatives guidelines**.

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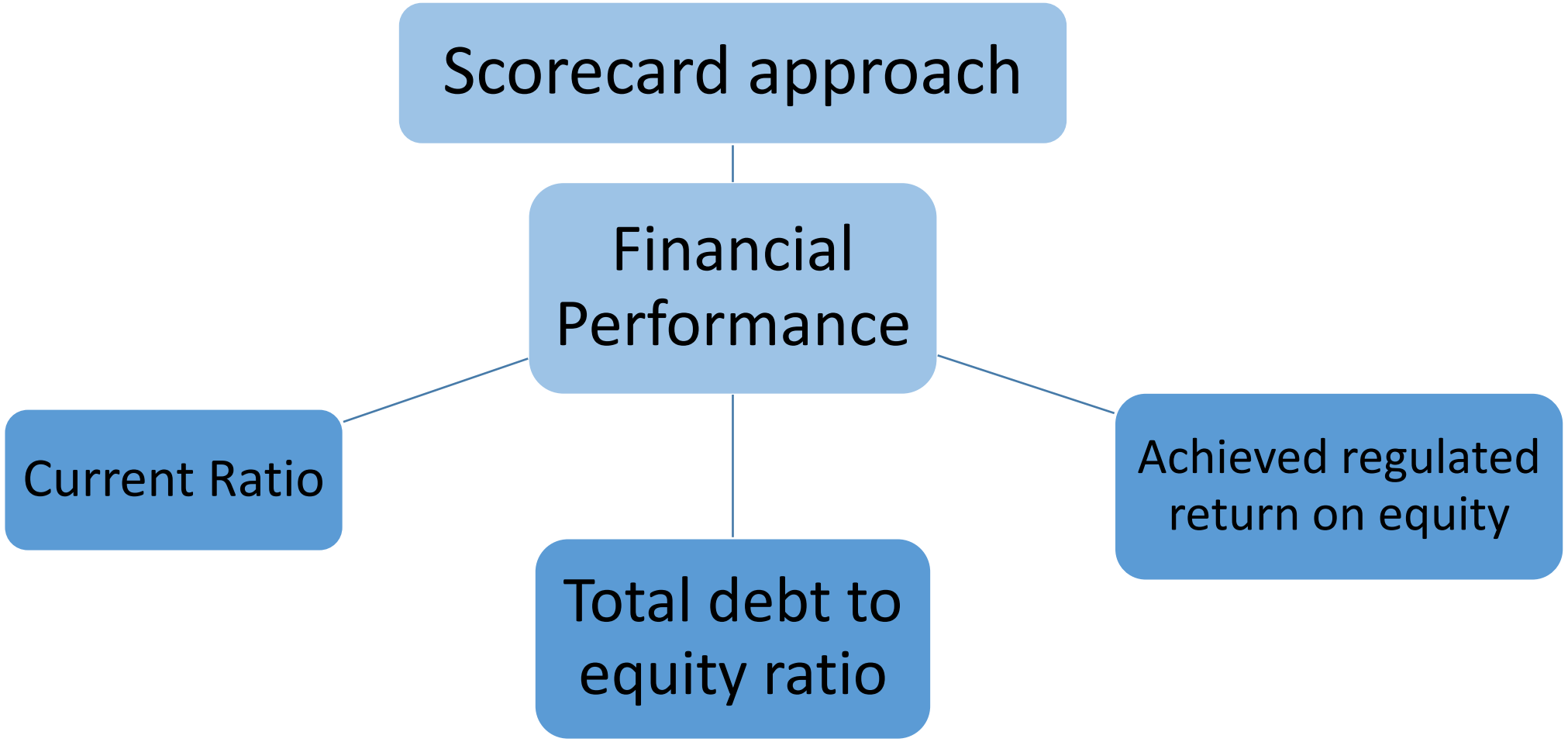
OEB



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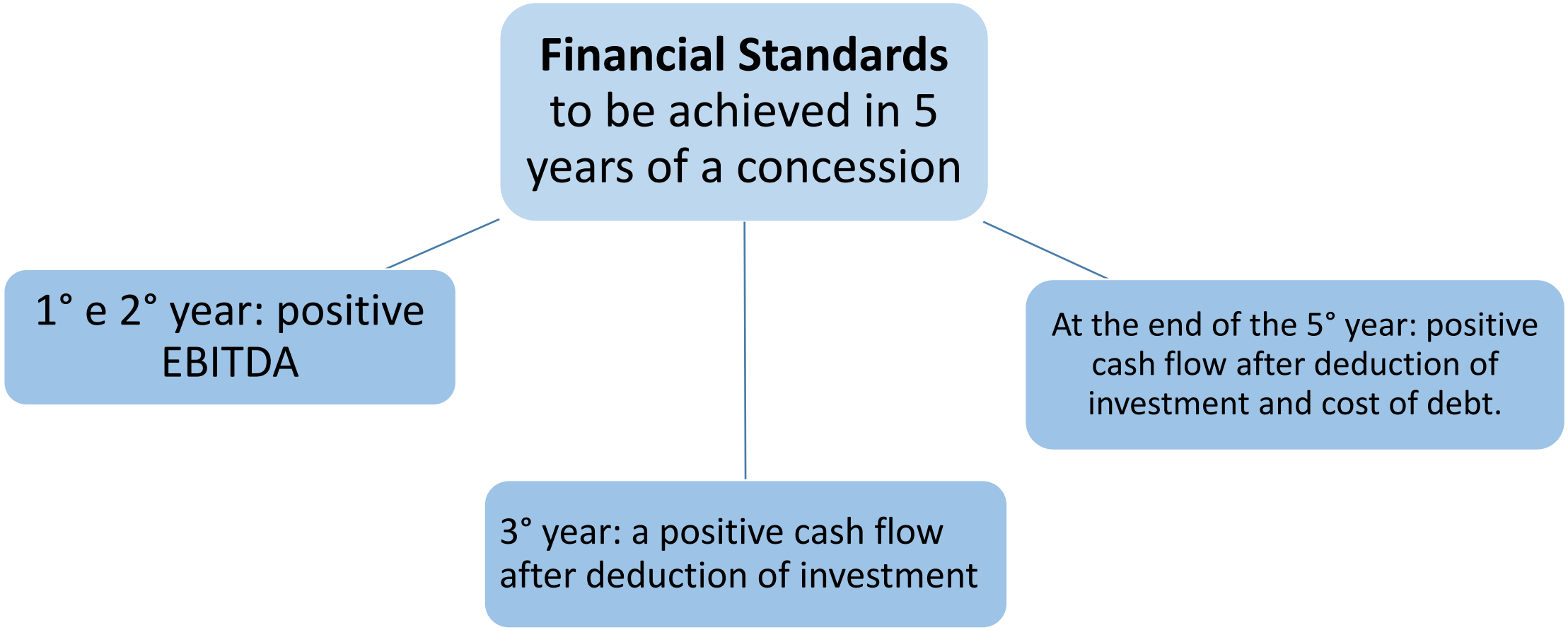
ANEEL

- The triggering event that led ANEEL to adopt a financial regulation of the electricity distribution utilities was the “Grupo Rede” collapse, a Distribution utility that operated in seven Brazilian States.
- ANEEL intends to use accounting and financial methodologies to develop a framework applicable to risk supervision in distribution companies, similar to the banking and healthy sectors.
- Framework important guideline
  - In the case of a distribution utility does not reach the minimum standards of sustainability:
    - the distribution of dividends will not be allowed until the regularization of the utility’s finances
    - In the case of persistent difficulties and non-achievement of the goals after five years, the concession can be canceled

ANEEL Framework Guideline



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Conclusions

- The need for financial risk management in the current tariff structure that raised the exposure of utilities to financial losses
- Financial regulation, already used successfully in other regulated sectors, could be applied to the electricity sector for financial supervision of the Distribution utilities, with the adoption of prudential practices to prevent future supply crises due to financial mismanagement.
- The general conclusion is that financial regulation is a highly relevant matter and has to be implemented in the electricity sector to avoid social losses.

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