Pricing: Regulatory Framework for Fair & Consistent Pricing

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Energy Regulatory Commission
The Energy Regulatory Commission (ERC) is established under the Energy Act 2006 (the Act), as a body corporate. ERC (being a State Corporation) is also subject to provisions of the State Corporations Act Cap 446 of the Laws of Kenya.
The mandate of the Commission is set out under Section 5 of the Act;
1. To regulate:
   a. Importation, exportation, generation, transmission, distribution, supply and use of electrical energy;
   b. Importation, exportation, transportation, refining, storage, and sale of petroleum products;
   c. Production, distribution, supply and use of renewable and other forms of energy;
2. Protect the interest of consumers, investors and other stakeholders;

3. Maintain a list of accredited energy auditors as may be prescribed;

4. Monitor, ensure implementation of, and the observance of principles of fair competition in the energy sector in coordination with other statutory authorities.
5. Provide such information and statistics to the Cabinet Secretary (CS) as he may from time to time require;

6. Collect and maintain energy data;

7. Prepare indicative national energy plans
Section 4(3) of the Energy Act provides that:-

“……………, the Commission shall be independent in the performance of its functions and duties and exercise of its powers and shall not be subject to the direction or control of any person or authority”.

The independence is not absolute and the Commission is accountable to the Government and Public.

The Commission has powers to develop Regulations under the Act which it recommends to the CS for approval after a consultative process with the public.
Energy Pricing Policy

- Section 6.6.5 (1) Where the market structure permits energy prices will be determined by the market mechanism. ... where it is necessary to regulate prices ... government will ensure efficiency pricing and a fair return on investments.

- Section 6.6.5(4) Electricity tariffs will reflect the cost of supply and also be efficient. In addition, consumer tariffs will also meet the social equity objective of affordability for the under privileged members of our population.

- The lifeline tariff ... will therefore be set but consumers will be expected to pay a tariff that at least covers the cost of power generation...
§43(1) All contracts for the sale of electrical energy, transmission or distribution services, between and among licensees and large retail consumers shall be submitted to the Commission for approval before execution.

• §43(3) In considering a contract under subsection (1), the Commission shall:
  
  (a) ensure that the rates or tariffs established in the contract are just and reasonable

• (4) … just and reasonable tariff shall mean a rate that enables a licensee to, *inter alia*
  
  – (a) maintain its financial integrity;
  
  – (b) attract capital;
  
  – (c) operate efficiently
  
  – (d) fully compensate investors for the risks assumed
The Commission shall, in setting the tariffs, apply the following principles:

(a) cost of efficient business operation;
(b) recovery of a fair return on the investment, provided that such investment has been approved by the commission;
(c) cost covered by subsidies or grants provided by the Government or donor agencies shall not be reflected in the costs of business operation;
(d) tariff stability;
(e) access charges for the use of a transmission or distribution system shall be based upon comparable charges for comparable use;
(f) no customer class shall pay more to a licensee than is justified by the costs it imposes upon such a licensee; and
(g) enhancement on efficiency in electricity consumption and encouragement of adequate supply to satisfy demand.
1. Rate of Return Regulation (RoR)

- Consists of setting an upper limit on the mark-up allowed on cost or the rate of return on the utility’s assets.

- with rate of return regulation the utility minimizes its risk because any shock is quickly passed through tariff adjustments

- This therefore gives the utility company little incentives to control their costs and the company tends to over invest.

**Advantages**

- Provides stable environment for investment
- Limit excessive returns
- Ensures financial viability of utilities
Disadvantages

- Incentive to over invest (inefficiently) – Averch Johnson Effect
- Provides a weak incentive to reduce costs, due to the linkage between allowed revenue and estimated costs.
- Provides weak incentives for technological innovation as cost increases and decreases are passed to consumers during rate reviews.
- Limits utility’s incentive to introduce new products into the market, exploring and fulfilling needs of the customers.

For Economic regulation of tariffs, The commission largely uses the Rate of Return (RoR) tool on regulated entities
2. INCENTIVE REGULATION

• Involves Setting upper limit to the average tariff or revenue

• The rationale is to incentivize the utility company to reduce costs and improve product efficiency above the regulatory targets.

• The greater the gap between the regulator cap and actual cost the larger the profit. This incentivizes the reduction of costs by utilities.

• In the short run the regulator sets the cap based on international benchmarks

• The regulator should monitor quality because the utility can cut investments to maximize profits.
3. REVENUE CAP REGULATION

• In this method, Utility’s gross revenue from regulated activity is limited to a fixed or capped amount.

• The cap is however subject to annual adjustment for productivity gains and inflationary effects.

• Initial revenue cap is set using the traditional RoR approach.

• Real revenue is adjusted annually using the adjustment factor until the next tariff review.

• The X factor represents the percentage reduction the utility is deemed to achieve.

• Revenue cap regulation permits a utility to earn a set level of income irrespective of actual level of demand for the service it offers.
4. Price cap regulation

- Controls the price charged by the utility company and not revenue or the rate of return.
- Any risks associated with the utility are assigned by the regulated entity.
- Price Caps could be set up as a series of separate price control or a form of weighted price cap.
- The weights could be based on volume or revenue at base year.
- Profit can increase if the utility’s sales exceed forecast values.
- Prices may be set independent of utility’s total revenue requirement.
Mini-grid refers to a small scale distribution network (LV) supplied by a variety of energy generation plants.

A mini-grid is comprised of:
- Electricity Generation part
- Electricity distribution part
- Electricity metering part
The Regulatory framework should set out clearly how the costs should be assessed.

Costs should be fair in that the consumer receives the most efficient service and at the most efficient price.

If possible, costs should be determined through a competitive process, effectively creating a market price discovery.
Role of Regulation in Mini grids

• Technical Regulation – Technical standards need to be set by the regulator, which should be harmonized for future integration.

• Economic Regulation- The tariffs are approved by the regulator but there is no uniformity, the tariff allows for recovery of prudently incurred costs in the provision of service.

• National Planning.
Thank You