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Structure of the Public Utilities Commission
Key ratios of the work of municipal regulators in year 2003

Introduction

Since year 1993 when the first regulatory authorities in telecommunication and energy sectors (Telecommunications Tariff Council and Energy Regulatory Board) were established, the Government of Latvia continues to implement regulatory reforms to support its privatisation and economic efficiency agenda. The Law “On Regulators of Public Services” was adopted in late 2000. The Law separated regulation of public services into State regulated sectors with the Public Utilities Commission as the responsible regulatory body and local government regulated sectors with municipal regulators as regulatory authorities.

The central regulatory body – the Public Utilities Commission (PUC) started its operation in September 2001 being responsible for regulation of electricity, natural gas, heat production in cogeneration process, telecommunications, postal services, passenger transportation by railway and railway infrastructure.

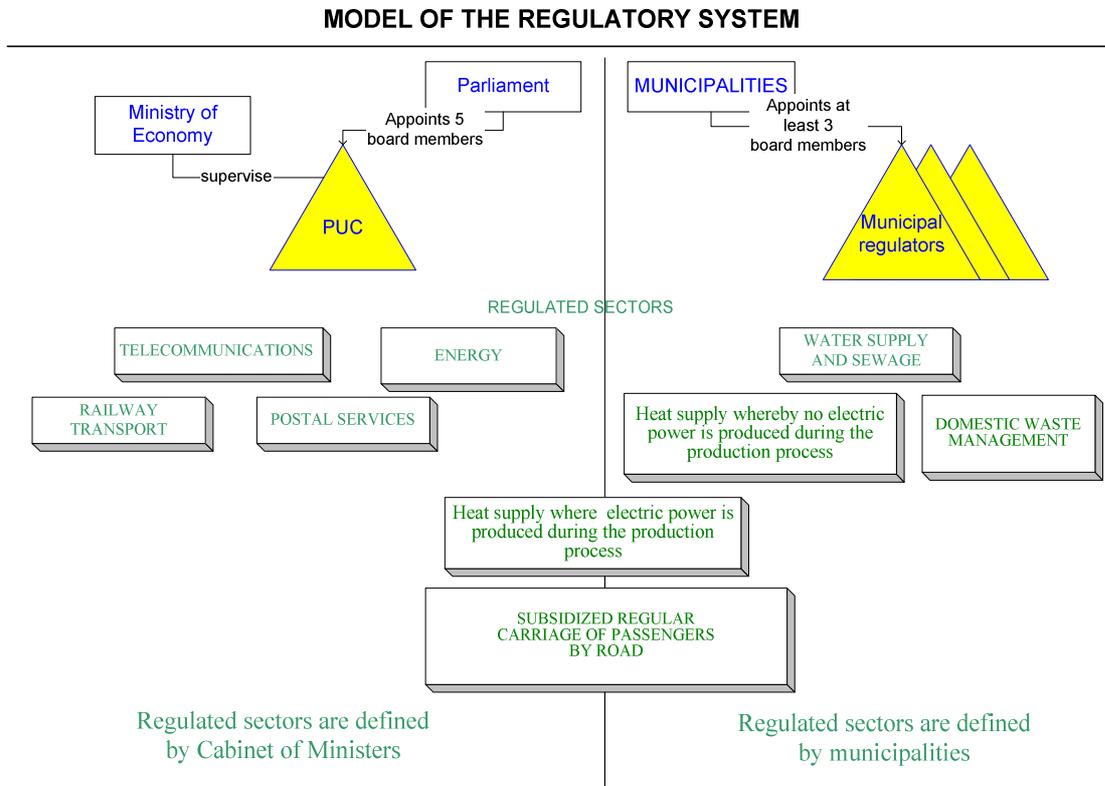
Local governments, according to the Law, were to establish of municipal regulators by June 2002, replacing the regulation of municipal public services by respective local governments. Municipal regulatory bodies are responsible for regulation of solid waste management, water supply and sewerage, heat supply and partly passenger transport.

The system of public service regulation implemented in Latvia in 2001, introduced two novelties (see the chart of the regulatory system in Figure1): One is the multi-sector regulator, unique in EU-context; the other is the Municipal Regulator, a world-wide novelty.

The concept of PUC as multi-sector regulator has proven its worth in practice. The experience, therefore, attracts wider international interest.

As expected by many Latvian experts in 2001, the implementation of the system of municipal regulators has proven to be complicated. When the regulatory law was adopted in 2000, a series of seminars were conducted in municipalities explaining the necessity to share the provision of regulatory services for number of municipalities (the study on Development of Local Government Regulatory Models proposed 5 regional regulators as the most cost effective model) both from the point of view of cost effectiveness and professional efficiency. It was expected that these two arguments would have served as a model that municipalities would adopt by forming joint regulators. However, it did not happen, although some municipalities set up a joint municipal regulator, others put up their own, and yet others have still not complied with the obligation to set up a regulator. It is important to note that the slow pace of administrative territorial and regional reforms illustrate the broader difficulties in dealing with joint decision making on municipal level. The size of Latvian municipalities is very small by EU-country standards, where a process of consolidation during the last three to four decades has led to a merger of municipalities.

Figure 1
Model of the regulatory system



The Government, represented by the Ministry of Economy, therefore, finds it opportune to undertake an assessment of the effectiveness of the current arrangements for regulation and suggest improvements, if necessary. The review is considered to be timely since the last broad-based investigation took place about 3 years ago. The Government feels that the time is right to consider implementing second-generation reforms. This assignment is meant to assist the Government with specific suggestion regarding implementing such changes.

The World Bank made available the finance for this study, which, under contract with the World Bank and supervision by the Ministry of Economy, was carried out by the consulting firm “Firma L4” with Wolfgang Mostert assisting as international advisor. “Firma L4” team included experts experienced with the issues related to regulation of which the following key experts should be named – Mr.Guntis Mačš, Mr.Aigars Krūms, Mr.Nikolajs Sprancmanis, Mr.Gunārs Lauks, Ms.Olita Lūks, Mr.Valdis Vītoliņš. Chapter on municipal regulator was mainly done by the group of experts of sub-contractor SIA “Baltkonsults” lead by Mr.Gatis Kristaps.

The objective of the study was to investigate and to provide short analyses of the current situation in regulation of public services both in municipal and state levels as well as to elaborate the Report evaluating the effectiveness of the regulatory system including suggestions and proposals for necessary improvements for its further development.

The study was aimed to evaluate two models of possible changes in municipal regulatory system where one would foresee the establishment of 4 or 5 independent regional regulators, but other - the establishment of 4-5 subsidiaries of PUC in the regions with the quality control as a responsibility of the PUC or sector Ministry.

Study was made to evaluate effectiveness of regulation, taking into account the following seven key principles: 1) clarity of its role; 2) independence in its decision-making ability; 3) accountability; 4) transparency of its decisions; 5) competency of its staff; 6) predictability of its decisions; 7) participation of key stakeholders in the process. Main attention was drawn to the municipal regulators as they had been identified to be the weakest part of the system.

The budget for the assignment being small, the study represents a stock-taking, as the resources did not permit the in-depth investigation of issues, which would have been the ideal approach to the subject. As a result, some observations are kept at a neutral level, pointing out different options, but not drawing conclusions that are stronger than merited based on the results and the data that were available. On other issues, the picture is clearer and firmer conclusions and recommendations are, therefore, drawn.

The methodological approach was based on the following key principles (i) expert reports were prepared on situation in the sectors being regulated, which outlined main problems; (ii) interviews with almost all (15 of 17) municipal regulators were concluded (iii) interviews with PUC and sector ministries were concluded (iv) legislative acts being in force were analysed. Initially it was proposed to include sector specific experts' reports as appendices to the Report as they give a more detailed explanation of the situation on which the conclusions are made, however the World Bank rejected this approach in the finalization stage of the Report due to too bulky and unsorted information. During the finalization of the Report the presentation of the conclusions was done as well as comments from sector ministries and PUC received and incorporated.

Executive Summary

1. PUC

PUC as Multi-Sector Regulator

PUC regulates the sectors of energy (except district heating where no CHP is used), telecommunications, postal services and railway transport. The application in Latvia of the US-concept of the multi-sector regulator, headed by a five-persons Commission working full time, has proven its worth in practice. The three-year experience of PUC shows, that the assumed advantages of establishing of the single multi-sector regulatory body for regulation of public services at the state level are real: (i) the structure gives economies of scale and of scope in using scarce legal and economic regulatory expertise; (ii) the household ability to pay problem of the transition period was addressed by introducing tariff increases across sectors in a balanced manner; (iii) uniform tariff setting principles and information collecting procedures are applied in the regulation of sectors, reducing the risk for investments by establishing a predictable regulatory environment; (iv) the risk of 'regulatory capture' is less for a multi-sector regulator than for a single sector regulator; (v) as some utilities undertake cross-sector activities (such as "Latvijas Dzelzceļš" and "Latvenergo") it is logical that the regulator is cross-sector.

The structure of one Chair with full direct management responsibility over PUC and four full-time working Commissioners with no direct formal responsibilities except at Board meetings has frustrated some of these four Commissioners. Some would prefer to be appointed as managers of departments, eliminating the position of Directors of Departments. The advantages of such a structure are (i) the increased specialized knowledge of each individual Commissioner through their direct hands-on-involvement in issues, and (ii) the reduction in the "top-heavy" management structure composed of a layer of both Commissioners and of Directors. The disadvantages are (i) the risk of "empire-building" by individual Commissioners and the associated reduction in the collegiate team spirit, and (ii) -depending on the degree of the politically nominated Commissioner's political agenda - a politicisation of the technical evaluation process, already before issues are brought to the Board for decision taking. The single-regulator solution to this issue – having a full-time Chair and part-time four Commissioners – is not practical for the multi-sector regulator: the number of different issues to keep abreast of and take decisions on is too large for a part-time job. However, if found advantageous by the Commission, PUC could by internal business procedure give each of the four commissioners special responsibility for one of the four sectors: energy, telecom, postal and transport. The responsibility would be limited to developing initiatives and concepts in collaboration with the responsible director of department – and ultimately the Chair, and keeping abreast with international regulatory, policy and technological developments in the sector, but not entail any direct authority over the management of staff or its work program.

The productivity of the work of PUC has been high during 2003. As foreseen by the Law on Regulation, the transparency of PUC's work is high. PUC has throughout its

existence had a high profile in terms of broad public consultations on critical issues, through public hearings, a consultative group of experts and close contacts with sector ministries, including active advice to the preparation of new laws and sector regulations. Decisions are published in leading newspapers and PUC's website apart from decisions includes copies of presentations and papers of PUC Commissioners and staff on regulatory issues and on results of PUC's work. PUC's Annual Report is a comprehensive and informative document, it could however, be further improved by including sections on key critical issues in sector regulation and PUC's opinion on it.

Regulation of Energy Sector

PUC has during 2003 adopted state-of-the-art methodologies for fixing tariffs in the power sector, natural gas sector and CHP-heat/power output. Compared to the Baltic neighbours, PUC has succeeded in keeping electricity and gas tariffs low. Whether this has had any negative impact on the level of investment in the two sectors it is not possible to ascertain.

PUC's work is, however, sincerely constrained by (i) the lack of a formulated coherent national cross-sector energy policy, (ii) by the unsolved restructuring of Latvernergo and (iii) the monopoly supply of gas from Russia, which partly penetrates into the ownership structure of Latvijas Gaze. For these reasons, even though PUC has accelerated the market opening in the power sector, with total opening to begin in 2007, no eligible customers have so far signed contracts with suppliers other than Latvernergo.

Regulation of Telecommunication Sector

Overall, the development in the telecom sector has moved in the right direction. In accordance with the requirements of the law "On Telecommunications" several telecommunications service markets were opened for competition from January 1, 2003. By December 31, 2003 PUC had issued 183 individual licenses and registered 26 general authorizations. 60 companies operate or plan to operate in the field of domestic/local voice telephony service, 64 companies – in the field of international voice telephony service, 88 companies provide leased line services, 182 companies provide Internet and data transfer services, 10 companies – payphone services, 8 companies – radio communication services and 35 companies – television and sound broadcasting services. Two UMTS licenses have been granted.¹

PUC applies a policy of asymmetrical regulation to assist newcomers in gaining market shares. Since market liberalization the market share of incumbent operator of fixed telecommunication services – LLC "Lattelekom" (51% of shares belongs to the state) – was reduced 4-5%. At the end of 2003, 19 companies provided fixed voice telephony services. Prices of telecom services fell in 2003.

The Communications department in Ministry of Transport had difficulties in coping with the high volume of new primary and secondary legislation that was and is required in the sector, due to its complexity and due to adjustments to the "acquis communautaire".

¹ PUC Annual report, 2003

The new Telecommunications law ("Electronic Communications Law") has been in force since May 1, 2004, but three of seven secondary legislation acts are not prepared and issued.

Like all countries, PUC and the Ministry are struggling to find the right paradigms for effective competition policy in telecommunications; with issues such as interconnection tariffs, access to local loop, national roaming, and the scope and scale of unbundling being subject to hot political debates.

Regulation of Postal Sector

In compliance with EU-directives, the postal sector is by law divided into three categories: (i) "Reserved postal services", comprising letters up to 100 gr. and from 2006 up to 50 gr. Provision is allowed to "Latvijas Pasts" on receipt of license. In this field there is no price competition. But these services may be provided by any postal service provider at tariffs not lower than triple tariff of lowest weight class letter correspondence item. (ii) "Universal postal service" for which there is a free market competition, and services can be provided by any postal service provider on receipt a license, which determines certain quality requirements. (iii) "Additional postal services", for which there is free market competition and services can be provided by any postal service provider after upon registration receiving a general authorization.

The state owned joint stock company "Latvijas Pasts" has the exclusive right to issue postal stamps and other postal service payments notes in the Republic of Latvia, as well as retire these notes. "Latvijas Pasts" has the right to provide reserved postal services as well it has an obligation to ensure the provision of the universal postal services in a whole territory of the state at uniform tariffs. Other postal operators are allowed to provide reserved postal services at a tariff not lower the minimal tariff set by EU Directives and Postal Law (in 2004 the minimal tariff is three times bigger, and from 1st of January 2006 two and half times bigger then the tariff set for lowest weight class postal sending). Competition is in additional services and postal parcel service fields, where in addition to besides "Latvijas Pasts" there are 29 private enterprises operating in these fields according to licenses issued or general authorizations registered.

The overall sector policy framework is about to be adopted, as in July, 2004, the Ministry of Transport submitted its draft Policy paper on development of Postal sector to the major operators in postal sector and to PUC for consultation.

Overall, PUC is performing its functions in postal sector. Yet, it is recommended that PUC consider the following issues:

1. Whether PUC should continue its policy of setting the tariffs for universal postal services, which is in a free competitive market, or whether tariff approval can be limited to the tariffs of reserved postal services.
2. Whether PUC has sufficient specialist staff assigned to the regulation of postal services.

3. The regulations on Types of Regulated Public Utility Services approved by the Cabinet of Ministers are in contradiction with Postal Law; these Regulations should be harmonized.

Regulation of Transport Sector

Complying with EU regulations, the railway industry structure has been divided into three types of services: passenger carriers, freight carriers and use of public railway infrastructure. The legislative acts of the railway sector provide free access to the railway infrastructure. 11 licenses have been issued for railway carriers: 5 for passenger carrier, 6 for freight carrier. The public railway infrastructure is a natural monopoly, owned and operated by State Joint Stock Company “Latvijas Dzelzceļš”.

There is no competition between railway carriers in passenger transportation; competition in this sector is mainly between railway and bus carriers. To some extent competition exists in freight transportation by railway.

Regulation of railway sector is split between three regulators: PUC, State Railway Administration and Technical inspection of State Railway. To obtain information about the conformity of carriers to the conditions of issued licenses, PUC must not only control carriers but also cooperate with State Railway Administration and Technical Inspection of State Railway and institutions responsible for environmental protection.

Economic regulation of passenger transport and railway infrastructure is done by PUC, while State Railway Administration (SRA) regulates freight transport. Public railway infrastructure usage fee is set by the public railway infrastructure manager “Latvijas Dzelzceļš” on the basis of the fee calculation methodology approved by PUC. Carriers are administratively and economically independent when determining railway transportation service and transportation fees. PUC has a right to give its opinion on tariff proposals and draw attention of the companies to possible risks of the proposal.

Separating the economic regulation of freight carriage from the regulation of carriage of passengers; is irrational from the efficiency of financial and human resources viewpoints. In disputes with the management of railway infrastructure regarding the access to the infrastructure the rights of the carriers are being represented by two different regulators, PUC and State Railway Administration. It is recommended to transfer the economic regulation fully to PUC and to transfer some staff from SRA to PUC to cope with the increased workload.

2. Municipal Regulator

The Law on Regulation entrusts the municipalities with regulation of waste management, water supply and sewage, heat supply where no electric power is being generated in production process in their administrative territory, and regulation of regular transportation of passengers by motor vehicles (except transportation in international routes) assigned to governmental and municipal institutions, according to their competence defined in the Law on Motor Vehicle Transportation.

By law, the municipal Council identifies the local activities requiring regulation, and contracts an outside regulator to carry out the regulation. After a tender for the services, the municipality by Council decision appoints the chairman and at least two members of Regulator, who may not be discharged during the four-year term. The regulator can be set up by an individual municipality or jointly by a group of municipalities. The Regulator is by law independent regarding the execution of his functions, and financed by a 4% fee on annual turnover of regulated companies.

Whereas the Ministry of Economics supervises PUC, municipal Regulators report to municipalities. The Union of Latvian Municipalities, a non-governmental organisation, acts to a certain degree as an institution coordinating municipal Regulators, and also as representative of municipal Regulators towards the government.

By mid-2004, 17 municipal Regulators have been established in Latvia, performing the regulation of public utilities in 202 municipalities, while such regulation of public services is not taking place at all, or is taking place partially, in the other 336 municipalities, although by law they should have contracted a municipal regulator by mid-2002.

The municipal regulator consists of Chairman and two members (Council of Regulator), and one accountant (all together referred to as administration). Municipal Regulators employ qualified professionals with higher education, experts in engineering sciences and economics, with broad practical work experience. In cases of necessity, outside experts are involved. For the Regulators of big cities (Riga, Jurmala), and the larger joint municipal Regulators (Liepaja, Daugavpils, Ventspils, Jelgava, Vidzeme), the funding and technical base may be sufficient. For smaller regulators, funding and expertise is insufficient.

The failure of the “bottom-up” concept for the municipal regulator calls for a reform of municipal regulation to be introduced by new legislation. It is clear that a concentration of the number of municipal regulators to three or five is required. But with regard to the organisational responsibility for municipal regulation, two issues call for thorough policy discussions:

1. First, there is the choice between the two competing options of (i) transferring municipal regulation to PUC, which would set up 3-5 decentralized offices to carry out its function in the area and (ii) that the Ministry of Regional Development and Local Government appoints 3-5 municipal regulators. In the latter case, the regulators could either each have a specific number of municipalities assigned to it, or make it compulsory for municipalities to contract one of the appointed regulators, but leave the choice of whom to each municipality.
2. Whether all regulatory functions associated with a regulated service in a municipality should be transferred to the external regulator, or the regulatory functions should be divided between the municipality’s technical administration and the external regulator according to the comparative advantage of each. The regulation of services that are clearly local in character, such as municipal waste collection and district heating can be divided between the municipality (licensing

and monitoring of service quality) and the municipal regulator (tariff control). The regulation of services with strong regional implications, such as water supply, should be transferred in to the municipal regulator.

1 Mega-Trends in Regulation

1.1 EU Entry: Acquis Communautaire in Industry Restructuring and Regulation

By finalizing the *acquis communautaire* before EU-entry in May 2004, Latvia has adopted a regulatory framework that complies with best practice principles at a formal level in the areas covered by the EU directives on electricity & gas, electronic communication & postal services and railways. The EU directives are very detailed on Governance principles such as independence, transparency, appeals, etc. The overall policy objectives in the regulated sectors and the basic principles for reform are also determined to a large extent by the EU. The scope and depth of EU regulations, directives, and recommendations² for the regulated sectors give the Government and PUC a strong reference framework for regulatory governance and for the exercise of regulatory decisions. The impact of the formal legal and semi-legal instruments on mainstreaming regulatory work in the EU is reinforced by the participation of regulatory bodies such as PUC in EU regulatory associations, groups and committees. The strategic goals for regulation quoted in Latvian laws and policy papers are, therefore, EU/international mainstream: (i) providing users with high quality, continuous and safe public services at economically reasonable prices (tariffs); (ii) stimulating efficiency and sustainable development of public service providers ensuring profitability levels consistent with the prevailing economic conditions; (iii) promoting economically justified competition in the regulated sectors.

As guardian of the Treaties, the Commission is responsible for oversight of the national regulatory decisions and initiates proceedings against member states whenever EU rules are not applied or misapplied: when a member state fails to transpose EU rules properly, or the regulator fails to enforce EU rules properly.³

The directives were driven by the internal market harmonization objective of the EU: to extend to public utilities the principles of the single market – “the free movement of goods, persons, services and capital.” As such they have done the job and are likely to remain basically unchanged for many years. What causes some friction and creates future rule-changing dynamism are raising energy security⁴ and environmental policy considerations. The EU, for example, has accepted the national mandated market regimes for renewable energy - although they are against the principals of the internal

² EU Regulations have direct application in member countries, EU Directives are implemented via obligatory national legislation, EU Recommendations are implemented by member states as appropriate on an individual, voluntary basis.

³ In either case the EU Commission can initiate proceedings only when there is a legal infraction. The EU Commission cannot take legal action against decisions because it believes that an alternative is economically more efficient.

⁴ EU Green Paper: Towards a European Strategy for the Security of Energy Supply”.COM 2000 769 raises the concern that “If no measures are taken, in the next 20 to 30 years 70 % of the Union’s energy requirements, as opposed to the current no coincidence, as the EU focuses on cross-border trade; and these are local / non-exported services. National energy policy during pre-liberalization towards the electricity supply industry typically consisted in ensuring that investment would preserve reliability (via the reserve margin) while meeting various goals on fuel use (to reduce oil import dependence or to defend local coal-mining interests).

market⁵ – because they contribute to the renewable energy policy goals of the EU. Yet, the Commission sees these as transitory arrangement, to be replaced by EU-wide arrangements. This reflects the Commission’s view that also energy policy can be managed by the Commission at the European level, largely by using market instruments. At that level, however, the Commission is likely to face frustrations, as witnessed in renewable energy policy⁶ and in the implementation of the CO₂-quota:

- The preference of the Commission, to replace the national mandated market schemes for renewable energy by an EU-wide green certificate scheme, is not likely to be realized for many years to come. The reason is (i) the differences in the political willingness-to-pay between member states and (ii) that the political “willingness-to-pay” for the development of green electricity in other countries is lower than for national renewable energy. Trying to enforce an EU-wide green certificate scheme would therefore slow down progress, rather than accelerate it: the strategy to maximize the contribution of renewable energy is to exploit the political willingness to pay within each member state to the fullest, and to put group pressure on those countries, where little progress takes place.
- The design of the EU’s CO₂-quota directive is fundamentally flawed. It is mirrored on the SO₂- and NO_x-quota schemes in the USA; benchmarking based schemes in which “under-performers” (those not investing in best-practice SO₂ and NO_x-technologies) pay the “good performers” (those who invest in best environmental technologies and processes) for over-achieving by buying quotas from them. The EU’s CO₂ directive asks the national authorities to make National Allocation Plans (NAP) allocating CO₂-quotas to individual industries with reference to “the national Kyoto CO₂-quota obligation” and the “CO₂-saving potential of the individual industries”. This is a “political mission impossible”. The countries with tight Kyoto-quotas are countries with high-energy efficiencies in industries (little saving potential); countries with easy Kyoto-quotas are countries with low energy efficiency in industry. In the former countries, industries argue that the benchmarking scheme be used, meaning that they get quotas corresponding to their full emissions. Otherwise, they as “good performers” would have to pay for energy efficiency investments by “under-performers”, who often will be direct competitors in the EU market for goods. In the latter countries, industries argue that there is no need for tight industry quotas, as the country faces no problems in staying within its Kyoto-quota target. The result is lax NAPs all over the EU, except in the UK, where the Government committed the “error” of automatically transferring the principles of its national CO₂-quota allocation scheme to its NAP under the EU’s CO₂-quota scheme.

Thus, despite the details of the EU-rules, countries are left considerable leeway in defining (i) the governance structure: the regulatory framework that is best suited to the specifics of their markets, as well as (ii) the content of regulation. Latvia has responded to the adaptation challenge by setting up, as the first EU country, a multi-sector

⁵ Providing subsidies to a *specific form of production* within a competitive market is against the free market.

⁶ The Commission announced in June 2004 that the goal of a 12% renewable energy share in EU electricity production no longer was realistic.

regulator; the Public Utilities Commission (PUC), regulating the sectors defined in the above directives. As expected by regulatory experts, Latvia chose a winning formula (see chapter 3), which will have an imitation effect on other EU-countries.

The municipal regulator is another EU and international novelty: a bottom-up identified and contracted regulator. As the municipal regulator regulates activities – district heating, water and sewerage, garbage collection and treatment – that are not covered by sector-specific EU market directives, there is no reference EU-governance framework to comply with, meaning that Latvian lawmakers have total leeway for designing governance structure and content of regulation of the municipal services.⁷ For them the most relevant EU regulations are the transport directive and recent European Court of Justice rulings, which force municipalities to open their local bus, tram, and subway systems to private competition over the next few years.

⁷ This is no coincidence, as the EU focuses on cross-border trade; and these are local / non-exported services. The municipal services are, however, on the input side, covered by the public procurement directives.

1.2 Recent Industry and Regulatory Trends

1.2.1 Selected governance issue

Formal structures or respect for administrative rules and principles – what is more important?

International experience shows that respect for the basic principles of regulation by the involved state bodies is more important than “best practice” formal structures for regulation. Despite general agreement on the principles of regulation, the formal structures for regulation still show surprising variation. Norway, Sweden and the Netherlands, which were among the early liberalizers, have ministerial agencies for regulation rather than fully autonomous bodies. In practice, these ministerial agencies operate with a large degree of autonomy, similarly to an independent agency. The system works because these countries have a long tradition of politically neutral civil service: governments come and go, the civil service is unaffected, and rules of conduct in carrying out duties and exercising power are respected. India, Malaysia and the Philippines have formally independent regulatory bodies, which are under heavy political influence in practice. Thus, conclusions from a comparative analysis of the legal framework for regulation in countries can be very misleading; as respect for compliance with formal rules and principles varies.

Active Restructuring – what Instruments does the Regulator have?

In countries, where the independent sector regulator is the driving force for the implementation of active restructuring policies, the regulator is given wide and substantially discretionary powers – England is the example here. In others, the ministries are in the driving seat for restructuring policies and the regulator plays a much more passive role. Thus, although all countries include the promotion of competition as a key objective for the regulator, some regulators are given stronger instruments to fulfil this objective than others.

The larger discretion and powers of the English regulator are balanced by a higher degree of accountability: In the UK, some sector specific regulatory agencies are bound by competition regulation. If a party is aggrieved by the decision of a regulator in a change in a license condition, it may request the regulator for an appeal to the Competition Commission. The regulators must follow the substantive proposals in the Commissions report.

Borderline between Regulation and Competition Policy

In most countries “ex ante” regulation – price and other approvals – is the chosen form of regulation. Such regulation inhibits competition by denying regulated firms the pricing and market flexibility needed to react to changing market conditions. New Zealand is the furthest country in carrying out “ex post” regulation – reacting to unwarranted developments, similar to competition agencies. In the EU, Finland may be the country relying most heavily on monitoring and ex post remedies.

Whereas competition agencies have a long history, independent sector regulators are a recent creation, and the question is how permanent an institution the independent regulator will be? Regulation is not supposed to be a substitute for competition but to promote it! In theory, sector regulators are to make themselves superfluous in most sub-areas presently under economic regulation: active restructuring is to provide the competition needed to eliminate the need for economic regulation.⁸ Thus, regulators should evolve, as competition emerges, focusing on network issues. As soon as the regulatory issues become general competition issues and technical standards rather than sector specific economic issues⁹, the competition authority can take over regulation of the sector. That goal, for various reasons, is still futuristic; as witnessed by the unconvincing results of the “competition policy approach” in New Zealand regulation, and by the difficulties the German competition authority has had in getting adequate rules for transmission agreed to by the owners of the regional transmission systems.¹⁰ Yet, the regulatory inventiveness in carving competitive niches out of previously integrated utility activities has been impressive and has enlarged the grey area between regulation and competition policy. The overlap between regulatory and competition agencies in areas such as network access and pricing, and the unbundling of networks, mergers and divestitures is leading to inter-agency rivalries and frictions in several countries.¹¹

Governments must monitor whether developments on the market motivate an adjustment in the division of labour between the competition authority and the sector regulators. It is natural for established agencies to defend their scope of work. Regulators will use arguments such as the advantages of an “holistic view” to defend the need for continued “across-the-sector” regulation. Yet, reducing the scope of regulation is a sign of success, and national governments can promote the adjustment of regulatory institutions by benchmarking their performance against progress in the field of transferring responsibilities to the competition authority. The widening of the free competition market in telecom, for example, leads to reflection on whether sub-areas can be transferred to the competition authorities? The principal mischief that competition law would address in telecom is the potential for a dominant firm to restrict access to a facility, or service to which access is essential if the competitor wishes to enter the market and compete.

⁸ *Economic Regulation* is the explicit public or governmental intervention into a market to achieve a public policy or social objective that the market fails to accomplish on its own. When monopolies disappear, the need for price regulation disappears, and social objectives, such as universal access can often more efficiently be solved via targeted social income support.

⁹ Unlike independent sectoral regulators, *competition authorities* do not regulate levels of service, quality, prices or profits. These outcomes are completely determined by market forces.

¹⁰ Effective competition in generation requires regulated third party access to separately owned networks. This in turn requires *ex ante* regulation by specialised utility regulators, as competition law alone is inadequate given the special properties of electricity.

¹¹ The relationship with the competition authority is confused when sectoral regulators are responsible for dealing with classical competition problems, such as exclusionary practices or mergers, under their own statutes rather than under the competition law. The result is fragmentation of competition principles across the economy.

Borderline between sector policy and sector regulation

In theory, the ministry makes policy, the regulator takes decisions with reference to this policy. In practice, the regulator may use his statutory responsibilities for consumer protection and protecting the commercial interests of operators to take decisions that run counter to Government policy. “Ofgem” in England has on various occasions made market rules, which imposed charges on renewable energy generators – for balancing power and transmission – which, while reflecting objective cost conditions, ran counter to the policy of the Energy Ministry to promote a wider penetration of renewable energy generators on the power market. In Latvia, PUC, reacted negatively in public to the increases in power tariffs that were caused by the feed-in-tariff for renewable energy, introduced at a time, when utility tariffs were still below full cost because of the ability-to-pay problems of household consumers.

The Government can over-rule opposition from the regulator by passing a law through Parliament which imposes market rules along the wishes of Government (as long as they do not run counter to EU Treaties). The system therefore, has good checks and balances: opposition by a regulator can force a Government to review law proposal to see if it, without jeopardizing the specific policy objectives, can be made more market friendly.

The railway sector is posing particularly difficulties for the independence of regulation because of the heavy budget support given by Government to sector operators. The government’s desire to control spending leads inevitably to attempts at some trimming of the regulator’s powers.

National independent regulators for regulating municipal services

The UK is one of the few countries in the world, which has established a national independent regulator for regulating water supply services. Although transport of water may cross municipal boundaries, the organisation and regulation of water supply has in other countries been left to the municipalities to decide. The Thatcher-government’s use of systematic privatisation and promotion of free market competition as the strategic instrument to improve the productivity and international competitiveness of the British economy provided the motivation for setting up a national regulator for local supply.¹² Getting individual municipalities, often being with parties other than the national party controlling the majority in city councils to agree to a rapid privatisation of local services, on a voluntary basis is difficult.

Contracting out of regulatory functions and tasks

In difficult or weak institutional environments, where effective regulators that can be competent, independent and legitimate are difficult to establish, recourse is made to contracting out either complete functions of regulation (e.g. regulation of price and service quality of an individual enterprise) or individual tasks of regulation (e.g. review of a tariff proposal by a consulting firm). Recourse to out contracting of regulatory

¹² The water regulator was set up by a later government, showing the sustainability of the paradigm shift in economic policy.

functions is done when there exists insufficient trust in the legitimacy or independence of the regulatory environment¹³; out contracting of functions is done by regulators to strengthen their specialised expertise in some areas or to cope with peak demands (e.g. annual tariff reviews for a multitude of companies arriving at the same time).¹⁴

Arrangements for out contracting vary.¹⁵ One key distinction is whether overall exercise of functions continues to be the ultimate responsibility of the regulatory authority accountable to taxpayers,¹⁶ or whether this responsibility is effectively transferred (as in Latvian municipal regulation). When the regulatory authority maintains ultimate responsibility, a distinction is whether the recommendations produced by the external agency are purely advisory (i.e. an external advisor presents several options in a decision-making framework to the regulator) or binding in nature (recommendations given by the external provider must be directly applied, with no choice given to the regulator on alternative options).

Scope for appeals and institutional arrangements for appeals

In some countries, grounds for appeal are restricted to factual or procedural errors, thus ensuring that the appeals body cannot overturn the judgement of the regulator. The Latvian Administrative Court, established recently, will not act in that way, if it receives complaints about regulatory decisions taken by PUC

In other countries, the economic-regulatory merits of the decision, can be reviewed by the appeals body. In the U.K. appeals can be made to the competition authority. In Chile, arbitration panels of independent experts with binding decision-making power have been put in place to settle disputes between the water and sanitation regulator and private operators, especially in tariff reviews. These panels, staffed by three private, independent experts, deliver decisions that are binding on both the government and the private operator.

1.2.2 Selected issues concerning the content of regulation

Regulation to control the incumbent's exercise of market power: case of Telecom

The development in the telecom industry gives confusing signals to regulators: advances in technology increase competition, whereas increasing market concentration, particular in mobiles, decrease competition. The huge investments volumes required in

¹³ This arrangement is decided by policy makers when designing a regulatory framework, or agreed to in concession contracts with private (normally foreign) investors, which stipulate that independent experts monitor the fulfilment of contractual conditions, review tariffs, or settle disputes.

¹⁴ Decided by regulators themselves during operation.

¹⁵ For a detailed overview of international experience with outsourcing of regulatory activities, please refer to "Contracting Out Utility Regulatory Functions", ERM, 2004.

¹⁶ For water and sanitation services in Bucharest, concession in 1998, expert panels are involved in setting tariffs. Funded through a customer levy and selected by the concessionaire and the municipality, these expert panels complement the functions of a technical regulator. The concession contract gives the panels important powers to adjudicate tariff decisions, but within a clearly laid out process. The Ministry of Economics still formally clears the tariff reviews, but the contract makes it difficult for the ministry to delay or disagree with panel opinions.

new communication technologies favour a concentration of the business. Under these circumstances, a general issue for regulators in telecom is whether asymmetric regulation is still warranted?¹⁷

Liberalization brought impressive results. Prices in many segments plummeted and former monopolies in the Telecom industry lost large chunks of market share in data services, long-distance and international telephone calls. In Europe, the amount of residential traffic that has shifted from fixed lines to mobile networks ranges from 6 percent in Germany to more than 50 percent in Italy. In one key area, where the results of liberalization have been less impressive: the local loop (“the last mile between consumers and the network”) which in most markets has remained under the incumbents’ control, the access bottleneck is being removed by new technologies and alternative platforms, such as cable and wireless and VoIP (Voice over Internet Protocol). Where there are extensive cable networks, these are being upgraded to offer voice and broadband services. These developments, combined with the continued application of existing regulatory models, are exerting pressure on the incumbents’ fixed-line revenues, which still tend to account for 60 to 80 percent of their total revenues and for most of their profits.¹⁸

The downside, or uncertainty of the development is, that the weakening of the incumbents’ fixed-line business might not lead to more competition, just to a different type of market dominance by a mobile operator or an oligopoly of mobile operators, where a strong tendency towards concentration is witnessed. As newcomers – who created the intensive price competition – are disappearing from the market, the risk arises that what will be left is a group of oligopolies who are content to share the mobile market without active price competition.¹⁹ That is not what liberalization was intended to achieve. Yet, mobile and other wireless networks face substantially less regulation than fixed-line incumbents do. The asymmetry formerly served a useful purpose: overcoming the fixed-line networks’ market power advantages in the early stages of mobile’s development. But now that mobile operators in many markets match or even surpass

¹⁷ Asymmetric regulation is a tricky and risky business in any circumstance. If prices that new telecom entrants must pay the traditional big phone companies to access their networks are set too low, entrants will be subsidised by the incumbent and lose incentives to build their own network, while the incumbent lets its own network deteriorate. The US’s FCC’s so-called *Telric rules* require the incumbents to make the various elements of their networks available to competitors at a favourable rate. That price is based not on the actual “historic” cost to the provider but on a hypothetical “best practice” in the industry - the price if a perfectly competitive market prevailed. New Zealand Telecom managed to persuade another court of last appeal to accept the opposite theory: the so-called *Efficient Component Pricing Rule*. It argued that economic efficiency dictated that the incumbent should be allowed to charge a high interconnection price equal to its opportunity cost - which in this case would mean its forgone monopoly profits, which is higher than historic cost.

¹⁸ Over the next five years, incumbents in Eastern Europe, for example, could lose up to 40 percent of the revenues they earn from the retail fixed-line business as customers switch to mobile telephones. Source: Scott Beardsley, Luis Enriquez, and Jon C. Garcia, McKinsey, Magazine, May 2004: Telecom Regulation Innovations

¹⁹ This would be similar to the situation in the retail market for oil products: there is no price competition at gasoline stations. Studies by competition authorities show that prices of all companies on the market move in parallel within 24 hours of a price shift. Yet, to prove price collusion is impossible: companies claim they just react to prices of others.

fixed-line businesses in subscribers and revenues, regulators concerned about the development and maintenance of networks need to reconsider this approach.

Regulation to achieve socially desirable policy objectives

A clear trend is the changing concept of how the provision of "universal service" obligations and "public interest" activities are to be organised. The classical regime was to impose the universal service obligation on an incumbent against a closed concession for providing that service. Now the tendency is to find free market solutions by imposing "universal service" on all as a condition in the licenses²⁰, or through incentive payments assigned on a competitive basis by tender.²¹

In the UK, discussions started early 2004 whether Office of Communications, Ofcom, which is responsible for the communications industry, the internet and commercial broadcasting should regulate BBC as well. BBC, as state owned enterprise, is regulated by a Board of governors, which acts like executive directors largely influencing content. Ofcom set out a new regulatory framework based largely on market economics. In a digital world, Ofcom argued, we can rely on commercial broadcasters to satisfy our wants as consumers. But market failure does occur because commercial broadcasters will not necessarily satisfy our higher wants as citizens. For instance, as a citizen one can desire high-quality programmes on science, the arts and religion, as well as impartial, accurate news - for "the good of society" - even if one has no intention of watching them. Ofcom did not rule out a future for an independent, publicly funded BBC. But it hinted at a model that would make it largely redundant. Instead of making direct allocations of public funds to a powerful institution such as the BBC, a new intermediary body could simply purchase public service broadcasting on behalf of the public from a diverse range of competing commercial suppliers of such programmes. Private bodies would compete for subsidies with which to make public service programmes that meet criteria defined by Ofcom.

This framework is in line with the structure envisaged by the EU Court Ruling in a case raised by commercial TV-companies in Denmark against the Danish Government for providing illegal state aid to the state owned television company, TV2. TV2 was created as a public program competitor to Danish Radio & TV, the public radio and TV-company; which is financed "100%" out of the compulsory radio-and television fee as it is banned from broadcasting commercials other than those paid by public information agencies. TV2 is banned from interrupting programs by sending commercials, but is free to broadcast commercials in between programs. These provide roughly 60% of TV 2's revenue, the other roughly 40% comes from a contribution from the radio and television fee. The commercial broadcasting companies protested that the latter represented a state subsidy giving unfair competition on the market, as TV2 could offer

²⁰ A universal service program should minimize any resulting distortion in the market outcome. Designing this is not easy. If one wished to avoid asymmetry among carriers resulting from universal service support, one would make the universal service obligation mandatory for all carriers as a condition of entry. But this would introduce a new distortion, because niche entry by carriers wishing to offer different services, or focus their efforts on certain market segments, would be precluded.

²¹ A process of competitive bidding would allow the regulator to assign the universal service obligation to carriers, and to determine the compensation those carriers should receive.

commercial slots at lower prices. The ruling by the EU Court confirmed this and ordered TV2 to repay most of the received support to the Danish Government. The fact that TV2 has a substantially larger journalist staff, broadcasts many more news-hours and purchases far more expensive nationally produced “prestige series” than the commercial companies was not satisfactory. The EU Court objected to the fact that the “public service support” was given without specifying in a contract what TV2 was supposed to provide for the financial support.

That Danish Radio & TV is “100” financed by the “TV and radio fee” does not pose a problem for the EU-Commission, because Danish Radio & TV is non-commercial public broadcaster, which does not compete with commercial broadcasters for commercial advertising revenue. Whether the UK in the case of BBC will break with this mode of organising public radio and TV, remains to be seen: there is concern in many quarters that the “commercial model for public interest radio and TV” would lead to politically less independent broadcasting.

Incentive based regulation

Incentive-based regulation has emerged as the clear choice worldwide, but with wide a variety of approaches. The most widely discussed and adopted schemes are based on price cap, revenue cap, and targeted-incentive regulation models. Other incentive-based models include yardstick regulation, sliding scale, menu of contracts, and partial cost adjustment. As under incentive regulation the tariff formula is revised every four to five years, “rate of return regulation” elements have not disappeared. The real difference is that incentive regulation is intrinsically forward looking and has longer intervals in between its tariff revisions.

Will the power pool market provide enough generating capacity in the power sector?

In the first 15 EU member states, competition in generation was introduced in a situation of generation surplus. The surplus capacity documented the inefficiencies of the monopoly model for organising utility services, which motivated the reforms for sector liberalization and provided the necessary framework condition for competition in generation. The early “rash-to-gas” race in the UK seemed to indicate that the investment uncertainties created by free competition did not deter investors from undertaking sufficient investment in generation. Yet, by hindsight it may be that this was a special situation created by the expectation that the removal of subsidies to the domestic coal industry would make investments in CCGT-plants competitive and rather risk-free.²² Recently concern is increasing that not enough capacity is being added. Whereas investment in renewable energy under mandated market regimes proceed vigorously; investments in conventional power for the free market are falling behind in some markets. The California market was one example, the Nordic power market situation is another: in 2003, the Danish system regulator had to pay generators to bring mothballed generation plants back into operational condition in order to have enough backup supply in the system. In some markets capacity shortages are caused by

²² The much lower costs of investment per MW in a CCGT power plant compared to a coal fired power plant and the shorter construction times were additional risk-reducing factors.

weaknesses in the public approval process for the licensing of new power plants, rather than by lack of investors response to economic signals.²³ Yet, the situation opens up for the discussion of whether the short-term price signals on the bulk power market provide sufficient long-term signals for investments?

Traditional utility regulation (and long-term PPAs for power) breaks generation costs into two separate components: capacity costs and energy costs. The capacity tariff is to recover the investment in the power plant; the energy tariff the cost of energy (composed of operating and fuel costs) at the plant consumed to meet the instantaneous demand for power. This pricing system provides first class security for investments in power. A key issue for the design of market rules for the power market is, whether intertwining these two costs in the real time wholesale energy market into a single kWh-tariff gives investors a sufficiently clear market price about the long term price for power. In most real-time power pools, capacity is paid separately, but only for stand-by and regulating capacity, that is, for a fraction of daily operational capacity. What price expectations does the pool market give an investor about his average price during the lifetime of a planned power plant? The kWh-tariff will most of the time be sufficient to cover variable and fixed costs (net of amortization and depreciation of investments in capacity). The issue for the investment decision is whether the kWh-tariff will provide a large enough margin to recuperate investments in capacity. In there is a structural problem on the power market:

- Overcapacity leads to prices approaching the marginal cost of existing power plants (the energy cost) with an insufficient margin to cover the cost of capacity.
- In times of under-capacity, the market price shoots over the long-term marginal cost of bulk power supply. But, whereas there is little regulatory intervention to provide a floor for power prices in times of over-supply, investors risk regulatory price capping in times of capacity shortage.

This asymmetry in regulation may lead to an expected average lifetime price of power, which does not allow investments to be fully recuperated during the lifetime of the project. The strategy for investors will be to postpone investments until there is a clear indication of short-to-medium term shortage of generating capacity.

There is not yet regulatory consensus about the optimal market design for securing adequate capacity at least cost to consumers. In the Nordic power market, the security of capacity is partly solved by direct long-term PPAs between distributors/retailers and generators; a distributor typically purchases only 30% of his power needs from the power pool. Yet, it is being discussed whether additional benefits can be gained by providing capacity payments to all power fed into the pool?

Pricing of transmission and ownership of networks: state ownership or private?

The transmission and distribution grids in the power sector and gas sector are subject to strict monopoly regulation.

²³ Domestic environmental concerns block the development of new hydropower plants in Norway, CO2-emissions the construction of gas-fired capacity. In California the environmental approval process made investments in larger coal fired or natural gas fired power plants close to impossible. In Sweden the problem is caused by the politically dictated future closure of nuclear power plants.

The transmission grid in the liberalized structure is the super-highway connecting generators and consumers. The power market works efficiently only when sufficient transport capacity is available. There are two basic schools of thought about the ideal regulatory-institutional structure and the ideal tariff-policy for providing transmission at least cost to society:

- One school believes in the free market approach. The recommended market arrangement is to use nodal pricing and congestion charges to provide private investors with the right location price signals for investing.
- The other school believes that it is not efficient to wait for capacity shortages to occur and be reflected in high prices; that it is more efficient to base investments on long-term planning. Direct state control over investments in transmission is more efficient. The recommendation is state ownership of transmission to directly ensure investments in sufficient transmission capacity and to apply the “postage stamp tariff” to enable maximum competition on the generation side. Nodal pricing, though, is not incompatible with state ownership of the transmission grid.

The US with its free market approach is experiencing a serious problem of underinvestment in power transmission: investments during the last ten years have been much smaller than in the UK. But, the underinvestment is in part due to a sub-optimal regulatory-institutional framework for investments in inter-state transmission, and not an indication of market failure as such. The fragmented ownership of the power transmission system in Germany has caused difficulties for establishing efficient competition in generation and for the marketing of green power; and is a contributing reason for the German Government’s decision to establish a regulator for power (jointly with Telecom). Norway’s and Sweden’s state owned transmission companies have operating successfully within the liberalized and very competitive framework of the Nordic Power Pool. The verdict on the winning formula may still be out, but the trend is towards state ownership of transmission. All countries that during the last three to four years implemented reforms to restructure the power sector, kept the national transmission company in state hands.²⁴

In railway, the liberalization of the railway sector in the EU led to the vertical break-up of previously integrated railway companies into (i) train operating companies, (ii) infrastructure, (iii) train leasing and (iv) rail maintenance groups. Many of these companies have subsequently been privatised except for infrastructure, which in many countries remains in state ownership. Whether the overall effects of the restructuring will be negative, positive or neutral (the latter seems to be the situation for the moment) still remains to be seen. The break-up between train operation and rail track maintenance has, however, led to a lack of transparency about responsibility for late arrival of trains: is it the train operator or repair work done by the rail track company which causes a train to arrive late? Often it is the latter, but the passengers will blame the train operator! The verdict on state-versus private ownership of the rail track is unclear. UK in 2001 turned the private company “Rail track” (which had run into deep

²⁴ Denmark turned in early 2004 to state ownership of transmission in both power and natural gas believing it to be the best instrument for securing a first class and interest-independent transport infrastructure.

problems after just a few years of operation) into the not-for-profit company “Network Rail” backed by a government guarantee but in the private sector. Instead of shareholders, the company has members who represent railway and public interests but have no financial interest in the business. Yet, some observers believe that “Rail track” had not performed as badly as claimed by the media; and in Denmark, the performance of the state owned rail network company has not been convincing.²⁵ In order to introduce competition into the railway sector, the Danish Government forced the incumbent state owned train operator to give up a section of its service area up for open tender. The bidding resulted in the Danish train operator offering a price, which was almost 50% lower than the price by the private British company Alvira; yet the Danish Government assigned the franchise to Alvira, claiming that the bid by the Danish train operator was not realistic.

The much stronger synergies between network and services in telecoms than in electricity generation and supply or in natural gas make it intrinsically less attractive – and harder – to separate natural monopoly and service elements from other output elements than in electricity and gas.

Is there a need for continued price caps on household retail prices?

A general tendency is that price cap regulation is gradually been withdrawn for telecom retail services and retail electricity prices. In the UK, for example, since 2002, there is only a residual “fail-safe” price cap on household retail call charges. Price regulation has been withdrawn from most network access price elements with the exception of access termination charges. Mobile termination charges are still regulated, as are many of BT’s wholesale service products.

Yet, some concern remains: households face a lack of transparency in the Telecom retail prices of competitors on the market because they bundle their products differently. This is a niche strategy to maximise market share in individual business services with specific demand profiles. These industries, due to the high cost of their annual communication bills can invest time in finding the most suitable product. Most households do not make the effort to figure out which product matches the consumption profile of the household at least cost.

In electricity retailing price transparency is high. Yet, a very low percentage of household consumers – in most countries around 2-3% only – have reacted to the opening of the market to free competition by changing supplier. The difference in annual cost of supply between the cheapest and the most expensive electricity retailer is too small and uncertain – price relationships may change the next year already – to motivate households to switch. In Denmark, for example, the difference in 2003 amounted to about 11 Euro in the annual electricity bill of an average household.

²⁵ In 2004, a train was derailed due to cracks in the rails; it turned out that the rail track company had known for several months about a potential problem on that track without doing anything. A report by National Audit Office criticised that the company had spent 12 million Euros on management consultant fees for PA-Consultant Group “without being able to document any results from that assistance”.

Whether the situation represents a problem is far from certain. The threat of losing market share if price differences vis-à-vis competitors become too high may be enough to keep retailers to keep prices low: the cost of transaction of first losing a customer and later re-winning him/her are too high to make a short-term high price strategy worthwhile.

Challenges in adapting local bus and tram systems to private competition as required by EU

Latvia faces a difficult challenge in adapting its regulation and the restructuring of the passenger transport to the liberalization requirements of EU law. The national transit authorities, PUC, the regional and municipal governments must adapt to the new role that includes administering a network comprising both public and private operators. The authorities can accomplish the goal of avoiding fare increases and a deterioration in service by giving careful thought to (i) the size and composition of the routes being offered for bid, (ii) to the duration of the contracts, and (iii) to managing the required transformation of public transport companies to the free market. This requires careful coordination between the regulatory strategy of PUC and the assistance strategy of the administrative authorities.

The transit industry in Latvia is fragmented and as liberalization progresses, market consolidation is inevitable. Incumbent operators aspiring to long-term survival will have to plan for consolidation. In doing so, they can follow any of three paths to a sustainable competitive edge: (i) scale (amassing a bus or rail network across a large market), (ii) scope (offering all transportation options within a single market), or (iii) specialization (carving off a unit with particular expertise, such as fleet maintenance). Any such strategy would be expensive, and incumbents can't expect public money to finance it. An option is to form alliances and partnerships with private operators, which have better access to capital and can help them develop the necessary skills to pursue such ambitious objectives. Since few private companies are operating in this sector, the public companies need to be "dressed up" to the new task to provide sufficient competition on a sustainable basis. Sustainable business development is a key benchmark, as witnessed by the experience of the public bus company of Copenhagen. The company, which was an amalgamation of public bus companies in larger Copenhagen, pursued an aggressive, un-sustainable route defending and new route acquiring strategy, largely based on under-pricing in public tenders for routes.²⁶ In the process it knocked previously viable private bus companies out of the business altogether by winning their routes in tenders and accumulated losses driving it into bankruptcy within four years of existence. It was sold for 1 Euro to a private bus company, which refuses to take on some of the liabilities.

²⁶ Under pricing – also by private companies – is a disrupting issue in public tenders for services, where there is potentially little supply of specialised know-how. Once the "winner" goes bankrupt, finding a replacement, or building up new public service supply (when the tender concerned "outsourcing") is a costly experience.

Experiences with regulating and restructuring of water and sanitation

Restructuring, privatisation and regulation of supply of water and sanitation services has proven to be far more difficult than for natural gas and power.

- Competition for the market is possible at the time of tenders for concessions and leases for previously publicly owned utilities.
- Competition in the market, the scope for introducing competition in the supply of water and sanitation services is far more limited than in other network utilities. Local networks of pipes and sewers remain quintessential natural monopolies. Unbundling is not as attractive because increased competition in supply will likely provide far fewer benefits than in other network utilities—the costs of producing water are low relative to the value added at the transportation stage. Greater opportunities exist to introduce competition in sewage treatment.
- Regulation of privatised water utilities has caused difficulties. Any insistence by regulators on higher investments in network modernisation and rehabilitation, are met by demands for higher tariffs. UK water companies post privatisation generated healthy profits for private investors and kept down consumer tariffs, as the water companies implemented cost-cutting measures (cutting away excess staff, ect.), whilst making few investments in long-term productivity improvements (rehabilitation and modernization of the network system).

Responsibility for district heating

District heating is promoted by Government policies in several countries for environmental and security of supply reasons, a policy which is supported also by a recent EU directive encouraging district heating. When a district heating is set up, it is normally done on the basis of long-term “take-or-pay” supply contracts with individual consumers/buildings in the service area, and subject to construction approval by the municipality. Once the system is set up, consumers are bound by the contracts for a long time, even if price conditions turn out to be unfavourable. Consumers and the municipality, approving the construction project, share a common interest in getting district heating systems established in areas where it is price competitive, since buildings located in a non-competitive service area are not attractive for consumers to move to. Consumers and small municipalities may, however, lack the technical-economic capacity to evaluate the information given to them by project promoters. This is problematic as shown by the experience of the Danish so-called - “free-field” district heating projects. In the beginning of the 1990s, some Danish energy consultants and manufacturers of district heating equipment undertook an aggressive promotion campaign for establishing district heating systems in small villages, using natural gas of fuel. The marketing drive was supported by the regional gas distribution companies (jointly owned by the municipalities in the region), which were bound by take-or-pay supply contracts and interested in finding outlets for their contracted gas. The Government, through the Danish Energy Authority, in general propagated the virtues of district heating as an environmentally superior technology to individual oil-fired heating (the heat technology is small villages). Municipalities and consumers in several villages were convinced by the propaganda, and set up district heating systems, organised as

consumer owned cooperatives. In practice they turned out to be a disaster: annual heating costs turned out to be vastly higher than predicted due to wide underestimation of heat losses in the feasibility studies prepared by consultants.²⁷ Quite a few households were threatened with ruin. The Danish Energy Authority washed its hands claiming it was not responsible for the approval of the district heating projects; the municipalities were. Yet, the Danish Parliament intervened approving a support package, which will cost Danish taxpayers close to 100 million Euro. The lesson is that regulatory failure in the end risks affecting general taxpayers, no matter was the responsibility officially located.

1.2.3 Regulatory style

The analysis of the regulatory style of regulatory agencies in countries casts light on two key issues.

One is the inter-agency efficiency of the new institutional structure for sector policy making and regulation:

- The regulator can perform efficiently only with reference to a well-formulated policy framework with clear sector policy objectives; providing this is a function of the sector ministry and the Cabinet. If the Ministry is weak in performing that role, inter alia, by producing “white papers” on the key sector issues, the regulator risks being pushed into a passive rather than pro-active role.
- Economic regulation must work under proper technical regulation framework, a task often entrusted to institutions outside the regulator (at least as setting standards is concerned).
- The responsibility for sector restructuring and the active promotion of competition in the sector must be clearly defined. It is of little use that the law creating the regulatory institution lists promotion of competition as one of the objectives of regulation (although de facto, this is a tool, not an objective) if the Government does not empower the regulator to adopt instruments to achieve these objectives. When the state still owns important sector assets (as in Latvia), the decision on restructuring and privatisation is often fully in the hands of the Government (proceeds from privatisation have never been a driving force for filling up budget).
- The dividing line between the sector regulator and the Competition Authority contains grey areas, which can give raise to inter-agency rivalry having positive as well as negative consequences.

²⁷ Heat losses in district heating, from the generating station to the inlet at the consumer, are a function of heat demand density per km of the district heating pipeline. In China’s mega-cities, heat losses, when modern pre-insulated pipes are used, can be as low as 5%. Average heat losses in Denmark dominated by its use in the “major” Danish cities are 22-23%. Yet, the feasibility studies for the low-density village system forecast heat losses of between 15-35%. In practice the systems have heat losses from 42-46%.

The second is whether de facto implementation of regulation corresponds to the formal, legal attributes of the regulatory authority. The formal attributes such as autonomy (separate/non-Ministry regulator, fixed term appointment, funding by industry) and accountability (statutory obligation to explain basis for decisions, redress / appeal rights) may look very impressive, as in the case of PUC. Yet, reviews of the situation in emerging and transition economies often reveal a substantial gap between *de jure* provision and de facto regulatory experience.

2 Contextual constraints to efficient regulation in Latvia

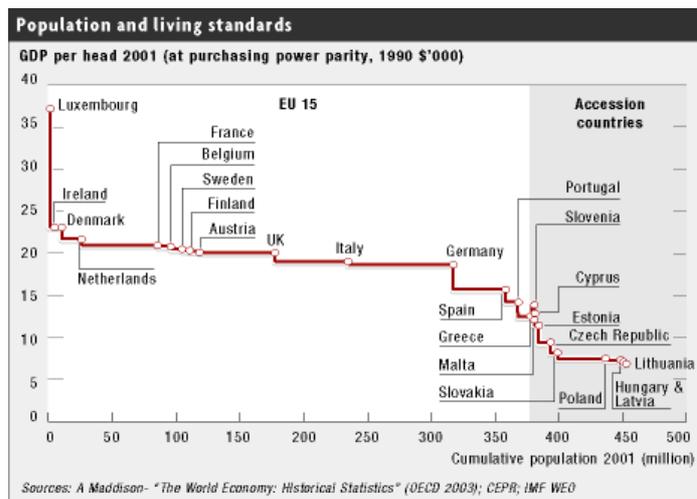
The regulatory regime set up in Latvia in the year 2001 faced a number of structural constraints which give “best practice regulation” a different practical interpretation in Latvia than for regulators in the first 15 EU member states. A key benchmark for evaluating the performance of PUC and the municipal regulators as far as the content of regulation is concerned, is their ability to address the problems of transition efficiently when taking regulatory decisions.

1. The creation of the new regulatory agencies carried with it a new distribution of functions and responsibilities among regulators, "line ministries", competition authorities and other parts of government only nine years after Latvia had gained independence. Latvia had succeeded incredibly fast in building up well-functioning national institutions; yet, the capacity to adapt to the functional requirements of the new situation differed between the institutions in the policy-making to regulation chain. Since no chain is stronger than the weakest link, some delays in the implementation of core regulatory decisions are an unavoidable outcome.
2. Although prices for utility services were in 2002 still below cost in many cases. This poses a strong handicap for quality of service regulation: unless revenues of utilities cover the full cost of efficient supply, they cannot finance investments, necessary to increase the productivity of the firm and the quality of supply.
3. GDP per capita in Latvia, measured by purchasing power parity, is the second lowest in the EU, see the Figure below. A large proportion of Latvian population faces a severe ability to pay problem, and services with prices subject to administrative price regulation, make up about one-fourth of average consumption basket in Latvia. Due to this, regulators may not increase tariffs to the full cost coverage level, but only to the maximum “socially bearable level”.²⁸ The problem for local governments is that tariff increases lead to increased payments from the municipal budget for income support to low-income households because the social assistance is fully transferred to municipalities in Latvia. Solid growth in GDP per capita is reducing the ability-to-pay barrier: in 2003 the purchasing power of the employed in Latvia increased by 7.8%.²⁹
4. The size of municipalities in Latvia is too small too efficiently perform the administrative and regulatory functions, which are required in a modern society. Latvia has 538 municipalities.³⁰ Not counting Riga, which is a super-Metropolis in terms of percentage of the national population living in it, the average municipality services a population of 2500.

²⁸ In 2004, for example, one regulator had to approve a tariff increase of 50% for a water provider (still not covering costs) and of 17% for the district heating company in the same municipality.

²⁹ Source: PUC Annual Report 2003

³⁰ Denmark with twice the population has 228, and they will during the next few years be reduced by two thirds in number to achieve the minimum scales required to provide the whole range of services efficiently.



5. The modernization of outdated and uncompetitive district heating systems is hampered by structural problems and lack of finance. Most district heating systems in Latvia are more expensive than the alternative of gas or oil-fired heat supply. Some are more expensive not because district heating in the service area is intrinsically inferior than alternative supply; but because funds for productivity improvements are lacking. Others, may have a market price which is higher; but the state may for security of supply or for environmental reasons want to preserve them. Still others are intrinsically inefficient, but serviced low-income households may not have the means to invest in alternative systems. The structural problem is the partial inability of district heating companies to improve their efficiency due to circumstances beyond their control. To improve the quality of heat supply and reduce the system losses, the distribution system must be changed from constant to variable flow; yet, change to constant flow in the distribution system requires that the internal heat piping installations in the buildings are changed to variable flow also. Common practice is that the decision on investments in internal piping is taken by the housing associations, which are very few. The best way is to get the internal investments financed by the district heating company as part of its overall investment in improved local heat supply, recuperating the cost via a monthly charge. That is already done in Riga DH case, where Rigas Siltums is installing new heat exchangers with automatic thermoregulation system. To modernize the systems required a state-directed program with part-finance from the EU's regional and structural funds. In the meantime, the inability of district heating companies to reduce costs complicates the regulatory task of enforcing higher efficiency.

3 PUC as Multi-Sector Regulator

In September 2001, PUC started its operation taking over the functions of public service regulation from the Energy Supply Regulatory Commission, the Telecommunications Tariffs Council and partly from Railway Administration and the Ministry of Transport. The Law “On Regulators of Public Services”, established PUC as a single multi-sector regulator, regulating the sectors of energy (except district heating where in the process of heat production no CHP is used), telecommunications, postal services and railway transport. The types of public services to be regulated within these sectors are determined by Regulations issued by the Cabinet of Ministers.

The functions of PUC are set by the law “On Regulators of Public Services” and corresponding sector laws. The law exists in parallel with the “Competition Law”, which entered into force in January 2002.³¹ Regulation for Public Utilities Commission by the Cabinet of Ministers specifies the organization of the work of the PUC. In addition PUC has developed and adopted several internal documents defining the strategy and basic principles of operation of the PUC.³²

³¹ The purpose of the Competition Law is to: (i) protect, maintain and develop free, honest and equal competition in the interests of the public in all economic sectors; (ii) restrict market concentration; (iii) impose as an obligation the termination of activities, which are prohibited by the regulatory enactments regulating competition, (iv) call to account persons at fault in accordance with procedures prescribed by regulatory enactments.

³² Five basic principles of work ethic of the PUC are outlined: (1) independence and neutrality, (2) objectivity, (3) openness and loyalty, (4) honesty and impartiality, (5) equality and proportionality.

3.1 Experience with the Multi-Sector Approach

3.1.1 Structure and staffing

PUC consists of five Commissioners, working full time, which are nominated by the Council of Ministers -after a selection process based on a call for tender for candidates - and appointed by Saeima, the national parliament. Together the five commissioners make up the Council/Board, the decision-taking organ of PUC.

The organization chart of PUC is placed at the end of this report. The Chair, a full-time position, has direct oversight responsibility over the Executive Secretariat headed by an Executive Director. The other four commissioners do not have direct formal responsibilities over the units of the secretariat, but have each an assistant.

The organizational advantage of the multi-sector regulator, the ability to save manpower through the pooling of support staff and making cross-sector use of scarce economic and legal expertise, is fully exploited in the structure. PUC has five departments, each headed by a Director: three sector departments - Telecommunications and Postal Department with 18 employees, Energy Department with 11 employees, Railway and Transport Department with two staff - and two cross-sector departments - the Economics Department with four employees and the Legal Department with 10 employees. In addition, there is a de-facto administrative department with a staff of 16 as the Executive Director directly supervises a number of administrative support units, including two advisors. The Chair directly supervises six staff: one adviser, the others working in Public Relations, External Relations, Development and Internal Audit.³³ Thus, staff of 45 is directly involved in regulatory work, 16 employees are in administrative work while 10 employees service the Board and undertake some PR-functions.³⁴ A new Electricity Law under preparation and revisions to the Energy Law are expected to assign new functions to PUC, making it necessary to hire more staff for the Energy Department.

The level of staff qualifications is high: 85% of the employees have higher or unfinished higher education. 66 have higher education, of which 5 have a Doctor's degree, 13 a Master's degree, 2 have two university degrees. 1 employee continues post-graduate studies, 7 are currently enrolled in graduate studies and 3 continue studies in the university for a second degree. 6 have secondary and special secondary education and 6 continue studies in university.

The Law on Regulation exempts PUC from the State Civil Service Law, enabling PUC to attract high quality staff by virtue of higher salaries. Yet, in particular the legal department, but also the Economic Department is vulnerable to loss of key staff to the private sector: there is no way that PUC can compete with the salaries offered by private law firms. That is obviously a cause for concern, but is a fact of life, which PUC

³³ The staff numbers mentioned all include the directors of department.

³⁴ The 2003 Annual Report quotes some slightly different figures: "At the end of 2003 the total number of the Commission's employees and officials was 78 (93 were planned), including five commissioners, an executive director, six department directors, 24 division managers, 37 experts, and five technical specialists.

has to live under and adjust to. One safeguard option is to use university students as interns on a part-time basis. They could upon graduation be potential candidates to fill vacancies and before that provide emergency backstopping if a void occurs.

The nomination process of the Commission with the involvement of Cabinet and Saeima was inevitably politicised – only the Chair, a Professor of Economics, has no political affiliations with any party - the other four come from four different parties. Yet, a highly qualified team emerged out of the process, of which two have strong background in telecommunication. That the Commission works as an external Board, with only the Chair having direct formal management responsibilities vis-à-vis the departments has been a source of frustration for some Commissioners. It is psychologically difficult being highly qualified, politically and technically motivated and having a full-time position, and yet not having any formal responsibilities beyond being part of a collegiate organ involved in final decision taking. Although a certain informal sector division of labour has developed between the Commissioners, according to his/hers specialist expertise and interest, some Commissioners would have preferred working in a structure, where they directly chaired a functional department, eliminating the position of Director of Department. The advantages of such a structure are (i) the increased specialized knowledge of each individual Commissioner through their direct hands-on-involvement in issues, and (ii) the reduction in the “top-heavy” management structure composed of a layer of both Commissioners and of Directors. The disadvantages are (i) the risk of “empire-building” by individual Commissioners and the associated reduction in the collegiate team spirit, (ii) loss of institutional “Director level memory” after the Commissioner is replaced and (iii) -depending on the degree of the politically nominated Commissioner’s political agenda - a politization of the technical evaluation process, already before issues are brought to the Board for decision taking. The single-regulator solution to this issue – having a full-time Chair and part-time four Commissioners – is not practical for the multi-sector regulator: the number of different issues to keep abreast of and take decisions on is too large for a part-time job.

3.1.2 Work load and scope of work

The Annual Report 2003 lists an impressive number of activities: “From 1 January 2003 to 30 December 2003, 59 board meetings took place, 347 decisions were adopted, 235 licenses were issued to public service providers or were altered (17 licenses in the postal sector, 23 licenses in the energy sector, 187 licenses in the telecommunications sector and 5 licenses in the railway sector) and 18 general authorizations of telecommunications service providers were issued, 7 licenses were cancelled. PUC approved more than 15 different documents – methodologies, technical regulations, etc. necessary for the practical operation of the liberalized market in telecom and further documents in the other sectors. Commission’s opinion was given on 26 drafts of legal acts developed by other institutions. PUC decided extra-judicial dispute settlement between public service providers and users, two in the energy sector and one in telecommunications. One more dispute application was received in the railway sector but the Commission decided not to initiate a dispute in this case. The Commission was involved in several lawsuits, due to appeal of PUC decisions to the court. LLC “Lattelekom” disputed Commission’s decision on setting regulation parameters; the court declared the request of the company as unfounded. The Trade Union of Latvia

sued the Commission's decision on natural gas tariffs. The court rejected this complaint, but its decision was appealed and the case will be examined by the court of appeal. Several complaints submitted in 2003 were examined in 2004: LLC "Latvijas Mobilais Telefons" disputes the licenses issued to JSC "Radiokoms" and JSC "Telekom Baltija", LLC "Tele2 Telecom" disputes the license issued to LLC "Lattelekom". "Small Hydro Energy Association" asks the court to cancel the Commission's decision on the average electricity sales tariff for energy purchase from the subsidized electricity generators."

3.1.3 Benefits from performing as multi-sector regulator

The three-year experience of PUC shows, that the assumed advantages of establishing of the single multi-sector regulatory body for regulation of public services at the state level are real:

- Unified principles are applied for the regulation of all sectors, in particular with regard to licensing and tariff calculation methodology – use of price caps, and risk adjusted rates of returns - and uniform procedures for providing information;
- PUC was able to coherently address the ability to pay problem of the interim period by introducing the increases in tariffs in different sectors in a balanced manner. Gas tariff increase corresponds to three year period from 2003, envisage increase each year from July 1. The approved tariffs for electricity took effect from January 1, 2004;
- Since some enterprises undertake cross-sectoral activities (such as "Latvijas Dzelceļš", "Latvenergo" and others) it is also logical that the regulator is cross-sector;
- PUC structure allows economies of scale and of scope in using scarce legal and economic regulatory expertise. It provides the regulator with the critical mass of legal and economic expertise, which lifts the quality of regulation, and ceteris paribus, makes the institutions less vulnerable to loss of specialized expertise.
- The risk of 'capturing' the multi-sector regulator is less than for single or sector regulator. The likelihood that a monopolist of a sector or a political party can pressure PUC to adopt a decision in its favour is less than the possibility of such likelihood in case of single-sector regulator;
- The risk for investments is decreased by establishing predictable regulatory environment.
- The risk of inadequate approach to evaluation of overall economic ratios has been diminished. The economic ratios are evaluated applying the unitary methodology in all sectors.

3.2 PUC independence

3.2.1 Measures to enhance independence of PUC

The Law „On Regulators of Public Services” stipulates that PUC is independent in accomplishing its duties and is not dependent on the decisions of Government, local government or their institutions.

For reasons of the Constitution of Latvia, assignment of a ministerial responsibility is a must. Article 7 therefore, establishes that “Commission shall be an institution under the supervision of the Ministry of Economy.” MoE holds the state shares of „Latvenergo” and of the privatization agency „Privatizācijas aģentūra”, which in turn holds the state shares of “Lattelekom” Ltd. The mentioned enterprises are regulated by PUC. MoE, therefore, has an obvious interest in trying to influence PUC decisions related to these enterprises. Yet, although PUC is formally under the supervision of MoE, the responsibility provides in practice MoE with few levers to apply on PUC. PUC can pass amendments in legislative acts or new legislative acts to be adapted at the Cabinet of Ministers or the Saeima under general procedure, meaning – through MoE. If the PUC and MoE are not of the same opinion, there is a risk that the document is submitted to the Government in different edition. But that is not a dependence-giving raise to major concern.

PUC’s independence is strong by international comparison. The members of the board of PUC are irremovable during the period of their authority, except cases mentioned in the Law; that facilitates making of predictable decisions as well as promotes making non-political decisions. Decisions and administrative acts made by PUC can be declared as illegitimate only in court. The budget of PUC is raised by means of a purpose-specific 0,2% charge on the turnover of regulated companies.³⁵

3.2.2 Appeals

Substantiation of PUC’s decisions and defending them in a court is an indispensable part of daily work. Court verdicts so far have confirmed that the decisions adopted by PUC are in most cases economically reasonable and legally correct. During the period of PUC activities the court has met the complaints of claimants in three cases.

Starting from 1 February 2004 the Administrative Court is put in action. Since then the appeal procedure of the regulator’s decisions and passed administrative acts has

³⁵ In theory, the dependence of PUC on the total amount of enterprises turnover may reduce the willingness of PUC to give up regulation of a sub-sector, such as LPG, although competition justifies elimination of tariff approvals. But, PUC will only succeed in the short term – postponing liberalization by a year or two – before pressures would mount. The development of competition requires change of regulatory instruments meaning deregulation, but not giving – up regulation as such. The experience proves that development of competition is strongly followed by serious disputes of market participants regarding i.e. access to infrastructure, etc requiring interference of the regulator – PUC i.e. in telecom sector.

become much faster and efficient. Appeals to the Administrative Court are free of charge for private persons (legal and physical persons).

According to the Administrative Procedure Law (Art.185) submission of an application to the court regarding the setting aside of an administrative act or declaring it as having ceased to be in effect or invalid, stays the operation of the administrative act from the day the application is submitted. If the court dismisses the application regarding the setting aside of an administrative act, declaring it as having ceased to be in effect or invalid, the operation of the administrative act shall be renewed as of the day the judgment comes into effect.

Appeals should not result in suspension of regulatory decisions. Otherwise, the involved persons may abuse opportunity to appeal, and every decision on raising tariffs, for example, will be appealed in the court and will not take effect until the judgment. Therefore there should be an exemption regarding appeals of decisions of the regulator from general system provided by the Administrative Procedure Law (Art.185). Currently such exemption is in place only for decisions regarding electronic communications

3.3 Consultation and information

3.3.1 Formal consultation structures

The Law on Regulation's article 10 "on the Rights of the Regulator" gives the Chairperson of the Commission the right to "participate in the meetings of the Cabinet of Ministers' Committee." It also requires that "authorities submitting to the Cabinet of Ministers the draft regulatory enactments related to the regulation of public services shall also submit them to the Commission for co-ordination". The only other formal structure established by the Law on Regulation is the obligation imposed on the regulator to "co-operate with the public organisations for consumer rights' protection" (article 15).

3.3.2 Hearing process in connection with tariff approval

The decisions taken by PUC affect whole community, therefore it is very essential to inform public on the decisions to be expected and on the taken decisions, in due time, as well as to explain the taken decisions and its effect on different users of public services. An important part of taking decisions is finding out and hearing the public opinion. PUC contracts specialized firms to undertake surveys of public opinion; yet the most important channel of information is through public hearing meetings in the process of decision-making. All interested parties can attend the meetings and pass their opinion on the issue. Since its start, PUC has organized more than 20 public hearing meetings. The meetings were organized regarding strategic matters – tariff calculation methodology, tariff projects, and other regulatory enactments mandatory to companies. The meetings give rights to everyone to pass its opinion, thus there is a theoretical possibility to inquire the opinion of all interested parties, to make decisions grounding on arguments considered from every point of view, and to improve the documents' drafts.

PUC's Year 2003 Annual Report describes the electricity tariff approval process as follows: "The new tariffs which took effect on January 1, 2004 were approved after a thorough analysis of the submitted and additionally requested materials, evaluation of opinions expressed in public hearings and expert opinions, analyzing the security of the electricity system in Latvia, as well as considering opinions of the Bank of Latvia, Ministry of Finance, Ministry of Welfare, Ministry of Agriculture and evaluation of state JSC "Latvenergo" administrative costs performed by audit company LLC "PricewaterhouseCoopers". Analyzing the total impact of tariff changes the Commission asked other institutions to express opinions regarding their competence. Experts from the Bank of Latvia evaluated the impact of tariff changes on inflation. The direct impact on the consumer price index (caused by higher expenses of individuals on the consumed electricity) will not exceed 0.45 percentage points. The indirect impact on inflation will be small because the tariff does not change or is reduced for the large consumers."

In addition to public hearings, PUC has formed an advisory institution – the Counselling Board comprised from experts not directly involved in the regulation process – recognized scientists and academics. The regular members of the Counselling Board

are representatives of the University of Latvia, Riga Technical University and Latvian Academy of Sciences – experts in law, economics, energy, telecommunications, and transport. The task of the Counselling Board is to evaluate the PUC's operations and its draft documents relevant to society, as well as tariff proposals. The Counselling Board has provided its assessment of tariff calculation methodologies and natural gas tariff proposals. Just like the opinions from public hearings, the opinions of the Counselling Board have been evaluated and taken into account before making decisions.

3.3.3 Publication of decisions and of general information

In compliance with the Law “On Regulators of Public Utilities” the decisions made by PUC are open and should be published in the newspaper „Latvijas Vēstnesis”. In line with the Law, the decisions taken by PUC regarding issue and annulment of licenses, refusal to issue a license, amendments in the conditions of a license, tariff calculation methodology, tariffs, procedure for consumers to get familiarized with the tariff projects submitted by public utilities' providers and to submit their proposals – must be published in the newspaper “Latvijas Vēstnesis”. Also the sector legislation obliges PUC to publish decisions taken in the newspaper “Latvijas Vēstnesis”, e.g., on the adopted regulations binding to enterprises.

PUC has a homepage – www.sprk.gov.lv, where it is possible to find necessary information on issued licenses, adopted tariff calculation methodologies, tariffs, regulations, etc.

Everyone can subscribe to PUC homepage news (informing about all decisions made in PUC) and receive them via email on weekly basis.

The Annual Report is a well-written and well-structured instrument for informing on PUC's activities. One recommendation, which can be made, though, is to include sections also on some of the politically more difficult issues which PUC is confronted with, explaining the considerations – with the pros and cons – of adopting one decision rather than another. In the 2003 report, for example, it would be interesting to get PUC's explanations about the tariff for CHP and the failed attempt to issue a license for the transmission SO in the power sector.

Collaboration on consumer protection

PUC observes in the 2003 Annual Report that PUC receives very few complaints from consumers about quality of service, and attributes it in part to the fact that consumers take contact directly with the service provider to complain. Some observers, however, believe that the general public may be sub-optimally informed about PUC's work and the possibility for complaining to PUC. They recommend therefore, that PUC considers setting up a separate department dealing with consumer rights protection. In fact PUC receives quite many complaints – on telecoms issues 150 in year 2003, on energy – 60, on postal issues – 7, and on railway – 4, so the observation about companies dealing with most complaints holds only for postal and railway issues. The idea about separate structural unit for dealing with complaints is considered and recognized as unpractical,

because most complaints are technically complicated and answers are prepared by the relevant specialists, so a separate unit will not be able to handle them.

An alternative approach may be both more effective and definitely cheaper. According to the Law on Regulation: ³⁶ “The Regulator shall co-operate with the public organisations for the consumer rights’ protection established in the procedure set by the Consumers Rights’ Protection Law and shall protect the consumers’ rights in the regulated sectors as well as shall co-operate with the supervision and control authorities for the consumers rights’ protection. A representative from the Consumers Rights’ Protection Centre or from another competent and authorised governmental institution or NGO? the competence of which is to supervise and control the consumer rights’ protection in the relevant regulated sector shall be entitled to participate in the Regulator’s meetings as an advisor, if the Regulator’s meeting considers questions regarding provision or ensuring of public services in the relevant regulated sector.”

Rather than setting up a separate consumer protection department, it may be more efficient and cost-effective for PUC to establish close collaboration bonds with the Consumers Rights Protection Centre, asking this center to undertake public awareness campaigns on the possibilities of appealing to PUC. PUC already ‘suffers’ from the Consumers Rights Protection Centre, as all complaints which are somewhat related to regulated sectors are forwarded to PUC without consideration at Consumers Rights Protection Centre.

³⁶ Article 15 of the Law “On Regulators of Public Services”.

3.4 Regulation of Telecommunications

3.4.1 Industry structure and privatization

In accordance with the requirements of the law “On Telecommunications” all telecommunications service markets were opened for competition from January 1, 2003. By December 31, 2003 PUC had issued 183 individual licenses and registered 26 general authorizations. 60 companies operate or plan to operate in the field of domestic/local voice telephony service, 64 companies – in the field of international voice telephony service, 88 companies provide leased line services, 182 companies provide Internet and data transfer services, 10 companies – payphone services, 8 companies – radio communication services and 35 companies – television and sound broadcasting services. Two UMTS licenses have been granted.³⁷

After telecommunications market liberalization the market share of incumbent operator of fixed telecommunication services – LLC “Lattelekom” (51% of shares belongs to the state) – was reduced approximately for 4-5%. At the end of 2003 19 companies provided fixed voice telephony services. The basic strategies of incumbent and entrants till year 2004 were “cream skimming”. For example, the modernization of rural networks was not attractive for undertakings. Really, there is a big difference between possibilities of incumbent and the entrants. Without support from PUC, the ability of entrants not having their own infrastructure to compete with dominant fixed telecommunications network operator “Lattelekom” is not realistic today in Latvia, as the market of electronic communications is regulated by PUC.

Operators holding significant part of the market are obliged to conclude interconnection agreements with other operators. In 2003 those were LLC “Lattelekom”, LLC “Tele2”, LLC “LMT”. The PUC has the right to take part in the negotiations for conclusion of intermediate compound agreements if they are at a deadlock. The PUC has set a procedure in accordance with which their representative participates in such negotiations. Dominant operator of fixed telecommunications – “Lattelekom” has entered 15 intermediate compound contracts.

More than 20 companies provided leased line services in 2003. New market participants play more and more significant role in the leased line service market. Their total market share was about 23% after the first half year of the market opening. In 2003 as a whole a similar trend was observed as the market share of the incumbent dropped to around 60%.

The first two UMTS licenses were offered to the existing GSM operators – LMT and Tele2. Period of validity of issued licenses are 15 years. The third UMTS/GSM license was put up for the auction at the initial price of LVL 7.6m, but no bids were submitted.

³⁷ PUC Annual report, 2003

3.4.2 Government sector policy and key regulatory issues

Situation in realization of key principles of electronic communications (adopted in March 2004) is more complicated than in other regulated sectors because several institutions are involved. Ministry of Transport (Communications department) is responsible for development of sector policy as well as for defining principles for financing of Universal Telecommunications services, monitoring of radio frequencies, and elaboration of drafts of a new laws and regulations of the Cabinet of Ministers. In February 2004, Ministry of Transport presented a draft of sector policy in Electronic communications sector (previously – Telecommunications sector) for 2004 – 2008, which after the Cabinet of Ministers approved incorporation of some corrections in March 2004. Since 1st of May, 2004 the new Electronic Communications Law, which was adopted by the Government on April 15, 2004 is in force.

Ministry of Culture is responsible for laws regarding intellectual property rights and also monitors operations among copyright agencies and the Patent Board. National Radio and TV Council is responsible for ensuring of the coating of the broadcasting system in the state.

JSC “Elektronisko sakaru direkcija” (Directorate of Telecommunications) is responsible for management of the radio frequency spectrum.

According to the EU communication package which was adopted on February 14, 2002, for eighteen markets of services competition shall be evaluated in telecommunications industry in Latvia. In accordance with the Law “On telecommunications” licenses and general permits were issued for the services, for which the groups differ from those set as new eighteen markets. These groups are following:

- 1) For providing public local/domestic voice telephony services in public fixed telecommunication network.
- 2) For providing public local /domestic voice telephony services in public mobile telecommunication network.
- 3) For providing public international voice telephony services apart from used technology.
- 4) For providing public payphones services.
- 5) For providing public radio communications services.
- 6) For providing least lines services.
- 7) For providing data and electronic information transmission services.
- 8) For providing internet access services.
- 9) For providing other unclassified telecommunication services.

The economic regulation and partly technical (quality control of telecommunication services) is implemented by PUC which according to the Law “On Regulators of Public Utilities” is under the supervision of Ministry of Economy. Partly economical regulation (spectrum management – compiling of the table of National frequencies) is also done by Telecommunication State Inspection, which is under the supervision of Ministry of Transport. The detailed role of mentioned institutions in regulating the telecommunication sector is shown in Table No.1 below.

At present, there are some unresolved key regulatory issues in the telecommunications sector such as frequency allocation, rebalancing of customer tariffs and setting the cost based interconnection tariffs.

Table No.1
Role of institutions in regulating the telecommunication sector

	Ministry of Transport	PUC	Ministry of Economy	National Broadcasting Council of Latvia	The Latvia Telecommunication State Inspection	Ministry of Culture
Setting of the policy						
Setting of the sectoral policy	X					
Setting of the funding principle of universal service	X					
The holder of State shares of "Lattelekom"			X			
Economic regulation						
Licensing (issuing licenses, registering of licenses)		X				
Surveillance of the conformity of public utilities to the conditions of a license/ permit, definite quality and environmental protection requirements, specifications, standards, and provisions of the contract		X				
Determining tariff calculation methodology		X				
Determining tariffs		X				
Preliminary extra judicial discussion of dispute		X				
Spectrum management (compiling of the table of National frequencies)					X	
Technical regulation						
Quality control of telecommunications services		X				
Protection of intellectual property						X
Ensuring of the coating of the broadcasting system in the state				X		

3.4.3 Regulatory approach of PUC

According to the Law “On Regulators of Public Utilities” and the Telecommunications law (from 1st of May, 2004 - “Electronic Communications Law”) PUC has following instruments for regulation of telecommunications sector:

1. To register general authorizations and to supervise the adherence of provided services to the general authorizations conditions. To obtain the information about the conformity of telecommunication service providers to the conditions of general authorizations PUC must not only technically control the service providers but also cooperate with Telecommunications State Inspection, which is under the supervision of Ministry of Transport.
2. To set tariff calculation methodology and approve tariffs. This methodology created preconditions for the market entry of new operators as cost calculation and allocation principles were precisely defined to ensure non-discriminatory, costs were aligned with the fee for the use of telecommunications infrastructure;
3. To take decisions on dispute between the participants of the market;
4. To carry out quality control of telecommunications services;
5. To carry out the a market research analyses, to determine the enterprises which are providing the electronic communications and have a dominant position in the mentioned market, to take measures for strengthening of the competition, etc.

3.4.4 Evaluation: Results and shortcomings

It should be concluded that:

1. It is a key issue that quality of legislation acts in Latvia should be higher. Also, Administrative capacity of the Communications department in Ministry of Transport should be increased (for implementation of its basic function: preparation of sector policy and legislation acts). Same conclusions should be made regarding the low quality of legislation acts, including the regulations set by PUC. For example, Art.28. of the Telecommunication Law of November 16,2001 requires a cost orientation of prices for interconnection “OR” access services. Actually, the conjunction must be “AND”. The next example, three of seven secondary legislation acts due to the Ministry of Transport were not prepared and issued at all;
2. Communication between PUC and relevant ministries (or other institutions) should be done in writing (processing the quarterly reports etc.);

3. It is strongly recommended to approve all necessary secondary legislation acts according to the new Telecommunications law ("Electronic Communications Law" which is in force since May 1,2004) and EC package;
4. To provide a proactive approach to the resolving of problems in telecommunication sector to make the processes published, predictable and analysed, the cooperation between Ministry of Transport and PUC should be improved and a system of drafting regular reports on the current situation in the telecommunication sector, the problems of regulation and the necessity of improvement of the legislation should be established;
5. Government support is necessary for promoting the effective competition policy in telecommunications (interconnection tariffs, access to local loop, national roaming, etc) and initiative of the PUC to deal with issues like interconnections and local loop unbundling;
6. Low activity of new entrants to compete in the electronic telecommunications market, as they are mainly waiting for support from the Government.

3.5 Regulation of Energy Sector

3.5.1 Industry structure and privatization

Electricity

The electricity supply in Latvia in 2004 is mainly provided by the vertically integrated state owned Joint Stock Company Latvenergo. In 2004, Latvenergo supplied 98% of all electricity consumed in the Latvia. It's operations cover generation of electricity and heat, transmission and distribution and also import and export of electricity from Estonia, Lithuania and Russia.

Privatization of Latvenergo and separation of its assets was forbidden by the Energy Law. But due to the conditions set in EU directives in July, 2004 the Government approved reorganization of Latvenergo. The transmission and distribution functions will be separated from generation of electricity.

There are more than hundred small independent power generators and 10 licensed electricity distribution and/or sales companies. But their share in electricity generation and supply is small: in 2003, Latvenergo generated 3,6 TWh of electricity, imported 2,5TWh and purchased 0.31 GWh from independent producers.

The fact that relatively low prices of imported electric energy do not facilitate entry of new energy producers into the market has slowed down the development of competition in domestic energy generation. During the last few years only generation operating under subsidised prices has been developed. The Energy Law imposes purchases of energy from generators using renewable energy resources (water, wind, bio mass-wood waste) and domestic peat and small CHPP (Combined Heat and Power Plants) as a public service obligation on the transmission and distribution system operators. The purchase prices are determined according to Regulations issued by Cabinet of Ministers.

The number of "eligible consumers" (having the freedom to chose an electricity supplier other than the distribution company serving it) has been progressively increased. The threshold of 1 GWh/year of electricity consumption (=> 496 eligible customers) was by July 1, 2004 expanded to include all commercial customers (=> 44% market opening). By 2007 the electricity market is open for full competition. Yet, by July 2004 no eligible consumer used the right to buy the electricity directly from a generator.³⁸

Gas

Natural gas accounts for some 32% of primary energy supply. Its share increased from 20% in 1996, largely due to increasing price of heavy fuel oil (HFO), the main competitor, which saw its share decrease to 7% of TPEC selling almost exclusively to

³⁸ The threshold has been reduced faster than in Lithuania (threshold 9 GWh annual consumption =eligible 28 consumers and market opening of 25% with full opening by 2010) and Estonia (threshold 40 GWh annual consumption = 11 consumers eligible and market opening of 12%, by 2009 – 35%). Source: "Prospects of Baltic Power Markets", Power Point Presentation by PUC-Chairman Prof. Inna Steinbuka.

areas not covered by gas grid (e.g. Ventspils and Rezekne). Since wood fuel has an advantage over both – in price and environmental effects - it is unlikely that gas in near future will continue to increase its market shares, unless a major gas-fired power plant is constructed in Latvia to compensate for the closure of reactors at Ignalina.

JSC "Latvijas Gaze", now fully privatised, is the only gas system operator in Latvia. The privatization process started in a year 1997, and the main shareholders are Ruhrgas Energie Beteiligungs AG (47,15%), AAS "Gazprom" (25%) and SIA "Itera-Latvija" (25%).

Latvia's energy balance for the year 2002 illustrates that only 30% of the gas consumption relates to final consumption while the remaining is transformed to heat and electricity with about 1,5% accounted for as losses.

In summary, the principal characteristics of the Latvian gas sector are:

- 1) Small gas market (total gas consumption 1.6 billion cu. meters in 2003),
- 2) High concentration of gas consumption in industrial, district heating and power generation end use sectors (together accounting for 85% of total gas consumption),
- 3) Small residential end use sector (6% of total gas consumption),
- 4) No indigenous gas production or reserves,
- 5) Total gas supply from one source ("Gazprom").

Natural gas is subject to a degree of competition from other fuels such as oil, coal and electricity, even though this is not as effective as direct 'gas on gas' competition for controlling prices and increasing efficiency in the gas sector. In Latvia, evidence suggests that large users have the capability to switch between gas and competing fuels such as HFO.

In the liquefied gas sector around 70 medium and small private companies provide gas storage, filling and sales services. LPG consumption was 2140 thousand tons in a year 2002, 53 % used in households and 41,3 % in transport. Competition exists among these companies and as a result none of the liquefied gas companies can significantly influence the price.

3.5.2 Government sector policy and key regulatory issues

Key elements of sector policy

Government (Ministry of Economy) has not yet elaborated a common market development policy for the energy sector. Ministry of Economy has developed sector development policy for electricity, but not set clear guidelines regarding the development policy in the gas and heat supply sectors. The main goal of electricity sector policy (adopted on 11.09.2001.) is to promote the development of the sector in accordance with balanced and sustainable growth in the national economy. The instruments for reaching the goals are stated as follows:

- 1) Increase and guarantee of the stability, security and quality of energy supply;

- 2) Reliance on market mechanisms;
- 3) Harmonization of environment protection, energy production, transportation and usage costs;
- 4) Sector development in accordance with economic development and promotion of regional economic activity and equity;
- 5) Promotion of renewable and domestic energy resources.

Scope of regulation

Electricity, natural gas and LPG are regulated by PUC, with technical regulation being done by National Energy Inspection. The following types of public services are regulated by PUC in energy sector:

- 1) CHP plants with the maximum capacity exceeding one megawatt;
- 2) Electricity generation with the capacity exceeding one megawatt;
- 3) Electricity transmission (110 kV and higher);
- 4) Electricity distribution (higher than 1 kV and lower than 110 kV);
- 5) Electricity sales to any energy user if the sales volume exceeds 4 GWh per year;
- 6) Natural gas storage, transmission, distribution and sales to any energy user;
- 7) Liquefied gas storage and filling into containers, cisterns or gas-cylinders for sales in any type of container (except oil gas and other gaseous hydrocarbons used as fuel).

Regulatory challenges in the power sector and PUC responses

In the power sector Latvia has specific structural features, which are outcome of fact that Latvia's and Baltic power systems were part of regional power system of former Soviet Union: (i) insufficient national generating capacity during winter, (ii) insufficient "regulating capacity" meaning capacity which can react upwards and downwards to changes in prices for bulk power and (iii) the dilemma that Latvenergo is a huge player on the national market, yet small in absolute terms.

The Latvenergo dilemma presumably explains the political difficulties, which the restructuring and privatization of Latvenergo ran into. The unsolved issue of Latvenergo's structure in itself poses a difficult for regulation, as PUC lacks a direct compass in its strategic decisions vis-a-vis Latvenergo. The difficulty is reinforced by the insufficiency of the installed capacity. Liberalization of the power sector leads to price reductions only if the reform takes place in a situation of surplus power capacity. Latvia is the only EU-country, which does not have a national power generating capacity equal to or higher than peak national demand.³⁹ Due to its inter-connections and historical

³⁹ Due to the high share of HPP generation import dependency in Latvia's electricity supply may exceed 50% (1992, 1996) or be below 10% (1998). On average, import covers around 1/3 of the country's gross domestic consumption. Source: Prospects of Baltic Power Markets", Power Point Presentation by PUC-Chairman Prof. Inna Steinbuka. Greece and Finland have a slight capacity deficit, see Table 6, page 20 of EU 3rd Benchmarking Report on the Implementation of the Internal Electricity and Gas Market, 2004. The rule-of-thumb for sufficient reserve capacity is 15% higher than peak demand

power exchange with Lithuania and Estonia, Latvia implemented its market liberalization in a regional market context of surplus capacity. But that surplus capacity is evaporating under EU-pressure, which for environmental reasons is pushing for the closure of Ignalina in Lithuania and a reduction in generation using shale oil in Estonia. The lack of regulating flexibility in generation in Latvia is due to use of run-of-the-river hydropower and CHP-plants.⁴⁰ The extent and the urgency of the capacity problem puts additional pressure on PUC in its balancing act between satisfying the demand from consumers for low tariffs and the need for Latvenergo to build up equity capital for investments in new generating capacity.

The strategic response of PUC comprised three measures:

- (i) PUC accelerated market opening as a way to lay the foundation for a future structure with more market players – end-2004 PUC has issued 4 licenses for sales activities only (pure traders)..⁴¹ Yet, Since July 2004 all commercial customers are “eligible” and full opening is to take place in 2007.⁴²
- (ii) PUC eliminated previous cross-subsidies in tariffs by introducing cost-reflective pricing for transmission and distribution,
- (iii) to increase Latvenergo’s tariffs to full-cost coverage levels, effective from January 2004, enabling the company to implement a needed investment program. PUC applies in power as in its other sectors the price cap approach with productivity targets, allowing Latvenergo a 7.6% rate of return. The tariff cycle is three year.

Regulatory challenges in the gas sector and PUC responses

The structure of the gas supply in Latvia offers limited possibilities for effective market opening. Because of sole supplier (Russia) Latvia could be considered as a non-connected market.⁴³ “Latvijas Gaze” is a vertically-integrated company, covering transmission, storage, distribution and sales and is co-owned by Ruhrgas, Gazprom and Itera Latvija; the latter two being the external suppliers of gas to the border of Latvia. During privatisation ‘Latvijas Gaze’ received exclusive licenses for natural gas transmission, storage and distribution till 2017, as part of the privatisation conditions. No other suppliers have so far entered the market.⁴⁴

The strategic response of PUC is to keep a tight lid on the whole tariff chain, including tariffs for industrial consumers where gas sales, in principle, are subject to inter-fuel

⁴⁰ Lack regulating flexibility as used here does not refer to its narrow meaning of balancing power, but to the ability to adjust output in reaction to price signals from the market.

⁴¹ According to Table 5 page 19 of EU 3rd Benchmarking Report on the Implementation of the Internal Electricity and Gas Market, 2004, Latvia has only 1 licensed electricity retailer, Lithuania 21 and Estonia 87.

⁴² By comparison, according to “Prospects of Baltic Power Markets”, Power Point Presentation by PUC-Chairman Prof. Inna Steinbuka, Lithuania plans full market opening by 2010, whereas Estonia in 2009 expects to have a 35% market opening.

⁴³ A *non-connected market* in the meaning of Article 28(1) of Directive 2003/55/EC as having only one main external supplier (*market share more than 75%*).

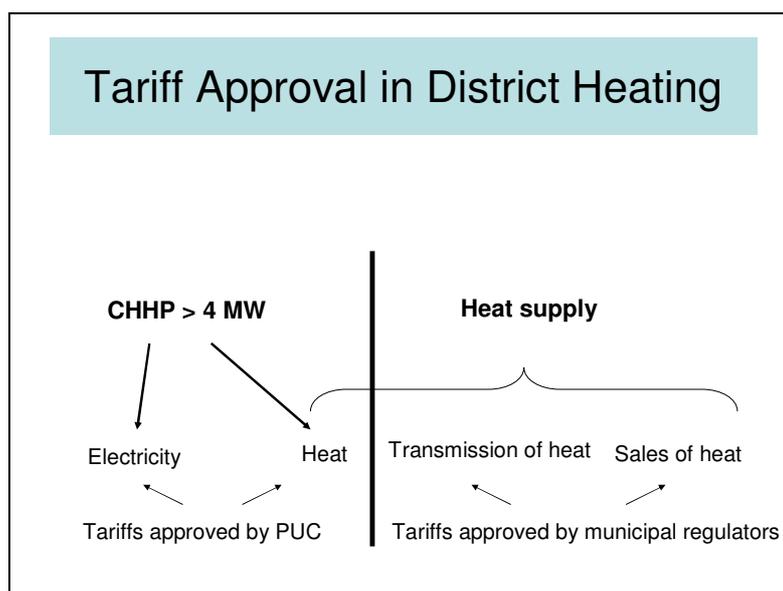
⁴⁴ Lithuania has 10 and Estonia 4 licensed suppliers, purchasing gas at the border, see Table 14 page 33 of EU 3rd Benchmarking Report on the Implementation of the Internal Electricity and Gas Market, 2004

competition from heavy fuel oil.⁴⁵ Since the two external suppliers of gas via their ownership shares in Latvijas Gaze have perfect insight in the dynamics of the national gas market, this decision probably helps to keep down also the import price of gas.⁴⁶ The tariff approval process under these circumstances was, logically, confrontational, with Latvijas Gaze putting investments on hold and PUC rejecting three tariff proposals, before in 2003 approving a gradual tariff increase over three years.⁴⁷ The new tariffs are calculated with an approved 8.4% rate of return. Latvijas Gaze in turn resumed the previously suspended investment plans to connect new consumers and to construct gas network in Rezekne, Preili and Smiltene. As part of the tariff approval, PUC rationalized the tariff structure, eliminating cross-subsidies and unfair competition of gas fired individual heating with gas-fired district heating: the tariff difference between low and high levels of annual gas consumption volume was increased.

Regulatory challenges in district heating and PUC responses

Regulation of heat supply is divided between PUC and municipal regulators (see Figure 2).

Figure 2



Regulation of district heating is straightforward, when no CHP-production is involved. Regulation of CHPs, on the contrary, is a tricky affair at both the conceptual and the practical level. Conceptually, the problem is that no methodology exists to objectively determine a

⁴⁵ The legal preconditions for eligible consumers and third party access are part of draft amendments to Energy law, currently reviewed by parliament.

⁴⁶ A free market price revenue maximisation tariff policy of Latvijas Gaze would be exploited to increase the border price of gas.

⁴⁷ On April 9, 2003 the Commission approved new natural gas supply tariffs which took effect on July 1, 2003 and increased the tariffs by 12.5% on average, the main reason behind this increase was a considerable rise in prices of natural gas supplied from Russia.

“fair allocation” of the joint cost of production to the outputs of heat and electricity respectively. In the end, the decision is political and motivated with reference to the precise energy policy objectives adopted by the Government. The problem for PUC is that the Government has not adopted a policy for heat supply. Therefore, although PUC adopted a CHP-tariff methodology after several rounds of discussions, and a review of international practices, the municipalities who want lower heat tariffs challenge the methodology. At the practical level, if a free Baltic power pool were to be established in the future, the electricity price will be a free market price, except for small scale CHP falling under a feed-in tariff scheme. It is then difficult to establish a fair heat supply price – unless it is left to free market negotiations between the CHP-company and the district heating supply company. Fuel consumption varies from day to day depending on the ratio between heat output (determined by district heating demand) and electricity output that day.

In its Year 2003 Annual Report, PUC does not explain the rationale for its choice of tariff setting methodology, limiting itself to the following description:” In the CHP sector the Commission’s methodology provides a special approach for new CHP plants which have just started operating or are in operation for not more than 10 years. For such plants electricity and heat energy generation tariffs are set according to internal rate of return on investment for 10 years, which is specified in the methodology. The rate of return is specified in such a way that during useful service of the CHP plant the investor would recover the funds and simultaneously the tariff would not exceed the benchmark level of an efficient CHP plant. For CHP plants, which are in operation for more than 10 years tariffs are set for a three year period limiting the average profitability of the capital employed, as well as imposing the criteria of benchmark level against an efficient CHP plant. Such tariff setting periods and calculation principles of capital costs constitute economically justified and proportionate support for development of CHP.” The methodology is explained in general provisions of CHP methodology. PUC believes that it gives a clear signal to investors and a higher predictability compared with the approach, which was used before.

Both PUC and the municipal regulators contest the division of labour in district heating. PUC is interested in regulating the whole district heating chain when heat is produced in cogeneration plants. Municipal regulators are interested in taking over the regulation of CHP-plants also, at least the regulation of CHPPs below 4MW capacity since their electricity tariffs are fixed in Energy Law or Regulations of Cabinet of Ministers. In addition, municipal regulators are arguing that the approval of the heat tariff of CHPPs with installed capacity above 4 MW would be approved jointly by PUC and the relevant municipal regulator, whereas PUC would set the electricity tariff alone. The joint-decision proposal seems to be impractical, and it is difficult to see what value added is brought by the involvement of the municipal regulator in tariff approval. They can, however, provide valuable contributions in the discussions and consultations on appropriate tariff-setting methodologies for CHP.

The regulatory framework and role of different state institutions in regulation of energy sector is shown in Table No.2.

Table No.2
Role of institutions in regulating the energy sector

	PUC	Ministry of Economy	National Energy Inspection	Energy Consumers' Committee
Setting of the policy				
Setting of the sector policy	X			
The holder of State shares of "Latvenergo"	X			
Economic regulation				
Licensing (issuing licenses, registering of licenses)		X		
Surveillance of the conformity of public utilities to the conditions of a license, definite quality and environmental protection requirements, specifications, standards, and provisions of the contract		X		
Determining tariff calculation methodology		X		
Determining tariffs		X		
Preliminary extra judicial discussion of dispute		X		
Technical regulation				
to control the inspections of assembling quality, reliability and exploitation of the objects of energy supply utilities and energy utilization equipment and devices, as well as appropriate and timely performance of any such inspections			X	
to control and supervise assessment procedure of the equipment used in supply of electricity, gas and heat energy and existence of relevant compliance proofs at energy supply utilities			X	
to check and supervise fulfilment and compliance with the requirements on electricity, gas and heat energy quality			X	
to participate in investigation of accidents in electricity, gas and heat energy supply systems and in the work of investigation commissions of accidents			X	
Protection of interests of all groups of energy users in energy supply and energy regulation				
To issue information and reports to the PUC on the situation at energy supply utilities if that relates to the interests of energy users				X
To co-operate with public organization of energy user interest protection				X
To provide information to energy users				X

3.5.3 Regulatory approach of PUC in energy sector

The conditions of licenses issued by PUC are standard, being extracts from the regulations of Cabinet of Ministers, Energy Law, Law of Regulators of Public Services and regulations of PUC. PUC does not tailor-make licenses defining special performance parameters that are specific for the energy company and license area.

The balance between uses of direct regulation versus active promotion of competition has been tilted towards the former in the energy sector. For reasons largely outside its control, and explained in the preceding sections, PUC has had little opportunity to develop an active policy for promoting competition. PUC has, however, by some been criticized for delaying the issuing of the license to the transmission system operator, TSO, as a legally separated company in accordance with EU Electricity Directive. PUC waited 6 months after the electricity company Latvenergo applied for the license. By then, the Government stopped the process of establishing a TSO as an independent entity. First in mid- year 2004 the government again set a task to form independent TSO.

PUC uses “state-of-the-art” methodology in setting tariffs for electricity, natural gas and heat produced in CHPP with capacity above 4 MW. Methodologies are based on a common approach using price caps and the regulatory rate of return method, where the rate is fixed by PUC according to the costs of capital. Latvijas Gaze, for example, is allowed a higher rate of return than Latvenergo because of its higher cost of capital: Latvenergo uses a higher share of loan finance, which is cheaper than equity finance, while loan finance in the case of Latvijas Gaze is limited. The authorized rate of return on equity is similar for both companies. The cost allocation model ensures price setting for each technological stage of the service provision process - generation (electricity), storage (gas), transmission, distribution, and sales.

Prices for CHPP and RER-E (electricity produced from renewable electricity resources) are defined in Energy law and Regulations of the Cabinet of Ministers. The tariff for TSO includes a fee for covering the costs associated with the feed-in-tariffs for small independent electricity producers so that also “eligible consumers” share in paying their part of the costs of these small independent producers.

A debated issue in setting the gas tariff in Latvia was the subscription fee. The subscription fee in the new tariff structure approved in 2003 is the same for all consumers, supposedly reflecting fixed or constant costs. The primary motive in Latvia for this policy is said to be social policy: to reduce the subscription fee for households. Yet, since at the same time from July 2003 and the next three years there is to be an increase in gas tariffs, the policy is also in line with the EU tendency to decrease constant costs of consumers and increase variable costs as a means to promote more effective fuel use..

The CHP tariff methodology is a mixture of 3 different methods - cost based, price ceilings and price cap methods.

Although regulators in Lithuania and Estonia do not set gas tariffs for industrial consumers, due to existence of inter-fuel competition, the approach is defensible in Latvia.

An example of “overregulation” is found in PUC’s policy of setting a maximum price for LPG supply. In 2004 PUC has adopted new methodology and approved new maximum tariffs applicable for wholesalers. Retail price has not been regulated before and will not be regulated in future. Companies working in a liquefied gas sector are not monopolists. The 70 companies involved in LPG gas storage, filling and sales services provide sufficient competition. None of the liquefied gas companies can significantly influence the price. In accordance with the EU requirements, LPG is a normal excise good in Latvia and that means that licensing and regulation activities should be carried out by excise goods authority. In other EU member states LPG is not included as a responsibility of energy sector regulators and PUC is moving towards this free market pricing policy also.

3.5.4 Evaluation: results and recommendations

PUC’s performance can be benchmarked against results in four areas: tariffs, service quality and promotion of competition.

A comparison with the electricity and gas tariffs charged in Estonia and Lithuania shows that PUC is doing well:⁴⁸

- The average monthly electricity bill for residential consumers with VAT and measured at average consumption levels amounts to 6.7 Euro in Latvia, 7 in Estonia and 8.4 in Lithuania.
- The average monthly electricity bill for an industrial consumer with a peak demand of 8 MW and 12 GWh of annual consumption amounts to 35,000 Euro in Latvia, 68,000 in Estonia and 51,000 in Lithuania. For a medium sized industrial consumer with peak demand of 0.3 MW and 1.3 GWh annual consumption the figures are: 4,400, 4,900, and 5,300 Euros.
- A household using gas for everyday consumption faces a monthly bill of 25, 29, and 32 Euros respectively.
- A medium sized industrial consumer with an annual consumption of 150,000 m³ per year faces a monthly bill of 1440, 1660, 2000 Euros.

Thus, in this ranking, based on electricity tariffs as per January 2004, Latvia comes out with the lowest tariffs. One should note though, using second half of year 2003-tariffs, Estonia has the lowest energy prices with Latvia being second.

No data is available for this report, permitting a judgement on results achieved in improving the quality of service, and in evaluating investment levels; appropriate benchmark figures with e.g. Estonia and Lithuania would have to be secured first.

⁴⁸ Source for quoted data: “Prospects of Baltic Power Markets”, Power Point Presentation by PUC-Chairman Prof. Inna Steinbuka, Tariffs in effect per January 1, 2004.

PUC has been unable in bringing competition into the gas and power sector; in this area Latvia is clearly behind Estonia and Lithuania. But, with the recent increase in tariffs and the rationalization of the tariff structure, and the increase in market opening in the power sector, PUC has at least provided a framework for competition to develop.

Areas meriting attention are:

1. A holistic energy sector development policy has not yet been developed by the Ministry of Economy. Only in electricity sector there is an approved sector development policy. In natural gas and heat supply sectors there are not set clear sector development guidelines because the sector development policy is not clearly defined. This policy void risks giving some friction in regulation.⁴⁹
2. Under the present structure, with Latvenergo still being an integrated near-monopoly and most alternative generation coming from CHPPs and renewable energy generators with fixed feed-in-tariffs, "all" domestic power generation is subject to tariff control, leaving no interest to look for direct sales to final consumers. Competition, therefore, has to come from imported generation.

⁴⁹ PUC has been criticized by some for regularly informing the public that tariffs in electricity are increasing because small independent electricity producers receive a supported purchase price. Since new generation from small independent producers amounted to no more than 2-3 % of the total, of which RER-E (electricity produced from renewable electricity resources) represented 1-1,5 percentage points, the claimed impact seemed a bit out of proportion and gave messages contradicting the energy sector policy goal of promoting generation of RER-E.

3.6 Regulation of Postal Services

3.6.1 Industry structure and privatisation

The postal services shall be divided in three groups – the reserved postal services⁵⁰, the universal postal services⁵¹ and additional postal services⁵². An incumbent postal operator - non-profit organization state owned joint stock company "Latvijas Pasts" has a right to provide reserved postal services as well it has an obligation to ensure the provision of the universal postal services in a whole territory of the state at the uniformed tariffs. Other postal operators are allowed to provide reserved postal services at a tariff not lower the minimal tariff set on EU Directives and Postal Law (in accordance with the Postal Law now the minimal tariff for the lowest weight class postal sending for the alternative service provider is three times bigger than for "Latvijas Pasts", but since 1st of January 2006 it will be two and half times bigger.

"Latvijas Pasts" has an exclusive right to issue postal stamps and other postal service payments notes in the Republic of Latvia, as well as retire these notes.

Today in the postal service sector the competition is in additional services and postal parcel service fields – besides "Latvijas Pasts" there are 29 private enterprises operating in these fields according to licenses issued or general authorizations registered. Among them there are some local branch offices of well-known international companies like TNT, DHL and UPS. These licensed private postal operators mostly operate in domestic and international express service market, in which "Latvijas Pasts" has comparatively small market share – over 20 % in average, but in international express service market just 5 %. It reflects that in competitive market "Latvijas Pasts" has substantial competitors. The general division of postal services according to the market accessibility schematically shows the Figure 3.

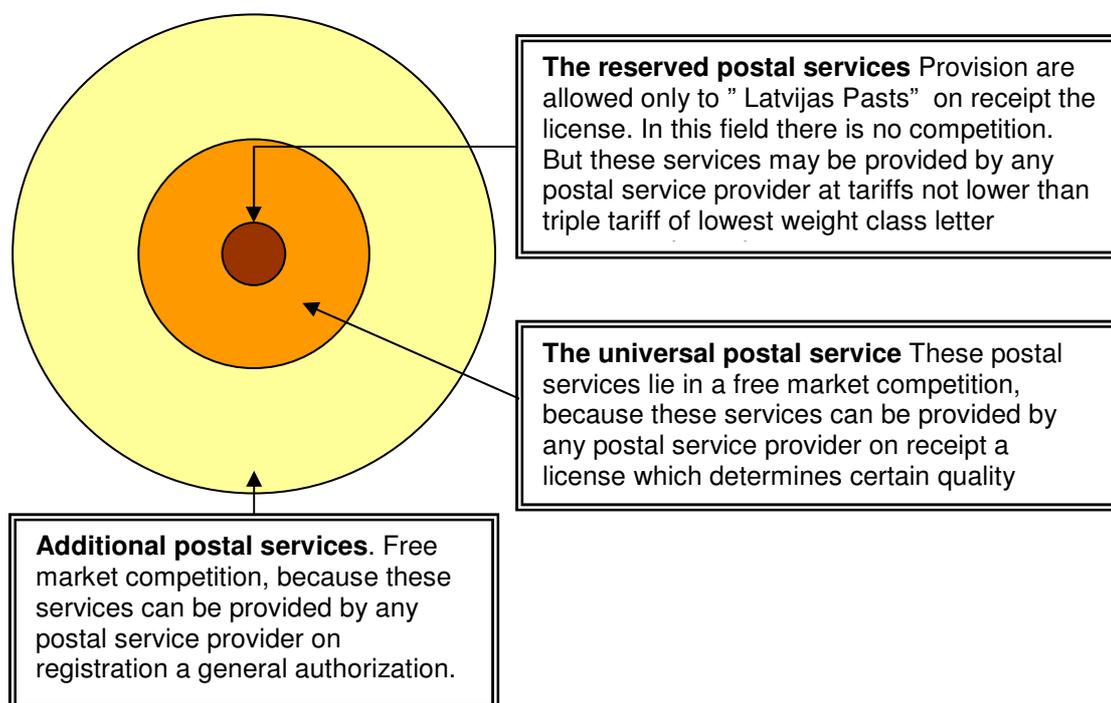
⁵⁰ According to the Postal Law **reserved postal services** are domestic and international letter correspondence items (postcards, letters, printed matter and small packets) up to 100 g, but from 1st of January 2006 domestic and international letter correspondence items (postcards, letters, printed matter and small packets) up to 50 g.

⁵¹ According to the Postal Law **universal postal services** are domestic and international letter correspondence items (postcards, letters, printed matter and small packets), including registered or insured items; domestic and international postal parcels (up to 10 kg), including insured parcels, which conform to the minimal requirements regulated in the Postal Regulations in relation to collection, sorting, carriage and delivery.

⁵² According to the Postal Law **additional postal services** are services that are unambiguously differentiated from universal postal services, which are characterised by additional added value and which, in addition to faster removal, transportation and delivery, have one or more of the following additional service features:

- 1) acceptance of correspondence directly from the sender;
- 2) delivery of correspondence personally to the addressee, or his or her authorised representative;
- 3) ensuring delivery by a specified date;
- 4) possibility of changing the final destination and addressee during transit;
- 5) confirmation of the fact of delivery to the sender;
- 6) an individual approach to clients;
- 7) the offer of services depending on requirements.

Figure 3
The scheme of postal services division according to market accessibility



3.6.2 Government sector policy and key regulatory issues

Postal sector policy for the period 1998 – 2003 was approved by Government and wasn't prolonged. In lieu of it Ministry of Transport prepares new Government postal sector policy draft for the period 2004 – 2008, which at this moment is in elaboration process. Guidelines set in the EU legislation for liberalization of postal sector are transposed in the Postal Law. It is determined that since the accession to EU the scope of the reserved postal services provided by "Latvijas Pasts" should be reduced from domestic and international letter correspondence up to 100 g. But from 1 of January 2006 the scope of the reserved postal services provided by "Latvijas Pasts" shall not exceed domestic and international letter correspondence up to 50 g.

"Latvijas Pasts" has an obligation to ensure the provision of the universal postal service in conformity with certain quality standards in the whole territory of the state to all clients at economically based tariffs. Tariffs should be uniform in the whole territory of the state.

Postal Law defines that the universal postal service consist of domestic and international letter correspondence (post cards, letters, printed matters, small postal packages), including registered and insured items, as well as domestic and international postal parcels (up to 10 kg), including insured items. But accordingly to Regulations on Types of Regulated Public Services (Governmental Regulations adopted on 3rd of July 2001) in the postal service sector there should be regulated following services:

- domestic and international common post cards;
- domestic and international common letters;

- domestic and international common printed matter;
- domestic and international common small postal packages;
- domestic and international postal parcels;
- domestic and international express parcels;
- domestic and international express letters.

It's obvious that above mentioned Governmental Regulations brings under regulation only the common letter correspondence but doesn't identify as regulated registered and insured letter correspondence. Therefore, the Regulations on Types of Regulated Public Services are contradictory to Postal Law, which determines that PUC issues a license thus ensuring regulation of the provision of universal postal services.

Economical and technical regulation of postal sector is done by PUC. The regulatory framework and role of different state institutions in regulating the postal service sector is shown in Table No.3.

Table No.3
Role of institutions in regulating the postal sector

	Ministry of Transport	PUC
State policy		
Setting of sector policy	X	
Development of drafts of state policy and legislative acts, as well as realization of state administration functions	X	
Holder of state shares of state owned joint stock company "Latvijas Pasts"	X	
Economic regulation		
Licensing (issue of licenses, registration of general authorizations)		X
Supervision of how provided public services meets the requirements of licenses/ authorizations, quality and environmental requirements, technical rules and standards as well as rules of agreements		X
Approval of tariff setting methodology		X
Setting the universal postal service tariffs		X
Setting of minimal tariff of added postal services		X
Pre court solution of disputes		X
Technical regulation		
Quality control of postal services		X

3.6.3 Regulatory approach of PUC

According to the Law “On Regulators of Public Services” and Postal Law, PUC has the following instruments for regulation of postal sector:

1. To issue licenses for providing of universal postal services and register general authorizations for additional postal services and postal services which are not included in universal postal services. All licenses preliminary issued to postal operators which provide only postal services outside the universal postal service should be registered as a general authorization before 1st of May 2005.
2. To set universal postal services tariff calculation methodology;
3. To set universal postal services tariffs. Before changes in Postal Law PUC set the tariffs of the reserved postal services only. Nevertheless the changes on Postal Law reduced the scope of reserved postal services, but at the same time increased the scope of services which tariffs should be set by PUC. Now PUC has rights to set the tariffs of the universal postal service instead of rights to set the tariffs of the reserved postal services only. So PUC has undertaken the regulation of the tariffs of the part of universal postal service that already lie in a free competitive market and which tariffs thus in fact should be regulated by free competitive market supply – demand rules. If PUC sets the tariffs of the part of universal postal service, which already lie in a free competitive market, PUC doesn't promote the competition in the postal service sector, but over the left rather derogate the competition in this sector.
4. To determine the lowest tariff rate for the additional postal services and postal services which are not included in universal postal services;
5. To control how universal postal service quality requirements are being met. Since 2002 PUC introduced special actions to control how much letter correspondence items in Latvia are being delivered to addressee within five days as it is stipulated in legislation. In 2002 PUC sent 200 control letters all over the Latvia's territory, but in 2003 already 800 control letters. However the results of these control letters are not reliable enough, because in 2002 the number of control letters made approximately 0,0004 % of whole domestic letter correspondence delivered by “Latvijas Pasts”, but in 2003 approximately 0,0016 %.

3.6.4 Evaluation: Results and shortcomings

In general PUC performs its functions in postal sector, but there are following shortcomings that must be solved:

1. PUC sets the tariffs of the part of universal postal service which already lie in a free market thus derogating the competition in postal sector and contradicting with one of PUC's functions – to promote the competition. PUC should keep rights to set only the tariffs of the reserved postal services.

2. Regulations on Types of Regulated Public Utility Services approved by the Cabinet of Ministers are in contradiction with Postal Law. Ministry of Transport should develop and after preliminary approval with Ministry of Economy should submit to the Cabinet of Ministers for approval the appropriate changes in Regulations on Types of Regulated Public Services harmonized the Postal Law.
3. It should be considered (by Ministry of Transport having discussions with Ministry of Economy and PUC) whether PUC have enough expert capacity and competence to regulate postal services as well as whether or not to start deregulation process in postal sector.
4. 5. In Postal division of PUC there is only one employee fully occupied with the postal sector as well as some other involved with postal issues. Therefore, PUC should consider whether they have enough expert capacity to regulate postal services.
5. Sector legislation and the law "On regulators of public services" should be improved in order to eliminate the possibility for free interpretation on specific provisions. For example, first part of Article 9 of the law "On regulators of public services", specifying the functions of PUC, is not precise regarding tariff setting: 2) determine tariff calculation methodology; ... 3) determine tariffs, if sector specific laws do not envisage a different tariff setting procedure; In the same time, as stated before, Article 19 contains the tariff setting procedure, according to which the function of PUC is to approve the tariff proposals submitted by regulated service providers. It is therefore necessary to supplement section 3 of Article 9 with more detailed function description - "approve the tariff proposals submitted by regulated service providers, or determine tariffs, if sector specific laws do not envisage a different tariff setting procedure".

It should be concluded that in July, 2004, Ministry of Transport have elaborated the draft Policy paper on development of Postal sector which has been submitted to the major operators in postal sector as well as to the PUC and "Latvijas Pasts". Within two weeks these institutions will submit their comments on the draft version of this draft Policy paper to Ministry of Transport.

3.7 Regulation of Railway

3.7.1 Industry structure and privatisation

It is possible to divide the railway industry structure into three provided types of services: passenger carriers, cargo carriers and the use of public railway infrastructure. The existing legislative acts of the railway sector provide free access to the railway infrastructure. 11 licenses have been issued for railway carriers: 5 of them – for passenger carrier, 6 of them – for freight carrier. The market of public railway infrastructure usage is a natural monopoly one and is operated by State Joint Stock Company “Latvijas Dzelzceļš”.

In the domestic passenger transportation there has always been one incumbent operator – State Joint Stock Company “Latvijas Dzelzceļš”, which after restructuring of “Latvijas Dzelzceļš” passed its functions of domestic passenger transportation to the subsidiary joint stock company „Pasažieru vilciens”. Narrow-gauge railway non-profit LLC “Gulbenes-Aluksnes banītis” provide passenger transportation only in one bay: Gulbene-Alūksne. The entry of new carriers into market of domestic passenger transportation is difficult as large investments are necessary to provide the service, and as shows the experience of other countries domestic passenger transportation is almost impossible without the support from the state and local governments.

There might be certain competition in the market of international passenger transportation if the transportation would be carried out by all the companies having a license for passenger carrier by the railway. At present the services of international passenger traffic is supplied by SJSC “Latvijas Dzelzceļš” and its subsidiary stock company “Starptautiskie pasažieru pārvadājumi”. LLC “L-Ekspressis” has not started operating yet.

Freight transportation has been carried out by „Baltijas ekspresis”, “Baltijas tranzīta serviss” un “Latvijas Dzelzceļš”, but the SJSC “Latvijas Dzelzceļš” still have the dominant position in the market.

3.7.2 Government sector policy and key regulatory issues

Railway sector policy guidelines are defined in the National program for transport development for years 2000-2006. Considering the important role of transit for the national economy, the strengthening of infrastructure on the main transit railway corridors in the east-west direction is one of the priorities in the railway sector. For a successful development of the sector, transition to the market economy principles will be ensured which would allow properly maintaining the infrastructure, renovating the rolling stock, and performing safe and environmentally friendly transportation.

Railway law on equal principles foresees that public railway infrastructure is open for freight and passenger transportation or for ensuring other technological operations.

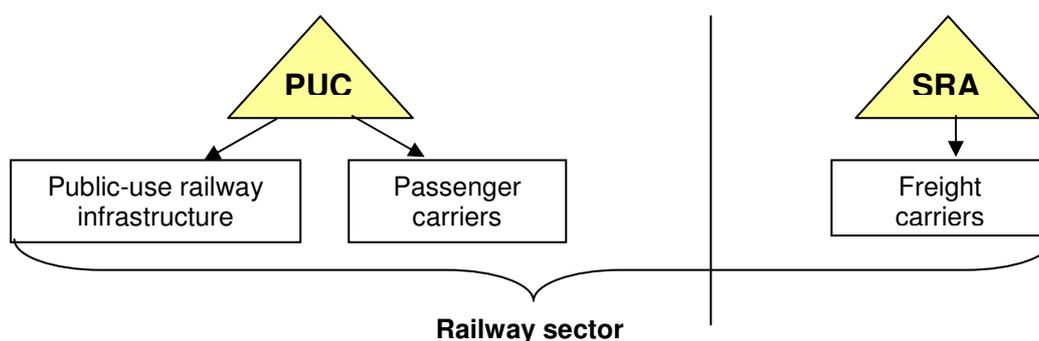
Regulation of railway sector is split between three regulators: PUC, State Railway Administration and Technical inspection of State Railway. The detailed role of mentioned institutions in regulating railway sector is shown in a Table No. 4.

Two regulators PUC and State Railway Administration (SRA) do economical regulation (see Figure 4). It should be admitted that maintenance of two regulators performing the functions of economic regulation within one sector is irrational from the point of view of efficient use of financial and human resources. In this case, there is also a possibility of using different approaches in the regulation of public service providers. In the disputes with the management of infrastructure regarding the access to the infrastructure, the rights of the carriers are being represented by two different regulators. Besides, only public railway infrastructure, services by which do not comply with the status of the public services as are provided to the legal entities not individuals (inhabitants), corresponds to the understanding of regulation in the railway sector as mentioned above.

PUC is the regulator in a wide spectrum of areas, including energy supply, gas supply, telecommunications and etc., but the Railway regulation is two-tier: International passenger carriers are subject to partial regulation, whereas carriage yards and depots are not subject to any regulation. Such practice is contradictory, since the costs of railway passenger transportation operators include the costs of repairs of trains in tariff calculations, the amount of which is fixed by the depots making repairs.

In general, profit and losses are calculated by the companies which are economically regulated by the PUC and technical regulation is provided by Railway Administration and railway technical inspection, but tariffs are coordinated with PUC, including the payment for use of infrastructure in accordance with PUC methodology. Hence, payment for use of infrastructure by freight and passenger carriers according to the planned mileage covered is not made equally; as a result, indirectly the cross-subsidies are taken from freight carriers in favour of passenger carriers.

Figure 4
Economical regulation of railway sector



The regulatory framework and role of different state institutions in regulating the postal service sector is shown in Table No.4.

As it is obvious from the Table No.4 some regulatory functions (such as Promotion of competition in the sector of railway transport and discussion of disputes between public-use railway infrastructure manager and carriers on several regulatory issues) are overlapping between PUC and the State Railway Administration. For some extent State Railway Administration is also involved in sector policy determining activities, which must be purely the responsibility of Ministry of Transport.

Table No.4
Role of institutions in regulating the railway sector

	The Ministry of Transport	PUC	State Railway Administration	Technical Inspection of State Railway
Determining of Policy				
Implementation of state policy according to the National Transport Development Program	X			
Implementation of state administration			X	
Development of policy for railway environment to be approved by the minister for transport and communications			X	
Holder of state shares of SJSC „Latvijas Dzelceļš”	X			
Economic Regulation				
Promotion of competition in the sector of railway transport		X	X	
Issue a carrier licenses: for performing carriage of passengers by rail		X		
for performing carriage of cargo by rail			X	
Surveillance of the conformity of public utilities to the conditions of a license/ permit, definite quality and environmental protection requirements, specifications, standards, and provisions of the contract		X		
Assignment of a method for calculation of fee for the use of public-use railway infrastructure		X		
Assignment of a method for calculation of fee for carriage of passengers		X		
Determining the charge of the use of infrastructure		X		
Discussion of dispute between public-use railway infrastructure manager and carriers on the collection of charges for the use of public-use railway infrastructure, and informing of the State Railway Administration about it.		X	O	
Discussion of disagreements between public-use railway infrastructure manager and carriers on the distribution of the infrastructure capacity and access to the public-use railway infrastructure, and informing of the PUC about it.		O	X	
Preliminary extra judicial discussion of dispute		X		
Coordination of draft contracts on order of freight traffic by rail			X	

	The Ministry of Transport	PUC	State Railway Administration	Technical Inspection of State Railway
Registration of contracts concluded on order of freight traffic by rail and control of their execution			X	
Efficient and rational promotion of carriers' activities			X	
Approval of program of action for the policy of railway environment protection; maintenance of environmental protection self-control system			X	
Registration of infrastructure			X	
Registration of rolling stock			X	
Technical regulation				
Assessment of danger caused by railway infrastructure to the human health and to the environment, and taking the necessary measures to reduce such danger			X	
Control of fulfilment of requirements set out in laws and other regulatory enactments related to railway operation and its safety				X
Control of preparedness and operation of the systems for railway civil protection and for prevention of emergency situations (conditions) and elimination of the emergency consequences				X
Investigation of train and manoeuvre emergencies and offences and participation in the investigation of railway accidents				X
Control of organization and performance of elimination of the consequences of rolling stock accidents				X
Control of putting into operation of new or rehabilitated railway infrastructure units and verification of their conformity with the requirements of technical operation of railway and labour protection regulations				X
Issue of safety certificates to the carriers				X
Issue of safety certificates				X
Issue of certificates on professional expertise in the regulated sectors				X

3.7.3 Regulatory approach of PUC

According to the Law “On Regulators of Public Services” and Railway law PUC has following instruments for regulation of railway sector:

1. To issue licenses for passenger carriers and to supervise the adherence to the license conditions. To obtain the information about the conformity of carriers to the conditions of issued licenses PUC must not only to control carriers but also must cooperate with State Railway Administration and Technical Inspection of State Railway and institutions which are responsible for environmental protection. Unfortunately, this cooperation mainly is based on “good wish” in spite that it should be determined.
2. To set public railway infrastructure usage fee calculation methodology.
3. To take decision on dispute between public-use railway infrastructure manager and carriers on the collection of charges for the use of public-use railway infrastructure, and informing of the State Railway Administration about it.

Public railway infrastructure usage fee is set by the public railway infrastructure manager on the basis of the fee calculation methodology. In case owner of infrastructure is not separated from the carrier as it is now with “Latvijas Dzelzceļš”, cost for the infrastructure is determined by PUC. Carriers is administratively and economically independent when determining its railway transportation service and transportation fees. PUC has a right to give its opinion on tariff proposals and draw attention of the companies to possible risks of the proposal.

3.7.4 Evaluation: Results and shortcomings

It should be concluded that:

1. There is no proper competition between railway carriers in passenger carriage in spite that the current situation in mentioned sector formally “complies” with the law “On Railways”. Competition in this sector is mainly between passenger carriage by railway and bus carriers.
2. To some extent competition exists in freight carriage by railway.
3. At the moment the functions of economic regulation of railway transport sector have been divided between two institutions – PUC and Railway Administration, separating the regulation of freight traffic from the regulation of carriage of passengers; this is an irrational solution both from the financial and human resources viewpoints. Exist a possibility of using different approaches in the regulation of public services providers in railway sector. Moreover, in the disputes with the management of railway infrastructure regarding the access to the infrastructure two different regulators are representing the rights of the carriers. One solution to rationalize the regulatory environment in Railway sector is to

share the functions of State Railway Administration between PUC, Technical Inspection of State Railway and Ministry of Transport (Railway department). In that case the capacity of PUC (Railway department consists of two employees, also the railway expert is not represented in PUC Council) must be seriously strengthened. Other possibility is to create "strong" and independent Railway Administration, which will deal with all regulatory issues in Railway sector, except determining of sector policy and technical regulation. In this case the risk that during reorganization some "regulatory gap" will be created is much lower.

4 The Municipal Regulator

4.1 Governance Framework for Municipal Regulation

The Governance framework for the regulation of “municipal services” is defined by:

- The Law “On Regulators of Public Services”, which makes the municipality responsible for regulation of public services in the areas of: (i) management of solid waste, except processing of solid waste; (ii) water supply and sanitation; (iii) district heating where the production process of heat energy does not include production of electrical energy.
- The Law “On Motor Vehicle Transportation”, which assigns roles to PUC and to local municipalities in regulating public transport services subsidized from the state budget and role to municipal regulators in regarding public transport services not subsidized from the state budget.
- Public services, not regulated by the above two laws are subject to the Law “On Local Government” and regulated according to Clause 21 of that law.
- Regulations issued by the Cabinet of Ministers with reference to the above laws.
- Regulations issued by local Governments in accordance with these laws, inter alia defining the types of local public services that need to be regulated.

The Law “On Regulators of Public Services” obliges the local government to perform its regulatory responsibilities through an outside institution, called the “municipal regulator”. The local government determines by resolution the composition of the municipal regulator and the organizational structure of an executive body. The resolution shall appoint the Chairperson of the municipal regulator and at least two members for a period of four years. The applicants for the office shall be selected by the local government by means of competition. In terms of organization, the law offers two options:

- a) A local Government can set up “its own regulator” via tender and contract the winner
- b) Local governments can by mutual agreement form a joint municipal regulator who operates on the basis of the Regulation approved by the relevant local governments. The members of the municipal regulator set up jointly by several local governments may be appointed either by each local government or by a meeting of representatives of the local governments that established the joint Regulator.⁵³

According to the Law “On Regulators of Public Services”, the municipal regulator has to perform the following functions:

- a) to protect the interests of the users and to promote development of public service’s providers;

⁵³ Presumably, this option also enables a local government to enter into contract with PUC on regulating public services in the administrative territory of the relevant local government. The duty for public services’ regulation paid into the budget of the respective local government shall in that case be transferred to PUC.

- b) to fix tariffs, if the special laws of the sector do not provide for other tariff calculation procedure;
- c) to licence provisioning of public services;
- d) to carry out preliminary extrajudicial examination of disputes;
- e) to promote competition in the regulated sectors and to supervise compliance of public services with the conditions of the licence, specific quality and environmental protection requirements, technical specifications, standards and other contract provisions;
- f) at the request of the ministries responsible for the regulated sectors to provide information and make proposals to such ministries regarding matters on public services' regulation;
- g) inform the public of its activities and also of the activities of public services' providers in provisioning of public services;
- h) to perform other functions as set out in special laws of the sector.

In the local government regulated sectors, the municipal regulator licenses the regulated companies⁵⁴, supervises their service performance and approves their tariffs. The regulator is to be independent from the municipality in decision-making and issuance of administrative acts.

The tariffs of regulated activities are approved by the municipal regulator in accordance with procedure set out in the Law "On Regulators of Public Services". The tariff calculation methodology in the local government regulated sectors is determined by the Regulation of Cabinet of Ministers "Methodology of Calculation of Tariffs of Public Services in Sectors Regulated by Municipalities". For types of public services not mentioned in the Regulation, there is no approved methodology of tariff calculation.

The budget of the municipal regulator is financed by a 0,4% levy on the turn-over of regulated firms, which is paid into the municipal budget and transferred to the municipal regulator. The budget of municipal regulators is part of the local government's budget. The municipal regulators are responsible for elaboration of their budget (cost breakdown). Municipalities are not entitled to make amendments in budgets of municipal regulators, because a levy on regulation of public services is a transfer payment.

At national level no institution is responsible for the coordination or supervision of the work of municipal regulators; the Ministry of Regional Development and Local Governments should play a more significant role in this process⁵⁵.

Compared to international approaches to outsourcing of regulatory activities, the municipal regulator scheme represents a hybrid:

⁵⁴ For provision of public transport services in cities and districts, district council issues licences to regulated companies.

⁵⁵ According to Clause 4.2. of the Regulation of Ministry of Regional Development and Local Governments, responsibilities of the Ministry include "organization and coordination of enforcement of functions mentioned in legal acts, which regulate the municipal sector."

- The system acknowledges that the ultimate responsibility for local regulation remains with the municipality, as the municipal council identifies which local services require regulation and appoints and contracts the regulator.
- Yet, all regulatory functions associated with the regulation of these services are transferred by force, not by choice, to an external regulator.

4.2 Services to Regulate in Municipalities: Why, What and How?

4.2.1 Core functions of a municipality

Securing good quality local public services and infrastructure – roads, schools, parks, water supply and sanitation, local transportation, old age homes, etc.. – at reasonable costs to the local population is the core function of a municipality. This general rule is also stated in the Latvian legislation. In accordance with Clause 15 of the Law “On municipalities”, one of permanent functions of municipalities is organizing public utility services for inhabitants (water supply and sanitation, district heating, management of solid waste, collection and treatment of rain water). The Law on Regulators of Public Services is, therefore, correct in allocating the responsibility for the regulation of local services to the municipal Governments. The Law is less right in imposing on the municipality the compulsory transfer of all regulatory functions to an outside regulator, although it is contracted by the municipality. As shown below, a more logical and cost-effective principle is to look at the individual regulatory functions and let these be performed either by the technical departments of the municipality or be outsourced to external regulators depending on the comparative advantage of each institution.

4.2.2 Organisation of local services and type of regulation

In accordance with Clause 15 of the Law “On Local Government”, one of the permanent functions of municipalities is to organize public utility services for inhabitants in water supply and sanitation, district heating, management of solid waste, collection and treatment of rain water. The need for and ideal form for regulation depends on the specific type of service and how it is organized by the municipality⁵⁶.

Municipalities can organise the production and supply of local utility services in three ways:

- 1) The municipality can directly produce a local commercial service and supply it to local consumers charging a cost-coverage service fee for it. Municipal production and supply of a commercial service can be organised as a municipal department or as an independent legal entity in the form of a municipally owned limited liability or joint stock company.⁵⁷
- 2) The municipality can outsource the supply of a local “monopoly” service to a private service provider; either a commercial entity or a consumer-owned cooperative. The right to provide the service on an exclusive basis is awarded by competitive tender. Dependent on the type of service, the legal instrument would

⁵⁶ According to the Law “On Regulators of Public Services”, once a municipality has decided that a service needs to be regulated, according to the law all regulatory functions associated with it are to be transferred to external regulation.

⁵⁷ The independent legal person business form has well-known advantages. It gives increased transparency about the cost of service, which allows benchmarking of performance and shows the full extent of subsidization as previously hidden subsidies are brought into the open municipal budget allocation process. A company can raise funds for investments from the capital market when it is needed. A municipal department has to rely on annual allocations from the municipal budget for its investments.

be either a concession (based on Concession Law) or a service contract, which defines the rights and obligations of the private service provider.⁵⁸

- 3) Local services of public interest, offered on a non-exclusive basis by competing private firms, may be subject to municipal authorisation.⁵⁹ Depending on the type of service, the regulatory framework can be defined by standardized authorisations (taxi) and/or by regulations that are specific for the municipality (garbage collection).

A service produced by a municipal department falls outside the framework of external regulation. A municipal department is not a legal person with independent assets and liabilities “provisioning services as an entrepreneurial activity”⁶⁰. It cannot loan-finance its investments, but must seek an allocation from the municipal budget for that purpose. This being the case, “cost-based” tariff regulation by an outside regulator can not be effectively implemented. Instead, the department is subject to direct regulation by the municipality: operating under administrative supervision by the municipal director and economic supervision by the City Council. The latter, as part of its annual municipal budget approval, approves the annual budget and investment program of the department as well as the fees it charges to consumers.

In order to enable external regulation of “entrepreneurial activities” and provide greater transparency, municipalities should transform municipal departments providing utility services into independent legal entities operating on commercial basis.⁶¹

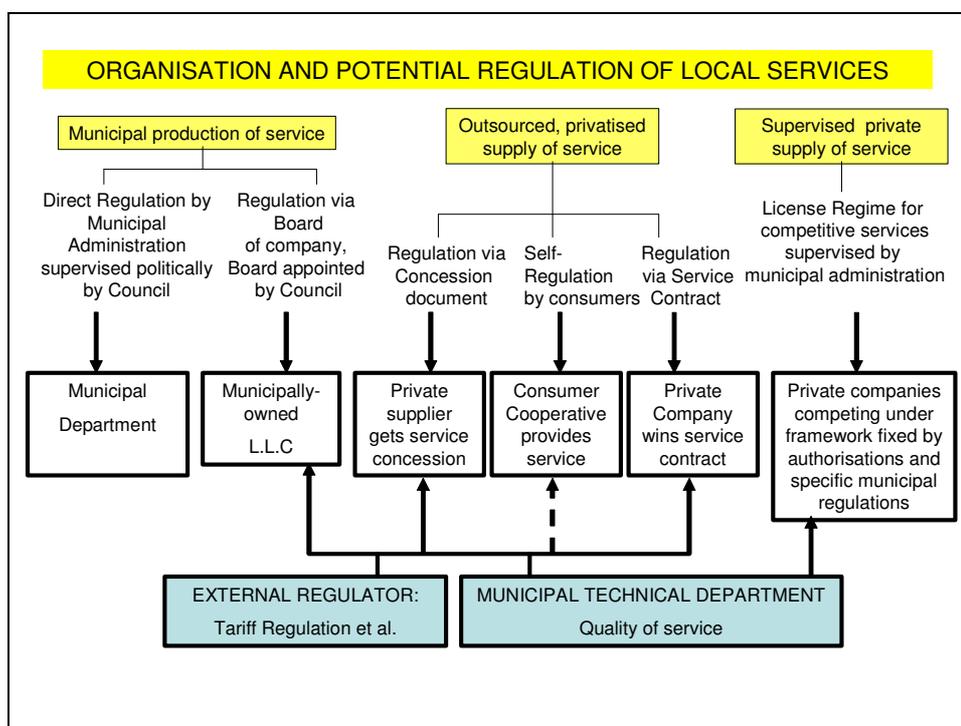
⁵⁸ In France the legal instrument for the outsourcing of a utility service like water is typically be a long-term affermage contract (where ownership of assets may rest with the municipality) whereas in the UK and most other EU countries a long-term concession/license is given to a legal entity, which owns the assets. In Denmark, municipalities sign a pluri-annual service contract with a private service provider for “non-utility services” like garbage collection and local bus routes; payments are performance-based.

⁵⁹ One example is local garbage collection contracted by households or by housing associations. The objective of municipal regulation here is to impose sanitary and environmental standards imposed by the municipality – e.g. insistence on source separation of garbage by households according to type of garbage. Another example is taxi-service. In theory, it is a competitive service, which could be left to the forces of competition. Yet, if the population wants 24-hours daily access to a taxi service and by phone, a system of authorization is warranted. A taxi driver gets a license, provided that he is willing to offer the same type of full service as other taxi companies. Otherwise, “taxi-pirates” operating purely during peak-hours would undermine the financial basis for 24-hour taxi service. Authorization also allows enforcement of transparent pricing (by rule) and to crack-down on cheating by withdrawing the operator’s license.

⁶⁰ Law “On Regulators of Public Services” section 2.(3).

⁶¹ Section 77 of the Law of Municipalities states:” Local government undertakings that provide services to residents shall operate on the basis of principles of non-profit-making organisations. If revenues of such undertakings exceed expenditures, the revenues shall be included in the reserve fund that is rolled over to the next financial year and shall be used for the acquisition of fixed assets and for infrastructure development.”

Figure 5
Organisation and potential regulation of local services



A municipally owned limited liability company or joint stock company would be supervised by a Board appointed by the City Council (which once per year in a meeting session can perform the annual shareholders meeting). Often, the majority of the board members would be drawn from politicians sitting on the Council.⁶²

An option, not encountered in Latvia, is to provide a local utility service through a consumer owned utility (in most cases organised as cooperative). Consumer owned utilities are self-regulated: a board elected by the consumers supervises the company. In some countries such utilities are not subject to economic regulation, other countries impose external economic regulation on consumer owned utilities as well or let cooperative consumer-members decide by vote whether they want their utility to be subject to external regulation by the official industry regulator. The dashed arrow in the chart indicates that the possibility for external regulation for a consumer-owned utility is an open option.

Outsourcing a local service activity by contract to a private service provider is one alternative to direct municipal production of a service; authorizing private entities to sell regulated services on a competitive basis to local households/businesses is another. In

⁶² Law on Municipalities "Section 61: For the performance of specific functions or for the administration of the administrative territory of a local government, a territorial local government city or county council (parish council) may form boards of directors, commissions or working groups from among the councillors of the territorial local government city or county council (parish council) and residents of the relevant local government"

outsourcing, the contract, drawn up by the municipality and assigned by competitive tender, defines the services to be offered and the performance standards for these services. The price, that can be charged for the services, is decided by the winning bid in the tender, although negotiations leading to a downward revision of the bid-price cannot be excluded when there is only one bidder. In an authorization scheme, the municipality issues standard regulations for service quality and performance standards; while the tariffs are a commercial outcome of free-market negotiations between households/businesses and the service provider. In this case, tariff regulation is not required, monitoring of service quality and compliance with environmental standards is.

Finally, “supervised private service delivery” such as taxi service, is not regulated by a specific service delivery contract, neither with municipality nor with consumers, but by the terms of a general operating “authorization”. It falls outside the Law on Regulation.

Despite the variety in the organisation of local services, the Law “On Regulators of Public Services” does not distinguish between concessions/licenses, service contracts and authorizations, using a single term “license” for all regulated activities. In addition, it assigns the whole scope of regulation - issue of the legal documents, tariff approval and monitoring of service quality - to the municipal regulator (article 9.4). The law does not reflect sufficiently on the “why”, “what”, “how” and “by whom” of local service regulation.

Since municipalities are responsible for “organising local service supply”, and municipal politicians are elected by the local population to provide high quality local services at low cost, **“why” is external regulation of local services needed?** The argument is improved quality, a municipality may under-perform in the execution of its regulatory function for a number of reasons:

- 1) Lack of local competence in the outsourcing of services and in their legal and economic regulation makes municipalities under-perform in undertaking the core function of local service regulation.
- 2) There is a risk of populist political opportunism leading to political rather than economic regulation. Particularly in election years, there is a risk that politicians will deny regulated utilities approval of justified tariff increases. Such short-terms may be a good re-election strategy, as the negative consequences in terms of lower quality of service or higher tariffs first appear in the longer run.
- 3) A utility organised as a municipally owned limited liability company (LLC) or joint stock company (JSC) is supervised by a Board appointed by the City Council. The Board, acting on behalf of the municipality to protect the interests of consumers, has direct responsibility over the affairs of the company, appointing the company director and approving major company decisions such as annual investments and tariffs. This direct regulation is, in principle, the strongest form of consumer protection: it eliminates the problem of asymmetric information. But there is a risk of management complacency due to lack of professionalism of politically appointed Boards and due to the absence of competitive pressure on the company. Tariff regulation by an independent regulator is justified to put pressure on performance.
- 4) Risk of corrupt local politicians who sit on utility boards and tender committees.

- 5) Local resistance to commercialisation and privatisation of municipal service supply, which the state wants for national economic efficiency reasons.

From the above, three types of external regulator functions can be identified:

- 1) Technical assistance -service provider (first structural problem);
- 2) Municipal watchdog (the next three structural problems);
- 3) Industry restructuring and privatisation enforcer (the last structural problem).

In the TA-function, the concept of full regulatory transfer to an external municipal regulator competes with the alternative of providing backstopping TA to regulation by the municipality. In the watchdog function it competes with alternative of limiting external regulatory functions to the critical areas of tariff approval, and monitoring the organisation of tenders. In the enforcer function, which the Latvian municipal regulator is incapable of fulfilling, the alternative is a state nominated regulator entrusted with a strong mandate and instruments for restructuring.

That external regulation can add value to exclusive regulation by the municipality is not enough to justify contracting an external regulator. The added value to consumers of external regulation must be higher than the associated increase in the cost of regulation (= result in net value added). This is not a likely outcome, unless external regulation is focused on those aspects, where external regulation is cost-effective compared to alternatives. A detailed analysis would:

- map the functions in required municipal regulation;
- for each function evaluate the comparative advantage in performing the function of the external regulator versus the municipal regulator (with TA included, where needed);
- estimate the cost of the external versus municipal performance of the function
- for those functions, where the external regulator holds the comparative advantage, make a qualitative judgement of whether the higher cost – if there is any – of external regulation is justified by the added value.

Thus, Latvian policy makers must reflect on both “what” is to be regulated externally and “how”?

The **“what” is to be regulated by an external regulator** question touches various issues.

1. What services need regulation, and which of these need external regulation? The laws on Regulation and on Local Government list water supply and sanitation, district heating, public transport and solid waste management. The inclusion of the first three is understandable: water and district heating are capital intensive long-term infrastructure; regulation of transport is intrinsically difficult. The inclusion of waste management, on the other hand, is questionable. Solid waste management is carried out by a mixture of private and municipal operators⁶³

⁶³ Domestic waste management is typically vertically separated, with different functions being undertaken by different companies in the chain, some of which can be private, others municipal. Garbage collection is “always” done by a private operator, final deposit is normally done in a municipal landfill, while the in-

hired by the municipality under short-term, one-year or pluri-annual “service contracts” awarded by competitive tender. Due to the short-term nature of the contracts, and the absence of any need to protect long-term infrastructure investments, tariff regulation by an external regulator is not needed. The tariff is decided by the tender - and service quality depends on local preferences.

2. Which business forms can be subject to regulation by an external regulator? A service produced by a municipal department or by a consumer owned utility falls outside the framework of external regulation.
 - a. A municipal department does not ensure “provision services as an entrepreneurial activity” (Law on Regulation section 2.3). The commercial business form enables external regulation to take place and increases the transparency of⁶⁴ and accountability for⁶⁵ the cost and quality of service supply.
 - b. Consumer owned utilities are self-regulated: (a) a supervisory board elected by the consumers monitors management efficiency; (b) over-charging cannot take place as “super-margins” are paid back to consumers. There is no justification for external regulation except when public subsidies are involved.

3. Which regulatory functions are to be entrusted to the external regulator and which are better – or cheaper - performed by a municipal department? Some Latvian regulatory experts hold the view that external regulation must be “comprehensive (meaning encompassing all regulatory functions) in order to provide maximum protection to consumers”. This view, accepted in the Law “On Regulators of Public Services”, confuses (a) the fact that regulation has to be comprehensive with (b) the need to entrust all regulatory functions to the external regulator. Municipal regulation can more effectively be performed by a division of labour between municipal technical departments and the external regulator under which the municipality does licensing and quality of service supervision, whilst tariff regulation is done by the external regulator. Local presence is a must for “quality of service” regulation, both for performing supervision and for accessibility to local consumer complaints. For tariff regulation, local presence is first of all irrelevant and secondly not recommended because of possible interest of conflict: distance provides some protection against “regulatory capture”. This recommended division of labour brings regulation de facto “closer to the people”, one of the stated aims of the municipal regulator concept in Latvia.

4. What supervisory roles and TA-functions are better entrusted to the Ministry of Regional Development and Local Governments rather than to the external regulator? The Ministry has an overall agenda in assisting local governments in organising local service efficiently, not just the few covered by the Law on

between functions of waste receipt and processing can be undertaken by a third entity, being private or municipal.

⁶⁴ Losses can no longer be hidden by cross-subsidies from the municipal budget.

⁶⁵ The company can raise loans to finance investments, which frees it from previous dependence on getting funds approved from the municipal budget before a needed investment program could be implemented.

Regulation. Outsourcing of activities and tenders for local service delivery are or can be undertaken in many other areas financed by the municipality. The Ministry, therefore, has a general interest in strengthening local expertise in organising and implementing service contracts.

The recommended division of labour between the three institutions is given in section 4.4.

The Latvian approach to **“how regulation is to be done”** is too rigid in municipal regulation. The cost of regulation in the medium and long term can be reduced and its quality improved by introducing more flexible regulatory instruments and approaches. Ex-ante regulation (approval of tariffs needed before it can be charged to consumers) can be used for some types of services and ex-post regulation (monitoring of tariff levels) in other situations, depending on their relative cost-and-efficiency effectiveness. Low-cost arrangements for appeal of regulatory decisions can be set up. It should be noted that starting from 1 February 2004 the Administrative Court is put into action. It has streamlined the appeal procedure of the regulator’s decisions (see Chapter 3.2.2. “Appeals”).

The recommended changes in the use of instruments are given in section 4.4.

4.3 Experience with the Municipal Regulator Approach

4.3.1 Status of achievement in signing contracts with regulators

By December 2004 the status of implementation is as follows:

- 17 municipal Regulators have been established in Latvia jointly by 81 municipalities.
- 121 municipalities have concluded contracts with a “single municipality” regulator
- 336 municipalities have not signed a contract with a municipal regulator.

4.3.2 Organisation of work

In most cases the municipal regulators consists of Chairman and two members (Council of Regulator), and one accountant or accountant-office manager (all together referred to as administration). The operation of Regulator is being managed by chairman, who manages and organises the work of Regulator, represents Regulator, presides over meetings, acts as manager of funds of Regulator. The council establishes the order of internal work organisation of Regulator, approves the budget of Regulator for the current year, and sets wage rates for chairman and members of council.

Council meetings of Regulator are summoned and presided over by the chairman. They are to be held not less frequently than once in a month. Extraordinary council meetings are summoned by the chairman if requested by at least two council members. Some employees are not working full time, or are employed on contract base.

Municipal Regulators employ qualified professionals with higher education, experts in engineering sciences and economics, with wide work experience in practical work. In cases of necessity, qualified experts are being involved. Regarding the Regulators of big cities (Riga, Jurmala), and merged municipal Regulators (Liepaja, Daugavpils, Ventspils, Jelgava, Vidzeme, etc.), the funding and material and technical base is sufficient. This is a pre-condition for successful performance of these regulatory institutions of public services, complying with governmental normative acts.

Regulators, when issuing licences to providers of public services, must take regard of the development plans of the municipality concerned in relation with the development of branches to be regulated and regulations binding to municipalities.

4.3.3 Problem with financing the municipal regulators

According to the opinion of, for instance the Regulator of Jurmala, this problem has arisen due to the haste with which the norms applicable to municipalities were incorporated in draft law. Regarding their financial, economical and organisational operation, the financial status of Regulators corresponds to that of municipal institutions. They are subordinated to municipalities regarding setting of budget and control over its execution, approval of personnel, etc., regulated by relevant governmental acts. For

instance, the regulatory duty is being initially transferred to municipal budget, and only after that these funds are being allocated to the Regulator. Since none of the laws "On Regulators of Public Services", " On Budget and Financial Management", and "On Municipal Budgets" provides a special order of compilation and approval of budget of Regulator, the appropriation of funds for Regulator is being determined by the state levy in amount of 0,4% of turnover of regulated companies. Regulator is independent in elaboration of budget, which is based on expenses by classification codes and sub-codes. The board (council) approves the budget of Regulator but is not authorized to make alterations in budget categories. Thus, the independence of municipal Regulator may be influenced when a municipality delays its official approval of the budget of Regulator.

The key problem, however, is the minimum size of Regulator and amount of available funds for running of Regulators. The funding and material and technical base of Regulators in Riga, Daugavpils, Ventspils, Jelgava, Riga district, Jurmala, and Liepaja is sufficient, that provides for successful work of these regulatory institutions of public services that complies with governmental normative acts. Nevertheless, it is still insufficient for other Regulators in order to provide for full time employment of at least one high class professional. Range of budget available for each Regulator is very high. For example, allocated budget for Riga Regulator in year 2003 was 290 000 LVL (the Regulator regulates public services in 12 companies) while for Bauska District Regulator only 3 700 LVL (the Regulator regulates public services in 13 companies). The work amount necessary for tariff setting in big and small municipalities is not as different as the amount of duty to be collected.

4.3.4 Insurance coverage

Council members can be sued for taking wrong decisions. The Law "On Regulators of Public Services" provides that, when entering his or her office, a member of Regulator must insure his or her civil and legal responsibility. It is difficult to meet this requirement, because this risk is not being insured in Latvia at the present and there are no Regulations of Cabinet of Ministers, which govern insurance of responsibility of Regulators. In the same time, it must be noted that Regulator is the first administrative tariff setting institution, to which direct personal civil and legal responsibility for its work is established by the law.

4.3.5 Legal inconsistencies

There are several inconsistencies in legal acts, which determine regulation of public services:

- 1) Municipalities have legal instruments how to avoid regulation of public services in municipal sector. The Law "On Regulators of Public Services" regulates the provision of services only as entrepreneurial activity. Municipalities can avoid external regulation by provision of public services on non-entrepreneurial basis (in the form of municipal department or municipal institution). It can be

considered as the most important legal inconsistency, which distorts the idea of regulation of public services in municipal sector.

- 2) It is not determined which public institution is responsible for supervision of regulators. It is especially important regarding the cases of jointly established regulators. In the absence in legal base the Union of Local Governments of Latvia carries out coordination of regulators on voluntary basis.

Besides, there are also inconsistencies regarding the time period for taking effect of tariffs. Article 21 of the Law "On Regulators of Public Services" provides that the approved tariffs take effect as from the date determined by administrative act of Regulator, but not earlier than on the thirtieth day after their publication. On the other hand, Article 11³ of the Law "On Rent of Residential Premises" requires that tenants be given written notice of at least three months on increase of prices of basic services (heating, cold water supply, sewage, and collection of household waste, indicating the reason of price increase and providing financial justification if requested by the tenant. The fact that different notice giving order is established by each of the laws (in one case, publication not later than 30 days before tariff increase is enough, while the other requires written notice of at least three months), is an evidence of contradictions, for it is not clear why a publication is necessary if written notice is to be furnished to the tenant. It could be assumed that the landlord is being notified in such manner, but in this case, the term provided by Article 21 of the Law "On Regulators of Public Services": "not earlier than on the thirtieth day after their publication" may not be regarded as correct. If the purpose is to provide warning to the landlord, the term should be "not earlier than four months after their publication", because the first thirty days should be left for landlords for making themselves acquainted with the new provision and completion of written notification procedure, and three months for fulfilment of requirements of the Law "On Rent of Residential Premises".

In order to avoid the risk of financial problems to service providers, as well as to preclude the necessity to include not justified additional costs due to time shift into tariff, and to avoid possible misunderstanding, services, the tariffs of which are being set by regulatory institution according to the order provided by law, should be struck off the list of services that require special notification in the Law "On Rent of Residential Premises".

4.3.6 Regulation of district heating

Regulation of district heating faces several problems. The tariff calculation formula for assigning the cost of supply from CHPs to electricity and to district heating needs to be revised. There is an unsolved problem of overlapping regulatory responsibility between municipalities and PUC for district heating systems, where part of the heat supply comes from CHP. It should be noted that PUC so far has made a serious effort to find the most appropriate solution for tariff methodology and current methodology is made to fit a wide range of public utility companies operating district heating sector.

4.3.7 Issues in regulation of household waste management

The costs to be included in tariff calculation are for the following services:

- a) for collection and removal of household waste;
- b) for storage and removing of household waste;
- c) for disposal of household waste;
- d) combination of any of above-mentioned services.

The most essential problem is the involvement of all residents in funding of household waste management. In many cases, residents of separate houses do not conclude contracts on waste disposal, and partially address this issue by mediation of other service recipients, placing their waste bags either in waste containers of big apartment buildings, or close to other large objects, or simply leaving them in gate drives, or even in forests. The subsequent collection of such waste is relatively expensive for municipalities. Some years ago, a proposal emerged to establish the payment for waste collection as a duty due to municipality, though it did not gain support, because it would constitute a compulsory payment for those residents who do not need this service for different reasons. As another solution, it was proposed to place containers in certain places, the transportation of which would be paid for from the budget of corresponding municipality (which would be less expensive than collection of waste from forests and parks).

4.3.8 Regulation of water and sewage supply services

The costs to be included in tariff calculation are for the following services:

- a) for obtainment, production, and channelling to water supply network of one cubic meter of water;
- b) for delivery of one cubic meter of water from water production location to service recipient;
- c) for collection and channelling to wastewater purification works of one cubic meter of waste water;
- d) for purification and channelling to output in water basin of one cubic meter of waste water.

Expenses that are economically justified and complying with technical standards or norms are included in their costs by water supply enterprises. Costs related to collection of rainwater and maintenance of its collection networks are not being included in costs. There may be one-stage or two-stages tariffs of water supply and sewerage services, and united complex tariffs.

The most essential problem is the metering of delivered water. In most apartment buildings, the technical solution of water supply is such that more than two meters are necessary for complete metering in each apartment. This is an obstacle for introduction of accounting. Therefore, the incentive of residents to save water is reduced, and these resources are not being used in a sufficiently economical way. Another problem related to metering is the reading of water meters. It involves hiring additional employees, and these employees do not always have access to water meters. If there is a meter

installed in house input, in most cases, residents are forced to also pay for sewage services for the water used for watering of orchards, although this water does not enter sewage system. Residents who do not have a meter installed at the house entrance may use water services for free.

4.4 Conclusions and Recommendations for Municipal Regulation

4.4.1 Conclusions about the governance structure

The analysis of the governance framework and of the experience in practice of the municipal regulator shows that the municipal regulator as conceived in the Law on Regulation is a misconception, except in cases of Regulators set up jointly by several local governments, where the regulator has the size and expertise to manage regulation efficiently, and has the local presence needed to perform also service regulation efficiently. For example, the municipal regulator for Riga can be considered as a sub-contracted specialised regulatory department of the municipality; which demonstrates to the population and to investors that regulation is de-politicised.

Otherwise, the concept has some weaknesses:

- Due to their small size, the municipal regulators, particularly those contracted directly by a small single local Government, do not have convincing breadth and depths in competence (technical expertise in law, finance, and economics);
- Due to their being contracted by the local municipality and the way the transfer of finance to them is authorised by the municipality, their independence from local government and service providers (as these often are municipally owned companies) is questionable (this problem is relevant for every regulator regardless of its size).
- The legitimacy for their undertaking of licensing can be challenged – not on legal grounds, as their authority is confirmed by the Law on Regulation and by the municipal council act appointing the regulator – but on matters of principle: is it reasonable to transfer responsibility for long-term licensing of firms to a an institution which, in case it is not re-contracted, has a lifetime of four years only.
- It is difficult to see what instruments the municipal regulators have to achieve the stated objective for their work of promoting competition as set forth in the Law on Regulation.
- By covering all functions of municipal regulation, including quality of service regulation, the municipal regulators do not “bring regulation closer to the people”: if service quality is insufficient, it is easier and more logical for a local resident to complain directly to an official in the relevant technical department of the municipality rather than to write or make a phone call to a regulator living residing outside the municipality. There will be no technical department in a small municipality, anyway.
- In the financing mechanism of municipal regulators there is an indication for a conflict of interest. Although budget of municipal regulators is approved by local governments, increase of tariffs has direct influence on personal welfare of employees of municipal regulators (revenues of municipal regulators depend on the vale of regulation levy, which is a fraction of net turnover of regulated public utility companies).

- The system for municipal regulation bears additional economic costs to society – adding 0,4% to the price charged by regulated companies to consumers plus the administrative costs of the regulated companies for providing required information to the regulator. Yet, the funds raised are hardly sufficient to fund adequate quality regulation by the municipal regulators. One of reasons for comparatively high regulation costs to society is too rigid regulation rules and lack of flexible regulatory instruments like ex-post regulation. It is explained by the fact that during the phase of restructuring of national economy and establishment of sustainable and cost-effective provision of public services in Latvia there is a need to establish a strong control over setting of economic tariffs in order to avoid political influence on regulation of public services.

4.4.2 Division of labour for regulation according to comparative advantage

It is recommended to establish a new responsibility structure for municipal regulation in which the individual functions and tasks are assigned to the institution best able to cope with it: municipality, external regulator, or Ministry. The reform of the regulatory structure is accompanied by changes in the form and style of regulation described in 4.4.3, by the introduction of the right of appeal of municipal regulatory decisions to PUC or to the Ministry of Regional Development and Local Governments. In the long term it would be worthwhile to consider a reduction of the fee for municipal regulation (for example, from 0,4% (actually, it is up to 0.4 or 0.2, but regulators charge max) to 0,2% of turn-over). Rationale of this proposal lies in the fact, that after the first years of extensive work in area of municipal regulation employees of municipal regulators have become familiar with situation in regulated public utility companies and since that time their work load has decreased considerably. The low fee rate would force external regulator to identify cost-effective approaches to municipal regulation; sub-delegating tasks to the technical department of the local municipality as a key cost-cutting procedure.

The recommended structure of responsibilities for regulatory functions and tasks is the following.

The **municipality** would be responsible for:

- Managing and internally regulating services produced by municipal departments. According to Government policy these services are to be commercialised. Producing these services through municipal departments is an interim solution, with the municipality having the responsibility to take steps towards their commercialisation as a limited liability or joint stock company.
- Issuing licenses and service contracts for local “monopoly” services. Licensing by an external regulator undermines the municipality’s authority in executing a core function. When a municipality does not directly produce a municipal service, it uses a concession or service contract with a private service provider. Defining the scope of work to be done and signing the contract with the private service providers is a

natural municipal function in the execution of its responsibilities.⁶⁶ The licenses are approved by the municipal Council and signed by its Chairman; service contracts may be signed by the director of the municipal department.

- Organising and implementing tenders for municipal services. This means describing the rights and responsibilities of service providers with a careful description in the license and service contract documents of services to be provided, performance benchmarks establishing rights to tariffs or imposition of fines; preparing the tender documents; implementing the tender, awarding the contract and finalizing the negotiations.
- Monitoring of service quality of all regulated local services by the technical department of the municipality, with the help of contracted consultants, when necessary. The monitoring of service quality of district heating is done via sub-delegation of responsibility by external regulator; an arrangement, which is confirmed in the license for district heating, issued by external regulator.
- “Price regulation” of service contracts for municipal solid waste management and for local bus routes, since the price for these services are established by competitive tender and the formula for revision of tariffs is clearly defined in the short term contracts for these services.

External regulator, would be responsible for:

- Licensing and regulation of district heating, with quality of service regulation being sub-delegated to the technical department of the municipality. District heating is not a monopoly service – consumers can and do switch to alternative sources of heat supply, such as natural gas and individual oil-fired heaters. For reasons outlined in section 2.2, the state and local governments are deeply involved in the problems of local district heating due to its impact on social heat support payments to low-income households and due to the need to make district heating competitive in Latvia and to replace inherently inefficient systems by alternative heat supply (for this purpose capital investments are needed and cost of capital has to be included in economically justified tariffs set forth by independent external authority). Therefore, the responsibility for the regulation of district heating needs to be transferred to an external regulator.
- Tariff regulation of water and sanitation. External tariff regulation is justified as tariff regulation in this sector is rather complex; the cost of water supply represents a relatively high burden for low-income consumers; the municipality has few benchmarks to judge the ability of the company to improve; unlike municipal waste management and transport, there is no competition in the market and competition for the market takes place only every 15 to 20 years, depending on the length of the license.

⁶⁶ There are trade-offs between the level of local service quality and the price, which the local population is willing to pay for quality. The appropriate balance is established by the local politicians and expressed in the documents for the concession, license and service contract.

- Undertake due diligence review of licenses for water supply prior for them being signed by the municipality.⁶⁷
- Serve as first institution of appeal with binding decision taking power against tariff approval decisions by the municipality in municipal waste management and local transport (this function is already delegated to municipal regulators in the Law “On Regulators of Public Services”).
- Organising training courses in technical service regulation for staff in municipal technical departments.
- Elaboration and approval of methodological basis for municipal regulation

As regards the external regulator, two alternatives are proposed: PUC and Regional Regulators.

a) PUC as an external regulator

If functions of regulation of public services of local government services subject to external regulation are transferred PUC, it will become the single regulatory authority in the country. Advantage of PUC as external regulator lies in its professional competence and expected cost-effectiveness of regulation services in the medium and long term period when public sector will be matured for ex-ante and ex-post type of regulation. In addition to that, PUC will have an opportunity to rationalize regulatory costs and introduce economies of scale principle in provision of regulation services in all regulated areas because PUC will be financed from levies of all companies which are subject to external regulation. Besides, PUC as the single regulatory authority could bring closer to inhabitants of municipalities issues related to energy, telecom, post etc. Disadvantage of PUC as a single regulator is that there is a two level public administration system in Latvia and distinction in national legislation is made between services provided by state and municipalities (decisions on regulation of services of local government services have to be made by local governments, based on condition that conflict of interest is avoided). Besides, provision of regulatory services for public services of local governments might be expensive in the short term as PUC will have to pay a serious effort to ensure quality of regulation (economic benefits has to outweigh economic costs to society). It means that PUC will have to establish regional branches in order to fulfil the functions currently provided by existing municipal regulators.

b) Regional regulator as an external regulator

An alternative to PUC as external regulator is establishment of regional regulators. There are three options for this alternative:

- Establishment of regional regulators after administrative reform of the first level local governments (that is, establishment of regions);

⁶⁷ District heating, although being a local activity, competes “at national level” with natural gas supply and individual oil firing. Therefore it makes sense to let the licensing be done by the external regulator. Water supply has no “national level” implications and needs careful environmental monitoring and regulation; therefore, licensing by an external regulator is not logical in this case.

- Establishment of regional regulators, based on existing 5 planning regions (Riga, Vidzeme, Kurzeme, Zemgale, Latgale);
- Establishment of regional regulators by setting minimum qualification criteria, for example, catchments area, population size, turnover of companies to be regulated.

As regards Option 1, the number of regions and date of start-up and completion of administrative reform is not known and there are no institutions in place which can undertake duties of external regulation.⁶⁸

It is possible to implement Option 2 because the planning regions are established and operating. But Regional Development Agencies, which are administrative bodies of the planning regions, do not have experience and capacity in management of public utility services, including external regulation. Option 2 is also related to administrative reform, because after completion of the reform Regional Development Agencies will be transferred to administrative bodies of particular region.

Option 3 is based on existing capacity of already established regulators and assumption that the most efficient regulators will survive. However, analysis has to be made on setting the most appropriate values for qualification criteria. Option 3 is not directly related to administrative reform.

The main advantage of regional regulators is the possibility to retain the power of external regulation at the level of local municipalities (regional level).

The disadvantage of regional regulators is that it might be difficult to select to optimal size of the regulator in order to provide the balance between quality and cost-effectiveness of regulation.

c) Financing of external regulator

Regardless of selected alternative, one of the most crucial issues is the financing mechanism of regulation of public services in municipal sector. It is quite evident that there will be economies of scale if existing municipal regulators are merged into regional regulators or established as regional subsidiaries of PUC. Particularly, it includes financial benefits (savings of administration costs) and economic benefits (better quality regulatory services as a result of increased specialization and professional competence).

There is not enough information to judge which of proposed alternatives is more cost-effective. It is the opinion of experts that in the long run regulatory costs will be similar for both alternatives, because in case of single regulatory authority there will be regional subsidiaries established and in case of regional regulators there will be regional regulators instead of regional subsidiaries of PUC.

⁶⁸ Currently there are 26 districts and 7 cities of state importance. In almost each main city of the rayon and city of state importance there is an established municipal regulator. According to opinions of regional development specialists and public authorities, there are several models of the first level administrative reform. The most frequently used opinions are establishment of 5 or 9 regions in Latvia.

If number of existing regulators is reduced, for both alternatives the total amount of funding allocated either for PUC or each of regional regulators will change. According to the Law "On Regulators of Public Services", a uniform quality standard of regulatory services has to be provided throughout the country. If we consider PUC as an alternative, PUC will make a decision regarding the allocation of funds among regional subsidiaries, based on total value of levies collected from companies offering regulated services in municipal sector. Regarding regional regulators, an outside institution is needed to reallocate the funds raised by levies to regional regulators (based on criteria, which ensure equity, efficiency and quality of regulated services). Ministry of Regional Development and Local Governments by its mandate could be entitled provide such function.

Detailed analysis of alternatives of provision of regulation services in municipal sector is outside the scope of this report. For example, in order to assess the feasibility of both alternatives, the functional audit has to be carried out in each of existing municipal regulators.

The **Ministry of Regional Development and Local Governments**, would be responsible for:

- Adopting regulations, pushing municipalities to commercialise service production by municipal departments;
- Allocation of financing for regional regulators in accordance with regulations approved by Cabinet of Ministers' (in case if alternative of regional regulators is considered as feasible);
- Providing technical training courses and technical assistance in the commercialisation and privatisation of local services (this function can also be undertaken by PUC);
- Preparing standard procedures for tendering and standard format tendering contracts. These forms will serve tendering of outsourced activities in general;
- In consultation with PUC, preparation of standard formats for licenses, service contracts and authorisation documents;

The **Ministry of Transport** would be responsible for:

- In cooperation with PUC, provide technical assistance to municipalities in carving up local transport routes to be licensed and assigned by tender;
- In consultation with Ministry of Regional Development and Local Governments, prepare standard formats for licenses in local transport.

It should be noted that on September 29, 2004 the Cabinet of Ministers of Latvia issued Order No 704 "Basic Guidelines for Development of Public Transport 2004 -1014". This document addresses 4 key issues: establishment of unified standard for public transport services, increase of effectiveness of public transport management system, elaboration of appropriate financing model of public transport services, development of unified and effective route network of public transport. It is assumed that changes in regulatory system of public transport services will be in line with above-mentioned Guidelines.

4.4.3 More reliance on “regulation by contract” and ex-post regulation

The licenses issued by municipal regulators are short “authorisation-type” documents, which do not provide suitable benchmarks for monitoring and measuring performance during operation. This “passive authorisation approach” should be replaced “regulation by contract” – where the license defines in detail the price, the scope and the quality of services to be provided as well as benchmarks for measuring achievement of the service conditions. Regulation by contract is a mean to compensate for lack of municipal know-how in regulating local services. It is also in line with outsourcing contracts in general. One implication of regulation by contract is that the contracts are tailor made to the specific requirements of the regulated service and the situation. It is recommended that the qualitative differences between the documents are reflected in using differing terms for these, reserving the word “licenses” to the long-term contracts for utility services (water, district heating and sanitation) and for transport routes, while the word “service contract” is used in solid waste management, and “authorisation” for simple operating approvals.

In order to reduce bottlenecks in the processing of approving tariff proposals arriving “simultaneously” from a number of regulated firms, the external regulator should apply an ex-post approach to tariff regulation. Companies are authorised to regulate their tariffs in accordance with the formula stipulated in the license; but submit the detailed justification for a change in tariffs to the regulator. If the regulator in his tariff review later during the year finds that the tariff revision is inappropriate, the company must reduce the tariff and compensate consumers for over-charging.

4.4.4 Interim arrangements leading to new structure

Most municipalities have already set up and signed a contract with an external regulator. Besides, if decision makers find the ideas mentioned in this report feasible, it will take time to make appropriate changes in legal acts regulating provision of public services in the municipal sector.

Based on above-mentioned, the new structure would not apply “immediately” to all municipalities not yet having signed a contract with an external regulator as well as to municipalities, which have already signed such contracts. A moratorium should be put on the signing, amending or breaching of contracts with regulators, until the Government has decided on which of the alternatives of external regulation to use.

4.4.5 Control of corruption under the proposed new structure

The proposed structure controls corruption ex-ante by use of standard documents for tender documents, licenses and services contracts and by the no-legal-objection review of water licenses by external regulator; and ex-post by the right of appeal about the implementation of tendering and tariff decisions to Administrative Court. The alternative

for proposed appeals system could be establishment of right of appeal about the implementation of tendering to the Ministry of Regional Development and Local Governments and against tariff decisions to Ministry of Regional Development and Local Governments or PUC (based on selected alternatives for external regulation – PUC or regional regulators).

4.4.6 Summary of the proposed structure

Table 5
Summary of the proposed structure for municipal regulator

Service	Legal Instrument	Responsibility for Regulation	
		Municipality	External regulator: PUC or regional regulator
District Heating	License (long-term 15-30 years)	Inclusion in town planning Approval of constructions Control of service quality sub-delegated by external regulator	Award of license Tariff regulation Authority to enforce restructuring and privatisation
Water and Sanitation	License (long-term 15-30 years)	Organisation of tenders Award of license Control of service quality	Tariff approval ¹⁾ Appeal body for irregularities in tender award Appeal body for irregularities in awarding contracts to suppliers ²⁾
Waste Collection	Service contract	Organisation of tenders Award of service contract Control of service quality	TA to organisation of tenders, to tender documents, and to contract design
Local bus and tram transport	Concession for a route (medium-term license)	Organisation of tenders Award of license Control of service quality	Tariff approval ¹⁾ TA to identification of routes, to organisation of tenders, to tender documents, and to contract design
Taxi service	Authorisation	Award of authorisation Monitoring of compliance with service standards	n.a. (TA in technical issues and supervision of municipal performance by Ministry of Transport)

1) Not applicable when a service is organised as municipal department or as consumer cooperative.

2) Applicable only for municipally owned companies.