Towards the establishment of an independent Egyptian Gas regulator: License Fees and Market Model

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Background document

Regulatory Financial Autonomy: Estimation of License fees

The issue of **funding** is much **connected** to the **quality of regulation**, since adequacy of resources, both human and technical is fundamental to ensure that proper regulation is in place. The **funding** of independent regulatory agencies varies from jurisdiction to jurisdiction, but there are **three basic methodologies** that are generally in use.

The most **common method** for funding regulation, and perhaps the most **logical**, is by **making regulated companies pay the costs of regulation through levies**, and **then allowing** them to directly **pass those costs to the consumers**. This method is logical because it internalizes regulatory costs to the regulated sector, treats **regulatory costs** as **fees for service** rather than taxes, and is a stable, reliable source of funds for the regulator. In addition, it is easy to administer and is consistent with regulatory independence and transparency requirements.

The **second** most used **method** is funding through an **appropriation from general tax revenues**. That methodology is less common because it **facilitates**, even though it does not necessarily attract, **political interference** in the operation of the agency, may not be as stable or reliable as levies, and does not internalize regulatory costs into the sector.

The **third**, and least common methodology, is establishing **specific fees for services/activities**. While fees, have the advantage of sending accurate price signals, the methodology shows the highest transaction costs, and may yield **less stability and**

reliability to ensure constant revenues to the agency. Fees, however, can be a very effective mechanism for providing agencies with supplemental funds when they are necessary for specific purposes.

Regulatory agencies' **independence** is a critically important element of effective regulation, as it is a concept that directly **applies to the substance of regulation**. A fundamental aspect to ensure fair and balanced regulation is that the authority is independent of the entities it regulates. The mechanisms used to fund the regulatory authority are therefore key to ensuring regulatory independence. At the same time, though, the **financial operations** of agencies, undergo **normal governmental controls** and oversight related, inter alia, to overall levels of spending, fiscal controls.

Assuring proper use of funds and accounting, prudent management of resources, auditing activities and the like are **legitimate forms of governmental oversight** on regulatory bodies. On the other hand, the **use of such oversight to punish or reward agencies for their substantive decisions would be improper**. Coherently, a governmental use of regulatory agency powers or funding to meet other goals of the government would be similarly not suitable.

The following are important considerations to bear in mind when determining the authority's funding scheme:

- **Funding needs to have a sound legal basis**, such as **enacted statutes** or decrees. Funding is not efficient if questions about its legitimacy are raised on a recurring basis.
- **Funding must be independent of the decisions made by the authority** and must not be linked to positions taken by the authority upon requests from regulated entities. For example, if funding is based on a percentage of revenue, then the regulator could be perceived to have a vested interest in higher rates, which would increase revenue, and thus funding. Similarly, if funding depends on licenses granted, stakeholders could perceive the regulator will be more keen to approve license applications.
- **Funding must be stable and not influenced by outside conditions such as cyclical fluctuations in the economy,** unusual weather conditions, or physical damages to facilities that could result in periodical changes in gas sales.

- It is important that the **amount and methodology of funding be coherent with the specific financial needs of the regulatory authority**. For example, if the authority requires greater levels of funding at certain moments during the fiscal year, the funding should be flexible enough to cover those requirements.
- Under certain circumstances, such as during sector restructuring and the **establishment of a new regulatory body**, there may be the need for **specific funding mechanisms to cover the costs of start-up expenses such as the hiring of new personnel, occupation of new office space, and other related costs**. **Short-term funding should be designed to meet these needs**. This funding may take the form of one-time appropriations or assessments on regulated entities for the purpose of developing the new regulatory authority. However, as the regulatory authority matures, it will be important to introduce a long-term funding scheme that can support the activities of the regulatory authority.

The Gas Market Model: Securing the Appropriate Regulatory Framework[1]

When discussing the development of gas markets, a leading issue concerns to **what extent the regional and local governance regimes in place mirror the characteristics of the various types of transactions in the regional gas markets**. It may indeed emerge that the **efficient development of markets of different nature**, maturity and risk profile **may require different structures of governance**, instead of one single market design suitable for full market competition.

The size and the complexity of gas projects entails providing a high degree of confidence and assurance to investors. **International gas markets** and public interests are in fact not static but **dynamic**. The task of the **government** is to **facilitate an investment climate** that changes in line with the evolving stages of market development but that also secures the public interests over time. In addition to the establishment of international treaties, transit arrangements and adequate regulation, **governments may wish to participate in the development of a gas industry** through some state participation in production and distribution entities. In certain markets or countries public participation may provide the stability required for gas developments, solidifying the confidence among the stakeholders involved, and assuring that risks and rents will be distributed in a balanced manner.

Regarding the **regulatory perspective**, the **question** seems to arise as to how this **setting** can **contribute to the development** of gas market regulation or, on the contrary, hinder it. Currently, much of the regulator’s toolkit and the framework for competition policy are based on the former paradigm of ‘full unbundling’ and maximum entry in competitive segments. Nevertheless, in the daily practice of regulation, elements of the transaction cost-based approach are already incorporated, like the conditional allowance of exemptions and large-scale mergers.

A completely liberalized gas market is governed by the free entry principle. Investors should be able to engage in the market, subject only to certain legal obligations in respect of land use, security and environmental impacts. However, the **several segments of the natural gas value chain exhibit specific characteristics in respect of the feasibility of competition** and therefore require specific forms of regulatory oversight and intervention.

[1] Based on Aad Correljé, Martijn Groenleer, Jasper Veldman (2013) *Understanding Institutional Change: The Development of Institutions for the Regulation of Natural Gas Transportation Systems in the US and the EU*, Loyola de Palacio Programme on Energy Policy.

In respect of the monopolistic segments of the value chain, like transmission, distribution and, possibly, gas storage, gas conversion, LNG terminals, or the long-distance interconnections between national, regulated, systems the regulatory function is substantial.

- Firstly, it has to **secure an independent management of the regulated systems** by **juridical or ownership unbundling and separate bookkeeping**;
- Secondly, it has to **organize regulated or negotiated access to the networks** and other system functions via Third Party Access, including a system of access conditions and tariffs;
- Thirdly, it has to **develop procedures to evaluate the need for capacity expansions** in the regulated market segments.

To an increasing extent, **gas systems stretch out** over **different countries** and world regions, which displays different traditions in terms of their institutional and structural characteristics. This begs for some **degree of coordination** between bodies regulating the gas industry, to arrive at mutually acceptable (coherent combinations of) regulatory approaches along the value chain.

General requirements to **regulators** are that they gain a close to **undisputed legitimacy** in carrying out their task. Yet, in the absence of adequate experience with the regulation of liberalized gas markets, often experiments take place with their inherent risk of failure and uncertainties about future change. To **operate effectively** regulators should have a **clear**, politically determined, **legislative mandate**, establishing in unambiguous terms, their objectives, their tasks and the degree of freedom in developing guidelines and rules.

To operate independently on behalf of their general public responsibilities, regulatory systems and regulators should seek to secure and carefully balance the interests of both the several segments of the gas industry and the (large and small) consumers. To achieve an appropriate level of legitimization, **regulators should be held accountable** both in respect of the reasons they give for their decisions and by making the regulatory process fair, open and accessible to the firms and stakeholders. To gain trust in the industry and among consumers, regulators should **have a more than adequate level of expertise**, which is as independent as possible from industrial, consumer, or political interests. Finally, a regulatory system should be **efficient**, in the sense that the **benefits of its**

involvement to society should outweigh the direct and indirect costs of its interventions.