

The World Bank
PPIAF Phase 2 Project for Brazil Power Sector
Task 4: “Strengthening of the Institutional and
Regulatory Structure of the Brazilian Power Sector”

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Executive Summary

The purpose of this report is to review the Recommendations made in December, 2002 as to how to strengthen institutional aspects of the regulation of the Brazilian power sector in light of all of the changes that have occurred, and of course, in light of international experience. Those changes, of course, include the adoption of a new model for the sector, new laws governing regulatory personnel, cessation of efforts to privatize the large state owned generating companies, new tariff arrangements for distributors, and specific regulatory proposals pending in the Congress. Other notable changes are trends are a more assertive Ministry of Mines and Energy and growing transparency in the operations of ANEEL, the electricity regulator.

The report reviews the 29 Recommendations made at the end of 2002 and analyzes them in light of the changes which have occurred since then, and in light of the debate about and proposals for regulation since then. The Recommendations fall into six general categories:

1. Resources and Ethics;
2. Accountability, Transparency, and Independence;
3. Decentralization;
4. Regulations and Market Operations and Functions;
5. Appeals and Judicial Interactions;
6. Distribution Tariffs.

Revised Recommendations 1-7 relate to the financial and human resources constraints under which ANEEL is compelled to operate. They are quite severe in relation to the ability to hire and retain senior personnel, in relation to competing in the same labor market as the regulated companies, who are able to offer superior compensation, and in relation to actually receiving the regulatory fees that are collected from consumers. These constraints are inextricably linked to ethical considerations, given that ANEEL loses about 20% of its senior staff to regulated companies each year. The Revised Recommendations propose a tradeoff between stronger ethical restrictions on ANEEL staff and Directors, particularly in regard to job mobility and investment opportunities, in exchange for higher levels of compensation that would enable ANEEL to recruit and retain senior, professional personnel. They also suggest that the removal of the obstacles precluding ANEEL from receiving the full amount of money collected from consumers for regulatory services.

Revised Recommendations 8-13, 24, and 26 relate to the closely related issues of accountability, transparency, and independence. They suggest a broad social compact defining the role and responsibilities of the regulator and a means for reviewing the performance of both regulators and the regulatory system as a whole to be conducted on a fully transparent basis by both the legislative and executive powers. It calls for a better definition of the boundaries of responsibilities between the regulators and the policy makers. The report makes a number of suggestions regarding practices of both ANEEL and the government might pursue in order to enhance and assure transparency. These include public voting by ANEEL Directors for each decision, better use of public hearings to explore substantive matters and provide easier public access to decision makers, and open communications between regulators and other government officials. The report suggests appropriate, and in some cases, inappropriate roles that the proposed Ombudsman might play in the regulatory process. It also proposes the creation of a permanent consumer advocacy function and the creation of an effective intellectual infrastructure for regulation in Brazil, in order to assure that all relevant points of view are presented, that all of those affected by regulatory decisions will have their interests protected, and to make it more likely that there is a strong intellectual foundation for regulatory actions and to promote the meaningful debate and generate new ideas regarding the regulation of the sector.

Revised Recommendation 14 suggests further exploration of ANEEL delegating more responsibility to, or collaborating more closely with, state regulatory agencies in the regulation of electric distribution companies. The goal is to find the ideal blend on sensitivity to local concerns and needs with broader regulatory and policy objectives.

Revised Recommendations 15-18 relate to the relationship between regulation and market functions and institutions. It suggests that the divergence in the evolution between the markets for natural gas and for electricity has become very costly and inefficient and should not continue to be tolerated. To help to facilitate the convergence of gas and electricity markets, ANEEL, and ANP, the natural gas regulator, should be merged into a single agency. The report also recommends closer, more transparent and more expeditious regulatory oversight of CCEE, the new market administrator, and ONS, the system operator, proposes an appropriate regulatory role in planning and in the oversight of capacity auctions, calls for studies on promoting demand side options and efficient transmission pricing and congestion management in transmission within the context of the new industry model. It also makes suggestions to assist in the evolution of the market monitor function.

Revised Recommendations 19-23 relate to the processing of appeals and other electricity related litigation in the Courts. Among the proposals are the creation of specialized *Varas*

(District Court), expert in regulatory matters, to hear appeals from regulatory agencies, criteria for appellate review, suggestions for management of electricity related litigation where ANEEL is being bypassed, criteria for appellate review, and for better coordination between energy officials, regulators, lawyers, and the judiciary on the substantive evolution of electricity regulation in Brazil.

Finally, Revised Recommendation 28 proposes that ANEEL continue its efforts to fully articulate the methodology for establishing distribution tariffs. In connection with that, it is suggested that ANEEL also examine how promoting demand side measure and energy efficiency, as well as mandate electrification programs will be internalized into the tariff setting process.

I. Introduction

In December 2002, the authors, with the financial support of the Public-Private Infrastructure Advisory Facility (PPIAF) of The World Bank, issued a report, “Strengthening of the Institutional and Regulatory Structure of the Brazilian Power Sector.” The intention was to analyze the state of institutional arrangements in electricity regulation as Brazil emerged from under the shadow of its recent energy crisis, or *apagao*, as it is known in Brazil, and to make very specific recommendations for strengthening the regulatory structure. In that report, there were 29 specific recommendations for improvements.

Since the publication of the report, much has changed. A new government, the administration of President Luiz Inacio “Lula” da Silva, has come into office, bringing with it new leadership for the Ministry of Mines and Energy and for the power sector as a whole. The government designed a new market model for the power sector and secured Congressional approval for it (see Appendix A for summary). The rules and other legal instruments required to implement it are being formulated as this report is being written. The government has also submitted a proposal to the Congress to better define the role of the independent regulatory agencies, including ANEEL, the electricity regulator (see Appendix B for summary). That proposal is currently pending in the Congress. Both the new market model and the proposed regulatory law emerged after considerable debate among various stakeholders and political figures over the direction of both the power sector and its regulatory framework. Beyond merely the power sector, there was also a debate regarding the need for “social control” and for “independence” in regard to all of the infrastructure regulatory agencies that had been created over the past decade.

This report, like the first, is focused on the governance, institutional framework, as well as processes and procedures of the regulatory system for the power sector. With the exception of the final recommendation, the report, by design, does not examine the substance of regulation (e.g. tariffs, service quality issues, asset valuation). Certainly, substantive matters are worthy of study and debate, but they are simply not the focus of this report.

The purpose of this report is to reexamine the 29 recommendations in the original report in light of subsequent developments, and to offer 28 revised recommendations that are more in line with current circumstances. The report is organized into two parts. The first part is divided into 29 sections. *Each section opens with a boldface restatement of the original recommendation, followed by an update on relevant developments since the issuance of the report, and concludes, where appropriate, with a Revised Recommendation.* The 28 revised recommendations follow

this introduction in addition to appearing in the text. The second part consists of three appendices: A, describing the new market model approved by the Congress; B, a description of the *Projeto de Lei*, pending before the Congress addressing the role of regulatory agencies; and C, a reprint of an article regarding the relationship between and the respective roles of policy makers and regulators.

Twenty-Eight Revised Recommendations

REVISED RECOMMENDATION 1

- a) ANEEL should be provided with authority under the law to establish its own hiring practices, or at least, allowed the flexibility to deviate from generally applicable practices, other than those specifically related to public integrity and ethics, where the skills and expertise required are unique.
- b) ANEEL should institute, or if necessary, propose to whoever must approve such a proposal, an alternative management/administrative model for the day-to-day management of the agency, a model which appropriately balances the need for oversight by the Directors with the need for the Directors to spend needed time on substantive matters.

REVISED RECOMMENDATION 2

- a) ANEEL should be enabled to establish compensation packages for employees which are either benchmarked to the levels of compensation paid by regulated companies, or, at least to allow ANEEL salaries to be comparable to other government agencies whose compensation is in excess of generally applicable government pay scales (e.g. Banco Central).
- b) Compensation for staff and Directors of ANEEL should be seen in tandem with the enhanced ethical restrictions, particularly in regard to job mobility and investment opportunities. Thus, ANEEL should be able to compensate its personnel at higher levels than other governmental personnel, but ANEEL staff should also be made subject to the more stringent ethical restrictions set out in Recommendation 4 below.
- c) Constitutional Amendments, which offer regulatory agencies the flexibility to relieve the constraints limiting compensation for regulatory personnel to non-competitive levels, should be supported.

REVISED RECOMMENDATION 3

The new legislation that recently passed Congress should be fully implemented as soon as possible to enable ANEEL to hire staff on a permanent basis at the earliest practicable time.

REVISED RECOMMENDATION 4

By law, the Directors and Staff of ANEEL should be subject to very strict ethical standards.

At a minimum, the standards should include:

- a) For a period of one calendar year from the date of leaving, an ANEEL Director or employee should be prohibited from employment of any kind, including on a consulting basis, which relates in any way to any matter pending at ANEEL. In regard to those specific cases on which a person worked while at ANEEL, the prohibition should be of lifetime duration
- b) Prohibition on all ANEEL personnel and immediate family, as defined by law (Law No. 9.784/99) owning any kind of financial interest (e.g. stock, debt, creditor) in a regulated entity;
- c) Any ANEEL Director or staff member owning any financial interest in a business which is a specifically identifiable party to a matter to be decided by the agency, must abstain from participation in the matter;
- d) Prohibition on ANEEL personnel accepting gratuities of any kind from parties having business with the agency;
- e) ANEEL personnel and immediate families, as defined by law (Law No. 9.784/99), should be required to file a disclosure of all financial assets or liabilities in excess of a *de minimus* amount;
- f) Prohibition of ANEEL personnel from engaging in any practice or behavior which might either be, or reasonably appear to be, improper, unethical, illegal, or harmful to the regulatory agency and/or process;
- g) A process for enforcing the Code and for handling complaints from the public regarding ethical issues involving ANEEL personnel.

REVISED RECOMMENDATION 5

Relevant legal instruments be amended to list the professions from which Directors must be drawn. At a minimum, appointments should be made from among experienced professionals in economics, law, engineering, and accounting, and perhaps other relevant professions. No more than two Directors can be drawn from the same profession. Consideration should also be given to inclusion of minimal, relevant technical/experience qualifications for directors in law.

REVISED RECOMMENDATION 6

ANEEL, while continuing to be authorized to collect 0.5% of the electricity revenues, should have to undergo precisely the same budget approval process to which other parts of the government are subject.

REVISED RECOMMENDATION 7

- a) The law should specifically preclude the funds collected from consumers for purposes of regulation from being diverted to other use by the Government. If the Government decides to make across the board cuts in spending, in accordance with the terms of Revised Recommendation 7.b., and apply them to ANEEL, then it could do so, but the excess created in regulatory fees by the cutback, would then automatically revert to the regulated companies for passing back to the consumers. That way the Government could impose controls on overall spending, but would have no incentive and no ability to divert funds intended for regulatory use.
- b) The law should preclude the government from reducing ANEEL's budget appropriation during the fiscal year for which it was approved, unless the reduction is part of a broad cutback generally applicable across the government and does not disproportionately impact ANEEL.
- c) ANEEL's budget should, for accounting and fiscal purposes, not be included on the balance sheet of the government. This provision, however, should not have any effect on the government's overall capability of exercising fiscal and budget oversight.

REVISED RECOMMENDATION 8

Instead of using performance contracts, social control should be exercised as follows:

- a) Legislators and/or executive policy-makers (e.g. CNPE), with the assistance and advice of the *Tribunal de Contas*, and perhaps utilizing the services of independent, impartial, expert advisers, should conduct regular, periodic reviews (no less than every three years) of the entire regulatory system, including re-examination of relevant laws and policies, prevailing practices, performance of regulatory agencies, processes and procedure being followed, and outcomes in terms of service quality, prices, profitability, and other relevant matters. These review proceedings should be open to public participation and conducted on a fully open and transparent basis. They should result in the issuance of a report which makes known the findings as well as recommendations regarding proposed legal and/or policy changes, expectations of regulators, resource allocations, and all other relevant matters. Each subsequent review should start by reviewing the status of the recommendations from the previous report. Although the report may praise or criticize individuals, the reviewing body will have no authority to take any steps to compromise the independence of individual regulators.
- b) Should the Ombudsman be created, it can assist the authorities conducting periodic reviews, it can urge special reviews, when it feels such a proceeding is required, and it can make such critiques as it believes are justifiable. It can also provide advice to ANEEL as to how it might be more effective. The Ombudsman's role should never, however, have supervisory power over ANEEL, or over any of its personnel.

REVISED RECOMMENDATION 9

Decree No. 2.335/97, which regulates ANEEL's law, should be amended to make it explicit that all communications between, and/or among ANEEL and any party, specifically including any agency/ministry of the Government, on a matter currently, or about to be, pending before the agency, be made in a publicly accessible, completely transparent way.

REVISED RECOMMENDATION 10

Decree No. 2.335/97, which regulates ANEEL's law, should be amended to make it explicit that all decisions of the agency be in writing and follow the format below:

- a) **General Description and History of the Matter(s) Under Consideration;**
- b) **Summary of the Views Offered by All Parties to the Matter;**
- c) **ANEEL's Analysis of Law Facts, Evidence, and Opinions Offered;**
- d) **Formal Statement of the Decision and its Rationale**

REVISED RECOMMENDATION 11

By law, all decisions of ANEEL should be taken by vote of the Directors in a public meeting with each Director having the opportunity to speak about his (her) decision, and with each Director having the opportunity to submit a separate written opinion either concurring with the majority of Directors, but for different reasons than those set forth in the majority decision, or dissenting.

REVISED RECOMMENDATION 12

- a) **ANEEL, when appropriate, but particularly on contentious or complex matters before it for decision, conduct public hearings where experts representing the various interests or perspectives represented, offer verbal testimony on their views, and that time be allotted for persons with different points of view to cross-examine those experts or to directly debate with them. Such hearings should be conducted in public and the Directors and designated staff of ANEEL should have their own opportunity to question the experts. Those proceedings should be made more meaningful by requiring that all presentations to be made at the public hearing be submitted to ANEEL in advance and that those presentations be publicly available to all interested parties. Additionally, all parties who wish to do so, should have the opportunity to submit written comments to ANEEL subsequent to the public hearings to further elaborate on matters covered at the hearing. Those comments, of course, should also be part of the public record.**
- b) **ANEEL, in all specific pending matters, complex or otherwise, should, where appropriate, offer interested parties the opportunity to make oral presentations to the Board in public meetings.**

REVISED RECOMMENDATION 13

The Ministry of Mines and Energy, perhaps in cooperation with other relevant agencies of the government (e.g. the Ministries represented on CNPE), should convene a conference involving relevant ministries, legislators, regulators, and stakeholders, as well as academics and other experts in the field of regulation, to propose basic legislation clarifying and fully defining the respective authorities of CNPE and ANEEL. The following principles should be used to assist in focusing the discussion and to serve as the base for beginning the discussions:

- a) The provision of the law and Executive policy determinations are binding where the executive agency acts within its defined authority and where its actions or articulation of policy precede any decision of ANEEL on the same subject;
- b) Only a duly constituted Court can determine, after the fact, if ANEEL has, in making a particular decision, exceeded its authority or failed to follow binding policy under the law, and reverse the decision for having done so;
- c) ANEEL be given the authority to seek guidance from CNPE where it believes such guidance is necessary for jurisdictional reasons, provided that ANEEL seek and obtain, and that CNPE provide the guidance in a fully transparent and open way;
- d) ANEEL, should it decide that no further guidance is necessary, be provided with the discretion to decide matters where the articulation of policy is not complete or comprehensive, but where a determination is necessary for the fulfillment of the agency's responsibilities, is relevant to a pending matter, and where the action constitutes a reasonable exercise of ANEEL's lawful authority.

REVISED RECOMMENDATION 14

ANEEL should promote greater interaction with the state regulatory agencies with which it has agreements by undertaking the following measures:

- a) Conducting joint public hearings with the state regulators whenever distribution tariffs are under review within their state, or whenever, there is some other matter of common interest (e.g. service quality) under consideration;
- b) Allow state regulatory agencies to have an advisory, or some other formal, role to ANEEL in setting tariffs for distributors within their state;

- c) Establish formal exchange programs where state regulatory personnel work at ANEEL for specified periods of time and where ANEEL personnel do the same at the state regulatory agencies;
- d) Allow the personnel of state regulatory agencies to work with ANEEL personnel on matters, such as distribution tariffs, where the agencies have a common interest;
- e) Develop joint training programs for the personnel of ANEEL and the state regulatory agencies.
- f) Experiment on a limited basis with the most competent of the state regulatory agencies, the delegation of setting distribution tariffs pursuant to guidelines from ANEEL, as well as the possibility of ANEEL review after a decision has been proposed by the state agency.

REVISED RECOMMENDATION 15

- a) The rules and protocols regarding both the conducting of auctions and the granting of concessions be adopted through a transparent process with opportunity for public participation, and then published. Such rules and protocols should include a clear and prescriptive description of the process to be followed and the criteria to be used in deciding the outcome. The adoption and publication of the rules and protocols should occur in advance of the actual carrying out of any of those activities. The process of conducting the auctions and the granting of concessions should be carried out in a completely transparent manner in compliance with all relevant laws, rules, and protocols. The discretion afforded to the agencies conducting the proceedings should be held to the very minimum necessary.
- b) It would be prudent for ANEEL to delegate the responsibility for conducting auctions to CCEE. The delegation of responsibility should be accompanied by guidelines/rules indicating how the auctions should be carried out.

REVISED RECOMMENDATION 16

- a) Since ONS and CCEE are now fully subject to the regulatory oversight of ANEEL. ANEEL should continue the process it has begun to make its exercise of regulatory oversight of both ONS and the market administrator more transparent and more open to and solicitous of public participation. ANEEL should specifically propose how it will

use its power to approve the CCEE and ONS budgets more effectively to provide incentives for improved overall performance. ANEEL should also fully explore, through a public, transparent process, how to make the overall incentives for CCEE and for ONS more symmetrical, more balanced, and more effective.

- b) MME, ANEEL, ONS, and CCEE should collaborate in formal studies of the options for managing transmission congestion in the new model and for incorporating demand side options into the capacity and energy markets.

REVISED RECOMMENDATION 17

The Monitoring Committee for the Electricity Sector should be implemented as quickly as possible. The Committee, pursuant to its authority, should engage independent consultants, and/or advisory committee(s) to issue public reports or declarations regarding their findings and analysis of the market sector(s) on which they were asked to report. In addition to the responsibilities given to it in the new market model, the Committee should monitor and issue reports on all aspects of the electricity system at regular time intervals or whenever else it believes to be necessary. In addition to its explicitly assigned tasks, the Committee, through its consultants and/or advisory committees, should focus its attention on transmission issues, the use of demand side resources, interplay between the free and regulated markets, and the effects of the segregated auctions, and on all other matters related to the ability of the sector structure to achieve sufficiency of supply and efficient outcomes.

REVISED RECOMMENDATION 18

It is recommended that ANEEL should establish an expedited dispute resolution process to be put in place in order to expeditiously resolve any complaints brought before it regarding actions of CCEE or ONS. In the event that the disputes involve the application or interpretation of ANEEL's rules or decisions, ANEEL should develop a "fast track" mechanism for issuing clarifications. It should also establish a procedure for the regulatory agency to initiate an inquiry into CCEE and/or ONS on its own.

REVISED RECOMMENDATION 19

- a) **If possible, all appeals from regulatory agency decisions should be directed to a single, expert forum, the decision of which would, in the absence of any constitutional issues, be subject to a single level of judicial review.**
- b) **The Minister of Mines and Energy and ANEEL, in cooperation with the Ministry of Justice and other relevant ministries. The judiciary interested lawyers, and any other entities whose input is of value, should form a committee to study the pros and cons of creating an administrative tribunal to hear appeals from regulatory agencies. The Committee should, at a minimum, examine how such a tribunal would be created and maintained, how its members would be selected, how its independence would be assured, whether the tribunal's decisions could be accorded any deference by reviewing courts, and whether it would streamline the appellate process or simply lengthen and/or complicate it.**

REVISED RECOMMENDATION 20

- a) **The Minister of Mines and Energy should submit a formal request to the President of the Supreme Tribunal of Justice to initiate a study of the possibility of creating a Vara for purposes of hearing appeals from ANEEL and ANP, and to hear all matters related to energy regulation, whether they are appeals from regulatory decisions, or are cases initiated in the courts without first being considered by the regulators. The Minister is also urged to consult with those Cabinet colleagues whose portfolios include responsibility for areas of infrastructure which have regulatory agencies in existence (e.g., water, telecommunications, transport) to seek their joining in the request so that the proposed scope of jurisdiction for the specialized Vara includes all infrastructure industries subject to regulation by national regulators.**
- b) **In all electricity matters brought directly to the Courts, bypassing ANEEL, or where a new issue is raised on an appeal that ANEEL never had the opportunity to consider the Courts should seek out ANEEL's participation in the case and pay close attention to the agency's position. Where neither the Judges nor the parties to such a proceeding seek out ANEEL's participation in the Judicial proceeding, ANEEL, on its own, should seek to intervene.**

- c) **The Ministry or Mines and Energy, ANEEL, the TCU, and the Judiciary, perhaps in coordination with professional associations and academic institutions, should conduct regular, periodic seminars on the legal aspects of electricity regulation. It might also promote the creation of a scholarly legal journal devoted to legal issues in Brazilian energy regulation.**

REVISED RECOMMENDATION 21

Appellate bodies reviewing regulatory decisions are required to affirm the decision of the regulatory agency unless it is specifically determined that the agency exceeded its lawful authority, or acted arbitrarily or unreasonably, acted contrary to the manifest weight of the evidence before it, or failed to follow proper legal and constitutional procedures and processes. In considering any application for a stay of execution of a regulatory order, pending full appeal, the appellate body must presume that the decision was correct. Such presumption, for purposes of temporary relief from a regulatory decision, may be rebutted, but only upon a clear showing that implementation of the decision will cause irreparable injury to the appellant, and that the appellant has a substantial likelihood of success on the overall appeal.

REVISED RECOMMENDATION 22

If the appellate body finds that a decision of the regulatory agency should be reversed the preferred method for undertaking further action is to simply declare the decision void for the reasons stated. It is then left to ANEEL's discretion to decide how to proceed.

REVISED RECOMMENDATION 23

In the event that a party seeks to bypass ANEEL on a matter otherwise within the agency's jurisdiction, by going directly to the courts, it is recommended that:

- a) **All electricity regulatory matters, even those originating in the courts rather than in ANEEL, be referred to the specialized Vara;**
- b) **In cases where injunctions are being sought against ANEEL, the courts exercise very strict scrutiny to make certain that the applicant to the court is, in fact, in imminent**

danger of harm, and that there is a substantial likelihood that the applicant will ultimately prevail in the case, before allowing the matter to proceed.

REVISED RECOMMENDATION 24

- a) ANEEL should establish a seven member Consumer Advocate Board of Directors (CAB) with each director serving a fixed term of office. The selection of the Board members should be done only after consultation with local governments, labor unions, consumer organizations, and the Ministry of Mines and Energy, as well as with such other groups as ANEEL believes should be consulted.**
- b) The Consumer Advocate Board should establish a public, transparent process for setting out the criteria for selection and then actually selecting the NGO that will be designated as the official consumer advocate for a period of time not less than five years. The NGO may be reappointed for as many times as CAB deems appropriate but never for more than five years at a time. The CAB will have ongoing oversight responsibility for the consumer advocacy function and should meet periodically to carry out that responsibility;**
- c) Each distribution company be ordered by ANEEL be required to contribute a certain percent (to be decided by ANEEL) of the funds it budgets for its consumer council to an NGO designated by CAB to serve as the consumer advocate;**
- d) A law should be enacted setting forth the criteria under which either the designated consumer advocate, or a private, professional advocate can recover its costs from a regulated company for successfully pursuing a complaint or other type of claim against a regulated entity, and ANEEL should then award such costs where the circumstances conform to the criteria ANEEL has defined.**
- e) If an Ombudsman is created, then some portion of its budget, by law, should be bundled with the other referenced sources of revenue to support the Consumer Advocate function. The Ombudsman, itself, should not serve as the Advocate unless it plays no other role in the regulatory process that might compromise its usefulness and integrity as an advocate for small consumers.**

REVISED RECOMMENDATION 25

The government should give very serious consideration to the merger and full consolidation of all national regulatory responsibilities for both the electric and natural gas industries into a single agency.

REVISED RECOMMENDATION 26

- a) A task force, consisting of regulators, regulated market participants, academics, and government officials (including the proposed Ombudsman) should be convened to propose a program for the creation and sustenance of a national program to provide the intellectual infrastructure for economic regulation in Brazil. The proposal should also include proposing a method for funding such programs, and coordination with related international activities.
- b) ANEEL should, perhaps in coordination with other Brazilian regulatory agencies and/or ABAR, should establish criteria for accrediting regulatory studies programs at Brazilian universities, and establish a program for providing such accreditation.
- c) ANEEL should announce that contributions from regulated companies to university regulatory studies programs can be passed on to consumers on a Real to Real basis, up to a stated maximum level.

REVISED RECOMMENDATION 27

ANEEL should, on request only, play only one role in the planning process.

- a) Determine whether certain costs or risks should be socialized by passing them through to consumers.

REVISED RECOMMENDATION 28

ANEEL should continue its efforts to fully explain the tariff methodology it is employing and the rationale for doing so in as clear a fashion as possible. The use of “Technical Notes,” for example should be not only continued, but perhaps expanded upon to make certain that there is wide understanding of the agency’s thinking and method of analysis in regard to the formulation of distribution and other tariffs. More specifically, future

technical notes should address the question of how mandated electrification programs will be incorporated into the establishment of distribution tariffs, and how incentives can be more neutral between supply and demand side options.

II. Original Recommendations, Updates, and Revised Recommendations

- 1. ANEEL should be provided with authority under the law to establish its own hiring practices, or at least, allowed the flexibility to deviate from generally applicable practices, where the skills and expertise required are unique.**

UPDATE:

Legislation, recently passed by the Congress, removes some barriers previously limiting the ability of the independent regulatory agencies to hire needed personnel on a permanent basis. The legislation does not, however, address another problem ANEEL faces, namely that it, like other government agencies, can only hire new personnel at entry-level positions and compensation. *Thus, ANEEL's ability to hire an experienced or even inexperienced but well-trained professionals is severely impaired by the requirement that it can only provide entry-level compensation to new hires.* All hires, regardless of entry level, would have to enter service at the lowest salary rung for the entry level at which they are hired.¹

Real leadership needs to be exerted in this area, particularly from players in the sector who can help to create a different political reality in regard to this question, a context in which the Executive Branch of the government, which possesses the power to address the problem, will be better positioned to undertake real reform. It is counterproductive and, frankly, harmful to the public interest to preclude ANEEL from hiring new personnel at senior levels and at senior level compensation. In fact, Brazil is somewhat out of the mainstream in this regard among countries with independent regulatory agencies. The FERC and state regulatory agencies in the U.S., regulatory agencies in the United Kingdom and elsewhere in Europe, as well as those in many other countries in Africa, and elsewhere in Latin America provide significant discretion to regulatory agencies to hire experienced new personnel at senior levels. Even in the Brazilian context, the limitations on ANEEL's flexibility in regard to personnel matters is particularly ironic because the agency was created as an autarchy with the capability of establishing its own personnel policies, and the only Constitutional limit on salaries is the not terribly limiting requirement that no public official or civil servant can earn more than a Supreme Court Minister, approximately 19, 000 Reais per month at present. The existence of the legislation and recent

¹ The requirement to hire only at entry-level positions is set out in Lei. No. 10.871 de 20 de Maio de 2004. That provision reflects the traditional Brazilian practice of hiring new administrative personnel only at entry-level positions.

developments regarding new hires is encouraging as an indication that the problem identified in the original report is now widely recognized², but the substance of the recommendation remains valid.

A related issue which did not arise during the discussions and preparation for the original report, but is generically related to the same question as having the discretion to establish its own personnel policies relates to the making of general administrative decisions for the agency. ANEEL directors have indicated that they spend an inordinate amount of their time on administrative details. The reasons for this are both legal, in terms of who has to approve decisions, but also political, in the sense that purchasing or other administrative errors, or as is often the case, perceived errors, are often followed up by investigators of mass media attention. *While it is certainly appropriate that Directors manage the agency's resources prudently, the degree to which they are required to be "hands on," in making day-to-day administrative decisions certainly has the potential for distracting directors from their primary responsibility for regulating the vast electric sector.*

Some balance needs to be struck in order to free the Directors to devote the time needed to substantive matters of regulation. There are a variety of mechanisms for attaining this type of balance. Examples from other countries include models where the Chairman of the Board possesses the executive authority (which may or may not be subject to veto by a majority of the other Directors) for making administrative but not substantive decisions, the Portuguese model where there is an additional, non-voting, Director whose job it is to manage the agency, and a related model where there is a powerful Executive Director who actually manages the agency subject to only broad oversight by the Board. It is not entirely clear which model is most appropriate for ANEEL, but the *status quo* appears unacceptable, so some action needs to be taken. ANEEL is currently working on a proposal to alleviate this burden.

REVISED RECOMMENDATION 1

- a) **ANEEL should be provided with authority under the law to establish its own hiring practices, or at least, allowed the flexibility to deviate from generally applicable practices, other than those specifically related to public integrity and ethics, where the skills and expertise required are unique.**

² Law No. 10.871/2004 established 835 new positions for core activities and 35 new attorney positions for ANEEL. Filling those positions is now at ANEEL's discretion.

b) ANEEL should institute, or if necessary, propose to whoever must approve such a proposal, an alternative management/administrative model for the day-to-day management of the agency, a model which appropriately balances the need for oversight by the Directors with the need for the Directors to spend needed time on substantive matters.

2. ANEEL should be enabled to establish compensation packages for employees which are either benchmarked to the levels of compensation paid by regulated companies, or, at least to allow ANEEL salaries to be comparable to other government agencies whose compensation is in excess of generally applicable government pay scales (e.g. Banco Central).

UPDATE:

This problem remains the same. There are legal and, perhaps constitutional reasons, why ANEEL cannot offer its employees compensation packages that differ from those offered to the civil service as a whole. There is an understandable logic to such rules. Fears of unfair discrimination and loss of appropriate fiscal and budgetary controls doubtlessly provide a basis for applying common rules across the entire civil service. Unfortunately, regardless of how well intended the rules might be, their application to regulatory agencies is perverse. It is perverse because of the nature of the mission of regulatory agencies, because the skill sets possessed by staff are assigned higher economic value by the regulated entities than by the government, and because of ethical considerations that should be applied. The regulator's mission requires agency personnel to interact very closely with the staff of regulated companies. *The skills and training on both sides should be, at least, comparable.*

The problem at present, however, is that once an ANEEL staff member advances beyond introductory level, the differentials in compensation grow substantially. The incentive for agency personnel to leave ANEEL and apply the same skills serving the interest of the regulated entities is overwhelming. ANEEL suggests that it loses 20% of its senior personnel annually to regulated entities. This constitutes a waste of public resources, a reduction in the quality of regulatory service, and a very considerable ethical dilemma. The waste results from the fact that ANEEL has to spend significant amounts of money training staff for their complicated and highly technical jobs. For reasons explained elsewhere in this report, ANEEL has had a great deal of

difficulty attracted fully trained personnel, so the agency has had to offer its personnel training in the skills required. It is simply wasteful to invest in training personnel who do not remain on the job after acquiring good skills at agency expense. Obviously, the quality of the protection afforded consumers and the public interest will suffer when regulatory agency personnel are less experienced and less knowledgeable than the people serving the interests of the regulated enterprises. It is simply unacceptable from a public policy point of view that those charged with protecting both the public and the public interest are less experienced and less knowledgeable than those who seek to advance private interests in the regulatory arena.

This is not a criticism of any particular individuals, most of whom are public spirited and well intentioned, but rather a blunt assessment of where the current personnel policies will lead, in general, over the long run. From an ethical point of view, the problem is no less acute. It should be simply unacceptable for a regulator to leave his/her job at ANEEL and immediately go to work for a regulated company on the same matters or even the same types of matters he or she worked on at the regulatory agency (See Recommendation 4). Good ethical standards necessitate that some barriers be put in place to preclude such improper behavior.

One of the ironies of the application of ethical standards regarding conflicts of interest to ANEEL personnel is that one method widely used to enhance the salaries of senior government staff, appointment to a Board of Directors of a state owned company, is foreclosed to senior personnel at ANEEL. That fact, however, illustrates that there is a strong rational basis for treating regulatory personnel differently than other civil servants. *They should be subject to stricter ethical standards than their peers in other parts of the government.* Other examples of appropriate higher levels of ethical restrictions include limitations of working for regulated companies after leaving ANEEL (e.g., one or two year prohibitions are common around the world), prohibitions against investment in regulated companies, financial disclosure requirements to make certain that there are no prohibited investments, and severe limitations on the acceptance of gratuities. *In short, there is a logical tradeoff. In exchange for accepting greater restrictions on professional mobility, investment opportunities, financial privacy, and gift opportunities, among other limits, regulatory personnel should receive higher compensation than their fellow government workers who have fewer constraints.*

The choice in regard to compensating ANEEL personnel is fairly stark. It is between continuing to apply rules without regard to the fact that regulatory agencies are different than other parts of the government, or recognizing that regulatory agencies are different and that the public interest is best served by recognizing that fact. The irony about the issue of compensation for ANEEL personnel is that the problem is broadly recognized and identified by a broad

spectrum of actors in the power sector. In fact, based on discussions and interviews there is a broad consensus that the problem is very significant. Nonetheless, in the face of political and legal circumstances, there has been precious little done to rectify the problem.³

There is a pending proposal to amend the Constitution that some contend has the promise of improving these serious human resource constraints. Constitutional Amendment Proposal 81/2003 ("PEC 81"), if approved, would provide constitutional status for regulatory agencies to do what they are already doing under law. It is not clear that the proposal would necessarily alleviate the problems associated with regulatory personnel, as the provision does not explicitly address human resource questions, or add to agency powers beyond that which currently exist. It simply makes them more permanent.

The original recommendation regarding compensation for ANEEL personnel should remain unchanged, but should be supplemented as follows:

REVISED RECOMMENDATION 2

- a) **ANEEL should be enabled to establish compensation packages for employees which are either benchmarked to the levels of compensation paid by regulated companies, or, at least to allow ANEEL salaries to be comparable to other government agencies whose compensation is in excess of generally applicable government pay scales (e.g. Banco Central).**⁴
- b) **Compensation for staff and Directors of ANEEL should be seen in tandem with the enhanced ethical restrictions, particularly in regard to job mobility and investment opportunities. Thus, ANEEL should be able to compensate its personnel at higher**

³ The *Projeto de Lei* on the role of regulatory agencies, has, in the views of some of the interviewees, the potential to drain the agency's resources. Language in the proposed law is vague on the point, but it could be interpreted that the Ombudsman will have the authority to call upon agency personnel to perform work he/she decides to undertake. Thus, it appears that ANEEL staff could be diverted from their primary regulatory mission, and removed from the "normal" chain of command to perform other tasks for an authority other than ANEEL itself. Thus, an agency already constrained in terms of human resources could well find itself even more shorthanded.

⁴ There is apparently little legal basis in Brazil for tying compensation arrangements for regulatory agency personnel to the labor market in which those agencies compete for talent. As discussed, the consequences of an inability to do so may put regulators at a very severe disadvantage in recruiting competent professionals. Thus, the intellectual and practical foundation for the recommendation is solid, but the legal precedents may not be easy to overcome. There may be a disconnect between market realities and the legal restrictions under which ANEEL must conduct its business. As noted, there is also the political and bureaucratic reality that the government is fearful that if regulatory agencies are given such flexibility, other agencies are likely to seek the same flexibility.

levels than other governmental personnel, but ANEEL staff should also be made subject to the more stringent ethical restrictions set out in Recommendation 4 below.

- c) **Constitutional Amendments that offer regulatory agencies the flexibility to relieve the constraints limiting compensation for regulatory personnel to non-competitive levels should be supported. (Please refer to footnote 16.)**

3. ANEEL must be permitted to hire staff on a permanent basis

UPDATE: When the original report was written, ANEEL’s legal authority to hire new staff was limited to doing so on three-year nonrenewable contracts. That requirement was clearly incompatible with building a competent staff with a career opportunity in regulation, or with any other public policy purpose. That intolerable problem, fortunately, should be fixed by the recent legislation passed by Congress. When fully implemented, the law will enable ANEEL to hire permanent staff and offer employees a career path.

REVISED RECOMMENDATION 3

The new legislation, which recently passed Congress, should be fully implemented as soon as possible to enable ANEEL to hire staff on a permanent basis at the earliest practicable time.

4. Directors and Staff of ANEEL should, for a period of one calendar year from the date of leaving ANEEL, be legally prohibited from employment of any kind, including on a consulting basis, which relates in any way to matters pending at ANEEL. In regard to those specific matters on which a person worked while at ANEEL, the prohibition should be of lifetime duration.

UPDATE:

ANEEL has been remarkably free of any ethical conflicts or controversies. Nonetheless, given the turnover in staff, the low compensation provided to staff, it, good public policy, and

credibility, it is critical that proper ethical rules be put in place and vigorously enforced. While some ethical standards, prohibitions on bribery, for example, are embodied in law and are applicable generally to government personnel; there are a number of other ethical provisions specifically applicable to regulatory personnel that should be adopted into either law or rules governing the behavior of regulatory personnel. The substance of the measures are derived from international standards and from experience regarding ethical controversies in which regulatory personnel have found themselves involved. Some of the recommended provisions are, as noted, in the footnotes, already addressed in other generally applicable laws, but it makes sense to consolidate all of the provisions into a single document. The generally applicable provisions, however, in some places, as noted in the recommendation, need to be strengthened by provisions more specifically applicable to regulatory personnel.

ANEEL is currently working on a Code of Ethics, which, upon completion, the agency plans to publish and implement. Thus, the earlier recommendation, which is still valid, should be reiterated and supplemented as follows:

REVISED RECOMMENDATION 4

By law, the Directors and Staff of ANEEL should be subject to very strict ethical standards.

At a minimum, the standards should include:

- a) **For a period of one calendar year from the date of leaving, an ANEEL Director⁵ or employee should be prohibited from employment of any kind, including on a consulting basis, which relates in any way to any matter pending at ANEEL. In regard to those specific cases on which a person worked while at ANEEL, the prohibition should be of lifetime duration**
- b) **Prohibition on all ANEEL personnel and immediate family as defined by law (Law No. 9.784/99) owning any kind of financial interest (e.g. stock, debt, creditor) in a regulated entity;**

⁵ Law No. 9.427/96 prohibits ANEEL Directors from working for any company regulated by ANEEL for one year. There is a more general law applicable to all regulatory agencies (9.986/2000) that subsequently reduced the quarantine to four months (during which, under both laws, they continue to receive their salaries). The *Projeto de Lei* proposes a specific quarantine period of four months. By way of comparison, the quarantine period for Sao Paulo state (CSPE) regulators is currently four years. No one, under current law, is subject to a lifetime prohibition from working on specific cases on which a person worked while in the employ of ANEEL.

- c) Any ANEEL Director or staff member owning any financial interest in a business which is a specifically identifiable party to a matter to be decided by the agency, must abstain from participation in the matter⁶;
- d) Prohibition on ANEEL personnel accepting gratuities of any kind from parties having business with the agency⁷;
- e) ANEEL personnel and immediate families, as defined by law (Law No. 9.784/99), should be required to file a disclosure of all financial assets or liabilities in excess of a *de minimus* amount⁸;
- f) Prohibition of ANEEL personnel from engaging in any practice or behavior which might either be, or reasonably appear to be, improper, unethical, illegal, or harmful to the regulatory agency and/or process⁹;
- g) A process for enforcing the Code and for handling complaints from the public regarding ethical issues involving ANEEL personnel.

5. Relevant legal instruments be amended to list the professions from which Directors must be drawn. At a minimum those professions should include economics, law, engineering, and accounting. No more than two Directors can be drawn from the same profession.

UPDATE:

There has been no change in the law regarding any requirements for professional diversity among ANEEL Directors, but it is worth noting that the current Board no longer consists exclusively of engineers, a circumstance that many interviewees for the first report noted with concern. Although no one interviewed complained about ANEEL appointments to date in regard to technical and experience qualifications, concerns were expressed that unqualified persons

⁶ Abstention in such circumstances is required under Law No. 9.784/99 (Federal Administrative Procedure Law).

⁷ The acceptance of gratuities in connection with their position is already grounds for termination of any civil servant under Law No. 8.112/90 (Federal Servants Act). Nonetheless, a flat prohibition included in a Code of Ethics applicable to ANEEL personnel deserves explicit restatement.

⁸ Laws No. 8.112/90, No. 8.429/92, and No. 8.730/93 require all federal employees to disclose such holdings to the agency where they are employed and to the *Tribunal de Contas*. These laws do not, as currently written, however, apply to the immediate families of the employees.

⁹ Law No. 8.429/92 (Corruption in Administration Law) lists a number of events or acts that constitute corruption by a public servant. The law also establishes penalties, such as termination, fines, or requiring restitution. Among the instances of corruption cited are violations of the duty to be honest, lawful, impartial, and loyal to the institution(s) served.

could be appointed in the future and suggested that protections should be put in place to avoid such an eventuality. Because the Congress is considering regulatory legislation it would be reasonable to address these concerns in law.

REVISED RECOMMENDATION 5

Relevant legal instruments be amended to list the professions from which Directors must be drawn. At a minimum, appointments should be made from among experienced professionals in economics, law, engineering, and accounting, and perhaps other relevant professions. No more than two Directors can be drawn from the same profession. Consideration should also be given to inclusion of minimal, relevant technical/experience qualifications for directors in law.¹⁰

6. The law should be amended to state that ANEEL, while continuing to be authorized to collect 0.5% of the electricity revenues, would have to undergo precisely the same budget approval process to which other parts of the government are subject. If ANEEL’s approved budget amounts to less than 0.5% of electricity revenues, then the difference between expenditures and collections should be subject to the measures set forth in Recommendation 7.

UPDATE:

ANEEL’s budget is, quite properly subject to the government’s overall supervision. At present, however, the government has decided that although it is still collecting .5% of electric sector revenues from regulated companies (passed through to consumers) it is permitting ANEEL to spend only 40% of what is being collected. The balance of the revenues being collected is not being applied to support the activities for which they are intended. The government is simply reallocating them to some purpose other than electricity regulation. The consequence is that the government has an incentive, or, at least no disincentive, to divert revenues that are supposed to be used for regulation. The discussion of this problem is continued below in Recommendation 7. The original recommendation is still valid and bears reiteration:

¹⁰ The law can also list specific minimal qualifications such as university degrees, professional experience and other such criteria.

REVISED RECOMMENDATION 6

ANEEL, while continuing to be authorized to collect 0.5% of the electricity revenues, should have to undergo precisely the same budget approval process to which other parts of the government are subject.¹¹

7. The second measure is a prohibition, written into the law, against those funds being diverted to other use by the Government. If the Government decides to make across the board cuts in spending and apply them to ANEEL, then it could do so, but the excess created in regulatory fees by the cutback, would then automatically revert to the regulated companies for passing back to the consumers. That way the Government could impose controls on overall spending, but would have no incentive and no ability to divert funds intended for regulatory use. This type of revolving fund mechanism is common in regulatory agencies in the United States and elsewhere.

UPDATE:

Although .5% of electric revenues continue to be collected for regulatory purposes, the Government is not spending all of the funds collected for its stated purpose. It has withheld 60% of it from ANEEL. As a result, the agency is forced to operate on only 40% of the funds that the law authorizes it to collect. Apparently, the difference between what is collected and what is provided to ANEEL is being retained for the government to contribute to the budget surplus the government wishes to run as part of its overall fiscal austerity program. While there is no evidence to suggest that ANEEL has been singled out for punishment by the government, this type of practice, although perhaps well intended from an overall fiscal policy perspective, makes it virtually impossible for the regulatory agency to properly carry out its responsibilities.¹² Regulatory fees or assessments are, in international practice, and perhaps even under Brazilian law, not part of the government's overall tax collection. Rather, they constitute a "fee for

¹¹ This is no different from what the current law requires. Given the debate ongoing in Brazil regarding the independence of regulatory agencies, however, it seems sensible to restate it in order to avoid any misunderstanding regarding the recommendation contained in this report.

¹² While there is no evidence or even suggestion that the government has used its budgeting powers to "punish" ANEEL for its decisions, there is no legal provision that would prevent some future government from doing so.

service,” or earmarked funds that should not to be diverted for other purposes. There are three compelling policy reasons for this. The first is to remove the temptation for any government to divert funds for other purposes. The second is to prevent a government from abusing fiscal controls in order to “punish” the agency for decisions not to its liking, thereby compromising the agency’s independence. The third is that the revenue to support regulation is collected within electricity rates because it is part of the overall cost of providing electric service and those costs should remain internalized within the sector.

There are two other matters that merit consideration in regard to ANEEL’s financial circumstances. They relate to the motivations the government may have in regard to its treatment of the agency’s budget. The first relates to political motives a government may have, and the second relates to fiscal motivations. While there is no clear indication that the Brazilian government, either the current one or its predecessor, has used the budget to penalize ANEEL for its decisions, experience elsewhere and the pending proposal for performance contracts (See Recommendation 8), raise the possibility of budgetary retaliation. To guard against that, it is worth considering the imposition of a legal restriction on the government’s ability to manipulate the budget in order to compromise regulatory independence. The proposition is simple, namely that the agency’s budget cannot be subject to reduction within the fiscal period for which the budget was approved, unless the reduction is part of an overall budget reduction by the government that is generally applicable to across the government and does not disproportionately impact ANEEL. In regard to the prospect of across the board budget cuts, that the government may feel fiscally pressured to effectuate, there is another consideration in regard to regulatory agencies, namely that the financial impact of regulation of the power sector is greater than merely the budget of ANEEL. Poor or weak regulation will almost certainly result in greater cost to the economy and to society than the expenditure made by regulators by many magnitudes. For that reason it is worth considering removing ANEEL’s budget entirely from the government’s balance sheet. In terms of actual *Reais*, the cost of taking such a step is minuscule, and substantively, it is justifiable because regulation should be seen as part of the overall operation of the sector, particularly its privatized parts, rather than as part of the cost of government.

Accordingly, the recommendation is renewed and changed as follows:

REVISED RECOMMENDATION 7¹³

- a) **The law should specifically preclude the funds collected from consumers for purposes of regulation from being diverted to other use by the Government. If the Government decides to make across the board cuts in spending, in accordance with the terms of Revised Recommendation 7.b., and apply them to ANEEL, then it could do so, but the excess created in regulatory fees by the cutback, would then automatically revert to the regulated companies for passing back to the consumers. That way the Government could impose controls on overall spending, but would have no incentive and no ability to divert funds intended for regulatory use.**
- b) **The law should preclude the government from reducing ANEEL's budget appropriation during the fiscal year for which it was approved, unless the reduction is part of a broad cutback generally applicable across the government and does not disproportionately impact ANEEL.**
- c) **ANEEL's budget should, for accounting and fiscal purposes, not be included on the balance sheet of the government. This provision, however, should not have any effect on the government's overall capability of exercising fiscal and budget oversight.**

8. The practice of having a performance contract for regulators should be discontinued.

UPDATE:

A great deal of the debate over the role of regulatory agencies in Brazil has focused on the idea of performance contracts. The idea of such instruments is not new in Brazilian electric regulation. The original law creating ANEEL (No. 9.427/96) had a provision calling for performance contracts and the Cardoso Administration, itself, had actually executed such a document on March 2, 1998 to run through December 31, 2000. In practice, however, it was never actually enforced, and was not renewed upon expiration.¹⁴ In its December 2003 Report (*Análise e Avaliação Das Agências Reguladoras No Atual Arranjo Institucional Brasileiro*) the

¹³ This recommendation is very similar to the method proposed for funding electric regulation in a recently issued World Bank document. See Elizabeth Kelley and Bernard Tenenbaum, "Funding of Energy Regulatory Commissions." World Bank Energy and Mining Sector Board Working Note #1, www.worldbank.org/energy.

¹⁴ The provision for a performance contract in the ANEEL statute stands in notable contrast to the law establishing ANP, the gas regulatory agency, which has no such provision.

Inter-Ministerial Working Group recommended that performance contracts be put in place. The recommendation was submitted to the Congress for approval as a *Projeto de Lei*. The debate over performance contracts, of course, grows out of a larger, quite understandable, concern about the accountability, or, as often described in Brazil, “social control,” of independent agencies. It is that larger context that this issue needs to be considered.¹⁵

It should be noted unequivocally that regulatory independence does need to be balanced against the legitimate need for “social control”. The issue is what form that control should take, not whether or not there should be a form of social control. (See the discussion in #9 below). In the December 2002 PPIAF sponsored report, it was suggested that a performance contract is not a particularly effective means of exercising social control over an independent regulatory agency.

There are a variety of reasons why performance contracts for regulators are an ineffective, perhaps even counterproductive, means of exercising social control.¹⁶ One category of reasons relates to enforcement of the document. *It is very difficult to see how performance contracts can be effectively enforced without seriously compromising regulatory independence.* What are the remedies for failing to meet the terms of the contract? Are regulators who fail to meet their contractual obligations to be summarily discharged or demoted in pay in the middle of their term? Is the agency to be penalized by having its budget slashed? None of these remedies can be applied without considerable cost to the independence and/or the effectiveness of the agency.

Another set of concerns relate to the specific terms contained in a performance contract. What benefits are to be gained that are not already derived from appellate processes, from the terms of concession contracts, from the powers of legislative oversight, from the dictates of existing law, and from the government’s own powers to issue decrees and *portarias*? Performance contracts seem very unlikely to add much substance to those instruments of authority.

A third set of concerns relates to the administration of performance contracts. For regulation to be transparent, the contracts must themselves be administered transparently. What mechanisms will be put in place to assure transparency in the administration of the contracts?

¹⁵ Generally speaking, performance contracts in government are often used as a means for the government to assure effective management and performance from state owned enterprises engaged in commercial enterprises. In fact, the two countries, Tanzania and Peru, as noted below, which have attempted to employ performance contracts for regulators drew the idea from precisely that commercial mode of using such a document as a tool for management. The applicability of such instruments in a non-commercial setting, such as a regulatory agency whose mission and objectives are more complicated than that of a commercial entity, seems dubious. Commercial objectives seem far more capable of quantification and metrics than are those of public policy and regulation, which are far more subjective in nature.

¹⁶ There is one positive attribute of performance contracts in Brazil. Under the provisions of Article 37, Paragraph 8, Item 3 of the Brazilian Constitution, agencies with such contracts appear to acquire special status that allows them to offer their employees higher salaries than they would otherwise be able to provide.

What measures can be put in place to assure that such instruments are not used by the government to pressure the regulators into making decisions to the liking of the government, and thereby compromising the agencies' independence? What precludes the performance contracts and the framework for enforcing them from being burdensome, costly, inefficient, and ultimately forcing the regulators to lose critical focus by encouraging a disproportionate inward looking focus and bureaucratic risk aversion that can be quite counterproductive in a regulatory agency when? How will the terms of a contract differentiate between performance objectives that go unmet because of external variables such as insufficient budgets or macroeconomic conditions, and those that are within the control of the regulators?

A final set of concerns relates to the signals performance contracts between ministers and regulators send to investors and consumers alike, namely that the regulators are accountable directly to the government rather than to the state and society as a whole, and seem likely, therefore, to be subject to political interference or other serious compromises of their independence. While the degree to which this would turn out to be true in Brazil is obviously not knowable at present, investors in capital markets are notorious for reacting quickly to seemingly minor events, so even the new potential for political interference, especially given the criticisms that some political figures have made of ANEEL over the past few years, makes it highly probable that the use of performance contracts will be looked upon as a very unfavorable development by investors. While the specific terms and methods of administering the contracts will give an indication of how much political interference, if any, will actually occur, those facts will not be known for some time, and they are always subject to change, so the big issues for investors who rely on the independence of regulators is that another vehicle to interfering with regulatory work has been added to the equation, and nothing good, from their perspective, can come of that.

Given all of those considerations, it is not surprising that performance contracts for regulatory agencies are extremely rare in the world. The first report noted that a quick survey revealed that only Tanzania had sought to employ them. Peru also attempted to use them, but solely in order to assure that the Minister of Finance was able to exercise fiscal control over the regulatory agency.¹⁷ There may be another example or two, but a performance contract, for the reasons noted, is an instrument that has almost always been rejected. Indeed, as noted, performance contracts had initially been put in place in Brazil for electricity regulation, but had fallen into

¹⁷ In both countries, the decision to adopt performance contracts was very controversial. The Tanzanian performance contracts are written into law, but it is not clear that they will ever actually be used. The Peruvian contract was put into effect, but, as noted, its scope was very limited..

disuse. *Accordingly, the initial recommendation that performance contracts are inadvisable remains valid.*

Although the recommendation that performance contracts not be deployed is still valid, the discussions conducted with Brazilians in preparation for the report, plus the fact that the Government has proposed such contracts to the Congress, make it clear that mere reiteration of the prior recommendation is insufficient. There appeared to be a wide diversity of opinion regarding the efficacy and substance of performance contracts. At one end of the spectrum were those who saw very specific, comprehensive contracts as an essential element of maintaining “social control” of the agencies. At the other end of the spectrum were those who believed, as was suggested in the earlier report, that the contracts were very difficult instruments to implement and enforce, sent the wrong signals regarding independence, and may be lacking in transparency. The most common position, however, seemed to be somewhat in the middle, namely that the performance contracts should be deployed, but that they should be focused primarily on administrative and management matters and should steer clear of substantive issues and avoid remedies that were too severe. As one proponent of the middle ground position explained, he did not see any likelihood that a regulator would be removed from office in the middle of his term because of failure to fulfill some provision of the performance contract. The middle ground position, at least according to its advocates, allowed for the government to exercise legitimate management, process, and fiscal oversight, but not to interfere with the agency’s independence on substantive matters. Seen from a slightly different perspective, the argument seemed to be that government was entitled to set specific criteria for its legitimate expectations of regulators, but was not entitled to interfere with substantive regulatory work. There is nothing inherently unreasonable about such a proposition. The question is whether performance contracts are the most effective ways to achieve that goal, or whether there are more effective, less counter-productive means to exercise “social control” than performance contract. The discussion in Section 9, below, will discuss such terms.

9. **The law should be amended, or policies put in place, to provide for periodic, public, transparent review of the activities of ANEEL by designated legislative and/or executive authorities on a regular, periodic basis (perhaps every 4 or 5 years).**

UPDATE:

The vigorous and rather thorough debate that has occurred regarding the role and performance of ANEEL, and other independent regulatory agencies, has highlighted the need to achieve the proper balance between independence and social control. *Indeed, the concurrent debate in Brazil over judicial reform has some very interesting parallels, although it is notable that no one has been advocating performance contracts in order to assure judicial accountability despite the fact that the need for oversight and accountability has been clearly identified.* Presumably, one of the reasons why performance contracts have not been demanded is because they seem ill equipped to provide the proper balance between independence and social control that both a well functioning judiciary requires. The situation in regard to infrastructure regulation, although different from the judicial system in its legal and constitutional context, is conceptually, almost identical. If performance contracts are not the most effective mechanism for exercising social control, then the obvious question is: what is the best means for doing so. There is no single answer to that query, but rather a series of measures, which, taken as a whole, seem quite appropriate. One of them is the recommendation noted above calling for oversight reviews by relevant legislative and/or executive branch personnel. Given all the debate that has raged over these issues, it is important to discuss the issue of social control in more depth.

In thinking about social control of regulation, the first task is to identify the areas where accountability is needed. They include making sure that, at a minimum, the regulators do the following:

1. Act only within the boundaries of their legal authority;
2. Follow all requisite legal procedures;
3. Adhere to all binding, articulated law and policy;
4. Meet all of their legal obligations;
5. Meet the highest ethical standards;
6. Operate transparently and with public participation
7. Meet responsibilities professionally and competently;
8. Manage their resources efficiently and effectively;
9. Make decisions in timely fashion;
10. Promote efficiency and productivity in regulated markets;
11. Protect consumers;
12. Assure service quality and reasonable prices;
13. Provide investors with a reasonable opportunity to earn a fair return.

These areas fall into three categories, in terms of how to hold the agencies accountable for their performance. The first category, matters of law, is found in items 1-4, and perhaps parts of 5, 6, and 9. They are precisely the types of subjects that lend themselves quite well to appellate/judicial review. The existence of such review is vital to effective regulation. Accordingly, that subject will be addressed in considerably more detail below (Sections 20-24), and requires no further elaboration here. The point in regard to social control, however, is that the existence of effective appellate/judicial review of the regulatory performance in these areas, should be sufficient to make certain that all legal obligations are complied with and enforced. It is difficult to see how performance contracts or any other form of social control would add much value in these areas, other than perhaps to identify a pattern that might exist.

The second category consists of administrative and fiscal matters (items 7 and 8, as well as parts of 5, 6, and 9). While these are areas where performance contracts might be of some value, they are also areas where a performance contract could have the effect of internalizing problems more than they ought to be. An excellent example of that effect is the problem that many observers have identified with the lack of experienced personnel at ANEEL. As noted earlier, much of this problem is beyond the capacity of ANEEL to resolve as a management issue. The compensation packages the agency is allowed to offer employees are simply inadequate to recruit and retain experienced, senior personnel. The problem is compounded by the budget uncertainties with which the agency has had to contend. In short, a performance contract focused on the agency's internal operations would be of little value in resolving performance problems caused by government decisions beyond the control of ANEEL, although they might help to expose the link between lack of resources and failure to perform up to expectations. Performance contracts could also have the effect of locking in a level of rigidity that wastes resources and interferes in the effective management of the agency. A simple example would be where the agency is required to hold a minimal number of public hearings in a given year, but the workload in that year did not involve many matters requiring or meriting public hearings. *In short, while management issues are important and are deserving of attention from the perspective of social control, performance contracts may not be the most effective way of addressing them*¹⁸.

The final category of issues (items 10-13) is substantive. *It is in the substantive areas that independence is most important, and social control, while clearly important, must be exercised carefully so as not to distort outcomes and/or preclude the types of independent, dispassionate*

¹⁸ Proponents of performance contracts generally noted in interviews that it is only in the area of administrative and fiscal matters that they intend for performance contracts to apply. Opponents of the contracts expressed cynicism that such contracts would actually be limited to administrative and fiscal matters, and foresee the use of performance contracts to interfere in substantive matters.

judgments regulators are required to make. Thus, social control on substantive matters can be achieved by doing three things. The first is the clear articulation of all of the principles and policies that regulators will have to follow in deciding substantive matters. This is, of course, best done by the enactment of laws or rules in advance of the decisions actually having to be made. In fact that is precisely what is occurring at present in the formulation of the new market model for electricity, a clear policy issue. The government proposed a new law to the Congress, the Congress responded by passing a new law, and the Government is now formulating the subsidiary legislation need to effectuate the new law. That law will provide the direction ANEEL will need to follow in the future. Without addressing the substance of the new law and new market model, the process followed constitutes precisely the way that social control should be exercised over regulatory agencies. The regulators are given legal direction on policy that they must follow, and if they fail to do so, their actions will be subject to reversal by the courts on appellate review. The existence of appellate (judicial) review constitutes the second aspect of social control that is required. The third is to require regulatory agencies to operate as transparently as possible and to publicly report all actions that they are taking. To some degree, that is already being done. ANEEL is required to issue annual reports, it makes its decisions public, provides opportunity for public participation in its decision-making, and periodically makes public reports on specific types of activities in which it is engaged or the effect of its actions. It has reported, for example, in order to make them as transparent as possible, on the subsidies and cross-subsidies that are embedded in tariffs. Elsewhere in this report, there are recommendations that ANEEL might follow in order to make its activities even more transparent. There may well be other areas where ANEEL should undertake, or be compelled to undertake, more such public reporting.

In the interviews, concerns were raised that regulators might not be as accountable to the Congress as Ministers because the legislators, unlike in the case of Ministers, lacked the capacity to compel the attendance of regulators at legislative hearings.¹⁹ It was, therefore, feared that the regulators would escape the level of scrutiny and oversight their importance to society might

¹⁹ Under the terms of the Constitution, the Chamber of Deputies, the Senate, or any of its Committees, may call upon any Ministry of State or head of any body subordinate to the Presidency to appear before it on a previously disclosed matter. Any unjustified failure to appear by such an official could render him/her subject to criminal charges known as “crime of responsibility.” Beyond those defined persons, however, the Congress may only invite authorities and/or citizens to appear as well, but it cannot, as a matter of course, compel their attendance. Regulatory agencies appear to fall into those categories of persons whose appearance cannot be compelled. The Congress does, however, have the power to create a Special Inquest Committee (CPI) with the authority to compel attendance, but CPI’s have been used to investigate specific incidents or facts, rather than to conduct general oversight hearings. Congress, of course, could always pass a law to require attendance at hearings by ANEEL personnel.

otherwise demand. If that deficiency exists, it is not at all clear how important it is. Given that the Congress clearly has the power to decide the continued existence of any regulatory agency, what powers, if any, are delegated to them, the power to define how the agency must perform its functions, and exercises considerable control over the agency's purse strings, it is hard to conceive of a circumstance where a regulator would refuse to voluntarily cooperate in a Congressional inquiry.²⁰ Moreover, the *Tribunal de Contas*, has already carried out an investigation of regulatory performance and can clearly be requested to do so at any time. Thus, even if the Congress lacked to power to compel agency personnel to appear before it, that does not appear to be a major impediment to the exercise of legislative oversight of regulatory matters.

While judgments will inevitably be made as to the effectiveness of regulators in deciding substantive matters, it is often difficult, if not impossible to determine whether successful or unsuccessful outcomes are most influenced by the relevant laws and policies or by the judgment and competence of the regulators themselves, or some combination of the two. For that reason, in the areas where social control is most important, it is apparent that one must consider the effectiveness of the overall regulatory regime, not just the performance of the current regulators themselves. That requires careful balancing of the larger framework of regulation, including relevant laws and regulations, with an assessment of the performance of the regulators themselves. In short, the optimal form of exercising social control is a process that looks at both the macro and micro aspects of the regulatory system. It is very difficult to separate evaluation of the performance of the regulators from larger questions of resource allocations, relevant laws and policies, and overall economic trends and circumstances. In that context, it makes sense that regulatory performance reviews be conducted by legislators and executive branch officials who can look at both the macro and micro performance of the regulatory system as a whole rather than at the narrower question of the performance of the regulators themselves. Thus, the idea of a performance contract should be seen not as a formal document between regulators and ministers, but rather as a broad social/regulatory compact in which policy-makers and regulators interact with investors, managers, and consumers. That entire compact, not just the performance of the regulators, to be effective, and to be responsive to changing needs, needs frequent review by officials in a position to not only render judgment, but also to do something about their findings.²¹

²⁰In practice, invitations to voluntarily appear before Congressional hearings are declined very infrequently.

²¹ One of the benefits of performance contracts cited by proponents, and even some of its opponents, as noted earlier, is that it helps to make the relationship between resources provided and performance more transparent. That may well be true, but only if the evaluation under the contract is conducted in a fair and transparent fashion. The same benefit, however, can be provided in oversight hearings where performance expectations will be articulated and regulators later evaluated on how well they fulfilled them. The benefit

For that reason it is best to avoid narrow performance contracts and to create instead a broad social/regulatory compact.

It is important that the oversight and review proceedings be conducted on a professional and technically competent level. That is why the involvement of the *Tribunal de Contas* and professional consultants is so important. While it is probably unrealistic to expect that a subject as full of policy issues, as critical to the quality of life, and as consequential for a country's economic well being as electricity policy and regulation will be devoid of politics, it is important that the oversight proceedings, to the extent possible, focus carefully, and to the extent possible, exclusively on the long-term policy, management, legal, and technical issues, rather than the political controversies of the moment. The role of the oversight hearings is to inform policy-makers and investigate what changes, if any, are required in the overall regulatory framework for electricity. *The mission and operation of ANEEL as well as the performance of its Directors and staff is certainly a critical element of the overall regulatory framework, but so is the policy, economic, and legal context within which the regulators must operate. The oversight and review process, to be effective and thorough, should cover all of those subjects, as well as any other matter that the reviewing authorities believe to be of consequence.*²²

In the context of a broader social/regulatory compact, the Ombudsman²³, as proposed in the *Projeto de Lei*, can play a role by publicly and periodically reporting on the state of the overall compact. It can assist the authorities conducting periodic reviews, it can urge special reviews, when it feels such a proceeding is required, and it can make such critiques as it believes are justifiable. It can also provide advice to ANEEL as to how it might be more effective. Two other roles for the Ombudsman will be discussed later in regard to consumer advocacy and to building an intellectual infrastructure. *The Ombudsman's role should not, however, be one of supervision over ANEEL.* To allow an Ombudsman to exercise supervisory powers over the agency or any of its personnel seems almost certain to add an additional level of bureaucratic complexity and expense and could seriously compromise independence and/or transparency while providing absolutely no assurance that any social benefit will accrue to justify those costs and risks.

One other note of caution is that care will have to be taken to make sure that the office of the Ombudsman cannot be used for political purposes. For that role to be filled effectively, it must be

of doing that in public hearings is that the transparency will be certain and that the persons with the authority to allocate resources will be conducting the evaluations.

²² Legislative oversight hearings are very common in the United States at both the state and federal levels. They often focus on specific issues of interest, but are sometimes much broader in scope. The scope of the hearings is left to the discretion of the legislators.

²³ The *Projeto de Lei* uses the term, *Ouvidor*. The term has been anglicized in this report as Ombudsman. For purposes of this report, the two terms are used interchangeably.

carried out on a completely professional basis. Several interviewees expressed concern that the Ombudsman would be more of a political than a technical operation. If that becomes the reality, the office will clearly add little of value to the regulatory process, or any actors within it.

REVISED RECOMMENDATION 8

Instead of using performance contracts, social control should be exercised as follows:

- a) **Legislators and/or executive policy-makers (e.g. CNPE), with the assistance and advice of the *Tribunal de Contas*, and perhaps utilizing the services of independent, impartial, exert advisers, should conduct regular, periodic reviews (no less than every three years) of the entire regulatory system, including re-examination of relevant laws and policies, prevailing practices, performance of regulatory agencies, processes and procedure being followed, and outcomes in terms of service quality, prices, profitability, and other relevant matters. These review proceedings should be open to public participation and conducted on a fully open and transparent basis. They should result in the issuance of a report which makes known the findings as well as recommendations regarding proposed legal and/or policy changes, expectations of regulators, resource allocations, and all other relevant matters. Each subsequent review should start by reviewing the status of the recommendations from the previous report. Although the report may praise or criticize individuals, the reviewing body will have no authority to take any steps to compromise the independence of individual regulators.**
- b) **Should the Ombudsman be created, it can assist the authorities conducting periodic reviews, it can urge special reviews, when it feels such a proceeding is required, and it can make such critiques as it believes are justifiable. It can also provide advice to ANEEL as to how it might be more effective. The Ombudsman's role should never, however, have supervisory power over ANEEL, or over any of its personnel.**

10. ANEEL's rules, or preferably, the law, should be amended to require that all communications between ANEEL and any party, specifically including any agency of the Government, on a matter currently, or about to be, pending before the agency, be made in a publicly accessible, completely transparent way.

UPDATE:

The nature of the communications between the government, albeit a new government, and ANEEL is still the subject of much speculation and debate among stakeholders. There is, therefore, no reason for reason to change the recommendation. It bears, with some minor editing, reiteration.

REVISED RECOMMENDATION 9

Decree No. 2.335/97, which regulates ANEEL's law, should be amended to make it explicit that all communications between, and/or among ANEEL and any party, specifically including any agency/ministry of the Government, on a matter currently, or about to be, pending before the agency, be made in a publicly accessible, completely transparent way.²⁴

11. All decisions of the agency be in writing and should explicitly follow the format below:

- a. General Description and History of the Matter(s) Under Consideration;**
- b. Summary of the Views Offered by All Parties to the Matter;**
- c. ANEEL's Analysis of Law Facts, Evidence, and Opinions Offered;**
- d. Formal Statement of the Decision and its Rationale.**

UPDATE:

ANEEL has clearly been moving in the direction that was recommended. The agency has committed itself to increasing transparency and this is part of that overall course. The agency has been doing so, however, based on the judgments of its directors. While their commitment is laudable, it does not necessarily establish the procedures on a permanent basis. The successors of the current set of directors may well choose to change directions. Given that Congress is currently considering legislation regarding the role of the regulatory agencies, it is urged that the recommendation, as restated below, be made permanent as part of any legislation that is enacted into law, as set forth in the recommendation below:

²⁴ Such conditions exist under Law No. 9.784/99.

REVISED RECOMMENDATION 10

Decree No. 2.335/97, which regulates ANEEL's law, should be amended to make it explicit that all decisions of the agency be in writing and follow the format below:²⁵

- a) **General Description and History of the Matter(s) Under Consideration;**
- b) **Summary of the Views Offered by All Parties to the Matter;**
- c) **ANEEL's Analysis of Law Facts, Evidence, and Opinions Offered;**
- d) **Formal Statement of the Decision and its Rationale.**

12. All decisions should be taken by vote of the Directors in a public meeting with each Director having the opportunity to speak about his (her) decision, and with each Director having the opportunity to submit a separate written opinion either concurring with the majority of Directors, but for different reasons than those set forth in the majority decision, or dissenting.

UPDATE:

As in the case of the Recommendation 11, ANEEL has already begun following at least some, if not all of the terms of this recommendation. There have already been dissenting opinions written and disseminated, and the Directors have publicly stated their own positions on matters being decided. As in the case of number 11, the only issue is whether the current practice will continue under subsequent directors. Significantly, ANEEL is also beginning to make its decisions through formal voting in public meetings. Accordingly, given that Congress is currently contemplating changes in the law regarding regulatory agencies, it is recommended that the following provisions be written into law:

REVISED RECOMMENDATION 11

By law, all decisions of ANEEL should be taken by vote of the Directors in a public meeting with each Director having the opportunity to speak about his (her) decision, and with each Director having the opportunity to submit a separate written opinion either concurring

²⁵ Such conditions exist under Law No. 9.784.99.

with the majority of Directors, but for different reasons than those set forth in the majority decision, or dissenting.

13. ANEEL should seek formal input from all interested parties into how it might make better use of public hearings for testing information and ideas that have been put before it. Upon receipt and analysis of the input, the agency should adopt procedural rules that provide for a more rigorous, open opportunity to test information given to ANEEL for consideration in any given matter.

UPDATE:

As was noted in the earlier report, ANEEL has, for some time, made extensive use of public hearings in order to encourage and facilitate public participation and input into the decision making process. Since the publication of the report, ANEEL has if anything expanded its efforts in that regard, as exemplified by the public consultations it conducted for setting the tariffs for distribution companies. That practice is laudable and should certainly be continued. One interviewee, however, suggested that ANEEL's public hearings were long on participation but short on substance. *Indeed, the original report specifically noted that there is another type of public hearing of which the agency had not made extensive use. That, of course, is a more technically oriented hearing where the opinions of experts are voiced and tested through counter-arguments and questioning by those with opposing views.* Public debates and opportunities for cross-examination of those offering opinions to ANEEL will enable the regulators to better analyze the information they are receiving and to determine what information and what sources of information are the most reliable and worthwhile. ANEEL has, however, been contemplating the possibility of initiating proceedings of that type. Many interviewees look favorably on the idea of having such proceedings. ANEEL appears to have it within its legal discretion to conduct such proceedings.

More specifically, what is being recommended is that there be meaningful, substantive public hearings at which regulated companies, various customers or groups of customers, ANEEL staff, and other interested parties (including the proposed consumer advocate), put forth their positions in the case under consideration. All presentations and supporting documentation should be submitted in advance, although they could be supplemented at the hearing, and would be publicly available to any party who wishes to review them in advance of the hearing. Any persons who

either wish to make a presentation, or who are required to do so by ANEEL, must make themselves available to answer questions from those interested parties, who indicate in advance that they wish to questions the presenters. ANEEL should be empowered to direct parties to make presentations when it believes it would be helpful to its decision-making. Such a proceeding would be particularly of value in contentious and complex matters (e.g. tariff revisions, service quality standards, market monitoring). The idea is not a U.S. style, court trial, with lawyers playing the critical role, but rather a public forum at which evidence in the form of facts or opinion is presented, tested through questioning, and thoroughly debated. The desired participants would be experts on the subject, particularly experts with diverse opinions and interests. Finally, to help crystallize the issues, all parties should have the opportunity to submit written comments for public record after the hearing in order to share their views and analyses with both ANEEL and all other parties. ANEEL might also consider the possibility of allowing oral presentations at its public meetings on specific matters.

REVISED RECOMMENDATION 12

- a) **ANEEL, when appropriate, but particularly on contentious or complex matters before it for decision, conduct public hearings where experts representing the various interests or perspectives represented, offer verbal testimony on their views, and that time be allotted for persons with different points of view to cross-examine those experts or to directly debate with them. Such hearings should be conducted in public and the Directors and designated staff of ANEEL should have their own opportunity to question the experts. Those proceedings should be made more meaningful by requiring that all presentations to be made at the public hearing be submitted to ANEEL in advance and that those presentations be publicly available to all interested parties. Additionally, all parties who wish to do so, should have the opportunity to submit written comments to ANEEL subsequent to the public hearings to further elaborate on matters covered at the hearing. Those comments, of course, should also be part of the public record.**
- b) **ANEEL, in all specific pending matters, complex or otherwise, should, where appropriate, offer interested parties the opportunity to make oral presentations to the Board in public meetings.**

14. A Conference should be convened including CNPE, legislative leadership, and the regulators, with stakeholder input, to propose basic legislation clarifying and fully defining the respective authorities of CNPE and ANEEL. The legislation can set the desired boundaries, but it should also include the following principles:

- a. Executive policy determinations are binding only where the executive agency acts within its defined authority and where its actions or articulation of policy precede any decision of ANEEL on the same subject;**
- b. Only a duly constituted Court can determine if ANEEL has exceeded its authority under the law, and reverse the decision for having done so;**
- c. ANEEL be given the authority to seek guidance from CNPE where it believes such guidance is necessary for jurisdictional reasons, provided that ANEEL seek and obtain, and that CNPE provide the guidance in a fully transparent and open way;**
- d. ANEEL be provided with the discretion to decide matters where the articulation of policy is not complete or comprehensive, but where a determination is necessary for the fulfillment of the agency's responsibilities, is relevant to a pending matter, and where the action constitutes a reasonable exercise of ANEEL's lawful authority.**

UPDATE:

While the substance of this recommendation has been and is still being debated, the recommended conference did not occur. Nonetheless, the jurisdictional boundaries between and specific role of agencies with regulatory and regulation-related responsibilities is clearly a subject of the regulatory agency *Projeto de Lei* pending in the Congress and in the implementation of the new market model. Given the ongoing nature of that discussion and the fact that there is little in the recommendation that is different than existing law, the idea of a conference still seems useful. In fact, given the new electric market model and all of the debate that has taken place over the roles of the various actors in policy and regulation in that model, there is a different, yet vitally important, context to convene a conference for all stakeholders which focuses on discussing and defining the respective roles of the Government (e.g., MME, CNPE), the Congress, the Courts, and of the regulators. In order to emphasize the importance of the topic and its centrality to the success of the new market model, the leadership for that conference should come from high levels of government. To assist in this analysis, Appendix A, a reprint of an article written by Ashley

Brown for The International Journal of Regulation and Governance (New Delhi, India), is attached as Appendix C to this report. The article attempts to clarify the respective roles of regulators and policy makers. In doing so, it suggests that policy makers, by articulating policy on any particular matter in law or relevant rule in advance of regulatory decisions can compel regulators to follow their view. If, however, regulators have to make a decision on a matter in which there is no articulated policy, then regulators are free to make “micro” (subsidiary) policy decisions in order make the required determination, as long as that decision does not conflict with articulated policy. In short, policy is whatever the policy makers say it is, as long as officials are operating within their lawful powers, but regulators may have to make subsidiary policy when the macro policy makers have failed to articulate their view in a binding document.

Because the original recommendation was made to clarify existing law and policy-making, rather than to call for any specific legal or policy changes, it is difficult, from a substantive point of view, to do anything more than reiterate the same principles that were articulated previously. One is struck, however, by the vagueness and uncertainty of the debate which has gone on in regard to the new market model, as to whether or not regulatory authority was being usurped by MME. *There appears to be little common understanding among the partisans in the debate about what it is that regulators are supposed to do, how they should interface with policy-makers, and over differentiating between policy and regulation.* Even if there are disagreements, there ought to at least be a common understanding of the basic concepts relevant to the issues. Unfortunately, the *Projeto de Lei* pending in the Congress regarding the role of regulatory agencies, regardless of its merits or demerits, does little to bring definitional clarity.

The emphasis in the revised recommendation, therefore, is to demonstrate commitment to a focused dialogue on clarifying the respective roles of legislators, ministers, and other policy makers and regulators, and to a commitment emerging from that dialogue with a widely understood definition of respective roles and responsibilities, or, at least a common understanding of the basic concepts underlying the debate. In fact, the implementation of the new market model for the power sector offers a most opportune moment to begin this process of clarifying and differentiating the roles of ANEEL and other public policy / regulatory bodies in the sector. Accordingly, the following is recommended:

REVISED RECOMMENDATION 13

The Ministry of Mines and Energy, perhaps in cooperation with other relevant agencies of the government (e.g. the Ministries represented on CNPE), should convene a conference

involving relevant ministries, legislators, regulators, and stakeholders, as well as academics and other experts in the field of regulation, to propose basic legislation clarifying and fully defining the respective authorities of CNPE and ANEEL. The following principles should be used to assist in focusing the discussion and to serve as the base for beginning the discussions:

- a) The provision of the law and Executive policy determinations are binding where the executive agency acts within its defined authority and where its actions or articulation of policy precede any decision of ANEEL on the same subject;
- b) Only a duly constituted Court can determine, after the fact, if ANEEL has, in making a particular decision, exceeded its authority or failed to follow binding policy under the law, and reverse the decision for having done so;
- c) ANEEL be given the authority to seek guidance from CNPE where it believes such guidance is necessary for jurisdictional reasons, provided that ANEEL seek and obtain, and that CNPE provide the guidance in a fully transparent and open way;
- d) ANEEL, should it decide that nor further guidance is necessary, be provided with the discretion to decide matters where the articulation of policy is not complete or comprehensive, but where a determination is necessary for the fulfillment of the agency's responsibilities, is relevant to a pending matter, and where the action constitutes a reasonable exercise of ANEEL's lawful authority.

15. ANEEL should open a formal proceeding in which comments are solicited through both written submissions and public hearings to determine the optimal level of centralization and decentralization of the regulation of the distribution sector. Among the questions to be posed should be the following:

- a. Does delegation have to be identical for all states?
- b. Is there an asymmetry between possession of service quality information and authority to use it?
- c. If ANEEL should delegate more authority to the states, what appellate and/or supervisory authority should it retain? What criteria, if any, should ANEEL set for the exercise of regulatory authority by the states? Who should oversee quality assurance in regulation?

- d. Will more delegation lighten the work burden borne by ANEEL or will it simply complicate matters?**
- e. What assurances are there that state regulatory agencies will function independently?**
- f. What will be the effect of state regulation of the energy buying practices of distribution companies?**

UPDATE:

The situation regarding delegation of regulatory powers to the states has remained largely unchanged since the issuance of the report. No formal proceeding examining the question, as recommended in the report, has been conducted, although there is frequent informal discussion of the issue. ANEEL now has contracts with regulatory agencies in 13 states. Typically, those agreements enable state regulators to perform auditing and consumer complaint handling services for distribution companies within their states in exchange for compensation by ANEEL for their services. There is also a fair amount of informal, and sometimes formal, dialogue between the state and national regulators. In fact, ANEEL conducts an annual workshop with the states to discuss decentralization and other issues proposed by ANEEL or the states. Opinions among stakeholders continue to vary widely over the wisdom of delegating more authority to the state agencies. Given the work to be done in implementing the new market model and the limited resources available to ANEEL, the likelihood that a major inquiry of the nature suggested in the earlier report will be conducted seems highly low. That low probability, however, is not a reason to ignore the subject. Given the size and diversity of Brazil, the issue of decentralization is always consequential and should remain under discussion. It seems, therefore, appropriate to shift the recommendation away from studying the issue and seeking more public debate to a more practical course of action.

The discussion of decentralization in this report is limited solely to the regulation of distribution companies. There is no compelling reason to think of decentralizing the regulation of either generation or transmission. In fact, there are strong reasons not to decentralize regulation in those areas. Thus, all of the discussion that follows in this section relates solely to distributors.

There are four basic policy courses to follow in decentralizing distribution regulation, or portions thereof (e.g., tariff setting, auditing, complaint handling). They are as follows:

- a. complete centralization;
- b. complete delegation;
- c. joint exercise of authority;

d. delegation of original decisions with ANEEL review.

Options a and b are both inappropriate, although for somewhat different reasons. Legally, of course, the Constitution does centralize all economic and service quality regulatory authority in the national government. The Congress, however, has provided ANEEL with the discretion to delegate some of its powers to the states, on a case-by-case (i.e., state-by-state) basis.²⁶ ANEEL has exercised this authority when there is a state regulatory agency in existence and when it believes that the state agency is capable of carrying out the delegated authority. As noted, 13 states have now received delegated powers from ANEEL. Thus, the Constitution appears to explicitly rule out option b, while both policy and practice appear to eliminate option a. It is worth noting that in natural gas, regulatory jurisdiction is divided by law. The national government has responsibility for regulation of exploration, production, and transmission (transport), but the states have exclusive jurisdiction over distribution and sales to end-users.

The course ANEEL has, for the most part, pursued to date is d, although it has, on occasion, followed course c, as when it has conducted joint public hearings with state regulatory agencies on matters in which they share a common interest (e.g. service quality problems in Rio de Janeiro). It has delegated auditing and complaint handling to those states with whom it has contracts, but has retained all final decision-making authority for itself. In fairness, however, although ANEEL has retained the authority to reverse a decision taken by a state regulatory agency it has never done so.²⁷ Consistent with c and d, however, there is a number of other steps ANEEL could take that would allow for greater state regulatory involvement and decentralized effect, without sacrificing the final decision-making authority ANEEL is compelled to retain by law and Constitution. These steps ought to be designed not only to improve coordination, cooperation, and state regulatory involvement, but also to promote regulatory capacity building at both state and federal level as well as more effective coordination and cooperation.²⁸ These additional suggestions are as follows:

²⁶ Law 9.427/96 provides ANEEL with fairly broad discretion to decide what regulatory functions regarding distribution companies can be delegated to the states.

²⁷ The delegation to the states has had some positive, although perhaps ironic, results. The CSPE in Sao Paulo, in response to service quality problems, adopted a *Termo de Ajustamento de Conduta* (TAC), a mechanism which may, by way of example, mandate a regulated distributor to invest a designated amount of capital in assets or activities specifically designed to correct the service defect. The idea was developed by the state regulators under their delegated responsibility, thereby demonstrating that decentralizations can be a breeding ground for experimentation and new ideas. Ironically, however, because the decision had to be approved by ANEEL, that agency not only endorsed the CSPE decision, but it adopted it for national use, thereby re-centralizing the issue.

²⁸ The states are supposed to receive payments from ANEEL to carry out their delegated responsibilities. The precise amount is set out in agreements between ANEEL and the state regulators in each state with a

REVISED RECOMMENDATION 14

ANEEL should promote greater interaction with the state regulatory agencies with which it has agreements by undertaking the following measures:

- a) **Conducting joint public hearings with the state regulators whenever distribution tariffs are under review within their state, or whenever, there is some other matter of common interest (e.g. service quality) under consideration;**
- b) **Allow state regulatory agencies to have an advisory, or some other formal, role to ANEEL in setting tariffs for distributors within their state;**
- c) **Establish formal exchange programs where state regulatory personnel work at ANEEL for specified periods of time and where ANEEL personnel do the same at the state regulatory agencies;**
- d) **Allow the personnel of state regulatory agencies to work with ANEEL personnel on matters, such as distribution tariffs, where the agencies have a common interest;**
- e) **Develop joint training programs for the personnel of ANEEL and the state regulatory agencies.**
- f) **Experiment on a limited basis with the most competent of the state regulatory agencies, the delegation of setting distribution tariffs pursuant to guidelines from ANEEL, as well as the possibility of ANEEL review after a decision has been proposed by the state agency²⁹.**

16. The responsibility for conducting auctions and for granting concessions should ultimately be assigned to another designated entity (either private or governmental), with

regulatory agency to whom regulatory responsibilities are delegated (13 currently). At present, however, because of ANEEL's fiscal constraints, the agency is only providing the states with 50% of what it has obligated itself to pay. Obviously, any additional delegation of responsibilities should be accompanied by additional payments from ANEEL to the state regulators.

These payments, however, are highly susceptible to ANEEL's fiscal constraints, because cuts in ANEEL's budgets, by law, must be applied last to salaries of employees, so ancillary expenditures, such as agreements with state regulators tend to get cut first.

²⁹ If the experiments have satisfactory outcomes, then the practice might be allowed on a broader, more permanent basis. There is, of course, precedent in Brazil for decentralized regulation of the distribution company while leaving the balance of the sector to national government to regulate. That is precisely how the natural gas sector is regulated.

experience in conducting auctions or other competitive solicitation. All concession related documents and the methodology used in conducting competitive solicitations should be pre-approved by ANEEL.

UPDATE:

The authority to grant concessions in the power sector has is an Executive Power delegated to MME by the President of the Republic.³⁰ MME, in turn, has delegated to ANEEL the responsibility for either conducting auctions.³¹ *In regard to the granting of concessions, there has been controversy regarding a perceived conflict of interest by MME in regard to its dual responsibility of overseeing the management of state owned generating assets and its new responsibility for granting concessions to entities that may well be competitors to the state owned generators.* The two issues of auctions and concession granting are very much related, but are sufficiently distinct to merit separate discussion.

The original report noted that there is an essential conflict between the responsibility for regulation and market oversight, and the responsibility of deciding who may or may not gain entry to the market. *The role of the regulator, as noted in the earlier report, is not to pick winners and losers, but rather to exercise oversight of the market by enforcing the rules, monitoring the market to make certain that no one is misbehaving and that the market is not suffering from design flaws.* If there is market dysfunction or misbehavior by a market participant, then, of course, the regulator must intervene to remedy the problem. Because the regulator must take action against a violator of the rules, it is best that the regulator have no bias, or even the appearance of a bias, regarding any market participant. If it was the regulator who selected a company to be a market participant, then one might reasonably contend that there is, at least, the appearance of a bias. That appearance, in the case of an auction, whose rules and protocols are well established in advance and not deviated from, might be mitigated by the fact that the actual selection is made by the process itself rather than through the exercise of any discretion by the regulator. In that case, the regulator did not actually make the selection of market participants, other than in the most technical of senses (i.e. simply approving the concession to the winner of the auction); rather, the selection was made by a process, the rules of which were established and operated without reference to any particular potential winner or loser. In the case of ANEEL, which has, in the past, contracted out to the *Bolsa* in Rio de Janeiro the actual conducting of the auction, the conflict is perhaps even more attenuated.

³⁰ Lei No. 10.848, dated March 15, 2004

³¹ Decree No. 4.970/04

The issue of MME being the grantor of concessions, while, at the same time, being the custodian of the government's assets in the sector is, while not identical, very similar to that of the regulator having responsibility for conducting the auction. It is not totally unreasonable to assert that there is, at a minimum, the appearance of a conflict of interest in MME being the grantor of concessions. To the extent, however, that the selection of grantees is determined by rules and protocols set in advance independent of any knowledge of the identity of potential grantees, rather than by some exercise of discretion by MME, the conflict is mitigated. It is further mitigated by the fact that the new market model calls for segregated markets for old energy, much of it state owned, and new energy whose ownership is, by definition, unknown at present. Moreover, MME has another mission besides looking out for the state owned assets. It is charged with implementing the new market model that will be attractive to new investment, which for the most part, will presumably be private. Additionally, the new market model appears to envision a new, perhaps somewhat independent, planning agency actually identifying sites and determining through rules set in advance, how the winners will be determined. While the details of exactly how the selection process will be carried out, there is some likelihood, especially given the critical role the price being offered is likely to play in determining the winners, that there will be relatively little discretion for MME itself to skew the selection process in one way or another. Because of the complexity of MME's role and because of all of the uncertainties surrounding the implementation of the new market model, it is impossible to assert definitively that MME has a conflict of interest in being the grantor of the concessions. It is also worth noting that it is not at all clear who the alternative to MME would be. ANEEL, for the same reason it might have a conflict of interest in carrying out the auction, would be conflicted in dispensing grants. That is precisely why regulators in many countries lack the power to grant concessions and why it is not accurate to suggest that taking the power to grant concessions away from ANEEL is an intrusion on regulatory independence or authority.³² The absence of a clear alternative to MME is also exemplified by the fact that all other Government ministries, such as *Fazenda*, would have the same perceived conflict as MME.

Given the changes that have occurred since the original report, and given the alternatives at hand, it seems best to alter the focus on the recommendation as to who should conduct auctions or

³² Many countries have privatization agencies that actually grant concessions. The government may have a variety of objectives in granting concessions, many of which are beyond the scope of the regulatory agency's authority (e.g. revenues from the sale of concessions, externality benefits), so it is not at all unreasonable to give the authority to grant concessions to an agency of government that can address all of the government's concerns.

grant concessions from conflict of interests that ANEEL, MME, or anyone else might possess, to the process itself. It is, therefore, recommended that:

REVISED RECOMMENDATION 15

- a) **The rules and protocols regarding both the conducting of auctions and the granting of concessions be adopted through a transparent process with opportunity for public participation, and then published. Such rules and protocols should include a clear and prescriptive description of the process to be followed and the criteria to be used in deciding the outcome. The adoption and publication of the rules and protocols should occur in advance of the actual carrying out of any of those activities. The process of conducting the auctions and the granting of concessions should be carried out in a completely transparent manner in compliance with all relevant laws, rules, and protocols.³³ The discretion afforded to the agencies conducting the proceedings should be held to the very minimum necessary.³⁴**
- b) **It would be prudent for ANEEL to delegate the responsibility for conducting auctions to CCEE. The delegation of responsibility should be accompanied by guidelines/rules indicating how the auctions should be carried out.³⁵**

17. ANEEL, after extensive, transparent proceedings, should promulgate performance standards for both MAE and ONS. In regard to incentives, ANEEL should, in the course of the same proceedings, seek out opinions as to what types of incentives are best suited for not for profit entities such as MAE and ONS, and should specifically inquire as to whether

³³ There is already substantial legislation in existence governing public bidding procedures for granting concessions (e.g. Laws No. 8.666/93, 9.074/95, and 9.427/96), but the specific auction design under the new electricity market model is not yet known and will have to be formulated, adopted, and publicized before the auction can occur.

³⁴ If the power to grant concessions is delegated to ANEEL, that delegation should not be arbitrarily reversed by the state. Delegating and removing delegation of the power to grant concessions will inevitably compromise both stability and transparency in ways that will severely undermine investor and consumer confidence.

³⁵ Current law permits MME to delegate to ANEEL the power to grant concessions, but neither can delegate to CCEE or anyone else the authority to grant concessions. Law No. 10.848/04, does, however, create the possibility of delegating the specific responsibility for actually administering the auction for power purchase and sale to CCEE or another entity, as long as the Ministry (or ANEEL if it is so designated) retains the ultimate authority for granting the concession.

incentives for managers at those institutions would yield the same results as incentives for the institution as a whole. Once the standards are in place, ANEEL should conduct oversight proceedings for both MAE and ONS on a regular, perhaps annual, basis in which input is sought from all market participants in regard to the performance of each institution, and as to the continuing applicability of the performance standards and incentives. At the conclusion of each proceeding, ANEEL should issue a report indicating its evaluation of the performance of the two organizations. ANEEL's report should also indicate what revisions, if any, are appropriate for the performance standards and incentives.

UPDATE:

The situation in regard to MAE has changed since the last report. MAE, itself, of course, will be replaced by CCEE after the Decree implementing the new model is issued. (See Appendix A).³⁶ Even before that, however, the passive role envisioned for ANEEL *vis a vis* a self-governing MAE had already been abandoned and the regulators had begun to exercise more regulatory oversight than they had exercised in the past. There have been, for example, monthly meetings between MAE and ANEEL technical personnel, a public process had been undertaken to establish rules for MAE, more routine matters regarding MAE had been coming to ANEEL for resolution than they had previously, and the regulators were planning this year to open a more visible process for monitoring MAE, a process that envisioned substantial opportunity for public participation. At present, however, with the new model and MAE's replacement by CCEE, there is considerable uncertainty as to how ANEEL will exercise its regulatory oversight. The basic characteristic of being a market administrator, however, will not be altered by the fact that CCEE will replace MAE. Thus the regulatory principles remain constant.

ONS, under the new model, while it may acquire a new governance model, will, nonetheless, have responsibilities under the new model that will be very similar to what they were under the previous model. Many of those interviewed indicate that a change in ONS governance was necessary because the closeness of the Board to market participants made it difficult to decide on appropriate rules and ANEEL had been compelled to intervene more than it should have been called upon to do so. In fact, ANEEL reports that it was exercising more vigilant oversight than ever, and, as in the case of MAE, it was planning to open the ONS review process to greater public participation, something the agency said it had already begun in regard to its approval of

³⁶ Because MAE will be replaced as market administrator by CCEE, the term "MAE" is used in reference to the past and present, while "CCEE" is used in references to the future.

ONS' rules. Another area that interviewees suggested was in need of closer oversight was the ONS and MAE budgets. The agency, the bulk of whose revenues are derived from transmission tariffs and a smaller percent from market participants, must have its budget and charges approved by ANEEL. Many interviewees suggested that ANEEL had not taken advantage of its power of the purse to create effective incentives for MAE and ONS. The point being made was not so much that there was a specific performance problem with MAE or ONS, but rather that effective regulation should always be providing meaningful incentives for greater efficiency and for more effective performance.

The incentives at present are not symmetrical and balanced, in that they focus primarily on negative incentives, such as penalties for poor performance and have few, if any, "carrots" for good performance. Moreover, since both MAE and ONS are not-for profit entities, the obligation to pay the penalties inevitably gets socialized across all stakeholders. Thus, there is a likely disconnect between who pays the penalties and who is actually responsible for the poor performance. That disconnect seems likely to render the penalties largely ineffective.

While there have been significant changes since the issuance of the report, the basic issues raised in regard to regulatory oversight of ONS and the market administrator, remain the same. ANEEL's specific role may be made more complicated by the suggestion of several interviewees that in the new model, ONS, CCEE, and ANEEL will be parallel agencies. *While it is certainly true that ONS and CCEE will have some regulatory responsibilities, good public policy and virtually universal experience points to the fact that all market institutions, even those with quasi-regulatory responsibilities, be subject to overall oversight by the sector regulator.* If that is not clear, then it certainly should be made so.

Two additional issues of consequence seem likely to emerge from the implementation of the new model that will inevitably affect the operations of both MAE and ONS. First is the question of managing transmission congestion. *The fact that new generators will gain access to the market by successfully bidding to serve multiple customers throughout inter-connected Brazil based on the price of generation at the bus bar, seems likely to change the dynamics of the grid. That change is likely to exacerbate the congestion that some interviewees have already noted. The effect, of course, will be that the actual delivery costs of energy will exceed, in some cases by a wide margin, the costs of production.* In some cases, as the market model itself notes, transactions across sub-markets will, as a practical matter, be impossible. It seems, therefore, obvious that alternatives to managing congestion should be carefully studied and analyzed. The other issue is that the model is focused almost exclusively on supply side. Both comments of

interviewees and international experience indicate a need to blend demand side options into the markets. Effectively demand side measures will enhance efficiency.

Since the underlying issues regarding regulatory oversight remain similar to those mentioned in the earlier report, although the institutions have changed in name and/or governance, and ANEEL has been exercising more vigilance than before, the recommendations are as follows:

REVISED RECOMMENDATION 16

- a) **Since ONS and CCEE are now fully subject to the regulatory oversight of ANEEL.³⁷ ANEEL should continue the process it has begun to make its exercise of regulatory oversight of both ONS and the market administrator more transparent and more open to and solicitous of public participation. ANEEL should specifically propose how it will use its power to approve the CCEE and ONS budgets more effectively to provide incentives for improved overall performance. ANEEL should also fully explore, through a public, transparent process, how to make the overall incentives for CCEE and for ONS more symmetrical, more balanced, and more effective.**
- b) **MME, ANEEL, ONS, and CCEE should collaborate in formal studies of the options for managing transmission congestion in the new model and for incorporating demand side options into the capacity and energy markets.**

18. ANEEL should propose and seek public input on the creation of an Independent Market Monitor in Brazil. The proposal should include a proposed structure, finances, and mode of operation for the entity.

UPDATE:

The new market model changes considerably the rationale on which the original recommendation for creating an independent market model was based. The old model carried over from the previous government envisioned, but never actually achieved, a robust energy market. There were a variety of reasons for failing to achieve the objectives, but some of them related to market failure and dysfunctional market institutions. Those are among the symptoms that an independent monitor would be expected to identify, diagnose, and call to the attention of

³⁷ Law No. 10.848/04.

market participants, consumers, and the regulators. The new model, while less reliant on spot markets for energy, nevertheless presents many new reasons to create an entity with the mission of monitoring the market, looking for warning signs of trouble, and calling them to public attention. There are a number of elements in the new market model that would benefit from the existence of a market monitor.

The need for market monitoring is identified in the new market model legislation. It creates the Monitoring Committee for the Electric Sector. The Committee, however, is not fully independent. It is to be coordinated by MME and will have the permanent participation of CCEE, ONS, ANEEL, and, of course, the new planning agency, EPE. The responsibilities of that body are explained in Appendix A.³⁸ another responsibility it should probably undertake includes reviewing the forecasted power demands submitted by the distributors. Because the forecasts, when aggregated, are determinative of how much capacity will be solicited and built, they constitute an absolutely critical element of the sufficiency of supply, and should be monitored. While the monitor should not be empowered to substitute its judgment for that of that of the distributors who are held accountable for their forecasts, the existence of an institution designed to analyze and critique the forecast submitted will undoubtedly be of value to regulators, planners, consumers, market participants, and even to the distributors themselves, as an early warning system and as part of the cumulative wisdom required to successfully plan to meet future demand for electricity.

At least two other aspects of the new model are complicated and could prove disruptive if they are not carefully monitored. They are the two divisions made in the market, the free and the regulated markets, and the segregation between old and new energy. Overall, the former, while perhaps necessary, has within it, elements that have proven destabilizing in other places.³⁹ The ability of customers to migrate back and forth between the new market, and the terms on which they can do so, will require constant monitoring to ascertain what adjustments, if any, will be required. A market monitor can provide very useful input into that process. While the segregated old and new energy markets may be somewhat less dynamic than customer migration, the functioning of those two markets and the interplay between them is another area where a market monitor can prove to be very valuable.

³⁸ Those include, but are not necessarily limited to, monitoring non-compliance with construction schedules, adverse hydrological circumstance, and unexpected increases in demand.

³⁹ In many U.S. states that have opened their retail markets to competition, customer migration back and forth between regulated and “free” markets, has often evolved in ways which were not foreseen and for which rules are difficult to enact and enforce. Customers, particularly large ones will often simply seek out the lowest price and migrate to the market that provides it. They are often able to use their political and economic influence to effectively bypass rules designed to limit their ability to migrate.

Another function would be to monitor two elements that are not currently addressed in the market model but which will inevitably have to be confronted. One is the issue of transmission congestion. With the new model's pooling of power contracts for all of the distributors, the impact of each contract on the transmission grid is likely to vary considerably from one location to another, depending on the congestion caused by the transaction. There are a variety of approaches to the problem ranging across a spectrum from administrative allocation of capacity rights to full-scale nodal, locational marginal cost, pricing. The issue is quite dynamic, and the existence of an effective, independent market monitor can prove quite useful in pointing out problems and suggested possible solutions. Another deficiency in the model is the absence of explicit mechanisms to encourage demand side response to market conditions should play in the market. As was discovered in both the *apagao* in Brazil and the crisis in California, demand side response was a critical element in dealing with the problems. While short-term energy price signals may be a little less important in the new market model, the overall role of demand side response to market circumstances is still likely to be a key element in achieving overall efficiency. For that reason, monitoring the market for price signals that might assist in the evolution of effective demand side responses is quite likely to be of value. Any efficient market must have both a "demand" and a "supply" side. To date it appears that most of the intellectual and policy efforts have been on the supply side and relatively little attention has been paid to the demand side. While the reasons for that are understandable, that deficiency will require rectification in the not too distant future.

There have been some questions raised regarding possible redundancy between the anti-trust regulator (CADE) and the market monitor. The question is whether there is some redundancy between the two. In fact, not only should the two not be redundant, they should complement one another quite well. Anti-trust agencies have responsibilities for many markets, but few, if any, are able to provide monitoring on the very dynamic, real-time basis on which electricity markets operate. The instantaneous need to match supply and demand requires a level of market scrutiny that is not usually required of an anti-trust regulator. Thus, the market monitor brings skills and expertise that an agency like CADE ordinarily has no need for and does not possess. Moreover, unlike CADE, which is also an enforcement agency, the market monitor is not. Its obligation is to observe, analyze, and report. It is for ANEEL or CADE to take the information generated by the monitor and develop regulatory and/or legal remedies for the problems identified. The other very important difference between anti-trust regulation and the monitor is that the anti-trust regulator generally exists to penalize anti-competitive behavior or unacceptable levels of market power and to provide remedies for it. The market monitor has a broader focus looking not only

for bad behavior and market power, but is also supposed to look for market failures, systemic problems, market design flaws, institutional breakdowns in the market, and other problems that either impede the efficient working of the market or preclude optimization.

There is an important institutional note to consider as well. The Monitoring Committee, as noted, is not fully independent of both the government and market participants. The lack of independence is somewhat out of step with the international practice of having fully independent monitors. Since the law establishing the Monitoring Committee is newly established in law, it seems unlikely that the Committee structure will be changed in the near term. For that reason, instead of recommending the restructuring of the Monitoring Committee to make it more independent, it is suggested that steps be taken to assure that the Committee receives considerable independent input on all of the activities and situations being monitored. That might be done by use of independent consultants and/or through advisory committees, composed of informed persons exercising independent judgments. The consultants and/or advisory committees should have been enabled to issue public reports or declarations based on its/their analysis whenever it deems it appropriate. The input of the consultants and/or the advisory committee(s) should be public information available to all interested parties.

REVISED RECOMMENDATION 17

The Monitoring Committee for the Electricity Sector should be implemented as quickly as possible. The Committee, pursuant to its authority,⁴⁰ should engage independent consultants, and/or advisory committee(s) to issue public reports or declarations regarding their findings and analysis of the market sector(s) on which they were asked to report. In addition to the responsibilities given to it in the new market model, the Committee should monitor and issue reports on all aspects of the electricity system at regular time intervals or whenever else it believes to be necessary. In addition to its explicitly assigned tasks, the Committee, through its consultants and/or advisory committees, should focus its attention on transmission issues, the use of demand side resources, interplay between the free and regulated markets, and the effects of the segregated auctions, and on all other matters related to the ability of the sector structure to achieve sufficiency of supply and efficient outcomes.

⁴⁰ Law. No. 10.848/04

19. ANEEL should establish an expedited dispute resolution process to be put in place in order to expeditiously resolve any complaints brought before it regarding actions of MAE or ONS. It should also establish a procedure for the regulatory agency to initiate an inquiry into MAE and/or ONS on its own.

UPDATE:

The principle rationale for the original recommendation of an expedited dispute resolution process for ANEEL to use with respect to complaints against MAE and ONS was the complete dysfunctionality of MAE and the heavy criticism, justified or not, directed at ONS. At the time of writing, ANEEL's authority over MAE had only recently been established, so the recommendation was designed, at least in part, to fill a void, and to ensure responsiveness to complaints about ONS. MAE, under the new model, will be replaced by CCEE, and the role it is required to play in the new model is significantly less than that MAE was supposed to fulfill under the old model. While there are still no set procedures for handling such complaints/disputes, the need for one, even with the diminished role that the market administrator might play, still seems apparent, and ANEEL's authority for establishing it is not in question, it seems appropriate to simply renew the recommendation. In doing so, however, it is worth noting that any dispute resolution mechanism should include mechanisms, such as escrow accounts, which will allow for revenue to continue to flow on an interim basis pending resolution of any dispute. The utter paralysis that characterized MAE for much of its life must be avoided.

REVISED RECOMMENDATION 18

It is recommended that ANEEL should establish an expedited dispute resolution process to be put in place in order to expeditiously resolve any complaints brought before it regarding actions of CCEE or ONS. In the event that the disputes involve the application or interpretation of ANEEL's rules or decisions, ANEEL should develop a "fast track" mechanism for issuing clarifications. It should also establish a procedure for the regulatory agency to initiate an inquiry into CCEE and/or ONS on its own.

20. All appeals from regulatory agency decisions be directed to a single forum, the decision of which would, in the absence of any constitutional issues, be final.

UPDATE:

Although there has been some discussion of this issue since the report was written, nothing of a concrete nature has changed. Indeed, the issue is not a new one. The idea of referring all appeals from ANEEL to a special administrative board was proposed in early drafts of the law that created the agency in 1996, but the provision was deleted during Congressional deliberations. The state statute in Sao Paulo that created the Public Service Commission in that state (CSPE) included a provision creating a special appellate body, or Deliberative Council, as it is called, just to hear regulatory appeals. Although, technically, the Council is not an independent tribunal, but rather an appellate body functioning within CSPE, it nonetheless, constitutes a useful Brazilian precedent for the proposition that regulatory appeals should be referred to a special forum, rather than running the risks associated with immediate access to the courts, risks which would almost inevitably lead to confusion and possible incoherence in the interpretation and administration of regulation.

The idea of creating an administrative appeals tribunal, perhaps along the lines of the one in Sao Paulo, surfaced in the interviews. Certainly, such a tribunal seems likely to serve the purpose of having a body with technical expertise handling appeals. On the other hand, if the tribunal followed the Sao Paulo model, it would be internal to ANEEL, and therefore, unable, to hear appeals from other regulatory agencies. There may well, of course, be a means of establishing such a tribunal on a multi-agency basis. The downside of establishing such a tribunal is that, as more fully explained in both the next paragraph and in the discussion of legal bypass of ANEEL below, the creation of such a tribunal would, rather than streamlining the appellate process, simply add another level of appeal to an already cumbersome process, although it is possible that, in practice, the tribunal's expertise would be such that the courts, or litigants themselves, would be inclined to accord it some deference.

The problem, however, is rendered more complicated because of Constitutional and legal issues in Brazil. Under the Constitution, Brazilians are entitled, as of right, to have at least two levels of appeal from an administrative decision. In practice, in some cases, there are actually three levels of appeal, and, in the case of a constitutional issue, four. The hierarchy of decision-making in the federal courts requires that appeals to the courts go, first to a Vara⁴¹, then to Regional Courts, then to the Superior Tribunal of Justice, the final level of appeal unless there is a

⁴¹ A Vara is the local court of first jurisdiction.

Constitutional issue, in which case there is an additional level of appeal to the Supreme Court. Deviating from that path is very difficult and would require amendment of the Constitution. It appears, therefore, that while the original recommendation makes excellent sense from a public policy point of view, it may be impractical in terms of what is realistically possible. For that reason, the original recommendation is modified as Revised Recommendation 19, and Revised Recommendation 20 (further below) is offered as a practical alternative to what might be optimal in concept.

REVISED RECOMMENDATION 19

- a) **If possible, all appeals from regulatory agency decisions should be directed to a single, expert forum, the decision of which would, in the absence of any constitutional issues, be subject to a single level of judicial review.**
- b) **The Minister of Mines and Energy and ANEEL, in cooperation with the Ministry of Justice and other relevant ministries. The judiciary interested lawyers, and any other entities whose input is of value, should form a committee to study the pros and cons of creating an administrative tribunal to hear appeals from regulatory agencies. The Committee should, at a minimum, examine how such a tribunal would be created and maintained, how its members would be selected, how its independence would be assured, whether the tribunal's decisions could be accorded any deference by reviewing courts, and whether it would streamline the appellate process or simply lengthen and/or complicate it.**

21. That forum should either be a specialized court formed for the sole purpose of hearing appeals from regulatory agencies, or, in the alternative, should be the Superior Tribunal of Justice (STJ). A panel of legal experts be assembled to consult with relevant parties, both public and private, and to conduct whatever research is necessary, to recommend the appropriate forum to be designated, and then to draft whatever documents are required to effectuate its recommendation.

UPDATE:

While the nature of the appropriate appellate forum has been the subject of some discussion, especially among regulatory lawyers, nothing of substance has been changed since the original report. It was noted, however, in the original report that appeals from regulatory agencies are new and unique questions for Brazilian courts, ones with which the judges have had little acquaintance or expertise. Given that the courts are likely to be called upon to make important decisions regarding regulatory matter, it seems obvious that regulatory issues should be presented to an appellate body which possess both expertise in the subject and an appreciation for the effect of its decisions. Thus, both logic and good public policy would seem to dictate that an appellate tribunal should have the requisite level of expertise to decide these matters.

Although Brazil, unlike European civil law countries, does not have separate administrative and civil courts, bypassing the courts of first recourse is not something that is commonly done in Brazil. In fact, the judiciary has traditionally opposed such efforts. As a result, the possibility of creating a process for appealing directly to the STJ seems highly remote. On the other hand, there is a tradition of creating specialized courts for arcane, or very specialized areas of law. That has been done, either by the Constitution, or by action of the STJ, after a specified process has been followed. Examples of specialized tribunals include military courts, labor courts, and election courts.⁴² Since amending the Constitution is a complex task, the other process, through the STJ, seems reasonable. The end result would be the creation of a specialized Vara, a court of jurisdiction in a defined, specialized area of the law. The process is usually initiated by a formal request by the Minister with responsibility for the subject matter in question to the President of the STJ asking for the creation of a specialized Vara. The STJ President then submits the request for a formal study by the *Centro Brasileiro de Estudos e Pesquisas Judiciais (Cebepej)*. The study looks at such matters of the volume of cases and uniqueness of the subject matter. On concluding its research and analysis Cebepej submits its finding to the STJ, which has the final authority to decide whether or not to create the specialized Vara.

Should a request be submitted to the President of the STJ, the other question is whether to limit the jurisdiction of a Vara to electricity regulatory matters, or, more broadly, to all areas of federal infrastructure regulation, including gas, water, telecommunications, and transport, as well as electricity. Since the legal and policy aspects of all areas of infrastructure are somewhat similar, and since the docket of the Vara would perhaps be too light to justify its creation if jurisdiction were limited to electricity, there is logic to providing the new appellate body with jurisdiction to hear appeals from all federal infrastructure regulatory agencies. If the relevant

⁴² While new Varas can only be created by law, the specialization of existing Varas requires only an administrative act of the judiciary.

Ministers are unwilling to join in making the request it still seems worthwhile to submit the request at least in regard to electricity regulation, and probably to gas as well since that is also an area for which MME has responsibility.

There are three additional complications to be considered. The first is that the Brazilian Constitution entitles each person to take matters directly to Court without having to first go through appropriate administrative channels. In fact, under the Constitution, an appellant from a decision of ANEEL could raise issues in the appeal that he/she failed to raise in the proceedings at ANEEL. Indeed, in Rio de Janeiro, and perhaps elsewhere, there are electricity regulatory issues being addressed in the courts, which have never even been considered by ANEEL. Thus, it makes no sense to limit a specialized Vara, which will presumably acquire regulatory expertise to merely hearing appeals from regulatory agencies. The definition of the special Vara's area of jurisdiction should be all regulatory matters, including but not limited to hearing appeals from regulatory agency decisions. The ability of persons to bypass the regulatory agencies could develop into a major impediment to developing a consistent and coherent body of regulatory principles and practice if steps are not taken to assure that the regulators are give ample opportunity to at least participate in legal proceedings within their domain and expertise but where the regulatory forum has been bypassed. Given that Judges have it within their authority to enable ANEEL to participate in matters before them related to the agency's expertise, they should do so⁴³. That may help to assure a little more coherence in the evolution of regulation in Brazil.

The second complication is the result of the fact that the Brazilian courts are divided into five regions. While the Varas are the local courts, the next level of appeal is to the Regional Courts. Thus, the creation of a specialized Vara actually means the creation of five special Varas, one in each of the country's five judicial regions. In practical terms in regard to electricity regulation, this means that appeals, or even original complaints which bypass ANEEL, will, with one major exception, go to the special Vara within which the appellant or complainant resides. The exception is that if the appellant is a regulated electric company, the concession under which it does business limits its appeals to the region within which Brasilia is located. Hence the bulk of regulated company first level appeals will be limited to a single specialized Vara. Thus, although many of the appeals will be heard in Brasilia, there appears to be no practical way to create a

⁴³ ANEEL can easily be joined as an assisting party to such a proceeding. A Court, under the rules governing civil procedure, can simply issue a notice to be served on ANEEL requiring its participation as "procedural assistance."

single forum for initial appeals. Nonetheless, the creation of the regulatory Varas does, however, retain the value of expertise.⁴⁴

The value of expertise at the Vara may be somewhat dissipated by the fact that appeals from Vara decisions go to the Regional Courts and then to the STJ, bodies which do not have the same level of expertise as a specialized Vara. That loss of expertise is perhaps somewhat mitigated by the fact that each of those forums does have some degree of specialization among the judges. One such specialization is public, or administrative law, which presumably will be of value in deciding appeals from regulatory agencies. Nonetheless, in view of the fact that the requisite level of judicial expertise may be less than what might otherwise be desirable, it would be useful for regular, periodic seminars to be conducted for judges, regulators, and participants in regulatory matters to meet to discuss legal issue related to regulation.

The third complication is the role of the *Tribunal de Contas* (TCU).⁴⁵ It has jurisdiction to assist in the external control that the Congress possesses over public administration. It can exercise oversight over how well an agency is performing in terms of achieving its legislative mandates, targets, and results. It can assess the performance of the agency in regard to economic issues, overall effectiveness, and effectiveness of regulatory decisions. Under the legislation in force, the TCU can make recommendations, and even order certain actions. If it does order an agency to do something, it must specify a reasonable date by which it must be done by the agency. In the event that the agency fails to meet the deadline imposed, the TCU may stay the actions performed in violation of its decisions and notify the Congress of the situation.⁴⁶ The power of the TCU is constrained, however, by the fact that it can only act with respect to specific laws or pre-specified targets or purposes. It has no authority, however, to interfere in matters where the law provides ANEEL with discretion. While not a Court in any legal sense, parties have a Constitutional right to request that the TCU review decisions that are particularly

⁴⁴ The mere fact that a special Vara is created, does not mean that there would be one in each region of the country. The study the STJ would request regarding the establishment of a special Vara could, for example, conclude that while a special Vara was justified in Brasilia, there were an insufficient number of cases in some regions to justify the creation of a regulatory Vara. Thus, it is within the realm of possibility that those appeals in regions that lacked a special Vara, would go to generalized Varas.

⁴⁵ TCU is an independent organ of the state, created by the Constitution that has the responsibility to review all administrative decisions of the government to ascertain whether all legal requirements and rules have been followed. Many, although not all (as defined by law), agency decisions must be submitted to it for review. TCU may also initiate inquiries on its own. Its findings are made in a public report to the Congress, but they can also be binding on an agency found to be out of compliance in making particular decisions.

⁴⁶ This, of course, is still another example of how Congressional oversight can be an effective means of exercising social control. While TCU does not function as an organ of the Congress, its efforts and capabilities can be of enormous assistance to the Congress in the course of conducting oversight of regulatory agencies.

unsatisfactory from their point of view. Thus, TCU effectively serves as an alternative forum for appeals in the sense that an unhappy party can file an appeal from a regulatory decision to TCU. Appeals can only go to the Courts⁴⁷. In short, TCU cannot substitute its judgment for ANEEL's in areas of regulatory discretion, but its actions could well have the same form of oversight as an appellate court.⁴⁸

REVISED RECOMMENDATION 20

- a) **The Minister of Mines and Energy should submit a formal request to the President of the Supreme Tribunal of Justice to initiate a study of the possibility of creating a Vara for purposes of hearing appeals from ANEEL and ANP, and to hear all matters related to energy regulation, whether they are appeals from regulatory decisions, or are cases initiated in the courts without first being considered by the regulators. The Minister is also urged to consult with those Cabinet colleagues whose portfolios include responsibility for areas of infrastructure which have regulatory agencies in existence (e.g. water, telecommunications, transport) to seek their joining in the request so that the proposed scope of jurisdiction for the specialized Vara includes all infrastructure industries subject to regulation by national regulators.**
- b) **In all electricity matters brought directly to the Courts, bypassing ANEEL, or where a new issue is raised on an appeal that ANEEL never had the opportunity to consider the Courts should seek out ANEEL's participation in the case and pay close attention to the agency's position. Where neither the Judges nor the parties to such a proceeding seek out ANEEL's participation in the Judicial proceeding, ANEEL, on its own, should seek to intervene.**
- c) **The Ministry or Mines and Energy, ANEEL, the TCU, and the Judiciary, perhaps in coordination with professional associations and academic institutions, should conduct regular, periodic seminars on the legal aspects of electricity regulation. It might also**

⁴⁷ Agencies found to be out of compliance by TCU have a right of appeal as well. They can appeal to the TCU itself or to the courts.

⁴⁸ Given the mission of TCU to review government agency decisions and actions to assure that all agencies comply with all legal requirements, it may well be that the proposed Ombudsman will be redundant in many respects. In fact, the opportunity for judicial review, the prospect of TCU review, and the possibility of Congressional hearings seem to provide an extraordinary level of oversight. It is not at all clear what an Ombudsman would add to the existing level of oversight and accountability. The Ombudsman, however, may have other virtues to recommend it, which is why the report suggests areas where it might add value.

promote the creation of a scholarly legal journal devoted to legal issues in Brazilian energy regulation.

22. Appellate bodies reviewing regulatory decisions are required to affirm the decision of the regulatory agency unless it is specifically determined that the agency exceeded its lawful authority, or acted arbitrarily or unreasonably, acted contrary to the manifest weight of the evidence before it, or failed to follow proper legal and constitutional procedures and processes. In considering appeals, the appellate bodies are prohibited from consideration of any evidence or argument that the appealing parties failed to put before the regulator and are prohibited from reassessing the policy implications of any decision as long as they are not defective for the reasons noted above. In considering any application for a stay of execution of a regulatory order, pending full appeal, the appellate body must presume that the decision was correct. Such presumption, for purposes of temporary relief from a regulatory decision, may be rebutted, but only upon a clear showing that implementation of the decision will cause irreparable injury to the appellant, and that the appellant has a substantial likelihood of success on the overall appeal

UPDATE:

There has been no change since the issuance of the report to cause any change in the original recommendation. Further research however suggests that limiting the introduction of new evidence at the appellate level may violate one of the "stone clauses"⁴⁹ of the Constitution.

REVISED RECOMMENDATION 21

Appellate bodies reviewing regulatory decisions are required to affirm the decision of the regulatory agency unless it is specifically determined that the agency exceeded its lawful authority, or acted arbitrarily or unreasonably, acted contrary to the manifest weight of the evidence before it, or failed to follow proper legal and constitutional procedures and processes In considering any application for a stay of execution of a regulatory order,

⁴⁹ A "stone clause" is a Constitutional provisions which cannot be changed by mere amendment of the Constitution. It can only be altered by means of a new Constitutional meeting called to enact a new Constitution.

pending full appeal, the appellate body must presume that the decision was correct. Such presumption, for purposes of temporary relief from a regulatory decision, may be rebutted, but only upon a clear showing that implementation of the decision will cause irreparable injury to the appellant, and that the appellant has a substantial likelihood of success on the overall appeal.

23. If the appellate body finds that a decision of the regulatory agency should be reversed and that additional corrective measures need to be taken, the preferred method for undertaking further action is to remand the matter to the regulatory agency with instructions to take such actions as are necessary and consistent with the decision of the appellate body. The appellate body may also set a deadline for re-assuming responsibility for fashioning a remedy if the regulator fails to act.

UPDATE:

The general practice in Brazil regarding appeals from administrative agencies is for the courts to simply determine the legality or non-legality of a decision. The reasons for the original recommendation that reversed decisions be returned to ANEEL to make a new decision consistent with the finding of the court are grounded in both law and policy. The policy reason is that the courts generally lack the expertise in the often technical, usually arcane, subject matters with which ANEEL must deal. The legal basis is that the Constitution, as part of the separation of powers, does not permit the Judiciary to make decisions reserved to the Executive. The role of the Courts in regard to regulatory decisions is simply to make certain that the agency fully complies with all legal requirements and does not exceed its authority. If a Court finds the agency was out of compliance it has the power to declare the decision null and void, but it cannot, under the Constitution, decide the matter itself.

REVISED RECOMMENDATION 22

If the appellate body finds that a decision of the regulatory agency should be reversed the preferred method for undertaking further action is to simply declare the decision void for the reasons stated. It is then left to ANEEL's discretion to decide how to proceed.

24. No person or party may appeal a decision of the regulator unless that person has been a participant in the proceeding in which the decision being appealed was made. No issue may be raised on appeal that was not presented to the regulator first.

UPDATE:

Upon further investigation, it appears that there may be Constitutional problems with the original recommendation. Article 5 of the Brazilian Constitution provides a fundamental right to any person to seek redress in the Courts. That right apparently cannot be abridged by requiring the exhaustion of administrative processes. The consequence of this provision, from the perspective of regulation, is that a party has the potential to entirely bypass ANEEL, even though the subject being brought before the court is jurisdictional to the electricity regulator. *In essence, the right to bypass the regulators and go directly to court, opens the door to the possibility of undermining the systematic and orderly progression of the regulation because it diffuses decision making authority to decision makers who are both unlikely to possess the requisite expertise or to be systematically engaged in the evolution of consistent regulatory policy and practice.* While the effect of the potential for bypass may prove to be insignificant, it could also turn out to be quite destructive of orderly regulation.

It would be optimal to amend the Constitution, not to prevent access to the courts, but simply to require that ANEEL's processes be exhausted before a matter could be considered by a judge. The provision guaranteeing access to the courts, however, is cast in stone, in the sense that it is not subject to the normal amendment process. As result, the original recommendation cannot be implemented and must be revised.

While access to the courts is guaranteed, the courts, themselves, in exercising their jurisdiction, have the discretion to limit the litigant's ability to bypass the regulatory process by applying two standards on a systematic basis, and by involving ANEEL in the litigation. The two standards are that the applicant before the court be required to demonstrate to the court's satisfaction that he/she is in imminent danger if the court fails to provide the requested relief and that he/she will prevail in the case. In considering the merits of the case, if the applicant to the court is seeking an injunction against ANEEL, the agency will automatically be involved in the case an the judge will have the opportunity to listen to the agency's position. Where the relief

being requested is not an injunction and ANEEL is not automatically involved in the litigation, a judge nonetheless has considerable discretion to bring ANEEL into the proceeding.

REVISED RECOMMENDATION 23

In the event that a party seeks to bypass ANEEL on a matter otherwise within the agency's jurisdiction, by going directly to the courts, it is recommended that:

- a) **All electricity regulatory matters, even those originating in the courts rather than in ANEEL, be referred to the specialized Vara;**
- b) **In cases where injunctions are being sought against ANEEL, the courts exercise very strict scrutiny to make certain that the applicant to the court is, in fact, in imminent danger of harm, and that there is a substantial likelihood that the applicant will ultimately prevail in the case, before allowing the matter to proceed.**

25. ANEEL should undertake the leadership, in coordination with other governmental and non-governmental entities to find ways of permanently funding continued advocacy for the interests of small customers before ANEEL.

UPDATE:

Since the publication of the report, the situation in regard to funding for permanent consumer representation in regulatory matters has changed very little. As was noted, the funding that had been received from the Inter-American Development Bank for this purpose has expired, and no alternative source of funding has been identified. There have been sporadic small efforts, often only discussions, in some places to use public prosecutors' offices as the advocate for small consumers in regulatory proceedings. Nothing, however, has been done on a systematic, national, basis, to fill this critical void in regulation. As was noted in the original report, the absence of effective, consistent representation of consumers in the regulatory process is a major shortcoming in the regulatory system, from the standpoint of both appearance and substance. Both the regulated companies and the large consumers of energy will inevitably spend a great deal of effort and money to try to convince ANEEL to make decisions favorable to them. Assuming they follow the law and reasonable ethical standards, there is absolutely nothing wrong with doing so. In fact, they have a right to lobby for their interest. *The problem is that ANEEL, as the regulator,*

does not have the opportunity to hear the full spectrum of advice and counsel it would get if small consumers had effective representation.

Indeed, the regulatory environment is quite different in Brazil's power sector than it is in those countries, where the regulator provides the forum for debate among different interest and acts as the arbiter between them. Some interviewees, for example seem to view ANEEL as just another partisan, rather than as the impartial arbiter and decision-maker. That circumstance has resulted in some large measure because of the lack of sufficient resources for effective small consumer representation in many matters. In order to assure fairness, symmetry, complete impartiality, and meaningful alternatives for the regulators, the small consumers should also have the opportunity to advance arguments that are consistent with their interest. Doing so will present ANEEL with a wider range of alternatives than they might otherwise have, will allow for a diversity of voices and interests to be heard, will provide an antidote against regulatory capture, and will allow for more effective, balanced debate and deliberation in decision-making. No one interviewed on the subject seriously contended that sustained advocacy is a bad idea. Two issues, however, have to be confronted. The first is how to fund such activities, and the other is to identify to whom the task should be assigned.

There appear to be three alternatives for funding. The first is to use public money to fund these activities. Those funds could either be obtained from the treasury, or by allocating a portion of ANEEL's budget for the task or by adding a surcharge to electricity bills to fund consumer advocacy in much the same way as ANEEL itself is funded. While there is a logic and precedent for either of these funding mechanisms, both have drawbacks in the Brazilian context. The first drawback is the chronic difficulty, mentioned earlier, that ANEEL has experienced in actually being able to obtain the funds to which it is legally entitled. *The agency's problems in financing its own regular activities make it a very unlikely source of funding for consumer advocacy.* Additionally, one might argue that it is a conflict of interest for the regulator to fund the consumer advocate. Using an appropriation from the Government treasury or adding an additional surcharge to electric bills also seems unlikely sources of funding. The same austerity that has contributed to the ANEEL's financial difficulties makes it very improbable that the Government has any serious interest in starting up a new activity, either through the treasury or through an additional surcharge on electric bills, regardless of how modest the funding need might be.

The second source of funding is voluntary funding from consumers themselves, or from a charitable foundation of some type. Voluntary contributions from consumers has worked reasonably well in some U.S. states (e.g., California, Wisconsin, and Illinois), and perhaps elsewhere, but it usually relies on the use of utility bills to collect the money, a sometimes

controversial practice. In the absence of access to the bills sent to consumers, any effort to collect the requisite amount of money would seem to be a very difficult and cumbersome process whose prospects for success are certain at best. In terms of charitable foundations, the prospect for long-term, stable funding also seems highly uncertain at best. Experience elsewhere suggests that funds derived in this way are usually only a short-term undertaking to assist in the start-up of the service (much like the funding received by the NGO, Institute for the Defense of Consumers [IDEC]) from the IDB for that purpose, or is designed not to protect consumers necessarily, but rather to promote environment, energy efficiency, rural electrification, or some other objective that the donor believes to be important.⁵⁰ Once again, as in the case of government funding, the prospects for obtaining funding from voluntary or charitable contributions seem less than promising.

The final source of funding is to tap an existing fund or potential funds and allocate some portion to underwriting consumer advocacy. Fortunately, there are two potential sources for this type of funding in Brazil at present. The first results from the fact that every electric distribution company in the country is required to organize and maintain a consumer advisory council. Those councils are designed to represent consumers on an advisory basis to each distribution company. The funding for the activity is provided by the local utility as part of its overall cost of doing business. The councils are composed of selected customers of the local company who serve on a voluntary basis. Whatever expertise they possess is provided either by their own personal qualifications, or, more likely, by the company itself, or by entities such as IDEC. In fact, IDEC, and perhaps other consumer organizations are often asked for expert advice and guidance, which resource permitting, they try to provide. Each of these councils operates on its own and not as part of any national movement or organization. That fragmentation makes any concerted advocacy for consumers very difficult, and by not capturing the economies of scale and scope implicit in national consolidation of the advocacy function, it also make it more expensive and less efficient. *It would seem efficient, appropriate, and prudent to take some portion of the funds used to support the consumer councils and consolidate it into a single fund to finance expert consumer council on a national scale.* That expertise would then be available to advocate in regulatory proceedings as well as to advise the individual consumer councils whenever requested to do so.

⁵⁰ Many states, and a number of municipal governments, have agencies known as PROCON which serve to protect consumers, and could, although they do not typically do so, intervene in matters being considered by ANEEL in order to protect the interests of consumers

Another potential source of funds is to allow a successful consumer complainant or advocate on a particular issue before ANEEL to recover the cost of pursuing his/her claim or issue from the company against whom the complaint is made. The rationale for allowing recovery of such expenses is that a party who prevails in such a case is acting as a private enforcer of public policy (e.g., enforcing tariff provisions, the rules on service quality or on safety through a private complaint). That encourages parties who have knowledge, or are victims of rules violations to come forward and bring them to the attention of the regulators in order to remedy them. To deter frivolous complaints, expenses will be awarded only where the complainant prevails and where ANEEL decides that the result merits the awarding of expenses (including fees). Such a procedure would enable consumers to access expert assistance to pursue their grievances in a highly professional way and would provide more expertise and perspective for ANEEL itself to have as a resource before deciding issues of consequence.

Apart from the question of funding, as noted earlier, there is the question of who should fulfill the role of consumer advocate. Again, the choices are for a government agency, either a bureau in an existing agency or a new one, or, a not-for-profit NGO, or a private lawyer or other qualified professional. The choice is not necessarily one or the other, because in addition to a permanent organization, individual persons or organizations could offer themselves on an *ad hoc* basis as the advocate. There is, however, for the reasons already noted regarding economies of scale and consolidation of expertise, real value in funding a permanent organization to do the work, although not precluding the possibility of allowing other persons or organizations to pursue claims on a case-by-case basis. There arguments for having a government agency perform the role and for contracting with an NGO for doing so. In the current circumstances in Brazil, for three reasons, it makes sense that an NGO take on the work. The first is that an NGO, unlike a government agency, would not have to endure the types of restrictive and counter productive personnel and budget constraints from which ANEEL has suffered. The second is that there are already NGO's (e.g., IDEC) with the expertise and capacity to fulfill the obligations of a consumer advocate and would. Therefore, an existing NGO would be more likely to be able to prepare quickly and efficiently to take on the responsibility than an entirely new organization could. The third reason is that, almost by definition, an NGO would be more likely to be fully independent than government agency.

There are two additional considerations. The first relates to the independence of the advocate from any interest (including market participants, government, and even ANEEL) other than small consumers themselves. The second consideration is to assure that advocate will always act in the interest of the consumers whose interests he/she is obliged to protect. Both of those

considerations will be served by created a Consumer Advocate Board, which will have as its responsibilities, the selection of the advocate and the ongoing supervision of its work on a policy level. While the advocate will have the authority to make day-to-day decisions, the policy positions it takes should be subject to the approval of the Board. The Board should consist of no more than seven members and should be broadly representative of small consumers from across Brazil.

Should an Ombudsman be created, of course, there is the question of what role that office should play. One option is that a portion of its budget should go to support consumer advocacy. Another possibility is that it becomes the advocate, although the performance of that function would compromise its ability to carry out other, more analytical functions that were mentioned earlier, since the office's impartiality could be called into question. It may be best to split the ombudsman function so that some portion of its budget be bundled and dedicated, with the other referenced sources of funds, to pay the NGO that successfully bids to fulfill the role of Consumer Advocate.

REVISED RECOMMENDATION 24⁵¹

- a) **ANEEL should establish a seven-member Consumer Advocate Board of Directors (CAB) with each director serving a fixed term of office. The selection of the Board members should be done only after consultation with local governments, labor unions, consumer organizations, and the Ministry of Mines and Energy, as well as with such other groups as ANEEL believes should be consulted**
- b) **The Consumer Advocate Board should establish a public, transparent process for setting out the criteria for selection and then actually selecting the NGO that will be designated as the official consumer advocate for a period of time not less than five years. The NGO may be reappointed for as many times as CAB deems appropriate but never for more than five years at a time. The CAB will have ongoing oversight responsibility for the consumer advocacy function and should meet periodically to carry out that responsibility;**

⁵¹ There is some precedent in Brazil for the creation of such a Board. The telecommunications regulator, ANATEL, has a "Consulting Board," within its structure. That Board is charged with promoting community participation in telecommunications regulatory processes. The Board interacts with IDEC, legislators, public attorneys, and executive branch officials. It is also worth noting that ANATEL already does, under law, have an Ombudsman.

- c) Each distribution company be ordered by ANEEL be required to contribute a certain percent (to be decided by ANEEL) of the funds it budgets for its consumer council to an NGO designated by CAB to serve as the consumer advocate;^{52 53}
- d) A law should be enacted setting forth the criteria under which either the designated consumer advocate, or a private, professional advocate can recover its costs from a regulated company for successfully pursuing a complaint or other type of claim against a regulated entity, and ANEEL should then award such costs where the circumstances conform to the criteria ANEEL has defined.
- e) If an Ombudsman is created, then some portion of its budget, by law, should be bundled with the other referenced sources of revenue to support the Consumer Advocate function. The Ombudsman, itself, should not serve as the Advocate unless it plays no other role in the regulatory process that might compromise its usefulness and integrity as an advocate for small consumers.

26. A task force consisting of representatives of ANEEL, ANP, and ANA, plus relevant Ministries and legislators be convened to study and issue a report proposing ways to achieve closer, more formal, coordination between the three agencies. Part of that study should include examination of all relevant options for closer coordination between the regulatory agencies (e.g., joint proceedings/activities, consolidation of functions, or common rules). Particular attention should be paid to coordinating regulatory policies in the evolution of generation and fuel markets. It would be useful to engage the services of consultants to facilitate the effort.

UPDATE:

⁵² There have been proposals in public discussions that funds committed to consumer councils be directed to universities. It is not clear how diverting funds in that manner will provide adequate consumer advocacy or improve consumer welfare, although it may help to enrich the intellectual environment for regulation.

⁵³ This method is being suggested merely because of the government's practice of confiscating a significant part of ANEEL's budget. It is less than optimal because it simply creates another charge on customers in their electric bills. Optimally, the funding for consumer advocacy should come from the regulatory fees.

The coordination between these agencies still appears to be minimal at best. In regard to natural gas, however, the situation has grown critical. As was pointed out in the earlier report, the gas and electricity markets have evolved along very different, and, in many ways, contradictory paths. Natural gas is available, for the most part, only on a take or pay basis. For gas-fired combustion turbine generators, that has meant that fuel supply is part of the overall capacity cost, rather than part of the variable cost as it constitutes in most other locations in the world. *That is because in Brazil, unlike in so many other countries, such instruments as a spot market for gas and a secondary market for pipeline capacity, both of which contribute significantly to the efficiency of the market, have not evolved.* To put it mildly, that is a grossly inefficient result and puts the nation's economy and consumers at a disadvantage. It makes the costs of reserve thermal plants much higher than they need to be, and it makes it almost impossible to develop an effective spot market in electricity. That shortcoming is reflected in the new market model's heavy focus on capacity. Even in that model, however, the cost of electric generating capacity will be elevated significantly by the need to reflect the cost of take or pay fuel contracts in capacity costs, rather than as a component of the marginal costs of consuming the fuel when the plant's output is required for dispatch. That is a grossly inefficient, costly result for Brazil's economy and for its consumers. Recent developments at some gas-fired plants in the *Nordeste*, where some thermal generators have been unable to operate at capacity because of lack of anticipated natural gas supply, even without regard to cost, provides an even more stark demonstration of the heavy toll being taken by the failure to adequately coordinate the evolution of gas and electric markets. *Simply stated, the asymmetry between the gas and electricity markets is not only intolerable, it is potentially disastrous.*

The 2002 assessment report noted that there were many understandable historical reasons for the asymmetrical development of natural gas and electricity markets, but noted the need to move past them in order to meet Brazil's overall energy needs more efficiently and less expensively. *The report called for greater coordination between gas and electric regulators in order to resolve the asymmetries between the two symbiotic markets. Unfortunately, by all accounts, that has not occurred.* In fact, some interviewees indicate that communications between ANEEL and ANP, the gas regulator, have actually become more infrequent. It is impossible to see any good coming out of such a circumstance. In the earlier report, the recommendation was very moderate, perhaps too much so. It merely called for more formal coordination between the regulatory agencies for gas and electricity. But even this very limited recommendation was not followed.

Apart from the operations of the markets themselves, there is another fundamental inefficiency in the separate operations of the regulators for gas and electricity. Both agencies lack sufficient

resources to carry out their responsibilities on an optimal basis. Both functions require identical professional skills, such as economics, accounting, engineering, and the law. Nonetheless, the economies of scale of using the same professional staff to address similar problems in both industries are lost because of the separation of the two agencies. Unfortunately, as developments have demonstrated, the personnel at each agency are less familiar with the evolution of the markets in the industry regulated by the other agency than the public interest demands. *It serves no useful purpose for electric regulators to be less than fully informed about the natural gas industry and vice versa.* Moreover, while the industries, themselves, may not be precisely the same, the concepts and skills for regulating gas and electricity are virtually identical. That central reality is borne out by the debate in Brazil over the role of independent regulators. That debate, for the most part, has focused not on single industry, but rather, more broadly, of the meaning of independence, on the nature of social control, on the nature of transparency, and on other issues that are generic to all infrastructure, and specific to none. It is also useful to note that experience with multi-sector regulatory agencies in other countries has provided evidence that regulating more than one infrastructure industry has provided an antidote to isolation and "regulator capture," a term which describes the process whereby the regulators are enveloped by the same mindset as that possessed by the industry being regulated. The recent consolidation of gas and electric regulation in England and Wales into a single agency is an excellent example of a country finding value in consolidating the regulation of gas and electric regulation after a period of trying to regulate the two industries separately. In the U.S., of course, gas and electric regulation have been done by the same agency at both the federal and state levels (except for Texas), the consolidated regulation has worked well to facilitate the evolution of both markets. In short, maintaining separate agencies for the regulation of both gas and electricity is costly both in terms of the amount of money required to maintain separate agencies, and in terms of the lack of highly desirable intellectual cross-fertilization.⁵⁴

In retrospect, given the loss of efficiency both in terms of market evolution and management of the state's resources, the recommendation may well have been too mild. Once the government has completed the work on the new model for the power sector, it seems likely, and quite

⁵⁴ Given that the Brazilian power generation sector is so heavily hydro, it is reasonable to think about the possibility of merging the water regulatory agency, ANA, with ANEEL as well. That may or may not be a reasonable proposition. For two principal reasons, the authors express no opinion about the possibility. The first is that the asymmetries in the evolution of water and electricity markets and regulation have not been nearly as pronounced as they have been in the case of gas and electricity. The second reason is that the externalities associated with the non-electric generation uses of water in Brazil are enormously complex and make the possibility of merging ANEEL and ANA, especially in view of the historic experience, a matter well beyond the scope of this report.

justifiably so, to turn more of its attention to natural gas issues. While merging ANEEL and ANP will not, on its own, assure that that gas and electricity markets will be fully integrated, it is, nevertheless, an essential and critical step in that direction. *It is simply too costly to continue on the course of non-coordination and non-communication in between the regulators of two industries whose evolution are so tightly connected. Brazil deserves better.*

REVISED RECOMMENDATION 25⁵⁵

The government should give very serious consideration to the merger and full consolidation of all national regulatory responsibilities for both the electric and natural gas industries into a single agency.^{56 57}

27. A task force, consisting of regulators, regulated market participants, academics, and government officials should be convened to propose a program for the creation and sustenance of a national program to provide the intellectual infrastructure for economic regulation in Brazil. The proposal should also include proposing a method for funding such programs, and coordination with related international activities.

UPDATE:

Nothing on a broad national level has changed since the issuance of the report to justify any change in the recommendation. In fact, the intensity of the debate over the role of independent regulatory agencies over the last two years has, if anything, dramatically demonstrated the need to implement this proposal. *That debate would have been far richer and insightful if Brazil had an even stronger intellectual foundation in the theory and practice of economic regulation in its universities.* The creation of an Ombudsman seems likely to enhance the debate even further. It

⁵⁵ It is possible under Brazilian Law for there to be a formal coordination conventions between regulatory agencies. In essence, that is what was proposed in the original recommendation. Given the lack of coordination historically between ANEEL and ANP, and given the problems that have evolved, suggesting such a convention again seemed inadequate for what is needed.

⁵⁶ Under the Constitution in Brazil, gas and petroleum regulation must be regulated by a single entity. Thus an unintended, but perhaps largely benign, byproduct of the revised recommendation is that if it were to be adopted, petroleum would also come under the jurisdiction of the proposed consolidated regulatory agency.

⁵⁷This recommendation relates solely to rearranging existing national regulation of natural gas. Natural gas distribution companies are subject to regulation by the states, and this recommendation should not be construed as suggesting that the state regulators should have that power removed.

will be further enhanced if there were a systematic national effort to enhance the intellectual infrastructure for economic regulation.

While there are some university programs, the burden of developing them has fallen almost exclusively on those institutions. They require more support and should be expanded to more academic institutions. Adding a strong dose of scholarship informed analysis, and enlightened discussion to the debate would be a very positive contribution. Toward that end, ANEEL, perhaps in coordination with such sister entities as ANP, ANA, ANATEL, and ABAR, should establish a program to accredit regulatory studies programs, and to develop incentives for regulated companies to financially support them.

REVISED RECOMMENDATION 26

- a) **A task force, consisting of regulators, regulated market participants, academics, and government officials (including the proposed Ombudsman) should be convened to propose a program for the creation and sustenance of a national program to provide the intellectual infrastructure for economic regulation in Brazil. The proposal should also include proposing a method for funding such programs, and coordination with related international activities.**
- b) **ANEEL should, perhaps in coordination with other Brazilian regulatory agencies and/or ABAR, should establish criteria for accrediting regulatory studies programs at Brazilian universities, and establish a program for providing such accreditation.**
- c) **ANEEL should announce that contributions from regulated companies to university regulatory studies programs can be passed on to consumers on a Real to Real basis, up to a stated maximum level.⁵⁸**

28. ANEEL should play only two roles in the planning process. One is to determine, upon request only, whether certain costs or risks should be socialized by passing them through to consumers. The other is to adjudicate planning disputes.

⁵⁸ This money might also be procured from the mandatory 1% contribution to research and development required of all regulated companies.

UPDATE:

The new market model will essentially codify the earlier recommendation that ANEEL should be removed from the planning process. The two residual planning roles for ANEEL noted in the original report, adjudicating disputes, and determining whether or not certain costs will be socialized through the planning process still remain somewhat vague. These roles, however, are visualized as adjudicative only; ANEEL could not initiate such proceedings, but would adjudicate if a party brought forth an appeal.

It seems uncertain whether the creation of EPE will reduce or increase the number of planning disputes. It is conceivable, particularly in regard to transmission planning, that planning disputes could emerge that will require ANEEL to make a decision.⁵⁹ Given that the Brazilian Constitution guarantees that any person who feels aggrieved by government action has the right to pursue an appeal to the courts, the issue posed is not if appeals from EPE determinations can be heard, but rather who would hear them. It is hard to escape the conclusion that the power sector is better served by giving ANEEL, with its expertise and experience, the first opportunity to decide the appeal. If the matter went directly to the courts, it is almost certain (unless perhaps there was a specialized Vara) that the matter would be decided by a judge with little experience or knowledge of the power sector or power planning. Because EPE reports to MME, any dispute would ultimately be with MME. Since the Ministry is higher than ANEEL in the hierarchy of the state, ANEEL would be powerless to resolve the dispute. Thus the logic of referring planning disputes to ANEEL appears to conflict with Constitutional reality.

In regard to the determine what costs will be passed on to consumers in the planning process, ANEEL still seems to have a role to play, in that it will have the final say as to what costs will be reflected in tariffs. Accordingly, although the new market model has changed the planning environment significantly, the original recommendation requires only limited modification.

REVISED RECOMMENDATION 27

⁵⁹ An excellent, hypothetical, although not at all improbable, example is where EPE proposes that a new transmission line should be constructed to relieve congestion, but that conclusion is vigorously contested by a potential generator who proposes to build a plant in a location that will provide much needed voltage support and thereby relieve the congestion, or by a very large customer who proposes to reduce its demand at the time of congestion in exchange for compensation below the cost of the proposed new transmission line. While this problem could be fixed by conducting an “all source” auction, which would allow all the hypothetical bidders to enter the contest on economic grounds, it is also not hard to imagine that technical specifications enumerated by EPE might preclude such a competition and tip the scales in favor of one of the proposals. Aggrieved parties may well seek appellate review of those types of barriers that serve to prevent them from entering the market.

ANEEL should, on request only, play only one role in the planning process.

- a) **Determine whether certain costs or risks should be socialized by passing them through to consumer.**

29. ANEEL should open a public inquiry into the continued use of price caps in the regulation of the distribution companies. The inquiry should focus on the pros and cons of the existing system and on the potential benefits or pitfalls of replacing price caps with a cost of service or revenue cap system.

UPDATE:

The debate over distribution company tariff methodology has advanced considerably since the publication of the first report. At that time there was a great deal of uncertainty as to what methodology should be employed and even some question as to ANEEL's authority to resolve that question. Since that time, ANEEL has attempted to enunciate the methodology more clearly and definitively and has already used the methodology to establish tariffs for a number the companies. It appears to have significantly revised an earlier, much criticized, methodology that would have tried to calculate the regulated asset base on an asset-by-asset basis. ANEEL has, in fact, issued a "Technical Note" to explain its actions in regard to tariff formulation. The issuance of that type of document is quite helpful and commendable. Some interviewees, however, have suggested, that the regulators' explanation is still inadequate for them to completely comprehend the methodology and its derivation.⁶⁰ While there is still some debate about whether ANEEL has chosen the appropriate methodology, whether the methodology is biased against urban areas, for example, the issue addressed in initial report, namely the need to formally establish a methodology, has been addressed, and this the original recommendation is no longer relevant.

It would, however, appear that ANEEL must further clarify how the capital and operating costs incurred by the distributors in complying with their mandated obligation to extend electrification will be reflected in the distribution tariff methodology. Similarly, concerns were

⁶⁰ The *Tribunal de Contas*, in a recent decision, noted its view that ANEEL, in specific cases involving the tariffs of CEMIG, ELETROPAULO, and LIGHT, had erred in applying the agency's own methodology. The TCU did not raise questions regarding the methodology itself, but rather its application. Despite the fact that the TCU did not impose a deadline for ANEEL to issue a new decision, the regulatory agency has indicated that it disagrees with TCU and may appeal the decision.

expressed that the distribution tariffs were exclusively focused on supply side options by linking distribution revenues to energy sales, rather than employing a methodology more neutral between supply and demand side options. Without judging the merits of the complaint that ANEEL is still not being as clear as it might be in regard to tariff methodology, the following is suggested:

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ANEEL should continue its efforts to fully explain the tariff methodology it is employing and the rationale for doing so in as clear a fashion as possible. The use of “Technical Notes,” for example should be not only continued, but perhaps expanded upon to make certain that there is wide understanding of the agency’s thinking and method of analysis in regard to the formulation of distribution and other tariffs. More specifically, future technical notes should address the question of how mandated electrification programs will be incorporated into the establishment of distribution tariffs, and how incentives can be more neutral between supply and demand side options.

Appendix A: Summary of the New Market Model

Proposal for the Institutional Model of the Energy Sector - Proposed in 2003

In July 2003, the Ministry of Energy and Mining – MME, published a document “Proposal for the Institutional Model of the Energy Sector”, the summary of which will be described below.

The new market model has the following main objectives:

- To guarantee the energy supply;
- To attract needed investment to the sector;
- To promote fair tariffs by means of efficient energy contracting for the regulated consumers;
- To provide large customers with the freedom to contract for supply; and
- To promote social inclusion into the electricity sector, especially through programs of universalized attendance.

Guaranteed supply

While there are no instruments providing a direct guarantee of energy supply, there is an indirect guarantee, stemming from the requirement for an assured energy reserve for the buying and selling contracts. For example, if 100% of the demand were contracted by generators whose assured energy corresponded to safety criteria of 95%, there would be, in theory a maximum risk of 5% of any supply problem occurring.

However, this indirect scheme of inducing guaranteed supply, presents a series of limitations:

- The current requirement is that 95% of the demand be contracted, and not 100%, in consequence of which, the generation offer tends to be less than what is necessary, which deteriorates the security factor;
- The assured energy calculation of the hydropower plants does not consider the effect of various operative restrictions, which leads to a sub estimate of the real risk of supply problems, even though 100% of the demand is contracted; and
- The differentiated contribution of the thermal power plants to the guaranteed supply is not considered, especially when they alleviate the more severe interruptions under extremely unfavorable hydrological conditions.

The model foresees an integrated group of measures to guarantee supply, including:

- Requirement for 100% contracting of the demand⁶¹;
- Realistic calculations for generation reserves;
- Making the existing criteria for structural supply guarantee, more adequate to the growing importance of electricity for the economy and for society, by establishing more rigidity than at present;
- Contracting the correct proportions of hydropower and thermal power so as to ensure the best equilibrium between guarantee and cost of supply. This, combined with the new supply criteria, will result in the same supply security as would be offered by the combination of the existing criteria with an externally established reserve, without the necessity of arbitrarily allocating a group of “reserve” projects; and
- Permanent monitoring of the supply guarantee, permitting the detection of unequal conjunctures between supply and demand and providing preventative measures capable of guaranteeing supply at the lowest cost to the consumer.

Fair tariffs

The basis for fair tariffs is the efficient contracting of energy for the regulated consumers. The main actions needed to engender this efficiency are:

- Contracting for energy supply in competitive auctions, the winning bidder being the one offering the “lowest tariff”;
- The contracting of energy through a bidding process with all the forecasted need of the distributors pooled with risks and benefits being distributed in proportion to each distributor’s forecasted demand and equalizing supply tariffs; and
- Segregating competitive auctions for new generating plants (meeting incremental demand) and existing plants.

Contracting markets

Two contracting markets will be created:

1. A regulated contracting market – ACR: means the contracting of energy for attending regulated consumers (captive consumption of the distributors) by means of regulated contracts with the aim of ensuring fair tariffs, and

⁶¹ In accordance with item 1.3 – December/2003 of the MME Report, the requirement for 100% contracting of the demand is not limited to distributors.

2. A free-contracting market – ACL: which means the contracting of energy to attend free consumers, by means of freely negotiated contracts. The existing bilateral contracts, which involve distributors, will be fully respected and traded within the ACL until they expire.

Participation of generators within the ACR and ACL

All the generators, both public and private, including self-producers with excess, may trade energy on both markets. For all generators, the rules for accounting and offsetting the energy buying and selling contracts will be essentially the same as in current practice.

Coexistence of markets

In commercial terms, the ACR could be seen as a “cooperative” which adds to the demands of various distributors and holds contracts with a group of generators. The accounting and offsetting of contracts from this “cooperative” will be identical to those of the ACL agents and basically follow the present rules. In particular, the differences between amounts contracted and effectively consumed on the ACR will be accounted for and liquidated on the basis of the marginal operation cost (CMO), and be subject to a “ceiling”.

Contracting of new energy on the ACR

The basic characteristics for contracting energy of new generation plants are two-phase bidding; offer of projects for bidding; selection of winning projects; signing of bilateral contracts and incentives to distributors for contract efficiency.

Sequence of bidding

In view of the fact that the maturity date of the new hydropower plant is around 5 years, the contracting of energy to attend the foreseen increase in demand should ideally be made with the same antecedence. However due to the large uncertainty about this increase in demand, it is necessary to be cautious with these contracts. In fact if the energy corresponding to a certain scenario of growth were contracted and it happened that the real increase were much less, an excessive capacity would have been installed, thereby increasing consumer tariffs. Because of the uncertainty, it is more efficient for the consumer when the energy contracts to attend increased consumption are made in 2 sequences:

1. Initial bidding, conducted 5 years in advance, through which energy would be contracted to attend one part of the expected growth in demand (for example, corresponding to a scenario between “probable” and “low” economic growth bringing less electricity consumption); and
2. Complementary bidding conducted 3 years in advance (2 years after the initial bidding) to contract the rest. As mentioned above, at this stage there will be better conditions for foreseeing the evolution of demand, with reference to the year in which the contracted energy will be supplied.

It is also anticipated that while the five-year-ahead bidding provides sufficient lead-time for developing hydro plants, the three-year time horizon will only be sufficient for thermal units. Thus, an indirect, but perhaps beneficial outcome of two-phased bidding is diversity in the use of energy resources.

Offer of projects for auction

The MME will offer for auction (initial or complimentary) a group of projects (hydro and thermal power) studied by the Energy Research Company – EPE and considered the most economic for attending to the demand. With the aim of increasing the efficiency of the bidding process, the total amount of capacity (assured energy) of the projects offered must substantially exceed the energy at auction. Apart from this, the hydropower projects offered will already have the required environment licenses. The fact that EPE will identify sites, however, does not serve as a limitation on bidders using different sites. Any agent may freely bid projects at other sites in the auction.

Selection of the group of winning projects

The selection criterion is the lowest price (cost of investment and operation which and compliance with non-economic criteria) within the type of offer chosen. The projects will be selected according to the following procedures:

1. The contracts will initially involve auction for new energy, for “available energy”, in which all the energy produced by the plant, in accordance with ONS dispatch procedures, will be placed at the disposition of ACR. This means that the risks and benefits of the generator are transferred to the ACR consumers.

2. The bidders will propose tariffs (R\$/MWh of assured energy) for the available energy of the project (hydro or thermal power). If there is more than one bidder for the same plant, the lower tariff will be chosen;
3. The hydropower generation is the most competitive source at the moment; therefore it will predominate in the expansion of the system of lowest cost. However planning experience shows that the expansion of lowest global cost, especially with the sequenced auctions, may include a share of thermal generation. Due to this possibility, if necessary, a desirable proportion of thermal generation will be established, complementing hydropower generation, leading to lower global cost for the consumer, with better-guaranteed supply; and
4. The contracting of hydropower or thermal plants will always be carried out in ascending order of the respective tariffs. The plants will be contracted in this order, maintaining the hydrothermal proportion sufficient to attend the demand. If it is economic to include a thermal share, the contracting will be effected from separate lists.

Signing of bilateral contracts

Although the amount of demands for which bids will be sought is the aggregated demand forecast by all of the interconnected distributors in the country, successful bidders to supply energy at the auction will sign separate bilateral contracts with each distributor. The sum of the assured energy contracted with the distributors will be equal to the assured energy of the generator allocated to each distributor in proportion to its forecasted need. As mentioned, the object of this type of contracting is to further large scale economy in the auction for new energy, to divide the risks and benefits across all distributors and to equalize the supply tariffs of the distributors.

Incentives and instruments of risk management for distributors

There will be a sole price for the pass through of new energy to all the distributors, found through the average of initial and complimentary bid prices, where determining factors will be the total quantities (sum of the assured energy contracted by the distributors) bought at these auctions. Therefore, the price that each distributor will pay to the contracted generators will be an individual average, in which the determining factors will be the quantities that the distributor bought at the auctions. In other words, if the individual price of energy purchase of the distributor is inferior to the sole pass through price (more efficient than the “market price”), the distributor will receive the gains for a period of 3 years. Apart from this there will be the possibility of

admitting incentive mechanisms which reduce the price of the quantity of energy/availability of energy, determined by the pool auctions, along similar lines to those admitted in the case of old energy.

In addition to these incentive mechanisms for more efficient contracts, the distributors will dispose of instruments for risk management and uncertainties, such as the contracting of adjustments on the ACL with one and 2 years' antecedents, the re-contracting of existing energy at annual auctions and the reception, or the transfer, at no cost, of excess energy contracts from other distributors. The risks mentioned refer to the exposure that a distributor may incur upon offsetting. This risk is associated with the uncertainties in the demand forecast, a key responsibility of distributors.

Contracting of existing energy on the ACR

Auctions will be held annually for the contracting of existing energy. The contracts will be of the bilateral energy type (the same as current contracts), with different durations of between 5 and 10 years.

Free consumers

Consumers apt to choose their supplier (free consumers) should notify this intention to the local distributor who will attend him in accordance with the following table of time limits:

<i>Demand (MW)</i>	<i>Advance notice (years)</i>
3-5	1
5-10	2
Over 10	3

Notification of “return” to the condition of being supplied by the local distributor should be given 5 years in advance. However, the distributor will have the prerogative of attending the consumer in within lower time limits.

Access to new hydropower generation for the ACL

In order to have access to a new hydropower project for self-consumption or trading on the ACL a generator must:

1. Participate in the auction of the project on the ACR and offer a lower tariff for all its assured energy.
2. Pay compensation for the share of the plant destined to self-consumption or trading on the ACL.

Main responsibilities of the institutional agents

The existing and new institutional agents will assume the following responsibilities:

National Energy Council (CNPE)

- National energy policy proposals to the President, in conjunction with the rest of public policy;
- Individual bidding proposals for special projects in the energy sector recommended by the MME (new function, which allows energy to be contracted outside of the auction if it falls into a desired category as defined by CNPE, such as renewable resources); and
- Proposal for structural supply guarantee criteria (new function).

Ministry of Energy (MME)

- Formulation and implementation of policies for the energy sector, as directed by the CNPE;
- Exercise of energy sector planning function (through EPE);
- Exercise of granting concessions;
- Monitoring the safety of supply in the energy sector, by means of Monitoring Committee of the Energy Sector – CMSE (new function), and
- Definition of preventative action for restoring safety of supply in the case of imbalance between supply and demand, such as demand management and or the contracting of eventual energy reserve from the interconnected system (new function).

National Electricity Agency (ANEEL)

- Mediation, regulation and supervision of the electric system operation;
- Conducting of auctions of concessions in generation and transmission if delegated by MME; and
- Bidding process for the acquisition of energy for distributors (new function).

Energy Research Company (EPE)

It is proposed to create a specialized institution – EPE – with the main aim of developing the necessary studies so that the MME may fully exercise its function as energy planning executor, having the following study responsibilities:

- definition of the Energy Matrix indicating the strategies to be followed and the goals to be reached in the long term;
- integrated energy research planning;
- planning expansion of the energy sector (generation and transmission);
- energy potential, including inventory of hydrographic basins; and
- technical, economic and socio-environmental feasibility and prior license.
- *Organization Characteristics*
- Executive power governance;
- Technical and administrative autonomy;
- Possibility of counting on external support from specialists; and
- Possibility of counting on support from energy sector agents.

Commercial Chamber of Energy (CCEE)

It is proposed to create a specialized institution – CCEE – with the following objectives:

- To administer buying and selling contracts of energy from public utility services of distribution;
- To hold auctions for the purchase of energy for distributors, as long as authorized by ANEEL;
- Carry out the present functions of accounting and offsetting of Wholesale Energy Market – MAE – on the 2 markets – ACR and ACL.

CCEE will succeed MAE, assimilating its present functions and incorporating all its structural and operational organization.

The governance structure of CCEE will be similar to that of MAE. The main difference is that the President of the Board will be appointed by MME, who will then have the power of veto in deliberations which conflict with policies or directives from the Government.

CCEE will identify the supply tariff for distributors to be considered by ANEEL in the establishment of final tariffs for regulated consumers.

Monitoring Committee for Electricity Sector (CMSE)

Within the ambit of MME, it is proposed to set up the Monitoring Committee for Electricity Sector of a permanent nature with the function of analyzing continuity and quality of supply for a 5-year period. It will also propose preventative measures of minimum cost to restore adequate conditions for supply, including action on the demand side and also conjuncture reserve contracts.

Among other events which may affect guaranteed supply and therefore should be monitored are included:

- Non-compliance with construction time- schedules;
- Exceptionally adverse hydrological conditions and
- Unexpected consumer increases.

CMSE will be coordinated by MME and will have the formal and permanent participation of the following institutions: EPE, CCEE, ONS and ANEEL.

National System Operator (ONS)

At present the ONS proposes the expansion of the grid, including reinforcement of existing assets, to ANEEL, for inclusion in the auction or any other required authorization.

In order that medium and long-term expansion of the grid may be considered the ONS proposal should be addressed to MME. The proposal will then be sent to EPE to be considered in the studies for long-term system expansion. After the process of public hearings, EPE will send the studies to MME who will establish the expansion plan and then forward them to ANEEL for auction.

ONS should publish monthly effected dispatch performance standards, which will be audited half yearly by ANEEL. Amongst which standards are: operational safety; losses; specific charges of system services; deviations from operational forecasts.

ANEEL should annually promote an audit of systems and technical procedures at the ONS, with the purpose of verifying and proposing improvement in the following aspects:

- Reliability and integrity of the operational systems utilized;
- Adherence to operative practice of the grid procedures; and
- Quality and state of the art of methodologies, computer models, systems and processes.

Law No. 10.847 and Law No. 10.848 of March 15, 2004

With basis on the above report, the MME encouraged debate and conducted or participated in meetings and seminars with representatives from the government, investors both current and prospective, market participants (public and private), consumers, unions, and other interested parties. Suggestions were put forward and discussed at these meetings. MME's proposal went through a number of changes before being finalized for submission to Congress, and approved by means of Law No. 10.847/04 (resulting from Provisory Measure No. 143/04) and Law No. 10.848/04 (resulting from Provisory Measure No. 144/04).

Law No. 10.847/04 created the Energy Research Company (EPE), establishing its functions as an energy planning entity with the following main study responsibilities: (1) definition of the Energy Matrix indicating the strategies to be followed and the goals to be reached in the long term; (ii) integrated energy research planning; (iii) planning expansion of the energy sector (generation and transmission).

Law No. 10.848/04 set the main rules for the reorganization of the Brazilian electric energy system, modifying the most important existing laws regarding the energy sector and introducing some of the MME's proposal foreseen in the document, *Proposal for the Institutional Model of the Energy Sector*, such as:

- I. creation of two contracting markets: regulated contracting market (ACR) and free-contracting market (ACL);
- II. change of the responsibilities for exiting institutional agents (MME, ONS and ANEEL) and creation of a new institutional entity, called Commercial Chamber of Energy (CCEE), which will succeed the Wholesale Energy Market (MAE);
- III. obligation of contracting 100% of electricity energy needs for generators, distributors, consumers and commercial agents;
- IV. for consumers with regulated contracts for indeterminate term, establishment of 36 months *as limit* to communicate to the distribution company its option to be a

free consumer, considering that the distribution company has the prerogative of attending such consumer within lower time limit;

- V. for free consumers, establishment of 5 years *as minimum* to notify the local distribution company in case of return to the condition of being supplied as regulated consumer, considering that the distribution company has the prerogative of attending such consumer within lower time limit.

The Executive Branch will better detail all these rules by means of a decree that has not yet been published.

**Appendix B: Proposed New Project of Law Addressed to Congress Regarding
Organization and Social Control for Regulators**

In this month of April, the Presidential Office addressed to Congress a project of law proposing a new organization for the regulators. Its main points include:

- decision- making process: by majority vote of the Board of Directors; public hearings for alterations of legal norms and decisions of the Board;
- accountability and social control: activity report; performance contracts between Energy Ministry and ANEEL specifying among others performance targets and budget resources estimate;
- ombudsman duties: service quality control, complaints department;
- interaction between Regulator and organs for defense of competition: preparation of technical reports;
- decentralization of activities at the State level: technical expertise is required at the decentralized levels;
- power of granting concessions comes from Federal Government;
- proceedings for granting concessions can be delegated to ANEEL by MME;
- mandate of the General Director terminates between January 1 and June 30 of the second year of the President of the Republic's term of office.

This project must be voted on by Congress.

Appendix C: Regulators, Policy Makers, and the Making of Policy: Who Does What and When Do They Do It? By Ashley C. Brown

Delineating between the roles of government policy makers and independent regulators is the subject of controversy and confusion wherever independent regulatory agencies have been established. Part of the controversy, of course, is the result of the natural “shaking out” process for newly established independent regulatory agencies in countries with no experience with such institutions. Part of the controversy, however, is simply that the boundaries between “policy-making” and “regulating” are inherently fluid and uncertain. Moreover, the very notion of distinguishing between “policy making” and “regulating” may well pose a false dichotomy. Both policy-makers and regulators make policy. The distinction is that policy-makers define the fundamentals and define the parameters within which policy-making is delegated to regulators. It is more useful to think, not in terms of policy-making versus regulation, but, rather, as macro policy versus micro policy. In fleshing out the distinction, it is useful to think in terms of the following key concepts:

1. Basic and macro policy must be set by the Government.
2. Government policy must be set and altered only on a prospective basis.
3. Regulators must follow and enforce policies articulated by the Government
4. Regulators are creatures of the state and not necessarily of the Government.
5. Policy vacuums are an inherent and to be expected.
6. Some policy issues require technical expertise to be resolved.
7. Regulatory decision-making, policy or otherwise must be subject to appellate review.

There is no debate whether Government has the power and the obligation to set basic policy. It not only has the capability, but it is its action that vests legitimacy, credibility, and legal authority to the regulatory regime. In fact, regulators, except in the rare circumstance where regulatory authority derives directly from the constitution (e.g., California), possess only those powers specifically delegated to them by the Government. Governmental failure to coherently articulate basic policy, will inevitably lead to instability, uncertainty, and blurred vision. Neither investors nor consumers will long tolerate a regime without basic form. The real question about the government establishment of policy is about the level of detail provided by government policy-

makers, the stability of established policy, and the means by which policy is articulated and communicated.

The level of detail provided by the Government is not a trivial issue. It is necessary that policy be articulated in sufficient detail to provide a level of stability and predictability adequate to attract capital and market participation. The general rules of the road and parameters of discretion delegated to regulators need to be stated in sufficient detail to enable a general understanding of the nature of the regime. Indeed, it is in articulating the basic policies that the difference between macro and micro policy is defined. Anything articulated in law or rule by the government constitutes the macro policy. Any policies that regulators articulate in order to carry out their duties to implement macro policy constitutes micro policy.

Macro policy should not be overly detailed for two basic reasons. The first is that things will almost inevitably change and regulators should not be entirely deprived of the flexibility needed to adjust to altered circumstances. Markets and circumstances evolve with time and it is prudent to enable regulators to make appropriate incremental changes. That degree of flexibility internalizes modest changes into the regulatory process and avoids undue politicization of relatively minor issues. It is also a recognition that policy makers are not and cannot be prescient. They simply cannot anticipate all issues that will require policy-making to resolve. Rather than attempt to micro manage all details, delegation of authority to regulators to fill in policy details seems quite sensible, particularly given the fact that policy-makers always possess the ultimate authority to change policy on a prospective basis, when they deem it appropriate to do so.

The second reason for avoiding overly prescriptive policy parameters is that some matters are simply too technical for policy-makers. An excellent example is in the area of pricing. While it is important that basic methodology be set forth on a policy level, the actual implementation and application of pricing principles is an extraordinarily complicated matter. What level of expertise, for example, can we expect to find in a legislative body on the relative merits of locational marginal cost pricing for electric transmission services? The matter, while an important sector policy issue, is self evidently too arcane, too technical, and too sophisticated to expect keen insights from makers of macro policy. That being said, however, it is critical that the government articulate at least a basic theory of pricing. It may range from the amorphous “just and reasonable” standard enunciated in the Federal Power Act in the U.S., to something slightly more prescriptive, such as mandating price caps, benchmarks, rate of return regulation, performance/incentive based regulation (PBR), reasonable opportunity to recover prudently incurred costs, or some other criteria. Even here the task is not easy. For example, enunciating PBR goals is much more general than describing the narrower framework of price caps. Further,

it is important to consider the general consistency of the guidance. For example, the proposed U.S. energy legislation currently under Congressional consideration gets into details such as “native” load protection that run against the open access provisions in unexpected ways. Very small changes in the wording can have profound, unintended, and often quite adverse effects. The purpose is to provide investors and consumers alike, some insight into what they may reasonably expect from the pricing regime, not to put the regulators into a strait jacket by rigidly defining every detail. Where policy-making requires technical sophistication, nuanced shaping, and expertise, it is prudent to simply delegate it to the regulators.

Delegation of micro policy-making also makes sense because no macro policy-maker, regardless of prudence and vision, will ever be able to foresee all of the policy issues that will be encountered in the exercise of regulatory authority. Consequently, there is an element of policy-making that will have to be done when unanticipated issues arise for which there is no pre-existing policy, or where the policies, articulated in broad terms, requires clarification or fuller definition in application. Examples might include refined definitions of what constitutes improper exercise of market power in electricity generation, or how to price a newly unbundled telecommunications service that had previously only been offered on a bundled basis with other services, or redefinition of customer classes based on unforeseen uses. It is, of course, theoretically possible that regulators, upon encountering such a situation, could stop their decision making process and seek guidance from government policy-makers. Unfortunately, doing so will inherently render the decision-making process more laborious, time consuming, and less effective. Moreover, there is no assurance that an answer will be forthcoming at all, much less on a timely basis. That seems, for a variety of reasons, quite likely in legislative bodies. It seems both more efficient and fairer to the parties involved to simply authorize the regulators to make the needed determinations. If the judgment of the regulators proves faulty, there will be many opportunities for them to reverse themselves, or for macro policy makers to step in and articulate a new policy.

It is useful to point out that macro policy can come from two sources, one legislative, and the other, executive. Obviously, basic policy should be set out in law. That requires legislative action. The other possibility for policy formulation, all be it within the scope of authority provided by law, is that executive agencies such as cabinets, individual ministries, councils of ministries (the National Energy Policy Council in Brazil, for example), the president or prime minister himself, will enunciate policy. Basic infrastructure ministries, and perhaps other institutions, may well possess comparable levels of expertise as is found in regulatory agencies. They, therefore, may well be as competent at analyzing arcane technical matters as the regulators.

The issue with executive policy makers, unlike legislators, as noted below, is often not lack of understanding or expertise, but, rather, one of timing, transparency, politicization, and application of decisions. It is important, however, to keep in mind that there is more than one level of delegation possible for micro policy-making.

While policy-makers should resolve broad policy questions, many areas of micro policy making, within defined parameters, are best delegated to regulators to decide. Doing so follows logically from one of the fundamental reasons for regulatory independence. The state performs three basic categories of functions: administration, legislation, and adjudication. It is impossible to put regulatory agencies in any single category, since they perform aspects of each. They operate agencies, buy supplies, enforce laws, manage personnel, and perform many other administrative tasks. They set tariffs, promulgate rules, enunciate micro policy within the authority delegated to them, and perform other functions that are universally applicable and prospective in nature. Those two attributes are classic legislative powers. Finally, they adjudicate disputes within their legal jurisdiction. Thus, regulators do not readily fit into any governmental table of organization. Policy-making, of course, is legislative in nature and is, therefore, a type of activity within which regulators routinely engage in. Their ability to do so, however, is governed by the scope of authority granted to them by the government. Once that authority is delegated, and, until it is rescinded, the regulators should be free, subject to appellate review, to apply their expertise and exercise their lawful authority free of governmental interference.

As noted, macro policy-makers always possess the legal capability to dictate policy to regulators. It is important, however, that when they do so, they act only on a prospective basis. The rationale for that principle is two-fold, decision-making coherence, and the legitimacy/transparency of the process itself. The first rationale is rooted in sound process management. There are three basic elements to the process: legal/macro policy formulation and articulation, implementation/micro policy formulation, and appellate review. It is an element of basic fairness that those who participate in the process are able, to the extent possible, to know what the rules and policies with which they will have to comply. It is, therefore, for the sake of both coherence and fairness that the three elements of decision-making be conducted in appropriate sequence by the proper authorities. Policy-makers, both legislative and executive, need to provide the regulators with the policy framework within which they must make their decisions. By articulating that framework, they are simultaneously providing all parties due notice of the basic parameters of regulatory policy and principles to be followed. Those policies are set forth in general terms and in contemplation of overall objectives rather than determining the

outcome of specific cases or fates of specific market participants. While vested interests will undoubtedly attempt to influence policy decisions, and certainly have a right to do so, it is important to keep policy-makers fully focused on the broad goals and objectives defining the public interest, rather than on the specifics of individual case outcomes.

It is for the regulators to decide individual cases and to actually apply the policies to specific factual contexts and players. In so doing they are almost certain to encounter matters that require detailed interpretation of policy, or even filling in the blanks left by the policy-makers. In fact, for the most part, it is in the context of specific cases or set of circumstances that issues of micro policy will arise. It is an inherent and unavoidable aspect of regulation that matters of micro policy, or clarification of broad policy, will arise in specific cases before the regulators. Whereas macro policy-makers are often the initiators of policy matters, regulators, more often than not, make micro policy in reaction to matters raised in specific cases or disputes, or, in order to specifically fulfill obligations imposed upon them by law. It is axiomatic, but true, that unforeseen issues or circumstances will arise, which the macro policy-makers did not, or could not, anticipate.

While regulators could, in theory, upon encountering a micro policy matter, stop their process, throw up their hands, and ask for guidance from government or legislative authorities before proceeding, the result, would be likely be highly disruptive, time consuming, and would almost certainly politicize the outcome of very specific cases or the fulfillment of specific regulatory objectives. Those inevitable effects of such a procedure would likely negate the very *raison d'être* of independent regulatory agencies. It makes better sense, therefore, to simply allow the regulators to proceed with their decision making process. That being said, however, there certainly does need to be a check in place to assure that the regulators neither exceed their legal authority nor violate policies that they are obliged to follow. That, of course, is the reason why there is an appellate process. If regulators, in deciding a matter, fail to follow obligatory laws and/or policies, then the offending decision should be reversed and reconsidered.

There is, therefore, a logical sequence to deciding regulatory matters. The first is the initiation of the entire regulatory regime through the articulation of basic principles and policy formulations. That process allows for public contemplation of basic policies through the political process, but in a broad context without specific cases or disputes in mind. That is, undisputedly, the role of legislators, and perhaps executive policy makers as well. Regulators can provide input in such matters, but are not empowered to decide them. The second part of the sequence is the actual carrying out of regulation. That process allows for regulators to adjudicate disputes, fulfill legal obligations such as tariff setting, and, where necessary, to provide micro policy details in

order to clarify or provide detail on policy. The latter, of course, is the essence of making micro policy. It must be carried out independently, transparently, and in an apolitical manner. The third sequence is to assure that the second sequence, the regulatory process, is carried out in a manner not inconsistent with the policies and principle enunciated in the first process. The third sequence is, of course, the appellate process. In fact, there are two appeals processes, one for resolving specific cases in dispute, and the other, for resolving policy issues on a prospective, going forward, basis. In the first type of appeal, a party who feels aggrieved by a decision by the regulator may ask that an appellate body (usually a court or tribunal of some sort) reverse the decision in that case. The appellate body, among its other obligations in reviewing the decision of a regulatory agency, must make certain that the regulators neither exceeded their authority or failed to follow the policies set forth by macro policy makers. This form of appeal should be carried out in an independent, transparent, apolitical manner. The other form of appeal, however, is to the macro policy makers. An appeal to macro policy makers, however, is merely to review relevant policy in order to determine whether policy needs to be altered or supplemented. Because, however, such an appeal can be carried out within the political process, any policy determinations will affect only future matters. In other words, it cannot affect the outcome of specific cases decided by the regulators prior to the re-formulation of basic policy.

Apart from sound principles for decision-making, there is another, perhaps even more important reason for allowing regulators to decide matters of micro policy. That reason is the transparency and integrity of the decision making process itself. The integrity of the regulatory process is rooted in many elements, but important among them is the idea that the process is transparent, fair, and independent of politics. As one observer has noted, regulators are agents of the state, but not necessarily of the government of the moment. In order to assure the integrity of decision-making, it is vital that the process is exactly as it appears to be. All parties have the same opportunity to access the decision makers and to know what information and arguments the regulators are considering in rendering their decisions.

Because the making of micro policy often arises in connection with individual cases involving specific and discrete financial interests, the process, like the judicial process, must be utterly transparent and, to the extent possible, divorced from politics. Investors in regulated infrastructure almost invariably will demand that regulatory matters be decided in a transparent, independent, and apolitical manner. They see greater predictability, more dispassionate analysis, and fewer risk variables in the regulatory arena than in a political one. Similarly, consumers in many places, have come to the same conclusion that they are better served by having an independent, transparent, apolitical body making key decisions regarding infrastructure than

having case specific matter resolved in a political forum where they are likely to possess less clout than are well funded lobbyists for private companies. The views of political figures may well be considered by regulators as one set of inputs, but those voices must be communicated in a transparent, public manner by the regulators, who, alone, should be responsible for decision-making. In short, the process must be internally open and complete.

Unlike the making of macro policy, which is inherently political, the regulatory process, because it usually involves weighing the interests of specific parties, and the making of technical judgments regarding the application of broad policy to a specific set of circumstances, to the extent possible, should be free of politics. It is, therefore, inconsistent with the very basic regulatory concepts of independence, transparency, and de-politicization for regulators to defer to political authorities in rendering their decisions.

It is theoretically possible to construct a relatively transparent mechanism for political consultation by regulators on matters of micro policy. Indeed, political authorities should always have a means of transparently offering their views to regulators. The problem is not the transparent offering of viewpoints, but, rather, the non-transparent bypass of the regulatory processes that seems likely to occur if regulators are not in a position to decide micro policy issues on their own. Parties seeking to advance their own interests will almost inevitably, whenever it suits their interest, seek out political officials to support their point of view. It would, for example, be grossly unfair to have all of the parties in a case present their evidence and arguments to the regulators through the prescribed process while another party to the same proceeding seeks out the clandestine support of a minister or other high political figure in order to secure a favorable decision. Success in such a maneuver would render the entire regulatory process in that proceeding a sham. All of the evidence offered, arguments made, processes followed would be made meaningless. It is for that very reason that independence of the regulators is, in fact, a critical element of transparency. No process can be deemed to be transparent when the real decision maker is someone other than whom it is supposed to be under the procedures, or, where the real reasons for a decision remain unrevealed.

While perhaps it cannot be said that the motives of regulators are always pure, the discipline imposed by the process can at least compel transparency. The same cannot be said when the process becomes politicized. While the motives of the government in interfering may well be for such legitimate policy reasons as controlling inflation, promoting investment, promoting specific resources, the opportunity of bypassing an established, transparent regulatory process by political officials also opens the door to politicization, corruption and/or de-legitimization. It is important, therefore, as elementary fairness to all parties, for the integrity of the process, and for

transparency that the regulators themselves make the decisions themselves, and that any effort by the government or any of its officials to influence the outcome only be carried out in ways that are open and transparent. Certainly, advocating legitimate goals can be done transparently without embarrassment. More importantly, if the goals being advocated by political authorities are meritorious, then the government is always empowered to change policies prospectively. It need not intervene in the regulatory process in specific cases in order to effectuate policy. Doing so is to effectively alter the rules in the middle of the game. By making policy on a prospective basis only, the integrity of the process is preserved without sacrificing the ability of political authorities to make policy.

In conclusion, governments must set basic, macro policy, but filling in the details of that policy, micro policy making, is an inherent part of what regulators have to do in order to carry out their mission. Policy making by regulators, however, is limited by two critical factors. The first is that policy made by regulators is subsidiary to government policy and is done only under a delegation of authority from the state. Secondly, the making of policy by regulators is incidental to and inherent in their duty to decide specific cases or disputes. That policy making role is derived entirely from the fact that macro policy cannot reasonably be expected to anticipate all aspects of policy that will have to evolve for the regulatory process to be fully functional. Gaps will have to be filled and it is the regulators, with technical expertise and hands on experience that are best positioned to accomplish that. Their role in doing so, however, is subject to two checks. The first is appellate review that determines if the regulators were acting within their lawful authority, followed policies they were obliged to follow, whether they were acting reasonably, and whether they followed fair and correct procedures. The second check is that the government retains the ability to alter micro policy determinations. In order to safeguard the integrity of the regulatory process, however, it is vital that that power be exercised only on a prospective basis. Recognition of the realities and limits of regulatory policy making will both safeguard the process and allow for a more orderly and predictable regulatory regime.

