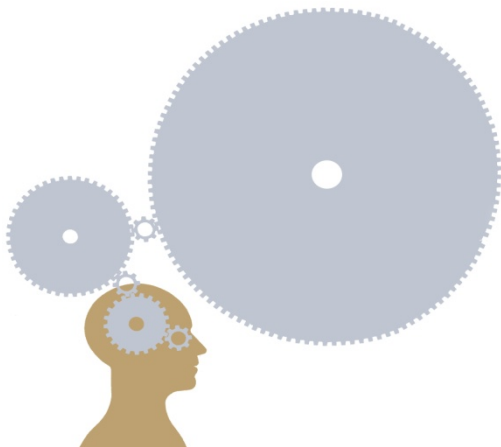


# Assessing the need for regulation and setting a path towards liberalised heat markets

Future of Heat Markets and DH Pricing in  
Baltic Countries and Poland—workshop, Riga

Jostein Kristensen, Managing Consultant

December 5th 2012



# Overview

- why regulate?
- towards liberalisation
- customer protection and engagement

# Why regulate?

Because monopolists do not deliver the benefits of competition

Prices, output

Price discrimination

Service

Innovation, investment

or

Because competition does not deliver public policy objectives

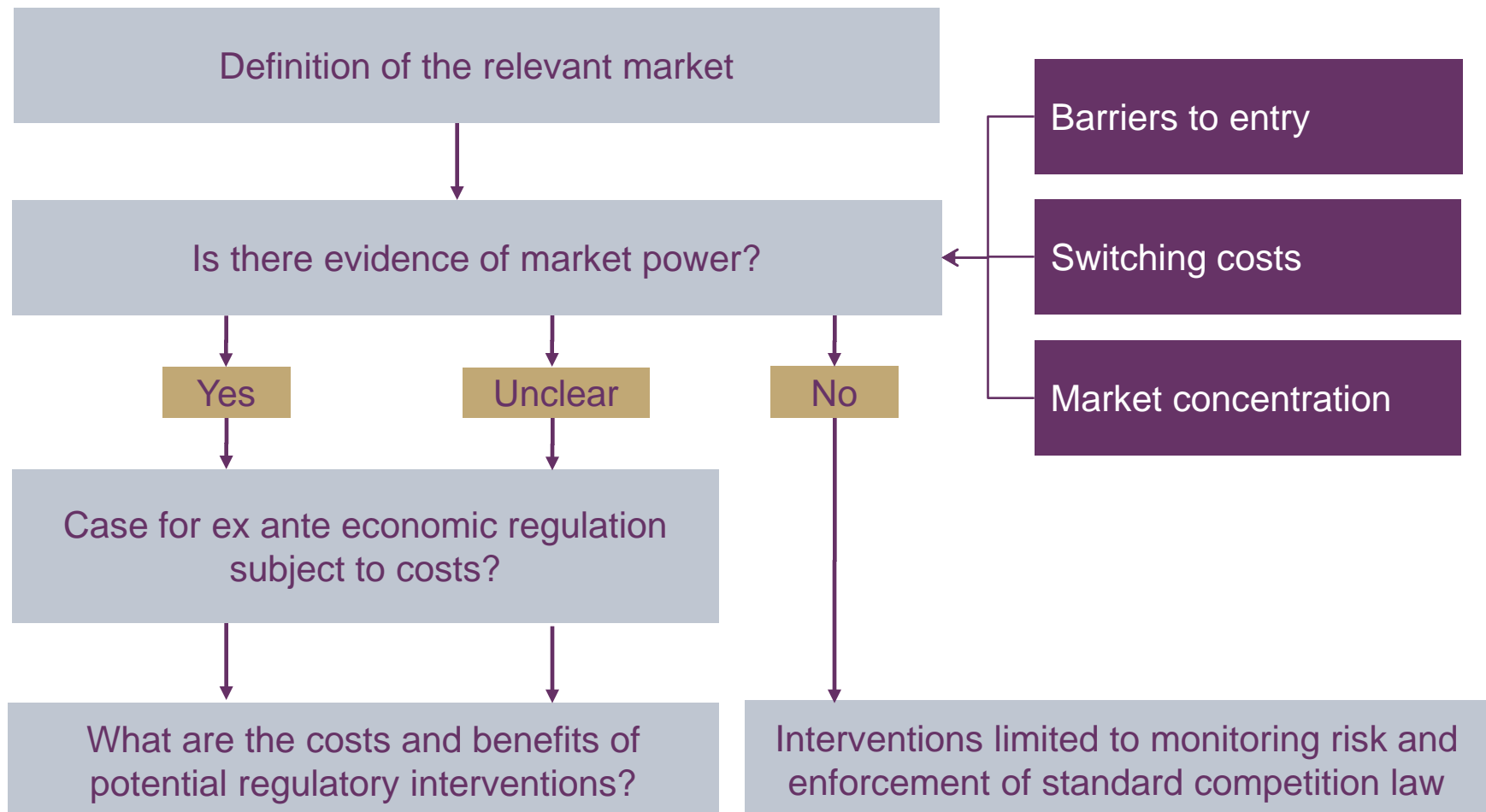
Sustainability

Social equity

Inter-generational equity

Public goods

# How can the need for economic regulation be assessed?



# What makes a 'utility' different to a 'normal' business? (I)

1. 'Essential service' characteristics

+

2. 'Naturally monopolistic' networks

=

Need for economic regulation

However...

- not all parts of the value chain are 'naturally monopolistic'
  - competition 'in the market' might be introduced
- market forces might also have a role in 'naturally monopolistic' elements
  - competition 'for the market' might be introduced
- regulation may exist for historical reasons only, rather than being based on an economic assessment of the need for it

## What makes a 'utility' different to a 'normal' business? (II)

Competition *in*  
the market

For example:

- customers
- rail franchises
- gas supply



Competition *for*  
the market

For example:

- auctions
- rail franchises
- contracting out



Price  
control



Natural monopoly characteristics of the industry



Intensity of regulatory intervention

## Why not regulate? (I)

Costs of regulation

Asymmetry of  
information

Uncertainty

Distorted incentives  
for companies

## Why not regulate? (II)

Regulators may not set an appropriate price control package



Firms need a high enough return on their assets to attract investment

Setting the wrong price may lead to lack of investment or poor service quality

Setting the wrong volume may lead to high prices

Negative effects on 'financeability' of companies



Unable to raise finance to carry out investment programme

Unable to refinance existing liabilities leading to financial distress

Jeopardise ability to deliver required level of service to customers

Regulatory risk: no guarantee that costs will be recovered or new investment financed



Risk of asset stranding

Uncertainty in planning

Negative effect on investor perception, and cost of finance

Distorted investment decisions



# Is district heating a 'utility' or a 'normal' business?

- in general, DH is not necessarily a natural monopoly but in some specific circumstances providers may have a degree of market power
- competing technologies help to provide substitution possibilities
  - conventional heat technologies (eg, electric, gas boilers)
  - solar thermal
  - heat pumps
  - micro-CHP
  - fuel cells
- substitution opportunities are likely to increase further in future, particularly as European markets become more integrated and climate change policies are implemented

Source: Enova SF (2007), 'Konkurransetilstand mellom fjernvarme og gass', January 22nd. Available at: <http://www2.enova.no/publikasjonsoversikt/file.axd?ID=294&rand=de6326a9-f50e-4db3-af80-277c28a588cd>.

# Overview

- why regulate?
- towards liberalisation
- customer protection and engagement

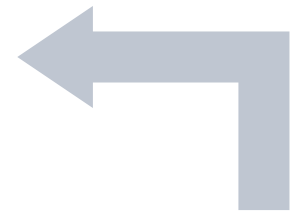
# An integrated approach to successful liberalisation of the market (I)

## 1. Long term vision and sustainable market

- understanding the vision for the market—what will the market look like in ten years?
- how does the vision shape regulatory decisions today, and do these support the market reform agenda?
- companies have a key role in shaping the long-term vision; for example, by identifying how a simplified and/or more flexible regulatory regime can support market development

## 2. Incremental evolution of regulation

- develop a strategic perspective: starting from today's regulation, what incremental changes should be considered while responding to market developments in the next 2–3 years?
- consider wider developments in the energy sector, as well as best practice and precedents from other countries and sectors
- gain stakeholder commitment, including from customer organisations
- make necessary legal changes



Working backward from a vision of the future market, a forward-looking regulator can adopt regulatory initiatives that are relevant for the type of market that is expected to emerge



# An integrated approach to successful liberalisation of the market (II)

What are the issues with the existing regulatory regime?

- complex and burdensome ex ante approach that constrains commercial flexibility?
- political intervention?
- lack of high-powered incentives?

Develop longer-term vision and set priorities

Develop options incrementally through focus on customers, best regulatory practice and lessons from other sectors

- timing and practicality of implementation
- is the expected benefit proportionate to the cost?
- identify key barriers to implementation

Determine the most appropriate industry structure and regulatory model for delivering the necessary investment

# What are the tools?

## Structural measures

Horizontal separation

Vertical separation

## Change the scope and degree of regulation

Access regulation

Relax price control towards 'light-touch' regulation

- price surveillance, reference prices
- self-regulation
- buyer power

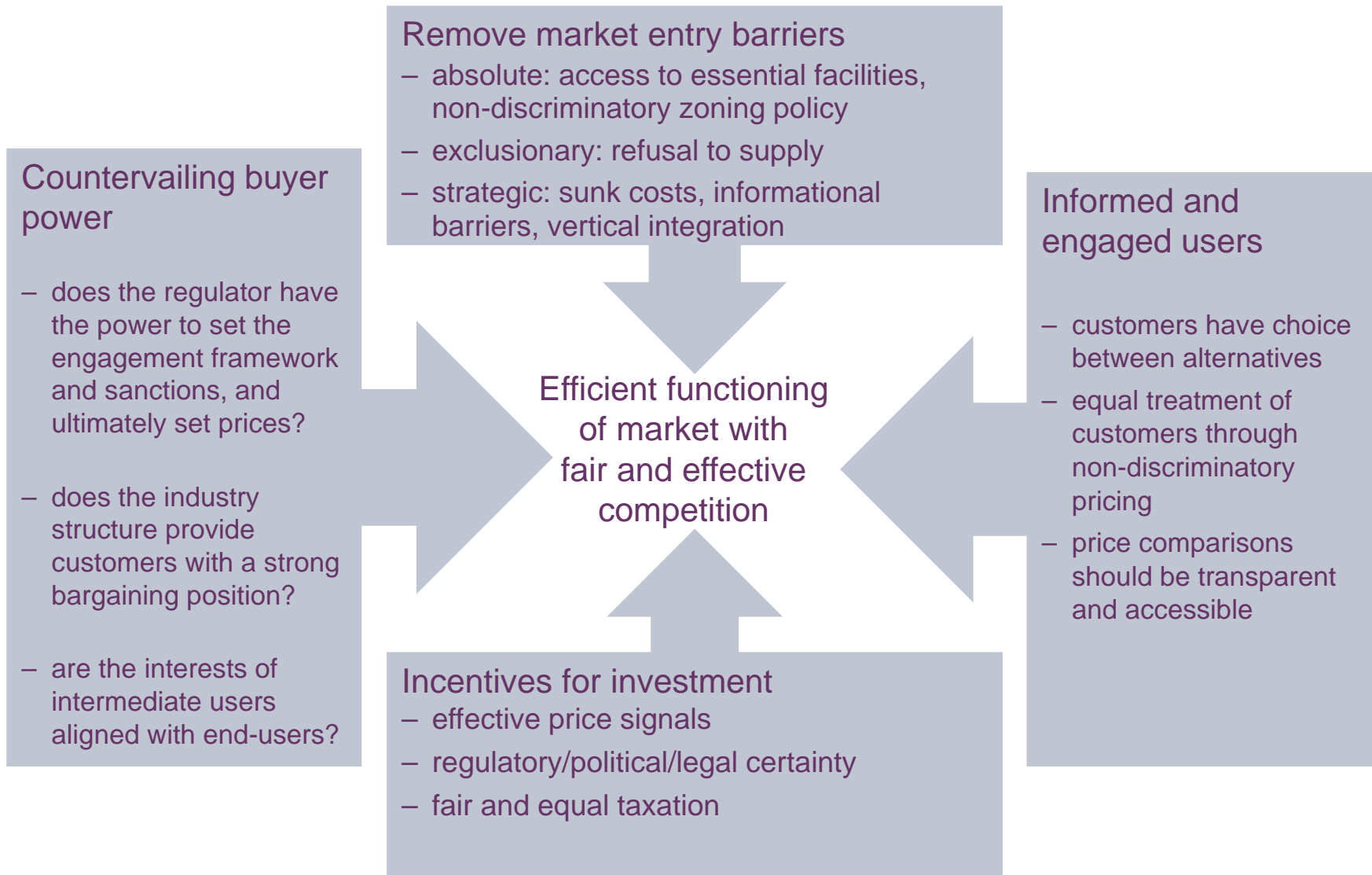
## Ex post measures

Abuse of dominance

Anti-competitive agreements

Merger control

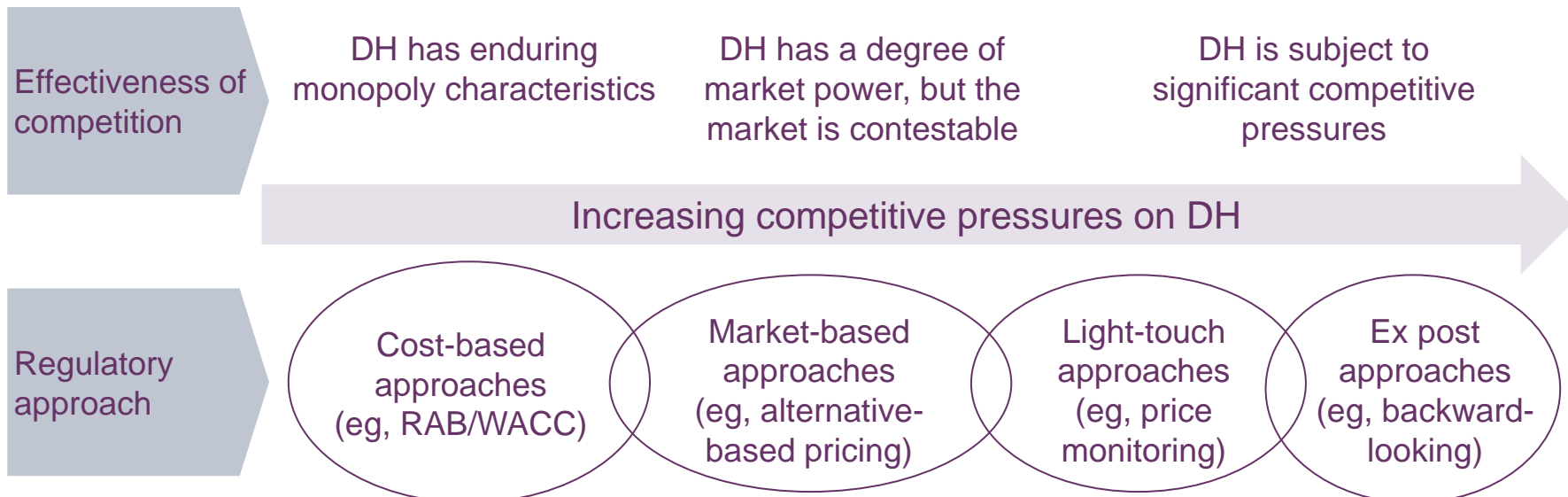
# Creating conditions for a liberalised market



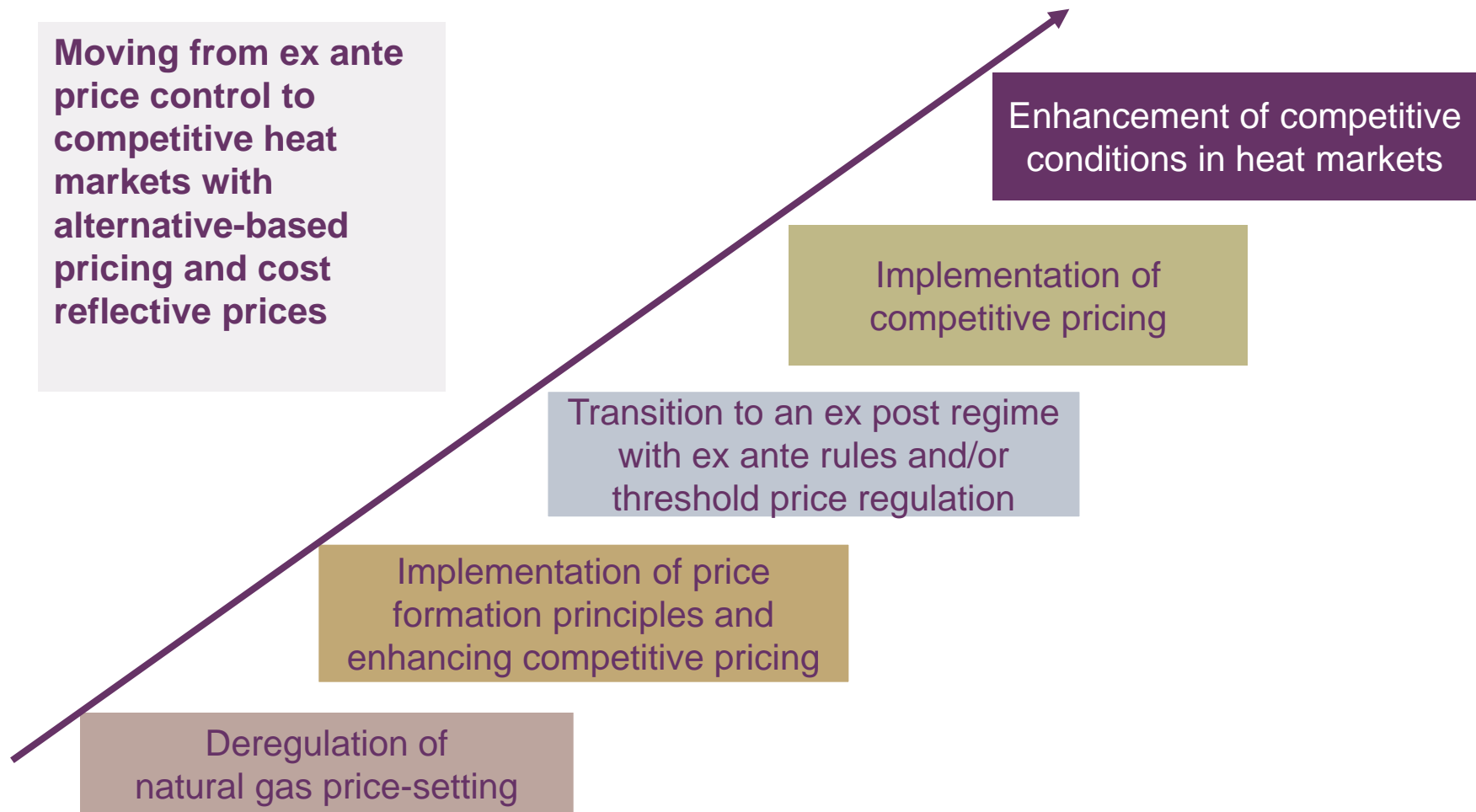
# Application to district heating (I)

What would be required for a less intrusive regulatory regime to be acceptable to regulators?

- **in economic terms**, there needs to be some evidence that competition in the heat market is a realistic prospect
  - precedent from countries in which DH companies set competitive prices and pricing is monitored based on competition law (eg, Sweden, Belgium)
- **in political terms**, there needs to be acceptability of market mechanisms, profit variability, and the role of consumers



## Application to district heating (II)





# Overview

- why regulate?
- towards liberalisation
- customer protection and engagement

# Will liberalisation be better for customers?

## Competitive markets:

- maximise welfare
- provide customers with choice
- incentivise investment
- drive technological improvements

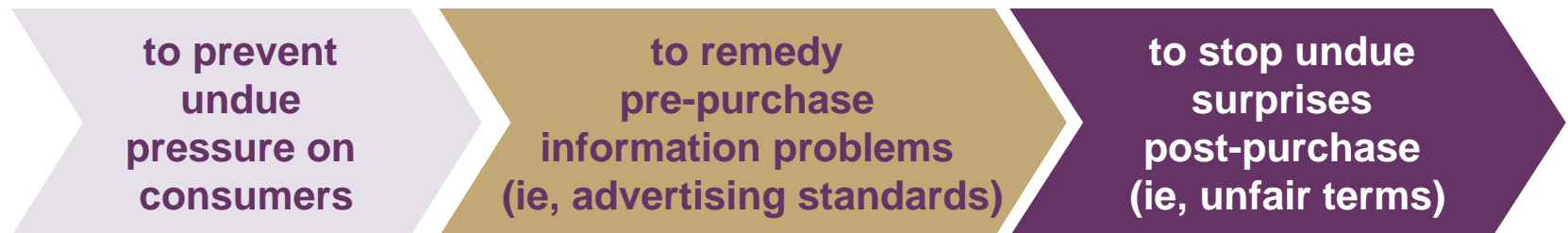
However, they may not achieve distributional policy aims or protect the vulnerable/socially excluded

Customer protection and customer engagement

Could the extent of ex ante intrusive regulation be reduced while ensuring that consumers are protected?

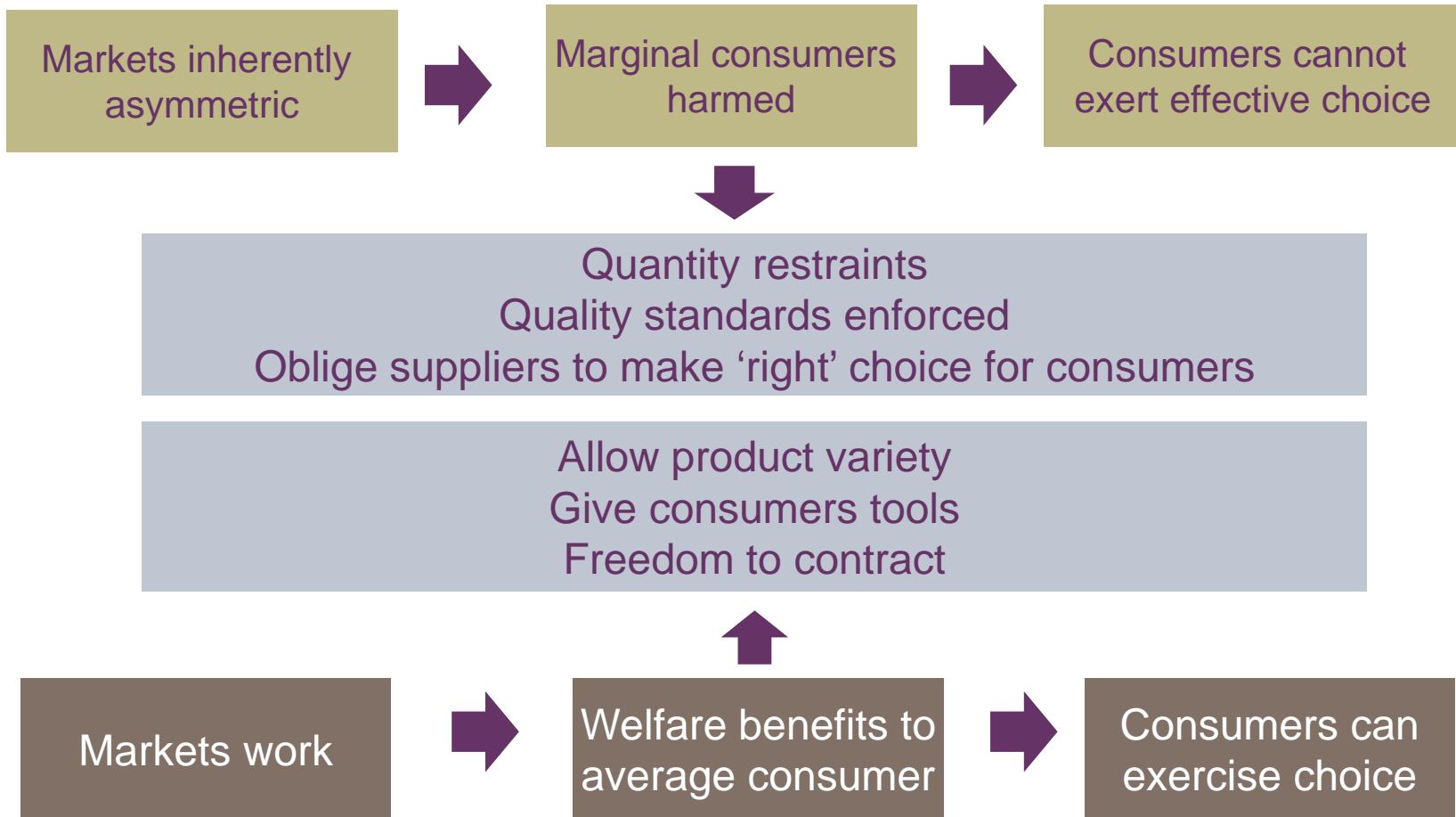
## Why customer protection?

- customer protection policies have three main aims:



- need to complement reliance on competitive market with policies to help ensure
  - information dissemination: access to transparent price comparisons and information about non-price elements
  - reduction in switching barriers: voluntary and easy connection and disconnection procedures
- remedies can be applied if firms do not comply with consumer protection policies/procedures

# Which customers should be protected and how?



## Risks of consumer protection policies

- these policies need to be designed carefully so that they do not impose additional costs and lead to distortions that actually harm, rather than protect consumers
  - risks from restricting consumer choice
  - risks from increased market transparency
  - moral hazard
- could lead to interventionist policies, despite the shift away from ex ante price regulation

**‘the best solutions often involve better consumer information than less consumer protection and choice. But improving consumer information is often easier said than done, especially information that is of immediate and practical use – for as consumers we are all boundedly rational’**

**John Vickers (2003)**

# What is customer engagement?



# Why is customer engagement important?

- customer engagement is an alternative or adjunct to detailed regulation
  - helps **companies** to focus on consumers' priorities and willingness to pay
  - helps **regulators** to understand consumers' priorities and willingness to pay
  - provides **customers** with a voice and an opportunity to participate

## Why is customer engagement important?

Utilities may be characterised by market failures

- **information problems**: lack of choice prevents market signals on willingness to pay
- **incentive problems**: even with some choice present, competition may be underdeveloped, or intermediate users/end-consumers may lack countervailing power
- **externalities**: the process of engagement needs to balance the needs of direct users, social needs and the environment; and between current and future users

## What are the practical issues?

- industry structure and degree of choice
- representativeness
- institutional responsibilities
- timing of customer involvement
- scope of customer involvement
- regulatory incentives

Customer engagement is not a panacea,  
and must be adapted to the specific context



## Lessons from other sectors?

Customer engagement/negotiated settlements can work and have a role; however...

1. does the industry structure provide customers (end-/intermediate users) with a strong bargaining position?
2. are the interests of intermediate users aligned with those of end-users and/or future potential competitors?
3. does the regulator have the power to set out the engagement framework and sanctions, and ultimately to set prices?

**US interstate gas pipeline negotiated settlements**

1. ✓ 2. ✓ 3. ✓

**New Zealand airport consult/monitor light-touch regime**

1. ✗ 2. ✗ 3. ✗

**UK airport constructive engagement**

1. ? 2. ✗ 3. ✓

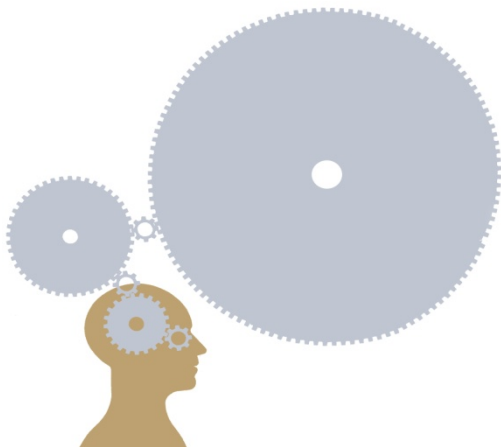
[www.oxera.com](http://www.oxera.com)

Contact:

Jostein Kristensen

+44 (0) 1865 253 000

[jostein.kristensen@oxera.com](mailto:jostein.kristensen@oxera.com)



Although every effort has been made to ensure the accuracy of the material and the integrity of the analysis presented herein, the Company accepts no liability for any actions taken on the basis of its contents.

Oxera Consulting Ltd is not licensed in the conduct of investment business as defined in the Financial Services and Markets Act 2000. Anyone considering a specific investment should consult their own broker or other investment adviser. The Company accepts no liability for any specific investment decision, which must be at the investor's own risk.

© Oxera, 2012. All rights reserved. Except for the quotation of short passages for the purposes of criticism or review, no part may be used or reproduced without permission.