Georgian National Energy and Water Supply Regulatory Commission (GNERC)

INCENTIVE REGULATION

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Basic Principles of Tariff Regulation

- In accordance with the Georgian Electricity and Natural Gas Law, tariffs in the power, natural gas, and water supply sectors are determined according to the methodology approved by GNERC
- Tariff methodology for the power sector was approved by GNERC in 1998
- Tariff methodology for the natural gas sector was approved by GNERC in 1999
- Tariff methodology for the water supply sector was approved in 2008

Basic Principles of Tariff Regulation

- Methodological basis for determining tariffs in all three sectors is the principle of total value
- Methodology allows a company to cover reasonable expenses
- It supports improvements in company's financial performance
- It protects customers from monopolized prices, especially in those fields of the sector where there is no competitive market
- Cost of service varies for different categories of customers

Incentive Regulation of Tariffs

Who participates in the tariff regulation process?

- GNERC, which is responsible for determining fair, transparent, and effective tariffs
- Regulated companies, which try to maximize profit
- Customers who want tariffs to be as low as possible

How do you balance these varied interests so that all parties are happy?

Incentive Regulation of Tariffs

Resolving this issue can be accomplished by incentive regulation of tariffs, which is currently being developed

by GNERC

Incentive regulation of tariffs means:

- Regulated companies will be given partial freedom in rate setting
- Marginal prices mean that profit ceiling is controlled
- Rewarding for efficiency and reprimanding for inefficiency
- Marginal prices (incentive regulation) support a reduction in operational costs and an increase in profits, which are strong economic incentives

Incentive Regulation of Tariffs

Regulating with marginal price method

- Expenses are mainly controlled by the companies
- In case of the upper marginal prices, companies are free to determine their own tariffs
- Tariffs should promote financial livelihood of regulated companies
- All registered expenses should be reimbursed
- Tariff regulation should be transparent

Regulation Using Marginal Price Method
Regulation Period

- Tariffs are determined based on regulation periods
- Duration of tariff regulation period is determined by GNERC
- Tariff regulation period can be determined for one individual company
- A basic tariff for a regulation period is determined based on the total value principle
- When calculating tariffs for regulation period, GNERC takes into account projected balances of electrical power (capacity)

Calculating Revenue Requirements

Revenue requirements (RR) include the following components**:**

- operational expenses
- depreciation
- taxes
- profit

Calculating Revenue Requirements
Operational Expenses

- **Operations and Service, including**
  - Major repairs and maintenance
  - Providing services to other organizations
  - Fuel expenses
  - Standard network losses
  - Cost of purchased energy
  - Cost of maintaining and using machinery and equipment
  - Interest on loans, etc.

Calculating Revenue Requirements

Operational Expenses

- **Administrative and general expenses (A&G), including:**
  - Wages
  - Business trip expenses
  - Rental expenses
  - Office expenses
  - Insurance expenses
  - Security expenses
  - Other administrative expenses
  - Contingency

Calculating Revenue Requirements

Depreciation

- Depreciation policy is set by a company at its discretion
- GNERC is allowed to apply different methods of depreciation
- Depreciation expenses are not added to the customers‘ financial assets
- In general, line depreciation method is used
- Based on the tariff regulation, accelerated depreciation might be used

Calculating Revenue Requirements

Taxes

- When calculating tariffs, GNERC takes into account taxes defined by the Tax Code, e.g.
- General state taxes
  - Tax on profit – 15%
  - Customs tax is regulated according to the Customs Code

Calculating Revenue Requirements
Taxes

- **Local taxes**
  - Property taxes – 1%

- Natural resources tax
- Land use tax

- Tariffs do not include the value added tax (VAT)
- VAT – 18%

Calculating Revenue Requirements

Profit

- Net profit is calculated in relations to the regulated assets
- WACC – standard profit**,** which is determined based on capital stock and investment
- Capital stock – shares funded by company’s own capital;
- Investor capital – amount of loaned capital invested in company’s main assets

Calculating Revenue Requirements
Profit

- Standard net profit on company's capital is determined by GNERC for each individual company
- Minimum margin of standard profit on company's own capital is the average interest added to long term deposits in commercial banks
- Value of investor capital is determined by interest on loans
- Comparative analysis method can be used for determining standard profit

Calculating Revenue Requirements

Base for regulated assets

- The base for regulated tariffs includes only those assets, which are in direct relationship with regulation
- The base for regulated tariffs includes only those investments that were used in regulated activities;
- Future investments can be included in the tariff base if a company can prove that it is necessary
- Financial assets of customers are not included in forming the base of regulated assets
- For regulation purposes, unused regulated assets are not included in the base of regulated assets

Adjusting Revenue Requirements in a Regulation Period

- Revenue requirements may be adjusted in the basic year of the regulation period;
- Adustment is based on the retail price index, currency index, and adjustment indicators
- Adjustment based on the retail prices index is done by GNERC for individual companies
- Currency index is used when adjusting expenses related to foreign currency
- Adjustment based on correction indicators is used to account for the difference between the actual and the projected revenues for the period determined by GNERC

Rate Setting

- GNERC determines tariffs on producing, transmitting, dispatching, distributing, importing, and using electrical power. It also determines tariffs on services of the commercial system operator (CSO), mandatory power purchases by the CSO, and system's reserves of capacity
- Rates on transmission, distribution, and using natural gas
- Rates on water use in the water supply sector
- Import tariffs are determined based on import agreements
- Dual rates tariffs are determined for reserve source

Rate Setting

- Small capacity (13 mgvt) power plants are regulated
- Small capacity power plants are allowed to sell power to qualified retail customers
- It is mandatory for ESCO to have a power PSA, if there is an agreement on constructing a new power plant between the government, the CSO, and a third party.

Incentive Regulation of Tariffs

Period for reviewing expenses

- It is expensive for companies to review (conduct internal audit of) its expenses, so in order to reduce the cost the companies are allowed to decrease the frequency of such reviews.
- Reducing cost and optimizing quality of service
- Reducing cost may undermine the quality of service
- Standards of services should be determined and monitoring should be conducted

Thank you for your attention!