

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK
MULTILATERAL INVESTMENT FUND
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URUGUAY

**SUPPORT FOR THE REGULATORY FRAMEWORK FOR
ELECTRICITY SERVICES**

(TC-00-10-03-6-UR)

DONORS MEMORANDUM

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CONTENTS

I.	PROGRAM ELIGIBILITY	1
II.	BACKGROUND	1
	A. Uruguay's strategy for the electric energy sector.....	1
	B. Institutional framework	2
	C. The Bank's country strategy.....	2
III.	OBJECTIVES AND MAIN COMPONENTS.....	3
	A. Objectives	3
	B. Main components of the program	3
IV.	PROGRAM BUDGET	5
V.	EXECUTING AGENCY AND IMPLEMENTATION ARRANGEMENTS.....	6
	A. Executing agency	6
	B. Implementation approach	6
	C. Execution period and disbursement timetable.....	6
	D. Accounting and financial audits	6
VI.	MONITORING AND EVALUATION.....	7
	A. Progress reports	7
	B. Evaluation.....	7
VII.	PROGRAM BENEFITS AND RISKS	7
	A. Benefits.....	7
	B. Risks	7
	C. Environmental aspects.....	7
VIII.	SPECIAL CONTRACTUAL CONDITIONS	8
	A. Conditions precedent to first disbursement.....	8
	B. Project readiness.....	8

ANNEXES

Annex I	Logical framework
Annex II	Proposed resolution

ABBREVIATIONS

COF	The Bank's Country Office
IC	interruption cost
MERCOSUR	Southern Common Market
MIF	Multilateral Investment Fund
OPP	Planning and Budget Office
UREE	Unidad Reguladora de Energía Eléctrica [Electric Energy Regulatory Agency]
UTE	Administración Nacional de Usinas y Transmisiones Eléctricas [national power authority]

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EXECUTIVE SUMMARY

Executing agency: Unidad Reguladora de Energía Eléctrica (UREE) (Electric Energy Regulatory Agency) and Departamento de Política Económica y Regulación, Oficina de Planeamiento y Presupuesto (Department of Economic Policy and Regulation, in the Planning and Budget Office)

Beneficiary: Eastern Republic of Uruguay

Amount and source:	MIF: Facility I	US\$371,000
	Local:	US\$159,000
	Total:	US\$530,000

Terms:	Execution period:	24 months
	Disbursement period:	28 months

Objectives: The program's general objective is to help consolidate the reform process in the electric energy sector and generate service efficiency gains, which will make the economy more competitive and improve consumer welfare.

The specific objectives are to: (a) strengthen the transparency, predictability and efficiency of regulatory activities by implementing a set of internal procedures within the UREE to systematize its work based on a quality management system; and (b) complete the implementation of the electricity regulatory framework by calculating the power supply interruption cost.

Description: The program will contribute to the financing of two main components: (i) implementation of UREE internal procedures and (ii) determination of the system interruption cost. As part of the first component the required procedures will be developed so that the UREE can perform its mandate in accordance with the current regulatory framework (response to customer complaints; quality control in distribution and transmission services; setting and adjusting transmission and distribution rates; open tendering of power purchase contracts for distributors, and procedures to protect competition and the environment). Organizational changes will be put in place that are concordant with the internal procedures devised, the information systems infrastructure will be adapted to be able to implement them, and personnel will be trained in the new procedures.

As part of the second component, financing will be provided for the tasks required to calculate the system interruption cost: calculation methodology, survey design, drafting of forms to be

filled out by consumers, physical completion of surveys, statistical analysis of data, and calculation of the value of the interruption cost assigned by type of consumer for unsupplied energy.

Social and environmental review:

The document was reviewed by the Committee on Environment and Social Impact at its meeting of 6 April 2001. As part of the “Implementation of Internal UREE Procedures” component, financing will be provided to devise mechanisms for coordination with environmental authorities and environmental protection procedures.

Benefits:

A significant stimulus will be given to the process of introducing competition into the Uruguayan electric energy system by implementing measures to bolster and invigorate the regulatory agency with financing from MIF resources. As a result, the system will become more reliable and achieve greater efficiency and quality. It will also become more attractive to private investors. All of this will contribute to consumer welfare, overall economic competitiveness, modernization of the State, and the process of integration into MERCOSUR.

Risks:

There is some measure of institutional uncertainty associated with the possibility of a decision to create a multi-industry regulatory agency (electricity, gas, water and sanitation) of which the UREE would be a part. Even in this scenario, the proposed technical cooperation measures would remain relevant. The benefits of improved operation of the regulatory agency and an accurate calculation of interruption costs will make for a more efficient power supply.

Special contractual conditions:

The executing agency must designate the program’s coordinator prior to the first disbursement (paragraph 5.2).

I. PROGRAM ELIGIBILITY

- 1.1 On 6 October 1993 the Donors Committee declared Uruguay eligible for all forms of MIF funding. The proposed program is considered eligible for MIF financing from the Technical Cooperation Facility, under the Line of Activity for Consolidation of Sector Reforms and Regulatory and Institutional Frameworks in the Infrastructure Sectors. The program described here confirms the usefulness of that line of activity as a catalyst, the anticipated benefits being to: (i) consolidate institutional and regulatory reforms; (ii) achieve improvements in efficiency, competitiveness and societal welfare; and (iii) foster a regulatory framework that will be attractive to private investors.

II. BACKGROUND

A. Uruguay's strategy for the electric energy sector

- 2.1 Electricity services in Uruguay have traditionally been supplied by UTE, a vertically integrated public enterprise that owns and operates generating facilities and the transmission system and is as the sole distributor of electric energy for the entire country. Since the 1997 enactment of Law 16,832, the electric power sector has been undergoing significant reforms. The new legal framework opens the industry up to private capital and calls for a competitive wholesale market for power generation, in which generators, distributors and major consumers can all participate. It also gives third parties fee-based access to transmission and distribution networks to the extent of their capacity.
- 2.2 Within this newly devised framework, the Executive Branch is responsible for formulating electric energy policy. The Unidad Reguladora de la Energía Eléctrica [Electric Energy Regulatory Agency] (UREE) is responsible for, among other functions, monitoring compliance with the law, issuing regulations and providing advisory support to the Executive Branch. The Administración del Mercado Eléctrico (Electricity Market Administration) is in charge of operating the National Load Dispatch system. Generation no longer falls within the public utility domain and has been opened up; power exports and imports require Executive Branch authorization. A company engaged in more than one power-sector activity must have segregated accounting systems and UTE (the national power authority) must unbundle its power generation, transmission and distribution operating results.
- 2.3 The Wholesale Electricity Market is being organized in this context. UTE generation business units will operate as agents, selling their output to the UTE Distribution Business Unit following clear buy/sell regulations set out in the Wholesale Market Regulations, using the services of UTE's Transmission Business Unit, which must abide by the Transmission Regulations. The UTE Distribution Business Unit will be authorized to charge captive customers rates that include the transfer of generation and transmission costs, to which a Distribution VAT will be added, pursuant to the specific regulation.

B. Institutional framework

- 2.4 The UREE began operations during the second half of 2000 as part of the Planning and Budget Office (OPP). This marked the establishment of a regulator with a mandate to spur competition in areas of the industry where this would be feasible, and to regulate transmission and distribution monopolies. Its aim is to safeguard the rights of electricity consumers in terms of quality, price and reliability of service.
- 2.5 In addition, the UREE monitors compliance with the sector's laws and regulations. It also has certain specific functions: advising the Executive Branch on the administration and enforcement of regulations governing approvals of concessions, licenses, and authorizations needed to enter the electricity sector, as well as rate approvals for public electricity service providers and for the end-consumer. Its responsibilities also include the drafting of quality and safety regulations, technical standards, and establishment of an Arbitration Tribunal.
- 2.6 During the agency's two years of existence, its initial activities have had to do with adopting measures needed for its launch along with the most pressing tasks to bolster the sector's regulatory framework. On this front the UREE coordinated the drafting of regulations for the wholesale market and for electricity transmission and distribution, which also specify requirements for each industry segment, outlining the rights and obligations of each actor.¹ This work was done jointly with the National Energy Directorate with participation of UTE and the Comisión Mixta Salto Grande (Salto Grande Mixed Committee). At the same time, the UREE continued to strengthen its own policy of transparency in its procedures and communication of its decisions to consumers, government bodies and agents.
- 2.7 The current state of reform in the electric energy sector has reached levels of sophistication that require the regulatory agency to continually improve coherence, professionalism and predictability. The measures envisaged in the proposed program are directed to these ends.

C. The Bank's country strategy

- 2.8 In 1996 the Bank approved nonreimbursable technical-cooperation funding for an energy sector reform program (ATN/MT-5276-UR) totaling US\$940,000, with MIF support in the amount of US\$630,000. Of the total amount, US\$305,000 was directed to the electricity sector (subprogram II) to help develop a new organization and institutional mechanisms for the sector (phase 1), and establish a regulatory and compliance monitoring agency for the electric energy industry. The balance was for activities in the fuel and natural gas industry (subprogram I). Subprogram I and the first phase of subprogram II were completed satisfactorily. However, parliamentary decisions and a change in authorities stalled the creation of the industry regulator—hence the decision to redirect the component's funds to

¹ Preliminary drafts of the regulations were submitted to the Executive Branch for review in March 2002. The regulations are scheduled to go into effect late in the first half of 2002. The complete regulations in their current draft can be viewed at: <http://www.uree.gub.uy/documentos/otros.htm>.

the natural gas sector. Despite these setbacks, the reform process remained on track, and the UREE began operating in the second half of 2000.

- 2.9 The proposed program will enable the country to complete the power sector's regulatory framework and will strengthen the newly created agency, thereby reinforcing the process begun with the aforementioned technical assistance. In this way, the program will promote efficiency in the electricity sector and the country's ability to compete, thus helping to achieve the Bank's first strategy objective in Uruguay: competitiveness and regional integration. The program will also pursue the Bank's second strategy for its activities in Uruguay—modernization of the State, by helping to distance and reorient the State's role in the economy through the creation of independent regulators.

III. OBJECTIVES AND MAIN COMPONENTS

A. Objectives

- 3.1 The program's general objective is to help consolidate the reform process in the electricity sector and improve the efficiency of the power supply, which will result in enhanced competitiveness for the economy and consumer welfare. The specific objectives are to: (a) consolidate the transparency, predictability and efficiency of regulatory activities by instituting a set of internal procedures within the UREE to systematize its work based on a quality management system; and (b) complete the implementation of the regulatory framework by calculating the power supply interruption cost.

B. Main components of the program

- 3.2 The program will help fund two core components: (i) implementation of UREE internal procedures and (ii) determination of the system interruption cost.

Implementation of UREE internal procedures (MIF: US\$253,000; UREE: US\$74,000)

- 3.3 A sound legal and institutional framework is crucial both for the operation of the electric power sector and to gain the confidence of power customers and other stakeholders, notably investors. Because UREE activities play a preeminent role within this framework, the transparency and predictability of those activities take on special importance. The agency's internal workings must therefore be systematic and adhere to known, auditable procedures, which will enable both regulated entities and regulators to act on a foundation of common knowledge. The ISO 9000 Standard, which is now entrenched as a methodological support, will adequately cover expectations as to the UREE's internal operations. The entire process of specification and development of these procedures, as well as the underlying organization, will be undertaken in accordance with that standard and its applicable chapters.

- 3.4 The internal procedures to be developed as one objective of this component must be consistent with provisions of the current legal and regulatory system for the electric power sector, specifically as regards UREE's functions. The proposed technical assistance will also help institute the necessary organizational changes for the agency's operation, in keeping with the internal procedures developed, technical specifications of the information technology required for their implementation and the training program required for all its personnel.
- 3.5 The proposed component will assist in the development of the following procedures, which will enable the UREE to operate as intended: response to customer complaints; quality control in distribution service; quality control in transmission service; setting and adjusting transmission and distribution rates; open tendering of power purchase contracts for distributors, and advisory assistance in drafting regulations and standards generally. The component also includes financing to design and develop procedures to protect competition and the environment.
- 3.6 The UREE has created a Web site to describe all its activities and give the public a variety of information on the industry. As part of the component, the required changes will be made in the agency's public information system, to match the new procedures or by revising existing ones.

Calculation of power supply interruption cost (MIF: US\$98,000; UREE: US\$57,000)

- 3.7 The aim of this component is to develop a methodology for determining the interruption cost (IC) in the Uruguayan electric energy system, and to produce studies required for the calculation. As part of the component, financing will be provided to design a calculation methodology, develop forms to be filled out by consumers, conduct the required surveys, perform statistical analysis of data, and calculate the value of the IC assigned by type of consumer for unsupplied energy.
- 3.8 The premise being that unsupplied energy is the amount of energy sought at a certain price that cannot be supplied given the available capacity, the value or cost of this unsupplied energy will be referred to as IC. This is the total monetary value per kWh that users assign to a service interruption, or the perception that service is likely to be interrupted. The IC can be defined as the market price for electric power service quality. Its value has a considerable impact on users' behavior and on the costs of investments in expansion and reserves, all of which affect rates and service quality.
- 3.9 This factor is relevant to all aspects in which service quality falling below the acceptable minimum for users has economic consequences for the industry. Thus, when substandard service is imputable to the distributor, fines are levied, calculated based on the IC. Likewise, when approval is given to transmission-capacity expansion projects that will affect customer rates, the avoided cost of losses is compared with the IC. In operations programming, short- and long-range reserves (reservoir levels) are set at levels such that the higher imputable costs do not exceed the IC.

- 3.10 An important consideration here is that the real prospective demand for active participation in the market is very limited, diminishing when prices rise because of the limited supply. This value thus has to be calculated indirectly, by means of surveys and studies from which values can be inferred from data elicited in representative samplings of different stakeholders' perceptions.

IV. PROGRAM BUDGET

- 4.1 The total cost of the program is US\$530,000, with US\$371,000 from MIF Facility I resources and US\$159,000 as the local counterpart, half of it in cash. The MIF financing would cover the bulk of the consulting and training expenses and a portion of equipment outlays. The local counterpart would cover all the expenses of conducting local surveys, most of the implementation costs, and part of the training and computer hardware expenses, as broken down in the following table.

PROGRAM BUDGET (US\$530,000)			
COMPONENT	MIF	LOCAL CONTRIB- UTION	TOTAL
1) Implementation of UREE internal procedures	253,000	74,000	327,000
Development of internal procedures based on quality standards	112,500	30,500	143,000
Development of a computer system to manage the new internal procedures	29,000	3,000	32,000
Hardware needed to implement the computer system	25,000	10,000	35,000
Updating UREE internal organization in line with the new procedures	38,000	9,000	47,000
Dissemination strategy for UREE activities	24,500	7,500	32,000
Training	24,000	14,000	38,000
2) Determination of interruption cost	98,000	57,000	155,000
Survey design and analysis of data collected	98,000	24,000	122,000
Field work (surveys)		33,000	33,000
3) Program execution	20,000	28,000	48,000
Coordination		21,000	21,000
Administrative support		7,000	7,000
Contingencies	7,000		7,000
Auditing	5,000		5,000
Evaluation	8,000		8,000
Total	371,000	159,000	530,000

V. EXECUTING AGENCY AND IMPLEMENTATION ARRANGEMENTS

A. Executing agency

- 5.1 The Planning and Budget Office (OPP) will be responsible for executing the program, through the Department of Economic Policy and Regulation and the Unidad Reguladora de Energía Eléctrica (Electric Energy Regulatory Agency).

B. Implementation approach

- 5.2 The OPP, through the Department of Economic Policy and Regulation, will be in charge of: (i) supervising and tracking achievement of the program's objectives and targets; (ii) reviewing and approving the program's annual work plan and budget, including availability of the local counterpart; (iii) allocating funds to ensure the continuity of the program; and (iv) administrative tasks for the program (scheduling and executing the necessary tendering processes, making arrangements and processing with the IDB, with the consultants hired, other institutions, etc.). To ensure that the program is properly executed the OPP will appoint a program coordinator (condition precedent to first disbursement).
- 5.3 The UREE will be in charge of: (i) proposing the program's annual work plan; (ii) drafting the respective bidding conditions (with regard to technical elements of the tender); (iii) drafting of terms of reference; (iv) selecting consultants; (v) technical supervision of work in process; and (vi) approval of reports drafted by consultants and/or consulting firms.

C. Execution period and disbursement timetable

- 5.4 The execution period will be 24 months and the disbursement period 28 months.

D. Accounting and financial audits

- 5.5 The OPP will set up and be in charge of maintaining complete and accurate financial accounts, internal controls and records systems, so as to identify sources and uses of program funds. The accounting system will be organized in such a way as to provide the necessary documents, facilitate verification of transactions and allow for timely preparation of financial statements and reports. Records related to the program will be filed so that: (i) monies received from various sources can be identified; (ii) program expenses can be reported in accordance with a chart of accounts approved in advance by the Bank; and (iii) records are sufficiently detailed to identify goods acquired and services contracted as well as the use of said goods and services. The OPP will also open separate, specific bank accounts to administer the MIF contribution and the local counterpart. Lastly, the OPP will process disbursement requests and the respective justification for expenses, according to the Bank's disbursement rules.
- 5.6 The program's financial statements will be audited by an independent auditing firm acceptable to the Bank. The firm's services will be paid using the MIF funding.

VI. MONITORING AND EVALUATION

A. Progress reports

- 6.1 The OPP will prepare and submit to the Bank's Country Office (COF) progress reports on the program within 30 days after the end of each six-month period and a final report prior to the final disbursement of MIF funds. These reports, using a format previously agreed to with the COF, will describe program activities and finances as well as outputs and outcomes measured by reference to performance indicators in the program's logical framework. The COF will use these semiannual reports to monitor the program's progress.

B. Evaluation

- 6.2 The Bank will hire individual consultants to perform two program evaluations. A midterm review will be conducted when 50% of the funds have been disbursed, and a final evaluation once the program has been concluded.
- 6.3 During execution of the program, the Planning and Budget Office will compile monitoring and evaluation indicators of the program. These indicators are set forth in the logical framework (see Annex I).

VII. PROGRAM BENEFITS AND RISKS

A. Benefits

- 7.1 A significant stimulus will be given to the process of introducing competition into the Uruguayan electric energy system by implementing measures to reinforce and invigorate the regulatory agency, with support from the proposed MIF financing. As a result, the system will become more reliable and more efficient and its quality will improve. It will also become more attractive to private investors. All of this will contribute to consumer welfare, overall economic competitiveness, modernization of the State, and the process of integration into MERCOSUR.

B. Risks

- 7.2 There is some measure of institutional uncertainty associated with the possibility of a decision to create a multi-industry regulatory agency (electricity, gas, water and sanitation) of which the UREE would be a part. Even in this scenario, the proposed technical cooperation measures would remain relevant. The benefits of improved operation of the regulatory agency and an accurate calculation of interruption costs will make for more efficient delivery of electricity services.

C. Environmental aspects

- 7.3 The document was reviewed by the Committee on Environment and Social Impact at its meeting of 6 April 2001. As part of the "Implementation of Internal UREE Procedures" component, financing will be provided to devise mechanisms for

coordination with environmental authorities and environmental protection procedures.

VIII. SPECIAL CONTRACTUAL CONDITIONS

A. Conditions precedent to first disbursement

- 8.1 The executing agency must designate the program's coordinator as a condition for the first disbursement.

B. Project readiness

- 8.2 During the most recent mission, the team received a commitment from the government authorities to contribute counterpart funds for the program. Preliminary terms of reference have been drawn up to hire consultants for all of the program's components.