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# THE NEXUS BETWEEN ENERGY SECTOR REFORM AND DEMOCRACY & GOVERNANCE

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# Executive Summary

This paper examines democracy and governance aspects of energy sector reform, especially power sector reform. It examines the difficult history of energy sector reform programs and some reasons why many of those programs have not proved to be sustainable. Chief among these reasons is a focus on the technical requirements for an efficient sector, with little or no attention to the social and political aspects of the sector. The job of making the sector run more efficiently has often been only partially realized and sometimes not realized at all.

The paper argues that paying attention to the political and social aspects of the sector means paying attention to the lessons learned as countries throughout the world have moved toward democracy. The paper examines five key diagnostic elements of determining the level of democratic governance in a country and applies those same lessons to the energy sector. The five diagnostic elements are (i) level of inclusion; (ii) extent of good governance; (iii) measure of consensus; (iv) degree of rule of law; and (v) extent of competition.

The paper argues that the convergence of energy sector reforms and democracy and governance principles is frequently found in the establishment and operation of an independent regulatory body to serve as both overseer of the reforms and protector of all stakeholders (government, utilities, investors and consumers). It discusses the need to design energy sector restructuring that explicitly includes public involvement and it posits some indicators of effective public involvement. These measures include (i) the availability of information to the public; (ii) the effectiveness of the means by which the public can participate; and (iii) the extent to which the regulatory body seeks interaction with the public.

The paper lays out some best practices for designing successful energy sector reform programs. These best practices include the absolute necessity of involving stakeholders early and often in the reform process; the need to protect societal values in the reform process; and the need to factor in, from the beginning, mitigation measures against harmful social impacts of restructuring. While the paper focuses mainly on power sector reform, the lessons learned are also applicable to the other energy sectors such as the oil and gas sectors.

Finally, the paper also lays out several best practices regarding the establishment and operation of an independent regulatory body:

- There is no substitute for well-qualified and well-respected regulators. They must be technically competent and have a demonstrated ability to deal constructively and honestly with the public.
- Whenever possible, unpopular actions should come at the same time as (or after) clear benefits.
- A new regulatory body cannot be expected to succeed if all its early decisions are unpopular with the public.
- A well-targeted subsidy program for the poor is essential.
- Privatization should always include public involvement in the regulatory review process.
- Corruption will kill reform efforts.
- A regulatory agency needs effective avenues for public involvement from the beginning.





# I. Introduction

“There are two dangers here: First that ‘democracy and governance’ will be seen by people working on technical sector reforms as a separate ‘technical’ sector believing it to be concerned only with broader issues such as electoral, legislative and/or judicial reform. Second, democracy and governance specialists risk concentrating solely on the broad macro-issues and losing opportunities to have more direct impact on the quality of citizen experience with democratic governance available through sector reforms. As a consequence of these twin hazards, sectoral reforms run the risk of not taking full advantage of democratic governance insight and vice versa.”<sup>1</sup>

The history of energy sector reform<sup>2</sup> is replete with well-intentioned programs undone by popular resistance expressed through democratic or non-democratic processes, some themselves of recent origin and some decades old. In some cases, the reforms were necessary to build a well-functioning energy sector, and the sector has continued to languish in their absence. In others, they were either unwise or poorly timed. Necessary financial and technical measures are often much easier to discern and recommend than are the means of accomplishing them in an enduring way. Too much attention gets paid to devising a theoretical reform framework—work done by economists, engineers, accountants and lawyers—and too little gets paid to implementation, which is more likely to be a job for those with political, community action or labor union experience.

Because many of the countries undertaking energy sector reform are also democracies or evolving toward democracy, the interplay between energy sector reform and democratic governance<sup>3</sup> is as important as it is complex. The need for energy sector reform to be acceptable to the public and for the public to be involved in shaping the reforms emerges as an inescapable lesson from failures in recent years. Less obvious but also very important are the ways that viable energy sector reforms can strengthen democracy, not only by enhancing prosperity and therefore stability, but also by providing an example to other economic sectors of the importance of the fundamental underpinnings of liberal democracy, including the rule of law and effective public involvement.

Little is to be gained from asserting that energy sector reform should precede democratic governance reforms (because public opposition will undermine reform) or that democratization should precede sector reform (because the public must have an effective voice in designing economic reforms). Democratic governance reforms<sup>4</sup> have been implemented worldwide at

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<sup>1</sup> Derick W. Brinkerhoff, “Democratic Governance and Sectoral Policy Reform: Linkages, Complementarities, and Synergies,” Monograph No. 5, Implementing Policy Change Project (Washington, DC: U.S. Agency for International Development 1998), p.5

<sup>2</sup> Energy sector reform is activity to improve the financial, technical, social, and environmental performance of the sector in providing clean, affordable and reliable energy services to as many people as possible.

<sup>3</sup> We use as our working definition and way of thinking about **democratic governance**: “The ability to coordinate the multiplicity of diverging interests, freely expressed by an informed public, into policies generally accepted as representing the public interest.” **Annex A gives more detail on the definitions of ‘Energy Sector Reform’, ‘Democratic Governance’, and ‘Civil Society’.**

<sup>4</sup> For our purposes, democratic governance reforms are not limited to reforms bearing directly on the people’s right to choose their leaders and to vote on their policies. We are concerned also with the ability of a free and an informed public to coordinate their multiple interests into policies accepted as a legitimate expression of the public interest. This concern extends to assuring an effective public voice in institutions of liberal democracy that act as checks on pure democracy, institutions such as an effective judiciary and constitutional protection for property rights, enforceability of contracts and individual rights.

least as fast and arguably more successfully than energy sector reforms over the last 20 years<sup>5</sup>. Both sets of reforms will often have to go forward at the same time. Democracy enhances development<sup>6</sup>. Development enhances democracy<sup>7</sup>. The task of reformers is to harmonize these undertakings so that a healthy energy sector supports both<sup>8</sup>.

Many countries are trying to resolve the conflict between the unwillingness of the public to tolerate economic pain—especially pain whose justification may be dubious and whose promised benefits will arrive years in the future—and the need for various energy sector changes that disrupt settled relationships regarding rates, investment returns, social welfare and employment. Unless ways are found to harmonize the unpopular but necessary aspects of energy sector reform with the will of electorates, too much reform will dissipate resources and goodwill in a series of governance train wrecks, each one of which will provide anecdotal fodder for the next. At the end of the day, energy policy needs to serve the needs of the public, not the other way around. And it needs to be arrived at and implemented in ways that make clear that it is doing just that.

Seen from within the energy sector, these disconnects have similar characteristics revolving around some or all of the following assumptions (some of which are accurate in some circumstances, and some of which, of course, are not):

- The customers do not want to pay the full costs of building and operating an adequate system because
  - It goes against historical political arrangements so embedded they are thought of as “cultural”.
  - They do not understand the realities of the utility business;
  - Their leaders, dependent on public support, do not dare to enlighten or to disappoint them;
  - Current economic conditions are so bad that people have no prospect of earning the money to pay higher bills;
  - Service is unreliable and not worth even the prices now being charged;
  - Highly visible corruption leads ordinary people to believe that increased tariffs will result not in improved service but in unjust enrichment of predatory criminals;
  - Higher tariffs will only benefit foreign investors.

In a random sample of Indian electricity consumers, about 30 percent reported paying bribes to employees of power enterprises. Usually, the bribes were paid to linesmen, meter readers and billing employees. This is probably an underestimate for two reasons. First, the survey was limited to individuals and therefore does not capture bribes paid by corporations. Second, it probably fails to capture consumer-initiated corruption.  
*Source: Transparency International (2002)*

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<sup>5</sup> “Since 1980 according to the 2002 United Nations Human Development Report, 81 countries have taken ‘significant’ steps toward democracy, with 33 military governments replaced by civilian governments. Of the world’s nearly 200 countries, 140 now hold multiparty elections. That may not make them fully democratic, but 82 of them are, and those have 57% of the world’s population.” (The Economist, June, 2003, p. 5).

<sup>6</sup> Joseph T. Siegle, Michael M. Weinstein, Morton H. Halperin, “Why Democracies Excel,” in Foreign Affairs (September-October 2004), pp. 57-71

<sup>7</sup> Fareed Zakaria, “The Future of Freedom,” (New York, W.W. Norton, from “Conducting a DG Assessment: A Framework for Strategy Development” (U.S. AID, Center for Democracy and Governance, November 2000), 2003)

<sup>8</sup> That said, the task remains complex: “. . . democratic consolidation and economic reform interact in complex ways, some positive and some negative. Reformers dedicated to both goals cannot simply assume that they are compatible. Rather, they must actively seek to reduce areas of conflict and expand areas of complementarity.” Joan Nelson, “The Linkages Between Politics and Economics,” (In Diamond and Plattner (1996) op.cit., 1996).

- Low-income citizens will oppose reforms for the foregoing reasons and because
  - They cannot afford tariffs that cover the cost of serving them and will therefore be disconnected or, at least have to cut back on their consumption;
  - The country has made provision of subsidized electricity and gas part of its welfare system and something to which all of its citizens are entitled;
  - Extension of energy services to unserved areas is less likely without substantial subsidies.
- Energy sector workers will oppose reforms because
  - Pressure to reduce costs will inevitably result in lower wages and fewer jobs, especially when the sector is overstaffed;
  - Jobs in the energy sector – even unnecessary jobs - are part of the social service system, so loss of these jobs will consign many more families to poverty;
  - Reduced subsidies may reduce the ability of the sector to increase (or maintain) wage levels.
- Private investors will not put money into the existing system because
  - The public will not accept tariffs adequate to provide a fair return (or even to assure recovery of) the original investment;
  - Corruption at every level from the meter reader to the operation of the wholesale market siphons off so much money that earning a reasonable rate of return is impossible;
  - The government retains so large a stake in much of the system that newcomers cannot hope to be treated fairly because, for example, access to the electric transmission system will be manipulated to favor the government-owned power plants, or the power plants owned by close friends of the government;
  - The country lacks the legal and judicial structure necessary to assure that contracts will be honored, that property rights will be respected, that decisions will be made in a fair and transparent manner;
  - The country lacks a regulatory process made up of honest and competent individuals with adequate powers, resources, training and distance from the political process to do their jobs in a capable and predictable manner;
  - The country lacks traditions of corporate governance sufficient to support either energy sector reform or broader reforms necessary to provide a stable investment climate;
  - Market rules and the process for establishing them do not inspire confidence.
- Existing government agencies oppose energy sector reform because
  - The creation of an “independent” regulatory institution and reliance on private ownership threaten the prestige (and perhaps the existence) of the existing bureaucracies;
  - The public discontent occasioned by the reforms will threaten the government’s hold on power;
  - Government will lose its ability to reflect national security and social policy in energy sector decision making;
  - Opportunities for corruption (or at least for the enhancement of inadequate salaries) flowing from the existing system of licensing, inspections and approvals will diminish;

- Ability to keep contracts, fund flows and “market” workings secret will diminish;
- Control of one or more major economic sectors will wind up in foreign hands.
- Environmentalists oppose (or do not support) reforms because
  - Provision for attention to cost effective energy efficiency has not been made;
  - Environmental impacts of various energy sources will not be evaluated or mitigated;
  - Potential contribution of renewable energy has not been taken into account;
  - Provision for consideration of environmental impacts of future energy supply investments and policies – with input from the public - has not been made;
  - Power plant siting proceedings will be no more transparent or accessible than before.

Many of these propositions are less intractable than they have seemed. The desire for improved service can mitigate the pressure to reduce energy sector employment. Customers are often willing to pay the cost of utility service as long as they see the improved service before they receive the higher bills. Energy efficiency programs – including those that reduce waste and losses before the energy reaches the customer – can often help generate the savings necessary to reduce the price impacts of reform programs, thus reducing political pressure against reforms. In some countries the savings achievable through loss reduction are enough to fund a substantial subsidy program for truly needy customers.

But these synergies and complementarities do not come to light when energy sector reform is presented only as a technocratic matter of policy arrived at by governmental leaders and outside consultants. This was not the pattern followed in the developed countries, especially the United States, where many of the central tenets of energy sector reform were first put into practice as a result of extensive democratic pressure. History suggests that energy sector reform divorced from democratic governance will not succeed in a non-authoritarian country.

Instead, energy sector reform needs be designed to draw upon lessons from democratic governance, particularly lessons in effective public interaction, in the creation of checks and balances against abuse of authority, in transparency and in accountability. In return, successful energy sector reform offers broad support to democracy, both through the stability that comes with robust economic growth and through “creating opportunities for participation, accountability and transparency that advance the larger transformation process toward more democratic governance.”<sup>9</sup> Without attention to the principles of democratic governance, sector reform can all too easily take on the trappings of public involvement without its substance, a process familiar in parts of the former Soviet Union but also from time to time in the developed countries<sup>10</sup>.

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<sup>9</sup> Brinkerhoff, 1998, p. 13

<sup>10</sup> Decades ago, a British Chief Justice warned of the potential for unelected “expert” ministers to convey unaccountable power on themselves. His formula for bureaucratic lack of accountability is striking today in that it contains so many of the pillars of energy sector reform and thereby warns against elevating the concepts of expertise and independence above concepts of public involvement and accountability:

Let him, under Parliamentary forms, clothe himself with despotic power and then, because the forms are parliamentary, defy the Law Courts.

This course will prove tolerably simple if he can (a) get legislation passed in skeleton form; (b) fill up the gaps with his own rules, orders and regulations; (c) make it difficult or impossible for Parliament to check said rules, orders and regulations; (d) secure for them the force of statute; (e) make his own decisions final; (f) arrange that the fact of his decision shall be conclusive proof of its legality; (g) take power to define the provisions of statutes; and (h) prevent and avoid any sort of appeal to a Court of Law. Senator Dan Lang, Senate debates, March 16, 1977, page 509.

In viable energy sectors, tariffs cover costs. Where subsidies are needed for social purposes – extending service to customers without access to energy or assuring that poor people have access to sufficient energy services regardless of ability to pay – they are fully furnished by the government rather than being hidden in the rates of other customers. Payments flow consistently with contractual or regulatory requirements from customers to the suppliers of goods, labor and capital. Remaining points of monopoly ownership are regulated fairly or capably. If publicly owned, they are operated by honest civil servants. Where competition is introduced, the sector functions under a system of vigorous safeguards against anticompetitive practices. Environmental impacts are factored into major investment decisions before those decisions are made, and effective public involvement is incorporated into major decisions.

Dysfunctional energy sectors lack combinations of these attributes. These shortcomings have created beneficiaries who do not want to give them up. Zajac<sup>11</sup> lists a range of “injustice propositions” that may confront energy sector reform. These include Proposition 3: “The beneficial retention of a status quo is considered a right whose removal is considered unjust.” Proposition 4: “Society is expected to insure individuals against economic loss because of economic changes,” but also Proposition 5, “The existence of numerous and significant economic inefficiencies is considered unjust, especially if their existence is seen as conferring benefits on special interest groups who oppose their removal.”<sup>12</sup> As noted above, these special interests may include the beneficiaries of subsidies, but also business and public sector stakeholders that benefit from operational inefficiencies or lack of transparency.

Major governance issues in the energy sector will need to be dealt with if reform is to be seen as legitimate and if the institutions implementing reform are to be credible. Civil society organizations are increasingly able to articulate demands for transparent and accountable energy institutions, and to seek out legal and civic channels for submitting these claims. These efforts have been inextricably linked to a more general outcry against corrupt state institutions and to a broader push for democratic processes to be implemented in practice as well as in law.

While success in energy sector reform is never assured, the chances of success are much greater when the reforms are perceived by the public to be legitimately arrived at and implemented with an ongoing concern for fairness and justice<sup>13</sup>. For such a consensus to exist in a democracy, certain preconditions must exist. These preconditions pertain to the public’s ability to influence the adoption of laws and the appointment of officials and also to its ability to influence the tariffs, the investments and the environmental impacts of day-to-day decision making in the reformed energy sector. As one reviews the history of energy sector reform, one finds many instances in which the public has been unconvinced – rightly or wrongly - that

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<sup>11</sup> Edward Zajac, “Perceived Economic Injustice: The Example of Public Utility Regulation” in *Cost Allocation: Methods, Principles, Allocation*, H. Peyton Young, ed. (Elsevier Science Publishers, 1985), p. 129

<sup>12</sup> *Ibid*

<sup>13</sup> For example, “The people we (public officials) serve are citizens as well as consumers, and they are entitled to public utility services that address their needs and concerns as citizens, not just their pocketbook concerns as ratepayers. As citizens, we share common concerns about the health of the environment, the well-being of our neighbors, the security of the nation, and the needs of future generations.” Richard Cowart, *Restructuring and the Public Good*, The Electricity Journal, April 1997, p. 53. See also Daniel Yergin and Joseph Stanislaw, *The Commanding Heights, The Battle between Government and the Marketplace that is Remaking the World*, Simon and Schuster, New York, 1998, “The economic tests are eminently measurable....The second set of tests cannot be expressed in figures, but it is no less powerful. It goes to the basic values by which people judge the world, the system in which they live, and their own lot....How widely shared is the success? Is the system fair and just? Or does it disproportionately benefit the rich and the avaricious at the expense of the hardworking of more modest circumstances? Does it treat people decently, and does it include the disenfranchised and the disadvantaged? Are there equity, fair play and opportunity?”, p. 383.

legitimacy, fairness and justice were core values of the reform process. Subsequently one also finds numerous examples where reform efforts have failed.

This paper will explore the necessity of a forum in which to express these views, and the mechanisms available for gaining credibility for the decision-making process that evaluates and weighs them, as well as the potential means to hold governments accountable for their actions. It will briefly discuss the history of energy sector reform, the interplay between the energy sector and the democracy and governance sector, and the convergence of the two. It will explore independent regulation as a functional outcome of the convergence of energy and democracy/governance. Finally, it will extract several best practices for development practitioners and governments to keep in mind when designing energy sector reforms.

## II. The History of Power Sector Reform

Throughout most of the 20<sup>th</sup> century, supplying electricity and natural gas was considered to be a natural monopoly, i.e. an industry in which permitting more than one supplier would raise rather than lower costs and would inhibit raising the very large amounts of necessary capital. A few countries, notably the U.S., preferred to allow most of the suppliers to be privately owned and government regulated. Most of the rest of the world ultimately settled on outright government ownership, particularly in the electric sector.

In the late 1940s, the supply of electricity in most developing countries was limited to larger cities and towns, sometimes just to the capital city. Power was supplied either by a government agency or under concession to a private company, commonly a subsidiary of a company in North America or Europe<sup>14</sup>. These governments believed that public ownership best promoted national security and social equity objectives. Under public ownership access to power – where it was available – was often heavily subsidized.

Reform efforts sought to improve rather than eliminate the public monopolies. Sector assistance programs by the World Bank and other multilateral finance organizations focused on building managerial capacity in electric sector institutions, improving capability to plan, and financing system upgrade and extension with repayment guaranteed by the government. This approach was meant to build power plants, expand the reach of the system, and improve management.

These government-owned energy systems performed adequately during the 1960s, but declined in the 1970s and 1980s under the pressure of higher oil prices, declining ability to subsidize, diminished maintenance and a shortage of managerial skills. Countries were unable to finance the massive financial needs of energy sectors that were simultaneously expanding and deteriorating<sup>15</sup>.

The resulting deterioration produced energy systems that fell short of acceptable standards by any number of measures. As demand increased, much of the population lacked access to electricity, or at least to reliable electricity. Efficiency—measured by power plant performance, by customers or output per employee, or by losses in the transmission and distribution systems—did not approach the norms established in well-run systems. Power supply planning paid little or no attention to energy efficiency or to environmental protection. Private capital was unavailable. The public had little or no voice in the governance of the sector.

The Soviet Union provided its own special variant of this history. The Soviet system extended electricity to virtually all of its citizens—and natural gas to many—at little or no cost and with disconnection for nonpayment being unusual. Many very large government-owned customers did not pay their bills. The difference between revenue and cost was made up largely out of the national treasury, specifically the revenue from Soviet oil sales. With the collapse of the Soviet Union, the subsidy source was lost to many of the newly-independent republics and the system

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<sup>14</sup> Hugh Collier, "Developing Electric Power: Thirty Years of World Bank Experience" (Baltimore, MD: Johns Hopkins Press Collier, 1984)

<sup>15</sup> James Bond, "Why Reform. Energy Mining and Telecommunications," (Washington, DC: World Bank). Available at: [http://wbln0018.worldbank.org/infrastructure/infrastructure.nsf/e1d662bfff684d33e852568e80064f31a/b20678647733b65e8525694d00623248/\\$FILE/Mexico\\_seminar.ppt](http://wbln0018.worldbank.org/infrastructure/infrastructure.nsf/e1d662bfff684d33e852568e80064f31a/b20678647733b65e8525694d00623248/$FILE/Mexico_seminar.ppt)

degradation that took place over decades in the rest of the world was accomplished in the early 1990s in many of these new countries.

In the early 1980s—beginning with restructuring in Chile—power sector reform expanded beyond the improvement of the government-owned systems, particularly into privatization of electric power generation<sup>16</sup> but also into broader restructuring of the monopoly energy sectors<sup>17</sup>. This trend was accelerated by a key shift in World Bank policy in 1993 toward requiring reform of national electric sectors, in particular opening them to participation of private capital, as a condition of continued provision of the substantial sums necessary for power system expansion and maintenance.

In theory, this approach could have emphasized the corporatization of the state-owned firms in an effort to remedy their severe management shortcomings while retaining the social benefits of public ownership. In fact, however, the poor and declining performance of most state-owned utilities in developing countries led to a more sweeping emphasis on privatization. Not only was this emphasis expected to improve efficiency, it was also designed to reduce the energy sector's drain on government budgets by enabling an infusion of revenues from privatization and reducing or eliminating future subsidies. This policy shift was also adopted by other development banks and supported by international donor agencies such as the U.S. Agency for International Development. A vast literature now describes this evolution.<sup>18</sup>

This history reveals three significant differences between the evolution of the regulated, privately owned energy sectors in the U.S. and those in developing countries. First, regulation in the U.S. emerged in part as a populist response to abuses by privately owned monopoly<sup>19</sup> whereas those in developing countries flowed from conditions imposed by external donors. Second, the early actions of U.S. regulators tended to benefit customers (for example, by lowering excessive tariffs) and therefore to be popular with the general public whereas the regulators in most developing countries are expected to raise tariffs – often by more than 100% during troubled economic times – during their first years of operation. Third, in the developing countries where rates had been held far below costs, the creation of nominally independent regulators was intended as much to protect the utilities from politically motivated decisions as it was to protect the general public from abuse by monopoly service providers<sup>20</sup>.

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<sup>16</sup> The first IPP plant in a developing country—the Shajiao Power Station in Shenzhen, China—went on line in April 1987. Pakistan's 1,292 megawatts Hub project was the largest IPP in the world. Following the Asian financial crisis in 1997, defaults on power purchase agreements grew as governments found themselves unable to pay for the power for which they had contracted.

<sup>17</sup> The term "restructuring" encompasses a range of activities including reorganizing government-owned sectors (often called "commercialization" and "corporatization", sometimes implemented through management contracts with private firms), privatization of some or all of the sector through outright sale (sometimes including "unbundling" or "disaggregation" when a vertically integrated monopoly is broken into its generation, transmission and distribution parts and sold to different buyers), introduction of competition (at least at the wholesale level and perhaps including some forms of outright customer choice) and the creation of a regulatory commission designed to insulate sector tariff-setting, licensing and standard setting from political and industry influence. Different countries embraced different combinations of these actions in the name of restructuring. A 1999 survey of developing countries assessing restructuring progress asserted that only about one-third of the steps necessary for fully effective reform had been taken (Bacon). The "necessary steps" do not have an express public involvement component.

<sup>18</sup> Both the literature and the evolution are well summarized in Navroz K. Dubash, "Power Politics, Equity and Environment in Electricity Reform," (Washington, DC: World Resources Institute, 2002)

<sup>19</sup> U.S. regulation was also embraced by many privately-owned utilities as an alternative to government ownership and to having rates and other conditions of service determined by elected state and municipal officials unfamiliar with the utility business (Macdonald, pp. 117-121).

<sup>20</sup> The pattern of rates below reasonable costs in state-owned utilities was not universal. In Chile and Argentina, for example, rates declined significantly in the years following restructuring



These distinctions do not mean that the reforms in developing countries have not been beneficial. Indeed, they have produced significant improvements, efficiencies and savings in almost every country in which they have been implemented<sup>21</sup>. However, they have also been vulnerable to popular backlash precisely because they did not arise in response to public concerns or because, absent transparent procedures, project design has been flawed. If the reforms of the 1990s were tested by whether they had been adopted through processes in which the public had had an effective voice or whether they established governance procedures for the energy sector of the future in which stakeholders had an effective voice, the answer would have been an unequivocal “no” in almost every case. The process of transformation has suffered both from process failures (the mere failure to consult the public resulting in profound distrust) and substantive failures (the failure to incorporate public input resulting in weaker decisions).

In the absence of public dialog and scrutiny, the reforms have often been stymied, and in some cases rolled back. In several countries, price increases and disconnections of service have been met with public protest, sometimes with violence. Independent power projects have faced renegotiation and sometimes cancellation. Since 2001, twelve strategic investors withdrew from projects in India alone. Peru, Bolivia and Brazil postponed any further privatization. Investors have sold off power sector assets at distress prices or abandoned them in bankruptcy.

The essence of energy sector reform has been a forty-year effort to transform unproductive state-owned and operated power and gas companies into economically self-sufficient entities<sup>22</sup>. The goals have included improving reliability, eliminating the drain on government budgets, extending service and reducing corruption. The strategies for doing so have included aligning tariffs with costs, reducing losses, increasing collections and improving management. The governmental tools have generally included establishing less politicized regulatory processes and privatizing the ownership, or at least the management, of sector assets.

Energy sector reform has required unpopular decisions. It realigns structural relationships in order to create economic efficiencies. But one person's economic efficiency is almost always another person's loss—a lost subsidy, a lost job, reduced power in a ministry, an increased tariff, a disconnected service, a reduced opportunity for illicit gain, or a foregone expenditure for environmental protection. These quests for increased efficiency have often been designed through top-down, sometimes externally motivated, processes, that have allowed for little or no input from those who will be most affected by the reforms.

Energy sector reform has placed heavy emphasis on full cost-recovery through increased tariffs and improved billing and collections. Yet, when governments have sought to close the revenue gap by increasing prices, some segments of civil society have challenged the assumption that low household tariffs are the principle cause of failing sectors. Consumer advocates, NGOs and

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<sup>21</sup> In 2003, the World Bank's overall evaluation of its energy sector private sector development assistance program found that “reforms have advanced, as in some Latin/Central American countries and Eastern European countries seeking accession to the European Union. In these cases, shortages have been reduced, energy access has increased, service quality had improved, fiscal gains have grown, and financial subsidies have declined. But where reforms failed, stalled, or were reversed, the power sectors remain weak and continue to deteriorate operationally and financially (as in Africa and South Asia), or are facing continued political or financial risk (as in South and East Asia). Most developing countries outside the Latin America region remain at low to moderate levels in the “reform scorecard”.

<sup>22</sup> Energy sector reform undertakings that have included introducing customer choice into former monopoly electric and gas sectors are beyond the scope of this paper. By finessing this discussion, we also avoid the debate over whether market competition is not a surer antidote for governmental abuse and incompetence than is improved governance. Whatever the theoretical merits of this proposition, the energy sectors in developing countries have many needs more urgent than taking on the complexities of retail competition.

academics have offered alternative analyses that point to non-paying state-owned enterprises, corruption and irrational power purchase agreements as important sources of economic inefficiency.

Experts looking at the stalemates of the last decade can reach widely divergent conclusions. Take for example two thoughtful recent articles, one concluding that energy sector reforms have suffered because they have been too attentive to the needs of investors and insufficiently sensitive to involving the public; the other concluding that newly formed regulatory processes are too often driven to short-change legitimate investor expectations at the behest of consumers or of politicians purporting to speak for them.

The first article states:

Efforts to attract capital, particularly through IPPs, have caused more problems than they have solved. In India and Indonesia, IPP entry has been accompanied by allegations of corruption and undermined the financial and institutional health of the sector. In Argentina, the urgent need for capital led to privatization at reduced prices. While reforming countries are criticized for not providing sufficient incentives to attract foreign capital, it is not clear whether such incentives are politically viable and socially desirable. Structuring reforms mainly to attract finance may not be a sustainable long-term strategy for the sector. Moreover, the focus on financial issues crowds out attention to public benefits.<sup>23</sup>

The other states with equal firmness that the necessary remedy should...

...limit the discretion of the regulator in areas that are known to deter investment while at the same time using independent regulation to avoid uncertainties for investors created by political micro-management and changes of government or governmental policy<sup>24</sup>

One set of remedies would expand reliance on democratic deliberative processes; the other recommends constraining them, or at least constraining the uncertainty that they produce. This paper argues that expanding democracy and public involvement – done wisely and in contexts that respect rights and legitimate expectations – will reduce uncertainty and enhance the quality of reform, even if the process is not smooth or free from setbacks. The key is to distinguish between arbitrary political interference and an orderly democratic process. Energy sector reform requires strong governance in some respects, but strong institutions of government do not require weak democracy. Indeed, for every country which can be cited for the proposition that authoritarian government has produced the competence and stability needed for economic reform, several democracies can be cited as having the same characteristics, to say nothing of the corrupt and incompetent authoritarian regimes in which economic reforms have little prospect of success.

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<sup>23</sup> Dubash, 2002, p. vii

<sup>24</sup> Tonci Barkovic, Bernard Tenenbaum and Fiona Woolf, "Regulation by Contract: A New Way to Privatize Electricity Distribution?" (The World Bank Group, March 2003), p. 2

### III. The Interplay of Democracy and Energy Sector Reform

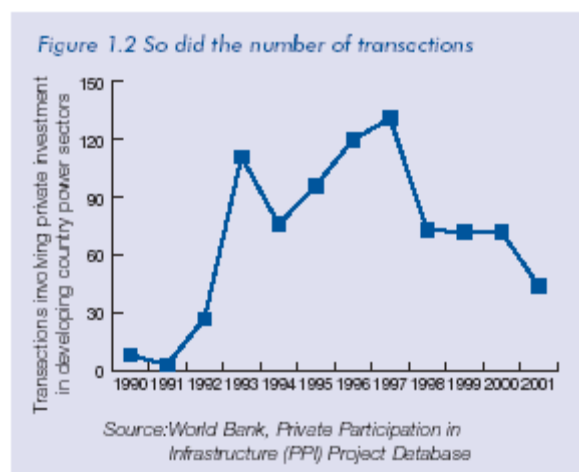
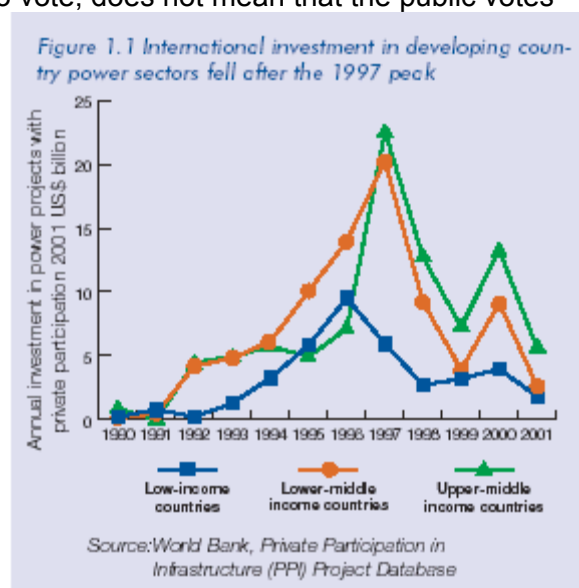
This section will briefly describe the basic ingredients of energy sector reform and the extent of energy sector reform programs around the world. This section will draw on the case studies commissioned for this study, and other materials for examples of failures, successes, lost opportunities and best practices with regard to the interplay of energy sector reform and democracy.

Government-owned energy sectors were performing very poorly for technical, financial and managerial reasons that were not likely to change because a government became more democratic. Democratic governance reforms matter greatly in improving the energy sector, but democratic governance, though it rests on the right to vote, does not mean that the public votes on all major decisions. Indeed, independence from the short-term political interests of any faction is one of the goals of most energy sector reform. Attaining that independence without stultifying the processes of public interaction is one of the more difficult balances for energy sector reformers to strike.

The interplay between democracy/governance and energy can be examined through the lens of three difficult reform issues—investment, tariff reform and access, which are affected by three “process” issues—private participation, public participation, and the role of civil society.

#### Issue #1 Increasing private investment in the power sector.

Over the period 1990 to 2020, International Energy Agency figures indicate that \$3.8 trillion in investment, or about \$125 billion per year, will be needed for developing and transition country power sectors. Total foreign direct investment to date in these countries is falling far short of that amount. Investment peaked in 1997 at over \$47 billion and has since declined by three quarters, falling to \$11.9 billion in 2001. The decline in investment has been paralleled by a drop in the number of transactions, declining by over half from nearly 130 in 1997 to 44 in 2001. These patterns are as shown below<sup>25</sup>:



<sup>25</sup> Ranjit Lamech, and Kazim Saeed, “What International Investors Look For When Investing in Developing Countries,” Discussion Paper No 6, (Washington, DC: World Bank Energy and Mining Sector Board, 2003)

The finance gap between foreign investment and funds needed to operate and expand the power sector is on the order of \$50 billion per year. Partially filling this gap is about one billion dollars per year from bi-lateral aid agencies and less than \$10 billion in loans annually in total from multi-lateral development banks<sup>26</sup>. The remainder—between \$40 and \$50 billion per year—must be made up from self-finance, public finance, energy efficiency or rationing.

**Political and governance factors:** Investment climate indicators relied upon by international equity investors cover a broad spectrum of governance and political economy issues. Factors related to political stability dominate many overall measures of investment climate. A World Bank survey of 48 firms that invest in developing countries<sup>27</sup> produced the following ranking of concerns:



However, investors in the energy sector have not always been so cautious. In the 1980s, independent power producers rushed to developing countries in order to meet dire shortages in generation capacity. Many early IPP projects were done through a non-competitive process that could not be termed 'transparent'. Countries solicited investor interest primarily through informal means and no real competition took place. Projects were developed that did reduce existing power shortages, but they quickly ran into trouble when economic or other conditions worsened.

Two early examples (see box on the right) of this course of events were Indonesia's Paiton project and Pakistan's Hub project. Both projects were developed by direct discussion and

<sup>26</sup> The largest development bank, the World Bank Group, averaged \$2.7 billion per year in lending and investment over FY1990-2001. Other development banks—European Bank for Reconstruction and Development, Asian Development Bank, Inter-American Development Bank were much smaller.

<sup>27</sup> Lamech, and Saeed, 2003

negotiation between governments and developers. Neither was the result of a formal competition. Both had the potential to alleviate severe power shortages. Both appeared unsustainable once financial problems in the sponsor countries undermined exchange rates and ability to pay the contracted prices. In both cases, charges of rampant corruption were made at or near project completion. The flow of power from both plants was seriously delayed by the controversy over the alleged improprieties. The negative repercussions of the nontransparent process in Indonesia contributed to investor flight. Indeed, the more reputable the developer, the less enthusiastic they will be about making substantial commitments in such circumstances. The consequences of discouraging such potential investor interest are likely to be higher prices and lower quality projects.

Energy sector restructuring has also been threatened in some countries as a result of public disillusionment. A poll in Peru showed that 72 percent of Lima residents would like to see their public utility in electric power renationalized. The declining popular support for privatization has made that program a target for the government's opposition, as shown by the riots in Arequipa in June 2001. Planned privatizations of distribution companies in Bolivia were cancelled early, partly because of political opposition by unions and local political leaders. Political controversy in Mexico has essentially stalled the reform process in that country. India, Georgia and Moldova have seen similar reversals.

### **The "Ideology of Fury"**

On October 17, 2003, Bolivia's democratically elected president, Gonzalo Sánchez de Lozada, was forced to resign by violent protests over his decision to export natural gas to the United States. The American Indian majority, joined by labor unions, student groups, peasant farmers and opposition parties, protested that the gas project would financially benefit foreigners rather than the people of Bolivia, the poorest of South America (per capita income of less than US\$950 per year.) The protestor's racial, economic, social and political grievances erupted over the gas issues and over globalization, which protestors called "just another name for submission and domination". Protest organizers say they will give the new regime three months to bring about reform or "we will return to our ideology of fury".

*Source: News articles of October 14, 15, 17 & 20, 2003 The New York Times*

### **Early IPP transparency troubles in Indonesia and Pakistan**

**Indonesia**, prior to the 1997 Asian financial crisis, intended rapid expansion of its power supply, mainly by opening its power market to Independent Power Producers (IPPs). However, the Asian financial crisis left the state-utility PLN, unable to pay for all of the power for which it had contracted with IPPs.

The largest of the IPPs was the Paiton I power project, developed in part by U.S. companies. In December 1998, the *Wall Street Journal* reported a series of corruption scandals associated with Paiton I. According to the head of Indonesia's state owned power company, PLN, "the US power companies dictated terms to us because they had Indonesia's first family behind them."

The final electricity tariff was set at 8.6 cents per kilowatt-hour, 32% higher than comparable tariffs in Indonesia and 60% higher than in the Philippines. Following the overthrow of Suharto and the economic crisis, PLN told Paiton's developers that it would not buy any electricity from the plant when it went on line in 2000. Some U.S. companies took their Indonesian partners to court for breach of contract and non-payment. In March 2002, after several years of negotiation, PLN announced that it had amended the power purchase agreement. PLN agreed to pay 4.93 cents per kWh for a contract period of 40 years and \$4 million a month for 30 years as part of the restructuring settlement.

**Pakistan** IPPs were involved in disputes and litigation with the government over the rates set in their Power Purchase Agreements with the national Water and Power Development Authority (WAPDA) grid. Pakistan's government charged that the IPPs had engaged in price fixing and had paid bribes to officials of the previous Benazir Bhutto government. The Sharif government's main demand was for a reduction in rates to 4.5 cents per kilowatt hour, from the 6.6 cents per kWh which most of the IPPs had in their original contracts. Both of the largest IPPs, HUBCO and Kot Addu, were targeted, as well as the Malaysian-owned Dharki power plant. In response to the Pakistani government's demands for a rate reduction, the IPPs demanded that prices for fuels be lowered, in particular oil, which was supplied by a state controlled monopoly. HUBCO's dispute with WAPDA was settled by an agreement on a new price of 5.6 cents per kWh in December 2000.

Most investors preferred that their negotiations with government be restricted only to the company and the government. The investment projects that have faltered show the inadvisability of such a two party negotiation. For projects that have proven to be sustainable, government has exercised its responsibility to both investor and to consumer. Well-designed reform has limited the discretion of government in areas that are known to deter investment while at the same time used independent regulation to avoid uncertainties for investors created by political micro-management and changes of government or governmental policy. Government's role is to (1) protect consumers from monopoly prices and inferior quality of service and (2) to protect investors who will make the investments to provide the service at affordable prices.

### ***Political Controversy in Mexico has Essentially Stalled the Reform Process There***

In Mexico, both the CFE and LFC unions opposed Minister of Energy Tellez's electricity reform proposal and took entrenched positions. But rather than bring labor unions in as stakeholders and work to find some common ground, including solutions for the pervasive corruption within the unions and between the unions and companies, decision makers have avoided confrontations. The posture of "no negotiation" typically applies with respect to labor issues. Similarly, the highly visible attempts by both the Salinas Administration and the Zedillo Administration to privatize Mexico's petrochemical industry (beyond the small concessions provided for in NAFTA) failed because of the aversion to negotiation between policy elites and unions.

Other civil society groups have not been active in supporting energy reform, but have become more active around perceived injustices associated with energy development. For some civil society experts, the inability for Mexico's companies to provide adequate supplies of energy at reasonable prices and with transparency is evidence of lack of legitimacy in Mexico's policy making processes. This problem also is expected to exacerbate income gaps. The general viewpoint among many civil society groups is that NAFTA/OECD achievements have not translated into improved economic and social development in Mexico.

However, it is not civil society resistance against energy sector reform that is the most intractable barrier to sustainable energy sector transformation. Civil society resistance is a symptom of a larger problem. It is the constitutionally mandated political control of Mexico's energy sector that remains the strongest, and most obstinate, barrier to meaningful energy sector reform. This unwavering control of the energy sector does not provide space for civil society to have a meaningful voice in the energy decisions that affect Mexicans. Or rather, it compels Mexicans to make their voice heard through other, sometimes disruptive, avenues.

A distinct, perhaps "bottom line," question is whether broader, democratic governance reforms were strengthened or weakened by success or failure in Mexico's energy sector reform process. There is no evidence that energy sector initiatives have had much positive influence on democratic governance in general. But a reverse linkage is widely acknowledged: the situation in Mexico is indicative of the difficulty in sustaining an effective energy sector reform process when democratic institutions and associated governance practices are weak.

*--University of Houston, Institute of Energy, Law and Enterprise, 2004*

## **Issue #2 Rationalizing tariffs**

Tariff reform is designed to:

- Recover the reasonable operating expenses of the sector;
- Repay amounts provided by investors as well as providing a fair return on the investment;



- Provide incentives to improve the efficiency of operations;
- Fairly allocate costs among customer classes<sup>28</sup>;
- Satisfy other policy goals—such as furtherance of energy efficiency, assuring service to low-income communities and economic development.

There are, of course, different ways to achieve these goals. Rate-of-return regulation, otherwise known as cost of service regulation, has been the rate setting method most often applied in the United States. An alternative method is performance-based regulation, which fixes either a utility's revenues or its prices for a defined time period, regardless of changes in costs. This form of regulation rewards a utility for improvements in efficiency and theoretically provides a better allocation of risk between investors and consumers. In theory, this approach more nearly mimics a competitive market, in which all sellers must compete against a market price that does not vary with their costs. However, tariffs that increase substantially by formula, without a case-by-case review, are vulnerable to public opposition, especially if the public has not been involved in designing the original formulas. The choice among variations of these methods is, like many aspects of tariff setting, a possible area of public involvement.

Public involvement in tariff setting processes in the U.S. and elsewhere has been at the heart of effective governance in energy sector reform. Indeed, from the public's point of view, prices and availability of reliable service are often the only issues of importance in energy sector governance. Only after meaningful expertise has developed among public representatives is the public's attention likely to shift to power supply planning as the main determinant of longer term tariffs, as well as environmental impacts. (It should be noted, however, that NGO critiques of the inflated IPP tariffs easily made the connection between pricing and planning.)

Before awareness has reached that level, tariff setting proceedings – and efforts to enforce the new tariffs through disconnection – are likely to be the most controversial challenges faced by energy sector reformers. Of course, this means that they also provide the greatest opportunity to develop meaningful programs of public involvement. However, if this opportunity is not seized at the outset, it will largely be wasted. The public's concerns will quickly transform into disillusion and anger, after which constructive engagement will be infinitely more difficult.

**Political and governance factors:** In most developing countries, tariffs and collection of tariffs remain extremely problematic. Prices are distorted for a number of reasons: to garner votes (setting tariffs too low) or to permit rent seeking by public and private officials (setting tariffs too high), or because the quality of the energy services is too poor to allow rational pricing. On top of that, tariffs are not enforced as many users of electricity simply pay little or nothing for the service either through direct theft of electricity or through failure to pay bills.

Effectiveness of rate-setting depends critically not only on economic and technical soundness but also on effective management of the political process of implementing rational tariffs. Raising tariffs for retail customers is a politically charged exercise. Inattention to these issues has often resulted in social, sometimes violent, turmoil. The box below illustrates the atmosphere of protests over tariff increases.

Independent regulation of the power sector is often viewed with trepidation. Political leaders fear that a genuinely independent regulatory commission may raise tariffs too quickly. Investors

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<sup>28</sup> Distribution utilities typically have three principal classes of customers - industrial, commercial and residential - but an infinite number of other classes can be established, with special rates to match.

fear that a new regulatory commission will not raise tariffs quickly enough for them to recover their costs and earn a profit. They are also afraid that, once they make their investments, they will face *de facto* expropriation through unfavorable regulatory decisions. And finally the new regulators themselves fear that they will be blamed for significant increases in retail tariffs, no obvious improvements in quality of service and highly visible profits for a new private company largely owned by foreigners. These conflicting fears mean that a new regulatory system cannot function solely as a technical and legal exercise.

What is needed is development of “second generation” approaches, that is, paying attention to the interplay among government, market and civil society in designing regulatory institutions and strategies.

### **Issue #3: Access: How to provide electric power to more people.**

Some 1.7 billion people lack access to electricity. Two billion people, one third of the world’s population, lack access to clean, safe cooking fuels and must depend on wood, dung and other traditional biomass fuels. This is time consuming and results in indoor and outdoor air pollution and concomitant harmful health effects. The impacts fall disproportionately on women<sup>29</sup>.

Because the utility business is capital intensive (\$2-3 dollars of investment is necessary to generate a dollar of annual revenue and the per capita costs of extending service to rural areas tend to be between five and ten times higher than the rest of the system), increasing access for rural populations remains difficult<sup>30</sup>. Utilities following conventional investment guidelines will not build their infrastructure in areas where consumption and payment levels do not assure recovery of the investment within a reasonable period of time. Additionally, off-grid, private-sector-supplied electricity is often subject to full commercial requirements, thus requiring the poorest, rural customers to pay

#### **Conflicts over energy tariff reform:**

In **Jordan**, in April 1989, an attempt to raise fuel prices resulted in riots that brought down the unpopular prime minister. Observers noted that the unrest was also rooted in the absence of economic opportunities (GDP per capita fell by 2.5 percent in 1986) and dissatisfaction with the lack of public participation in decision-making.

**Indonesians** took to the streets in May 1998 to protest energy price increases proposed by the Suharto regime. In March 2000, there were renewed protests against a proposed hike in fuel prices and the price increase had to be postponed until a compensatory scheme for the poor households could be put in place.

In **Ecuador**, in September 1998, the government increased prices of cooking gas, gasoline, and diesel. To compensate poor households, the government introduced a cash-transfer program targeted to poor women with dependent children, senior citizens, and the disabled. Despite the success in reaching 1.3 million beneficiaries (50 percent of households), the government changed its position on the price increases after street protests in July 1999. Subsidies for fuels reemerged in 1999 as import costs increased and the exchange rate continued to depreciate.

In **Nigeria**, in June 2000, the government increased the price of gasoline by 50 percent. This price increase followed an effective doubling of civil service wages and a major adjustment of the minimum wage in May. However, in reaction to protests by organized labor and students in the major cities, the government agreed to a reduced price increase of 10 percent, while apologizing for not consulting various stakeholders more widely. Observers have linked the protests to an IMF-supported program and the absence of social safety nets in an environment of widespread poverty.

Source: Gupta, Sanjeev, et.al. *Equity and Efficiency in the Reform of Price Subsidies, A Guide for Policymakers*, International Monetary Fund, December 15, 2000

<sup>29</sup> World Energy Assessment, “Energy and the Challenge of Sustainability” (New York, NY: United Nations Development Programme, United Nations Department of Economic and Social Affairs, and World Energy Council, 2000), pages 44-47

<sup>30</sup> The increased cost of rural electrification through grid extension is largely because of the need to add miles of lines--sometimes in difficult terrain--for relatively few customers.



full costs while the grid is subsidized. When grid-based service is available in poor rural areas, it may well be substandard and characterized by high prices, low voltage, voltage fluctuations, excessive electricity losses and frequent lengthy power outages. Problems of access are therefore closely related to income and ability to pay.

In some countries, access to electricity in low-income urban areas is also a problem. In such areas, people often live in structures and areas that are not sanctioned by law. Many have no access to electricity because they cannot afford it, and many steal from the grid. Squatters illegally occupying temporary or semi-permanent structures often cannot receive legal electricity service. Utilities are unwilling to provide funds for wiring and metering illegal settlements. Small-scale operators of illegal utilities tap power lines and sell electricity to slum dwellers, often at exorbitant prices.

**Political and governance factors:** The provision of electricity to unserved areas involves a number of public policy choices. These include whether subsidy programs are necessary, the shape and size of those subsidy programs, whether to connect the areas to the central grid or to employ small-scale generators – renewable or not - and the nature of the organization(s) to take responsibility for providing rural utility services. These issues have a substantial governance component that can benefit both from initial public input and from ongoing public involvement.

In addition, the provision of access to energy creates opportunities for civil society institutions to take an active role as suppliers in situations for which they are better suited than traditional utilities, whether investor or government-owned. A wide variety of such institutions exist, taking different organizational forms and roles in different nations, and more are constantly evolving. Samples include electric cooperatives, user associations and community-based organizations. Examples of each of these follow:

**Electric cooperatives:** Electric cooperatives are electric utilities that are owned by their 'members'—the consumers they serve. The owner/members are normally asked to make a minimal investment in return for their stock. Sometimes, electric cooperatives are eligible for various forms of government assistance, including capital at very low costs with long payback times and freedom from many forms of taxation. Although privately owned, cooperatives operate on a nonprofit basis. Excess earnings are either held in reserve against future deficits or are returned to the customer/owners.

Additional potential advantages of a cooperative form of organization/ownership include:

- The ability to purchase power, or generate power to distribute to their members;
- Boards of directors elected by the customers, who are also the owners of the cooperative's stock;
- Board supervision of a professional management team, which uses common private utility measures of performance such as consumers per employee, cost per kilowatt-hour, return on assets, and outage hours per year;
- Technical and financial performance that commonly meets international standards;
- Consumer and community participation occurring through the public election of directors as well as annual meetings (and other meetings as needed) in which the customer/owners can participate;
- Rates and other conditions of service that may or may not be regulated;

- Electrification programs that often re-invest in the communities themselves, especially in school electrification. This re-investment can build the economic base for further electrification and economic growth.

Electric cooperatives are used extensively throughout the world to deliver electricity services. In the United States before 1930, few rural areas were electrified because investor-owned utilities would not serve them. Following the creation of the federal Rural Electrification Administration in 1935, the availability of low cost loans resulted in rapid expansion of the cooperative movement and of the availability of electricity. Within 20 years electricity was almost universally available in the mainland U.S. Today, some 900 cooperatives supply about 9% of the electricity sold in the U.S.

**Community-based organizations:** Established community-based organizations – whether or not they have worked in the energy sector – have credibility and access among the citizenry that utilities need and often lack. Working with such organizations can enable a utility to benefit from the expertise and the credibility of the CBO. Of course, the utility must be prepared to engage in a meaningful two-way dialogue with the CBO, rather than expecting that the CBO will become a messenger for the utility.

**User associations:** User associations are made up of small businesses or farmers who have organized to manage resources needed for that business. The most common of these are water users associations, which typically manage parts of an irrigation system and collect charges for water and related activities such as stream flow reduction, treatment of effluent and waste or use of water for recreational or environmental purposes. Water user associations have functioned as civil society mechanisms to improve the management and performance of use of scarce water resources, particularly irrigation water for agricultural development.

Of course, in many countries the water sector and the energy sector are closely interrelated for at least three reasons. First, hydroelectricity is one of the main claimants for water rights. Second, the water sector—beset by problems of nonpayment and under-collection similar in many ways to those of the electric sector—is likely to be one of the largest and most intransigent debtors to the energy sector, especially because disconnection of electric service to water suppliers and sewage treatment plants is not likely to be a viable collection option. Third, irrigation pumping in many countries is also a significant portion of the total electric load. When, as in India, irrigation has been a heavily subsidized activity, many farmers have developed a sense of entitlement to the subsidized electric rates. India has found ending the economic harm from these subsidies to be particularly challenging.

As innovative ways are being sought to improve access and sustainability of rural energy supplies, water user associations are one potential area for attention. Pilot studies offer hope that, through increased stakeholder understanding and painstaking negotiation between water management bodies, energy stakeholders, and agricultural interests, consensus favoring the necessary reforms can be developed<sup>31</sup>.

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<sup>31</sup> “Addressing The Energy Water Nexus In India: Improving Rural Power Delivery and Ground Water Management Through Community Based Interactions – Sector Governance, Improved Consumer Services, and Stakeholder Participation” by Amit R. Dalal and John Armstrong of PA Government Services. See also, O'Donnell.

# IV. The Energy-Democratic Governance Nexus

This chapter will discuss the convergence, or coming together, of the energy sector and the democracy/governance sector. The energy-democratic governance nexus is multi-faceted. It includes:

- The specific quest for participation and accountability in the energy sector as part of the overall push for democratic reform in the country;
- The technical and financial requirements of the energy sector as impacted by the competence of the governance structures in which energy policy decisions are made and implemented;
- The demands of citizens without access to energy to have such access;
- The insistence of citizens affected by power plant environmental ramifications – especially hydroelectric dams – to have a voice in those decisions;
- The likelihood that citizens who band together to influence energy sector decisions will use their new skills and networks to influence other societal decisions, including elections;
- The likelihood that investors will insist on a well-functioning and predictable civil society if they are to make capital available on affordable terms and without sovereign guarantees;
- The balance between market mechanisms and regulatory mechanisms to be employed in the electric and gas sectors;
- The “delegated democracy” function of the autonomous energy regulatory body.

The credibility of both political structures and energy sector institutions is constantly at issue. USAID’s Office of Democracy and Governance uses five key elements to determine the main democratic governance problem in a given country. The five key elements are: inclusion, good governance, consensus, rule of law, and competition.

All of these have implications for reforming the energy sector. Those designing energy sector reform programs would benefit from reviewing the democratic governance assessments for an indication of likely trouble spots and opportunities for public involvement. Getting a handle on the 5 elements of democratic governance in any particular case should assist in defining the energy governance problem of a country and develop an appropriate development strategy. A summary of the five criteria follows.

## **Consensus:**

Consensus describes a broad acceptance of the political order and rules governing peaceful competition for power. In the energy sector, consensus would suggest broad public acceptance regarding the rules for deciding the shape of reform, regulations for awarding licenses for extraction, generation, transmission and/or distribution of energy; setting tariffs and conditions of service; and permitting disconnection for nonpayment. Such consensus is fundamental to growth and progress, but it must be earned. The vested interests benefiting from the inefficiencies and other shortcomings of the energy sector are likely to weigh heavily against a supportive consensus at the beginning of the reform process.

## Competition:

Democracy is about the competition of ideas and public policy as well as competition for public offices. Pluralistic civil society – the profusion of non-governmental forms of public organization – is also an arena for the competition of ideas and organizational forms. The free media, in particular, are indispensable to liberal democracy as vehicles for information, analysis and debate, and as checks on the power of government. When assessing the level of competition, one should examine the state of elections; competition of ideas; civil society; media; economic pluralism; and checks and balances in government.

In fact, competition of ideas is inevitable to any change process, and energy sector reform is no different. Perhaps one of the more frequent errors in managing the politics of reform is by restricting the debate about the shape reform should take. The extent to which this dynamic takes place within an institutional framework or on the streets greatly determines the quality and constructiveness of this competition. In particular the space for alternative views to be based on data rather than rumor, and to be considered rather than suppressed will have a profound impact on the pace and effectiveness of reform. The case studies presented in *Power Politics* offer qualitative portraits of the substance of these debates and the unfolding dynamics in 6 developing countries.<sup>32</sup>

In the U.S. energy sector, competition between government and investor-owned systems has for decades been said to provide a “yardstick” by which the performance of both can be judged. In recent years, actual competition at the supply level (for both electricity and gas) has actually displaced governmental decision-making as to many aspects of electricity and gas but has also required an enhanced governmental presence with regard to market manipulation of the type that occurred in California. An active media and civil society can be especially important to successful energy sector competition (especially in the policy realm), because of the complexity of the subject matter and the need for citizens to be informed about it.

## Inclusion:

As authoritarian systems liberalize, the political mobilization of previously excluded groups can have destabilizing effects that jeopardize the democratic transition. Transitions frequently begin with agreements among elites – but only among elites – for limited reforms. Tension often arises between the aspirations for political representation by disadvantaged and excluded groups and the more limited reforms negotiated by the elites, especially if the agreements provide for a different kind of participation among the elites but not full democracy.

In the energy sector, inclusion could refer both to inclusion in the sense of access to energy services, and inclusion in the sense of the ability to participate in governance processes – for example, access to information, decision-making and the judicial system. In many developing countries, access in both these senses has historically been quite exclusive. As energy reforms have gotten under way, we can see a sectoral parallel to the process described above, where environment, labor, consumer, and other groups are clamoring to be part of the decision making process that they argue does not represent their views or concerns.

If their concerns are addressed, the improved inclusiveness will assist democratic reform as well as energy sector reform. If not, both may suffer.

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<sup>32</sup> Dubash, 2002

In testing for inclusiveness, one would ask the same questions, whether of the country as a whole, or of the energy sector in particular:

- Are any parts of the population excluded, formally or informally, from meaningful participation? For example, groups based on race, gender, ethnicity, religion, language, or geography.
- Despite guarantees of inclusion, is participation low and apathy high? If so, why?
- Are people dissatisfied with the system? Are there incidences of informal exclusion? Are the people content?

### **Good governance:**

In democratic settings, good governance includes transparency, accountability, efficiency, and rule of law. Transparency refers to the public accessibility of government operations. Accountability denotes the extent to which government officials and agencies are regulated by and responsible to public approval and formal rules. Efficiency relates to the effectiveness of government at delivering public goods at lowest cost. The rule of law reflects the degree of adherence to legal principle and procedure. Good governance is evident in relatively low levels of corruption, consistent, minimum levels of service provision, and responsiveness to changing conditions and public needs.

Of course, citizens will ultimately judge their economic sectors by their performance in terms of price, availability of goods and services and service quality. The energy sectors will be no exception. Nevertheless, governance issues are also critical, given that energy sectors remain so substantially intertwined with government in so many ways. Especially where the energy sector remains a monopoly, and therefore impervious to influence in the form of customer choice, considerations of good governance apply to the sector very much as they do to the society as a whole.

One way of assessing the level of good governance in a given energy sector is through the “electricity governance toolkit”, of the World Resources Institute (WRI). This framework assesses the extent to which decision-making processes in national electricity sectors are transparent, allow for public participation, are held accountable to the public interest, and allow access to redress<sup>33</sup>. In addition, the toolkit seeks to address institutional and civil society capacity to adequately meet the requirements of good process. While the framework looks at governance issues from a public perspective, it is believed that improvements in governance in terms of the public interest will also contribute to the protection of genuine investor interests by fostering more credible decisions and the legitimacy of the governing bodies.

This pilot toolkit was developed against the backdrop of problems in electricity sector governance in four Asian countries: Indonesia, India, the Philippines and Thailand. The framework thus attends not only to generic governance principles that would be optimal for all public institutions, but also to specific sectoral issues with which these institutions must grapple. Perhaps the most obvious example is the unhappy Asian experience with IPPs detailed earlier in this paper. The inability of governments to honor long term IPP commitments is usually

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<sup>33</sup> The full toolkit may be downloaded at <http://electricitygovernance.wri.org>. The approach to electricity sector governance builds on WRI's experience with the Access Initiative (TAI), which in turn is based on the pillars of the Aarhus Convention. See also footnote # 41

framed by the investment community as a rule of law problem. But, while framing broken contracts in this way might provide a basis for litigation, closer analysis has revealed improbable and inherently unsustainable contracts stemming from a variety of governance problems: problems with transparency in the bidding process, inadequate involvement of the legislature in IPP policy development, lack of public information about the demand-supply scenario, inadequate public consultation and other governance failures. The toolkit offers indicators with which to assess the governance structures and processes for such critical sector events, with the goal of identifying weaknesses and constraints that need to be addressed. Other sector specific issues include criteria for assessing the methodology for asset valuation/balance sheet restructuring in terms of transparency and accountability, and monitoring systems for the allocation and disbursement of subsidies. The resulting interventions are intended to build more credible institutions that can develop policies that are responsive to both investor and public needs for equity and predictability.

It is in light of these sectors and country specific issues that the more generic governance indicators become interesting. The toolkit surveys the main institutions through which electricity sector decisions are made and implemented, including the legislature, the executive and the regulatory body. For example, the capacity of legislative committees to examine issues of relevance to the electricity sector is assessed, including the access of staff to documentary resources and the authority of the committee to call on elected representatives or appointed officials in order to seek evidence and information. The independence of the Electricity Department/Ministry in the Executive is assessed in terms of criteria for appointment, fixed tenure and removal procedures, disclosure of interests and conflict of interest rules. The functions and jurisdiction of the regulatory institution is similarly appraised, including disclosure of documents and procedure for public access. While the assessment can be customized to the needs of a particular country assessment, a total of 45 such indicators are available, with an additional 23 targeted at social and environmental aspects of governance.<sup>34</sup>

### **Rule of Law:**

The formal institutions of a rule of law are: a legislature to pass the laws, an executive to implement them, and a judiciary to adjudicate them. Virtually all countries have the trappings of a rule of law: judges, courts, statutes and lawyers. But in authoritarian countries, for example, the law is personalized. It serves the interests of the regime itself, the ruling elite, or the group it represents. The questions to be asked about the rule of law in the society as a whole are the same as those to be asked about the energy sector:

- Does the government abide by the laws, rules and procedures that govern its actions?
- Is there a culture of impunity? Is the government held legally accountable for its actions?
- Are the rules public?
- Are similar cases treated similarly?
- Are disputes decided in the courts and are laws enforced?
- Does the judicial system have integrity, competence and independence?

The rule of law has both democracy/governance (DG) and economic dimensions. The DG perspective usually refers to the capacity and authority of the courts and police force to contain

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<sup>34</sup> *Ibid.* <http://electricitygovernance.wri.org>.

criminal behavior. The economic dimension is usually dealt with from an investor's point of view, for example, sanctity of contract or protection of property rights. Both dimensions are important in the energy sector since many developing country governments with weak democratic institutions remain unable to make credible commitments over time, which is a factor inhibiting investment in the energy sector. The rule of law is at least as important from the standpoint of ordinary citizens and of customers—whether small or large—as it is for investors.

The answers to the questions above clearly have implications for the energy sector. They can also be asked about energy regulatory institutions, about the administrators of the energy markets and about the courts with jurisdiction to review energy sector decisions. In addition, the applicability of the concept of the rule of law to energy sector reform must include an understanding of the basic rights of customers and investors, a general framework for the establishment and protection of property rights (as well as for identifying and compensating those whose legitimate equitable claims are to be negated by the reforms), and clear delineation of the roles of the various governmental agencies that will retain responsibilities in the energy sector.

### **Stages of Democratization**

The USAID democracy framework also provides some guidance on the level of openness that can be expected at various stages of political change. Awareness of the stage of democratization in a given country can frame the expectations and the goals of energy sector reform.

#### **Liberalization:**

Totalitarian regimes typically relax controls over non-political areas, like religion or the economy, but not over political life. In effect, they become authoritarian regimes. Authoritarian regimes, which have already relaxed their control over these areas and have allowed even advocacy-oriented NGOs, may now allow greater political participation and even some political competition, particularly at the local government level. Such regimes are likely to resist those aspects of energy sector reform that involve meaningful interaction with the public. If they permit establishment of an independent regulatory commission but sever it from meaningful public interaction, then the pressures on it will come only from the government, which may well retain ownership interests in some parts of the regulated energy sector. In that case, any independence will be short-lived.

#### **Transition:**

If they continue to reform, authoritarian elites may undertake a transition to a fully competitive democracy. Indeed, authoritarian regimes often claim that they are just way-stations toward democracy, which can be achieved only after this or that social or economic condition has been achieved. The transition is marked by a decisive shift from one set of political rules which discourages competition and inclusion to one that institutionalizes them. Because these are fundamental, constitutional changes, they call for a new consensus which embraces competition, inclusion, and a wide-ranging rule of law. Energy sector reform taking place during such a transition obviously has a higher likelihood of being able to draw upon democratic governance institutions as well as effective public involvement.

Transitions are diverse but they commonly reflect three general patterns: top-down (led by incumbents who exert considerable influence over the process), bottom-up (popular groups

seizing the initiative from the incumbents) and negotiated transitions (a combination – incumbents and challengers agree on the contours of political reform). Energy sector reform proposals are likely to mirror the character of the overall transition in the country. However, the interrelationship may well be complex, with public discontent over top-down sector reform potentially leading toward something closer to a negotiated transition or – in the case of Georgia – actually helping to turn the transition into something close to a true democratic revolution.

### **Consolidation:**

For democracy to become consolidated, it must become commonly accepted that ordinary crises be resolved through democratic means. That requires the construction of institutions that make democratic procedure routine and constrain the possibility of a usurpation of power. The meanings of inclusion, competition, and the rule of law are always being reconsidered as experience tests the balances that have been struck, for example, between liberty and order, consensus and dissent, competition and concordance. The same evolutionary process is inevitable for energy sector reform. The measures of financial integrity and the physical workings of the network may not change much, but the governing institutions and means of public and customer involvement will change constantly.

The political level at which balances are tested will vary according to the broader context. For example, in Brazil and Georgia, in which new regimes have recently come to power, the very autonomy of the regulatory function and its relationship to government has been reconsidered. In a more stable polity, however, it is the regulatory body itself which presides over the dynamism of the sector. Successful regulation, for example, has been compared to administration of a long-term contract which contemplates the regulator as the agent approved by all parties to make the adjustments required by time and technology as the years go by.<sup>35</sup> For reform to be successful, there must be a societal consensus empowering the regulator or another institution to play this role, with disaffected interests appealing to other legitimate democratic governance institutions such as courts (for review of decisions), legislatures (for changes in law) or the executive (for different regulatory appointments).

Donors, such as USAID, can and often do assist that institutionalization. They help develop democratic skills and behaviors. They advise on judicial and governmental reform. They assist parliamentarians to work effectively. They help the initial democratic regime confront its immediate challenges. They facilitate a smooth relation between the military or police and the civilian authorities. They counsel political parties, investors, consumer groups, judges with jurisdiction over energy sector decisions, and the media.

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<sup>35</sup> VP Goldberg, "Regulation and Administered Contracts," (Bell Journal of Economics 10(2), 1976) pages 426-448, and G. Priest, "The Origins of Utility Regulation and the 'Theories of Regulation' Debate," (Journal of Law and Economics 36(1), 1993), pages 289-323



# V. Regulation as a Source of Legitimacy and Ongoing Adjustment in the Energy Sector Reform Process

While supporting institutions of democracy, such as legislatures and courts, is crucial to sustainable energy sector reform, the establishment and support of independent regulatory bodies are similarly important and relevant. Regulatory commissions perform an essential representational function, balancing the sometimes-competing interests of the government, private companies, and the consumer/citizen. As an institution of “delegated democracy”<sup>36</sup> they also offer some potential as a buffer against popular backlash and as an avenue for public participation in the energy sector reform process. Delegated democracy refers to government-sanctioned institutions, staffed by technical experts, that are intended to be isolated from the normal pressures of politics and that therefore contribute to the overall efficient running of the government and the economy. The US Federal Reserve is one example of delegated democracy. The US Supreme Court is another, as are many of the institutions of the European Union.

For regulatory bodies to fulfill their function, they must satisfy several conditions:

- They must have the expertise to devise and administer the necessary reforms with fairness.
- They must have the legal mandate and the financial resources necessary to do this job.
- They must have a measure of independence both from the rest of government and from the utility industry.
- They must operate transparently, and they must engage with the public in a constructive, ongoing dialogue.

However, the institutions of delegated democracy are likely to lack legitimacy in the eyes of the general public if they have been created in response to the demands of donors or lenders. Effective public interaction can perform a legitimizing function for the controversial decisions of such institutions. Indeed, public participation in regulatory processes is not so much an extension of democracy as it is a vehicle for legitimizing a body that exists in substantial part to circumscribe the tendency of democracy toward short term gratification of the electorate, even against its longer term interests. The distinction between forms of public participation that achieve this result meaningfully and those that seek to do so through propaganda and public relations techniques makes all the difference in the world.

Of course, regulation itself has a paradoxical relationship with democratic decision making in the energy sector. Regulatory institutions were charged with energy sector responsibility in the U.S. a century ago in part to displace more democratic forms, namely public ownership of utilities and the awarding of franchises and setting of tariffs by city councils and by state legislatures. Indeed, regulation emerged as a compromise solution, championed in large part by utility executives seeking a solution that would on one hand serve as an alternative to government-owned power systems while on the other ending the corruption and uncertainty inherent in rates

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<sup>36</sup> Zakaria, *supra* n. 1, pp. 241ff

and franchise decisions made by directly-elected bodies. To this day, the power of state regulatory commissions in the U.S. is routinely described by courts and treatises as a “delegated” legislative power, even though it is exercised by appointees of the executive branch<sup>37</sup>.

Against this background, public interaction emerges as an effective means for improving the quality and the legitimacy of regulatory decisions by involving the public. It is also a means of strengthening civil society.

### **Designing Restructuring with Effective Public Involvement**

Effective regulation is a chain with many links. Each of those links provides an opportunity and a need for public interaction. How those opportunities are used will do much to determine the eventual success or failure of the regulatory process.

The links include 1) a comprehensive energy law that conveys the necessary powers and responsibilities, 2) the appointment of people who are honest, qualified and dedicated, 3) adequate financial resources devoted to regulation from sources that do not compromise the commission’s integrity, 4) decision making processes that obtain all necessary information and are responsive to the public, to the licensees and to investors, 5) vigorous monitoring and enforcement and 6) written, publicly available decisions that explain the Commission’s reasons for its conclusions and that are reviewable by a court or other independent entity. Weakness or failure in any one of these links cannot adequately be offset by strengthening one of the others. All require continuous attention.

Public interaction is important at every stage of the regulatory process, from the shaping of the law and the appointment of the commissioners to the making of decisions to the protection of individual customers. Such interaction can take many forms, ranging from concerns by individuals about their utility service to participation in commission proceedings to participation in regular sessions with the regulatory commission and/or the utility. For the interaction to be effective, the public must have adequate information about the commission’s workings and the decisions being made. The public must feel that its concerns have received a fair hearing and a reasoned decision.

In many countries, one hears such phrases as “But we don’t have the time (or the money or the people) for such procedures yet,” or “We don’t really need to have public meetings to know that the public cannot afford higher tariffs and doesn’t want to pay them,” or “Such practices do not fit the culture of our country”. Of course, there is some truth to each of these statements. Nevertheless, the credibility of a regulatory agency is always fragile, while its importance in sustainable energy sector reform is significant. A demonstrated willingness to listen can be important in itself. Furthermore, the public may have views about ways to implement or to mitigate necessary but unpopular decisions that can be very useful even when the decisions themselves cannot be avoided. Certainly the most effective public education programs elsewhere have been those that understood that the regulatory commissions and energy

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<sup>37</sup> However, some 10 U.S. states provide for the popular election of utility regulators, a blend of democracy with regulatory institutions not followed in other nations. In two other U.S. states the regulators are selected by the legislature rather than the governor. The regulators in those states tend to be former legislators. One of the most famous populists in U.S. history, Huey Long, began his career by being elected to the Louisiana Utilities Commission, and elected regulators are far more likely to have aspirations toward higher elective office. Studies over the years have not shown any clear differences in the overall quality of regulation attributable to the method of commissioner selection, though the courts have been unusually active in setting utility rates in some of the elected jurisdictions.

companies needed to learn from the public as urgently as the public needed to learn from them.<sup>38</sup>

Case studies, experience and common sense all indicate that the public is more willing to accept measures such as tariff increases, metering, and disconnection policies if they are accompanied by service improvements or other benefits. Effective public interaction provides the most effective means for shaping packages that link potentially unpopular but necessary decisions with the measures likely to make them more palatable.

Public interaction can also broaden the extent to which different constituencies – small customers, large customers, workers, environmentalists, farmers, utility managements, investors – come to understand each other's needs and motivations. When this occurs, and these groups begin to talk meaningfully to each other, the regulator is less likely to become the focal point for the disillusionment of groups that do not understand why their particular demands could not be fully met.

Furthermore, the general public is not the only group concerned with the processes of public interaction. A number of the criteria set forth in this paper are important also to potential investors and to the regulated enterprises themselves. A survey of problems encountered by private sector entities in former socialist countries indicated that in the Caucasus region (Armenia, Azerbaijan and Georgia), policy surprises were a problem for some 60% of those surveyed, unpredictable changes in announced policies for 45%, lack of information about important rules and policies for 70% and lack of opportunity to participate in the development of important rules for 78%<sup>39</sup>.

Finally, carefully conceived public education can be a method of informing customers about the need to take some unpopular steps, about actions that can mitigate the impact of rising prices (such as more efficient use of energy) and about the rights of customers and citizens in energy sector decision making.

A concise and comprehensive justification for public interaction from a country struggling to implement both democratic and energy sector reform comes from a professor with long experience in Ukraine:

Why is public participation important? Some government officials are likely to think that public participation is an unnecessary burden. It may appear to make decision-making processes more complicated and time-consuming. On the other hand, the public may suggest alternative solutions that will increase the quality of the decision and save resources and money. An improved decision may decrease or prevent negative impacts... Transparency of decision making also helps to avoid corruption. Since economically powerful private interests will always find a way to participate, even without legal provisions, allowing public participation can provide a counterbalance of forces,

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<sup>38</sup> See for example, Brenda Dervin and Peter Shields, "Some Guidelines for a Philosophy of Communicating with Citizens in a New Regulatory Environment", in "Compendium of Resources on Consumer Education", (National Regulatory Research Institute, Columbus, Ohio, 1998), pp. 69-86.

<sup>39</sup> Aymo Brunetti, Gregory Kisunko, and Beatrice Weder, "Institutions in Transition: Reliability of Rules and Economic Performance in Former Socialist Countries", World Bank, August 1997.

allowing well-intentioned civil servants to carry out their responsibilities free of outside pressure<sup>40</sup>.

Half the world away, studies of the licensing process of the U.S. Nuclear Regulatory Commission also concluded that public involvement improves the quality of decision making as well as the performance of industry and government participants. The chairman of the NRC's Atomic Safety Licensing Boards described the benefits of the NRC public hearing process as follows:

(1) Staff and applicant reports subject to public examination are performed with greater care; (2) preparation for public examination of issues frequently creates a new perspective and causes the parties to reexamine or rethink some or all of the questions presented; (3) the quality of staff judgment is improved by a hearing process which requires experts to state their views in writing and then permits oral examination in detail.... and (4) staff work from two decades of hearings and Board decisions on the almost limitless number of technical judgments that must be made in any given licensing application.<sup>41</sup>

No regulatory agency in a democracy has the option of not interacting with the public<sup>42</sup>. The question is what kind of a relationship will exist. Failure to pay close attention to the soundness of the ongoing public interaction is like a failure to exercise. It does no particular damage on any given day, and other matters will seem to have a higher priority. But if it goes on for too long, the effects are very hard to reverse, and the necessary credibility and familiarity will not be available when a real crisis arrives.

### **Effective Public Involvement in the Regulatory Process Itself**

Public interaction involves all aspects of a regulatory commission's work. However, the following are the most significant:

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<sup>40</sup> Svitlana Kravchenko, "The Role of Civil Society" IUCN Academy of Environmental Law 2003 Colloquium, p. 220. A variation on this theme from an environmental perspective is no less true of economic regulation, "Environmental and energy-related decisions are in part a process of determining what level of risk society is willing to accept or tolerate and what it is willing to spend to reduce those risks. Senior citizens and mothers with asthmatic children who breathe polluted air contribute important intuitions about the human context and tolerance for risk. Even technical decision-making tools such as risk assessment and cost-benefit analysis include significant subjective judgments that are best made with explicit attention to public values in consultation with the public." Ruth Greenspan Bell, "Improving Air Quality in Asian Cities Through Public Participation: Modified Final Report," (Washington, DC: submitted by Resources for the Future (RFF) and Advanced Engineering Associates International (AEAI) to US Agency for International Development, June 2004), p. 5

<sup>41</sup> Memorandum of B. Paul Cotter, May 8, 1981, quoted in The Union of Concerned Scientists, Safety Second: The NRC and America's Nuclear Power Plants (Indiana University Press, 1987), p. 58. This conclusion was echoed in the independent analysis of the Three Mile Island nuclear accident commissioned by the NRC, which stated, "Intervenors have made an important impact on safety in some instances – sometimes as a catalyst in the prehearing stage of proceedings, sometimes by forcing more thorough review of an issue or improved review procedures on a reluctant agency". Another Licensing Board member suggested that public involvement improves agency conduct even when the improvement cannot be documented, "You can't decide how many robberies a policeman on the beat has prevented by checking how many arrests he's made. Just his presence on the beat discourages a lot of robberies." (Safety Second, p. 59).

<sup>42</sup> In the context of environmental decision making, the concepts of public access and public interaction are enshrined in the 1992 Rio Declaration on Environment and Development, of which Principle 10 reads "At the national level, each individual shall have appropriate access to information concerning the environment that is held by public authorities....; and the opportunity to participate in decision making processes. States shall facilitate and encourage public awareness and participation by making information widely available. Effective access to judicial and administrative proceedings including redress and remedies shall be provided". Online at <http://www.unep.org/unep/rio.htm>. For Europe, the 1998 Aarhus Convention on Access to Information, Public Participation in Decision making and Access to Justice in Environmental Matters requires basic participatory guarantees including access to information, ability to participate and access to appellate review.

- Public involvement in the appointment of regulators whose past performance shows them to be capable of honest and creative resolution of economically complex matters in ways responsive to public concerns;
- Meaningful participation in proceedings having broad public impact, particularly tariff setting and the conditions included in licenses;
- The handling of individual or widespread customer concerns in such areas as reliability of supply, billing, disconnection and service quality; and
- Participation in setting the Commission's overall priorities.

The criteria by which to judge effective public participation might include:

- Availability of information to the public.
  - Does the public receive meaningful notice of commission proceedings at the earliest possible moment? Does that notice specify what topics are being considered, what the schedule will be and what the public must do in order to participate in the proceeding?
  - Does the public have easy access to information on the functioning of the commission, through – for example – printed materials, an accessible web page, public service announcements, frequent public appearances by commissioners and commission employees?
  - Are the rights of utility customers clearly set forth in a single document, also available in brochure form, on a web page and in the form of public service announcements?
  - Do customers have access to all information in the possession of the commission regarding utilities, including the utilities' periodic reports of financial and technical data?
  - Does the commission explain its decisions in a clear and publicly available fashion that discusses the law, the facts, the positions of the participants and the commission's reasoning in sufficient detail to give the reader a clear sense of how the commission will treat similar matters that may come before it in the future.
- The effectiveness of the means by which the public may participate in the decision making of the Commission.
  - Can individuals or companies become participants or otherwise be represented in proceedings affecting their interests and thereby gain prompt access to the information filed by the utility? In particular, does a mechanism exist by which small customer interests are assured of representation, from the Commission staff, a consumer advocate or an adequately funded NGO?
  - Can participants or their representatives ask questions of the utility and the commission staff about tariff or other proposals during the proceedings in which they are being considered?
  - Can participants or their representatives present views to the Commission during such proceedings at a time before the commission has reached its decision?
  - Can participants or their representatives be present at all meetings between the commission staff and the utility after a proceeding has begun?
  - Are participants in regulatory proceedings protected through procedural rules from sudden changes in fundamental theory and basic data presented by the utility or commission staff late in a proceeding?

- Do participants have a right to appeal a commission decision to a capable and honest court for review of whether the commission decision and procedures are consistent with applicable laws and constitutional requirements?
- The extent to which the Commission seeks interaction with the public
  - Do the Commission and staff meet regularly with groups representing all customer classes affected by forthcoming commission decisions?
  - When undertaking major tariff or other major regulatory decisions, does the commission develop a strategy for seeking input from and interaction with the public on the best ways to proceed?
  - Does the Commission have a strategy for public education regarding matters of long term importance to the energy sector, such as improvements in service, availability of low income assistance, reduction of theft, need for metering and disconnection policies?
  - Does the commission meet regularly with the media to answer questions and explain commission decisions?

Any reform program seeking to meet these criteria might consider the following best practices.

First, public interaction is unlikely to be effective unless the appointees to the commission have demonstrated an aptitude for dealing constructively and honestly with the public and with complex economic issues in their previous positions. There is no substitute for well-qualified and well-respected utility regulators, especially in the position of chairperson. Individuals with such capabilities will be able to avoid many of the pitfalls often alleged to accompany public involvement. In particular, they will be able to manage the processes of public involvement with a mixture of fairness and firmness that will mitigate the delay, demagoguery and unpredictability that accompany regulatory processes entrusted to individuals incapable of managing them.

Second, wherever possible, actions that are likely to be unpopular should come at the same time as (or after) clear benefits. Customers in many reforming countries indicate a willingness to pay more in return for a reliable power supply<sup>43</sup>. What is not acceptable is a series of substantial tariff increases and disconnections accompanied by little or no service improvement. Explanations to the effect that service standards take longer to develop than do tariff formulae carry little weight with customers being asked to pay for services that they will not receive for several years<sup>44</sup>. In some cases, phasing in increases so that they apply only to neighborhoods that have received upgraded service (as has been done in some countries with telephone and water service) may make the increases more acceptable. Another alternative would be to provide for tariff reductions if electricity availability fails to meet expected standards. Not only will a policy in which benefits accompany burdens make the burdens more acceptable, but this combination is more likely to create support for ongoing reforms as surely as having reforms seen to be all burden and no benefit will have the opposite effect.

Third, a new regulatory agency cannot be expected to succeed if all of its early actions must be unpopular. The creation — especially upon the demand of an external lender or donor — of an

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<sup>43</sup> “We can fight the political battles if the supply is good” in the words of an Indian government official (Bakovic, Tennenbaum and Woolf, 2003).

<sup>44</sup> In the U.S. construction of new facilities is not normally financed by advance payment from customers. Utilities are expected to raise the money from lenders or investors, and the new facilities are not reflected in tariffs until they go into service. In legal parlance, customers do not pay for expenditures that are not “used and useful” in providing service. But of course, this principle, which is part of U.S. state and federal law, is employed against a backdrop of tariffs that provide revenues already adequate to cover the utilities reasonable costs.

agency whose primary initial purpose is to increase tariffs and approve disconnections is designed to fail<sup>45</sup>. Care must be taken to assure that the early results of regulatory action include some results that the public will see as a benefit – such as improved service reliability and quality, reduction of privileged treatment or reestablishment of gas service in areas that have lost it.

Fourth, no program of tariff increases and customer disconnections should go forward under circumstances in which poor customers are likely to be disconnected because they cannot pay their bills.

Fifth, if the privatization documents purport to bind the regulatory commission to specified results or methodologies, then they themselves should go through a process of regulatory review informed by public involvement. A regulator issuing tariff increases without following statutory procedures because such increases have been agreed to by the government will not have much public credibility – especially if the regulator itself has signed the commitment documents.

Sixth, a regulatory commission must have enforcement powers consistent with its mission. Corruption and the existence of special privileges are particularly destructive of public confidence in reform.

Seventh, a regulatory agency needs effective channels for public involvement from the beginning. Hindsight in country after country has shown ways in which early public involvement would have revealed pitfalls and suggested alternative courses of action that might have averted or mitigated the backlash against energy sector reforms.

In addition to these seven general best practices, there are a number of more specific measures that can be taken to increase the effectiveness of public involvement in the regulatory process. These include:

- Preparation and distribution of written (and perhaps video) materials explaining what the regulatory body does, how it works, and what the rights and responsibilities of the customers are. Such materials should be available at commission offices and meetings. They could also be made available to customer groups, as could a periodic newsletter. In the U.S. such materials typically have titles like "The Answers to Frequent Questions Regarding Utility Service", or "The Rights of Utility Customers" or "Advice Regarding Energy Efficiency."
- Requiring through license conditions or as a condition of tariff approvals that the utilities themselves undertake to improve their interaction with the public. Each distribution utility could be required to have a consumer advisory council<sup>46</sup>. Of course, such councils require individuals who have some stature as leaders of the groups that they represent if they are to be useful and not just a reflection of the views of the utility.

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<sup>45</sup> U.S. regulatory commissions came into being in substantial part as a result of public outcry over monopolistic abuse in several different industries. In most cases, they were able to deliver immediate public benefits, including rate reductions. Of course, the U.S. commissions also paved the way for a system in which investor ownership could compete with government ownership for public approval.

<sup>46</sup> In New York such utility consumer councils typically consist of some fifteen people who represent different types of customers (for example, large, small, commercial, people with different ethnic backgrounds, people living in apartments). They meet perhaps every two months with the senior management of the utility to discuss issues of customer concern. Perhaps once a year one or two of the commissioners meet with the council.

- A commission could also have its own consumer advisory council, consisting of representatives who could attend several meetings per year on topics of particular interest. Such meetings would, of course, tend to have more structure and purpose than a meeting with the general public. The results of these meetings, including the main questions and answers, can be written up in brochure form for a wider distribution to the public.
- A commission can also consider the use of advisory councils with technical or economic expertise to advise periodically on matters pending before the commission. Such councils might not only provide useful advice; their involvement would also enhance the credibility of commission decisions if the outside experts were in agreement with them. Regular consultations with individual outside experts — from academia, for example — are also worth considering.
- It is particularly important that a commission prepare detailed explanations of the reasons for its decisions.<sup>47</sup> Such material would be helpful to entities with a particular interest in the decisions of the commission, such as the utilities, organized customer groups, potential investors in the utilities, serious commentators in the media and staff and commissioners in future years. In the U.S. the absence of such a document would cause a court to reverse the decision, at least until it was explained well enough to permit judges to review it.
- Donor agencies could consider assistance to create and train Public Advocate offices inside or separate from the regulators in techniques of responsible public representation. At least half of the U.S. states provide for representation of the public through an agency of government apart from the Commission, such as an Office of People's Counsel (Maryland), Division of the Ratepayer Advocate (New Jersey), Consumer Protection Board (New York), Attorney General's Office (Massachusetts), Department of Public Service (Vermont), or Public Advocate (Maine). And in almost all states, part of the staff of the regulatory agency is separated from the Commission and acts as an advocate for consumers or for "the public interest" in most major proceedings.
- A few U.S. states (notably California) and several Canadian regulatory commissions (notably British Columbia and Quebec) provide (or require utilities to provide) financial assistance to customer groups intervening in particular cases. Overall assistance is less common, but a good case for such institution-building expertise exists in countries in which the basic consumer movement institutional infrastructure is lacking. Undertakings as basic as the distribution of informational newsletters are beyond the means of many customer groups at this time. Obtaining expert advice on energy and regulatory matters seems completely out of reach. It is hard to see how public interaction can become a reality until an informed public exists to interact with.
- Regulators need to make their principles known to the public outside of capital cities as well. In countries where travel can be difficult and the postal system is not reliable, regional offices used primarily for interaction with utility customers could also be very beneficial. Public meetings in other parts of the country would be a possible starting point. However, such measures are unlikely to have much impact unless they are part of a coordinated strategy.

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<sup>47</sup> The importance of a careful explanation of regulatory decisions goes beyond public interaction. As a basic U.S. administrative law summary states, "The aim is to urge the agency to give careful rather than cursory consideration, to keep it within statutory bounds, to assist judicial review of agency decisions and to develop a body of available precedent...Unexplained administrative actions may be inexplicable and unjustifiable. As Judge Frank once stated so well: '[A]dministrative agencies, when acting judicially, have an obligation to be as articulate as practically possible. For no aspect of a democratic government should be mysterious.'" Ernest Gellhorn, *Administrative Law*, (West Publishing Company, 1972), pp. 236-37.



- Surveys, perhaps in conjunction with "focus groups" could help to inform the Commission on the likely public response to certain types of decisions. The regulator cannot, of course, allow its basic tariff decisions to be made on the basis of public opinion, but that is quite different from seeking to understand the likely public response to types of decisions when success or failure of those decisions depends on changes in the public's behavior.
- Each utility could be required to have programs for customers with special needs (such as disabilities or the elderly). These programs can be developed through the consumer advisory councils or by special working groups set up by the utility.
- Commission proceedings must provide an early opportunity for significant public input. This is not to say that the Commission needs to adopt the judicial model often associated with U.S. regulation. Even in that system, which is sometimes criticized for offering excessive public participation and procedural requirements, ample opportunity exists to choose procedures that are applicable to particular situations. Informal or hybrid procedures based on public notice, access to information and an opportunity for comment before the decision have long been available as an alternative to fully litigated cases. In recent years, many commissions have experimented with alternative dispute resolution, mediation, and negotiation formats. In these proceedings, such safeguards as cross-examination and prohibition of *ex parte* contact are often relaxed relative to their application when a matter is decided through formal litigation. Even with such less formal processes, the need for a reasoned decision remains.



# VI. Designing Potentially Successful Energy Sector Reform Programs

This section will focus on ways to harmonize democratic governance with the goals of energy sector reform in order to create reform programs and processes that have a reasonable chance of success. It will focus both on the measures necessary to assure that legitimate public expectations are reflected in the reforms and on those necessary to secure and adjust the reforms in the inevitable situations in which they encounter a public backlash.

This chapter will discuss two emerging best practices for energy sector reform (i) involving stakeholders early and often; and (ii) protecting societal values in the restructuring process.

## Involving Stakeholders Early and Often

In most developing countries, energy sector restructuring is initiated by donors and lenders. The proposed law is drafted by consultants working with the relevant government ministries and with the legislative body but without significant public input. The law is enacted without a systematic process through which the stakeholders have a meaningful opportunity to be heard and to work together to craft solutions that a majority of them would find acceptable. It should thus come as no surprise when such restructuring processes lead to political crisis.

An alternative approach is a “collaborative process” of reform. As an example, the collaborative process that many U.S. states have used to formulate their restructuring plans is a unique outgrowth of the long U.S. tradition of extensive public participation in the regulatory process. As many parties wearied of the sterile interactions that occurred during formal litigation, a number of states began in the late 1980s and early 1990s to experiment with alternative dispute resolution procedures, public outreach programs and mediated forums of several sorts.

With the onset of electric restructuring, with its myriad of issues and affected parties, these various techniques for enhanced public participation were applied to amalgams of stakeholders that were more numerous and more diverse than had previously taken part in utility proceedings. As a result of these processes, the potential claims of many affected parties were identified early and became part of the grand restructuring bazaar that displaced formal adjudication as the preferred means of assembling the restructuring package in most states.

These procedures tended to place a premium on successful coalition building rather than on building a case through formal litigation. Because electric restructuring touched so many interests, many state legislatures concluded that they - and not the regulators - should set the underlying policies. Indeed, in some states, courts held that existing law did not give the regulators the power needed to adopt retail competition. Consequently, the collaborative processes often ran ahead of, in parallel with, and subsequent to, the overtly political legislative process. As a result, solutions that could command broad political support had an inherent advantage, a factor that helps to account for the predominance of solutions based on paying off the claims of many stakeholders, usually through “nonbypassable” (or mandatory) charges<sup>48</sup>, (i.e. systems benefits charges), as discussed below.

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<sup>48</sup> **Nonbypassable charge:** Any of several types of charges applied to all customer billings in a given region whether they receive service from a local utility or from a competitive supplier. These charges include transition charges, access charges, regional levies and taxes among others ([http://www.energyvortex.com/energydictionary/nonbypassable\\_charge.html](http://www.energyvortex.com/energydictionary/nonbypassable_charge.html)).

As a rule, these "collaboratives" were overseen by regulators and resulted in recommendations to the executive and legislative branches. The resulting legislation then provided the general restructuring framework, while leaving the specific implementation to the regulatory agency. In a few cases - notably New York - the collaborative process led directly to regulatory decisions implemented without separate action by the legislature.

While this approach has been the unique outgrowth of the United States' historical experience, it is illustrative of an approach that gives greater voice to stakeholders and therefore is germane to the subject of the role of democratic governance in energy sector reform. This type of approach is likely to be more appropriate in countries that have relatively well developed rule of law, traditions of public participation and strong civil society organization. Countries that do not share these characteristics may choose to explore an "achievable middle way" solution, incorporating aspects that are appropriate to the country's political and social realities, while also working to strengthen those institutions that encourage constructive public participation. The important issue is that designing energy sector reform programs with little or no public input is unlikely to produce favorable or sustainable results and therefore, stakeholders ought to be involved early and often.

### **Protecting Societal Values Woven into the Existing Industry Structure**

In many jurisdictions, "power sector reform" will expose certain expectations that have been built into many years of experience with the existing electric system. Those who have benefited from the inefficiencies of the existing system have a strong and understandable reason to claim that fairness requires their accustomed benefits be protected during any transition, and perhaps beyond. In this regard, the similarities of many stakeholders—investors faced with stranded assets<sup>49</sup>, municipalities faced with declining property taxes, workers faced with the prospect of job losses, and customers faced with substantial rate increases and unprecedented disconnection for nonpayment—are much greater than the differences.

Every country has such impacts and such claimants.<sup>50</sup> To say that the U.S. experience with potential stranded investment is irrelevant to, for example, the Indian experience with discontinuing free electricity for farming, is to misunderstand the fact that the investors and the farmers are asking for the same thing for the same reasons. Neither claim is supportable in the context of economic efficiency, but both also press claims based on long reliance and other

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<sup>49</sup> "Stranded assets," or "stranded investments," are the assets of a regulated utility that are not used due to changes in technology or in economic conditions. The utility is no longer able to recover the cost of the asset through traditional rate-making models. Similarly, "transition costs" are utility costs that have not yet been recovered through electricity rates and are now above market costs.

<sup>50</sup> Consider the applicability of the following, written about the U.S. experience, to restructuring in other countries:

Any major change in regulatory policy... requires some market participants to incur stranded costs, i.e. one time changes in wealth attributable to the change in regulatory policy. Stranded costs are inevitable when a change in regulatory policy increases the efficiency of a previously regulated market. The prior regulatory system inevitably induced the firm to have to hire too many employees, to pay excessive wages, to make excessive investments in capital assets, to invest in the wrong mix of capital assets.....Elimination or relaxation of regulatory constraints and introduction of competition forces many market participants to restructure their operations to eliminate excessive costs.

No market participant willingly bears large stranded costs. Participants in a regulated market that expect to absorb large stranded costs as a result of a proposed regulatory reform engage in a series of actions designed to avoid incurrence of these costs or to reduce the magnitude of the costs each must absorb. These actions include: attempts to block regulatory reform, attempts to delay regulatory reform, and attempts to convince legislatures, agencies and courts to reallocate stranded costs to other market participants. Proponents of regulatory reform often must devote more time and energy to disputes concerning allocation of stranded costs than to all other aspects of the process of regulatory reform. Richard Pierce, Jr. and Walter Gellhorn, Regulated Industries, (4<sup>th</sup> Ed, West Group, St. Paul, Minn., 1999), pp. 399-401.

social considerations. Because most countries have long believed that considerations other than pure economic efficiency are important in this vital industry,<sup>51</sup> such claims must be carefully heard and wisely resolved.

Furthermore, those pressing these claims have in one way or another the potential to slow and stymie the restructuring process to such an extent that their societies may find it easier to buy them out than to insist that they accept the necessary changes regardless of the disadvantage to them. There are a number of useful techniques for identifying these impacts, for presenting and considering them.

Restructuring in the U.S. - with its emphasis on retail customer choice - entails impacts quite different from those to be expected in Asia, Africa, Latin America, Eastern Europe or the former Soviet Union. Nevertheless, there are techniques for identifying, negotiating and mitigating those impacts that may be useful in other countries as well. The following section sets forth the disadvantageous impacts that U.S. states have sought in one way or another to mitigate. It also discusses the substantive and procedural mitigation techniques that have been employed and offers some observations on their possible applicability in other countries. While substantive solutions should not be confused with good governance per se (after all, attention to social impacts can also be paid by benign dictatorships), it is worth outlining possible mitigation techniques that respond to public claims, whether voiced or unvoiced.

### **Low Income Assistance Programs**

Low income customers (usually defined in terms of eligibility for other assistance programs) have for many years benefited from assistance rolled into traditionally set U.S. utility rates. This assistance has taken the forms of reduced rates as well as bill payment by the government. Other forms of assistance included targeted energy efficiency measures (particularly weatherization and limitations on the utility right to disconnect for nonpayment).<sup>52</sup>

One can formulate some generic principles to assure that restructuring programs do not unduly disrupt the social welfare considerations woven into existing utility systems and thereby avoid much of the political backlash that they have encountered to date.

No program of tariff increases and customer disconnections should go forward under circumstances in which poor customers are likely to be disconnected because they cannot pay the cost of a reasonable amount of electricity and/or gas. Subsidy systems should be reformed

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<sup>51</sup> For example, "The people we (public officials) serve are citizens as well as consumers, and they are entitled to public utility services that address their needs and concerns as citizens, not just their pocketbook concerns as ratepayers. As citizens, we share common concerns about the health of the environment, the well-being of our neighbors, the security of the nation, and the needs of future generations." Cowart, 1997, p. 53. See also Yergin and Stanislaw, 1998, "The economic tests are eminently measurable....The second set of tests cannot be expressed in figures, but it is no less powerful. It goes to the basic values by which people judge the world, the system in which they live, and their own lot....How widely shared is the success? Is the system fair and just? Or does it disproportionately benefit the rich and the avaricious at the expense of the hardworking of more modest circumstances? Does it treat people decently, and does it include the disenfranchised and the disadvantaged? Are there equity, fair play and opportunity?", p. 383.

<sup>52</sup> However, a clear precedent for allocating the cost of such programs across all suppliers was set in the U.S. federal Telecommunications Policy Act of 1996. This law required the use of a nonbypassable fee to create a universal service fund of several billion dollars, to be designed by the Federal Communications Commission). This fund provides support for universal service, lifeline, rural areas, and handicapped users, as well as discounts for schools, hospitals and rural health facilities. Much of the information in this section is from Jerrold Oppenheim and Theo Macgregor, *Low Income Consumer Utility Issues*, a report to the Utah Low Income Task Force, October 1999. The authors observe that low income assistance programs are likely to be cost beneficial for all customers when full account is taken of the impact of uncollectibles on the utility bills of other customers as well as reduced collection costs and reduced taxpayer costs as a result of such impacts as homelessness.

to extend support primarily to those who needed it. Often, the removal of subsidies from those who can afford to pay coupled with a firm collection policy will bring in enough money to offset the cost of such a program. Where such funds are not likely to be freed up promptly by reform measures, donor assistance along the lines of that provided by USAID in Georgia might do much to eliminate a strong source of resistance to sectoral reform.

In addition, any reform program that includes customer disconnections must be preceded by a careful program to assure that payment information is accurate. Disconnection of customers who have fully paid their bills is certain to undermine the credibility (among all customers, not just the poor) of the entire reform process and cannot be tolerated. Until metering and collection procedures have reduced the likelihood of mistaken disconnections to a level to which the regulatory agency can quickly respond, an aggressive disconnection program will be counterproductive.

### **Employment Impacts**

With the onset of restructuring, U.S. utility managements for the first time had to examine their payrolls aggressively. The International Brotherhood of Electrical Workers estimates that jobs in the electric sector declined by 27% in the first five years after California announced its decision to establish retail choice. In the face of this pressure, utility workers and utility investors became allied in a formidable coalition opposed to the retail choice aspects of restructuring until their interests were safeguarded.

In fact, very few of the lost jobs in the U.S. electric industry have resulted in layoffs. The workforce reductions have largely been achieved through attrition, early retirements and buyouts. Retraining agreements and agreements limiting the pace of workforce reduction have also been commonplace. In addition, increased use of bonuses and other forms of incentive compensation have increased management's ability to control its labor costs.

Here again the nonbypassable charge has been a favored vehicle for financing the transition costs. The California Competitive Transition Charge, for example, includes the retraining and severance costs incurred in the first four years of retail competition. The Connecticut restructuring law also provides explicitly that such costs are to be included in the transition charge.

The collaborative nature of the restructuring process assisted consumer groups and labor unions in discovering their common interest in maintaining high service quality standards. For the customers, the reasons were self-evident; for the workers such standards were a safeguard against rapid downsizing with its potential for reduced reliability and increased customer complaints. This linkage was driven home to regulators when several telephone companies experienced substantial delays in key customer service indexes as a result of excessive workforce reductions in the mid-1990s.

In many developing countries, excess jobs – even “no-show” jobs – in the energy sector have functioned as part of the national social welfare network<sup>53</sup>. Those designing restructuring need to be mindful that the efficiencies obtained by eliminating these jobs need to be accompanied by

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<sup>53</sup> The same is true of many categories of subsidy to customer groups. For example, in Georgia some of the categories receiving either free electricity or a 50% discount included invalids of World War II (13, 900 customers), families of those injured or killed cleaning up the Chernobyl nuclear power plant accident (3,000 customers), employees of the Ministry of Internal Affairs and their families (60,000 customers), people employed in psychiatry (2,000 customers) and victims of political repression (3,000 customers). None of these customers were required to establish that they were too poor to pay for electricity.

adjustments to the state welfare system if economic hardship (and attendant political discontent) are to be avoided.

### **Reliability and Service Quality**

The responsibility of U.S. regulators to set service quality standards is as old as regulation itself. Of course, a regulator's duty and ability to set standards for the distribution network is not fundamentally changed by restructuring. The state legislation that has passed to date is either silent on this topic or contains a mandate that service quality must not decline. However, such mandates do little to address the difficult issues of changing institutional responsibility presented by restructuring in the U.S. or elsewhere.

Some commissions have sought to deal with these impacts by adopting enforceable service quality standards. In order to be sure that utilities under cost pressure do not defer necessary maintenance, some commissions have linked service standards to ratesetting in a way that rarely existed under traditional ratesetting<sup>54</sup>. This linkage is characterized by substantial penalties - much larger than ordinary fines - in the event of failure by the utility to meet its customer service obligations in such areas as service restoration times, complaints to the commission or response times to customer requests. The penalties may also include direct payments to aggrieved customers for such offenses as failure to appear for service connection appointments.

An emphasis on reliability in developing countries will take different forms but may have considerable political benefit. Because service is so often substandard, a regulatory regime that brings real improvement will also bring political benefit. This is doubly true if the improvement precedes - or at least accompanies - any necessary rate increases. Furthermore, service quality commitments are popular with work forces concerned about job cuts, so they are a potential basis for alliances between customer and employees in support of reforms.

### **Rate Shock**

As noted earlier, both legislatures and regulators implementing restructuring have generally sought to avoid rate increases to any class of customers and have tended to endorse equal distribution of the savings among customer classes. This concern has less to do with universal service than with public acceptance of restructuring. Because U.S. restructuring came during a time of declining costs, most utilities have been able to commit to long-term freezes, often coupled with substantial reductions. The largest rate reductions tended to go to large users, but this was less controversial when all customers are getting rate reductions.

In other nations, where substantial rate increases are often an inevitable part of energy sector reform, ways to cushion and smooth these increases over time are a critical part of making restructuring publicly acceptable. This provides an opportunity for groups speaking for consumers to negotiate or advocate on behalf of such measures as energy efficiency, increasing revenues by reducing line losses and corruption and a gradual phase-out of subsidies.

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<sup>54</sup> Barbara Alexander, *How to Construct a Service Quality Index in Performance-based Ratemaking*, Electricity Journal, April 1996, p. 46.

## Corruption

Nothing contributes more rapidly to public disillusion with reform than a sense that decisions are being influenced illegitimately, through the paying of bribes or by less direct methods.

Before the California energy crisis and the collapse of Enron, the U.S. prided itself on the relative absence of direct corruption in its regulatory processes and in its restructuring. Until those two events, it was possible to assert that the U.S. learned its lessons about the harm that

In 1997, Vietnam launched a demand-side management plan to help curb the exploding electric power demand (15-18% per year) needed to fuel its substantial economic growth. Concurrently, the electric power utility, Electricity of Vietnam (EVN), had been under pressure from the World Bank and other donors to continue to rationalize tariffs to full cost-recovery levels. EVN was concerned with public response to the increase and, thus, timed the launch of some of their energy efficiency lighting programs to coincide with the planned tariff hike, which took place October 1, 2002. The idea was to try and help residential customers reduce their energy usage in an effort to at least partially offset increases in their electricity bills from the tariff hike. Public response to the energy efficiency programs was overwhelmingly positive and several customers and media outlets praised EVN for helping customers offset the effects of the tariff increase. The positive response was also evident from the results of the energy efficiency lighting program; during the month of October 2002, sales of efficient fluorescent tube lamps and CFLs increased by more than fivefold.

can accompany corrupt and inadequate regulatory processes many years ago, in the utility holding company scandals of the 1920s. As a result of these lessons, most U.S. regulatory jurisdictions employed a significant array of measures to prevent illegitimate influence. However, it now appears that these safeguards were insufficient to prevent immense harm to customers and investors as well as to public confidence in restructuring. Indeed, no state has gone forward with electric restructuring in the U.S. since the California crisis, and several states have delayed restructuring programs or suspended them altogether.

It is now clear that illegal conduct occurred and that other conduct took place that should have been illegal. That said, the U.S. record on regulated energy sector corruption nevertheless remains a relatively good one, reviewed over decades. Even with the recent scandals, its underpinnings are worth understanding, given the extent to which real and perceived corruption haunts restructuring in some nations.

These protections include not only the encouragement of public involvement but measures to assure transparency, measures to

assure independence, rules against *ex parte* contact and codes of ethics. At times regulators and participants chafe at the delay and awkwardness imposed by these procedures and at times they violate them. Nevertheless, U.S. regulators have made decisions in the last five years reallocating the flow of tens of billions of dollars in annual revenues with only a few instances of scandal. To those who have worked on restructuring in many nations, this is not a small achievement.

## Energy Efficiency Programs

Programs to educate the public regarding efficient use of energy and to promote such efficiency are a desirable part of a reform package in that they can reduce energy bills for both individuals and for the nation. In rapidly growing societies, applying current energy efficiency best practices to new buildings is likely to reduce future investment requirements substantially, with a large savings to the nation's future electric bill as well as to its environment.



The choice of tariff methodologies is also critical to the furtherance of cost effective energy efficiency. Methodologies that reward utilities for selling energy but not for saving it will create a powerful political constituency opposed to energy efficiency. However, failure to include energy efficiency in energy sector reform programs is a lost opportunity for coalition building across civil society. The interest of environmental organizations in reducing air emissions and avoiding new construction is one pillar of such efforts. The interest of customers in reduced bills is another. In addition, energy efficiency is relatively labor intensive and provides opportunity for an enhanced and constructive level of utility contact with the customers.

In light of the above, one can formulate some generic principles to assure that restructuring programs do not unduly disrupt the social welfare considerations woven into existing utility systems.

- No program of tariff increases and customer disconnections should go forward under circumstances in which poor customers are likely to be disconnected because they cannot pay the cost of a reasonable amount of electricity and/or gas.
- Any reform program that includes customer disconnections must be preceded by a careful program to assure that payment information is accurate. Disconnection of customers who have fully paid their bills is certain to undermine the credibility of the entire reform process and cannot be tolerated. Until metering and collection procedures have reduced the likelihood of mistaken disconnections to a level to which the regulatory agency can quickly respond, an aggressive disconnection program will be counterproductive.
- Subsidy systems should be reformed to extend support primarily to those who need it. Often, the removal of subsidies from those who can afford to pay coupled with a firm collection policy will bring in enough money to offset the cost of such a program.
- Where such funds are not likely to be freed up promptly by reform measures, this is an especially promising area for donor assistance in order to eliminate a strong source of resistance to sectoral reform.
- Involve labor unions early and often to develop mutually acceptable methods of mitigating against negative employment impacts that focus on shared interests.
- Consider non-bypassable charges as a vehicle for financing transition costs of employee rationalization.
- Where rate increases are an inevitable result of energy sector restructuring, ensure that the increases are spread over time and that consumers have all available information regarding the rationale behind the increases, the level of the increases, and the timing of the increases.
- Ensuring transparency and accountability are essential components to decreasing corruption and thus increasing public confidence in sector reforms. Therefore, these factors must be openly incorporated into any energy sector restructuring process.



## VII. Conclusion

In summary, this paper has examined the commonalities between energy sector reform programs in developing and transition countries and programs seeking to build capacity for democratic governance there. It has briefly reviewed the history of energy sector reform, the interplay between energy and democratic governance, the convergence of these two sectors—largely in the form of independent regulatory bodies—and, broadly speaking, how that convergence can be utilized to design energy sector reform programs that have a greater likelihood of being effective, efficient and sustainable.

Many of the examples have been drawn from the U.S. experience in energy sector restructuring and, while this experience provides some valuable lessons, the U.S. model of energy sector restructuring is not set forth as the only or best way to undertake reforms in the energy sector. Rather, the lessons learned from the U.S. experience, coupled with the experience of two decades of energy sector reforms worldwide, provides for some general principles and best practices. *These best practices consist of including the public early and often, protecting societal values during the restructuring process, and mitigation of harmful social impacts of restructuring.*

These best practices also provide some useful guidelines for bilateral and multilateral donor agencies seeking to strengthen the energy sectors of developing countries. Donors should acknowledge that energy reform programs that are designed with a view only to the technical requirements of the sector are likely to fail in that they ignore the social and political dimensions inherent in energy sector reform. *Donors should consciously incorporate democratic governance principles of transparency, accountability, efficiency, and rule of law into all energy sector reform programs.*

Equally important, donors must recognize that energy sector reform does not occur in vacuum. Single sector, stove-piped, reform programs are both inefficient and ineffectual. *Successful energy sector reform requires that donors and host governments pay attention not only to strengthening the energy sector, but also to strengthening the institutions of democracy, such as legislatures and courts, so that governments are able to make credible commitments over time and thus attract private sector investment.*

Finally, it should be noted that sometimes energy sector reform programs that have tried to focus on including the public have really been about public relations and social marketing of reform efforts to achieve public buy-in. While public relations and social marketing certainly play a vital role in educating citizens about energy sector reforms, they only address part of the predicament. The part that often receives less attention is the strengthening of and civil society so that citizens have a meaningful voice in the energy decisions that affect their lives. *This civil society building aspect is as crucial as the education component and should be deliberately included in energy sector reform programs. A clear example of the diversity both of organizations and of approaches was on display at the USAID “Public Participation and Understanding Energy” Symposium, Cape Town, South Africa, March 16-18, 2004. A CD record of the symposium is available from USAID.*

Successful and sustainable energy sector transformation is dependent on involving stakeholders early and often, and to that extent, the energy sector and the democracy and governance sector are inextricably and powerfully linked.



# Annex A: Definitions of basic terms: Energy Sector Reform, Governance & Democratic Governance

It is important to place boundaries around this discussion by carefully limiting what we mean by such broad and even vague terms as “energy sector reform” and “democratic governance.” These are working definitions and are not intended to be academically exhaustive.

**Energy sector reform:** Energy Sector Reform is activity to improve the financial, technical, social, and environmental performance of the sector in providing clean, affordable and reliable energy services to as many people as possible. While this paper is largely about electricity sector reform in particular, the principles and lessons derived from the study are useful and valid for other energy sectors, such as the oil and gas sectors.

**Governance:** In its simplest form, governance refers to the process of decision-making and the process by which decisions are implemented. In broad terms, governance involves the institutional environment in which citizens interact among themselves and with government agencies and officials. The term governance can be used in several contexts such as corporate governance, international governance, national governance or local governance. This study restricts itself to governance by national, state and local governments.

A definition of governance that will be particularly useful in this report is that of Kaufman<sup>55</sup>: Governance is government—the process and set of institutions by which authority in a country is exercised: (1) the process by which governments are selected, held accountable, monitored, and replaced; (2) the capacity of governments to manage resources efficiently, and to formulate, implement, and enforce sound policies and regulations; and (3) the respect for the institutions that govern economic and social interactions among them. Note that this definition is not normative, it can describe good—or bad—governance practices.

Development agencies are concerned with “good” governance and each has adopted its own working definition. Here are two that will give the reader a good sense of what the development community believes is “good” governance.

The United Nations Economic and Social Commission for Asia and the Pacific (ESCAP) identifies eight components of good governance:

- Consensus oriented
- Accountable
- Transparent
- Responsive
- Equitable and inclusive
- Effective and efficient

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<sup>55</sup> Daniel Kaufmann, Aart Kraay and Pablo Zoido-Lobaton, “Governance Matters,” (Washington DC: Policy Research Working Paper 2196, World Bank, 1999)

- Follows the rule of law
- Participatory

The U.S. Agency for International Development (USAID) includes aspects of democracy in defining governance. USAID defines governance as “The ability of government to develop an efficient, effective, and accountable public management process that is open to citizen participation and that strengthens rather than weakens a democratic system of government.” The USAID definition adds that “democratic governance” refers to the political dimensions of the public management process: transparency, pluralism, citizen involvement in decision-making, representation, and accountability.

It is fair to say that several aspects of good governance—those that deal with efficiency—are rarely subjects of debate. All forms of good government, from the far left to the far right, strive for effective and efficient uses of resources. No aspects of governance, however, are more controversial than those that deal with how government interacts with its people.

Democratic Governance: Frischtak<sup>56</sup> defines democratic governance as “the ability to coordinate the aggregation of diverging interests and thus promote policy that can credibly be taken to represent the public interest”. This report’s authors choose to slightly modify this definition and use it as our working definition and way of thinking about democratic governance: *“The ability to coordinate the multiplicity of diverging interests, freely expressed by an informed public, into policies generally accepted as representing the public interest.”* This draws from the notion of a “liberal democracy” meaning: a political system marked not only by free and fair elections but also by the rule of law, a separation of powers, and the protection of basic liberties of speech, assembly, religion, equal treatment and property.<sup>57</sup>

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<sup>56</sup> Leila Frischtak, “Governance Capacity and Economic Reform in Developing Countries,” (Washington, DC: Technical Paper No. 224, World Bank, 1994)

<sup>57</sup> Zakaria, 2003

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