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The World Bank

1818 H Street NW

Washington DC 20433

Telephone: 202-473-1000

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Chile - General - 1v

2918.03 PROJECT FILES FOR COMPLETED PROJECTS.
CHILE - GENERAL - 1992.

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OFFICE MEMORANDUM

DATE: May 11, 1993

TO: Paul Meo, Chief, LA4TF

FROM: Danielle Berthelot, LA4TF

EXTENSION: 31980

SUBJECT: CHILE - Regulatory Work in Electricity and Gas

RECEIVED

93 MAY 12 PM 4:07

RICHARD STERN, IENDR

1. A mission comprising an electricity specialist --Mr. Bakovic (IENPD), a gas specialist --Mr. Brierley (IENOG), a lawyer specialized in regulatory issues --Mr. Stewart-Smith (LEGEC), and myself visited Chile from April 22 to 30, 1993 to discuss the revision of the electricity and gas regulatory framework with the National Energy Commission (CNE) and the Ministries of Economy and Finance.

2. The mission agreed with the Government: (i) to hold for a while the revision of the electricity framework; and (ii) to accelerate the revision of the gas framework along the lines agreed in the field with CNE and the Economy and Finance Ministries.

3. These agreements were discussed upon the mission's return to Washington and confirmed in the attached letter to the Ministers of Economy and Finance as well as to the CNE's President. The letter also outlines the process and timing of the revision of the gas regulatory framework, the profiles of Chilean and foreign consultants that would be involved in the process as well as key issues to be addressed under their Terms of Reference.

4. Electricity. CNE's current strategy is to undertake minor revisions of the electricity law, for example the way in which distributions tariffs are calculated and fixed as well as the toll system of transmission. CNE has been discussing directly with key electricity firms to secure their support when those minor legal reforms would be discussed by Parliament, obviously before the change of Administration in December 1993. For that reason, CNE is very reluctant (at this stage) to touch on basic issues related to improving the overall transparency of the Chilean electricity sector, particularly sectoral issues related to competitive behavior, information flow and consumer protection. Although CNE had embarked in the process which we had agreed on last fall and had completed a preliminary diagnostic with local consultants, it became evident during the mission that the CNE did not want to either sharpen or deepen the analysis carried out under the preliminary diagnostic. Furthermore, the CNE no longer wanted to discuss possible legal reforms in a seminar aimed at objectively reaching a public

KJ/HR
interesting stuff.
Should be
get the
regulatory
group in
involved
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consensus on required electricity reforms. The mission argued against such fundamental changes in the reform strategy but finally had to agree with CNE that it would be rather confusing and therefore risky to keep on pursuing a long-term strategy for major electricity reforms while at the same time trying to secure short-term agreement with private electricity firms on minor reforms. CNE's President preferred that the Bank withhold its assistance to identify long-term reforms until the CNE could establish the feasibility of actual legal reforms before the change of Administration.

5. Gas. There was a keen interest of the three government entities, i.e. Economy, Finance and the CNE, in discussing the regulatory and legislative environment enabling the large scale import, transport and distribution of natural gas from Argentina --the Neuquen Basin. This project, which would cost the equivalent of about US\$one billion, is now the object of a confrontation between two politically powerful Chilean private sector consortia: one led by the electricity distribution company Chilectra, with a small participation of the Chilean state oil company ENAP; the other with a large representation of the Chilean companies which are now distributing to the main urban centers the little amount of gas produced in the south of the country. Since the prospective gas market is not considered as being able to support two distinct consortia, the Chilean Government would like to see the two private consortia join forces in developing the project. Discussions between the consortia have reached a dead end. Furthermore, under repeated pressures from individual private companies of the consortia, the Government, under the leadership of the Economy Ministry, has finally come to recognize the urgency of clarifying the regulatory and legislative environment under which the private project will take place. This is the context in which our assignment took place last month.

6. ~~6.1~~ Owing to the urgency mentioned above and the fact that the government team in charge of developing the gas regulatory and legislative framework --CNE's gas group; Economy Ministry's group in charge of sectoral policies; and the advisor to the Finance Minister-- did not seem to have much experience in gas regulations due to the paucity of natural gas in Chile, the mission structured with the team the analysis of a possible gas framework for Chile. The objectives, process and basic issues of the analysis were discussed in detailed and agreed terms of the work to be carried out to prepare the gas regulatory and legislative framework were summarized in a document for the consideration of the Ministers of Economy and Finance and the CNE's President.

7. This document was faxed to the three Ministers last Friday, at the request of the Economy Ministry's official in charge of Sectoral Policies who wants to organize this week a meeting between the three Ministers to discuss the approach developed with the Bank mission. This approach calls for a workshop on regulatory alternatives in October 1993. During the workshop,

the Bank and the Government would identify the steps necessary to implement the preferred regulatory and legislative framework. Steps that are already foreseen as requiring significant technical assistance include institutional support to the new regulatory framework and regime of gas concessions. Preparation during the next five months will require close supervision, especially on the part of the gas specialist, Christofer Brierley.

8. I coordinated with the IDB, particularly with the manager of the Multi-Investment Fund, to ensure that there was not overlapping of responsibilities in assisting the Chilean Government with the development of the gas framework. This was also discussed with key officials of the Government, particularly of the Finance Ministry, during the mission. While there will always be the risk of seeing the Government of Chile being tempted to finance consulting assignments with grant funds, the specificity and sensitivity of the gas regulatory assignment will make it difficult for the Government to switch from one development institution to another one.

9. Next Steps. i) Electricity. The CNE's President indicated that he will confirm the joint position of the Ministries of Finance and Economy and of the CNE before the end of this month.

ii) Gas. The Ministry of Economy will call a meeting between the Ministers of Economy and Finance and the CNE's President on the development of a new gas framework. The Bank gas specialist, Christofer Brierley, should visit Santiago in late June 1993 and in early September 1993 to review: the analysis done by Chilean consultants; the selection of foreign consultants and later their contributions to the analysis; and finally the preferred regulatory options that would be submitted for discussions in the October 1993 workshop.

Attachments

cc. Messrs./Mmes.: Stern (IENDR); Loh, Rowat, Hanson, Miller (LA4DR)
Dowsett-Coirolo, Levy, Williamson (LA4CO)
Alber (LA4TF); Sanchez, Araujo, Kriegler (LA4IE)
Moscote (LATAD); Jechoutek, Bakovic (IENPD)
Razavi, Khelil, Nore (IENOG)
Collell, Carvalho (LEGLA)
Webb, Stewart-Smith (LEGEC)
LAC Files, Div. Files, Div. B.B.

May 7, 1993

Mr. Jorge Marshall, Minister
Ministry of Economy
Teatinos 120, Piso 10
Santiago, Chile
Fax: 56-2-696-6305

Mr. Jaime Toha González, Minister President
National Energy Commission
Teatinos 120, Piso 7
Santiago, Chile
Fax: 56-2-695-6404

Mr. Alejandro Foxley Rioseco, Minister
Ministry of Finance
Teatinos 120, Piso 12
Santiago, Chile
Fax: 56-2-698-1663/696-4798

Re: CHILE - Regulatory Work in Electricity and Gas Mission

Dear Messrs. Ministers:

Following the visit of Ms. Danielle Berthelot and Messrs. Bakovic, Brierley and Steward-Smith last month to discuss the revision of the electricity and gas regulatory framework with the National Energy Commission (CNE) and the Ministries of Economy and Finance, I am pleased to inform you of the conclusions of the Bank mission.

Regarding the improvement of the electricity regulatory framework, we have been considering the intention of the Government of Chile, at CNE's recommendation, to focus on minor reforms of the electricity regulatory framework in the coming months. We therefore concur with Minister Toha that it may be appropriate to hold for a while the preparation of the three-step reform approach that was initially envisaged. This approach, which includes a local diagnostic of regulatory issues, foreign consultations and a public seminar to form a consensus on changes required in the electricity law, would not be congruent with the reform strategy that the Government and the CNE have currently in mind. The Bank would however stand ready to resume assistance along the lines initially agreed as soon as the Government sees it appropriate.

Regarding the preparation of the reform of the regulatory and legislative reform to enable large scale import, transport and distribution of natural gas, the mission has had a fruitful work with the CNE's and Finance and Economy Ministries' team. They jointly developed a working document (which is attached), focusing on the reform preparation process and timing, profiles of both Chilean and foreign consultants as well as the key issues to be addressed in the studies' Terms of Reference. The reform preparation process encompasses a seminar open to Government officials and key representatives of the private sector and Universities in October 1993, to try to reach a consensus objectively on what would constitute the preferred --yet financially feasible-- regulatory and legislative framework for the import and distribution of natural gas in Chile. This last step is very important as it would not only facilitate the introduction of a new gas legislation but also help identify specific regulatory and institutional development measures that would be needed to efficiently and timely implement the new gas regulatory framework.

Sincerely,



Paul M. Meo

Chief

Trade, Finance & Private Sector Development Division
Country Department IV
Latin American and Caribbean Region

Attachment

cc: Mr. Nicolas Flaño
Executive Director, World Bank

GAS REGULATORY AND LEGISLATIVE FRAMEWORK

PREAMBLE

1. Objective and Process

The Government of Chile is preparing a reform of the regulatory and legislative framework to enable large scale import, transport and distribution of natural gas. Preparation will be done in four distinct steps:

- a diagnostic by Chilean consultants of issues that would need to be addressed to permit the purchase, transport and distribution of gas and preferred options to resolve such issues, taking into account constraints imposed by the feasibility of financing preferred options;
- a critical review of this diagnostic and optimization of options by foreign consultants, working closely with the Chilean consultants;
- a financial assessment by an international financial institution of the feasibility of financing the preferred options emerging from the joint Chilean / foreign diagnostic. A short iterative process of consultations between the Chilean and foreign consultants on one hand and the financial advisers on the other hand is expected to lead to the development of a final set of preferred options with a good probability of success in obtaining finance;
- a seminar to debate the set of preferred options, with the objective of developing a form of public consensus on what would be the preferred -- yet feasible financially-- regulatory and legislative framework for the import and distribution of natural gas in Chile. To try to reach the consensus objectively, the seminar will include participation of key government officials, representatives of private sector and of Universities as well as international gas specialists.

2. **Timing**

The Seminar is tentatively scheduled in October 1993. To reach this deadline, Chilean consultants should be recruited in May 1993. It is expected that the foreign consultants will be providing feed back to their Chilean counterparts on the emerging preferred regulatory options in July 1993 and that financial advisers will assess the financial feasibility of the joint set of options suggested by the Chileans/foreign consultants in September 1993. International gas specialists should be approached for participation in the Seminar as early as possible, by the end of June 1993 at the latest.

GAS : CONSULTANT PROFILES

It is recommended that the consultants appointed meet as closely as possible the following profiles:

1. Chilean Consultants

- **Independence**

The Chilean consultants should be completely independent from any of the parties interested in the gas pipeline project in order to form an objective view of the issues

- **Utility experience**

They should have a good working knowledge of the role of utilities, preferably with some direct experience.

- **Skills**

They should have a high level of expertise in the following disciplines:

- (a) economics
- (b) engineering
- (c) Chilean law

They should have experience in working with foreign specialists.

- **Resources and Time Commitment**

They should have adequate support staff in order to produce the report independently and in a confidential manner. They should also have the capability and time to play a prominent role in the setting up and running of the Seminar.

2. Foreign Consultants

- **Independence**

The foreign consultant(s) should likewise be independent from any of the interested parties.

- **Utility experience**

The foreign consultant(s) should not only have an excellent understanding of utilities, but also particular expertise in the issues which arise in the gas industry. In addition, the foregoing consultant(s) should have direct experience of regulation in practice and knowledge of different regulatory systems.

- **Skills**

The consultant(s) should also have the ability to think conceptually in order to develop new solutions tailored to the needs of the project.

- **Time commitment**

The foreign consultant(s) should be prepared to commit a significant share of his time exclusively to the diagnostic and yet be prepared to be actively involved in the Seminar.

3. Financial Advisers

A respected and well-known international financial institution with particular experience in the financing of private sector utility companies and projects.

They must be prepared to give advice to the Chilean Government on the potential impact on the availability of financing as a result of the emerging preferred options. They should also give guidance to the consultants in their development of the preferred options which will be presented for discussion in the seminar to give a high probability of success in obtaining finance.

KEY ISSUES FOR GAS TERMS OF REFERENCE

It is recommended that the Terms of Reference for the Chilean and foreign consultants appointed for the diagnostic in respect of the development of the gas pipeline project should require their reports to contain a precise summary of the advantages, disadvantages and consequences of each of the following key issues (but not so as to exclude any other important issues which may arise from the study):

1. **Division of Ownership**

The gas supply system envisaged involves a high pressure transmission pipeline, part of which is to be in Argentina and part of which is to be in Chile. There will also be local distribution systems for the cities to be served.

One option would be for the entire system to be owned by a single company, which would be responsible for the purchase of gas at the well-heads and its sale to end-users.

Alternatively, different companies could own the different segments of the system and the buying and selling functions could also be split.

Integration or separation can have significant effects upon monopoly power and transparency and as a consequence, on regulatory effectiveness.

2. **Open Access / Common Carrier**

There are three basic options:

- ***no open access / no common carriage obligation*** : this means that the pipeline owners could refuse to allow any other party to use their pipelines; this gives total freedom of contract thus limiting the prospects for competition. A consequence of this will be a need for very close regulation of the full monopoly power.
- ***open access obligation*** : this means that the pipeline owners must provide a service to others who wish to have their gas carried, but only up to the limit of the capacity of the pipeline. Of course, the pipeline owner may charge proper

fees for providing the service. In some cases, the pipeline owner may publish a tariff whereas in other cases, each request for the service must be individually negotiated.

Open access obligations may be placed on either the transmission system only, or on both the transmission system and distribution system operators.

The terms on which the service is provided may need to be subject to regulatory supervision to ensure fair treatment between all applicants.

- ***common carrier obligation***: this means that the pipeline owners must provide a service to others who wish to have their gas carried, but when the pipeline is full the pipeline operator must take steps to enable him to carry the additional gas either through scaling down existing quantities or increasing the capacity of the system.

Common carrier obligations may be placed on either the transmission system only, on both the transmission system and distribution system operators.

The terms on which the service is provided may need to be subject to regulatory supervision to ensure fair treatment between all applicants.

3. **Direct Purchasing**

By direct purchasing, we mean the ability of consumers or distributors to purchase gas directly from the producers.

There are two principal options:

- ***no direct purchasing***; which means that distributors can only buy from the transportation company, and the consumers can only buy from the distributors. This will require the heaviest regulation.

It is also an option under this to allow large consumers to purchase directly from the transportation company.

- *to allow direct purchasing*; there are several options: to allow distributors only to purchase direct from the producers; to allow distributors and large customers; to allow distributors, large customers and the transmission pipeline operator.

With regard to "large customers", this may be defined or simply left to the market. ie. any customers.

With regard to the level of regulation, the more open the system, the more competitive the market can become, and competition generally assists regulation.

4. **Regulation of Prices**

There are three options:

- *no price regulation whatsoever*; if the energy market acts as a sufficient constraint on natural gas prices in all markets, this could be the best arrangement.
- *fully regulated prices* in the form of published tariffs under the control of the regulator and calculated on the basis of a published methodology.
- *partially regulated prices*; some defined degree of flexibility for the company or companies to set prices with reserve powers to the regulator to intervene in the case of abuse.

Each segment of the system needs to be considered separately as does each market. In particular, consideration should be given to non-discrimination on prices, especially for large consumers. ie. is gas to be sold on a cost related basis or simply at the prices which each market will bear.

5. **The rights and obligations of the companies**

It is assumed that no entity may enter the gas supply business without first having obtained from the Government a Concession or some similar authorization which defines the scope of the business to be carried on under it.

It will be necessary to consider the rights and obligations of the concessionaire, treating transportation and distribution separately. These rights and obligations would include the following:

- the geographical scope (eg. one or more distributors in Santiago?)
- the duration
- exclusivity
- rights to enter / obtain land on fair terms
- public service obligations (eg. continuity of supply, right for end users to be connected, customer service standards, non-discrimination between customers and classes of customers)
- safety (ie. the form of the obligation to maintain a safe supply and the role of the regulator (if any) in monitoring and enforcing it)
- investment commitment for the development of the network between the companies and the government (ie. should some commitment be made to the government?)
- information to the regulator

Note: This section should consider the issues and not whether they should be contained in a law, decree, regulation or concession as these matters are to be dealt with in the Legal Issues section (see item 8 below).

6. The Concession awarding process

The development with Government of a Concession awarding process which could include steps along the following lines:¹

¹ We understand that there is a procedure similar to this in respect of public infrastructure which was recently enacted.

- either (a) the private sector applicant identifies a particular geographic area for which it wishes to have a Concession, or (b) the Government decides on the geographic areas for which it wishes to award concessions (transportation and distribution) ie. either the private sector or the Government may start the process
- next the primary rights and obligations which the Government intends to convey by the Concession are identified; the preferred profile to which the applicants should conform; the information which applicants should provide which should include evidence of financial support (in principle)
- the Government publishes an invitation containing the information mentioned above with a specified closing date for applications
- the evaluation of applications received in order to identify one or two preferred applicants in each case
- detailed negotiations to finalize the terms of the concession with the successful applicant followed by public announcement.

Note: As these concessions will undoubtedly have a value, the Government could give consideration as to whether or not it will require the application for concession to contain a payment in respect of this value.

7. **The Regulatory Framework**

Consider the duties and powers of the regulator taking account of the following three principles:

- independence (ie. from undue political or commercial capture)
- transparency (ie. an established and visible process and openness as to the reasons for decisions)
- objectivity (ie. rules of the game with some reasonable flexibility)

It will be necessary to reflect on the duties and powers of the regulatory framework in the light of the emerging major options resulting from the study of the issues listed above (items 1 to 6 inclusive).

8. Legal Issues

It is recognized that the development of the necessary legal and regulatory framework for the gas project needs to be carried out in the light of the existing laws. A separate legal section should therefore include a review of these laws in order to ascertain the extent to which the existing legal framework is adequate.

There are several discrete areas that should be reviewed in a separate legal section as follows:

- the existing laws in relation to gas, in particular Law 15.985 of 30 May 1931 as modified by Law 18.856 of 2 December 1989, but including any other relevant laws.
- the position of any existing Concession under the Constitution and what solutions exist under Chilean law
- the existing procedure for the awarding of concessions under Chilean law and the extent to which the sort of process envisaged in item 6 above diverges from this; solutions to any legal problems which arise from this.
- the legal position in respect of the grant of exclusivity by a Concession; and if this is not permissible under Chilean law, the solutions. (For example: is it the case that the existing gas concessions relate only to *manufactured gas*, and therefore these concessions do not effect in any way the grant of new Concessions for *natural gas*)
- consideration as to where the detailed rights and obligations of the companies should be placed (ie. the law, regulation, decree or the concession) and the emphasis between them in order to facilitate a fast-track approach to the establishment of an effective legal and regulatory framework for the gas industry.

- consider the extent to which the existing contract for the purchase of gas constrains the Chilean government's decision making.
- consider what matters (if any) need to be added to the existing Protocol between the Governments of Chile and Argentina to protect the interests of investors and consumers and the governments themselves; for example to allow direct *selling* by the Argentinean producers if direct purchasing is to be permitted (see item 3 above).

The Role of the State

The consultants will not consider the role of the State. It is understood that the natural gas industry will be established within the private sector and the Government's role will be confined to that of regulator.

General

In carrying out this work, the consultants should liaise with independent financial advisers appointed by the Government to give advice on the prospects of financing of the project on the basis of the emerging preferred options.

7th May 1993