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INDEPENDENCE OF ENERGY REGULATORS: NEW CHALLENGES

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I. INTRODUCTION

The energy sector is far more important than its share in the economy in every country in the world. Over the last years, the energy sector has undergone considerable structural change by introducing market competition in energy production and supply, together with new governance methods and institutions, which have been included in the process of general regulatory reform.

The economy as a whole has also undergone considerable change, as competition takes place on a global and continent scale, rather than on the level of each single country. Globalization of the economy has been based mostly on the free movement of capitals. In this context, economic efficiency and competitiveness facilitated by market liberalization and privatization is widely employed as a means for providing adequate structures that would attract foreign capital given the intensity of global competition.

However, despite these changes, energy is not depoliticized. Implications from the energy sector are considerable for economic competitiveness, security of supply, environment and geopolitics, in brief for the defense of “national interests”, as perceived in the politics.

Nowadays, there is a remarkable uniformity of the institutional arrangements for the energy sector, especially for electricity and gas, all over the world. Independent regulatory institutions have been first established in those developed countries that strongly emphasize the separation of politics and administration. On the contrary, developed countries with tradition in state-driven dirigisme hesitated before establishing independent regulators and empowering them with decision authority. Under the context of globalization, developing countries and economies in transition also rushed to the establishment of a similar regulatory institutional framework, although their economic and administrative structures are lacking behind, because this has been understood as an imperative condition in their quest for capital investment in infrastructure and the modernization of the old state-owned utilities.

As a result, independent energy regulators exist or are about to exist in most countries of the world. To deliver accepted results in terms of competitiveness, security of supply and environment, policy making and administration for the energy sector is a big challenge, in particular under the present circumstances of globalization and world-wide liberalization and privatization.

It is even a bigger challenge for regulators, because in addition they are supposed to be independent, not only from industry but also from the government. An additional burden is added: the effectiveness in terms of economics of the industry, capital attraction and reliability requires, as never did before, market and energy system integration across multiple countries. As a condition for the success of the broad market integration, the independent regulator, previously having competences only on a national scale, is asked to act also for the broader area. Still, “national interests” exist and exert pressure on the national regulator, while he is not acting in the broader market as a national representative but within the context of independent region-wide regulation.

So, in this conflicting situation, is the regulator obliged to compromise his potential of independence?

II. NECESSITY OF INDEPENDENT REGULATION

Market liberalisation has led to the emergence of a new type of organisation named independent regulatory authorities. In the EU legislation on the common market for electricity and gas, the crucial requirement regarding the regulatory design is that the regulators must be independent of commercial interests in the sector. In the case of countries where state-owned public monopolies had prevailed, the liberalisation further necessitates a clear separation of the state as a regulator, and the state as the owner of public utilities, either through privatization or through the establishment of independent regulators or both. Even after privatization of utilities, the fact that the state still has, at least potentially, economic or political interests particularly with the incumbent companies, suggests that the regulator needs to be independent also from the government.

Independence is usually conceived along four dimensions. 1) independence of the regulators from government, 2) independence from stakeholders, 3) independence in the decision-making of the regulators, and 4) organisational autonomy and autarky.

The institution of independent regulators in the form of commissions or agencies is not a new phenomenon. For almost a century, independent regulatory agencies have played an important role in the regulation of network industries and utilities in the US. In Europe, as public ownership has prevailed in the network industries, the regulatory functions have been exercised mostly by the governments. The market opening process changes the regulatory task as the prices set by power generators are no longer subject to the approval by a regulatory body and as consumers are given the possibility to choose their own suppliers.

But in spite of the liberalisation there is still a need to regulate the electricity supply sector, mainly for three reasons:

- 1) The network is still an essential facility and remains under a monopoly regime, so traditional regulatory tasks are needed firstly to control the network monopoly for keeping their cost low and operate in an efficient way, and secondly to preserve third party access to the essential facilities on fair and equal terms.
- 2) The liberalisation and the development of competition takes place progressively, so the regulatory task to independently set rules and to monitor the developments is defended as a necessary condition for the realisation of a credible liberalisation and privatisation process. The aim is to facilitate new entry into the market and create competition.
- 3) But natural monopolies are not the only reason why regulation persists even after the liberalisation getting into maturity. It is widely accepted that even not state-driven, some degree of dirigisme should persist in the energy sector. Ex-ante regulation (in contrast with ex-post control like the tasks of competition authorities) persists firstly because the economy and the interests in any country cannot afford an energy market failure, either in terms of supply disruptions or extreme business cycles with moments of extreme price spikes. Secondly because, as the energy market involves considerable external costs, it is necessary to exert market regulation by balancing conflicting objectives some of which (like environment, consumer protection and security of supply) lie outside the competition in the market.

Economic theory suggests that a regulator independent from industry, better fits to overcome the problems of asymmetric information between the regulator and the regulated industry, than general regulators. Similarly, independent regulation of the network monopoly is justified as driving effectiveness in rational choice and principal-agent analysis.

Performing progressive liberalization and privatization advocates in favour of assigning a regulator independent from the state. This allows new generators, wholesale and retail companies to enter into the market and create competition and facilitate private investors requiring a high degree of certainty that there is sufficient demand for them to sell their energy product at prices exceeding the costs given that most utilities are heavily capital intensive, have very long-life assets and are highly specific and the high irreversible fixed costs. The same holds true in the case of developing countries and economies in transition that seek to attract foreign investment in energy infrastructure.

Independence of regulators preserves stability and continuity in the setting of rules, avoids political interference in business decisions and regulatory risks, and maintains high standards of expertise and professionalism. A sense of continuity, rationalization and business trust is embedded because potential market participants realize that the transition from purely state monopoly to free competition is achieved under the auspices of third independent institutions, without personal interest in the energy market, as it is in the case of the state, which exercises business activities in the energy sector.

Particularly in the case of developing or unstable economies, but also, for another reason, in the case of multi-country market integration developments, in order to handle the problem of credible commitment, governments choose to delegate decision making power to show that they are so committed to the policy that they are willing to prevent both others and themselves from intervening and obstructing the implementation of it. In both cases however, often politicians choose to do so, also in order to wash their hands either by giving the regulatory authority the blame for what happens – or for what does not happen.

Particularly, in the case of a multi-country market development, such a motivation of a national government will directly threaten the independence of the national regulator: the latter is exposed to blames about responsibility for the impacts of the multi-country developments on the national interests and entities.

III. CRITERIA FOR INDEPENDENCE

The definition by James W. Fesler captures what is now widely admitted about the meaning of regulatory independence: “independence of control by the governor and legislature, independence of control by utility companies, and independence in the sense of integrity and impartiality”.

It is widely admitted that if met, the following conditions ensure independence: a) Legislation prevents arbitrary dismissal of regulators; b) Regulators are appointed mainly on the basis of professional competence and integrity; c) The Parliament or for example the Council of Ministers is somehow involved in the appointment procedure; d) During mandate, the regulators enjoy functional and personal independence; e) The regulatory authority is entitled

to adopt their own personnel policy, management rules, ensuring competitive salaries; f) The regulatory authority also enjoys budgetary independence from government budget and is endowed with sufficient funding to hire personnel of high professional skills and access to information and expertise; g) Rules prevent a regulator from having actual or potential personal interests in the regulated industry or in politics.

To deliver the benefits expected from independent regulation of the energy industry, the regulatory authorities cannot be simply advisory agencies of the Government and be deprived from decision-making competences.

In the absence of sufficient decision making power, the independence of the regulator is equivalent to independence of professional advice. One may argue that the advisory regulator may still attempt to build a reputation for professionalism and balanced judgment, reducing the likelihood of being overruled and enhancing its authority. However, in case of issues with high political interest for the government, the regulator empowered only with advisory competences, will be in practice obliged to negotiate with the government before submitting his official advice, in order to avoid seeing his advice rejected by the government. For an advisory regulator it is very difficult to maintain independence from political pressures and make credible long-term commitments to private investors. In the case of progressive market opening and privatization, the potential market players will have the false impression that the control of the incumbent company and the access to the network takes place under the responsibility of an independent regulator, while the true regulatory power stays with the government having interests in the regulated industry.

The Governments that still are hesitating to delegate decision making to independent regulators are rather few: it is because defending “national interests and champions” politically prevails. This is the case of multi-country markets in which competition on the regional scale develops rather as competition among countries than competition within an integrated market. It is also the case of governments seeking to delay the development of competition in order to obtain bigger revenues from privatizing the state-owned monopolies.

In the case of integration of national energy markets into a single one, like the European Union Internal Energy Market, the existence of asymmetries regarding the independence and the decision-making powers of national regulators undermines the market integration process and is a source of uncertainty for the market players. For this reason, the new energy directives of the European Union prescribe a set of minimum competences for the independent regulatory authority: they must have the power to set the prices of the monopoly components of the market, monitor and control all aspects of market operation, supervise competition and finally resolve disputes among market players.

Benchmarking for assessing the independence of regulators should not be limited to the usual criteria about functional and personal independence of the regulators. The benchmarking also needs to assess whether or not the regulator is empowered with a minimum set of competences. The view that the organization and management of regulation are largely country-specific issues, linked to the legal and administrative tradition of each country, is incompatible with market integration objectives. Benchmarking to facilitate convergence to the best practices is imperative.

Summing up, independent regulatory agencies are defined as autonomous public bodies empowered to regulate specific aspects of an industry. Regulatory agencies may also have judicial or quasi-judicial powers such as setting fines and penalties for non-compliance or acting as an arbitrator in disputes among industry participants. Independence, in this context, specifically means that the regulatory agency is protected from short-term political interference. Political independence is primarily meant as a commitment to provide for a stable regulatory framework over time. This commitment protects investors against opportunistic government intervention.

However, empowering the independent regulator is not sufficient. The following two issues must be appropriately addressed: a) Independence needs to be reconciled with measures to ensure that the regulator is accountable for its actions; b) Mitigating the risk of misuse of regulatory discretion is essential for credibility and continuity, conditions that are vital for potential new entrants and investors.

Independence and accountability are not incompatible concepts. Sources of accountability are among others: the unambiguous primary legislation limiting the discretion of the regulator, the existence of an appeal mechanism and formal rules prescribing the use of fair and acceptable procedures and the justification of methods and decisions by the regulator.

The following are widely admitted as essential ingredients of best practice for an independent regulator:

- Performing consultation (participation of stakeholders) and ensuring consistency and predictability
- Mandating rigorous transparency, including open decision-making and publication of decisions and the reasons for those decisions.
- Prohibiting conflicts of interest.
- Providing effective arrangements for appealing the agency's decisions.
- Providing for scrutiny of the agency's budget, usually by the legislature.
- Subjecting the regulator's conduct and efficiency to scrutiny by external auditors and parliamentary procedures.

IV. REGULATORY PRACTICES

A part from institutional and procedural aspects, an effective regulatory policy in the energy sector also requires the development of specific regulatory instruments and procedures. The choice of appropriate instruments depends on market context and the objectives followed.

Market liberalization is combined with the emergence of a new type of rules, issued within a "framework"-primary legislation and addressing technical and detailed issues of the market operation, such as access to the networks, dispatching and scheduling of power production and generally network and market operation or even financial transactions between market participants. Such rules, that concretize the principle of non discrimination between market

participants, are often enacted with the participation of independent regulators or solely by such authorities and normally incorporated into consistent Codes, Regulations and Guidelines. This enables uncomplicated access to the relevant information and therefore transparency, ensures legal stability and predictability and promotes a sense of legal security, which is mostly appreciated by investors. Security against arbitrary change of these rules is essential. The Codes and Regulations have to reflect changes in the market but for that purpose they have to include procedures that ensure consistency and predictability.

The Codes and Regulations implement a preventive regulatory intervention via mechanisms and institutions designed to ensure flexibility, performance and speed so as not to disrupt the smooth operation of the market. Completeness and stability of these preventive rules is a prerequisite in the case of progressive market opening and privatization.

In the case of developing countries, economies in transition and in all cases primarily seeking to attract capital investment, perceived uncertainty with respect to regulatory discretion plays a critical role. Investors are aware of political pressures and objectives that may lead to abrupt change of rules, while they are vulnerable about their usually large, long-term, and immobile investments. Unless a government has made a credible commitment to rules that ensure an opportunity to earn reasonable returns, private investment will not flow. Weak credibility will be reflected in higher capital costs and thus higher tariffs. In privatization, this translates into smaller proceeds from sales of existing enterprises and higher financing costs for new projects. The long-term nature of most infrastructure investments and in particular the transboundary electricity and gas networks makes creating credible commitments difficult. Highly specific rules, if considered sustainable, can provide assurance to investors and lower the cost of capital. This is one reason for which regulation by contract develops.

Under mature and stable economies with sufficient competition development, preventive regulatory intervention is often minimized, and the market is self-regulated through professional self-discipline and compliance, along with an incentive-based regulatory policy. Regulatory authorities supervise and can impose sanctions in case of infringement, but they mainly rely on instruments such as contracts, incentives and penalties as means for obtaining self-regulation. In this context, the regulatory authorities prefer using rule setting mostly based on guidelines rather than on traditional regulations. Guidelines are not legally binding in the same way as regulations, but are imposed and maintained by the entities they apply to, who accept them and commit themselves to adhere to them. The regulatory authorities retain the ability to revert to specific preventive regulatory measures in case adherence is low.

V. DIVISION OF RESPONSIBILITIES

The establishment of the independent regulatory authorities does not cancel the role of governments.

Delineating between the roles of government policy-makers and independent regulators is the subject of controversy and confusion wherever independent regulatory authorities have been established. Both policy-makers and regulators make policy. The distinction is that policy-makers define the fundamentals and the parameters within which policy-making is delegated

to regulators. It is more useful to think, not in terms of policy-making versus regulation, but, rather, as macro policymaking versus micro.

The government is solely responsible for setting the overall policy objectives for the energy sector, define the targets in relation to the three energy policy pillars (security of supply, competitiveness and environment), determine the requirements in terms of services of public interest (for example universal service, affordability criteria for social groups, etc.), and develop initiatives in the domain of international cooperation, agreements and treaties.

The administrative methods for the implementation of the above mentioned division of responsibilities may vary. There must be clearly defined

- domains for which decision-making is assigned to the regulator,
- domains for which decision-making is assigned to the regulator subject to the consent of the government, and
- domains for which decision-making relies solely on the government.

VI. REGULATION UNDER GLOBALIZATION

As a natural complement and extension of liberalization and privatization, as this process initially developed within the national borders, the framework for inter-state energy trade is currently progressing towards market integration. This is further driven by the need of attracting investment in the context of the global economy. In the past, the country-specific, hence fragmented energy sectors and markets had required at least technical interoperability of networks in order to ensure security of supply and benefits from international trade.

However, developing competition and trade in a multi-country single market goes far beyond interoperability. As mentioned, energy infrastructure is capital intensive and need long term planning and commitment. The development under private financing of large energy networks and energy production facilities that sell across countries, require a regulatory and institutional framework that is unified across several countries and stable enough in the long term.

The traditional means of international cooperation, such as inter-state bilateral agreements or charters, are not enough. Legally binding and comprehensive treaties are more appropriate. Under such legislation, the regulatory approaches for the integrated market and the network are far more complex than at single country level. At the integrated level several companies might partly own the integrated network and several private investors are interested in further developing parts of the network. For example regulatory approaches, that opt for flat pricing for the network use, fail to adequately reward the owners and provide the correct signals for the effective maintenance of networks and location-oriented investment.

This at least calls upon regulatory coordination at the regional level. The delegation of powers at a regional level, the decision-making rules and the relationships between the national regulators and the supranational regulatory body are still open issues, not only for multi-country integrated markets, as for example the EU and regional developments such as

the Nordic Pool, the Iberian market and the Southeast European Market, but also for federally organized countries like the USA. Energy market integration also requires the establishment of solid and stable multi-country bodies for network operation and control.

VII. THE EUROPEAN INTEGRATION CHALLENGE

Before waiting for the completion of a truly integrated single market for energy in the area of the fifteen member-states, the European Union attempts a considerable opening of the energy sector towards the East. The broadening does not only concern the adherence of the energy markets of the ten new member-states that will soon participate in the EU Internal Energy Market.

It is mainly about the opening of the energy market towards Eurasia, including Russia, the South-East peninsula and furthermore the Caucasian area and Turkey. This process is driven by strategic considerations in relation with long term security of supply and the growing dependence of Europe on imported natural gas. It will take of course several years before speaking about an integrated market that extends from the West to the East.

Before attending that stage of integration, regional integrated energy markets on a smaller scale, which are supposed to follow a unified institutional framework and a standard market design, are now promoted in the European Union. The Nordic Pool is such a successful example, since several years. Similar efforts that are expected to materialise in the near future, concern the development of an Iberian regional energy market and a similar market for Southeast Europe.

Recent policy papers of the European Commission demonstrated a strong policy preference in favour of such regional energy markets that divide the European area in multi-country zones. Each zone shall experience true electricity market integration, as if it was a single country. In the domain of natural gas, similar policy reports promote the development of hubs as poles for the development of free gas trade and gas-to-gas competition, which is expected to provide long-distance gas transportation infrastructures with economic viability.

Such energy market integration does not cancel the basic distinction between the monopolistic part of the market, that is the network infrastructure, and the competitive part of the market which comprises production and supply. However, competition may arise among alternative routes, and traded volumes may increase. Incumbent companies that hold a quasi-monopolistic position in the national context are driven to competition.

The appropriate institutional framework to design, regulate and operate such energy market integration goes beyond the current European model, which consists of applying the energy directives, and leave ample room to national divergence justifiable on the basis of subsidiarity. Uniformity of the institutional structures, the Codes and Regulation and harmonization in all domains that may affect competition will be additionally required. As a consequence, the regional market structure sooner or later will require supranational bodies for regulation and operation.

Even if the regulators are sufficiently independent and empowered with decision-making authority on the national scale, the establishment of independent supranational regulation will

be a new experience and a challenge. A supranational regulation shall be needed, because it will be the only way to mitigate business risks and attract investment on the scale of the region, where uncertainties multiply at least in the initial stages of market integration. Experience shows that directly or indirectly the independent national regulators will feel pressure to act as a representative of national interests rather than a party of the independent supranational regulation. Governments participating in the region must be ready to delegate power not only for national matters but also on the scale of the region. If accepted, such delegation strengthens the powers of the national regulators as they obtain authority that extends beyond the national borders.

The surveys carried out by the CEER for the energy regulators of the EU Member-States and the US-Aid for the countries of Southeast Europe justify the need for applying new and advanced standards that would ensure independence of regulators and harmonization about the assignment of competencies for at least all 25 Member-states of the EU.

VIII. THE CHALLENGE WITH CONCENTRATION AND “NATIONAL CHAMPIONS”

Over the last couple of years, the European energy regulators observe a growing degree of market concentration in both the electricity and gas markets. This concentration grows faster than the pace of the growing cross-border energy trade. This market concentration, taking place through attempted or materialised mergers and acquisitions, mainly involves the incumbent, previously state-owned monopoly, companies. Evidently, these companies anticipate the future unification of the energy market and attempt to get a dominant position on the broader scale, before competition develops. Theoretically, on the broader market scale the optimum size of the company is larger in comparison with the smaller national markets. However, if such a concentration takes place before the completion of the unification of the market, new entry is deterred and the whole effort about the EU Internal Energy Market is jeopardized.

The difficulty for the national regulators and competition authorities arise from the fact that the governments of the member-states are inclined to support the incumbent companies when they seek to strengthen their position in other countries. In other words, they consider the incumbents as “national champions”. The argument in favour of this logic of supporting the “national champion” is not only political. They also do so, because these companies are considerably driving other national enterprises, hence national economic activity and employment.

The governments even attempt to provide the incumbents with privileges and various protection measures within their national territories, in order to facilitate their expansion abroad. To do so they argue that allowing these companies to pertain their quasi-monopolistic dominant position in the national market does not matter since dominance is measured on the pan-European scale.

It is obvious, that under these circumstances the regulators are under pressure to defend these national interests when they participate in the European coordinated regulation. Even if they

enjoy fully guaranteed institutional independence on the national scale, the regulators cannot escape from the trap of the “national champions” logic.

To improve upon this situation, it is of course necessary to accelerate the completion of the energy single market of Europe and employ as much as possible the combined efforts of the European Commission and the network of national regulators and competition authorities. In this context, the perspective of supranational regulation might be justified along with the further unification of the energy market.

IX. THE GENERAL PUBLIC INTEREST CHALLENGE

Both the public opinion and the governments have currently growing concerns about the issues of general public interest in association with the performance of the energy market. The economic theory suggests that most of these issues are poorly addressed in the functioning of the market and hence they are said to entail external costs. Such issues may be categorized in three classes: a) long-term security of supply including investment in energy infrastructure; b) universal access including last resort supply and affordability; and c) protection of the environment, including greenhouse gas emission reduction and the support of renewable energy technologies.

Within the framework of a consistent division of responsibilities between the Government and the independent regulator, the Government should undertake the responsibility for setting the targets, the norms and the requirements regarding the level and quality of services of public interest that the energy market must deliver. The Government should define the priorities and the strategy for the security of supply, set the targets for pollution reduction and for the degree of penetration of renewable energy sources, determine the standards about universal service (for example for remote geographic areas and last resort supply), and set goals related to the issue of affordability of the energy service (an issue that particularly matters for the new member-states and the eastern European countries).

Meeting these goals and norms entails significant costs and burden to the market participants, and requires the adoption of detailed implementation measures. These measures further entail an allocation of costs and sometimes benefits among the market participants. The choice of the implementation measures certainly affects the development of competition and the relative market position of competing firms.

If the implementation of the Government policy in these domains remains outside the competencies of the energy regulator, there will be serious adverse implications. Firstly the effectiveness of the implementation will be reduced, because the measures will be poorly integrated into the energy market. Secondly, the consequences, in terms of costs and burden on the firms, competing in the energy market will be higher. Thirdly, the part of the energy sector that will be left on the authority of the regulator will be gradually decreasing, a fact that ultimately cancels the mission of independent energy regulation.

The above approach on the division of responsibilities between the Government and the Regulator for the issues related to services of general public interest has not been yet widely accepted in the European Union, including the policy papers of the European Commission. It

is imperative that the EU follows a unified approach for the division of responsibilities regarding these issues because their importance grows steadily and in the future their economic implications for the EU Internal Energy Market will be considerable.

Two examples are mentioned:

- 1) The failures in the functioning of the transmission systems and the adequacy of supply problems recently experienced in some areas and countries of the EU raise the issue of long-term security of supply. Governments would be inclined to employ some of the old but experienced method of mandatory investment planning for transmission infrastructure or the public tendering processes for the building of new generation. The new European Union energy directives do not exclude such possibilities and allow the eventual assignment of responsibility to a body other than the regulator. It is obvious however that, although the Governments have such rights and should continue to actively set the targets and the norms about infrastructure and long term security of supply, excluding the energy regulators from the design of the appropriate market implementation and the monitoring of the associated developments shall have serious adverse effects on the development of competition, the effectiveness and economic efficiency. The EU must adopt a unified guideline about these issues and the specific role of independent energy regulators.
- 2) Recently the EU adopted a new directive ruling the greenhouse gas emission trading mechanism. This mechanism prescribes the use of tradable emission rights and introduces an obligation on power producers and energy-consuming industries about holding, at any time, the adequate emission permits before they produce commodities and emit greenhouse gases. The Directive assigns the responsibility to the national Governments to determine the initial allocation of emission permits to the power producers and the industries, under the condition that they respect the EU competition law and follow some general principles (for example non discrimination). The concrete allocation, in other words the endowment of every company with an amount of permissible emissions, is crucial for her competitive advantage or disadvantage in the market. The place of incumbent companies and “national champions” within this allocation shall be a determinant factor for the development of competition, new entry and investment. It is of course necessary that the Government sets the targets about emission reduction and the macro-economic allocation of initial emission rights among the sectors of the economy. However, further allocation of initial emission rights to the companies of the power generation sector needs to take place under the auspices of the independent regulator who is the guarantor of non discrimination and fair competition. The Directive does not provide for any involvement of national energy regulators in the process of allocation of emission rights and in general at the stage of emission trading. Regarding emission trading, the setting of the concrete trading and technical rules, the processing of disputes, the respect of transparency, etc. require the involvement of the energy regulator in the part of the emission trading that concern the power generators. It is therefore imperative to further specify the role of the regulators in the greenhouse emission trading mechanism.