

Case Study:

COSTA RICA

PROJECT:

Regulatory Frameworks and The Role Of State–Owned
Oil & Gas Companies

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1. EXECUTIVE SUMMARY

In Costa Rica, importing, refining and distributing bulk hydrocarbons is a State monopoly that is managed by *Refinadora Costarricense de Petróleo S.A. (RECOPE)*, whose stock capital is owned entirely by the Costa Rican State.

The governing body of the hydrocarbons industry, in accordance with the law, is the Ministry of Energy and the Environment (MINAE), and the regulatory entity in accordance with Law 7593 is the *Autoridad Reguladora de los Servicios Públicos (ARESEP)*.

PURPOSES OF THE REGULATORY FRAMEWORK

The purposes of the Regulatory Framework, as defined in Law 7593 as per articles 4 and 31, are basically the following:

- To harmonize the interests of consumers, users and providers of the public services defined in this law and to be defined in the future.
- To seek a balance between the users needs and provider interests regarding public services.
- Ensure that public services are offered in conformity with what is established in part b)¹ of article 3 of this law.
- To formulate and ensure fulfilment of requirements regarding the quality, quantity, timeliness, continuity, and reliability needed to optimally provide the public services under its authority.
- To support the State entities charged with environmental protection in cases of providing regulated services or granting concessions.
- The criteria of social equality, environmental sustainability, energy conservation, and energy, defined in the National Development Plan, should be central concerns when setting prices, tariffs and rates on public services.

In the light of these purposes, regulated companies should provide an economically efficient service with environmental sustainability and quality.

However, the regulatory framework is affected by current sectoral interrelations, in which the duties of State entities and ARESEP overlap, causing problems such as low corporate autonomy and confusion in the RECOPE. In addition, the methodology being applied makes it possible for sales prices to include company management inefficiencies. The regulatory entity has now changed the method for setting rates on sales prices for RECOPE plants, seeking to meet the purposes mentioned above, and the periodicity with which tariff adjustments can be requested.

A review of sectoral interrelations, including its regulatory framework, shows that it is very complex because of its current legislation, the number and complexity of the laws passed, some new and others reforming existing laws or eliminating others. This has caused overlapping and duplication of functions among the different entities that govern and regulate RECOPE, for instance in service quality and price-setting, in which several State entities have authority. These overlapping jurisdictions make it difficult to manage regulated companies. In

¹ Tariffs are set on the principle of service at cost with retribution to enable company development.

the specific case of RECOPE, current legislation² hampers contracting goods and services, which are subject to laws that make procedures highly bureaucratic. Awards and procurement can take over a year, with the respective consequences of higher costs and operational difficulties. The exception is hydrocarbons purchases, which are under a special regime due to the nature of that market. It is impossible to contract skilled personnel at market salaries and provide wage incentives for performance. As for yearly budgets, they must be submitted to different institutions for both approval and liquidation, such as the Treasury Department, the Ministry of Economic Planning and Policymaking, and the Comptroller General of the Republic.

ROLE OF STATE-OWNED COMPANIES IN THE REGULATORY FRAMEWORK

RECOPE's Executive President and board members are named by the Executive Branch, except for the Vice-president, who is the Ministry of Energy and the Environment or whomever he delegates. This does not foster technical excellence, as these assignments are usually political.

With regard to filling managerial vacancies, which are considered positions of trust, this is done by the company's Executive President, who can do so either directly or through a public bidding contest, posting the requirements of experience and education.

The existing interrelations in the regulatory framework, as mentioned above, make it difficult to manage the company.

Although evaluating business performance exists from a legal perspective, in practice it is taken as a simple requirement when submitting yearly budgets and their liquidation for auditing agencies. Neither is there any form performance evaluation for managerial positions in the company.

The corporation is obliged to receive an internal audit and a yearly external audit by an independent public accountant firm, and both ARESEP and the Comptroller General of the Republic can perform financial and operational audits.

This lack of company evaluation means that the company works without any type of real supervision that would oblige it to be efficient and help the country achieve sustainable development.

LEGAL STATUS OF THE COMPANY

RECOPE was created in 1963 with a majority private sector participation and a minority Costa Rican State share. It was set up as a stock company, i.e., governed by private law. In 1973, the Costa Rican State purchased all the shares of the company and left it operating as a stock company. Over time, although it still remains as a stock company, through the different laws passed, it has been included under the supervision and control of the respective State institutions that entrusted with governing, supervising and regulating the hydrocarbons industry.

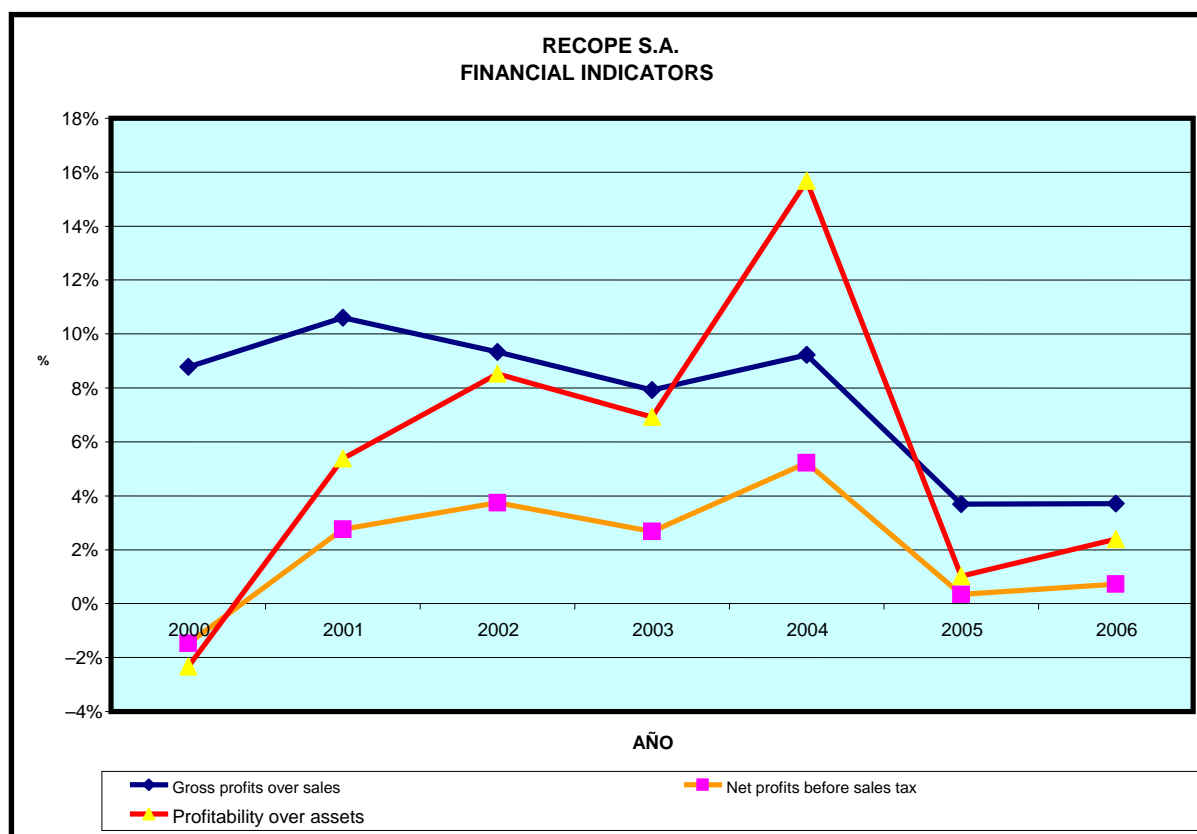
² A complete review of current legislation would be needed to define which laws need to be reformed or eliminated to expedite RECOPE management and improve its performance.

IMPACT OF THE REGULATORY FRAMEWORK

Company management is negatively affected, as mentioned above by overlapping and duplication of functions among the entities in the sector that govern, supervise and regulate the company.

Regulation generates low autonomy and generates confusion in company management. The tariff method does not promote company efficiency, which means that administrative inefficiencies are transferred to the final consumer prices. In addition, the regulatory entity takes several days, which may be fifteen to thirty, to approve a plant-wide sales price adjustment, which negatively affects RECOPE's finances and cash flow.

Some of the financial and operational indicators seen in company management are found on the following graphs:



Note the great variability of these indicators, which have been negative or practically zero in some of the years under study. This could be explained partially by the regulations that RECOPE receives from ARESEP, in which plant-wide sales price adjustments, which generate the company's working revenue, on some occasions take longer than fifteen days and in some cases up to thirty, while RECOPE's purchase prices on the international market, for both crude oil and finished products, are subject to daily variations that usually tend to rise, affect company finances and are seen in the financial indicators presented. Another element that may cause this behaviour is the lack of new investments to expand or replace the refineries, delayed by Central Government decisions due to fiscal deficit issues.



These indicators show that RECOPE has maintained a fairly acceptable borrowing capacity, in part due to the State prohibition for public sector companies to go into debt, which had grown considerably by 2006 with the debt to build the products pipeline. Despite the terms for approval of sales price adjustments by ARESEP, liquidity has always been greater than one.

Another indicator is the capacity to utilize a refinery. The following graph shows production in m³.

PRODUCT	2003	2004	2005	2006
AC 30 ASPHALT	15.738	28.242	14.840	30.210
DIESEL OIL	103.098	187.134	157.569	269.638
HEAVY DIESEL	6.697	2.643	0	0
FUEL OIL	236.923	262.816	227.399	314.162
LPG				
MEDIUM	—	4.164	3.503	6.292
MEDIUM GASOIL	—	2.944	3.248	5.072
KEROSENE	—		2.847	2.538
GASOLINE	127.485	106.601	88.527	152.780
TOTAL	489.941	594.544	497.933	780.692

The average refinery use during the 2003–2006 period, considering 330 days of operation, has been about 41 %. This utilization factor is affected by the refining pattern in which fuel oil,³ being a lower value-added product, represents a large percentage of a refinery's production. This product lacks a significant domestic market, meaning that RECOPE has to import a large amount of finished product to meet the domestic demand. It has not been possible to improve this refining pattern, since RECOPE has not had authorization from the respective State entities to finance works that would change this pattern and produce greater volumes of gasoline and diesel and less fuel oil.

LESSONS LEARNT

1. Current legislation for the hydrocarbons industry, which causes overlapping and duplication of functions among various institutions, creates a lack of legal security for the companies of the sector, both regulated and non regulated, which hampers RECOPE's decision making and management.
2. As a product of said current legislation, interrelations among the institutions of the sector are also fairly complex and hinder RECOPE's management. Each sectoral entity's regulations are often confusing for the company and cause excessive expenses in financial and human resources with no payback for preparing usually the same information for each institution but in different formats.
3. The sectoral interrelations, with so many actors either governing or regulating, generates and causes low level of autonomy for RECOPE, which obviously makes it difficult to manage.
4. There is no true evaluation of RECOPE's management by the sector's governing and regulating bodies, partially due to the lack of clarity in the current legislation, and in part because of the scarcity of resources among the State institutions.
5. There is no accountability for company management at the highest levels of the company, whether by the Board members or at the managerial level.
6. Existing regulations are not clear enough regarding service quality assessment, and several entities are assigned that responsibility by current legislation, making it relatively weakly regulated.
7. Existing control regulations and standards make it difficult for RECOPE to promptly meet the need to renew and expand existing infrastructure in order to ensure production of higher value-added refinery products, greater capacity for storage and products pipeline transportation,⁴ in accordance with the country's consumption and with less environmentally damaging quality standards.

RECOMMENDATIONS

In the spirit of the National Development Plan, which states that regulations should be transparent and modern, current legislation should be reviewed on the short term, insofar as it

³ It is presently under study for use in thermoelectric generation instead of diesel.

⁴ The new 30-cm diameter products pipeline is in the testing phase.

is causing the overlapping between the different functions of the State institutions that govern and regulate the activities of the country's hydrocarbons industry.

RECOPE's Board of Directors is named entirely by the Executive Branch, which is one element that lessens independence in decision making, which may stray far from technical and financial criteria. It would be advisable to consider the possibility for the private sector, either through the professional associations of engineers or economists or the chambers of industry, construction or Commerce, to participate in naming this Board of Directors for the purpose of contributing ideas that, while not necessarily more technical are certainly less political, never forgetting that all company actions are of the State.

RECOPE would have a greater possibility of improving its management if the legal and institutional framework governing the hydrocarbons industry were simplified, enabling greater levels of indebtedness to finance enhancements to the refinery or lending greater agility to procuring goods and services and contracting skilled workers. However, along with these changes, the company should be obliged to give account for its management, both to its owner (the State) and the civil society, and to focus its management on sustainable economic development of the country.

It could consider implementing of management contracts, both between the national Government and the Board of Directors, and between the latter and the company managers, specifying management indicators with which all involved parties are in agreement. These indicators should be simple, clear, easy to measure, and in a reasonable number, and could be used to extend appointments, allocate salaries, etc.

2. INTRODUCTION

Costa Rica is located in the southern part of Central America, with Nicaragua to the North, the Caribbean Sea to the East, Panama to the South and Southeast, and the Pacific Ocean to the West. The surface area of Costa Rica is 51,100 km², and its population is some 4.3 million persons (2005). The capital of the country is San Jose, and the official language is Spanish.

The present political structure is divided into three main branches: the Legislative Branch (one unicameral Congress) consisting of 57 representative congresspersons elected for 4-year terms; the Executive Branch that includes the President, the Vice-Presidents and 18 Ministries, whose Ministers make up the Presidential Cabinet; and the Judicial Branch, consisting of the Superior Court of Justice, four courts of appeal, and the Criminal, Civil and Special Courts. Each branch functions independently of the others.

3. BACKGROUND

This background will be presented within the framework of the sector's evolution in accordance with the variations suffered basically by the legal framework, causing significant changes in the hydrocarbons business.

The main significant events in this activity, which have marked significant changes, are the following:

Through Decree N° 5 of November 26, 1913, inalienable State ownership was declared over all coal mines, deposits and sources of oil and other hydrocarbons, and this was included in the 1936 Constitution. During these years, all hydrocarbons-related activities were in private enterprise hands, basically trans-national companies.

Law 33 of March 1931 established a State monopoly on gasoline importing and distribution, to keep foreign companies out. In 1933, Law 186 regulated gasoline dispatch, establishing that the *Banco de Seguros*, a State entity, was the institution in charge of implementation. It was forbidden to sell to final consumers and could only sell to what at that time was called service pumps, and also directly to farmers and industrialists for their respective businesses.

In 1940, Law 29 of December 13 of that year derogated the State's gasoline monopoly and authorized the Executive Branch to enter into contracts with private companies,⁵ enabling them to import bulk oil products. Article 3° of this law obliged these companies to sell solely to the owners of service pumps, at a uniform price throughout the country.

In 1961, the *Refinadora Costaricense de Petróleo S.A.* (RECOPE) was founded by private business group that requested permission to build a refinery under Law 2462 of Industrial Protection and Development. In November 1962, it received that authorization under Industrial Contract N° 53-62, which was approved via Law N° 3126 of 1963. The State had 15 % of the capital stock,⁶ 51.665 % was in private Costa Rican hands, and the rest belonged to Allied Chemical Industries.

With Law N° 5508, in 1974 the State purchased RECOPE and by Executive Decree decided to nationalize fuel distribution and forbid the Company to operate service stations for sale to the final consumer. Sale to the final consumer was in private hands: trans-national companies⁷ and national businesses, most under the *Asociación Costaricense de Expendedores de Combustible* (ACEC).

In 1981 Law 6588 was passed, regulating RECOPE's activities and defining its purposes as: refining, transporting, and marketing of bulk oil and oil products; maintaining and developing the facilities required for this; and implementing the energy sector development plans, upon authorization from the Comptroller General of the Republic, in conformity with the National Development Plan.

⁵ Five contracts were formalized with transnational companies: ESSO, GULF, SHELL, CHEVRON, and TEXACO.

⁶ It was delivered to it at no cost.

⁷ Currently operating are SHELL, TEXACO AND TOTAL.

In 1990, the Legislative Assembly reiterated the decision to maintain a State monopoly on bulk fuel imports, refining and distribution when it passed Law 7352 and charged RECOPE with managing the monopoly.

In April 1993 the Hydrocarbons Act was passed, also allowing private companies to carry out in exploration and future exploitation activities. The Ministry of Energy and the Environment was charged with governing all oil exploration and exploitation. The *Dirección General de Hidrocarburos* and the *Consejo Técnico de Hidrocarburos* were created. This Act opened the door to private participation in these activities through different contracting models: association, operation, service, concession, or any other nature. The State may participate in these contracts through RECOPE, which for this purpose will have same conditions as any another bidder and may do so directly or in partnership with other companies.

The exploration period of may be up to three years, an may be extended up to three more years. The exploitation contracts may be for up to 20 years. During the exploitation phase, contractors must pay the State a royalty on daily production volumes. For this purpose the Law has defined production ranges with different payment percentages, whose amounts vary from 1 % to 15 %. With regard to income tax exemptions for autonomous or parallel generation projects, article 22 of Law N° 8114 on Tax Simplification and Efficiency published in the Official Gazette of July 9, 2001, derogated the exemption established in article 47 of the Hydrocarbons Act, N° 7399, of May 3, 1994.

Presently, although current legislation allows it, there is no exploration contract of with private enterprise.

The service of supplying fuels derived from hydrocarbons in Costa Rica is presently covered by the following companies:

- *Refinadora Costaricense de Petróleo S.A. (RECOPE)*, a company that is governed by private law, whose shares belong entirely to the State, which manages the State monopoly established over activities of importing, refining and distributing bulk crude oil and oil-derived fuels.
- Private companies devoted to transporting fuel in tanker trucks from RECOPE's plants to service stations and other consumers such as industries.
- Private companies in charge of distributing oil products to final consumers at service stations.
- Private companies in charge of the bottling and distributing liquefied petroleum gas.

It is clear that private sector participation is limited solely to the final link of the fuel chain, i.e., sale of different types of fuels (gasoline and diesel) to final consumers.

The current administration of Costa Rica, in its governmental program, stated that it would study the possibility of opening all State monopolies that manage public services such as oil & gas. There is presently a commission made up of governmental and private sector members to study possible arrangements to open up the monopoly managed by RECOPE under the principle of selective, gradual, regulated liberalization.

4. GENERAL SECTORAL POLICY

4.1 Background

Costa Rica is a net importer of hydrocarbons. Through RECOPE it imports diverse grades of crude oil that it processes at the refinery, plus products that primarily include gasoline, diesel, jet fuel, and Liquefied Petroleum Gas.

Costa Rica's energy development model is characterized by significant dependency on oil product imports. Over the past years, this country has experimented an explosive growth of its oil bill, which surpassed US\$ 225 million in 1990, a over US\$ 1,200 million in 2006. Its automobile fleet, consisting of a million vehicles, consumes approximately 76 % of all hydrocarbons imports and is responsible for 65 % of all emissions.

Commercial energy consumption is supplied primarily from three sources: imported hydrocarbons, electricity and biomass resources such as firewood, sugarcane bagasse, coffee shells, and rice husks. In 2006 the percentage shares were 76.3 % for hydrocarbons, 23.5 % for electricity, and 0.2 % for biomass resources, which shows that Costa Rica utilizes a very large proportion of imported energy.⁸

In view of this heavy dependency on imported hydrocarbons, with the consequential negative effects on the fiscal situation, the environment, and the health of the general populace, due to the green-house gas emissions, the last governments of the Republic have taken actions to reduce this dependency and the current regime (2006–2010 term) translated these actions into the National Development Plan and the IV National Energy Plan for 2002–2016,⁹ which are the basic axis of the current national energy sector policy.

4.2 The “Jorge Manuel Dengo” National Development Plan for 2006–2010

At year-end 2006, the Costa Rican Government presented its “Jorge Manuel Dengo Obregón” National Development Plan for 2006–2010. One of the great challenges posed was to “Reduce the dependency on imported fuels, take better advantage of the country's renewable energy resources, and eventually produce 100 % of all the country's electricity based on renewable energy sources.

“The energy policy will aim to modernize and strengthen the sector as a whole, its sub-sectors and the public organizations that make it up, such as the ICE, CNFL, RECOPE, the Ministry of Energy and the Environment, and the ARESEP, in such wise that they can successfully operate in the XXI Century and continue driving national development. As part of this strengthening and modernizing process, an effective, modern regulatory framework should be created for the sector and its sub-sectors (underlining added).”

⁸ “Estado de la Nación: Desafíos e Impactos en el Uso de la Energía para el Desarrollo y Crecimiento Económico del País”, June 2007.

⁹ Currently under review by the Dirección Sectorial de Energía.

“This policy will see to ensure the country’s energy supply with environmental, social and economic responsibility, and reduce the high, dangerous dependency on imported hydrocarbons, which presently surpasses two thirds of the national energy supply, through the use of autochthonous energy sources that are economically, environmentally and socially viable. This line of action is driven by the urgency to reduce our economic and social vulnerability to ‘oil shocks’.”

One of the core issues¹⁰ of the National Development Plan is the Environment, Energy and Communications Policy, one of whose components is the energy policy. Among its sectoral goals is the following: “To further the development of the national biofuel industry”¹¹ and the strategic actions include “...incorporating sustainable domestic agroindustrial production and consumption of biofuels” and having a law that will make it possible “...to create a competitive wholesale and retail fuel market that will enable development of the fuel industry, including biofuels, and a sustainable investment environment.

The National Development Plan also states that it is important to promptly, adequately meet the society's fuel needs within the context of global trends such as mitigating greenhouse gas emissions, and enhancing fuels with greater energy content and environmental quality.

Finally, this Plan contemplates a gradual, selective liberalization of the State monopoly managed by RECOPE. For this purpose, the Government formed a Commission made up of officials from the institutions of the sector and private sector representatives, which began working in October 2006 to analyze the different alternatives to implement this liberalization.

4.3 IV National Energy Plan for 2002–2016

The IV National Energy Plan for 2002–2016 is based on four basic, fundamental principles, which will serve as a guiding star in the energy development of the country:¹²

1. To ensure that energy development contributes to preserving the social, economic, political, and environmental equilibrium.
2. To make sure that the energy sector contributes to sustainable development and to enhancing its inhabitants' quality of life.
3. To reduce the vulnerability of energy infrastructure and of foreign supply.
4. Maintain the State’s preponderant role in activities relating to energy resource development.

As stated in the Plan, annual evaluations are foreseen for the first quarter of each year, performed by the *Dirección Sectorial de Energía*.

The energy sector is presently at a stage of study and transformation, based on the domestic and foreign situation: new governmental policies on the need for a sustainable energy sector

¹⁰ The core themes are: the Social Policy; Production Policy; Foreign Policy; Institutional Reform; and the Environmental, Energy and Telecommunications Policy.

¹¹ This goal is also part of the Production Policy theme.

¹² Source: *Dirección Sectorial de Energía*.

that contributes to economic development and is environment friendly; the international oil & gas price situation; and the current supply deficit in the electric sector that forced rationing during March and April 2007 and a more intensive use of thermal generation, which could happen again in the Summer of 2008.

The *Comisión Nacional de Conservación de Energía* (CONACE) was also created for the purpose of coordinating inter-agency actions for rational, efficient energy use. This Commission is made up of representatives from all the public institutions of the energy sector and cooperatives of the electric sector.

Under study is the possibility of private sector participation at all stages of the hydrocarbons marketing chain, which are currently a State monopoly, or that RECOPE might form strategic alliances with the private sector. Priority is being given to the promotion and use of renewable energy sources such as the ethanol and biodiesel. The possibility of reactivating the Hydrocarbons Act N° 7399¹³ is also being reviewed again. It is currently in effect, but without any of the activities allowed by this law, such as private sector participation in exploration, exploitation and production activities.

In the light of these principles, the country has been taking action to achieve sustainable, efficient, rational use of energy:

- Promoting the use of energy-saving light bulbs in the public and private sectors: public institution buildings, residences, industries and businesses.
- RECOPE has been implementing a pilot plan since February 2006, to mix ethanol with regular gasoline¹⁴ in percentages that vary from 5 % to 10 % depending on the percentage of oxygenates in the base gasoline. This plan is being carried out in the northern Pacific part of the country, and the product is distributed through 63 service stations.
- There are private initiatives to produce biodiesel, which is being used as part of a pilot plan in some private public transportation companies.
- There is a Government program to regulate the use of private vehicles, which forbids traffic within the metropolitan area of the capital depending on the last license plate number.¹⁵
- The hour that public sector employees start work was moved up.
- LPG use is being promoted in public transportation, primarily taxis (public service).
- The tax rate on vehicles has been rationalized, in the sense that the tax rate goes up once the vehicle is 5 years old. The purpose for this measure is as an incentive to use more recent models, as vehicles are more fuel efficient and produce less greenhouse gas emissions.
- Introducing hybrid vehicles (gasoline and electricity) with lower tax rates than normal vehicles.
- Certain transportation routes that serve the San José Metropolitan Area are being sectorized.

Some of these programs have not produced the expected outcomes in fuel savings, such as restricting vehicle use, using Liquefied Petroleum Gas (LPG) (which lacks strong

¹³ This is discussed more fully in the next chapter, on “Legal Framework for the Hydrocarbons Sub-Sector.”

¹⁴ Regular gasoline is 88 octanes.

¹⁵ The registration number.

governmental support), and combining ethanol with gasoline had very little acceptance from the start due to a lack of adequate, timely information to final users on the advantages and prerequisites of using this product correctly. However, by early 2007 perceptions of this product had changed, and it was consumed more in the area of influence. RECOPE has said that it will expand the pilot plan to the national level as of 2008 for both gasolines¹⁶ that are marketed in the country. Implementation of the sectoring project has been delayed.

On the price side, in late 2006 ARESEP began rebalancing sales prices to final consumers, in view of the crossed subsidies policy that had been applied for several years, primarily with gasoline subsidizing diesel.

¹⁶ Super gasoline with 95 octanes, and regular gasoline with 88.

5. LEGAL FRAMEWORK OF THE HYDROCARBONS SUB-SECTOR

The country's overall legal framework, including reference to hydrocarbons, is based fundamentally on what is set forth in the 1949 Constitution.

5.1 *The Constitution*

According to article 6 of the Constitution, the State has absolute, inalienable and imprescriptible ownership of all oil resources and deposits and of all other hydrocarbons found within national borders, over which the State has complete, exclusive sovereignty or special jurisdiction.

5.2 *The Executive Branch*¹⁷

The Executive Branch made up of the following bodies: the President of the Republic, the Governing Council, the Sectoral Councils, the Executive Branch per se, and the Ministries. The Executive consists of the President of the Republic and the Cabinet Minister. The Governing Council includes the President of the Republic and the Ministers, with or without a portfolio or, where applicable, the Vice-Ministers in office. The Sectoral Councils will be made up of Ministers in charge of the respective sectors and the administrative heads of the decentralized institutions that are part of same. The Ministries will consist of the Ministers and technical Vice-Ministers as needed to best attend to their portfolios.

The Environment, Energy and Telecommunications Sector, headed by the Minister of the Environment and Energy, includes the following centralized and decentralized institutions: the *Instituto Costaricense de Electricidad* (ICE), *Refinadora Costaricense de Petróleo S.A.* (RECOPE), *Radiográfica Costaricense S.A.* (RACSA), *Compañía Nacional de Fuerza y Luz S.A.* (CNFL S.A.), *Instituto Costaricense de Pesca* (INCOPECA), for environmental matters, the *Consejo Nacional de Transporte Público*, *Instituto Costaricense de Acueductos y Alcantarillados* (AyA), except for health matters, *Compañía de Servicios Públicos de Heredia S.A.* (ESPH), *Junta Administrativa del Servicio Eléctrico de Cartago* (JASEC), *Instituto Costaricense de Turismo* (ICT), *Instituto de Fomento y Asesoría Municipal* (IFAM), *Instituto Meteorológico Nacional* (IMN), and the programs pertaining to the Environment, Energy and Telecommunications Sector of the Ministry of Agriculture (MAG) and the Ministry of Health, and the National Programs of the Ministry of Government and Police and of the Ministry of Foreign Trade.

5.3 *Current legislation*

The main laws that govern and regulate the hydrocarbons sector activities are the following:

A. HYDROCARBONS ACT N° 7399 OF MAY 13, 1994

This Law opens the door to private participation in exploration and production activities under different models of contracts: partnership, operation, service, concession, or others. The State

¹⁷ As per Executive Decree 33151 – MP published in Official Gazette N° 95 of May 18, 2006.

may participate in them through RECOPE, which to this end will have the same conditions as any another bidder and may do so directly or in partnership with other companies.

Some important articles of this law are detailed below:

ARTICLE 1.– The State has the absolute, inalienable, imprescribable ownership of all oil resources and deposits and of all other hydrocarbons found within the national borders, over which the State has complete, exclusive sovereignty or special jurisdiction, in the tenor of article 6 of the Constitution.

ARTICLE 2.– The purpose for this Law is to develop, promote, regulate, and control the exploration and exploitation of deposits of oil and any other hydrocarbons, regardless of the physical state they are in. Furthermore, it proposes to preserve and protect the environment, in order to ensure its rational use and guarantee the interests of the State. Excepted from the provisions of this Law are coal exploration and exploitation.

If during hydrocarbons exploration and the exploitation other related substances are found, the Government of the Republic may exploit them. Otherwise, the contractor may develop them under the regulations to be established for that purpose.

ARTICLE 3.– The *Dirección General de Hidrocarburos* is created as the specialized technical body of the Ministry of Natural Resources, Energy and Mines¹⁸, which will be in charge of all steps and procedures to correctly formalize and execute any contracts that the Executive Branch enters into for hydrocarbons exploration and exploitation.

Without prejudice to other tasks delegated to it, it will have the following specific functions:

- a) Develop the public bidding contest instruments and submit them to the approval of the Technical Council.
- b) Review bids for hydrocarbons exploration and exploitation and remit the respective technical recommendations to the Executive Branch via the Technical Council.
- c) Supervise all activities developed by the contractors.
- d) Review the concurrence of causes for contract annulment or caducity and submit its recommendations to the Executive Branch, via the Technical Council.
- e) Present its recommendations to the Executive Branch regarding the legality or illegality of assigning all or part of the contracts.
- f) Review and recommend to the Executive Branch whether to grant extensions requested by contractors.
- g) Determine the maximum production efficiency rate.
- h) Keep the records cited in articles 20 and 21 of this Law.
- i) Approve information presented by contractors.
- j) Certify fulfilment of the requirements referred to in article 22 of this Law.

ARTICLE 4.– The Executive Branch, through the Ministry of Natural Resources, Energy and Mines, will promote and foster hydrocarbons exploration and exploitation; and may carry out those activities, either directly or through association, operation, service, concession or any other type of contracts, entered into by the Executive Branch with national or foreign legal

¹⁸ Presently the Ministry of Energy and the Environment (MINAE from the Spanish).

entities, of recognized technical and financial capacity, being experienced in and suited to the hydrocarbons industry.

ARTICLE 5.– The Executive Branch, making use of the authority assigned to it in this Law, will have the following powers and duties:

- a) To adopt all work methods and systems to ensure the greatest performance and economy in the activities regulated in this Law.
- b) To plan and implement equipment modernization, purchase new equipment and replace existing equipment.
- c) To purchase and build any immovable assets needed to carry out its activities.
- d) To execute all activities relating to the hydrocarbons industry, as established in this Law, and enter into all kinds of agreements and contracts in connection with such activities.
- e) To administer, explore, exploit and manage all oil & gas fields, oil pipelines, refineries and, in general, all real estate and chattel pertaining to it in accordance with this Law.
- f) To allocate to meet the needs of the internal consumption all the oil and natural gas it has a right to based on the contracts it enters into. Likewise, it may sell any surplus on the domestic or foreign market.
- g) To receive loans from domestic or foreign entities, following approval by the Legislative Assembly. These loans will be applied solely to the works, jobs, and other purposes established in the previously developed plans.
- h) To oversee the good conditions of the oil or gas fields, their facilities and annexes and take all measures required for their appropriate maintenance.

ARTICLE 19.– The Executive Branch, through the Ministry of Natural Resources, Energy and Mines, will make hydrocarbons policies, respecting the directives of the National Development Plan and the National Energy Plan. Likewise, this Ministry will be in charge of the administration, supervision, control, and oversight of all activities relating to the object of this Law, without prejudice to any powers granted by law to other Public Administration entities.

ARTICLE 52.– All information that RECOPE has on the country's hydrocarbons potential will be transferred to the Ministry of Natural Resources, Energy and Mines, and will be used to attract foreign investment, in keeping with the respective international mechanisms and the following rules:

- 1.– All companies, whether domestic or foreign, will have access to said information upon request.
- 2.– When the Ministry reproduces that information at the request of an interested party, it may collect a fee for the right to use it.
- 3.– The fee to reproduce information will be estimated by the Ministry of Natural Resources, Energy and Mines, and its value will be set at international levels for the purpose of promoting the country.
- 4.– The revision of promotional information at the offices of the Ministry of Natural Resources, Energy and Mines or in other authorized offices, both inside and outside of the country, will have no cost.

B. LAW N° 7356, OF SEPTEMBER 6, 1993, ON THE STATE MONOPOLY ON IMPORTING, REFINING AND WHOLESALE DISTRIBUTION OF CRUDE OIL, ITS FUEL PRODUCTS, ASPHALTS AND NAPHTHAS.

This Law was a ratification by the Legislative Assembly that the State monopoly on bulk fuel imports, refining and distribution, and that their administration was charged to RECOPE. The entire text of this law is presented.

ARTICLE 1.– Importing, refining and wholesale distribution of crude oil and its derivatives, including fuel, asphalts and naphthas, to meet the domestic demand, are a State monopoly.

ARTICLE 2.– The State grants administration of that monopoly to the public company *Refinadora Costaricense de Petróleo, Sociedad Anónima* (RECOPE S.A.), to perform the activities described in the above article, while its stock capital belongs entirely to the State.

ARTICLE 3.– The State may not assign, sell, nor give in warranty any representative stock in the capital of *Refinadora Costaricense de Petróleo, Sociedad Anónima*.

C. LAW OF RECOPE N° 6588 OF JUNE 30, 1981

This law regulates all normal operational activities of RECOPE and establishes that fuel sales prices will be set by the *Servicio Nacional de Electricidad* (presently ARESEP) and that the company will be subject to external audit by the Comptroller General of the Republic.

Some of the pertinent articles of this law are included below:

ARTICLE 1.– The *Refinadora Costaricense de Petróleo, S.A.* is subject to the regulations of this law and to all legal, regulatory and statutory provisions that do not contradict it.

ARTICLE 2.– The products of *Refinadora Costaricense de Petróleo, S.A.* should be of optimum quality. The Executive Branch, by decree, will set the quality standards that products should meet. Any change to those standards will also be established by decree.

The sales price for the products of RECOPE will be determined by the *Servicio Nacional de Electricidad*,¹⁹ within no more than twenty-two working days from the date on which it receives the request of RECOPE.

The *Servicio Nacional de Electricidad* must take into account, when determining prices, both total costs and ensuring a profit that will enable growth in accordance with the needs of the country. The *Servicio Nacional de Electricidad* will set these prices within no more than twenty-two working days from the date on which RECOPE requests the respective readjustment.

ARTICLE 3:– In fulfilment of the tasks entrusted in *Servicio Nacional de Electricidad*, RECOPE is obliged to cooperate with it and to supply it with all information it requests to such ends. Likewise, the *Servicio Nacional de Electricidad* will have free access to all of RECOPE's accounting books, accounts, vouchers, files, and records, in order to verifying any

¹⁹ In the actuality is the *Autoridad Reguladora de los Servicios Públicos* (ARESEP)

data relating to operating costs, hydrocarbons sales, and other activities as needed in the price setting process.

RECOPE must abide by any corrective indications prescribed by the *Servicio Nacional de Electricidad* in this regard. It is also obliged to adopt and maintain any accounting systems that it may agree on with the latter.

ARTICLE 6.– The purposes of the *Refinadora Costaricense de Petróleo, S.A.* are to refine, transport and market bulk oil and oil products, to maintain and develop the facilities needed for this, and to implement energy sector development plans in all things pertaining to it, with prior authorization from the Comptroller, and in conformity with the National Development Plan. RECOPE may not grant loans, make donations, grant subsidies or subventions, nor build inter-oceanic oil pipelines without prior legal authorization.

The *Refinadora Costaricense de Petróleo, S.A.* may allocate to the Ministry of Natural Resources, Energy and Mines any financial, human, technical and logistic resources that are required to fulfil the obligations entrusted to it in the Hydrocarbons Act.

Likewise, the *Refinadora Costaricense de Petróleo, S.A.* may participate, individually or through partnerships, in any public bidding contests promoted by the *Dirección General de Hidrocarburos* for hydrocarbons exploration and exploitation, in conformity with the provisions of the Hydrocarbons Act.

D. ARESEP LAW N° 7539 OF SEPTEMBER 5, 1996

This law is the one that converted the *Servicio Nacional de Electricidad* (SNE), which regulated power services, into the *Autoridad Reguladora de los Servicios Públicos* (ARESEP), that presently regulates nine public services, including hydrocarbons. This law will be commented in greater detail in the part on the Regulatory Entity.

E. LAW N° 7152 – ORGANIC LAW OF THE MINISTRY OF ENERGY AND THE ENVIRONMENT, DATED JUNE 5, 1990

This law transformed the Ministry of Industry, Economy and Mines (MIEM) into the Ministry of Natural Resources, Energy and Mining (MIRENEM from the Spanish) and established that the Minister is the director of the Natural Resources, Energy and Mining Sector. The basic functions of the Ministry are formulation, planning and execution of policies for the Natural Resources, Energy and Mining, and Environmental Protection, as well as direction, control, supervision, promotion, and development of those resources.

It must also perform and supervise technical research and economic studies on the resources of the sector. It should also foster the development of natural resources, energy and mining, aside from promoting and administering legislation on natural resource conservation and rational use, for which it will issue binding rules and regulations regarding rational use and protection of natural resources, energy and mining.

F. LAW NO. 7554 – ORGANIC LAW OF THE ENVIRONMENT, DATED OF OCTOBER 4, 1995

This Law turned the MIRENEM into the current Ministry of Energy and the Environment (MINAE from the Spanish).

With regard to energy resources, article 56 states that: “Energy resources are essential factors for the country’s sustainable development. The State will maintain a preponderant role and will dictate general and specific measures relating to research, exploration, exploitation and development of those resources, with what is set forth in the National Development Plan.

Article 58 states that: “In order foster economically sustainable development, the competent authority will evaluate and promote the exploration and exploitation of alternative, renewable and environmentally sound energy sources.”

G. OTHER RELATED ENTITIES AND LAWS

Some of the entities and laws that govern specific activities are the following:

- The Ministry of Economy, Industry and Commerce (MEIC), in charge of setting fuel quality standards and coordinating matters of price setting and tariffs with ARESEP.
- The Ministry of National Planning and Economic Policy (MIDEPLAN), in charge of defining and monitoring the National Development Plans and authorizing investments made by public entities.
- The Treasury Department, which sets indebtedness limits and decides whether or not to authorize disbursements of credit obtained by the sector for development of its works.
- The Budget Authority, an agency of the Treasury Department, has the following functions, among others: to formulate the directives and general and specific guidelines of the budget policy, including with regard to salaries, employment, investments, and indebtedness. It may also, based on macroeconomic planning, propose limits to the credit of the non-financial public sector.
- The Comptroller General of the Republic, in charge of overseeing the correct administration and good use of public resources and to authorize the budgets of State companies and institutions for their functions, and their budget execution.
- Ministry of Health: establishes occupational health standards and emergency plans.
- Central Bank of Costa Rica: approves levels of indebtedness jointly with the Treasury Department.
- Law of Administrative Contracting and its Regulation: regulates matters regarding the goods and services procurement regime.
- Law of Financial Administration and Public Budgets, Law N° 8131.
- General Internal Control Act, Law N° 8292.

The legal framework for the sector is very broad, with the additional element that it is very common for new laws that are passed not to entirely eliminate what is established in former laws. The resulting proliferation of laws causes serious problems such as the lack of clarity in the powers of institutions that govern and regulate, making it difficult to manage public sector companies.

5.4 *Regulated Activities*

In concordance with current legislation, primarily with the Hydrocarbons Act and the law creating the ARESEP, all activities relating to the oil & gas chain, from exploration to sale to the final consumer, are broadly regulated and ruled. Only now, being a recent activity economic, is there a process of regulating and standardizing all things relating to biofuels,²⁰ for which the Government of the Republic set up a high-level commission made up of public and private sector officials.

5.5 *Unregulated Activities*

In accordance with what is mentioned in the above paragraph, there are activities in the hydrocarbons industry that are not regulated, except for biofuels due to a special situation, being a very recent activity, which are in process of being regulated by the State.

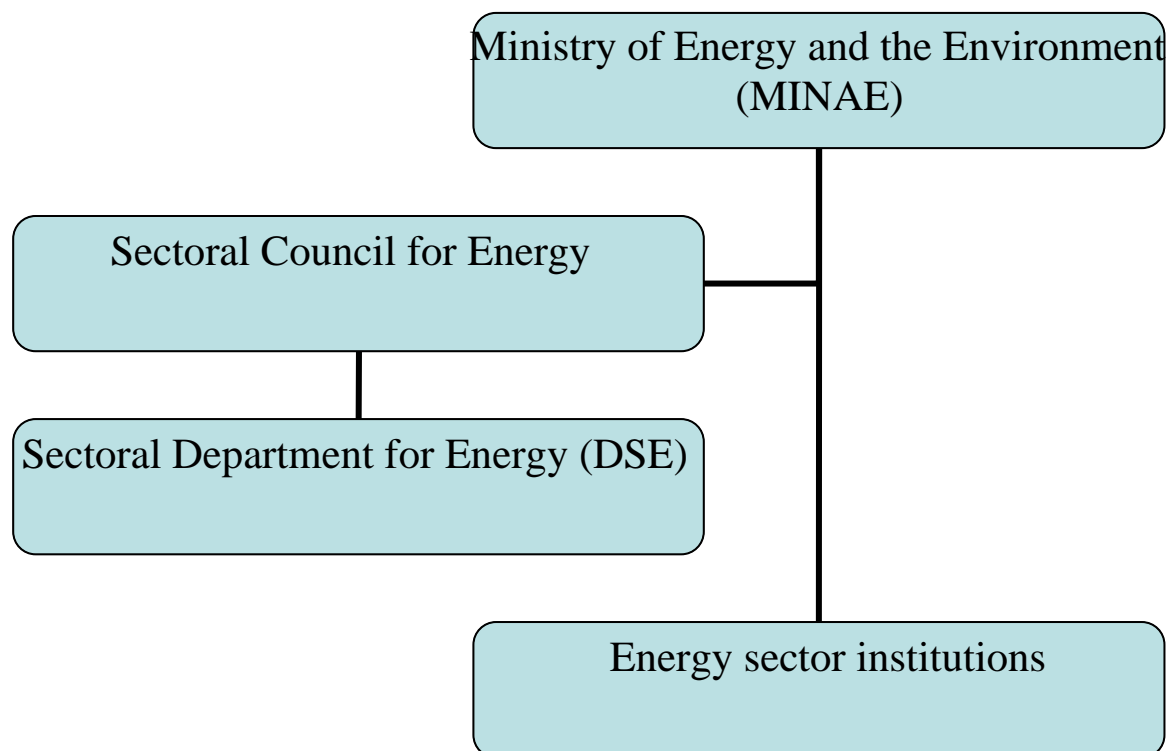
²⁰ RECOPE has a pilot plan in progress since February 2006 to combine regular gasoline with ethanol, and both the quality standards and price setting are governed by the regulations on the fuels marketed by that company.

6. INSTITUTIONS AND ENTITIES

6.1 General Layout of the Sector

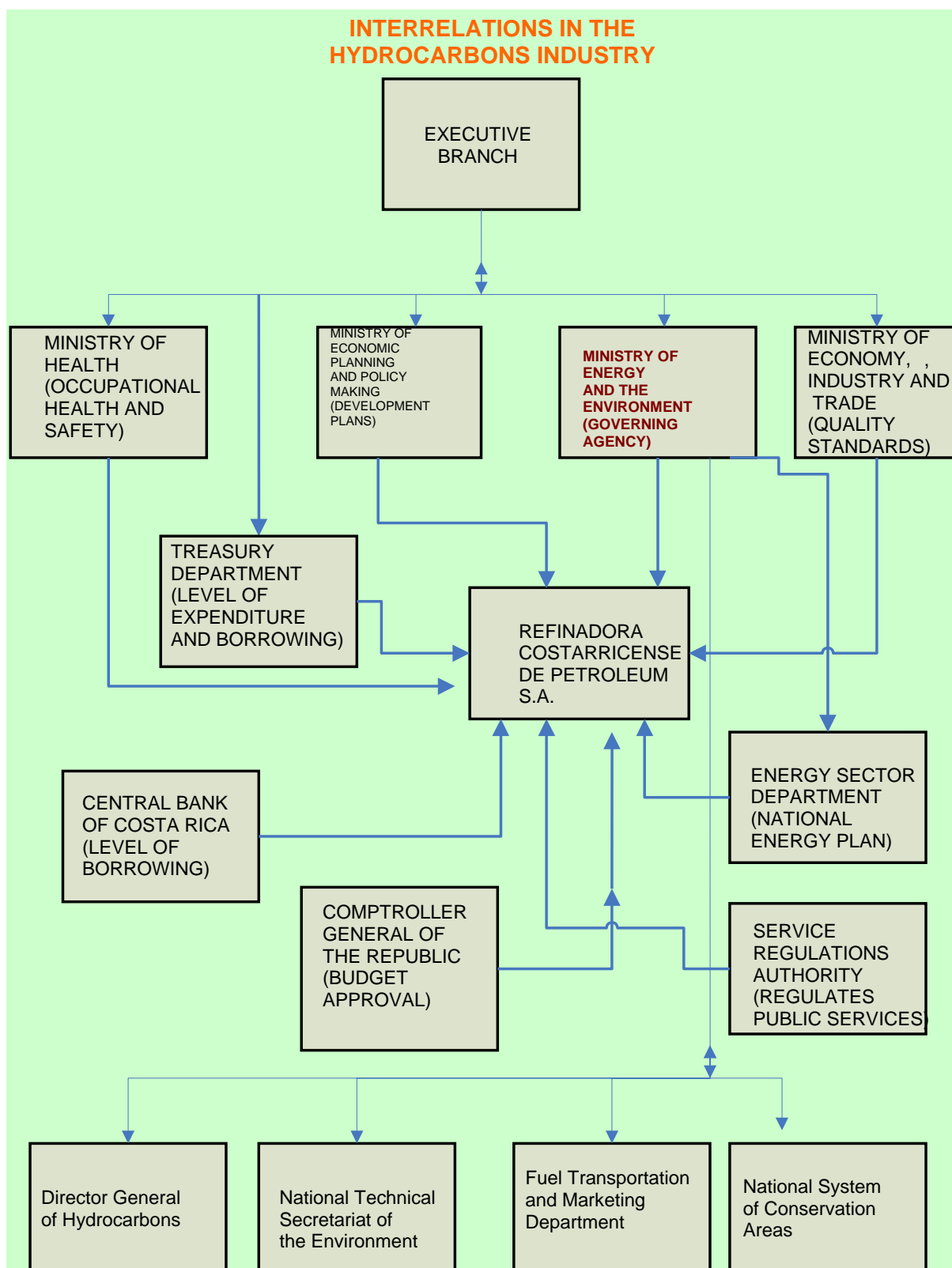
As an introduction to describing the institutions and entities that make up the oil & gas industry, below is a layout of the energy sector:

Figure 1 – Energy Sector Structure



Specifically for the hydrocarbons industry, there is a link with different public sector entities that, although their primary activity is not hydrocarbons, have a direct influence on certain types of approvals or supervision, primarily over RECOPE. The figure below shows the entities that participate in one way or another in the sector and the different linkages between these public entities.

Figure 2 – Structure of the Oil & gas industry



6.2 Ministry of Energy and the Environment (MINAE)

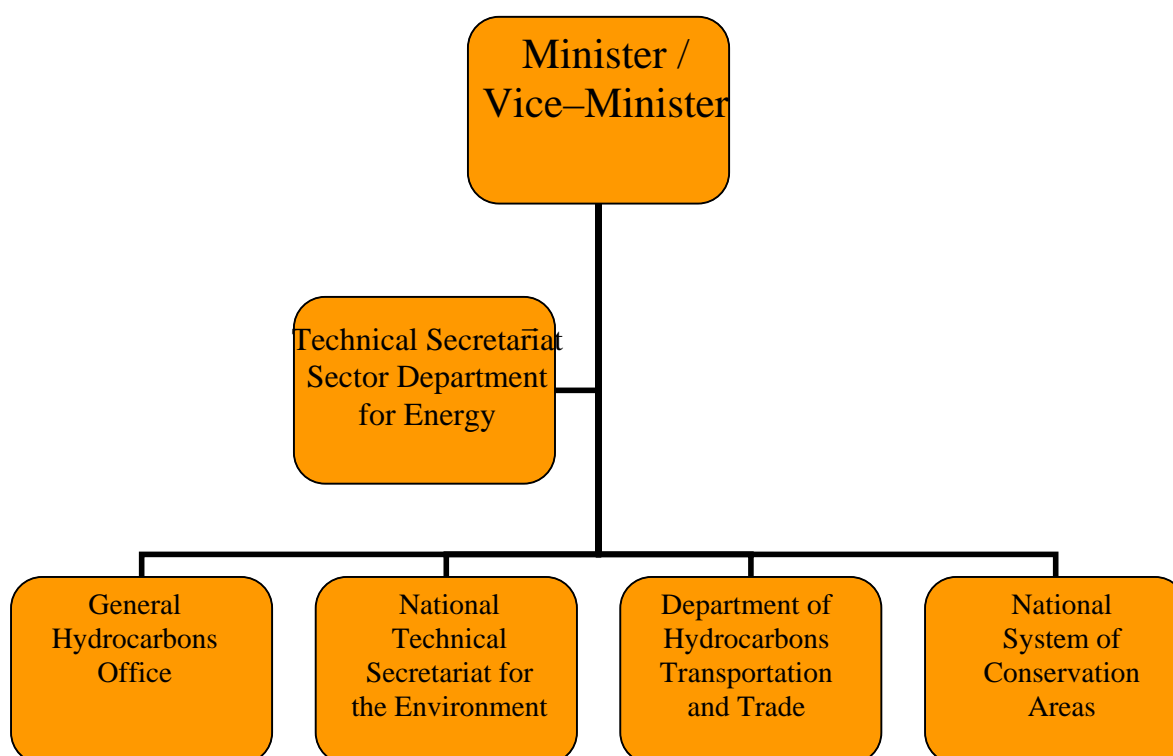
Law N° 7152 turned the Ministry of Industry, Economy and Mines (MIEM) into the Ministry of Natural Resources, Energy and Mines (MIRENEM from the Spanish) and established that the Minister is the Director of the Natural Resources, Energy and Mining Sector. It also defined the basic functions of the Ministry as policy making, planning and implementation of natural energy and mining resources and of environmental protection, as well as direction, control, supervision, promotion, and development of those resources. It has an obligation to foster the development of Natural Resources, Energy and Mining, in addition to promoting and managing law on conservation and rational use of natural resources, for which it will dictate binding rules and regulations regarding rational use and protection of natural resources, energy and mines.

Article 116 of the Organic Law of the Environment, Law N° 7554, modifies Law N° 7152 changing the Ministry of Natural Resources, Energy and Mines (MIRENEM) to the Ministry of Energy and the Environment. Articles 56 to 58 establish that energy resources are essential factors for the country's sustainable development, and that the State will maintain a preponderant role and dictate the general and particular measures regarding research, exploration, exploitation and development of those resources, based on what is set forth in the National Development Plan, and must ensure that energy resources are utilized in a rational, efficient manner. Therefore, it must also assess and promote the exploration and exploitation of alternative, renewable, environmentally sound sources of energy aimed at environmental conservation and protection, and fostering sustainable economic development.

The present Administration of the country, by Decree N° 33151–MP of 2006 designated the Ministry of Energy and the Environment as the director of the Environment, Energy and Telecommunications Sector.

The organizational structure of the MINAE is as presented in the following figure:

Figure 3 – Organizational structure of the Ministry of Energy and the Environment



The basic functions of the MINAE as a governing body are the following:

- a) The Minister is the maximum authority and director of the Energy sector.
- b) The sectoral layout is maintained, and its planning function is strengthened.
- c) It defines and establishes the means of coordination with different entities and actors in the sector.
- d) It defines the Plan National for the Sector in harmony with the National Development Plan, including the priorities of the sector fuel.
- e) It defines the technical specifications for product quality.
- f) It monitors the fulfilment of development plans and policies.
- g) It issues directives.
- h) It is the representative on fuel matters in different international forums.
- i) It is the inter-sectoral coordinator in fuel-related matters.

The work arrangement of the director is the following:

- a) The director will have a Council and it in turn will have a Technical Secretariat for Energy with instrumental legal status. It receives its resources through planning.
- b) The Council will be made up of the Minister of the Environment and Energy (President), the Minister of Economy, the Minister of Planning, the President of RECOPE, the Executive President of the ICE, the ESPH Manager, the JASEC Manager, the CNFL Manager, ARESEP, and a representative of the private sector.
- c) The director issues general directives that should guide the management of public entities that are responsible for regulation and the companies and public institutions at the different stages of the chain.
- d) Permanent coordination will be maintained with SUCOM to guarantee fulfilment of the policy, plans and directives.

6.2.1 *Dirección Sectorial de Energía (DSE)*

It originated in Executive Decree N° 21351 of MIRENEM – PLAN, article 45 of which establishes that the Energy Sector Council will have the support of the *Dirección Sectorial de Energía*, which will assume the functions and powers of the *Secretaría de Planificación Subsectorial de Energía*. This Secretariat will be the executive body of the respective Council. Part c) also establishes that the *Dirección Sectorial de Energía* and the *Secretaría de Planificación Subsectorial de Energía* must develop, evaluate and monitor the Sub-sector Development Plan and achieve compatibility among the initiatives and contributions of the planning bodies of the institutions in the sub-sector.

The figure below shows the current organizational structure of the DSE, which acts as a technical advisory body to the Minister.

Figure 4 – Organizational Structure of the *Dirección Sectorial de Energía*

	Ministry of Energy and the Environment	
	Technical Secretariat Energy Sector Department	
Administrative Assistant		
Planning Area	Information Area	Development Area

Vision

The *Dirección Sectorial de Energía* (DSE) is the organization that heads overall planning in the energy field, formulates and monitors the directives, policies and strategies of the sector, orients the activities of the sector's institutions and companies, and is the primary reference source, both nationally and internationally for decision making in the Costa Rican energy sector.

Mission

To promote harmonious, efficient, effective development of the national energy sector through the formulation, monitoring and dissemination of policies, strategies, plans, and projects considered by institutional coordination, rational use and resource of new energy sources, seeking to enhance the quality of life for the population and protect the environment.

Functions

- a) Develop the National Energy Plan considering the guidelines of the National Development Plan, the directives issued by the Ministry of Environment and Energy (MINAE) and the initiatives and contributions of public and private sector institutions.
- b) Perform and coordinate integrated energy studies and assessments for decision making relating to planning and development for the sector.
- c) Develop the energy price policy for inclusion in the National Development Plan, through the National Energy Plan.
- d) Promote research and development of different energy sources and related technology.
- e) Develop and maintain an information system that supports energy planning and development in the sector.
- f) Evaluate and monitor fulfilment of the policy and goals contained in the National Energy Plan.
- g) Promote rational energy use, establishing the mechanisms required to implement actions in this field.
- h) Play the role is has been given in its capacity as the Technical Secretariat of the Energy Planning Sub-sector.

6.2.2 Dirección General de Hidrocarburos (DGH)

The organizational structure of the DGH is the following:

Figure 5 – Organizational structure of the *Dirección General de Hidrocarburos*

Minister of Energy and the Environment		
Director		
Administrative Coordinator	Legal Coordinator	Technical Coordinator

The basic functions of this department are the following:

- a) Develop the public bidding contest instruments and submit them to the approval of the Technical Council.
- b) Review bids for hydrocarbons exploration and exploitation and remit the respective technical recommendations to the Executive Branch via the Technical Council.
- c) Supervise all activities developed by the contractors.
- d) Review the concurrence of causes for contract annulment or caducity and submit its recommendations to the Executive Branch, via the Technical Council.
- e) Present its recommendations to the Executive Branch regarding the legality or illegality of assigning all or part of the contracts.
- f) Review and recommend to the Executive Branch whether to grant extensions requested by contractors.
- g) Determine the maximum production efficiency rate.
- h) Keep the records cited in articles 20 and 21 of this Law.
- i) Approve information presented by contractors.

6.2.3 *Secretaría Técnica Nacional Ambiental (SETENA)*

The organizational structure of the SETENA is the following:

Figure 6 – Organizational structure of the *Secretaría Técnica Nacional Ambiental*

	Minister of Energy and the Environment		
Plenary Commission	Secretary General		
	Technical Departments	Legal Office	Administrative Office
	Institutional Management		
	Project Management		

The basic functions of the SETENA are the following:

- a) Review environmental impact assessments.
- b) Develop guidelines for environmental impact assessment activities, works and projects, and take steps towards their provision and dissemination.
- c) Perform the respective field inspections prior to issuing its resolutions.
- d) Receive and investigate reports presented regarding environmental degeneration and damage.
- e) Perform monitoring tasks and oversee the implementation of resolutions.
- f) Set guarantee amounts for compliance with environmental obligations.

6.2.4 *Dirección de Transporte y Comercialización de Combustible* (DTCC)

The *Dirección de Transporte y Comercialización de Combustible* is an organizational unit of the MINAE.

Vision:

“To achieve consolidation as the specialized technical body of the MINAE in inspecting efficient, secure fuel supply for society and environmental protection.”

Substantive Outputs:

The basic responsibilities of the DGTCC are inspection of companies that market and transport fuel, in addition to providing these companies with services and procedures to enable them to perform those activities under the specifications of current legislation. The DGTCC carries out the following priority processes.

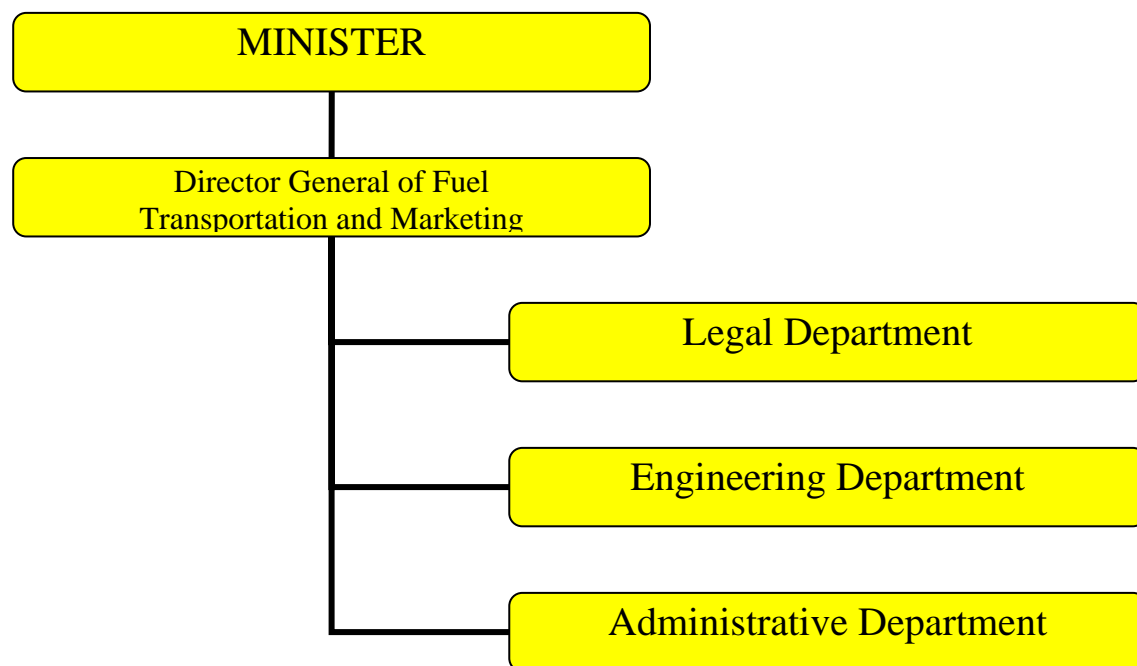
- 1.1. **Regulating** fuel transportation, storage and marketing, as well as raising safety and health measures for the operations and work of companies involved in that public service.
- 1.2. **Control and inspection** of the activities and related facilities based on current laws and specific regulations as defined by DGTCC along all national borders.

- 1.3. ***Processing*** requests to install, move, remodel, renovate, and operate the involved companies, as well as receiving denouncements.
- 1.4. ***Justifying and recommending*** operation authorizations, as well as suspending and/or cancelling the respective permits.
- 1.5. ***Attending to different types of users*** in relation to the public service of fuel storage and transportation, as well as providing appropriate information for decision making and accountability.

Administrative Structure:

The *Dirección General de Transporte y Comercialización de Combustible* (DGTCC) reports directly to the Ministry. The current organizational chart is as follows:

Figure 7 – Organizational structure of the *Dirección de Transporte y Comercialización de Combustible*



The main functions of the DGTCC are:

- Regulate, supervise and control hydrocarbons transportation and marketing (over 950 tanker trucks throughout the country).
- Verification of matters relating to the security and correct functioning of self-consumption facilities (industries, hospitals, public administration, etc, and of facilities for oil & gas products storage and distribution to final consumers.
- Process requests to install, move, change owners, remodel, and operate self-consumption or storage and distribution establishments, and to develop the respective recommendation for the Minister of the Environment and Energy.
- Recommend that the Minister of Environment and Energy suspend or cancel the authorizations that are regulated in this Executive Decree.
- Go through the administrative procedures to determine whether to suspend or cancel the authorizations granted.

6.2.5 Sistema Nacional de Areas de Conservación (SINAC)

The *Sistema Nacional de Areas de Conservación* was created through the Biodiversity Act, Law N° 7788, of April 30, 1998.

The system will be made up of territorial units called Conservation Areas under the general supervision of the MINAE.

This System brings together competencies in the fields of forestry, wildlife and protected areas in order to make policies, plan and execute processes aimed to achieve sustainability in managing the country's natural resources.

The organizational structure of this System is presented in the following figure.

Figure 8 – Organizational structure of the SINAC

	Minister of Energy and the Environment	
	National Council for Conservation Areas	
	Executive Secretary	
Regional Department	Scientific and Technical Committee	Administrative and Financial Entity

The basic functions of the Executive Directorate are the following.

- Enforce the Biodiversity Act and other laws governing the matter.
- Implement the national policies dictated in the National Development Plan.
- Execute directives from the Minister and the Regional Council.
- Oversee the formation and correct functioning of the Technical Committee and of the Financial–Administrative Entity.
- Oversee the training, supervision and wellbeing of all personnel.

6.2.6 Central Bank of Costa Rica

The Central Bank, together with the Treasury Department, approves the levels of [...].

6.2.7 The Ministry of Economy, Industry and Commerce (MEIC)

The MEIC is responsible for setting regulations for fuel quality standards, and should coordinate them with the *Autoridad Reguladora de los Servicios Públicos*.

6.2.8 The Ministry of Economic Planning and Policymaking

This Ministry is in charge of defining the National Development Plan together with the Executive Branch and authorizing yearly investment plans. It is also empowered to fix the terms of the Yearly Institutional Plans on the basis of the National Development Plan, including management indicators that the company should present in order to be evaluated together with the yearly budget execution.

6.2.9 The Treasury Department

The Treasury Department is in charge of authorizing levels of indebtedness and should authorize the yearly disbursements on loans authorized for investment projects.

6.2.10 The Ministry of Health

The Ministry of Health is responsible for establishing the regulations to ensure public health and environmental protection in hydrocarbons management. This it does in coordination with the Ministry of Energy and the Environment.

6.2.11 The Comptroller General of the Republic

The Comptroller General of the Republic is the entity in charge of external inspection and oversight of the efficient use of public resources. It authorizes annual operation and maintenance budgets as well as investments, the latter in coordination with the MINAE.

6.3 *Autoridad Reguladora de los Servicios Públicos (ARESEP)*

The *Autoridad Reguladora de los Servicios Públicos* (ARESEP) is the regulating agency of Costa Rica. Its legal status is that of an Autonomous Institution, whose independence is guaranteed in the Constitution. Therefore, it does not depend on any ministry or secretariat. Its functions and structure will be given in greater detail in the following chapter.

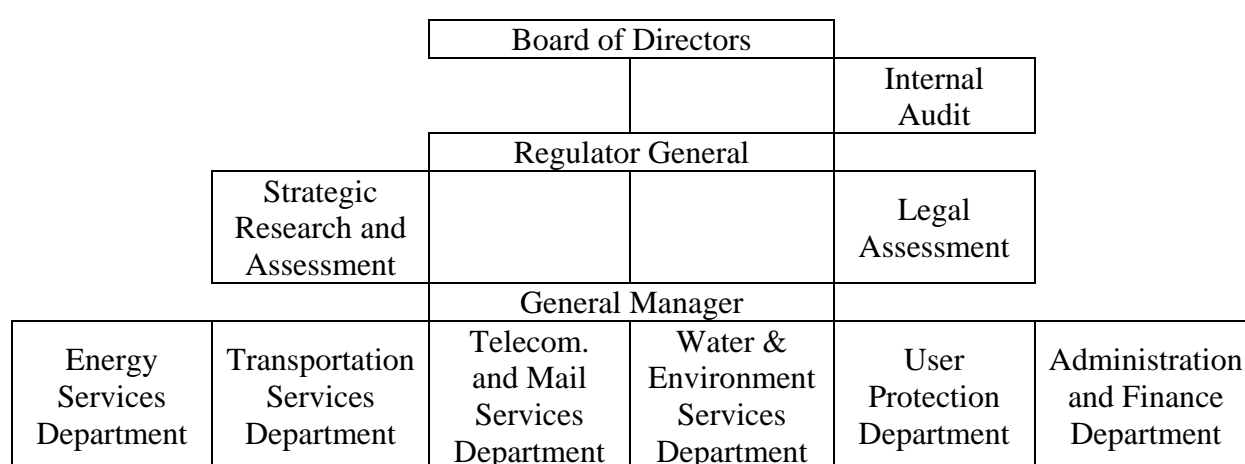
7. THE REGULATORY FRAMEWORK

As mentioned in the above chapter, the entity with the legal authority to regulate public services, including hydrocarbons, is the *Autoridad Reguladora de los Servicios Públicos* (ARESEP).

It was created through Law N° 7593 of October 1996, by transforming the former regulating agency, the *Servicio Nacional de Electricidad* (SNE) that was created in 1928 to regulate the electric sector, which was operated by the private sector.

The organizational structure of the ARESEP is presented in the following figure:²¹

Figure 9 – Organizational structure of the *Autoridad Reguladora de los Servicios Públicos*



Some important definitions established in the law creating ARESEP are the following:

- Public services*: Those whose importance for the country's sustainable development makes them qualified as such by the Legislative Assembly, in order to subject them to the regulations of this law.
- Service at cost*: A principle that determines the way tariffs and prices are set for public services in such wise to only include costs that are needed to provide the service, that allow for a competitive retribution and guarantee the appropriate development of the activity, in accordance with what is established in article 31.
- Public service provider*: A public or private subject that provides public services under concession, permit or law.
- Environmental impact assessment*: A scientific–technical study done by subject matter professionals to identify and predict the effects a given project would have on the environment, quantifying and weighting them and giving recommendations.

The basic purposes of the Regulating Authority are the following:

- To harmonize the interests of the consumers, users and providers of public services defined in this law and those to be defined in the future.

²¹ Source: ARESEP Web page.

- b) To seek a balance between the needs of public services users and the interests of public services providers.
- c) To ensure that public services are provided in conformity with what is established in this law, article 3,²² part b).
- d) Formulate and oversee compliance with the quality, quantity, timeliness, continuity, and reliability requirements needed to optimally provide the public services under its authority.
- e) To collaborate with State entities having authority in matters of environmental protection, in the case of providing the regulated services or granting concessions.
- f) To regulate the public services as set forth and defined in this law.

The main powers of ARESEP are the following, as stipulated in Law N° 7593 – Setting tariffs, issuing rules and regulations in matters of quality, and receiving complaints and denouncements from users.

Nine different public services are regulated:

- a) Electricity supply, including the generation, transmission, distribution, and commercialization stages.
- b) Telecommunications services whose regulations are authorized by law.
- c) Water and sewage services, including water supply, collection, treatment, and disposal of sewage water, waste water and rain water.
- d) Oil & gas fuel products, which include: 1) oil products, asphalts, gas, and naphthas designated to meet the domestic demand in distribution plants; and 2) oil products, asphalts, gas and naphthas designated for final consumers. The Regulating Authority must set the transportation tariffs that are used to supply the domestic demand.
- e) Irrigation and drainage, when services are provided through public companies or via concessions or permits.
- f) Any means of public transport that is paid by the public, except for air transport.
- g) Sea and air services at domestic ports.
- h) Railroad cargo transportation.
- i) Collection and treatment of solid and industrial wastes.

ARESEP includes a Board of Directors of five members presided by the Regulator General, whose designation is proposed by the Executive Branch, ratified by the Legislative Branch, and may be re-elected.

All tariff petitions are solved in the first instance by the Regulator General and may be appealed before the Board of Directors. The Regulator General does not attend the session at which recourses are resolved.

The present structure of the sector is complex. There are legal, regulatory, and normative overlaps regarding the functions of the institutions involved in same, since in some cases the limits for action are not clearly defined, and this causes duplication of functions and inefficient use of scarce State resources, produces insecurity between regulated entities and regulatory / supervisory entities regarding the rules that should be fulfilled in their specific activities. The lack of legal clarity also makes institutional coordination difficult, with the normal problems that this generates, such as duplication of human and financial efforts, with very few results and in some cases even negative ones. One example of this overlapping is the power ARESEP

²² The tariff is set based on the principle of service at cost plus a retribution to enable company development.

has to set fuel quality standards, as well as the Ministry of Economy, Industry and Commerce, while the Ministry of Health oversees product quality as an environmental protection measure. Another example of overlapping functions is the yearly budget approval and liquidation, which is to be done by the Treasury Department through the Budget Authority, by the Ministry of Economic Planning and Policymaking as far as the investment budget goes, and also by the Comptroller General of the Republic, who approves the final budget.

Regulatory Principles

The *Autoridad Reguladora de los Servicios Públicos* bases its regulatory task on the following basic principles, which were recently established:²³

a) Service at cost

The Regulating Authority sets tariffs in accordance with the principle of service at cost, understood as the long-term social opportunity cost of the services. The criteria of economic efficiency, social equality, environmental sustainability and resources conservation are central elements in this definition.

b) Competition

To the degree that competition can be used as an instrument to minimize prices and raise public service quality, it will be promoted by the authorities. When this is not possible, it will recur to whatever mechanisms have the least social cost possible to regulate quality and set tariffs.

c) Tariff buffering

In order to encourage the investments needed for public service sustainability and modernization, tariff setting will recognize depreciation and capital costs. In order to avoid disproportional variations and distribute costs among those who receive the benefits in time, it will not recognize the financing of investment plans through tariffs increases.

d) Lender responsibility

Regulatory agency intervention in internal company affairs should be reduced to the bare minimum to ensure fulfilling the purpose of the regulation. The authorities of each institution are responsible for developing their plans, budgets, contracts, collective contracts, and other instruments pertaining to their administration.

e) Prospective tariff setting

Tariffs are set for given time periods, for the purpose of providing incentives for administration to reduce costs and generate extra surplus, which may be used by the entities during the period within which they were generated or in the following one. Subsequently, the unused portion of the surplus will be applied to tariff reductions.

²³ Source: ARESEP Web page

f) *Ex post* review

The Authority reviews the actions of regulated entities *ex post*, for the purpose of verifying fulfilment of the responsibilities established for regulatory matters, especially investments needed to ensure services.

g) Indivisibility of price and quality

When the Regulating Authority sets tariffs, it will make explicit the relationship between the tariff set and the quality of the goods and services being regulated.

Tariffs

Law N° 7593 establishes that tariffs set by the *Autoridad Reguladora de los Servicios Públicos* (ARESEP) will be based on the principle of service at cost, defined as the principle that determines the way public service tariffs and prices are set. Thus it only contemplates those costs that are necessary to provide the service, that allow a competitive retribution or profitability and guarantee adequate development of the activity. Annex 1 details the current economic regulations and the ARESEP proposal that was reviewed in a public hearing in July 2007.

The overall tariff methodology is based on calculating an average accounting cost and adding a percentage of profit, also called development earnings, profitability rate, earnings margin, etc., depending on the particular model and the public service in question. This methodology is called Rate of Return or Profitability. In economic terms it is said that this methodology seeks to balance total revenues with total costs, where the latter recognize a payment on the capital factor, expressed as earnings, since according to current legislation, tariffs should enable a competitive retribution on capital and ensure adequate development of the activity.

As commented above, in practice this methodology implies balancing the revenues with the economic costs, where the latter include a reasonable, fair profit according to the capital invested. Expenditures also include operating and maintenance expenses, including depreciation (historic and reassessed), overhead and any other expenditures associated to effectively supplying the public service. This is done under the principle that all expenses included in tariff calculations should be useful and utilized, that is, necessary to effectively supply provide the public service on question and be an actual expenditure.

The mathematical model by which tariffs are calculated is as follows:

$$I = OMAO + R * (NFARO + WC)$$

Where:

I = Total revenues

OMAO = Operating, Maintenance and Overhead

NFARO = Net Fixed Assets in Re-evaluated Operation (Average)

WC = Working Capital

R = Profitability Rate

If:

BT = Base Tariff = NFARO + WC

NRO = Net Revenue from Operations = I – OMAO

Then:

$$R = \frac{NRO}{BT}$$

The working capital varies depending on the company and regulated sector, but is usually calculated as a fraction of the revenues or operating expenses or as minimum inventory days.

In the case of fuel, according to ARESEP statements, the basic principle is that the different tariffs or prices should reflect production and distribution costs, and that distortions in this rule should be eliminated or at least significantly reduced, in such wise that prices give the right signals to producers and consumers.

Since 2006, based on the principles stated above and on Law N° 7593, ARESEP has been gradually eliminating existing crossed subsidies, primarily on gasolines and on diesel and LPG, with the goal that final consumer prices reflect RECOPE's actual production and distribution costs.

In August 2007, ARESEP approved a reform to the final consumer price approval method, saying that only two tariff adjustments can be requested per month and changing some of the price-setting parameters. RECOPE objected this approach, claiming that it could work against the company's financial health and that it uses a comparison factor based on benchmarking, which is not well defined in the methodology and would be used to determine the company's operating costs.

8. STATE-OWNED COMPANIES – ORGANIZATION, FUNCTIONS AND INTERRELATIONS

As mentioned in the background chapter and when describing the sector's legal framework, Costa Rica has a State monopoly, managed by RECOPE, on the oil & gas business, and the only private sector participation is in bulk distribution to service stations for sale to final consumers, or to final-consumer type industries, or to be bottled and sold to final consumers in the case of LPG. Therefore, this chapter is dedicated entirely to RECOPE.

8.1 Description

The *Refinadora Costaricense de Petr leo, S.A.* (RECOPE) is a State-owned company set up as a stock company, in which 100 % of the shares are owned by the Costa Rican State. It is the State-owned company in charge of managing the oil & gas monopoly.

RECOPE's legal framework has been given basically by Laws N  7358 and 6588 and related laws, which were commented on in the chapter on the sector's legal framework.

The current organizational structure, at the managerial levels, is shown in the following figure:

Figure 10 – Organizational structure of the *Refinadora Costaricense de Petr leo, S.A.*

		Ministry of Energy and the Environment (Governing Body)		
		Board of Directors		
	Internal Audit		Legal Counsel	
		Executive President		
		General Manager		
	Quality Assurance		Information Technology	
Refining Manager	Administration and Finance Manager		Marketing and Distribution Manager	Foreign Trade and Development Manager

The Executive President and the other Board members are named by the Executive Branch for a 4-year period, except for the Board's Vice-president, who according to current legislation is the Minister of Environment and Energy or delegate. Managerial positions are assigned by the company's Executive President and are considered positions of trust. There is no instrument to

assess the performance of the Board of Directors or of company Managers, nor any accountability obligations.

The present Board of Directors, in the sole article of Special Meeting N° 4119–75 of Thursday, January 18, 2007, approved a new organizational structure,²⁴ which should be supported by the Minister of Economic Planning and Policy. It also approved the new vision, mission and strategic objectives in accordance with that structure, which are transcribed textually below:

MISSION:

We are a public company based on knowing people's talents, devoted to the fuel business and related products and services. We serve the needs of our customers and Costa Rican society with efficiency, quality, social and environmental responsibility, contributing to the sustainable development of Costa Rica.

VISION:

To be the leading company on the domestic and regional fuel market, with related products and services, through creative, innovative management of technological and human resources to enhance the country's competitiveness in an environmentally sustainable way, adding value to Costa Rican society and our customers.

STRATEGIC OBJECTIVES:

- a) To strengthen the company, making it more competitive;
- b) To enhance its process management, efficiency and productivity, aligning operational concerns with strategic ones, so that its performance indices will be recognized as the highest in the region.
- c) To expand our field of business to the entire fuel chain, other related products and services, adding public and private value.
- d) To position RECOPE as a leading company by developing a culture of customer service and of knowledge, in harmony with the environment.

8.2 Control Regulations

RECOPE is subject a the following institutions that govern and regulate the operation of the company:

- a) General policies are dictated by the Executive Branch, as owner of 100 % of the company shares.
- b) The Ministry of Energy and the Environment, as the energy sector's governing body, dictates the company's energy policies in concordance with Executive Decree N° 33151–MP of June 2006.
- c) The Comptroller General of the Republic (CGR), in accordance with article 5 of Law N° 6588, is in charge of external inspection. The CGR approves and controls the

²⁴ Should be approved by MIDEPLAN and then the Treasury Department from a budget content perspective.

company's yearly budgets. More specifically, in accordance with said article, the CGR is basically in charge of the following:

- Exercise control, in ways and at times it deems appropriate, on the revenues, expenditures and, in general, the capital of RECOPE, through audits or special investigations as it deems necessary.
 - Request any type of information, documents, files, or dossiers.
 - Examine and evaluate internal control and make recommendations as needed to improve it.
 - Examine and evaluate the degree of efficiency, effectiveness and economy in the use of resources managed by RECOPE.
- d) The *Autoridad Reguladora de los Servicios Públicos* is the entity in charge of regulating price setting at a distribution plant level, in accordance with Law N° 7593, and also of overseeing service quality. The Regulatory Entity also has the power to perform tariff audits, that is, on operational and financial matters relating to fuel sales price approvals.
- e) The Ministry of Economic Planning and Policymaking should approve all investment plans, which should be in accordance with the National Development Plan and the National Energy Plan.
- f) The Ministry of Economy, Industry and Commerce dictates quality standards for the products that are marketed by the company.
- g) The Central Bank of Costa Rica and Treasury Department should approve loans for company infrastructure development.
- h) The Ministry of Health dictates regulations relating to protecting health human, safety, and emergency plans.
- i) The Internal Auditor who is hierarchically under the Board of Directors, as shown in Figure 10, is in charge of inspecting and evaluating internal control. The basic functions of the Auditor are to oversee compliance with the provisions established under the following headings:
- Fulfilment of the company goals and objectives.
 - Faithful fulfilment of all legal provisions and external / internal regulations that govern the company's activities.
 - Oversee fulfilment of the procedures regulating the company's activities.

The General Auditor participates actively as a guest at the Board meetings, with a right to speak but not to vote. The Internal Audit structure is divided basically into three areas.

- General Auditor
- Financial Assistant Auditor
- Technical Assistant Auditor

The General Auditor can only be removed from the position with the respective authorization from the Comptroller General of the Republic.

- j) In addition, RECOPE contracts a yearly external audit, both financial and operational, with an independent, external audit firm through a merits-based public bidding contest. The Comptroller General of the Republic and the *Autoridad Reguladora de los Servicios Públicos* are also empowered to perform external audits.

- k) The Service Comptroller, attached to the maximum authority of the company, has the following basic functions:
- Oversee the establishment of operational indicators to identify different service issues, in order to minimize customer complaints.
 - Issue image enhancement recommendations for public service provision.
 - Collaborate with internal control regarding public service provision.
 - Promote the establishment of information instruments and procedures for presenting customer complaints.
 - Present proposals to adopt policies, regulations and procedures aimed towards more timely, efficient, effective service.

Regarding the goods and service procurement regime, the Company is governed by the Law of the Administrative Contracting and its Regulations. There is a specific procedure for procurement of crude oil and oil products, which was approved by the Comptroller General of the Republic, by which suppliers should be recorded in a specific registry in order to participate in public bidding contests of this type.

With regard to company management evaluation, along with the yearly budget that is presented to the Comptroller General of the Republic, it should present the Yearly Work Plan that includes an institutional matrix, the form for which is presented in Annex 2, with goals, objectives and strategic actions as per the National Development Plan and the National Energy Plan when pertinent. The annual budget liquidation should include the respective review of the goals and objectives achieved as set at the beginning of the budget period.

Similarly, at each fuel price adjustment, the *Autoridad Reguladora de los Servicios Públicos* assesses company management in terms of expenditure levels and investment project execution, for the purpose of verifying whether resources from former price adjustments were utilized in accordance with their approval.

However, these management reports of sent to the CGR have no effects on company management, as they are viewed as mere bureaucratic procedures that need to be followed in the yearly budget approval process. With regard to reports sent to ARESEP, the only measure is to approve a smaller raise than requested due to non-compliance with former sales price adjustments.

8.3 Description of the National Oil System

The following is a brief description of the National Oil System, which is owned by the State and managed by RECOPE:

a) Moín Port Terminal

- Approved Draft: 11 m
- Capacity to receive ships: 50,000 tpm

b) Refining plant

- Capacity: 25,000 Bbl / day
- Units: atmospheric distilling, naphtha hydro-treating and reforming, kerosene hydro-treating, vis-breaker and vacuum distilling.

c) Distribution plants

- Moín: 335,789.54 m³
- *El Alto*: 83,745.20 m³
- *La Garita*: 55,197.56 m³
- Barranca: 22,187.00 m³

d) Products Pipeline System²⁵

- Length: 550 km of tubing composed of two 6 cm diameter lines.
- Pumping Stations: Moín, Siquirres and Turrialba, *El Alto* and *La Garita*.

8.4 Management Indicators

It is deemed advisable to present the management indicators for a five-year period in order to show their trends and thus study the true behaviour of each indicator.

a. Financial indicators

For analyzing these indicators, below are RECOPE's audited financial statements for the 2002–2006 period, both the Balance Sheet and the Profit and Loss Account.

Table 1: Balance Sheet at December 31.

ASSETS	2000	2001	2002	2003	2004	2005	2006
Total current assets	33.361.998	41.131.430	60.745.009	68.661.373	79.768.796	121.071.092	127317154
Total fixed assets	62.641.703	65.186.820	72.215.303	78.836.030	89.038.859	104.707.177	139682283
Total other assets	2.263.130	2.317.973	1.618.254	2.235.830	4.343.294	3.115.820	3833357
Total assets	98.266.831	108.636.223	134.578.566	149.733.233	168.807.655	228.894.089	270.832.794
Liabilities and net worth							
Liabilities							
Total current liabilities	30.889.486	32.257.507	43.845.766	43.576.874	34.872.287	69.231.053	73939685
Total long-term liabilities	2.525.446	2.320.385	2.784.499	3.287.904	3.569.527	17.730.404	37003896
Total other liabilities	1.358.774	1.443.849	1.727.560	3.239.818	4.840.601	6.773.199	837531
Total liabilities	34.773.706	36.021.741	48.357.825	50.104.596	34.872.287	93.734.656	111.781.112
Total net worth	63.493.125	72.614.482	86.220.741	99.628.637	129.868.534	135.159.433	151051682
Total liabilities and net worth	98.266.831	108.636.223	134.578.566	149.733.233	164.740.821	228.894.089	262.832.794
Exchange rate: Colón per Dollar	318,6	341,94	379,05	419,01	459,64	497,71	519,95

Source: RECOPE Web page

²⁵ A 30 cm diameter line is currently undergoing operational testing.

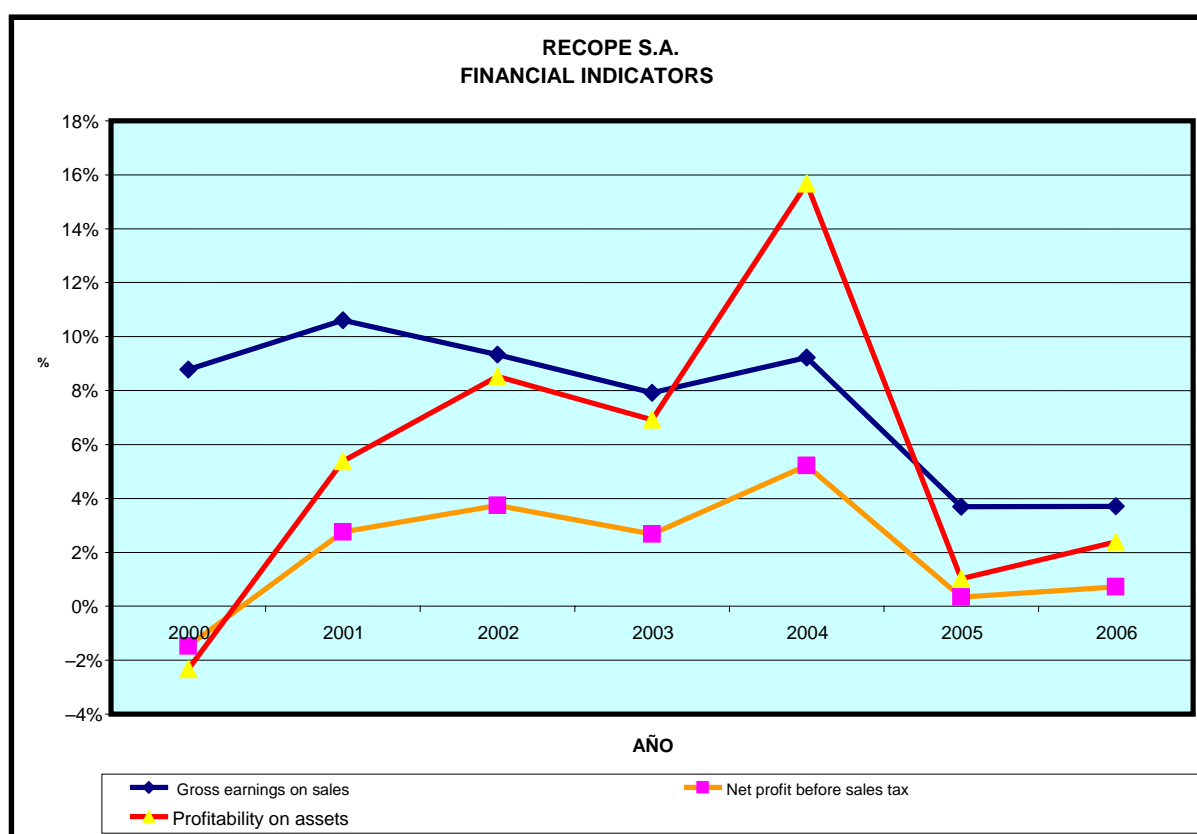
Table 2: Profit and Loss Account from January 1 to December 31

ITEM	2000	2001	2002	2003	2004	2005	2006
Net sales	155.951.281	211.759.284	306.435.663	386.191.461	507.565.676	685.110.963	894.617.215
Minus: sales cost	142.268.255	189.299.202	277.840.590	355.593.842	460.732.778	659.755.254	861.363.850
Gross earnings in sales	13.683.026	22.460.082	28.595.073	30.597.619	46.832.898	25.355.709	33.253.665
Minus: operating expenses	14.833.437	17.660.526	17.855.403	21.313.151	21.336.770	24.885.621	28.130.192
Operating profit or Loss							
DE OPERACIÓN	-1.150.411	4.799.566	10.739.670	9.284.468	25.496.128	470.088	5.123.473
Plus: other expenses	925.586	1.561.443	1.965.783	2.781.969	2.503.076	3.306.926	3.077.018
Minus: other expenses							
Financial expenses		96.627	782.705	988.857	720.555	16.276	622.577
Other expenses	2.071.733	424.795	441.114	716.887	808.913	1.424.126	1.113.758
Net profit or loss for period							
	-2.296.558	5.839.617	11.481.634	10.360.693	26.469.736	2.336.612	6.464.156
Net profit or loss for period	-	686.645	2.682.104	1.544.378	6.010.445		
Net profit or loss after taxes	-2.296.558	5.152.972	8.799.530	8.816.315	20.459.291	2.336.612	6.464.156

Source: RECOPE Web page

The primary financial indicators showing RECOPE management are shown in the following graph:

Graph 1: Financial Ratios of the Profit and Loss Account



One can see the great variability of these indicators, which were negative or practically zero during some of the years under study, which may be partially due to the regulations that RECOPE receives from ARESEP. Adjustments in plant-level sales prices, which generate the company's operational revenue, often take over fifteen days and sometimes even thirty. Meanwhile, RECOPE's purchase prices on the international market, for both crude oil and finished products, are subject to daily variations, usually upward, and this affects the company's finances and is reflected in the financial indicators shown. Another element that could influence this behaviour is the lack of new investments to expand or replace refining equipment. This is delayed by Central Government decisions due to fiscal deficit issues.

Other financial indicators relating to the Balance Sheet are presented in the following graph:

Graph 2: Balance Sheet Financial Ratios



These indicators show that RECOPE has maintained a fairly acceptable borrowing capacity, due in part to the State prohibition on public sector companies going into debt. It was only in 2006, with the loan to build the products pipeline, that it grew considerably. Liquidity, despite ARESEP's terms for approval of sales price adjustments, has always been greater than one.

b. Operational Indicators

In view of the fact that the country no has oil & gas exploration or production, as stated in the above chapters, the most important operational indicator presented below is use of refining capacity, shown as a percentage of the overall capacity. Another indicator is the evolution of infrastructure investments in the National Oil System.

- RECOPE's production and refinery utilization capacity during the 2003 – 2006 period is show in the following table, where we see that utilization rates show levels very low.

Table 3: Refinery production in barrels

PRODUCT	2003	2004	2005	2006
AC 30 ASPHALT	99.000	177.656	93.351	190.036
DIESEL OIL	648.537	1.177.166	991.187	1.696.157
HEAVY DIESEL	42.127	16.626	0	0
FUEL OIL	1.490.363	1.653.243	1.430.452	1.976.235
LPG				
MEDIUM	0	26.194	22.036	39.580
MEDIUM GAS OIL	0	18.519	20.432	31.905
KEROSENE	0	0	17.909	15.965
GASOLINE	801.944	670.573	556.879	961.062
TOTAL	3.081.971	3.739.976	3.132.245	4.910.939
DAILY PRODUCTION	8.444	10.247	8.581	13.455
% CAPACITY UTILIZED	34%	41%	34%	54%

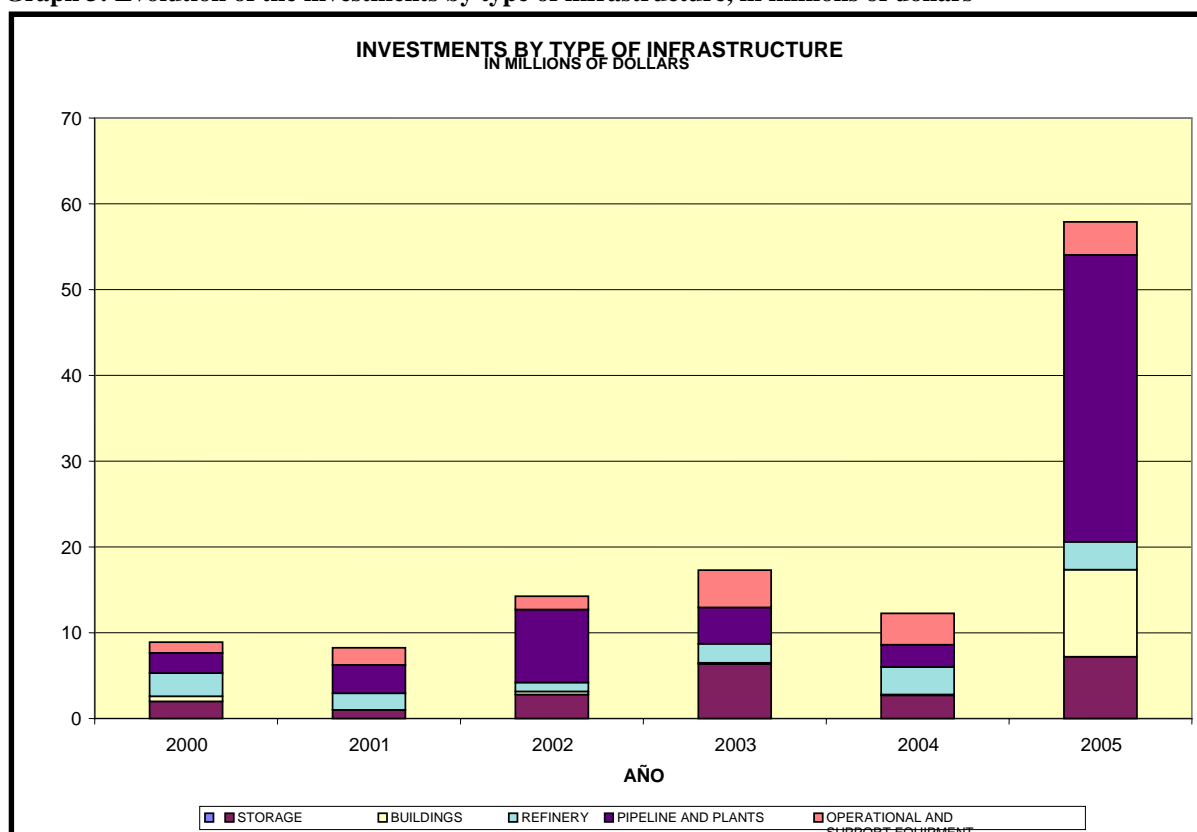
Source: Self-designed with DSE data

A very low nominal refinery capacity utilization rate is shown, giving an average of 40.7 % for the period under study, explained in part by the high rate of fuel oil production. Fuel oil has very little consumption, and the company no has capacity to reprocess it and produce lighter, products with added value for the company and the country, such as diesel and gasoline, which are most consumed products.

Other operational indicators are the following:

- As for the evolution of investments, they are shown on the following graph:

Graph 3: Evolution of the investments by type of infrastructure, in millions of dollars

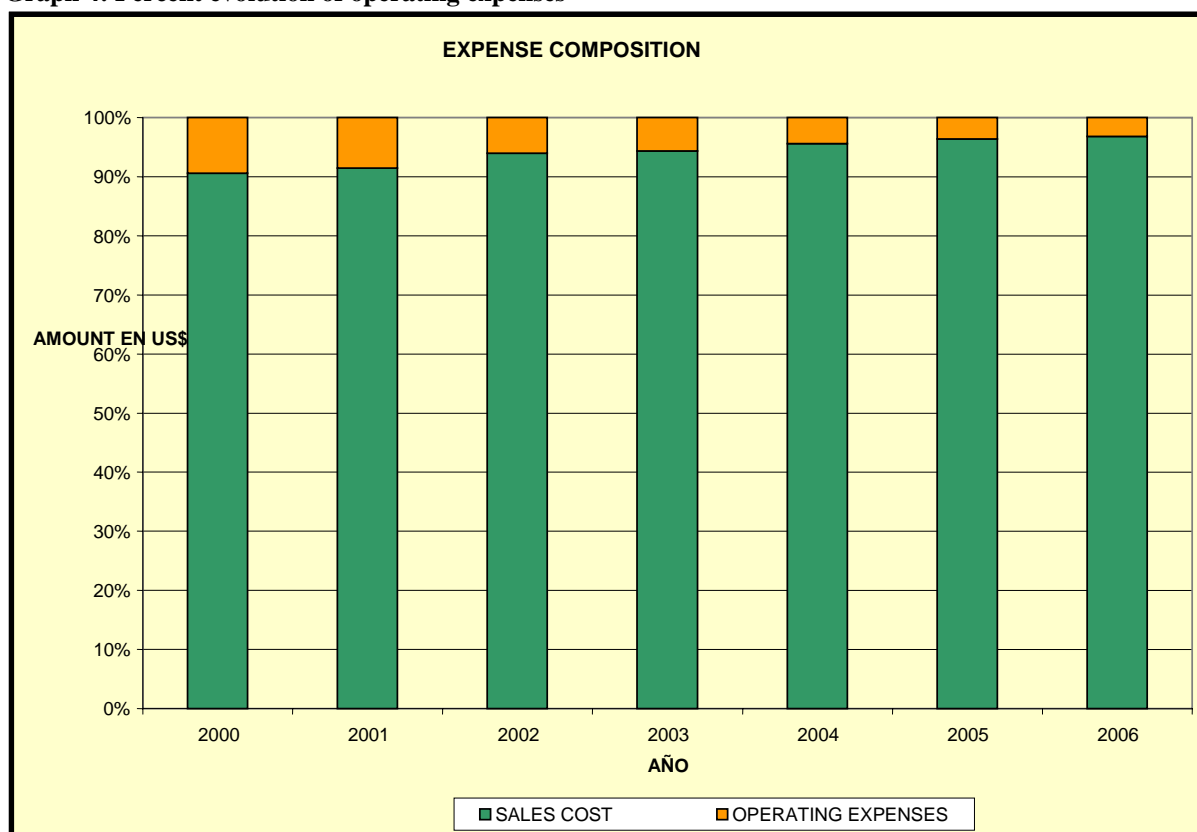


Source: Self-designed with data from RECOPE's Planning Department

There has clearly been a considerable increase in the yearly amount allocated to investments in infrastructure during 2005, with growth vis-à-vis former years of over 100 %. Note also that this increase is in the products pipeline as a result of beginning to build the new line. During several years the Government of the Republic, due to problems with a relatively high fiscal deficit, has kept a restriction on public investments, either through their own resources or via indebtedness, which also affected RECOPE as a State-owned company. This policy has begun freeing up gradually, enabling the company to start executing priority works such as the products pipeline, and the bids received to modernize the refinery are under study.

- With regard to operating expenses, its makeup is presented in the following graph:

Graph 4: Percent evolution of operating expenses



Source: Self-designed with data from RECOPE's Financial Statements.

It is very clear that over 90 % of the company's expenditures are for the purchase of crude oil and finished products. This is increasing due to continual price increases on the international markets to which RECOPE must turn in order to purchase these products. The company has no control over these prices.

8.5 Company Management

As mentioned in the above chapters, RECOPE manages the oil & gas monopoly in Costa Rica and therefore enjoys all the benefits of that status. It has no type of competition in any of the activities in the oil & gas chain. The only one where private business is allowed (exploration, exploitation and production) is currently paralysed.

RECOPE's monopoly environment, in which the owner is the State, has allowed it to work with practically no need for management to be accountable to any institution, except for the Comptroller General of the Republic and MIDEPLAN since Law N° 6588 was passed.²⁶ However, those management procedures or reports are seen as red tape, more for yearly budget approval and liquidation. More recently, the *Autoridad Reguladora de los Servicios Públicos* has regulations on fuel price setting at a distribution plant level and on service quality. This, however, does not clearly define the scope of that activity and there is some confusion regarding the powers of other entities that regulate the company in this area.

²⁶ Reviewed in the chapter on the sector's legal framework.

The current price regulation²⁷ sets prices based on the rate of return or profitability approach, and with historical data from the financial statements. That is, it does not take into account the factor of efficiency in company management, nor does it consider financial projections that could show the future situation under the sales price adjustment.

On the other hand, the current legal and institutional framework does not allow RECOPE to act as a stock company (private law), despite being structured as such. This would enable it to make use of the advantages of that status, such as more expedite goods and service procurement, hiring highly qualified personnel with competitive salaries close to market rates, greater investment and borrowing capacity, and finally establishing strategic alliances with private sector companies that could further its efforts as a company that is responsible for the hydrocarbons industry, which is so vital for the country's sustainable human development.

In consideration of the policies set forth in the National Development Plan regarding gradual, selective, regulated liberalization of State monopolies, the company should prepare internally to make full use the advantages that could accrue from liberalization, such as strategic alliances with domestic or foreign private companies in the sector.

²⁷ This is being changed and is expected to include elements of efficiency in price setting.

9. OIL & GAS BUSINESS STATISTICS

Detailed below are certain statistics on the hydrocarbons industry in Costa Rica in which, as mentioned through this paper, basically all activities are entrusted to RECOPE as manager of the monopoly on bulk importing, refining and distribution of hydrocarbons. These statistics are only relative to imports of crude oil and finished products and to refinery production, because as commented in the above chapters, Costa Rica has no oil or gas exploration / exploitation activities.

9.1 Imports

Import volumes are presented in the following tables, both on a whole and for primary finished products, crude oil and other derivatives.

Table 4: Volume of imports, in barrels

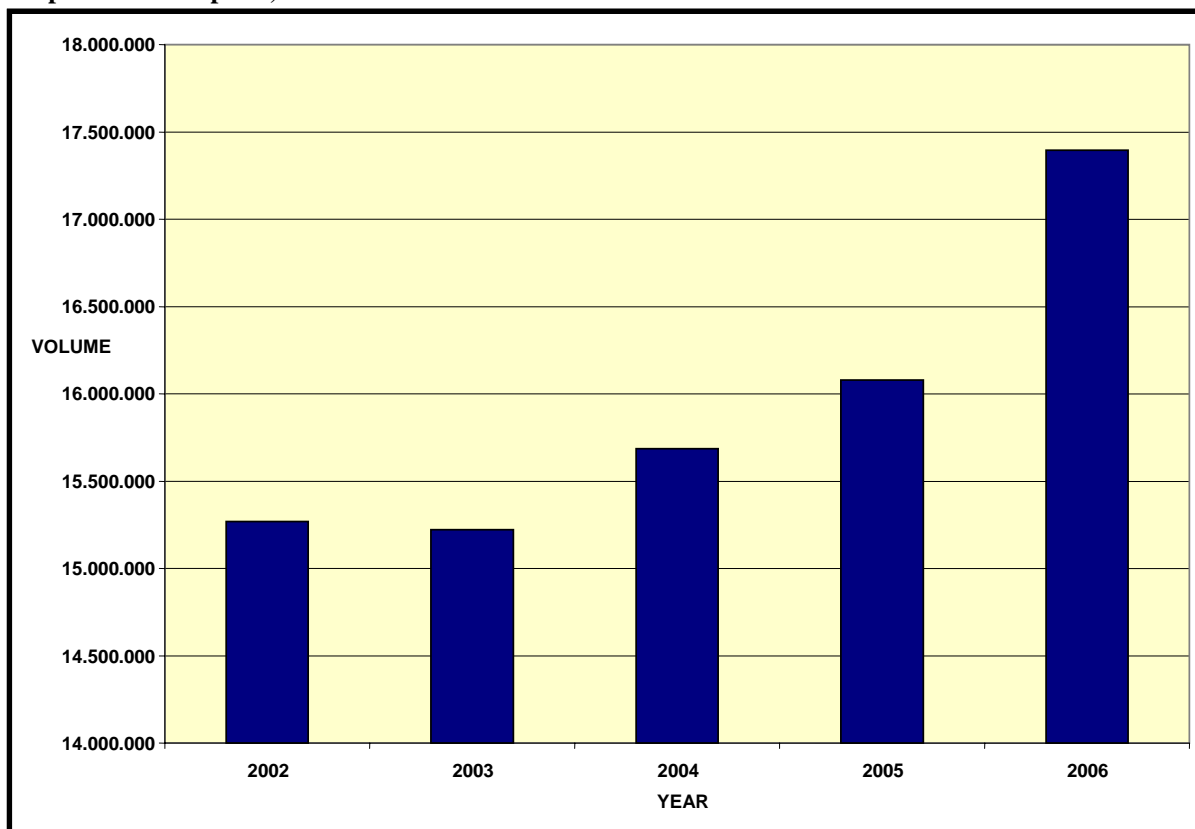
	2002	2003	2004	2005	2006
CRUDE OIL	3.493.543	3.815.624	3.814.006	3.911.854	4.851.301
DIESEL	4.019.841	4.234.176	4.400.200	4.643.754	5.407.280
GASOLINES	4.944.226	4.363.299	4.495.941	3.987.470	4.235.803
LPG	968.348	1.000.647	1.114.099	1.081.980	1.133.519
JET FUEL	1.016.051	963.872	1.259.934	1.482.643	1.494.759
MTBE	99.407	82.499	93.812	55.475	100.926
NAPHTA	—	—	120.736	416.108	45.562
OTHERS	726.199	761.915	386.689	499.417	104.216
TOTAL	15.267.615	14.460.117	15.298.728	15.579.284	17.269.149

Source: Foreign Trade Department – RECOPE

The following graphs show the trends for these imports, by total volume and by product, with an upward tendency, achieving a greater percent increase in 2006 than in 2005. This is partially due to the sustained growth²⁸ in the automobile fleet over the past five years and the strong influence of gasoline and diesel imports.

²⁸ As mentioned in the energy sector background, the automobile fleet is responsible for a large part of hydrocarbons consumption in the country.

Graph 5: Total imports, in barrels



Graph 6: Imports by product, in barrels

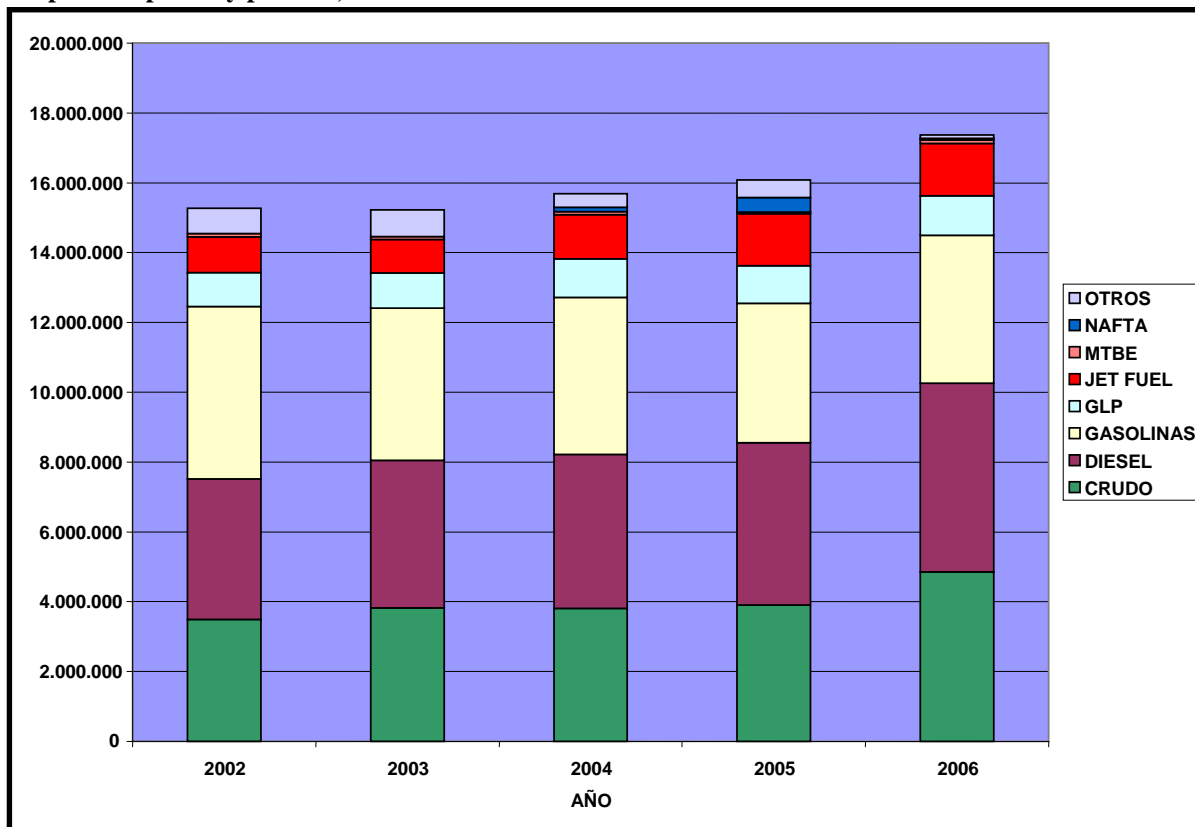
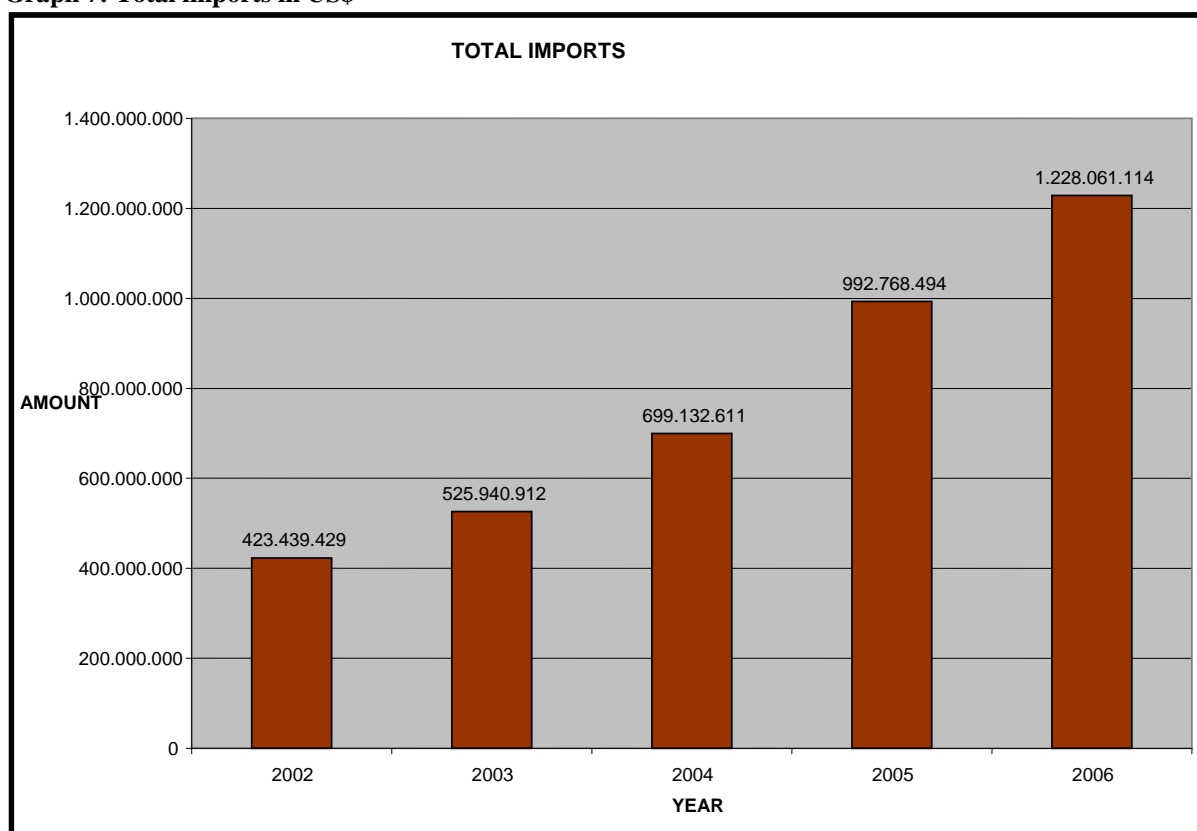


Table 5: Imports of crude oil and products, in US\$

PRODUCTO	2002	2003	2004	2005	2006
CRUDE OIL	84.699.284	110.716.339	149.427.216	203.760.789	274.759.011
DIESEL	114.444.135	55.413.764	204.276.363	321.718.859	422.319.063
GASOLINE	148.267.668	65.630.694	217.809.444	263.776.661	329.936.869
MTBE	4.507.397	3.745.324	5.369.187	3.953.892	8.178.817
NAPHTA			5.591.856	24.747.393	3.238.192
JET FUEL	30.976.686	35.461.049	63.572.315	108.194.509	124.053.145
LPG	21.482.966	30.487.215	41.154.353	49.066.289	56.982.235
OTHERS	19.061.294	24.486.527	11.931.877	17.550.102	8.593.782
TOTAL	423.439.429	525.940.912	699.132.611	992.768.494	1.228.061.114

Source: Foreign Trade Department – RECOPE

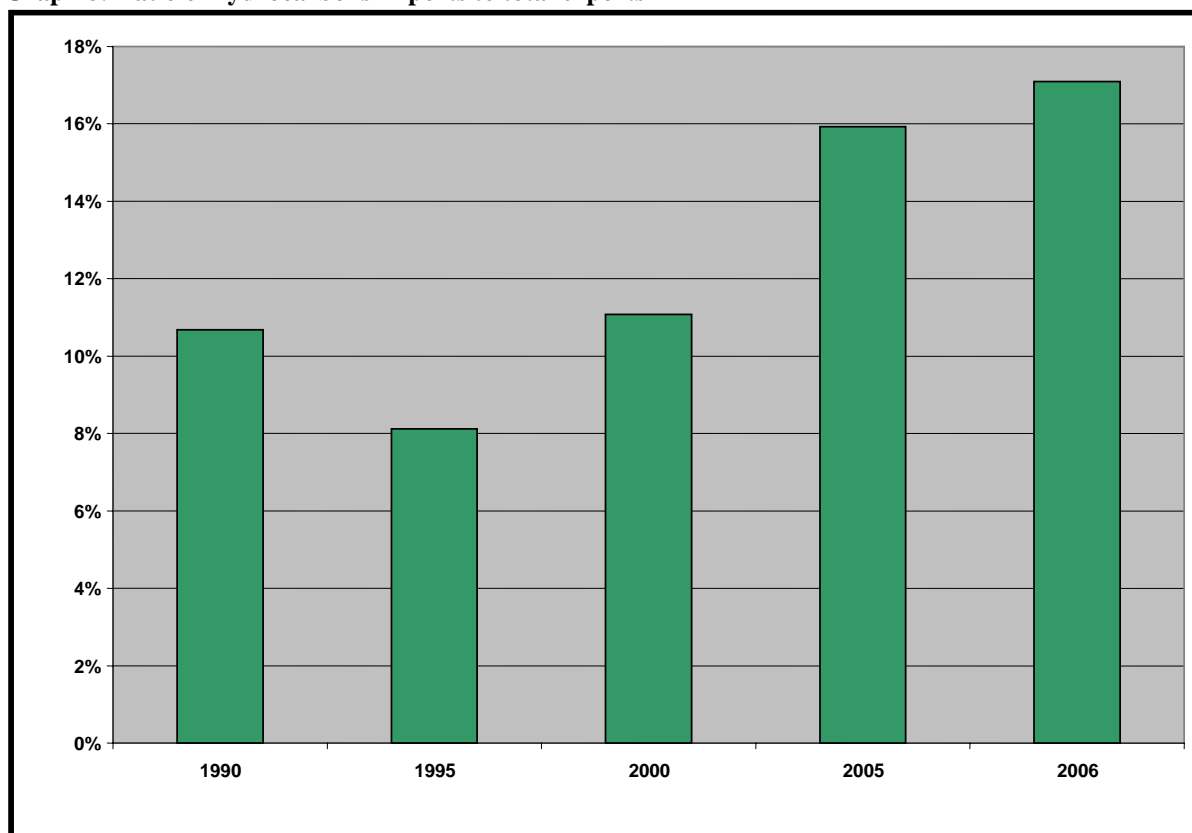
In graphic form, the following table shows imports, with a clear upward trend, caused basically by the behaviour of international prices on crude oil and oil products that are imported by RECOPE.

Graph 7: Total imports in US\$

These growing imports cause macro-economic problems in both the balance of payments and greater inflation, due to the rise they cause in domestic sales prices and the cascading effect on the prices of other goods and services traded in the country. This situation is presently compensated by the significant revenues generated by the tourism sector in the country as an environmental destination, which has practically become one of the largest revenues for the private sector and the Treasury Department.

The following graph shows oil & gas imports as a percentage of the country's total exports:

Graph 8: Ratio of hydrocarbons imports to total exports



9.2 Production

Refinery production was interrupted for several years, due to the improvements made during the 1998 – 2002 period to expand capacity to 25,000 barrels per day, and enhancements to the process. During this period, basically all the finished products that are marketed in the country such as gasoline, av-gas, diesel, jet fuel, and LPG, were imported. The following table shows refinery production for the 2003–2006 period.

Table 6: Refinery Production, in m³

PRODUCT	2003	2004	2005	2006
AC 30 ASPHALT	15.738	28.242	14.840	30.210
DIESEL OIL	103.098	187.134	157.569	269.638
HEAVY DIESEL	6.697	2.643	0	0
FUEL OIL	236.923	262.816	227.399	314.162
LPG				
MEDIUM	–	4.164	3.503	6.292
MEDIUM GASOIL	–	2.944	3.248	5.072
KEROSENE	–		2.847	2.538
GASOLINE	127.485	106.601	88.527	152.780
TOTAL	489.941	594.544	497.933	780.692

Source: Foreign Trade Department – RECOPE

The average refinery use for the 2003–2006 period, considering 330 days of operation, has been 41 %. This use factor is affected by the refining pattern, in which fuel oil²⁹ being a lower value-added product, represents a high percentage of refinery production. This product has no significant domestic market, meaning that RECOPE must import a large amount of finished products to cover domestic demand.

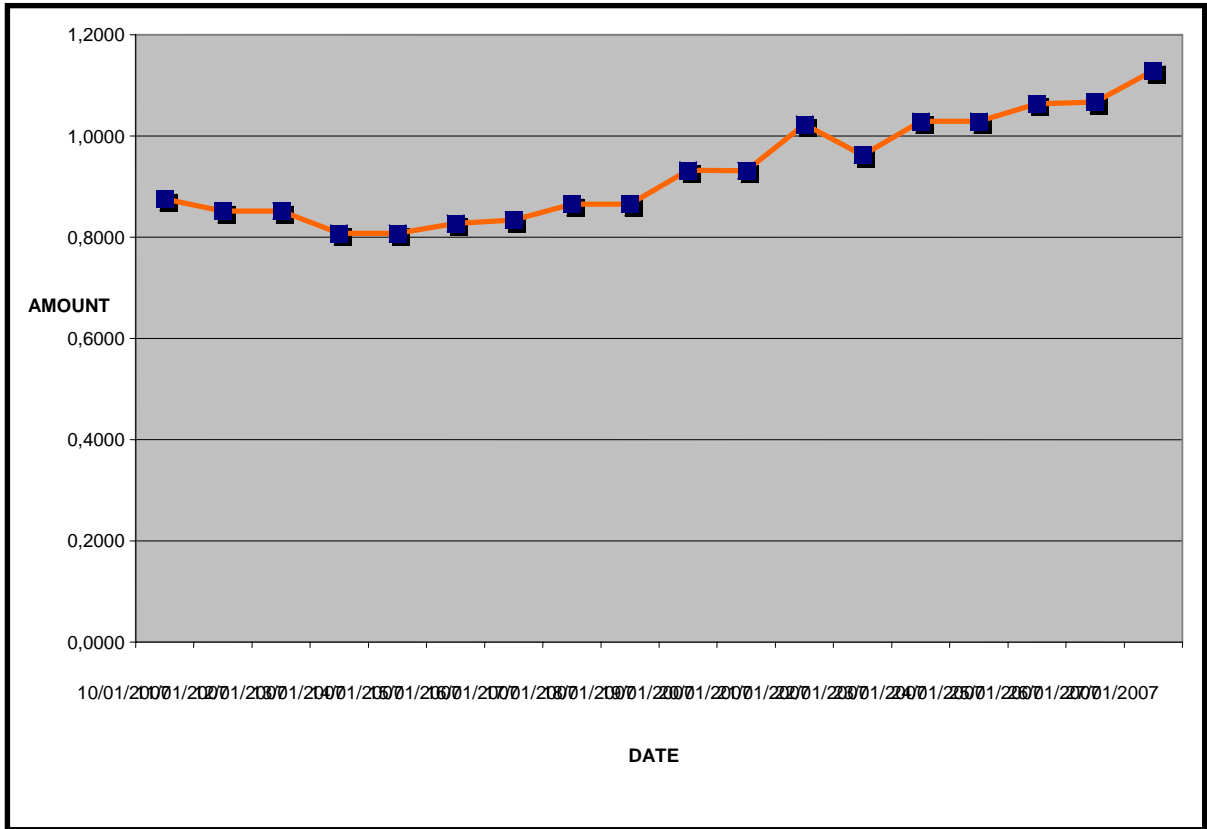
9.3 SALES PRICES TO FINAL CONSUMERS

The following graphs present the sales prices for the three major products that were retailed at service stations for the period from January to August 2007. The final price covers the following: sales price at the RECOPE plant, the sole tax³⁰ and the final price, which includes the cost of transportation to the service station and its marketing margin. The sales price is uniform throughout the national territory, and is considered an element of social solidarity.

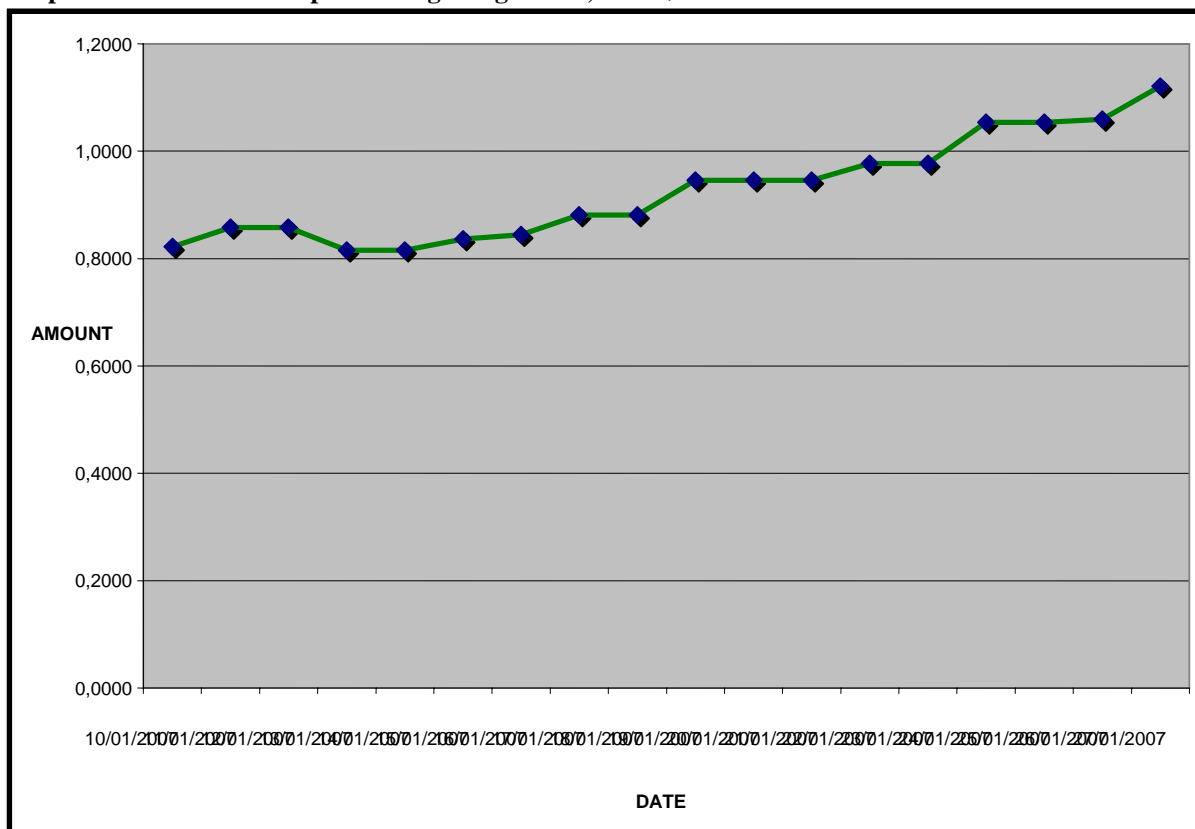
Graph 9: Final consumer price of super gasoline, in US\$ / litre

²⁹ It is presently being studied for use in thermoelectric generation instead of diesel.

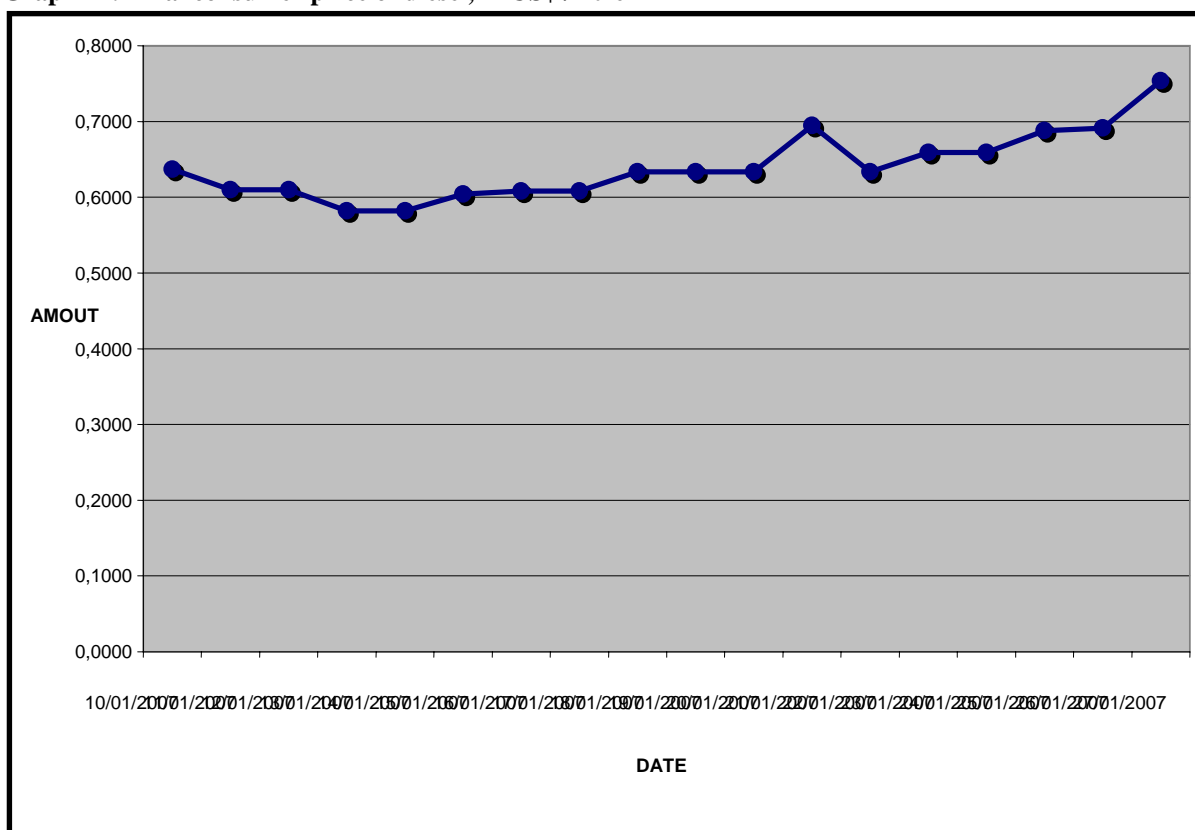
³⁰ A tax that enters the Treasury Department and is reviewed every three months.



Graph 10: Final consumer price of regular gasoline, in US\$ / litre



Graph 11: Final consumer price of diesel, in US\$ / litre



Final consumer sales prices vary continually in response to international prices for crude oil and finished oil products, which RECOPE imports.

Recently, ARESEP approved a change of methodology for price setting. Only two prices changes may occur each month, and not an unlimited number as before, as seen on the above graphs, when changes were very frequent.

10. LESSONS LEARNT AND COMMENTS

- a) Current legislation in the hydrocarbons industry, which causes overlapping and duplication of functions among different institutions, creates a lack of legal security for the companies of the sector, both regulator and regulated, hampering RECOPE decision-making and management.
- b) As an outcome of that legislation, relations among the institutions of the sector are also fairly complex and make it difficult to manage RECOPE. The regulations for each entity of the sector are often confusing to the company and cause excessive expenses in terms of financial and human resources. No benefit is had from preparing this information for each institution, which is usually the same but has to be delivered in different formats.
- c) The dynamics of the sector, with so many actors issuing standards or regulations, diminishes RECOPE's autonomy and obviously hampers its management.
- d) There is no real evaluation of RECOPE management by governing and regulatory entities in the sector, partially due to the lack of clarity in current law, and in part because State institutions have scarce resources.
- e) There is no accountability at the company's highest levels regarding company management, whether at the Board of Directors or managerial levels.
- f) Present regulations are not sufficiently clear regarding service quality evaluation, and current law assigns that responsibility to several entities, making regulation relatively weak.
- g) Current control rules and regulations have made it difficult for RECOPE to promptly meet needs for renovation and expansion of existing infrastructure to ensure production with more value-added refinery products, greater capacity for storage and transportation through the products pipeline,³¹ more in line with the country's consumption and with quality standards that are less damaging to the environment.

In its 2006–2010 National Development Plan, the current Government of the Republic stated that one of its goals is to entirely reform the country's energy sector, ensuring that existing legislation, governance, regulation, and standardization contribute efficiently and effectively so that all actors in the sector can work within a framework of legal and regulatory security. This will make it possible for its efforts to support sustainable human development with rational, efficient energy use, taking maximum advantage of all renewable energy sources available in the country. In the light of these goals, it would be advisable on the short term to revise and simplify the legislation of the hydrocarbons industry.

RECOPE's Board of Directors is named in its entirety by the Executive Branch, which subtracts independence in decision making and tends to distance resolutions from technical and financial criteria. It would be advisable to consider the possibility for the private sector, either through professional associations of engineering or economics or through the Chambers

³¹ The new 30-cm diameter products pipeline is in the testing phase.

of Industry, Construction or Commerce, to participate in naming this Board of Directors in order to contribute criteria that, while not necessarily more technical, may be less political, keeping in mind that all company shares belong to the State.

RECOPE would have better probabilities of improving its efforts if the legal and institutional framework governing the hydrocarbons industry were simplified and allowed it greater autonomy. This would facilitate, for instance, greater indebtedness in order to finance refinery improvement works or make purchasing goods and services and hiring skilled personnel more expedite. It should be able to form strategic alliances with the domestic and foreign private sector, to carry out infrastructure projects of importance in its management, for example. However, along with these changes, the company should be made accountable for its actions, both towards its owner (the State) and to civil society, and focus its activities the sustainable economic development of the country.

Implementing performance-based contracts could be considered, both between the national government and the Board of Directors, and between the Board of Directors and the managerial levels of the company. They should specify management indicators with which all involved parties are in agreement. These indicators should be simple, clear, easy to measure, and of a reasonable number, and could be used to renew appointments, approve raises, etc.

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12. NOMENCLATURE

ARESEP: *Autoridad Reguladora de los Servicios Públicos*
AyA: *Instituto Costarricense de Acueductos y Alcantarillados*
CNFL: *Compañía Nacional de Fuerza y Luz S.A.*
DSE: *Dirección Sectorial de Energía*
DGH: *Dirección General de Hidrocarburos*
DTCC: *Dirección de Transporte y Comercialización de Combustibles*
ESPH: *Compañía de Servicios Públicos de Heredia S.A.*
ICE: *Instituto Costarricense de Electricidad*
ICT: *Instituto Costarricense de Turismo*
IFAM: *Instituto de Fomento y Asesoría Municipal.*
INCOPECA: *Instituto Costarricense de Pesca.*
JASEC: *Junta Administrativa del Servicio Eléctrico de Cartago*
MAG: *Ministry of Agriculture and Animal Husbandry*
MIDEPLAN: *Ministry of Economic Planning and Policymaking*
MINAE: *Ministry of Energy and the Environment*
PND: *National Development Plan*
RECOPE: *Refinadora Costarricense de Petróleo, S.A.*
SETENA: *Secretaría Técnica Nacional Ambiental*
SINAC: *Sistema Nacional de Areas de Conservación.*

13. ANNEX 1: CURRENT ECONOMIC REGULATIONS

This Annex 1 details the current tariff methodology for price setting at RECOPE's final consumer distribution plants.

To set the price for the fuel derived from hydrocarbons at distribution plants and to final consumers, the Regulating Authority, public service providers and users that are allowed to request changes in fuel prices must follow this procedure:

a) **Ordinary price-setting:** Setting fuel prices will follow what is established in Law N° 7593 and its regulations, and the following formula will be applied:

$$NPPCi = (PRi * TCR + K)$$

Where:

i: Is the fuel expended by RECOPE at distribution plants, within national borders.

NPPCi: Is the new sales price at RECOPE's distribution plant, in Colons per litre, of fuel i, before the sole tax; which in turn will directly affect the price of fuel i to final consumers.

PRi: Is the average, simple, referential FOB price in US\$ per barrel. It is calculated based on the international price 30 calendar days prior to the cut-off date of the study, where the daily price is the simple average of all high and low quotes of the source reference Platt's Oilgram Price Report on the Gulf Coast by Standard & Poors,¹ as long as there are no other referential markets for the region. The referential prices for fuels homologated to products for domestic sale are the following:

- Super Gasoline (unleaded mid-graded: 89 octanes $R + M / 2$).
- Regular Gasoline (regular unleaded: $87 R + M / 2$).
- Diesel (N° 2 Oil, 0.2 % sulphur).
- Kerosene (jet kerosene 54, 0.3 % sulphur).
- Jet A-1 general (jet kerosene 54, 0.3 % sulphur).
- Bunker, fuel oil (N° 6 3.0 %, Resid. 3S).
- Liquefied Petroleum Gas (mix of propane and normal butane from Mt. Belvieu).
- Heavy naphtha.
- Light naphtha.
- Others depending on new needs of the country.

Fuels for which the Regulating Authority has no reference from Platt's Oilgram Price Report for the Gulf Coast:

- Asphalt
- Asphalt emulsion
- Av-gas
- Ifo 380
- Heavy diesel
- Others depending on new needs of the country

¹ The daily international price report for crude oil and oil products by Standard & Poors.

The reference will be given initially by RECOPE by specialized subscription, or else it can be calculated based on referential prices for fuels that conform to the mixture.

TCR: The exchange rate (Colons / US\$) for sale to the non-bank public sector to be used on the study cut-off date, as established by the Central Bank of Costa Rica.

K: The cost that is admitted to RECOPE, for projected internal costs needed to place the product in the distribution plants. That is, it represents the difference between the international fuel price and the price at the distribution plant, excluding all things relating to the refining business. K may be established as follows:

- Through a comparative study of margins among several countries (benchmarking), which means searching out best practices in management, through an ongoing, systematic procedure of evaluating products, services and work processes in organizations that are recognized as leaders. That is, the search for best practices in an industry that resulted in higher performance.
- Historic and referential costs such as the cost of sea transportation, insurance, loss in transit, port costs, financial costs (debt service), fuel delivery terminal costs, costs for transportation via the products pipeline or tanker trucks, costs at distribution plants (storage and dispatch), depreciation, insurance inventory of finished product, other charges established by law (levies, contributions to entities and tax rates) and other tariff costs that contemplate the cost of distributing finished products, set at each distribution plant.

This operating cost (K) will be established at least once per year ordinarily, following the procedure established in Law N° 7593 and its Regulations, so that its value remains close to the opportunity cost of a market that operates at competitive market levels.

b) **Extraordinary price-setting:** For setting fuel prices through an extraordinary procedure, the following formula will be used:

[...]

Where:

i: Is the fuel expended by RECOPE at the distribution plant, within the national borders.

PEi: Is the same definition as the average reference price (PRi) used in the last price setting.

Ai: Is the percentage of adjustment in each fuel price on the international market, calculated by the following formula:

[...]

The above formula will be applied as follows:

The Regulating Authority will set prices for each of the products **i** on the second Friday of each month. When that Friday of the month coincides with weekend or holiday, calculation will be done on the next working day, using the same cut-off date of the second Friday of the month. Price adjustments will be submitted to the public hearing procedure within the term

stipulated by the regulations to Law N° 7593 to solve extraordinary price adjustments (15 working days).

TCR: The exchange rate (Colons / US\$) for sale to the non-bank public sector to be used on the cut-off date of the study, as established by the Central Bank of Costa Rica.

TCE: The same definition of the TCR, pertaining to the last price setting.

K, PRi and NPPCi, defined under point a).

c) **Price adjustment transfer to the final consumer:** Once the price at the distribution plant is adjusted, this adjustment will be transferred to the final consumer price, including the sole tax on each fuel in the price. The formulas to transfer the adjustment to the final consumer are the following:

[...]

Where:

i: Is the fuel expended by RECOPE at the distribution plant, within national borders.

PPCi: Price at the distribution plant, in Colons per litre per type of fuel, with the sole tax included.

NPPCi: The new sales price at the RECOPE distribution plant, in Colons per litre, for fuel **i**, before the sole tax, which in turn will directly affect the price of fuel **i** for the final consumer.

Ti: Sole tax in Colons per litre per type of fuel, reviewable each quarter, as established by the Treasury Department, as per Law N° 8114, Tax Simplification and Efficiency Act.

PCiDF: Price of fuel **i**, in Colons per unit of volume, for the fuel retail distributor.

MgTi: Total margin of each distributor, in Colons per litre, per type of fuel including transportation charges. The transportation charges and distributor margin will be determined based on the tariff methodology for each activity in the chain of this public service.

d) For the purpose of controlling these ordinary and extraordinary procedures, RECOPE must provide the Regulating Authority with the following, in writing and in electronic format, no later than 60 calendar days after the end of the tax period:

- a. List of effective purchase prices per type of fuel and report of the amount of fuel imported per supplier, in absolute and percentage terms.
- b. A detailed progress report based on accounting results for the last tax period completed, including at least:
 - Statement of origin and application of tariff funds, both actual and projected to one year.
 - Financial analysis.
 - Price structure per type of fuel, in Colons per litre.

e) Therefore, in accordance with what is established in Law N° 7593, the Regulating Authority will continue setting uniform prices at the supply plants for the *Refinadora Costaricense de Petróleo, S.A.*, and will set uniform final consumer prices for each distributor, according to the distribution cost structure for each public service activity.

Wrapping the model presentation, ARESEP concluded that the goal is to set prices that reflect efficiency standards, through economic regulations, to send the right signs to public service users and providers, thus making the best use of resources. Citizen's participation is also included in extraordinary price adjustments, by submitting price-setting to a public hearing.

14. ANNEX 2: YEARLY INSTITUTIONAL PLANNING FORM

INTERNAL CHECKLIST OF REQUIREMENTS TO BE MET BY PUBLIC ENTITIES AND AGENCIES WHEN SUBMITTING PLANS SUBJECT TO BUDGET APPROVAL BY THE COMPTROLLER GENERAL OF THE REPUBLIC

Requirements ¹	Yes	No	NA	Observations
I. General Aspects:				
1. The institutional work plan complies with what is established in the current regulations, ² that is:				
1.1. Strategic Institutional Aspects				
a) Budgetary schedules				
b) Institutional priorities				
c) Mission and vision				
d) Strategic objectives				
e) Output indicators				
1.2. The following matrices were developed:				
1.2.1. Yearly Institutional Programming Matrix (MAPI from the Spanish)				
1.2.2. Program-level Strategic Planning Matrix, for each budgetary program				
1.3. The Yearly Institutional Programming Matrix (PEP from the Spanish) has the approval of the respective Minister(s) governing the sector				
1.4. Each Program-level Strategic Planning Matrix includes the following elements:				
1.4.1. Program mission				
1.4.2. Institutional strategic objectives				
1.4.3. Final and/or important output				
1.4.4. Users				
1.4.5. Beneficiaries				
1.4.6. Strategic objective of program				
1.4.7. Performance and/or outcome indicator				
1.4.8. Formula				
1.4.9. Historical performance				
1.4.10. Indicator targets				
1.4.11. Estimated budget resources (per expense item, amount in thousands of Colons, and origin of resources)				
1.4.12. Source of indicator data				
II. Complementary aspects				
The institutional plan ³ complies with what is established in the general guidelines to consider in the formulation				

¹ These requirements are part of the legality block. Therefore, non-compliance generates liabilities imputable to the officers defaulting on their duties, as established in the Law of Financial Administration of the Republic and Public Budgets, and the General Law of Internal Control.

² Especially in the "Technical y Methodological Guidelines for Developing the Institutional Work Plan: Results-based Budget Planning and Scheduling for Public Institutions," Executive Decree N° 33832-H-PLAN, published in Official Gazette N° 118 of June 20, 2007.