

privatesector

Regulating Quality

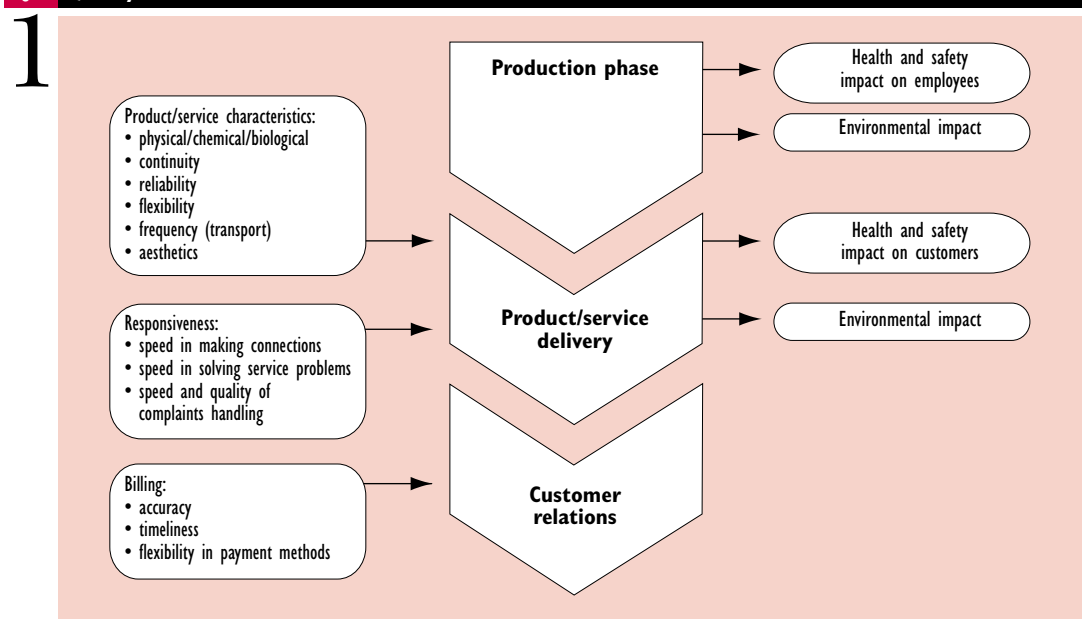
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Let Competing Firms Offer a Mix of Price and Quality Options

In many developing countries, the regulation of infrastructure service standards is rigid and makes services too expensive for the poor. The current wave of liberalization of infrastructure is an opportunity to address this problem. Debate on expanding access under such reform has so far centered on price, not quality. This Note proposes a new regulatory framework where large and small providers compete to supply a range of services at prices that better reflect consumer willingness to pay.

Figure Quality dimensions of infrastructure services



One size does not fit all

The regulation of infrastructure services standards has many dimensions. For some, such as the effects the services have on public health or the environment (the right-hand side of figure 1), standards can be publicly defined relatively objectively. For example, consumers do not expect drinking water to make them sick. Bus passengers do not expect to be injured.

For requirements above the minimum, or for other service dimensions such as customer relations (the left-hand side of figure 1), quality is more a matter of consumer choice. Offering different levels of quality for these services is equivalent to changing the economic value of the service, and could therefore be expected to elicit a different willingness to pay from each customer or group of customers.

Such flexibility in the setting of quality standards is rare. Consumers are often unaware of the potential for service quality differentiation and utilities unwilling or unable to explore it. Standards are typically set by governments with centralized infrastructure provision in mind, often using developed countries' standards (Viewpoint 219). They are usually above what would be acceptable to the poor and socially optimal. They rarely take into consideration affordability or the costs and benefits of different quality standards. By increasing the price of service, they invariably limit access for the poor.

Regulation can be justified, in principle, by market failures such as market power, the imperfect sharing of information, and the existence of broadly beneficial effects such as reducing disease and pollution. For example, some infrastructure services have natural monopoly characteristics, due to economies of scale (one network is more economic than two) and scope (coordination is often cheaper within one organization than using a transfer price between two organizations). Regulation in the event of such market failures is justified (see box 1 for mechanisms), but only when it can achieve a better outcome than the market alone, with all its imperfections.

Adapting quality regulation to serve the poor

The drawback of supplying poorer areas is that they are more expensive to serve because they

Box How governments regulate quality

I Governments can respond to market failures with a range of instruments:

- Licensing and certification rules, to regulate market entry.
- Minimum quality standards.
- Provision of information to consumers.
- Encouraging quality signaling by private providers, such as the establishment of reputation through brand names or the setting up of self-regulating producers' associations.
- Laws making suppliers liable for unsatisfactory goods or services.

The choice of instrument should depend on the market failure being addressed and the instruments' associated costs. Market power can be reduced by encouraging competitors to enter the market. The granting of a license to enter could be made conditional on certain minimum quality requirements. Information asymmetries can be reduced by improving consumer education and publishing information on service quality. Private providers may publish quality information voluntarily, as a signal to their customers and to enhance their image. Laws making suppliers liable to consumers for unsatisfactory service can be effective, but because such redress is costly and time-consuming, and requires reliable courts, it is seldom relevant to the poor in developing countries.

are often less accessible, their low consumption does not cover the cost of connection, and the risk of fraud or non-payment is higher.

Regulators need to recognize these realities and to allow for the delivery of various price and quality bundles. If a private provider wants to serve the poor and remain profitable, it must diversify its pricing or supply arrangements, or both. This can involve charging higher prices to the poor to reflect the real supply costs (which might not be politically acceptable) or finding alternatives, such as group supplies or lower quality levels, to reduce costs. While data on poor consumers is scant, studies suggest that they are willing to pay a higher percentage of their income for infrastructure services than the rich—a measure of their desire for service.

Figure 2 suggests how, by using a low-cost solution with reduced quality, the provider could adapt to poor consumers' willingness to pay. Both the high and low cost options include "regulatory" costs, such as monitoring. The figure assumes these costs could be lowered for the

low-cost option through the use of self-monitoring by the provider. (If the price were still too high for poor consumers, a subsidy might be needed, as shown in figure 2.)

In almost every country traditional utilities provide a standardized product, aiming for relatively high quality, and exploiting economies of scale and scope in production. Where there are alternatives to the main provider, providing different price or quality, governments generally regard them as temporary (Viewpoint 220). There are good reasons for preferring network supply in the long run, but alternative providers, given the chance, can grow, evolve, and compete with the main provider to drive down prices or improve quality. Yet governments often ban new entrants or alternative providers from the market by granting exclusive concessions to private operators. Further, when a regulator is set up, as is usual when a utility passes into private hands, it generally concentrates on the main provider, paying little attention to alternative providers.

Table 1 shows how the current regulatory approach can be adapted to facilitate service quality differentiation and thus to improve access for the poor. As a first step, in the legal and regulatory framework countries should set quality standards according to their own circumstances, taking into account the costs and benefits of the target level of quality, and enforce these standards properly, instead of setting unachievable objectives at developed countries' levels that will not be met.

Quality standards should be reviewed to see whether a lower minimum requirement would be acceptable to the poor and would allow the fulfillment of social objectives. Providers should be free to compete on quality above the minimum standards in order to meet the needs of other market segments, especially for business needs. If minimum quality requirements still cost more to produce than the poor can afford, subsidy schemes should be designed in order to ensure that providers offer services to the poor without compromising profitability.

When private participation is being introduced the whole sector structure should be assessed in order to identify the types of services which are or could be provided by alternative operators, and their price and quality characteristics. Exclusivity clauses should be avoided. This would avoid cutting service options for the poor in an arbitrary way.

Quality objectives for alternative providers should be set on the basis of minimum standards leaving them flexibility to meet the needs of the poor more appropriately on aspects of service which do not call for regulation. Alternative providers should be allowed to evolve, through a gradual tightening in service standards for example, with some incentives for them to enter the formal sector and upgrade their service in the long run.

Governments should allow the main provider to offer different quality levels to different customer groups. Delivery should be

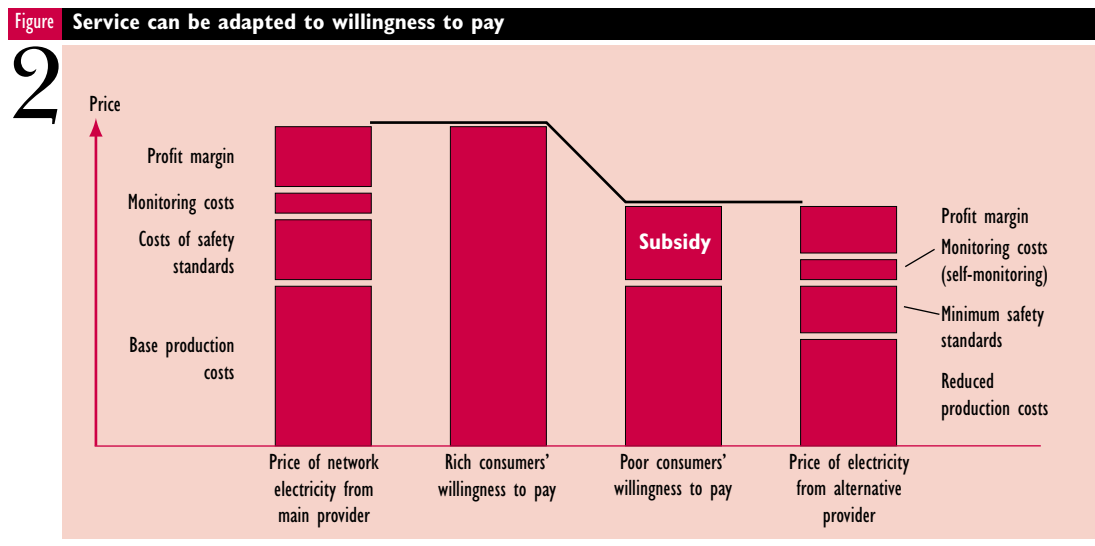


Table Pro-access rules for regulation

Policy decision	Common approach	Recommended approach
Legal framework	Quality standards set on basis of developed countries.	Assess which quality aspects could be improved by regulation (market failures) and whether minimum standards can be defined, above which private providers can compete.
Privatization of main utility		
Market structure	Exclusivity granted to main operator for natural monopoly activities. Competition introduced for activities with no natural monopoly (electricity generation, telecommunications).	Analyze current market structure and services by alternative providers. Formally allow competition in all areas—consider quality explicitly in the definition of rules for market entry.
Level of quality standards	Uniform quality standard, limits access by the poor, Set on basis of developed countries' examples (relatively high level).	Examine whether quality objectives and payment options can be differentiated by service area—if so, reflect in contract obligations. Set on basis of willingness to pay and costs of supply alternatives (including low-cost provision). Develop methods for identifying group preferences.
Regulation of alternative providers	Mostly informal status. Neglect (no regulation) or clampdown and repression, if they cannot fulfill standard quality rules.	Realistic quality objectives, can be lower than main provider. Focus regulation on correcting market failures: information gathering and publication, output standards simple to monitor.
Regulatory institutions	Regulatory agency is set up in parallel with privatization, mostly dealing with the main private operator. Design regulatory institutions with a view to minimize regulation costs. Limited institutional capacity to enforce.	Set up agencies expert in regulating services for the poor (experience of low-cost alternatives, community contact for encouraging community level regulation). Self-monitoring, publication of quality performance, community and NGO regulation, compensation schemes for consumers.
Regulatory instruments	Input standards. Little consideration of quality signalling by private providers. Poor enforcement.	Output or outcome standards: leave flexibility to private operators. Quality signalling recognized as substitute or complement to government intervention, diffusion of information. Tighten enforcement of minimum standards.

identified on objective criteria. This should be explicitly allowed for in contracts so that operators do not end up paying undue penalties for lower quality.

For areas not reached by the main provider at the time of privatization, the government should consider granting licenses to alternative providers (for example, independent power distributors in rural areas) to accelerate access for poor. The main provider could be allowed to tender for these licenses, so long as the process promotes competition, not exclusivity.

The mandate of regulators should be to protect consumers especially the poor. Regulatory agencies will need specific expertise in low-cost

solutions and community contact, especially for the regulation of alternative providers. The dissemination of information by regulators on the quality performance of all providers could be a cheap and efficient way of reducing information asymmetry.

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