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Utility Regulators—The Independence Debate

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The global trend of utility privatization has pushed regulatory issues to the fore, among them the role of regulatory agencies. These agencies have a long history in the United States, and creating or strengthening them has become a central goal of reforms around the world. But many issues remain contentious, particularly the notion of agency independence. Some governments are reluctant to surrender political control over regulatory decisions. And even those who agree on the desirability of independent agencies may question whether they are feasible or appropriate in all country settings. This Note considers the debate over the independence of utility regulators, focusing on the position of developing countries.

Independence—What and why?

Independence is subject to different interpretations. Some use it interchangeably with *autonomy*; others perceive greater or lesser differences in meaning between the terms. This Note defines independence for utility regulators as consisting of three elements:

- An arm's-length relationship with regulated firms, consumers, and other private interests.
- An arm's-length relationship with political authorities.
- The attributes of organizational autonomy—such as earmarked funding and exemption from restrictive civil service salary rules—necessary to foster the requisite expertise and to underpin those arm's-length relationships.

The rationale for giving regulators independence as broadly defined here lies in the special challenges posed by utility regulation, including the critical role of regulatory discretion.

Regulatory challenges

Utility regulation has three main aims: to protect consumers from abuse by firms with substantial market power, to support investment by protecting investors from arbitrary action by government, and to promote economic efficiency. While there is growing recognition that competition can reduce the need for regulation in utility industries, most industries contain some areas of monopoly where the benefits of regulation potentially outweigh the costs.

Regulating utilities is complicated by three related considerations. First, prices for utility services are usually political. There are no votes in raising utility prices, and history is replete with examples of justifiable price increases being withheld at the expense of investors and the long-term interests of consumers.

Second, investors are aware of these pressures and of the vulnerability of their usually large, long-term, and immobile investments. Unless a government has made a credible commitment to rules that ensure an opportunity to earn reasonable returns, private investment will not flow. Weak credibility will be reflected in higher capital costs and thus higher tariffs. In privatization, this translates into smaller proceeds from sales of existing enterprises and higher financing costs for new projects.

Third, the long-term nature of most infrastructure investments makes creating credible commitments difficult. Highly specific rules, if considered sustainable, can provide assurance to investors and lower the cost of capital. But they make it difficult to adjust regulation to unforeseen developments, including changes





in technology and market conditions. They also make it difficult to tailor responses to situations and to provide incentives for efficiency. There is thus an important tradeoff between reducing the risk of expropriation, and with it the cost of capital, and retaining the flexibility to pursue efficiency and other objectives.

In designing regulatory systems, then, policy-makers need to resolve two fundamental challenges: How much discretion should regulatory systems contain? And how should that discretion be managed to reduce the risk of misuse and thus the cost of capital?

How much discretion?

The discretion in regulatory systems differs widely among countries and industries. At one extreme, U.S. laws typically delegate broad discretion to regulators, often vaguely defining pricing standards as “just and reasonable” and limiting other powers only by reference to broad public interest criteria. At the other end of the spectrum, some countries implement regulation through tightly specified laws or contracts that seek to eliminate discretion. They attempt to deal with all contingencies foreseen at the time an arrangement is finalized, usually relying on detailed cost-based formulas for tariff adjustments. This approach—sometimes called “regulation by contract”—is often favored by investors who perceive a high risk of misuse of discretion by the government or regulator. Adjustments to the initial arrangement will require renegotiation, which can be difficult if the bargaining power of the parties changes once the investment is made.

Most regulatory systems lie somewhere between these extremes. Key policies and principles tend to be defined in laws, licenses, or contracts, which carefully delimit residual discretion through reference to criteria, factors, and objectives. Greater flexibility and discretion are usually more important in industries in which there is rapid technological change, in which the introduction of competition requires continuous adaptation of rules to changing market conditions, and in which high priority is placed on providing incentives for

efficient operation. Discretion is thus typically more important for telecommunications than for toll roads. Another consideration is a country’s stability and reputation for respecting private property rights: the higher a country scores on these criteria, the more discretion it can retain without significantly increasing the cost of capital. This consideration is especially relevant for reforming and developing countries, many of which lack a long track record of good performance in these areas.

How to manage discretion?

When discretion is retained on tariffs or other issues of concern to investors, the challenge is to manage it in a way that minimizes the risk of misuse. The exercise of discretion needs to be insulated from short-term political pressures and other improper influences and to be based on competent analysis.

Entrusting discretion to ministers will not meet these tests, particularly when the state continues to own utility enterprises. In this case, there will be no arm’s-length relationship between the regulator and the firm, and there may be concerns that, in exercising discretion, ministers will favor the state enterprise over rival private firms. But even if the state has no ownership role, ministers will still be subject to short-term political pressures, and changes in government can lead to abrupt changes in regulatory policy. Restrictive civil service salary rules in many countries also make it difficult for ministries to attract and retain well-qualified professional staff. What is required is an agent at arm’s length from political authorities, utilities, and consumers. Organizational autonomy helps to foster the requisite expertise and preserve those arm’s-length relationships.

The quest for independence

Creating an independent agency, no easy task in any setting, is even more challenging in countries with a limited tradition of independent public institutions and limited regulatory experience and capacity. The two main elements of independence—insulation from improper influences and measures to foster the

development and application of technical expertise—are mutually supporting; technical expertise can be a source of resistance to improper influences, and organizational autonomy helps in fostering (and applying) technical expertise.

There is strong consensus on the formal safeguards required:

- Providing the regulator with a distinct legal mandate, free of ministerial control.
- Prescribing professional criteria for appointment.
- Involving both the executive and the legislative branches in the appointment process.
- Appointing regulators for fixed terms and protecting them from arbitrary removal.
- Staggering terms so that they do not coincide with the election cycle, and, for a board or commission, staggering the terms of the members.
- Exempting the agency from civil service salary rules that make it difficult to attract and retain well-qualified staff.
- Providing the agency with a reliable source of funding, usually earmarked levies on regulated firms or consumers.

Formal safeguards of this kind are especially important in countries with a limited tradition of independent public institutions. But they are not enough. Persons appointed to these positions must have personal qualities to resist improper pressures and inducements. And they must exercise their authority with skill to win the respect of key stakeholders, enhance the legitimacy of their role and decisions, and build a constituency for their independence.

Some argue that governance traditions in some countries make independence illusory—“If the Palace calls, the regulator will comply.” Certainly, adopting even the most sophisticated law will not magically transform the basic institutional environment. Nevertheless, for several reasons, creating such agencies is worth the effort, even in more challenging environments.

First and foremost, independence must be understood as a relative rather than an absolute concept. In any system, the goal can only be

to reduce the risk of improper political interference, not to provide ironclad guarantees. Progress must be measured at the margin—and relative to the outcome of ministers retaining direct control over regulatory decision-making. Second, the ability of independent agencies to sidestep civil service salary restrictions and to have access to earmarked funding makes it possible to recruit and retain better-qualified staff and to hire external consultants. This can improve the technical quality of decisions and thus enhance the agency’s authority. Adequate salaries can also help to reduce concerns about corruption. Finally, even if there are reasons to doubt that an agency will exercise truly independent judgment in the short term, that may change in the longer term. Concentrating expertise in a body with a specialist mandate sharpens commitment to professional norms, which can be an important source of resistance to improper influences. And as the regulator enters the fray, it will have the opportunity to build a constituency of its own, increasing insulation from political interference.

Reconciling independence with accountability

Independence needs to be reconciled with measures to ensure that the regulator is accountable for its actions. Checks and balances are required to ensure that the regulator does not stray from its mandate, engage in corrupt practices, or become grossly inefficient. Striking the proper balance between independence and accountability is notoriously difficult, but the following measures to do so have been adopted by a growing number of countries:

- Mandating rigorous transparency, including open decisionmaking and publication of decisions and the reasons for those decisions.
- Prohibiting conflicts of interest.
- Providing effective arrangements for appealing the agency’s decisions.
- Providing for scrutiny of the agency’s budget, usually by the legislature.
- Subjecting the regulator’s conduct and efficiency to scrutiny by external auditors or other public watchdogs.
- Permitting the regulator’s removal from office in cases of proven misconduct or incapacity.



Possible paths of transition

Resistance to independent agencies is breaking down. Ministers once adamant about maintaining political control over tariffs and other regulatory matters increasingly see the benefits of creating such agencies, which include improving offers from investors, helping to sustain reforms, and shifting responsibility for unpopular decisions to someone else. But what if the government resists?

The choice can be stark. Governments can reduce discretion by adopting highly specific rules, forfeiting flexibility and other advantages. Or they can retain discretion, pay investors risk premiums, and accept reduced proceeds from privatization, higher tariffs or both. In either case, ministerial structures will usually make it difficult to develop expertise to deal with regulatory problems arising after privatization.

But several options lie between the traditional ministerial model and the delegation of broad discretionary authority to a fully independent agency. These options can form a path of transition to greater independence and delegation of discretionary authority. First, a dedicated regulatory unit can be created within a ministry, to coordinate regulatory activity and foster the development of technical skills and professional norms. The autonomy of the unit can often be enhanced by placing it under the responsibility of a minister other than a sectoral minister—particularly important if there is potential for conflict between private firms and state enterprises under the purview of the sectoral minister. Once such a unit has been created, governments can increase the transparency of regulatory processes and approximate an independent agency in other ways. Exempting staff from civil service salary rules will usually be more problematic, but concerns about technical competence can be addressed by contracting out certain tasks to consultants.

Second, an agency can be created with many of the attributes of an independent agency, but with one or more ministers taking part in

decisionmaking (as in Colombia). This approach can improve the technical quality of regulatory decisionmaking, particularly compared with the first option. But as long as ministers retain significant influence, the risk of misuse of regulatory discretion remains.

Third, a more truly independent agency can be created, but with some or all of its powers limited to making recommendations to the minister (as in Hungary). A variant is to give the agency decisionmaking authority but have appeals go to the minister rather than another independent authority (as in Argentina). This approach reinforces the separation of professional and political considerations in decisionmaking and usually provides the agency with greater insulation than under the second option. Political considerations are not excluded from the regulatory process, but the agency can build a reputation for professionalism and balanced judgment, enhancing its authority and reducing the likelihood of being overruled. Models can also be devised in which the minister is permitted to depart from the agency's recommendations or decisions only in narrowly defined circumstances.

Even where the minister has withdrawn completely from regulatory decisions, a transition strategy may still be appropriate. Delegating broad discretionary powers to an untested agency poses risks, particularly in countries with limited regulatory experience and capacity. The broader the agency's authority, the more enticing a target it will be for those with incentives to undermine its independence. And lack of detailed standards—like those that have taken more than a century to develop in the United States—can create uncertainty and risk for investors. The prudent course is to take the time to carefully define a new agency and ensure that it has access to adequate resources and other support. These issues are examined in two companion Notes.

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