

PUBLIC POLICY FOR THE

# Private sector

Note No. 128

October 1997

## Utility Regulators—Roles and Responsibilities

*Warrick Smith*

Creating independent regulatory agencies has become a key element of utility sector reforms around the world. As discussed in a companion Note, these agencies are intended to insulate decisionmaking from improper pressures and foster technical expertise. This Note focuses on the defining of responsibilities of such agencies, particularly in developing countries. It considers the scope of agencies' industry coverage, their role relative to ministers, and their role relative to other regulatory objectives and bodies.

### Industry coverage

Specialist utility regulators can be organized on three main bases:

- Industry-specific, in which there is a separate agency for each industry—such as gas, power, water, and telecommunications—as in the United Kingdom.
- Sectorwide, in which there is an agency for each more broadly defined sector, such as the energy regulator in Colombia and the transport regulator in Canada.
- Multisector, in which there is a single agency for all or most utility industries, such as the state-level regulators in Brazil and the United States, and the national regulators in Costa Rica and Jamaica.

### Advantages of multi-industry agencies

Making an agency responsible for more than one industry offers several potential advantages.

**Sharing resources.** Economists, financial analysts, and other professionals can work across industries, and administrative staff and facilities can be shared. This is particularly important in countries where regulatory expertise is scarce.

**Facilitating learning across industries.** All utility industries have unique features, but the main issues in their economic regulation are substantially the same: administering tariff adjustment rules, managing the introduction of competition into traditionally monopolistic industries, and managing relationships with stakeholders. Having a single agency aids the transfer of insights and experience between industries.

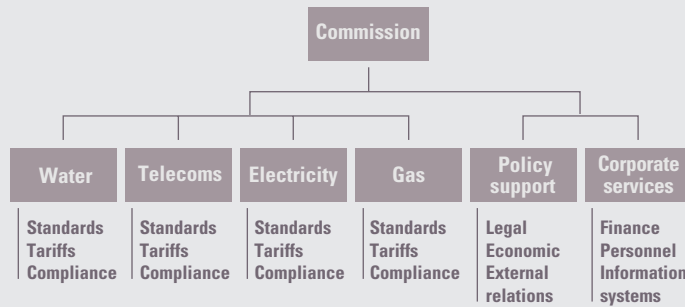
**Reducing the risk of industry capture.** A key challenge in utility regulation is to guard against the agency's capture by the regulated industry. If the industry and the regulator develop too close a relationship, the industry may be able to divert regulatory effort to promote its own interests rather than the public's. The broader responsibilities of a multi-industry agency help to reduce this risk.

**Reducing the risk of political capture.** Agencies intended to operate at arm's length from political authorities remain vulnerable to interference from them. Placing responsibility for several industries in one agency may make it a more attractive prize for political authorities. But there are two reasons why a multi-industry agency might be exposed to less risk of political capture rather than more. First, the agency's broader constituency raises the stakes of political interference: interfering in a decision on, say, water tariffs will be seen as a threat to all industries regulated by the agency. Second, an agency responsible for more than one industry can develop greater independence from sectoral ministries. Political pressures are unlikely to have effect unless they come from higher-level authorities, who can consider the repercussions of short-term actions from a broader perspective.





**FIGURE 1** MULTISECTORAL AGENCY—  
ILLUSTRATIVE ORGANIZATION



**Reducing the risk of economic distortions.** All industries compete for investment capital, and there is direct competition between some utility industries in meeting consumer needs, such as between gas and power or among different transport modes. Some regulatory issues are unique to specific industries and thus warrant different approaches. But many issues, such as the valuation of capital and the treatment of inflation, are common to all industries. Inconsistent approaches to these issues in competing industries can create economic distortions. Having a single agency makes it easier to adopt consistent approaches.

**Dealing with blurred industry boundaries.** Traditional boundaries between utility industries are rapidly blurring. Gas, power, water, and railway firms are entering telecommunications markets. Gas utilities are entering the power industry, and water and power utilities are merging. Such developments can pose important regulatory challenges. A firm involved in several industries may be able to exploit differences in the rules that apply to its activities in different industries. And regulatory decisions on one industry can affect other industries. Multi-industry agencies can deal with these challenges in a coordinated way.

**Offsetting disadvantages?**

Proponents of industry-specific agencies often argue that multi-industry agencies have weaknesses or limitations that offset their advantages. One concern is that a multi-industry agency may lack sufficient industry-specific expertise or focus. This concern can be ad-

ressed in several ways. Industry-specific departments can be created within the agency, but with a cross-sectoral decisionmaking body and cross-sectoral departments for pooling expertise and managing shared resources (figure 1). The agency can also draw on advice from industry-specific advisory groups.

A second concern is that placing responsibility for several industries in one agency is tantamount to “putting all your eggs in one basket”—the agency’s failure would have costs for all industries. Although industry-specific agencies help to diversify this risk, they do so at the expense of the strength of a single agency, increasing the risk of failure.

A third argument is that having a number of agencies allows experimentation with different approaches. However, industry-specific experiments are still possible in multi-industry agencies.

Finally, it is sometimes suggested that multi-industry agencies are appropriate only for very small economies. Certainly, the arguments for such agencies are especially strong in these cases. Yet California’s Public Utilities Commission is responsible for gas, power, water, transport, and telephony in an economy with a population of more than 30 million, a GDP and utilities that dwarf those of most countries, and no evident shortage of trained professionals.

**Creating multi-industry agencies**

The preferred approach to creating a multi-industry agency is usually to set it up as one from the outset, adding industries to its jurisdiction as they undergo reform. If an industry-specific agency already exists, it may be possible to expand its mandate to cover additional industries.

The alternative strategy—creating a series of industry-specific agencies and later merging them—has disadvantages. It delays such benefits of a multi-industry agency as fostering learning between industries, which are particularly important during an agency’s early years. And the obstacles to later merger should not

---

be underestimated. Industry-specific regulators will have incentives to resist merger, not least because of the implications for their jobs. Regulated firms may also resist, often out of concern that they will have less influence over a multi-industry agency. Mergers thus usually require substantial political will and effort.

The main challenge in creating multi-industry agencies is to ensure an effective coordinating mechanism during their design and establishment. Because advisers with industry-specific responsibilities have little incentive to propose multi-industry approaches, leadership usually must come from a central ministry.

### **Role relative to ministers**

One of the most sensitive relationships for a regulatory agency is that with the relevant ministers. It is sometimes suggested that the ministry is responsible for policy and the agency for regulation. But this distinction is unhelpful in practice, because the dividing line between the concepts is fuzzy at best, and agencies with significant discretion clearly have a policy role.

Four main considerations generally determine the allocation of responsibilities between agencies and ministries. The first is whether the matter in question is judged to be appropriate for decision on political or technical criteria. Such judgments can change over time. For example, while political control over tariffs was once considered the norm, there is now growing recognition that, once the key policy principles or rules are established, society's interests are best served by delegating responsibility to an independent agency. Tax and subsidy issues, by contrast, are still widely regarded as the province of political rather than independent bodies.

The second consideration is whether collocation of particular functions could create significant conflicts of interest. For example, responsibility for actively promoting investment in a sector often conflicts with a regulatory agency's role as an impartial arbiter of investor and consumer interests, as well as dilute its focus.

The third consideration is which body has the expertise for a task and whether having related tasks performed by the same body yields any economies. Once created, an agency usually becomes the main repository of public sector expertise on the industries it regulates. If the ministry is subject to restrictive civil service salary rules and the agency is not, the ministry may find it difficult to maintain expertise. This often justifies giving the agency an advisory role on matters remaining under ministerial control.

The fourth consideration is the degree of confidence political authorities have in the agency. Agencies tend to be given greater authority once they have proved their reliability.

Based on these considerations, there is general consensus that ministers should retain responsibility for broad sector policy, including public investment, privatization, sector restructuring, taxation, subsidies, intergovernmental relations, and the legislative framework. But even in these areas, agencies may be given advisory roles.

There is less consensus on where responsibility for granting licenses or concessions should lie. Much depends on the criteria governing the award of licenses: the more objective and technical the criteria, the stronger the case for delegating the responsibility to an agency.

Most systems give agencies responsibility for administering tariff adjustment rules, elaborating detailed standards, monitoring compliance with norms, and facilitating the settlement of disputes. In some systems, the power to impose sanctions for noncompliance with norms is reserved for the courts. In most, however, the agency performs this role, although major sanctions—such as cancellation of licenses—may require ministerial decision.

### **Role relative to other regulators**

Utility regulators' main focus is economic regulation of firms with monopoly power. But utilities, like other firms, are subject to regulation to meet a raft of other objectives, including safety,



antitrust, and environmental aims. How should a utility regulator's role be defined in relation to these objectives and to other regulators?

A sound general rule is to avoid a proliferation of agencies. Creating numerous agencies can dissipate expertise, forgo the economies in having one entity perform related tasks, create coordination demands, and introduce additional complexity. But as with most general rules, there are exceptions. Separate agencies may be required to avoid significant conflicts in the mandate of a single agency. When an existing agency responsible for, say, environmental regulation is performing well, immediately transferring its responsibilities in utilities to a new utility regulator is usually inadvisable. And there are inescapable tradeoffs between cultivating expertise, economies of scale, and coordination in utility regulation and doing the same in environmental or other regulation for the economy as a whole.

There is one rule that should have no exceptions: If more than one agency is involved in regulating utilities, the role of each should be defined as clearly as possible to avoid duplication, jurisdictional uncertainty, and turf disputes.

### Service quality issues

Customer service standards are usually the province of the utility regulator. The allocation of responsibility for safety and environmental regulation can vary widely, even between sectors in a single country. Two main issues warrant consideration.

**Standard setting.** Quality standards have a direct impact on utilities' costs and thus on prices. If the utility regulator is not responsible for determining standards, it may have a role in providing advice to the agency that is responsible.

**Tariff adjustment.** Because changes in quality standards affect costs, they may require tariff adjustments. When different agencies are responsible for regulating tariff and quality parameters, coordination issues can arise. These

issues can be addressed in several ways, including through tariff rules that permit certain cost increases to be passed on automatically.

### Antitrust matters

Antitrust regulation includes prohibitions on certain anticompetitive agreements and mergers and on the misuse of market power. In countries with modern antitrust regimes, these matters are usually entrusted to a specialist agency with economywide jurisdiction. How should a specialist utility regulator's role be defined relative to the antitrust agency? There are two main issues.

#### Clarifying the interaction between regimes.

There may be overlap between utility and antitrust regulation in some areas—for example, between industry-specific regimes governing access to networks and economywide rules governing the misuse of market power. The interaction between the two regimes should be defined clearly from the outset.

**Exploiting complementary expertise.** Utility regulators and antitrust agencies have complementary expertise. Both agencies may be involved in reviewing proposed mergers or allegations of anticompetitive conduct in utility industries. In some cases, a member of the antitrust agency is also made a member of the utility agency, or the agencies make formal submissions to proceedings conducted by the other. Antitrust agencies may also be given special roles in utility regulation, such as hearing appeals of decisions by the utility regulator.

Decisions on the responsibilities of a utility regulator have important implications for other aspects of the agency's design, including its decisionmaking structure, its resources, and the start-up strategy. These and related issues are considered in a companion Note.

*Warrick Smith (wsmith3@worldbank.org),  
Private Participation in Infrastructure Group*

Viewpoint is an open forum intended to encourage dissemination of and debate on ideas, innovations, and best practices for expanding the private sector. The views published are those of the authors and should not be attributed to the World Bank or any of its affiliated organizations. Nor do any of the conclusions represent official policy of the World Bank or of its Executive Directors or the countries they represent.

To order additional copies please call 202-458-1111 or contact Suzanne Smith, editor, Room F6P-188, The World Bank, 1818 H Street, NW, Washington, D.C. 20433, or Internet address [ssmith7@worldbank.org](mailto:ssmith7@worldbank.org). The series is also available on-line ([www.worldbank.org/html/fpd/notes/notelist.html](http://www.worldbank.org/html/fpd/notes/notelist.html)).

♻️ Printed on recycled paper.