REGULATORS, POLICY MAKERS, AND THE MAKING OF POLICY:

WHO DOES WHAT AND WHEN DO THEY DO IT?

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Delineating between the roles of government policy makers and independent regulators is the subject of controversy and confusion wherever independent regulatory agencies have been established. Part of the controversy, of course, is the result of the natural "shaking out" process for newly established independent regulatory agencies in countries with no experience with such institutions. Part of the controversy, however, is simply that the boundaries between "policy-making" and "regulating" are inherently fluid and uncertain. Moreover, the very notion of distinguishing between "policy making" and "regulating" may well pose a false dichotomy. Both policy makers and regulators make policy. The distinction is that policy makers define the fundamentals and define the parameters within which policy making is delegated to regulators. It is more useful to think, not in terms of policy making versus regulation, but, rather, as macro policy versus micro policy. In flushing out the distinction, it is useful to think in terms of the following key concepts:

1. Basic and macro policy must be set by the Government.
2. Government policy must be set and altered only on a prospective basis.
3. Regulators must follow and enforce policies articulated by the Government
4. Regulators are creatures of the state and not necessarily of the Government.
5. Policy vacuums are an inherent and to be expected.
6. Some policy issues require technical expertise to be resolved.

7. Regulatory decision making, policy or otherwise must be subject to appellate review.

There is no debate whether Government has the power and the obligation to set basic policy. It not only has the capability, but it is its action that vests legitimacy, credibility, and legal authority to the regulatory regime. In fact, regulators, except in the rare circumstance where regulatory authority derives directly from the constitution (e.g. California), possess only those powers specifically delegated to them by the Government. Governmental failure to coherently articulate basic policy, will inevitably lead to instability, uncertainty, and blurred vision. Neither investors nor consumers will long tolerate a regime without basic form. The real question about the government establishment of policy is about the level of detail provided by government policy makers, the stability of established policy, and the means by which policy is articulated and communicated.

The level of detail provided by the Government is not a trivial issue. It is necessary that policy be articulated in sufficient detail to provide a level of stability and predictability adequate to attract capital and market participation. The general rules of the road and parameters of discretion delegated to regulators need to be stated in sufficient detail to enable a general understanding of the nature of the regime. Indeed, it is in articulating the basic policies that the difference between macro and micro policy is defined. Anything articulated in law or rule by the government constitutes the macro policy. Any policies that regulators articulate in order to carry out their duties to implement macro policy constitutes micro policy.

Macro policy should not be overly detailed for two basic reasons. The first is that things will almost inevitably change and regulators should not be entirely deprived of the flexibility needed to adjust to altered circumstances. Markets and circumstances evolve with time and it is prudent to enable regulators to make appropriate incremental changes. That degree of flexibility internalizes modest changes into the regulatory process and avoids undue politicization of relatively minor issues. It is also a recognition that policy makers are not and cannot be prescient. They simply cannot anticipate all issues that will require policy making to resolve. Rather than attempt to micro manage all details, delegation of authority to regulators to fill in policy details seems quite sensible, particularly given the fact that policy makers always possess the ultimate authority to change policy on a prospective basis, when they deem it appropriate to do so.

The second reason for avoiding overly prescriptive policy parameters is that some matters are simply too technical for policy makers. An excellent example is in the area of pricing. While it is important that basic methodology be set forth on a policy level, the actual implementation and application of pricing principles is an extraordinarily complicated matter. What level of expertise, for example, can we expect to find in a legislative body on the relative merits of locational marginal cost pricing for electric transmission services? The matter, while an important sector policy issue, is self evidently too arcane, too technical, and too sophisticated to expect keen insights from makers of macro policy. That being said, however, it is critical that the government articulate at least a basic theory of pricing. It may range from the amorphous "just and reasonable" standard enunciated in the Federal Power Act in the U.S., to something slightly more prescriptive, such as mandating price caps, benchmarks, rate of return

regulation, performance/incentive based regulation, reasonable opportunity to recover prudently incurred costs, or some other criteria. The purpose is to provide investors and consumers alike, some insight into what they may reasonably expect from the pricing regime, not to put the regulators into a straight jacket by rigidly defining every detail. Where policy-making requires technical sophistication and expertise, it is prudent to simply delegate it to the regulators.

Delegation of micro policy making also makes sense because no macro policy maker, regardless of prudence and vision, will ever be able to foresee all of the policy issues that will be encountered in the exercise of regulatory authority. Consequently, there is an element of policy making that will have to be done when unanticipated issues arise for which there is no pre-existing policy, or where the policies, articulated in broad terms, requires clarification or fuller definition in application. Examples might include refined definitions of what constitutes improper exercise of market power in electricity generation, or how to price a newly unbundled telecommunications service that had previously only been offered on a bundled basis with other services, or redefinition of customer classes based on unforeseen uses. It is, of course, theoretically possible that regulators, upon encountering such a situation, could stop their decision making process and seek guidance from government policy makers. Unfortunately, doing so will inherently render the decision making process more laborious, time consuming, and less effective. Moreover, there is no assurance that an answer will be forthcoming at all, much less on a timely basis. That seems, for a variety of reasons, quite likely in legislative bodies. It seems both more efficient and fairer to the parties involved to simply authorize the regulators to make the needed determinations. If the judgment of the regulators

proves faulty, there will be many opportunities for them to reverse themselves, or for macro policy makers to step in and articulate a new policy.

It is useful to point out that macro policy can come from two sources, one legislative, and the other, executive. Obviously, basic policy should be set out in law. That requires legislative action. The other possibility for policy formulation, all be it within the scope of authority provided by law, is that executive agencies such as cabinets, individual ministries, councils of ministries (The National Energy Policy Council in Brazil, for example), the president or prime minister himself, will enunciate policy. Basic infrastructure ministries, and perhaps other institutions, may well possess comparable levels of expertise as is found in regulatory agencies. They, therefore, may well be as competent at analyzing arcane technical matters as the regulators. The issue with executive policy makers, unlike legislators, as noted below, is often not lack of understanding or expertise, but, rather, one of timing, transparency, politicization, and application of decisions. It is important, however, to keep in mind that there is more than one level of delegation possible for micro policy making.

While broad policy questions should be resolved by policy makers, many areas of micro policy making, within defined parameters, are best delegated to regulators to decide. Doing so follows logically from one of the fundamental reasons for regulatory independence. The state performs three basic categories of functions, administration, legislation, and adjudication. It is impossible to put regulatory agencies in any single category, since they perform aspects of each. They operate agencies, buy supplies, enforce laws, manage personnel, and perform many other administrative tasks. They set tariffs, promulgate rules, enunciate micro policy within the authority delegated to them,

and perform other functions which are universally applicable and prospective in nature. Those two attributes are classic legislative powers. Finally, they adjudicate disputes within their legal jurisdiction. Thus, regulators do not readily fit into any governmental table of organization. Policy making, of course, is legislative in nature and is, therefore, a type of activity within which regulators routinely engage in. Their ability to do so, however, is governed by the scope of authority granted to them by the government. Once that authority is delegated, and, until it is rescinded, the regulators should be free, subject to appellate review, to apply their expertise and exercise their lawful authority free of governmental interference.

As noted, macro policy makers always possess the legal capability to dictate policy to regulators. It is important, however, that when they do so, they act only on a prospective basis. The rationale for that principle is two fold, decision making coherence, and the legitimacy/transparency of the process itself. The first rationale is rooted in sound process management. There are three basic elements to the process, legal/macro policy formulation and articulation, implementation/micro policy formulation, and appellate review. It is an element of basic fairness that those who participate in the process are able, to the extent possible, to know what the rules and policies with which they will have to comply. It is, therefore, for the sake of both coherence and fairness that the three elements of decision-making be conducted in appropriate sequence by the proper authorities. Policy makers, both legislative and executive, need to provide the regulators with the policy framework within which they must make their decisions. By articulating that framework, they are simultaneously providing all parties due notice of the basic parameters of regulatory policy and principles to be followed. Those policies are set forth

in general terms and in contemplation of overall objectives rather than determining the outcome of specific cases or fates of specific market participants. While vested interests will undoubtedly attempt to influence policy decisions, and certainly have a right to do so, it is important to keep policy makers fully focused on the broad goals and objectives defining the public interest, rather than on the specifics of individual case outcomes.

It is for the regulators to decide individual cases and to actually apply the policies to specific factual contexts and players. In so doing they are almost certain to encounter matters that require detailed interpretation of policy, or even filling in the blanks left by the policy makers. In fact, for the most part, it is in the context of specific cases or set of circumstances that issues of micro policy will arise. It is an inherent and unavoidable aspect of regulation that matters of micro policy, or clarification of broad policy, will arise in specific cases before the regulators. Whereas macro policy makers are often the initiators of policy matters, regulators, more often than not, make micro policy in reaction to matters raised in specific cases or disputes, or, in order to specifically fulfill obligations imposed upon them by law. It is axiomatic, but true, that unforeseen issues or circumstances will arise, which the macro policy makers did not, or could not, anticipate.

While regulators could, in theory, upon encountering a micro policy matter, stop their process, throw up their hands, and ask for guidance from government or legislative authorities before proceeding, the result, would be likely be highly disruptive, time consuming, and would almost certainly politicize the outcome of very specific cases or the fulfillment of specific regulatory objectives. Those inevitable effects of such a procedure would likely negate the very *raison d'etre* of independent regulatory agencies. It makes better sense, therefore, to simply allow the regulators to proceed with their

decision making process. That being said, however, there certainly does need to be a check in place to assure that the regulators neither exceed their legal authority nor violate policies that they are obliged to follow. That, of course, is the reason why there is an appellate process. If regulators, in deciding a matter, fail to follow obligatory laws and/or policies, then the offending decision should be reversed and reconsidered.

There is, therefore, a logical sequence to deciding regulatory matters. The first is the initiation of the entire regulatory regime through the articulation of basic principles and policy formulations. That process allows for public contemplation of basic policies through the political process, but in a broad context without specific cases or disputes in mind. That is, undisputedly, the role of legislators, and perhaps executive policy makers as well. Regulators can provide input in such matters, but are not empowered to decide them. The second part of the sequence is the actual carrying out of regulation. That process allows for regulators to adjudicate disputes, fulfill legal obligations such as tariff setting, and, where necessary, to provide micro policy details in order to clarify or provide detail on policy. The latter, of course, is the essence of making micro policy. It must be carried out independently, transparently, and in an apolitical manner. The third sequence is to assure that the second sequence, the regulatory process, is carried out in a manner not inconsistent with the policies and principle enunciated in the first process. The third sequence is, of course, the appellate process. In fact, there are two appeals processes, on for resolving specific cases in dispute, and the other, for resolving policy issues on a prospective, going forward, basis. In the first type of appeal, a party who feels aggrieved by a decision by the regulator may ask that an appellate body (usually a Court or tribunal of some sort) reverse the decision in that case. The appellate body, among its

other obligations in reviewing the decision of a regulatory agency, must make certain that the regulators neither exceeded their authority or failed to follow the polices set forth by macro policy makers. This form of appeal should be carried out in an independent, transparent, apolitical manner. The other form of appeal, however, is to the macro policy makers. An appeal to macro policy makers, however, is merely to review relevant policy in order to determine whether policy needs to be altered of supplemented. Because, however, such an appeal can be carried out within the political process, any policy determinations will have affect only future matters. In other words, it cannot affect the outcome of specific cases decided by the regulators prior to the re-formulation of basic policy.

Apart from sound principles for decision making, there is another, perhaps even more important reason for allowing regulators to decide matters of micro policy. That reason is the transparency and integrity of the decision making process itself. The integrity of the regulatory process is rooted in many elements, but important among them is the idea that the process is transparent, fair, and independent of politics. As one observer has noted, regulators are agents of the state, but not necessarily of the government of the moment. In order to assure the integrity of decision making, it is vital that the process is exactly as it appears to be. All parties have the same opportunity to access the decision makers and to know what information and arguments the regulators are considering in rendering their decisions.

Because the making of micro policy often arises in connection with individual cases involving specific and discrete financial interests, the process, like the judicial process, must be utterly transparent and, to the extent possible, divorced from politics. Investors in

regulated infrastructure almost invariably will demand that regulatory matters be decided in a transparent, independent, and apolitical manner. They see greater predictability, more dispassionate analysis, and fewer risk variables in the regulatory arena than in a political one. Similarly, consumers in many places, have come to the same conclusion that they are better served by having an independent, transparent, apolitical body making key decisions regarding infrastructure than having case specific matter resolved in a political forum where they are likely to possess less clout than are well funded lobbyists for private companies. The views of political figures may well be considered by regulators as one set of inputs, but those voices must be communicated in a transparent, public manner by the regulators, who, alone, should be responsible for decision making. In short, the process must be internally open and complete.

Unlike the making of macro policy, which is inherently political, the regulatory process, because it usually involves weighing the interests of specific parties, and the making of technical judgments regarding the application of broad policy to a specific set of circumstances, to the extent possible, should be free of politics. It is, therefore, inconsistent with the very basic regulatory concepts of independence, transparency, and de-politicization for regulators to defer to political authorities in rendering their decisions.

It is theoretically possible to construct a relatively transparent mechanism for political consultation by regulators on matters of micro policy. Indeed, political authorities should always have a means of transparently offering their views to regulators. The problem is not the transparent offering of viewpoints, but, rather, the non-transparent bypass of the regulatory processes that seems likely to occur if regulators are not in a position to decide micro policy issues on their own. Parties seeking to advance their own interests will

almost inevitably, whenever it suits their interest, seek out political officials to support their point of view. It would, for example, be grossly unfair to have all of the parties in a case present their evidence and arguments to the regulators through the prescribed process while another party to the same proceeding seeks out the clandestine support of a minister or other high political figure in order to secure a favorable decision. Success in such a maneuver would render the entire regulatory process in that proceeding a sham. All of the evidence offered, arguments made, processes followed would be made meaningless. It is for that very reason that independence of the regulators is, in fact, a critical element of transparency. No process can be deemed to be transparent when the real decision maker is someone other than whom it is supposed to be under the procedures, or, where the real reasons for a decision remain unrevealed.

While perhaps it cannot be said that the motives of regulators are always pure, the discipline imposed by the process can at least compel transparency. The same cannot be said when the process becomes politicized. While the motives of the government in interfering may well be for such legitimate policy reasons as controlling inflation, promoting investment, promoting specific resources, the opportunity of bypassing an established, transparent regulatory process by political officials also opens the door to politicization, corruption and/or de-legitimization. It is important, therefore, as elementary fairness to all parties, for the integrity of the process, and for transparency that the regulators themselves make the decisions themselves, and that any effort by the government or any of its officials to influence the outcome only be carried out in ways that are open and transparent. Certainly, advocating legitimate goals can be done transparently without embarrassment. More importantly, if the goals being advocated by

political authorities are meritorious, then the government is always empowered to change policies prospectively. It need not intervene in the regulatory process in specific cases in order to effectuate policy. Doing so is to effectively alter the rules in the middle of the game. By making policy on a prospective basis only, the integrity of the process is preserved without sacrificing the ability of political authorities to make policy.

In conclusion, governments must set basic, macro policy, but filling in the details of that policy, micro policy making, is an inherent part of what regulators have to do in order to carry out their mission. Policy making by regulators, however, is limited by two critical factors. The first is that policy made by regulators is subsidiary to government policy and is done only under a delegation of authority from the state. Secondly, the making of policy by regulators is incidental to and inherent in their duty to decide specific cases or disputes. That policy making role is derived entirely from the fact that macro policy cannot reasonably be expected to anticipate all aspects of policy that will have to evolve for the regulatory process to be fully functional. Gaps will have to be filled and it is the regulators, with technical expertise and hands on experience that are best positioned to accomplish that. Their role in doing so, however, is subject to two checks. The first is appellate review that determines if the regulators were acting within their lawful authority, followed policies they were obliged to follow, whether they were acting reasonably, and whether they followed fair and correct procedures. The second check is that the government retains the ability to alter micro policy determinations. In order to safeguard the integrity of the regulatory process, however, it is vital that that power be exercised only on a prospective basis. Recognition of the realities and limits of

regulatory policy making will both safeguard the process and allow for a more orderly and predictable regulatory regime.