

The Independent Regulator

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Countries considering introducing regulation of utility services are invariably advised by the funding agents and consultants to establish “independent regulators”. There is however no universally accepted definition of what is meant by the term “independent” in this context, and the question “independent of whom” may therefore be legitimately asked. To some, the regulator’s independence refers to arm’s length relationships with regulated service providers. For instance, the World Trade Organization, in its Schedule of Specific Commitments for Telecommunication Services, defines an “independent regulator” as “the regulatory body, separate from, and not accountable to any supplier of basic telecommunication services”. Another group, primarily that formed by the providers of utility services, may be concerned that the regulator, in the hope of obtaining popular approval, may become a consumer advocate, paying undue attention to consumer demands for lower prices or unreasonably high levels of service. To many others “independence” implies primarily freedom from interference by the executive arm of the government in the conduct of regulatory affairs.

A truly independent regulator will function in arms-length relationships with all stakeholders. “Arm’s length in this context means that regulatory decisions are not influenced by special considerations (favorable or unfavorable) being given to any of the parties involved. Such decisions and any resultant actions will be taken in accordance with transparent processes and within the context of a clearly defined legal framework. It is the regulator’s responsibility to establish, to the greatest extent feasible, the proverbial level playing field in which the interests of all stakeholders are considered, and no stakeholder will receive preferential treatment or have reasonable grounds to consider itself unfairly disadvantaged.

Independence from the Utility

Regulatory literature often discusses what is termed “regulatory capture”, that is where the utilities gain undue influence over the regulators, and regulatory decisions tend to favor a specific utility or the utilities generally. Regulatory capture is indeed a danger, but if the regulator is aware of the hazard and is on guard against it, then its control becomes primarily a question of the competence and diligence of the regulator. Procedures designed to ensure transparent decision-making will also serve to make regulatory capture less likely. This assumes that the regulators are not only competent but also persons of integrity, but both these attributes must always be fundamental assumptions for effective regulation.

The objectives of the service provider and those of the public interest may conflict in many areas, regardless of whether the utility is publicly or privately owned. Potential areas of conflict include pricing, service standards and universal service. If the regulator is to be seen to be independent of service providers it is essential that appearances of cordiality in the relationships be avoided. The arm’s length relationship will prevent the regulator from accepting gifts or other favours from the regulated, even if these are not thought to convey significant financial benefit. Acceptance of favours will affect the general

perception of the regulator's impartiality, even if in reality it has no bearing whatsoever on the regulatory decision making process.

If utility services are provided by monopolies, one of the prime functions of the regulator is to prevent abuse of monopoly privileges. In a competitive environment the regulator needs to be vigilant in preventing abuse of dominance by the incumbent and ensure fair and non-discriminatory access pricing.

Independence from Consumers

Consumers may be the most difficult stakeholders to convince of the advantages of independent regulation. Typical consumers are interested in only two aspects of utility services; the cost and the quality of the service they receive. They seldom appreciate that generally there is a relationship between the two. Consumers comprise numerically the largest group of stakeholders but it is a heterogeneous group whose interests are normally not coordinated, and arguments in favour of those interests often not strategically organized. The industrial and residential consumer may both agree that the costs of utility services are too high and the quality of service unsatisfactory, but they may have very different opinions as to the solutions. The home owner/occupier thinks the burden of costs should be shifted to the industrialist whose financial resources are less constrained and who, in any case, can roll utility costs into the sale price of his end product. The industrialist complains that high utility costs make his product less competitive in an increasingly global marketplace. Neither can understand why the regulator cannot see the logic of their respective positions. These are only two examples of a large number of special interest groups within the consumer category.

Because the consumer group is numerically the largest, a regulator may be seduced into gaining popular approval by adopting consumer positions without objective analysis of the issues involved. The credibility of the regulator is critical, but is not achieved merely by seeking popular support. The regulator gains credibility when his decisions can be seen by all stakeholders to be the results of objective reasoning, even by those whose narrow interests may not be served by the decisions.

Independence from the Government

Independence of the regulator from the regulated is more easily understood than independence from the political authorities. Perhaps precisely for that reason, political pressures endanger true regulatory independence much more than the undue influence of the regulated. The regulatory body is an agency of the government, and to speak of such an agency being independent of political authority can be confusing, it may sound like an oxymoron. The confusion is often greater when the regulated enterprises are state-owned as then the distinction between the responsibilities of the owner and operator on the one hand and those of the regulator on the other are frequently ill-defined.

Those departments of the government through which the day-to-day objectives of the government are achieved are referred to as the "executive branches". The political directorate issues instructions directly to such departments, often in great detail, as to what actions are to be taken. A regulatory agency is not, if it is independent of the political process, part of the government's executive arm. The only government objective that the regulator should be directed to achieve is independent regulation. This ought to take place within clearly defined legal and policy frameworks that render unnecessary the issuance of instructions from the political directorate to the regulator as to actions to be taken.

A regulator whose decisions are subject to review or approval by the political directorate is not independent. In many countries the nominal regulator acts in an advisory role to the Minister or Cabinet. An obvious problem with this scenario is that the regulator could quickly become irrelevant if the Minister consistently ignores the advice.

The foregoing is not intended to suggest that the political directorate has no role in regulating utility services. The government has the authority and responsibility to establish the policies under which the various sectors of the economy are to operate, and it is the duty of the regulator to ensure that his actions comply with these policies. However, such policies must be formally announced and properly communicated. They must be written and preferably placed before the legislature. It should not be necessary for the Minister or anyone in the political directorate to make pronouncements as to what actions the regulator should take in order to conform to a government policy of which nobody outside of the political directorate had previously heard. In many countries, especially those influenced by British common law, the legislation establishing the regulatory agency will stipulate that the responsible minister may give “instructions of a general nature as to policy”, but these instructions should be for guidance only and never become the medium through which the policy is first communicated.

It is also necessary to differentiate between strategy and policy. The government will develop a strategy by which to its policy objectives are to be achieved. But the mere existence of such a strategy, even if publicly announced, will not necessarily mean that decisions of the regulator must support the strategy. For instance, in order to achieve certain economic targets, the government may develop a strategy to restrain annual inflation to single digit percentages. However, that strategy should not be a factor in the regulator’s decisions on the pricing of utility services. The principles guiding these decisions should continue to be that the revenues earned from the services must cover the costs of efficiently providing them and enable the investor to obtain a reasonable return on capital invested, even if the objectives of the strategy are not supported by that decision.

The general experience internationally has been that independence from the political process is the most difficult to achieve. In dealings with the government the regulatory agency cannot reasonably speak from a position of authority since it is from the government that it derives such authority as it does have. The government can change formal policies, even legislation, to achieve its ends. In the final analysis the regulator can only be as independent as the government wants him to be. The commitment of the government to the independence of the regulatory agency is the single most important factor in determining the ability of the agency to maintain credibility with all stakeholders.

Regulatory Autonomy

If a regulator is to be truly independent of the government’s executive arm, then it needs also to be autonomous in its operations. The characteristics of autonomy cover a wide range of issues, among the more important of which are:

- Independent funding – the regulator should be funded by some means independent of the treasury, generally by regulatory fees paid directly to the agency by the providers of regulated services. If the treasury provides the funding the regulator may be subject to periodic shortage of financial resources as the government’s budget is put under strain. Funding from the treasury also provides the political directorate with opportunities to use the threat of withholding funds as a lever by which regulatory action may be influenced;

- Independence from civil service salary structures and hiring procedures. Civil servants typically receive lower compensation than their counterparts in the utilities, even government-owned utilities. However the regulator needs to attract and retain staff with the same levels of competence as those of the utilities. If the regulator should be hampered by civil service rates of pay or hiring procedures, he will probably not be able to understand issues important to the utilities' operations, and so be subject to what is known as "regulatory capture" or an acceptance of the service providers' arguments as to what is best in the public's interest;
- Security of tenure for regulators. Regulators should not be appointed on the basis of political allegiance; and should be subject to involuntary removal from office only for previously defined cause.

Regulatory Authority

If the desired degree of regulatory independence is to be achieved, the regulator will need to be vested with appropriate authority and powers of enforcement to ensure that its instructions and decisions are not lightly disregarded. Responsible regulatory decisions are dependent on reliable information, but the service providers have no fundamental incentive to provide all the information that may be relevant to the operations of the sectors. The regulator must therefore have the authority to require submission of such information as it considers necessary for the effective discharge of its responsibilities. An example relates to the provision of accounting information. Utility accounts are normally kept to comply with statutory requirements for submission of financial information to government departments. The resultant statements will seldom provide the regulator with the information needed to determine the cost of providing specific services, an important factor in deciding on equitable tariffs. The regulator ought therefore to be empowered to instruct the utilities as to the scope of the information he requires and the format in which it is to be submitted. He must also be able to instruct service providers to take such action as may be necessary to improve the efficiency of sector operations, but these instructions should be directed at results, and not comprise specific actions to be taken by the management. The regulator must never micro-manage.

Regulatory Accountability

Considerations of independence, authority and accountability should not provide the regulator with an opportunity to act in an irresponsible manner. As a servant of the people the regulator must be accountable to the people to assure them that he acts with integrity, openness and fairness, and abides within the legislative framework under which the agency was established. Some of the ways in which the regulatory agency may be required to give an account of its stewardship are:

- Its financial accounts should be independently audited annually and submitted to the parliament;
- A report on its activities during the previous fiscal year should be prepared annually and submitted to the parliament;
- Its annual budget for the ensuing year, including the proposed regulatory fees, should be submitted to the cabinet before the end of each fiscal year;
- Its internal policies and procedures should be open to public scrutiny;

- Written reports on its regulatory decisions and the considerations by which those decisions were reached, should be made available to the public;
- Hearings being held on important regulatory issues should be open to the public;
- Information should be kept confidential from the public only if it has potential to divert the course of justice; contains personal information which the affected party or parties do not wish to have disclosed; contains commercial information of a proprietary nature; or if its disclosure would in some way be prejudicial to the interests of one or more of the affected parties.

Review of Regulatory Decisions

Regulators are human and may make mistakes. Provision of some avenue of appeal for those who consider themselves aggrieved by regulatory decisions is not an infringement of regulatory independence. The courts are always a possibility for appeal, but in many countries they tend to be slow in response to non-criminal offences. An alternative to the courts can be tribunals, established to consider appeals against regulatory decisions and determine the validity of the complaint. In some instances, if the tribunal determines that the regulator has erred it can over-ride the regulator's decisions; in others it must return the issue to the regulator for reconsideration. The minister, or anyone in the government's executive hierarchy, is an inappropriate avenue of appeal, as the independence of the regulator is thereby compromised.

Conclusion

The foregoing outlines the basic framework required if a utility regulator is to be enabled to act independently in the exercise of his functions. There is however at least one additional consideration. Regardless of the freedom of decision making with which he is endowed, the regulator is only going to be as independent as he himself wants to be. He needs to be seen to be accountable to the society at large, and not to any specific group of interests. An effective regulator must believe more firmly in the importance of principled action than in the security of his position. In the 1966 Annual Meeting of National Association of Utility Regulatory Commissioners Commissioner Lundy, who was then President of the Association and also Chairman of the Public Utilities Commission in New York State, stated that "the task of the utility regulator is one which requires the wisdom of Solomon, the patience of Job, the determination of a bulldog, and the hide of a rhinoceros". He was speaking, of course, of the independent regulator.