

GRID LINES

Sharing knowledge, experiences, and innovations in public-private partnerships in infrastructure

Matching regulatory design to country circumstances

The potential of hybrid and transitional models

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Developing countries attempting to implement the standard model of independent regulation have encountered many problems and challenges. These may arise when a regulatory system is incompatible with the country's regulatory commitment and institutional and human resource endowment. Selecting from a menu of regulatory options to create a hybrid model—one that best fits a country's own circumstances and challenges—can improve regulatory performance.

The most common feature of infrastructure reform in developing and emerging economies in 15 years has been the establishment of independent regulatory agencies. The aim of regulation is to encourage efficient, low-cost, reliable service provision while ensuring financial viability and new investment. And regulatory agencies, it was hoped, would reduce risk for private investors by insulating tariff setting from political opportunism and making decisions more transparent and predictable.

How well have these regulatory agencies performed? International debate and research on infrastructure regulation are increasingly focusing on these issues. Ironically, many now argue that some of the new regulatory agencies have exacerbated the problems they were meant to address and led to a new risk for investors—regulatory risk. Some view this risk as arising from incapable regulators making unpredictable or noncredible decisions. Others see it as simply the result of regulators—given wide discretion and broad objectives—attempting to make difficult decisions with important social and political consequences.

Alternative regulatory models that offer a better fit with a country's circumstances can alleviate some of the problems and thus improve regulatory performance. These circumstances include

the degree of regulatory commitment—the willingness of governments to minimize political opportunism in tariff setting and service standards and to transfer regulatory decision-making powers to an independent regulator, a regulatory contract, or an expert panel. Regulatory commitment is expressed in strong political support for constitutional and legislative frameworks that underpin transparent regulatory systems and encourage the honoring of contracts.

Challenges and problems

Many challenges and problems have emerged with utility regulation in developing countries. Two of these are limits to independence and institutional fragility and capacity challenges.

Limits to independence

The creation of separate regulatory agencies was intended to foster independent decision-making. But regulators often are far from independent. Government can exert pressure on regulators to modify or overturn decisions. In some countries commissioners have been forced to resign. As a result, there is often a large gap between law and practice.

Tariff setting remains highly politicized, and governments are sensitive to popular resentment against price increases, often necessary to cover costs. Establishing new, “independent” regulatory agencies in these contexts can be a risky strategy for all stakeholders—government, utilities, investors, and customers.

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FIGURE 1

The World Bank rethinks the classic independent regulator model

THEN

A requirement of all power lending will be explicit movement toward the establishment of a legal framework and regulatory processes satisfactory to the Bank . . . This requires countries to set up transparent regulatory processes that are clearly independent . . .

—World Bank 1993

NOW

A credible regulatory system requires more than a formally independent regulatory entity . . . Other transitional arrangements may need to be established . . . including limiting the amount of discretion that regulatory bodies have in setting prices and key parameters.

—World Bank 2004

Institutional fragility and capacity challenges

Many regulatory institutions in developing countries are no more than a few years old, and few are older than 10. The challenge of establishing new public institutions in developing countries has often been underestimated. It takes time to build and entrench governance, management, and organizational systems and practices and to build new professional capacity. Many regulatory institutions are still quite fragile and lack capacity.

In a recent global survey of regulators the most frequently reported constraint was lack of specialized skills in utility regulation: 30 percent of respondents cited insufficient training as a significant constraint, and 61 percent characterized training as deficient because it lacked continuity and was poorly targeted. The survey concludes that “quality human resources are scarcer than money” (Tremolet and Shah 2005, p41).

Regulatory options

Clearly, independent regulation requires strong regulatory commitment and competent institutions and people. The reality is that developing countries often show only weak political commitment to independent regulation and face big constraints in institutional capacity (Tremolet and Shah 2005). These limits of independent regulation are beginning to be recognized, including in policy documents at the World Bank (figure 1).

Acknowledging that limits might need to be imposed on regulatory discretion—because of weak regulatory commitment, political expediency, fragile institutions, and capacity constraints—does not mean that independent regulation is not desirable. Building credible, independent regulatory

institutions may remain a goal in many countries. But the challenges and problems point to a need to start considering complementary, transitional, or hybrid regulatory options and models. These include regulating by contract and outsourcing regulatory functions.

Regulating by contract

Regulating by contract involves pre-specifying regulatory regimes (including multiyear tariff-setting systems) in detail in such legal instruments as basic law, secondary legislation, licenses, concession contracts, or power purchase agreements (Bakovic, Tenenbaum, and Woolf 2003). Regulatory contracts are generally constructed for private participation but may also be used to improve the performance of state-owned utilities.

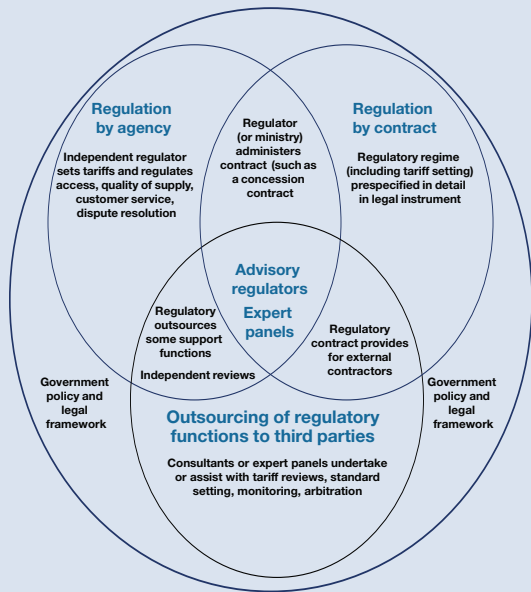
A regulatory agency can successfully coexist with a regulatory contract where it is incomplete and additional regulatory mechanisms are needed. The law or contract could explicitly define the role of the regulator—for example, in periodic tariff setting, monitoring of performance, or mediation and arbitration. The regulator could also enhance the transparency of regulatory contracts by collecting, analyzing, and publishing performance data.

But welding legal traditions together can also lead to problems. Even when the contract specifies the tariff-setting formula, the regulator might feel obligated by its legislative mandate to intervene in the public interest. In these cases, clarifying regulatory roles and functions is essential.

Outsourcing regulatory functions

Outsourcing or contracting out regulatory functions involves relying on external contractors to perform such functions as tariff reviews, benchmarking, compliance monitoring, or dispute resolution. Outsourcing might be considered

Some regulators are far from independent

FIGURE 2**Different regulatory options can often coexist**

where there are challenges or problems relating to a regulator’s independence, capacity, or legitimacy—or where regulatory contracts need additional support for effective administration. Outsourcing might also be used for cost-benefit reasons (Tremolet, Shukla, and Venton 2004).

There are two main models of regulatory outsourcing. The first involves consulting or technical support for regulators or the parties to a regulatory contract. The second involves the government’s contracting of separate advisory regulators or expert panels. In the strongest version of this model the advisory regulator or expert panel must give its advice in a publicly available document that clearly explains the decision. The minister (or other relevant authority) may request reconsideration of the recommendations, but must do so within a specified period. If the minister fails to react, the recommendations are enacted. And if the minister rejects or modifies the recommendations, the minister must provide a written public explanation. The minister’s policy directives and other communications to the regulator or expert panel must be in a public document. The regulator or expert panel holds public consultations with the parties affected and is funded from an earmarked budget outside the line ministry (Brown et al 2006, p100).

Expert panels may also be used to arbitrate

disputes between regulators and utility operators or disputes that arise out of contested interpretations in regulatory contracts. In contrast with conventional arbitration mechanisms, expert panels have the specialist expertise needed to analyze comprehensive tariff reviews and use procedures that are less formal and adversarial.

One interesting use of expert panels could be at the regional level. Regional economic bodies or regulatory associations could employ an expert panel to provide technical assistance to a number of national regulators. Regional panels would provide greater continuity and consistency in specialist support and could make better use of scarce regulatory expertise. They could also assist in harmonizing regulatory regimes, aiding the integration of regional networks.

Toward better regulatory systems

The different regulatory models embody varying degrees of regulatory discretion. But they are not mutually exclusive and often coexist (figure 2). How to choose between these options or decide on an appropriate combination?

Some have argued that the fundamental challenge in regulatory design is to find governance mechanisms that restrain regulatory discretion over substantive issues such as tariff setting (Levy and Spiller 1994). Others argue that some regulatory discretion is inevitable (and even desirable) and so the fundamental problem is how to establish governance arrangements and procedures that allow a “nontrivial degree of bounded and accountable discretion” (Stern and Cubbin 2005, p7).

A model to fit the context

The level of regulatory discretion should be determined by the context. Regulatory models and governance systems should be securely located within the political, constitutional, and legal arrangements of the country. They should also fit the country’s regulatory commitment, institutional development, and human resource capacity.

Where there is weak regulatory commitment and capacity, the initial choice might be a set of low-discretion regulatory contracts without a regulatory agency (figure 3). Where there is strong regulatory commitment but weak institutional development and capacity, regulatory functions could be contracted to an expert panel.

The level of regulatory discretion should depend on the context

Hybrid and transitional models

We have already noted the possibility of hybrid models. Yet another possibility is a transitional path (as indicated in Figure 3). The situation in a country may change over time. While regulatory commitment is being increased, strong advisory panels could be contracted or a separate regulatory agency established, perhaps initially with limited discretion. As institutional and human resource capacity is built, the responsibilities and functions of the regulatory agency could be expanded. And as these transitional and hybrid models evolve, sensible decisions could be made on outsourcing certain regulatory functions where cost-effective.

There is no ideal destination. The transition may not always lead to a full-fledged independent regulatory agency. There may well be situations where an independent agency is simply not justified and an expert panel or a well-designed regulatory contract would suffice.

Conclusion

The idea that infrastructure reform should involve setting up independent regulators became a mantra over the past 15 years. But mantras become substitutes for thinking—and may not fit all settings. The success of a regulatory system depends on its compatibility with a country's regulatory commitment and institutional and human resource endowment. Each country needs to select from a menu of regulatory options to create hybrid models that best fit its own circumstances and challenges. And as the country builds regulatory independence and capacity, these hybrid models will evolve. Designing and implementing legitimate, competent regulatory institutions in developing countries will always be a dynamic challenge.

Note

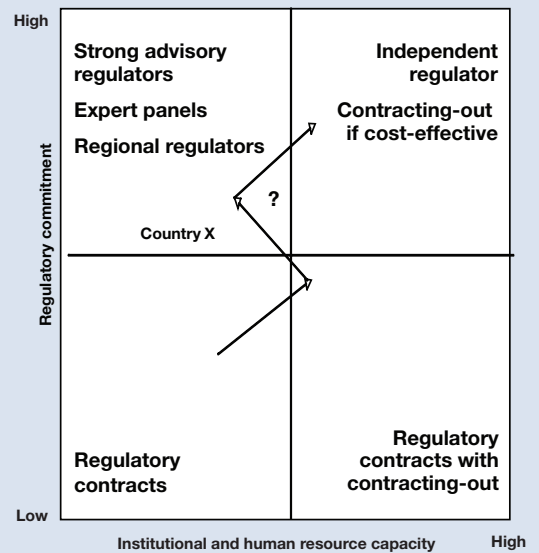
This note is based on a number of papers by the author. The papers can be accessed at www.gsb.uct.ac.za/mir.

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FIGURE 3

The choice of regulatory option should fit the context



Source: Adapted from Brown and others 2006.

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