

CREATING RELEVANT REGULATORY FRAMEWORKS TO ATTRACT PRIVATE SECTOR CAPITAL

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Introduction

The regulation of public utilities in the USA has been the subject of controversy and judicial experimentation since the early decades of our Republic. Arguably that experimentation continues, yet equally arguable is the success of the regulatory process in creating a robust and generally accessible infrastructure of utility supply and service that is all the more envied by developing and transitional economies for its attraction of private capital to meet public interest. This paper addresses the functions of the regulatory process and creating institutional frameworks that support those processes and the achievement of those objectives.

The Context of Economic Regulation

Although governments have often allocated essential services in accordance with a centrally-planned strategy, many have found that a free and competitive market makes those goods and services available to customers on a more sustainable basis and at levels of quality with which they are satisfied and at prices for which they are willing to pay. However, when the market is in transition or the cost of developing a competitive infrastructure is prohibitive (i.e. a “natural monopoly”), intervention is needed as a proxy for the marketplace and in such a circumstance the internationally-recognized “best practice” for that intervention is the independent regulator.

Some may question why this regulatory function cannot effectively be managed from within the government by ministries that are otherwise dedicated to developing their sectors. Consider, however, the excellent answer from Achmad Lanti, Chairman of the Jakarta Water Supply Regulatory Body, in his article, “A Regulatory Approach to the Jakarta Supply Concession Contracts”:



Robert Eric Borgström is a senior advisor in energy and water regulatory policy and management with over 40 years of management and international consulting experience with utilities and regulatory authorities. Building upon 17 years of experience in the natural gas sector, since 1992 he has been focused on developing regulatory environments to attract sustainable private-sector investments in emerging and transitional economies. He has led energy projects and advised on the start-up of utility regulators in 36 countries including resident management projects in India, Romania and Tanzania. He is currently advising the Millennium Challenge’s power sector reform activity in Malawi, and the Zambian National Water and Sanitation Council. Since 2005, Mr. Borgström has been a frequent lecturer on regulatory issues at IP3’s management training courses.

“When a government itself is responsible for all aspects of infrastructure, achieving a balance between the various players might be regarded as less vital, the assumption being that the Minister will act in the best interests of all. Governments can, as sole provider, determine what is needed, although this is increasingly open to debate as the voice of the customer is seen as increasingly important. In the search to find more effective institutional set-ups for infrastructure provision, there is increasing emphasis on separating roles so that better incentives can be designed for each party and their performance better scrutinized.”¹

Regulatory Functions

There are two primary objectives for the economic regulator:

1. To ensure that consumers have essential goods and services on a sustainable and affordable basis, and
2. To encourage private sector investment in the development of an infrastructure to provide those goods and services.

In pursuing these objectives the economic regulator typically has the following functions:

- Setting (approving) tariffs and other service charges
- Establishing standards for the terms and conditions of supplying goods and services
- Making and enforcing market rules for the sector
- Monitoring economic and management performance of the regulated entities.
- Issuing, reviewing and canceling licenses
- Review concession agreements.
- Arbitrating disputes within the sector

Although the foregoing are broad responsibilities, the regulator’s role does not include the following functions:

- Planning for infrastructure development. – This is a governmental function although the regulator may have advisory input to the process.
- Contracting including the *evaluation* of tenders (although the regulator may monitor the evaluation process).
- Ownership and/or operation of a regulated entity. – This would be create a conflict of interest in that the regulator’s decisions must be made from an objective and disinterested perspective.

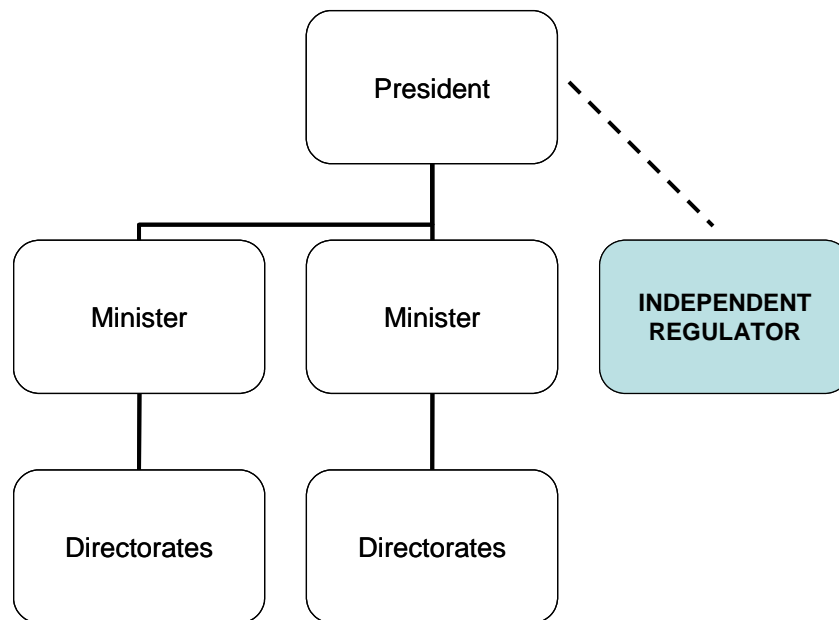
¹ Lanti, Achmad: “A Regulatory Approach to the Jakarta Water Supply Concession Contracts,” in *Water Management for Large Cities*, edited by Cecilia Tortajada, et.al. (London: Routledge. 2006), pp. 80-81.

The Independent Regulator

The Independent Regulatory Model is consistent with the essential elements of a good regulatory framework as outlined by The World Bank's 1993 policy paper to include:²

- Transparent regulatory processes
- Independence from suppliers
- Avoidance of governmental interference
- Decentralized, market-based systems
- Government retention of responsibility for policies, objectives, planning and sectoral coordination; and
- Government establishment of legislation and a sound legal framework to protect stakeholders' interests

Figure 1: Example of the “Independent Regulator” Framework



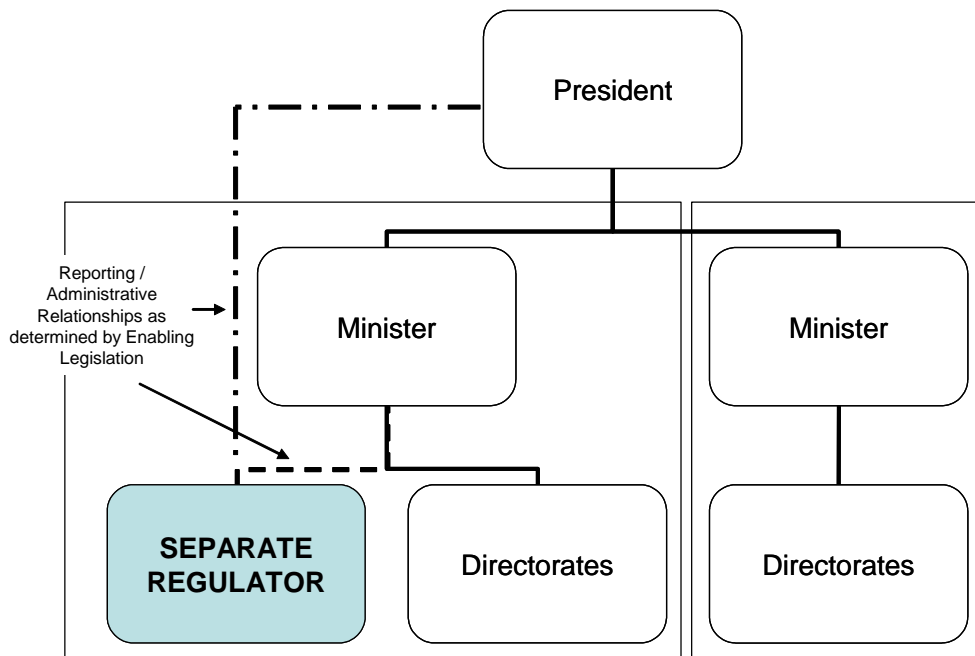
Regulatory independence is internationally recognized as the “best practice”, however, it remains for many countries a modality that is yet to be implemented. In its place many governments have established various organizational arrangements either with the title “regulator” or with terms of reference that may include such regulatory functions as the review and recommendation of tariff levels but subordinate decision-making to political control or the inequitable influence of special interests. These mechanisms may have been established as interim steps, but if they are not part of a purposeful and pro-active evolution from governmental control to independent regulation they cannot hope to achieve the objectives of development and sustainability of affordable infrastructure services that stakeholders, as well as national economic agendas, are seeking.

² “The World Bank’s Role in the Electric Power Sector; policies for effective institutional, regulatory and financial reform.” World Bank Policy Paper, Jan. 1993. p. 14.

The Separate Regulator

In many countries, an autonomous regulatory authority has been established according to what we'll call the "Separate" Regulatory Model.

Figure 2: Example of the "Separate Regulator" Framework



This framework identifies a separate organization that may take final regulatory decisions but is, by virtue of its functional establishment, subject to higher authority. Many times it is called an "independent" regulator – and this is the intent of its establishment - but its structure leaves the door open to intervention by the politically appointed leadership of the ministry in which it has been placed.

Often this is unavoidable. Although independence is sought for the regulator, the over-riding national constitution requires that all functions within government (e.g. the regulatory authority) be placed within a ministry (or department) of government. Changing constitutions is usually impractical, but providing for the independence of a regulator's decision-making is something that *can and should* be accommodated within the enabling legislation for the regulator.

For example, the Energy and Water Utilities Regulatory Authority (EWURA) of Tanzania was established by the EWURA Act of 2001 within the Ministry of Water. In doing so EWURA meets our definition of a Separate Regulator. However, within that Act, the following section makes assures the independence of EWURA's regulatory authority by excluding the Minister from exercising authority over regulatory matters:

... the Minister may, from time to time as occasion necessitates it, give to the Authority directions of a specific or general character on specific issues, *other than in relation to the discharge of the regulatory functions...*³ [emphasis added]

³ EWURA Act, 2001; Section 7(4).

Even the United States’ Federal Energy Regulatory Commission (FERC) is “established within the Department [of Energy] as an independent regulatory commission...”⁴ This somewhat contradictory phrase places FERC within our definition of the Separate Regulator, however, as with the Tanzanian example, above, the following language makes clear FERC’s functional independence:

“In the performance of their functions, the members, employees or other personnel of the Commission [i.e. FERC] shall not be responsible to or subject to the supervision or *direction* of any officer, employee or agent of any other part of the Department [of Energy].”⁵

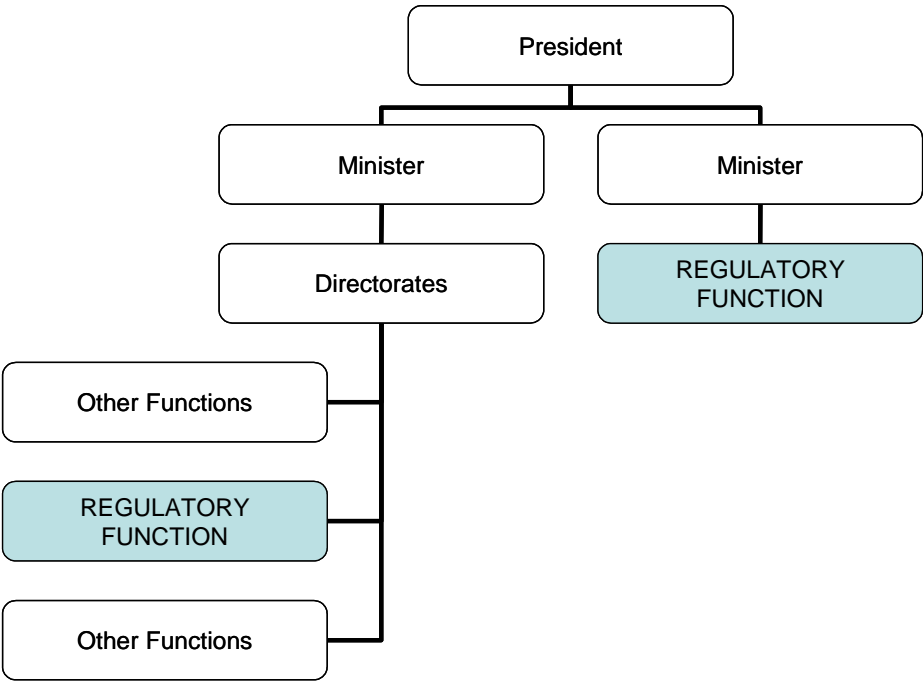
The Embedded Regulator

Whether completely “Independent” or “Separate,” the important criteria is whether or not the regulatory authority is free of political direction or the possibility of political intervention. This criterion is not met by the Embedded Regulator.

In many countries regulatory functions are executed by a number of governmental offices, agencies or bureaus within one or more ministries. These regulatory functionaries may issue licenses, collect information, conduct analyses or recommend actions on issues of a regulatory nature.

This is the least desirable of the regulatory frameworks because the individual functions are scattered throughout government without a unified policy for their development and execution. At the same time the embedded relationship of each function with respect to the state’s governing structure invites political intervention and control over processes and procedures that should otherwise be independent.

Figure 3: Example of the “Embedded Regulator” Framework



⁴ Department of Energy Reorganization Act (1977), Title IV, Section 401(a).
⁵ *Ibid*, Title IV, Section 401(d).

Value Added by the Regulator

It must be remembered that a principal objective of the independent regulator is the creation of an environment that will provide prospective private sector investors with a degree of security that encourages investments that are critical to the nation's economic development. A newly-constituted regulator – particularly one that is still wrestling with organizational start-up issues such as (a) insufficient staff; (b) untrained staff; (c) inadequate secondary legislation (rules, regulations and procedures) – conveys to the potential investor a high degree of risk that may well cause abandonment from the country of otherwise provide constructive debt and equity investment.

Moreover, investors who have been working with the government for many months (or even years) to approach a deal with respect to an important infrastructure project are unlikely to be pleased with the sudden establishment of a regulatory authority. On the contrary, deals that are signed with a government are relatively “known” quantities in comparison with the untested rules and procedures of a newly-constituted regulatory body.

Bi-lateral contracts – regulation by contract -- may address these concerns *over the near term*, but it is only over time and with dedication to implementing internationally-accepted best practices that the regulator will develop the credibility that the Optimal Regulatory Framework is intended to encompass.⁶ There are, however, those who will argue that independent regulation is, by itself, insufficient to achieve the goals that were outlined in the World Bank's 1993 Policy Paper⁷ and, therefore, “regulatory independence should be combined with a clearly specified regulatory contract that must be negotiated by political authorities.”⁸

Perhaps, however, this view over-reacts to stakeholder disappointment with regulatory regimes without accepting that the time-line for building regulatory credibility in states without a regulatory tradition can be generational. Eberhard's caution in this regard is instructive:

“If the utility is state-owned and operating under non-commercial conditions, with tariffs below costs, then it may be politically unrealistic to expect an independent regulator to be successful in moving tariffs quickly to revenue sufficient levels. The initial focus may need to be on building political and regulatory commitment with parallel work on commercialization reforms coupled with diminishing subsidy support.”⁹

Conclusion

The relatively recent history of regulation in transitional economies is replete with examples of disappointments as well as success stories. The failures and misjudgments of fledgling regulators in the past do not, however, present a convincing argument for departing from the basic regulatory principle of independence and pro-actively meeting the challenge of its implementation. However one proceeds to establish regulatory credulity, the elementary principles of having the conditions of market entry and

⁶ See Robert Borgström, “Mobilizing Resources for Power Sector Development: A Cautionary Note about ‘Regulation by Contract,’” *International Association for Energy Economics' Forum*, 1st Quarter (Feb.) 2008.

⁷ *Op. Cit.*

⁸ See Tonci Bakovic, Bernard Tenenbaum and Fiona Woolf. “Regulation by Contract: A New Way to Privatize Electricity Distribution,” World Bank Energy and Mining Sector Board Discussion Paper No. 7, May 2003, p. 3.

⁹ Eberhard, Anton. *Infrastructure Regulation in Developing Countries: An Exploration of Hybrid and Transitional Models*. Public-Private Infrastructure Advisory Facility, Working Paper 4. (2007), p. 25.

the level of market pricing be free from exogenous control (either political, or the influence of one stakeholder group) are not in dispute. They form the generally accepted preconditions for the attraction of investment that is essential for the sustainability of utility service and the development of national and regional economies.

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