

## About the Author...



**Robert Taylor** has 25 years of experience as professor of law and commercial lawyer. During that time he has worked in 20 countries, acting on behalf of governments, private investors on all manner of commercial and infrastructure projects. Recently he has acted as senior regulatory lawyer for regulatory authorities in Kosovo, Serbia and Montenegro and Egypt. Presently a consultant with the Institute for Public and Private Partnerships, Robert is the legal advisor to the President's Parastatal Reform Commission of Tanzania for the purpose of establishing the Energy and Water Utilities Regulatory Commission.

# Independent Regulation and Infrastructure Reform

## Robert Taylor

### Abstract

There are many reasons why governments have elected to undertake the risky business of restructuring infrastructures and public utilities. Most are linked to economic history of the development of infrastructure. Although governmental regulators have been around as long as governments have, in today's world, a strong regulator that is independent from government is essential to any successful restructuring. However, regulatory independence means more than simply having a regulator that can operate autonomously from the government that created it. Today, regulatory authorities must be designed so to work insulated from all forms of undue influence — political, industrial and private. When regulatory tasks are delegated by a government ministry to an independent regulator, policies *and* politics both benefit. Not only is the credibility and efficiency of the regulatory intervention improved, (policy benefits), the government can avoid being blamed for unpopular or even wrong regulatory decisions (political benefits).

### Introduction

In the best of times and under ideal circumstances, the restructuring of infrastructure and utilities is a tricky business that rarely comes off without a hitch. In more parlous circumstances, say, for example, a poor but developing country where the citizens are accustomed to receiving basic utility or other infrastructure services for little or nothing, restructuring is fraught with political and commercial risks. One might be forgiven therefore, for imagining that the occurrences of restructuring would be few and far between. In fact, the opposite is true. The momentous decision to move from vertically integrated, state-owned monopoly dominated markets to open markets driven by market prices and numerous operators has, of late, been taken with increasing frequency in countries throughout the world. So why is it that today, so many believe that the stakes of the game are worth the gamble?

### It is what it is because it was what it was

As is so often the case, historical antecedent explains why. During the nineteenth century most large investments in infrastructure and public utilities were undertaken by private investors on the basis of government concessions. Significant portions of the world's railways, electricity and telecommunications networks were created and had their period of greatest growth during this period. During the

twentieth century however, private investment in infrastructure declined in favor of governmental entities that financed their projects using either public funds, or public debt instruments (such as loans from national or foreign banks or international financial institutions).

Following World War II, the international trend was to nationalize energy and other infrastructure assets and institute strong controls over private monopolies in order to limit abuses of market power. In addition, because financial returns were too low to attract private capital, governments in many countries were required to play a significant role in infrastructure expansion. In socialist countries state ownership of utilities and infrastructure became the rule. With time public ownership, political control and the absence of competition eroded effective management, innovation and operational efficiency. Many governments used infrastructures to artificially create employment and to provide hidden subsidies to “needy” segments of the market.

As the costs of public ownership and monopolistic market structures became increasingly obvious, many countries began to reform their power sectors. By the 1980s, it was clear to many policymakers that electricity, natural gas, and telecommunications were no longer the “natural monopolies” that they had once been. As a result of technological advancements, new economic theories and new and sophisticated regulatory methods, it had become possible to introduce competition, achieve substantial improvements in operational and financial efficiency, reduce end user costs, improve services, and more rapidly innovate. During the 1990s, many countries transformed much of their infrastructure and utilities by overhauling regulatory frameworks, introducing competition and increasing private participation. This trend to restructure has been observed in developed and developing countries alike.

### **Why is independence so important?**

Today it is practically an article of faith that restructuring and effective, independent regulation go together – well, like a horse and carriage. Most hold that it is impossible to have one without the other. But is it truly impossible to introduce market opening and competition without an effective *independent* regulator? Does a regulator have to be independent to be effective? In order to answer these questions it is first necessary to understand what regulation is and what it intends to achieve. Considered from an economic perspective, regulation (assured by the power of sanction) is simply a way for a government to impose rules or limitations on the discretionary acts of the economic agents that move in its society. Confident that it is acting in society’s best interest, a government posts a policeman to impose “speed limits” in economic sectors where market inefficiencies pose a risk of market failure. Later on, more sophisticated methods such as speed breaks, traffic lights and turn lanes are placed at or near the commercial crossroads where public goods, market power, externalities or asymmetric information frequently pass. Because market failures of one form or another are often seen in market niches inhabited by infrastructure and public utilities service providers, regulation is therefore seen as an effective remedy.

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In effect, governments have been conducting the economic regulation of infrastructure and public utilities since the Romans built their roads, aqueducts and the first London Bridge. It is recognized of course that as our societies have evolved, regulation has become much more involved than simply delivering the water or collecting access fees to bridges and roads. Today most regulation is based upon notions such as universal service on demand, uniform terms and conditions for all service, service that is reasonably acceptable both in terms of safe delivery,

quality and quantity, and finally, return on investment. Modern regulation is intended to assure, therefore, the fair and transparent treatment of all sector participants – the state, the investors, and the customers.

Is it really true that today regulation can be much more effectively carried out by an independent institution rather than a government? Again, the answer can be found in historical antecedent; in an appreciation of Roman notions of power and control. The Roman maxim, “*Quis custodiet ipsos custodiet?*” perfectly crystallizes most issues related to independent regulation. Literally translated “who, therefore, will guard the guards”, it gives rise to some obvious answers to questions of regulatory oversight of sector restructuring. Employing common sense, societies do not put young children in positions of control and authority over other young children. Rarely in our homes do we give custody over the care and feeding of the canaries to our cats. On the public side of things, modern notions of transparency in government dictate that the keeper of the keys to the door of commercial opportunity can never be the person or institution that stands to gain or lose from its opening. On that basis, the institution of the ombudsman has found great popularity and financial auditors are nearly always employed to certify the timing and execution of financial dealings that relate to issues of public trust and confidence. Similarly, being prudent and ever aware of potential financial liability, investment houses separate the oversight of front and back office financial transactions. Although the diurnal headlines constantly remind us that our efforts to do the right thing do not always work as efficiently as we had hoped they might, each of these reflects a good faith effort to protect society by using *independent* custodians of public welfare.

Governments have vested interests in public infrastructures, whether they are bridges, roads, airports, power plants or water works. Undoubtedly they have an interest in the delivery of the particular infrastructure service. They may also be the owner, in which case they also employ perhaps thousands of workers, and probably the operator. On the basis of the fact that a guard cannot be expected to guard itself, neither can the government be expected to effectively serve the manifold and diverse interests that arise when infrastructure services are being managed, services are being delivered and state resources are being efficiently allocated. To be done effectively, the regulation of these activities must come from beyond the walls of state power.

However, regulatory independence is much more than merely ensuring that the regulator can operate autonomously from the government that created it. More to the point, regulatory authorities must be designed so that they can work insulated from all forms of undue influence — political, industrial and private. Two issues come immediately to mind. The first is how to protect against a regulator’s objectivity being “captured”, either by specific industry groups or by political interests. A related concern is sometimes styled the “the principal — agent problem”. How can all stakeholders (the government, the industry being regulated and the consumers) be protected against the risk of regulatory failure, that is, that a regulator might fail to do its job, either because it is incompetent, negligent, or because it has chosen to follow its own bureaucratic agenda? Many countries have answered both questions by carefully institutionalizing through a strong legal framework, both the fact of and the acts of an independent regulatory authority. Legally speaking, there is more than one way to build a strong regulatory authority. However, while there will often be cultural considerations on matters of detail, there will be very little variation on matters of substance. If the regulator is to be strong and effective its powers must be clearly separated from the power of the government to intervene. In addition, the regulator will have plenary powers to take all necessary steps to regulate the sector. When properly constructed, independent regulatory bodies enjoy the following benefits:

- **Enhanced Expertise** – Because independent regulators are closer to the regulated sector than traditional bureaucratic agencies, they are in a position to more effectively compile and analyze relevant information. In addition, their less formal organizational structure creates a more attractive working environment for sector experts.
- **Greater Flexibility** – The independent regulators’ greater autonomy facilitates rapid adjustment to sector changes.
- **Greater Predictability** – When regulators are insulated from political and electoral influence, they can tailor their regulatory policies to long-term requirements and thereby create a more stable and predictable regulatory environment.
- **More Open** – Independent regulators operate in a far more open and transparent manner than do ministries. They are also more sensitive to consumer needs.
- **More Cost Effective** – Independent regulators bring cost efficiencies to decision transactions. When governments delegate decision making to independent regulators, particularly in situations where the advantages and/or political costs of the process are not clear, the costs associated with the time spent in debates and policy discussions are reduced.

### **Conclusion: How can you tell if it’s working?**

State-owned, vertically integrated utilities often require substantial government subsidies to maintain existing levels of service. This is because frequently, they do not collect revenues that are sufficient to cover the cost of serving those customers. As a result, many governments have concluded that the potential rewards of reform justify the risks that they see as being inherent in the process. These governments have taken the path of infrastructure reform. They have been encouraged to do so by the weight of evidence that demonstrates that carefully executed reforms benefit all stakeholders in the particular infrastructure. Governments benefit when the financial burdens of providing additional infrastructure are removed. Reformed utilities (wherever they are located on the production and supply chain) become more efficient and provide better services. Customers receive better service at reasonable prices. The economy benefits from better infrastructure services and this promotes the development of jobs and growth.

*“The regulatory art is to combine and maximize... different and conflicting objectives.”*

Corporate restructuring of vertically integrated companies is a pre-condition for most infrastructure reform. Because tariffs enable companies to fund operating costs, future capital requirements and reasonable profits, a key element of the restructuring process is for a regulator to play an active role in the process. Regulator-driven efficiencies also help to reduce customer costs at each point of sale. Finally, customer service standards imposed by the regulator improve service throughout the system.

Although the performance of the regulated market is an important indicator of the performance of the regulatory agencies, the objectives of the agencies can be multiple and conflicting. For example, oftentimes the interests of regulated companies are in direct conflict with the consumer’s welfare. The regulatory art is to combine and maximize these different and conflicting objectives. The credibility and effectiveness of regulatory institutions varies according to the country’s political and social institutions. In many countries regulators have become, even more than the government, the driving forces behind restructuring and market reform.