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REGULATORY BRIEF

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Becoming an Ideal Regulator:
Best practices from Independent Regulators across the Globe

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KEY HIGHLIGHTS

- Five essential dimensions that determine a regulator's de facto independence;
    a. role clarity,
    b. transparency and accountability,
    c. financial independence,
    d. independence of leadership, and
    e. staff behaviour and culture of independence

- When adopting "best practices", a regulator must consider the central problem of the sector, which may require reform, and seek the appropriate redress, regardless of any reform necessitated.

1.0 Introduction

It is is an undeniable fact that, a strong regulatory environment is required for the utility sector to function efficiently and fairly (Drago and Gatto, 2022). A substantial and growing body of economic theory investigates what an ideal regulatory regime should aspire to achieve and the best methods for doing this. A key challenge, is society's inability to guarantee how regulatory authorities should act in the best interest of society, instead of being controlled by special interest groups.

The independence of utility regulators, has been a topical issue for decades. The difficulties surrounding a number of large energy and infrastructure projects around the globe, have highlighted how regulators should perform their duties, the data they must access, and what they have the authority to determine, as against what is proposed by service providers. Some stakeholders fail to appreciate the unique role of regulators: to objectively analyse and decide on projects and proposals based on facts, best regulatory practices, legislative mandates, and other declarations of government policy. Many times, stakeholders doubt regulators' independence and suggest that, regulatory choices and processes are more of "rubber stamp" of the decisions, which were made by the political class. What exactly is meant by the term, "regulatory independence"?

According to the Organisation for Economic Co-operation and Development (OECD), regulatory independence can be defined as "protection from attempts to exercise undue control, to curtail the roles and responsibilities of the regulator, or intervene in exclusive areas of responsibility for the regulator" (OECD, 2017). This means that, regulators are protected "against some form of undue influence which seeks to change their behavior and the outcomes of their regulatory decisions or activities" (ibid). Notably, the OECD makes no distinction between exogenous and endogenous effects, that is, undue influence from government and stakeholders outside of the regulator, and those who aim to unduly influence regulatory decision-making from inside.

The OECD has identified "five essential dimensions that determine a regulator's de facto independence: role clarity, transparency and accountability; financial independence; independence of leadership; staff behavior, and culture of independence" (OECD, 2017). It has also identified seven key best practice principles for regulatory policy and regulatory governance, which will support or enable an independent regulator: role clarity, preventing undue influence and maintaining trust, decision making and governing bodies for independent regulators, accountability and transparency, engagement, funding, performance and evaluation (ibid).

2.0 Goal of the Policy Brief

The Public Utilities Regulatory Commission (PURC), Ghana, has over the years, embarked on a mission to become a model utility regulator on the African Continent. A number of measures have been undertaken to ensure that, best practices are adopted to achieve the Commission's goal. This regulatory brief, synthesizes information gathered from empirical literature on the best practices of ensuring an independent regulatory institution.

The brief also seeks to invoke discussions on policy formulation on the need to institute measures, which promote independence, while avoiding regulatory capture in the sector. The paper highlights some key implications of regulatory capture, while outlining some very popular concepts of regulatory independence practiced across the globe.

3.0 Regulatory Capture

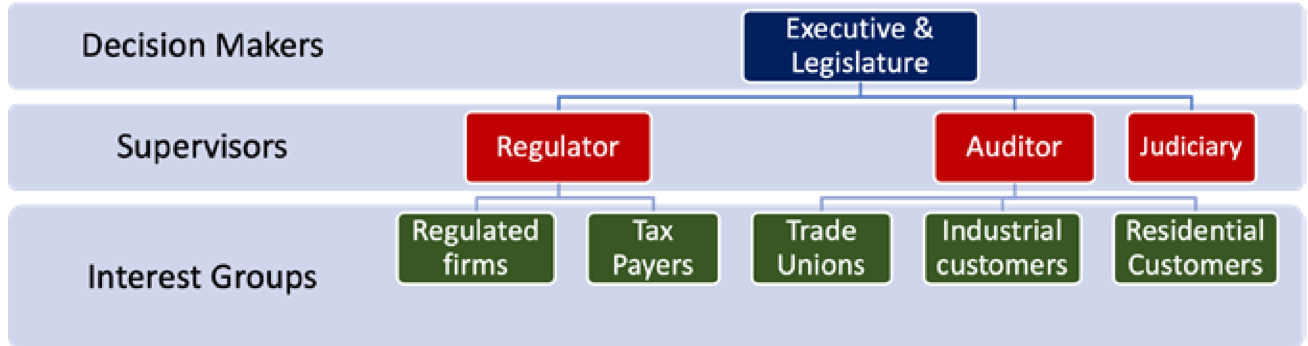
The challenges of the African power regulatory authorities, stems from the difficulties in resolving regulatory capture of state regulators by political actors and the utility businesses they seek to oversee. Regulatory capture occurs when regulated utilities or other sector stakeholders, exert undue influence on the regulator's financial and operational autonomy, compromising the regulator's decision-making independence[1]. Regulatory capture in Africa is sometimes caused by the legislation which establishes the regulatory institutions. These laws, often include clauses, which require regulatory institutions to rely on government for financing its operational activities, as well as the failure of government to keep itself at arm's length from regulatory decisions.

There is no clear-cut definition of regulatory capture in the economic literature. Dal Bó (2006) makes the case for both a broad and narrow definition. In a broader sense, regulatory capture, refers to the ways in which, special interests influence state intervention in any form; in a more focused sense, regulatory capture is the process by which regulated monopolies ultimately manipulate state agencies or regulatory institutions which have been tasked with the responsibility of overseeing these monopolies. This paper employs a definition of regulatory capture, which falls in the middle of these two extremes.

Liam (2014) posits that, a wide range of actors might be engaged in regulatory capture. Potential actors are depicted in Figure 1. These are divided into three categories: decision-makers, supervisors, and interest groups. The regulated firm itself, is of key interest and the subject of this paper (the regulator's principal goal is to regulate the firm's conduct). However, it is possible that, other parties may, in the interim, also want to influence the regulatory authority. Various consumer segments, (residential, non-residential or industrial class), are likely to have conflicting interests and concerns over the rates they pay. For instance, different consumers may respond differently to a regulatory decision, which allows for cross subsidization to cushion a particular group of customers, depending on the customer class they find themselves in. Thus, every class of consumer or actor along the chain tends to seek their personal or group interest, which ultimately, may not align with either the regulator or national goal.

[1] https://repository.uneca.org/bitstream/handle/10855/10448/bib. 51176 I.pdf?sequence=1&isAllowed=y

Figure 1: Potential Players in Utility Regulation



Source: Adapted from Liam (2014)

The theoretical framework depicted in figure 1 indicates that, supervisors only relay information from interest groups, especially the regulated firms, to decision makers, without really making regulatory policy decisions. On the other hand, regulations, such as who participates in what activities in the supply chain and whether or not to subsidize pricing, are taken by decision makers. Thus, auditors are often considered as supervisors; yet, it goes without saying that decision-makers in the legislative and executive branches make choices without first obtaining information. Other participants, the regulator in particular, could be involved in both decision-making and data collection. It is howeverlikely that, the governing body itself could divide these opinions.

By categorising actors in this way, we can distinguish between two types of capture. The first type of regulatory capture mostly overlooks the supervisor category, focusing on the direct effect of interest groups on decision makers. This type of capture is called "capture of choices". This might involve a regulated firm paying a regulator to establish a higher price in a rate review or not to enforce a certain regulation. The second sort of capture is labelled "information capture." This might involve a regulated corporation paying an auditor to conceal the fact that it is earning a higher profit than it declares.

Typically, the classical reference of "capture" or interest group theory centres on the capture of choices. This was first proposed by Stigler (1971), who maintained that regulations would really be created with the interests of the regulated enterprise in mind. Theorists' such as Posner (1974), Peltzman (1976), and Becker (1983), went on to expand on this idea by stating that a variety of interest groups with conflicting goals were probably present. An overview of this and other materials is given by Levine and Forrence (1990). The aforementioned theory emphasises that the determination of regulatory policy may be attributed to the relative strength of the various interest groups involved, which can be influenced by many factors such as group size.

The significance of asymmetric information in identifying capture is emphasised by the second method of modelling capture. This method employs a principal-agent structure and focuses on the interaction between a principal and a supervisor, wherein the supervisor may have access to knowledge, which the principal does not. Laffont and Tirole's (1991, 1993) model is a trailblazing example in this area. It considers

a scenario where a supervisory agency (for instance an audit firm) has knowledge about a regulated firm's cost structure, which it can subsequently conceal from a decision maker. Since the principal will now have to pay the firm directly to find out this information, the firm will then have an incentive to bribe the agent not to pass it on. According to the model, if the principal does not provide a proper incentive programme, the supervisory agency, which is driven by private payoffs, will accept the bribe. The main distinction between this strategy and the previous one (capture of choices) is that, even in cases where the decision maker is acting in good faith, there remains a chance of capture due to knowledge asymmetries between the supervisory agency and the decision maker.

4.0 Implications of Regulatory Capture

The ramifications of regulatory capture have been debated in empirical literature, where various schools of thought have been argued: redistribution of surplus (Estache, Laffont, and Zhang, 2006); price differentials to proxy for capture (Duso, 2005), and economic efficiency (Evans, Levine, and Trillas, 2008).

Utilities and key consumers capture regulators by taking advantage of regulatory gaps, shoddy processes, and understaffed regulatory bodies. Regulatory capture severely impairs the institutional, financial, and operational autonomy of regulatory bodies who oversee these regulated entities, thereby impeding their ability to carry out their duties effectively and efficiently.

In addition to autonomy, regulatory capture has an impact on other crucial areas of regulation related to the electricity industry. These include tariff setting, accountability, transparency, and predictability. Interference in regulation can damage the regulator's credibility and openness, particularly with regard to institutional capacity and tariff-setting. This raises obstacles for new business owners in the industry and deters investors from making long-term investments in the electricity sector of a nation.

5.0 Remedy to Regulatory Capture

Regulatory capture varies in degree and nature depending on legislation and authorities. This basic remark is both significant and evident, eventually laying the basis for a new focus on preventing regulatory capture (Moss & Carpenter, 2013). An initial emphasis on regulatory decision-making models is now giving way to fine-grained empirical research on special interest impact in the regulatory process. In a world where capture varies, it appears that certain regulatory systems and agencies have performed better than others in fighting it. To put it another way, the notion of preventing or minimising capture becomes a definite possibility, creating an intriguing new area in social science research.

A variety of defence systems are prevalent. Some, such as judicial scrutiny and the media's role in informing the public and holding leaders responsible, are firmly ingrained in many countries' democratic institutions. Others, such as administrative procedural regulations (especially the public notice and comment time), are the result of legislative action, while others, such as standardised cost-benefit analysis, are implemented (ibid).

Regulators ought to prioritise their efforts on building adequate capacities in technological advancement. It is anticipated that efficient regulators would increase economic efficiency, safeguard the public interest, strengthen consumer protection, and boost sector performance. Gaps in technical competence makes these obligations difficult. When regulators have the necessary personnel to carry out important tasks, they may show other stakeholders that they are competent and earn their trust.

6.0 Recommendations on how Regulatory Bodies Can Move Towards Independence

Over the last 25 years, a plethora of research (Rao, 2004; Dubash and Rao, 2008; Kale, 2015; Koop and Jordana, 2022) has been published, which offer a range of independence criteria. The criteria for regulatory independence presented in this paper is based on industry best practices for the administration of the electricity sector, which places emphasis on who has the last say in governing the sector and how individuals with that authority are chosen. The following measures, if adopted, will ensure regulatory independence.

6.1 Fixed Terms of Office for Board Members

A degree of independence is conferred upon a regulatory authority by virtue of the fixed-term appointment process, which allows for removal only for justifiable reasons. Fixed-term mandates have the potential to improve policy stability and mitigate issues of confidence that may arise from situations where tenure of boards is linked to change in political parties (Gilardi, 2002). For example, in the event where the appointing authority wants to have a say in how a tariff application is handled, ideally under a fixed term tenure, a board member would most likely rely on the technical evaluation of the application. Although, such a board member's chances of being reappointed by the appointing authority may be effectively reduced for such a stance against the appointing authority, it does not mean the board member may be fired for it. Security of tenure is key.

6.2 Staggering the Expiration of Board Members

Staggering the expiration and hence the appointment of replacements allows a board to have a mix of members appointed by several governments. The advantage of this is that a board with members selected by two or more governments is more likely to be independent of any one government or pursue the agenda or philosophy of one government. Lesotho has a statute, which explicitly requires that the tenure of board members should be staggered. This clause is normally captured in the legislation to assist in maintaining the continuity of expertise. Some of these laws might be used to increase the likelihood of members of a board, which transcends governments.

6.3 Appointment of the Chief Executive Officer (CEO)

In many parts of Africa, it is standard practice for the CEO of a regulatory institution and its Board to be appointed by the Government, who also own the regulated public utility. It is however ideal for the Government to appoint the Board of Directors and thereafter, the Board is given the authority to competitively select the CEO. This will ensure that, the CEO is answerable to the Board and not the political class. A survey of the relevant literature indicates that, choosing a CEO is a long-standing, widely-held practice among Boards. This is practiced in Malawi, Namibia and Zambia, where the CEO is competitively selected by the Board. In the case of Malawi, the Board is made up of members of the government who serve as ex-officio members.

According to the Institute of Directors-Southern Africa, the selection and appointment of the CEO should be left to the Board and free from government intervention. It is better to ensure unequivocal independence in such key appointments by completely eliminating the potential of political interference, thereby minimising "the perceptions of undue proximity" between the administration of a regulatory authority and the executive arm of government. In a nutshell, this indicates that the CEO is more accountable to the Board than the government[2]. The African Development Bank's (AfDB) 2022 ERI report revealed that, among the nations surveyed, 90% of them indicated that, the executive arm of government had the authority to appoint Board members and Heads of regulatory institutions. This implies that, there exists a possibility of "the regulator being subjected to subtle and direct political pressure to skew key regulatory decisions towards the political inclinations of the party in power"[3].

6.4 Decision-Making Authority Over Tariffs

A regulatory institution makes several choices in the course of carrying out its duties. However, the choice regarding a licensee's ability to charge a particular tariff or rate approved by the regulator, is perhaps the most significant of them all. Economic control ultimately comes down to money and economics. As a result, in order for the regulatory body (the Board) to be genuinely independent, its decision on tariffs must be final and unchallengeable beyond the national judicial system. Similarly, other authority judgements ought to be final, albeit with the same conditions.

[2] Institute of Directors – Southern Africa, King IV – Report on Corporate Governance for South Africa, 2016, page 58
[3] AfDB – ERI Report, p. 7

Some regulatory agencies across the world only have the authority to suggest tariffs to the sector Minister. While those tariffs are normally accepted by the Ministry, they may also be denied. This might lead to politically popular decisions to keep rate increases modest, while jeopardising the utility's financial integrity. Alternatively, the effect might be a greater-than-necessary raise in the tariffs for commercial and industrial customers and a lower-than-necessary decrease for residential customers. Over time, these sorts of measures, may cause commercial and industrial customers to abandon the system and seek alternatives, thereby jeopardising the utility's financial integrity and its very existence.

6.5 Independent Funding Source

All of the preceding pillars of independence can be rendered ineffective if the government is able to successfully suffocate the regulatory authority by dramatically stifling its source of funding. When the regulatory authority is subject to an annual appropriation from Parliament or the Legislative arm of government, there is no guarantee that it will have the resources to carry out its statutory tasks. This is due to the regulatory authority's annual funding being in competition with that of other government agencies. A legislative instrument, which mandates the regulatory authority to charge a levy on the services provided to the regulated entity and other stakeholders will help to ameliorate this challenge of funding if not fully eradicate it. This will give the regulatory institution the confidence, free hand and the independence to undertake its operational activities.

7.0 Problems with "Best Practices"

Most often, when institutions are embarking on reforms to become an industry standard, they are pushed to adopt practices referred to as "best practices" mostly from developed economies. Albeit, this practice is viewed as the most common and obvious practice for emerging countries to align their institutions with industry practices, Thurber, (2023) argues that, when such "best practices" are not adapted to the unique characteristics of the country, they fail.

First, Thurber (2023) argues that, when adopting "best practices", one must consider the central problem of the sector, which requires the reform and seek the appropriate redress and not just for the sake of reforming the entire sector. For instance, countries are advised not to implement reforms of unbundling a sector into smaller companies, when the real problem is deficient regulated tariff structure, which does not allow for cost recovery. In this case, the implementation of "best practice" of sector unbundling, may not solve the challenge in the sector.

Secondly, countries must ensure that, they have the necessary and required institutional structures to depend on, before they proceed to implement reforms on identified "best practices". Norway touts its model of separate policy, regulatory, and operational functions as the key to its success in the oil sector (Thurber & Heller, 2011). However, Nigeria actually beat Norway to the punch, separating administrative functions in its oil sector one year before Norway did, although, Nigeria achieved very poor results. The reality however, is that, Norway's mature political checks and balances, which were not in place in Nigeria, played a crucial role in its oil success story (Thurber & Istad, 2012).

This further strengthens the point that, countries must consider the basic structural differences and the uniqueness of their respective countries before adopting certain "best practices" and adapting to them in the best way for that country. The argument does not push the idea that best practices should not be adopted by emerging countries, however, countries should not in the name of best practices, avoid the implementation of the key and basic structures on which "best practices" can thrive.

8.0 Conclusion

In conclusion, regulators are typically set up to handle difficult technical jobs, which the government may not, cannot or will not perform, in part because the government wants to absolve itself of accountability for certain decisions. However, in this paper, it has become obvious that governments, after giving regulatory authorities some significant powers, occasionally take over or find various ways to disrupt their independence, leading to excessive government pressure or interventions. These interventions are the result of either regulatory shortcomings or the desire of politicians to exert their own regulatory authority, which they regret ceding to established regulatory bodies. Internationally, regulatory independence from political interference and regulatory freedom from political considerations are acknowledged as crucial components of effective economic regulation. However, in certain cases, these elements may be subject to pressures so great that the regulatory system breaks, severely undermining public trust in the regulatory framework as well as in the host government's reputation for justice and respect for the integrity of the checks and balances system designed to safeguard investments.

The PURC, thus far, remains one of Ghana's independent regulatory institutions with respect to some international standards. However, in order to become the model regulatory institution in Africa for independence, policymakers will need to further ensure that some regulatory structures as enumerated above in this paper, are put in place. These include staggering the appointments of Board members, selection of the Chief Executive Officer by the Board and the avoidance of regulatory capture in the sector, among others. This paper, hereby makes a case for both the Commission and the national agencies of interest to take the necessary action.

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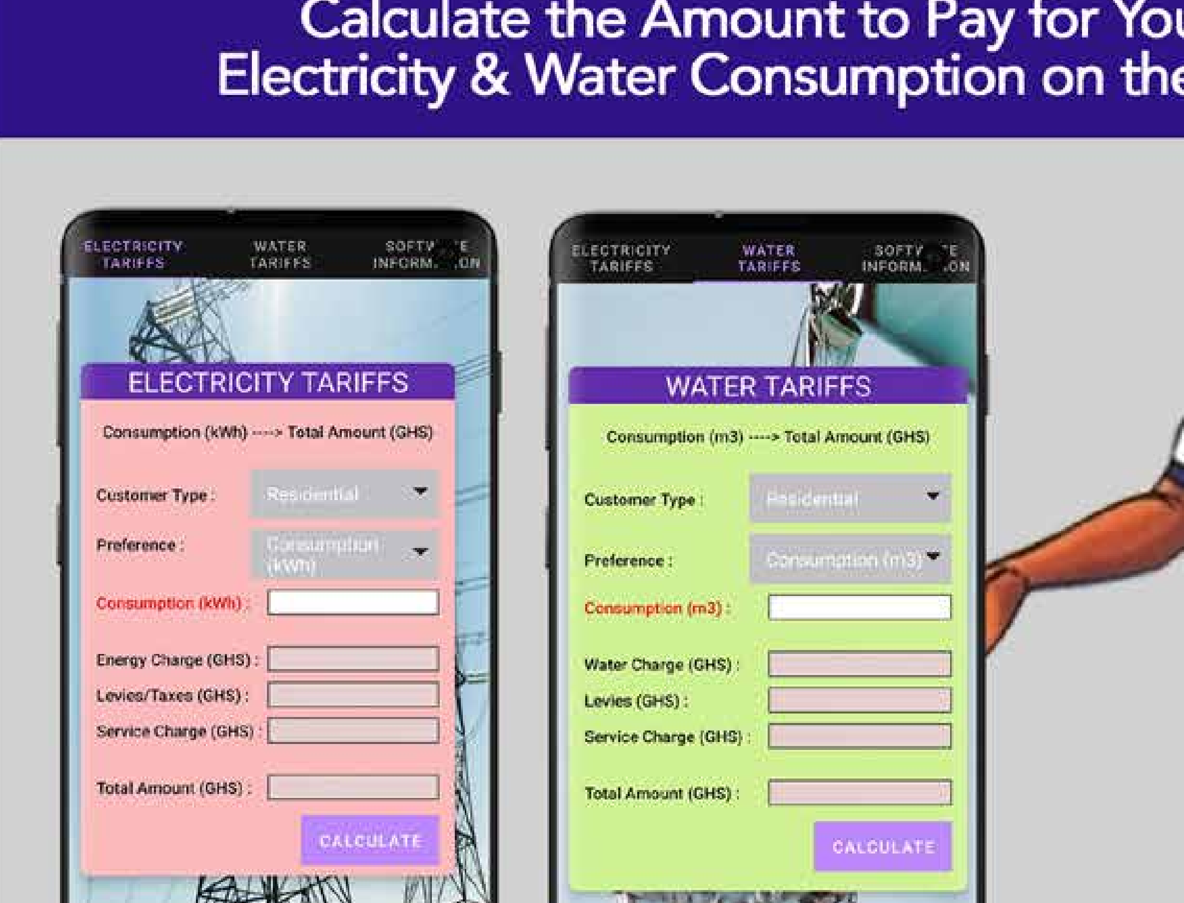

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