BRIEFING PAPER

CUTS Centre for Competition, Investment & Economic Regulation
CUTS C-CIER

No. 4/2007

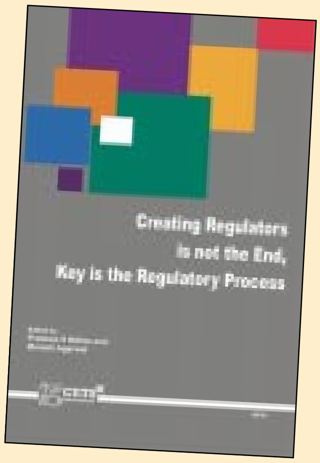
Sectoral Regulation

– *Challenges for the Developing World*

In the past, most developing countries were characterised by significant government involvement in economic activities and a command and control regime. The process of economic reforms in many countries was initiated during 1980s-90s, when most of them adopted policies of deregulation, privatisation and trade liberalisation.

Many developing economies have adopted competition laws commensurate with their market-oriented economic reforms process. Additionally, most countries adopted sector-specific regulatory laws as they were opened up for private players. This upsurge in interest in competition and regulatory laws in developing economies reflects substantial changes that have been taking place in their political and economic environment as a result of both internal and external factors.

This briefing paper summarises experiences of developing countries in a project which did a comparative study of sectoral regulation in India, Indonesia, Vietnam, Cambodia, South Africa, Kenya and Zambia and brings out challenges that developing countries generally face.



Trends in Establishing Regulatory Agencies

The thrust of economic reforms has been to allow for greater competition. The underlying rationale is that competitive markets ensure efficiency resulting in best possible choice of quality, lowest prices and adequate supplies to consumers. An appropriate definition of competition is a situation, which ensures that markets always remain open to potential new entrants and that enterprises operate fairly under the pressure of competition.

A competition law is enacted to check behaviour of market players and evolve a level playing field to promote contestability. It lays down legal principles and institutions that govern behaviour of firms in markets including curbing their restrictive trade practices (RTPs), with provisions to deal with mergers, abuse of dominance, cartels, etc. In cases where competitive markets do not exist or yield desired results, some form of intervention to control price, quality of products and services in the market is required, and thus regulation is needed for competitive outcomes.

Adoption of competition and regulatory regime is necessary but not a sufficient condition for it to be a part of market reform agenda. Implementation is equally important. Implementation of competition and regulatory laws encounters specific challenges in the face of national, political and administrative practices and cultures.

Evolution of Regulatory Framework

The above-stated reasons collectively stress on the need for putting in place effective regulatory institutions to administer a set of transparent, consistent and non-discriminatory rules that create a competitive, dynamic environment in which firms can thrive, consumer interests are protected, and orderly growth of sector is facilitated. In developing countries, regulation might not only be concerned with the pursuit of economic efficiency but with wider social welfare goals.

An important factor that calls for regulatory intervention both from economic and social perspectives is 'access to essential facilities', that all consumers, regardless of their income status, have access to certain services, for example, electricity. This requires regulatory intervention to promote equitable outcomes.

In principle, following three broad forms of regulation have emerged:

- *regulatory authority*, which is integrated into government machinery, notably in a section of a ministry and is controlled by a Minister as observed in Vietnam and Indonesia;

- *semi-independent regulator*, which has some independence from ministry but where decisions can still be over-ruled by a higher government authority as in some sectors of India, Cambodia, Zambia, South Africa; and
- *independent regulator*, where there is no right of appeal to a higher government authority, though there usually is a right of appeal to the courts to ensure fairness and rationality in decision-making process as in Kenya.

In developing countries, as noted above, regulation might not only be concerned with the pursuit of economic efficiency but with wider social welfare goals. This is because the economic development policies in these countries have the objective of reducing poverty and improving the well-being of masses.

There are cases where government intervenes to meet some social objectives, but ends up distorting the regulatory regime. For instance, in the electricity sector in India, Government intervenes in tariff regulation in the name of providing cheap power to people, with or without subsidies. Due to continuous Government intervention in regulators' functioning, the regulatory environment in power sector is perceived as poor. Moreover, investment in the sector is not coming primarily because principal buyers, the state electricity boards/companies, are bankrupt. In Vietnam, the only independent regulatory agency is the State Bank of Vietnam, the country's central bank, whose autonomy is severely limited, as Government interferes with the credit allocation mechanism to serve multiple socio-economic objectives of the economy.

An important feature of regulatory reforms relate to separation of policy-making, regulation and operation functions. It is generally observed that separation of the three functions is seldom affected in the true sense and these continue to be interlinked. The most prominent being cases where an independent regulator has been set up, but is made to report to a line ministry, which also manages the state-owned incumbent. There are also instances where a regulatory body has been set up within a line ministry that also manages the State-owned Enterprise (SoE). These often raise conflict-of-interest issues. A good example of separation of policy-making, regulation and operation functions is the framework adopted by Zambia in water supply and sanitation sector.

In Zambia, responsibility for water supply and sanitation service provision is under the Ministry of Local Government and Housing. In order to follow the principle of separating policy-making and regulatory functions, the regulator, National Water Supply and Sanitation Council is made to report to the Government through the Ministry of Energy and Water Development, which is the water sector's 'line' ministry.

In this context, the practice with respect to the Electricity Authority of Cambodia (EAC) is quite revealing. The enabling Act specifies clear separation of EAC's function as regulator from that of the ministry, and interaction between EAC and the ministry is clearly stated in the Law. This ensures clarity in respective roles of the Minister and the regulator.

Sectoral regulation has, therefore, not evolved at the same pace in the project countries. Variations are observed in terms of setting up of regulatory bodies and their relationship with the government. Considering the experiences in regulatory reforms, they can be clubbed into two broad categories:

- One set comprises Kenya, Zambia, South Africa, India, and Cambodia (to an extent) that have taken measures to separate policy-making, regulation and operation functions and created independent agencies to undertake regulatory functions in several (if not all) sectors; and
- The other set comprises Vietnam and Indonesia where the state continues to hold sway over policy and regulatory matters.

Regulatory reform is still at an evolutionary stage in these countries and there is a need for them to continuously probe their regulatory environment.

Regulatory Mandate

Independent regulatory bodies, where established in project countries, have been assigned similar mandates (see table 1). Variations are nevertheless observed in respect of whether the regulator's role is advisory in nature or absolute.

Administration and Governance

Regulation is acknowledged as a function in which people make a difference, i.e. implementation of regulation is also a human and not only a technical function. The quality of regulators is, therefore, important. 'Quality' is generally implied to mean, people with relevant expertise. This requires having in place proper administrative and governance mechanisms to ensure appointment as well as dismissal of regulators.

Variations are observed in approaches to selection, appointment and dismissal:

- Selection, appointment and dismissal at the discretion of line Minister (primarily in Kenya).
- Selection by search committee and appointment at the discretion of line Minister and suspension of the regulator by the government, with either explanation provided to Parliament (in the case of central bank in India) or by referral to a competent court for decision (in the case of electricity regulator in Cambodia).
- Nomination and dismissal by line Minister, ratified by Parliament (telecom regulator in Zambia).

Table 1: Mandate Assigned to Regulatory Agencies in Project Countries

<table>
<tr><th rowspan="3">Country</th><th colspan="4">Sectors</th></tr>
<tr><th rowspan="2">Communications</th><th colspan="2">Energy</th><th rowspan="2">Banking</th></tr>
<tr><th>Electricity</th><th>Oil & Gas</th></tr>
<tr><td>Kenya</td><td>• Licensing
• Tariff regulation
• Interconnection
• Spectrum management
• Quality of Service (QoS) Standards
• Dispute resolution</td><td>• Licensing (advisory)
• Tariff regulation
• QoS Standards
• Dispute resolution</td><td></td><td>• Monetary policy
• Licensing
• Supervision and regulation</td></tr>
<tr><td>Zambia</td><td>• Licensing
• Tariff Regulation
• Interconnection
• Spectrum management
• QoS standards
• Dispute resolution</td><td>• Licensing
• Tariff regulation
• QoS Standards
• Dispute resolution</td><td></td><td>• Monetary policy
• Licensing
• Supervision and regulation</td></tr>
<tr><td>South Africa</td><td>• Licensing (advisory role in telecom)
• Tariff regulation
• Interconnection
• Spectrum management
• QoS standards
• Dispute resolution</td><td>• Licensing
• Tariff regulation
• QoS Standards
• Dispute resolution</td><td></td><td>• Monetary policy
• Licensing
• Supervision and regulation</td></tr>
<tr><td>India</td><td>• Licensing (advisory)
• Tariff regulation
• Interconnection
• Spectrum management (advisory)
• QoS Standards</td><td>• Licensing
• Tariff regulation
• QoS Standards
• Dispute resolution</td><td>• Licensing
• Tariff regulation
• QoS Standards
• Dispute resolution</td><td>• Monetary policy
• Supervision and regulation</td></tr>
<tr><td>Indonesia</td><td>• Advisory role</td><td>• Advisory role (regulator only for tariff matters)</td><td>• Licensing
• Tariff regulation
• QoS Standards
• Dispute resolution</td><td>• Monetary policy
• Supervision and regulation</td></tr>
<tr><td>Vietnam</td><td>• Licensing
• Tariff regulation
• Interconnection
• Spectrum management
• QoS standards
• Dispute resolution</td><td>• Licensing
• Tariff regulation
• Dispute resolution</td><td></td><td>• Monetary policy
• Licensing
• Supervision and regulation</td></tr>
<tr><td>Cambodia</td><td>• Licensing
• Interconnection</td><td>• Licensing
• Tariff regulation
• QoS standards
• Dispute resolution</td><td></td><td>• Monetary policy
• Licensing
• Supervision and regulation</td></tr>
</table>

- Nominations invited from public and ratified by departmental parliamentary committee and dismissal when proven guilty in a finding, either through a judicial probe or through a finding of Parliament (telecom sector in South Africa).

Considering selection/appointment as well as dismissal provisions, the telecom regulator of South Africa scores well. In both selection and appointment, Parliament plays a decisive role, and the line Minister has a minimal role.

Some regulatory legislations provide for appointment of representative of stakeholders on the board of the regulatory body. In Kenya, the enabling legislation provides for appointment of representatives of stakeholders on the board of the electricity regulator. In Zambia, boards of telecom and water regulators include representatives of government institutions, private sector, consumer organisations and other agencies. This

Table 2: Selection Mechanisms for Regulatory Agencies in Project Countries

Country	Sectors				
	Communications	Energy		Banking	Water Supply & Sanitation
		Electricity	Oil & Gas		
Kenya	Chairman (appointed by President) Members (appointed by line Minister); board includes officials from related ministries	Chairman (appointed by President) Official from related ministry Members (appointed by line Minister)	–	Governor and other members (appointed by President in consultation with line Minister); board includes officials from related ministries	Chairman (appointed by President) Members (appointed by line Minister)
Zambia	Nominated from identified stakeholder groups (ratified by Parliament)	Appointment by line Minister		Chairman (appointed by President) Directors (appointed by line Minister) Nomination by line Minister	Nominated from identified stakeholder groups (ratified by line Minister, different from the ministry responsible for WSS service provision
South Africa	Chairman and members (appointed by President based on advice of Parliamentary Committee and nominations from public); board includes officials from related ministries	Appointed by line Minister		Chairman and other members (appointed by President) Directors elected to represent different sectors	–
India	Appointed by the line Minister concerned. *Nomination by search committee comprising government officials and (judiciary, in some cases)*	Appointed by the line Minister. *Nomination by search committee comprising government officials and (judiciary, in some cases)*		Appointed by the line Minister. *Nomination by search committee comprising government officials and (judiciary, in some cases)*	–
Indonesia	Chairman and members (appointed by line Minister) Members (other than Chairman) selected based on a competitive process	Appointed by line Minister	University of Indonesia appointed as consultant to nominate right candidates (ratified by Parliament)	Parliament approves name for Governor (appointed by President); Nomination of Deputy Governors by Governor BI (appointed by President)	Chairman and members (appointed by line minister) Members (other than Chairman) selected based on a competitive process
Vietnam	–	–	–	Governor and other members (appointed by Prime Minister); all are government officials	–
Cambodia	–	Chairman and members (proposed by Prime Minister and appointed by King)	–	Governor and Deputy Governor (proposed by government and appointed by King); other members (appointed by government)	–

facilitates stakeholder involvement and ensures that risk of capture by one particular group is kept at a minimum.

Decision Making Process

Three main categories of procedural rules can be identified that are designed to encourage transparency and third-party involvement in regulatory decision-making: notification, i.e. one-way communication between regulator and public; consultation, i.e. collecting of information relevant to decision; and participation, i.e. use of public hearings to allow oral representations and discussion.

Independent regulatory bodies in most project countries involve stakeholders in the regulatory process. This is generally done by providing a link on regulators' websites, holding public hearings and open house discussions. Efforts are also made to disseminate relevant information to the public and the media.

A good model followed in involving stakeholders in the decision-making process is that by the National Water Supply and Sanitation Council, the water regulator in Zambia. It involves various stakeholders at all levels of decision-making.

In cases where the regulator chooses to bypass the ministry, and takes decisions not amenable to the ministry, it could earn the wrath of minister, as experienced by Communications Commission of Kenya (CCK) that led to the disbanding of the CCK board by Minister of Communications.

Interface with Competition Authority

Despite common goals, conflicts between sectoral regulators and competition authority could arise, resolution whereof would depend on which of the two authorities is judged to be more effective on the basis of specific problem under consideration. Following approaches are observed across the project countries:

- Division of responsibility based on practice:
  - Sector regulators and competition authority cooperate with each other (as in Kenya and Zambia); and
  - Competition authority negotiates agreements with sector regulators (as in South Africa).
- Formal relation between sector regulator and competition authority provided in the law (energy and water regulators in Zambia; telecom regulator in India).
- Competition authority given an upper hand (as in Indonesia and Vietnam).
- Relation is ambiguous and no cooperation mechanism exists (electricity regulator and central bank in case of India).

There is a need for developing cooperation frameworks between the competition authority and sector regulators. This could be done through establishing a regular information exchange with all sector regulators. For instance, in South Africa a Regulators' Forum has been established as an informal body through which sector regulators envisage maintaining a consistent and coherent approach while dealing with competition matters.

Accountability and Autonomy

Appropriate mechanisms are required to make independent regulatory agencies accountable. Broadly speaking, the following two approaches are followed in project countries to make independent regulatory bodies accountable:

- Annual reporting to legislature; and
- Provision of appeals against orders of regulatory authority.

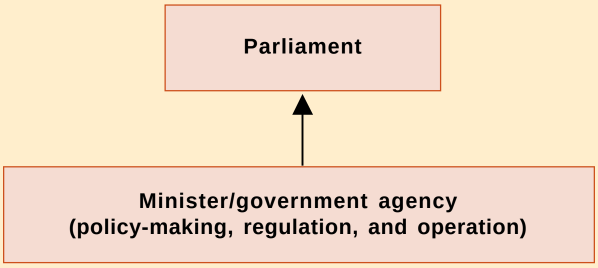
All independent regulatory bodies in project countries are required to submit their annual reports and/or audited accounts to legislature. In most such cases, regulatory bodies are made accountable to legislature through the line Minister.

It is argued that regulatory institutions need to enjoy a certain degree of autonomy. Yet, autonomy should not be at the cost of inadequate co-ordination or conflict between the policy-maker and the regulator. The line between policy-making and regulation is often blurred. It has been noted that governments intervene in the functioning of regulatory bodies in project countries. Variations are observed with good practices existing in some countries. This includes influencing selection process, enjoying powers to remove regulators, determining financial resources at the disposal of regulators, intervening in decision-making process, etc. The relationship between the ministry (concerned with development of policies) and the regulator (concerned with implementation) should thus be supportive, as the two are governed by a common vision.

Governments intervene in operational aspects of regulation in the name of issuing policy directives thereby impacting independent functioning of regulators. For instance, the Bank of Zambia Act provides that "the Minister may convey to the Governor such general or particular Government policies as may affect the conduct of the affairs of the Bank and the Bank shall implement or give effect to such policies". The sectoral regulatory laws in India also have similar provisions, which *per se* are not wrong, but experience shows that these have been misused when the Minister has transgressed the thin line between policy directives and operational issues.

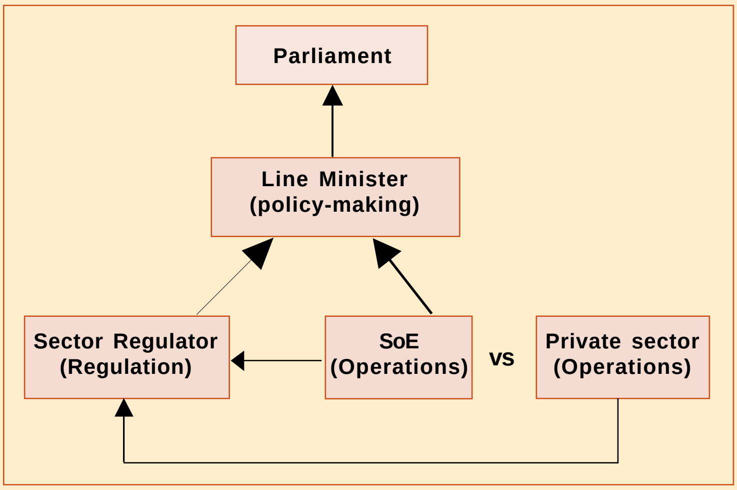
Conclusion and Challenges

The project countries started with a situation where the line ministry or a government agency undertook all the three functions, namely, policy-making, regulation and operation. The regulatory model followed was as illustrated just below:



As a result of regulatory reforms, project countries have significantly progressed from the situation where in most cases the operation and regulatory functions have been separated from the policy-making functions (which remains with the line ministry/government). The regulatory and operation functions have been given to the sectoral regulator and SoEs and private sector firms respectively.

The regulatory model that has now emerged is thus as follows:



Nevertheless, separation of the three functions has not been effected in a true sense as functions continue to be interlinked, as the line minister exerts considerable influence over the regulatory and operational functions as well.

However, there are challenges that remain to be addressed to evolve an effective regulatory regime, such as:

- In order to ensure effective implementation of the regulatory mechanism, efforts have to be made to incorporate the principles of regulation into regulatory processes;
- Regulatory regimes need to provide a set of transparent, consistent and non-discriminatory rules that create a competitive and dynamic environment in which firms can thrive, consumer interests are promoted and protected, and orderly growth facilitated. Good practices in certain areas, often are nullified by various bad practices making the overall regulatory system weak;
- Commitment on the part of the government and clear and consistent policy objectives are required. Need for lesser bureaucratic interference in regulatory agencies is warranted;
- Political will to create a strong regulatory regime from the outset is crucial for future success. A strong regulator would be able to balance multifarious demands of various interest groups; and
- National, political and administrative cultures are bound to be interventionist and impact regulatory processes. It is, therefore, important that regulatory regimes are designed in a manner to integrate such factors and overcome challenges they present.

This Briefing Paper is written by Udai S Mehta and Richa Bhatnagar of and for CUTS Centre for Competition, Investment & Economic Regulation (CUTS C-CIER) as part of the project entitled, 'Comparative Study of Sectoral Regulation in Select Developing Countries: Lessons for Policy, Governance and Implementation' with support from Agency Francaise de Developpement (AFD), France.