

# Regulatory approaches & instruments

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# Historically . . .

- Infrastructure services were not supplied by governments
- Were first supplied by private entrepreneurs
  - Who were then subjected to various forms of controls
  - And were then “nationalized”
    - Except in the US, Canada, the Philippines, Latin America, and a few other places
- Starting in 1980s, remedies sought for weaknesses of integrated government-owned monopolies

# Current thinking on how infrastructure services should be supplied

- Markets
  - But subject to varying degrees of market failure
- Appropriate response
  - Use non-market mechanisms: Government supplies directly
  - Remedy specific market failures with targeted solutions that will hopefully not exacerbate other problems

# Responses to market failure

- The cure must be no worse than the disease
- “Primum non nocere” (Above all, do no harm)
  - The oath of the physician is also applicable to policy maker

# **REGULATORY APPROACHES**

# Regulatory approaches

- Command and control
- Structural regulation
- Conduct (or behavioral) regulation
- Technical (or safety) regulation

# Core problem of regulation

- Principal agent problem
  - In non-regulated industries
    - E.g., early electricity or early transport industries
  - Within government
    - After nationalization
  - In regulated industries
    - Government/private suppliers regulated by an independent agency

# Principal-agent problem

- How to get the employee or contractor (agent) to act in the best interests of the principal when the employee or contractor has **an informational advantage over the principal** and has **interests different from those of the principal**



# Government ownership as response to P-A problem

- Problems in performance of unregulated infrastructure industries
  - Why?
  - What kind?
- Government had trouble dealing with unregulated firms
  - Egged on by unions
    - Why do unions like nationalization?
- Nationalization
  - But does the P-A problem go away?

# How is control exerted within government?

- Political authorities (P) seek to get officials (A) to act in certain ways
  - But officials have all the information (esp. in complex infrastructure sectors) & have interests different to those of political authorities
- Favored regulatory approach: Command and control
  - Lots of requests for information
  - Lots of orders issued
  - Penalties
    - When information is not provided/is inaccurate
    - When orders are not followed

# P-A problem in regulated industries

- Pure case
  - Government as regulator (Principal)
  - Private firms/operators (Agents); no government operators
- Actual case in most countries
  - Independent (?) regulator within government (P)
  - Private firms and fully/partially government owned firms (As)
- Peculiar forms
  - Independent (?) regulator within government (P)
  - Fully government owned firms (As)
    - Given tradition of massive intra-government litigation, may make sense in India
    - But in Sri Lanka?

# Command & control regulation?

- Can the C&C approach used within government be applied to private actors?
  - Legislation, regulations, licenses constrain actions
  - C&C is likely to add a superfluous layer of management
- Intrusive actions may work with regard to information
- But giving orders will completely negate benefits of private ownership/management

# Structural regulation

- What type and how many organizations can engage in which activities
  - Entry regulation
  - Concessions and licenses
- Enforcing functional separation such as vertical and horizontal disintegration
  - E.g., New Zealand and UK solution of different companies for backhaul and access
- Merger control
  - Market share of incumbent firms

# Illustration

- Judge Greene regulating entire US telecom system in his “spare time” in 1984-1996 vs. FCC with over 1800 employees finding it difficult to do so . . .

# Problems with structural regulation

- The boundaries/interfaces shift in dynamic markets such as telecom
- Policing the interface may require sophisticated regulatory interventions
- Most importantly, prior commitments in licenses may preclude compulsory disintegration

# Conduct (or behavioral) regulation

- Permitting (or not permitting) behavior of organizations
  - Product price regulation
  - Access price regulation
  - Regulation of non-price behavior (anticompetitive behavior)
  - Regulation of service and product quality and
  - Environmental regulation



# Technical/safety regulation

- Standard setting and monitoring
  - A form of conduct regulation
- Technical/safety regulation can affect market entry (structural) and competition (conduct)

# Problems with conduct regulation

- Is highly resource and information intensive
- Requires significant expertise within regulatory agency
- Thin line between conduct regulation and command-and-control

# What is actually practiced: Hybrid

- Some elements of structural regulation to ease work load and friction
  - Some times regulator and operators can agree on vertical disintegration, e.g., BT Openreach
- Significant amount of conduct regulation
  - Tempered by regulatory forbearance, complete (India) or within a band (Bangladesh)
- Small component of C&C
  - Information reporting requirements
  - Security/emergency related

# Another distinction

- Ex-ante regulation (sector specific)
- Ex-post regulation (general)

# Ex-ante, sector-specific

- What Telecom Regulatory Agencies do
- Before the fact
- Intrusive
- Requires expert personnel, properly managed

# Ex-post

- Is usually associated with general competition authorities
- Is less intrusive
- Requires less sector expertise
- Has ex-ante elements
  - When a body of practice and precedent has built up, they serve to constrain operator actions before the fact

# Can ex-ante and ex-post co-exist?

- Yes, in developed economies
- But in developing economies, must be handled with caution
  - Forum shopping → increased regulatory risk
  - Higher regulatory costs
  - Delays
- Can be managed with MOUs that specify division of authority, and are easier to modify than legislation

# **REGULATORY INSTRUMENTS**



# Rules/regulations

- Binding directions of general applicability to a class of licensees
- Have advantages of
  - Applying equally to all in the class (“level playing field”)
  - Less burdensome than individual directions
  - Tend to require prior consultation
  - Tend to have degree of permanence, contributing to reduction of regulatory risk
- Have disadvantages of
  - Taking time to set in place
  - **Not** necessarily suited to unique circumstances of operator

# Rules/regulations

- In many countries, legal requirement for notice and opportunity to comment, e.g.,
  - US Administrative Procedures Law requires Notice of Proposed Rule Making
  - TRAI Act in India requires consultation and the conduct of open houses in multiple locations, not just New Delhi
- In technical subjects where the substantive knowledge lies with manufacturers and operators essential to consult even if not legal requirement

# “Determinations”

- Different terms in different countries, but what is meant is a quasi-judicial ruling with serious consequences, e.g., re a license-condition violation
  - The affected party must have opportunity to comment, as part of adherence to rules of natural justice
    - *Nemo iudex in causa sua*, or " Judge must be unbiased"
    - *Audi alteram partem*, or " Hear both sides"
    - Make decision based on the record
  - And, of course, the authority must have the power to make the determination

# “Directions”

- Again, different terms in different jurisdictions
- What is meant is an order to do something/desist from some action, but with less force than with a determination
  - In some countries, these types of orders may be delegated to an official

# “Jaw boning”

- American slang for technique used by persons in authority (e.g., President, Regulatory Authority Chair) to simply talk about certain desired actions without legal force
  - Indicates to target audiences that an issue is rising in salience and it would be prudent to pre-empt official action
- Advantages are that it’s low-cost to regulator & it allows the licensee to define his response
- Disadvantage is that it is not strictly within the law and its overuse may increase regulatory risk

# Informational Processes

- Technical conference
  - For disputes with technical aspects where knowledge is unsettled and in early stages
  - Experts & representatives of parties discuss
  - Preview of parties' positions
  - Could be used to develop consultation paper or request for comments
  - A step in settlement process
  - Smoothens adjudication/rule-making process

# Alternative Dispute Resolution (ADR)

- Out-of-court resolution or settlement of disputes
  - Alternative to traditional litigation
- Less resource intensive (time & money)
- Less harmful to relationships that must continue

# ADR & ARP

- Resolution or settlement of disputes (medicine)
  - Regulator-Operator disputes
  - Operator-Operator
  - Operator-Consumer
- Preempting disputes (preventive health)
  - Use of Alternative Regulatory Practices (ARP) with ADR at the core



# ADR Consensual Processes: Mediation

- Essentially negotiation with assistance from mediator
- Mediator
  - Neutral with no preference for any party or term of settlement
  - Cannot impose outcome on parties
- Parties in control of process
  - There may be no outcome

# Where mediation may not be appropriate

- Matters affecting the public interest
- Where outcome is zero sum, e.g.,
  - Setting the revenue requirement in a tariff proceedings is zero sum between the utility and customers (as a whole)
- “Too early” stage of a dispute, e.g.,
  - The model and assumptions in one party’s demand forecasts are not known by the other

# ADR Informational Processes

- Help focus issues & induce agreement
  - Neutral evaluation
    - Assessment of case by experienced neutral person based on presentations by both parties
  - Informational arbitration
    - Non binding
    - Only advisory

# ADR Informational Processes

- Mini-trial
  - Settles scientific/technical issues in business disputes
  - Panel with neutral advisor & both parties' representatives
  - Parties attempt settlement based on neutral advisor's help

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# ADR Adjudicatory Processes: Arbitration (conventional)

- Voluntary: arbitration agreement
- Binding: court order to enforce
- Finality of award
  - Exception: power of court to review on specific limited grounds

# Conventional arbitration vs. trials

- Outside conventional legal system and its delays
  - Toll road that allows faster movement than congested highway
- Less expensive to parties; no cost to the public
- Arbitrator selection different
  - May have expertise
- Procedures may be less rigid
- Grounds for appeals circumscribed

# ADR Adjudicatory Processes:

## Final-offer arbitration

- Variation: Remove power of arbitrator to fashion a remedy
- Has to pick one or the other of the solutions proposed by the parties
- Corrects polarization incentives of conventional arbitration



# Assessment of arbitration

- Fast-track trial, with some expertise thrown in
- Adversarial, not cooperative
- Neither variety addresses the cognitive and emotional dimensions of the conflict
  - They may get addressed if arbitrator is skilful
  - Not optimal for long-term cooperation

# ADR hybrid processes

- Mediation-Arbitration (Med-Arb)
  - Combination of two processes
    - Mediation first, arbitration upon failure
    - Same neutral
- Advantage: efficiency
- Disadvantage: possible damage to mediation dynamics
  - Information will not be disclosed in phase one

# ADR Hybrid processes

- Arbitration-Mediation (Arb-Med)
  - Mitigates Med-Arb disadvantages
  - Arbitration in first instance, decision kept in sealed envelope (BATNA)
  - Mediation follows
    - If successful, envelope is not opened
    - If unsuccessful, arbitral decision is binding
- Adopted by PUC of Sri Lanka