

Role of the regulator

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Regulation cannot be seen in isolation

- The overall market structure is very important
 - What is the extent of competition?
 - Have the sources of market power been identified?
- The regulated entities must be ones that are responsive to incentives and disincentives
 - Usually, at least partial private ownership is necessary
 - If not, only benchmark regulation and “name and shame” can be used
- Regulation requires evidence-based and fair procedures
 - Usually, an independent regulatory agency is needed

Regulation basics

Why independent regulation?

- In countries thought likely to engage in administrative expropriation, provide assurance to investors
 - Especially important in infrastructure industries where investors can be held captive to sunk investments
- Basic fairness: level playing field for all suppliers
- Insulation from political interference

Ingredients of effective design of independent regulatory framework?

- Proper market design at point of reform
 - Second or third best solutions cannot be ruled out
- Preset regulatory framework, constraining discretion as much as possible
- Provide for competent and adequately endowed regulatory agency
- Ensure that decision makers understand regulation and do not intrude into political or judicial space

Examples of necessary conditions for effective regulatory agencies?

- Insulation from “line” ministry, which tends to represent the incumbent, reformed or otherwise
- Own fund; financed through regulatory levies → immune to funding-based pressure & capable to obtaining the necessary skilled personnel
- Accountability to Parliament through annual report
- Staggered appointments of members by President/Prime Minister/Minister with concurrence of Constitutional Council
- Qualifications for decision makers
- Removal only for cause by Parliament

What are the sufficient conditions?

- Organizational structure, recruitment and training that
 - Realizes economies of regulation
 - Emphasizes commitment to “new” regulation
- How to enable, not restrict
 - Breaks from command and control mindset
 - Does not create easy path from incumbent to regulatory agency

Tariff regulation

S. 30 of Sri Lanka Electricity Act, No. 20 of 2009

- The relevant licensees to set the tariff according to a cost reflective methodology approved by the PUCSL
- The tariff must permit the licensee to recover all reasonable costs incurred in the carrying out of the activities authorized by its licence on an efficient basis
- Commission shall prescribe a procedure for review, which shall include—
 - A timetable for the review of tariffs by the Commission; and
 - Provision for consumers and other interested parties to participate in the procedure for review.
- The tariff must be approved by the Commission in accordance with general or specific policy guidelines approved by Cabinet and be published

Constrained discretion

- Reactive to proposals made by licensees
- Must be in accordance with policy guidelines from Cabinet
- According to previously announced timetable and tariff methodology
- Providing for public participation
- Must permit recovery of reasonable costs
- Specific provisions re subsidies from Treasury

How to assess reasonableness of costs

- Depends on the methodology, the quality of the data, and the assumptions
- Does PUCSL have adequate in-house expertise? Many regulatory agencies deploy consultants for the peak work of assessing tariff proposals
- Is the timetable realistic? Is it over-ridden on occasion?

What can be done if certain costs are found to be unreasonable?

- In the case of privately-owned utilities, the disallowed costs would result in the reduction of what utility earns → consumers would enjoy lower tariffs and the investor would have lower profits and receive a strong signal about containing costs and being efficient
- When the state owns 100% of the utility, what value is a disallowance?
Treasury would have to bear the costs caused by the managers of the utility
 - Will the managers be disciplined? Fired?
 - Even then, will that result in the unreasonable costs being borne by someone other than the tax-payers/consumers?
 - Will it create conditions for efficient operations in the future?

Second-best solution: Benchmarking

- Licensees must be independent of each other and opportunities/incentives to collude must be removed
- Managers must be responsive to “name and shame” or “name and praise” incentives
- Abandonment of uniform national tariff may be necessary
- PUCSL should be able to get data from licensees and ensure quality of data
 - If the only way to get data is by means of fines . . . Repeat of the disallowed costs problem