

private sector

Regulating Utilities

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Contracting Out Regulatory Functions

Regulating infrastructure utilities can be extremely complex and fraught with risks of political interference and capture by interest groups, especially in countries with little tradition of politically independent government agencies. To deal with these challenges, policymakers and regulators have sometimes contracted third parties—such as independent experts and consultants—to provide advisory or binding input into the administration of regulatory functions. This Note examines international experience in this area and explores the key implications for policymakers.

Over the past decade the provision of infrastructure services has undergone a big change, with many countries moving away from the traditional public sector model and introducing private participation. This change has called for establishing strong, credible regulatory frameworks—including regulatory rules and institutions—to protect the interests of consumers but also those of the public and private parties to infrastructure arrangements.

Institutions administering regulatory functions need to be competent (with access to technical expertise in such wide-ranging areas as law, finance, and economics), independent (free from government interference and capture by service providers and interest groups), and legitimate (abiding by legal principles and providing transparency and accountability). Mustering these qualities is not easy for regula-

tors, particularly in countries with weak or fledgling institutions, limited human and financial resources, and a history of repeated political interference in regulatory decisions.

To foster regulatory effectiveness, policymakers and regulators in some countries have contracted regulatory functions or inputs to third parties, such as external experts or technical panels. Contracting-out arrangements differ: while some are built into the design of the regulatory framework, others are not, and while some involve purely advisory input from the contracted experts, others call for binding input.

■ *Built-in or contracting out by regulators.* Contracting-out arrangements are sometimes built into concession contracts, for example, which may require that independent experts monitor the fulfillment of



contractual conditions, review tariffs, or settle disputes. In other cases established regulatory institutions may be granted the authority to procure the services of external consultants to strengthen the capacity, autonomy, and credibility of regulatory decisionmaking.

- *Advisory tasks or binding input.* When advisory tasks are contracted out, an external consultant usually develops a menu of options, leaving the final decision to the regulator—an arrangement allowing room for political influence. When binding input is contracted out, the external provider gives recommendations that must be applied, allowing no choice for the regulator. The success of arrangements for binding inputs hinges on the external experts maintaining a reputation for independence, fairness, and technical excellence.

Built-in contracting out

Much creativity has gone into designing institutional frameworks that prescribe contracting out, whether through clauses built into contracts or through sector laws passed by executive decree.

Monitoring

The 20-year water and electricity concession contract in Gabon, one of Africa's first real concession contracts, prescribes the use of external experts to monitor the service provider's performance in achieving coverage targets. The experts, paid from dedicated funds set aside from the concessionaire's revenues, produce only non-binding studies. This monitoring mechanism is aimed at strengthening the independence and competence of the ministerial department responsible for supervising the contract.

The Gaza water services management contract, one of the first private sector initiatives in the Middle East water sector, also requires the contracting out of compliance monitoring. The contract calls for binding technical and financial audits by a private third party to calculate the performance-linked management fee. The external auditor's binding input has increased the credibility of the regulatory process and helped reduce

the stark information asymmetry between the operator and the local regulatory authority.

Tariff setting

For water and sanitation services in Bucharest, concessioned in 1998, expert panels are involved in setting tariffs. Funded through a customer levy and selected by the concessionaire and the municipality, these expert panels complement the functions of a technical regulator. The concession contract gives the panels important powers to adjudicate tariff decisions, but within a clearly laid out process. The Ministry of Economics still formally clears the tariff reviews, but the contract makes it difficult for the ministry to delay or disagree with panel opinions. Delegating decisionmaking on tariffs, as is done in the Bucharest concession, may give investors comfort that sensitive decisions are made by competent and independent parties. It may also reduce regulatory costs.

Dispute settlement

In Chile arbitration panels of independent experts have been put in place to settle disputes between the water and sanitation regulator and private operators, especially in tariff reviews. These panels, staffed by three private, independent experts, deliver decisions that are binding on both the government and the private operator. Establishing arbitration panels with binding decisionmaking power lends substantial credibility to the regulatory process. In Chile, unlike in neighboring countries, the water sector has seen no substantial disputes.

Dispute settlement—whether through mediation, conciliation, arbitration, or litigation—may also be “contracted out” to international bodies such as the International Chamber of Commerce, International Centre for Settlement of Investment Disputes, or London Court of International Arbitration. These bodies, operating on the basis of their strong reputation for competence and independence, draw their legitimacy from obligations undertaken by governments to recognize and enforce arbitral awards. Thus arbitral awards may substitute to some extent for regulatory decisionmaking (such as in tariff setting) and provide an appeal

mechanism for regulatory decisions (such as on the rate base). But their practical effectiveness is limited by the timeliness of the arbitration process, the availability of expert capacity, and the ease of enforcement. Moreover, for some stakeholders the confidentiality of most arbitration procedures may call into question the legitimacy of the regulatory process.

Regional regulators

Policymakers also obtain regulatory assistance from regional regulators or from other countries through twinning arrangements. For example, the Eastern Caribbean Telecommunications Authority (ECTEL) serves the member countries of the Organisation of Eastern Caribbean States as a shared regulatory body. ECTEL not only provides regulatory functions to national regulators; since it is small, it also contracts out—for functions ranging from tariff reviews to impact assessment studies. That reduces fixed costs for national regulators, which are too small to efficiently regulate the rapidly evolving telecommunications sector.

Contracting out by regulators

Over the past decade some 130 countries have established an estimated 200 regulatory bodies—including independent agencies, government departments, and contract supervision units. These institutions may contract out for a range of reasons:

- *To supplement limited in-house capacity.* Many regulators face sharp peaks in their workload or need small amounts of specialized inputs and technical skills that tend to be in short supply, particularly in the public administration.
- *To reduce costs.* Contracting out may help reduce the costs of procuring expertise or, for a given cost, increase regulatory competence. Indeed, third parties can spread the fixed costs of acquiring specialized experience over large markets, both national and global.
- *To improve the quality and credibility of regulation.* Contracting out may assure investors of the independence of the regulatory process from short-term political capture, particularly in

countries with weak or fledgling institutions.

Regulatory institutions may decide to use contracting out at different stages of their life cycle and for different reasons. New regulators typically need support during start-up to build credibility and competence. More experienced regulators may contract out a particular task because doing so is less expensive than performing it in-house.

A recent survey of 51 regulatory agencies throughout the world shows that most (75 percent) engage external parties to perform regulatory tasks and plan to continue to do so.¹ Regulators seek external assistance particularly for tasks relating to tariff reviews, compliance monitoring, and dispute settlement, though only a few (15 percent) contract out binding input into regulatory decisions.

Regulators devote a large share of their annual budgets (more than 20 percent for a third of respondents) to hiring external experts, and most report that contracting out reduces costs or improves quality. Survey respondents consider contracting out particularly helpful in improving competence (92 percent of respondents), building trust with key stakeholders (71 percent), and ensuring independence (62 percent).

The survey results also highlight challenges faced by regulators in contracting out, including budgetary constraints (70 percent of respondents), the small market of appropriate consultants (less than 50 percent), and difficulty in specifying and managing contracts. While more than 80 percent of regulators have a clear decisionmaking strategy for contracting out, only 30 percent have performed a legal review to determine which functions they can contract out and which they cannot. Moreover, only 44 percent have accounting systems to compare the costs of performing a task in-house and contracting it out.

Designing contracting-out arrangements

Policymakers have given a great deal of emphasis to developing independent regulatory agencies. Even so, administering regulatory functions is complex and demanding, both technically and politically. And for countries

emerging from social strife and with fledgling institutions, setting up an institution with adequate independence—let alone competence and legitimacy—may be extremely difficult.

Contracting out regulatory functions can play a key part in enhancing regulatory effectiveness, providing comfort to investors. And in emergency or postconflict situations, contracting out may make it possible to establish regulatory arrangements that can start functioning immediately.

But to be effective, contracting out must be based on a clear strategic framework that includes:

- Assessing the desirability of contracting out (such as its legal feasibility, its costs relative to in-house costs, and its impact on regulatory credibility).
- Specifying the payment mechanism for the contracted party, its responsibility and authority, and whether it will have a binding or advisory role.
- Maintaining adequate in-house capacity to specify performance targets and monitor their achievement.
- Creating adequate arrangements to ensure transparency and accountability, including mechanisms to avoid capture by external contractors and to encourage competition.

Moving forward, policymakers and regulators will require more effective instruments for assessing, designing, and monitoring arrangements for contracting out regulatory functions—a need calling for more attention from donors.

Notes

This Note is based on Environmental Resources Management (ERM), “Contracting Out Utility Regulatory Functions” (report prepared for the World Bank, Infrastructure Economics and Finance Group, Washington, D.C., 2004).

1. The survey was conducted in 2003 by ERM for the World Bank, Infrastructure Economics and Finance Group.

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