V. RECOMMENDATIONS FOR REGULATORY POLICY FOR THE INFRASTRUCTURE INDUSTRIES AND ITS IMPLEMENTATION

A. Introduction

This chapter summaries the key recommendations for regulatory policy in respect of the infrastructure industries and their implementation. The recommendations are aimed at providing guidance to policy makers and make special reference to the provision of infrastructure facilities and services in the transport sector.

B. Regulatory principles and policy

1. It should be recognized that regulation is the sustained and focused control, normally exercised by a public agency, over activities that are valued by a community and it can either prevent undesirable behaviour, actions and activities or enable and facilitate desirable ones.

2. Regulators should examine the different ways of effecting regulation, including the establishment of specific rules or commands and also those actions designed to affect the social behaviour and activities of companies, organizations or individuals such as taxation, subsidization, contractual requirements, licensing and franchising.

3. Where markets do not function adequately, governments may consider regulation to ensure the adequate provision of goods and services at reasonable prices. There are three main instances of market failure: natural monopoly, externalities and asymmetric information.

4. If the state wants to control an infrastructure provider that possesses a natural monopoly, it should evaluate the use a number of different strategies, including:

- Harnessing markets by use of:
  - Competition laws
  - Franchising
  - Regulation by contract
  - Tradeable permits
- Command and control;
- Incentives;
- Informing;
- Acting directly;
- Self-regulation.

5. In deciding whether to regulate or to leave matters to the market, it is important to be realistic about the performance of particular regulatory methods. In most regulatory systems a combination of methods are normally employed.

6. Policy makers should recognize that regulation can be undertaken by a variety of bodies:
7. Regulators need to be aware that different types of regulatory institution have varying strengths and weaknesses. In broad terms:

- Self-regulators tend to be strong on industry expertise, but weak on public accountability;
- Local authorities tend to be strong on local democratic accountability, but weak on coordination;
- Courts and tribunals are likely to be fair, but weak on planning;
- Central government departments tend to be strong on planning and coordination, but weak on neutrality;
- Agencies are strong on expertise and political neutrality, but weak on accountability;
- Directors General are likely to be expert and responsive, but weak on spreading discretionary powers.

8. To decide whether a system of regulation is good, acceptable or in need of reform, policy makers should be clear about the benchmarks that are relevant to such an evaluation. Typical benchmarks include:

- The extent of the legislative mandate;
- The quality of accountability and control;
- The use of due process;
- The expertise employed;
- Efficiency and effectiveness.

9. Cost-benefit analysis and other methods of economic evaluation should be used to assess the efficiency of a particular regulatory regime.

10. Regulators need to consider the following issues in enforcing regulation:

- Styles of enforcement;
- Rules of enforcement;
- When to intervene;
- How much to enforce;
- How to control corporations.

11. Regulatory rules should link a regulatory response (for example, a fine, tax or administrative order) to a standard of performance. The setting of standards is not exclusive to command and control regimes, but is common to the regulation of performance contracts, franchising, and concessions. Regulators need to address two issues in setting standards:
The types of standard to employ;  
The required performance levels.

12. Self-regulatory schemes must be able to command public confidence and should operate within a statutory framework.

13. Regulators should focus on the control of risks such as the risk that infrastructure facilities and services will be inadequate or that prices will be excessive.

14. While there may be some benefits from regulatory competition particularly where this leads to improved standards of consumer protection, in general, regulatory coordination across national or sectoral boundaries is desirable.

C. Economic reform, competition policy and regulation

15. The first step, in introducing or increasing competition in the provision of services previously provided either directly by the state or by state-owned enterprises, should be to design and implement a “liberalization programme” aimed at:

- Depoliticization;
- The commercialization of operational management;
- The selection and detailed design of an appropriate competitive market form;
- The development of effective competitors;
- The development of regulatory institutions appropriate to the market form.

16. Policy makers should evaluate the main ways in which the private sector can be involved in the provision of infrastructure facilities and services including:

- Corporatization and performance contracts;
- Affermage contracts, concessions and franchises (designed to create “competition for the market”);
- Privatization (designed to create “competition in the market”).

17. In designing an economic reform programme, policy makers should determine, on a sector-by-sector basis, the appropriate mix of policy instruments necessary to create and maintain a competitive market and an efficient allocation of resources. Policy makers must initially consider the technical nature of the industry, or sector, in which competition is to be introduced.

18. It is now widely accepted that the introduction of competition during the process of and preferably prior to privatization will result in increased benefits to the consumer and economy in the long run. It is however, desirable that regulatory measures are taken to ensure that consumers’ interests are protected.

19. Industries with different competitive potential at each stage of production should be broken up by privatization, and the monopolistic and competitive elements should be sold as different entities. The aim should be to create “competition in the market” for the potentially competitive activities.
20. Under full privatization with open competition in the market, ownership and control should be transferred to the private sector, and operators should be subject to the prevailing commercial laws. In its extreme form, the only regulation that will be necessary is the general legislation on monopolies and restrictive practices.

21. If “competition in the market” cannot work, then it may be possible to create “competition for the market” as a means of obtaining improvements in the efficiency of a monopolist. This form of competition is created by organizing an auction to force the potential monopolists to compete with each other for the right to be the sole provider of infrastructure facilities, networks or services.

22. Long-term contracting can offer a solution to increasing private participation in natural monopoly industries. However, care should be taken that long-term contracting does not result in unsatisfactory outcomes in terms of inhibiting competition and strategic behaviour by firms that is contrary to the public interest.

23. The principle objectives for competition and regulatory authorities should be to promote long run economic efficiency and to promote consumer welfare.

24. Competition policy and regulatory agencies need not only to create competition, but also to maintain it by controlling and regulating:

- Anti-competitive behaviour by dominant firms;
- Mergers, acquisitions and other corporate combinations.

25. Normally competition authorities, rather than sector regulators, should review and approve mergers, acquisitions and other corporate combinations. However, in many network industries there is increasing globalization and as a result the concerns and work of regulators and competition authorities should be coordinated.

26. Where a number of authorities exist, it is important that an industry is not subjected to duplicative or inconsistent intervention.

27. An effective competition policy must take into account the specific characteristics of an industry to which it is applied. The network service markets present special challenges for the application of competition policy in effecting the transition from a structure based on a state-monopoly to one with private sector competition. It is generally desirable to minimize government intervention in competitive markets. However, it is widely agreed that regulatory intervention is required to implement a successful transition from monopoly to competition.

28. In developing a regulatory policy for a particular industry, it is necessary to analyse its structure in order to determine whether to reform its structure to create greater competition and how best to regulate the remaining areas of monopoly. It is price setting by the monopolist that is the greatest potential cause for public concern.
29. The competition authority and/or regulator must decide how far to go in restructuring an industry and choose the most appropriate form of competition for each element of an industry. The unbundling, or the vertical and horizontal separation, of activities can affect this. Basically, if it is cheaper and technically feasible to have more than one provider, in both the short and long-run, then “competition in the market” can be created. In such circumstances, regulation should be confined to ensuring that service providers meet their public service obligations and that government compensates them as necessary. The competition authorities, and possibly the regulatory bodies, should also have responsibilities for ensuring that the competitors do not individually or collectively engage in any anti-competitive behaviour.

30. As markets become more competitive, through technological innovation etc., the need industry specific regulation may diminish or even expire. Flexibility and transparency in the design of regulatory tools and institutions will be required to ensure appropriate responses to rapidly evolving competitive conditions.

31. Regulation of the activities and pricing decisions of the residual monopolies should be a central concern of competition policy. The regulatory response to a natural monopoly of a multi-product service, where there is a requirement to break even, should be to encourage differential mark-ups on marginal-cost for services with differing elasticities of demand.

32. Where price regulation is necessary, price capping is superior to rate of return regulation since it provides greater incentive for efficiency and is administratively convenient.

33. In some respects, competition and monopoly regulation are potentially substitutes. However, harnessing competitive incentives can enhance the effectiveness of regulation. Franchising by creating “competition for the market” essentially auctions the regulatory contract and has the scope to provide information that is often not available to the regulator. Regulators should recognize that, properly managed in appropriate circumstances, franchising is capable of both extracting monopoly profits and encouraging the efficient use, and in some cases, the efficient development, of infrastructure.

34. Regulating the quality of service provided is essential and, in practice, this can be effected by offering tiered levels of service with regulated price differences. Regulators must attempt to elicit information about consumer valuations of quality improvement, compared with the cost of providing that improvement.

35. Efficiency and cost reduction should be major objectives of regulation. However, most regulators suffer from a lack of adequate information about the costs or potential for improvement by the firms they regulate. Regulators can remedy these inadequacies by securing better information about the firm’s productive potential by benchmarking a firm against comparable competition and setting productivity improvement targets.
36. Economic reforms involving privatization and the introduction of competition do not remove the political requirement to assist the poor. However, formal mechanisms are required to reconcile such goals and private participation in the provision of infrastructure facilities and services. Regulators should select a regime that provides sufficient incentives to operators to provide such services but a preferable approach is to include the clear specification of the USOs in the scope of monopolies’ responsibilities and provide direct subsidization for the specific services to be provided.

37. The evolution of the global market has lead to the emergence of providers of infrastructure facilities and services that are capable of operating in more than one country. Privatized former state enterprises, private sector firms, and private investors have increasingly sought to participate in foreign markets in the water, gas, electricity, telecommunications, and transport industries. In general, such developments are wholly consistent with the goals of competition policy aimed at improving the contestability of markets and economic efficiency. Indeed, the benefits of globalization are perceived to be the more efficient production and marketing of facilities and services, lower prices and improvements in quality. Increasing globalization in such sectors however, means that regulators should harness the benefits of globalization and international competition by promoting market access through competition.

38. The accountability of regulators should be given due importance particularly where the legislative mandate for regulation is less than clear and where the interests of consumers and producers have to be carefully balanced.

39. Transport regulators should recognize that there are no standard solutions applicable to all modes and in all markets and locations. It is the market and cost characteristic of a particular subsector that will determine the appropriateness of a wide range of alternative market arrangements and their associated regulatory requirements.