



DNA Economics
Making economic sense of common problems

Regulatory independence choices in the regulatory design phase

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The practicalities of designing for independence

- Substantial body of evidence that regulatory independence is a crucial component of good regulatory performance for economic regulators
- However, regulators still need to function within a wider system of democratic accountability
- Regulatory design needs to manage the tensions and trade-offs between the two concepts
- Economic Regulation of Transport Bill, 2018 proposes the establishment of a Transport Economic Regulator (TER) and a Transport Economic Council (TEC), to undertake economic regulation of the aviation, ports, road and rail sectors
- We now investigate some of the theoretical and practical questions illustrated by the regulatory design choices made in the Bill
- Disclaimer:
 - I consulted to the Department of Transport on the design of the Bill
 - Views presented are however my own, and do not represent the Department of Transport

Independence and infrastructure regulators

- Economic regulation is a means of dealing with natural monopolies in infrastructure
- May not be possible to duplicate such infrastructure, but regulation can facilitate competition in access to infrastructure, and thus achieve better outcomes in terms of the price, volume and quality of products and services
- Strong incentives to capture the regulator:
 - The regulator will constrain the ability of the infrastructure owner to charge monopoly fees, so regulatory capture by industry can restore monopoly profits
 - The regulator will set prices to cover costs, so political regulatory capture makes it possible to (temporarily) ignore costs, in order to deliver larger volumes of cheaper, better public services and win votes
- Regulatory independence creates an agency deputised by the state to meet a specified set of policy objectives, but delinked from its political authorities - can credibly commit to long term objectives and constrain rent seeking

De jure and de facto independence

- Difficult to design legislation which fully protects regulatory independence – much of the independence of regulators is affected by de facto practices
- For example: study of appointees to regulators in Western Europe between 1996 and 2013 found that higher levels of de jure independence were associated with more politicised appointments
- Also a link between the wider political system and regulatory effects: Acemoglu et al (2008) found that the impact of central bank independence was greatest when political governance systems are of intermediate strength
 - Independent central bank is unlikely to be effective if governance systems are very weak
 - Conversely, in countries with strong political accountability, the central bank is likely to already be pretty well-governed, even if de jure independence is weak
 - Impact of improving de jure regulatory independence is thus strongest with intermediate governance systems
- Similar findings by Guidi (2014) for national competition authorities in the EU

Independence and principal-agent problems

- An independent regulatory agency (IRA) is designed to act as an agent for its political principals (who are in turn agents of the electorate), and the relationship is thus characterised by principal-agent problems
- Need for accountability mechanisms is highlighted by what is known about sources of bureaucratic failure:
 - Niskanen (1968) pointed out that the pecuniary and non-pecuniary perks of office at a regulatory agency increase as that agency's budget does, and thus that bureaucrats are incentivised to grow the budgets of the institutions they manage beyond what is socially most beneficial
 - Also risks as regards corruption, shirking, capture by industry, and so forth
- The pursuit of regulatory independence thus needs to allow for balance with systems of accountability

Regulatory independence and the Economic Regulation of Transport Bill, 2018

Formal independence attributes

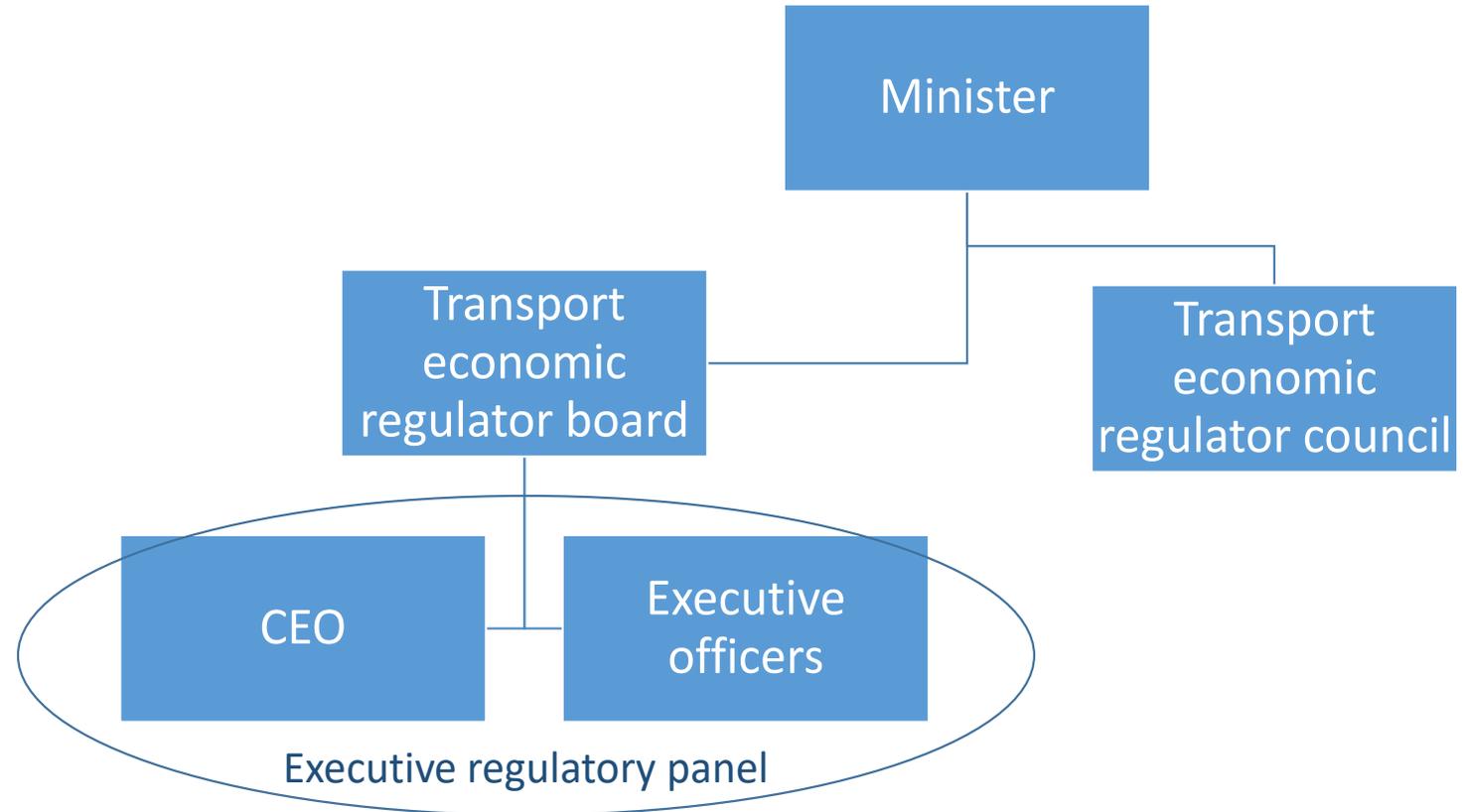
Chairperson and management board	- Term of office
	- Appointment procedure
	- Dismissal procedure
	- Renewability of Appointment
	- Compatibility with other offices
	- Formal requirements of independence
Relationship with elected politicians	- Independence formally stated
	- Formal obligations
	- Overturning of decisions
Finances and organisation	- Source of the budget
	- Agency's internal organization
	- Control of human resources
Regulatory competencies	- Rule-making
	- Monitoring
	- Sanctioning

De facto independence attributes

From politicians	- Frequency of revolving door
	- Frequency of contacts
	- Influence on budget
	- Influence on internal organization
	- Partisanship of nominations
	- Political vulnerability
	- External Influence on regulation
From regulates	- Frequency of revolving door
	- Frequency of contacts
	- Adequacy of budget
	- Adequacy of internal organization
	- Professional activity of chairperson/board members
- External influence on regulation	

Overview of the TER and TEC

- Structure of the TER board is unusual for SA
- Purely governance board, with regulatory decisions made within the TER, by the executive regulatory panel
- More typical to see governance and regulatory decisionmaking vested in a single structure
- TEC as a specialised appeal body most closely resembles Competition Commission/ Tribunal model



Organisational autonomy

- The manner in which the regulator is organised plays a big role in determining its functional level of independence. From least to most de jure independence, the following four forms of regulatory organisation can be used (Malyshev, 2008):
 - Ministerial departments: regulation carried out directly by the department, possibly with some limited statutory independence. Example: Independent Police Investigative Directorate (IPID)
 - Ministerial agencies: report to the Minister, but housed in an arm's length agency. Example: Government Printing Works
 - Independent advisory bodies: agency is independent of the department, and can offer advisory opinions/recommendations, of varying levels of force. Examples: National Health Research Committee (NHRC); B-BBEE Advisory Council
 - Independent regulatory authorities: political intervention in agency decisions is deliberately limited to policy matters. Chapter 9 constitutional institutions such as ICASA, and PFMA Schedule 3A institutions such as Ports Regulator SA, Railway Safety Regulator, NERSA
- The chosen form for the TER and TEC is a Schedule 3A independent regulatory authority
- Section 28 of the ERT Bill formally states that the “Transport Economic Regulator is established as an organ of state within the public administration, but as an institution outside the public service,” and further that it “is independent, and subject only to the Constitution and the law.”

Appointment, dismissal and employment terms of senior staff

- Much of the independence of an IRA is embodied in its staff
- The appointment process:
 - Line ministry responsible for policy is arguably more motivated to intervene in the regulatory than other parts of government, so Brown et al (2006: 69) suggest that senior regulatory staff should be appointed by the head of state and/or the legislature
 - In South Africa, appointment by the National Assembly has proved time-consuming and unwieldy in practice
 - ERT Bill empowers the Minister of Transport to appoint the board of the TER and the members of the TEC. The board then appoints the CEO and the executive officers, who make up the ERP - while board appointments are made by the line ministry, there is arguably a layer of insulation provided by the fact that the ERP is then appointed by the board
 - May need to include more public consultation and transparency in appointment processes
- Terms and conditions of dismissal of senior regulatory staff:
 - Board members, council members and CEO are appointed for four year terms, can be reappointed once
 - ERP members are also appointed for four years but may be re-appointed indefinitely - allows for the retention of highly skilled technocrats in the ERP
 - Limitations on the grounds for which a Board/Council member, member of the ERP may be removed from office

Funding sources

- Economic regulation of infrastructure is a data intensive and highly technical task, which cannot be adequately performed unless the regulator receives sufficient funding. Funding is thus an important component of regulatory independence
- Regulators such as the PRSA and ICASA are funded from National Treasury, via allocations made in the departmental vote during the annual budget process – involvement of line department means this funding model potentially compromises independence
- Chosen funding model:
 - TER and TEC assess the amount of funding needed to perform statutory tasks
 - Funds are collected from regulated entities – closer to self-funding model used by NERSA
 - Model designed to avoid material cross-subsidisation between modes regulated, and between the Regulator and the Council
- This model reduces of political capture, but does create a risk that non-payment of regulatory fees could be used by regulated entities to attempt to choke regulatory capacity
 - Partially mitigated by the fact that a number of entities will be regulated, which will spread the funding sources of the regulator, and make it more difficult for any one entity to materially affect cashflow

Relationship with elected politicians

- The approach taken by the ERT Bill has been to formally allow for/describe interactions which could otherwise happen behind closed doors
- S37(1)(a) requires the regulator to “exercise economic regulation of transport facilities and services in line with prevailing national economic policy.” May need greater clarity on which kinds of policy pronouncements (for example, gazetted white papers) should be given credence by the regulator
- S42 allows the TER to provide feedback to the Minister on regulatory matters, and s39 (2) allows the TER to “advise the Minister to consider the promulgation of new regulations in terms of this Act, or the amendment or repeal of any existing regulations”
 - Arguable whether this needs to be formally provided for in the legislation
 - Provision is intended to signal a strong expectation that the Regulator will be encouraged to provide feedback
- S21(2)(a) empowers the Minister to appeal decisions of the TER to the TEC
 - Can be argued that the Minister always has a legitimate policy interest in regulatory decisions in the sector
 - This mechanism requires the Minister to go through a transparent public process of appealing TER decisions, which will hopefully reduce the incentive for the Minister to informally lobby the regulator
 - This is the only point at which the Minister is provided a means of input in the regulatory decision-making process

Relationship with elected politicians – regulatory scope

- S4 of the Bill outlines a somewhat unconventional means of setting the scope of the regulator’s authority. Specifically, the Minister is allowed to extend or retract the scope of the regulator’s oversight functions, if the following holds (or stops being the case):
 - (i) the facility or service is provided by only a single operator; or
 - (ii) the entity, market, facility or service is not functioning competitively; and
 - (b) economic regulation can adequately address the economic consequences resulting from the non-competitive nature of the market.
- Aim of s4 is to ensure that there is a mechanism in place which will allow the scope of regulation to be tailored to circumstances where it is actually warranted, to reduce unnecessary regulatory burden
- S4 mechanism does involve the Minister in decisions on how regulatory scope is set, but political discretion as regards who should be regulated is substantially restricted by the transparent procedural and technical requirements to investigate market conditions laid out in s4
- S9 also requires the Minister to undertake five-yearly reviews of “the exercise of the functions and powers of the Regulator and of the Council, relative to the policy and purposes of this Act” – an accountability mechanism for the Minister to ensure that the regulator remains fit for purpose

Conclusions

- The theory and the practice of regulatory independence are fraught with ambiguities and uncertainties, and the process of designing an independent regulator must take cognisance of the need to keep in place sufficient political accountability mechanisms
- TER Bill provides an illustration of the complexity of the process, and includes some regulatory innovations which are as yet untested in South African circumstances, but which will hopefully meet the right balance between independence and accountability for this regulator going forward
- Bill itself is currently under review by the Department of Transport

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