

Regulators, policy-makers, and the making of policy: who does what and when do they do it?

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Abstract

The formation of independent regulatory agencies for infrastructure has led to considerable controversy in many countries over the respective roles of government policy-makers and of 'independent' regulators. The fact that independent regulatory agencies are not only new entities, but also new concepts, has contributed to a lack of clarity on their role in policy formulation. The issue is often characterized as distinguishing between the setting and implementation of policy. That characterization, however, is not very useful. For a variety of reasons relating to politics, expertise, inability to be prescient, transparency, jurisprudence, imprecision in wordsmithing, and finance, the issue is perhaps better defined in terms of two levels of policy-making, macro and micro. The former is the domain of government policy-makers, while the latter seems best suited for regulators. While government always retains the ultimate responsibility for the formulation of policy, it is best to delegate nuanced policy decisions, micro policy, to regulators. Doing so makes for less politicization, more predictability, more transparency, and more informed decision-making.

Introduction

Delineating between the roles of government policy-makers and independent regulators is the subject of controversy and confusion wherever independent regulatory agencies have been established. Part of the controversy, of course, is the result of the natural 'shaking out' process for newly established independent regulatory agencies in countries with no experience regarding these institutions. Part of the controversy, however, is simply that the boundaries between 'policy-making' and 'regulating' are inherently fluid and uncertain. Moreover, the very notion of distinguishing between 'policy-making' and 'regulating' may well pose a false dichotomy. Both policy-makers and regulators make policy. The distinction is that policy-makers define the fundamentals and define the parameters within which policy-making is delegated to regulators. It is more useful to think, not in terms of policy-making versus regulation, but, rather, as macro policy-making versus micro. For purposes of this paper, macro policy is defined as the basic policy parameters. It constitutes the fundamental principles of the regulatory system. Micro policy-making is defined as the action of regulators, operating within their legal authority and consistent with the macro policies formally enacted by the government, to apply, clarify, interpret, and fill in details left unspecified by macro policy-makers.

In flushing out the distinction, it is useful to keep key concepts in mind.

- 1 Basic and macro policy must be set by the government
- 2 Government policy must be set and altered only on a prospective basis
- 3 Regulators must follow and enforce policies articulated by the government
- 4 Regulators are creatures of the state and not necessarily of the government
- 5 Policy vacuums are inherent and expected
- 6 Some policy issues require technical expertise to be resolved
- 7 Regulatory decision-making, policy or otherwise must be subject to appellate review.

Policy-making

The government has the power and the obligation to set basic policy. It not only has the capability, but also takes the action(s) that provides the regulatory regime with its legitimacy, credibility, and legal authority. In fact, except perhaps, in the rare

circumstances where the regulatory agency, as in California, is created in the Constitution itself, regulators possess only those powers specifically delegated to them by the government. Governmental failure to coherently articulate basic policy will inevitably lead to instability, uncertainty, and blurred vision. Neither investors nor consumers will tolerate for long a regulatory regime without basic form. The real question about the government establishment of policy is about the level of detail provided by government policy-makers, stability of the established policy, and the means by which policy is articulated and communicated.

The level of detail provided by the government is not a trivial issue. It is necessary that policy be articulated in sufficient detail to provide a level of stability and predictability adequate to attract capital and market participation. The general rules and parameters for discretion delegated to regulators need to be stated in sufficient detail to enable a general understanding of the nature of the regulatory regime. Indeed, it is in articulating the basic policies that the difference between macro and micro policy is defined. Anything articulated in law or rule by the government constitutes a macro policy. Any policy that regulators articulate in order to carry out their duties to implement macro policy constitutes micro policy.

Macro policy-making

Macro policy should not be overly detailed for two basic reasons. The first being that regulators should be allowed the flexibility needed to adjust to inevitably changing circumstances. Markets and circumstances evolve with time and it is prudent to enable regulators to make appropriate incremental changes. That degree of flexibility internalizes modest changes into the regulatory process and avoids undue politicization of issues of lesser magnitude. It is also a recognition that policy-makers are not and cannot be prescient. It is not possible for them to anticipate all issues that require policy-making to resolve. Rather than attempting to micro manage all details, delegation of authority to regulators to fill in policy details seems sensible, particularly as government policy-makers always possess the ultimate authority to change policy on a prospective basis, when they deem it appropriate to do so.

The second reason for avoiding overly prescriptive policy parameters is that some matters are too technical for policy-makers.

An excellent example is in the area of pricing. While it is important that the basic methodology be set forth on a policy level, the actual implementation and application of pricing principles is an extraordinarily complicated matter. What level of expertise, for example, can we expect to find in a legislative body on the relative merits of locational marginal cost pricing for electric transmission services? The matter, while an important sector policy issue, is self evidently too arcane, too technical, and too complex to expect keen insights from macro policy-makers. That being said, however, it is critical that the government articulate at least a basic theory of pricing. It may range from the amorphous 'just and reasonable' standard enunciated in the Federal Power Act in the US, to something slightly more prescriptive, such as mandating price caps, benchmarks, rate of return regulation, PBR (performance/incentive-based regulation), reasonable opportunity to recover prudently incurred costs, or some other criteria. Even here the task is not easy. For example, enunciating PBR goals is much more general than describing the narrower framework of price caps. Further, it is important to consider the general consistency of the guidance. For example, the proposed US energy legislation currently under Congressional consideration gets into details such as 'native' load protection that goes against the open access provisions in unexpected ways. Very small changes in the wording may have profound, unintended, and often quite adverse effects. The purpose is to provide investors and consumers alike, some insight into what they may reasonably expect from the pricing regime, not to put regulators into a strait jacket by rigidly defining every detail. Where policy-making requires technical expertise, nuanced shaping, and expertise, it is prudent to delegate it to the regulators.

Micro policy-making

Delegation of micro policy-making to a regulatory authority makes sense because no macro policy-maker, regardless of prudence and vision, will ever be able to foresee all policy issues that might be encountered in practice. Consequently, there is an element of policy-making that will have to be done when unanticipated issues arise for which there is no pre-existing policy, or where the policies, articulated in broad terms, requires clarification or fuller definition in application. Examples include refined definitions of what constitutes improper

exercise of market power in electricity generation, or how to price a newly unbundled telecommunications service that had previously only been offered in a bundled basis with other services, or redefinition of customer classes based on unforeseen uses. It is theoretically possible that regulators, upon encountering such a situation, could stop their decision-making process and seek guidance from government policy-makers. Unfortunately, doing so will almost certainly render the decision-making process more labourious, time-consuming, and less effective. Moreover, there is no assurance that there will be an adequate response, much less a timely one. Certainly, legislative bodies are not famous for either timeliness or precision. It seems both more efficient and fairer to the parties involved to simply authorize the regulators to make the needed determinations. If the judgement of the regulators proves faulty, there will be many opportunities for them to reverse themselves, or for macro policy-makers to step in and articulate a new policy on a going forward basis.

Delegation of roles in policy-making

It is useful to point out that macro policy can come from two sources—one legislative and the other executive. Obviously, basic policy should be set out in law. That requires legislative action. The other possibility for policy formulation, all within the scope of authority provided by law, is that executive agencies such as cabinets, individual ministries, councils of ministries (for example, The National Energy Policy Council in Brazil), the president or prime minister himself, will enunciate the policy. Basic infrastructure ministries, and perhaps other institutions, may possess comparable levels of expertise as is found in regulatory agencies. They, therefore, may well be as competent at analysing arcane technical matters as the regulators. The issue with executive policy-makers, unlike legislators, is often not the lack of understanding or expertise, but, rather, one of timing, transparency, politicization, and application of decisions. It is important, however, to keep in mind that there is more than one level of delegation possible for micro policy-making.

While broad policy questions should be resolved by policy-makers, many areas of micro policy-making, within defined parameters, are best delegated to regulators. Doing so follows logically from one of the fundamental reasons for regulatory

independence. The state performs three basic categories of functions: administration, legislation, and adjudication. It is impossible to put regulatory agencies in any single category as they perform administrative, legislative, and judicial tasks. They operate agencies, buy supplies, enforce laws, manage personnel, and perform other administrative tasks. They set tariffs, promulgate rules, enunciate micro policy within the authority delegated to them, and perform other functions which are universally applicable and prospective in nature. Those two attributes are classic legislative powers. Finally, they adjudicate disputes within their legal jurisdiction. Thus, regulators do not readily fit into any governmental table of organization. Policy-making is legislative in nature and is, therefore, a type of activity in which regulators routinely engage. Their ability to do so, however, is governed by the scope of authority granted to them by the government. Once that authority is delegated, and, until it is rescinded, regulators should be free, subject to appellate review, to apply their expertise and exercise their lawful authority free of governmental interference.

Macro policy-makers always possess the legal capability to dictate policy to regulators. It is important, however, that when they do so, they act only on a prospective basis. The rationale for that principle is twofold, decision-making coherence, and the legitimacy/transparency of the process itself. The first rationale is rooted in sound process management which has three basic elements.

- Legal/macro policy formulation and articulation
- Implementation/micro policy formulation
- Appellate review.

It is an element of basic fairness that those who participate in the process are able, to the extent possible, to know the rules and policies with which they will have to comply. It is, therefore, for the sake of both coherence and fairness that the three elements of decision-making be conducted in appropriate sequence by the proper authorities.

Policy-makers, both legislative and executive, need to provide regulators with the policy framework within which they must make their decisions. By articulating that framework, they simultaneously provide all parties due notice of the basic parameters of regulatory policy and principles to be followed. Those

policies are set forth in general terms and in contemplation of the overall objectives rather than determining the outcome of specific cases or fates of specific market participants. While vested interests will undoubtedly attempt to influence policy decisions, and certainly have a right to do so, it is important to keep policy-makers fully focused on the broad goals and objectives defining the public interest, rather than on the specifics of individual case outcomes.

It is for the regulators to decide individual cases and to actually apply the policies to specific factual contexts and players. In doing so, they will encounter matters that require detailed interpretation of policy, or even fill in the blanks left by the policy-makers. In fact, for the most part, it is in the context of specific cases or set of circumstances that issues of micro policy will arise. It is an inherent and unavoidable aspect of regulation that matters of micro policy, or clarification of broad policy, will arise in specific cases before the regulators. Whereas macro policy-makers are often initiators of policy matters, regulators, more often than not, make micro policy in reaction to matters raised in specific cases or disputes, or, in order to specifically fulfill obligations imposed upon them by law. It is axiomatic, but true, that unforeseen issues or circumstances will arise, which the macro policy-makers did not, or could not, anticipate.

While regulators could, in theory, upon encountering a micro policy matter, stop the process, throw up their hands, and ask for guidance from government or legislative authorities before proceeding, the result, would be likely be highly disruptive, time consuming, and would almost certainly politicize the outcome of very specific cases or the fulfillment of specific regulatory objectives. Those inevitable effects of such a procedure would likely negate the very *raison d'être* of independent regulatory agencies. It makes better sense, therefore, to simply allow the regulators to proceed with their decision-making process. That being said, however, there needs to be a check in place to assure that the regulators neither exceed their legal authority nor violate policies that they are obliged to follow. That, of course, is the reason why there is an appellate process. If regulators, in deciding a matter, fail to follow obligatory laws and/or policies or adhere to required processes, then the offending decision should be reversed and reconsidered.

The process of policy-making

There is, therefore, a logical sequence to deciding regulatory matters. The first is the initiation of the entire regulatory process through the articulation of basic principles and policy formulations. It allows for public contemplation of basic policies through the political process, but in a broad context without reference to specific cases or disputes. That is, undisputedly, the role of legislators, and perhaps executive policy-makers as well. Regulators can, and perhaps should, provide input to such matters, but are not empowered to take a decision.

The second part of the sequence is the implementation of regulation. That process allows regulators to adjudicate disputes, fulfill legal obligations such as tariff setting, and, where necessary, to provide micro policy details in order to clarify or provide detail on policy. The latter, of course, is the essence of making micro policy. It must be carried out independently, transparently, and in an apolitical manner.

The third sequence is to assure that the second sequence, the regulatory process, is carried out in a manner not inconsistent with policies and principle enunciated in the first process. The third sequence is, of course, the appellate process. In fact, there are two appeal processes, one for resolving specific cases in dispute, and the other, for resolving policy issues on a prospective, going forward, basis. In the first type of appeal, a party who feels aggrieved by a decision by the regulator may ask that an appellate body (usually a court or a tribunal of some sort) reverse the decision in that case. The appellate body, among its other obligations in reviewing the decision of a regulatory agency, must make certain that the regulators neither exceed their authority nor fail to follow policies and processes set by macro policy-makers. It is important to note, however, that this type of review is not to formulate new policy, but merely to assure compliance with existing laws and policies. This form of appeal should be carried out in an independent, transparent, and apolitical manner. The other form of appeal to macro policy-makers, however, is merely to review relevant policy in order to determine whether a policy needs to be altered or supplemented. Because such an appeal can be carried out within the political process, any policy determinations will affect only future matters. In other words, it cannot affect the outcome of specific cases decided by the regulators prior to the re-formulation of basic policy.

Integrity and transparency

Apart from sound principles of decision-making, there is another even more important reason for allowing regulators to decide matters of micro policy. That reason is the transparency and integrity of the decision-making process itself. The integrity of the regulatory process is rooted in many elements, but important among them is the idea that the process be transparent, fair, and independent of politics. As one observer noted, regulators are agents of the state, and not necessarily of the government at the moment. In order to assure the integrity of decision-making, it is vital that the process is exactly as it appears to be. All parties have equal opportunity to access decision-makers and to know what information and arguments the regulators consider while rendering their decisions.

The making of micro policy often arises in connection with individual cases involving specific and discrete financial interests, the process, like the judicial process, must be absolutely transparent and, to the extent possible, divorced from politics. Investors see greater predictability, more dispassionate analysis, and fewer risk variables in the regulatory arena than in a political one. Similarly, consumers in many places have come to the same conclusion, namely that they are better served by having an independent, transparent, apolitical body making key decisions regarding infrastructure than having case-specific matters resolved in a political forum where they are likely to possess less clout than well-funded lobbyists from large companies. The views of political figures may well be considered by regulators as one set of inputs. Such views, however, must be communicated in a transparent, public manner. It should, however, be the regulators, alone, who are responsible for actual decision-making. In short, the process must be internally open and complete.

Regulatory process

Unlike the making of macro policy, which is inherently political, the regulatory process should be free of politics to the extent possible, because it usually involves weighing the interests of specific parties, and making technical judgments regarding the application of broad policy to a specific set of circumstances. It is, therefore, inconsistent with the very basic regulatory concepts of independence, transparency, and depoliticization for regulators to defer to political authorities in rendering their decisions.

It is theoretically possible to construct a relatively transparent mechanism for political consultation by regulators on matters of micro policy. Indeed, political authorities should always have a means of transparently offering their views to regulators. The problem is not the transparent offering of viewpoints, but, rather, the non-transparent bypass of the regulatory processes that seems likely to occur if regulators are not in a position to decide micro policy issues on their own. Parties seeking to advance their own interests will almost inevitably, whenever it suits their interest, seek out political officials to support their point of view. It would, for example, be grossly unfair to have all of the parties in a case present their evidence and arguments to the regulators through the prescribed process while another party to the same proceeding seeks out the clandestine support of a minister or other high political figure in order to secure a favourable decision. Success in such a manoeuvre would render the entire regulatory process in that proceeding a sham. All of the evidence offered, arguments made, processes followed would be meaningless. It is for that very reason that independence of the regulators is, in fact, a critical element of transparency. No process can be deemed to be transparent when the real decision-maker is someone other than whom it is supposed to be under the procedures, or, where the real reasons for a decision remain unrevealed.

Politicization

While perhaps it cannot be said that the motives of regulators are always pure, the discipline imposed by the process can at least compel transparency. The same cannot be said when the process becomes politicized. While the motives of the government in interfering may well be for such legitimate policy reasons as controlling inflation, promoting investment, promoting specific resources, the opportunity of bypassing an established, transparent regulatory process by political officials also opens the door to politicization, corruption and/or de-legitimization. It is important, therefore, as elementary fairness to all parties, for the integrity of the process, and for transparency that the regulators make the decisions themselves, and that any effort by the government or any of its officials to influence the outcome only be carried out in ways that are open and transparent. Certainly, advocating legitimate goals can be done transparently without embarrassment. More importantly, if the

goals being advocated by political authorities are meritorious, then the government is always empowered to change policies prospectively. It need not intervene in the regulatory process in specific cases in order to effectuate policy. Doing so is to effectively alter the rules in the middle of the game. By making policy on a prospective basis only, the integrity of the process is preserved without sacrificing the ability of political authorities to make a policy.

Conclusion

In conclusion, governments must set basic policy, macro policy-making. Filling in the details of that policy, micro policy-making, however, is an inherent part of what regulators have to do in order to carry out their mission. Policy-making by regulators, however, is restricted by two critical factors. The first is that policy made by regulators is subsidiary to government policy and is done only under a delegation of authority from the state. Secondly, policy-making by regulators is incidental to and inherent in their duty to decide specific cases or disputes. That policy-making role is derived entirely from the fact that macro policy cannot be reasonably expected to anticipate all aspects of policy that will evolve for the regulatory process to be fully functional. Gaps will have to be filled in and it is the regulators, with technical expertise and hands-on experience, those are best positioned to accomplish that. Their role in doing so, however, is subject to two checks.

The first is the appellate review that determines if the regulators were acting within their lawful authority, followed policies they were obliged to follow, whether they were acting reasonably, and whether they followed fair and correct procedures. The second check is that the government retains the ability to alter micro policy determinations. In order to safeguard the integrity of the regulatory process, however, it is vital that that power be exercised only on a prospective basis. Recognition of the realities and limits of regulatory policy-making will safeguard the process and allow for a more orderly, transparent, and predictable regulation, both in terms of process and substance.