RARA AVIS?
SEARCHING FOR
REGULATORY
INDEPENDENCE
IN ITS NATURAL
HABITAT

Directorate for Public Governance and Territorial Development
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Searching for regulatory independence in its natural habitat

In conjunction with its Network of Economic Regulators (NER), the OECD set out to understand the nature of regulatory independence and how it thrives—or doesn’t—in a variety of environments.

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The Deepwater Horizon disaster, a major environmental catastrophe in the Gulf of Mexico, and the 2007/2008 financial meltdown whose aftershocks are still reverberating globally, have at least one trait in common: in both crises regulation failed. This is not to say that the principal actors in both catastrophes were mere bystanders. A District Court decision in 2014 found British Petroleum grossly negligent in the Deepwater Horizon disaster. And a handful of banks were instructed to pay out billions of dollars in settlements for their role in the subprime mortgage scandal. Yet, ex post analysis in both cases concluded that, with better regulatory oversight, the disasters could have been prevented. In the case of Deepwater Horizon, flagrant conflicts of interest within the now-defunct Minerals Management Service were cited in which revenue and regulatory priorities were at cross purposes. Investigators concluded that government regulations did not address several key causes of the blowout and regulators lacked the resources and technical expertise to address many of the issues.1 The complex causes of the financial crisis of 2007/2008 included regulatory failures that allowed banks to become “too big to fail” that enabled off-the-balance-sheet activities to go unchecked and permitted banks to undertake short-sighted and excessively risky behaviour.2

Of course, not all regulatory failures have planetary consequences. The excessive downtime of a rail network, electricity rates that favour the energy provider and penalise the public—or conversely, an unstable regulatory environment that discourages capital investment—or toxic waste disposal practices that fly under the radar but put the health of a local community at risk—are all examples in which, somewhere along the way, regulators and those they regulate have failed to protect the public interest.

REGULATORY INDEPENDENCE

Regulators fail when their activities are captured by special interests. To paraphrase a well-known economist, regulators make people do things they wouldn’t otherwise do. Different stakeholders – whether the regulated industry, government, politicians, consumer groups or other interest groups – thus have powerful incentives to influence, or capture, regulatory policies. For example, an electricity rate hike that is justified by regulatory policies may affect the operating or investment costs of the operator, and may face political opposition by stakeholders wishing to make their hay. Equally, the operator may lobby for rate hikes that unnecessarily promote shareholders over consumers. In each case, stakeholders may attempt to influence their regulator. The question is how to limit undue influence in practice and create a strong culture of independence, requiring a mix of formal and informal, de jure and de facto elements, such as mechanisms that protect from undue influence, a strong internal organisational culture; and appropriate working relationships with the government and other stakeholders.3

WHY INDEPENDENCE?

Intuitively, one wants one’s regulators to be independent just as one wants one’s judges and sports referees to be independent. In other words, a regulator’s decisions and activities should be objective, impartial, consistent and expert. More formally, the independence of regulatory agencies is expected to enhance the role of regulation in minimising market failures, with the ultimate aim of effective and efficient public service delivery to citizens and consumers. This takes place via a number of mechanisms. First, by insulating the regulated industry from
AN ANTI-CAPTURE STRATEGY OR 'WHACK-A-MOLE?'

The life of a regulatory agency is fraught with potential entry points for undue influence. These “pinch points” are specific to each phase of the regulatory cycle. Successfully navigating these powerful forces can be accomplished with clear regulatory governance policies addressing such issues as agency finances, staff behaviour, the appointment and removal of leadership, how the agency interacts with political cycles and interaction with the various actors in the regulatory sphere.

The danger of capture is all the more present due to the nature of the relation between the regulator and the regulated. Independence cannot come at the price of accountability or engagement and regulators need to keep their fingers on the pulse of the market through interaction with industry and consumers. While best practices in regulatory governance as defined by the OECD stipulate that regulators should be able to conduct their functions without interference from the executive or legislative body, alignment is also required between the long-term policy goals of the regulator and the broad, strategic national priorities as set by elected representatives in the executive, congress or parliament. Autonomy should be compatible with maintaining helpful feedback loops between the regulator and the executive.

ARE REGULATORS ACHIEVING INDEPENDENCE? THE OECD SOUGHT TO FIND OUT

Recently, the OECD set out to understand how regulatory agencies around the world were organised for independence. It first developed a unique dataset of the formal arrangements for independence (in addition to accountability and scope of action) of regulators across 33 OECD countries, complemented by detailed case studies on holding regulators accountable for their performance. A follow-up study attempted to fill in many of the gaps in our understanding of how de jure independence plays out in the daily life of regulators. The study differs from other research on independence which tends to focus on institutional arrangements. In the study, published under the title ‘Being an Independent Regulator’ (OECD, 2016), the chief concern is how and how well regulators are configured to deal with the day-in and day-out challenges of independence. Questionnaires were submitted querying regulators on a number of dimensions of de jure and de facto independence. Forty-eight regulators from around the world participated, representing institutional arrangements including independent regulatory institutions, ministerial regulators and single- and multi-sector regulators. The following pages present some of the top-line results.

HOW MINISTRIES MAKE THEIR IDEAS CLEAR

How the executive communicates to the regulator is of course of major significance in establishing the regulator’s autonomy, no matter whether the agency sits within or outside the Ministry. Formal processes that are made in the light of day and are available for public scrutiny are preferable. When executive issues statements of their expectations, the extent of political interference can be determined by whether the statement provides specific marching orders or whether it is a loose policy framework leaving the regulator with the freedom to determine how it will meet the policy goals. Typically, these statements are relatively short and lay out some government expectations on process. While informal exchanges can take place via the media and in briefings and exchanges at the staff level, a formal statement of expectations issued by the executive renders the intentions of the executive clear and transparent to all stakeholders. The statement of expectation can even be used by the executive to express a commitment to the principles of independence as is the case in the Australian government’s Statement of Expectations (SoE) delivered to the Australian Competition and Consumer Commission (ACCC).

Twelve regulators indicated that they receive some sort of expectation/policy statement of which eight indicated that such statements are binding or influence their actions. Three regulators respond to formal expectations through a statement of intent. However, among the forty-eight respondents to the survey, thirty-six regulators did not receive formal statements of intent regarding the conduct of the regulator’s activities.

Among the 48 respondents, 75% of regulators did not receive formal statements of intent regarding the conduct of the regulator’s activities.

Beyond these formal statements, mechanisms through which the executive can openly express its preferences tend to be limited due to the obvious risk of undue influence. For most regulators, the government is limited to expressing preferences through participation in public consultations where its input theoretically carries the same weight as other stakeholders. Thirty of the forty-eight regulators surveyed restrict the expression of the executive’s preferences to public consultations. A number of regulators mentioned that, while government is able to participate in public consultations, it almost never does in practice. Regulators, in turn, are able to make recommendations or issue opinions on draft legislation or policy documents prepared by the government. For some regulators this role is part of their formal mandate and even required by law in certain cases.

**Two thirds of the regulators surveyed restricted the expression of the executive’s preferences to public consultations.**

Five regulators reported that their ministries use the media to make public statements. This can expose the regulatory environment to heightened political and media scrutiny. At the same time, regulators can also use the media to respond to attempts to unduly influence their decisions. Ultimately, the media can work both ways, if the media landscape is sufficiently open and pluralistic.

**Informal contacts are mentioned by four regulators. At these contacts escape any public scrutiny, they could potentially be occasions for undue pressure and influence.**

Only eight regulators reported that nominations were made by a selection committee.

**Once named, safeguards such as fixed terms, clear rules for dismissing board members, policies for managing conflict CHOOSING A DIRECTOR OR BOARD**

The nomination and appointment process of the director or board is a critical juncture where perceptions of undue proximity could be strong. These perceptions can be particularly prevalent if the choice of the nominee happens inside a “black box”. The use of independent search committees can mitigate these perceptions and ensure that the nomination process is based primarily on competence. Only eight regulators reported that nominations were made by a selection committee. Three reported that nominations were made by an external selection committee. Twenty regulators reported that the executive is solely responsible for the nomination of the board/head. The appointment process appears more transparent than the nomination process. For eight regulators, nominees were vetted by parliament prior to appointment.

For most regulators surveyed, the board or head of the organisation is directly appointed by the executive branch of government. In fifteen per cent of cases the appointment is made by parliament.

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of interest and cooling-off periods can minimise the opportunities for undue pressure and dupel perceptions of cosiness with industry or government.

OVERTURNING REGULATOR DECISIONS

98% of the regulators surveyed indicated that the executive is unable to overturn individual decisions that they make, with appeals settled through the judiciary.

ENGAGING WITH STAKEHOLDERS

The consultation process has been likened to Japanese Kabuki theatre—a “highly stylised process for displaying in a formal way the essence of something which in real life takes place in other venues.” The idea infers that the real business of defining regulation may be “off mic”, in informal consultations, often between the regulator and the regulated industry. A well-known study of the Environmental Protection Agency in the United States determined that, prior to proposed rules on hazardous air pollutants, industry groups engaged in 170 times more informal communications with the regulator than public interest players.¹ There is significant potential for stakeholder consultation to be hijacked by powerful special interests. Because of this, all regulators rely on some formal process for collecting inputs. This can include the issuance of consultation papers to be followed by online consultations and/or public hearings. A number of regulators make public the results of public consultation on their websites. Only five out of the forty-eight regulators surveyed have permanent bodies to facilitate regular exchanges with industry. These bodies serve a two-way function: they can be public consultation platforms that contribute to development of regulations or decisions, and they can provide a channel for the transfer of information and data on the evolution of the sector from industry to the regulator.

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Some regulators proactively attempt to involve more stakeholders in the process by reaching out to less powerful users and consumers. Many regulators have also intensified their communication activities to explain the issues at stake on a particular decision.

MANAGING THE STAFF ECOSYSTEM

Regulatory agency staff represent the “stable core of the agency, with employment periods generally longer than board members or directors. Because agency staff have the greatest amount of day-to-day contact with the regulated industry, instilling a culture of independence is essential but means taking an employee lifecycle approach. This starts with offering employment packages designed to recruit and retain highly professional staff. A majority of regulators surveyed—twenty-seven—follow the governmental remuneration policy. Fourteen regulators may set their own salary policy which nevertheless remains subject to public sector spending reviews. Seven regulators follow the government remuneration policy but have some leeway in terms of bonuses and augmenting the basic civil service salary. After recruitment, twenty-six regulators have codes of ethics promoting the values of objectivity and independence among staff. Sixteen regulators have created specific codes of ethics while nine use the civil service code. Four regulators have adapted the existing code with a special section on regulator-specific issues.

A majority of regulators surveyed—27—follow the governmental remuneration policy.

Attrition of staff to the regulated industry with the promise of higher salaries and bonuses is inevitable, particularly amongst senior level and some highly-specialised staff. Being able to set competitive salaries is often cited as one of the safeguards against capture (through revolving doors between regulator and the regulated). However, over sixty per cent of the regulators signalled no particular problem in attracting and retaining their professional staff. The majority of those who did signal difficulties in staff recruitment and retention were limited to the government salary schedule although some regulators could set their own remuneration policies subject to government review.

Over 60% of the regulators signalled no particular problem in attracting and retaining their professional staff.

Twelve regulators have cooling-off periods of one to three years, restricting staff from employment in the regulated industry upon leaving. For six regulators, staff is subject to the civil service-wide policy protecting against conflicts of interest. Eighteen regulators have no restrictions whatsoever concerning employment prior to or after employment. By contrast, twenty-four regulators have restrictions on the kind of employment board members can seek at the end of their appointment, setting cooling off periods from between one and two years.

FUNDING

How the regulator is funded (and whether funding is adequate) will determine the extent to which the regulator can carry out its mandate and exercise its autonomy. How funding needs are determined, decided upon and the extent to which the regulator can manage these funds autonomously, all contribute to creating a culture of independence.

Half of the regulators consulted are funded by levies on the regulated industry (with some revenue coming from licenses and fines). Eleven regulators are funded through a blend of fees and general revenues although the lion’s share came from fees. These funds are generally appropriated through the national budget. This process guarantees transparency and accountability of regulators to citizens that can strengthen (rather than undermine) their independence. In the case of three respondents surveyed, fees were collected directly by the regulator.

Among regulators funded at least in part by fees, nineteen are responsible for setting the fees or making a fee proposal to the ministry or cabinet for formal approval. Eight regulators report that the government sets the fee without a formal submission from the regulator. Of course there is always the danger of undue influence when the minister or the cabinet sets the fees. One regulator saw its fees reduced by the ministry from 0.2% to 0.17% during the financial crisis. Other regulators have established a structured and consultative process to estimate the costs of the regulator’s activities and therefore the charges for the regulated industry.

Among regulators that are funded in part or fully by general revenues, eleven regulators receive annual appropriations while two negotiate their appropriations over a three to four-year period. Single-year, as opposed to multi-year, budgets raise more opportunities for questioning the regulator’s budget or reducing it, a possible source of undue influence. Despite higher risks to independence, 88% of regulators receive an annual budget appropriation.

Despite higher risks to independence, 88% of regulators receive an annual as opposed to a multi-annual budget appropriation.

REGULATORY PERFORMANCE

—THE NEW PARADIGM?

Regulatory independence is not an end in itself, and having protection from undue influence should be seen as the best guarantee of ensuring effective and efficient public service delivery by the different market players. Developing a culture of independence is just another way of saying performance. Citizens probably spend little time worrying about regulatory institutional arrangements and the relation of the regulator to the ministry. They might however react when cries of unethical behaviour fill the airwaves, when network services are overpriced, or when the trains don’t run on time—not to mention the large, systemic shocks that alter life trajectories. Ensuring performance while engaging fully with the pressures from all sides requires the existence of essential governance structures that help a culture of independence flourish. It’s the best way of preventing tomorrow’s regulatory failures, big or small.

¹http://house.majority.org/commerce/pdfs/27/deep_water_summary_to_president.pdf
²http://www.tobinproject.org/sites/tobinproject.org/files/assets/New_Perspectives_Ch1_Stiglitz.pdf
³Slighiot, see above
⁴Slighiot, see above
⁵Thecher, 2003, Giarani and Maggetti, 2010
⁶Governance of Regulators 2010, p. 30
⁷OECD Best Practice Principles on the Governance of Regulators (2014)
Further reading:

> OECD work on Regulatory Policy
> Regulatory independence on GOV web
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