



# THE REGULATION OF PUBLIC SERVICES IN OECD COUNTRIES: ISSUES FOR DISCUSSION

NOV 2007

## TABLE OF CONTENTS

Regulatory Rules.....	4
Controlling Market Entry .....	4
Controlling Prices.....	4
Controlling Quality .....	5
Regulatory Bodies.....	5
Expertise.....	5
Independence.....	5
Levels of Government.....	6
Regulatory Processes .....	6
The Relevance of OECD practices for China .....	7
The Access Priority .....	7
Affordability Constraints.....	7
Administrative and Regulatory Capacity .....	7
Economic and Regulatory Risk.....	7
Putting OECD Practices to Use .....	8

## **THE REGULATION OF PUBLIC SERVICES IN OECD COUNTRIES: ISSUES FOR DISCUSSION**

1. For much of the last century, OECD governments typically provided public services, particularly those related to infrastructure, through state-owned monopolies, mandated to provide “universal service”, often within the framework of a system of uniform national tariffs. This approach was intended to take advantage of economies of scale and scope in “naturally” monopolistic activities. Likewise, the approach aimed at providing access to stable funding for major investments and to meet the goal of universal access through a system of cross-subsidies between high- and low-income users.

2. Results with this approach were mixed, and governments across the OECD developed a number of new policy responses to confront the problem of how to provide efficient, reliable, safe and affordable public services. Governments across the OECD have used a number of regulatory rules, bodies and processes in a variety of ways to provide public services to citizen. Analysis of this experience provides a rich body of knowledge which developing countries such as China could use to develop policy responses that suit their own situation and context. This note outlines a number of issues for discussion which the Group on Regulatory Policy may wish to consider in its deliberations. It supplements SG/GRP(2007)10, which provided a detailed review of the regulatory framework for water, waste management and public transport services in a number of OECD countries.

3. The aim of this paper is to promote discussion of the implications of implementing in China the regulatory approaches adopted by OECD countries for the provision of infrastructure services. This is preliminary and exploratory work. The OECD Regulatory Reform Review on China is not yet complete, and as such final conclusions have not been drawn for China to improve its regulatory framework to secure future investment in and the efficient delivery of infrastructure services. However, even when the work is complete it would in fact be overly ambitious, and analytically misguided, to hope to identify a single correct model that will address the challenges for multiple sectors. For example each of the sectors of the provision of water and sewage services, waste management and public transport have different structural and market characteristics which require different approaches. In addition, the stage of economic development for the provision of these services across China is very uneven, both within the sectors and geographically.

4. It is however worthwhile to consider the approaches undertaken by OECD countries in regulating infrastructure services and the rationale for those approaches as a starting point for assessing possible solutions in China. A strong argument can be made that the economic issues faced by OECD countries in addressing natural monopoly provision of infrastructure are *a priori* likely to be similar in China. Even if an analysis of the situational aspects of China at its current stage of development, available resources, or political situation requires careful evaluation of whether the solutions can be readily applied or adapted to suit China’s needs.

5. This short issues paper draws on SG/GRP(2007)10 and discusses aspects of the regulation of public infrastructure services in OECD countries. Its focus is on providing an introduction to the economic and regulatory issues surrounding the delivery of, and investment in, infrastructure services. In particular the way in which OECD countries have established market and regulatory frameworks to manage natural monopolies through the unbundling of infrastructure and introducing elements of contestability in infrastructure service delivery, and the creation of independent regulatory roles.

6. The paper does not aim to give a comprehensive account of all elements of the frameworks employed by OECD countries across all sectors, but it attempts to encourage a discussion of the salient aspects of regulatory frameworks that have been effective in OECD countries and may be applicable, with or without adaptation, to China in the future.

7. To this end delegates are asked to consider the following questions:

- What are the implications for the models of regulation adopted in OECD countries?
- Does China's stage of development necessarily preclude certain regulatory frameworks? Is the approach adopted by OECD countries dependant on a certain level of development for success? How should approaches be adapted?
- In China what are the options for promoting consumer representation to advocate the provision of consumer benefits in service delivery?
- To what extent does China's political administration preclude the establishment of independent regulation?
- Is political independence central to regulation of infrastructure services, or can the aims be achieved by establishing a separation of powers among the administration?

### **The Regulatory Framework for Infrastructure Services**

8. The overall regulatory framework governing infrastructure sectors is a key lever which policy makers across the OECD use to provide efficient, reliable, safe and affordable public services. In this context, the regulatory system can be defined to include three distinct but closely related elements:

- a set of regulatory rules defining permissible conduct that will be embodied in laws, licenses, contracts or similar instruments;
- one or more regulatory bodies responsible for administering and enforcing those rules; and
- a set of regulatory processes undertaken or managed by regulatory bodies to discharge their responsibilities.

## **Regulatory Rules**

9. Regulatory rules in infrastructure services typically have three main focuses: controlling market entry, controlling prices, and controlling service quality. Over the last two decades, experience in OECD countries has highlighted the many costs associated with over regulation. This has led to a growing consensus that governments should intervene sparingly and with care. At the general level, constraints in administrative and regulatory capacity and other adverse features of the regulatory environment will reduce the likelihood that regulation will achieve its intended results, and increase the likelihood of unintended costs. This affects the basic calculus of whether the expected benefits of intervention will exceed the likely costs, and should thus lead to much more modest regulatory ambitions. There are also implications for each of the main forms of regulatory intervention.

### ***Controlling Market Entry***

10. Traditionally, most infrastructure services were assumed to involve “natural” monopolies, in the sense that a single firm could supply the market at lower cost than two or more firms. Advances in technology and in economic thinking have challenged the notion of natural monopoly. This resulted in new policies and regulations that expanded opportunities for more competitive delivery of infrastructure services. This has led to efforts to relax or eliminate regulatory barriers to entry and to actively facilitate competition by restructuring existing enterprises. Strategies of this kind are now widely adopted in transport, telecommunications, energy, and water services.

11. In markets dominated by an incumbent utility, unleashing substantial competition has required the incumbent to undergo pro-competitive restructuring. OECD countries have traditionally used both horizontal unbundling — such as separating an existing electricity enterprise into several generation companies — and vertical unbundling — such as separating electricity generation, transmission, and distribution activities — to provide new opportunities for competition and market entry. A deliberate focus on expanding market access requires regulators to carefully scrutinise exclusivity provisions and other regulatory barriers to entry.

12. Regulatory initiatives of this kind have often created a market or led to an increase of competition in the market. This, in turn, spurred both cost reductions and a more aggressive pursuit of new customers, including those who lacked access to services. Amongst other benefits, more liberalised approaches reduce demands on more intensive price and quality regulation.

### ***Controlling Prices***

13. The regulation of prices by the state is traditionally motivated by concerns over possible abuse of the monopolies created or sanctioned by the state, as well as the desire to use infrastructure prices to meet various social objectives. But experience in OECD countries has shown that price regulation is technically demanding, particularly for those countries with weak institutional capacity. Regulators need information on utility costs, consumer characteristics, and price responsiveness to set appropriate prices; they need additional institutional capacity to enforce price regulations. Of potentially greater concern, infrastructure prices tend to be politically sensitive, and regulation has been vulnerable to short-term political considerations that are not consistent with the longer-term interests of the sector or its customers.

14. Given the problems associated with traditional pricing approaches, a number of OECD countries have relaxed intensive price regulation and relied more heavily on competitive disciplines imposed by new market participants. In establishing new price regulations, OECD countries have had to ascertain the extent

of the market to be liberalised as well as the extent to which control are relaxed. For a number of countries, liberalising service prices has face resistance. For some countries, new entry was slow and uneven thus limiting the size of the new market. In case where markets did develop, price differentiation often provoked concern about unequal treatment. No less important, governments and regulators often found it difficult to resist populist urges to intervene to “protect” consumers from paying what are perceived to be “excessive” prices.

### ***Controlling Quality***

15. OECD countries regulate service quality based on concerns over environmental, safety, health or other consumer protection concerns. Likewise controlling quality has also been required in order to avoid the risk of price regulation being undermined.

16. For many countries, expanding the role of competition has changed the role of quality regulation and required a more dynamic, output focused approach. For instance, where regulation of quality is justified, setting standards at the appropriate level has proven to be essential. Policy makers have had to recognise that higher standards result in higher cost and thus prices. Likewise the form of intervention has also changed, attempting to regulate outputs or outcomes instead of inputs, which has proven to reduce firms’ incentives to search for and apply lower cost ways for achieving the required result.

### **Regulatory Bodies**

17. Most regulatory systems for infrastructure in OECD countries include some agency or agencies charged with administering the rules. There is no standard institutional model across the OECD for these agencies. The optimal characteristics of individual agencies have proven to depend on the tasks that they have been mandated to perform and the environment in which they operate. Despite these differences, these agencies have a number of characteristic features; the expertise required of regulators, notions of “independence”, and the optimal location of regulatory agencies among levels of government.

### ***Expertise***

18. The expertise required of regulators depends on their specific responsibilities. In most OECD countries, this includes the ability to administer price regulation, even if this is limited to regulation of interconnection to networks. There will also be a need to monitor and enforce compliance to quality standards.

19. For those countries that have taken a more liberal approach to market entry, price and quality control, the burden on regulators has changed. These agencies have tended to shift their focus from supervising a single utility and its existing customers to overseeing a larger number of more diverse suppliers adopting different technologies and business strategies to serve customers with more diverse service packages.

### ***Independence***

20. One of the key trends across the OECD over the last 30 years is the emergence of the independent regulator. Notions of regulatory “independence” comprise two main ideas. First, that the regulator operates at arm’s length from regulated firms—to reduce concerns over ‘capture’ or other forms of undue influence. Second, that the regulator operate at arm’s length from political authorities, in order to reduce the regulatory risks faced by investors, and hence the cost of investment capital.

21. The objective of ensuring that regulators operate at arm's length from regulated firms can be particularly important under a more liberal market environment. In all OECD countries, a key task for the regulator is to maintain competitive neutrality or a "level playing field." This is all but impossible if regulatory agencies have an interest in the success of an individual firm. Failure to meet this requirement can have a profound effect on the legitimacy of the regulatory system, and increase the risk of political backlash against more liberal reform approaches.

22. The importance of ensuring regulators operate at arm's length from political authorities will depend on the responsibilities entrusted to the regulator. Insofar as the regulator controls prices or other politically sensitive issues, insulation from short-term political pressures will be important to reduce the risks faced by investors. Pricing may also be important to induce responsible use of resources such as water. Pragmatically, however, establishing a fully "independent" regulator has been difficult in many OECD countries, even in countries with a strong tradition of independent public institutions.

### ***Levels of Government***

23. In OECD countries, regulatory bodies responsible for infrastructure services are located at supra-national, national and various sub-national levels of government. There is general consensus about the main factors that should be considered in deciding on the optimal location, although there can be difficult tradeoffs involved. Factors supporting decentralisation to lower tiers of government include: greater proximity to users, which enables approaches to be adapted to local preferences and conditions; greater proximity to service providers, which facilitates effective monitoring; and enhanced opportunities to innovate. Factors supporting more centralised approaches include economies of scale in administration; improved ability to deal with spillovers that cut across jurisdictional boundaries; and reduced vulnerability to "capture" by regulated firms and by local political authorities. Weighing these factors in the context of local constitutional and political realities may lead to different results in different societies.

24. A number of pragmatically choices have been made by a number of countries in order to divide regulatory responsibilities. For instance, a central agency can be responsible for overseeing the market as a whole and dealing with inter-connection and pricing issues for the dominant utility. More decentralised actors - such as municipal governments or NGOs - have responsible for monitoring performance of individual service providers, dealing with customer complaints that cannot be resolved directly between the supplier and its customers, and helping to manage relations with local communities. This type of joint responsibility has implied a major change in the roles played by these entities, with implications for capacity-building efforts.

### **Regulatory Processes**

25. OECD countries have designed a number of regulatory processes in order to better engage stakeholders. These processes have taken account of a range of factors, including: the effectiveness in reflecting a full range of relevant views and perspectives; accessibility to parties in remote locations or with limited sophistication; safeguards associated with being seen to be "too close" to any particular interest; and the impact on the costs and delays associated with regulatory decision-making. Countries have developed diverse approaches including formal regulatory hearings of the kind common in the United States, specialist consultative or advisory committees – such as those established in the water sector in the United Kingdom- as well as a range of less formal approaches. Public education has become an important part of the new regulatory agenda. A key feature of all modern approaches is transparency—to ensure accountability, to provide assurance to stakeholders, and to increase the predictability and perceived fairness of decisions.

## **The Relevance of OECD practices for China**

26. The success of policy measures intended to expand access to infrastructure services depends on how well it is adapted to the particular implementation environment. A central consideration is the degree to which the experience of OECD countries will be of relevance to the Chinese government as it develops its own regulatory framework for public services. There are four areas where the implementing environment is considerably different between OECD countries and China. These differences may well limit the application of OECD policies and practices for public services policy in China.

### ***The Access Priority***

27. In OECD countries, the overwhelming majority of citizens have access to modern infrastructure services, and policy and regulatory strategy focuses on overseeing established industries and customer relationships. In contrast, large proportions of Chinese population lack access to any formal infrastructure services. The effectiveness of the regulatory framework for service delivery in China will have to be tested against the goal of expanding access to services, rather than just improving the convenience of those who already have service.

### ***Affordability Constraints***

28. The prices for public services are sensitive in all country, both in OECD and elsewhere. But Chinese citizens face real constraints on their ability to pay, which affect both access and the consumption possibilities of those with access. Any framework to improve services in China will have to place particular emphasis on affordability concerns, and thus strive to minimise costs, including the costs imposed by the policy intervention itself.

### ***Administrative and Regulatory Capacity***

29. Most OECD countries have well-established administrative and regulatory capacity, including a pool of qualified legal and economic professionals and the physical infrastructure to interact effectively with regulated entities. China is not so well endowed with administrative and regulatory capacity that are under-developed, particularly outside Beijing. Poor transport and communication networks exacerbate the difficulties faced by regulators in monitoring the behaviour of firms and interacting effectively with consumers and other stakeholders. Although there has been marked progress, anecdotal evidence indicates that weak administrative and regulatory capacity co-exists with corruption concerns. In such environments, there is the risk that regulation can be used to create rent-seeking opportunities for officials rather than to pursue legitimate public purposes.

### ***Economic and Regulatory Risk***

30. Most OECD countries have relatively stable political systems and reasonably independent and trusted judiciaries. They have also established long track records in treating private investors equitably, and so are perceived by investors to involve relatively little political and regulatory risk. In contrast, China is still transforming its economic and judicial institutions. It will take additional time to establish a track record in protecting private and intellectual property rights. As a result, investors may well perceive high political risks associated with infrastructure investments, which in the regulatory sphere usually translates into particular sensitivity about regulatory discretion.

### **Putting OECD Practices to Use**

31. Changing traditional ways of doing things is never easy – whether on the relatively modest scale of making stakeholder more active in decisions about how to improve their infrastructure services or on the grander scale of overhauling regulatory policies to enable competition in sectors that have long-standing state-owned monopolies. To weather the inevitable resistance to change, the Chinese governments will need a strong commitment to improving outcomes for public service delivery. As in any area of policy innovation, much can be gained by the Chinese government from a concerted effort to draw lessons from reform experiences in OECD countries. The success of any policy will depend ultimately on careful adaptation to China's priorities and conditions.