

# The Principles of Economic Regulation and their Application



**Presentation to: Department of Water Affairs Roundtable Discussions  
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## OUTLINE

1. Introduction
2. Principles of Economic Regulation and their application
3. Conclusion

## Introduction

- Why regulate?
  - Where there is no competition or inadequate competition
  - To mimic competition and exact efficiencies
- What is regulated
  - Natural monopolies mainly water, electricity, pipelines, and telecommunications = utilities
  - Characterized by high barriers to entry, e.g. high upfront capital outlay; the nature of the market structure is such that only one player can operate (avoid wasteful duplication)

## **Introduction – Broad Principles or Specific Rules?**

- Legislation/Acts underpinning regulation sets out broad regulatory principles – e.g., “balance” various interests, act in public interest, not in contradiction with published government policy, etc.
- Secondary legislation (i.e., Regulations issued in terms of the legislation/ Acts), sometimes becomes more specific but often not to the degree required
- Hence regulatory principles often require interpretation by regulators or courts
- Principles also provide for regulatory discretion

## **Introduction – Broad Principles or Specific Rules?**

- Rules on the other hand are more specific
- Precise rules lead to decisions with high predictability
- There are trade-offs in using, on the one hand, broader principles with inbuilt flexibility versus precise rules with high predictability, on the other
- Whichever approach, ultimately what is required is regulatory certainty to signal long-term commitment by the regulators to attract investment in the sector

## **Economic Regulation Principles**

- Clarity of Roles (Policy making versus Regulation)
- Independence
  - Authority
  - Accountability
- Integrity, Transparency and Public Participation
- Predictability
- Efficiency
- Appropriate Institutional Operating Framework

## Regulatory Principles – Clarity of Roles

- Regulators are not policy makers; they are implementers of policy
- Policy signals the intent of government with respect to regulation
- Policy clarifies the roles and responsibilities of the regulator in implementing policy
- Clarity of roles :-
  - Avoid overlap/duplication
  - Reduce intra agency conflict
  - Accountability

## Regulatory Principles – Clarity of Roles

- The South African White Paper on Energy Policy (1998), Policy Objective No. 2 provided for the creation for Energy Regulator:-  
*“Improving energy governance: - The focus will be the clarification of roles and responsibilities of the various governance institutions, such as the Energy Regulator, Government departments and other spheres of government, as well as consultation with stakeholders on the formulation and implementation of energy policies”*
- The mandate of the regulator is then further spelt out in the enabling legislation



## Regulatory Principles - Independence

- Regulatory independence is a durable balance between authority and accountability
- **Authority** requires that a regulator have the authority to make independent decisions consistent with its designated mandate
- **Accountability** to the executive, legislature, judiciary for oversight of the regulator to ensure that the regulator performs its assigned tasks in the public good. A regulatory body is accountable for their decision in a court of law if taken for review, and accountability on the management of its financial affairs

## Regulatory Principles – Integrity and Transparency

- Code of conduct governing the behaviour of decision makers should be in place so as to preclude improprieties or any conduct appearing to be improper
- *Ex-parte* rules that govern decision-makers' communication during decision making period
- Administratively fair and just procedures that allow for public participation
- Reasons for decision in writing; decisions based on facts and evidence, available for public inspection

## Regulatory Principles – Predicable

- Provide reasonable, certainty as to the principles and rules that will be followed within the overall regulatory framework
  - Changes should occur only after extensive public consultation and notice
  - Preferable to introduce changes gradually (e.g. EPP phase in over 5 yrs)
  - Prospective (rather than retroactive) application of changes
  - Set out the procedure/ process by which the basic regulatory framework can be changed

## **Regulatory Principles – Efficiency**

- Requirements for all new regulation to pass an economic cost-benefit test to prevent inefficient regulations being implemented
- Regulatory intervention should therefore be the minimum necessary to remedy the problem being addressed and should be undertaken only if the likely benefits outweigh the expected economic and social costs
- Avoid imposing unnecessary regulatory burden on the utilities

## Regulatory Principles – Institutional Characteristics

- Regulatory body must be able to consistently perform professionally, competently, and thoroughly :-
  - Competent staff and commensurate remuneration competitive with what is available at regulated utilities
  - Able to retain external experts/consultants when needed
  - Appointment that insulates regulator from short-term political pressures
  - Budget to execute mandate

## Conclusion – Principles into rules

- The risk arising from using mainly broad regulatory principles is that it gives too much discretion to regulators and reduces certainty
- Some rules, in addition to broad principles, are required to provide greater transparency and predictability to regulated utilities and consumers.
- Rules will give more specifics on:-
  - the role of information and accounting rules
  - affordability and tariff design issues
  - determining efficient prudent costs=efficiency requirements
  - the choice of the length of the price control period

**END**

**Thank You**

## Summary

- Broad principles can be advantageous in some circumstances - especially if the decision maker is highly competent, experienced, and unbiased.
- On the other hand precise rules have advantages:-
  - they can provide greater certainty and predictability and aid in creating credible commitment;
  - they give more consistent treatment and greater fairness;
  - they provide more constraints on political influence;
  - they facilitate appeals;
  - they might be preferred if the decision making body is in a start-up stage and in the process of building up its capacity
- A balance is needed - one that is optimal for a specific context



## **Role of NERSA: Legal Basis and Mandate**

- NERSA decision-making and public participatory processes are conducted under the Promotion of Administrative Justice Act, 2000 (Act No. 3 of 2000) (PAJA)
- NERSA determines how to treat access to information under the Promotion of Access to Information Act, 2000 (Act No. 2 of 2000) (PAIA)
- NERSA's funding is through levies paid by the regulated entities under the three industries' respective Levies Acts.
- NERSA conducts its financial affairs in accordance with the Public Finance Management Act, 1999 (Act No. 1 of 1999) (PFMA)