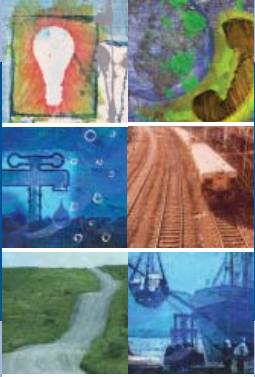


WORKING PAPER
NO. 5



Outsourcing Regulation

When Does It Make Sense and How Do We Best Manage It?

Sophie Trémolet

HELPING TO ELIMINATE
POVERTY THROUGH
PRIVATE INVOLVEMENT
IN INFRASTRUCTURE

WORKING PAPER NO. 5, 2007

Outsourcing Regulation When Does It Make Sense and How Do We Best Manage It?

Sophie Trémolet

Public-Private Infrastructure Advisory Facility

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FOREWORD

This publication is the fruit of the collaboration and support to the **African Forum for Utility Regulators (AFUR)** by the **Public-Private Infrastructure Advisory Facility (PPIAF)**. Since the formal launch of AFUR in 2002, it has become the practice that the PPIAF along with the World Bank commission regulatory studies that are based on AFUR's Annual Conference theme. This current collection is based on papers jointly commissioned and sponsored by both PPIAF and AFUR for the 3rd Annual Conference and General Assembly of AFUR. The theme for this conference is- **Regulatory Governance: Exploring Innovative and Hybrid Models**.

The AFUR Conference took place from 15 – 16 March 2006, in the midst of other AFUR activities organized from 11 – 17 March 2006, in Windhoek, Namibia.

During the Conference, Panelists, whose presentations could be found on the AFUR website (www.afurnet.org), enriched the debates, with country and sector experiences on the issues and challenges of regulating the telecommunications, water and electricity industries. In essence, regulation in Africa remains relatively very young, and is an effective instrument, if applied correctly for advancing affordable access to quality service from the utilities by the vast majority of the continent's people, whilst ensuring that the investor gets a fair return on investments. This collection is a first in the series of publications that AFUR intends to publish. In this regard, I must extend my appreciation to the PPIAF for making this possible. In the same vein, AFUR appreciates the contributions of the consultants whose papers feature in this collection.

AFUR aims to establish and foster co-operation amongst utility regulators on the African continent in support of Africa's growth and socio-economic development. AFUR's primary focus is on issues pertaining to the regulation of infrastructure (energy, communications, water and sanitation as well as transport sectors). The participants at the 3rd AFUR Conference were Chairpersons, Commissioners, CEOs and Senior Executives of African Regulatory organizations. Also present at this conference were policy makers, development partners and utility operators, consumer groups and large consumers as well as consultants. In the quest to further develop and strengthen regulatory institutions on the continent, I hope regulators will find this collection very useful.

Smunda Mokoena

AFUR Chairperson

1.

Introduction

Over the past decade, about 200 regulatory bodies have been established in some 130 countries to regulate services such as telecommunications, water, and electricity. In sub-Saharan Africa as elsewhere, administering regulatory functions is a complex and demanding task, in both technical and political dimensions. In countries emerging from social strife and with fledgling institutions, it may be extremely difficult to set up regulatory institutions with adequate degrees of independence, let alone competence and legitimacy. For different reasons, policy makers and regulators consider outsourcing regulation at various stages of the regulatory cycle.

Outsourcing regulatory functions or tasks can play a significant role in improving the effectiveness of institutions in charge of utility regulation, be they independent regulatory agencies or other types of institutions (including line ministries or contract supervision units set up at the level of the contract). The focus of this note is on outsourcing regulatory functions, to understand when it makes sense and how it can be best managed. For illustration purposes, the note contains references to a World Bank survey of outsourcing practices by existing regulators that was conducted in 2004; results were received from 51 regulation agencies throughout the world. Full survey results can be found in Trémolet, Shukla, and Venton (2004). Additional discussion of outsourcing as a means to tackle human and financial resource constraints for regulation is contained in Trémolet and Shah (2005), which also contains results of an extensive survey of regulators.

2.

What Does Outsourcing Utility Regulation Entail?

Outsourcing of utility regulation is defined as the use by a regulator of an external contractor, instead of its own employees, to perform certain regulatory tasks or function(s) (a detailed list of regulatory tasks and functions is presented in Annex A). Outsourcing is usually done on a temporary or transitional basis. External contractors can be private consultants, individuals, universities, other regulators (in country or outside, including at regional level), or NGOs.

Regional groupings are particularly important sources of external support, as they can provide, in addition to external advice, an informal support network and create peer pressure to improve regulation. Examples of such regional groupings in Africa include the African Forum for Utility Regulation (AFUR, www.afurnet.org) or the Regional Electricity Regulators Association of Southern Africa (RERA, <http://www.rerasadc.com/>). The role of such regional forums is particularly developed in the telecommunications sector in the Caribbean, where the Eastern Caribbean Telecommunications Authority (ECTEL, <http://www.ectel.info/>) is playing a significant role in favor of regulation harmonization at the regional level (see Box 1).

Box 1. ECTEL: Pooling Regional Resources for Telecommunications Regulation in the Caribbean

ECTEL is the regional telecommunication regulator for five Eastern Caribbean states: the Commonwealth of Dominica; Grenada; Saint Christopher and Nevis; Saint Lucia; and Saint Vincent and the Grenadines. ECTEL acts as a shared regulatory body for each of the member countries and is the regional telecommunication regulator for the Organization of Eastern Caribbean States (OECS) region. As telecom markets opened up in the region and new services were introduced, there was a vital need for a strong regulatory system. ECTEL was expected to match this need by harmonizing the regional telecom framework and carrying out (essential but expensive) technical and economic studies, thereby reducing the fixed cost burden on national regulatory agencies that are too small to efficiently regulate the sector. ECTEL's role is split between activities that it carries out itself and guidance that it provides to the Contracting States. ECTEL is specifically responsible for a number of activities, such as preparing and maintaining a harmonized radio plan, designing and operating tender procedures for individual licenses, reviewing applications for licenses, and coordinating with other organizations. However, the vast majority of its role is to provide guidance to the Contracting States, including policy advice, recommendations for licensing (including terms and conditions, policy, and fee structures), and guidance on technical standards. The organization is funded through budgetary transfers from member countries, linked to the royalties the countries receive for the use of radio spectrum.

Source: Trémolet, Shukla, and Venton (2004).

3.

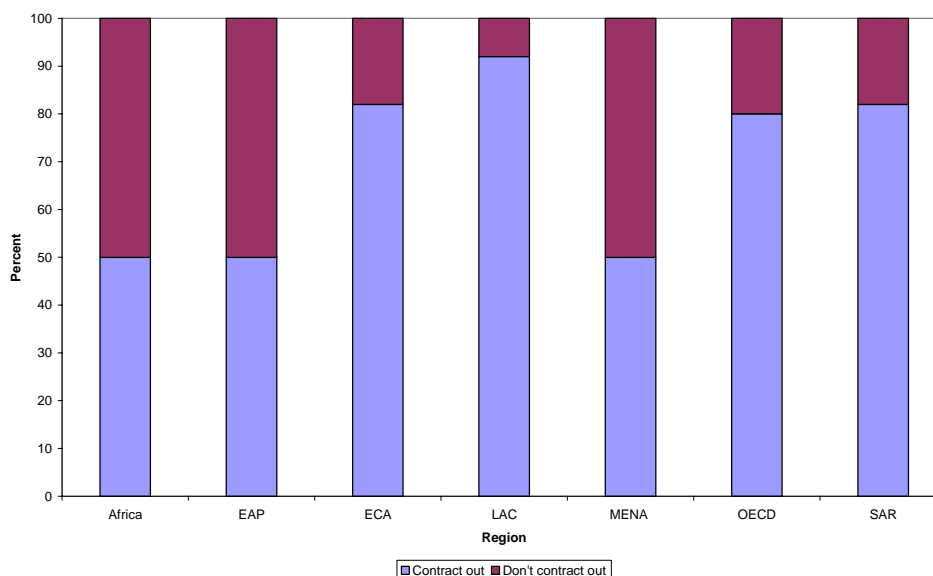
What is the Current Practice ?

Public bodies and private companies are permanently confronted with the decision of whether they should make (produce internally) or buy (contract out) products and services. Regulation as an exercise of public authority is no exception.

According to the results of the World Bank survey on contracting-out practices, it appeared that nearly all regulators outsource, in developed and developing countries alike. The survey showed that most regulators (75 percent of survey sample) engage external parties in the administration of regulatory tasks and plan to continue to do so in the future. Of those regulators that outsource, 61 percent rated results from outsourcing as good whereas 39 percent said it was average. Regulators also dedicated a considerable share of their annual budgets (over 20 percent for 33 percent of the respondents) to hiring external expertise. Of regulators that do not yet outsource, 90 percent indicated that they were planning to do so in the future.

Somewhat paradoxically, regulators that are comparatively more developed appear to contract out more (such as in developed countries, or in more advanced sectors such as the telecommunications sector), as shown in Figures 1 and 2 below.

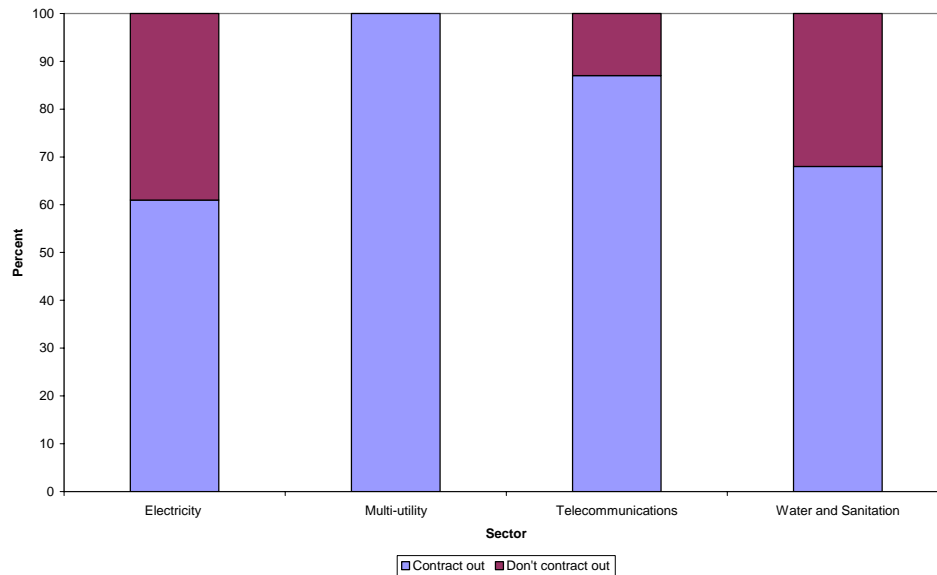
Figure 1. Breakdown of Outsourcing by Regions



Source: World Bank contracting-out survey (Trémolet, Shukla, and Venton 2004).

Note: EAP = East Asia and Pacific, ECA = Europe and Central Asia; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa; OECD = Organization for Economic Co-operation and Development; SAR = South Asia.

Figure 2. Breakdown of Outsourcing by Sector

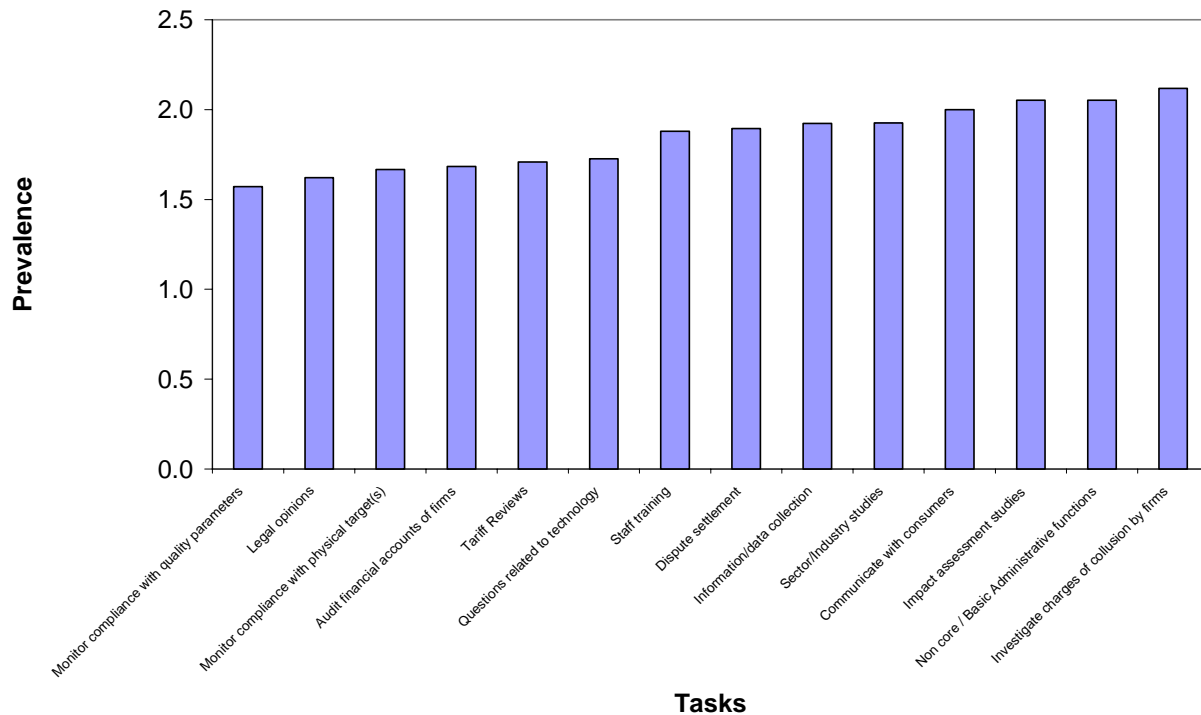


Source: World Bank contracting-out survey (Trémolet, Shukla, and Venton 2004).

Functions and tasks of regulation

The range of tasks that is outsourced is varied, from one-off studies (such as tariff reviews, cost of capital estimates, benchmarking) to ongoing quality monitoring. External contractors can also be brought in to resolve conflicts, acting as external experts. They may bring technical or specialized skills (such as regulatory accounting and finance, or technical evaluations) or deliver more strategic advice. Sometimes the delivery of an entire regulatory function can be outsourced. The type of tasks that are typically outsourced is shown in Figure 3.

Figure 3. Most outsourced Tasks



Source: World Bank contracting-out survey (Trémolet, Shukla, and Venton 2004). Regulators were asked to rank outsourced tasks by order of importance: a number close to one indicates a task that regulators gave as their first choice, i.e. is most outsourced.

Two main types of outsourcing: advisory, and binding in nature

There are two main types of outsourcing. In *advisory* outsourcing, an external advisor presents several options in a decision-making framework to the regulator; in *binding* outsourcing, the recommendations given by the external provider must be directly applied, with no choice given to the regulator on alternative options.

This distinction is critical, because it is only at the institutional design stage that sufficient powers can be granted to an external agency for performing tasks that can be binding on the regulatory process. An example of binding outsourcing arrangements is presented in Box 2.

Box 2. Binding Outsourcing Arrangements in Gaza for Performance Auditing

The Gaza Management Contract for the Palestinian Water Authority (PWA), one of the first private sector initiatives in the Middle East water sector, used an innovative outsourcing strategy to overcome the limitations posed by weak local regulatory capacity. The contract used private, third-party technical and financial audits to calculate the performance-linked management payment. The auditor evaluated the operator's declared performance against the targets set out in the management contract, once or twice a year. The contract created a simple qualitative scale to measure progress against target. If the operator earned "excellent" on the performance variables, its weighted average composite score would be 1 and this would allow it to earn 100 percent of the allotted annual performance-linked fee of US\$750,000. In the opinion of the PWA, the use of an external auditor helped to increase pressure on the operator to perform. The auditor was also able to bridge the stark information asymmetry gap between the operator and the PWA. This example highlights the potential for using external auditors for formulating binding recommendations and addressing issues such as lack of competence and limited independence in nascent regulatory agencies.

Source: Trémolet, Shukla, and Venton (2004).

In some cases, however, even if the recommendations are purely advisory in nature, they may be difficult for the regulator to ignore if they are disclosed to external stakeholders or if there are effective appeal mechanisms in place.

4.

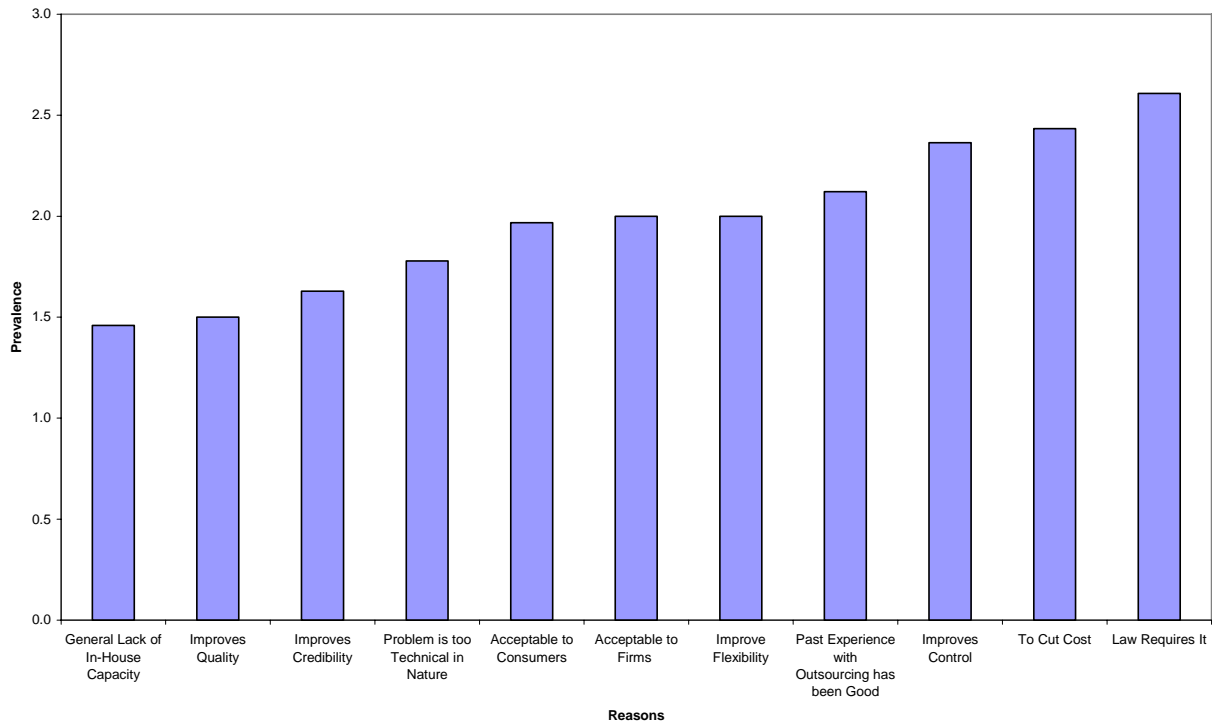
When Does It Make Sense?

Policy makers and regulators can use outsourcing at various stages of the regulatory agency's lifecycle and for different reasons. When designing a regulatory framework, policy makers would be well advised to think about how to build in and fund outsourcing mechanisms. Once set up, regulators can consider outsourcing at various stages of their existence: some regulators have just been set up and need external support for the initial start-up phase; others have just come out of such an initial phase of assistance and need external support to establish their autonomy; others are better established and would need to carefully consider the costs and benefits of outsourcing when deciding whether to perform a task in-house or via external consultants.

Regulatory activity is typically cyclical with peaks around the time of the five-year reviews, although there may be other peaks as well (for example, in the event of a competition case being investigated by the regulator). For a regulator conducting five-year reviews of prices, the number and capacity of staff within the regulatory agency will typically be growing over time but may decline slightly after a regulatory review has been carried out (for example after 10 years), as more experienced staff may leave to get better-paying jobs in the regulated industry or consultancy. Because of these different trends, there may be times (for example, when the regulator is gradually building capacity and has to conduct its first review) when the number and capacity of staff will be insufficient. Such deficits may occur later in the life of the regulator as well—for example, when dealing with an unplanned competition enquiry. At any of these points, outsourcing can help to address a capacity deficit.

Outsourcing also can help regulators address several other objectives, such as improving their legitimacy or independence. According to the World Bank survey, regulators rely on outsourcing for a variety of reasons, as shown in Figure 4.

Figure 4. Reasons for Outsourcing



Source: World Bank contracting-out survey (Trémolet, Shukla, and Venton 2004). Regulators were asked to rank reasons for outsourcing tasks by order of importance: a number close to one indicates a reason that regulators gave as their first choice.

5.

What are the Main Benefits from Outsourcing?

Outsourcing can help utility regulators improve their performance with respect to the three main qualities required for regulators: competence, independence, legitimacy.

Competence. Outsourcing can increase regulatory competence by helping agencies respond efficiently and appropriately to variable workloads and changing market structures. For many regulators, the workload is variable or it requires small amounts of specialized inputs (for example, for initial activities such as asset inventory, or recurrent activities such as tariff reviews). Outsourcing can provide access to specialized skills as needed, mitigate the risk of regulatory obsolescence, and leverage international experience in specialized areas of regulatory practice. It can also help build core in-house skills through training.

Independence. Outsourcing can foster regulatory independence as it enables the regulatory body to benefit from the reputation of an external agent, and gives the regulator a higher degree of control over who does the work, particularly in countries where there are constraining civil-service rules. For example, third-party technical studies are used in court cases in Bolivia, and hiring external agencies is required by law in the Brazilian electricity distribution sector and the Chilean water sector. In the Argentinean water sector, the law requires that two sets of external agencies (one for the regulator, one for the regulated entity) be hired to carry out studies on the same issue, in order to compare results and arrive at a fair conclusion.

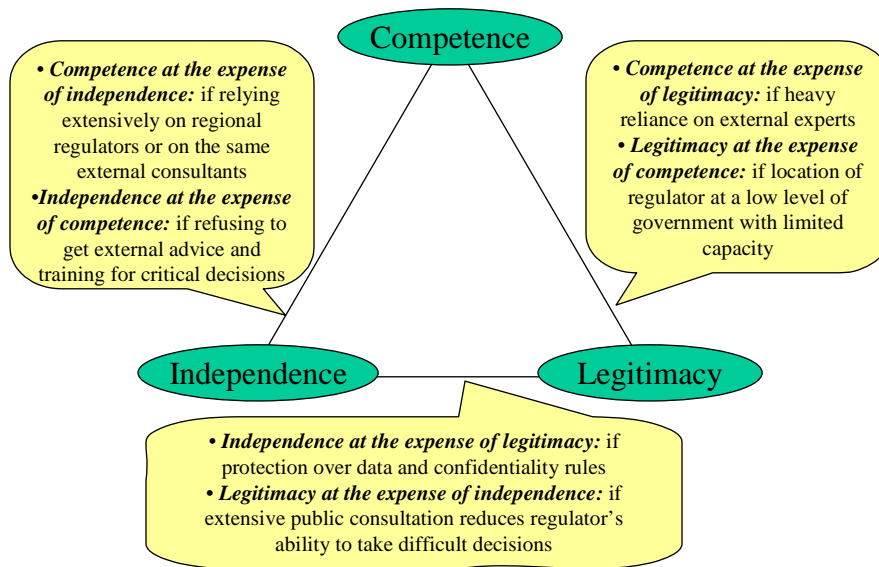
Legitimacy. Countries with weak or fledgling institutional capacity may find that outsourcing specific regulatory functions can increase the legitimacy of the regulatory process. In those circumstances, external studies may be perceived to be more credible and can increase the transparency of the whole process.

Besides enhancing the three regulatory qualities above, outsourcing can also help reduce costs (without compromising quality) because it can provide information about the real cost of performing the task or service, allow economies of scale (as external providers can spread fixed costs of acquiring specialized experience over much larger markets, including national and international), and can save precious management time that can be used on core functions rather than on specialized regulatory tasks.

Outsourcing may not improve the performance of regulators on all of these dimensions at once, and there are inherent trade-offs between the three qualities as shown on Figure 5 below. For example, outsourcing a major decision-making function such as conducting a tariff review may secure ample access to otherwise limited technical competence but actually lower the perceived legitimacy in the regulatory process. In these cases, the decision to outsource will depend on whether the trade-off between increased competence and decreased legitimacy makes outsourcing worthwhile, and whether possible measures exist to improve the trade-off.

According to the findings of the World Bank survey on outsourcing, 41 percent of regulators surveyed say outsourcing has helped reduce costs and improve quality. They also thought that outsourcing helped improve organizational competence (91 percent), as well as independence (62 percent) and trust with key stakeholders (71 percent).

Figure 5. Impact of Outsourcing on the Trade-Offs between Regulatory Qualities



Source: World Bank contracting-out survey (Trémolet, Shukla, and Venton 2004).

6.

What are the Main Risks and Limitations?

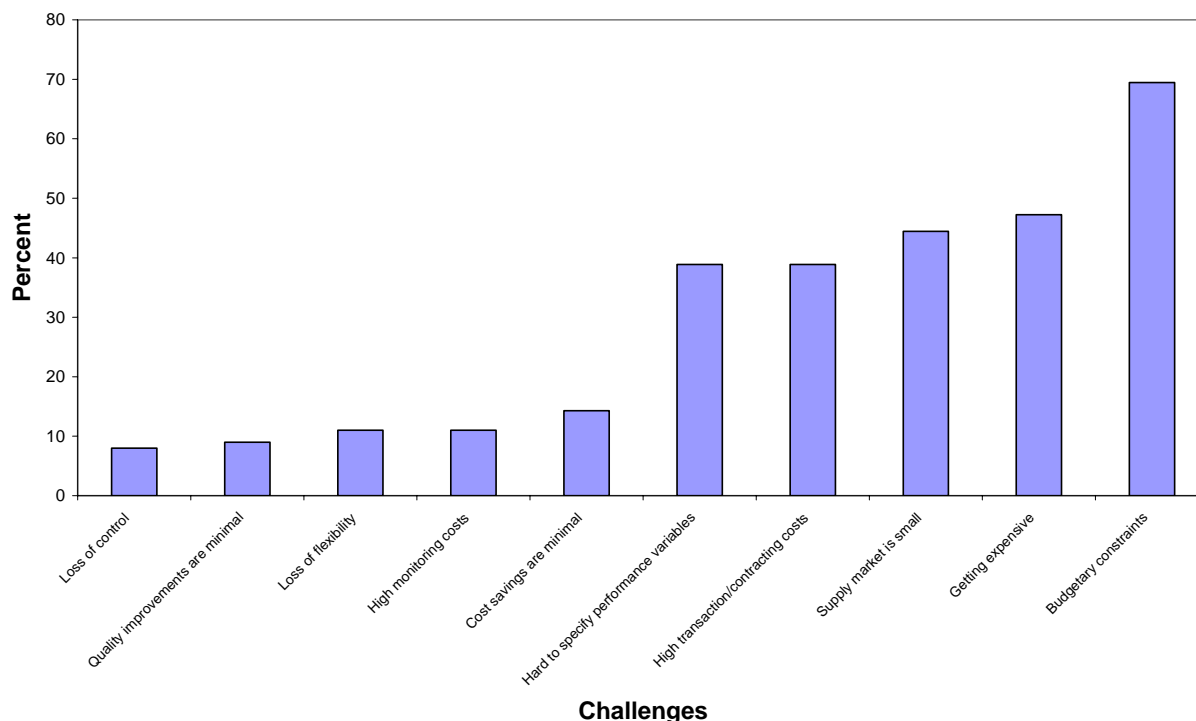
Regulators are sometimes reluctant to outsource as they fear that it may have the following impacts:

- ***Involve high transaction cost.*** The cost of an effective outsourced process may be higher than that of a less-effective internal process. Regulators have the perception that outsourcing is more costly, although this would need to be considered within a cost-benefit framework as there may be some hidden costs with the internal process.
- ***Be difficult to manage.*** It can be hard, especially for newly set-up regulators, to specify the outputs and to monitor performance, and it may be even harder to apply penalties in the event of poor or unsatisfactory performance so as to improve the quality of the advice received.
- ***Be politically sensitive.*** Regulators may have the impression that they are “relinquishing” regulatory autonomy and independence whereas policy makers may fear that outsourcing would impact their ability to influence the regulatory process.
- ***Generate difficulties in ensuring continuity and independence in decision making.*** For example, such difficulties may arise if a report produced by an expert is disputed by the regulated utility but the expert is no longer there to support the regulator in explaining the rationale for the decision.
- ***Create a dependence on external advice.*** Dependence in the long term can weaken regulation (or at least, the regulatory agency).
- ***Generate potential conflicts of interest.*** An external advisor may itself be exposed to the risk of capture. Where the external advisor is chosen and paid by a political entity (often the national or municipal government), it will be difficult to resist the suggested solution proposed by the paying client. This conflict may be alleviated by employing an international firm, which needs to protect its reputation, as an external advisor. In this case it would be important to check that the firm was not advising the regulated company in other jurisdictions, as this too could generate the risk of conflict of interest.
- ***Introduce a risk of conflict.*** The multiplication of stakeholders, with the regulator and the consultants involved as well as other stakeholders, introduces a risk of conflicts due to differences in opinion and could make it more difficult to reach consensus.

According to the regulators surveyed by the World Bank, the top challenges faced for outsourcing were budgetary constraints (70 percent of respondents cited it as a challenge) and a small supply market (47 percent), as shown in Figure 6. Many agencies believe that the supply market for regulatory functions is not sufficiently deep: only 6 percent rated the supply market as

being “abundant.” The supply problem would be particularly acute in most African countries, which have not developed markets for regulatory expertise and have to rely on more expensive international advice. In such cases, it would be important to think of ways of diversifying sources of advice to include regional regulators or local universities and think tanks.

Figure 6. Key Challenges as Seen by Regulators



Source: World Bank contracting-out survey (Trémolet, Shukla, and Venton 2004). The figure shows the percentage of regulators that cited a given challenge as critical.

The budgetary constraint can change over the lifecycle of regulators. In the start-up phase, agencies have to deal with more issues and challenges (such as sector studies and writing sector laws) but the revenues from levies take time to stabilize. This may be a temporary mismatch, but if not addressed early on, it can severely hamper the long-term effectiveness of agencies. In addition, the problem of the market getting expensive (identified as one of the three most significant challenges by regulatory agencies) may become significant, particularly in the context of short supply. With the possibility of demand for high-quality services exceeding supply, agencies are paying more for certain services. This may result in a financial squeeze for the agencies whose budgets have not been adjusted accordingly. For many agencies, funding is linked to levies on regulated companies or customers that may grow in proportion with the increase in service coverage, but growth in service coverage and hence adequate budget funding can take some time.

Nearly 40 percent of the agencies rate difficulty in contract specification as one of the top five key challenges, and more than 53 percent could not comment on the effectiveness of outsourcing in improving quality. This reflects difficulties in monitoring the quality of the advice provided. Problems of performance monitoring and evaluation can be traced back to limited in-house core skills for specifying and monitoring external advisors' contracts.

As the agencies outsource, they may fear that lower costs are being achieved at the expense of quality, and so they become more aware of the quality dimension of the regulatory function than when it was performed in house. However, good comparisons are hampered by the lack of baseline data; only 44 percent of agencies reported having an internal cost accounting system to compare the costs of internal service provision and outsourcing. In addition, regulators expect more from external agencies than from their own staff.

7.

What is the Best Way to Manage Outsourcing?

Two entities need to take outsourcing decisions:

- **Policy makers** should have an initial view about outsourcing when designing a regulatory framework (either in legislation or through a contract). When selecting an institutional model and assigning utility regulatory functions to different institutions, they should creatively integrate mechanisms for outsourcing into the regulatory framework.
- **Regulators** should develop a clear strategy for approaching outsourcing decisions and not treat them as a quick-fix measure. To this end, they need to go through all the trade-offs involved in outsourcing.

Below, we review how each type of outsourcing decision can best be managed.

Outsourcing decisions by policy makers at the regulatory framework design stage

When designing institutional and regulatory frameworks for utility services, policy makers need to consider a variety of options. There are a number of ways in which outsourcing decisions can be built into institutional arrangements from the start, usually at the transaction stage. These arrangements can be considered in difficult or weak institutional environments, where regulators that are competent, independent, and legitimate may be more difficult to establish.

The example of the water and electricity contract in Gabon, discussed in Box 3, shows steps taken at the time of the transaction to address some of the perceived capacity limitations on the ground. In Gabon's case, rural coverage studies were outsourced; these studies were crucial for performance monitoring but costly to undertake.

Box 3. Strengthening Regulatory Competence through Contract Provisions in Gabon

In July 1997, the Société d'Énergie et d'Eau du Gabon (SEEG) signed a 20-year concession contract with the state of Gabon for the operations of both water and electricity services throughout the country. The contract was one of the first "real" concession contracts in Africa, with concrete investment obligations and extensive coverage targets for expanding service to previously unconnected rural areas. The government chose not to set up a regulatory body; instead, it incorporated outsourcing mechanisms in the contract design that strengthened the independence and competence of the ministerial department in charge of regulating the contract. In particular, the contract incorporated clauses that required the outsourcing of key regulatory functions such as monitoring of coverage performance (with dedicated funds set aside from the concessionaire's revenues), although external agents were limited to producing nonbinding studies. Also, outsourcing was specifically used for initial studies that could not take place prior

to signing the contract (because the contract was let in a short period). These studies were left to an initial transition period during which many contractual terms were to be defined.

Source: Trémolet, Shukla, and Venton (2004).

Other interesting cases would include the inclusion of independent experts or expert panels in contractual or regulatory arrangements. Such experts can be called in to resolve disputes between the regulator and regulated industries, and thereby increase the legitimacy of the overall process. For example, in Bucharest, an expert panel in charge of the tariff-setting process is complementing the functions of an existing technical regulator for water and sanitation. In Chile, arbitration panels made up of independent experts have been put in place in order to settle disputes between the Superintendence of Water and Sanitation and regulated companies, especially for tariff reviews. This type of mechanism was also allowed for in the Senegal water affermage contract, although on a more informal basis (see Box 4).

Box 4. Reliance on an Independent Conciliator in the Senegal Affermage Contract

In 1995, the government of Senegal initiated major reforms in the urban water sector, which entailed splitting the existing national utility, Société Nationale d'Exploitation des Eaux du Sénégal (SONEES), into three entities. An asset-holding company, Société Nationale des Eaux du Senegal (SONES), owns the water service assets and is responsible for investments under a 30-year concession contract with the state. A private firm, Sénégalaise des Eaux (SDE), operates the system and provides water services under a 10-year affermage contract with SONES. The state-owned company, Office National de l'Assainissement du Sénégal (ONAS), owns and operates the wastewater assets. Regulation is by contracts between the various entities. There is no independent regulatory agency.

Although the Minister of Water (Ministre de l'Hydraulique) is in charge of approving tariffs, the asset-holding company, SONES, is the main organization in charge of supervising the contract and estimating tariffs based on a pre-agreed financial model. Two contract supervision committees were set up to maintain ongoing dialogue between the parties, although the affermage contract supervision committee has been much more active than the one established for the concession contract.

The Water Director within the Ministry can also bring in an independent conciliator on an ad hoc basis. This independent conciliator played a significant role in reconciling a number of differences between the parties, especially at the start of the contract (up to 2000). The conciliator role was loosely based on the affermage contract. The independent conciliator flew in and out of Senegal to mediate differences between the parties (mostly between SONES and SDE, but also between SONES and the state) up to 30 times between 1993 and 2000. The costs of the conciliator's involvement, borne by a World Bank loan, were €140,000–€150,000 for the overall period (with approximately €90,000 in fees). The conciliator's interventions focused on the renegotiation of SDE's performance targets; disputes about the attribution of responsibilities for repairs, maintenance, renewals, and rehabilitation; and tariff revisions.

Source: Trémolet (2006).

If policy makers wish to build in some degree of outsourcing in the arrangements, they will need to decide on the following:

- The type of regulatory functions (or specific tasks) that are to be outsourced.
- Whether external agencies' findings on the regulatory process should be binding or advisory. This would largely depend on whether the law allows findings to be binding and whether it would be acceptable given the context.
- Whether any measures need to be introduced to compensate for a potential reduction in independence or legitimacy due to outsourcing.

Allowing external financing for outsourcing arrangements that are built into the initial regulatory framework may also alleviate the problem of capture of external advisors. Donors should therefore consider funding outsourcing, as it may reduce the need for setting up fully-fledged regulatory agencies as part of a sector reform process (and the expenses involved in doing so). Another source of funding can come from the regulated entities themselves, especially if the outsourcing is binding. The Transmission Wheeling Rate Guidelines in the Philippines provide an interesting example of the mandatory use of experts, where the costs are recovered from the utility even though the consultant's advice is not binding on the regulator.

Outsourcing decisions by existing regulators on an ongoing basis

For ongoing outsourcing to be successful, regulators should take the following measures:

- ***Develop a well-considered outsourcing strategy.*** Regulators should treat outsourcing decisions as strategic ones that influence the running of the whole agency, rather than as quick-fix measures to control costs and get around difficult problems. As a result, they need to ensure top management support for these strategies, to identify the core areas of competitiveness within the agency, and to review the trade-offs between in-house provision and outsourcing on the basis of the three regulatory qualities of competence, independence, and legitimacy. Some regulatory agencies, such as those in New Zealand and Australia, have already taken a long-term view by identifying a set of core functions that should be performed in-house, and by instituting formal guidelines and procedures for hiring, monitoring, and performance measurement.
- ***Continue to build the regulator's internal capacity.*** Outsourcing should be used to strengthen rather than debilitate regulators. As a result, regulators' staff should work together with external contractors in combined teams in order to ensure continuity and avoid consultants substituting themselves for staff. This collaboration should also help strengthen the ability to supervise external experts and, if need be, interrupt their services (if deemed inappropriate). Regulators should ensure that tools are developed that match the level of development of regulatory practice. They should request delivery of the financial models and underlying analytical tools developed by external experts and obtain training.
- ***Carefully consider the costs and benefits of outsourcing to guide future decisions.*** In many cases, the lack of internal accountancy systems prevents regulators from comparing in-house and outsourcing costs. Such a comparison would require "booking" internal time to specific

projects, for example, which may be difficult. Where possible, it would be useful to carry out an ex post analysis of the costs and benefits outsourcing in order to provide a more reliable basis for future outsourcing decisions.

- ***Ensure maximum transparency in the recruitment process to avoid corruption and maximize accountability.*** As seen above, external advisors are not immune to potential conflicts of interest. Adopting rules and procedures regarding potential conflicts of interest that would exclude firms and individuals tied to a specific interest would ensure maximum transparency in recruitment. The regulator should seek to foster competition in the providers' market and use local consultants whenever possible, in order to deepen the supply of advice. (Certain countries, particularly in Latin America, have an excellent local consultancy scene, whereas such skills are often lacking in sub-Saharan Africa, with the exception of South Africa.)
- ***Encourage long-term ongoing relationships with experts*** rather than short-term missions, as a way to minimize the costs of bringing the experts (particularly foreign experts) up to speed with local issues. This approach was taken with the adoption of long-term advisory relationships in Gabon and Senegal (water and electricity). However, for transparency purposes, it may be necessary at regular intervals to put long-term contracts out for tender through framework contracts with a set of experts that can be called in for specific tasks (as done in the United Kingdom by Ofgem, the gas and electricity regulator).
- ***Develop back-up plans in the event of nonperformance by contracted agencies.*** In the event of unsatisfactory performance by the adviser, the regulator should adopt a serious but nonconfrontational attitude of applying penalties or withdrawing final payments. It may be useful to include conciliation or conflict-resolution clauses in the contracts in the event of conflicts, potentially calling on regional groupings such as AFUR to facilitate the settlement of such conflicts.

What Role Could AFUR Play in Facilitating Better Outsourcing of Utility Regulation in the Region?

AFUR's main role could consist of acting as a clearing house with the following potential activities:

- ***Supply side: develop a roster of "accredited" consultants*** that can be called on for short- or long-term missions by regulators. Preferably, this roster should be made public to facilitate "matching" between local and international consultants when a combined team is required. This could also foster the development of the African market for consultants in regulation, so that the solutions recommended by these consultants can be better suited to the local context.
- ***Demand side: develop a central database to advertise consultancy opportunities*** so that it becomes easier for consultants to know what type of advice is required, and the market can become more competitive. The European Commission has done this, for example, to improve transparency in the consultancy market and break down country barriers.

- ***Facilitate the exchange of regulators' views on the performance of external advisors,*** through well-designed forms for feedback or evaluation. Such feedback would help regulators select future advisers and policy makers choose the most appropriate model of built-in outsourcing. Feedback could also help regulators form a clearer view of the ideal qualities a consultant should have.
- ***Pool resources to contract out studies of common interest.*** In some cases, and with a view to reduce costs, AFUR could coordinate the preparation of studies that would be of interest to a group of regulators. For example, such studies could investigate the most appropriate ways to estimate the cost of capital in countries where there are no liquid capital markets. However, risks associated with commissioning these types of studies, including managing expectations with respect of study results, would need to be carefully managed.
- ***Develop an approach for sharing resources between African regulators to contract in staff from another regulator.*** During peaks of activity (such as a price review), some regulators may be able to share “excess” staff with regulators in other countries so that the latter can benefit from their experience and the former can get exposed to different methodologies and challenges. This is already done to some extent. For example, staff members from SONES, the asset-holding company in the water sector in Senegal, were hired to estimate water tariffs for SONES' equivalent in Niger, the SPEN. The financial model for estimating SPEN's water tariffs was built by external French consultants and based on the SONES model, making it easier for SONES staff to audit and improve the SPEN's model. Such solutions, while attractive, would need to be carefully managed so as to avoid depleting existing regulators of key staff sent on external assignments.
- ***Develop common tendering procedures,*** which would be used when external experts are brought in without support from donors. When donor funds are financing the establishment of regulators, the donors' procurement procedures usually apply and donors would usually recruit consultants themselves. However, as donor support is reduced, it would be important for the regulatory agency to develop its own transparent tendering procedures. The advantage of regulators developing common tendering procedures would be increased transparency and market fluidity. Below a certain threshold, a regulator could potentially be allowed to contract-in a consultant directly, as this increases flexibility and reduces transaction costs. However, in order to avoid the risk of capture of regulators by a small number of consultants, regulators (with the help of AFUR) could draw up a consultant registry and swap information on performance.
- ***Play a role in building the capacity of local support.*** At present, regulatory skills are often difficult to locate as regulation is not established as a profession (unlike engineering or accountancy) and there is little formal training available. AFUR could help strengthen the relationships between regulators and universities and local consultancies, for example by offering scholarships for PhDs in regulation or organizing internships in regulation for students. AFUR could also relay training needs to those in charge of establishing training programs, particularly at the level of donors or universities.

- ***Provide training on managing external advisors and making best use of their advice.*** Training in regulation is not the only type of training that is required. As mentioned above, specifying performance requirements and monitoring the performance of external advisers can prove difficult. Therefore, training on managing external advisors could usefully be provided by AFUR, and could utilize the shared experiences of its member regulators.

Annex A

Regulatory Tasks and Functions

<i>Functions</i>				
<i>Tasks</i>	Price regulation	Service quality regulation	Competition regulation	Consumer protection
<i>Gather information and data</i>				
	<ul style="list-style-type: none"> • Get information on current and projected tariff revenues and costs • Get information on willingness-to-pay, for alternative service levels 	<ul style="list-style-type: none"> • Obtain information on current service levels • Carry out technical studies 	<ul style="list-style-type: none"> • Obtain information on illegal conduct or monopoly behavior 	<ul style="list-style-type: none"> • Conduct customer surveys • Organize call centers to file complaints
<i>Monitor the implementation of existing rules</i>				
	<ul style="list-style-type: none"> • Audit financial accounts • Ensure that adequate tariffs are charged 	<ul style="list-style-type: none"> • Monitor that levels of service are met • Monitor that coverage targets are met 	<ul style="list-style-type: none"> • Investigation of abuses of monopoly power, such as predatory practices 	<ul style="list-style-type: none"> • Conduct administrative audit of systems and procedures in place to educate customers, and share information
<i>Determine rules</i>				

Functions

<i>Tasks</i>	Price regulation	Service quality regulation	Competition regulation	Consumer protection
	<ul style="list-style-type: none"> • Reviews tariffs, linked to inflation or tariff rebasing • Modify tariff structures and payment methods 	<ul style="list-style-type: none"> • Define or review quality standards • Adapt existing quality standards to real needs 	<ul style="list-style-type: none"> • Organize bidding process • Rule on competition case following complaint 	<ul style="list-style-type: none"> • Define consumer service standards or requirements
<i>Enforce decisions</i>	<ul style="list-style-type: none"> • Define tariff adjustments on basis of performance • Apply penalties 	<ul style="list-style-type: none"> • Require improvements in service quality 	<ul style="list-style-type: none"> • Mandate breakup of monopoly power or changes in access terms 	<ul style="list-style-type: none"> • Resolve disputes between consumers and regulated firm

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