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Why Should there be Regulators?

The starting question is why should there be regulators in the utility markets at all. In most other markets, regulators do not exist. However, in utility markets (e.g. telecommunications, water, gas, electricity, etc.), it is common to have regulators either within the government or as separate “independent regulatory agencies”.

Apart from the significant public interest dimensions of services supplied by utilities, regulation is necessary to mimic, or be a surrogate for, competition in the market. Competition is the best vehicle to enhance and protect users’ interest. When the users have a choice, there would be pressure to drive prices down, to improve quality of service and to be responsive to users’ need. However, in utility markets, competition may not have fully developed. In some cases, for reasons that the operation of certain utilities might still be a “natural monopoly”, there might be only one player in the market. In some other cases, the market might be operated as an oligopoly. When a competitive market has not yet been fully established, some regulation is still necessary to take the place of competition. However, the level of regulation should be the minimum necessary to protect users’ interest. The level of regulation should also be progressively reduced as the market becomes more competitive. Eventually, when the market has become fully competitive, no regulation would be required apart from the general law which would be applicable to all markets, for example, general competitive law to promote fair competition, law to prohibit deceptive practices (e.g. law against false trade description), law to protect consumer interest (e.g. law to render void and unenforceable unfair contract terms), etc.

Sector-specific regulators are generally more effective than general regulators because the former are able to become experts in the issues and to focus on the particular needs of the industry. New Zealand used to have no sector-specific regulator for the telecommunications industry. Experience has shown that sole reliance on general competition law and the judicial process is unable to cope with the technical and commercial complexities in the telecommunications market. A ministerial review in 2000 has led to the recent enactment of a telecommunications law and the establishment of a Telecommunications Commissioner within the Commerce Commission with the responsibility of resolving industry disputes over regulated telecommunications services.

What Makes an Effective Regulator?

Many utility markets around the world are progressively open to competition, particularly the telecommunications sector. The regulator has an important role to play in the implementation

of the policy of privatization and liberalization. Its decisions would have significant impact on the welfare of the consumers and producers in the market. Thus a regulator must aim to perform its functions fairly and effectively, and be seen to be doing so, so as to gain the trust and confidence of all in the industry.

Openness and Transparency

For the regulator to be accepted as a facilitator of the development in the industry, rather than an obstructive or opaque bureaucracy, the regulator must be conscious in maintaining a high degree of openness and transparency in its operation and decision-making process. Openness and transparency can be achieved by being approachable, adequate dissemination of information, involvement of the public and the industry through open hearing procedure or consultative process, and publication of reasons for decisions made.

In Hong Kong, the office of telecommunications regulator (Office of the Telecommunications Authority, OFTA) is highly approachable. Apart from formal written correspondence, the staff of OFTA are approachable through the more informal means of communications, such as telephone or electronic mail. They readily accept meetings with current operators, potential operators, manufacturers, interest groups, analysts, academics, the media etc. to disseminate information and discuss matters of interest to them. Invitation to speak at seminars and conferences are accepted as far as possible because these are valuable opportunities to explain the work and thinking of the regulator.

The website is an extremely effective medium to achieve openness and transparency. OFTA is among the first batch of regulators to establish a website. In principle, all information that may be useful to the industry and the general public, subject to the rule of protecting confidentiality of information obtained within the government or from the operators, should be put on the website as far as possible. This includes consultation papers, reports, rules, guidelines and decisions, as well as some statistics, licence and market information. Effort should be made to make the information on the website as updated as possible.

The openness and transparency of OFTA in Hong Kong are enhanced through the establishment of four advisory committees focusing on various aspects of the responsibilities (spectrum management, numbering administration, technical standards and consumer affairs) of the regulator. The regulator uses these forums to solicit views on issues before it takes a decision. The forums on spectrum management, numbering administration and technical standards have also been useful in getting the operators involved in the development of spectrum plans, numbering plans and specifications that would critically affect their operation in the industry.

By law, the Hong Kong regulator has to make annual reports to the legislature. Senior staff of OFTA are required to attend before panels of the legislature to brief the members on various aspects of telecommunications regulation, sometimes alone, and sometimes in support of the policy bureau (the equivalent of the ministry in other governments).

The media has an important role to play in enhancing the openness and transparency of the regulator. Press releases to accompany important regulatory decisions can explain to the general public the salient points and reasons for the decisions in layman language. Press briefings enable the media to ask the questions they want to ask, and would often dispel misunderstandings and establish good working relationship between the regulator and the media.

Some operators have a tendency to argue that certain information provided to the regulator is commercially sensitive and disclosure of it would harm the interest of the operator. Over-protection of such confidentiality could lead to an opaque regulatory process. The way Hong Kong deals with this is to provide expressly for a procedure in the law and licence conditions to handle such claims of confidentiality. The party which claims to be affected would be given a fair opportunity to make a representation to the regulator on why the disclosure of certain information would harm their business interest. The regulator would then consider the representation, but is given the statutory power to make a decision on whether to disclose after balancing the business interest of the operator against the public interest to disclose.

Consistency and Predictability

The role of regulator is to create an environment conducive to investment and efficient supply of services. As is well known, the cost of capital for investment increases with risk and one type of risk is “regulatory risk”. Regulatory risk is associated with the consistency and predictability of the decisions of the regulator. To reduce the regulatory risk associated with investment in a particular market, the regulator of that market should ensure that its decisions are consistent and predictable. That is to say, the regulator is expected to follow published rules and guidelines and the players in the industry can most probably predict the outcomes of matters brought before the regulator.

Strict observance of the rules of law is of course the fundamental requirement to achieve consistency and predictability. Apart from the legislation, which is usually general in nature, regulators are expected to publish more specific rules and guidelines on different aspects of regulation. The availability of clear and specific rules and guidelines would have the added advantage of minimizing the need for regulatory intervention as they would guide the behaviour and commercial negotiations

of the players in the industry. Once published, the rules and guidelines must be strictly adhered to by the regulators. Statement of reasons is to be given for any decision. Deviation from the published rules and guidelines must be adequately explained.

Prior to making any decision that might affect players in the market, ample opportunity should be given to the parties affected to make their views known to the regulator. Such opportunity may be offered by a general invitation of comments or a specific invitation to the parties that may be affected by the decision.

In Hong Kong, the administrative law provides safeguards to ensure consistency and predictability. The common law requires that the regulator must take decisions reasonably and observe the rules of natural justice. Procedural impropriety would become grounds for judicial review with the possible consequence of the regulator's decision being quashed. Failure to provide reasonable opportunity to the parties affected by a decision prior to making that decision would be a procedural impropriety likely to lead to a judicial review.

Independence

An attribute of the regulator which is often discussed is "independence". Certainly the regulator must operate within the legal and policy framework and there is no such thing as independence from the law and policy of the country. There are two aspects of regulatory independence.

The first aspect is independence from players in the market. The regulator should have no interest in the business of any operator in the market. The Reference Paper on regulatory principles which has been incorporated into the basic telecommunications agreement under the auspices of the World Trade Organization has defined an "independent regulator" as a regulatory body "separate from, and not accountable to, any supplier of basic telecommunications services" and stipulated that "the decisions of and the procedures used by regulators shall be impartial with respect to all market participants". The importance of such independence is for obvious reasons. It is only a regulator independent from the players in the industry that is able to take impartial decisions, and be seen to be taking impartial decisions.

The second aspect is whether the regulator should be independent from the government (or the executive arm of the government). The relationship between the regulator and the government must necessarily reflect the legal and political systems of the particular country and the present status of development of the utility market in that country. In some countries, the regulator may be a part of the ministry, or a separate body, but accountable to the ministry. In some other countries,

the regulator may be a separate body not accountable to the ministry.

Independence from the government is particularly important in countries where the government or the state either wholly owns or has majority shares in the equity interest in the operators in the market. In such countries, a clear separation would be necessary between the regulator and the ministry to ensure that regulatory decisions are not influenced by considerations relating to the interest in the revenue or profitability of the business of the operators.

Where the government does not own any interest in the players, independence of the regulator from the government would insulate the regulator from political pressure. Because of the democratic process and the need for the government to address a wide range of social and political concerns many of which are not related to the utility markets, the government could be susceptible to influence by powerful industry players. Maintaining an arm's length relationship between the regulator and the government would bolster confidence that regulatory decisions are based on objectivity and merits and not behind-the-scene lobby or pressure. Detachment of the regulator from the government would also have the added advantage of not having the regulatory approach directly affected by a change of government.

In the Hong Kong situation, the telecommunications industry is fully privatized and therefore the government does not have any financial interest in any operator in the market. The equivalent of the ministry (called a policy bureau in Hong Kong) is headed by a civil servant, not by an elected politician. The need for the independence of the regulator from the government may not be as pressing as in other countries. The regulatory body is actually a department within the government hierarchy and the head is a civil servant reporting to the policy secretary who is the head of the policy bureau. Nevertheless, regulatory independence is a declared policy of the government and is achieved through clear demarcation of the jurisdictions of the policy bureau and the regulator, clear vesting of the statutory powers in the regulator, and appeal against regulation only through channels outside the government (e.g. to an independent board or the court).

Independence can be achieved by clarity in the definition of responsibilities of the executive arm of the government and the regulator. The ministry in the government is normally vested with the responsibilities of policy formulation, legislation enactment, interface with the politicians and in some cases, licensing. The regulator is responsible for implementing the policies and enforcing the legislation. This is basically the dividing line in Hong Kong, except that in Hong Kong, OFTA rather than the policy bureau, is responsible for licensing. In practice, because the regulator is in the front line and has first hand information about the industry, the regulator will have to work closely with the ministry and play an active role in recommending policies and legislation.

Independence is achieved by a clearly defined mandate and powers of the regulator in the law. Such powers of the regulator are necessary to provide certainty in the market. The market operators look to the regulator to dispose of disputes efficiently and effectively. To resort to the court procedure would be too time consuming or costly. A regulator without adequate powers to take decisions and enforcement actions cannot be expected to be an effective regulator. The regulator often has the power to make the rules, enforce the rules and impose penalty for violation of the rules. In Hong Kong, the powers for the regulator to various regulatory decisions are clearly provided for in the legislation. It is provided in the law that the policy secretary may give only general policy directions to the regulator. Such general policy directions are to be in writing and published to enhance transparency. Thus the policy secretary would not be able to give specific policy directions to the regulator so as to interfere with the day-to-day exercise of the statutory powers of the regulator. Under administrative law, an authority vested with the power must exercise it taking into account only relevant factors and disregarding irrelevant factors, and must not act on the direction of other persons. Breach of this rule would lead to judicial quashing of the decisions. This common law provides a safeguard for regulatory independence in Hong Kong.

The telecommunications regulator in Hong Kong may lay down guidelines on the principles and methodology for the determination of interconnection charges. The regulator may determine the actual level of the interconnection charges based on the published guidelines. The determination of the regulator is binding on the operators. If the operators do not abide by the determination of the regulator, the regulator may issue directions to operators to enforce the determination. Failure to comply with the directions may result in financial penalty imposed by the regulator. These powers rest clearly with the regulator.

Appeal to the executive may weaken or undermine the independence of the regulator. Therefore in Hong Kong, the decision of the regulator is final in the executive arm of the government and any person feeling aggrieved by the decision of the regulator has to lodge an appeal to an appeal board separate from the government or seek judicial review of the regulatory decision by the court.

Regulation may be economic regulation or social regulation. The main consideration of economic regulation is based on economic principles. In social regulation, the broader public interest is considered. For example, based on economic principles, the prices of telephone services to an area should have reflected costs and whether the service should be provided should be based on commercial considerations. However public interest considerations might require the imposition of an "universal service" obligation on at least one operator so that service would always be supplied to all customers at a unified price irrespective of the cost of serving the customers.

On the one hand, the regulator is expected to take decisions based on sound economic principles, considering what it judged to be in the long-term interest of the users, rather than being influenced to follow the popular view because of considerations to gain votes. For example, tariff rebalancing for telephone lines may not be popular with the politicians, but would be in the long-term interest of the development of healthy competition in the market. Therefore ideally the regulator should be insulated from the political influence.

On the other hand, it is unrealistic to expect the regulator to base its decisions only on economic considerations. Other public policies (e.g. universal access, safety, environment, privacy etc.) will have to be considered. After all the basic rationale of having a regulator is to protect and enhance public interest. The regulator must therefore act, and be seen to act, in the public interest. Confining the task of the regulator to that of an economic regulator would actually lead to the undesirable consequence of the government having to override regulatory decisions based on the wider social considerations. This undermines the foundation of regulatory independence.

In practice, it is also unrealistic to expect complete independence of the regulator from the government. Very often the government appoints the members of the regulatory body and controls the resources available to it. Besides the measures discussed earlier, there are some additional features in a regulatory system that can enhance regulatory independence.

The regulator should have security of tenure. If the regulator did not have such security, it would not be able to function effectively. In Hong Kong, the security of tenure is to a certain extent safeguarded by the fact that the regulator is a civil servant and its employment or dismissal is governed by the civil service regulations.

To enhance regulatory independence, the regulator has to be provided with adequate resources and relevant expertise. Without such resources and expertise, the regulator cannot be performing its functions competently and meet the expectation of the industry. Complaints and criticisms of the regulator could lead to government intervention and undermine regulatory independence. In Hong Kong, OFTA has been operating on what is called a "Trading Fund". Basically although OFTA remains as a department within the government, the activities of OFTA are financed from revenue in the form of licence fees paid by the operators for the services provided to the industry. OFTA therefore does not have to compete with other government departments for appropriation under the budget and in general can be more flexible and react faster to deploy resources to handle demand from the industry.

Some countries have competition authorities separate from the sector-specific

regulators. In such cases, the respective jurisdictions of the competition authority and the sector-specific regulator must be clearly spelt out. Where a general competition authority exists, there might still be advantages for the sector regulator to enforce competition rules in the particular sector the regulator is responsible for. This is because of the familiarity with the sector under the regulator's responsibility. Where concurrent powers exist in the law for the general competition authority and the sector regulator to enforce competition law, there should be agreement among the two authorities to deal with competition issues in the sector. For example, in the UK, the Director-General of Fair Trading and Director-General of Telecommunications exercise concurrent powers under the competition legislation, but a coordination committee coordinates the investigation of cases in the telecommunications sector. In practice, the UK telecommunications regulator deals with competition cases related to the telecommunications sector. In Hong Kong, there is no such problem for the time being as the telecommunications regulator doubles up as the competition authorities in the telecommunications sector.

Credibility and Legitimacy

The regulator must command the respect, confidence and trust of the operators subjected to the regulation as well as the general public. This necessitates the establishment of credibility and legitimacy of the regulator.

It goes without saying that the fundamentals of the credibility and legitimacy are the conformity to the highest ethical standards by all staff of the regulator. Any conflict of interest (e.g. personal investment in shares of operators) must be avoided.

Credibility and legitimacy are safeguarded by scrupulous adherence to rules protecting confidential information provided by players in the industry. Disclosure in the public interest must follow pre-defined procedure. High standard should be maintained for security of offices and information systems. Adequate but reasonable restrictions are to be incorporated into staff employment contracts for staff likely to have access to commercially sensitive information during their employment in the regulatory agency.

Credibility and legitimacy can be achieved by adequate skills and expertise in the regulator's organization. In Hong Kong, the telecommunications regulator was originally housed in the Post Office. In the monopoly days, the regulator was staffed by engineers and administrators. As the market develops, the regulator finds that it is necessary to have expertise in multi-disciplines - law, economics, accountancy, technology and business management. In order to improve transparency, it has been found necessary to employ staff with public relation expertise to handle publicity activities. What OFTA has done was to create a new category of staff called Regulatory

Affairs Managers with different background to undertake the wide range of issues encountered. High priority is accorded to allocation of resources for training and development of existing staff. Short-term and very specialized tasks may be out-sourced to consultancy firms. As tackling a regulatory issue typically involves many disciplines, a project-based approach is adopted for the more complex tasks. The project manager can be from many background (e.g. a lawyer, an economist, an engineer, etc.) but the manager is expected to possess the skills to integrate contributions from team members of different background to complete the task.

Regulatory decisions are often taken in imperfect knowledge. Operators in the industry may not be forthcoming in providing all the information that a regulator needs in taking its decision. There is always an asymmetry of knowledge between the regulator and the operators concerning the intricacies of the systems with which the operators have intimate contact on a daily basis while the regulator would have to rely on the statutory powers to call for the information that it thinks it needs from the operators to make a sound regulatory decision. Taking regulatory decisions in such an environment without compromising credibility and legitimacy is a real challenge to all regulators. The law should provide clearly for the power of the regulator to obtain information that is reasonably required for the performance of its regulatory functions.

Imperfect knowledge can be complemented by information exchanged between regulators. Valuable information can often be acquired by participation in regional or international associations of regulators where information and experience can be shared. Best practices of the regulators can be monitored and applied to the home environment.

Credibility and legitimacy can be achieved by fairness, even-handedness and professionalism in approaching issues in the industry. The decision-making process should be timely and clear timeframe should be defined for regulatory decisions such as licensing and making determinations to resolve industry disputes. “Regulatory capture” (defined as close relationship between the regulator and the operators in the industry to the extent that the regulator sees its function as safeguarding the interest of the operators) should be avoided.

In Hong Kong, the “light-handed” approach is advocated for regulation. Reliance on market forces is made to the maximum in the determination of the number of players, technology, prices and quality of services. Commercial settlement of inter-operator disputes is encouraged. However, where necessary, the regulator should act swiftly and decisively. On the one hand, unnecessary regulatory intervention could lead to over-reliance on the regulator or other forms of “gaming” behaviours. The legitimacy of regulatory actions is questioned when the regulator is seen to be intervening unnecessarily to distort market forces. On the other hand, the lack of, or untimely, regulatory actions would delay the development of competition. The credibility of the

regulator is also undermined when it is seen to be indecisive or ineffective. Striking the right balance is an art that has to be mastered by the regulators based on actual experience.

Accountability

As the regulator is vested with such extensive powers, adequate checks and balances should be available to prevent abuse and the regulator should be fully accountable for its decisions. In this regard, the regulator should be subjected to the supervision of the judiciary, the legislature, the Ombudsman and the media.

In some countries, e.g. USA and Canada the regulator is a commission. The committee decision would ensure consistency of decisions, provide more checks and balances because of the increased number of decision makers and collective responsibility. In some places, e.g. UK and Hong Kong, the regulator is a public officer in the telecommunications sector. A single decision maker has the advantage of swifter decision to react to a particular situation. A collective decision might be bogged down by differences in views within the committee or commission. In this regard, a smaller commission would have advantages over a large commission. The UK government has decided to set up a new regulator (the OFCOM) to oversee the communications industry comprising a small body of executive and non-executive members, rather than an individual.

The regulatory process can be made more accountable by conducting hearings before any decision is taken. Open hearings are used extensively in the USA. However, extensive use of the open hearing procedure may be too legalistic and adversarial. The process would certainly take longer. In Hong Kong, the consultative process is used. The regulator will publish consultative papers and invite comments. The regulator considers all views submitted, prepares a report and takes a decision. In this way, the regulator has to be seen to have addressed all the relevant concerns. The experience of OFTA is that the consultative process enables the regulator to identify the conflicting views in the industry or the community. Although it is rarely possible to satisfy all wishes because of the often divergent positions of different parties, the consultation process has enabled the regulator to make better and more informed decisions.

The question of whether the decision of the regulator should be final in the executive is a vexing question. In some countries, decision of the regulator is final within the executive channel. In some countries, there may be an appeal tribunal which may review the decisions of the regulator. If the decision of the regulator is not final it could undermine the effectiveness of the regulator.

In the common law system, judicial review is the process used to check that the regulator does not act beyond the ambit of the law. However, it has often been criticized that the judicial

review process does not deal with the “merits” of the regulator’s decision. A process enabling an appeal to be lodged with an independent board or tribunal would complement the judicial review process as all aspects of the regulator’s decision may be examined.

The legislature may set up special panels or Select committees to monitor the performance of the regulator. The regulator is required to submit regular (e.g. annual reports) to the legislature and be accountable to the legislature for the actions that it takes. Attendance of the regulator before the legislature is actually of mutual benefit. The legislature would be able to discharge its functions of supervising the executive while the regulator can make use of the opportunity to enhance its openness and transparency.

The Ombudsman of a country may investigate any mal-administration by regulator. Some government auditing functions may include value-for-money or efficiency audits on the work of the regulator.

Finally, the media can be a very effective supervisory mechanism for the performance of the government, including the regulator.

The regulator should not regard these checks and balances as hindrance to its work. Demonstration of its accountability would enhance its standing in the industry and its effectiveness.

Conclusion

The regulator has a very important role to play to guide a utility market in its transition from a monopoly to a fully competitive one. The regulator must therefore be set up to perform its function effectively. To gain the trust and confidence of the players and the public, the government must create the framework to enhance the regulator’s openness, transparency, consistency, predictability, independence, credibility, legitimacy and accountability. This paper aims to share the experience of Hong Kong’s regulator in the telecommunications sector. Most of the experience is sector non-specific and may well be applied to the regulation of other utility markets.
