PUBLIC UTILITY RESEARCH CENTER
WARRINGTON COLLEGE of BUSINESS

Key Lessons from the 41st PURC/World Bank International Training Program on Utility Regulation and Strategy

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Teachers learn from their students, and students learn from each other. As in the past, the 48 participants from 20 nations in this training course identified the key lessons learned over the two-week period. During the concluding session of the program, they shared their reactions to formal presentations and informal networking. The PURC team appreciated the dedication and energy exhibited by participants: attendees brought insight and understanding to the sessions and shared their ideas with all of us.

Note that while most of the key lessons refer to regulatory agencies and to those developing infrastructure reforms, the principles apply to operators as well. Organizations face the same challenges: creating a sustainable infrastructure system where all stakeholders have confidence in the integrity of the process and have a shared vision of improved infrastructure performance.

As PURC's Director, Mark Jamison, observed: "Many of the lessons tend to be strategic rather than technical in nature – suggesting that many of the important ideas involve how regulators, representatives from government ministries, infrastructure managers, and consumer advocates need to 'get on the balcony'." Intentionally stepping back from the "give and take" of regulation allows leaders to see how various stakeholders limit or promote reform. We hope that the annotated list of lessons stimulates further discussion among those involved in these important sectors. Some of the elaborations on the points identified by participants are drawn from Key Lessons from previous course deliveries. I take full responsibility for errors of interpretation in this summary of *Key Lessons.*

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1. ***Well-designed regulations affect sector performance.*** Any rule establishes incentives so careful analysis must support regulatory decisions to ensure that outcomes are those sought by those implementing public policy. Service quality is one area warranting attention: One approach to measuring Service Quality (in the water sector) is the **RATER** system (Parasuraman, 1994):

    - **R**eliability (continuity)
    - **A**ssurance (employee knowledge and courtesy in interactions, promoting trust)
    - **T**angibles (pressure, purity, color, taste, smell)
    - **E**mpathetic (care and individual attention)

- **R**esponsiveness (prompt service, billing corrections, and repair)

Clearly there are many dimensions to quality. Regulations need to focus on a few, since external perception is likely to give substantial weight to a few of these dimensions (with many of them being highly correlated).

2. ***Those determining regulations and those affected by regulations need to understand the why, how, and what of regulation.*** *Why?* Regulation represents a way to obtain outcomes that arise in well-functioning competitive markets, even when the sector being regulated is a natural monopoly. Thus, regulation is intended to promote efficiency and innovation by the supplier. It also attempts to address issues of fairness so vulnerable groups can obtain access to infrastructure services. *How?* Regulation utilizes agencies that operate with transparent processes. Decisions are evidence-based, based on the law. *What?* Regulation affects prices, service quality, coverage, and other aspects of service delivery.

3. ***Regulation is a collaborative effort: many groups are affected by the way national policies are implemented, so stakeholder engagement is required to obtain input regarding impacts.*** The OECD has *just published* a volume entitled *Stakeholder Engagement for Inclusive Water Governance*. The principles apply to all infrastructure sectors. The report includes mapping techniques, obstacles to engaging stakeholders, mechanisms for promoting substantive interactions, and profiles of stakeholders: national governments, sub-national governments, international organizations, service providers, regulators, business, financial actors, civil society, science and academia, and advisors. Add this report to your growing Library: http://www.oecd-ilibrary.org/docserver/download/4215051e.pdf?expires=1429623873&id=id&accname=ocid194682&checksum=99E61E77FEA2E1E6596266CFA4456814

4. ***Information is central to determining the quality of regulation.*** It is said that infrastructure executives "manage what they measure". In addition, regulators monitor what is measured. Therefore, data are crucial for identifying trends, describing current patterns across suppliers, and determining feasible targets. Benchmarking has become a key tool for sound regulatory decision-making. However, data collection, authentication, and analysis are costly—both for the operators supplying data and for the regulator. Thus, data requirements should be based on legitimate and clear needs.

5. ***The dynamics between the sector regulator and operator(s) are complex, with each organization having roles and responsibilities.*** It is important to note that the organizations need not be adversaries. Their interest in improving sector performance is shared, though disagreements can arise regarding the pace of improvement and the implications of business plans and cash flows. The key is to identify those shared

objectives and work to achieve those goals. If (arms-length) relationships break down, citizens are the ultimate losers.

6. ***Communication skills are essential for managing stakeholder expectations.*** Organizations have many ways to connect with citizens: web sites, newsletters, press conferences, meetings, and other times. Intermedia Communications Training Inc. presents five tips for communicating with different groups through the media: these can be applied to effectively answering questions (while avoiding jargon):

- **Begin with an honest direct answer** (yes . . . or no)
- **Position your message** ('our role or goal')
- **Provide evidence through a specific example, story, analogy, or facts**
- **Connect to the audience – recognize concerns or interests of listeners / readers**
- **Conclude with a summary or memorable image** (a good punchline)

It is amazing how these simple steps can make SUCH a difference in how listeners and viewers react to the message. Many Presentations and Press Releases violate these steps by (1) not focusing on the key message, (2) not linking the message to the organization's objectives, (3) not providing evidence or a story line, (4) not acknowledging audience concerns, and (5) not leaving the listeners with a solid conclusion or image. Reporters need some good "talking points" for their stories--so give them the images and words that are convincing! Some other themes that communications specialists emphasize include:

a. Never use the phrase 'no comment'; b. Remember the acronym **MAP** – have your **M**essage, **A**udience (build a connection) and **P**roof (examples, stories, analogies, vivid details); c. Avoid jargon; and d. Prepare, prepare, prepare.

In the case of essential water services, an organization's internal and external communications are too important to be left to chance *or* to beginners – communication must become part of the organization's DNA.

7. ***Regulators need to understand the strengths and limitations of methodologies used to develop incentives and give operators a realistic opportunity to cover costs.*** Rate of return tools are used for determining price levels. Both revenue caps and price caps have been utilized to promote efficiency, with both requiring substantial data regarding past and expected cash flows under realistic scenarios. Hybrid plans can limit the likelihood of financial distress and politically unsustainable profits, though there are corresponding incentives issues with such approaches. No single recipe is appropriate for all developmental and institutional contexts. However, the ingredients are similar around the world: data, analysis, communication, stakeholder engagement, and careful implementation (and review).

8. ***Regulation is best when expertise, political awareness, and compassion are present.*** Without engineers, lawyers, accountants, economists, financial analysts, and other professionals, regulatory offices are not likely to develop and implement rules that promote sustainability and efficiency in infrastructure. Of course, being politically aware does not mean becoming politically active: mechanisms need to be developed to limit political interference. Finally, Politicians traditionally promise programs that improve access to infrastructure, but the funding seems (somehow) to be forgotten after the election. A pro-poor orientation must be more than words: it is captured in budgets, funds, and in actions of politicians, utility managers and regulators. Ultimately there is the question of balancing compassion with efficiency and sustainable growth, where the timing of outcomes affects current and future citizens differently. Such generational issues can be very difficult to resolve.

9. ***Regulators should never work alone: they require input from all stakeholders.*** Each of us wears blinders (associated with our professional training, ideology, or aspirations). We see what we expect to see ("Believing is seeing") and tend to listen to those whose preconceptions match our own. However, to reach an acceptable consensus in the capital-intensive network industries being regulated, all parties need to be heard from and their views taken into account. Dealing with stakeholders is a messy process, but it is also essential if regulation is to have a positive impact on the long term prospects for citizens who seek infrastructure services.

10. ***Capacity-building (such as the learnings obtaining in this program) provide a foundation for improved interactions that affect infrastructure performance.*** With changes in technologies, improvements in analytic techniques, and a better awareness of how we can all provide leadership, participants return to their home countries with a deeper appreciation for the resources available for capacity-building. An "educated guess" is a starting point, not the end-point when analyzing reform options and selecting the one that best meets the nation's objectives. Thus, ministries, regulatory agencies, and operators alike must take advantage of on-going educational opportunities. Technical terms, while inappropriate for a Press Conference, provide a common basis for communicating within an organization; given the complex financial, economic, engineering, and managerial environment, professionals must keep up-to-date regarding best practice. Furthermore, new regulatory and managerial techniques are becoming embedded in information systems, making information technology (IT) a key tool in a modern organization.

11. ***Ask the right <u>questions</u>.*** Some answers are easy to obtain, but the associated questions may not be important to those receiving service. So significant attention should be given to the kinds of information requests made by the regulator and the analyses conducted at the agency (given the scarce resources available for studies). It is better for the regulator have a rough estimate of an important variable than a precise calculation of some variable (or piece of data) that is not very important. Yet we often focus on the dimensions of performance that are easy to measure, but not significant in terms of the long term financial sustainability and effectiveness of those delivering infrastructure services. Detailed cost allocations can be useful, but they also mask causation and can lead to price signals that damage efficiency.

12. ***It is helpful when an operator gains fresh perspectives on the way regulators are evaluating proposals from companies.*** Understanding the concerns and responsibilities of those developing and implementing public policy is essential if the relationship between operator and regulator is to be healthy. This process requires regular communication via workshops and reports. It is better to avoid "surprises" in the process! Furthermore, role-playing can be a good technique for anticipating what might transpire in the next rate hearing—helping both sides anticipate what will be needed in the next review period.

13. ***Benchmarking and models are valuable tools in the regulatory process.*** Benchmarking enables the regulator to review past trends, compare performance across comparable operators today, and to identify realistic targets (based on actual best practice). Key Performance Indicators (KPIs) represent a good starting place for yardstick comparisons. Of course, incentives need to be devised to promote the achievement of targets. In addition, models of financial and operating scenarios represent another tool that can help decision-makers determine the sensitivity of forecasts to underlying factors affecting outcomes. Excessive complexity in such models is not a plus—models are like maps, representations of reality but not so detailed that the destination is obscured or unable to be identified.

14. ***Transparency and accuracy are two other important dimensions of regulatory performance.*** Stakeholder confidence in the regulatory system depends on information being available so citizens can evaluate procedures and outcomes. Transparency is enhanced when responsibilities are clearly identified, accountability given attention, and codes of conduct developed. In addition, data supporting decisions should be authenticated—giving confidence the related analyses. Accurate data provide the foundation for sound regulatory decision-making.

15. ***The tasks of regulators involve protecting consumers <u>and</u> protecting investors/company.*** Current customers need to be protected from monopoly prices and inefficiencies associated with lack of incentives for high performance. Private investors—those putting

funds into projects—need to be protected from opportunistic behavior by ministries and from political pressure for excessively low prices that result in returns that are below the cost of capital. The long term financial sustainability of infrastructure sectors depends on investor being confident in the opportunity to earn returns commensurate to the risks. In the case of state-owned utilities, taxpayers have supplied the funds—and deserve to have those funds used wisely in the operation and expansion of infrastructure services. Thus, both consumers and investors will look for decisions that encourage the long term network expansion, improvements in service quality, and efficiency.

16. ***"Successful regulators make everyone unhappy."*** That sentence reflects the view that the competing claims of all stakeholders (operators, ministries, consumer advocates, unserved customers, and others) cannot be completely met. At a minimum, future customers will be made worse off if revenues from current customers do not cover costs: maintenance expenditures are deferred and investments lack funding. The decisions of regulators must, therefore, disappoint some (if not all) stakeholders. The key is for regulators to explain the rationale behind and the full consequences of decisions. Ultimately, successful regulators need to satisfy the core needs of stakeholders.

17. ***Effective regulators are able to <u>balance</u> the interests of diverse stakeholders.*** This point echoes the previous point. Efficiency and equity (fairness) are not mutually exclusive: rather, they are complementary objectives, though their achievement generally requires a sequential approach to expansion: ultimately, financial sustainability is necessary (but not sufficient) for fairness. In addition to the potential complementarity of efficiency and social equity, balancing interests requires strong regulatory oversight and utility governance:

- Well-performing institutions make information available, implement incentives, and evaluate performance.
- Insulation from daily political pressures and regulatory micro-management is necessary for strong utility performance.
- Access to benchmarking information provides a foundation for establishing better external and internal governance and incentives.
- Professionalism and engineering expertise are necessary (but not sufficient) for good planning and operational efficiency.
- Continuity and accountability for both utilities and their oversight agencies is essential for long term sustainability.
- The utility's Board of Directors is a key component of the governance system: it needs to track and incentivize good performance (and avoid becoming part of the political patronage system).
- Stakeholder participation in the regulatory process promotes the exchange of ideas necessary to identify win-win options and develop consensus among key groups.

- Political support for reform initiatives helps agency funding and the attraction and retention of strong leadership and skilled staff.

The extent to which these activities are not occurring in any country is evidence that reforms are necessary for improving utility performance.

18. ***Regulation is a complex activity, requiring professionalism, insulation from excessive political intervention, and good leadership.*** Policies are not self-implementing. The governance features of institutions determine transparency, accountability, autonomy and the authority required for sound policy development and implementation. Nevertheless, the process requires leadership—from individuals at all levels of organizations. Those exercising leadership both "stir and steer"; they make sure that issues get raised and addressed and they guide the organization once the appropriate strategies have been identified. If the political, economic, and social conditions are ready for change, leadership can help organizations develop ***i****nitiatives* (programs) that improve infrastructure performance.

19. ***Ethics and principles play a role in promoting citizen support for regulatory systems.*** First, even the appearance of a conflict of interest can call into question the legitimacy of the regulator (and the operator). Here is a Prayer I found a while back:

    - Spare us from cowardice that shrinks from new truths;
    - Spare us from laziness that is content with half-truths; and
    - Spare us from arrogance in thinking that we know all truth.

    The Prayer reminds us that we all need to be brave, committed, and humble in our work.

Concluding Observations

Here are seven elements that (in my opinion) are necessary for strong regulatory performance:

Information—*Information matters*: the collection and authentication of data is necessary to identify trends, understand current patterns of performance, and determine realistic targets for utilities; technical skills and on-going capacity-building can support such initiatives.

Institutions— *Social Structures* and *Organizational cultures matter*: the sector regulatory commission is one component of the regulatory (and governance) system, which includes the legislature, courts, utilities, unions, and the laws that establish roles, accountability, and responsibilities for these organizations. Yet, behind these organizations are sets of traditions, the *rule of law*, and political arrangements that affect organizational interactions and sector performance. As part of the cultural context for governance, institutions include the customs and accepted patterns of behavior that encourage or discourage a wide range of actions.

Interests—*Stakeholders matter:* both sector regulators and state-owned water utilities are formal organizations embedded in a social structure, so we will include these organizations as *interests* (or stakeholders). A primary responsibility of oversight agencies (like sector regulators) is to balance the interests of consumers, operators, and government. Special interests can be concentrated or diffuse—which gives them incentives to participate (or not) in policy forums and political campaign financing; they can have significant influence or be (relatively) apathetic bystanders who are affected by infrastructure policies.

Incentives—*Incentives matter:* decision-makers behave in accordance with payoffs associated with different outcomes; every regulatory rule rewards or penalizes actions affecting utility performance.

Ideas—*Ideas matter*: each of us brings a conceptual framework to our decisions; new perspectives can serve as catalysts for activities that improve the operation and financial sustainability of water utilities.

Ideals—*Values matter*: when we are clear about our objectives and communicate those priorities to stakeholders, the resulting dialogue can clarify our goals and promote greater consensus regarding sector objectives.

Individuals—*People matter*: ultimately, leadership is essential for improved sector performance; no matter how dysfunctional or inefficient current arrangements are, someone is benefiting from them—which implies that overcoming institutional inertia requires strong leadership.

Policies are not self-implementing. They require leadership. Some of the leaders who will make a difference in their nation's economic and social growth participated in the PURC Training Program. Hopefully, the discussions equipped them to be more effective when they returned to their nations—to continue the ***initiatives*** identified during their stay at the University of Florida.

Additional Resources

Handbook for Evaluating Infrastructure Regulatory Systems by Ashley C. Brown, Jon Stern, and Bernard Tenenbaum, The World Bank, 2006. This volume provides an overview of why, what, and how to evaluate regulatory systems. A CLASSIC!

Check out other web-links at www.purc.ufl.edu and at www.regulationbodyofknowledge.org.