Contracting Out Utility Regulatory Functions

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Contracting Out Utility Regulatory Functions

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For and on behalf of
Environmental Resources Management

Approved by: __________________________
Signed: ________________________________
Position: _______________________________
Date: __________________________________

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## CONTENTS

### 1 INTRODUCTION

1.1 **STUDY OBJECTIVES**  
1.2 **BACKGROUND TO THE STUDY**  
1.3 **RESEARCH METHODOLOGY**  
1.4 **REPORT STRUCTURE**

### 2 ANALYTICAL FRAMEWORK FOR UTILITY REGULATION

2.1 **OBJECTIVES OF ECONOMIC REGULATION**  
2.2 **REGULATORY FUNCTIONS AND TASKS**  
2.3 **REQUIRED QUALITIES FOR REGULATORY EFFECTIVENESS**

### 3 RATIONALE FOR CONTRACTING OUT

3.1 **THEORETICAL BACKGROUND: THE “MAKE VS. BUY” DECISION**  
3.2 **RATIONALE FOR CONTRACTING OUT UTILITY REGULATION**

### 4 BUILT IN CONTRACTING OUT IN INSTITUTIONAL ARRANGEMENTS

4.1 **INSTITUTIONAL MODELS FOR REGULATION**  
4.2 **REGULATORY MODELS WITH BUILT-IN CONTRACTING-OUT**  
4.3 **IMPLICATIONS FOR POLICY-MAKERS DESIGNING REGULATORY FRAMEWORKS**

### 5 CONTRACTING OUT DECISIONS FOR EXISTING REGULATORS

5.1 **ANALYSIS OF CURRENT PRACTICE: SURVEY RESULTS**  
5.2 **IMPLICATIONS FOR REGULATORS CONSIDERING CONTRACTING OUT**

### 6 CONCLUSIONS

6.1 **SUMMARY FINDINGS**  
6.2 **IMPLICATIONS FOR POTENTIAL EXTERNAL SUPPORT**
EXECUTIVE SUMMARY

The World Bank initiated this research to capture experience with contracting out economic regulation functions and tasks, in order to understand how it can be made more effective. The World Bank commissioned Environmental Resources Management (ERM) to conduct a review of international experience on contracting out of regulatory functions, based on a survey of regulators and a series of case studies, and to provide a decision-making framework for policymakers and regulators considering contracting out regulation in the presence of financial, human, or credibility constraints that hamper traditional regulatory approaches. For the purpose of this study, contracting out is defined as:

“The use by a regulator of an external contractor, instead of its own employees to perform certain function(s). Such external contractors can be consultants, individuals, other government entities (in country or outside, including at a regional level) or NGOs. Contributions by external contractors can either be solely advisory in nature or be binding on the ultimate regulatory decision. The overall exercise of functions, however, usually continues to be the ultimate responsibility of the regulator, who is accountable to taxpayers for the role conferred to it by the relevant statute(s).”

Policy makers and regulators can use contracting out at various stages of the regulatory framework lifecycle and for different sets of reasons. When designing a regulatory framework, policy makers can think about how to build-in and finance contracting out mechanisms. Once set up, regulators can consider contracting-out 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 initial phase of assistance and need external support in order to establish their autonomy; others are better established and would carefully consider the costs and benefits of contracting-out in order to decide whether to perform a task in-house or via external consultants. The focus of this study is on the decisions regarding contracting out that are taken when designing institutional models and on the contracting out decisions that regulators which have already been set-up would need to take, rather than on the type of assistance that is required during the initial start-up phase.

Utility Regulation and Principles of Regulatory Effectiveness

Utility regulation can typically be broken down into a set of regulatory functions (price, service quality and competition regulation and customer protection) and tasks (gathering information, monitoring compliance with existing rules, determining new rules and enforcing rules).

Regulatory functions should preferably be administered by entities possessing three qualities: competence, independence and legitimacy. Such qualities may be difficult to combine within a same agency because there are clear trade-offs between them. For example, independence may be at the expense of legitimacy because maintaining independence often requires a degree of protection over the data and the analysis used in reaching regulatory decisions. Such trade-offs need to be taken into consideration when taking decisions about the legal and institutional framework and means of
counter-balancing such trade-offs need to be thought through with the introduction of an appropriate set of checks and balances.

Many, if not all, regulators in developing countries lack one or all of these qualities. These shortcomings can be due to many reasons, including limited resources, short or no history of performing regulatory functions, repeated political interference in regulatory decisions or difficulty in attracting and retaining competent staff. They are particularly apparent in the case of countries emerging from social strife or where the political environment makes it difficult to set up any kind of institution with degrees of independence, let alone legitimacy or competence. This in turn limits their capacity to act as effective regulators, i.e. to foster adequate levels of investment in the regulated sector through the setting of tariffs that recover costs, to attract private investment and/or to monitor the public sector for superior performance. In these circumstances, contracting out of regulatory functions can play a key role.

Rationale for Contracting Out

Public bodies and private companies are permanently confronted with the decision of whether they should “make” (i.e. produce a product or service internally) or “buy” (i.e. contract it out). Several factors come into play in reaching such decisions, including the need to fill a competency gap or to reduce costs (maintaining quality constant). Such decisions should be based on the identification of the agency’s core functions (versus what can be contracted out) and consideration of the costs and benefits of contracting out versus in-house provision.

Contracting out can help utility regulators improve their performance with respect to the three main required qualities for regulators: competence, independence and legitimacy and to reduce regulatory costs.

Competency - Contracting out can increase regulatory competency, by helping agencies to respond efficiently and appropriately to variable workloads and changing market structures. Contracting out can provide access to specialised skills only when needed, mitigate the risk of regulatory obsolescence and leverage international experience in specialised areas of regulatory practice. It can also help in building core in-house skills through training.

Independence - Contracting out 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.

Legitimacy - Finally, countries with weak or fledgling institutional capacity may find that contracting-out 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.

Cost reductions - Contracting out can also help in reducing costs (without compromising quality) because it can provide information about the real cost of performing the task or service, allow benefiting from economies of scale (as external providers can spread fixed costs of acquiring specialised experience over much larger
markets, including national and international), and it can save precious management time which can be used on core functions rather than on specialised regulatory tasks.

It may be difficult for contracting out to improve the performance of regulators on all of these dimensions at once, however. For example, contracting out 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 contract out will depend on whether the trade-off between increased competence and decreased legitimacy makes contracting out worthwhile, and whether possible measures exist to improve the trade-off between legitimacy and competence.

**Institutional Models with Built-in Contracting Out**

In certain difficult institutional environments (because of lack of experience with regulation or difficulties in establishing independence), policy-makers have decided to build into the institutional framework mechanisms that prescribe contracting out. Considerable creativity has gone into the design of such arrangements, to address specific shortcomings, resulting in a great variety of models. The study reviewed a total of five cases of such built-in contracting out arrangements, but this is by no means an exhaustive list of models: hybrid arrangements taking features from some of those cases or entirely new arrangements, could be designed.

Those potential models are summarised in Table ES.1. below. A key distinction is drawn based on whether the recommendations that are produced by an external agency are purely advisory (i.e. an external advisor presents several options in a decision-making framework to the regulator) or binding in nature (recommendations given by the external provider must be directly applied, with no choice given to the regulator on alternative options). This distinction is seen as 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.

When designing institutional and regulatory frameworks for utility services, policy-makers therefore need to consider alternative options. There are a number of ways in which contracting out 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 effective regulators that can be competent, independent and legitimate are difficult to establish. The relative merits of alternative options will need to be assessed on the basis of a number of factors affecting the type of institutional arrangements that can be put in place.

If they decide to build in some degree of contracting out in the arrangements, policy-makers will need to decide the type of regulatory functions (or specific tasks) that are contracted out; whether external agencies’ findings should be binding or not on the regulatory process, depending on whether binding contracting out is allowed by law and would be acceptable in the institutional context; and whether any compensatory measures need to be introduced in order to compensate for a potential reduction in independence or legitimacy due to contracting out.
Table ES.1. Examples of “Built-in” Contracting Out Regulatory Arrangements

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Gabon, water and electricity concession</td>
<td>Regulation by contract with contract supervisory unit housed in the line Ministry. The contract includes the requirement to use external contractors for specified data gathering and performance monitoring exercise, with specific funding.</td>
<td>• Data gathering • Monitoring compliance with coverage targets</td>
<td>No</td>
<td>↑</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Gaza, water management contract</td>
<td>Regulation by contract with contract supervisory unit in the national sector agency. The contract defines that an external auditor should set the performance-based payment for the contractor.</td>
<td>• Monitor compliance with quality targets • Determine payments to regulated company</td>
<td>Yes</td>
<td>↑</td>
<td>↑</td>
<td>—</td>
</tr>
<tr>
<td>Bucharest, water and sanitation concession</td>
<td>Contract supervisory unit at the municipal level. A national Ministry is in charge of setting tariffs but Expert Panels have a key role in adjudicating tariff reviews, and their decision are almost binding.</td>
<td>• Tariff determination</td>
<td>Almost</td>
<td>↑</td>
<td>↑</td>
<td>—</td>
</tr>
<tr>
<td>Chile, water divestitures</td>
<td>National regulatory body with limited independence. Arbitration Panels can settle disputes between the regulatory body and regulated companies</td>
<td>• Dispute settlement (for enforcing decisions)</td>
<td>Yes</td>
<td>—</td>
<td>↑</td>
<td>↑</td>
</tr>
<tr>
<td>Caribbean, telecommunications</td>
<td>Regional regulator set up by international Treaty. Responsible for a number of specific activities, but majority of role is devoted to providing guidance to the Contracting States</td>
<td>• Develop new rules • Dispute settlement</td>
<td>Yes?</td>
<td>↑</td>
<td>↓</td>
<td>↑</td>
</tr>
<tr>
<td>Tri-sector partnerships in water (Global)</td>
<td>Tri-sector partnerships allow</td>
<td>• Data gathering • Develop new rules • Dispute settlement</td>
<td>No</td>
<td>↑</td>
<td>—</td>
<td>↑</td>
</tr>
</tbody>
</table>

Key: ↑: Positive; —: Neutral.
Contracting out decisions in practice

A survey of contracting out practices by existing regulators was conducted for this study; results were received from 51 agencies throughout the world, representing a 38% response rate. The survey showed that most regulators (75% of survey sample) engage external parties in the administration of regulatory tasks and plan to continue to do so in the future and 61% rated results from contracting out as good whereas 39% said it was average. Regulators dedicate a considerable share of their annual budgets (over 20% for 33% of the respondents) to hire external expertise.

Regulators may contract out for a variety of reasons, including:
• Addressing limited in-house capacity. For many regulators, the workload is peaky or it requires small amounts of specialized inputs and technical skills that tend to be extremely limited, particularly in the public administration. Contracting-out may help reduce the costs of procuring the required expertise, or for a given cost, increase the competence with which regulatory functions are performed.
• Improving the quality and credibility of regulation. Contracting-out may reassure investors as to the independence of the regulatory process from short-term political capture, particularly in countries with weak or fledgling institutional capacity.

From the perspective of regulators, contracting out reduces costs and 41% say it has helped reduce costs and improve quality. Contracting out helps improve organizational competence (91%), but also independence (62%) and trust with key stakeholders (71%). Top challenges are budgetary constraints (70%) and small supply market (under 50%).

Contracting out is sought for tasks related to tariff reviews, monitoring compliance, and dispute settlement. A few (14%) contract out binding input while most contract out advisory work.

One of the key implication from the survey for regulators considering contracting out is that they should treat such decisions as strategic ones, influencing the running of the whole agency, rather than as resorting to quick fix measures to control costs and get around the 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 contracting out on the basis of the three qualities identified, competence, independence and legitimacy. For contracting out to be successful, regulators should seek to foster competition in the providers’ market, introduce mechanisms for ensuring transparency in the selection process to avoid corruption and establish systems for strong performance monitoring.

Implications for External Support for Regulators

Paradoxically, those regulators who would most benefit from contracting out are the ones that have most difficulties in entering into such agreements to bring about a satisfactory outcome, either for lack of financial capacity or capacity to monitor performance, or insufficient access to the external contractors’ supplier market. They need external support in doing so, and this area should receive increased attention from international donors. Potential ways for donors and lending agencies to support the development of contracting out practices are therefore put forward as a conclusion.
INTRODUCTION

1.1 Study Objectives

The World Bank initiated this research to capture regulators’ experience with contracting out, in order to understand how it can be made more effective. The World Bank commissioned Environmental Resources Management (ERM) to conduct a review of international experience on contracting out of regulatory functions and to provide a decision-making framework for policymakers and regulators considering contracting out regulatory tasks in the presence of financial, human, or credibility constraints that hamper traditional regulatory approaches.

The motivation for this study was the observation that contracting out is already commonly used in developed and developing countries for regulatory functions but that there is no currently published analysis of how this can be made to work better and can be applied for a broader range of functions, or in more challenging environments where regulatory capacity is weak. (1)

1.2 Background to the Study

The provision of infrastructure services has undergone major changes in the last decade with many developed and developing countries choosing to move away from the traditional public sector model of service provision and to introduce private sector participation. This calls for strong and competent economic regulation of infrastructure services, in order to ensure that the interests of all parties are protected: first and foremost, customers’ interests but also those of the public and private parties to a contract. Since the beginning of utility reforms in the late 1980s – early 1990s, it is estimated that about 200 regulators in some 130 countries have been granted the functions of regulating public services such as telecommunications, water, and electricity. Those institutions can either take the form of an independent regulatory agency, or be set up as a specialised cell under line Ministries, or even be a department within line Ministries.

The role of institutions in charge of carrying out regulatory functions, which we refer to as “regulators” in this report, is even more important where, for reasons like non-competitive industry structures and/or lack of capital market discipline, too little market information gets revealed and information asymmetries result, requiring them to conduct a much more intrusive and demanding form of regulation. In addition, regulators in developing countries need to rise to specific challenges, when large portions of the customer base for infrastructure services are poor and unconnected, tariffs are being kept artificially low, baseline information for decisions tends to be limited or

(1) The conceptual framework for this research and examples of institutional frameworks and case studies is based on initial ideas set out in the note “Contracting Out Utility Regulation” prepared by Lorenzo Bertolini at the World Bank.
unreliable and the agencies in charge of regulation have difficulties in establishing their credibility and sound governance arrangements.

To be effective, agencies in charge of regulation are required to be competent (measured by access to technical expertise in a wide variety of areas), independent (from government interference and capture by service providers and interest groups) and legitimate (abiding by existing legal principles and practices and being transparent and accountable). Those features are not always fully present in developing countries because of limited resources. Regulators may fill this resource gap by contracting out a variety of regulatory functions to a variety of external providers, including other public agencies (in-country or international), private consultants, NGOs, etc. Contracting out is here defined as:

“The use by a regulator of an external contractor, instead of its own employees to perform certain function(s). Such external contractors can be consultants, individuals, other government entities (in country or outside, including at a regional level) or NGOs. Contributions by external contractors can either be solely advisory in nature or be binding on the ultimate regulatory decision. The overall exercise of functions, however, usually continues to be the ultimate responsibility of the regulator, who is accountable to taxpayers for the role conferred to it by the relevant statute(s).”

Contracting out decisions need to be taken in two main instances:

- **Policy-makers** need to take an initial view about contracting out 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 need to be creative as mechanisms for contracting-out can effectively be “built-in” into the regulatory framework;

- **Regulators** are constantly confronted with the “make vs. buy” decision for all their activities. They need to develop a clear strategy for approaching those decisions, and not treat them as a quick fix measure. To do so, they need to go through all the trade-offs involved in alternative ways of carrying out their regulatory functions.

Policy makers and regulators can use contracting out at various stages of the regulatory framework lifecycle and for different sets of reasons. When designing a regulatory framework, policy makers can think about how to build in and fund contracting out mechanisms,. Once set up, regulators can consider contracting-out 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 initial phase of assistance and need external support in order to establish their autonomy; others are better established and would carefully consider the costs and benefits of contracting-out in order to decide whether to perform a task in-house or via external consultants. The focus of this study is on the decisions regarding contracting out that are taken
when designing institutional models and on the contracting out decisions that regulators which have already been set-up would need to take, rather than on the type of assistance that is required during the initial start-up phase.

1.3 **RESEARCH METHODOLOGY**

This research used a variety of instruments in order to gather as much representative and detailed information as possible on the theory and on the practice of contracting out utility regulation functions around the world, both in developed and developing countries. The following instruments were used:

- **Secondary literature search**: we reviewed the literature on the “contracting out issue” in other contexts and looked for readily available materials on the practice of contracting out on the Internet. However, comparatively little has been written on this issue for utility regulation so this review proved largely insufficient (see bibliography in Annex E).

- **Direct interviews**: we complemented this initial analysis through interviews and discussions with World Bank staff and other professionals who have extensive experience in working with regulators in order to define the list of key issues to be reviewed through the research (see list of people contacted in Annex F).

- **Primary survey**: we conducted a survey of about 136 regulators, sending a survey instrument (contained in Annex A) and following up with direct contacts. Following repeated contacts, we obtained responses from a total of 51 agencies, with a 38% response rate. Detailed survey results are presented in Annex B and the list of the regulators that took part to the survey is in Annex D.

- **Case studies**: in addition, the contracting out decision and its context was analysed in greater depth for the case of five regulators, including for water regulation in Gaza, Bucharest and Chile, for telecommunications regional regulation in the Caribbean region and for multi-utility regulation (water and electricity) in Gabon. The case studies were chosen to achieve a balance in terms of sector and regional coverage, quality of learning and experience, agencies in different stages of evolution (nascent to advanced), different initial conditions and motives for regulation, types of institutional models and the level of success achieved. Full results of the case studies are contained in Annex C.

Considering the limited amount of readily available information and the short time frame for this project, this research could not be exhaustive but it sought to set the basis for drawing out an overall framework for contracting out and identifying areas for future research. A workshop was held at the World Bank to discuss the study findings on 11th September 2003. Feedback from this workshop has been critical in determining recommendations and identifying areas that warrant further research.
1.4 REPORT STRUCTURE

The results of these different streams of research were brought together in order to provide a concrete basis for the issue of contracting out utility regulatory functions. On this basis, we developed a decision-making framework for policy-makers and regulators to assist them with the contracting out decision— we also formulated recommendations for ways in which international donors could provide assistance for maximising the benefits and effectiveness of such contracting out. The structure is as follows:

- **Section 2** sets out an analytical framework for analysing utility regulation, setting out our definition of utility regulation, identifying the main regulatory functions and tasks that utility regulation involves, establishing principles for regulatory effectiveness and identifying trade-offs between those principles;

- **Section 3** discusses the theoretical rationale for contracting out by public or private agencies and how this rationale may be applied to utility regulation in order to improve regulatory effectiveness;

- **Section 4** sets out the main institutional models for regulating utility services and analyses how contracting out decisions can be formulated through the design of institutional models for regulation, in particularly challenging or weak institutional environments;

- **Section 5** presents the practical experience of contracting out as experienced by utility regulators that we have surveyed, focusing on their stated reasons for contracting out, their degree of satisfaction in doing so, and examining the critical issues to be considered by regulators once they have taken the decision to contract out. It then sets out a decision-making framework for regulators considering the contracting out of regulatory tasks in the presence of financial, human, or credibility constraints;

- Finally, **Section 6** draws out conclusions and highlights how external support can be provided to regulators to help them develop better informed contracting out practises.

In addition:

- **Annex A** contains the survey instrument;
- **Annex B** presents a detailed analysis of the survey results;
- **Annex C** contains the case studies of contracting out;
- **Annex D** shows the regulators that took part in the survey;
- **Annex E** contains the bibliography for this study; and
- **Annex F** shows the list of people contacted for the purpose of this research and the list of participants to the workshop held at the World Bank.
This Section sets out an analytical framework for analysing the issue of contracting out in the context of utility regulation. It starts by setting out our definition of utility regulation and identifying the main regulatory functions that need to be performed. It then turns to the analysis of key principles for regulatory effectiveness and examines trade-offs between those principles.

2.1 OBJECTIVES OF ECONOMIC REGULATION

The objectives of the economic regulation of infrastructure services can be broken down into three basic elements:

- To protect customers from private sector abuses and political interference;
- To protect the private sector from politically-driven decisions;
- To enable the public sector to carry out long-term policy objectives.

Such regulation is more or less needed depending on the economic characteristics of the activity under consideration; it is most needed when private markets are not operating as efficiently as they should be and when they are not delivering the optimal solution for consumers and society as a whole, i.e. in the presence of “market failures”. Regulation is different from merely supervising the application of rules defined in a law or contract, because it entails a certain level of discretion, in order to adapt the application of such rules to changing circumstances.

Finally, although in theory, regulation is needed for overseeing both private and public sector firms, in practice, regulating publicly owned organisations has proved more difficult, due to difficulties in establishing regulatory independence over a publicly owned utility (for the application of sanctions, for example) and in obtaining such utilities to be incentive or performance driven.

2.2 REGULATORY FUNCTIONS AND TASKS

Utility regulators are expected to facilitate efficiency in regulated industries, and to ensure that users and consumers can benefit from competition where appropriate. Economic regulation consists of a set of key functions, mainly price, service quality and competition (or “market entry”) regulation, as well as consumer protection. Those functions need to be performed according to a number of principles, preferably established by law, for specified outcomes, such as the delivery of an efficient service in equitable terms. Adequate

(1) For an analysis of the market failures that may drive infrastructure regulation, see Baker and Trémolet (2003), “Regulation of the Quality of Infrastructure Services in Developing Countries”, in “Infrastructure for Poor People: Public Policy for Private Provision”, World Bank/ PPIAF.

(2) Other functions may also be carried out by utility economic regulators, such as the definition and monitoring of health and safety or environmental standards but, most commonly, such tasks fall under the responsibility of other types of regulators (such as environmental or public health regulators) and are therefore not reviewed in detail here.
performing of such functions requires carrying out a number of tasks, i.e. specific activities that are instrumental in bringing about the required outcome, such as conducting studies to obtain information, or taking decisions on disputed matters.

The overall objectives of the main regulatory functions are defined below, together with examples of tasks for each function:

**Price regulation** consists of setting overall tariff levels and tariff structures so as to ensure delivery of services at an affordable cost while ensuring the long-term financial viability and efficiency of the sector. Price regulation entails a number of common tasks, such as the organisation of tariff reviews, which are usually conducted at regular intervals or following an extraordinary change in circumstances. Those tariff reviews represent a significant amount of work for regulators, especially if the number of regulated entities is large, and they call for specialised inputs in all domains, including economics, finance, legal, technical and communication skills.

**Service quality regulation** entails defining levels of service that meet customer needs and can be provided at a financially sustainable and affordable cost, and monitoring that such levels of service are actually provided. Related tasks include revising quality standards periodically, especially if existing standards are found to be rigid or excessively high service standards, thereby introducing barriers for the poorest customers for having access to those services. Monitoring for quality standards requires ongoing efforts, even though these can be reduced by the use of survey techniques and intermittent monitoring.

**Competition regulation** consists of ensuring that operators compete on a levelled playing ground. Regulators can carry out such functions in different ways. In the case of natural monopolies, in which firms tend to benefit from exclusivity conditions over a defined service area, they would need to ensure that competition for the market is fair and open. They may also seek to perform “comparative competition”, in order to replicate competitive pressures for the setting of tariffs or quality standards. Where no such exclusivity is granted, regulators need to ensure that new entrants have access to the market (or to parts of the existing network) on fair terms and to prevent the misuse of monopoly or market power by facilitating entry. This particularly applies to small-scale providers, who may purchase services in bulk to the main operator, and need to be able to obtain such services on the basis of fair terms.

**Customer protection** entails protecting consumers from potential abuses of the entity in charge of providing services. Such a function is particularly important where providers are in natural monopoly positions. Tasks related to customer protection include acting as a secondary complaint resolution mechanism, to ensure that consumers can argue their cause in front of a fair arbiter without having to resort to the Court system. Diffusing information
and raising public awareness are important tasks related to the consumer protection function.

*Table 2.1* below outlines the main tasks that are commonly carried out by utility regulators in order to perform their functions (note that some regulators may perform some or all of these functions simultaneously). These tasks are grouped into four clusters, distinguishing between tasks that entail:

**Gathering information** - Information is key for the performance of regulatory functions. Gathering and analysing information, and presenting it to the public or to regulated companies in a format that can be considered fair and objective is a very positive contribution that regulators can make. In some instances, where Governments are reluctant to transfer too much power to regulators or where markets are very difficult to regulate (this is the case for small-scale providers for example), it can be the only type of task that regulators actually perform and they need to make best use of it. For example, the publication of league tables on service quality performance can have an impact on firms’ reputation and make them improve quality. Those tasks do not require much discretion on the part of regulators, since transparency and fairness is of the essence of their effectiveness. On the other hand, they may require substantial technical skills, particularly with respect to quality regulation or competition regulation in order to produce information that is comparable and meaningful.

**Monitoring compliance with existing rules** - The second important series of tasks for regulators is to monitor that existing rules (embodied in the legal or contractual framework) are being complied with. As with information gathering, this does not require much discretion, but may require a high level of technical competence.

**Determining new rules** - A key distinguishing factor for regulators is whether they are able to go beyond the two sets of tasks above and actually have sufficient discretion for determining new rules, either to adapt to new circumstances not foreseen in the original legal or contractual framework (either on the demand or supply sides of the market, following from fluctuations in demand, technological change, financial market take-overs, etc). Regulators need to be sufficiently independent to be able to exert such discretion, as discussed in the next section.

**Enforcing rules** - Finally, for both existing and new rules, regulators must carry sufficient weight in order to enforce rules, particularly in the event of conflict. Not all regulators have been granted the power to enforce rules, which are sometimes viewed as judicial powers rather than regulatory ones. Such issues can be addressed through the setting up of specific bodies that can deal with appeals from regulatory decisions on rule enforcement. In all events, the performance of such tasks requires a high level of discretion.
### Table 2.1  Examples of Regulatory Functions and Tasks

<table>
<thead>
<tr>
<th>Tasks</th>
<th>Price Regulation</th>
<th>Service Quality Regulation</th>
<th>Competition Regulation</th>
<th>Consumer Protection</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gather information and data</strong></td>
<td>Get information on current and projected tariff revenues and costs</td>
<td>Obtain information on current service levels</td>
<td>Obtain information on illegal conduct or monopoly behaviour</td>
<td>Conduct customer Surveys</td>
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<tr>
<td></td>
<td>Get information on willingness-to-pay, for alternative service levels</td>
<td>Carry out technical studies</td>
<td></td>
<td>Organise call centres to file complaints</td>
</tr>
<tr>
<td><strong>Monitor the implementation of existing rules</strong></td>
<td>Audit financial accounts</td>
<td>Monitor that levels of service are met</td>
<td>Investigation of abuses of monopoly power – predatory practices, etc…</td>
<td>Administrative audit of systems and procedures in place to educate customers, and share information</td>
</tr>
<tr>
<td></td>
<td>Ensure that adequate tariffs are charged</td>
<td>Monitor that coverage targets are met</td>
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<td></td>
</tr>
<tr>
<td><strong>Determine rules</strong></td>
<td>Tariff reviews, linked to inflation or tariff rebasing</td>
<td>Define or review quality standards</td>
<td>Organise bidding process</td>
<td>Define consumer service standards or requirements</td>
</tr>
<tr>
<td></td>
<td>Modify tariff structures and payment methods</td>
<td>Adapt existing quality standards to real needs</td>
<td>Rule on competition case following complaint</td>
<td></td>
</tr>
<tr>
<td><strong>Enforce decisions</strong></td>
<td>Enforce decisions</td>
<td>Require improvements in service quality</td>
<td>Mandate break-up of monopoly power or changes in access terms</td>
<td>Resolve dispute between consumers and regulated firm</td>
</tr>
<tr>
<td>Enforce decisions</td>
<td>Define tariff adjustments on basis of performance</td>
<td></td>
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<td></td>
<td>Apply penalties</td>
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2.3 REQUIRED QUALITIES FOR REGULATORY EFFECTIVENESS

International experience indicates that to a large extent, the long-term sustainability of sector reforms depends on the effectiveness of the underlying regulatory environment and of the institutions administering the regulatory process. In this regard, regulatory functions should preferably be administered by entities possessing three qualities: competence, independence and legitimacy. (1)

2.3.1 Three core qualities: competence, independence and legitimacy

**Competence** - Regulators are expected to possess or muster, when needed, a diverse pool of knowledge. This includes industry knowledge, economic skills, knowledge of a range of regulatory instruments, understanding of quantitative and analytical models needed to carry out cost benefit analysis, and some technical background to appreciate ever expanding technology, particularly in sectors like telecommunications and power. Also required is a background in law and finance. In the absence of this knowledge base, agencies will be at risk of being dominated by service providers, who possess a far superior understanding of these issues and have no incentive to voluntarily share it with regulators. Regulators with limited competence may ask for too much information, increasing the cost of compliance and compromising trust, or ask for too little information, not paying sufficient attention to the quality of the information provided, for example. This increases the likelihood of regulatory failure.

**Independence** - Regulators are expected to maintain an arm’s length relationship with regulated firms, consumers, government, and other private interests in order to avoid being captured by any of the interest group that they are expected to protect. This is possible only if agencies have a high degree of autonomy in taking decisions, which itself is dependent on factors such as the existence of a legal framework on which to base those decisions, independent funding sources, and clear rules limiting political appointments and dismissals. Regulators with limited independence may compromise the long-term benefits of the sector at the favour of short-term political interests.

**Legitimacy** - Regulators have to exercise a certain degree of discretion (particularly for the determination of new rules or the enforcement of decisions) and they need to be independent from political powers, and therefore ensuring their accountability and legitimacy can be a critical issue. This is complicated by the fact that they have to be accountable to parties with a set of conflicting interests. Governments have fixed terms in office and may try to put pressure on regulators to meet their short-term objectives. Investors are aware of the vulnerability of their sunk and immobile investment, and expect credible long-term commitment from governments and enforcement from regulators. Consumers, on the other hand, expect quality services at the lowest price, and this makes utility pricing decisions politically sensitive.

(1) See works by Warrick Smith in Bibliography contained in Annex E.
In this conflicting environment, regulators must establish trust and reputation, and they acquire these qualities by adopting a mix of transparency-enhancing measures like formal and informal consultative measures, external audits and appeals processes. They need to be accountable for their decisions in order to minimise the risk of such decisions being questioned or disputed.

2.3.2 *Trade-offs between required qualities*

Such qualities may be difficult to combine within an agency because there are clear trade-offs between them, as represented in the *Figure 2.1* below.

*Figure 2.1 Trade-offs between Required Qualities for Regulatory Effectiveness*

*Independence vs. legitimacy* - independence may be at the expense of legitimacy because maintaining independence often requires a degree of protection over the data and the analysis used in reaching regulatory decisions. In addition, independence is related to the potential for an increased degree of discretion, and if that is not wisely used, can compromise accountability and legitimacy. In reverse, legitimacy may be increased by extensive public consultation, included with elected officials, but that may limit the regulator’s ability to take decisions independently.

*Competence vs. independence* - competence can be increased through drawing in external experts in order to perform key tasks or through relying on other public agencies for providing support. However, this may affect independence if the agency becomes over-dependent on such experts (which may themselves be subject to conflicts of interest, if part of their firm is also advising the utility operator, in the same country or abroad) or if such external public agencies have their own agenda. In reverse, independence may be
increased through reducing dependence on external experts, but at the expense sometimes of competence.

**Competence vs. legitimacy** – as above, competence may be increased through reliance on external experts but that may be at the expense of legitimacy, if such experts are from abroad and are seen as not having any local legitimacy. In reverse, means of increasing regulators’ legitimacy, such as locating agencies closer to customers in an environment, may compromise competence.

Such trade-offs need to be taken into consideration when taking decisions about the legal and institutional framework and means of counter-balancing such trade-offs need to be thought through with an appropriate set of checks and balances. Alternative institutional models for regulation, and how they can balance those three principles are discussed further in Section 4.

Many, if not all, regulators in developing countries lack one or all of the qualities required for effective regulation (competence, independence and legitimacy). These shortcomings can be due to many reasons, including limited resources, short or no history of performing regulatory functions, repeated political interference in regulatory decisions or difficulty in attracting and retaining competent staff. They are particularly apparent in the case of countries emerging from social strife or where the political environment makes it difficult to set up any kind of institution with degrees of independence, let alone legitimacy or competence. This in turn limits their capacity to act as effective regulators, i.e. to foster adequate levels of investment in the regulated sector through the setting of tariffs that recover costs, to attract private investment and/or to monitor the public sector for superior performance. In these circumstances, contracting out of regulatory functions can play a key role.
This Section discusses the theoretical rationale for contracting out by public or private agencies and how this rationale may be applied to utility regulation in order to improve regulatory effectiveness on the basis of the qualities highlighted above.

3.1 THEORETICAL BACKGROUND: THE “MAKE VS. BUY” DECISION

Public bodies and private companies are permanently confronted with the decision of whether they should “make” (i.e. produce a product or service internally) or “buy” (i.e. contract it out). Several factors may come into play in reaching such decisions:

**Evaluating the costs and benefits of contracting out** - Public bodies and private companies need to consider the costs and benefits of contracting out versus in-house provision. Contracting-out generates higher transaction costs, including both contracting and monitoring costs. It requires maintaining minimum levels of qualified staff in-house in order to specify employment terms clearly and in a way that fits the specific purposes of the activity, or to correct the service provided externally in the event of provider failure. However, contracting-out also allows savings on the long-term costs of hiring specialised experts, who may be required in very specific cases only and under-employed the rest of the time.

**Filling the competency gap** - By contracting out functions where “in-house” capacity is limited, public bodies and private companies often attempt to fill the “competency gap”, i.e. to acquire competence on a short-term basis to develop specific systems or carry out training. This may be particularly required for competencies that are highly specialised, which is directly linked to the cost/benefit assessment highlighted above.

**Reducing costs, for the same level of quality** - Contracting out, if done in the right fashion, enables agencies to benefit from the combined force of specialisation and competition, and therefore to reduce their costs substantially (despite a perceived increase in transaction and monitoring costs). Overall, it has been estimated that the benefits of competitive contracting out may allow reductions in costs by as much as 10-20 percent, whilst maintaining constant quality.

**Identifying the agency’s core functions and contracting out the rest** - Public bodies and private companies need to assess their functions according to their relevance to their core values, and contract out others. For example, schools in...
United States have found it easier to contract out mundane functions like building maintenance and transportation, where in-house capacity would be easy to establish (if not the most economical), but have found it very hard to contract out teaching itself because of debates about its “public good” value. All of these standard reasons for contracting out apply to utility regulators but in addition, it appears that utility regulators have very specific reasons for seeking to contract out the tasks that carry out under each of their functions.

### 3.2 Rationale for Contracting Out Utility Regulation

Contracting out can help utility regulators in improving their performance with respect to the three main qualities highlighted in Section 2: competence, independence and legitimacy. In addition to these three themes, the reduction in regulatory costs is also considered, even though such impact may have clear linkages with other benefits in the short-term (such as increasing competence). Ways in which contracting out can serve each of these purposes are presented below.

**Increase Regulatory Competence**

Contracting out can increase regulatory competency, by helping agencies to respond efficiently and appropriately to variable workloads, changing market structures, and can enhance competency through the use of external experts.

**Contracting out can provide access to specialised skills only when needed** - In many developing countries technical skills are extremely limited, particularly in the public administration. Contracting-out may help reduce the costs of procuring the required expertise, or for a given cost, increase the competence with which regulatory functions are performed. Contracting out may also give regulators access to specialised skills only when needed (i.e. at peak times), thereby reducing costs. Indeed, for many regulators, the workload is variable or it requires small amounts of specialised inputs (for example, for initial activities such as asset inventory or recurrent ones, such as tariff reviews). In addition, binding public service rules may prevent the hiring of highly specialised experts who tend to be more expensive than what the standard civil service salary scale could afford. While contracting out may help attract technical expertise at a lower cost, regulators would still need to maintain adequate in-house skills to determine regulatory requirements, supervise hired consultants and take credible decisions.

**Mitigate the risk of regulatory obsolescence** - The senior management in regulators may not have all the technical expertise to quickly react to new market expectations or keep up to date with technical and regulatory advances. This is especially true for dynamic sectors like telecommunications, power, gas etc., where “vertically integrated” structures limit regulators’ access to rapidly changing market segments, such as in the case of mobile telephony or Internet services. Contracting out can provide a strategy to
mitigate the risk of regulatory obsolescence, by tapping into a pool of specialists who have the ability to keep up to date with market changes.\(^{(1)}\)

**Leverage international experience** - Even in the countries where a strong local regulatory capacity exists, such as in Latin America or South East Asia, there is still a preference to tap international consultants through global bids. There is no single region where all regulatory skills are concentrated, and by hiring consultants that have worked on similar issues in other countries and regions, agencies are able to leverage this experience at competitive prices. For example, experts specialised in financial engineering or in estimating the cost of capital, are frequently called upon to contribute to specific portions of tariff review exercises.

**Build core in-house skills** - Agencies frequently use external organisations to train their managerial and technical staff because without a strong in-house team, agencies find it difficult to specify and monitor contracts, and this diminishes the potential impact that contracting out can have on an agency’s competence and effectiveness in the long run. External experts are therefore not only required during the start-up period, but also on an ongoing basis.

**Foster Regulatory Independence**

**Benefiting from an external agent’s reputation** - Contracting out a regulatory function to an external entity such as a reputable international firm may reassure investors as to the independence of the regulatory process from short-term political capture. However, the ability of external agencies performing regulatory tasks to avoid conflicts of interest and withstand pressures from industry, government, and other stakeholders varies widely across countries. In some circumstances, external agencies performing regulatory tasks may have more reputation at stake than a public authority, and thus be more credible in terms of their ability to withstand undue pressures. In other cases—for example, in small markets with limited competition for consulting services—an external agency may find it more challenging to preserve independence vis-à-vis stakeholders.

**Issues of control** - Many agencies do not have the freedom to hire core staff or even to fire incompetent staff. There are also instances where the staff selection process is highly politicised or very rigid due to constraining civil service rules. In such cases, even if there are no budgetary constraints, senior managers seek to contract out the work to private agencies that can be better controlled than the in-house staff.

**Ensure Regulatory Legitimacy**

Countries with weak or fledgling institutional capacity may find that contracting-out specific regulatory functions may increase the legitimacy of the regulatory process.

External studies may be perceived to be more credible - For example, external consultants are often used in public hearings for presenting neutral viewpoints on important policy decisions, whereas in-house studies carried out by regulators would be afforded much less credibility. As a result, even where in-house capacity exists to carry out such studies, consultants are often hired to provide a second or third opinion to lend greater credibility to the process, and some cases, external advice may be required by law. For example, third party technical studies are used in court cases in Bolivia, and hiring external agencies is required by law in the Brazil electricity distribution sector and the Chile water sector. In the Argentina 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.

The need for transparency mechanisms - This being said, the contracting out decision does not absolve the regulators of their accountability; they are still responsible to ratepayers for efficient service delivery at the lowest cost possible. Regulators need a clear understanding of the underlying “policy” and/or “technical” issue, and the ability to specify, monitor and measure contract performance. In order to foster legitimacy, contracting out needs to be complemented by sound transparency mechanisms and clear accountability procedures. Transparency and ongoing communication with key stakeholders help regulators build and sustain legitimacy. Regulators sub contract external firms to prepare public consultation documents, to undertake public relations campaigns, and also to serve as a first window of information for consumers.

Reduce Costs (without compromising quality)

High fixed costs are a common problem for regulators, particularly in countries where utility markets are still small, as it is typically the case in developing countries. (1) Cost reductions can be brought about by contracting out for a number of reasons, as detailed below. As a rule of thumb, the benefits of contracting out will likely increase when the outputs and the performance of the external contractors can be specified and measured easily, so as to limit counterbalancing monitoring costs.

Information about the real cost of performing the task or service - in the same way as competition for utility service provision reveals important market information to the regulators, competition between external providers for carrying out regulatory tasks reveals information on the cost and quality of carrying out such tasks to the senior regulatory managers, which would not be possible if they were simply delivered “in-house”. In addition, as every work contract can be treated like a stand-alone profit centre, the providers are continuously striving for improved efficiency and effectiveness in order to increase their chances of winning the next contract. This competitive element is hard to replicate in-house by regulators bound by rigid civil service rules.

**Economies of Scale** - Like the market for utility service provision, the market for regulatory services is also driven by economies of scale. The market is characterised by high start-up fixed cost, and continuous investment needs, in the form of large staff training costs. External providers can spread such fixed costs over much larger markets (including national and international), and therefore offer superior consulting services at lower per unit cost. Regulators, with their limited budget, find it uneconomical to invest in building internal competency when they can procure such competencies outside for less cost.

**Saving Management Time** - Management time is the scarcest resource for many agencies, and contracting out helps the management to focus on their core competencies, which can often be the coordination of various regulatory functions, rather than the performance of specific ones. Therefore, costly management time can be better used on core functions through appropriate contracting out of more specialised regulatory functions.

Increasing competence is often seen as a key motivator for contracting out, but it is seldom considered that contracting out can also assist budding regulators or regulators with limited independence to increase their independence and legitimacy.

It may be difficult for contracting out to improve the performance of regulators on all of these dimensions at once, however. For example, contracting out 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 contract out will depend on whether the trade-off between increased competence and decreased legitimacy makes contracting out worthwhile, and whether possible measures exist to improve the trade-off between legitimacy and competence.
This Section starts by setting out the main institutional models that have been developed for regulating network industries and analyses some of the problems that they have encountered to be effective in certain developing countries. To overcome such institutional shortcomings, we suggest that contracting out decisions can be built into the design of institutional frameworks for utility regulation, in particular, when such regulation needs to be performed in challenging or weak institutional environments. This section presents existing examples of cases where contracting out has been built-in, which are presented in more detail in Annex C and draws out implications for policy makers designing regulatory frameworks.

4.1 INSTITUTIONAL MODELS FOR REGULATION

Regulatory functions can be performed by a variety of institutions, which are more or less effective in terms of establishing regulatory independence and legitimacy and which may require more or less effort in terms of establishing regulatory competence.

Since the start of the utility sector reforms in the 1990s, strong emphasis has been placed on the establishment of independent regulatory agencies (either focused on one sector or on several sectors) as this model was deemed to be the most able to combine all the qualities described above and to minimise the potential trade-offs. Policy-makers have also considered a broader range of institutional options when deciding on the establishment of a regulatory framework, including strengthening regulatory oversight within line Ministries or contract supervisory units.

Below, we give a brief introduction to these alternative models.

4.1.1 Independent regulatory agencies

Since the early 1990s, the World Bank and other donors have encouraged developing countries to create independent regulatory agencies for utility services. These agencies have a long history in the United States or more recently in the United Kingdom, where they are deemed to be the most efficient institutional model displaying the qualities set out in Section 2.3: they tend to be specialised bodies with a higher potential for strengthening competence; they are set up to be independent from policy-making functions and therefore from political interference; and adequate safeguards are usually in place in order to ensure that they strive to maintain their legitimacy in the eyes of regulated companies, politicians and the public at large.

Geographical location - Regulatory agencies can be set up at various levels of government (federal, regional, municipal), often depending on the regional level at which the service is itself being provided. Certain sectors are more
national in nature, a good example being telecommunications, whereas others like water and sanitation are more local in nature with no interconnection issues involved. It may be more effective to have a national regulator for the former and a municipal regulator for the later, although national regulators can also play a role in the water sector in ensuring comparability of services from one provider to another. Other factors that determine the location decisions include the country’s institutional endowment, the size of the market, the jurisdictional size and the capacity and scope of responsibility of the regulatory agency.

**Sector coverage** - Regulatory agencies can be set up for one sector only or for several sectors. In many countries, regulatory agencies were set up for single sectors due to the different pace of reform in each of the utility sectors. Other countries have preferred setting up multi-sectoral regulators, to oversee a sector as a whole (for example, the energy sector including natural gas and electricity) or several sectors (often including telecommunications, energy and water and sanitation). An increasing number of countries with a small client base and limited regulatory capacity have opted for multi-utility institutions over single sector regulators.\(^{(1)}\)

Experience with the independent regulatory agencies, under their various forms, has not always been successful for several reasons: \(^{(2)}\)

- *Some regulatory agencies were established but were given only limited independence* when they were originally set up, since independence is often a relatively new legal concept for many legal traditions and it can be difficult to establish (both legally and politically);

- *Many of the regulatory agencies that were established have never become truly independent*, because Commissioners find it difficult to assert their authority over politicians, who have many ways at their disposal to compromise regulators’ long-term prospects if they go against their political motives, even if outright dismissal is not legally allowed;

- In the case of decentralised services (such as for water and sanitation services), *municipal governments often resist the establishment of independent agencies at the national level* which they see as an attempt to re-centralise service provision whereas units set up at a municipal level have tended to be contract supervising units rather than full-blown regulatory agencies;

- In other cases, resistance to the establishment of regulatory agencies has come from a *lack of understanding of what their specific functions may be, or a reluctance to create additional agencies in order to contain costs*.

\(^{(1)}\) See Smith (1997) c.d. on the advantages and disadvantages of multi-utility regulation.

4.1.2 Alternative Institutional Models for Utility Regulation

The establishment of independent regulatory agencies has not always proven to be the most effective institutional option to ensure sound regulatory administration. Policymakers have considered alternative regulatory, such as the assignation of regulatory functions to existing institutions (such as line Ministries or municipalities) or heavier reliance on regulation by contract with possibly, the establishment of contract supervisory units. These regulatory models may not necessarily achieve all the qualities that have been highlighted for regulatory effectiveness (i.e. competence, independence, and legitimacy). But they may have other advantages, such as avoiding the higher costs and complexity of creating new institutions with potentially overlapping functions, and reducing the level of regulatory uncertainty that independent agencies with broader discretionary powers could imply.

Regulation by contract with supervising units - Regulation by contract is the most common alternative model to independent regulation. It consists of pre-specifying, in one or more informal or explicit agreements the main operating conditions for the utility that is regulated. If the terms are specified adequately, important decisions such as tariff reviews should be fairly mechanistic and can be simply processed by a supervising unit located at the level of government where the contract has been let, i.e. national (such as within a Ministry) or municipal.

The main difference between supervisory units and regulatory agencies is that the former have a more limited degree of autonomy and depend more on policy-makers or the Court system to deal with unforeseen circumstances. Their independence from political interference therefore tends to be more difficult to maintain, whilst their competence is more challenging to establish, as they are not set up as a specific unit concentrating on regulatory competencies. One benefit of this model, however, is that it avoids multiplying institutional structures in countries where resources (both financial and human) are already limited. However, the potential for contract incompleteness remains an important issue under this kind of model, where the risk of dispute and contract renegotiation is therefore higher than in a regulated framework.

Other forms of regulatory frameworks with “built-in” contracting-out - Other forms of regulatory models can be employed, such as the use of technical panels, or advisory panels, or the reliance on regional regulators which have an implicit degree of “built-in contracting out”, whereby part of the responsibility for regulatory functions is transferred to an external agency. These models are reviewed in more details in the next section.

4.2 Regulatory Models with Built-in Contracting-Out

When deciding on the establishment of a regulatory framework, policymakers are implicitly (or sometimes explicitly) making a judgment about the level of contracting-out that needs to be built into in the institutional
framework itself, because of constraints to regulatory effectiveness that can already be observed at the design stage or that they can readily anticipate.

In certain difficult institutional environments (because of lack of experience with regulation or difficulties in establishing independence), policy-makers have decided to build into the institutional framework mechanisms that prescribe contracting out. Considerable creativity has gone into the design of such arrangements, to address specific shortcomings, resulting in a great variety of models. Therefore, the arrangements presented here are not a narrowly defined list - hybrid arrangements taking features from some of those presented here, or entirely new arrangements, could be designed.

Those potential models are summarised in Table 4.1. below and presented in more details in subsequent sections. In this table, we draw a key distinction based on whether the recommendations that are produced by an external agency are purely advisory or binding in nature. This characteristic is seen as 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. The difference between contracting out advisory and binding regulatory tasks is explained below.

**Contracting out advisory tasks** - When contracting out advisory tasks, regulators expect expert advice, but are under no obligation to accept the recommendation. Considering the political nature of underlying policy decisions that technical information are supposed to back, it will be rare for the external provider to recommend a single option. Rather, it will often come up with a menu of options, leaving the final decision to the regulator and providing more room for political influence and reduced independence. Used in such a way, contracting out is mostly used to foster competence, but can do little to enhance independence or legitimacy. This form of contracting out is the most prevalent but is not necessarily the most effective in difficult institutional environments.

**Contracting out tasks that are binding in nature** - There are cases where more binding forms of contracting out are being used for utility regulation. (1) In such cases, recommendations given by the external provider must be directly applied, with no choice given to the regulator on alternative options. The clause permitting the use of binding contracting out is either explicitly built into the contract ex-ante or broadly allowed in the sectoral laws passed by executive decrees. This form of contracting out, in a way, tests the limit of contracting out utility regulatory functions. Where the ability of civil servants in charge of regulation to serve public sector interests is severely curtailed, i.e. in weak institutional environments, contracting out decisions to external bodies is seen as a useful way to not only increase competence, but also to foster independence and legitimacy.

(1) Note that construction contracts have for a long contracted out binding decisions to independent engineers. However, the content of such contracts tends to be more technical and less political in nature than utility regulation.
|--------------------|---------------------------------------------------------------------------------|---------------------|---------|----------------------|------------------------|---------------------|
| Gabon, water and electricity concession | Regulation by contract with contract supervisory unit housed in the line Ministry. The contract includes the requirement to use external contractors for specified data gathering and performance monitoring exercise, with specific funding. | • Data gathering  
• Monitoring compliance with coverage targets | No | ↑ | — | — |
| Gaza, water management contract | Regulation by contract with contract supervisory unit in the national sector agency. The contract defines that an external auditor should set the performance-based payment for the contractor. | • Monitor compliance with quality targets  
• Determine payments to regulated company | Yes | ↑ | ↑ | — |
| Bucharest, water and sanitation concession | Contract supervisory unit at the municipal level. A national Ministry is in charge of setting tariffs but Expert Panels have a key role in adjudicating tariff reviews, and their decision are almost binding. | • Tariff determination | Almost | ↑ | ↑ | — |
| Chile, water divestitures | National regulatory body with limited independence. Arbitration Panels can settle disputes between the regulatory body and regulated companies | • Dispute settlement (for enforcing decisions) | Yes | — | ↑ | ↑ |
| Caribbean, telecommunications | Regional regulator set up by international Treaty. Responsible for a number of specific activities, but majority of role is devoted to providing guidance to the Contracting States | • Develop new rules  
• Dispute settlement | Yes? | ↑ | ↓ | ↑ |
| Tri-sector partnerships in water (Global) | Tri-sector partnerships allow | • Data gathering  
• Develop new rules  
• Dispute settlement | No | ↑ | — | ↑ |

Key: ↑: Positive; —: Neutral.
4.2.1 Contracting out contract compliance monitoring functions

Contracting out can be used for reinforcing contract supervisory units, which are often the institutional model in place for performing regulatory functions when regulatory bodies have not been set up, as described in Section 2.4.2.

Detailed contracts can specify the use of contracting out for specific functions, ranging from monitoring the fulfilment of contractual conditions by the private operator to settling disputes. Contracting out of monitoring functions can be more or less binding and as such, can simply reinforce competence, as in Gabon (see Annex C and Box 4.1 below), or also independence and legitimacy, as in Gaza (see Annex C and Box 4.2 above).

Box 4.1 Strengthening regulatory competence through contract provisions in Gabon

In July 1997, SEEG (Société d’Energie et d’Eau du Gabon) 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 the service to previously unconnected rural areas. The Government chose not to set up a regulatory body but incorporated contracting out mechanisms in the design of the contract for strengthening the independence and competence of the Ministerial department in charge of effectively regulating the contract. In particular, the contract incorporated clauses that required the contracting out of some key regulatory functions such as the monitoring of coverage performance (with dedicated funds, set aside from the concessionaire’s revenues), although external agents are limited to producing non-binding studies. Also, contracting out 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), and that were left to an initial transition period during which many contractual terms were to be defined.

Source: see full case study in Annex C.

Box 4.2 “Binding” contracting-out arrangements in Gaza for performance auditing

The Gaza Management Contract, one of the first private sector initiatives in the Middle East water sector, used an innovative contracting out 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% of the allotted annual performance linked fee of $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 of lack of competence and limited independence in nascent regulatory agencies.

Source: see full case study in Annex C.

Note that such contracting out is frequently used in some sectors in developed countries: for example, monitoring and allocation of frequency spectrum in telecommunications, and environmental, quality and health certifications are often provided by private companies in the U.S. and other countries.
4.2.2 Contracting out Decision Making on Tariff Determinations

Decision-making regarding a wide range of regulatory decisions (and particularly important ones such as tariff determinations) may be delegated, under the contractual arrangement concluded by a private operator and a conceding authority.

One particular way of doing so is to contract out much of the decision-making functions to a technical panel – independent in some cases and reporting to existing regulatory bodies in others. In some cases, the rationale of a technical panel may be to comfort investors as to the competence and independence with which sensitive decisions such as tariff setting decisions are taken. In others the motivation may simply be to reduce regulatory costs, in recognition of the efficiency of available market-based alternatives. Rules regarding the mandate and procedures of an expert panel are included as part of the regulatory framework underlying the water and sewerage concession contract for the City of Bucharest, as summarised in Box 4.3.

Box 4.3 The role of Expert Panels in Tariff Adjustments in Bucharest

Water and sanitation services in Bucharest were privatised in 1998. As part of the privatisation process, a new technical regulator was created to oversee contract compliance. For legal reasons, the responsibility for setting tariffs could not be taken away from the Ministry of Finance, so Expert Panels - funded through a customer levy and selected by the concessionaire and the Municipality - are involved in the tariff-setting process, complementing the functions of an existing technical regulator. The contract gave these panels important powers to adjudicate tariff decisions, but within the processes laid out in fine detail in the contract. On paper, the Ministry of Economics still clears the tariff reviews, but the contract made it very difficult for it to either delay or disagree with the opinion of the Expert Panel.

To a large extent, the effectiveness and legitimacy of technical panels will depend on their independence and on the measurability and accountability of their responsibilities. In the case of small and medium sized countries, experts probably need to be hired internationally — as in the case of Panama’s power market surveillance group — in order to minimise perceptions of capture due to past connections in the industry. (2)

However, in order to maintain the legitimacy of such external contractors (be they Technical Panels or others) in the process of tariff determination, it is preferable to have a sound regulatory framework in place. For example, in Honduras, a multi-sectoral municipal Contract Supervision Unit is in charge of supervising the concession contract for water and sanitation services in San Pedro Sula, a large city in the north of the country. Three years into the contract, this Unit will need to reset tariffs and according to the terms of the

Contract, it will need to hire an external adviser to do so according to international best practice. In the absence of a sound regulatory framework for setting tariffs at the national level and in the absence of clear tariff-setting principles in the contract, however, this could be subject to interpretation and decrease the legitimacy of the external adviser. The validity of this contractual clause has yet to be tested in a context where sound national regulatory arrangements for water and sanitation services are repeatedly being delayed.

4.2.3 Contracting out dispute settlement mechanisms

Dispute settlement is an important element of the regulatory process. Many regulators have developed internal mechanisms to settle disputes between operators, consumers, government, and the regulator, as an alternative to the often lengthy and costly procedures available through ordinary courts.

In cases where regulators are not entirely independent (no security of tenure, dependent on government for budget, limited freedom from civil service rules etc), the private sector doubts agencies’ credibility and effectiveness. In such cases, arbitration panels can be established to enhance the regulator’s independence, as it was done in Chile, as described in Box 4.4 below.

Box 4.4 The role of Arbitration Panels in Chile

The Chile water sector is characterised by a two-level regulatory system: on the one hand, the Superintendence of Water and Sanitation (SISS), responsible for regulating the water and sanitation sector in Chile suffers from limited independence; on the other hand, arbitration panels made up of independent experts have been put in place in order to settle disputes between SISS and regulated companies, especially for tariff reviews. These panels are staffed with three private independent professional experts (not the employees of regulators), and their decisions are binding on both the government and the private operator. Arbitration panels with their binding decision making power lends substantial credibility to regulatory process, by giving the private sector an avenue to appeal decisions, deemed unjust by them. As a result, and unlike in other neighbouring countries, no substantial disputes have affected the Chilean water sector.

Source: see full case study in Annex C.

In other cases, particularly those involving international investors, dispute settlement (including mediation, conciliation, arbitration and litigation) can be “contracted-out” to an international dispute settlement body through the contract. International dispute settlement bodies such as the ICC, ICSID, or the LCIA operate on the basis of their reputation for high competence and independence, and their legitimacy stems from obligations undertaken by Governments to recognise and enforce arbitral awards. Arbitral awards may thus substitute to some extent for regulatory decision-making (e.g. vis-à-vis tariff setting); provide an appeal mechanism for decisions taken by regulatory bodies (e.g. on decisions regarding the rate base) and as such, constitute a way of enforcing the contractual obligations.

However, its practical effectiveness depends heavily on three uncertain variables: i) timeliness of arbitral decision-making process, ii) availability of
expert capacity, and iii) ease of enforcement of arbitral awards. (1) Furthermore—due to the relatively limited public participation and confidentiality of most arbitration procedures—contracting out dispute settlement to arbitration bodies may somewhat challenge the legitimacy of the regulatory process in the eyes of some stakeholders. In such cases, the legitimacy of the decisions can be improved through measures to increase transparency, as it was done during the extraordinary price adjustment arbitration process for water services in Manila. When hearings were held, there was a debate about whether the public should be allowed to attend. The final decision was to set aside a room for the public with a television monitor showing the arbitration; also, the hearings were taped and are available to anyone a year after the hearings if both sides agree.

This being said, contracting out dispute settlement functions to a recognised international or domestic arbitrator may indeed serve as a powerful tool to comfort investors as to the competence and independence with which potential disputes would be addressed, and would strengthen the commitment of countries with weak public institutions to honour their contractual and regulatory obligations.

4.2.4 Contracting out to regional Regulators

Another type of institutional option for contracting out a large number of regulatory functions and tasks is to obtain regulatory assistance from regulators in other countries or regions, either through the setting up of a regional regulator as in the Caribbean (see Box 4.5 on ECTEL below), or through twinning arrangements.

Box 4.5 Pooling regional resources for telecommunications regulation in the Caribbean: the case of ECTEL

ECTEL is the regional telecommunication regulator for the East Caribbean States and acts as a shared regulatory body for each of the member countries. As such, it exemplifies the possibility of contracting out certain regulatory functions to regional regulators. In addition, as ECTEL is small in size, it has been contracting out extensively, for functions ranging from tariff reviews to impact assessment studies, thereby reducing the fixed cost burden on national regulators, who are too small to efficiently regulate a rapidly evolving sector.

Source: see full case study in Annex C.

Some competent regulators, such as IPART in Australia, actually lease their employees to other state regulators in Australia. They therefore have a quasi-consultancy role with government in that they can do reviews outside of their normal regulatory functions on request, on a fee for service basis.

4.2.5 Implicit contracting out of regulatory functions to non-profit organisations

A common way of contracting out to non-profit organisations is to contract out to leading universities and policy institutes, which can then be leveraged

to play an important role in framing and leading debate on crucial questions concerning infrastructure provision. These universities have the credibility and reputation for fair play and technical competence that government agencies and even regulators do not have.

In other rarer but nonetheless important cases, “non-traditional” forms of contracting out, such as the setting up of tri-sector partnerships between the public, private and civil society sectors can be supportive for the regulatory process, especially for adapting the practice of regulation to the needs of the poor (see Box 4.6).

**Box 4.6 The role of tri-sector partnerships in making utility regulation more pro-poor**

Around the world, partnerships have been formed between the private, public and civil society sectors in an effort to better tackle the challenge of providing water and sanitation services to the poor. The underlying premise is that, through working together, these sectors can provide services to the poor more effectively than by working alone. The BPD Water and Sanitation Cluster supported research on eight such partnerships throughout the world to examine their potential contribution to the process of developing and carrying out regulation in the water sector. Some of the key functions that such partnerships can take on are described below:

- **Partnerships can help gather information on the needs of the poor and make it available for regulation.** In many cases regulators tend to ignore the poor because they do not have readily available information about them, or enough human and financial capital to go and collect it. Partnerships can play an important role in gathering and relaying information to decision-makers, thanks to their continuous presence in the field. For example, in La Paz-El Alto, the concessionaire in partnership with international donors, the regulatory body and local organisations conducted a series of anthropological surveys of the Aymara population in order to understand why actual demand was much lower than forecast prior to signing the concession contract. These surveys conveyed some very important information about cultural beliefs and consumption patterns that explained such low consumption.

- **Partnerships can serve as a recourse mechanism for customer’s complaints,** particularly relaying poor customer’s concerns. This role is especially useful when regulatory institutions are weak or inaccessible to the poor, because they are located at a different level of government. For example, in Colombia, the water sector regulatory bodies are located at national level whereas contracts are signed at municipal level, which is where the impact on poor customers materialises. In this case, local partnerships have played a useful role in relaying complaints and, for example, highlighting the need to adapt payment schedules.

- **Partnerships can create a more flexible, innovative and cooperative environment for developing rules better suited to the needs of the poor.** Existing rules may hinder the provision of services to the poor because they do not fit their requirements in terms of costs and quality. Partnerships can provide the framework for experimenting with alternative services (and corresponding rules): for example, in La Paz El Alto, the partnership described above experimented with new standards not allowed in the contract (condominial sewerage) and following successful experimentation, turned this into a new national standard which helped reducing costs of service to all, and not only poor customers. Partnerships can achieve this because they contribute to building a climate of trust between partners, who are no longer seen as wanting to change a particular rule simply to serve their own interests.


Such forms of contracting out have not been much explored in a pro-active way so far, however, as demonstrated by the survey results (see Section 5). The next section analyses contracting-out practices by existing regulators based on survey results.
Policy-makers need to consider alternative options when designing institutional and regulatory frameworks for utility services. The model of the “one-size fits all” independent regulatory agency is not necessarily suited, even if such regulators have the opportunity to later contract out their functions in order to increase their competence, legitimacy or independence.

As presented in this section, there are a number of ways in which contracting out decisions can be built into institutional arrangements from the start, usually at the transaction stage. These arrangements need to be considered in difficult or weak institutional environments, where effective regulators that can be competent, independent and legitimate are difficult to establish. The relative merits of alternative options will need to be assessed on the basis of a number of key observations:

• Whether similar regulatory functions are already carried out by existing institutions, whose role should not be duplicated or infringed upon in order to avoid conflict of interests or loss of resources;
• Whether or not the institutional and legal framework provides a sound basis for real and effective independence of the regulator;
• Whether or not competencies for carrying out regulatory tasks are available in the country or whether they would need to be strengthened.

Based on this analysis, and if weaknesses have been identified, policy-makers can review the alternative models presented here to identify how gaps can be filled. They will need to decide on:

• The type of regulatory functions (or specific tasks) that are contracted out;
• Whether external agencies’ findings should be binding or not on the regulatory process, depending on whether binding contracting out is allowed by law and would be acceptable in the institutional context;
• Whether any compensatory measures (such as the introduction of transparency rules) need to be introduced in order to compensate for a potential reduction in independence or legitimacy due to contracting out.

It will also be necessary to examine whether there are any legal obstacles against contracting out, and in particular, against the contracting out of binding decisions: in some countries, regulatory functions are regarded as a public sector prerogative which cannot be contracted out to an external private agent. If such obstacles exist, but contracting out otherwise appears as an attractive solution, it may be necessary to remove them through passing a general legislation, applicable to all areas of utility regulation.
This Section presents a snapshot of the practical experience of existing utility regulators with contracting out based on an extensive survey of regulators around the world (see the survey instrument in Annex A and full results and graphs of all survey results in Annex B) and discussions with experts. Based on the observation of such experience, it then sets out a framework to help existing regulators formulate contracting out decisions.

5.1 Analysis of Current Practice: Survey Results

5.1.1 Contracting out is a common practice

75% of the agencies that responded to our survey contract out some or all of their functions (question 1). Contracting-out is particularly widespread for agencies in Latin America and Africa, and in the water and sanitation and telecommunications sectors, as shown in Figures 5.1 and 5.2 below. The strong incidence of contracting-out in those two sectors may be due to different reasons: in telecommunications, to the need to constantly keep up with a rapidly changing and innovative environment, and in the water and sanitation sector, to the fact that most regulators are set up at a local level and have limited regulatory capacities.

Figures 5.3 and 5.4 show contracting out for single versus multi sector utilities, as well as a breakdown according to the level of government at which regulators operate (Federal, State and municipal levels). All multi-utility and all municipal regulators included in the survey contract out.

Of those that contract out, the contracting-out budget represents a significant portion of their budget, with 33 percent of respondents stating that it represents more than 20 percent of their budget (question 7).

Of those that do not contract out, high costs and difficulties to access expert advice represent the biggest obstacles (question 2). But 90% of surveyed agencies that do not currently contract out could see a role for contracting out in future (question 4), which confirms the current importance of contracting out in regulatory practices.

(1) Some, such as the Palestinian Water Authority in Gaza, have responded that they do not contract out despite evidence that they do so in practice, which means that this percentage may be under-valued.
Figure 5.1  **Breakdown of contracting out by region**

![Bar chart showing breakdown of contracting out by region](image)

Source: ERM survey. EAP = East Asia Pacific, ECA = Eastern and Central Europe, LAC = Latin America and Caribbean, MENA = Middle East and North Africa, SA = South Asia.

Figure 5.2  **Breakdown of contracting out by sector**

![Bar chart showing breakdown of contracting out by sector](image)

Source: ERM survey. Note: One survey was received from the transport sector but was not included in this graph, due to lack of representativeness.
5.1.2 Why do Regulators Contract Out?

Our survey finds that regulators contract out to improve quality, to compensate for general in-house lack of resources and to improve their quality and credibility (question 8). All of these reasons appear to be far more important than to cut costs, although a lack of in-house resources would indirectly point to cost saving rationale. Cost considerations are important but are not given priority at the expense of quality (they would not contract out if it results in lower costs and lower quality of effectiveness). Legal requirements, or the need to improve flexibility or control are some of the less important reasons why agencies contract out.
The survey indicates that a vast majority of agencies (79%) take a long-term strategic perspective to the question of contracting out (question 10) and that 53 percent of respondents have actively studied the advantages and disadvantages of contracting out over carrying all functions “in house” (question 13).

Some agencies like those in New Zealand and Australia have taken a long-term view by identifying a set of “core functions” that should be performed “in-house”, and instituted formal guidelines and procedures for hiring, monitoring and performance measurement. Other agencies have adopted a more ad-hoc route, whereby services are contracted on a need basis, and formal guidelines may not be present, although they would still indicate that a strategy for contracting-out has been developed.

5.1.3 What Functions do they Contract Out?

Our survey suggests that in practice, the functions most contracted out include monitoring compliance with physical and quality targets, monitoring compliance with quality parameters, and legal opinions (question 6).

Most regulators would mostly contract out functions that are simply advisory/ non-binding in nature, however. Only 15 percent of the agencies that responded to our survey use contracting out to produce binding inputs into the decision making process (question 9). Such limited use of binding forms of contracting out is often due to the fact that the laws creating regulatory frameworks in most of the countries hold them accountable for fulfilling their roles and for their decisions to governments (and through them to end consumers).

5.1.4 What impact does contracting out have on their activities and effectiveness?

Experience with Contracting Out has been quite positive….

Around 60% of the agencies report that their experience with contracting out has been ‘good’ (question 28). About 40% of the agencies feel, that when compared with in-house service provision, contracting out has helped them to improve quality and at the same time reduce cost (question 31), although many of the respondents to this question found it difficult to answer.

A majority of the agencies believe that contracting out has helped them to improve moderately or significantly their competence (a total of 92%, question 32), independence (a total of 62%, question 33), and trust with key stakeholders (a total of 71%, question 34). The agencies that rate their experience with contracting out as ‘poor’ or having ‘no impact’, share common attributes like limited freedom to hire core staff, and no exemption from the civil service rules (according to a cross-comparison with questions 51 and 52). These attributes are discussed later in greater detail under the section on challenges, because some of the challenges highlighted by the agencies have their roots in such organisational design issues.
Several residual, unintended, gains but equally powerful in terms of improving agency’s overall effectiveness, have also been realised. The residual gains are not just limited to cost reduction, contracting out has also helped the agencies to exert better control over the outcomes (question 30) and does not limit their flexibility (question 36). There is extensive literature on why this happens. (1)

… But Challenges Remain

**Budget Constraints** - The problem of budgetary constraints seems to be affecting all agencies, but some more than others. Seventy percent of respondents to the survey, with the exception of those from ECA, rate budget constraint as the most significant challenge to future contracting out practice (question 36).

**Lack of appropriate consultants** - Many agencies believe that the supply market for regulatory functions is not sufficiently deep: only 6 percent rated the supply market as being “abundant” (question 29). Also, the problem of the market getting expensive is one of the three most significant challenges identified by agencies (question 36). With the possibility of demand for high quality services exceeding supply, agencies are paying more for certain services. This may be resulting in a financial squeeze for the agencies whose budgets have not been adjusted accordingly. There may be other reasons also like the nature of the work that is being contracted out, gradual pick up in levies, and high start up cost. Our survey finds that tariff reviews and output measurement are the two functions that are most contracted out. Incidentally, both are extremely time and resource intensive and, if not contracted out, would represent the regulators’ major expense. This presents a significant cost cutting opportunity, but if budgetary pressures continue, agencies might compromise on quality to keep the cost of these contracted out activities low. For many agencies, funding is linked to levies on regulated companies or customers, which grows one to one with the increase in service coverage. This could take some time and budget squeeze could be a temporary phenomenon. Finally, the budgetary constraint can change over the life cycle of regulators. In the start-up phase, agencies have to deal with more issues and challenges (sector studies, writing sector laws etc) but the revenues from levies take time to stabilise. This is again a temporary mismatch, but if not addressed early on, it can severely hamper the long-term effectiveness of agencies.

**Contract Specification** - Nearly 40 percent of the agencies rate difficulty in contract specification as one of the top five key challenges (question 36), and more than 53 percent could not comment on the effectiveness of contracting out in improving quality (question 31). This reflects the problem of difficulties in contracting service quality, (2) associated with difficulty in measuring the quality element of the performance. The problem of quality measurement can be traced to limited in-house core skills to specify and monitor contracts.

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(1) Domberger (1998)
As the agencies contract out, they fear that lower cost is achieved at the expense of inferior quality, and so they become more aware of the quality dimension of the regulatory function than when they were being done ‘in-house’. However, very limited baseline data exists in most agencies to make a worthwhile comparison (44 percent of agencies stated that an internal cost accounting system exists to calculate the cost of internal service provision versus the cost of contracting out, according to question 14). And finally, there is an asymmetry of expectations with regulators expecting more from external agencies than they would from their own staff.

The above problem is exacerbated in cases where the core in-house skills are rather limited in terms of effective specification and monitoring of the work. This in turn impacts their experience with contracting out in terms of improving their competence, independence and legitimacy. The survey finds that agencies that have narrow exemption from civil service rules and limited freedom to hire core staff rate their experience with contracting out in terms of improving their competence, independence, and legitimacy “less satisfying” than those that do (based on interpolation with questions 51, 52, 53, 32, 33, 34). This may be because such agencies find it difficult to develop ‘core skill base’ needed to specify and monitor work.

5.1.5 How do regulators select providers?

The majority of agencies use either competitive sealed tenders or a combination of sealed tenders and negotiations to award contracts, very few use negotiations, and none use unsolicited offers (question 17). Such methods of selection help the agencies to leverage market competition and keep the contracting out costs under check. If it were not for competitive outsourcing practices, the problem of budget constraint might have been even more pervasive.

5.1.6 Who do regulators contract out to?

By and large, regulators contract out mostly to international consultants, which would have the unique and specialised set of skills that are required for tasks such as auditing or tariff reviews (see question 15), and are often eager to maintain service quality in order to protect their reputation. Such reputation effect would also impact the performance of local subsidiaries: since those subsidiaries only represent a small fraction of their overall revenue, they would be reluctant to let poor performance affect their global brand.

However, international consultants seldom operate alone. They would form consortiums with domestic companies, as seen in Gaza, where Deloitte & Touche used the services of local financial firm for certain financial auditing functions. This may be because in many cases agencies lay out stringent qualifications standards, which makes almost impossible for local companies to pre-qualify on their own, but which would often require international companies to associate with local ones.
Regional regulators and other regulating agencies in the country also rank high, whereas contracting out to non-profits has yet to reach its full potential or to be defined in more creative ways. Domestic consulting firms are also important players, although as mentioned above, the lack of appropriate supply is often seen as a limiting factor. Some countries, such as Chile, rely exclusively on domestic consultants whereas smaller countries tend to call on international consultants more frequently for lack of local resources.

5.1.7 What kind of contracts do agencies sign with providers?

Length of contract - Regulators prefer discrete short-term contracts to long-term and retainer fee contracts (question 19). This maintains the pressure on external agencies to innovate, and stay competitive. But the roll-over contracting pattern raises the explicit contracting cost for the agencies, which, in general, can be as high as 5 percent of the contract value, according to a study done by the Industry Commission in Australia. (1) With long-term contracts, there are implicit contracting costs like the costs associated with renegotiations to resolve unforeseen events, which can be higher than the explicit costs, and the use of short term contracts help to reduce this cost. The use of discrete contracts also helps to minimise the hold up costs that result from opportunistic behaviour by external agencies.

Selection criteria - The choice of selection criteria is as important as the choice of contractual method, and particularly so in the service sector contracts, where quality of the product is hard to describe and measure. If too much weight is given to the price variable, good consultants will be gradually driven out of the market. To resolve this adverse selection problem, agencies use screening criteria that place lower weight on the price variables and a much higher weight on non-price variables (question 18). Likewise, external agencies are extremely careful about their reputation, as a means to signal their quality and commitment. Our survey finds that overall, non-price variables receive 58 percent weight in the selection matrix, but there is significant variation across the regions.

5.1.8 How do agencies monitor their service providers?

In terms of contract monitoring, 95 percent of the agencies monitor the contracted out functions while underway (question 22). This reflects public agencies higher risk aversion and consequently increased need for detailed safeguards. The choice of monitoring arrangement is also related to the problem of quality measurement, which the regulators try to overcome by greater insistence on inputs going into contracted out work. This being said, the cost of contract monitoring is rated as reasonable by 86 percent of the agencies (question 27), and likewise it is one of the least important challenges that regulators identify (question 36).

5.2 **IMPLICATIONS FOR REGULATORS CONSIDERING CONTRACTING OUT**

Based on the analysis of this practice, we draw out key implications for regulators considering whether or not to contract out.

5.2.1 *Take a strategic perspective on contracting out*

Contracting out should not be used as a quick fix measure to just control costs and get around the difficult problems. Such an approach may save money in the short run, but will the hamper long-term development of core skills in these agencies. Identification of these skills depends upon the conditions specific to every agency, as discussed below.

5.2.2 *Ensure top management support*

The support of top management is important because contracting is not an operational decision to save costs but a strategic decision to develop and leverage agency’s core skills. Because of the over-arching goal of contracting out, the exercise of contracting out should be led from the top. The top management needs to debate the trade-offs involved, and how these trade-offs will impact the organisation’s effectiveness. Once a clear vision exists around this question, a set of operational guidelines for the managers and staff need to be published. Likewise, top management support is also required because contracting out decisions will impinge on the sensitive issue of staff recruitment and performance evaluation. *(1)* These issues have to be incorporated in the trade-off analysis and figure in the strategy paper.

5.2.3 *Identify core competitiveness*

To start identifying which functions or tasks can be contracted out, it is important to take a strategic perspective in order to identify the regulator’s core competitiveness by doing the following:

- Identify and analyse the regulatory functions (and corresponding tasks) that the agency needs to perform;
- Identify where the agency’s core competencies lie;
- Choose to contract out services to external agencies for competencies that they believe lie outside the purview of their core competency.

This specialisation can help agencies conserve their limited resources for the development of core team skill sets, and at the same time, provides the economy of scale to external agencies to specialise in certain functions. Indeed, contracting out does not absolve the government agency from its responsibility. It just changes the need for the type of skills needed in-house. Some countries that have limited in-house core skills may hire consultants to specify and oversee the work. However, this practice has raised problems of conflict of interest and charges of collusion between consultants.

*(1)* See OMB (2003).
Contracting out, therefore, cannot substitute for core in-house skills, and agencies need to seriously think about investing in staff training to build long term monitoring capacity. Ideally, regulators should be exempted from the rigid civil service pay rules to enable them to hire the most competent staff. But more important is the need to understand that contracting out will demand more oversight and managerial responsibilities from the core staff, as opposed to the purely technical skills that were required when work was done in-house. Training and recruitment programs should ensure that core staff stays abreast of latest market developments so that they can deal with private agencies on unequal terms.

5.2.4 Review trade-offs

Regulators have limited financial resources and they need to use them to develop competency in areas that are most likely to improve their overall effectiveness. This involves making choices, after evaluating tradeoffs inherent in these choices in terms of their impact on agency’s independence, competence and legitimacy. There is no standard trade-off evaluation model that is applicable to all the agencies; every agency makes its own decision based on the resource availability, in-house skills, degree of risk aversion, past experience with contracting out, and organisational priorities.

In addition, regulators should build internal accounting systems that let them calculate the in-house cost of service provision. Many regulatory functions draw resources from different departments and so activity based accounting, and not the department based accounting will give the true cost. Also, both immediate and long-term costs have to be included for valid comparison. This may include adding severance payment cost to the price if the existing staff will be displaced from contracting out, and likewise if it has saved the agency long-term pension and/or other long-term costs.

5.2.5 Encourage competition

Competition in the supply market, resulting in more innovative, better quality and lower cost services, is the single most powerful argument in favour of contracting out. Every agency can influence the nature of the consulting market from the decisions it makes on the key contractual questions: is the selection process competitive, are the pre-qualifications too rigid, are there sufficient internal checks and balances to minimise the incidence of conflict of interest, are the weights on price variables too high that it is resulting in good consultants existing the market, is the contract too detailed and puts too much emphasis on procedures than outcomes, and are the contracts attractively packaged so that it’s profitable for companies to bid. These are some of the questions that agencies should consider, because any wrong design choice is not just limiting their experience with contracting out, but depending on how big the agency is, it is affecting their ability to carry out their functions adequately.

(1) See OECD(1997)
In addition, limited competition between external advisers can be problematic as it increases the risk of capture by operators, either because they contract out to a small group of external contractors or because such external contractors are themselves captured by the operators. Indeed, regulators often have to compete with operators for access to consultants and they have limited resources to do so.

5.2.6 Establishing mechanisms for ensuring transparency

Contracting out potentially increases the risk of corrupt practices in the letting of contracts to external contractors, which can reduce the regulator’s legitimacy. To minimise such risks, regulators must adopt clear and transparent practices for recruiting external advisers. According to the survey, 85% contract-out under public procurement guidelines. However, existing procurement guidelines may be poorly suited to these kinds of contracts (which would involve studies rather than public works, and often ongoing advice) and may need to be reviewed.

5.2.7 Strong performance monitoring

Finally, once the decision to contract out has been taken and the external agencies have been selected, it is important to set up reliable systems for monitoring the performance of these external agencies in-house. Regulators rank quality improvement more than cutting cost as key motivations for contracting out. But many suffer from the problem of non-contractibility of quality, and so the challenge is to identify the types of monitoring systems that should be introduced to improve the contract performance. Regulators currently use mostly process monitoring, but as the supply markets become deeper and more competitive and the agencies gain more experience with contracting out, an output based contract specification may work better.
| **Table 5.1** Analysis of the Trade-Offs with Contracting Out Regulatory Functions |
|-----------------------------------------------|--------------------------------|-----------------|-----------------|
| **Comments/ Analysis**                      | Competence | Independence | Legitimacy |
| **Factors to be evaluated in Contracting Out Vs. In House Provisions** |
| **Considerations regarding the institutional position and degree of development of the regulator** |
| Not an Independent Regulator                 | In-House   | CO             | In-House | CO            | ↓   | ↑   | ↓   | ↑   | ↓   | ↑   |
| Agencies that are not fully independent, for any of the reasons discussed earlier, do not enjoy the trust of operators, who fear captures by either consumer organisations or government, under pressure from such groups. Contracting out for key regulatory functions, if done transparently, helps to improve agency’s legitimacy by helping the agency to withstand pressure and capture from line ministries and/or consumer groups. Also, it lets the agency hire competent resources that may not be possible under the existing rigid hiring guidelines. |
| Limited Local Skill Base                     | In-House   | CO             | In-House | CO            | ↓   | ↑   | ↓   | ↑   | ↓   | ↑   |
| Countries where the local skill base is very limited, the choice of in-house provision does not exist. Contracting Out helps to build and sustain competency, independence and legitimacy, but sooner or later such regulators will have to think about strategies to develop core skills like heavy investment in staff training. But until that skill base is not present, contractors may even be needed for core in-house functions. But this situation should not persist for very long, lest the agency loses its credibility. |
| Start up Regulator                           | In-House   | CO             | In-House | CO            | ↓   | ↑   | ↓   | ↑   | ↓   | ↑   |
| For a start-up organisation in an environment of limited local regulatory skill base, insistence on in-house provision will cripple its competence, and very soon its independence if it can’t deal with the operator on equal terms. Contracting out majority of functions, but at the same time using limited resources to build core competency will be the ideal strategy. |
| Accountability                               | In-House   | CO             | In-House | CO            | ↑   | ↓   |
| Regulators are absolved from the responsibility of functions it contracts out, but that by no means absolve sit from its accountability to public and government. But many regulators equate responsibility with accountability, and risk compromising their legitimacy by blaming consultants for the poor quality of work. |
| Trust                                        | In-House   | CO             | In-House | CO            | ↓   | ↑   |
| If the agency suffers from lack of public trust than contracting out will help to improve it. But if the agency has an established good history, contracting out can help to sustain this advantage by letting the agency
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<td>focus on its core work and saving the management time for important issues.</td>
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<td>Transparency</td>
<td>Contracting out is a more transparent mechanism than opaque negotiations between the in-house staff. Its use improves credibility with key stakeholders.</td>
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<td><strong>Cost considerations</strong></td>
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<td>Coordination Cost</td>
<td>Contracting Out raises the coordination work, and regulators that had previously been doing more work in-house need new work processes and skill sets to manage this transition. The chances of coordination failure are rather high in regulators, which are more used to working in the traditional command and control environment. Every agency goes through the learning phase, but if the 'breakdown' is the rule rather than exception, it will cost the agency its competence and independence.</td>
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<td>Monitoring Cost</td>
<td>Contractual monitoring is required independent of whether the work is done in house or contracted out. But contracting out makes regulators more focussed on quality, for the reasons discussed in the report. It raises agency’s monitoring cost, but if an overall cost-benefit analysis is undertaken, a well-monitored work process will more than recover this extra cost.</td>
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<td><strong>Quality considerations</strong></td>
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<td>Quality of Services</td>
<td>With in-house service provision, quality benchmarks rarely exist and where they do, they are quite opaque. Contracting Out open the services to market competition, and the agency that offers the best price-quality mix survives. This competition is hard to replicate in-house because Regulators have limited capacity to either punish bad output or award superior output.</td>
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<td>Reputation Bond</td>
<td>Some consulting companies value their reputation more than many agencies because their regulatory consulting practise represents only a small fraction of their overall revenues. But the agency employees, with time bound promotions and standard pay structures, may place less weight on the reputation bond. The emphasis on reputation yields better</td>
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### Comments/Analysis

#### Factors to be evaluated in Contracting Out Vs. In House Provisions

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<td>Independence</td>
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<tr>
<td>Legitimacy</td>
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</tbody>
</table>

- **Comments/Analysis**
  - Quality output, a fact widely recognised by key stakeholders and resulting in improved competence and legitimacy.

- **Consistency of approach**
  - In-house service provision is more consistent in terms of the regulator’s memory, and therefore has greater credibility with key stakeholders. But it can quickly turn into a liability, if the basis of decision-making is error prone, and it would help to have diverse perspectives on the policy decisions. This will also give the agency an opportunity to make a mid-course correction.

- **Control over the Outcome**
  - Contracting out because of some of the reasons discussed earlier provides better control over the outcome, whereas in-house provision provides better control over the agency staff (which also is questionable) and that may or may not result in desirable outcome. And superior outcome improves competence.

- **Penalty (Financial)**
  - Regulators if not satisfied with contractor’s performance can impose financial penalty, a major disciplinary tool, something totally missing in the in-house provision for the same reasons, as explained above. The threat works like an implicit option: it signals agency’s resolve and that itself will be sufficient to ensure contractual compliance and the agency may never end up using it, and second, where the non-performance becomes a real issue, the agency can exercise this option and use its back-up plan to ensure delivery.

- **Management considerations**
  - **Organisational Flexibility**
    - The senior management in the regulator may not have all the technical expertise to quickly react to new market developments, especially in the more dynamic sectors. Contracting out helps regulators to diversify the risk of regulatory obsolescence, which improves their competence and prevents capture by market operators.

  - **Budgetary Flexibility**
    - For a given budget, contracting out is more effective as a way to seek resources when they are needed. It is the counterpart of the Just in Time Approach in manufacturing. Since it helps agencies to do more for less, it
<table>
<thead>
<tr>
<th>Comments/ Analysis</th>
<th>Competence</th>
<th>Independence</th>
<th>Legitimacy</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Factors to be evaluated in Contracting Out Vs. In House Provisions</strong></td>
<td>**In-House</td>
<td><strong>CO</strong></td>
<td>**In-House</td>
</tr>
<tr>
<td>limits their dependence on budget transfers (where government funded), and levies (where customer funded).</td>
<td>↓</td>
<td>↑</td>
<td>↓</td>
</tr>
<tr>
<td>Time taken to reach decisions</td>
<td>Contracting out may speed up agency’s decision-making process, as consultants are able to leverage their special skills and experience from working on a similar assignment somewhere else.</td>
<td>↓</td>
<td>↑</td>
</tr>
<tr>
<td>High Level of Information Requirements</td>
<td>Regulators that demand extensive information (either because there are many market participants, or the agency is in the start-up phase) will find it difficult to ramp up internal capacity to meet the information requirements. Contracting out helps regulators to meet peaky/ cyclical demands more economically.</td>
<td>↓</td>
<td>↑</td>
</tr>
<tr>
<td>Core Capability Development</td>
<td>Blind reliance on external contractors to just cut the cost or to find solution around immediate problems, will significantly dent agency’s core people based skills. In the long run the agency will find it difficult to deal with external contractors on equal terms, and would find it harder still to specify, monitor and judge the contracted out work. This will cost the agency its independence, long-term competence, and trust with consumers and companies.</td>
<td>↑</td>
<td>↓</td>
</tr>
<tr>
<td>Confidentiality</td>
<td>Contracting out may compromise the confidentiality of operations, if the external agency shares market sensitive information with operators. The general assumption is that a public servant has a greater commitment to public values than a profit targeting private company, and so key stakeholders are more willing to trust them. This, however, may not always be true, particularly in countries with high incidence of corruption and extremely low civil sector pay.</td>
<td>↑</td>
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</tr>
</tbody>
</table>

**Considerations regarding service suppliers’ market**

Conflicts of Interest | External contractors (international consultants, in particular) are locked into multiple principal-agents contracts, many of which conflict. The same company could be working for the government, regulator, and one or more private operators in the market. Though many companies have internal procedures in place to avoid this problem, recent events in Corporate America suggest that the once “best names” lacked such | ↑          | ↓            | ↑          | ↓          |   |   |
<table>
<thead>
<tr>
<th>Comments/ Analysis</th>
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<th>Independence</th>
<th>Legitimacy</th>
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<tbody>
<tr>
<td><strong>Factors to be evaluated in Contracting Out Vs. In House Provisions</strong></td>
<td>In-House</td>
<td>CO</td>
<td>In-House</td>
</tr>
<tr>
<td>safeguards. Using private contractors, particularly the ones that do not have reputation, may compromise agency’s independence and legitimacy.</td>
<td></td>
<td></td>
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</tr>
<tr>
<td><strong>International Expertise</strong></td>
<td>Regulatory expertise is not localised and even the countries where strong regulatory knowledge base exists want international firms to participate because of the breadth of their exposure. By performing all the functions in-house, Regulators loose out on the diverse and practical knowledge pool that many of these consultants possess.</td>
<td>↓</td>
<td>↑</td>
</tr>
<tr>
<td><strong>Contract Specification</strong></td>
<td>Contracting out involves writing detailed contracts, which takes significant staff time. Because of concerns like quality shading and agency hold-ups concerns, regulators prefer to use input, process and output linked variables in their contracts, which puts extra monetary and physical burden on agency’s resources. Besides these explicit costs, there are implicit costs in the form of renegotiations, which further raise the total cost of contracting out. In the in-house service provision, regulators have to enter into one-time employment contracts with its staff and this provides greater flexibility and lower cost base.</td>
<td>↑</td>
<td>↓</td>
</tr>
<tr>
<td><strong>Threat of Hold Up by External Contractor</strong></td>
<td>Contracting out will increase the likelihood of hold ups when compared with in-house provision. But threats of financial penalty and concerns about loosing reputation will keep such threats under check. Contracting out is like a multiple stage game, and the parties to contract (contractor and the agency) gain from cooperation.</td>
<td>↑</td>
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</tr>
</tbody>
</table>
CONCLUSIONS

6.1 SUMMARY FINDINGS

It transpires from this study that contracting out regulatory functions or tasks can play a significant role in improving the effectiveness of institutions in charge of carrying out 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). Such contracting-out mechanisms are particularly useful when regulators find it difficult to develop their competence (for lack of previous experience or resources) or to establish their independence and legitimacy.

Contracting out decisions can be built into the legislative or contractual arrangements when institutions are first set up and a variety of examples have been reviewed to demonstrate ways in which this can be done. In doing so, it is important to specify whether the advice given by external agencies is binding or purely advisory in nature, as this can have a substantial impact on the independence and legitimacy of the regulatory arrangements.

When existing regulators need to decide whether or not to contract out, they should develop a clear framework for taking such decisions as they have a strategic impact, with implications on the structure of the regulator (which core in-house skills should be developed, what monitoring and evaluation systems should be set up, what mechanisms can be developed to avoid capture by external contractors, etc...). It is important for regulators to carefully review the trade-offs and to establish appropriate monitoring systems, whilst fostering competition between external contractors in order to avoid being captured by them.

6.2 IMPLICATIONS FOR POTENTIAL EXTERNAL SUPPORT

Paradoxically, those regulators who would most benefit from contracting out are the ones that have most difficulties in entering into such agreements to bring about a satisfactory outcome, either for lack of financial capacity or capacity to monitor performance, or insufficient access to the external contractors' supplier market. They need external support in doing so, and this area should receive increased attention from international donors.

International donors and policymakers have placed considerable emphasis on developing independent regulatory bodies, based on the experience practised in Western Europe or North America. This institutional approach faces significant challenges in countries with limited technical and financial capacity and fledgling institutions.

More creativity is therefore needed and can be used to build in contracting out arrangements into the institutional and regulatory framework (for example, when a contract supervising unit is set up to monitor a contract).
This approach can improve the competence, independence and legitimacy of utility regulation. Successful examples of such arrangements already exist and are presented in this report (see for example Section 4.2).

This may reduce the need for establishing independent regulatory bodies from scratch, which is often difficult because it does not conform to the local public administration and political tradition. In emergency or post-conflict situations, it may also give the possibility of establishing regulatory arrangements that can start functioning immediately, and which could in time be replaced by more permanent local arrangements.

Although regulators undoubtedly require assistance during the set-up phase, more ongoing attention would be required to provide regulators with the means of accessing and managing expert advice via contracting out arrangements during the later phases of their life-cycle. In doing so, however, it would be important to try and limit regulators’ reliance on external funding or advice in order to foster their sustainability: this can be done by building in mechanisms to finance external experts (such as a small levy for carrying out a specific study required in the determination of tariffs, for example) and by encouraging regulators to build and access a wider market of advisers than those on which they routinely rely on.

One way of diffusing results more effectively would be to encourage more sharing of contracting-out experience between regulators in developing countries. A number of fora for regulators have been put in place in recent years (such as SAFIR in South Asia, AFUR in Africa or ADERASA in Latin America) and such fora could be used more actively as a way of comparing contracting-out experiences, sharing access to consultant resources in the form of a clearing house, or providing training on how to make best use of external advice.
Annex A

Survey instrument
Background
The provision of infrastructure services has undergone major changes in the last decade with many developing countries choosing to move away from the traditional public sector model of service provision and introducing private sector participation. This calls for an increased role of regulatory agencies.

To be effective, regulatory agencies are required to be **competent** (measured by access to technical expertise in a wide variety of areas), **independent** (from government interference and capture by service providers and interest groups) and **legitimate** (abiding by existing legal principles and practices and being transparent and accountable), features that are not fully present in many developing countries because of limited resources.

Regulatory agencies may fill this resource gap by **contracting out** a variety of regulatory functions. Contracting out is defined as:

“The use by a regulatory authority of an external contractor, instead of its own employees to perform certain function(s). Such external contractors can be consultants, individuals, other government entities (in country or outside, including at a regional level) or NGOs. The exercise of functions continues to be the responsibility of the regulator, who is accountable to taxpayers for the role conferred to it by the relevant statute(s)”.

Survey Objectives
The World Bank has initiated this research to capture regulatory agencies’ experience with contracting out in order to understand how it can be made more effective. The World Bank has commissioned the consultancy Environmental Resources Management (ERM) to carry out this survey and to collate and analyse results. The results will be used to develop a decision-making framework for policymakers and regulators considering contracting out regulatory tasks in the presence of financial, human, or credibility constraints which hamper traditional regulatory approaches.

Confidentiality/Anonymity Policy
Individual responses will not be disclosed but they be used in an aggregated manner to learn about overall trends. The results of this review will be disseminated in printed and electronic form to help policy makers learn from the experience of other regulators. A copy of the results can be provided to you upon request as soon as the study is completed.
Survey Instructions
Most questions are followed by a list of choices. Please choose one or more to describe your best response. If none of the available choices accurately describe your response, it would be helpful to have you describe your response. **How to select your option(s) in electronic copy of the survey?**
Place cursor on box next to your choice(s), click right button of mouse, select “Properties”, and choose “Checked” option under “Default Value”.

You can either email or fax your responses to:
Mr. Padmesh Shukla (Study Coordinator)
Email: Padmesh.Shukla@erm.com
Fax: 001-202-466-9191
Phone: 001-202-466-9090 ext.23

If you have any questions, please don’t hesitate to get in touch with Mr. Padmesh Shukla (Study Coordinator) or with Sophie Trémolet (sophie.tremolet@erm.com), acting as Study Supervisor.

Estimated Time Burden
The survey contains 59 questions and the estimated time burden is one hour. Please answer as many questions as you can but do not hold back from sending the survey even if it’s only partially completed. We would appreciate the opportunity of contacting you directly in order to get additional information over the phone if needed. Please let us know if you would NOT want to be contacted directly or nominate an alternative person whom we could contact.

Thank You!
Section A. Respondent Profile

Kindly provide us information about yourself.

<table>
<thead>
<tr>
<th>Name of Respondent</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Title</td>
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<tr>
<td>Agency Name</td>
<td></td>
</tr>
<tr>
<td>Designation</td>
<td></td>
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<tr>
<td>Country</td>
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<tr>
<td>Contact Number</td>
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<tr>
<td>Email</td>
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</tbody>
</table>

Section B: Contracting out Regulatory Functions

1. Do you contract work out to external institutions?
   Yes [ ] No [ ]

   *If your answer to the above question is ‘No’, please answer Questions 2 to 5 and then skip directly to Section C.*

   *If your answer to the above question is ‘Yes’, skip directly to Question 6 of this Section.*

**IF YOU DO NOT CURRENTLY CONTRACT OUT**

2. Reason(s) for not contracting out:
   *Give a weight to the proposed factors below (H: High  M: Medium  L:Low)*

<table>
<thead>
<tr>
<th>Reason(s)</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>In-house Capacity Exists</td>
<td></td>
</tr>
<tr>
<td>Legal Barriers</td>
<td></td>
</tr>
<tr>
<td>Too Expensive, Budget Does Not Permit</td>
<td></td>
</tr>
<tr>
<td>Hard to Define Contract Terms</td>
<td></td>
</tr>
<tr>
<td>High Transaction/ Contracting Cost</td>
<td></td>
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<tr>
<td>High Cost of Monitoring Consultants</td>
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<tr>
<td>Loss of Flexibility</td>
<td></td>
</tr>
<tr>
<td>Loss of Control</td>
<td></td>
</tr>
<tr>
<td>Compromises Credibility</td>
<td></td>
</tr>
<tr>
<td>Not Acceptable to:</td>
<td></td>
</tr>
<tr>
<td>Firms</td>
<td></td>
</tr>
<tr>
<td>Consumers</td>
<td></td>
</tr>
<tr>
<td>Difficult to Locate Good Consultants</td>
<td></td>
</tr>
<tr>
<td>Past Experience with Outsourcing has not been Good</td>
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</tr>
</tbody>
</table>

   Any other (kindly indicate)....................
3. Is the lack of contracting out affecting the effectiveness of your agency?
   Yes [ ] No [ ] Can’t Say [ ]

4. In future, do you see any role for Contracting Out in your organization?
   Yes [ ] No [ ] Can’t Say [ ]

5. Assuming it were possible to Contracting , kindly rank in the order of importance functions you might contract out:

<table>
<thead>
<tr>
<th>Function</th>
<th>Ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td>1  Information/ Data Collection</td>
<td></td>
</tr>
<tr>
<td>2  Monitoring Compliance with Quality Parameters</td>
<td></td>
</tr>
<tr>
<td>3  Monitoring Compliance with Specific Physical Target(s) (service coverage for example) set out in the Contract</td>
<td></td>
</tr>
<tr>
<td>4  Auditing Financial Accounts of Regulated Firms</td>
<td></td>
</tr>
<tr>
<td>5  Questions Related to Technology</td>
<td></td>
</tr>
<tr>
<td>6  Tariff Reviews</td>
<td></td>
</tr>
<tr>
<td>7  Investigate Charges of Collusion/ Restrictive Practises by Regulated Firms</td>
<td></td>
</tr>
<tr>
<td>8  Sector/ Industry Studies</td>
<td></td>
</tr>
<tr>
<td>9  Legal Opinions</td>
<td></td>
</tr>
<tr>
<td>10 Impact Assessment Studies</td>
<td></td>
</tr>
<tr>
<td>11 Communication with Consumers and other Stakeholders</td>
<td></td>
</tr>
<tr>
<td>12 Staff Training</td>
<td></td>
</tr>
<tr>
<td>13 Non Core/ Basic Administrative Functions</td>
<td></td>
</tr>
<tr>
<td>14 Dispute Settlement</td>
<td></td>
</tr>
</tbody>
</table>

Thank you

..........................................................
**What functions are Contracted Out?**

6. What kind of functions do you Contract Out? Kindly rank in the order of importance:

<table>
<thead>
<tr>
<th>Function</th>
<th>Ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Information/ Data Collection</td>
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<td>2 Monitoring Compliance with Quality Parameters</td>
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<td></td>
</tr>
<tr>
<td>14 Dispute Settlement</td>
<td></td>
</tr>
</tbody>
</table>

7. What is the share of Contracting Out in your Total Budget?
   - Less than 10% ☐
   - Less than 20% ☐
   - More than 20% ☐
   - Can’t Comment ☐

**Why do you Contract Out?**

8. What are the Reasons for Contracting Out?
   - Give a weight to the proposed factors below
   - (H: High  M: Medium  L:Low)
<table>
<thead>
<tr>
<th>Reason(s)</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Lack of In-House Capacity</td>
<td></td>
</tr>
<tr>
<td>Law Requires It</td>
<td></td>
</tr>
<tr>
<td>To Cut Cost</td>
<td></td>
</tr>
<tr>
<td>Improves Quality</td>
<td></td>
</tr>
<tr>
<td>Improve Flexibility</td>
<td></td>
</tr>
<tr>
<td>Improves Control</td>
<td></td>
</tr>
<tr>
<td>Improves Credibility</td>
<td></td>
</tr>
<tr>
<td>Acceptable to:</td>
<td></td>
</tr>
<tr>
<td>Firms</td>
<td></td>
</tr>
<tr>
<td>Consumers</td>
<td></td>
</tr>
<tr>
<td>Problem is too Technical in Nature</td>
<td></td>
</tr>
<tr>
<td>Past Experience with Outsourcing has been Good</td>
<td></td>
</tr>
<tr>
<td>Law Requires It</td>
<td></td>
</tr>
</tbody>
</table>

Any other (kindly indicate)……………………

9. The Contracted Out functions are:
   - Advisory/ Non Binding in nature □
   - Binding Input into a Decision □

**Procedures for Contracting Out**

10. Is the contracting out decision based on:
    - A well documented strategy □
    - Ad-hoc Basis □
    - Other (please specify)…………

11. Has any comprehensive risk and legal assessment been done to ascertain what functions can or cannot be contracted out within legislative requirements and interest of the stakeholders?
    - Yes □
    - No □
    - Not taken but plan to Undertake □
    - Not taken and don’t plan to undertake □
    - Can’t say □

12. Is contracting out done under the Existing Public Procurement Guidelines?
    - Yes □
    - No □
    - Any other (please indicate)……

13. Has the advantage/ disadvantage of Contracting Out over carrying out all of these functions “In House” ever been studied?
    - No □
    - Yes □
    - Plan To □
    - Can’t Say □

14. Does your Accounting System permit you to calculate the internal cost of regulatory activities to enable meaningful cost comparison with Contracted Out functions?
    - No □
    - Yes □
    - Can’t Say □
Who do you Contract to?

15. Indicate the kind of parties that you contract out to and rank them from 1 (most important) down to the least important.

<table>
<thead>
<tr>
<th>Parties</th>
<th>Ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals</td>
<td></td>
</tr>
<tr>
<td>Former Employees</td>
<td></td>
</tr>
<tr>
<td>Domestic Consulting Firms</td>
<td></td>
</tr>
<tr>
<td>International Consultants</td>
<td></td>
</tr>
<tr>
<td>Government Owned Companies</td>
<td></td>
</tr>
<tr>
<td>Universities</td>
<td></td>
</tr>
<tr>
<td>Non Profits</td>
<td></td>
</tr>
<tr>
<td>Other government agencies in country</td>
<td></td>
</tr>
<tr>
<td>Regulatory agencies outside of the country (regional or based in third countries)</td>
<td></td>
</tr>
</tbody>
</table>

16. Give examples of the kind of functions for which you use the parties.

<table>
<thead>
<tr>
<th>Parties</th>
<th>Kind of Functions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals</td>
<td></td>
</tr>
<tr>
<td>Former Employees</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Regulatory agencies outside of the country (regional or based in third countries)</td>
<td></td>
</tr>
</tbody>
</table>

How do you Contract Out?

17. How are the agencies selected for Contracting Out?
   Competitive Sealed Tendering [ ]   Negotiations [ ]
   Combination of the above two [ ]   Unsolicited offers [ ]
   Any Other ..........................

18. How much weight, in percentage, is apportioned between price and non-price selection variables in Contracting Out?
   Price Variables:
   Non-Price Variables:

19. What kind of Contract Arrangements are used?
   Long-Term [ ]   Retainer Fees [ ]
   Discrete Contracts [ ]
20. Are your contracts based on:
- Fixed Price
- Fixed Price plus Incentives
- Schedule of Rates
- Combination of above
- Any Other

21. Level of political interference in Contracting Out Decisions?
- None
- Moderate
- High
- Can’t say

**How are Contracted Out Functions Managed?**

22. How are the functions that are Contracted Out monitored?
- Direct Monitoring (while the work is underway)
- Follow up Monitoring (after the work is completed)
- Monitoring by Exception (following any complaints)
- Can’t say

23. In the event of non-performance by contracted agencies, are there any backup plans?
- Yes
- No
- Can’t say

24. Has financial penalty ever been imposed on contracted agencies for sub-standard or incomplete work?
- Yes
- No
- Can’t say

25. Has any contract ever been cancelled for sub-standard or incomplete work?
- Yes
- No
- Can’t say

26. Are the costs of hiring external contractors:
- High
- Reasonable
- Can’t say

27. Are the monitoring costs:
- High
- Reasonable
- Can’t say

**What are the Benefits of Contracting Out?**

28. How has been your experience with Contracting Out?
- Good
- Average
- Poor
- Can’t say

29. Is the private supply market for Contracting Out regulatory functions:
- Very Small (hard to find good consultants)
- Adequate
- Abundant

30. Does Contracting Out when compared with “In-house” provision gives you better control over the outcome?
- Yes
- No
- Can’t say
31. Has Contracting Out resulted in:
   - Lower Cost and Better Quality of Services
   - Lower Cost and Inferior Quality
   - Lower Cost and No Change in Quality
   - Can’t Say

32. How effective has Contracting Out been at improving your Agency’s Competence?
   - Extremely
   - Moderate
   - Low
   - No Impact
   - Can’t say

33. How effective has Contracting Out been at improving your Agency’s Independence?
   - Extremely
   - Moderate
   - Low
   - No Impact
   - Can’t say

34. How effective has Contracting Out been in improving your agency’s trust with key stakeholders?
   - Extremely
   - Moderate
   - Low
   - No Impact
   - Can’t say

**Expectations and Challenges**

35. Do you expect the future share of Contracting Out in your agency?
   - To stay the same
   - To increase
   - To decrease in future
   - Don’t know

36. Identify the “Top 3” challenges in Contracting Out?

<table>
<thead>
<tr>
<th>Challenges</th>
<th>Please tick</th>
</tr>
</thead>
<tbody>
<tr>
<td>Getting Expensive</td>
<td></td>
</tr>
<tr>
<td>Budgetary Constraints</td>
<td></td>
</tr>
<tr>
<td>Hard to specify performance variables</td>
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<tr>
<td>High transaction/contracting Cost</td>
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<tr>
<td>High monitoring cost</td>
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<tr>
<td>Loss of flexibility</td>
<td></td>
</tr>
<tr>
<td>Loss of control</td>
<td></td>
</tr>
<tr>
<td>Supply market is small</td>
<td></td>
</tr>
<tr>
<td>Cost savings are minimal</td>
<td></td>
</tr>
<tr>
<td>Quality improvements are minimal</td>
<td></td>
</tr>
</tbody>
</table>

Any other (please indicate)………………………………………….
### Section C: Information about the Regulatory Agency

#### Agency Mandate

37. The regulatory agency is set up at:
- Federal Level
- State Level
- Municipal Level

38. Is the regulatory agency an:
- Independent Agency
- Dedicated Unit within Ministry
- Dedicated Unit within Municipality
- Other

39. Who is the primary decision maker of last resort?
- Regulatory agency
- Government Minister/ Line Ministry Bureaucrat

40. Coverage of regulatory agency:
- Sector Specific
- Industry Specific
- Multisector

**If Sector Specific, which sector(s):**
- Energy
- Water & Sanitation
- Telecommunication
- Transport

**If Industry Specific, which industry (ies):**
- Electricity
- Gas
- Water & Sanitation
- Telecommunication
- Road
- Port
- Airport

**If Multisectoral, which sectors (mark several):**
- Energy
- Water & Sanitation
- Telecommunication
- Transport

41. Specific Task(s) of Regulatory Authority:
- Award of Licenses or Concessions
- Settlement of Disputes
- Administration of rules embedded in licenses/ concessions
- Tariff setting
- Setting Standards
- Monitoring for Compliance
- Prosecution of firms for non-compliance

Any other, please indicate……………………………

#### Section G: Agency Structure

42. Number of decision-makers/regulator(s):
- Single
- Committee with odd number of members
- Committee with even number of members
43. Who appoints regulator(s)?
   Executive ☐    Legislative ☐    Jointly ☐
   Others ☐
   Comments:______________________________

44. Term(s) of appointment
   Fixed Period subject to renewal ☐    Fixed Period with no renewal ☐
   Open Ended ☐
   Comments:______________________________

45. Security of tenure:
   Rules to Allow removal ☐
   Protection from arbitrary removal ☐
   No protection from arbitrary removal ☐

Profile of the Regulated Firm(s) and Market

46. Number of firm(s) agency regulates?
   Less than 5 ☐    Less than 10 ☐    Less than 20 ☐
   More than 20 ☐

47. Institutional Arrangement for infrastructure delivery?
   Government Department ☐    Public Utility ☐
   Service Contracts ☐
   Management Contracts ☐    Lease Contracts ☐
   Concession contracts ☐
   Majority Private Ownership ☐    Cooperatives ☐

48. Industry Structure in which regulated firms operate?
   Integrated Utilities ☐
   Unbundled Utilities ☐
   Multiple Firms Competing for Clients ☐

49. Population served by regulated firm(s)?
   Less than 1 million ☐    Less than 5 million ☐
   Less than 10 million ☐    Greater then 10 million ☐
   Other: ☐
   Comment:______________________________

Agency Resources

50. Please indicate number of agency staff:
   Professional/ Core staff: .......
   Supporting staff: ............

51. Freedom to hire Core Staff?
   Absolute ☐    Medium ☐    No Freedom ☐
52. Is the core staff exempted from Civil Service Salary and Recruitment Rules?
   Yes ☐  No ☑

53. Funding for agency?
   User Fees/ Levies on the regulated industry ☐
   Government Funded/ Budgetary Transfers ☐

54. Please indicate, approximately, the Annual Budget of your agency (in US$):

55. Level of involvement of Stakeholders (consumers and regulated firms) in decision making?
   Low ☐  Medium ☐  High ☐

56. Are any consultation policies used to ensure transparency?
   Presence of consultative/ advisory bodies ☐  Public Hearing ☐
   Interested parties making submissions ☐
   Providing information to consumers ☐
   Publishing the Decisions and Reasons for reaching it ☐
   Any Other ☐

57. Are these Openness and Consultation measures: Formal ☐  Informal ☐

58. External Audit(s) used to ensure Transparency?
   Annual Report on Activities ☐
   Budget review by Executive/ Legislature ☐
   Specialized Audits/ oversight Institutions ☐
   Any Other .............................

59. Can agencies decisions be appealed against, and if yes, where?
   Courts ☐  Special Commissions/ Tribunals ☐
   No Provision Exists ☐
   Any Other Forum(s) ..........................

Thank you for taking the time out to assist us today.
Annex B

Contracting Out Survey
Results
The objectives of the survey were to gather information on current contracting-out practices by utility regulators around the world, in order to better understand how they reach contracting out decisions and what their experience in this regard has been in the last few years.

The survey instrument was sent to a total of 136 agencies around the world and a total of 51 responses were collected, which amounts to a 38 percent effective response rate.

<p>| Table 1.1 Characteristics of the Sample of Regulatory Agencies that were Surveyed |
|-------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|</p>
<table>
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<th>MENA</th>
<th>OECD</th>
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<td>15</td>
<td>34</td>
<td>4</td>
<td>28</td>
<td>136</td>
</tr>
</tbody>
</table>

<p>| Table 1.2 Characteristics of the Agencies that Completed the Survey |
|-------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|</p>
<table>
<thead>
<tr>
<th>Sector/Region</th>
<th>Africa</th>
<th>EAP</th>
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<td>4</td>
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<td>1</td>
<td>1</td>
<td>1</td>
<td>6</td>
<td></td>
</tr>
<tr>
<td>Telecom</td>
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<td>5</td>
<td>1</td>
<td>5</td>
<td>1</td>
<td>3</td>
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<td>2</td>
<td>8</td>
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<td></td>
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<td>Transport</td>
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<td>1</td>
<td></td>
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<td>6</td>
<td>13</td>
<td>2</td>
<td>10</td>
<td>51</td>
<td></td>
</tr>
</tbody>
</table>

Responses had to be collected in a very short space of time and a considerable amount of direct contacts were required in order to obtain additional responses and clarify ones that had already been obtained. It is possible that, with additional time, a more comprehensive set of regulatory agencies could be consulted on this topic, which generated considerable interest, especially from developing countries regulatory agencies. (1)

The survey instrument, contained in Annex A, was structured as follows:

- The first section requested information on the profile of the respondent;
- The second contained questions on functions contracted out, motivation guiding these decisions, and experience with contracted out functions; and
- The third section requested information about the agency.

The results of the survey with regards to contracting out are presented in the first section whilst information on the sample characteristics is presented in the second section below. Note that respondents could choose more than one answer to some of the questions, and therefore the percentages do not always add to 100%.

(1) Some regulatory agencies from OECD countries were somewhat reluctant to answer the survey as they could not see their direct interest in making use of its findings.
B1.1 **CONTRACTING OUT PRACTICES ACCORDING TO SURVEY RESULTS**

**B1.1.1 Question 1: Do organisations contract out regulatory functions?**

- **75%** Yes
- **25%** No

**FOR AGENCIES THAT DO NOT CONTRACT OUT**

**B1.1.2 Question 2: Reasons for not contracting out, where 1 = most important**

- Too Expensive
- Too Difficult
- Good Consultants
- Legal Barriers
- Compromise Credibility
- Not Acceptable to Consumers
- High Cost of Monitoring
- Loss of Flexibility
- Compromises
- High Transaction Costs
- Hard to Define Contract Terms
- Loss of Control
- Negative Past Experience with Outsourcing
- Not Acceptable to Firms

<table>
<thead>
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<th>Reason</th>
<th>Level of Importance</th>
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</thead>
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<td>Too Expensive</td>
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</tr>
<tr>
<td>Too Difficult</td>
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<tr>
<td>Good Consultants</td>
<td>2.0</td>
</tr>
<tr>
<td>Legal Barriers</td>
<td>1.7</td>
</tr>
<tr>
<td>Compromise Credibility</td>
<td>1.5</td>
</tr>
<tr>
<td>Not Acceptable to Consumers</td>
<td>1.5</td>
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<tr>
<td>High Cost of Monitoring</td>
<td>1.5</td>
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<tr>
<td>Loss of Flexibility</td>
<td>1.5</td>
</tr>
<tr>
<td>Compromises</td>
<td>1.5</td>
</tr>
<tr>
<td>High Transaction Costs</td>
<td>1.5</td>
</tr>
<tr>
<td>Hard to Define Contract Terms</td>
<td>1.5</td>
</tr>
<tr>
<td>Negative Past Experience with Outsourcing</td>
<td>1.0</td>
</tr>
<tr>
<td>Not Acceptable to Firms</td>
<td>1.0</td>
</tr>
</tbody>
</table>
B1.1.3 Question 3: Does not contracting out have an impact on effectiveness?

- Yes: 30%
- No: 30%
- Can't say: 40%

B1.1.4 Question 4: Any future role for contracting out?

- Yes: 90%
- No: 0%
- Can't say: 10%
B1.1.5 Question 5: Functions that they would contract out in order of importance (where 1 = most important)¹

FOR AGENCIES THAT CURRENTLY CONTRACT OUT

¹ Because responses to this question varied in terms of ranking, the results were reclassified in some instances to provide consistency.
B1.1.6 Question 6: Functions currently contracted out in order of importance (where 1 = most important)

B1.1.7 Question 7: Share of contracting out in total budget

(1) Because responses to this question varied in terms of ranking, the results were reclassified in some instances to provide consistency.
B1.1.8 Question 8: Reasons for Contracting out (where 1 = most important; 3 = least important)

B1.1.9 Question 9: What is the nature of the functions that are contracted out?
B1.1.10 Question 10: What is the basis for taking contracting out decisions?

[Diagram showing 79% for A well documented strategy and 21% for Ad-hoc basis]

B1.1.11 Question 11: Has any comprehensive risk and legal assessment been undertaken to ascertain what functions can and cannot be contracted out within the legislative requirements and interest of the stakeholders?

[Diagram showing 31% for Yes, 44% for No, 6% for Not taken but plan to undertake, 11% for Not taken but don't plan to undertake, and 8% for Can't say]
B1.1.12  Question 12: Is contracting out done under existing Public Procurement Guidelines?

- Yes: 85%
- No: 15%

B1.1.13  Question 13: Have the advantages/ disadvantages of contracting out over carrying out all functions "In House" ever been studied?

- No: 53%
- Yes: 28%
- Plan to: 17%
- Can't say: 3%
B1.1.14  Question 14: Does your accounting system allow you to carry out cost comparisons between the internal cost of regulatory activities and contracted out functions?

![Pie chart showing distribution of responses to Question 14]

- 33% Yes
- 44% Can't say
- 22% No

B1.1.15  Question 15: Which kind of parties do you contract out to? (where 1 = most important, 3 = least important)

![Bar chart showing distribution of responses to Question 15]

- International Consultants: 2.5
- Regulatory agencies outside of the country (regional or based in third countries): 2.0
- Other government agencies in country: 1.5
- Domestic Consulting Firms: 1.0
- Non Profits: 1.0
- Individuals: 1.5
- Universities: 2.0
- Government Owned Companies: 3.0
- Former Employees: 3.0

B1.1.16  Question 16: What kind of functions do you contract out to different types of entities?

Question 16 was purely qualitative and responses vary depending on each agency. Full results can be provided if necessary.

(2) 11 Because responses to this question varied in terms of ranking, the results were reclassified in some instances to provide consistency.
**B1.1.17 Question 17: Procedures used in the selection of agencies for contracting out**

![Pie chart showing distribution of procedures used in the selection of agencies for contracting out.](chart1.png)

**B1.1.18 Question 18: Criteria for selection of agencies providing services**

![Pie chart showing distribution of criteria for selection of agencies providing services.](chart2.png)
B1.1.19 Question 19: Contract arrangements used

- Long-term: 24%
- Retainer fees: 27%
- Discrete contracts: 65%

B1.1.20 Question 20: Basis for remuneration in contracts

- Fixed price: 62%
- Fixed price plus incentives: 30%
- Schedule of rates: 6%
- Combination of above: 0%
- Other: 0%
B1.1.21 Question 21: Level of Political Interference in Contracting out Decisions

- 89% None
- 8% Moderate
- 3% High
- 0% Can't say

B1.1.22 Question 22: Monitoring of Contracted Out Functions

- 95% Direct monitoring
- 30% Follow up monitoring
- 8% Monitoring by exception
- 0% Can't say
B1.1.23 Question 23: Presence of back-up plans in the event of non-performance by contracted agencies

- Yes: 71%
- No: 24%
- Can't say: 6%

B1.1.24 Question 24: Have financial penalties ever been imposed on contracted agencies for sub-standard or incomplete work?

- Yes: 46%
- No: 38%
- Can't say: 16%
B.1.1.25  Question 25: Has any contract ever been cancelled for sub-standard or incomplete work?

- Yes: 43%
- No: 49%
- Can't say: 8%

B.1.1.26  Question 26: Assessment of the costs of hiring external contractors

- High: 33%
- Reasonable: 3%
- Can't say: 67%
B.1.1.27 Question 27: Assessment of the costs of monitoring

- High: 86%
- Reasonable: 11%
- Can't say: 3%

B.1.1.28 Question 28: How has been the experience of the organisation with contracting out?

- Good: 61%
- Average: 39%
- Poor: 0%
- Can't say: 0%
B.1.1.29 Question 29: How is the supply market for contracting out regulatory functions?

B.1.1.30 Question 30: Does contracting out give you a better control of the outcome when compared with "In-House" Provision?
B.1.31 Question 31: What has been the impact of contracting out on cost and quality?

![Impact of Contracting Out Pie Chart]

- 41% Lower cost and better quality of services
- 53% Lower cost and inferior quality
- 0% Lower cost and no change in quality
- 6% Can't say

B.1.32 Question 32: How effective has contracting out been at improving the Organisation's competence?

![Effectiveness of Contracting Out Pie Chart]

- 26% Extremely
- 66% Moderate
- 3% Low
- 3% No Impact
- 3% Can't say
B.1.33  Question 33: How effective has contracting out been at improving the Organisations' independence?

B.1.34  Question 34: How effective has contracting out been at improving the Organisation’s trust with key stakeholders?
**B.1.35**  
*Question 35: What are reasonable expectations on the future share of contracting out in your agency?*

![Pie chart](image)

**B.1.36**  
*Question 36: What are the top challenges in contracting out?*

![Bar chart](image)

**B1.2**  
*Sample Characteristics*

Answers to the following questions provide more information on the characteristics of the sample of regulatory agencies that were surveyed.
B1.2.1 Question 37: Level of government where regulatory agencies are set up

- Federal level: 50%
- State level: 42%
- Municipal level: 8%

B1.2.2 Question 38: Type of regulatory agency

- Independent agency: 13%
- Dedicated unit within Ministry: 2%
- Dedicated unit within municipality: 2%
- Other: 83%
**Question 39: Primary decision makers**

![Pie chart showing the distribution of primary decision makers. 80% are Regulatory agency, 20% are Government minister/Line Ministry bureaucrat.]

**Question 40: Characteristics of the Agencies that Completed the Survey**

<table>
<thead>
<tr>
<th>Sector/Region</th>
<th>Africa</th>
<th>EAP</th>
<th>SA</th>
<th>ECA</th>
<th>LAC</th>
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<td>6</td>
<td>13</td>
<td>2</td>
<td>10</td>
<td>51</td>
</tr>
</tbody>
</table>

**Question 41: Specific task(s) of regulatory authority**

- Prosecution of firms for non-compliance: 80%
- Award of licenses or concessions: 70%
- Setting standards: 80%
- Tariff setting: 50%
- Settlement of disputes: 30%
- Administration of rules and regulations: 100%
- Monitoring for compliance: 80%
**B1.2.6  Question 42: Number of decision makers/ regulators**

- 24% Single
- 69% Committee with odd number of members
- 18% Committee with even number of members

**B1.2.7  Question 43: Responsibility for appointing regulator(s)**

- 69% Executive
- 16% Legislative
- 7% Jointly
- 9% Others
B1.2.8  Question 44: Term(s) of appointment

![Pie chart showing percentages for term(s) of appointment]

- 67% Fixed period subject to renewal
- 16% Fixed period with no renewal
- 18% Open ended

B1.2.9  Question 45: Security of tenure

![Pie chart showing percentages for security of tenure]

- 40% Rules to allow removal
- 40% Protection from arbitrary removal
- 23% No protection from arbitrary removal
B1.2.10 Question 46: Number of firm(s) agency regulates

![Pie chart showing the distribution of the number of firms agency regulates: 61% regulate less than 5 firms, 18% regulate less than 10 firms, 16% regulate less than 20 firms, and 5% regulate more than 20 firms.]

B1.2.11 Question 47: Institutional arrangement for infrastructure delivery

![Pie chart showing the distribution of institutional arrangements: 33% use lease contracts, 26% use concession contracts, 21% use government departments, 20% use public utilities, 5% use cooperatives, 5% use service contracts, and 2% use management contracts.]

- Lease contracts
- Management contracts
- Service contracts
- Cooperatives
- Concession contracts
- Government department
- Public utility
B1.2.12 Question 48: Industry structure in which regulated firms operate

- Integrated utilities: 33%
- Unbundled utilities: 41%
- Multiple firms competing for clients: 22%

B1.2.13 Question 49: Population served by regulated firm(s)

- Less than 1 million: 30%
- Less than 5 million: 15%
- Less than 10 million: 33%
- Greater than 10 million: 22%

B1.2.14 Question 50: Number of agency staff in the regulatory agency

On average:
- Professional/Core staff: 62
- Supporting staff: 34
B1.2.15  Question 51: Freedom to hire core staff

![Pie chart showing percentages of responses to Question 51]

- 44% have absolute freedom
- 42% have medium freedom
- 13% have no freedom

B1.2.16  Question 52: Core staff to be exempted from civil service salary and recruitment

![Pie chart showing percentages of responses to Question 52]

- 52% support exemptions
- 48% do not support exemptions
Question 53: Agency funding

On average, USD 9.9 million per year with wide discrepancies.

Question 54: Agency's annual budget (US$)

On average, USD 9.9 million per year with wide discrepancies.

Question 55: Level of involvement of stakeholders (consumers and regulated firms) in decision making
B1.2.20  Question 56: Formality of openness and consultation measures

- Presence of consultative/advisory bodies: 77%
- Public hearing: 75%
- Interested parties making submissions: 57%
- Providing information to consumers: 50%
- Publishing the decisions and reasons for reaching it: 77%

B1.2.21  Question 57: Consultation policies used to ensue transparency

- Formal: 81%
- Informal: 30%
### Question 58: External audit(s) used to ensure transparency

- Annual report on activities: 89%
- Budget review by executive/legislature: 70%
- Specialized audits/oversight institutions: 55%
- No provision exists: 7%

### Question 59: Appeal against agencies' decisions and whereabouts

- Courts: 86%
- Special commissions/tribunals: 30%
- No provision exists: 2%
Annex C

Case Studies of Contracting Out Utility Regulatory Functions
C1 INTRODUCTION

The purpose of the case studies is to understand, in greater depth, various dimensions of regulatory contracting out as practised in some countries, and its role in improving regulatory effectiveness.

The case studies were chosen to achieve a right balance in terms of: sector and regional coverage, quality of learning and experience, agencies in different stages of evolution (nascent to advanced), different initial conditions and motives for regulation, and the level of success achieved. A particular focus for the selection was to look for examples where agencies have gone a relatively long way in the contracting out decisions, i.e. not only for gaining competence, but also legitimacy or independence, i.e. to improve on the qualities defined as key for regulatory effectiveness as per Section 2 of the main report. In many cases, this was contained in the original regulatory design, which is why those case studies help to highlight potential options for policy-makers when designing a regulatory framework. Specific features of those case studies include:

- The use of auditors for the binding determination of the performance fee of the private management contractor for water services in Gaza;
- The role of arbitration panels in tariff reviews in the water sector in Chile;
- The use of Expert Panels for tariff reviews for Bucharest water services;
- The setting up of a regional regulator and its difficulties in contracting out in the telecommunications sector in the Caribbean region;
- The prescription of contracted out services for supporting the Ministry of Water and Energy in its supervision of a concession contract for water and sanitation services in Gabon.

For each case study, information gathered from the survey was complemented by more in-depth discussions with respondents (over the phone) and combined with a quick review of local institutions and context and sector specific developments, which have set the context and background for contracting out decisions.
C1.1 GAZA WATER AND SANITATION MANAGEMENT CONTRACT (1)

The Gaza Management Contract, one of the first private sector initiatives in the Middle East water sector, used an innovative contracting out 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 to the private operator. This experience is interesting as such mechanism could be used wherever the regulatory capacity and experience with private sector is limited, not only in the water sector, but in other sectors as well.

C1.1.1 Sector Background

In 1995, an interim agreement between the Palestine Liberation Organisation (PLO) and the Government of Israel made the Palestinian Authority responsible for managing water and sanitation sector in the Gaza Strip. At the time of takeover, the system was in very bad condition. The water quality had deteriorated due to an overexploitation of aquifers, water production or consumption records did not exist, and more than half the water pumped into the system was not accounted for due to leakages, illegal connections and malfunctioning meters.

A decision was made to involve the private sector to improve the system, but the uncertain political environment and limited availability of baseline data meant that a Management Contract was the only option that could be pursued. In mid 1996, following a competitive bidding process, the consortium of Lyonnaise des Eaux/Khatib and Alami (LEKA) won a four-year contract management contract for services in the Gaza strip. The Palestinian Water Authority (PWA), in charge of regulating the sector, was created in 1996, only a few months before the contract.

The management contract expired in the year 2000. PWA has since negotiated two annual rollovers with the same company and it is now trying to turn the existing management contract into a full-fledged concession, for which it has already received bids from several private companies.

C1.1.2 Regulatory Arrangements

Mandate

The Palestinian Water Authority is set up as an independent regulator at the State level to oversee water and sanitation sector in the areas under the oversight of the Palestinian Administration (PA). It can make independent decisions without being challenged or influenced by the line ministry.

Its general responsibilities include:
• Strategic Sector Planning and Policy Studies;

(1) PWA: Dr. Khairy Al-Jamal, Director, Palestine Water Authority; Deloitte & Touche: Mr. Knut Ore, Project Manager and Mr. Trond Ivar Skar, Financial Auditor.
• Award of licenses, concessions and contracts;
• Administration of rules embedded in licenses/ concessions;
• Setting tariffs;
• Setting standards;
• Monitoring for compliance and prosecution for non-compliance.

Tasks specific to the regulation of the Gaza Management Contract include:
• To approve all the works undertaken;
• To follow up the progress of the project;
• To co-operate with the Operator to ensure smooth functioning;
• To establish formal procedures for approval or “non-objection”;
• To appoint regional co-ordinators and design their job descriptions and remuneration;
• To design and monitor systems for quality control.

Structure

The decision committee of PWA has an odd number of members, which ensures internal checks and balances. The President of the State directly appoints the committee members, who have open-ended terms but there is no protection from arbitrary removals.

Resources

The PWA has a core staff of 80 and a similar number of support staff. It has some freedom to hire core staff, but the hiring procedure is not exempt from the Civil Service salary rules. The Government funds the agency and this limits its independence.

Decision Making Process

There is medium level involvement of stakeholders (consumers and regulated firms) in the decision making process. The agency uses internal audits in the form of consultative/ advisory bodies, public hearings, and publishes the decisions with explanations to ensure transparency. External audits are also encouraged through annual report on activities, budget reviews by the executive and legislature, and specialised audits. PWA decisions can be challenged in Court.

C1.1.3 Contracting Out in Practice

The basis of the Gaza management contract

In the original Management Contract for water and sanitation services in Gaza, the annual management fee in the contract had two components: a fixed payment of US$1.5 million and a performance linked payment, capped at US$750,000. The incentive payment was calculated based on the operator’s annual composite score on thirty-one performance targets, which were grouped under four broad criteria- the quantity of water produced, the quality
of water supply, the management of water and waste-water systems, and institutional strengthening implemented by the operator.

The management contract specified the use of an independent agency to carry out the technical and financial audit of the private operator to calculate the composite score. An internationally recognised company, Deloitte and Touche (Norway) was selected as the project auditor. Its fee was entirely funded by the Norwegian bilateral donor agency, and the auditor was selected through a competitive process.

The auditor evaluated the operator’s declared performance against the targets set out in the management contract, once or twice every year. The contract created a simple qualitative scale to measure progress. The scale measured the operator’s performance on broadly two criteria: first, whether the improvements by the operator met the contract quality specifications, and second, whether the timeline of the improvement met the contract guidelines. If the performance criteria was met on time and on target in terms of quality, the operator earned the mention “excellent”, if it met the timeline criteria but not the quality guidelines it earned “fair”, and if neither was met it earned “poor”. The qualitative scores were then converted into quantitative scores, by assigning a score of 1 for “excellent”, 2 for “fair” and 3 for “poor”, and this methodology was used for all of the performance variables.

On this basis, the operator’s performance fee was calculated using the following formula:

\[
\text{Performance Fee} = \left(\frac{3.5 - \text{Composite Score}}{2.5}\right) \times \text{US$750,000}
\]

If the operator earned “excellent” on all performance variables, its weighted average composite score would be one and this would allow it to earn 100% of the allotted annual performance linked fee of $750,000.

How did the audit work?

The purpose of the technical audit was to review the project’s engineering parameters and records, whereas the purpose of the financial audit was to review the operator’s administrative systems, invoicing and bill collection processes, consumer marketing practices, and staff training practices.

The contract required both the operator and the regulator to prepare independent reports on the project progress. The operator prepared half yearly performance report in each of Gaza’s sixteen municipalities and villages, which indicated the progress on 36 performance indicators and provided substantive evidence supporting their claims. The Palestinian Water Authority prepared its own assessment report and also got the chance to comment on the operator’s report, but the final decision on performance-linked fee was based entirely on the auditor’s report.
Each year, the audit lasted a few weeks during which the audit team reviewed the reports presented by the operator for accuracy, vetted the operator’s records, inventories and administrative procedures, and conducted random site surveys, in addition to visiting sites where the PWA officials believed anomalies could exist. Since the audit team would visit for only a few weeks each year, it placed particular emphasis on developing a reporting system that would be transparent, well documented, and traceable. For this purpose, a “Data Room” was established in the first year in which the operator was required to file all the backup documents for the fieldwork performed, or any other activities that would support its claim on any of the 32 performance variables. The auditor also laid out guidelines for the fieldwork. The installation of new meters, one of the most expensive and important element of the contract, was streamlined. The operator had to present documentation on the number of meters installed and where they were installed. To minimise the risk of corruption, one person from the operator’s side, PWA and the municipality had to sign the installation completion report.

After the survey, the auditor assigned scores on each of the 36 performance targets and calculated the operator’s composite score. This formed the sole basis for setting the operator’s annual performance fee. Disputes have been minimal and were handled through negotiations, without the need for an external recourse.

C1.1.4  Assessment of the impact of contracting-out

Contracting out improved the PWA’s Competence

In the PWA’s opinion, the use of external auditor put greater pressure on the operator to perform, which would not have been possible if the PWA alone had had to oversee the operator’s performance. The auditor bridged the stark information asymmetry gap between the operator and the PWA.

Developments in the project’s first year of operation explain how this was achieved. In the first year, the audit team was unsatisfied with the operator’s performance, and made quarterly visits (even though it was not obliged to do so) to bring those deficiencies to the operator’s notice and, more importantly, to suggest remedies to improve performance. Despite that, however, the first year performance was extremely poor because the operator did not pay much attention to the auditor’s suggestions. At the time of performance evaluation, the auditor downgraded the operator from “full compliance” to “poor compliance” on three of the performance indicators, and demanded higher standards in reporting, documentation and traceability of records. The result was that the operator received only 64 percent of the total incentive payment.

Following this, the operator decided to completely revamp its operations, including through the nomination of a new management team. It began to follow contract guidelines more closely and communications between the operator and PWA also improved significantly. Compliance improved
dramatically in the following years on all but the improvement in management (see Table 1.1).

Table 1.1  Performance of the Gaza Management Contractor

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Weight</td>
<td>Score</td>
<td>Weight</td>
<td>Score</td>
<td>Weight</td>
</tr>
<tr>
<td>Improving Quantity of Water</td>
<td>.46</td>
<td>1.6</td>
<td>.53</td>
<td>1.2</td>
</tr>
<tr>
<td>Improving Quality of Water</td>
<td>.24</td>
<td>1</td>
<td>.28</td>
<td>1</td>
</tr>
<tr>
<td>Improving Management</td>
<td>.21</td>
<td>3.2</td>
<td>.11</td>
<td>2.9</td>
</tr>
<tr>
<td>Promoting Institutional</td>
<td>.09</td>
<td>4.1</td>
<td>.08</td>
<td>2.5</td>
</tr>
<tr>
<td>development</td>
<td>Composite Score</td>
<td>2.02</td>
<td>1.41</td>
<td>1.1</td>
</tr>
</tbody>
</table>

Source: Deloitte & Touche, Norway- with 1 being “excellent”.

In the opinion of the PWA, the auditor’s pro-active intervention early on in the project cycle, managed to send a strong signal to the operator that only total compliance with all the project parameters would result in full payment of the performance linked fee. This was the single most important reason why the operator’s improved performance in the remaining years of the contract.

But the trust and cooperation was important

Both the PWA and auditor feel that strong partnership and trust between the two parties was important for the success of the contracted-out auditing functions. PWA was involved in the day-to-day project monitoring. It appointed and trained municipal area coordinators to oversee the operator’s work and to report deviations and this information was given to the auditor. In the auditor’s opinion, this intelligence helped them to detect problems, which may have gone completely unnoticed if they relied entirely on their random site visits. Likewise, PWA gained from the world-class reporting systems that the auditor put in place early on in the project.

Several disagreements arose between the operator and the auditor, particularly in the first year of the contract. The operator did not agree with the auditor’s assessment of its performance. There were several instances where the auditor disagreed with even PWA’s assessment of the operator’s performance. But the auditor received full support from the PWA to resolve these disputes through a process of open dialogue and meetings, where the only issue up for discussion was the technical merit of each side’s argument. In PWA’s opinion, the auditor’s technical competence helped to bring many of these contentious issues to a close.
The Tradeoffs Involved

The decision to hire private third party to take binding decisions involved the consideration of several tradeoffs. For the PWA, which had been created only a few months before the contract began, it represented some loss of control. It also demanded greater coordination with the private auditor, and above all, if the arrangement did not work, it would have severely dented its credibility with the consumers since both the operator and the auditor were not locals.

The decision to contract out did not have substantial cost implications, however, given that the costs of the auditor were fully funded by international donors, such activities did not add to the costs of carrying out regulatory functions and if anything, cut down the costs of developing the PWA’s regulatory capacity.
The Chile water sector is characterised by a two-level regulatory system: on the one hand, the Superintendence of Water and Sanitation (SISS), responsible for regulating the water and sanitation sector in Chile suffers from limited independence; on the other hand, arbitration panels made up of independent experts have been put in place in order to settle disputes between SISS and regulated companies, especially for tariff reviews. These panels are staffed with three private independent professional experts (not the employees of regulatory agencies), and their decisions are binding on both the government and the private operator. As a result, and unlike in other neighbouring countries, no substantial disputes has affected the Chilean water sector.

### C1.2.1 Sector Background

In 1990, Chile initiated broad and ambitious reforms in the water sector that instituted changes in four areas: tariff, subsidies, regulatory structure and company status. An independent regulator, the Superintendence of Water and Sanitation (SISS) replaced the National Service of Sanitary Work (SENDOS), the organisation that until then had both managed and regulated the water and sanitation sector in Chile. Public water companies gained more autonomy with their legal status changed from state owned corporations (under public law) to independent companies (under private commercial law). Tariffs were indexed to inflation and re-based every five years, a major departure from the past practice of the Economic Ministry, which used to reset tariffs on a totally ad-hoc basis. The system of cross-subsidies to low consumption consumers was discontinued, and replaced by direct payments to companies by municipalities.

Eight years later, with the sector in better financial health, the government initiated a privatisation process via sales of assets through its holding company CORFO. Five companies were privatised in the next three years, including the three largest. These included ESVAL (Region V) during the second half of 1998, EMOS (Metropolitan Region), ESSAL (Region X), and ESSEL (Region VI) in 1999, and ESSBIO (Region VIII) in the second half of 2000. Management Contracts were used for the Region VI company ESSAM and Region IX company, ESSAR.

Chile’s reform strategy has been gradual, in contrast with the full-blown privatisations seen in some other Latin American countries. Independent public companies were gradually forced to operate more efficiently through firm enforcement of performance-based contracts with company managers. This alone would not have worked, if the government had not introduced market-based tariffs and transparent subsidy structure. All these measures made the transition to private sector provision less painful than has been experienced in other countries, as no major (tariff) adjustments were needed.

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(1) People Interviewed: 1. Several local consultants, including some that have served on the expert panels (but who would like to stay anonymous) and María Concepción Palominos, SISS.
Overall the water sector reform has been quite successful. The reform has delivered urban water coverage of close to 100%, and sewerage coverage of about 94%. Sewage treatment was about 21% as of 2001, with a target to go beyond 99% by 2010. The pace of privatisation has been nothing short of phenomenal. In three years, beginning 1998, the percentage of the population served by private companies increased from 6% to over 78%. (1)

C1.2.2 Regulatory Arrangements

The Superintendence of Water and Sanitation (SISS), the national water and sanitation sector regulator, was established in 1990. Even though the reforms separated the regulatory and service provision roles, SISS remained dependent on the line ministry for funding. The Agency suffers from other design flaws that compromise its independence and legitimacy. Individuals make the key decisions, which limits the scope for internal checks and balances. The executive power appoints the regulator without consulting the legislature, and the regulator is granted no protection from arbitrary removal.

SISS oversees over 19 firms, all of which are integrated utilities, and cover close to 100% of the urban population. The majority of private owned firms provide services to about 72 percent of this population, public utilities to about 18 percent, and the remaining population is served through other arrangements like management contracts and cooperatives.

Mandate

The agency has a very broad mandate, which includes:

- Award of Licenses or Concessions;
- Settlement of Disputes;
- Administration of rules embedded in licenses / concessions;
- Tariff Setting;
- Setting Standards;
- Monitoring for Compliance;
- Prosecution of firms for non-compliance.

Staffing

The agency has staff strength of about 140, of which almost 70% are professional. Medium level of freedom exists to hire core staff, and no exemption from Civil Service Salary and Recruitment Rules are available.

Resources

The Agency is funded through budgetary transfers from the line ministry.

(1) Medina (2002).
C1.2.3  Contracting Out Practices

SISS contracting out practices

Tariff Reviews are the most common task that the agency contracts out, followed by compliance monitoring and dispute settlement (see Table 1.2).

Table 1.2  Tasks Contracted Out by SISS (1= most contracted out)

<table>
<thead>
<tr>
<th>Tasks Contracted out</th>
<th>Ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tariff Reviews</td>
<td>1</td>
</tr>
<tr>
<td>Monitoring Compliance with Quality Parameters</td>
<td>2</td>
</tr>
<tr>
<td>Dispute Settlement</td>
<td>3</td>
</tr>
<tr>
<td>Communication with Consumers and other Stakeholders</td>
<td>4</td>
</tr>
<tr>
<td>Staff Training</td>
<td>5</td>
</tr>
<tr>
<td>Legal Opinions</td>
<td>6</td>
</tr>
<tr>
<td>Investigate Charges of Collusion/ Restrictive Practises by Regulated Firms</td>
<td>7</td>
</tr>
</tbody>
</table>

Source: ERM Survey.

The primary reason for contracting out is the lack of in-house capacity and legal requirements. The lack of in-house capacity in functions that are contracted out is a strategic choice that the agency has made. Tariff reviews take close to two years to complete and are by nature very complicated, requiring reviewers to have core technical skills and knowledge of international best practices. The agency finds it more economical to contract this out to external agencies that specialize in this area. The studies are competitively tendered, and this permits SISS to benefit from competition to have the most optimal mix of price and quality.

Contracting out also helps the agency to hire specialised services that cannot be established in-house because of rigid civil service rules. In the opinion of SISS, several trade-offs need to be resolved in the ‘make’ vs. ‘buy’ decisions. Contracting out does not dilute its accountability to the public for the work done by external agencies. But it changes the nature of in-house skills needed. The agency’s managerial and oversight skills are becoming more important than pure technical skills. The agency has accordingly restructured its systems, and changed its resource allocation priorities to create improved in-house capacity to coordinate and monitor the work of external agencies.

Table 1.3  Reasons for Contracting Out Stated by SISS

| Very Important                          | Law Requires it |
|                                        | Compensate for general lack on in-house capacity |
|                                        | Acceptable to Firms |
|                                        | Good Experience with Contracting Out |
| Important                             | Improves Quality |
|                                       | Improve credibility |
| Less Important                        | Cut Cost |
|                                       | Improves Flexibility |
|                                       | Improves Control |
|                                       | Acceptable to Consumers |
|                                       | Technical nature of problem |

Source: ERM Survey.
Chile enjoys a very strong local regulatory talent base, which is the reason why international consultants get rarely hired for the work. Local domestic companies and individuals, who are fairly active in the Latin America market and elsewhere, win most of the work. The selection methods and monitoring procedures employed by SISS are summarised in the Table below.

**Table 1.4 Contracting out methods and monitoring procedures employed by SISS**

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Method used by SISS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Parameters</td>
<td>Price- 30% Quality- 70%</td>
</tr>
<tr>
<td>Type</td>
<td>Fixed Price Discrete Contract</td>
</tr>
<tr>
<td>Monitoring</td>
<td>Direct while work is underway</td>
</tr>
<tr>
<td>Backup Plans in the event of non-performance</td>
<td>Exists</td>
</tr>
</tbody>
</table>

*Source: ERM Survey.*

The contract design and the quality of the monitoring system shape the performance of the contracting-out arrangements. SISS puts a far greater weight on quality rather than prices for the selection of consultants, and does not view contracting out as purely a cost cutting tool. The agency actively monitors work-in-progress to ensure compliance with the terms of reference, and has a back-up plan, in-case product quality is not up to-desired standards.

**The Binding Role of Independent Arbitration Panels in Tariff Reviews**

The Law requires that detailed tariff review be undertaken in all the 19 water regions (whether operated by the private or public sector) every five years. The review includes the study of efficiency gains, proposed expansion plans, quality levels, and the cost of capital, amongst several other things.

Considering the multiple and complex nature of study parameters, it is not uncommon for disputes and disagreements to arise between operators and the regulator. The sector law (Decree with Force of Ley (DFL) Nº 70 de 1988) has therefore provided for the use of Arbitration Panels to resolve these differences. Most importantly, their decisions are binding on both the government and the operators. The working of panels is explained below.

Both the regulator and operators undertake extensive tariff studies, which are exchanged in the presence of a Public Notary, who certifies the exchange and seals the documents for safekeeping. If tariffs demanded by the operators are higher than the regulators had proposed, the regulators decision is considered to be final. However, operators have the right to request a tariff review within 30 days from the date when the studies were exchanged. Both parties have 45 days (from the date of the exchange) to mutually resolve the matter. If that does not happen, the regulator establishes an arbitration panel to force a decision. The panel is formed of three experts. One member is named by the operator, another one by the regulator and, a third one, is chosen from a list of experts, agreed by both the regulator and the operator before the beginning of

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(1) Note that similar panels have been set up in other regulated sectors by decree: in telecommunications (D.F.L. Nº 1 de 1982), and in transports for road concessions (Decreto 900 of 1996).
each process of tariff fixation. The panel members are mostly eminent personalities from the field of Economics, Engineering, Law, and Finance, with an established track record and good public image.

The panel reviews each of the parameters, where discrepancy exists between the study conducted by the regulator and operators, and makes its final decision based purely on the merit of the case. Its final decision is recorded by the public notary, and is definitive, binding and obligatory on both the operator and the regulator. The law ensures that the public is informed of not just the panel decisions but also how the panel reached its decisions by requiring all studies, procedures of calculation and information used by the panel to be made public once the tariff fixation process is completed. According to the Law, the regulator and the operator have to split the costs of the Panel equally.

**C1.2.4 Assessment of the impact of contracting out**

The ERM survey conducted as a part of this report, gathered data on the overall assessment of contracting out by SISS. This assessment included a number of parameters, with questions regarding overall experience with contracting out, whether contracting out provided a variety of benefits, as well as data on the cost of hiring and monitoring consultants. The results of this analysis for SISS are presented below (and a similar analysis is presented in the following case studies). Respondents could choose from a range of answers (for example, overall experience could be: no impact, low, moderate, or high), and these responses are summarised in this Table for SISS and in subsequent tables for other case studies (for greater detail, refer to the survey instrument in *Annex A*).

SISS stated that its overall experience with contracting out has been “average”, and that its impact on the agency’s competence quite moderate. Also, the agency has not found contracting out to be very effective in improving its independence and credibility with stakeholders, particularly consumers, but, at the same time, it did not find that it had compromised those factors either.

**Table 1.5 Overall Benefit Assessment of Contracting Out by SISS**

<table>
<thead>
<tr>
<th>Parameter of analysis</th>
<th>Assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall Experience to date with Contracting Out</td>
<td>Moderate</td>
</tr>
<tr>
<td>Improved Quality</td>
<td>No</td>
</tr>
<tr>
<td>Lowered Cost</td>
<td>Yes</td>
</tr>
<tr>
<td>Improved Competence</td>
<td>Moderate</td>
</tr>
<tr>
<td>Improved Independence</td>
<td>No Impact</td>
</tr>
<tr>
<td>Improved Trust with Key Stakeholders</td>
<td>No Impact</td>
</tr>
<tr>
<td>Cost of Hiring Consultants</td>
<td>Reasonable</td>
</tr>
<tr>
<td>Cost of Monitoring Consultants</td>
<td>Reasonable</td>
</tr>
<tr>
<td>Parameter of analysis</td>
<td>Assessment</td>
</tr>
<tr>
<td>----------------------------------------</td>
<td>------------------------------------------------</td>
</tr>
<tr>
<td>Loss of Control</td>
<td></td>
</tr>
<tr>
<td>Past Incidences of Cancelled Contracts</td>
<td>Yes</td>
</tr>
<tr>
<td>Top Challenges</td>
<td>Hard to specify performance variables</td>
</tr>
<tr>
<td></td>
<td>Loss of flexibility</td>
</tr>
<tr>
<td></td>
<td>Supply market is small</td>
</tr>
</tbody>
</table>

*Source: ERM Survey.*

SISS found arbitration panels to be very effective in resolving whatever disputes have arisen with operators at the first round of 5-yearly periodic reviews. Since many of the concessions were signed in the late nineties, 5-yearly tariff reviews are either underway or will be taking place shortly, and it will be interesting to see the kind of disputes that go to these panels, and how the arbitration panels manage to resolve them.

The agency lists difficulty in specifying performance variables as one of the top three challenges with contracting out, and its successful resolution could hold the key for better quality outcome.
C1.3 Bucharest (1)

Water and sanitation services in Bucharest were privatised in 1998. As part of the privatisation process, a new technical regulatory agency was created to oversee contract compliance. For legal reasons, the responsibility for setting tariffs could not be taken away from the Ministry of Finance, so additional guarantees were required to the independence of the tariff-setting decisions. This was accomplished through the establishment of “Expert Panels”, which could give their expert opinion on tariff decisions in a binding manner, both in the first instance and following potential appeals. The contract gave these panels important powers to adjudicate tariff decisions, but within the processes laid out in fine detail in the contract. On paper, the Ministry of Economics still clears the tariff reviews, but the contract made it very difficult for it to either delay or disagree with the opinion of the Expert Panel.

C1.3.1 Sector Background

Bucharest, the capital of Romania, is the country’s largest urban center with a population of over 2.3 million. Until 2000, a state-owned municipal company managed water and sanitation services in the city. It was faced with a difficult operating and financial environment, and the city’s water services were in poor condition. Tariffs and non-payment of bills had made capital investment difficult to carry out, resulting in the loss of over a quarter of water produced. Water pressure was so low in some parts of the city that residents in the upper floors of apartment buildings routinely did not get any water.

As part of decentralisation initiatives undertaken in 1990, municipalities were given the responsibility of providing public services through local utilities, and regulating them in consultation with the Department for Prices and Protection of Competition under the Ministry of Finance (MOF). In theory, local utilities were to be run like independent profit making entities that could raise finance from the capital market. However, in practise tariffs barely covered operating costs, and capital investment was financed through budgetary transfers from the central government. In Bucharest, for example, transfers were close to 95% of total investment, yet failed to keep pace with the real investment needs. And defaults on bill payments put further pressure on the investment decisions. Finally, it was not clear for how long the central government would continue to support the utility as its finances were under pressure.

Against this background, in 1998, the municipality of Bucharest retained the IFC to advise on the restructuring, corporatisation and concessioning of the city’s water and sewerage system. Two years later, following an extremely transparent bidding process, the French firm, Vivendi won the 25-year concession based on the lowest average tariff.

(1) People interviewed: 1. ARBAC: Adrian Criste, General Manager; World Bank: Robert Taylor, Private Sector Advisory and Moazzam Mekan, Private Sector Advisory.
C1.3.2 **Regulatory Arrangements**

Bucharest has different layers of governments responsible for public services and arrangements in place at the time of letting the contract would not have provided sufficient comfort to any private operator, which meant that the establishment of a new regulatory body was required. The existing laws did not permit tariff review decisions to be separated from the Department for Prices and Protection of Competition, and so a middle ground was reached, whereby a new agency called the Bucharest Agency for the Regulation of the Levels of Service water-Sewerage (ARBAC), was created as project’s technical regulator, but the power to review tariff remained in the hands of the Department for Prices and Protection of Competition, under the Ministry of Finance.

**Staffing**

ARBAC is an autonomous, non-governmental, non-profit agency managed by an Executive Council, consisting of a general manager, a customer service manager and technical manager. Members have a fixed term of six years. The City Council Commission selects the General manager; the customer service manager is selected by the agency for Consumers Protection; and the technical manager is selected by the Professional Associations for the Communal Administration of Public Services.

**Mandate**

- To establish a data bank of the performance indicators;
- To supervise compliance with levels of service defined in the contract;
- To carry out technical surveys to assist in the settlement of disputes between the customers and the concessionaire;
- To co-ordinate and monitor the certification of the quality standards;
- To advice municipality on any future concession and contracts;
- To apply penalties in case of non-compliance and verify compliance.

**Resources**

ARBAC is funded by a levy on the revenues of the concessionaire, which cannot exceed the lower amount between $300,000 (adjusted for US inflation) and 0.3% of the revenue. From this pool, $100,000 is earmarked for an “Expert Panel”, which has the mandate to give binding opinions on tariff review questions, as explained below.

C1.3.3 **Contracting Out Practices**

**The Use of Expert Panels**

The concession contract’s most significant feature in terms of contracting out is the availability of “Expert Panels” to give binding opinions on the questions concerning tariff reviews. ARBAC is authorised to competitively select external agencies, experts and legal advisors on a contractual basis.
The contract requires the Expert Panel to be an independent body formed of a water engineer, a regulatory economist and a financial analyst, selected jointly by the operator and the municipality. So once the private concession was signed, both the municipality and the operator submitted a list with three names for each position on the Expert Panel. To ensure neutrality, the candidate(s) on the panel could not be a national of either Romania or the operator’s home country. There was also a provision that in case they failed to agree on the names, selection was to be made by ARBAC in accordance with the rules of the ICC International Centre for Expertise.

The contract lays out the key attributes of the Expert Panel and procedures for tariff reviews:

- Panel members are appointed for a period of 5 years;
- The panel convenes on a need basis and the members are required to make a decision within 60 days of any request;
- Decisions are taken by a simple majority;
- Experts are paid from the levy imposed on the concessionaire. In case, the existing levy cannot cover it, the technical regulator can ask the concessionaire to pay the difference, which is recovered from customers;
- Panel members are required to develop their own internal conduct and procedural rules;
- Their decisions are binding on the concessionaire and the municipality.

The contract specifies various types of tariff review decisions, ranging from simple pass through adjustments to more comprehensive periodic reviews. The Expert Panels is central in more complicated type of adjustments.

**Simple tariff appraisals:** In simple tariff appraisals, which include pass through and level of service attainment tariff adjustments, the review is based on well-defined procedures, methodologies and detailed formulas specified in the contract. The role of the Department for Prices and Protection of Competition (the “economic regulator”) is limited to ascertaining the accuracy of some of the observable variables in the calculations.

**Extraordinary tariff adjustments:** These adjustments are driven by events that could not have been quantified in the contract. Tariff Adjustment Request is given to the economic regulator and copied to the ARBAC and Expert Panel. The former assesses the monetary impact of the event and presents the adjustment required to the tariff. The panel reviews the request using the extraordinary tariff adjustment guidelines of the contract. These guidelines cover the issues ranging from calculation of the project discount rate and accounting for the project period to minimum absolute value of any material impact that can trigger such adjustments. The panel has to make a decision within 30 days, and once it makes a decision, it sends its report to all the parties involved. The Economic Regulator makes its final decisions relying exclusively on the recommendations made in the expert report.

**Periodic Review and Re-basing Tariff Adjustment:** such tariff re-basing adjustments are required to be undertaken at the year 5, 10, 15, to check the
achievement of Level of Service (LOS) compliance at the end of these periods. The Expert Panel uses international best practices to issue guidelines for the preparation of business plans that review key project parameters like the IRR, the cost of capital, and the need for periodic tariff adjustment required to get the project back to its IRR target band. The panel reviews the operator’s final report and submits its recommendation to the Economic Regulator, who approves or rejects tariff request relying exclusively on the Expert Panel recommendations.

In cases where the request is rejected against the panel’s recommendation, the Economic Regulator is required to provide detailed reasons for this, and at the same time, to provide the operator with the option to re-appeal to the Expert Panel. If the panel, which technically is reviewing its own decision, finds no merit in the Economic Regulator’s justification and/or no new information to change its earlier decision, it can recommend one or all of the following options to compensate the operator for any financial loss:

- Extension of the contract duration;
- Extension of the time period for compliance with quality compliance deadlines;
- Suspension of the concession fee.

The contract allows the operator to invoke a force majeure clause if the Economic Regulator rejects the Expert Panel’s recommendation on tariff adjustment on the third occasion.

*Overall Contracting Out practices*

In its survey response, ARBAC indicated the functions that it most commonly contracts out (ranked in order of importance). In addition to the use of Expert Panels, ARBAC contracts out mostly data collection and monitoring for quality compliance, and very rarely for staff training (see Table 1.6 below).

<table>
<thead>
<tr>
<th>Table 1.6</th>
<th>Functions Contracted Out by ARBAC (1 = most contracted out)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ranking</strong></td>
<td><strong>Function</strong></td>
</tr>
<tr>
<td>1</td>
<td>Information/ Data Collection</td>
</tr>
<tr>
<td>2</td>
<td>Monitoring Compliance with Quality Parameters</td>
</tr>
<tr>
<td>3</td>
<td>Investigate Charges of Restrictive Practices by the Operator</td>
</tr>
<tr>
<td>4</td>
<td>Communication with Consumers and other Stakeholders</td>
</tr>
<tr>
<td>5</td>
<td>Dispute Settlement</td>
</tr>
<tr>
<td>6</td>
<td>Legal Opinions</td>
</tr>
<tr>
<td>7</td>
<td>Impact Assessment Studies</td>
</tr>
</tbody>
</table>

Source: ERM Survey.

As ARBAC is a new agency, it contracts out for several reasons. It rates the ability to cut costs, improve flexibility and technical nature of the problem as some of the key reasons. The contracting out process conforms to broad public procurement guidelines and is undertaken as part of a well-documented strategy, which includes an accounting system that lets it compare the internal cost of activities with that of outsourced activities.
ARBAC is exempted from the civil service rules, which gives it the flexibility to hire competent full-time staff at competitive wages. Yet, it has relied on external agencies to carry out key regulatory functions, and expects their role to increase, in future. It has mostly hired international consultants for the technical panel, and domestic companies and local non-profits for financial auditing and environmental studies, respectively.

The agency uses competitive sealed tenders to select agencies, but unlike many other agencies, gives more weight to price than quality in the selection process. But the agency’s management believes that it has not compromised the quality of the work. Most contracts are fixed price, long-term and this helps the agency to reduce its contracting costs, but at the same time limits the efficiency gains possible from frequent competition among the service providers.

C1.3.4 Assessment of the impact of contracting out

Overall

In its survey response, ARBAC answered a number of questions indicating its overall experience with contracting out, and the results are indicated below (for greater detail on the survey questions, see Annex A). As explained in the Chile case study, each respondent had the choice of several answers to rank their response. ARBAC’s overall experience with contracting out has been extremely good. In its opinion, contracting has improved the agency’s competence, independence, and trust with key stakeholders. It has also reduced the agency’s cost of regulating, and at the same time, improved the quality of its services.

<table>
<thead>
<tr>
<th>Parameter of analysis</th>
<th>Assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Experience to date with contracting out</td>
<td>Good</td>
</tr>
<tr>
<td>Improved Quality</td>
<td>Yes</td>
</tr>
<tr>
<td>Lowered Cost</td>
<td>Yes</td>
</tr>
<tr>
<td>Improved Competence</td>
<td>Extremely</td>
</tr>
<tr>
<td>Improved Independence</td>
<td>Extremely</td>
</tr>
<tr>
<td>Improved Trust with Key Stakeholders</td>
<td>Extremely</td>
</tr>
<tr>
<td>Cost of Hiring Consultants</td>
<td>Reasonable</td>
</tr>
<tr>
<td>Cost of Monitoring Consultants</td>
<td>Reasonable</td>
</tr>
<tr>
<td>Loss of Control</td>
<td>Better Control over Outcomes</td>
</tr>
<tr>
<td>Past Incidences of Cancelled Contracts</td>
<td>None</td>
</tr>
<tr>
<td>Top Challenges</td>
<td>Affordability</td>
</tr>
<tr>
<td></td>
<td>High monitoring cost</td>
</tr>
<tr>
<td></td>
<td>Supply market is small</td>
</tr>
</tbody>
</table>

Source: ERM Survey.

Its experience with the Expert Panel, in particular, has very been very positive. To date, the panel has recommended seven extraordinary tariff adjustments, and the Economic Regulator has accepted them all without any modifications. There has been at least one occasion where the panel has rejected an operator’s tariff adjustment request. In ARBAC’s opinion, the panel enjoys everyone’s
trust (including consumers) because of the competence and reputation of its members. This has de-politicized the tariff review process, and has helped the municipality, which had no prior regulatory experience, improve water services and using private sector participation.
ECTEL is the regional telecommunication regulator for the East Caribbean States and acts as a shared regulatory body for each of the member country. As such, it exemplifies the possibility of contracting out certain regulatory functions to regional regulatory agencies. In addition, as ECTEL is small in size, it has been contracting out extensively, for functions ranging from tariff reviews to impact assessment studies. Its experience with contracting out has been mixed and ECTEL is anticipating the share of contracting out to go down in the future. Understanding the problems it has faced with contracting out can generate important lessons for other agencies and service providers alike.

**C1.4.1 Sector Background**

The Eastern Caribbean Telecommunications Authority (ECTEL) was created on 4th May 2000 by a treaty between the five member countries of the Organization of Eastern Caribbean States (OECS). The member countries are the Commonwealth of Dominica, Grenada, Saint Christopher and Nevis, Saint Lucia, and Saint Vincent and the Grenadines. The agency’s mandate is to coordinate regional telecommunication policy by promoting harmonised technical standards throughout the region in addition to giving advice and technical support to national regulators, on request. It is not allowed to impinge on member countries’ sovereign power to issue and monitor licenses, but disputes can be referred to ECTEL for an opinion or for mediation.

The agency has its root in the legal case filed by an Internet service company in Dominica against the public telecom monopoly for disconnecting its 1-800 access service. The case argued that the public sector company, with its monopoly powers conferred through its licence, violated citizens’ right to freedom of speech and this violated the constitution. The case went all the way up to the region’s highest court, which ruled that monopoly was justified only if effective regulation expanded the availability of affordable network.

Even though this case originated from Dominica, it had ramifications for the entire OECS region for three reasons. First, a similar “freedom of speech” provision existed in the constitutions of other OECS member countries; second, all the OECS member countries fell under the jurisdiction of the same highest court in London; and finally, all member countries had a similar industry structure, a public monopoly. Sensing a floodgate of similar cases in their countries, governments realised that there was no alternative but to strengthen the regulatory capacity in their countries. But the local markets in member countries were too small to support the fixed cost of setting up full-fledged national regulatory agencies, so the idea of a regional telecom regulator was born. The idea gathered further momentum with the boom in the IT sector that begged for an improved telecom infrastructure and harmonized regional network.

(1) People interviewed: ECTEL: Anderson Reynolds, Senior Economist, and ECTEL’s Senior Technical Person.
C1.4.2 Regulatory Arrangements

ECTEL is the regional telecommunication regulator for the OECS Region. As telecom markets open up in the region and new services are introduced there is a vital need for strong regulatory system. ECTEL is expected to match this need by harmonising the regional telecom framework and carrying out (essential but expensive) technical and economic studies, thereby reducing the fixed cost burden on national regulatory agencies, who are too small to efficiently regulate the sector.

Staffing

It is an independent agency with a Board of Directors (one from each member country) reporting to a Council of Ministers. The agency has seven core staff and an equal number of non-core staff. The agency is exempt from the Civil Service Salary and Recruitment Rules. The key decision-making committee has an even number of participants. Regulators enjoy fixed period of appointment subject to renewal and there are clear rules to allow removal and giving protection from arbitrary removal.

Mandate

- Regulate the sector in relation to universal service, interconnection, numbering and pricing, and monitor its implementation;
- Prepare and recommend instruments and regulations to encourage harmonisation;
- Design and operate open tender procedures for individual licences when requested by the member countries;
- Review license applications on technical and financial parameters;
- Management of frequency authorisations, including its sale;
- Monitor licenses in collaboration with the member countries;
- Recommend the suspension or revocation of licenses;
- Recommend a fee structure for licences;
- Recommend a regional cost-based pricing regime;
- Recommend technical standards and procedures for the approval of Equipment.

Resources

The organisation is funded through budgetary transfers from member countries, which are linked to the royalties that countries receive for the use of radio spectrum. If in any year, the revenues are insufficient to meet the budgetary requirements, additional contributions from the member states are requested. Likewise when there is a surplus, it is returned. To ensure transparency, ECTEL uses a range of both formal and informal audit tools. These include annual report on activities, budget reviews by legislature, public hearing, publishing decisions, and submissions by interested parties.
### Contracting Out Practices

#### Contracting Out Built Into the Institutional Structure

ECTEL in itself is a form of “contracted out” agency, since it is carrying out regulatory functions that would be too costly or difficult to carry out at the level of each state that makes up its membership. ECTEL’s role is important because it not only has to assist member countries with regulation, but also with the liberalisation of their telecom sectors.

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 harmonised radio plan, designing and operating tender procedures for individual licenses, reviewing applications for licenses, and coordinating with other organisations. 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, fee structures, etc), and guidance on technical standards.

ECTEL’s organisational structure interlocks regional interests with local interests. Telecom ministers of member countries are both the chairmen of respective local regulatory commissions, the National Telecommunication Regulatory Commissions (NTRC) and members of ECTEL Board of Directors. This ensures a certain level of interlocking control and coordination between local and regional interest, and helps resolve disputes between ECTEL and local regulatory bodies, if any, through negotiations. Without this, it would otherwise become difficult to roll out harmonised technical standards, one of ECTEL’s key mandates.

#### Contracting Out Practices

ECTEL itself has also been “contracting out” many of its regulatory functions under a well-documented strategy and existing public procurement guidelines. Some of the functions contracted out, in the order of importance, include:

- Tariff Reviews;
- Staff Training;
- Legal Opinions;
- Impact Assessment Studies

ECTEL also reported on its reasons for contracting out, as reported in the following table.

<table>
<thead>
<tr>
<th>Table 1.8 Reasons for Contracting Out stated by ECTEL</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Very Important</strong></td>
</tr>
<tr>
<td>To compensate for general lack of in-house capacity</td>
</tr>
</tbody>
</table>
Table 1.3  Overall Benefit Assessment of Contracting Out by ECTEL

<table>
<thead>
<tr>
<th>Parameter of Analysis</th>
<th>Assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Experience till date with Contracting Out</td>
<td>Poor</td>
</tr>
<tr>
<td>Improved Quality</td>
<td>Can’t Say</td>
</tr>
<tr>
<td>Lowered Cost</td>
<td>Can’t Say</td>
</tr>
<tr>
<td>Improved Competence</td>
<td>Low</td>
</tr>
<tr>
<td>Improved Independence</td>
<td>Low</td>
</tr>
<tr>
<td>Improved Trust with Key Stakeholders</td>
<td>Low</td>
</tr>
</tbody>
</table>

**C1.4.4 Assessment of the impact of contracting out**

As in the previous two case studies, ECTEL was asked to report on its experience with contracting out, for a number of parameters. ECTEL experience with “contracting out” has been extremely poor. It has rated the cost of hiring external agencies as “high”, and its experience with “contracting out” as average. It has found “contracting out” completely ineffective in improving the agency’s competence, independence and credibility. It also feels that compared to “in house” provision, contracting out has compromised its control over the outcomes. Because of this poor experience, it expects the share of “contracting out” to come down in the near future.

International Consultants are hired for the majority of contracting-out work, followed by individuals and domestic consulting firms. Their portfolio of work is also quite broad, covering everything from tariff reviews, technical studies to staff training and legal assessment. Work given to domestic companies is limited to legal reviews. The selection is made through a combination of sealed tendering and negotiations, and the non-price variables are assigned close to 70% weight in its selection decisions, which lets the agency choose more competent consultants.

In addition, ECTEL conducts workshops with the help of external agencies for its own staff and the staff in national bodies, which allows benefiting from economies of scale in training. The workshops are organized along three broad areas: general, technical and policy-making. Very recently, ECTEL organised workshops on negotiations for staff members. It has had several workshops on tariff adjustment and interconnectivity issues both for its own staff and staff from local bodies. The policy workshops are targeted towards concerned ministers and senior governmental officials in member countries. This helps to get them on common footing on key economic issues affecting the telecom sector, which makes the dialogue process more constructive and decision-making much faster at the ECTEL board level.
<table>
<thead>
<tr>
<th>Parameter of Analysis</th>
<th>Assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of Hiring Consultants</td>
<td>High</td>
</tr>
<tr>
<td>Cost of Monitoring Consultants</td>
<td>Reasonable</td>
</tr>
<tr>
<td>Loss of Control</td>
<td>Better Control over Outcomes</td>
</tr>
<tr>
<td>Past Incidences of Cancelled Contracts</td>
<td>Yes</td>
</tr>
<tr>
<td>Top Challenges</td>
<td>Budgetary Constraints</td>
</tr>
<tr>
<td></td>
<td>High Contracting Cost</td>
</tr>
<tr>
<td></td>
<td>Quality Improvements are minimal</td>
</tr>
</tbody>
</table>

*Source: ERM Survey.*

The senior management team at ECTEL identifies the following reasons for its poor experience:

- External Agencies did not fully incorporate the local institutional framework in their analysis;
- There was a general tendency for consultants to use “of the shelf” studies;
- More often than not, consultants used top down approach to assignments, starting with the study and tailoring it to their needs;
- The studies were too much “theoretical” in nature, with very limited applied value;
- Workshops for staff training were also not rooted in the local legal framework;
- Initial work involved critical sector studies and rule writing and because of the out of context recommendations, lot of work had to repeated;
- Concerns about the quality increased their monitoring cost;
- Not many consultants had prior experience in the context of small economies.

ECTEL believes that it has learnt important lessons from contracting out. It plans to upgrade its core skill base in important regulatory disciplines, which will help it to have a more control over the contracting process.

It also expects the nature of contracting out to change. In the initial years, sector studies and impact assessment reports constituted most of the work contracted out. But it expects that in the future, more mundane tasks like performance measurements and tariff reviews will dominate its contracting out portfolio. Also, it sees very limited application for binding form of contracting out contracts. In its opinion, the private sector does not have the degree of legitimacy needed in regulatory decisions and its use for binding decisions would compromise the long-term credibility of the institution.
In July 1997, SEEG (Société d’Energie et d’Eau du Gabon) 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 the service to previously unconnected rural areas. The Government chose not to set up a regulatory body but incorporated contracting out mechanisms in the design of the contract for strengthening the independence and competence of the Ministerial department in charge of effectively regulating the contract.

In particular, the contract incorporated clauses that required the contracting out of some key regulatory functions such as the monitoring of coverage performance (with dedicated funds, set aside from the concessionaire’s revenues), although external agents are limited to producing non-binding studies. Also, contracting out 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), and that were left to an initial transition period during which many contractual terms were to be defined.

**C1.5.1 Sector Background**

SEEG is a national utility providing water and electricity services to the major urban centres above 1,000 inhabitants in Gabon. The signing of the concession contract in 1997 was preceded by about ten years of reforms, during which important reforms were conducted, such as legal and tariff reforms, and staff reduction. However, once the decision had been taken to let a contract, the IFC was appointed by the Government to carry out the transaction, which was carried out in less than 12 months, with little time for carrying out in-depth baseline studies on the state of the services or of the assets. Vivendi was awarded the tender on the basis of a proposed 17.25% price reduction; it later acquired 51% of SEEG’s shares and simultaneously signed a 20-year concession contract with the State.

The concession contract is largely output-driven, with the incorporation of urban and rural coverage obligations and the definition of a number of quality objectives at a relatively low level of detail. As SEEG went straight into a concession contract and given the relatively high level of uncertainty about the state of the systems at the time of privatisation, a 2.5-year “transition period” was defined in the contract (up to December 2000). During that period, no penalties could be applied but the concessionaire also had a number of obligations, such as to define (and implement) an emergency repair plan and to establish the methodological basis and the tools for controlling the enforcement of the contract (such as an inventory of assets and an analytical accounting system). A number of preliminary studies also had to be carried out by the Ministry in charge of supervising the contract, as described below.

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C1.5.2 Regulatory arrangements

Mandate

The Ministry of Mines, Energy, Oil and Water Resources is the line Ministry for both sectors served by the concession. Within the Ministry, the Direction Générale de l’Energie et des Ressources Hydrauliques (DGERH) is directly in charge of controlling the application of the contract by the concessionaire, including economic, financial and technical control. In addition to its regulating role, the DGERH plays other roles in the sector:

- Defining the overall policy for both sectors;
- Carrying out large investments in both sectors, specifically investments in hydro-electricity and major transportation networks;
- Organising service provision in rural areas outside of the perimeter;
- Managing the Special Funds for Water and Electricity, which provide financing to municipalities for public electricity and water services; and
- Owning the assets of the concession.

The control responsibilities of the DGERH are very much akin to those that would be entrusted to a regulatory body in other countries. In fact, the setting-up of a regulatory body was explicitly discussed at the time of privatisation (and given the small size of the country, the setting-up of a multi-sectoral regulatory body was the preferred option). However, the Government did not retain this option for a number of reasons:

- It was considered that regulatory bodies can only regulate sectors with more than one operator, which was not the case in Gabon since SEEG is the sole private provider of water and electricity services;
- Although they have recently begun to spring up (particularly in France), regulatory bodies are not commonly encountered in Francophone legal contexts, which are mostly based on regulation by contract;
- In Gabon, the separation between policy-setting functions and regulatory functions appeared very difficult to achieve in practice. In addition, it was feared that the creation of a new regulatory body would create extra costs and potentially, duplication of functions.

Resources

In practice, the functioning and financing of the DGERH are similar to that of a regulatory body, but with a number of key differences. Its budget is funded via the State budget (hence a limited autonomy) but the concessionaire must also pay an annual contribution to the costs of the Conceding Authority (to cover running costs and the costs of commissioning external studies), set at 0.2% of the previous year’s turnover for a normal year and at 0.5% in a year where a five-year review is taking place.
Staffing

The DGERH has assigned dedicated staff to the control of the concession. The Director himself was formerly at the SEEG. However, the DGERH’s means are relatively limited for carrying out all of these functions. With only 38 staff (of which only 3 engineers are available to carry out controls), its capacities to exercise direct control of the concessionaire’s activities are quite limited.

C1.5.3 Contracting out in practice

The concession contract includes a number of specific circumstances in which the DGERH needs to contract out some regulatory tasks, and makes an allocation for specific funding of this contracting out. In particular, the Concessionaire must fund separately the costs of the study to establish the methodology for estimating coverage rates, which is then used to assess whether the concessionaire has met its coverage obligations or not. Those studies are not strictly binding but are treated as the main information base and therefore used in tariff calculations or wherever else it is required as per the contract. In addition, the DGERH contracts out other functions that are not specified by the contract, as detailed in Table 1.4 below.

Table 1.4 Functions contracted out by the Directorate General in Gabon (1= most contracted out)

<table>
<thead>
<tr>
<th>Function</th>
<th>Example of activities</th>
<th>Ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auditing Financial Accounts of Regulated Firms</td>
<td>Audit the Concessionaire’s accounts and tariffs</td>
<td>1</td>
</tr>
<tr>
<td>Monitoring Compliance with Specific Physical Target(s) (service coverage for example) set out in the Contract</td>
<td>Service coverage studies</td>
<td>2</td>
</tr>
<tr>
<td>Monitoring Compliance with Quality Parameters</td>
<td>• Control of drinking water quality</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>• Control of assets to be returned to the Government at the end of the concession</td>
<td></td>
</tr>
<tr>
<td>Information/ Data Collection</td>
<td>• Asset inventory</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>• Demand forecast studies</td>
<td></td>
</tr>
<tr>
<td>Sector/ Industry Studies</td>
<td>Master Plans for water and electricity</td>
<td>5</td>
</tr>
<tr>
<td>Legal Opinions</td>
<td>Legal assistance for the revision of the concession contracts</td>
<td>6</td>
</tr>
</tbody>
</table>

Source: ERM Survey.

The use of contracting-out for carrying out a key study: the coverage study

During the initial Transition Period, the contract specifies that a methodological study on coverage should be carried out in order to further specify the methodology for defining coverage and revisit the validity of the baseline coverage targets defined in the contract. External consultants completed this study within the prescribed period. It was a very substantial study because to measure the coverage targets specified in the contract, it is necessary to collect information on population figures, which can either be difficult or very costly to obtain. It is followed by five-year study on coverage, to verify whether the concessionaire has met its coverage obligations or not. If
not, it is liable to pay hefty penalties. The findings of external consultants are therefore very important, as they determine the amount of penalties paid.

**Procedures for contracting out**

The most important reasons for contracting out according to the DGERH include a general lack of in-house capacity, and the need to improve quality and control. The lowest were that the law requires it or that it allows them to cut costs, given that the costs of contracting out are actually included in the contract.

The agency follows a well-documented strategy for contracting out, as outlined in the contract itself. It mostly contracts out to international consultants (for activities such as the initial asset inventory, the service coverage studies, the audit of the concessionaire’s accounts and tariffs and the demand studies), whilst it relies on domestic consulting firms for controlling the technical quality of assets to be returned to the Government at the end of the concession and other government agencies for monitoring drinking water quality. For most of those tasks, it relies on discrete contracts. There is no political interference in the selection of consultants, which is done following public sector procedures and on a competitive basis. The DGERH has a roster of pre-selected consultants that they can contract work to when they need services. Nevertheless, the DGERH has tended to use a small number of consultants on a repeated basis, who know the system well and with whom they have established a relation of trust.

The DGERH prefers carrying out direct monitoring over contracts and has the possibility to apply penalties (maximum 5 percent of the value of the contract) in the event of sub-standard or incomplete work. It has never cancelled a contract altogether but has sometimes requested that the consultants would start its work all over again, at its own expenses, due to poor quality.

**C1.5.4 Assessment of the impact of contracting out**

The overall experience of the Directorate with contracting out has been good. Hiring and monitoring costs are deemed to be reasonable, and it considers that contracting out give them better control over the outcome, lower cost and better quality of services. It has been extremely effective in improving the agency’s trust with key stakeholders.

Nevertheless, the Directorate expects the share of contracting out to be going down in future, since a lot of initial activities will have been completed and the agency wants to reinforce its in-house competencies. It mentions that the top three challenges in contracting out are the budgetary constraints and the difficulties in specifying performance variables. Coverage targets are gradually being met (or exceeded), which means that they have been effective in giving a strong incentive for the company to extend services in areas that are not very lucrative. The contracting out of the monitoring of coverage targets has allowed defining such targets with a higher degree of detail than would have otherwise been possible.
Annex D

List of Respondents to the Survey
<table>
<thead>
<tr>
<th>S.No</th>
<th>Name of the Agency</th>
<th>Country/ Region</th>
<th>Region</th>
<th>Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Palestine Water Authority</td>
<td>Gaza</td>
<td>MENA</td>
<td>Wat&amp;San</td>
</tr>
<tr>
<td>2</td>
<td>PUC</td>
<td>Belize</td>
<td>LAC</td>
<td>Multiutility</td>
</tr>
<tr>
<td>3</td>
<td>ECTEL</td>
<td>OECS</td>
<td>LAC</td>
<td>Telecom</td>
</tr>
<tr>
<td>4</td>
<td>Electricity Council</td>
<td>Malawi</td>
<td>Africa</td>
<td>Electricity</td>
</tr>
<tr>
<td>5</td>
<td>OFWAT</td>
<td>UK</td>
<td>OECD</td>
<td>Wat&amp;San</td>
</tr>
<tr>
<td>6</td>
<td>Electricity Commission</td>
<td>Malawi</td>
<td>Africa</td>
<td>Telecom</td>
</tr>
<tr>
<td>7</td>
<td>Energy Regulatory Commission</td>
<td>Armenia</td>
<td>ECA</td>
<td>Electricity</td>
</tr>
<tr>
<td>8</td>
<td>National Electricity Regulator</td>
<td>South Africa</td>
<td>Africa</td>
<td>Electricity</td>
</tr>
<tr>
<td>9</td>
<td>Electricity Commission</td>
<td>Ghana</td>
<td>Africa</td>
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**Table D.1.3  List of Respondents which Declined to Complete the Survey**

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Annex E

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