Six Choices in Regulatory Models for Brazil

INTRODUCTION

A nation contemplating the restructuring of an infrastructure industry, and/or the market within which it operates, must make a concurrent decision regarding the nature of the regulatory regime that will be superimposed on the restructured industry. This decision is essential while making a choice of whether to have state ownership to investor ownership, or whether to retain a monopoly or move to competition. While the precise structure of the industry itself, or of the market within which it operates, may be altered, the overall public policy goals that are sought from the industry do not necessarily change.

In the electric utilities industry, a shift in ownership from the public to private sector, or in the market from monopoly to competition, does not alter the desirability of major goals, a) universal availability of service, b) promoting economic development, c) attaining a high level of efficiency and reliability, d) reasonable prices, etc.

In contemplating the nature of the regulatory system to be deployed, there are essentially two levels at which decisions ought to be evaluated. The first is in designing the system that best provides the appropriate economic context for balancing competing interests of the investors, small consumers, large consumers, and the various public interests that need to be protected. The second level is political, cultural and geographical; namely devising a system which is credible, accountable, and effective for the country in which it is deployed. It is useful to keep that context in mind in exploring options for Brazil in establishing a regulatory system for a restructured electricity industry.

It is useful to approach the question of the nature of the regulatory regime in the context of the critical choices to be made. For analytical purposes, those critical choices, largely derived from the first level of decisions, might be divided into six categories, or dilemmas to be resolved. While these choices are framed in terms of competing concepts, they are not inconsistent with one another. The six are as follows:

1. Economic Efficiency vs. Social Considerations
2. Rule Basis vs. License Basis
3. Cost Basis vs. Price Basis
4. Promote Competition vs. Anti Trust Enforcement
5. Deliberative Process vs. Administrative Process
6. Centralization vs. Decentralization

This teaching note was prepared by Ashley C. Brown, Executive Director, Harvard Electricity Policy Group, as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation or public policy.
In evaluating these choices, it is useful to think of them in the political, cultural, and geographical milieu of Brazil. While the discussion that follows is broadly analytical of the issues themselves, the reader needs to think of them in terms of the politics, culture, history, institutional development, resource bases, and other realities of contemporary Brazil.

1. Economic Efficiency vs. Social Considerations

From a purely economic point of view, a perfect market achieves the most efficient outcome. However, markets suffer from imperfections, better known as market failures. The role of regulation is to redress market failures. Imperfections that can preclude the attainment of full efficiency include a) the presence of a monopoly or monopsony power, b) the existence of bottlenecks, c) the presence of significant barriers to market entry or exit, d) incorrect price signals, e) non-transparency of market information, f) significant state or administrative intervention in the market, and g) the injection of exogenous factors beyond the control of market players into the economic signals.

Some market imperfections are the result of inherent characteristics of a market, such as bottleneck transmission and distribution wires in electricity. Others are the result of interference with the operation of the market, as in the case of state intervention. From the standpoint of economic efficiency alone, it can be argued that the appropriate public policy response is to remove, or at least minimize, all of the outside interference with the marketplace while providing the minimal level of regulatory oversight to such inherent imperfections as bottleneck facilities.

Electricity is one of those industries that has constantly been assumed to be a natural monopoly. In addition to this, the importance that this industry has in assuring quality of life, vests it with a public purpose. Few, if any, nations have chosen to resist the temptation of injecting questions of fairness, social considerations, and equity into the regulation of electricity. It is common for rates to be structured to promote universal availability or provide subsidies for preferred customers.

For proponents of economic efficiency, the appropriate emphasis of a regulatory regime is to promote competition where it is workable. Where competition is not workable regulation should be focused on replicating the results a competitive market would have achieved had the imperfections not existed. For those who advocate taking social aspects into consideration, the focus of regulation is to identify desired social effects and provide incentives to accomplish them. Indeed, proponents of considering social concerns would argue that markets inherently produce social effects and a regulatory regime that ignores them is not being socially neutral, but is, in fact, endorsing the results bred by the marketplace.

Some opponents of taking social effects into consideration in regulation would concede the fact that the market may well have unintended, or even undesirable social effects, but that those problems are best addressed in larger public policy arenas and ought not be addressed within the regulatory regime. While these two approaches are not necessarily irreconcilable in all instances, they are quite different in orientation and approach and ought to be understood as the poles defining the spectrum of options in the establishment of a fundamental approach to regulation.
Consumers, investors, and the regulators themselves are entitled to know precisely what to expect of regulation, what matters the regulators need to keep under active consideration, and what the rules of the game will be. Silence on the objectives of regulation is likely to inject uncertainty into the regulatory system, which heightens the risk for prospective investors. From the standpoint of reducing uncertainty in the regulatory process, it is better if the legislative and executive authorities set out the objectives of the regulatory system at the outset, rather than letting these fundamental matters drift into protracted dispute with uncertain results.

Substantively, the question of whether to pursue economic efficiency alone, or to add additional public policy concerns to the regulatory agenda is not an easy one to decide. Theoretically, of course, many economists would argue that regulators have no social function other than to facilitate the achievement of efficient results. They would contend that whatever social objectives are being sought, they should be pursued from the public treasury. Investors are likely to agree with that position, and even thought they may not favor a demand for social taxes, they will incorporate those into their business planning.

It is essential to note, though, economic efficiency and social considerations are not always opposed to each other. The question of subsidized service is probably the most critical social consideration that regulators need to consider. In a market governed by economic efficiency alone, the ability to impose cross subsidies is significantly reduced. These cross subsidies may otherwise be used to support certain types of service, such as reduced prices to low income or other target groups. From a social and political standpoint, a new regulatory system that results in significantly higher costs for those least able to bear them, is one that is almost certainly destined for political hard times. It may well be that historic subsidies were too generous, justifying their elimination. However, eliminating subsidies could well prove to be so unpalatable, socially or politically, that the stability of the regulatory regime will be undermined. Thus, it may be optimal to pursue efficiency not by eliminating cross subsidies entirely, but rather by targeting the subsidy more efficiently. A good example could be the diesel oil subsidy in Brazil that is provided to all isolated electrical systems. It might make more sense to target that subsidy at low income consumers in such systems rather than at all customers rich and poor alike, who happen to be served by an isolated system.

The key issue for Brazil, or any other nation contemplating the establishment of a new regulatory system, is to set out the degree of discretion that regulators are to be given in setting forth the balance between these competing considerations.

2. Rule Basis vs. License Basis

A fundamental legal question in the establishment of a regulatory regime is whether, as in the United Kingdom and Argentina, it is rooted in contract law between the state and the regulated entities, or whether, as in the United States, it is rooted in a series of statutory and constitutional protections provided to a variety of parties in the regulatory process. The distinction between the two systems is less esoteric than it might seem at first glance. The distinction goes to the degree of flexibility and discretion that is given to regulators, the expectations and degree of certainty afforded investors, the degree of risk of politicization of
the regulatory process, the degree of uniformity that is assured in the applicability of fundamental precepts and prerogatives, and the method of enforcing rights and privileges.

A license based system is one where all of the rights and privileges of a licensee, as well as the recognized expectations of consumers, are set forth in a document that authorizes the licensee to engage in its business. A rule based system, on the other hand, is one in which a regulated entity may well have to obtain a license, but the terms and conditions of doing business are not set out in that document. Rather, they are articulated in generic laws or regulations approved by the relevant legislative, executive, or regulatory authorities (i.e., statutes or rules).

The license based system appears to be the one that is currently favored by multilateral lending institutions and international investors. The license based system, in theory, provides considerably more certainty for investors, which reduces the risks perceived by investors. The license spells out, in advance, all of the expectations, duties, and obligations of the licensee in doing business. The license has the same legal rights as a contract. Within clearly stated limits, the license cannot be altered without the agreement of the licensee. The job of the regulator is not to set policy but simply to make certain that the license obligations are complied with. The consequences of noncompliance, are usually fully set forth in the license.

In contrast to the license based system, the rule based system would appear to be less certain because the terms and conditions of operation are subject to ongoing change. These risks may be more apparent than real, at least in the context of the United States where the rule based system has been in existence for a very long time. Legally, there are processes which have to be employed before rules can be changed. Those procedures provide all interested parties a chance to participate in decision making and the right to appeal to courts. There are constitutional protections that ensure a right to a fair opportunity to earn a reasonable return on and recovery of prudently incurred investment.

One caveat, applicable to Brazil, however, is that a rule based system in a country without a tradition of regulation within the type of circumstances described, may well be viewed by prospective investors as significantly riskier than a similar investment where the relevant institutions have a history which makes them more predictable.

It is well worth noting that in a rule based the system, the rights of licensees are formally enforced through contract law, whereas in a rule based system, they are enforced by the legal rights and privileges guaranteed in statute or constitution. The degrees of certainty in both systems are, to some extent, dependent on the ability of the Courts to exercise jurisdiction. While some international investors have succeeded in having disputes between licensees and regulatory authorities be subject to the jurisdiction of courts in another nation as part of the license conditions, the fact remains that the existence, credibility, and strength of judicial institutions and enforcement of commercial obligations are a necessity in both a rule based as well as a license based system.
3. Cost Basis vs. Price Basis

Broadly there are two basic approaches to ensuring a reasonable price for electricity. The United States has used rigorous regulatory oversight over the costs associated with building and operating generating facilities. The other approach is the establishment of a viable competitive market, as in the United Kingdom. The regulatory oversight approach can be employed to develop a benchmark for determining fair competition even in a competitive market. Because of the increasing role of competition in the generating sector throughout the world, further discussion of this sector will be deferred to the section below on Competition and Anti-Trust.

Transmission and distribution, unlike generation still retain economies of scale that strongly discourage competition, and seem likely to remain monopolies into the foreseeable future. The regulation of the distribution sector in the future is particularly relevant to Brazil because the greatest efficiency gains can probably be made there. There is considerable opportunity to unbundle these services in such a fashion as to reduce the scope of the monopoly (e.g., separate the retail merchant function in distribution from the delivery function), but the core wires business in transmission and distribution is likely to remain noncompetitive. Pricing these core monopoly services will remain a question in the restructuring debate.

In conceptual terms, two basic approaches have evolved for pricing monopoly services in electricity. The first is the cost based approach briefly described above in regard to the generating sector. The second is one that focuses not on costs per se, but rather on the prices themselves. The second model has a number of variations such as pure price cap incentive regulation or performance-based regulation, but can be approached generically from the perspective of a price cap. The differences in the two approaches are significant and merit scrutiny.

The teaching note, Ratemaking Scenarios: Rate Of Return Regulation Vs. Price Cap Regulation -- Differences And Similarities deals with the specifics of these issues.

4. Promote Competition Vs. Anti-Trust Enforcement

The issue of whether the government should pursue an activist, pro-competition direction, or play a more passive role of anti-trust enforcement is an issue that relates to public policy in general as well as to regulatory policy and practice. Once a decision has been made not to maintain a monopoly structure of the industry, the role of the government and its regulatory agencies must be decided upon. For purposes of definition and illustration, the options can be divided into three basic approaches.

The first is a laissez faire policy in which the government and regulators take a “hands off” approach. Given the history of monopoly power and the existence of critical bottleneck facilities in the sector, such an approach is probably the least advisable to pursue. The second option is one of anti-trust enforcement, in which regulatory authorities monitor the market for evidence of anti-competitive practices (e.g. price fixing, predatory pricing, collusion and/or conspiracy to reduce the level and scope of competition), review the impact of proposed mergers and acquisitions on the overall level of competition, and generally maintain vigilance
over such matter as market share and market power of the various players. The third approach is for the government to pursue an activist posture in shaping the industry in the fashion most likely to produce competitive results that will ultimately require less state intervention.

The last approach is the most ironic because it requires a high level of state involvement in order to reduce the ultimate level of state involvement. In Brazil, a high level of state involvement in the beginning is unavoidable because most of the electric sector is state owned. Nonetheless, the question of the ongoing level of state activism is yet to be decided. The initial question in deciding the ultimate role of the regulator is how far to go in doing away with monopoly power. For a variety of reasons it is inadvisable, to attempt to break up the “natural monopolies” of transmission and distribution. Nonetheless, the extent of those monopolies beyond the provision of wires service is very much open to discussion. The distribution sector, of course, is a series of bundled services including wires service, retail merchant function, billing services, demand side management, metering, and a host of other business activities. Similarly, transmission services include many diverse activities including dispatching, telecommunications, information services, voltage support, and a number of other ancillary services. In both the distribution and transmission sectors, many, if not most, of these services, unlike the wires business, are not “natural monopolies.” How far to go in desegregating the sectors is therefore a policy decision that has to be made.

In distribution, for example, it would not be at all unusual to separate the commodity function (retail merchant) from the wires function and have competing retail merchants using the same wires service provided by the residual monopoly. Similarly, in transmission, it is possible to divide ancillary services from the basic wires services. While the latter would remain a monopoly, the former could very well be provided on a competitive basis. In the generating sector, there is a question as to how many competitors are required to make the market viably competitive. The English experience seems to suggest that two competitors is not enough to assure competition. The Argentine fragmentation of the sector into more than 30 generators, on the other hand, seems to have achieved a competitive result.

Another fundamental question relates to the organization of generation markets. Should there be a central pool into which all generators must sell, or should the market be based on bilateral contracts? Who is eligible to buy power directly off the transmission grid? Is the competition to be conducted solely on an energy basis? Should the competition include breaking up and/or privatizing existing assets, or should it be limited to new entrants? All of these questions need to be viewed in the context the reliance of the Brazilian generating sector on hydroelectricity, something that makes it significantly different from the predominantly thermal generating sectors of the United Kingdom, Argentina, and most other countries which have undergone restructuring. (Norway, a predominantly hydro system is an exception).

Privatization may not yield the same level of efficiency gains that have been found in thermal units elsewhere in the world; indeed there is reason to question whether such gains would even offset the increase in the rate of return privatization will require. The restructuring model chosen by the government will determine whether the market will produce enough competition to allow a more relaxed regulatory posture. Restructuring, more
than anything else, will define whether the task of public policy will be to promote competition or merely to prevent inordinate concentrations of market power.

A policy of promoting competition is focused on reducing the power and role of monopolies to the bare minimum. Public policy should dictate that, wherever possible, a monopoly be replaced by a competitive market, and the subsequent role for regulators be reduced.

Proponents of this approach contend that consumers would benefit because of the innovation and efficiency gains produced by competition while investors will know that it is skill in the marketplace that will determine their fate rather than the prevailing attitude of the government. Proponents of the anti-trust approach would focus less on looking for ways that the market could be more competitive and more on regulating and/or rearranging assets and institutions in such a fashion as to mitigate undue concentrations of market power.

5. Deliberative Process Vs. Administrative Process

The process by which regulatory decisions are made is perhaps best demonstrated by the dichotomy of a deliberative process vs. an administrative process. A deliberative process is one in which there are multiple decision makers, operating on an independent, fully transparent basis, with systematic public input. An administrative process is one with a single decision maker operating on a non-transparent basis that may or may not be independent, with perhaps some opportunity for public input. The issue of transparency is addressed separately in the appendix.

It is useful to define the notion of regulatory independence. Regulatory independence evolved from the nineteenth century United States experience in setting up regulatory bodies, an effort that required the drawing of both assignments and authority from all three branches of government, executive, judicial, and legislative. The result was a hybrid type of agency that had no clearly defined home in any single, established branch of government, but which arguably was a part of all branches. Inevitably, the conclusion was reached that regulatory bodies were a different type of government agency; hence the birth of the idea of an independent regulatory agency. That legal theory of independence is reinforced by the generally accepted proposition that regulatory decisions need to be based on the internalized logic and long term considerations rather than on short term political calculations. The agency making those decisions ought to be capable of making them independent of political authorities. Indeed, in the United States the appeals to regulatory decisions are to that branch of government that is the least subject to politics, the courts.

With independent regulation matters are resolved long before they reach political decision makers, thus protecting the long term interests of both the investors and consumers. Certainly, investors will be loath to invest in an enterprise whose well being is wholly dependent on a political process. Similarly, consumers are best served by a decision making process that provides some degree of assurance that decisions will not simply be a matter of self-interested political insiders getting together and making deals. That being said, however, it is entirely unreasonable to expect that regulators will be apolitical or politically insensitive. While there may appear to be some contradiction between the need for independence and the
requirement that regulators be politically sensitive, the fact is that regulatory systems can only operate within the framework of what is acceptable within society. Where it is necessary to make decisions that are politically unpopular, skilled regulators should be capable of doing so and explaining and justifying them.

Since the frequency with which regulators are called upon to make decisions which will anger somebody, political attacks on the regulatory system are likely, particularly in a newly created system, to be regular occurrences. It will take political skill for regulators to respond effectively to those challenges without sacrificing on principles which are crucial to the integrity of regulation. Another reason for sensitivity is that independence does not mean non-accountability. Legislative and/or executive mandated changes in the regulatory processes, or in the resources made available to regulators to perform their duties, or appellate reversals of regulatory decisions serve as checks on the power of regulators to exceed acceptable social or legal norms.

In an administrative process, there is a single regulator who makes the ultimate decisions, subject to appeal to the courts or some other designated authority. The regulator, may, as in the United Kingdom, be given a fixed term contract and permitted to act in an independent fashion, or the regulator may, in fact be a functionary of a Ministry, or perhaps a Minister himself/herself. In the latter case, of course, the independence of the regulator is highly questionable. Similarly, even, where the regulator himself/herself can operate independently, if the final authority or appellate body is a political entity, such as a minister or cabinet, the independence of the regulatory process itself can be open to some doubt.

Interestingly, in administrative processes, particularly in a license based system such as the one in the UK, the regulator may only be empowered to make final decisions where the license permits him/her to do so. In all other cases, the regulator may either negotiate an arrangement with the licensee, in discussions which may or may not be public, or be reduced to making a formal recommendation that the licensee can either accept or reject.

The decision of what type of process is employed to make regulatory decisions is a matter of culture and socio-political credibility. The administrative process in the UK is acceptable in that country though it would not be accepted in the United States, even though it shares the Anglo-Saxon legal tradition. In Brazil, the choice of the decision making model to be followed is dependent on what is acceptable and credible within the country. The decision making model must also be acceptable by capital markets which may demand certain assurances before capital is put at risk, especially since regulatory decisions, such as setting rates, have traditionally been heavily influenced by social or political considerations. The credibility of the regulatory process must be achieved both in the domestic political arena as well as international capital markets.

6. Centralization Vs. Decentralization

In a country as vast and as diverse as Brazil, a serious discussion of decentralizing regulatory authority is in order. Not only does the nation’s scale justify such a debate, but the fact that the assets in the sector are owned by both state and national governments bears
testimony to the fact that decisions regarding privatization and restructuring will have to be made at both levels of government.

A centralized model of regulation has some clear advantages. The lines of authority are clear, the regulatory signals that are sent to the sector are more likely to be coherent and consistent, parochial views and interests are less likely to prevail in the decisions that are made, and national policies, such as electrification in those remote areas of the country served by isolated systems, could be accomplished by a regulatorily created national subsidy fund to finance the effort.

There are, however, some clear disadvantages to centralization. Decisions made at the state level are more likely to be sensitive to local priorities and concerns. Access to regulators is easier for both interested parties and the public in general. Moreover, decentralization seems more likely to result in experimentation and diversity of experience. Decentralization, however, has the disadvantage of creating jurisdictional disputes, clashes between divergent parochial interests as well as between parochial and regional interests, and potential confusion.

Perhaps the strongest argument in favor of maintaining centralized regulation is that it is easier than trying to define who will decide what in a decentralized model. The two best examples of federalism at work in electricity regulation, Canada and the United States, are perhaps best looked to for how not to do things. Federal authorities in these countries have limited powers. The reluctance of states to engage in wheeling power to or from another state is often regarded as retarding the evolution of a bulk power market.

One common denominator of the U.S. and Canadian situations is that there has never been a comprehensive effort to sort through which levels of government should make which decisions, and how the various regulatory agencies can work together in order to produce coherent regulatory signals. One country, Argentina has made an effort to conceive a system of regulatory federalism in electricity by dividing regulatory jurisdiction between the provinces and the national government. The model is simple in concept. The distribution sector is regulated by the provinces, and the generation and transmission sectors by ENRE (National Electric Regulatory Agency). The experience is very new and has yet to evolve sufficiently for any meaningful lessons to be derived.

Similarly, the European Economic Community (EEC) is slowly moving to deal with the electricity market within it. It is not yet clear exactly what will be the respective roles of the EEC itself and of the individual national governments. Another place where the issue is being discussed is in India, whose electric sector has, like Canada’s, evolved on a state by state basis with little trade between the different state owned electricity companies. The resulting inefficiencies, coupled with capital constraints in the capital markets, have led policy makers to rethink federalism in electricity, but, as in the case of the EEC, it is not yet clear how the situation will evolve. Similar discussions have been going on in Russia, Central America, Australia, and could well evolve in the future in places like China and Mexico. Finally, even the UK has stepped ever so slightly into the question of regulatory decentralization by creating one electric system for England and Wales, and an entirely
separate one, albeit interconnected, for Scotland, and by creating regional Consumer Councils
to deal with each of the distribution companies.

In addressing the question of how to structure an electric regulatory system along
federal lines, a simple starting point might be the Argentine model, namely that distribution is
essentially a local function while generation and transmission are part of a larger, national,
perhaps even international market. That model, however, may not be entirely relevant to
Brazil, where the entire sector has evolved somewhat differently from region to region, where
the ultimate structure of the generating sector is as yet unknown, and where hydro is so much
more dominant. An additional difference is that the thermal capacity that is likely to be added
may well be more focused on local markets, such as that of Sao Paulo, rather than on broader
national markets. Indeed, one could well argue that, electrically speaking, Brazil is three
countries, not one. The south and southeast, the interconnected north and northeast, and the isolated systems of the north and west, are quite different from one another in their load characteristics, underlying economics, retail access regimes, energy
resource bases, and even in physical characteristics. Given that fact, one could well argue
that decentralization might be better examining on a trilateral approach, regional, state, and
national. Whether one undertakes to look at the electric sector bilaterally or trilaterally, it
would be useful to approach the issue from the standpoint of first determining the nature of
the market structure, and then deciding which interests are predominantly local in concern,
which regional, and which are national. Where interests appear on more than one list, then it
might also be helpful to think how each level of regulation ought to interact, preempt, or
cooperate with one another.

The fact is that Brazil has a remarkable opportunity to do what the U.S. has thus far
failed to do, carefully think through how a decentralized regulatory regime might work in
the electric sector. While the effort could be bypassed by simply maintaining the existing
centralized system of electric regulation, given the dynamism and diversity of Brazil, it could
well be argued that the potential errors that one could make in creating a decentralized regime
are outweighed by the previously identified risks associated with a centralized system.

**Conclusion**

The choices that are open to Brazil in deciding on the nature of the regulatory regime
that it creates for the electric sector cannot be decided in a vacuum. Other critical decisions
that have to made for the sector, including the market and industry structure, degree of
privatization and/or public ownership, and such public policy calls as resource preferences,
degree of competition, and others will invariably affect the regulatory structure that is
adopted. These issue need to be considered together, but in doing so there is an extraordinary
opportunity to reexamine the entire sector. The design of the regulatory structure is critical.
Some of the key decision points have hopefully been laid out in the foregoing document.
Appendix: Transparency -- Its Importance and Its Elements

If there is a single concept that is absolutely critical to the successful implementation and conducting of a regulatory process it is transparency. The process, the reasoning, the mathematics, the logic, the transactions, the administration, and the mechanics of regulation must be absolutely transparent to all if the system is to inspire confidence in it. Without that confidence, investors will not risk their capital, consumers will not tolerate adverse rate changes, politicians will not refrain from tampering with the process, and restructuring will be but an empty shell. Transparency is the glue that holds the regulatory compact together. So, what is this glue made of? What is transparency? Why is it so important?

Transparent regulation conducts business in full view of anyone who cares to watch. While the intricacies of regulation can be quite arcane and complex, the manner in which the work is done is simple and plain. The integrity of the decision makers, their reasoning, the facts and arguments that they consider, the process by which decisions are made, and the rules by which all must abide are clear, well known, and verifiable.

Of equal importance is the existence of transparency in the markets that are subject to regulation. The transparency of the transactions that occur within the regulated scope of activity serve as a further guarantee that the process has led to results that are at least straightforward and honest from a business perspective. Transparency makes it likely that either the market will correct itself or that the problems will be apparent and the regulators will be signaled to intervene. Different cultures may require different levels of openness, though the fundamental principles of decision making are universally applicable. While there is no single factor that defines transparency in regulation, it is useful to examine six aspects of it that are critical:

1. Integrity of the decision makers;
2. Integrity and logic of the reasoning process;
3. Integrity of the evidence considered;
4. Integrity of the decision making process;
5. Clear and verifiable rules;

1. Integrity of Decision Makers

The integrity of decision makers is absolutely mandatory. They must not only be incorruptible, but must refrain from any type of activity or involvement which might even give the appearance of impropriety. Some of the rules in this area are clear. Bribes of any kind, or even small favors that give the appearance of special favors must be absolutely prohibited and violators subject to at least removal from office if not criminal prosecution.

There are, however, a number of more subtle rules that the regulatory body itself can adopt that will strengthen the perception of honest decision making. Such rules include requiring mandatory disclosure by commissioners and critical staff members of all of their major financial interests to make it clear that they hold no financial interests that are either in conflict, or even appear to be in conflict with their official duties. A prohibition of ex parte
communications, or a rigidly enforced requirement that such contacts be subject to full disclosure will go far to assure even the most skeptical of observers that the decisions made are not the result of “cozy, quiet little arrangements among friends.”

In addition to limitations on the conduct of decision makers there are appropriate protections that can be built in to shield regulators from improper influences. Regulators serve fixed terms and cannot be removed from office without a demonstration of sufficient cause for doing so; sufficient cause arising only from demonstrated malfeasance or non-performance of duty. Mere disagreement with a Commissioner’s position on a matter, no matter how unpopular that position is, does not constitute grounds for removal. The salary and benefits of Commissioners can be set out specifically at the time a person is appointed to the position and changes from that can be prohibited during the term of office in order to preclude the possibility of punishing or rewarding a commissioner for a decision that he or she made in good faith performance of duty.

In summary there are a variety of institutional mechanisms that can be put in place to either regulate the conduct of decision makers or to protect them from improper manipulations or temptations. It goes without having to say so, of course, that the first and most important protection is the appointment of high minded, dedicated, public servants to the Commission. The personal integrity and personal commitment to integrity of the decision maker is of paramount importance.

2. Integrity and Logic of the Reasoning Process

An essential component of the integrity and transparency of the regulatory process is its intellectual foundation. It is that basis in logic and reason that precludes both arbitrariness and too much politicization of the process. Indeed, it is also an insulation against corruption. While there are many policy decisions on which reasonable people could disagree, the decision must be at least justifiable on intellectual, policy, and factual grounds. In short, transparency of the process does not necessarily demand that the correct result is always reached. Human beings may well make errors or reasonable judgments with which other people may disagree. It does, however, demand intellectual rigor, well reasoned decision making, and coherent policy. While such a standard requires both intelligence, honesty, diligence, and perhaps even courage on the part of the regulators, transparency demands something more; those qualities must be demonstrated.

The demonstration of intellectual rigor and honesty is not easily accomplished, particularly in areas where there are many advocates on all sides with very different points of view, none of them per se unreasonable. It can only be accomplished by a disciplined and consistent effort over time to explain the rationale for each substantive decision taken. That rationale should almost invariably include the policy objectives sought or being pursued, an explanation as to how the measures being taken will contribute to the policy objectives articulated, and such other considerations as went into the decision.

When one of the Commissioners disagrees with the majority on a decision that is taken that Commissioner should issue a separate, dissenting opinion setting forth a full explanation for his/her disagreement. Similarly, when a Commissioner agrees with the
outcome but does so for different reasons than those set forth in the opinion of the majority, he/she should write a separate, concurring opinion setting forth the reasons for the agreement and disagreement. The reasons for the issuance of separate opinions is to stimulate debate on the subject being discussed. The dissenting or concurring Commissioner sets out a record which might be used by the Commission, a Court, or even another policy maker in the future. The issuance of such opinions, however, serves two vital institutional interests. The first is that the ability of any one of the Commissioners to speak out helps to keep all of the Commissioners intellectually honest, rigorous in thought, and serious in purpose. Secondly, and of at least equal importance, separate opinions, particularly ones that are well reasoned, provide very clear indications of thoughtful debate and careful analysis that can go far in presenting a decision making process that is intellectually honest, rigorously analytical, well reasoned, and utterly transparent.

The critical element on the reasoning and integrity implicit in the regulatory process is that no substantive opinion is rendered without full explanation, that Commissioners clearly reveal the thought process by which they arrived at their decisions and opinions. All parties have a right to know the reasoning process. Even if some people may disagree with the reasoning and/or the conclusion, the publication of an explanation for every decision will add immeasurably to the transparency of the process, and thereby render disagreement matters of substance and not a matter of how fair or honest the process itself was.

3. Evidence Considered

The context of the discussion and debate that preceded the rendering of the decision is important in achieving transparency. It does little for the credibility of the Commission to render a perfectly reasoned decision based on facts that are hidden from view. Consumers angry about a price increase will not feel less aggrieved because the Commission had secret information, not available for anyone to scrutinize, upon which it based a decision to raise prices. Similarly, no one is likely to risk their capital in a regulated market where the regulators make decisions based upon information which they are unwilling to share. Indeed, transparency demands that not only the decision and the reasoning behind it be publicly exposed, but that all of the evidence, be it fact, opinion, or argument, that was presented to the decision makers in an effort to persuade them be similarly unveiled on the public record.

There is little way to completely expose the entire basis upon which opinions are formed that lead to particular decisions. On the other hand, those facts and arguments that were presented on a particular matter and which shaped a decision maker’s view of a particular set of circumstances are capable of exposition. Accordingly, it makes sense to make a formal record of the information, all of the information, that was provided to the Commission on a particular matter. There are two critical elements to that record in order to attain transparency. The first is that all of the information that was submitted on the matter is included in the record, including the transcript of any formal proceedings that occurred. The second is that all of the information is open and available to anyone who wishes to see it. Indeed, there should be a presumption that all of the records in possession of the Commission are public records open to anyone.
While it is reasonable that the Commission retain authority to deem a document confidential, that authority should be used sparingly, and only upon a very clear demonstration of the need for confidentiality by a party who is seeking such a designation for a document. As a matter of practice, it is probably not wise for the Commission to designate a document as confidential on its own unless it is an internal personnel document, an early draft of a proposed action or decision by the Commission that is not yet ready for release, a security matter, or matters that are related to litigation in which the Commission is involved, such as a matter pending in the courts.

The simple principle that should be followed if transparency is to be achieved is that both the reasoning and the information upon which that reasoning is based should be public and open to public exposition. Absent compelling circumstances, no information should be withheld from public view.

### 4. Decision Making Process

In the effort to achieve transparency, there can be no substitute for making certain that all parties having an interest in the outcome of a particular matter are afforded a full opportunity to provide meaningful input into the decision making process. The credibility of the Commission and of the regulatory process in general would be ill served if decisions were taken without public notice that they were being contemplated, without the opportunity for the diverse affected interests to express their views and offer their evidence in some meaningful way in the process.

For there to be transparency key elements of the process should include: 1) public notice that a particular matter is under consideration at the Commission; 2) provision for ample opportunity for anyone, either a formal participant in the process or perhaps just a residential consumer with an opinion, who wishes to provide the Commission with input on a particular matter to do so; 3) maintenance of a formal, publicly available record of all arguments and evidence provided to the Commission on a particular matter which constitutes the entirety of the information upon which the Commission will make its decision; 4) ample provision for the opportunity for a person or entity interested or materially affected by the outcome of such a proceeding to participate in the process. Participation would include offering relevant arguments and evidence which the Commission needs to consider before taking its decision, and examining, testing, and responding to all of the opinions and evidence offered to the Commission by other parties.

In establishing the process, the Commission will want to make certain that it accomplishes three very important goals: 1) making certain that the process is truly transparent by making information public about the initiation of a case, decisions in process, information available to it, the process for coming to a conclusion, and the decision itself; 2) assuring that anyone who wishes to participate or provide input on a particular matter has ample opportunity to do so at whatever level a party wishes to do so, ranging from full participation to the simple act of merely offering an opinion; 3) assuring that the Commission gathers all of the relevant information necessary on a particular matter, that that information is tested in some meaningful way in order to distinguish what is reliable and what is not, what is of value and what is not, and making whatever other judgments need to be made about
information in order to enable the Commission to make a well informed, well reasoned decision.

5. Clear and Verifiable Rules

Transparency would be impossible to attain in the absence of clear, fully articulated, publicly known, and consistently applied rules and policies regarding the criteria to be applied in making various types of decision, the public policy objectives the Commission is pursuing in making various types of decisions, the expectations and obligations of licensees, and the process by which decisions will be taken. Anyone having business before the Commission, regardless of whether that party is a licensee or just a simple consumer, is entitled to know how the Commission will conduct its business. The inability to know that information will render meaningful participation before the Commission virtually impossible thereby putting the confidence of both capital investors and consumers at considerable risk.

It is, therefore, of great importance that the Commission use consistent and predictable terms and conditions on licenses applied with little or no discrimination. The Commission should adopt and publish rules which, among other things, set forth: 1) the precise nature of the procedures to be followed in making decisions; 2) the standards (including explanation of the burden of proof) that the Commission will apply in evaluating the performance of, or complaints against, licensees (e.g. quality of service or anti-competitive behavior); 3) the public policy goals that the Commission is pursuing; 4) a statement of the rights and obligations of consumers; 5) the terms and conditions governing access to the records of the Commission and; 6) such other matters which may be necessary for the Commission to conduct its business in an open, transparent, and publicly accessible fashion.

While a significant part of the value of adopting and publishing rules and letting policy objectives be known is to attain stability and predictability in the process, the status quo need not endure forever. Changes are likely to be necessary or beneficial from time to time. Accordingly, the process for making changes in the rules should also be set forth, and that process should also be quite open and accessible for anyone to participate. The principles that should be honored consistently are complete openness on what is contemplated in terms of the subject matter under consideration, public notice that matters are pending, and ample, meaningful opportunity to participate. Stability and predictability in honoring those principles even when contemplating changes in previously adopted rules should be sufficient to maintain public confidence in the regulatory process even in the midst of change.

6. Financial Transparency

To achieve the desired level of transparency, the financial and other transactions that occur within the scope of the Commission’s jurisdiction should also be transparent. The workings of the energy market, the financial records of monopoly licensees, the power sales of the generating companies, annual reports of licensees, and perhaps other financial records should be accessible as public records at the Commission. In order for those records to be easily understood and meaningful, the Commission will need to adopt reporting requirements and accounting standards with which licensees will need to comply as part of their license conditions. The Commission will need to further require, as part of its license conditions that
licensees comply with all reasonable information or data requests from the Commission. The Commission may well want to issue periodic reports on the operations of the market -- reports that are replete with market information.

The critical factor is that the market be open, that financial data be available and accessible, that consumers and investors alike have access to systematic and meaningful information on the market, and that the regulators will have the information that they require in order to maintain their requisite level of scrutiny over the market. Such transparency will go far in assuring both investors and consumers.

The importance of financial transparency cannot be overstated. Indeed, the transparency in the regulatory process is designed to build confidence and credibility in the system of regulation. The ultimate proof of whether such confidence is merited or deserved is derived from the actual operation of the market itself. It is financial transparency that will provide the ultimate evidence of whether the system is working as it is envisioned to do so, and whether the public interest is being well served.