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Regulating Competition

S L Rao

Institute for Social and Economic Change
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This small collection of essays that appeared at different times in various publications has been extensively edited. Competition is not an answer by itself to the problems of exploitation, poor quality and high prices. These essays discuss many aspects of competition. Competition to be effective requires a radical change in governance and demands independent, transparent, consultative and predictable regulation of the different sectors of the economy as well as of competition.

Foreword

The decade of 1990's witnessed a number of changes in the economic scenario under the process of economic reforms. These broadly included opening up of the economy along with certain steps towards liberalisation for the development of the market. The process of reforms towards globalisation, free trade and liberalisation led to a new competitive environment, the contours of which are not new but certainly challenging. As a consequence, predominance of the market as an institution emerged slowly and steadily. Similarly, competition and competitive spirit took the vanguard position in managing industrial development and other developmental schemes. The changes incorporated relaxed the controls which had hitherto worked more as hurdles and raised the transaction costs and also built the confidence of entrepreneurs. Movement towards a clear competition policy will serve a number of objectives. These may include not only ensuring the proper operations in the market and integration of the markets but also protection of the small- scale industries and finally the consumer. The shift away from the restrictive policies not only encourages new investment, increase in productivity and reduction in the transaction cost-time but also ensures high growth rate. All these steps had their associated impacts across sectors and on the pattern of investment.

Competition as defined in the book of economics, clearly perceives free supply and movement towards equilibrium. The entry barriers are assumed-out. As we know, India has got into this new paradigm after about five decades of continuous controlled economy under the licence raj. The transition from the planned economy with lots of control to a liberalised free market structure creates a good number of externalities and these have to be manoeuvred through a proper institutional framework. Therefore the issue of regulation comes here but in a different context. The Competition Commission of India is constituted for that. It goes without saying that competition is successful if there is no information barrier and other entry barriers are done away with. Therefore the rules and regulations become prominent. Effective competition policy must work towards adequate representation of the interest of consumers while ensuring overall social welfare, crucial for efficient working of market economics.

This monograph packs the rich experience of Shri S L Rao both as a management expert and an academic thinker. He uses his insights gathered as an insider and as a ringside observer of the economic scenario. Through his many articles, columns in prestigious newspapers and speeches, he has been arguing about many of these issues. He also analysed the issue in the most perceptive manner and presented the whole debate in a succinct way. All this is now available in this monograph. I am sure that this monograph will provide a good reading for the policy makers as well as industrial managers.

R S Deshpande
Director

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CHAPTER I

INTRODUCTION

Barry Goldwater, Presidents Reagan, Nixon and Bush in the USA, and Margaret Thatcher in the UK introduced the idea that markets rather than governments should determine economic outcomes. The recent financial crisis (2008) in the developed world and the consequent economic decline with high unemployment destroyed the belief that markets were self-regulating and that the rational behaviour of human beings would ensure best outcomes.

There are some who say that India went for a similar market orientation after the introduction of the economic liberalization policies of 1991. Until around 1985 India was a very controlled economy. Market forces had little freedom. All economic decisions were subject to state approval. Setting up a new industry, its location, capacity, technology, if imported the country of import, raising of resources, pricing of shares, remuneration to top management, and every other decision was subject to government approval and decision. The size of the market was estimated by the government and its growth and production capacities were licensed in relation to that estimate.

The Monopolies and Restrictive Trade Practices Act defined monopolies by turnover sizes that were a fraction of companies in many foreign countries with who Indians had many times to compete. "Groups" of companies in which a 'promoter' family had shareholding interests had other restrictions on them. Their expansion was prevented, they had to diversify into other unrelated areas or those that would be seen favourably by government. Unrelated diversification was common.

Efficiencies in most Indian industries were low; there was low productivity per person employed and costs tended to be high. This resulted in many export goods having to be given price support through "cash assistances" and "import replenishment licenses" that could be sold in India at a premium since imports were strictly licensed and subject to heavy import duties.

There was a psychology of shortages. People would hoard goods acquired from overseas. There was a thriving black market in smuggled consumer as well as industrial goods. For instance, polyester and nylon fabrics were available at high prices since they were smuggled. Many companies would smuggle equipment and parts in order to avoid the delays in getting government licenses to import. The consumer had no choice and

had to buy what was available even when the quality was poor. Manufacturers took little pains in improving quality since they ahd licenses for manufacture or imports and hence had a monopoly.

Competition has been offered as the solution that will defeat supplier cartels, trader exploitation of consumers, keep prices low and assure improving quality. It will give choice to buyers. Consumers can move between suppliers who will go for efficient and good quality production.

After 1991 when the regime of licenses and controls was disbanded, India did see a huge growth of industries, with many times world-class capacities and were able to compete overseas. With imports being freely possible at very low duties, Indian producers had to improve or perish. Companies began to focus on core businesses and unrelated diversifications became a memory as companies sold off business interests in which they did not see potential for themselves.

Competition does improve efficiency in operations and thus lowers costs of manufacture, which many times are passed on to consumers in lower prices. However, competition to be effective must have a free flow of information regarding products and services, and information must be available to all. There must be freedom to enter and exit an industry or service sector and no compulsion to stay. Suppliers must not be able to collude and exploit customers. The firm that manufactured the product or service must be so organized that it is efficiently run. It must therefore have a professional management; invest in research and development, in advertising, have well-though out policies to motivate its employees and base succession on performance. It must be governed to look after the interests of all shareholders and other stakeholders and have a clear and transparent system of corporate governance.

All this demands effective regulation. To be effective, the regulators must act in a transparent, consultative and reasoned manner. They must be independent and not subordinate to governments. Independent regulation is a new form of governance. It requires accountability and must be subject to judicial review. Even existing opaque government departments can be made to function in this way. The Right to Information Act enables the public to get information on government decisions which can be challenged if decisions appear to be faulty. If competition and independent regulation are to benefit society, public as well as corporate governance must follow similar principles of transparency.

In recent years the idea of competition has also been extended to the infrastructure. In financial markets, the USA experience of 2008

demonstrates the need for effective regulation to ensure that markets do not damage the economy.

The Competition Act, the establishment of the Competition Commission and the Competition Appellate Tribunal enable India to lay the foundations for competition and competitiveness. But there are many other conditions that must be satisfied to make them effective.

CHAPTER II

WHEN COMPETITION IS NOT THE ANSWER

Competition has become a buzzword for reformers in India as the answer to problems of shortages, high prices, and collusion by suppliers to exploit the consumer, unfair trade practices, false and misleading claims, etc. But competition can not be an answer by itself. Competition must always be accompanied by transparent, predictable, consultative, comprehensive and independent regulation. The collapse of global financial markets in 2008 demonstrates this.

Competition itself must satisfy certain pre-conditions if it is to deliver desired results to society. There must be no constraints on expanding supply. There must be no trade barriers or financial limitations of availability or excessively high interest costs (in relation to other countries and in real terms after allowing for inflation) to prevent new capacities from being built or alternative products or services from being made. There must be a strong and well-enforced legal system that sets standards, inspects for their implementation and punishes violators. An honest and transparent regulatory framework is necessary to ensure all this. There must be a speedy mechanism for customer grievances to be submitted, dealt with and redressed fairly, with provision in case of dissatisfaction, for appeal to a higher authority. There must be an easy and comprehensive flow of information on products and services, their availability, prices, quality, etc.

Even when all these pre-conditions are met, there are instances where competition is not helpful to the consumer interest, and indeed could be harmful.

A good example is that of health services. A sick person is usually at the mercy of whoever is treating him. He does what the doctor asks him to do to get well soon. If the doctor prescribes some tests he gets them done. Medicines that are prescribed are bought, of the brand prescribed. Rare is the patient who will take a substitute even when the ingredients are the same and the manufacturer has a good reputation. If the doctor suggests surgery, most patients will have it done.

This gives immense power to the doctor. Less power but power nonetheless is with the others in the health delivery system: nurses, pharmaceutical retailers, hospitals, nursing homes, clinical laboratories, and pharmaceutical manufacturers. There are many instances of doctors who are tied to clinical laboratories, and take commissions on all tests that they have sent a patient for. Doctors control beds in many public hospitals and

their patients get beds without difficulty in those hospitals. The doctor has a bond with his patient and some doctors exploit this, as well as to limit the number of their patients, by relatively high charges. How can one doctor who does not have such control, compete with another who does?

Pharmaceutical manufacturers take advantage of this close and trusting bond between the patient and his doctor. They 'buy' (with money, free trips overseas, entertainment, free samples) the doctor so that he prescribes only their brand of medication, ensuring sales since the patient will not easily buy a substitute. The doctor is remunerated in many ways apart from straight cash.

These few examples show that there can be no real competition in the health services industry and even in pharmaceuticals. A Drugs Regulator who must prevent abuses has almost never taken action in India. He is not an independent regulator but is under beauraucrats and politicians and hence subject to influence. Nor is the National Pharmaceutical Pricing Authority an independent regulator. It functions like a government department, without transparency and consultation with all concerned interests. This is demonstrated by the rise in prices approved over the last decade for almost all medicines. Another example is that though India is a major global factor in the production and marketing of generic drugs, very few generic drugs are available to Indian consumers. Generic drugs are invariably much lower priced than their branded equivalents with the same therapeutic effect. The consumer as patient thus has little protection from rapacious manufacturers, doctors and clinics on which he places all his trust.

Health services need firm, fair and transparent regulation at all stages-of doctors and their practices, pharmaceuticals manufacture, distribution, promotion and pricing, to prevent exploitation of the customer's vulnerability when sick.

Many infrastructure services are also not open to competition especially since finance is restricted, procedural bottlenecks to investment are many and political interference is great, preventing remunerative tariffs. As natural monopolies, investments are large and no other such facility built nearby can be viable. Electricity, ports, roads, railways, water for drinking as well as agricultural and industrial use, are some areas where competition is possible only at the construction stages. One way to bring in some competition is for contracts to build that are competitively bid. Since the number of players might be limited, it is essential that tenders, their processing, bidding documents, are all prepared thoroughly and carefully, allowing no room for subjective criteria.

There are many sectors of the economy where services might not be open to competition. Electricity and water can in theory be provided by many suppliers. But the one experience in the UK where retail competition in electricity was tried has not been successful. For bulk customers there could be competition among suppliers, provided transmission lines are open and accessible to all. Ports can compete with each other if their hinterlands are well-developed with transport and at best can be only limited. Dubai and Singapore are good examples of ports that have competitively taken traffic from intermediate ports. Roads and airports are in similar situations. Railways can introduce competition for customers between trains and for different services but the UK has had these, with considerable financial losses and poor service.

In such services, the customer interest of supply, quality and reasonable tariffs must be protected by independent regulation that also must, in a services-short country like India, promote investment. Governments must not interfere with independent regulatory decisions. Customers must be encouraged to pay the tariffs determined transparently and in consultation with all stakeholders, by the regulator. India has been poorly served by governments and many infrastructure regulators. This has kept private investments away.

Telecommunications and airline services are examples of infrastructure services where competition in retail supply has been effective for the customer. Telecommunications consumers have benefited by the competition between different operators. But the competition is not complete because consumers are tied to the number given to them and are reluctant to shift to another operator if they have to change the number. Telecommunications has an independent regulator who is trying to introduce number portability.

Airlines do not have an independent regulator. Airlines depend on the availability of suitable airports with enough capacity, landing slots, terminals, air control, and reasonably priced aviation fuel. Airlines and airports must be independently regulated by the same regulator. An independent regulator might not have permitted so many airlines to come in when the airport capacities were so inadequate. A wise government that was licensing airlines would not have made their largest cost element, fuel, more expensive with high taxes.

Clearly, competition is not the only or the complete answer for optimizing customer satisfaction in many products and services. In all cases, competition requires an independent regulator to ensure that the conditions

for competition are not violated. In the case of life giving services or natural monopolies that have inherent barriers to competition, the role of the independent regulator has to be even greater, since he has to determine and award licenses, tariffs, ensure fair market practices, etc.

CHAPTER III

CREATING A CULTURE OF COMPETITION

In the years before 1991 when the Indian economy was under a regime of licenses and controls, resulting in a "command and control" economy, economic legislations were intended more to strengthen government control than to benefit investors or consumers. Industrial licenses to start new industries were not easily given. Importers needed import licenses, and were told where to import from. They could not choose a preferred location for their industry and there were limits to expanding capacities. 'Large' industrial groups had many restrictions on their freedom to add new capacity or diversify. 'Monopolies' were discouraged and what was a monopoly was narrowly defined. Companies and their managers had lived under these restrictions for so long that they could not conceive of another regime in which they could take their decisions without external diktats. Dealing with government was a special art. Every company had Resident Representatives in Delhi. This was apart from suitcase carrying 'public relations' firms whose money gave them intimate access to some bureaucrats and Ministers.

A major law inhibiting entrepreneurship and innovation was the Monopolies and Restrictive Trade Practices (MRTP) Act. A Monopolies Commission would tell you what you could not do and haul you up, for example, for producing more than your licensed capacity. After 1991 the consumer movement led the effort to place the consumer at the centre. The new approach was to encourage enterprise and competition, not look for monopolistic characteristics. This new thinking was the genesis for the Competition Act of 2002, revised in 2007.

There are effective non governmental organizations that have for years advocated competition. They have advocated liberalization and competition, competition policies, and competition laws to check market failures, and engage in actively pursuing competition routes to social and economic development. Some have naturally extended themselves into research on economic, industrial and social issues and related issues of trade, regulation, governance and development. They have pioneered in issues of energy and environment, competition and the consumer interest.

A competition culture has yet to take root in India. Policymakers and the public meekly accept anti-competitive practices. The Competition Commission of India, created over five years ago, and properly staffed only

this year, has just started functioning. It has undertaken useful studies on competition and the obstacles to it in many sectors of the economy. It has yet to consider any issues and give decisions. It has also to resolve the problem of conflict in jurisdiction with other regulatory agencies.

The Competition Act, a Competition Commission and a Competition Appellate Tribunal, are not by themselves enough to ensure competition. We need tough regulation by other regulators with powers to impose stiff penalties. We need to be clear on the jurisdictions of sectoral regulators and the Competition regulator. Professional management and good corporate governance create a good enabling environment for a competition culture. Placing the consumer at the centre is the focal point for a culture of competition.

Despite the lack until now of an active competition regulatory authority, significant changes to consumers' lives have come about because of: liberalization from licensing restrictions, opening of the economy to foreign goods, services and investment, and the new technologies in information and communication. The prominent example is of telecommunications which has seen an explosion in its reach and a continuous fall in cost, making India the cheapest for telecom tariffs in the world.

Economic reforms have brought positive and speedy results for the consumer. By itself, even if it existed, a competition commission may not have achieved them. For example, when Unilever, owners of Walls ice cream, bought up the dominant player Quality in 1993, many saw it as an anti-competitive act. Today, fifteen years later, new entrants, an essential prerequisite for competition, have increased the availability of ice cream manifold, prices are low, quality is better and Unilever is not the dominant player.

In contrast, many anti-competition practices remain. For example, banks collude to change interest rates by the same amount and at about the same time, sometimes at the public instance of the Finance Minister (not by the regulator who is the Reserve Bank of India). In the midst of a severe diesel shortage in the country, the largest oil refiner, a private company, is exporting almost all its diesel overseas at higher prices. The Indian consumer does not get any benefit from having a large domestic refiner in India. The same company is unable to supply gas from its rich fields leased from government, for power generation at prices that the power sector and its consumers can afford. Prices are linked to 'international market' prices. Government leases nationalized coal mines for power generation to ultra mega power projects but will not follow the same practice for gas.

Maharashtra and Karnataka governments compel their consumers to buy wines produced within their states by imposing special taxes on wines coming from outside their states.

There is so far no regulation of overseas mergers and acquisitions by companies operating within India, enabling market dominance by the merged entity in India.

With the absence of a watchdog and enforcing authority for competition, regulation is not proactive in most sectors. Thus in health care delivery almost every aspect is redolent of exploitation. These include all elements, from manufacturers producing sub-standard quality, bribing of medical practitioners to prescribe a manufacturer's products, retailers freely supplying all-even the most dangerous- without prescription or recording, and the selling of 40% of drugs that are fake. The consumer is thus not protected from huge health risks.

In education and especially professional and technical education, which are in great demand, there is similar regulatory failure. Management education for example, has almost 2000 government recognized schools charging high fees that students pay because of the hopes of good jobs on graduation. Most of them have poor facilities, untrained faculty, poor libraries, etc. The student as consumer of management education is being ripped off. The Regulator, the All India Council for Technical Education, is ineffective and alleged to be corrupt. The Competition Commission must protect the consumer interest in such areas as well.

Development requires Competition. But competition must be subject to oversight by Regulators. Market players look for monopoly positions to 'own' the consumer through fair means like advertising, distribution, quality, service, etc. They can also entrench themselves by misusing their larger size to dominate and even destroy competition. Collusive acts through seller cartels joining to divide markets and fix prices to benefit each member of the cartel are difficult to prove. It has been alleged that industries like cement and tyres have engaged in such behaviour.

Competition policy, law and a Commission cannot by themselves ensure that competition benefits the consumer. Easy entry for new entrants and exit, ample information available to all, preventing cartels, misuse of inside information, practices that intimidate competitors, are all necessary. At the same time, competition enforcement must recognize that India is a country of many poor. Many might need specially low pricing, cross-subsidized by better-off consumers. Such seemingly anti-competitive acts are inevitable to protect the poor and vulnerable. Similarly competition must

not be allowed to destroy livelihoods of millions of small and self-employed producers. Hence how much competition a nation must have depends on its stage of development and the country's place in the world economy.

CHAPTER IV

ACHIEVING COMPETITIVENES IN A GLOBALIZING WORLD

Competitiveness demands that companies are managed efficiently. That requires professional management, preference to competence over chromosomes in succession planning, investment in research and development, understanding the macro scenarios in the country and the world to take advantage of new opportunities. It demands a commercial and entrepreneurial culture, not one of restrictive licenses and controls.

Theodore Levitt, who invented the concept of market "segmentation", said that a company could benefit by marketing uniform products around the world. There is today integration of national economies into the international economy through trade, direct foreign investment, short-term capital flows, international flows of workers and humanity, and flows of technology.. People, money, technology, products and services, flow freely into India. Many local manufacturers have changed their operating methods radically to compete successfully with these new entrants. Those that have not, have declined.

Such radical change in organizations and people requires changing human behaviour. The organization must understand the context of the society, economy, the market and the company's own internal dynamics. It must develop alternate scenarios as did Burmah Shell when it had been working on "what if" questions and building alternate scenarios and their responses to each. They were thus able to anticipate the oil shock of 1973. They were the only oil company to benefit from it. Similarly companies that did not anticipate that India would move from a command, control and 'contact' regime soon died or declined. Hindustan Unilever had a plan ready and a list of businesses that they would like to enter or expand into. They had identified in advance the companies and the lines of businesses in which they saw opportunities. They acquired, Kissan processed foods, Quality ice creams, Modern Bread, Lakme cosmetics, Tata Oil Mills. (It is another story that the company was unable to manage most of these acquisitions and lost market shares and profits).

The best way to introduce change is not gradually as many do in order to minimize the pain of adjustment, but in large measures. Air India and Indian Airlines merged but did not do anything else like rationalizing routes, staff, facilities, service engineering, etc. The result is that they are losing vast sums of money and have also lost market shares.

A complex large Group might take a few years in implementing changes but it has a time scaled action plan. Thus the Aditya Birla Group, which was a highly diversified conglomerate when Kumaramangalam Birla inherited it, has now after some years of major changes, developed a definite shape. Mr Birla's vision of the ultimate shape of his group required a series of bold steps. He brought in a new generation of managers, hived off some businesses, amalgamated others, developed an acquisitions plan that included Larsen & Toubro's cement unit, Madura Garments, Colour Plus, etc, and persisted despite serious bottlenecks and opposition.

Radical change requires a fundamental change in mindsets. Thus, state electricity boards have functioned as departments of government. They developed administrative, not commercial or enterprise cultures. Though they separated generation, transmission and distribution into separate companies, each retained the inherited culture. People, their attitudes, structure, systems, remained unchanged. SEBs remain inefficient and unprofitable.

India is now almost entirely open to products, services, funds and technologies from anywhere in the world. It is the second fastest growing economy in the world, with a young, hard working population and many skilled professionals. It is among the largest producers of engineers, managers, computer software specialists, doctors, nurses, science graduates and others. It has a sophisticated 'software' for industry, of economic researchers, market researchers, advertising agencies, chartered accountants, cost accountants, company secretaries, merchant bankers, stock brokers and exchanges and a strong regulatory environment for financial markets. This 'software' is growing in numbers and quality. There is no longer an aversion to consumption (though there is to ostentation), and unlike in the 1970's and 1980's there is no moral crusade against consumption or against making profit. There are no limitations on investment in terms of capacity or location. Real interest rates are comparable to the world and overseas funds are easily available.

India has also become a major 'outsourcing' destination, not as in China for manufacturing, but for advanced 'brain' skills. Many of the world's most research oriented companies have establishments for research, design and engineering in India. Many of them are in collaboration with universities and research institutions.

But India is still far behind in manufacturing, with hardly 15% of GDP. The quality of many of the products of small and medium enterprises is abysmal. There is massive copying and faking of products. For example,

in pharmaceuticals and automotive components, 'fake' medicines are estimated at 40% of the total.

Manufacturing processes are not improving rapidly. A study in Vikalpa of the IIMA sometime ago, sees very slow improvement in manufacturing parameters in most companies: parameters such as productivity, quality, on-time delivery, manufacturing cycle time, on-time delivery, procurement lead times, raw materials inventory, raw material defect rates, on-time completion of new production projects, average unit production costs, etc. Of course, there are some that match the best in the world. TISCO is the lowest cost steel producer; Sundaram Fasteners is rated the best supplier, some TVS companies have been awarded the Deming Award for quality; many companies have applied Six Sigma successfully. But manufacturing has yet to receive the attention and prestige it demands, in a country where there is scope for vast increases in consumption of manufactured goods.

An example of how the environment influences management behaviour is that the shortages of electricity and high cost have made Indian products among the most energy efficient in the world. Such price signals can influence competitiveness.

The 'new' economy of information technology, telecommunications and video can help improve efficiencies in manufacturing because of better monitoring, catching defects before they arise, mentoring at the work place, etc. It can help customized production at no additional costs, thus making products more unique to the consumer. It can enable speedier innovation by cutting the time from getting an idea to getting it converted into a product in the market. By making it possible for each individual to update his learning it improves the quality of the workforce continuously.

Indian industry continues to largely acquire technology from overseas for a fee. There has been little investment in developing technology. Few attempts at cooperative research or even to contract premier institutions like IITs, etc, have been made by Indian companies. R & D expenditures are still very low at around 0.70% of sales.

Another major lacuna is the inability to organize the many small scale and cottage producers to get standard products from them and market them on a centralized basis. That is done very effectively by China, explaining its dominance in world markets in labour-intensive products like, garments, toys, leather goods, etc. The organized sector has not made entry into labour intensive production as China has done. Part of the problem is the existence of excessive labour legislation that compels the permanent employment of such labour even in cyclical industries.

Indian industry has done little to build brands. The best measure of this is the spending on advertising as a percentage to sales turnover. It has remained static over the years (ET list of 645 companies) at 1.50% in 2000-1, 1.41% in 2002-3, 1.36% in 2003-4 and 1.26% in 2004-5. (Later data was not available). Total advertising expenditures have been rising by 9.01% in 2002-3 and 9.45% in 2004-5. The increase has come mainly from new spenders like banks, automobiles, white goods and entertainment electronics. Most others have been static or have declined. If Indian companies are to fight the world, they must build their own brands, not manufacture for others who put their brands on them (as happens for example with most garment exports). These brands must then achieve visibility in overseas markets.

Managements must watch the macro economy for new opportunities and threats to existing products. For example, Lever was not ready for the erosion of margins and the loss of brand values as nimble local manufacturers in India found new ways of cutting costs and improving quality. Companies must also study how the consumer is changing. No one expected the huge demand from low income consumers for cheaper products, or their ability to repay the loans taken for buying durable consumer products. Premium personal care products have lost out in relative terms. Indian marketers must understand the almost unlimited potential demand in the Indian market. The concept of the Indian market as a pyramid, first enunciated in my book "Indian Consumer Market Demographics" (1994), highlighted the vast numbers of "destitutes", "aspirants" and "climbers" in India's markets who want to consume but for whom products have to be designed and priced according to their abilities to pay.

While corporate governance and professional management have become mantras for some companies, the transparency of Indian companies has yet to improve sufficiently in many cases. Family members, not always of the best competence, dominate the top echelons of many companies. Indian companies must reward people's competence, hard work and innovativeness, not their chromosomes or connections. A clearly articulated set of corporate values common to all in the organization, with no compromise for any reason or individual is essential. This is a feature of strong and growing companies in this competitive and globalizing world.

Becoming competitive on a global scale requires not merely good management, but visionary leadership and motivated people. Leaders have to build organizations that share a common purpose and a set of core values. Competing globally demands people who have been selected carefully, oriented to the organization so that wherever they are working, they do so

to common purposes and values. It demands empowerment of people and technologies for unobtrusive monitoring.

CHAPTER V

CONSTRAINTS ON COMPETITION IN INFRASTRUCTURE

In one decade India has begun a U-turn on Competition. The Monopolies and Restrictive Trade Practices Act like many laws before liberalization, constrained, not encouraged, competition. The MRTP was to restrict and control monopolies and monopolistic trade practices. It has more or less ceased operations ever since the Competition Act was passed in 2005. The new Competition Act aims to encourage competition and prevent anti-competitive practices. It has been awaiting implementation because of dispute over its adjudicatory role in addition to its rule-making and executive powers. That has been resolved by giving adjudicatory powers to an appellate Tribunal that has a person from the judiciary heading it.

Meanwhile the opening up of the economy and liberalization has resulted in many practices that are uncompetitive in nature but not regulated in the absence of an appropriate authority. The emergence of vertical monopolies in the oil and gas sector, apparent collusion in raising prices of tyres, cement or interest rates by banks, uniform price increases by airlines, 'user development fees' charged by some airports allegedly on the basis of padded capital costs, are some examples.

When it comes to infrastructure – roads, railways, posts, power, water, oil and gas, coal, airports, etc, – government has been ambivalent about competition. It is not clear in many cases as to what the pre-conditions for competition in infrastructure are and whether India is ready for them in all cases. Legislation in some sectors like power has the stated objective of achieving competition. Others like coal do not even state such an intention. Recent government policy permits "captive" users to be allocated coal blocks and allowed to sell the resultant output to other users in their "captive" network. Monopolies like Posts allowed couriers to encroach into their monopoly area and are now trying to get legislation to keep some of their monopoly position.

The Indian context in infrastructure is the reason given for not moving ahead with competition. Markets and demand are highly segmented between the well off and the poor; the urban and the rural, industry and agriculture. Services have to be available at affordable tariffs to the poor and to rural India. Costs of delivering infrastructure services to them are higher than to the well to do and urban consumers or to consumers who buy in large quantity. Cross-subsidies or dual pricing alleviate the inability of government finances to bear these costs. The better off are made to pay much more.

Cross-subsidies have led to leakage through corruption, waste and only a fraction of the subsidized services reaching those for who they are meant. An inefficient and relatively ineffective means has also evaded competition.

The other set of constraints on competition starts with the limited number of service producers and providers, the relative shortage of the services and the constraints imposed by limited transportation mechanisms. This is made worse by single or limited ownership of the transport mechanisms. Nor is the effect of limited ownership contained by open access to the available transportation methods. Political interference in pricing keeps adding more people to the subsidized groups. Ownership of the whole chain from production to supplying customers tends to be concentrated with governments who have shown that at the state government levels they are largely inefficient (e.g., state water and electricity boards and their accumulated losses). At the central government level they have been lacking in vision and enterprise even if their management is good (e.g., the inability of central government electricity generating companies to leverage their resources to substantially add to capacity or of ONGC to discover oil and gas).

The resultant subsidies strain government finances, create inefficiencies and leakages and strain the finances of producers and providers. Private distributors find ways to avoid losses. Government owned distributors of electricity make huge losses, reimbursed by concerned governments. However, when laws are amended to enable greater private entry as with electricity through captive generation, regulators, governments and state-owned companies ensure that the laws are not given effect to, by procrastinating on implementation.

There has been some progress in private entry for providing such services but it has raised new issues. For example, competition could be between bidders for projects, with decisions to be taken on the basis of earlier agreed rules. This could be on different parameters, from the lowest cost quoted for the project, to the tariffs that will be charged to customers, to the subsidies that need to be paid by government. The experience with privatization of Bombay and Delhi airports shows that there are enough pressure groups and interests to change the rules and parameters and so skew the decision in unfair ways and against the consumer interest.

Another problem is with services that have huge lumpy 'natural monopoly' costs like airports, railway lines, roads, etc. British Railways split the loose parts out of the 'lumps' by treating the rail tracks and signaling as one item on which all users paid rents and the railway trains and carriages as competing elements using the common tracks and signaling. In the event

it has not been particularly effective in offering convenience, cheaper rates or safety nor in running profitably.

The limitations imposed by shortage of transportation and by dominant government ownership create other issues. Transmission and distribution of electricity and oil and gas through pipelines were considered natural monopolies in the days of the command and control economy. In electricity the law was amended in 1998 to allow private investment. In oil and gas the issue has been debated over years. In both instances the incumbent government enterprises have resisted private entry.

On 'natural monopoly' India has recognized in the Electricity Act 2003 that parallel transmission lines could be laid, thus accepting that more than one transporter could cover the same route. This has been implemented in telecommunications when multiple and separate fibre optics wires have been laid all over India by different providers. The utilization of these multiple wires is improving as operators devise new services. But neither electricity nor gas has seen parallel networks to date. However, in the case of roads, this seems to be happening without forethought as for instance in the Bangalore-Mysore highway where both government and a private provider are creating their own highways. In the case of electricity the justification was that the existing transmission and distribution lines had no redundant capacities and were unable to carry much more than they already were doing. Also, most distribution wires were installed a long time ago and since then there has been much technical progress, making new lines laid in parallel, more cost effective.

Another issue in competition in infrastructure awaiting resolution is that of monopolies being encouraged by permitting vertical integration. Vertical integration is believed to enable exploitation of the consumer. A truly independent regulator can ensure that there is no exploitation by closely monitoring capital and revenue expenditures.

In electricity the law does not allow a generating company to own transmission lines and there is a move to do similarly in the case of oil and gas. Similarly, airlines cannot own airports. One argument for vertically integrated enterprises is that ownership of its source of fuel (coal or gas), generation plant, transmission and distribution, can guarantee for its consumers, steady supplies and tariffs. Independent regulators can insist on separate business units for each activity, separation of costs and determination of tariffs at each point, and so avoid exploitation of consumers. Of course the integrated monopolies with state electricity boards have led to the worst results: erratic supplies, poor quality, high and rising tariffs, waste, thefts and gross inefficiencies.

Government ownership does not stop exploitation of stakeholders. Thus, the state electricity boards have had their biggest increase in costs from electricity bought from central government enterprises like NTPC. Central government enterprises have long-term contracts (up to 30 years) for supply of committed quantities of power with each of the state utilities. Tariffs are determined for 3 to 5 years (now by the central Regulator for sales and by the concerned state Regulators for purchases). There are Exchanges that have electricity trading. Spot transactions, an important element for a competitive market, have now begun. But the electricity regulator has capped the prices because of rising prices. This may be due to shortages and not a rigged spot market but the regulator does not accept this argument. In a vast country with considerable variations in demand over seasons, time of day, etc, there are always surpluses and deficits for short periods that can be traded on spot transactions. There is considerable scope for Exchanges to better match demand and supply.

Futures transactions can also help to stabilize prices but regulators have been reluctant to allow futures trading in electricity on the exchanges. There is also a dispute between the Forward Markets Commission and the electricity regulator about respective jurisdictions.

Many issues need to be resolved in introducing competition into infrastructure services. One is whether competition is going to be on capital cost bids, tariffs to users, loss reductions or revenue shares to government. The bid process must be faultless and transparent, including the selection of the independent assessors of the technical and financial bids. No participant must have an unfair advantage over others. Hence production of the service and its transportation to users must be clearly separated. When the service has consumer segments that need price support, the eligible users and methods for giving that support as well as reimbursing the supplier must be clearly identified and spelt out. There must be no changes made to rules and procedures after the process has started or during implementation. The price relationships between different services must be clear.

India has to go a long way before we can have true and maximum competition in infrastructure services.

CHAPTER VI

THE DIFFERENT TYPES OF REGULATION IN INDIA

Legislatures pass laws that reflect the intent of governments. But laws have to be implemented and that requires the work of many people, chiefly in government. They are the people who frame rules, procedures, penalties for violation, and use precedents. This is the regulatory framework. However there are many details that need decisions and are not provided for in the legislation. All regulating authorities therefore exercise discretionary powers in interpreting the rules, etc. In India, implementation is poor and sometimes there is either no implementation or it is not respectful of the law.

There are four types of regulators. Government departments are the main ones, there is self-regulation created by law, independent regulators as for electricity, telecom and some other sectors, and no regulation at all.

Government departments are now required by the RTI Act to release documents and cannot be secretive. The law is new and not always understood by officers and public, or not implemented. Government decision making is not usually transparent. Many affected parties concerned with or affected by a decision neither are asked for their views or have them considered. Even projects under competitive bidding have been so framed as to allow discretion to officers to decide on who is to bid and even who is to be awarded the contract. The principle of bids being awarded on transparent competitive bids only is many times vitiated. Government has poor monitoring, follow-up and penalties for violation of regulations. Nor does the government regulating department have staff for adequate inspection.

Regulation of drugs and pharmaceuticals is illustrative. Retailers are expected to sell ‘ethical’ drugs only on doctors’ prescriptions. But it is easy anywhere to buy the most dangerous drugs in almost any quantity without prescription. Retailers and their books are not regularly and comprehensively inspected and checked for valid doctors’ prescriptions against sales, and that the prescriptions and sales relate to the same customer. Drug Control Authorities have very few inspectors. With political, bureaucratic or money influence retailers are able to put off punishment. Years ago, the Lentin Commission in Bombay identified sub-standard intravenous fluids as causing many deaths. The guilty remain unpunished.

Similarly, regulation by the university, or other department of government like AICTE allows for little inspection and penalties for violations.

Rarely are inadequacies and malpractices found out and rectified, for example, inadequate classrooms, rest rooms, water in the toilets; unqualified teachers, inadequate teaching aids or equipment, charging excessive extra fees, etc. In most of India huge expenditures on roads show little visible improvement and are of poor quality. The grandiose Ganga Action Plan after spending almost Rs 2000 crore has not improved the Ganga.

The second type of regulatory agency is of autonomous and self-regulatory institutions with quasi-judicial powers of investigation and punishment, created by the legislature. These institutions have rules and standards, authority to inspect, monitor and punish violators. Self-regulation with statutory powers is mostly in specialized fields, for example, Institute of Chartered Accountants, Institute of Cost and Works Accountants; Institute of Company Secretaries, Institute of Architects, Medical Council of India, Bar Council, etc. Only those qualified by the self-regulator can practice that profession. Like ancient guilds of professions, entry to this profession is only for those approved by the guild. The self-regulatory bodies may also have rules of conduct of the profession in ethical and technical terms, design curricula, admit students, run classes, conduct examinations and declare results. Self-regulating bodies earn substantial fees from these activities. They have committees to rule on allegations of malpractice. But in India, these malpractising professionals are rarely punished after investigation by statutory professional bodies It is rare in India for one professional to give evidence against a fellow professional. In the USA malpractice suits are common with evidence by fellow-professionals.

The third type of regulators are the statutory quasi-judicial and independent bodies to whom government give its powers. Reserve Bank has powers to regulate commercial banks; SEBI regulates financial products, agents and markets. There has been a proliferation of such institutions for the infrastructure areas (electricity, telecommunications, and minor ports) and more are in the offing for downstream oil and gas, civil aviation, coal, railways, pharmaceuticals. They are expected to be time-bound, transparent and consultative. However, their members are mostly retired bureaucrats (with a lifetime of operating in government systems and procedures) and chary of innovative measures within the law as well as of using their penal powers.

The splitting of functions between too many Ministries and departments prevents a holistic approach and results in delays and inefficiency, both in government and for the independent regulator. For example electricity regulators have no control over input prices (accounting for 40 to 60% of the cost of power) of coal or oil or gas and are confined to

the power sector. Instead there should be a single Energy Regulator. Concurrent subjects between Centre and states like electricity, mean around 20 state regulators. Instead, four regional bodies instead of one for each state, with powers to respective state governments to issue directions to the regional body would be more sensible. All such bodies must be accountable to a higher judicial body for discipline, quality of members and their decisions. Regulatory bodies must enable a body of regulatory law and precedent to evolve and enable predictability from regulatory decisions.

The fourth type where, government does not at all exercise regulatory oversight, are of courier services, nursing homes, (until recently) smaller banks, chit funds, etc and broadcast media. The user has little protection from exploitation.

Regulation is inevitable and necessary in all areas of activity. It should be transparent with rights of consultation for all; the regulator should be accountable for his functioning and quality of his decisions. Regulatory positions should be independently selected and open to all.

CHAPTER VII

MAKING MULTIPLE REGULATORY AGENCIES EFFECTIVE

Indian governance has alienated people from government. Procedures are complex and secretive so that even many government servants find them hard to follow. Governments are unable to implement programmes faithfully, fully and without waste and corruption. Consultation and participation of people most affected by decisions of government is poor. There is no holistic decision-making but only sectoral ones. Major decisions are announced without giving reasoned arguments to show why one decision was made as against other options.

The institution of independent regulation was introduced to overcome such criticism especially where large sums of money were to be spent. These decisions could have major effects on the economy or could affect large groups of people.

Independent regulation is modeled on similar agencies created in the USA to deal with interstate commerce, aviation, transport, etc over the last century. President Roosevelt created many such agencies during the 'New Deal'. Other countries like the United Kingdom followed suit. The UK's bonanza of North Sea Gas led to the creation of the Gas Regulator (followed by the regulator for electricity when it was being privatized).

The unique feature of an independent regulatory agency is the distancing of the influence of government and the other stakeholders and interested groups. All matters in its purview have to be decided in consultation with all concerned, every view is available to all, all data and documents are open to inspection and copying, and every decision has to give reasons to support why that particular decision and not any suggested by others was taken. Transparency, consultation and reasoned Orders are mandated. The intention was to give investors the confidence that decisions that affected their investment would be taken in a manner that was free from other external influences and took into consideration the investor and the consumer interest. Decisions would be predictable and not subject to frequent change and uncertainty.

The first such independent regulatory commission in India was set up in Orissa for electricity. The Central Electricity Regulatory Commission (CERC) came in 1998 and since then every State in India has established an electricity regulatory commission since electricity is a concurrent subject

under the Constitution. There are now 24 or so electricity regulatory commissions with perhaps 50 members.

An Oil and Gas Regulator is now existent but has but been notified the powers by government that will make it fully operational; independent regulators have been talked about for coal as also railways, civil aviation, steel and other sectors. Any Ministry that deals with infrastructure services or which has to take tariff decisions or permit investment or license activity seems to be considering the creation of a regulatory commission. This proliferation of new 'independent' regulatory bodies could add another layer of clutter to our governance structure without improving it. We must build safeguards to keep them effective.

There are few people that can run them. A Member of an independent regulatory agency must be very open minded and willing to be persuaded by reasoning, with a modicum of understanding of corporate financial statements, essentials of cost accounting, of the law that created them and related legislation, of basic management concepts, and knowledge of the essential features of the system to be regulated. Members must carry no ideological baggage for or against the private or the public sector. They must not be cut off from the sociopolitical context of India and the sector they have to regulate. This is the chief reason why proliferation of regulatory agencies must be discouraged.

However, the idea of making decisions transparent, consultative and reasoned is a good one and will restore confidence in our governance. We must find ways whereby we get the benefit without the excessive proliferation.

We can do this by creating such agencies without reference to the closely held turf boundaries of Ministries and departments of governments. In this way we can also deal with another fault in our governance that decisions are taken without coordinating with other aspects that might fall in the purview of other ministries or departments.

We will need a better selection process than we had till now. It has so far largely shifted retired and retiring government servants to these regulatory commissions. Instead, a standing group of eminent citizens chaired perhaps by a Lok Ayukta could be created to select Regulators. Candidates must go through an intensive training programme to familiarize them with the topics mentioned earlier. With classroom exercises to reinforce their learning, it should be possible to weed out those who do not take to the training. The rest could then be appointed. The standing group could also be responsible to consider complaints against regulators, have them examined and with powers to take the necessary actions. We would then have

accountability of the Regulators. The Courts should pull up Agencies whose Orders are frequently overruled on appeal.

It should be open to any citizen to go to court demanding that government and the commissions perform their duties as required by law. Governments have most times for example, delayed selection and appointments within the time frame laid down by law or the qualifications required of regulators. Regulatory Commissions have not submitted to the legislature the reports required of them. These violations must not be condoned and severe action must be taken to enforce them.

To avoid regulatory proliferation and ensure holistic decision-making we could have a central energy regulator instead of separate ones for electricity, upstream oil, downstream oil, gas and coal. This regulator would be responsible for tariffs and licensing of production, transmission, distribution, and supply of coal, gas and electricity. This will ensure that the interests of all can be coordinated, especially since electricity, a major user of the others, has its prices capped. Oil and oil products could be regulated separately since issues of national security and highly technical issues in oil exploration have to be considered. Retail distribution of oil and oil products has very different issues for consideration.

At the state level the state electricity regulatory commissions could also be made responsible for a closely related area, namely water, including permission for ground water exploitation, pricing, etc. Since subsidized or free electricity is responsible for the massive over exploitation of ground water, this could help to relate the one to the other.

We have a national pharmaceutical pricing authority, separate Drugs Regulatory Authorities in each State, while public health aspects like water quality, sanitation, garbage removal, etc, are not coordinated but are departmentally and poorly regulated. We could instead consider national and state level health regulators who could look at specific health issues in an integrated fashion. Licensing of hospitals, nursing homes, laboratories, retailers, drug manufacturers, their inspection by a neutral agency at periodic intervals, prices charged for selected medicines, holding responsible the agencies and individuals responsible for water contamination, poor sanitation, could come under such an agency. Admittedly it will be a large brief but if the tasks are performed in the open and with public petitions and participation we might get better results than we have till date. This will also make it possible to put the inspectors in the public gaze and hopefully make them effective.

The essence is to promote transparency, public participation and open decision-making wherever the public interest is involved. If government could be so in its normal functioning, such new agencies may be redundant. But governments in India have invariably been secretive, tend to engage in superficial and limited consultation and rarely give reasons for their decisions. They are unlikely to change soon.

If we do not look at such holistic responsibility for regulatory agencies we would have a multitude of regulatory agencies in addition to government departments, without any improvement in the quality and cost of the services they have to regulate. A regulatory morass is the inevitable consequence of regulatory proliferation. It does not have to be so.

CHAPTER VIII

RATIONALIZING ON INDEPENDENT REGULATORS

A deluge of independent regulators is about to descend on us, apart from the financial regulators. There are now 20 or so in electricity. There might soon be separate ones for Gas, downstream Oil, Exploration, Coal, Steel, Civil Aviation, Rail, Pharmaceuticals, and health services and possibly for Water at the Centre and the States. Before we go ahead we need to consider what has been the experience so far and also whether the people exist to run so many agencies and provide staff with the necessary expertise.

Electricity has had a central regulatory commission since 1998 and state commissions subsequently (except Orissa which had one earlier). The structure of the electricity industry as well as of its principal fuels, coal and gas, is likely to witness major changes over the next five years. These will be in ownership structure and rising private investments in their production, transportation and distribution.

Private investment in pipelines and electricity transmission lines must result in independent and non-profit load despatch operations, not under GAIL or Power Grid as now. Electricity exchanges in place and parallel to the load despatch centres at State and regional levels, facilitate trading. Rural electrification will progress with the replacement of low with high voltage lines, metering of distribution transformers and building capacity in panchayats to distribute electricity and collect payments at tariffs determined by the Regulator. Wind Power along with bio mass will become the main renewable sources of energy, also supplying the Grid. Incentives will be related to generation performance and not capacity. New projects will be licensed on the basis of committed forward tariffs with the Regulator laying down formulae for dealing with fuel price variations. Electricity Regulators will over the next five years be regulating a changed electricity scenario.

At no point in the next twenty years can we expect that governments will not dominate ownership of the energy sector though there will be a more significant private sector presence. Transmission and pipeline capacity will be more adequate. Distributed generation will have taken over to a significant extent in rural energy supply and panchayats will have become largely responsible for rural distribution and collection. Renewable energy and particularly wind power will have risen substantially in total supplies. Subsidized energy supplies, electricity for small and marginal farmers and the rural and urban poor, subsidized kerosene for the poor, will remain but better targeted and the expense capped per user. As a result gas prices will

also be regulated to provide satisfactory returns to all participants but related to prices of electricity.

Vertically integrated operations in Energy (where one entity controls all operations from fuel to final supply to consumers) will require special attention from Regulators to ensure that transfer pricing is fair to consumers. Regulators must also deal suo moto with issues that push up cost of projects (such as red tape, bureaucratic delays, padding of equipment costs, efficiencies, etc).

The electricity regulators have to find ways to improve the distribution, improve efficiencies in subsidy targeting and costs, reduce or eliminate subsidies to the non-poor and make the subsidy reach the really needy. These require data on the poor and non-poor and a system to ensure that the non-poor are kept out of the subsidy mechanism. Cross-subsidies must be replaced by direct government funding.

Energy Regulators will continue with cost-plus tariffs for many years to come. This is because there will be consumers who are supplied below the cost to serve, capacities might not be adequate and gas prices being subject to international cartels, end users must be protected from paying exorbitant prices. However such detailed tariff regulation might be confined to long-term contracts. Regulators might focus more on trading, markets and information to ensure that they function in a fair and transparent manner.

Governments must also make greater use of the expertise built up in the Regulatory Commissions and invite their advice on reform measures in each sector and other areas like taxation.

A formula to assure a relationship between end electricity prices and of coal and gas that also recognizes the requirement of profits for attracting investment into the fuels must be agreed between Regulators. That is the logic for hoping that ultimately Ministries will opt for a single Energy Regulator. Regulators for Gas, Coal, Rail, must be given responsibility for their tariffs, an element missing from the present Oil and Gas Regulatory Bill and in the 1997 discussions on amendments to the Coal Nationalization Act.

For some time, because of the protection by the different Ministries of their turfs, there will be separate Regulators for Coal, Gas and Electricity. These will be in addition to ones for Rail, Shipping, Environment and Energy Efficiency. These Regulators along with TRAI will need to have agreements with each other to ensure coordination on specified issues between them. For example, how much rent and profit sharing must the telecom tariff include as payment for operators stringing their lines on electricity

transmission and distribution lines? Electricity Regulators could also use their tariff determination and licensing powers to enforce regulations relating to environment and energy efficiency. State Electricity Regulatory Commissions could be given powers to oversee ground water regulation since cheap electricity for agriculture is used to pump ground water and that has become a scarce resource.

The roles of the new Competition Commission and the Appellate Authorities for Electricity and (proposed) for Gas in relation to the other regulatory agencies are unclear. The Competition Commission should ideally confine itself to mergers and acquisitions and take advice from the concerned Regulatory Commission before coming to decisions.

We should be aiming to get to a situation where there is a single Central Energy Regulatory Commission for electricity, coal and gas, regulating transmission and pipelines, bulk tariffs, licensing of transmission and distribution entities, setting rules and enforcing them for trading and markets and grid discipline. The State Electricity Commissions must enforce environmental rules set by environmental agencies, energy efficiency rules set by the Bureau of Energy Efficiency and oversee the functioning of local agencies that enforce rules for ground water usage.

The multiplicity of regulatory agencies by sector and by State in the case of electricity (and perhaps Water and other subjects that are concurrent or wholly with the State governments) strains the available limited talent for appointment to them. We must encourage as many States as possible to have common Regulators, with Benches in each State and the power to the concerned State government to issue directives to the Joint Commission in relation to its concerns.

No modern society can do without Regulation. Its nature might change as the structure and context change. Better that regulation is done in a transparent, consultative and reasoned way.

CHAPTER IX

SELF-REGULATION

Government's proposal to protect anti-terrorist operations from being compromised by intrusive and instant media coverage was accused of taking India back to the Emergency. Media freedom was said to be under attack, and this of course was interpreted by the media and some extreme civil libertarians as censorship by heavy-handed government officials. The political leadership and government have therefore given up duty in return for a friendly media and political mileage.

Television news media with hordes of news vans, reporters, cameramen, and accompanying curious crowds, flocked to the Taj Mahal Hotel and the Oberoi Trident on 26/11/2008, though not as many at Nariman House. No doubt the young reporters were very brave under gun fire and grenades thrown out of the windows at the Taj. But non-stop coverage over almost 18 hours was unreasonably excessive. It may have satisfied the voyeuristic inclinations of viewers watching from the safety of their homes, but served no purpose beyond raising passions against Pakistan and even Muslims in general. For Indian television news, the staple is "breaking news" and this was its best “break”.

Live non-stop coverage did serve two sets of viewers. Guests trapped in hotel rooms could watch the television without sound to hope for their chances of survival. For the terrorists and their handlers elsewhere who were following the television coverage, it was the best source of minute-to-minute information on exactly what the police, naval commandoes, Army and the National Security Guards, were doing. A former senior bureaucrat has called this a puerile objection. By this, he demonstrates like the media, poor judgment about the effect of live publicity during an evolving terrorist attack. This live coverage probably delayed the completion of the operation. T.V. anchors out to get the highest TAM rating for their channels, and spunky but young and immature reporters, did not show restraint and discipline. Rightly, the agencies whose people were risking their lives to battle the terrorists, want that such high risks to them because of live television coverage, be banned in future. Recognizing the need for restraint, broadcasters now offer self-regulation against any legislated restraint.

Self-regulation has existed for years in many professions, legislated by government. Among them are accountants. Like Price Waterhouse for Satyam, Arthur Anderson was Enron’s auditor in the USA. To a

Congressional Committee of the United States, Anderson said that Enron did not give them complete information. So they missed the large-scale fudging of profits over many years in the accounts of Enron. PWC similarly have said that they relied on the information from Satyam management, even about bank balances, and that after Raju's confession; their audited accounts cannot be trusted. .

The Institute of Chartered Accountants of India has regulatory powers given to it by government over Chartered Accountants who can practice only if licensed by the Institute. The American accounting association also has such self-regulating powers. Self-regulation has not prevented accounting scams caused by carelessness or fraud. What is worse is that in India, the rules allow penalties only on individual members of the association, not on the firm that employs them.

In the USA and India, another self-regulated profession is medical practice. American practitioners fear damage suits by patients and their relatives for malpractices and mistakes. If found guilty, damage payments and insurance premium are high. This makes medical care costs in the USA very high. Apart from the Courts, the professional medical association hears such complaints and takes stern action. Lawyers are another self-regulated group. American lawyers are hauled up for malpractice and other lawyers give evidence against them, as they do in other professional practices. American professionals are willing to testify against fellow-professionals. This is not the case in India. Similarly, no broadcaster under self-regulation is likely to testify against a fellow broadcaster.

There are practically no instances in India of professionals being hauled up and punished, or giving testimony in Courts against fellow professionals. There are powerful professional bodies representing chartered accountants, cost accountants, company secretaries, medical practitioners, lawyers, etc. They regulate entry into the profession, set the rules and standards for their profession, conduct the examinations that admit new members, lobby to expand their turf (cost accountants have a guaranteed corporate cost audit market, company secretaries have a guaranteed corporate market), and prevent foreign qualified professionals from practicing in India. Their standards and rules have legal sanction. No professional association severely punishes the individual and the firm he works for, for carelessness or involvement or abetment in a scam.

Sports associations controlling different sports are akin to such chartered associations of professionals. Each jealously guards its independence to regulate the sport. Mostly led by top political leaders,

bureaucrats, policemen and businessmen, they lack vision for the sport they control and are not accountable for consistently poor and deteriorating performance. They do not attempt to identify, train and nurture talent, but fully control the funds available for the sport. Self regulation has not improved our sports. We need legislation to ensure that all sports associations give representation to sports persons, are transparent in their governance and finances, and the leaderships are accountable for performance.

While Indian professional associations never severely punish misbehaviors by members and their companies, they are protective of the rights of their members. For example, when a Delhi lawyer was arrested and handcuffed on a criminal charge, the lawyers agitated against their colleague being treated like one of their clients. Innumerable horror stories of wrong diagnosis, treatment and sheer carelessness of doctors and surgeons in public and private hospitals and nursing homes are told. Abused patients are unable to exercise legal remedies, though in the recent past consumer courts have sometimes corrected this. Many times relatives of mistreated patients cannot even access their medical records. Medical experts will not publicly testify to what they might admit privately.

Self-regulation in the professions has been ineffective in India. Associations can set standards, conduct examinations, license practitioners, but misdemeanors should be covered by legislation, not self-regulation. Indeed, this should extend to all professions, for example, real estate agents, who have no minimum levels of qualification of service quality, nor a mechanism to deal with wrongdoers. Self-regulating professional associations favour their members over customers and community. The Satyam scam should be a wake-up call not only for corporate governance, but against the myth of self-regulation. Parliament must create a new independent regulatory body for chartered professionals that will be open, transparent and consultative. Disciplining professionals must not be left to ineffective self-regulation. The process must give confidence that complaints and wrongdoing will be heard and decided objectively. Professionals must follow a code whose violation triggers legal penalties.

Thanks to fears of censorship and their control over publicity, broadcasters hae not so far been regulated for content. They must be in covering live situations of life and death. Terrorist attacks when in progress are clearly in this category. Broadcasters must be legally compelled when covering episodes like Mumbai on 26/11, to exercise restraint. The lives of hostages and the forces trying to rescue them are more valuable than the TAM ratings that maximize advertising revenues of news channels.

The proposed legislation (now withdrawn by a government preparing for elections), went too far by going beyond terrorism. It must be confined to coverage of terrorism and made effective immediately by Ordinance. The next government can decide how to take it forward.

CHAPTER X

THE 'SATYAM' EFFECT ON CORPORATE GOVERNANCE

Earlier crises in Indian stock markets were due to manipulation of the markets, using insider information to corner or dump stocks, getting allotments of initial public offerings reserved for small buyers by using fictitious applicants, subverting bank operating systems by bribery or credulity of bank managements, etc. But they were all aimed at market manipulation mostly with the aid of brokers, bankers and others. The Satyam brought to the fore the possibility of extensive fraud over many years by company 'promoters' and those who controlled the company even without dominant shareholding. It exposed the futility of all the methods evolved under Clause 49 of SEBI's listing agreement to ensure transparency and full disclosure, prevent fraud and manipulation.

In the Satyam case all the independent directors appointed during the Raju reign have resigned. Some have lost their full-time jobs in academia or elsewhere and have stepped down from many other Boards. The signing partners of the auditors, Price Waterhouse, Hyderabad, have been arrested and have been in judicial custody for many weeks. Companies related to Satyam are under investigation and Maytas, the Raju family's real estate and construction venture is in disarray. Different investigators-Andhra police, SEBI, Serious Frauds Investigation office of the Central government's finance Ministry, the Registrar of Companies, the Institute of Chartered Accountants of India (ICAI), are some of the investigating agencies that are all sifting through what happened. Meanwhile the 'promoters', the Raju brothers, are in police custody, and by newspaper accounts getting special treatment there.

It is reported that over 180 "independent" directors have resigned from a similar number of companies. At the outset there were newspaper stories of Satyam's reputed independent directors being arrested. There was debate on what these people were doing when Raju was building the biggest self-confessed corporate fraud so far uncovered in India. The other actors whose lack of knowledge or even suspicion are the many regulators-the Registrar of Companies who receives copies of all Annual Reports and Accounts, SEBI, the Institute of Chartered Accountants, and the auditors, Price Waterhouse.

We must recognize at the outset that a clever Chief Executive can build a ring of collaborators in the company to mislead directors, and regulators as seems to have happened in Satyam. Might there be other companies in India and elsewhere who indulge in similar activities? There is

no guarantee that there no others doing similar things, perhaps on a smaller scale and for a shorter period.

Outside Directors spend little time apart from attending Board meetings in the companies they are associated with. Clearly this is not enough and independent Directors must spend a great deal more time. They must meet auditors and managers privately, they must talk to analysts tracking the company, and keep themselves informed about what is being said or written about the company. In the Boards they must insist on receiving papers well in advance of meetings and when major projects are to be approved, have opportunities to consider them in depth with the concerned managers. They must ensure that queries and answers are incorporated in the minutes. In the United States, directors can be held personally liable for frauds of the type that have occurred in Satyam. In India, neither the law nor practice appears to result in such liability. But the directors do have the responsibility of applying themselves to find out as much as possible and to satisfy themselves. Perhaps the duration of Board and Committee meetings, the time spent outside Board meetings with company managers and auditors might also be recorded. High levels of commissions, and stock options, might deter directors from being outspoken and could be reconsidered. Commissions might be replaced with higher limits of fees for each meeting attended.

Appointment of independent directors is almost in all companies, an initiative of the owner or controlling group. This is true of government owned and controlled companies and banks, and privately owned or controlled companies. Nominations committees where thye exist, usually follow the suggestions made by the controlling authority. Perhaps such nominations should be from a list given by a regulator like SEBI and be passed by the Nominations Committee of the Board on their own.

There is talk of companies having two auditors so that one can check on the other. This will only take more time away from operating managers and serve little purpose. Better would be for auditors to serve for only three years at a time with any company and for different partners to service the company on the next appointment. The selection of auditors for appointment should be left to the Audit Committee with no involvement of management. Their income from the company must be monitored by the Audit Committee, over time, in relation to other companies and in absolute terms. The Audit committee should interview auditors who want to be considered. Perhaps a list of suitable auditors might be given by SEBI.

Auditors ask all banks and debtors to confirm their balances belonging to the company. In the Satyam case huge fixed deposits certified by the auditors were found missing. We need auditors to be required to

personally verify balances, especially those that account for a large portion of receivables.

The regulator for auditors is the ICAI which over the years has shown itself to be slow in investigating and punishing bad practice or worse by auditors. The regulation of auditors should now rest with a quasi judicial body than with the self-regulating ICAI. This regulator might also regulate agencies that rate companies for their credit worthiness or for governance. Stock market analysts and others recommend investment or otherwise in many companies and get wide publicity. They might have hidden nexus with the company. They must be regularly checked by the Serious Frauds Inquiry Office or similar body to ensure that they do not.

In the United States the Remuneration (called Compensation) Committee consisting of independent directors decides the remuneration of CEO and top executives is involved in succession planning, appointment of the CEO, and the relative compensations within the company. It might employ consultants for this purpose. All this has not prevented blatantly extravagant compensations, very lucrative post-retirement or exit benefits, as evidenced recently by banks seeking bailout by government. In India the Remuneration Committee tends to follow the recommendation of the CEO or the controlling group. The Remuneration Committee should be more proactive than it is.

There are also procedural issues. ICAI introduced a rule that asset values must be marked in the balance sheets to their current market value, even when there was no immediate impact if their value was diminished in the market. This leads to balance sheets being affected strongly when there is a serious change in foreign exchange values of the Rupee, or some impairment in value of assets. ICAI is now considering how the impact can be staggered till it actually arises (when loans have to be repaid or assts sold).

The Satyam fraud has hopefully had a positive effect on companies, auditors, independent directors and regulators. They might now be much more scrupulous in performing their functions and ask the necessary questions. Ultimately however it is the will of the management to be above board that will determine the extent of information disclosure.

CHAPTER XI

TRANSFORMING INDEPENDENT ELECTRICITY REGULATION

Background

Independent regulation of electricity in India started in Orissa. It spread nationally after the formation of the CERC in 1998. It has had limited success especially at the state level. While there has been rebalancing of tariffs between user groups and in some states, an effort to improve quality, there has been

- Little consistency between state regulators on similar issues;
- No attempt to regulate the function of load despatch and to make it independent of the utility;
- No effort to introduce the highly effective (in inter state transmission) availability based tariff mechanism to better regulate the power system within states;
- Over protection in many states of the interests of the state owned sector and in some, using regulatory instruments to continue monopoly of state owned enterprises on purchase and sale of third party power;
- No effort to develop base line data on efficiencies in transmission and distribution;
- Continuance of one year tariff determination; and
- No attempt on a continuing basis during the regulated period to monitor and follow up the implementation of commitments and orders issued to the distribution entities.

This relatively poor performance is due to

1. Lack of political and administrative support to the regulatory commissions,
2. Selection processes that are skewed to selecting former government servants on the verge of or after retirement,
3. Inadequate staff and their relatively poor skills due to the almost total dependence on staff deputed from government.

The lack of an integrated national energy policy and the absence of linkages between different bodies whose decisions affect electricity tariffs and performance, have led to a squeeze on the financial viability of electricity enterprises in distribution. Lack of political consensus and agitations to destabilize reformist governments has been a feature of power sector

decision-making. They have affected independent decision-making of state regulators who have to worry about the unreasonable political fallout of their decisions.

Expected Regulatory Scenario by 2025

The electricity and energy contexts can be expected to change by 2025. They will change the regulatory context and practices in many ways.

There will be continuing domination of the energy sector by government owned enterprises. But there will also be a more significant private sector presence. For example, in electricity the private sector might account for 30% against hardly 5% today. Capacity for transmission of electricity and pipelines for gas will be adequate (unlike today), though with low redundancy capacity. There will therefore be continuing shortages in meeting peak load demands, but better than today. Distributed generation, with substantial central financial support for capital investments, will have taken over to a significant extent in rural energy supply. Panchayats will have become largely responsible for rural distribution and collection. They will regulate ground water usage. Tariffs will be determined by regulators for ground water withdrawals based on assessments of ground water availability in each water basin. There will not be a single tariff over the whole state. Renewable energy and particularly wind power will have risen substantially in total supplies. So, will nuclear power. Gas based power may not make the progress that was anticipated, because of high prices of gas.

Subsidized energy supplies, electricity for small and marginal farmers and the rural and urban poor, subsidized kerosene for the poor, will remain, but be better targeted, with the subsidy capped per user. There will be a mechanism to regulate gas prices so that there is satisfactory return for all participants, but related to end prices of electricity so that viability of the electricity sector is improved. Efficiencies will have improved at all stages. Trading and markets will be well established in all energy supplies. Competition would have been introduced in spot sales of energy and transmission and pipelines capacities, as well as in bulk supplies to large users. However, long-term contracts will account for a major portion of sales, not spot sales.

There will be a single Central Energy Regulatory Commission for electricity, coal and gas, regulating transmission and pipelines, bulk tariffs, licensing of transmission and distribution entities, setting rules and enforcing them for trading and markets and grid discipline. The State Energy Commissions will also

- Enforce environmental rules set by environmental agencies,
- Energy efficiency rules set by the Bureau of Energy Efficiency and
- Oversee the functioning of local agencies that would by then be in operation to enforce rules for ground water usage.

The Energy Regulator will have MOUs with other central Regulators for rail, shipping, telecom, etc, for mutual consultation and agreement on pre-defined common issues.

The multiplicity of regulatory agencies by sector and by State in the case of electricity (and perhaps water and other subjects that are concurrent or wholly with the State governments) strains the available limited talent for appointment to them. There might be an attempt to encourage as many States as possible to have common Regulators, with Benches in each State and the power to the concerned State government to issue directives to the Joint Commission, in relation to that state's concerns.

Desirable Norms for Regulators

Selections of Regulators must not be by government influenced search committees. There should be a group of Eminent Persons that will nationally be responsible for the search, selection and appointment of all Independent Regulators. Chairpersons and Members must be younger (45 to 55 against the present normal of around 60) and enjoy full five-year terms that last irrespective of age. They must have high status, maximum remuneration and perquisites, at least health benefits for life if not other retirement benefits after they have completed their terms and very limited restrictions on post-retirement employment. Not more than one Member in a Commission should have served as a permanent government servant or in a government enterprise. The Eminent Persons Group must oversee training of Regulators and their staff and be the agency to which Regulators will be accountable. While technical skills in the sector are not essential, there must be ample interdisciplinary expertise in the Commissions in law, economics and finance, management (not the same as administration) and an overall understanding of the principal technical parameters of the sector. Training should ensure that all Regulators are enabled to contribute to all aspects of this interdisciplinary work.

Appellate Tribunals are being created and they must not proliferate so that there is one for each sector. There must be only one for the whole Energy sector, not different ones for electricity, coal, gas, etc. These Appellate bodies must rule primarily on matters of law in hearing appeals against

Orders of Regulatory Commissions. They must submit reports to the Group of Eminent Persons about the regulatory commissions that need to be disciplined because their Orders have been frequently overruled on appeals.

At least four research, training and education institutions for training, education and research in electricity regulation must be created with government funding support. Funding support must also be made available for consumer groups to develop their expertise in the sector. They should be able to draw on the research output of these institutions. Every Commission must have a Consumer Advocate who will represent and coordinate between consumer groups.

Transition Scenario (2005 to 2025)

There is no reason why most of these expectations as far as regulatory commissions are concerned have to wait till 2025 and cannot be met within the next five years. However, since there has too be a major change in attitudes and mindsets among politicians and bureaucrats, a transition period of around five years may be necessary from 2005 to 2010.

During this transition period, there will be rapid changes in the ownership structure in gas, electricity and coal as private investments increase in production, transportation and distribution. Private investment in pipelines and electricity transmission lines will soon result in the functions of transmission operation and load despatch becoming independent of operations. Electricity exchanges will be in place parallel to the load despatch centres at State and regional levels. Electricity trading will increase as the capacity for captive generation increases, but will not be more than 10% of total generation, without counting bulk deals between central generators and state owned distribution entities. Rural electrification will progress with the replacement of low with high voltage lines, metering of distribution transformers and building capacity in panchayats to distribute electricity and collect payments at tariffs determined by the Regulator. Wind Power along with bio mass will increase substantially and tariffs must be regulated to encourage generation, not merely investment, as now. Incentives must be redesigned to be related to generation performance and not capacity. Spot and forward contracts will become widespread. Competitive tariff bidding for new projects will for such projects remove the regulator from the present detailed examination of costs and expenditures.

Over the next five years, Regulators will increasingly also be regulating trading and markets to ensure that there is fairness and transparency. Regulators will clear long-term contracts. New projects will

be licensed based on committed forward tariffs, determined through competitive bids, with the Regulator laying down formulae for dealing with fuel price variations.

There might be separate Regulators for Coal, Gas and Electricity as well as for Rail, Shipping, Environment and Energy Efficiency. But even if they are separate, these Regulators along with TRAI, will have MOU's that ensure coordination between each other on specified issues between the Regulators. Until electricity tariffs can be left entirely to market forces, the prices of principal fuels, namely coal and gas, must be regulated, by separate regulators, or preferably by a single regulator for Energy.

Electricity Regulators could use their tariff determination and licensing powers to enforce the regulations relating to environment and energy efficiency. State Electricity Regulatory Commissions could be given powers to oversee ground water regulation with water basin regulation by local authorities like panchayats. The roles and jurisdictions of the Competition Commission, the Appellate Authorities and the respective sector Regulatory Commissions will have to be clarified. Preferably, the Competition Commission might confine itself to mergers and acquisitions and take advice from the concerned Regulatory Commission before coming to decisions. Governments must make greater use of the expertise built up in the Regulatory Commissions and invite their advice in reform measures in each sector and in other areas like taxation. There must not be a proliferation of appellate tribunals and there must be only one for all energy issues. No government must issue policy directives to Regulatory commissions without prior consultation with them and publishing the record of the discussions.

As part of the requirement of accountability, all Regulators must be required to meet annually with the concerned legislative committee to explain their approach and progress, but not to discuss specific Orders issued by them. Regulators must have a formal arrangement whereby issues of common concern can be sorted out between each other. A formula to assure a relationship between end electricity prices and of coal and gas, that also recognizes the need for them to make adequate profits (for attracting investments), must be agreed. New Regulatory bodies that are created for Gas, Coal, Rail, must be given responsibility for their tariffs, an element missing from the present Oil and Gas Regulatory Bill and in the 1997 discussions on amendments to the Coal Nationalization Act.

All independent regulators in India must be subject to a common framework of rules on appointment, terms, accountability, etc. Search, selection, appointment and training of regulators must be the responsibility of a high-powered committee composed of Eminent Persons, not as at

present, of a government dominated/influenced committee. This Group will also examine and rule on accountability issues. Government Ministries and their responsibilities will be rationalized as some of their work is transferred to independent Regulators.

Government must urgently establish four Institutes in each Region to conduct training, education and research on Energy issues and their regulation.

Regulatory Behaviour

Regulators must take special interest in supply and demand forecasting. Distribution companies must have freedom (subject to Regulatory Orders) to sell their Energy supplies over which they have contractual rights, to any customer. Vertically integrated operations (where one entity controls all operations from fuel to final supply to consumers) will require special attention from Regulators to ensure that transfer pricing is fair to consumers. Regulators must also deal suo moto with issues that push up cost of projects (such as red tape, bureaucratic delays, padding of equipment costs, efficiencies, etc).

The electricity regulators have to find ways to improve the distribution, improve efficiencies in subsidy targeting and costs, reduce or eliminate subsidies to the non-poor and make the subsidy reach the needy. This requires data on the poor and non-poor and a system to ensure that the non-poor are kept out of the subsidy mechanism. Cross-subsidies must be replaced by direct government funding.

Given that the supply-demand balance for Energy is unlikely to be in surplus even in 2025, Regulators will continue with cost-plus tariffs even in 2025. But the balance will change as competitive bidding comes into force for new projects and transmission capacity expands. Cost plus regulation by which the

Regulator looks at all costs including investment and allows or disallows costs for tariff purposes might become increasingly confined to long-term contracts.

Predictability is an essential requirement from Regulators. One-year tariffs do not offer this. Tariffs must be determined for at least three years at a time. Tariffs must ensure reimbursement of prudent expenditures. Independence must not be carried so far that Regulators do not interact with different stakeholders, at least to understand different points of view. Independent

regulators must have the requisite powers to make policy in relation to the tasks assigned to them. All data submitted to regulators for tariff determination must be accessible to anyone who is interested. If any information is to be withheld, the Regulators must give reasons in writing for nondisclosure.

Involvement of consumers must be ensured in the regulatory process. This should extend beyond well-informed and large consumers and must focus on the relatively ill-informed small groups. They must be supported with funding so that they can build their expertise. The office of a Consumer Advocate must be created in each Regulatory Commission to look after the interests of consumer groups. They can also help in selecting consumer group to be encouraged.

A good way to fund the regulatory commissions might be to put regulatory costs as an item in all consumer bills. The consumer then knows at all times what he is paying for the Regulator and evaluate the benefit in relation to the cost. Funding could also be by the creation of a corpus from which the income is available to cover regulatory expenditures and subject to external audit. It is undesirable that license fees and other fees levied on petitioners before the Commission, be used to fund the Regulatory expenses since there is an obvious conflict of interest.

The Regulator must demand that he be supplied all the information he needs from all parties: utilities, users, input suppliers and government. Appointment/reappointment of a Regulator must not be left to the Minister or his bureaucrats. Government should be definite on whether cross-subsidies are to be eliminated and within what period. If consumers are to be subsidized governments must be compulsorily made to make up the difference to the utility.

Independent commissions must use all possible ways to know the different shades of public opinion. For this purpose, the regulators must visit different locations, meet a variety of interests, use conferences and consultation papers to elicit opinion, conduct formal public hearings and in contentious matters, issue draft Orders that can be finalized after further opinions have been elicited.

CHAPTER XII

REGULATORY CAPTURE

Definitions

Responsible regulatory authorities by their active or passive behaviours (or their absence), that result in wrong, biased or unfair decisions, can be said to have been 'captured'. 'Regulatory Capture' protects the illegal, unethical, or immoral practices, against the public interest, by the same authorities that are charged with 'policing' the regulated entities.

Who are the Regulators?

'Regulators' in the widest meaning include professionals, authorities within corporations, governments and their officers, organizations or jurisdictions holding formal administrative, legislative, or ethical responsibilities for maintaining service, accountability, equity, in a predictable manner and transparently . They have specific jurisdictions in units of society, community and government. Examples from this 'regulator' class include auditors and accountants, lawyers and police, clergy and ethicists, medical practitioners and nurses, departments of government, private industry, 'watchdog' authorities, other professional bodies that have quasi-judicial status or relative independence for recognizing and disciplining their professional members, practicing professionals, researchers and scientists; and of course the independent regulatory authorities.

We could also add to this list, sports bodies like the Indian Olympic association, Indian Hockey Federation, etc. In almost all of them, office is practically held in perpetuity and the office bearers are not necessarily practitioners of the sport they regulate. Government rarely interferes with them. For example, the IHF under KPS Gill saw the nadir of Indian hockey but there was no change in the office bearers. This is true of many other Indian sports associations who regulate the particular sport.

Who are the captors?

The 'captors' are the 'regulated', again defined widely, and include organizations or coalitions or classes or networks of individuals who would be the focus of the accountability regime but for their success in 'capturing' that regime. Examples can include major industries, corrupt or pliant officials, important customers, large corporations, political associations, professional

elites-including members of professional 'guilds', community leaders, and in-house employees.

How is capture achieved?

The obvious way is through bribery and corruption. But that is a hazardous route since whistleblowers and a vigilant media can find out. Another method is by packing the regulatory authority with compliant members.

The selection process can be so manipulated that only such members are selected who will act according to the desires of the appointing authority, usually governments. The Indian regulatory legislation has ensured that by and large only retired or retiring government servants get selected for positions in regulatory bodies. In a government department, the Minister selects a compliant Secretary. In an 'independent' regulatory body, a retiring government official is more likely to be conditioned to think like the government and therefore to support government actions or desires. Almost every Chairman and Member of regulatory bodies in India is a former government official: this is so with few exceptions for Information Commissioners at the central and state levels under the Right to Information Act, Securities and Exchange Board of India, Central as well as State Electricity Regulatory Commissions, Telecommunications Regulatory Authority of India, Petroleum & Gas Regulatory Board, the newly appointed Competition Commission of India, the Directorate-General of Hydrocarbons, are a few examples. In every legislation creating these authorities the selection process that is legislated ensures that the dominant parties on the selection committees are people with present or past backgrounds in government service. This enables the packing of regulatory authorities with sympathetic, many times pliable, members.

This is not to say that all former government officials should be debarred from appointments to independent regulatory authorities. It is to say that they must be selected for their independence, and more importantly, they should constitute only a fraction of the total membership of the regulatory authority.

When state owned enterprises are a large part of the regulated entities, they do many times get their owners, the government, to act in ways that are in the interest of the enterprise. The 'independent' regulator follows the government's lead.

When there is one dominant player, publicly or privately owned, that player has a good chance of getting regulators and governments to act

in his interests. This has been the case especially in the oil and gas exploration and production sector all over the world.

How is capture used?

Let us say there is an electricity regulator who is to decide tariffs. He accepts gold plating of capital costs and this gives a much better return on investment because tariffs are set accordingly. Dhabhol and its continuing problems of high tariffs are according to the Godbole Committee's findings a result of the then regulator, the Governments of Maharashtra and India and their representatives accepting the capital costs quoted by the promoters. Those involved in the decision-making included Ministers, bureaucrats and officials of the electricity undertaking.

Obviously the governments concerned, abandoned the interests of the consumers that they were supposed to look after in order to allow Dhabhol much higher returns than should have been allowed. There was poor scrutiny and verification of all costs. Despite public protests by informed people, the costs were accepted. No one has been penalized for this wrongdoing.

In other cases the Regulator has compromised on legitimate tariffs and allowed much lower than permissible tariffs because the regulator had been captured by the government concerned. Postponing acceptance of a sizeable amount of legitimate and proven expenditures and declaring them as 'regulated assets' to be reimbursed later, is penalizing the investor because the political and bureaucratic masters want to prevent tariffs from rising, for electoral or other reasons.

Then there are state-owned enterprises, especially at the central level, who exercise considerable influence over the representatives of the owning Ministry. A good example is the way in which private investment in transmission was delayed over seven years after the law was amended to enable it. Power Grid Corporation, the central government monopoly in interstate transmission, was against this policy and was able to prevent action being taken.

The load despatch centre in electricity is the neutral and objective signaling and systems control mechanism that ensures that electricity flows over the wires and in acceptable frequency and voltage. It needs to be independent of all other users of the system. In India, the state government owned distribution enterprises have been able to maintain their control over the LDCs in order to safeguard their own interests.

There is of course blatant corruption when one of the parties bribes the regulator to take decisions that favour the bribe giver. This is common in almost all regulatory systems, including independent and transparent ones.

How does the captured regulator behave?

The captured regulator continues to carry out his responsibilities for lower level issues, and save his captured behaviours for the critical, higher level issues, where there is much more at stake. The captured regulator pursues such low level events with great vigour, even to the point of illegality, so as to convey the pretence of a dedication to duty that the captured regulator surrendered when it ignored the rules during the more strategic events.

In the case of electricity regulation, he might for example issue safety standards, introduce consumer advocacy etc, and receive kudos for doing so, but dance to the government's tune or that of the operating companies.

For example, 'open access' is a cardinal principle in the regulation of all public utilities. This is because the cost of transmission lines, pipelines, airports, etc, is high and there cannot be more than one in a prescribed area. The Electricity Act 2003 mandates open access, that is, all generators, distributors and buyers are entitled to use the transmission and distribution lines, so long as capacity is available. They cannot be denied and they cannot be discriminated against by higher tariffs. But state governments (Karnataka, Tamil Nadu, as instances) did not want the power generated in their state to be sold outside and have asked the electricity company to refuse open access to send the electricity out to another state, and also refused to pay the same higher price as could have been got by selling elsewhere. The respective state regulatory commissions have gone along with the denial of open access, an important element in electricity reform and legislation. The CERC has ordered that the states should follow the law. The matter is now before the Courts.

Another instance of capture is that of the self-regulating institutions like that of chartered accountants, cost accountants, company secretaries, etc. They are captured by their Members. In India these self-regulating institutions do not merely operate as Guilds by conducting examinations and permitting those that they pass to practice the profession. They are supposed also to enforce a code of conduct on their Members. However it has been very rare for almost any of them to punish wrongful behaviour, inefficiency or incompetence. The investigation itself takes many years, as for example in the case of the ICAI investigation of Price Waterhouse of faults in the auditing of Global Trust Bank accounts. Even when the transgression is proven, the firm is never punished, only a few individuals. At most there might be a brief suspension of the license to practice for one or more individuals.

This is like the police who even when they have carried out serious violations, usually find the low level constables or officers being punished, not the higher officials.

Self-regulators like the ICWAI or the ICSI also try to maximize incomes and employment for their members. Thus the ICWAI has lobbied successfully to make cost audit compulsory and in the process getting their members appointed as cost auditors, though most companies who go through this process do not see any value addition from it.

The Institute of Company Secretaries has ensured that any company with Rs 2 crore or more of capitalization has to have its own Company Secretary. Even if there is little to do for him, he cannot be shared with one or more small companies.

It is almost unheard of for the Medical Council of India or the Bar Council of India to punish its doctors or lawyers. Lawyers have vandalized Courts, battled the police and gone on strike but no action has ever been taken against them. Similarly doctors who are incompetent and damage patients have until recently gone scot-free. In recent years, the Consumer Courts have intervened to punish such doctors. Sports associations are another example of self-regulating bodies whose lack of competence has never affected the long tenure of office bearers.

What is the captured regulator's offence?

The principals of the captured organization act in breach of the relevant laws, or currently accepted morals and ethical standards, but they rationalize and cover-up that breach by invention of policies or legal interpretations that circumvent their sin or illegality. In their contrived rationale, they are merely following a policy or legal opinion or protocol or procedure, not breaking a law! Thus the regulatory authority might say he is protecting the consumers in his state, merely obeying state government directives, etc.

The captured organization rationalizes its behaviour. It might argue that its adversarial policy or legal interpretation is due to its perception that there is some perceived 'impossibility' about the strategic situation of the organization that demands such 'captive' behaviour.

There are instances where the captor organization selects its internal and external 'referees' - auditors, legal advisers, inspectors, investigators, consultants, researchers, ethicists, archivists, and others - for their compliance with the policy and for their silence about the breach. The recent example of Satyam is a good illustration.

In this way the regulator is robbed of its expertise and of its reason for being, namely to ensure that the regulated organization carries out its responsibilities to its stakeholders and the community that the regulator is supposed to ensure are achieved.

When the captors break a rule, the easiest thing would be to have the rule that they are breaking, deleted. They would rather prefer the sham of pretending to comply with the rule rather than doing away with it. The captors will exercise this preference because doing away with the rule would raise a furore in the media and public. Better to have the rule but find willing accessories among the regulators to violate it. .

What can be done to prevent capture or minimize its ill-effects?

Selection of independent regulators should be by a Search and Selection committee that is not dominated by any single interest-government, industry, academia, and judiciary. It must be advertised widely. All possible interest groups should be asked to make suggestions.

The media should be alive to misuse and abuse of powers by independent regulators, self-regulating bodies and departmental regulators in government and elsewhere. All instances should be publicized.

There should be provision for appellate bodies for each regulator in all categories, who can be informed of such capture or captive behaviours and who can investigate and take action. There should be provisions for each regulatory body that they can recommend suitable measures if the charges are proven.

All regulatory bodies should have the provisions that listed companies follow in having a Whistleblower Policy.

All regulatory bodies should consider decisions in an open and transparent manner.

Conclusion

Regulatory capture can be prevented only by a watchful media, community, customers and other stakeholders. It might help if the regulators are carefully selected for their values and integrity as well as independence. Unfortunately in India by and large, regulators are selected because they will be compliant to vested interests. Some steps can be taken to minimize the ill-effects.

CHAPTER XIII

REFORMING INDEPENDENT REGULATION

Governments in India have been opaque, with little consultation with affected parties, and enabling external influences of money and position on major decisions, especially those where high financial stakes are involved. Independent regulation, by which regulators were appointed under special legislation, was mooted by international financial institutions as a way to reassure private investors in power and telecommunications. This is a new type of governance in India. It is now 15 years old.

TRAI was the first independent regulatory commission, soon followed by the Orissa Electricity Regulatory Commission (ERC). The ERC Act in 1998 was the comprehensive legislation that led to the creation of the central and state electricity regulatory commissions. Some states had their own legislation for electricity regulatory commissions-Orissa, Haryana, Andhra, etc. Subsequently others came into being for oil and gas and for competition. Many are in the offing-for coal, civil aviation, roads, railways, airports, ports (absorbing the tariff authority for major ports-TAMP), energy as a whole, broadcasting, cable television, communication, (a sectoral regulator to promote, facilitate and develop carriage and content of all communications), water supply and sanitations, and for ground water. Education and health may also be regulated by independent bodies.

Prayas (a highly qualified NGO) conducted the first survey of electricity regulatory commissions in 2000. The report was reviewed by an expert group consisting of EAS Sarma, Madhav Godbole and myself. My book "Governing Power" was the first comprehensive review of independent regulation as a form of governance.

These and other papers and conference findings identify gaps between the different regulatory commissions on each of the major issues: independence & autonomy, their empowerment, accountability, transparency & public participation, and enhancing the quality of professional inputs for the regulatory bodies. New legislation that government is considering for a standard approach between the different bodies must take account of the many suggestions. The purpose must be to make independent regulatory bodies sturdy and independent, and with common objectives and functions.

Thus, selection committees for the regulatory bodies must not be ad hoc standing committees. Delays in constituting them must not take place, delaying (as they have repeatedly done), and the selection process. Statutory selection committees must not be composed primarily of current or ex-

bureaucrats but by others like current or retired superior Court judges nominated by a Chief Justice, Directors of reputed institutions like IITs, Lok Ayuktas, Chairman of the Central Administrative Tribunal, and Chairman of a national regulatory commission, with the Ministerial Secretary as convener. Not more than one current or retired government official, if at all, must be selected for any regulatory body, to signal the independence of the Commission. The Selection Committee should give justification for their recommendations and government, if it does not accept the selections, must record its reasons. These documents should be placed in the public domain and reported to the appropriate legislature.

The age limit for all appointments should be with reference to the date of appointment to ensure that they serve for one full term, of not less than 5 years. The procedure for the removal of members should ensure absence of political considerations. There must be no second term of office. No member or convener of a selection committee for any regulatory body shall seek appointment as chairman or a member of any of the regulatory bodies.

To provide financial autonomy to the regulatory bodies, each must have a separate fund raised through a cess on the regulated item. The regulatory bodies should be allowed to fund in-house consumer advocacy, promotion of consumer organizations and professional consulting support.

Government's powers issuing directives to the regulatory bodies must be transparent and severely constrained so that there is minimal interference in the work of the bodies. All the regulatory, licensing and other related powers must be incorporated as inherent powers of the regulatory body and not subject to government discretion. This will avoid the present farce of regulatory bodies created but not notified with their authorities.

The primary accountability of the regulatory body should be to the concerned legislatures before whom their Annual Reports must be placed within a prescribed time limit. These reports must explicitly disclose the number of public hearings held, the orders pronounced and their implementation by the concerned government, the directives issued by the government either under the statute or otherwise, the views of the regulatory body thereon, and the administrative and financial constraints imposed by the government on their functioning. It must also disclose the decisions, statements or announcements of the government on matters that are essentially within the domain of the regulatory body as well as such other decisions that tend to preempt the decisions of the ERC.

Government audits of regulatory bodies must be only of the expenditures, not of their decisions or their financial effects on government. All proceedings of the regulator should be translated into local languages and made available to the public, if necessary, by suitably pricing them, and through publication on the web. All regulatory orders should be circulated to the print media, especially in local languages. The regulator must be permitted by law to formulate a scheme to fund consumer organizations, provide for their training and to hold public hearings in states or districts, as the case may be, by rotation.

The objectives of regulatory bodies must have common features. Thus they must encourage, even stimulate, competition; and in cases where natural monopolies or other factors inhibit the development of competition, simulate its effects by regulation. In sectoral regulation they must have the powers not merely to promote competition, but also efficiency of operations and capital employed, achieve rapid growth, and enable equity of access and geographical dispersion of services. All regulatory bodies should have powers to make regulations, issue licenses, set performance standards, determine tariffs of the sector and not just parts of it, have powers to enforce their regulations, lay down licensing conditions, and take punitive measures including suspension or cancellation of licenses in case of violation.

All regulatory bodies must have oversight by an appropriate body like the appellate Tribunal or High Court, or through legislative committees through periodic reports that contain rules, regulations and notifications; summaries of provisional and final orders, with compliance status; disclosing methodology for inviting public opinion on important matters; recommendations made to government. Government policy directives to regulators must be general and not specific regarding decisions, issued only with Cabinet approval, only after consultations with Commission, and available to all. To stimulate the development of a body of regulatory law with precedents that can apply between and within sectors, the Indian Law Reporter must be encouraged to bring out a regulatory law digest for the benefit of all regulatory bodies, lawyers and the public.

The present structure of independent regulatory bodies has developed in a haphazard manner. It needs to be more uniform. The suggestions made here will go a long way to making it so. However legislatures and the executive are reluctant to allow the creation of such quasi judicial bodies that will take away authority from them, giving them to non-elected bodies. Already it is accepted that they should not be given adjudicatory powers, which must be with appellate bodies that are headed by someone form the higher judiciary. Electricity, telecom, competition, securities, already have them. They will

surely come up for other sectors. We must try to limit the proliferation of both the regulatory and the appellate bodies by combining them, alo ensuring coordinated functioning.

This new institution of governance enables public involvement through transparent functioning. It involves all stakeholders in decisions that affect them. Accountability is assured by their giving justification for all decisions.

ABOUT THE AUTHOR

Shri S L Rao is presently (2003-2009) Chairman, Board of Governors of the Institute for Social and Economic Change, Bangalore, a widely read newspaper columnist, writer and speaker on management, consumer markets, the economy and energy issues.

He is an economist by training and a professional manager with 28 years of work experience in Hindustan Lever Ltd, Warner Hindustan Ltd (now part of Pfizer) and Beardsell Ltd, at various levels including top management in marketing and general management, and five years running his own management consultancy.

He has taught marketing in the most reputed management schools in India as visiting faculty (Bajaj, IIMA, IIMB). In 1988, as executive chairman, he conceptualised, designed and conducted the National Management Programme, a unique effort of the three Indian Institutes of Management, Xavier Labour Relations Institute and Management Development Institute. This was a fifteen-month management programme aimed at mid-career government officers from the central services and business executives, all selected on the basis of objective testing.

In 1990 he was appointed Director-General of the National Council of Applied Economic Research (NCAER), the premier applied economic research institution in India. In his tenure of six years, NCAER became known the world over for its data on Indian markets, human development indicators, social infrastructure and economic forecasting. He also turned around the financial performance of NCAER and made it much less government, and more industry-oriented.

In 1998 he was invited by the Government of India to become the first chairman of the newly formed Central Electricity Regulatory Commission (CERC). He set up the Commission giving it a high image for its independence, transparency and objectivity. His writings and speeches on the subject of electricity reform greatly influence policies in this area.

He has been and continues to be associated with or on the boards of many institutions of management education, economic research and NGOs, such as Indian Institute of Management, Lucknow, Aga Khan Foundation, India, and Crafts Museum of South India. He is currently on the boards of Reliance Infrastructure Ltd, Reliance Natural Resources Ltd, Reliance Power Ltd., Honeywell Automation India Limited, Kanoria Chemicals and Industries Ltd, Rain CII Carbon Ltd, and Trustcapital Finance (Pvt) Ltd. He has been on the boards of SBI Mutual Fund, IFCI, Rane

Engine Valves, (advisory board) of Grindlays Bank, HEG, Jindal Strips and other companies. He is chairman of the audit committee of Honeywell Automation, Reliance Infrastructure, Reliance Power, Rain CII Carbon.

He has been (1996-98 and 2001 to 2009) a distinguished visiting fellow at The Energy & Resources Research Institute (TERI), and writes columns in the "Telegraph" and "Deccan Herald".

He was visiting fellow at the Indian Ocean Centre in Perth, Australia, in 1996-98, for many years wrote a column in the "Economic Times", has been a frequently featured television commentator and anchored the weekly television programme 'Crossfire' on Doordarshan TV (1996 to 1998).

He was president of the Madras Management Association in 1983-84, All-India Management Association in 1985-86, a founder and vice-president of the People's Union for Civil Liberties in Tamil Nadu in 1981-84, president from 1980-88 of the Society for International Development, Madras Chapter, and Convenor of the Futures Study Group in Bombay and Madras from 1972 to 1984. He was founder-chairman of the Forum of Indian Regulators.

He has written, co-authored or edited fourteen books and written hundreds of papers and articles on the economy and management. His books include *Successful Negotiations* (1994), *Indian Market Demographics - The Consuming Classes* (1996), *Elephants can't Dance -Managing in a Reforming Economy* (2001), *Governing Power: A New Institution of Governance; The Experience with Independent Regulation of Electricity (2004), Management Education in India* (2005) and *From Servants to Masters? - The Evolution of Professional Management in India* (2007). He was awarded the Ravi J Mathai Fellowship Award by the Association of Indian Management Schools in August 2001.

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