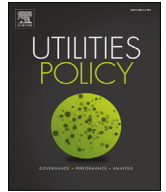


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## Utilities Policy

journal homepage: [www.elsevier.com/locate/jup](http://www.elsevier.com/locate/jup)

## Regulation inside government: The challenges of regulating a government-owned utility<sup>☆</sup>

Alketa Peci<sup>\*</sup>, Márcio Leite D'Assunção, Michelle Moretzsohn Holperin, Celso Florêncio de Souza

Brazilian School of Public and Business Administration, EBAPE Getulio Vargas Foundation, FGV EBAPE/FGV, Brazil

### ARTICLE INFO

#### Article history:

Received 16 August 2017  
 Received in revised form  
 17 September 2017  
 Accepted 18 September 2017  
 Available online xxx

### ABSTRACT

This article explores the process of independent regulation of a government-owned utility (GOU) in the water supply and sanitation (WSS) sector drawing on the theory of regulation inside government. Our fieldwork focused on recent efforts by the Rio de Janeiro state WSS utility (CEDAE) to comply with requirements imposed by an independent regulatory agency (IRA). Our findings highlight the challenges of regulating GOUs and identify key political factors that induce state governments, through state-owned companies, to shirk regulation. The multi-level governance structure of Brazilian WSS sector adds to the complexity of “regulating inside the government”.

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### 1. Introduction

Most water supply and sanitation (WSS) companies in developing countries are government-owned, with less than 10% of the urban population being served by private operators (Marin, 2009). In Brazil, this holds true. Private operators served only 316 out of the 5570 municipalities in Brazil, or 5,6% of the total (ABCON, 2016). This scenario has not changed in 2017: there are only 320 municipalities attended by private operators, an increase of less than 2% when compared to 2016. The lack of private investments imposes obstacles to WSS growth in a context of restricted public investments (Motta and Moreira, 2006).

Since the 1990s, a decrease in the number of partnerships with private operators has been counter-balanced with alternative reforms toward corporatization, meaning efforts to make government-owned companies “operate as if they were private firms facing a competitive market, or, if monopolies, efficient regulation” (Shirley, 1999: 115). Corporatization may include a broad array of strategies, such as incorporating government-owned utilities (GOUs) under the same commercial laws as private firms; removing barriers to entry, subsidies, and special privileges; forcing

GOUs to compete in financial markets on an equal basis with private businesses; or giving more discretionary powers to GOU managers (Bottomley, 1994; Marin, 2009; Shirley, 1999).

Corporatization strategies have been partially adopted in several government-owned WSS utilities in Brazil, accompanied by a growing trend to subject these GOUs to the regulatory scrutiny of Independent Regulatory Agencies (IRAs) with the aim of implementing regulatory models patterned after those used for private utilities (Ehrhardt and Janson, 2010). Given the governmental affiliation of both IRAs and GOUs, we find this relationship to be a typical case of government regulating government, with its specific regulatory challenges, different in many aspects when compared to the regulation of private utilities (Hood et al., 2000; Lodge and Wegrich, 2012; James, 2000).

The literature offers little theoretical leverage and even less empirical evidence on regulation inside government (Konisky and Teodoro, 2015). Previous studies have been particularly critical of the challenges that regulators of private water suppliers face in developing countries (Marin, 2009; Rivera, 1996), despite the dominance of government-owned water utilities. Ehrhardt and Janson (2010) demonstrated that conventional regulatory regimes applied to GOUs might be of little use. Barbosa and colleagues showed in different studies that WSS companies regulated by independent agencies that use price-cap and revenue-cap instruments are associated with lower efficiencies than those that can negotiate directly with the municipality (Barbosa and Brusca, 2015; Barbosa et al., 2016). Only utilities subordinated to hybrid

<sup>☆</sup> The authors would like to acknowledge the funding received from Brazil's National Council for Scientific and Technological Development, CNPq (Grant Nr. 310976/2014-6).

<sup>\*</sup> Corresponding author.

E-mail address: [alketa.peci@fgv.br](mailto:alketa.peci@fgv.br) (A. Peci).

regulatory regimes, i.e., combining two or more instruments, and rate of return are associated with better efficiencies in this sector (Barbosa, 2013). In the same direction, Carvalho and Sampaio (2015) explored the performance of regulatory authorities in fostering efficiency among regulated companies and found that (i) technical efficiency was higher among unregulated companies and (ii) regulatory activity has so far failed in assuring better performance among utilities providers. What those studies suggest is that the presence of an independent agency is not a necessary or sufficient condition for a better performance of WSS service providers.

Within this scenario, our field research explored the recent efforts of the state of Rio de Janeiro WSS utility (CEDAE - Companhia Estadual de Aguas e Esgotos) to comply with the regulatory requirements imposed by a relatively new multi-sector (energy and WSS) state-level IRA (AGENERSA - Agência Reguladora de Energia e Saneamento Básico do Estado do Rio de Janeiro). Our research is based on historical and archival research, participant observation, and direct interviews with GOUs and IRA reformers, executives, representatives, and current and former regulators of the company.

Drawing on the political theory of regulation inside government (Konisky and Teodoro, 2015; Lodge and Wegrich, 2012; James, 2000), this article argues that the tendency of the state government, through its state-owned company, to shirk regulation is related not only to the political costs of losing direct control of the GOU, but also to the potential loss of a traditional instrument of political control in several municipalities. Despite the formal and legal trends to grant municipalities more power in the WSS sector, several mechanisms reinforce the dual dependency of the GOU and IRA on the state government, which, in turn, becomes an obstacle to effective regulatory enforcement.

Further, the singularity of the political configuration of Brazilian WSS both, in relation to its similar in the rest of the world and in relation to other regulated sectors in Brazil (Motta and Moreira, 2006; Pinheiro, 2016), adds to the challenges of regulation inside the government. We argue, particularly, that the multi-level governance structure that characterizes Brazilian WSS sector adds complexity in “regulating inside the government” dynamics, and translates in complex procedures, flexible regulatory schedules, and ongoing negotiations to set up and enforce regulatory instruments.

## 2. Regulating inside government

GOUs present a classic case of regulation inside government, as regulator and regulated are both governmental organizations (Konisky and Teodoro, 2015). On the surface, GOUs might seem to be questionable exemplars, because they avoid strict categorization as public or private entities. In practice, many GOUs are seen as government-affiliated bodies involved in private sector activities, or as representing governmental usage of the corporation, which is usually regarded as a private legal formation (Bottomley, 1994; Prosser, 1986). Despite the fact that most GOUs are separate corporate entities incorporated under the private company law, research has demonstrated that mimicry of private companies generally fails, and that most GOUs behave like government bodies (Ehrhardt and Janson, 2010).

Regulation, the act of ensuring that things are done properly by public and private organizations, is related to legal rules, indicating that the organizations are somehow held “accountable for their behavior and performance” (Ashworth et al., 2002: 196). According to Hood et al. (2000: 321), regulation inside the government domain relates to “the range of processes by which standards are set, monitored, and/or enforced in some way, by bureaucratic actors.” Broadly speaking, regulation inside government refers to the army of inspectors, auditors, grievance-chasers, standard-setters,

and other monitoring bodies that oversee contemporary public organizations (Hood et al., 1999). Regulatory activities encompass both third parties that carry out public services on behalf of the government, and public structures developed and maintained to ensure economy, efficiency, effectiveness, quality, and equality in the service delivery process (James, 2000).

Regulators rely on different types of enforcement mechanisms involving, for example, binding standard-setting, monitoring, and imposing sanctions (Koop and Lodge, 2015). Some view regulatory instruments more broadly, as a mix of sticks (legal mandates), carrots (incentives or disincentives), and sermons (communication) (Zehavi, 2011). Inside government, Lodge and Wegrich (2012) indicate four modes of regulation: (i) oversight – monitoring and directing from a point of authority; (ii) competition – the use of private and public providers of public services; (iii) mutuality – when standards are set by consensus and result from participatory processes; and (iv) contrived randomness – when standards and approaches remain uncertain or are acted upon in unpredictable ways.

The role of freestanding regulatory bodies that monitor GOUs and other public organizations (Lodge and Wegrich, 2012) is particularly relevant for our case. Our research focuses on secondary regulators, or the oversight of bureaucracies by other public agencies endowed with some sort of official authority (Hood et al., 2000: 284), what are referred to in this paper as Independent Regulatory Agencies (IRAs). Secondary regulators generally operate with different institutional procedures and divergent aims, namely “one public bureaucracy in the role of an overseer,” with “an organizational separation between the ‘regulating’ bureaucracy and the ‘regulatee,’” and “some official ‘mandate’ for the regulator organization to scrutinize the behavior of the ‘regulatee” (Ibid.). The common feature of these regulatory bodies is that they operate, to some extent, outside of the normal chain of command but within the governmental structure (Lodge and Wegrich, 2012:122).

Though regarded as important, regulation inside government has scarcely been theoretically or empirically explored (Boyne, 2003; Konisky and Teodoro, 2015). Most contributions to the literature focus on the formal presence of regulatory bodies and their influence on the performance of certain sectors, particularly in the case of private operators. In the context of water utilities, research has revealed the imbalance between the limited means and capabilities of public regulators and the capacity of experienced private operators (Rivera, 1996), but such an imbalanced relationship can also result when the regulated company is a GOU.

Strong evidence suggests that public firms are more likely to violate regulators' requirements than private ones (Konisky and Teodoro, 2015). Regulation inside government is more problematic than third-party regulation due to the political nature of government activities, the turf battles between organizations, and the inherent inability of government entities to respect hierarchical authority for compliance, as supposedly occurs in private regulation (Lodge and Wegrich, 2012; Wilson and Rachal, 1977). James (2000) has also pointed out reasons for the failure of regulation inside government, including the risks of being captured by regulated bodies, regulation in the interest of the regulators, and excessive costs of regulation.

Previous empirical research in the water sector supports this view. Ehrhardt and Janson (2010) demonstrated that regulation does not improve the performance of government-controlled water utilities, and, consequently, may be of little use for GOUs. They attribute this evidence to the fact that GOUs are not commercially competitive and face systematic incentives for short-termism in tariff setting, because both regulator and GOU fail in the necessary role-playing that the “corporatization plus regulation” model requires (2010: 36). Berg (2013) also concluded that the mere

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