

Independent Regulatory Agencies: A Theoretical Review With Reference To Electricity and Water in India

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Independent regulatory agencies have become an important part of the governance landscape in India and elsewhere. Some regulators have achieved useful outcomes. However, the creation of independent sectoral regulators in India has not been accompanied by critical reflection on their role, or attention to the political, legal, and institutional contexts within which they operate. This study explores various theoretical perspectives on the political economy of regulation, and elaborates on the implications these have for electricity and water regulation in India. The paper focuses on three themes: why governments create independent regulators, the meaning of “regulatory governance” and how it can be improved, and how regulators can address concerns such as social issues embedded in economic decision-making.

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The creation of independent regulatory agencies is a relatively recent phenomenon in India, and indeed in much of the developing world. Worldwide, one study (including but not limited to utilities) found that the number of new regulators (including but not limited to utilities) created per year burgeoned from less than five between the 1960s and 1980s to more than 20 in between the 1990s and 2002 (based on a study of 49 countries and 16 sectors), with a peak of almost 40 new agencies a year in the period 1994-96 (Jordana, Levi-Faur, and Marin). Clearly, independent regulatory agencies have become an important part of the governance landscape worldwide, increasingly so in India. In the Indian public service or utilities sectors, independent regulation is well established in telecoms and electricity, and may now be emerging in water.

1 Introduction

What do I mean by “independent regulation”? While regulation in some form has always been a key part of the state role, independent regulatory agencies (IRAs) are distinguished by being separated from the executive branch of government so that they function independently. Moran defines regulation as “the administrative technology of controlling business through law-backed specialised agencies”. Originating in the US, this approach spread to the European Union (EU), and, particularly during the 1990s, to the developing world.

This paper is motivated by a perception that the dash to create independent sectoral regulators in India has not been accompanied by critical reflection on their role, or attention to the political, legal, and institutional contexts within which they operate.¹ This is not to say that these institutions have been unhelpful or should not have been created. But it is to say that their functioning has been considerably muddled, and occasionally undermined, by a failure to ask and develop answers to the broader questions about the role of independent regulators. For example, given their control over a sub-set of economic decisions, how should regulators be placed under political control, while not compromising their independence? Is it possible to draw a clear line between the economic and social content of decision-making, or do regulators have to be attentive to social concerns while making economic decisions? For instance, in eliminating cross-subsidies (an important theme in India) regulators are likely to impose costs on the poor and the vulnerable. Should they be required to balance these agendas or should social issues be dealt with elsewhere? These are the kind of issues that motivate this

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paper. Addressing these political, legal, and institutional questions will both help strengthen existing regulatory bodies, as well as help make informed decisions about the need for new regulatory agencies and their structural design.

To stimulate and contribute to this broader discussion on the role of independent regulation in governance, I explore various theoretical perspectives on the political economy of regulation, drawing from the international literature on the topic.² While the paper is predominantly theoretical, I begin by grounding the discussion with a short review of the status of electricity and water regulation in India, to understand the concerns that motivate debate today. The body of the paper is organised around three theoretical themes. First, I deal with the underlying theories of regulation—how do we understand the reason for establishing IRAs and what frameworks can we draw on to understand how they work in practice? Second, I explore the idea of “regulatory governance,” which examines different ways of understanding how the regulator interacts with governments and other stakeholders. Finally, I turn to some consideration of the scope of regulatory action, particularly examining whether there is a clear line between economic goals on the one hand, and social or environmental goals on the other. I conclude by briefly returning to the electricity and water context in India.

2 Electricity and Water Regulation in India

I begin with a short overview of electricity and water regulation in India to understand contemporary concerns, and highlight the importance of the political and institutional context for regulation. Electricity regulation has a track record of just under a decade in the country, with regulators operating in almost all states. In contrast, water regulation is an entirely new area, with only one state, Maharashtra, having formally established a regulatory agency. Below, I describe each sector in turn.

Since independence, state-level departments have regulated public-owned State Electricity Boards (SEBs).³ The first departure from this model occurred in Orissa, as part of a larger World Bank-supported programme of reform and restructuring of the SEB, aimed at “unbundling” the component parts of the sector, introducing management reforms, and privatising the sector.⁴ In practical terms, the key role of the regulator was taking over the tariff-setting role of the government, but also more generally exercising oversight that allowed the producer’s and consumer’s needs to be balanced. The vision for regulation within the larger reform project was “... to ensure the sustainability of tariff reform ... *inter alia* to attract sufficient private investment and protect the interests of consumers” [World Bank 1996; 7]. To do this, the regulator was “... to insulate Orissa’s power sector from the government and ensure its ... autonomy”. In other words, the fundamental purpose of electricity regulation was to create an apolitical space for electricity decision-making, both to send a signal of credibility to investors and to protect consumers. Thus regulation has been based on the somewhat questionable premise that it is feasible to create an apolitical regulatory sphere simply by legislating one.

Once the Orissa Electricity Regulatory Commission (OERC) began its work, the double-edged nature of regulatory

“independence” became apparent. The OERC did not raise tariffs to attract investors as reform designers had assumed, but instead expressed concern that consumers should not bear the cost of past mismanagement. While the government lost control over using tariffs for populist and other political ends, so did the reformers as a means to attract investors. The Orissa approach to regulation has rapidly spread to other states, and was adopted more or less intact by the central government in the form of the Electricity Regulatory Commissions Act (1998).

The Electricity Act (2003) has retained but extended the same approach. In practical terms, regulators have a central role in implementing both electricity markets and the rule-based mechanisms for regulating tariffs and quality of service. Given the continued salience of regulators, the 2003 Act provides no solution to the larger structural problem, while governments formally commit themselves to tying their hands to the mast by establishing regulators, though in practice they use very loose knots.

In sum, electricity regulators were introduced as a way to signal credibility to attract investment rather than directly help the consumer. Moreover, given that regulators regulate state-owned enterprises, the regulatory system requires one branch of government to regulate another.⁵ As a result, perhaps the most frequently cited concern is that regulators are not really independent of the government, and therefore fail to achieve the primary objective for which they were established. Other concerns focus on how best to improve regulatory effectiveness by improving institutional capacity and procedural robustness.⁶ An additional challenge is their role in moving a sector towards competitive market structures, which raises important questions about how to balance efficiency and social safeguards.

Turning to water, independent regulation is in its early stages, and raises quite different questions from those in electricity. A water regulator was constituted in Maharashtra in 2005, and legislation to introduce water regulators is in process in at least three other states—Arunachal Pradesh, Gujarat and Delhi [Warghade 2007]. As with electricity in Orissa, the Maharashtra water regulator was established as part of the larger World Bank-supported “Maharashtra Water Sector Improvement Program”. Within the programme, the Maharashtra Water Resources Regulatory Agency (MWRRA) is tasked with regulating and facilitating judicious, sustainable and equitable management of water. Its functional tasks include determining entitlements, establishing tariffs, reviewing projects, and addressing other concerns such as conservation.

While the MWRRA is too new to have a track record, its creation itself poses important questions. One set of issues relates to perceived weaknesses in its procedures, which could come in the way of ensuring transparency, participation and accountability [Warghade 2007]. Even more significant, the MWRRA controls key decisions such as allocating entitlements over water, and establishing and regulating water trading to ensure that water goes to the highest value user, decisions which carry significant potential social consequences [Dharmadikary 2007]. How will the associated trade-offs between social objectives, economic objectives, and efficacy in regulation be managed? In addition to these operational questions, the very newness of the regulatory

experiment in water suggests an even more fundamental question: is independent regulation the right mechanism for governance in the water sector?

What issues does this brief review throw up for discussion of independent regulation in India? The case of electricity suggests that regulatory independence from the executive is not easily achieved by the stroke of a pen. It also points to concerns over how procedures are implemented in practice, something the case of water potentially shares. In both electricity and water, as critics have pointed out, the World Bank's role in promoting regulatory formation has led to an emphasis on using regulation as an instrument of financial reform, to the possible exclusion of other concerns such as equity, equal access, and environment (ibid). Most fundamentally, both cases suggest the challenge of resolving potential conflicts and trade-offs between social and economic objectives.

Whether, and how, regulators are structurally equipped to deal with these issues was inadequately considered when regulatory agencies — in particular those for electricity — were established, and even now it has received only incomplete attention.⁷ With electricity regulation ripe for a review, and water regulation only now being introduced, it is appropriate that we take a fresh look at theories and ideas on the subject to understand how independent regulation can be a tool for governance, as well as its limits.

3 Theories of Regulation

The literature on regulation is voluminous, and spans political science, law and sociology, as well as economics. Each of these traditions frames its questions in different ways. One useful way to cut across disciplines, however, is to group the theories under the categories of public interest, private interest, and institutional theories of regulation [Morgan and Yeung 2007].

3.1 Public Interest Theories

Writings on regulation have their longest history in the us. The intellectual justification for regulation appeared in an early judgment of the us Supreme Court, *Munn vs State of Illinois*, which dealt with whether a legislative assembly could limit the prices charged by private railway companies for storage of grain being transported by those railways. In this frequently cited judgment, the court ruled that when "...one devotes his property to a use in which the public has an interest, he, in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good..." [Touro Law Centre 2005]. The judgment is significant because it provides a basis for state control over private property when the public interest is involved.

The most common invocation of regulation in the public interest is that of regulating monopolies. From this perspective, regulation is a substitute for competition, where competition is not possible for reasons of natural monopoly,⁸ for provision of public goods, or to address externalities. From this starting point, the goal of regulation is clear: to increase allocative efficiency.

However, the practice of regulation is seldom that straightforward, for at least two reasons. First, perspective regulation rests on neutral and competent regulators reliably choosing a single correct answer to regulatory problems. Both assumptions—

neutrality and competency — as well as the existence of a single correct answer, are problematic, as I discuss further below.

Second, this approach unduly limits the scope of regulation. Scholars such as Sunstein suggest that there are grounds for regulating in the public interest when various "substantive" values such as social justice, diversity, or redistribution are involved [cited in Morgan and Yeung 2007: 27]. Sunstein notes that the choices that individuals make as consumers may not be equivalent to those they make as citizens; as citizens they may wish to live in a society that has attributes that cannot be obtained simply by buying goods as a consumer. Note that the Munn judgment, although delivered in the context of a private rail monopoly, suggests that pursuit of the "common good" is an overarching rationale for regulatory intervention, which provides legal space for intervention beyond the narrow case of monopoly to include substantive values.

If such substantive values are to be promoted in the regulatory process, however, then we have to move beyond a vision of regulators as a neutral technical entity to one capable of choosing between alternative social values. This leads immediately to a discussion of regulatory legitimacy; since regulators are unelected, how do they derive the legitimacy to make alternative social choices? One influential answer, given by Prosser (1999) is that regulatory legitimacy is derived from procedural robustness, which allows for social choices to emerge from deliberation within regulatory processes. I return to this theme below.

The public interest view of regulation is criticised for its naiveté about the good intents of regulators, a critique particularly developed by the private interest theories that follow. Moreover, when regulation extends beyond the vision of neutral and competent regulators applying well-known principles to regulators as social decision-makers, the public interest view of regulation also raises concerns about legitimacy and accountability.

3.2 Private Interest Theories

Private interest theories of regulation begin with a critique of the public interest view as politically naive. They question the optimistic assumption that simply because a case can be made for promoting the public interest, regulatory actions will indeed do so. They suggest, instead, that regulators emerge to serve the private interests of individuals or organised groups. If they also serve the public interest, then that is merely a fortunate side-effect of serving private interests. There are many variations of the private interest view, including a Marxist perspective which sees regulatory agencies as a sort of franchise on public power handed out by the state to private interests [Moran 2002].

Perhaps the best known elaboration of the private interest approach is the theory of regulatory capture most closely associated with George Stigler (1971). Stigler argues that "as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit." Indeed, "... the problem of regulation is the problem of discovering when and why an industry (or other group of like-minded people) is able to use the state for its purposes."⁹ An interesting variant of the capture theory (which preceded Stigler's work) suggests that regulatory agencies go through a life-cycle, characterised by an early pioneering spirit,

only to fall prey to capture as they develop increasingly close relations with industry [Bernstein, cited in Moran 2002].

Stigler's work is part of a larger school of "public choice" theories that place the emphasis on regulation as the outcome of a political marketplace in which voters, politicians and bureaucrats all work to maximise their self-interest. More recent versions go beyond other forms of the capture theory by moving beyond only the bilateral relationship between regulator and regulated. Regulation may be designed to further the interests of a political elite and to preserve its power [Cook et al 2004]. For example, the regulatory bureaucrat may collude with both the regulated and politicians to maximise his agency budget. The prescriptive implication of public choice is to rely on the market where possible, and severely limit reliance on regulation and regulatory agencies.

The main criticism of the private interest view is its absolutism [Morgan and Yeung 2007]. While this may be a necessary corrective to the naiveté of the public interest view, it leaves no space whatever for expression of the public interest. For the theory to serve its predictive role, all action has to be understood as entirely self-serving, and self-serving in terms of either narrow economic or political returns. Moreover, the capture theory has been critiqued for exercising a circular form of reasoning: if a regulation benefits an interest, it must have been designed to do so. This form of thinking excludes competing explanations. At the same time, the public choice variant of private interest theories does seem to resonate in the Indian context, given that electricity and water utilities are for the most part owned by the public sector. While little has been written on situations where the regulated entity is publicly owned, as is often the case in India, the public choice perspective that allows for "political capture" may yield some insights.

3.3 Institutional Theories

While the theoretical categories of public and private interest views on regulation are well established and widely used, the institutionalist category is somewhat less cogent. Morgan and Yeung (2007) suggest the term "institutionalist" to capture the rule-based (formal and informal) explanations of these ideas, their examination of internal institutional dynamics, and their common efforts to blur the divide between public and private rules. Here, I briefly discuss three such approaches: "regulatory space", "responsive regulation", and a "stakeholder model" of regulation. The first is largely focused on providing a model with which to understand regulation, while the latter two have clear normative implications.

The *regulatory space* idea associated with Hancher and Moran (1989) starts by questioning the assumption that there can be a distinct and inviolable public sphere separate from the private. Instead, they argue that under advanced capitalism, the large companies being regulated carry out many functions of an essentially public nature. Thus, they do not just provide basic services, their decisions on investment, employment, output and research have implications that carry over to the public sphere. Hence, the key question becomes not trying to force apart public and private, but better understanding the space within which organisations with these mixed attributes interact. Doing so requires not only looking at those within the regulatory space, but also those

excluded from it, and seeking to understand why. The authors suggest that exclusion is often driven by the details of institutionalised procedure such as standard operating procedures and customary assumptions. As a result, national peculiarities also become important; regulation is not the same everywhere. In sum, the regulatory space idea prompts us to look at the empirical specifics of regulatory spaces, including national legal traditions, organisational actors, and specific procedures.

The idea of *responsive regulation* makes the paradoxical suggestion that regulation should aim for an optimal level of capture [Ayres and Braithwaite 1992]. Too much interaction of the wrong sort risks capture, but equally, too little interaction and limited regulatory discretion — typical solutions proposed to the problem of capture — risk rigidity, limit innovation, and stifle cooperation. The proposed solution is regulatory "tripartism", where a third actor, civic associations or "public interest groups" (PIGs), is introduced as a "fully fledged" player in the regulatory game. As suggested here, PIGs have access to all the information available to the regulator, have a seat at the table when all deals are done, and have equivalent standing to sue as does the regulator. Accountability of PIGs is accomplished either through competition for assuming the role of a PIG, most likely through a vote, or making them accountable in some way to other PIGs. Notably, the PIG need not be a disinterested party. For example, trade unions could be involved in occupational health and safety regulation, or an industry association of flour grinders could help regulate wheat prices. The idea is that insiders may be the ones with both information and interests to participate effectively, and in promoting their own interests, will also promote the larger interest. More broadly, in different circumstances, responsive regulation may involve delegating regulation to PIGs, unregulated competitors, or even self-regulation by companies. An underlying idea is that to achieve the objective of effective regulation with limited interference, conditions should be created where persuasion is the dominant strategy. Command regulation with punishment must remain a realistic, but little used, threat. This idea is captured in the image of a regulatory pyramid, where the broadest part comprises self-regulation and the narrow top, command and punishment. In a subsequent paper, Braithwaite (2005) argues that developing countries with a regulatory capacity problem are particularly ripe for responsive regulation in a model of "networked governance", where the regulatory state relies heavily on non-state actors to participate in the task.

The role of external actors beyond regulator and regulated is also central to Prosser's (1999; 2005) *stakeholder model* of regulation. Similar to the regulatory space approach as well as tripartism, regulation is explicitly understood as a network of relations that includes not only regulator and regulated, but also competitors, consumers, employees, and so on. But now regulators are expected to explicitly pay attention to the interests of different stakeholder groups, and seek to achieve a balance among them. The legitimacy of regulators is then tied to how well they do so. Note that this is exactly the opposite of what comes out of the capture theory of Stigler and others. The stakeholder approach leads directly to a focus on strong procedures in the regulatory process to ensure openness to a full range of interests. Prosser

also takes the argument further and argues for explicit efforts to compensate for inequalities in power or information across different stakeholder groups. Not surprisingly, the main problem with this theory is the challenge of implementability, both conceptual and practical. Conceptual challenges with implementing this approach include the difficulty of developing criteria to determine which interests should be considered, how to weigh them, and how to decide among them. Practical challenges include managing the potential risk of deadlock, and implementing a more proactive form of stakeholder regulation which compensates for existing inequalities.

Institutionalist theories share the common aim of bringing more realism to understanding regulatory processes than either public interest or private interest theories. Public interest theories are naïve in seeing regulators as straightforward agents of the public interest, do not provide any answers to situations where the means of limiting monopoly power are unclear, and provide no basis for pursuing substantive aims through regulation. Private interest theories swing too far in the opposite direction, and tautologically equate regulation with capture, though they provide a useful corrective to the naïveté of the public interest perspective. For these reasons, I suggest that an institutionalist perspective is a useful starting point for considering regulator agencies in India. From this brief review of a few leading theories of regulation, it emerges that with an effort at realism comes a greater attention to the wider web of stakeholders that surround a regulator: that regulatory space theories explicitly call attention to actors that surround the regulator; that responsive regulation emphasises interaction between regulator, regulated, and other stakeholders; and that stakeholder theories start by presuming that regulators should be designed to serve the interests of stakeholders. While there remain many unanswered questions about how to practically engage stakeholders, the literature suggests a common attention to the importance of their role.

4 Regulatory Governance

The above discussion suggests that regulators have to take on a significantly expanded role, indeed, as Prosser (1999) puts it, be “governments in miniature”. This is at a considerable distance from the vision of regulators as narrowly focused entities that derive their legitimacy from technical expertise and political neutrality alone, as with the simple version of the public interest theory. It requires exploring further how regulators fit within, and are shaped by, larger governance structures, and how regulators operate when they are viewed as a governance structure. In this section, I discuss how the concept of regulatory governance arose from the imperative of protecting investor interests, and also how the concept has progressively been broadened, so that it can equally be understood to focus on questions of the accountability and legitimacy of regulation to the public.

4.1 An Investor Perspective

The term “regulatory governance” was popularised by Levy and Spiller (1994) in a path-breaking paper. The paper was significant for introducing regulatory economists to issues that had hitherto been the domain of political scientists, and for doing so using the

language of “transaction cost” economics.¹⁰ The task of regulation was understood narrowly as limiting the scope for arbitrary administrative action (such as expropriation or politically motivated tariff setting), thereby creating conditions favourable to investment.

The key insight of the paper was that while much attention had been paid by economists to regulatory incentives — how regulators could use their tools to set incentives for efficient performance — too little had been paid to the “mechanisms that societies use to constrain regulatory discretion and resolve conflicts ...” In other words, regulatory governance. Understanding these mechanisms required exploring issues such as the separation of powers between different branches of government, the extent to which the judiciary could be counted on as a dispute resolution forum, whether bureaucracies were strong or weak, and other features of the larger political environment within which regulation operated. Notably, Levy and Spiller concluded that the model of independent regulatory agencies was only appropriate in a limited set of contexts, and in other contexts, the use of contracts, or continued public ownership and control, were more appropriate.

4.2 Delegation and Regulatory Creation

A more overarching framework within which to understand regulatory governance is the issue of delegation. Regulation is characterised by the delegation of authority from elected bodies to “non-majoritarian” institutions, that is, those that exercise authority but are not directly accountable to the people. The problem, then, is to explain why elected bodies would voluntarily choose to delegate authority, and with what consequences. The problem is further made complex by the need to consider where, in fact, authority does reside prior to delegation. As Anant and Singh (2006) note with reference to the Indian Constitution, when there is a “weak” separation of powers, the problem is not only one of legitimate delegation, but also effective delegation.

Typical answers to the problem of why delegation occurs include governments’ desire to signal credible commitment (for example, by handing over tariff decisions they promise not to interfere in), overcome information asymmetries (specialised bodies may do better at unearthing information), and avoid taking blame for unpopular policies (by blaming decisions on “independent” regulators) [Thatcher and Sweet 2002]. These are all functional explanations (that is, the existence of the regulator is explained by the function it is meant to perform) consistent with the transaction cost framework of Levy and Spiller.

However, there are other, more sociologically oriented explanations to explain the problem of delegation. Sociologists argue that institutions such as independent regulators spread because a perception is created through a complex process of social construction that regulation is the best solution to a particular type of problem. Once constructed, regulators may be created through an epidemic of borrowing, often for symbolic reasons [Thatcher and Sweet 2002]. The result is that regulation as a form of governance becomes more legitimate than others, and indeed, can favour one set of actors over another. Moreover, institutional design by copying — “isomorphism” in sociological terms — can

also occur through coercive means, through the imposition of conditions as has occurred in Europe (such as regulation as a precondition for entering the EU), and through donor conditions, as in many developing countries. This sociological explanation certainly appears to fit the way in which electricity regulation, for example, spread in India.¹¹

4.3 Problem of Accountability and Legitimacy

Viewed from the perspective of delegation, the creation of IRAS raises questions beyond Levy and Spiller's narrow concern with signalling predictability to investors, to larger issues of legitimacy and accountability. If democratically elected legislatures and appointed executive bodies hand over a portion of their powers to regulators, then it is incumbent on them to ensure that the regulators are also accountable in some form. Moreover, ensuring accountability is a precondition for regulatory legitimacy.

The question of how to ensure regulatory accountability was the subject of a substantial study by United Kingdom's House of Lords, entitled 'The Regulatory State: Ensuring its Accountability' (House of Lords 2004). The British experience is of interest because many experiments in developing countries, including India, have followed the attempts made by the UK in utility restructuring, and regulation and competition in areas such as electricity and water. The Lords study suggests accountability should be achieved through a three-part approach: the duty to explain backed by robust processes; exposure to scrutiny, including but not limited to parliamentary scrutiny; and scope for independent review and appeals. Moreover, it calls for a "360 degree" view of accountability, whereby the regulator is accountable not only to parliament, ministers and courts, but also to citizens, interest groups, consumer representatives, individual consumers, and regulated companies.

As Prosser (1999) notes in his discussion of the stakeholder model of regulation, this vision of regulatory accountability places considerable emphasis on robust procedures, particularly to ensure open access to information and participatory procedures in regulation. From this perspective, "regulatory governance" moves from the investor-focused emphasis on predictability espoused by Levy and Spiller to a citizen-focused emphasis on democratic accountability.¹²

This perspective has recently inspired both theoretical and empirical work that suggests ways to improve regulatory governance. Palast et al (2003) argue that the democratic checks in place in the US regulatory system have served well and resulted in a relatively well-functioning electricity system. Hira et al (2005) review the mechanisms for public participation in operation in different electricity regulators around the world. These range from the common public hearing model, and a public survey and research model, to direct public participation. The Electricity Governance Initiative is an effort to develop an analytical framework for governance procedures in electricity, including but not limited to regulation, and apply it to four Asian countries, including India [Nakhooda, Dixit and Dubash 2007]. That the concept has become mainstream is exemplified by a US Agency for International Development Study which sees the legitimacy

of regulators tied to the effectiveness of their public participation processes [USAID 2005].

There have also been multiple efforts to examine democratic regulatory governance in India, with most of the work focused on the electricity sector. A survey of regulators by Prayas Energy Group examined the functioning of multiple electricity regulators, documenting several loopholes in regulatory procedures [Prayas 2003]. The Electricity Governance Initiative concludes that while legal procedures are relatively robust in India's electricity regulation, the "software" of selection processes, use of procedures, and civil society's capacity to use those procedures pose problems [Mahalingam et al 2006]. A case study-based analysis of three state regulators — in Delhi, Andhra Pradesh and Karnataka — found that while public participation has brought some gains, the degree of confidence in regulatory stakeholder processes is well short of that required to confer legitimacy on existing regulators [Dubash and Rao 2007].

In some ways, the literature on regulatory governance has gone full circle. The early literature explored the conditions under which regulators could serve as a way around the unpredictability in decision-making that comes with the rough and tumble of political processes. More recent literature seeks to explore whether the full range of interests are sufficiently well represented in regulation, evoking Prosser's idea of regulation as "government in miniature". Regulation, it would appear, cannot legitimately bypass political processes. Instead, the question that now emerges is whether through attention to procedures and processes, regulation can be both a robust and efficient process for representation of interests

5 Regulation and Social Objectives

To summarise the argument so far, the institutionalist perspective provides a middle road between the extremes of public and private interest theories. It thereby reclaims some space for regulation in the public interest, although with the caution that particular attention has to be paid to the national and historical context. It cannot be taken for granted that regulation *will* act in the public interest. The discussion on regulatory governance led us to consider the importance of procedures as a way of providing space for the full range of stakeholders, thereby bolstering the accountability and legitimacy of the regulatory process.

Are robust procedures that provide space for the voices of all stakeholders a sufficient basis for regulatory effectiveness and legitimacy? As Prosser (1999) argues, robust procedures still require some basis on which alternative competing interests are to be weighed and prioritised. In other words, even procedurally robust regulatory processes require some "substantive" guidance.

5.1 Market Efficiency as Substantive Value

The latest wave of regulatory agencies has come bundled with public enterprise reform and privatisation. As a result, maximising economic efficiency has either implicitly or explicitly emerged as the predominant substantive goal of the regulatory process. This is certainly true of Indian electricity, and is also a major factor in the processes emerging for water regulation. Combined with the goal of regulatory predictability, utility regulation

has emphasised formula-based, predictable regulation that achieves the goal of efficiency enhancement.¹³ In practice, however, this approach has proved problematic, conceptually and practically.

On the conceptual plane, Stewart (1975) notes several obstacles to using economic logic as a determining rule for regulation: applied economics is an art that often produces multiple, not single answers; preferences over alternative choices do not remain fixed by change over time, leading to questions about which set of preferences decisions should be based on; distributional concerns are inadequately addressed; and economic analysis leaves no space for “process values” on which legitimacy depends. In her insightful analysis of larger regulatory trends, Morgan (2003) argues that competition, or the prioritisation of market logic, casts a “shadow” over social citizenship, by which she means the aspiration to growing equality and fairness in the social and economic spheres.

From a practical viewpoint, the experience of the UK, the benchmark for regulatory reforms, is useful to consider. The first UK electricity regulator, Stephen Littlechild, is known for formulating a price-setting formula linked to the retail price index that purported to automatically promote efficiency while reducing regulatory discretion. In practice, however, the formula has had to be modulated for political reasons such as ensuring that companies receive an acceptable rate of return on assets. As a result, regulators have had to return to scrutinising the internal functioning of utilities, re-introducing regulatory discretion [Thomas 2005]. In another example, the regulator has been forced to grapple with social issues such as the interests of low-income groups. Thus, the country’s Utilities Act of 2000 makes consumer protection the primary duty of the regulator [Owen 2004]. Over time, the onset of privatisation in the UK has had the ironic result of the emergence of an explicit body of public service law where none existed before [Prosser 2000].

Similar lessons on the blurring of economic and social objectives emerge from a close scrutiny of Indian electricity regulators [Dubash and Rao 2007]. While the regulator is legally mandated to reduce cross-subsidies (a higher price paid by one consuming class to reduce prices for another), in practice, regulators make political judgments about whether and how much to do so. There is also substantial evidence that instead of following the mandated cost-plus formulae to determine tariffs, they use various creative means to keep tariffs within politically acceptable bounds. Despite these tensions, nothing analogous to the UK’s emergence of a body of public service law has, as yet, occurred in India.

This discussion suggests that the implicit assumption that regulation in India can and should be a single-minded instrument of applying economic logic is both misplaced and unworkable. Seeking to exclude social objectives only drives the consideration of these objectives underground. As Prosser (1999) puts it, “No single logic can or should form a basis for their [regulators’] decision-making and they should not be seen as capable of implementing a mandate of simply applying government guidance.” Instead, the aim should be development of an *explicit* framework within which social choices are made in the regulatory process.

5.2 The Search for Workable Substantive Principles

An important precondition for regulation as a means of governance is for the policy process to determine the substantive principles (or outcome-oriented goals) that will guide regulators. There are two parts to the task.

First, the broad substantive guidelines handed down to regulators from the legislature need to be defined, and done so in an open and transparent fashion. At the moment, the Electricity Act 2003, for example, provides a long list of regulatory tasks, but does not set clear priorities for how competing priorities are to be met.¹⁴

Second, keeping in mind that regulatory discretion cannot entirely be legislated away, the literature suggests the need for a robust set of procedures that allow discretion to be legitimately applied in keeping with substantive principles. One interesting approach to defining these principles is to suggest that the proceduralist approach (interest representation through robust participation) can only work under conditions of certain minimum social welfare rights. Then implementing these rights — such as the right to water, a livelihood, etc — then themselves become part of the regulatory objective [Prosser 1999].

Arguments against implementing substantive goals — such as ensuring reasonably priced access to water and electricity — through regulatory process are based on the perceived lack of legitimacy of unelected regulators. However, as discussed above, regulators already make these decisions; they simply do so in non-transparent ways and without clear substantive guidance. Acknowledging this discretionary and substantive role of regulators and providing them guidance would be a step forward. Moreover, with appropriate procedural safeguards, regulatory processes could be potentially more legitimate than parliamentary ones, in that they could provide greater scope for consideration of all interests and issues.¹⁵ This argument is strengthened in the context of many developing countries, such as India, where parliamentary processes are not seen as highly legitimate or effective.

In closing this section, it is important not to give the impression of scholarly consensus on the issue of whether and how regulators should be guided by substantive values, and the link between procedural values (good processes) and substantive values (good outcomes). There remains considerable debate on how to ensure regulatory consistency and legitimacy while steering clear of unrealistically rigid and rule-bound regulation. What is clear, however, is that robust procedures are an important part of the regulatory story, and that there needs to be space for debate and discussion on substantive values for regulation that goes beyond the application of economic logic alone.

5.3 Substantive Values to Tangible Social Outcomes

The concerns that motivate a social agenda in regulation include issues of access to electricity and water; appropriate pricing for low-income groups; attention to quality of service issues, including special provisions such as those that permit the use of prepaid meters; and related social issues such as the rights of labour employed in the electricity and water sectors. Given the limited experience with regulation in the developing world, there is a

definite scarcity of literature examining the implementation of these social issues within a regulatory framework. The literature that does exist tends to detail individual cases rather than drawing larger lessons.

One experience, however, that reinforces the larger point being made here about substantive values is that of South Africa. In South Africa, the right to basic services such as electricity and water is enshrined in the constitution. This provides a ready benchmark for substantive guidance to the regulator. Hence, debate over regulatory approaches and objectives in that country tend to centrally include discussions over access [Camay and Gordon 2005]. For example, the city of Johannesburg held a major international conference on pro-poor regulation as part of its development of a regulatory framework. The lesson that emerges is that a large part of the battle involves the appropriate framing of regulatory responsibilities; as in an enabling act or, as in South Africa, by including it in the constitution. For instance, the potential formulation of water-related regulatory acts by India's states cries out for intervention to include social objectives.

The recent trend toward replacing public control with privatization and market principles has had the effect of orphaning social policy. This example suggests that there is some precedent for viewing regulators as a place where the details of social policy can be worked out. If indeed the state, in the form of the executive, is to play a less central role in delivering electricity and water services, then regulators remain perhaps the only viable option for pursuing a social agenda. Moreover, with appropriate procedural safeguards and a substantive mandate, it is worth asking whether independent regulation, under some circumstances, can even be an improvement over a centralised bureaucracy as a space for social policy.

6 Conclusions: Regulation and Social Policy in India

Regulation in India is still a recent institution. It is also an institution that has not fully gained public confidence (at least in the electricity sector) even as there is talk of expanding regulation in other sectors (notably water). In this concluding section, I wish to briefly return to the specifics of electricity and water regulation in India and relate it to the larger ideas on regulation discussed in this paper.

The establishment of electricity regulators broadly followed the Levy-Spiller template outlined above — regulation as a means of limiting arbitrary decisions, so as to attract investors.¹⁶ At the same time, following establishment, the official rhetoric has been one that conforms to the naïve public interest view that regulators can, in a straightforward manner, ensure the common good. In practice, however, regulators have had to apply discretion and judgment at every turn, on some occasion making decisions on the basis of efficiency enhancement, on others, bowing to political dictates and pressures to account for social outcomes. The original hope that electricity regulators would function as some sort of island insulated from politics appears to have been flawed in its conception.

The institutionalist view provides a more realistic representation of how regulation works in practice, but, in India, little thought has been given to how regulatory mechanisms can be

designed to legitimately cope with stakeholder, or indeed government, pressures. Public participation procedures enshrined in regulatory statutes have led to some transparency and discussion, but neither have these been followed diligently, nor have they been used to their full potential, in part due to the weaknesses of civil society. In pursuing their functions, electricity regulators have largely adopted the rhetoric of economic efficiency as the dominant substantive value, even while their actual decisions have reflected political and social compulsions, albeit in a non-transparent fashion.¹⁷ While regulators have led to some gains in both process and outcome, regulatory performance across states is erratic and idiosyncratic, resting heavily on particular individuals. Taken together, it is hard to avoid the conclusion that the assumptions on which electricity regulators were built are largely incompatible with the political and institutional context within which they operate, requiring regulators to make ongoing ad hoc adjustments.

Water regulation is a far more recent institution. Once again nudged along by donor influences, the early signs are that water regulation will share in the fiction of an apolitical space for decision-making. The role of procedural safeguards and the need for active public participation as central elements in the regulatory process once again seem to be lost. The process is seemingly driven by the vision of handing over problems to an apolitical, objective, and competent technocrat — the naïve public interest view. However, the social stakes in water regulation, and therefore the latent political pressures, are, if anything, greater than in electricity regulation. Without greater thought and a course correction, water regulation is likely to repeat many of the weaknesses of electricity regulation. Given the greater and more direct social stakes in water, water regulators will be called on even more often to exercise judgment on politically sensitive matters, based on an even thinner base of legitimacy and credibility. Indeed, the basic question whether independent regulators are an appropriate form of governance for water has not been posed and answered, but only assumed.

There are grounds for scepticism about regulatory institutions, but at the same time, decades of state control over electricity and water services have not inspired confidence. In this model, social goals were intended to be directly addressed by ministries. However, there was little scope for public debate and discussion over what the social goals should be and how they should be addressed. So, the option of public ownership and control also offers little guarantee of success. The choice is between imperfect options.

One way is for policymakers, academics and activists to consider whether there is an altered vision of regulatory bodies that provides a workable route to more democratic and effective governance of water and electricity. What might such an altered vision look like?

Regulatory design might be usefully based on three sets of ideas, as the above discussion makes clear. First, regulatory bodies should be explicitly based on an institutionalist perspective that allows for regulation to be an effective instrument of promoting the public good (unlike capture theories), but does not presume that it always will (like public interest theories). Instead, regulators have to be carefully designed, with attention to the

political and institutional context within which they operate. In India, this context includes the reality of public ownership of most electricity and water providers; the existence of a few large and dominant private firms in some segments of the electricity sector; a limited pool of both skilled commissioners and staff; limited public familiarity with regulatory processes; and the nascent, though potentially potent, state of civil society. While the specifics of regulatory design defy easy prescriptions, recognising the nature and parameters of the institutional design problem are an important first step.

Second, the concept of regulatory governance needs to be expanded, with the emphasis shifting from signalling credibility to investors to larger concerns of democratic legitimacy with the public. Indeed, the two are related, since without legitimacy with the public, assurances to investors may be overturned at any time under populist pressure. In a complete reversal of the conventional wisdom, the route to legitimacy and effectiveness of electricity regulation lies in reorienting the institution to be an active site of political debate, rather than an island in a sea of politics. At the same time, the delegation of important decisions on electricity and water to regulatory agencies can only be considered legitimate if the political playing field is level. This requires robust procedures of transparency and participation, their active implementation in letter and spirit, reasoned evidence to indicate that public participation actually effects regulatory decisions, and explicit efforts to build public capacity to participate in regulatory processes. In other words, credible regulation would have to truly provide a democratic space for decision-making.

Third, regulation would have to be guided by a larger substantive framework debated and defined at the legislative and

executive levels, which makes consideration of social goals an explicit part of regulatory objectives. At the moment, regulators operate as if there is one economically correct answer to every question, but make back-door adjustments to accommodate social and political pressures. A clear substantive framework would force explicit and transparent consideration of trade-offs and alternatives.

This discussion is particularly salient to the water sector. Substantive guidance to the regulator that defines the scope of decisions that can be taken by the regulator, and provides a set of parameters within which regulatory discretion can be applied, is essential if regulators are to take on social concerns. Since regulatory acts are yet to be written in most states, there is a moment of opportunity to shape the framing of water regulators. Also, the experience of electricity regulators suggests that the first few years of operation is critical in setting down the institutional norms that shape how the regulator actually functions. It is important that sound procedures for participation be enshrined at this early stage.

In conclusion, this paper has highlighted that independent regulatory agencies are a complex institutional form. Questions of regulatory legitimacy, the extent to which they can provide a democratic space, the degree to which they can and should have discretion, are all questions that should be actively debated and contested. Whether regulatory institutions hold greater prospects for gain or harm needs to be discussed on a sector by sector basis. If, on balance, regulatory institutions hold out promise, there is the need to frame an agenda of their substantive purpose, which includes social policy, and reorient them towards democratic governance.

NOTES

- 1 There is, however, a reasonable amount of work on techniques and methods through which new IRAs exercise their powers, such as on alternative regulatory approaches to tasks such as price setting, and controlling entry and exit. This work, which is not the focus of this paper, is complementary but by no means a substitute for attention to the political economy of regulation.
- 2 Notably, as correctly pointed out by M H Zerah, an author and reviewer, this review is largely restricted to the Anglo-Saxon tradition that focuses on distinct regulatory agencies, as opposed to a quite different mainland European tradition that examines the function of regulation without assuming the need for a separate regulatory commission. This paper is restricted to the Anglo-Saxon tradition of independent regulatory agencies because its introduction in India is a fait accompli. However, examining other institutional traditions would yield important insights on alternative institutional forms for regulatory tasks.
- 3 In addition to state regulators, there is a central regulator that is responsible for issues that cross state borders, such as electricity transmission.
- 4 For comment and discussion on electricity reform in India and worldwide, see Dubash and Singh (2005). For a brief review of the history of India's electricity sector, particularly during the 1990s, see Dubash and Rajan (2000).
- 5 I am grateful to E A S Sarma for stressing these points in his review of this article. For further perspectives along these lines, see Sarma (2004).
- 6 See, for example, Rao 2004, Prayas Energy Group 2003, Godbole 2000, Mahalingam 2005, Dubash and Rao 2007.

- 7 The only attempt to do so is contained in a Planning Commission discussion paper 'Approach to Regulation of Infrastructure: Issues and Options' released in 2006 and available at <http://planningcommission.nic.in>.
- 8 A natural monopoly occurs when it is less costly for one rather than many firms to produce a commodity for reasons of economies of scale. Under such conditions, forcing many producers would lead to efficiency losses, so it is better to simply allow a single firm, but regulate the price it charges.
- 9 Notably, the evidence amassed to support the capture theory rests heavily on studies of IRAs as opposed to other forms of regulation (e.g. environmental or health regulation from within a government department).
- 10 More recent work seeks to update the Levy and Spiller approach and apply it to Asia (Cubbin and Stern 2005; Stern and Cubbin 2005).
- 11 I have tried to reconstruct this process elsewhere, in Dubash and Rajan (2000).

- 12 For one, partial effort to spell out a governance-based analysis of regulation, see Minogue 2001.
- 13 Often associated with this is the view that social objectives are best served through minimalist regulation, through allowing market forces to drive down prices to everyone's benefit [Smith 2000].
- 14 In contrast, the Utilities Act of Britain clearly states the primary interest of regulators is to protect the interest of consumers, with the rider that wherever appropriate this is to be done by promoting competition [Owen 2004].
- 15 Wood (2005) argues forcefully that "confusing democratic governance with voting should simply be unacceptable". She suggests that limiting discussions of democracy to voting alone exclude sensible and full consideration of governance in decision-making processes such as regulation.
- 16 However, it must be noted that Levy and Spiller are much more nuanced in limiting the conditions under which regulators can work than were the designers of regulation in India.

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17 This composite snapshot is compiled from several different recent sources [Prayas 2003; Mahalingam et al 2006; Dubash and Rao 2007].

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