

## *Chapter 1*

### **The why and the how of being an independent regulator**

*Understanding the benefits, challenges and the practical implications of independence is crucial for the performance of the regulator. However, fully understanding these different aspects of independence can be difficult. This chapter presents the methodology adopted to address some of these difficulties. It provides an overview of what independence is expected to bring to regulators and some key insights on the practical requirements and practices in place to safeguard independence.*

## Purpose

Independence does not mean that regulators are “anonymous... silent... above... over... beyond the System”.\* Regulators are key players in the policy arena with an active role in implementing public policies (Box 1.1). It is inevitable and desirable that regulators interact with ministries, who are ultimately responsible for developing the policies for the regulated sector; parliaments, who approve those policies and often evaluate their implementation; the regulated industry, which need to comply with the decisions of the regulator; and citizens, who are the ultimate beneficiaries of the actions of governments and regulators. Understanding the benefits, challenges and the practical implications of independence is therefore crucial for the performance of the regulator.

### Box 1.1. What is a regulator?

The *OECD Best Practice Principles on the Governance of Regulators* define a regulator as an entity authorised by statute to use legal tools to achieve policy objectives, imposing obligations or burdens through functions such as licensing, permitting, accrediting, approvals, inspection and enforcement. A regulator can use other complementary tools such as information campaigns, to achieve the policy objectives, but it is the exercise of control through legal powers that makes the integrity of their decision-making processes, and thus their governance, very important.

There are a number of different types of regulators with different roles and responsibilities – among others, economic, financial, overseeing competition and/or consumer protection or setting technical standards and/or a mix of some of these roles. This report focuses on economic regulators and regulators with both economic and competition/consumer protection responsibilities. While the sector and the responsibilities of a regulator can affect the relevance of some of the issues discussed in this report, these issues, including what is appropriate influence of the political power, regulated industry and other stakeholders can apply to all regulators.

*Source:* OECD (2014), *The Governance of Regulators*, OECD Best Practice Principles for Regulatory Policy, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264209015-en>.

- \*. Regulators are not Men in Black, who will “not stand out in any way. Your entire image is crafted to leave no lasting memory with anyone you encounter. [...] Anonymity is your name. Silence your native tongue. You're no longer part of the System. You're above the System. Over it. Beyond it.” From the film “The Men in Black” (United States, 1997), directed by Barry Sonnenfeld.

This report responds to the request from members of the Network of Economic Regulators to better understand the practical implications of independence for regulators (Box 1.2).

### Box 1.2. The OECD Network of Economic Regulators

What makes a “world-class regulator”? The OECD Network of Economic Regulators (NER) has been addressing this question through objective data, rigorous analysis and dialogue. A subsidiary body of the OECD Regulatory Policy Committee, the NER facilitates peer-to-peer learning and exchange of experience across approximately 80 regulators from OECD members and non-members responsible for network sectors such as communications, electricity, gas, payment services, transport and water.

The work of the NER builds on the recognition that governance matters to ensure good regulatory outcomes and the delivery of essential services to citizens. The NER has contributed to developing the *2014 OECD Best Practice Principles on the Governance of Regulators* (OECD, 2014) to help regulators assess their governance arrangements and strengthen their performance. It has contributed to improving the relevance and focus of the first Product Market Regulator Survey on Regulatory Management of Network Regulators, which look at formal arrangements for independence, accountability and scope of action of regulators overseeing energy, telecommunications, rail, air transport and ports. In parallel, specific work on water has identified the governance arrangements of water regulators, based on a survey of 34 regulators. The NER has also developed a Performance Assessment Framework for Economic Regulators (PAFER) for reviewing regulators’ efforts towards measuring their own performance, which is being applied to a number of NER members, including regulators in Colombia, Latvia and Mexico.

*Source:* OECD (2014), *The Governance of Regulators*, OECD Best Practice Principles for Regulatory Policy, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264209015-en>; OECD (2016a), “The OECD Network of Economic Regulators”, [www.oecd.org/gov/regulatory-policy/ner.htm](http://www.oecd.org/gov/regulatory-policy/ner.htm) (accessed 15 April 2016).

At a roundtable on the independence of regulators organised during the 4th meeting of the NER in April 2015, NER members discussed the rationale, practical implications and impact of independence on regulated sectors. The discussion highlighted:

- **Long-term regulatory stability:** regulators can help align the interests of users and, more broadly, citizens and society with the interests of investors in key sectors like energy, water, transport and telecommunications. Independence from the executive government (which would, for example, require specific procedures for agency head/board appointments and dismissals, protection from political influence on regulatory decisions and some autonomy in managing

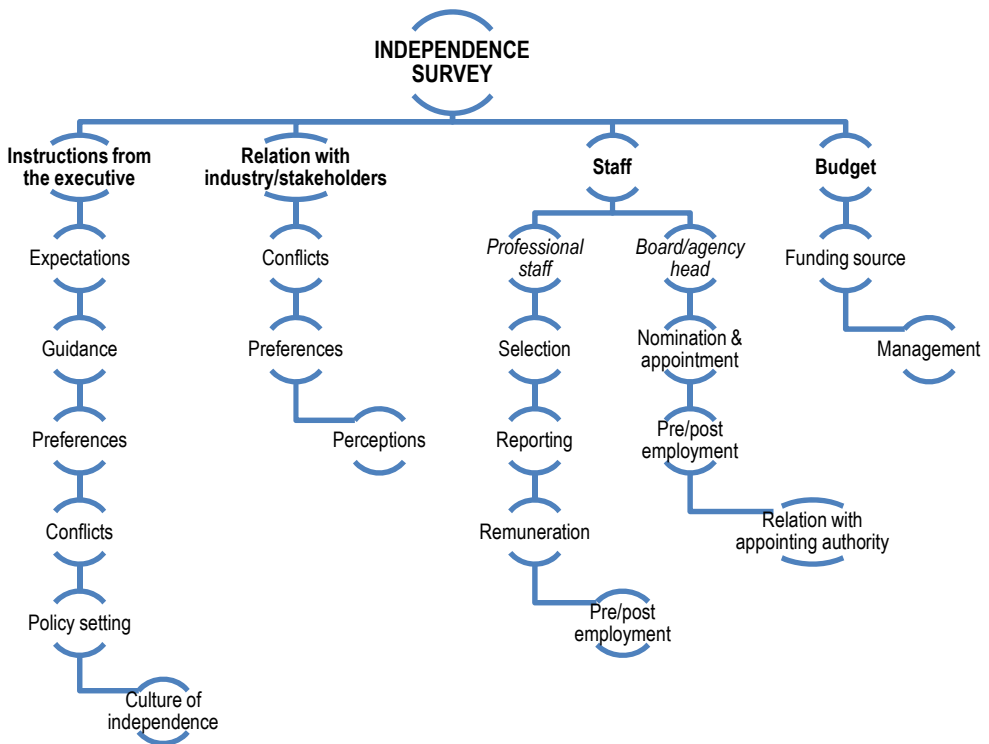
human and financial resources) can shield regulators from short-term party politics and help ensure a stable and credible regulatory environment that facilitates long-term investment. If protecting regulators from the “undue” influence of the executive can strengthen investors’ confidence, it is equally important that regulators do not fall prey to “undue” influence from the regulated industry or be captured by the narrow interests that could be expressed by consumer groups, especially when consulting on regulatory decisions. The integrity of the regulator vis-à-vis industry helps address the shortcomings that usually characterise these markets (e.g. monopolistic power and asymmetric information) and make the best use of available resources. It is equally important for ensuring trust of citizens (i.e. the end users of network industries) in an unbiased regulatory environment where regulators are also not captured by powerful consumer lobbying groups (either directly or indirectly through other pressure from other parts of government): users can thus make decisions that fit their preferences and provide the “right” signals to markets.

- **Role clarity and accountability:** independence does not mean that regulators will work in a vacuum, without appropriate checks on their work or disconnected from executive government’s decisions. Independence is hard to realise if the roles and respective responsibilities of the executive government and regulators are unclear and ill-defined. Little clarity on the respective roles creates “grey areas” where the decisions on policy priorities and objectives (the responsibility of elected governments) are mixed with regulatory decisions that should contribute to achieving these objectives (the responsibility of independent regulators). Setting clear and transparent boundaries on who does what and which institution can be held accountable is essential to guarantee independence of regulatory agencies and make them accountable for what they do.
- **Changes:** independence is not a static given. The composition and preferences of executive governments (and parliaments) change and, ultimately, these institutions retain the responsibility for the institutional framework of regulatory agencies. Regulated sectors tend to evolve rapidly, responding to technological change and changing user preferences. In such a dynamic institutional and economic environment, a deeper understanding of the practical implications of independence and how to realise it is paramount, not only for regulators but also for executive governments and other stakeholders.

## Methodology

The report draws on a *literature review* prepared in co-operation with the Chair of Governance and Regulation of the Paris-Dauphine University to present the rationale, determinants and some of the expected outcomes of independence (Chapter 2). To identify some of the practical implications of independence (Chapter 3), the report draws on the answers provided by NER members to an independence survey that includes a set of *practical questions on the independence of regulators* and was circulated among NER members between July and October 2015.

Figure 1.1. Structure of the independence survey



Source: OECD (2015), OECD Survey on the independence of economic regulators.

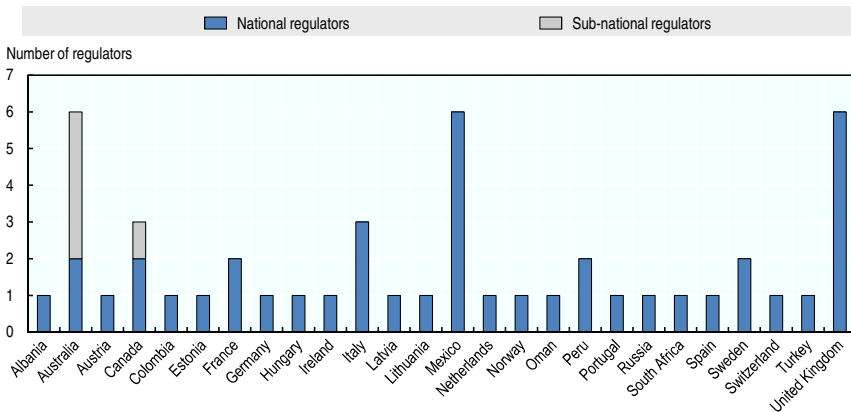
The survey contains mostly descriptive data on *de facto* and some *de jure* arrangements supporting the independence of regulators. To deepen the body of knowledge already collected through the Product Market Regulation – Regulatory Management (PMR – RM) dataset, the survey is

structured around the same themes that were surveyed for the independence section of the PMR – RM dataset plus a section on the relationship with stakeholders, which was included at the request of NER members. An early draft of the survey was discussed at the 4th meeting of the NER. The final survey reflects extensive inputs from NER members (Figure 1.1).

### Data coverage

Forty-eight regulators from 26 countries completed the independence survey questionnaire. Respondents included 18 OECD countries, 3 accession countries (Colombia, Latvia and Lithuania) and 5 non-members (Albania, Oman, Peru, Russia and South Africa). For eight countries, more than one regulator responded to the questionnaire. Respondents included also five sub-national regulators from Australia and Canada (Figure 1.2).

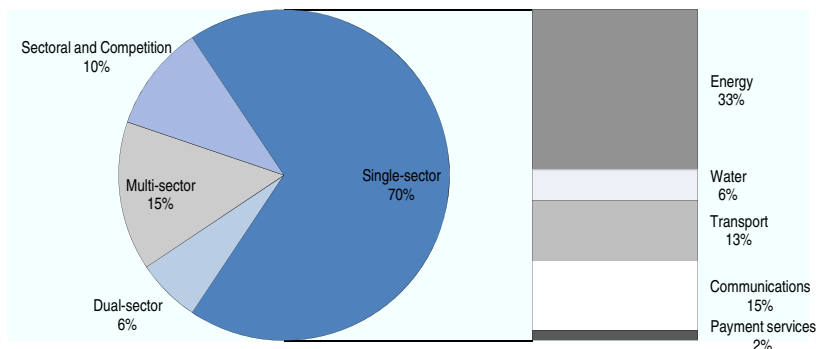
Figure 1.2. Independence survey respondents by country



Source: OECD (2015), OECD Survey on the independence of economic regulators.

A diverse mix of regulators is represented in the results, ranging from single-sector regulators to regulators that have both sector and competition functions. Participating regulators are mostly responsible for a single sector (70%), the majority of which oversee energy regulations, followed by communications, transport, water, and payment services. Two dual-sector regulators are responsible for both water and waste management sectors. There are also seven multi-sector regulators included, as well as five regulators with both sector and competition functions (Figure 1.3).

Figure 1.3. Profile of participating regulatory agencies



Source: OECD (2015), OECD Survey on the independence of economic regulators.

## The why of independence

### *Rationale*

There is value in separating some of the regulatory functions, especially those related to administering regulation, from the policy-setting and fiscal policy functions that are exercised by government. Regulation is expected to mitigate market failures at minimum cost. Independence of regulatory agencies can enhance the role of regulation in minimising market failures, by enabling regulatory agencies to address:

- **Lack of commitment, time inconsistency and political uncertainty:**
  - ❖ An independent regulator can *resist pressures to lower or increase prices at the expense of cost recovery, long-term maintenance and service quality* in the regulated sector;
  - ❖ A *long-term mandate of the regulator (beyond the electoral cycle, for example)* can help resolve time inconsistency and fluctuations linked to the political as well as economic business cycles.
- **Lack of competitive neutrality ensuring a level-playing field for all operators:**
  - ❖ An independent regulator signals to investors that the *rules will be set and followed without interference from the government*, and without undue preferential treatment linked to state ownership of certain market actors.

- **Information and expertise asymmetries:**
  - ❖ Independence promotes professionalism and expertise when the selection of staff (both senior management and professional) is based on merit. A regulator staffed with technical experts and shielded from political interference should have the *competence and skills* to: set prices which accurately reflect and adapt to costs; and monitor and enforce quality standards that preserve incentives for long-term performance, while maximising efficiency and welfare.
  - ❖ An independent regular might be more inclined to consult a broader spectrum of the population to *get a diversity of opinions* before making any regulatory decisions.
- **Regulatory capture:**
  - ❖ *Financial autonomy* of the regulator would mean in principle that the regulator has adequate resources to carry out its duties. This can help minimise opportunities for capture by industry and other lobby groups, as well as by government. Lack of resources can impede the capacity of regulators to take informed independent decisions.

### ***Determinants***

Understanding fully the determinants of independence across different market contexts, however, remains relatively difficult. Academics have developed a number of indices to measure and assess the drivers of independence (Box 1.3).

#### **Box 1.3. Independence indexes: most frequent dimensions**

- Budget independence;
- Conditions for dismissal of the head of the regulatory agency;
- Appointment of members/head of the regulatory agency by parliament or the legislature;
- Accountability and reporting to executive, legislature, or representatives from regulated industry;
- Power to set tariffs or price-setting; and
- Power to review or approve contract terms between regulated entities or market actors).



The majority of these indices have been produced taking the telecommunications market as a reference, in part because regulatory independence has a longer history in this sector. This sector focus masks some sector-specific differences. The OECD Product Market Regulation (PMR)'s Regulatory Management (RM) indicators for sector regulators, developed with inputs from the NER and drawing on the *OECD Best Practice Principles on the Governance of Regulators* (OECD, 2014), seek to address this sector bias by providing a more granular approach to independence (Koske et al., 2016). In addition, the PMR-RM indicators make a clear distinction between independence, accountability and scope of action of regulators, which tend to be somewhat blurred in the academic literature (Box 1.4).

#### **Box 1.4. Product Market Regulation's sector regulators: independence**

##### **Instructions from the executive**

- The regulator can receive instructions/guidance from the government regarding long-term strategy, work programme, individual cases, appeals.
- Which body, other than a court, can overturn the decisions of the regulator?
- Is the regulator an independent body and is its independence explicitly stated in the law?

##### **Staff**

- How is the majority of the staff recruited?
- Which body has the legal authority to make the final appointment of the agency head/board members?
- Are there restrictions regarding the employment history of the agency head/board members?
- May the agency head/board members hold other offices/appointments in the government/the regulated industry?
- How can the agency head/board members be dismissed from office?
- Can the agency head/board members take jobs in government or regulated sector after their term of office?
- How long is the term of office of the agency head/board members?

##### **Budget**

- How is the regulator financed?

*Source:* OECD (2016b), "Indicators of Product Market Regulation Homepage", [www.oecd.org/economy/growth/indicatorsofproductmarketregulationhomepage.htm](http://www.oecd.org/economy/growth/indicatorsofproductmarketregulationhomepage.htm) (accessed 15 April 2016).

The PMR-RM indicators, like most of the indexes developed by academics, focus on *de jure* formal requirements for independence. Yet a regulator can be part of a ministry and in fact be more “independent” than a regulator that is a separate body. Studies and surveys conducted by transnational networks of sector regulators have stressed the importance of the financial autonomy of regulators as a key practical determinant of independence. This attention for this practical aspect of independence partly reflect EU legislation in the energy and telecommunications sectors, which prescribes some form of autonomy for national regulatory authorities to manage their budget. Nevertheless, with the exception of these few surveys, attempts to capture *de facto* regulatory independence have been few. Some examples include measuring time-sensitive political variability, mostly based on leadership turnover in regulatory agencies. These attempts have been mostly focused on the telecommunications sector.

### ***Outcomes***

Independence is a means to an end: if regulatory independence truly provides a solution to market failures, the results should be visible in terms of improved market outcomes. Some econometric studies have used independence as an explanatory variable to investigate the determinants of, among others: efficiency and performance in the regulated sector; infrastructure quality and coverage in the sector; or consumer prices. At the micro-economic level, effects on levels of firm investment, as well as leverage of the incumbent, have been analysed. In general, revenue stability and investor certainty (rather than predictability) are viewed as important elements which regulators can bring to markets. In part due to methodological constraints, few authors have so far assessed the counterfactual: for example, to what extent private investment may be crowded out, or the market share of incumbent operators increased, in the absence of independent regulation.

Overall, due to the frequently binary nature of the regulatory independence measure in most studies, and /or to the variety of other much broader governance variables included in the analysis (such as generic rule of law measures), it is very difficult to pinpoint the effect of independence itself on these macro- and micro-economic outcomes. Few attempts have been made to isolate the effect of any specific feature of independence.

### **The how of independence**

There have been few attempts to unpack some of the practical implications and features of independence and how these features are practiced by regulators. The independence survey conducted among NER

members fills this gap. The analysis of the survey responses (presented in Chapter 3) points to some insights on the practical implications of the requirements and practices currently in place to safeguard independence:

### *Instructions from the executive*

- **In some cases, executives issue statement of expectations and in a few cases, regulators respond with formal statements of intent to clarify how they plan to meet these expectations.** This process brings a certain degree of formality, as well as integrity and credibility to the relationship between the regulator and the executive and could potentially help resolve potential conflicts or misunderstandings between the regulator and the executive. The way in which these statements are delivered and their content can be particularly important. If the statements provide guidance on the direction of the regulatory activities, they can potentially bring clarity to the respective roles of the regulator and the executive and serve as an incentive to strengthen and improve internal processes (for example by providing guidance on better regulation policies or clarifying performance indicators). They could have little use if the statements become a “shopping list” of vague and broad expectations. They could end up being counterproductive if they are perceived as heavy handed, suggesting outcomes on technical areas which are clearly within the scope of the regulator's functions.
- **There are certain instances where the lack of clarity on roles and functions can open the door to undue government interventions.** Some regulators have been proactive in signalling these issues. In other cases, the deadlock has become evident and has been solved by a government intervention sometimes in conflict with the regulator. These instances can be disruptive for the regulatory environment, create uncertainty for investors and market operators on who is ultimately in charge of supervising the sector. Some degree of overlapping is inevitable and intrinsic to the relationship between the executives and the regulators. However, confusion should be avoided, in order to minimise opportunities for deadlock. For instance, confusion could be dispelled and deadlocks could be prevented, by laying out in advance possible problematic areas and having regular exchanges on how to find solutions, in accordance with the legitimate and appropriate roles and responsibilities.

- **The legislative process and parliament can prove useful in solving deadlocks created by lack of clarity on the boundaries between regulators and governments.** Grey areas will inevitably remain as it is challenging to set clear roles and boundaries between the responsibilities of the executive and those of the regulator. Dialogue and regular exchange of information between regulators and parliament can inform parliamentarians on the role of regulators and facilitate an informed debate when issues emerge.
- **The use of public consultations in the development of policies, laws, and regulations can help regulators obtain and disclose the views of the executive in a transparent way. Yet, the government or industry could also be heavy handed and try to hijack the process.** Informal and regular exchange of information could also be an effective way of complementing more formal channels of communication. However, there must be clarity in making exchanges transparent when appropriate, for instance through guidelines on legal obligations from, for example, “Freedom of Information” or “Public Ethics and Behaviour” rules and standards.
- **Media statements go beyond the usual institutional channels and can become a solution of “last resort” either to exercise some influence on regulators or to respond to attempts by government to unduly influence the work of the regulator.** They seem to be used with some care by government and regulators but used nevertheless. The media can serve as a useful, transparent reminder of the respective roles of the regulator and the executive (and in some instances the media have been relied upon for this purpose). However, the media can also have their own biases and, in the absence of a pluralistic media landscape, their useful role can be seriously diminished.
- **Some regulators have been proactive in scanning the horizon of the markets they oversee and signal potential emerging issues.** This proactivity has been sometimes perceived as an encroachment on the prerogatives of the executive. Yet, it can also provide precious advice to ministries and ultimately serve society. As noted above, some degree of overlapping is inevitable and “grey areas” are almost intrinsic to the work of regulators as it is not always easy to clearly define where role of the regulator ends and policy setting by elected officials start. In certain instances, it might be more appropriate for the regulator to signal issues that need to be taken into consideration by policy makers in advance to ministries before going public. Circumstances where ministries lack the political or

administrative capacity to undertake this important function, regulators should be enabled with a legitimate mechanism to provide strategic foresight.

### *Relationship with industry and other non-government stakeholders*

- **Regulators have developed a wide range of consultative tools to interact with industry and collect their inputs during the preparation of the regulatory decisions. Some regulators have also set up advisory bodies composed of industry representatives to institutionalise consultation.** Transparency and consultation can be an effective way of ensuring that decisions build on a wide range of evidence and are perceived as reflecting the needs and the legitimate demands of industry and users.
- **More problematic are those cases where stakeholders (especially industry) can exercise pressures on ministers and members of parliament to affect the decisions of the regulator. The effectiveness of these pressures can depend to a large extent on the degree to which the regulator is protected from (undue) pressures from the executive and parliament.** However, elected governments are ultimately responsible for determining the mandate and powers of regulators and these interventions can ultimately impact the power and role of the regulator.
- **Consultation can also be hijacked by powerful lobby groups that can delay or block decisions that go against their interest (but not necessarily against the collective/public interest).** In these cases, transparency and consultation could undermine or curtail rather than strengthen the regulators' independence.
- **Consultation can also become erroneously conflated in the public's mind with consensus. Mixing up consultation with negotiation can create unrealistic expectations on the extent to which the broad range of stakeholder views can be reflected in the final decision.** Informed participation by stakeholders could help dispel some of these confusions. Informed participation might be facilitated by providing clear and simplified information on the issues at stake and proactively reaching out to those stakeholders who can be less resourceful like residential consumers or new market entrants. Holding multilateral and bilateral discussions before public consultation can also be a means of placing all stakeholders on a level playing field, setting the ground rules for consultation, and identifying critical questions on which stakeholder input should be solicited. Clear timelines for consultation could also

assist regulators so as to avoid prolonged or untimely interference (as well as deadlock) in the decision-making process.

- **There should be a balance between having accountability for regulatory decisions and “gaming” of the regulatory process so that decisions are made in the best interests of citizens.** Some consultations can be very technical and only of interest to few interested parties. In such cases innovative processes should be developed that enable regulators to conduct due diligence without wasting resources. These processes should be compatible with the relevant legal obligations should an appeal by an interested party be made to the judiciary.
- **Beyond formal consultations, stakeholders can try to influence regulators’ decisions through lobbying targeting directly the regulator and, more indirectly, through lobbying or informal contacts with ministers and members of parliament.** Regulators have been relying on lobbying rules like obligations to register lobbyists and meeting with lobbyists to make the relationship with industry more transparent. More problematic are those cases where stakeholders (especially industry) can exercise pressures on ministers and members of parliament to affect the decisions of the regulator. The effectiveness of these pressures can depend to a large extent on the degree to which the regulator is protected from undue pressures from the executive and parliament. Some regulators have in part counteracted these pressures by going public on these issues and stirring at least a public debate among the citizens to whom governments are accountable.

## *Staff*

### *Professionals*

- **The way in which the regulators attract, retain and motivate staff is ultimately a key determinant of the capability of the regulator to *act independently and take decisions that are objective and evidence-based.*** Beyond the level of remuneration, that can be an issue in retaining senior level staff and more acute for some regulators, a number of regulators appear to have made a clear effort to create a culture of professionalism that provides a stronger guarantee of independence. This seems to have been achieved in part by inheriting public service values (including codes of conduct and procedures) and also a clear distinction between board (inevitably more political) and the professional body. This culture of

professionalism accompanied by attention for “soft” incentives like having responsibility for making real impact, career progression, work-life balance and professional development appear to have in part compensated for the inevitable remuneration gap with the industry.

- **A number of regulators have conflict of interest policies and cooling-off periods for staff leaving the organisation. These policies appear to signal a clear and useful distinction between the regulator and the regulated industry.** Some of these policies often apply to the whole public sector and they appear to be relatively “light touch” (cooling-off periods tend to be in place mostly for senior professional staff). This is not necessarily an issue especially for more junior staff as some “back and forth” between the industry and the regulator can be mutually beneficial and provide useful exchanges of knowledge and skills.

### *Board/agency head*

- **Board and agency heads are inevitably under more pressure from government and industry as they are ultimately responsible for the regulator’s decisions. Accordingly, safeguards and protection from meddling and pressure is paramount. The nomination process (rather than the appointment) seems to be the crucial juncture.** The appointment of the regulator’s head and/or board members is relatively transparent and can include checks and balances like parliamentary hearings and debates (with or without a formal vote). Yet, the process that leads to the choice of the nominees is in certain instances more of a “black box”, where the proximity with the nominating authority or some “horse trading” deal could be perceived as more important than professionalism and objectivity. In some countries, the nominating authority – usually the executive – relies on independent search committees that could help in part open the black box and dispel these perceptions.
- **Most board members/agency heads are subject to cooling-off periods after leaving their position of 2 to 3 years in most cases.** Cooling-off periods can contribute to **signalling and promoting a culture of independence** and mark a clear boundary between industry and the regulator. However, they can also create **perverse incentives** in limiting the attractiveness of positions for experienced industry experts (or limiting the pool to end-of-career experts) and attract civil servants (who could potentially return to their positions

but could also be more prone to pressures from the executive). Some of these perverse incentives can be minimised by having some compensation during the cooling-off period, which is the case for some regulators.

### *Budget*

- **Source of funding – fees, general revenues or a mix of the two – vary but the source appear less important than the way in which funding needs are determined, appropriated and ultimately spent to determine the extent to which regulators can *act independently*.** Regardless of the source of funding, most regulators' budgets are part of the national budget. Far from being an encroachment on their independence, this appears to be a guarantee of transparency and accountability of regulators to citizens that can strengthen (rather than undermine) their independence.
- **For regulators funded through fees, an appropriate cost-recovery mechanism appear to be essential to set the “right” fee and avoid having a regulator that is under-funded or captured either by industry or undermined by the executive (for example in countries with still large regulated state-owned enterprises).** For most regulators, the fee is set by the executive within a legislated ceiling. This could be problematic especially in those countries where the government has large shares in some of the regulated companies. Some regulators have set up advisory committees composed by regulator and industry officials to review cost estimates.
- **For regulators funded through general revenues, it can be easier to influence the regulator by reducing the resources at the disposal of the regulator especially if the executive or parliament is not satisfied with a decision taken by regulator.** Annual appropriations can make it easier to influence the regulator than multi-annual appropriations that are less contingent to short-term political/electoral imperatives. Adequate safeguards should be provided so that the budget process does not become a tool to unduly direct the regulator.



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