

Appeals and Dispute Resolution – Using Detailed Rules and Processes to Prevent and/or Resolve Disputes

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Abstract

A primary aim of regulation is to create an environment in which investment can take place so that both the level and quality of services provided to consumers can be improved (or maintained). Yet, regulatory systems where a high degree of discretion is vested with the regulatory agency may actually work against this aim – investors fear arbitrary decisions that could expropriate value and consequently they either do not invest or require a higher rate of return than would otherwise be the case to compensate for this risk.

There are ways in which the credibility and commitment within the regulatory regime can be strengthened to overcome this perceived problem. This paper focuses on one specific set of actions that can be taken – the establishment of guidelines or rules by which a regulator can commit to future actions. There are different levels of commitment possible with a trade-off inasmuch as the greater the commitment the lower the flexibility in the regime – examples of the different forms of guideline and rules are provided to illustrate the various approaches. Given this trade-off, the decision about when different levels of commitment should be employed is an important one. These circumstances are also investigated in this paper.

This paper is based on aspects of the Tariff Adjustment Rules: Guidelines for Regulators, prepared by Chris Shugart and Ian Alexander, available to download from the PPIAF website (accessed July 2008):

http://www.ppiaf.org/index.php?option=com_content&task=view&id=224&Itemid=214&sub_action=activities&action=show_project_details&project_id=253&post_action=sector&post_action_val=water%20and%20sanitation

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1. INTRODUCTION

The Fifth Annual Conference of the African Forum for Utility Regulation (AFUR) had as a central issue “REGULATORY NON-DISCRIMINATION, PROMOTION OF COMPETITION AND PROTECTION OF INVESTORS”. Utility investment is typically long-term and large scale and disputes are almost certain to arise over the life of an investment. Where investors have concerns about the outcome of disputes and in particular about the process that will be followed when disputes arise, it is likely that the level of investment will be reduced or that investors will seek a higher return. Both these factors may lead to an increase in the cost of capital or in extreme cases lead to investors choosing to invest elsewhere.

In a situation where it is important to encourage investment, it may be necessary to introduce credible and transparent rules for the handling of disputes. Alternatively, reduced discretion rules can be introduced to provide a set process for all decisions to be made by the regulator. Where reduced discretion rules have been established, disputes can be simplified because the question is simply whether the set process has been followed.

In this paper, we examine methods for reducing the uncertainty surrounding dispute resolution. In particular, we look at setting the rules in a way that pre-empts disputes by removing the discretion of the regulator. In practice, it is difficult to set rules for all decisions to be made by the regulator in a way that avoids disputes, hence we also set out rules for establishing dispute resolution mechanisms.

2. WHY HAVE RULES FOR DISPUTE RESOLUTION?

As discussed in the introduction, investors in long-term, large-scale projects are less likely to invest or may require higher returns where there is considerable uncertainty about the returns to their investment. One significant area of uncertainty is the resolution of disputes. In this paper, we look at the creation of rules to overcome this uncertainty. The two broad approaches we examine are:

- reducing/removing the risk of dispute; or
- providing credible and transparent rules for handling disputes.

3. POSSIBLE APPROACHES

3.1 Pre-empting disputes

A potential method for removing uncertainty in relation to possible disputes is to limit the possibility of such disputes (or at least the scope of any dispute) by tightly specifying how the regulator will make decisions. This can be achieved by the introduction of reduced discretion rules which set out the procedure to be followed by a regulator in making regulatory decisions.

An example of pre-empting disputes through reduced discretion rules can be seen in the rules that have recently been proposed for the provision of water and sanitation services – the Shugart and Alexander rules recently published by PPIAF.

Box 3.1 provides an example of a reduced discretion rule. This particular rule is for determining the market risk premium in relation to investments in water and sanitation services.

Box 3.1: Reduced Discretion Rules for Establishing the Market Risk Premium

The market risk premium (“MRP”) is determined as follows:

(a) Calculate the mean of the estimates of MRP made by the following regulators: [*specify names*]. For each regulator, the final determination from the latest [water utility] price review should be used. If a regulator has quoted a range and not a single-point estimate, the mid-point of the range is to be used for that regulator. The value obtained is the MRP to be used.

Source: Shugart, C. and I. Alexander, “Tariff Adjustment Rules: Guidelines for Regulators”

The rule set out in Box 3.1 demonstrates how disputes can be pre-empted by having reduced discretion rules for regulatory decisions. In this example, the regulator is given a clear process for deciding on the market risk premium – this is a simple average of the final determination of a number of pre-specified regulators. In such a case, were a dispute to arise, a simple assessment of the calculation can be made:

- i. Have the pre-specified regulators been used?
- ii. Have the most recent determinations been considered?
- iii. Are the right numbers collected?
- iv. Is the calculation right?

For each of these questions there should be an unambiguous answer that can be used to determine whether the regulator has followed the pre-set rule.

An example of employing reduced discretion rules in practice is provided by Bucharest Water. The Bucharest Water concession provides for three types of price adjustments. These are:

- Ordinary tariff adjustments (following the agreed formula);
- Extraordinary tariff adjustments; and
- Periodic tariff adjustments (every five years).

Bucharest Water uses a three member expert panel (water sector engineer, regulatory economist and financial analyst). This panel is formed at the beginning of each five year price control period with rules for how selection will occur in the case that contract parties cannot agree.

For both extraordinary tariff adjustments and periodic tariff adjustments, the expert panel undertakes a review (without employing additional consultancy support) and the recommendations of the expert panel are sent to the national regulator. Under the rules, the regulator is required to accept these recommendations unless “substantial failures to follow the procedure and methodology” set out in the concession documentation can be identified.

This system was put in place prior to the establishment of the national regulator and there is some question as to whether it would have been accepted if the regulator was already in existence. However, it does provide a nice example of how the possibility of intervention by a regulator can be reduced and the basis for any intervention carefully limited.

3.2 Alternative dispute resolution systems

While reduced discretion rules may provide a better understanding of what is required from the regulator, it is generally not possible to specify rules for all decisions that a regulator will make. Therefore, in addition to rules specifying the process that a regulator might follow, investors may be encouraged by the inclusion of rules on how disputes should be resolved where they do arise – Bucharest Water can also be perceived as a form of this. In this context, reduced discretion rules may be used to provide:

- a clear choice about the form of alternative dispute resolution (ADR); and
- rules for the selection of the personnel to be involved in the ADR.

It should be noted that there are many types of alternative dispute resolution mechanism, ranging from arbitration (which is binding on the parties) to conciliation and mediation (a non-binding process) and many more informal mechanisms. Under a system of arbitration, parties submit their disputes to a tribunal that is authorised to make binding decisions. Arbitration tribunals are generally comprised of a panel of members who have been chosen on the basis of their expertise. Conciliation and mediation processes also involve a third-party, however, the recommendations of this party are not binding.²

The form of ADR to use will depend on a number of inter-related factors such as:

- the legal environment;
- practical considerations; and
- international treaties (investments may be covered under bilateral trade agreements).

In the following sections, we examine some examples from the Philippines and Chile of ADR mechanisms that have been applied in practice.

3.2.1 Manila Water Alternative Dispute Resolution Mechanism³

The Concession Agreement outlining the legal and regulatory framework for the privatised Metropolitan Waterworks and Sewerage System (MWSS) companies contains a provision for the establishment of an ‘Appeals Panel’ that has responsibility for a binding arbitration process. The panel consists of three members, with the exact composition being dependent on whether the issue is a ‘minor dispute’ or a ‘major dispute’. The criteria for what type of dispute is being addressed are provided in the contract. In both cases, one member of the panel is appointed by the Regulatory Office and one member is appointed by the concessionaire. The choice of the third member differs between whether the dispute is considered to be major or minor.

² Kerf M. et al (1998) “Concessions for infrastructure: A guide to their design and award”, World Bank Technical paper no. 399 Finance, Private Sector, and Infrastructure Network, [Link](#)

³ Houston, G. and C. Bowley (2000) “The Use of Arbitration to Resolve Regulatory Disputes: A Case Study”, A Report for the World Bank, prepared by NERA (mimeo)

For a minor dispute, the third member of the panel is designated by the two existing members. By comparison, for a major dispute, the chair of the panel is appointed by the President of the International Chamber of Commerce.

The types of disputes generally arise from the terms of the Concession Agreement and may cover:

- the Interconnection Agreement (governing the flow of water from one company to the other);
- the joint venture arrangement for the Common Purpose Facility (a common water resource for both concessionaires); and
- access to Shared Facilities, such as MWSS's billing and telemetry systems.

The First Dispute

The first dispute arose in relation to the pricing of the interconnection agreement between MWS, the West Concessionaire, and MWC, the East Concessionaire. In particular, MWS sought an interconnection agreement at 0.40 Philippine pesos per cubic metre, whilst MWC required a payment closer to 10.00 Philippine pesos per cubic metre. At the time of the dispute, the concession agreement was not yet governing the two concessionaires and hence the MWSS did not have the power to compel the parties to arbitration. Eventually, it was agreed that arbitration was required to solve the dispute.

Each party to the dispute chose an arbitrator with relevant expertise. These two arbiters then agreed that it would be possible to come to some form of agreement and a third arbitrator was not chosen. The arbiters decided that the interconnection price should be 1.80 Philippine pesos per cubic metre. Both parties abided by the decision, although MWS did not like the outcome. [Need to check whether the numbers are in the public domain or whether a simplified version has to be used.]

The Second Dispute

The second dispute was an extraordinary price adjustment to account for the effects of a large devaluation of the Philippine Peso and a reduction in the water supply as a result of El Nino. The arbitration was carried out formally as a 'major dispute'. When the dispute notice was served, there were no standing members of the Appeals Panel and the appointment process began following receipt of the notice. This process took several months. The decisions of the Appeals Panel were originally due on December 1998 but were actually received over 18 months later in August 2000.

Discussion

The 'ad hoc' arbitration of the bulk water dispute, while informal, was considered to be efficient. While one Concessionaire was not happy with the final result, no attempt was made to have the decision over-turned.

The second and more formal process was widely considered to be impartial but the time taken to conclude the proceedings made it inefficient. The drawn-out nature of the process removes some of the advantages of an arbitration process over the court system.

There were two inefficiencies in the process. First, it took a long time to appoint panel members. Second, the decision process was lengthy.

There are also some potential weaknesses in the system that may arise in the future:

- Decisions can be appealed to local courts where Philippines law applies. In the case that grounds for appeal are established and the appeal is successful, this may act to undermine the value of precedent in appeals panel decisions.
- The extraordinary price review process also identified legal advocacy as an important issue in the dispute resolution. A particular issue was the disparity between the parties. MWC had legal costs of 16 million Philippine Pesos while the Regulatory Office had costs of 2 million Philippine pesos. This disparity was partly a result of the restrictions on the Regulatory Office which could only make use of government lawyers. Any disparity could lead to a disadvantage for the resource constrained party and acts to remove the benefits of an arbitration system as compared to the court process.

3.2.2 The Chilean Approach to ADR⁴

Chile reformed its water supply and sanitation sector in the late 1980s. As part of the reform, new laws were established with rules for:

- setting tariffs;
- the concession regime; and
- the provision of subsidies for low income customers.

The regime also established a role for the Superintendency of Sanitation Services – note the Superintendency is not the regulator, a separate regulator was also established.

Under the new laws, tariffs for water supply and sanitation services are to be reviewed every five years, with expert panels being formed to resolve any disputes. The sector began with ad hoc panels but eventually standing expert panels were created. The process is as follows:

- Following the preparation of a tariff study by the Superintendency, the regulated company has a chance to state its objections.
- In the case that the two parties are unable to agree on a new tariff after a period of 45 days, the regulator must set up an expert panel to resolve the dispute.
- The panel is limited to choosing between the values used in the company's tariff study or those in the superintendency's study.
- The final tariffs are then calculated by the regulator, applying the values chosen by the panel. These are then included in a decree by the Minister of the Economy.
- Each panel consists of three experts – one chosen by the superintendency, one by the regulated company and one selected by the regulator – from a list agreed on by both parties at the beginning of the review process.

⁴ Jadresic, A. (2007) "Experts Panels in Regulation of Infrastructure in Chile" PPIAF Working Paper No. 2, 2007, [Link](#)

- The costs of the panel are shared equally by the parties to the dispute and decisions by expert panels are final and binding for both parties.
- Expert panels have been used quite frequently to resolve disputes in the water supply and sanitation sector. Of the 21 tariff reviews between 2000 and 2004, six made use of expert panels.

However, although most companies have now been privatised, only a few recent tariff reviews have ended in expert panels. This may be because the use of criteria set by past panels has tended to narrow the differences.

3.3 Rules for alternative dispute mechanisms to handle disputes

3.3.1 Selection Procedures

The examples given above indicate that the rules need to clearly establish the selection procedures for choosing the particular alternative dispute resolution system. Such rules may include:

- form of the expert panel, i.e. whether it is an ad hoc panel or a standing panel;
- who chooses the members of the expert panel;
- criteria to be met by members of the expert panel (technical background, nationality etc);⁵
- treatment of any conflicts of interest (nationality, work experience etc);
- terms and conditions of experts (remuneration, length of selection etc); and
- treatment of disagreements or inability to select a panel.

The rules are broadly equivalent to those required for selecting regulators, although the nationality aspect is often missing from the selection of regulators.

There will be a number of factors that will dictate the particular form that the ADR mechanism should take. For example, if the rules state that policy-related issues will be addressed then this may require the formation of an expert panel to have more of a standing body status.

3.3.2 What else is needed?

In addition to rules for selection procedures, there need to be rules for the actual dispute handling process. If these rules are not in place, then the dispute resolution process will simply be a shift of discretionary decision-making power from the regulator to the dispute resolution body. Therefore strong rules are needed about how the dispute resolution process should work. In the examples outlined above, the Bucharest Water example demonstrated clear rules for the process of decision making. By comparison, the example from Manila Water demonstrated clear rules for selection but not for the process of decision making. In order to create certainty for investors, it is important that the rules for ADR cover both the selection procedure and the substantive nature of the decisions being made. In the following section we look at an example of such rules.

⁵ Some dispute systems do not allow panel members to be from either the country in which the project is based and the country of origin for the investors if they are foreign companies.

3.3.3 Shugart and Alexander: Rules for the Dispute Resolution Process

Setting out the exact rules for the involvement of an expert in the dispute resolution process may be helpful in ensuring that disputes are resolved in a timely manner and that the outcomes are considered to be fair by all the parties involved.

Here we set out an example of how such rules could work. The example concerns the selection of comparator companies for purposes of determining the value of beta to use in the WACC owing to a disagreement about how the WACC is calculated, although the procedure is one that could be used for any element where external comparators are being employed.

The procedure involves choosing between five and ten comparator companies and calculating the average of the beta values, as determined by regulators in their most recent price reviews. This value is then used for the company's beta in the price review.

The final list of comparators is determined in the following manner:

- If the number of retained candidates (from both parties) is at least 5 and no greater than [*specified number*], this is the list of comparators.
- If the number of retained candidates is less than 5, the expert, in his or her absolute discretion, adds qualifying comparators (after discussing possible new comparators with the parties and taking into consideration their views) to reach 5.
- If the number of retained candidates is greater than [*specified number*]:
 - Each party ranks the candidates and gives them scores
 - The expert multiplies the scores given by the two parties for each candidate. Low combined scores are progressively eliminated until only [*specified number*] candidates remain. That is the list of comparators. If scores are tied making it impossible to select those [*specified number*] that have the highest combined scores, the expert (in his absolute discretion) selects the best from among those with tied scores so that the total number of comparators is [*specified number*].

4. REVIEW OF THE APPROACHES

In this section we examine the two approaches to reducing the uncertainty about the way in which regulatory disputes will be resolved.

4.1. Problems with pre-emption

With pre-emption, the possibility of a dispute is reduced or removed by specifying exactly how the regulator should approach a regulatory decision. In practice, it would be difficult to provide such detailed rules for all decisions that a regulator might make. Further, in some cases, fully constraining the discretion of the regulator may not be appropriate. For example, some of the decisions made by a regulator may be more policy-related, such as pro-poor tariff structures and tariff rebalancing.

The use of pre-emption is easiest where the process or simple rules can be pre-set. Where some discretion is likely to be needed then the trade-offs involved in losing discretion or finding an alternative approach that may have less certainty is required.

4.2. Why ADR?

There are three main reasons for using ADR. These include:

- the degree of specialist knowledge needed;
- choice over the identity of the adjudicator; and
- speed and cost.

For the last point there is always a concern, especially with local courts, that the time taken before a hearing takes place, or for the hearing, will be especially long. The court system also involves the possibility of appealing to a higher court which may add to the length of such a process. This was a perceived problem in India.

Degree of specialist expertise

High	Special tribunal, eg. LUL OPPPA, bankruptcy or tax courts	Expert panel
	Ordinary courts	Conventional arbitration
Low	No	Yes

Party choice over identity of adjudicator

v. SUMMARY AND NEXT STEPS

RDR or other forms of guidance are likely to leave some discretion

So, need clear checks and balances

Courts could possibly be enough – especially with very detailed RDR

BUT, may not be enough

So, RDR must cover:

- The form(s) of ADR being used
- The selection procedures
- Process rules for the ADR

Finally, these rules need to be enshrined in a way to make them enforceable, i.e. either in a contract or through a secondary legislation/licence that cannot be changed without both sides agreeing. Further, significant penalties for breach need to exist – such as enshrined in Partial Risk Guarantees.