

What is Regulatory Best Practice?
Comments at the ACCC Conference on Incentive Regulation

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The views expressed here are those of the author writing in a strictly personal capacity.

Australia has long been an innovator in the provision and regulation of utility services. The development of the statutory authority model – one of our more successful if not necessarily more beneficial exports – was an early attempt to more sharply separate the commercial activities involved in providing service from the exercise of political and regulatory control. Even then – a century ago – the virtues of transparency, consistency and accountability were accepted in theory, albeit more rarely in practice.

In the last decade, the Australian tradition of regulatory innovation has continued, with “incentive regulation” being at the centre of many of the initiatives taken. This conference is a timely opportunity to stand back and draw some lessons from those initiatives.

What incentive regulation is about

A useful place to start is by reminding ourselves why incentives should play a major part in the design of regulatory arrangements. The simple reason for being concerned about incentives is that the information available to regulators is imperfect and asymmetrically distributed. If regulators knew all there was to be known – if the ACCC and its State counterparts were not only omnipotent but also omniscient – “command and control” methods would work perfectly well, as firms could be given production plans that maximised the sum of consumer and producer surplus. In the real world, of course, regulators do not know the most efficient production plans, nor the prices to which those plans would correspond. As a result, they must seek to ensure that regulated firms have the incentives to discover and implement those plans – a requirement which, in turn, implies that the firms’ owners must obtain some gain from doing so.

Since the early 1980's, price cap regulation has been seen as providing an effective means of achieving this goal. Writing in 1983, Professors Beesley and Littlechild concisely set out the nature of a price cap when they proposed that “the price of a bundle of telecommunications services should not increase by more than X percentage points below the retail price index (the RPI-X) for a period of five years. This could be applied to any set of services, perhaps weighted as the bills of the representative consumer.”¹ They then went on to enumerate the gains such a form of regulation would bring. The regulated firm would be encouraged to cut costs, as it could keep any profits that resulted from out-performing the target rate of productivity growth built into the “X” factor. Moreover, they said, and I would expect a few wry chuckles at this point, such a scheme would be simple to devise and implement: for “.. The level of X would, in practice, be the outcome of negotiation between BT and the government; an exhaustive costing exercise is not called for.”

Has it worked?

Whether CPI-X regulation has lived up to its promise is debatable. At least some of its stated benefits are now seen to have been exaggerated, at times significantly so. Two factors stand out in this respect.

¹ Beesley and Littlechild (1983) “Privatisation” Lloyds Bank Review.

Allocation of risk

First, the allocation of risk differs as between CPI-X regulation and the more conventional forms of regulation by the control of the rate of return. A price cap is based on **anticipated** performance, and (at least in principle) places on the regulated entity the risk for deviations from expectations. This in turn will affect the regulated firm's cost of capital and (given a close link between investment and productivity growth) the rate at which efficiency improvements are made.

Duration and renewal

A second and related problem arises from the duration and renewal of the cap. I will spare you the much quoted line in Beesley and Littlechild about CPI-X being merely a temporary safeguard, not a permanent method of control. But I do need to remind you that "the one-off nature of the restriction is precisely what preserves the [regulated] firm's incentive to be efficient, because the firm keeps any gains beyond the specified level."

"In life", says an old French proverb, "only the temporary lasts"; and claims of price caps' transient nature have proven to be greatly exaggerated. This may be partly because regulation, once in place, sticks. It is also because the mechanism has been used to regulate industries the natural monopoly elements of which show little sign of themselves withering away. And last but not least, it is because no-one has found a sensible way of setting a price cap for very long periods of time. After all, forecasts even 2 or 3 years out are hugely unreliable; so any attempt to set caps for say, 10 or 20 year periods would entail very large risks. As a result, those who would rely on CPI-X seem condemned to relatively short duration caps with concomitantly frequent renewals and reviews.

Frequent reviews increase the cost of designing and implementing the price caps. Even more importantly, they necessarily blunt the incentive properties of the CPI-X mechanism. The regulated entity surely knows that outcomes in this period will affect the cap in the next, with performance targets being ratcheted up and supra-normal earnings clawed back. Under these circumstances, it will game the regulator, for example, through the timing of productivity improvements and of capital investments. Attempts to offset this gaming through closer scrutiny and control merely make the price cap regime ever less "light-handed" and its incentive properties ever weaker.

Theory and Practice

In short, incentive regulation is no panacea. But the manner in which it has been implemented in Australia has, in my view, tended to make matters even worse than they needed to be.

Telecommunications is the case I know best. Here the problems are two-fold: the price caps themselves; and the interaction between the caps and the other regulatory instruments being used.

The price caps

Starting with the first of these, any reasonable observer would, I submit, have to conclude that CPI-X regulation has been applied in a manner which, at best, has only coincidental resemblance to the underlying theory. Although announced as an interim measure, the caps are now celebrating their 10th anniversary. Services that are strongly competitive – such as IDD – are still subject to caps. Far from promoting a closer alignment of prices and costs, the price caps, with their multiple and interacting sub-caps, have served to aggravate price distortions. Indeed, there is strong evidence that far greater price rebalancing was achieved during the price surveillance period than under the price cap regime – the simple reason for this being that the setting of the price cap is a far more visible, politically sensitized process than the essentially administrative process of price surveillance ever was: and hence leads to outcomes even more strongly tinged in populism. Finally, price caps have been set for periods as short as 6 months – a shorter regulatory lag than in any rate of return regulation system that I know of!

Interaction with other regulatory instruments

However bad the price caps are, they look better when compared to some of the other instruments being applied.

Thus, while a CPI-X approach has been used to control Telstra's retail prices, access prices are being set on a completely different basis. Here the regulator is relying on TSLRIC ("Total Service Long Run Incremental Costs") – essentially, a forward looking, efficient cost standard.

Now, in my view, TSLRIC is an instrument without a theory, in the sense that no-one has yet been able to articulate an internally coherent economic question to which TSLRIC is the answer. Moreover, from an analytical point of view, it seems odd to use price caps to regulate output prices and then choose a means of setting upstream, access charges which will not, as a general matter, validate the caps. Surely if society has determined an appropriate level or path for output prices, then the upstream revenue requirement should be determined by some variant of the Efficient Component Pricing Rule, which simply discounts the allowable upstream revenue for the avoidable cost of the last stage of processing.

These are, perhaps, theoretical quibbles; but even putting them aside, it is difficult to reconcile a TSLRIC approach with the underlying premises of incentive regulation.

In effect, like any other form of price-setting on the basis of forward-looking, efficient costs, TSLRIC assumes that the regulator can actually know what the "right" level of costs is or ought to be and then direct the firm to produce according to those costs. Like Freud said of psychoanalysis, this has two problems: first, it is impossible; second, it is very, very difficult. As purely hypothetical networks are constructed and deconstructed, the process of setting access charges by means of TSLRIC can rapidly degenerate into a battle between competing economists at dawn, with ever more arbitrary assumptions being hurled from the opposing encampments. Given the highly complex mechanics involved in constructing hypothetical cost models, errors are all too easily made. And the time it takes to bring the process to resolution is most succinctly described as a consultant's dream.

I wish I could say that this was the end of the story – but I would be misleading you if I did. For just as the TSLRIC saga casts the price cap in a better light, so some of the other regulatory instruments used in telecommunications make TSLRIC look good. The Consumer Services Guarantee, for example, under which Telstra has to make payments to consumers for failing to meet specified service standards, appear to have been set in blissful ignorance of cost-benefit analysis, with penalties set at levels which are unrelated to the consumer harm. Thus, Victorians, when forced to go without hot showers for two weeks, received a payment of all of \$4.22; but if Telstra is late in activating a consumer's call waiting service, it must pay that consumer \$40 per working day. That alert consumers have been actively exploiting this system (for example, by applying for multiple lines in areas where it is known that Telstra cannot meet current demand) has not diminished the willingness of politicians and regulators to further raise the standards at every hint of rural discontent. Having thus raised the standard, they then show little willingness to acknowledge the increased service costs either in the caps on retail prices or in the cost models used to set access charges.

Can we do better?

Of course we can do better than this. But the experience with incentive regulation should induce a healthy degree of scepticism about miracle remedies to regulation's illnesses.

Auction mechanisms, for example, seem to be this month's fad. And it is true that major benefits could be gained if the regulator, rather than relying on administrative processes to determine service costs, could use market mechanisms to identify least cost supply. There are some areas where this can be done; but I am sceptical about just how significant these are. Unfortunately, franchise bidding is poorly suited to handling situations in which service provision involves substantial sunk costs. Since this is a nearly universal feature of the natural monopoly components of the regulated industries, auction mechanisms seem unlikely to solve regulation's core problems.

Lessons

I do not need to tell you that regulation can confer benefits by offsetting market failures; but it imposes costs of its own, and these can be high. This suggests that considerable caution is needed in bringing activities within the scope of regulatory control.

Here too, we have innovated in recent years, notably through the new Part IIIA of the Trade Practices Act. That Part separates the decision about the coverage of regulation from that about regulation's operational content, and sets down a series of criteria that facilities and services must meet before they can be brought within the scope of the regulated arrangements. There are deficiencies in the structure and precise content of Part IIIA; but the broad approach it takes is, in my view, an important step to rationalising the scope of regulation². It is a pity that rather than addressing the deficiencies in the general regime, industry-specific regimes have been created which rely on far weaker criteria than those Part IIIA sets out. The predictable result has been a dramatic extension of regulation's scope under these regimes.

² See H. Ergas and L. Evans "The Australian Experience with Access Regimes to Essential Facilities", The University of Auckland, September 1999.

Such an extension of regulation is far from costless. It seems to fly in the face of the lessons experience suggests. These, like all good lessons, are best expressed in a ditty, and mine, which I have shamelessly adapted from George Stigler, goes like this:

“No law in economics is more firm

Than that of diminishing marginal returns.

For regulators, the lesson is simple:

To regulate well, regulate little.”