# Compecon Limited - Competition Newsletter No.4.

## Customers Should Be Very Afraid of Stamp Price Increases. [1]

### Introduction.

The Communications Regulator (ComReg) has granted An Post a 7 cent (17.1%) increase in the price of a stamp. This follows substantial price increases for electricity, gas, public transport and telephone line rentals.

The July CPI figures show electricity prices went up 13.7% in the past year, while gas prices went up by 10.1%. Bus and train fares are up 12.6% and 10.9% respectively, while health insurance charges have risen 18.7%. Newspaper reports indicate that the electricity regulator is set to approve a further electricity price increase.

It is clearly time to ask why so-called liberalisation of many former State monopolies has resulted in such massive price increases.

### The Trouble with Regulation.

Industries such as gas, electricity and telecommunications combine potentially competitive activities with natural monopolies. A natural monopoly arises when competition is not feasible. The wires which make up the electricity grid are a classic example. Separate transmission grids do not make economic sense.

Traditionally governments sought to regulate such monopolies either by nationalising them, a common solution in Europe, or by regulating them, the preferred US solution. It was believed that public ownership would ensure that firms operated in the public interest, so state ownership was really a form of regulation.

Frequently legislation extended the monopoly into potentially competitive markets. For example, only the ESB was permitted to sell electricity. In bus transport state provision was considered the most effective option, even though there was no natural monopoly.

### Regulatory Reform.

Experience on both sides of the Atlantic showed that traditional forms of regulation failed to keep prices down and ensure that firms operated efficiently. Regulatory failure was inevitable because regulated firms knew more about the business than the regulators.

The failure of traditional regulation resulted in two key policy changes in many countries. First, because competition is more effective than regulation at keeping down prices, many countries have introduced competition into those industries or parts of industries where it is possible. Frequently regulation has been retained for a period of time until effective competition has developed. Second,

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where regulation remains necessary, either as a temporary transition measure, or as a permanent measure in the case of natural monopolies, attempts have been made to overcome the regulator's lack of information.

**Incentive Regulation.**

One common way of addressing the information problem is CPI - x or incentive regulation. X is the regulator's estimate of the efficiency savings the regulated firm might be able to make. The firm is permitted to increase its prices every year by the annual rate of inflation, as measured by the consumer price index, minus x. If the regulator believes that the firm could cut its costs by 5% a year, for example, it sets a price cap of CPI -5. The firm might actually have to cut prices if inflation is less than x. In order to maximise profits, the firm will try and achieve higher cost savings than those set by the regulator. This provides the regulator with better information about the potential cost savings that can be made, which the regulator can use the next time it reviews prices.

**More Competition Needed.**

The Government appears unwilling to confront trade union opposition to increased competition in State monopolies. The introduction of competition in electricity and telecoms was delayed. Trade unions have opposed proposals to introduce competition in bus and airport services.

Many countries have transferred ownership of the natural monopoly gas and electricity transmissions systems to separate independent companies because the former monopolist has an obvious incentive to impede rivals' access to the grid. Ireland has established an independent company, Eirgrid, to control the electricity grid, but the ESB continues to own the grid and Eirgrid must rely on it to carry out all construction and maintenance work. This hardly represents a pro-competitive solution. Many countries have broken up former monopolists into competing firms to ensure adequate competition.

**Rewarding Inefficiency.**

ComReg has indicated that increased postal charges are necessary because An Post has failed to reduce its costs. Earlier this year it relaxed the price cap on Eircom, again justifying this on the basis that the firm had failed to achieve efficiency targets.

Price cap regulation is supposed to encourage firms to increase efficiency not reward them for failing to do so. Allowing regulated firms to increase prices to recover the cost of inefficiencies simply mimics what an unregulated monopolist would do. Why have regulators in that case?

The gas and electricity regulator has chosen to review ESB and BGE costs to see if price increases are justified. Essentially the regulator is seeking to second-guess company management, while ignoring the lesson that such regulation does not work because the firm knows more about the business.

Ministers are able to wash their hands of responsibility for price increases and blame it on the regulators resulting in inadequate scrutiny of regulatory decisions.

**Conclusion.**

If regulators reward inefficiency or try and second-guess management of regulated firms, then it is truly time for customers to be very afraid indeed.