

## **It's the Structure - Stupid! Turf Wars Over Utilities Between Sectoral Regulation and Competition Law, Miss the Point.**

*'Regulation and competition are rhetorical friends and deadly enemies: over the doorway of every regulatory agency.....should be carved: Competition Not Admitted.'*<sup>1</sup>

### **The Rationale for Regulation.**

The preceding quote from George Stigler came to mind at a recent ISEL presentation on the relative effectiveness of sector specific rules and general competition rules in public utility industries, i.e., gas, electricity and telecommunications. At the heart of this debate is the question why such industries need special rules. Is mobile telecommunications, for example, any different to many other economic activities that are not subject to sector specific regulation? However, introducing competition in public utilities depends largely on decisions about industry structure. Arguments about the relative merits of general versus sector specific rules largely ignore this reality.

The essential characteristic of public utility industries is that one or more segments of the industry constitute a natural monopoly. In the case of gas and electricity, for example, transmission and distribution constitute natural monopolies.<sup>2</sup> In telecommunications the local loop was traditionally considered a natural monopoly. This may no longer be true in urban areas at least. However, an owner of a telecom network must be able to interconnect with rival networks in order to provide the comprehensive service required to compete in the market so that new entrants require access to the existing network. Some form of regulation was considered essential to protect consumers from the exercise of market power arising from the natural monopoly segment of the industry.

Regulation of public utility industries has a long history. In Ireland and many other European countries regulation took the form of State ownership with the natural monopoly extended into the upstream production and downstream supply markets thereby establishing vertically integrated monopoly public utility firms. The belief was that state ownership would ensure that the monopoly operated in the public interest. In the United States private ownership of such industries was the norm with the potential for

abuse of market power, due to natural monopoly, being dealt with by regulation which traditionally involved fixing a maximum rate of return on capital for the industry.

### **Regulatory Shortcomings.**

Over the past thirty there has been a growing recognition by economists that neither of these traditional forms of regulation worked particularly well. In the case of state firms commercial decisions were frequently blocked for short-term political reasons. While regulation was traditionally justified on the grounds of ‘market failure’, the potential for ‘regulatory failure’ is now widely recognised.

Regulatory failure arises as a result of what economists refer to as information asymmetries. In simple terms a regulator simply does not and cannot know as much about the business as the regulated firm. Regulators are therefore heavily reliant on regulated firms for information. This allows regulated firms to manipulate regulatory decisions in their favour. Thus, over time regulators tend to identify with the regulated industry and end up defending it rather than policing it. This process is known as regulatory capture.

A second source of regulatory capture arises because regulatory bodies, once established, tend to perpetuate and enlarge their activities. International experience over a long period of time shows that regulation is not a substitute for, and will not deliver the benefits which can accrue from competition. In fact, certain forms of regulation may even hinder the development of competition.

### **Making Regulation More Effective**

Based on this experience countries throughout the world have radically altered their approach to regulating public utilities over the past two decades. This process is frequently referred to as de-regulation but is more accurately described as regulatory reform. Essentially there are two key features common to the regulatory reform process in most countries.

First the scope of regulatory controls in public utilities was reduced with competition being permitted in those activities where it was possible. The second element involved

developing better forms of regulatory control that were specifically designed to overcome the information asymmetry problem facing regulators.

The second element involved the introduction of 'price capping' instead of rate of return controls in many countries. This type of regulation is frequently referred to as incentive regulation. The regulator sets a maximum rate for annual price increases for certain activities of the regulated firm usually by reference to the general rate of inflation as measured by the consumer price index. Where the regulator believes that the regulated firm can cut costs by improving efficiency the rate of price increase permitted is less than the rate of inflation, i.e., the price cap is expressed as  $CPI - x$ , where  $x$  is the regulator's estimate of possible efficiency gains. The price cap applies for a number of years, normally five.

The regulated firm faces a strong incentive to achieve greater cost savings than the target set since this will increase its profits. However, this in turn provides more accurate information to the regulator about potential efficiency gains when the price cap is due for review. At least this was the theoretical model, which underpinned price caps. As regulation is effectively a repeated game there is scope for strategic behaviour by the regulated firm. It will recognise that, while it can retain additional efficiency gains in the short-run, they are going to lead to tighter price caps in the future and it will take this into account in determining its behaviour. In addition, price caps have proved to be far more complex than originally envisaged and essentially involve implicit assumptions about the appropriate rate of return on capital for the regulated firm.

Price capping is based on an assumption that firms are profit maximisers and relies on providing firms with an incentive to increase profits as a means of inducing them to provide information to the regulator. It is designed to apply to private sector firms. In Ireland, however, the firms subject to regulation are state owned and may therefore have quite different objectives. This raises questions about whether such a regulatory regime is appropriate in the present Irish context.

As noted earlier the other key element in the regulatory reform process involved permitting competition in the case of those segments of the utility industries where it was possible. Experience in many countries, however, indicates that simply permitting

competition in such areas is insufficient to produce actual competition for a number of reasons.

A vertically integrated incumbent firm has obvious incentives to deny its rivals access to the natural monopoly network or to provide it on less favourable terms than those it applies to itself, thereby frustrating attempts to introduce competition.<sup>3</sup> An independent network operator on the other hand has no incentive to discriminate against new entrants. Consequently, vertical separation of the natural monopoly elements from the potentially competitive segments can greatly simplify the task of regulating access charges and is more effective at fostering competition. Unless there are economies of scope which greatly exceed the potential gains from competition vertical separation is the way to go. Simple accounting separation is not enough, as it is very difficult for a regulator to ensure that costs are correctly apportioned between different business activities. In the case of electricity steps have been taken to provide for the establishment of an independent transmission system operator but the ESB retains ownership of the system thus effectively stopping some way short of full vertical separation. Whether such an arrangement can effectively deal with the type of problems that are likely to arise is open to serious question.

Similarly, where the incumbent has historically enjoyed a monopoly over a prolonged period of time, simply permitting entry will be insufficient to promote competition. Positive steps to promote competition are required in such circumstances. This may entail the horizontal break up of incumbent firms or possibly restrictions on their installing new productive capacity until competition is sufficiently well developed. For example it may be necessary to exclude the ESB from building new generating plant until such time as other generators account for a certain proportion of generating capacity.

### **Overseas Lessons Ignored.**

Regulatory controls are required in addition to general competition law rules, where there is inadequate competition in the market. However, the level of competition in the market is not necessarily a given. Rather it can be affected by policy choices. Thus, policy measures designed to increase competition may eliminate, or at least greatly reduce, the

need for sector specific regulation. Such measures are likely to produce greater benefits to customers than regulation.

Policy in Ireland to date, however, has chosen to ignore this point. In effect in establishing various regulatory agencies in recent years the government has effectively ignored a key lesson from international experience which is that, rather than viewing regulation as some form of magic solution, the primary objective should be to promote competition as much as possible. Arguably policy has focused, not on introducing competition, but on making the minimum changes necessary to satisfy the EU Commission.

Complete vertical separation in gas and electricity has been avoided to date. Similarly, there has been no attempt to either create a number of competing generating businesses out of the existing ESB or to prevent the ESB increasing its capacity at least until competitors account for a significant share of the market.

Similarly, in the case of airports the possibility of enabling competition by allowing the construction of a competing terminal in Dublin Airport along with splitting up the existing airports into competing entities has been eschewed in favour of simply appointing a regulator. I am not in any way being critical of my former colleague the new Airport Regulator since he is not responsible for such decisions. However, simply creating such an agency is not an effective solution. The best way to ensure efficient charges for airports is to allow competition not appoint a regulator.

### **Conclusion.**

The image of the Competition Authority and sector specific regulators engaging in a ‘turf war’ over which agency should police public utility industries is all good knock about stuff. However, the debate about the merits of general competition versus sectoral rules largely misses the point. If we want to achieve the considerable benefits which greater competition in public utility industries can produce, then it is essential that we first create the industry structures that are necessary for competition. In the absence of such measures neither general competition rules nor sectoral regulation are likely to prove very effective.

That is the real lesson from the regulatory reform process that has taken place overseas over the past twenty years. This serves to illustrate that what really matters in the final analysis is the wording carved over the Minister's doorway.

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<sup>1</sup> G.J. Stigler, "First Lecture", in M.F. Cohen and G.J. Stigler, (1971), *Can Regulatory Agencies Protect Consumers?*, Washington DC, American Enterprise Institute

<sup>2</sup> In electricity transmission refers to the high voltage nation-wide network of lines which carry power from the generating stations. Distribution involves taking power from the high voltage transmission network, reducing voltage by means of transformers to levels suitable for industrial and domestic usage and then supplying power to individual homes and business premises by means of the lower voltage local line network. Similarly, gas is transported over the national high-pressure transmission network, and then through regional distribution pipelines, where pressure is reduced, for supply to individual customers.

<sup>3</sup> Of course, it is also true that new entrants will naturally seek to gain access at as low a price as possible.