'Why Johnny Can't Regulate': A Reply to Henry Ergas

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Henry Ergas is a talented, erudite and articulate economist, and a long-time critic of the ACCC/AER. In a recent paper in this journal[2] he raises the possibility that public utility regulation is doomed to end in failure. He draws on the vignette of primary-schooler Johnny, who wants to grow up to be a regulator. Is Johnny's career destined to end up with nothing but disappointment?

Of course, this raises the question as to what public utility regulation is designed to achieve. Ergas addresses this issue at the outset, by allowing that, due to transactions costs, a Coasean bargain contract between the customers and a monopoly supplier would be subject to the risk of ex-post opportunism — both on the side of the supplier (who might threaten to shade quality or raise the price ex-post) and on the side of the customers (who might seek to expropriate the sunk investment of the supplier by collectively agreeing to lower the price to the supplier). Given these risks, either side may fail to make valuable sunk investments, or, as Ergas puts it, either side may make investments which are inefficient due to the threat of opportunism: 'each side would invest in costly precautions so as to ward them off. But … those investments, seen from a societal perspective, are merely a waste, reducing welfare.''[3]

Ergas is thereby led to ask: can the government directly step in to re-create the Coasean bargain on behalf of small customers? He rightly points out many problems in this, including problems of aggregating customer preferences, problems of monitoring and enforcing by customers of the government in its interactions with the supplier, and problems of time-inconsistency and opportunism.

Perhaps these problems can be resolved by delegating certain powers to an independent authority. Such delegation might make it easier for customers to monitor, might improve the information-collection ability, and might resolve the commitment problems. After all, delegating monetary policy to an independent central bank as a means of overcoming the time-inconsistency problem has been a success. Might not the same principle apply to an independent regulatory authority? Ergas goes to some lengths to distinguish the role of a central bank

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2 Ergas 2013.
3 Ibid: 45.

from the role of an independent regulator. According to Ergas, an economic regulator is likely to have much wider range of instruments at its disposal and more vaguely specified objectives. Moreover, the incentives for time-inconsistency are much stronger for a regulator than for a central bank. He also suggests that newly established central banks seek to invest in a reputation for being tough on inflation, whereas newly established regulators seem to do the opposite:

> This [need to establish a reputation] would suggest that the initial period following the transition to regulatory independence would be associated with regulator's credibly signalling a strong aversion to expropriating sunk investments. But in no major country has that been the case … If anything, utility regulators seemed to preference delivering price reductions to consumers, as evidenced by tough price caps and steep falls in regulated revenues.[4]

As an aside, we may note that any tendency for new regulators to favour customers is still consistent with the regulator seeking to establish a reputation for protecting sunk investments — but with rather more focus on the sunk investments of the customers. If the primary reason why the regulator is established in the first place is a concern that — in the absence of the intervention of the regulator — the customers will be unwilling to make sunk investments for fear of expropriation by the monopoly supplier,[5] it makes sense for a regulator to counter that fear, proving its mettle by being tough on the monopoly supplier. Such actions may improve the climate for investment by those customers who need to invest in reliance on the monopoly service.

'Last but not least', Ergas expresses concern that regulatory decisions are affected by the wider political context, citing as examples changes to the merits review process in electricity and ministerial powers of discretion in NBN. Ergas concludes:

> In short, regulation is no magic wand that can, at no or low cost, replicate the outcomes of the idealised Coasean bargain. Moreover, conventional nostrums for the conundrums it raises — most obviously, the 'solution' of delegating powers to an independent regulator — create many problems of their own. To those problems there are no simple solutions, and most of the attempted solutions have yielded very mixed results.[6]

4 Ibid: 51.

5 This approach is consistent with the rationale for regulation Ergas articulates at the outset. See also, Biggar (2009).

6 Op. cit.: 52.

Johnny is destined for disappointment. Although he is assured of steady work as a regulator 'if he expects regulation to meet the lofty goals so often set for it, that is less simple and far less assured'.[7]

There is no doubt that Ergas has identified many real difficulties in regulation, including the problems of aggregating customer preferences and effective monitoring and oversight of the regulatory authority by customers. Some of these difficulties can be mitigated by separating the responsibility for aggregating and representing consumer views in regulatory processes to an agency separate from the regulator, leaving the regulator the task of arbitrating between competing views of the customers and the monopoly supplier. It is a common practice in institutional design to allocate separate tasks to separate agencies. Doing so clarifies the objectives of each agency — in this case clarifying that the task of the regulator is to act as a neutral objective decision-maker, while it is the task of the customer-representative organisation to negotiate and litigate for the interests of the customers in regulatory proceedings.[8] Organisations responsible for representing customer interests in regulatory proceedings are common in the US.[9] Australian governments are in the process of establishing a customer advocacy body for the energy sector.[10]

Some of the other problems seem to stem from expectations about what a regulator is established to achieve. One line of thinking suggests that the role of a regulator should be thought of as being akin to that of an arbitrator in a long-term contract.[11] In that sense the role of a regulator is something more akin to a dispute-resolution body — albeit a specialist, permanent dispute-resolution body: something closer to a tribunal or a court than a central bank.

The idea here is that faced with the need to protect sunk investments, firms face two basic choices: vertical integration or long-term contracts. Where the number of customers of the monopoly supplier is small we do find both vertical integration (for example, in the iron-ore railways in the Pilbara) and long-term contracts (such as the foundation contracts for some natural-gas pipelines). But when the number of customers is large (such as might be the case for, say, an electricity distribution business), vertical integration and long-term contracts are a bit more difficult. Vertical integration might take the form of a co-operative or customer-owned trust or even government ownership. But these ownership arrangements have their own governance issues.

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7 Ibid: 53.

8 See Biggar (2011).

9 Nearly every state has such a body. The national umbrella body for such agencies is the National Association of Utility Consumer Advocates (www.nasuca.org).

10 See http://www.scer.gov.au/workstreams/energy-market-reform/national-energy-consumer-advocacy-body/.

11 See Biggar (2009; 2012).

This leaves us with a long-term contract. I have argued elsewhere that public utility regulation should be viewed as a form of government-imposed long-term contract between the customers and the monopoly supplier.[12] The purpose of that long-term contract is to protect and promote the sunk investments of both parties (the supplier and the customers). But any long-term contract faces a problem: circumstances change over time. The terms and conditions of the contract must be continually adjusted to adapt to changing conditions, without disrupting the incentives for the parties to make sunk investments. This process of adjustment can be facilitated by allowing disputes to be resolved by an arbitrator. All substantial long-term commercial contracts include arbitration clauses. Public utility regulation is no different. The only difference is that the arbitration function is carried out by a specialist, permanent dispute-resolution body known as the regulator. This body resolves disputes in a way which allows for the long-term contract to adapt over time in a manner which is fair and which preserves the incentives for the parties to make sunk investments.[13] In other words, the task of a regulator should be thought of as a form of dispute resolution, akin to that of an arbitrator or a judge.

If little Johnny had said he wanted to be a judge when he grew up, I doubt that Ergas would have had reason to comment, other than on a precocious interest in legal dispute resolution. Being a judge or arbitrator will not always win applause or accolades. But it can earn respect — respect for wisdom, fairness and consistency. Judges are not there to keep their constituents happy, but to resolve disputes in a manner which is wise, fair and which commands respect. The same is true for regulators. As a regulator, Johnny will not always be able to give the affected parties what they want — in fact Johnny will almost certainly have to get used to disappointing people. Mark Jamison (of the Public Utility Research Center of the University of Florida) is fond of saying that 'the art of regulation is disappointing people at a rate they can endure'.[14]

But Johnny is not doomed to fail. My response to Ergas is that he seems to be expecting more from public utility regulation that it is designed to provide. Rather than the 'lofty goals so often set for it', we should expect no more of Johnny than to act with wisdom and fairness, to resolve disputes in a manner consistent with the long-term contract (the Coasean bargain) that the parties would themselves have entered into. In this, I can see no reason why Johnny cannot succeed. There is no need for the counsel of despair. I can see no reason why we could not (using Ergas' words) 'in good conscience commend that career choice, as one likely to ultimately lead to personal fulfilment and worthwhile community service'.[15]

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12 Biggar (2011).

13 For a discussion of the role of fairness in public utility regulation, see Biggar (2010).

14 Jamison (2008).

15 Ergas 2013: 43.

References

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