

Martin Cave: Regulatory Success

ACCC, Brisbane July 27, 2017



ACCC Regulatory Conference 2017
27-28 July 2017

“What does it mean for a regulator to succeed? Two approaches, and an illustration.”

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Agenda

- 1. The public interest perspective**
2. The behavioural perspective
3. A platform illustration

1. Public interest regulation

- Assume well-intentioned but fallible regulators
- What can they do, the better to pursue their (possibly ill-chosen) statutory goals?
- What is the equivalent for regulators of self-help guides?

An early attempt

- 5 key tests for good regulation:
 - is the action or regime supported by legislative authority?
 - is there an appropriate scheme of accountability?
 - are procedures fair, accessible, and open?
 - is the regulator acting with sufficient expertise?
 - is the action or regime efficient?

Source: R Baldwin and M Cave, Understanding Regulation, 1999/2012.

The Better Regulation background

- An important but modest (note ‘better’, rather than ‘good’) step forward
- General process-related injunctions
- Accompanied by mandatory regulatory impact assessments
- Getting harder to reverse engineer the RIAs *ex post facto*

The World Bank guide*

- Distinguishes:

- process: quality of regulatory governance

- substance: quality of regulatory decisions

- Involves

- 3 meta-principles: credibility (with investors), legitimacy (with end users), transparency

- 10 principles

- a set of detailed standards

**Brown, Stern & Tenenbaum, Evaluating Infrastructure Regulatory Systems, 2006*

More interesting: the World Bank's do's and don'ts (extracted)

Sins of commission

- Unrealistic efficiency benchmarks
- Removing investment incentives
- Revisiting earlier 'sunk cost' decisions
- Allowing growing divergence between costs and prices
- Perverse incentives

Sins of omission

- No regulatory accounts
- No methodologies
- No market monitoring
- No cost monitoring
- No contestability of new capacity
- No standards for wholesale or retail tariffs
- No nothing

An ACCC contribution*

“This report aims to provide a comprehensive coverage of the issues that can arise, and the methods that can be used, in evaluating competition and regulatory reforms affecting economic infrastructure in areas such as energy, communications, water and wastewater, and transport.

The report then reviews techniques that have been used in evaluating infrastructure reforms, including social cost-benefit analysis (SCBA), Computable general equilibrium modelling (CGE), econometric analysis, productivity studies and qualitative methods. While the aim is always to capture the full range of effects flowing from reforms on an economy-wide basis, the empirical methods do vary in their degree of inclusiveness.”

(Emphasis added)

* ACCC, EVALUATING INFRASTRUCTURE REFORMS AND REGULATION: A REVIEW OF METHODS, 2010

‘Achieving regulatory excellence’

(Cary Coglianesse, ed. Brookings 2017)

- Useful practical and consoling advice, supported by academic contributions. Thus (pp. 8-10):

“How regulators are like parents

Even parents who are excellent can have a child who turns out to be self centered, rude, indolent or needy. Likewise, examples abound of highly successful individuals who had parents who were at least neglectful and decidedly sub-par.

..[Like parents,] to be successful regulators will need to adapt their strategies to account for differences [in outside factors]. [Like parents] regulators will not always be able to control completely regulated firms’ behavior or its resulting outcomes

..Regulatory excellence is not the same as perfection...Too much risk aversion will be no more conducive to regulatory excellence than too much risk taking.”

Some examples: 1 UK postal regulation to develop competition

- Mid 2000s: access prices to local delivery network set by PostCom at too low a level – leading (with other factors) to losses
- 2011/12: new regulator Ofcom deregulates prices. Privatisation accomplished and end-to-end competition encouraged
- 2015: end-to-end entrant exits
- Now: delivery monopoly now unchallenged; price monitoring continues

Example 2: regulating separation – a telecoms example

- Pros and cons

1. Moral hazard: what arrangement ensures high effort/absence of shirking by the retailer? ambiguous
2. Transactions costs, including hold-up: generally anti-separation
3. Market power, vertically leveraged: generally pro-separation

Results of an empirical review: Lafontaine and Slade (JEL 2007):

“We did not have any particular conclusion in mind when we began to collect the evidence..We are therefore somewhat surprised at what the weight of evidence is telling us. It says that in most circumstances, profit maximising vertical integration decisions are efficient, not just from the firms’ but also from the consumers’ point of view. The vast majority of studies support this claim,..even in industries which are highly concentrated..”

Degrees of separation of BT in UK telecoms (with date of implementation)

Types of separation

Ownership
Legal (2017)
Operational (2006)
Virtual/lite
Accounting (1994)

Example 3: UK water innovation

- Regulation risked penalising unsuccessful innovation, but did not reward success
- Firms basically were 'fast followers,' but there was nothing to follow'
- Solution (work in progress) is to switch focus from commitments relating to inputs to those relating to outputs – ie change the metrics and use higher-powered incentives

Should regulators be foxes or hedgehogs?

- According to Archilochus, a 7th century BCE Greek poet and philosopher:

'the hedgehog knows one big thing, the fox many little things'

- Do those regulators do better who piece together different bits of evidence than those who follow a single big theory?
- (According to Tetlock, *Superforecasting*, foxes out-forecast hedgehogs)

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2. Behavioural regulation*

(Yet) another branch of behavioural economics, which began with:

- rationally challenged *consumers*. Then,
- firms* with cognitive difficulties (Armstrong & Heff, CPI (2006)). Now
- imperfect *regulators*.

If bias is present, how can regulators be 'debiased'?

**Thanks are due in relation to this section to the work of Fransesc Trillas, of the Autonomous University of Barcelona*

A precursor

- Joskow, JLE, 1974, pp. 296-7

‘In terms of the objectives of the firms being regulated, there is little question about the fact that they “like” profits... The objectives of regulatory commissions are naturally less clear and probably more complex than those of regulated firms....’

‘Given this fairly large amount of flexibility [for regulatory agencies] the general view taken here is that [they] seek to limit conflict and criticism appearing as “signals” in the economic and social environment in which they operate....’

Note the relationship with contemporaneous (Stigler, Posner) capture or interest group theories of regulation

Regulatory 'minimal squawk' behaviour (Leaver, AER 2009)

- Regulatory decisions are taken to keep interest groups quiet and to keep mistakes out of the public eye.
- The model hinges on informational asymmetry: the regulator knows her limitations; interest groups have private knowledge of the state of the world, which they can reveal or disclose.
- An able regulator has an incentive to gain reputation by pursuing the public interest: a less able one buys off squawk by generosity
- This is distinct from capture theory, according to which regulatory favour is universally sold to the highest bidder
- The MS hypothesis implies that longer tenure of utility regulators will reduce poor regulators' concerns about the long term reputational effects of squawk, while capture theory suggests the opposite
- US data suggest that electric utility rate reviews are more likely to occur in times of falling costs with longer than with shorter tenure.

Cooper/Kovacic: Behavioral Economics: Implications for Regulatory Policy, (JRE 2012)

- A regulator is torn between pursuing the public interest in the long term and short-term political rewards (future promotions, a good press, more resources etc.) associated with seeking political advantage from short-sighted politicians or electorates,
- Thus the outcome depends both on scale of the short-sighted preferences of politicians and on the regulators' balance of self-interest and principle
- The above three contributions are inspired by the US environment
- Such behaviours can be accompanied (or even disguised) by more accidental but universal behaviours

More mainstream 'behavioural' mistakes which regulators might make

- Regulators regard themselves as experts, performing System II 'slow' thinking, but this does not relieve them of characteristic biases, such as:

Flawed heuristics and myopia:

- availability/salience
- representativeness
- optimism
- myopia
- time-inconsistent (hyperbolic) discounting

Status quo bias

Confirmation bias

Imitative or herd-like behaviour

How competition among regulators works

- Focussed on outputs (decisions), not outcomes (effects)
 - *Outcome feedback slow in coming, and the product of many factors – including firm behaviour (cf. quicker feedback to firms via markets)*
 - *Outcome counterfactuals are hard to come by*
- Political/interest group involvement introduces ambiguity into the evaluation
- Regulatory competition chiefly in outputs (eg in high profile interventions) gives regulators with short term bias an advantage

How can regulators be 'debiased'?

Ex ante actions

Better selection mechanisms (investigate pre-existing implicit biases?)

Require clear reasons for decisions, and specification of underlying assumptions

Challenge groups

Anti group-think measures

Institutional arrangements which do not reward dysfunctional behaviour

(Conditional) long tenure

Pre-commitment to sunset clauses?

Ex post actions

Improve accountability, focussed on outcomes

Systematic review of decisions

Audit

Institutional issues - horizontal and vertical: what flows from 'behavioural regulation'?

- Vertically, the whole process of regulation, involving an independent agency and an court-based appeal process has to be considered. Can the process be designed to deliver the right combination of (possibly) biased expertise and (possibly) unbiased ignorance?
- Horizontally, a reconsideration of the big tent vs. 'separate pair of eyes' debate about institutional structure.

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3. The disruptive effects of the digital economy: the case of platforms

- The process of digitisation is in its infancy; while developments so far relate mainly to the communications sector, henceforth no act of production and consumption in the public, private or personal sectors will be untouched
- Thus e-health, mobility as a service (including connected, shared and autonomous cars), advanced manufacturing, smart cities, etc.
- These effects much broader than current focus focus on mobile broadband, social media, trade in digital goods
- Telecoms operators might lose their key and profitable role as the end users' contracting party and become the supplier of a wholesale input

The regulatory challenge of platforms

- Platforms in the sense of two-sided markets existed in the analogue world – newspapers, advertiser-supported television, dating agencies, shopping malls; but their explicit recognition in economic analysis and regulation dates back to 2003 (Rochet and Tirole)
- Digital platforms are cheap and easy to construct, and immensely profitable: vide GAFA – the European acronym for Google, Apple, Facebook and Amazon
- Look out for platforms as a new ‘intermediary bottleneck’ complementing the familiar ‘local access bottleneck’ (which in communications – though not elsewhere – may be losing its potency)
- From a competition and consumer welfare perspective, the analysis of such markets overturns precedent on market definition and pricing
- It also draws together communications and other sectoral regulators and privacy regulators – for example in transport (Uber) and elsewhere

What have other regulators done: the case of the EU

- In 2015, the European Commission began a consultation on its approach to the regulation of Online Platforms
- Should they be subject to ex ante regulation, or only to competition law?
- The background included dominant positions held by GAFA – the US-based Google, Apple, Facebook, Amazon
- Also, discussion of extending the ‘neutrality’ principle (no discrimination, transparency) further, for example into search
- The initial consultation document seemed quite receptive to intervention
- But the EC concluded that platforms were too diverse to be analysed in one way, or even defined in a future-proof way; they propose a ‘problem-driven’ approach, beginning with whether the existing framework is adequate, also considering self-regulation, subject to fairly anodyne guiding principles

Meanwhile in Germany

- In 2017, the Govt. proposed creating a special ‘digital regulation agency’ with wide powers; later endorsed by the competition authority, which proposed telecoms regulation as an analogy
- Components include:
 - *Creation of a “level playing field” in the telecommunication markets*
 - *Establishment of a dual, proactive competition law*
 - *Establishment of a clear legal framework for the use of data*
 - *Introduction of basic transparency and information duties for digital platforms*
 - *Elimination of legal vacuums in the internet*
 - *Establishment of a digital agency*

What position should Australia take – eg on the Productivity Commission’s recent *Data Availability and Use* report? See

https://www.gtlaw.com.au/insights/competition-policy-reform-productivity-commission-recommends?utm_source=Email&utm_medium=CampaignerConcept

4. Conclusion

- Regulatory statements are ‘performative utterances’: they not only describe a given reality, but also change the social reality they are describing
- Those outcomes are simultaneously important, uncertain (as my earlier examples seek to show) and mutable: they also shift a lot of rents
- Trying to improve such statements (and actions) is an unceasing task, for which both learning internationally from the past and projecting the future are necessary
- One useful mechanism, discussed above, is inscribed above the Temple of the Oracle at Delphi:

‘know thyself’