

**Response to Professor Berg  
“Institutional Requirements for Second Generation Reform”**

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Consideration of the need for evolution in regulatory arrangements is a valuable and daunting undertaking. There is always a danger in relation to any organisational design to believe that the work is now done, that a framework is established, and that life can now merely be allowed to continue. The reality is that we are more likely to be wrong in any organisational arrangement than right. In addition, the behaviour of other participants is partially framed by the structure of the arrangements, and therefore is likely to change as a consequence of the initial structure. This change will require further amendment of the arrangements. These statements apply to simple corporate organisation arrangements and certainly to regulatory arrangements.

I wish to comment on Professor Berg’s contribution in two parts. The first is to specifically address some of the considerations of potential regulatory reform addressed in the paper. The second is to ask a question in relation to overall regulatory structures and a view of the long term.

Fundamentally my comments are based on my understanding of the regulatory arrangements as they apply to telecommunications. While many of my comments would be equally true of the regulation of other infrastructure industries in Australia, I make no claims to expertise beyond the field of telecommunications regulation.

Professor Berg’s paper presented a generic review of regulatory arrangements, and does not necessarily reflect what I would regard as three potential, significant distinctions of Australian regulatory frameworks:

- The first of these is the fact that almost all the regulated industries in Australia have come from a period of long Government ownership prior to the introduction of new regulatory arrangements. This has significant consequences for consideration of where we are up to in terms of regulatory life cycles. Not only were these organisations in Government ownership for a long time, they were very mature organisations at the point of the regulatory change.
- The second consideration is the separation in most industries in Australia between economic regulation, which has been vested in the ACCC, and social regulation or standards regulation. This puts a slightly different complexion on the role of the regulatory agency in relation to the infrastructure industry compared to those arrangements where the one agency is responsible for both activities.
- The third consideration or distinction is the extent to which Australian regulatory processes have been designed to be both supportive of self-regulatory processes, and also have tried to be supportive of negotiation as a primary source of resolution.

## **The Regulatory System**

### **A Systems View**

The central component of the paper's considerations of regulatory performance is summarised in the diagram given as Figure 1. Before attempting to comment on some of the elements of this diagram, one of the important aspects this diagram demonstrates is the fact that we need to take a systems perspective of regulation. If we look at the number of feedback loops within the system described, it is clear this is quite a complex system. A consequence of complex systems is that they are likely to be self-healing, and to behave in unpredictable manners if put under significant stress. Therefore, one should not necessarily expect to see radical and dramatic changes as a consequence of any variation to any component of the structure. One also needs to be alert to the potential for significant negative consequences of any individual change.

A consequence of the systems view is the need to recognise that the industry outcomes are not entirely derived from the regulatory realm. As a result, there is a potential for significant policy error if analysis of industry's performance is reviewed only as a consequence of regulatory behaviour.

For example, in telecommunications, investment patterns appear to be driven more by features other than specific regulatory decisions. Work prepared by Access Economics for AAPT in the Productivity Commission Inquiry into Telecommunications Regulation identified that the pattern of telecommunications investment to that point in time had shown significant dips at times of regulatory change. Consequently it could be inferred that the biggest impact of investment patterns was uncertainty in regulation, rather than any specific regulatory outcome.

More recently, however, the global re-assessment of the attractiveness of telecommunications investment is having a greater impact on investment patterns than any specific regulatory outcome. Therefore, making conclusions about the regulatory framework as a consequence of investment itself is liable to introduce errors in the assessment.

Within the systems view presented in the paper, there are a couple of other key distinctions worth highlighting. In the relationship between Objectives and Regulatory Governance, the distinction is made between the role of policy makers and the regulatory agency. A consequence of this distinction is to recognise the role of the policy makers in clearly enunciating the objectives of the regulatory arrangements. Ideally these objectives will be themselves explicitly enunciated in the documentation, be that legislation or explanations of legislation, that has established a regulatory regime. Clear enunciation of objectives then assists in the process of establishing appropriate regulatory governance including agency design and regulatory process.

### **Regulatory Governance**

It is in the area of Regulatory Governance that some of the more interesting considerations of the roles of regulatory agencies have occurred. The establishment of the American regulatory commissions as independent commissions had its own

history and has its own considerations to the relationship between the independent commissions, the judiciary, the executive, and the legislature.

The very different constitutional arrangements in Australia make an exact comparison between the independent commissions in the US and the role of an agency such as the ACCC problematic. It is particularly interesting to note the extent to which the Dawson Review of the Trade Practices Act has drawn out proposals for alternative governance arrangements in relation to the ACCC including proposals for an Inspector - General and an independent Board that would then separately report to Parliament.

It appears to me that these comments reflect the indistinct processes available under the Australian constitutional model for direct reporting by any body or any agency to the Parliament. Those who have concerns in relation to the accountability of the ACCC probably need to look to wider issues of governance in Australia than merely the role of the ACCC. For example, we have also recently seen calls for the establishment of an independent committee to select the Board members of the ABC, begging the question as to how the independent committee can be appointed any more independently than the existing process of appointing ABC Board members.

It appears that the only effective means of providing satisfactory safeguards of the operations of an independent commission of any kind is transparency of process. However, the difficulty with transparency of process of economic regulation is the extent to which such transparency must come at the cost of disclosure of matters considered by the agency. Those seeking greater accountability by the ACCC need to weigh up the balance between their desire for accountability and their equally strong desire for commercial confidentiality.

This is particularly the case in regards to matters in telecommunications regulation specifically. It is exceedingly difficult to make arguments in relation to how effectively the ACCC is performing its functions, when the relevant information that might be important to assess that performance is jealously guarded by all participants in the industry. This conflict, however, is probably part of the wider consideration of regulatory reform or the future of regulation, not merely the approaches of an independent commission or a regulatory agency of infrastructure industries.

### **Investor Considerations**

The next consideration is the relationship between the regulatory arrangements and investor considerations. A serious issue in the consideration of regulatory objectives as they have been applied to telecommunications in Australia has been the distinction between the existing objective of the long-term interest of end users, versus the contending objective of efficiency of investment. As already mentioned the explication of the objective is important in the operation of the regulatory framework. While a view can be advanced that both statements of objective ultimately result in the same outcomes, there is a need to reflect upon what the specifics are of a regulatory regime that impact on investors.

Clearly the specification by a regulatory agency of some aspects in relation to price of services built around a consideration of what would be a reasonable return for a

natural monopolist were they in a competitive market has a consequences for an investor. This may determine the return they might expect on their investment. The more interesting question is the transmittal of that information to the parties considering the investment. Here the structure of investment decisions needs to be considered and the different roles of the entrepreneurs represented by company management and capital represented by the investment community. The two elements that then flow from this are what are reasonable expectations that investors should have in relation to investment, and what information the regulatory agencies should be providing to potential investors about likely regulatory outcomes.

Beside the ongoing institutional arrangements, the key input to this consideration is experience. Interestingly in Professor Berg's model experience is shown as a new input though an earlier version showed an input from performance. However, this perhaps ignores the fact that experience is itself subjective and is framed not only by what has transpired but by how what has transpired is perceived by the relevant participants. An interesting consideration for this is the extent to which some investment analysts, when considering regulation or regulatory risk, provide a down-rating of investment because of regulatory activism, not from an assessment of any specific harm.

This can occur despite the fact that regulatory activism may be equally valid in generating stable institutional considerations for further investment. For example, in telecommunications the regulatory activity that may be perceived to be a negative because of its potential to limit return on investment by an infrastructure owner is the self-same activity that may guarantee an infrastructure investment access to complementary facilities for their network.

The long-term in infrastructure industries can be quite long – major structural changes take decades not years. The ability to use a feedback loop from performance to experience can only be about short-term performance.

### **Overall Regulatory Institutions and the Longer Term**

I now wish to turn my attention to the question of longer term implications for the regulation of infrastructure industries, and indeed monopoly of all forms - be that natural monopoly or otherwise. That is in Bernstein's terms, what should we be looking to in maturity, and what do we need to do with our youthful adolescent to create a responsible adult.

### **The Paradox**

It is interesting the extent to which this question is not regularly addressed. The question of regulation tends to still be left in a box at the corner, separated somehow from the other institutional arrangements required for the operation of a market economy. Regulation is placed in the realm of the operation of the state rather than the operation of the market. Consequently, we allow ourselves to have an unresolved paradox of the need to regulate for competition. However, this paradox appears to be no more complicated than the essential paradox of market economies. That is, how does the operation of self-interest ever allow for the creation of the institutional

arrangements that support the property rights essential for the operation of a market economy and the realisation of the gains of trade?

Consideration of these institutional arrangements for the regulation of monopolies, as opposed to regulatory agencies sometimes referred to as regulatory institutions, is going to become more important rather than less over future years. There are two reasons for this. The first is that the nature of many of the industries of the information age represent a greater potential for economies of scale, be they demand or supply side economies, and the greater potential therefore for near natural monopolies to emerge. The second consideration is the extent to which the ongoing information revolution is continuing to facilitate efficient organisation, and therefore reducing the transaction costs of organisation. This results in the boundary for declining returns to scale due to the internal organisational problems continuing to move out at a fairly rapid rate.

### **Corporate Governance**

The system view of the effect of regulatory policy on sectoral performance has identified the ordinary processes of corporate governance as being the mechanism for the feedback loop between firm performance and behaviour. Its inclusion highlights the importance of these institutional arrangements.

However, an exploration of the recent failure of these institutional arrangements tends to focus on the tendency for excessive short-term focus on performance assessment. This short-term focus is particularly relevant for monopolies. Most of the arguments that monopolies are relatively benign arise from an attack on the static nature of the traditional analysis of monopoly, and argue that a firm acting in its own long term profit maximising interest would not exploit the short term advantages of monopoly.

But we have become increasingly aware that the attempt to resolve the supposed problem of the distinction between the interests of managers and the interests of owners has actually magnified the extent to which consideration of short term consequences dominate. And this tendency to the short-term has potentially greater errors when the industry is a fundamental input to other industries – efficiency in telecommunications affects overall economic growth, and lower growth results in lower future demand.

### **Culture**

The shared values of the regulatory agency have been identified as its organisational culture, just as the shared values of society overall are reflected in culture. The culture is embedded in the language, conversation and symbols of the organisation.

While the culture of the agency is important, it is the wider social culture and our attitude to regulation that counts. In this regard the ongoing tension between the role of the regulator as an arbiter versus its role to act in the public interest becomes significant. This is a real distinction and has been particularly relevant in PSTN Interconnection regulation where the ACCC identified a public interest role that would not be met by simply getting to a deal on price. However, it does not need to be a focus of attention – it is possible to proceed on the basis of delivering the public

interest by arbitration. That is, recognise the dynamic nature and that a number of cycles of arbitration will allow the outcome to converge with the public interest.

But the biggest contributor to culture will remain the objectives as specified and, importantly, discussed by the policy makers.

## **Conclusion**

The analysis framework proposed for discussing regulatory evolution is primarily a closed system. The biggest single external input is the objectives as described by policy makers. These will drive the operation of the system, and will continue to drive the wider institutional environment. And in this conversation we need to stop talking about economic regulation as if it were something at odds with the operation of the market, it is an essential part of the market. Our objective must be to make it as unobtrusive as possible.