What constitute good regulatory outcomes, and good regulator performance?

Paper[1] prepared by Rod Shogren, Member of the Australian Competition Tribunal and ex-Commissioner, ACCC

ACCC/AER Regulatory Conference 2015: "Better regulatory outcomes; less regulatory burden", Brisbane, 6 August 2015

The session notes prepared by the conference organisers were as follows:

> *The Australian regulatory frameworks all have at their core the overall objective of regulating for the long term interests of end-users. This can incorporate considering the effect of regulatory decisions on encouraging competition, achieving economic efficiency, promoting economy-wide productivity, and honouring the 'regulatory contract'. It can also involve balancing what are at times competing objectives of providing appropriate returns to network owners and broader community expectations that prices should be fairly stable over time.*
>
> *How the performance of the regulator is judged can depend on which of the above objectives are considered most important. Is general confidence that the two key stakeholder groups —regulated businesses and consumers — are receiving relatively fair outcomes, sufficient? Or does a reasonable assessment rely on an understanding of the details of the regulatory framework?*

There are two parts to the topic, and I propose to address them separately, and then make the connection. The first is: what constitute good regulatory outcomes?

Who's asking? I take it that in this conference the question is being asked from the point of view of the community interest. That is, from the point of view of the overall community, what are good regulatory outcomes? Obviously that perspective differs from that of particular interests, although I will argue that one particular interest is in fact paramount.

It is tempting to say that if the regulatory outcomes are good, then the regulator's performance must have been good, too. But I think it is more complicated than that, and that it is also necessary to examine how the regulator goes about its job. That requires thinking about what the relevant dimensions of the regulator's performance are.

[1] The principal presentation at Plenary 2 of the Conference was by Luigi Carbone, Commissioner, The Italian Regulatory Authority for Electricity, Gas and Water and Chair, OECD Network of Economic Regulators (NER). This paper was the basis for the author's presentation as discussant on Mr Carbone's presentation. It has been revised for publication.

Good regulatory outcomes

But let's start with regulatory outcomes. I'm not convinced that it is true that all the Australian frameworks for economic regulation have at their core the overall objective of regulating for the long-term interests of end users. That is, of course, the legislative purpose of the telecommunications access provisions.

The objective of the National Gas Law is to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas. The objective of the National Electricity Law is similar.

But the object of the prices surveillance provisions is quite differently expressed: to have prices surveillance applied only in those markets where, in the view of the Minister, competitive pressures are not sufficient to achieve efficient prices and protect consumers. These provisions apply in a range of industries: Australia Post's reserved services, some waterfront services, and airports and AirServices Australia.

The Water Act has multiple objects, including "to promote the use and management of the Basin water resources in a way that optimises economic, social and environmental outcomes" and "to achieve efficient and cost effective water management and administrative practices".

One of the objects of the Part IIIA of the CCA, which contains the National Access Regime, is "to promote the economically efficient operation of, use of, and investment in infrastructure by which services are provided, thereby promoting effective competition in upstream and downstream markets".

And so it goes. That's before we look at the States' regulatory frameworks. How to cut through all this?

I'm not a lawyer, but I suspect that many lawyers would say that you can't safely cut through by asserting that it all comes back to the long-term interests of end-users. Only the legislature can stipulate what the regulatory purpose is, and regulatory outcomes can only be assessed by reference to the legislative purpose, the object stated in the relevant Act.

On the other hand, I'm pretty confident that most economists feel that they know what a good regulatory outcome looks like without needing to be told exactly what the Act says. And what would they say?

Well, what I'd say is that the key objective of economic regulation of utilities is to improve economic efficiency. Why is this needed? Because of market failure. Where does the market failure stem from? From market power. Where does the market power come from? From market structure, the result of economies of scale and scope, sunk costs, bottlenecks, and so on.

And why is economic efficiency a thing to be pursued? Because it allows a higher level of consumer welfare for a given level of resource use.

As far as I know, you won't easily find terms like the long-term interests of end-users in the academic literature regarding "economic regulation: its purpose and effects". Rather, you will see discussions of market failure and economic efficiency. It should go without saying that economic efficiency has to comprehend the three components: productive efficiency, allocative efficiency and dynamic efficiency.

But it is interesting that in Australia, to a degree in New Zealand, and almost nowhere else, we have gone down this route of talking about the long-term interests of end-users. In my view, this focus on end-users is intended to explicitly get away from a notion of balance between producers and consumers, much less fairness in the treatment of them as two opposing interests.

In my view exactly the same result would be achieved if the objective was expressed in terms of economic efficiency. But the use of the term "end-users" makes the emphasis clear.

As soon as you go down the path of emphasising consumers' interests – making consumer welfare the be-all and end-all – you have to acknowledge that in the long term, consumers' welfare cannot be maximised at the short-term expense of the interests of producers. That is, regulation will not lead to good outcomes for consumers if it focuses, for example, on lower prices without regard to reasonable producer returns.

The reason is obvious: without the expectation of reasonable returns, investment will dry up, and eventually consumers will be worse off than they would have been.

It may be worth mentioning that, harking back to the ACCC's 2002 regulatory conference, there are other formulations of good regulatory outcomes, for example 'to achieve the lowest possible prices for consumers (on, say, an annual average basis) consistent with a financially viable industry'.[2]

Here's another one relating to access regulation: competitive neutrality is achieved when a firm's ability to compete successfully on the basis of efficiency advantages and to recover total costs is invariant to the identity of the firm that provides access. The access price will have been set at the right level by the regulator if a firm is indifferent whether it sells access or purchases access.[3] (Tye 2002).

In much of economic regulation an objective is to limit firms' ability to extract excessive profits. That is almost always understood by politicians and users as a question of fairness, but economists generally think in terms of output being restricted to an inefficient level; ie below the level that could be achieved with a given level of resource use, causing deadweight losses in the economy.

Where does this leave us, though, in assessing whether regulatory outcomes are good?

The telecommunications access legislation goes on to specify that in determining whether something promotes the long-term interests of end-users, the ACCC must have regard to the extent to which the thing is likely to result in the achievement of:

- promoting competition
- achieving any-to-any connectivity; and
- encouraging the efficient use of, and investment in, infrastructure.

---

[2] Wolak, Frank A. (2002) 'Market-based regulatory mechanisms in re-structured network industries', presentation to the ACCC Regulation and Competition Conference, Sydney, July.

3 Tye, William B. (2002) 'Competitive neutrality: regulating interconnection disputes in the transition to competition', paper presented to the ACCC Regulation and Competition Conference, Sydney, July.

Moreover, the ACCC is precluded from taking anything else into account.

These intermediate objectives – sub-parts of the regulatory outcome – give useful guidance, but can't easily be observed or assessed directly, although they may be more amenable to assessment than the long-term interests of end-users.

Similarly, you can't easily observe whether resources are allocated efficiently, although you may be able to see where the allocation is grossly inefficient. You can't see whether an industry has the right amount of dynamic efficiency. Some people might say you can't have too much, but what exactly do they mean? There is no single measure of dynamic efficiency. Do we really expect electricity transmission businesses to be innovating their hearts out? An important aspect of dynamic efficiency is the availability of choices for consumers. Do we really expect users to be able to choose between gas distribution networks?

Again, the absence of such choice is the reason for regulation in the first place. (Note that I am not intending to downplay the importance of technological change, such as electricity storage becoming cheaper, distributed generation and off-grid developments.)

What we do know is that the driver of economic efficiency is cost-reflective prices. And that inefficiency proceeds from prices that vary too far from costs. Obviously costs is a portmanteau word and we have to know whether we are talking about the short run or the long run, and costs include a return on capital commensurate with risk.

But we can't say for sure whether regulated prices are "right". Setting prices is the task of regulation – that's a simplification, but I would say it's the largest and hardest part – and an observer cannot see directly whether prices are right. The reason is that the right price would be that set in a competitive market, and we don't have a competitive market; that's the reason the market is being regulated.

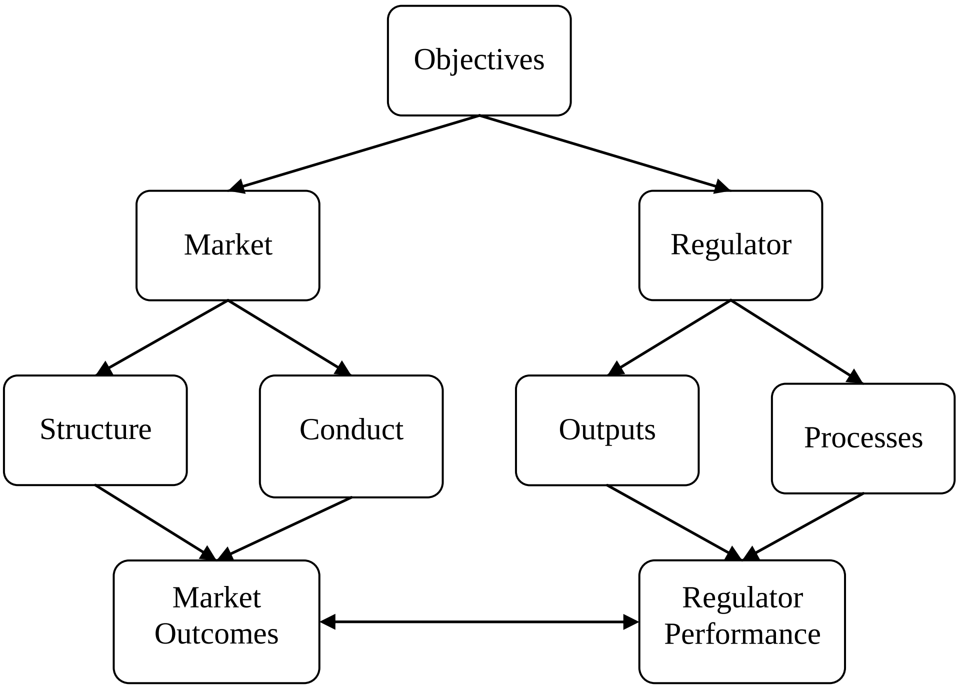
What we can do is, from time to time, undertake in-depth studies – the kind that the Productivity can carry out – of regulated industries and assess whether, over time, the market structure changes for the better, whether competitive forces are strengthened, whether upstream and downstream markets are healthier. We can also form views about the degree to which inefficiencies are sustained, whether costs are minimised or padded, whether firms are moribund or full of life.

Such reviews would often be in the context of deciding whether regulation is still necessary, or whether more appropriate tools of regulation could be employed.

But even with all this, I think it is unavoidable to look at what the regulator actually does on a day-to-day basis. If much of the regulator's task is setting prices (or deciding whether prices set by firms are too high), then we need to see how the regulator goes about those tasks.

Bringing regulatory outcomes and regulator performance together

I try to bring the ideas of regulatory outcomes and regulator performance together in the following diagram:



My theme is that how good regulatory outcomes are, and how good a regulator's performance is, must be assessed against objectives. Objectives come in several forms. In the first place there are those related to market and industry outcomes, such as changes in industry structure, reductions in anticompetitive behaviour, and so on. There are also objectives related to the regulator, such as the number and quality of its decisions, and issues like transparency and consistency.

In referring to market structure and conduct, I do not intend specifically to introduce a structure - conduct - performance approach; rather to make the obvious point that market outcomes are influenced by both the market structure and the conduct of firms in the market.

In some regulated industries the market structure has been completely changed by the removal of vertical integration. Admittedly, this was generally the work of legislation rather than regulators' decisions, but the reconstruction of the market, including delineation of property rights and the way trading takes place, was heavily influenced by regulators.

In terms of conduct, an objective is to prevent the foreclosure of competition upstream and downstream of a bottleneck. That might be expressed as promoting competition in those markets. Remember the things that the ACCC is required to take into account in determining whether something promotes the long-term interests of end-users. I see those things as sub-objectives that can be assessed more directly than can the long-term interests of end-users, or economic efficiency.

Of course, market conduct comes together with the market structure in the sense that structure partly determines what conduct is permitted – eg not precluded by competitive forces – and structure and conduct jointly determine market outcomes.

Similar points could be made about the objective of not allowing the extraction of excessive profits. I note in passing that elements of general competition policy such as merger regulation can be thought of in this framework. I mention this because I think we sometimes make too great a distinction between general competition policy and economic regulation, remembering that the Australian model is to conduct both forms of regulation in a single regulator.

I would also like to think that a robust approach to this topic could also be applied in large measure to, for example, the regulation of financial markets.

Market outcomes is the area we traversed earlier, but it should be acknowledged that in some areas there are other objectives imposed on the regulatory framework. I am thinking of universal service obligations, retailer of last resort provisions, cross-subsidisation. Multiple objectives set up tensions that the regulator may not be able to resolve. What has to give? Clearly with a universal service obligation, economic efficiency has to give.

In the case of water regulation, where various objectives are to be optimized, who knows?

Good regulator performance

The regulator should also have objectives that go to the means of achieving good regulatory outcomes. Whether these are called sub-objectives or KPIs or something else does not matter; but a regulator needs to have ways of measuring its internal performance as well as market outcomes, not least because market outcomes are influenced by many things in addition to the regulator's performance.

The ACCC has done a good deal of work in this area in response to the Government's Regulator Performance Framework that has applied to major Commonwealth regulatory agencies since 1 July 2015.

The framework establishes a common set of six outcomes-based key performance indicators (KPIs) that will allow for the comprehensive assessment of regulator performance and their engagement with stakeholders, specifically:

1. Regulators do not unnecessarily impede the efficient operation of regulated entities.

2. Communication with regulated entities is clear, targeted and effective.

3. Actions undertaken by regulators are proportionate to the regulatory risk being managed.

4. Compliance and monitoring approaches are streamlined and coordinated.

5. Regulators are open and transparent in their dealings with regulated entities.

6. Regulators actively contribute to the continuous improvement of regulatory frameworks.

The ACCC has produced a comprehensive self-assessment methodology, measures and output/activity-based evidence that it will use to assess its performance against the six KPIs annually. There is an external panel to “validate” the ACCC’s self-assessment.

I shan’t elaborate on that framework. There’s a lot of overlap between the Regulator Performance Framework KPIs and what both Mr Carbone and I are saying. Rather, I will say a little about how I thought about such self-assessment before becoming aware of the ACCC’s recent efforts. My own thoughts date back about 13 years to around the time I left the ACCC.

I have characterised the regulator’s self-performance objectives as relating to outputs and processes. Outputs include matters such as the quantity and quality of decisions, guidelines for firms on the regulator’s approaches to its functions, and success in court proceedings. Processes include such things as the timeliness of decisions, the effectiveness of consultations, and compliance with the requirements of administrative law.

These categories overlap. For example, the quality of decisions depends partly on the effectiveness of consultation processes. Nevertheless, it is useful for a regulator to set itself objectives that try to capture its essential outputs and important aspects of its processes and to monitor its performance against both sorts of objectives.

Outputs

The regulator’s outputs – decisions, explanations of decisions, publication of approaches to issues, and many more – are all subject to examination against quality measures. This is set out in the ACCC’s response to the Regulator Performance Framework, and I won’t elaborate on that. Rather, I will turn to processes, which affect the quality of outputs, and where I think more can be said.

Processes

Under the heading of processes are some areas over which the regulator itself has substantial control.

An example is **transparency**. The regulator should strive to make its objectives, administrative procedures, approaches to issues and decision-making principles as widely known and easily understood as possible. In addition, it should clearly explain the reasons for its decisions. Of course, various requirements for achieving transparency may be imposed on the regulator through its legislation. However, the regulator should seek to establish high standards of transparency beyond what is formally required of it. Always prick up your antennae if you hear the words ‘decisions are matters of judgement’.

Transparency is necessary to ensure fairness, but most importantly because it improves the quality of decisions. A wise regulator will facilitate scrutiny of its decisions; in the long run that is the best safeguard against sloppy thinking and eventual embarrassment.

There are important objectives that are partly in competition with each other, and it is a question of getting the balance right. I am thinking of consistency, predictability and flexibility. **Consistency** is highly desirable, but can be a debilitating constraint if taken too far. Consistency in decision-making applies across industries, firms and time. It is obviously necessary to achieve fairness, although, paradoxically, in extreme circumstances breaking with consistency may be fairer if an approach is shown to have become so outmoded and inappropriate that it would create injustice to persist with it.

The adage goes: there is no virtue in consistency if you are consistently wrong. If circumstances change, if the evidence changes, generally you should change your mind, and then your approach. In relation to the law, Justice Brandeis famously said: ‘in most matters it is more important that the applicable rule of law be settled than that it be settled right’. I personally think that in Australia we could do with a lot more of that principle in the interpretation of – and restraint in making legislative amendments to – Part IV of the CCA. But regulatory decisions are different; they are not principally about great principles but about getting the nitty-gritty of hard analysis right.

Predictability is related to consistency. As far as possible, businesses should not be subjected to unexpected changes in the policy and regulatory environment. Similar conduct should be treated in a similar manner. Business should be able to plan and act in accordance with the regulator’s past decisions. More than that, the regulator should try to foreshadow how it will act in the future, given particular circumstances, and then stick to its promises.

The tendency can be for a decision-maker to keep its options open: to be afraid to say what it would do in hypothetical circumstances in case it wishes to act differently when a real case comes along. This is a temptation that, while natural, should be resisted. The regulator should of course be careful about how it circumscribes its discretion and freedom to act in the future, but it should positively seek to do so nonetheless. Again, so long as reckless promises are not made, signalling future approaches leads to better decision making. This can be done by publishing decision-making criteria, timetables, and so on.

Flexibility in decision making is in my view a mixed virtue. Certainly a regulator needs to be able to respond appropriately as circumstances change. In addition, a mix of regulatory tools may be available, to some extent alternative approaches can be experimented with, and major changes in the regulatory environment need to be acknowledged. However, in practice, flexibility is much easier to achieve than predictability and consistency. This is because consistency and predictability reduce discretion and require more forward thinking if they are to be exercised sensibly. Flexibility can degenerate into indecisiveness. It is a question of balance, but courage and skill are required to get the right level of consistency and predictability.

Other elements of best-practice processes include administrative efficiency, timeliness and good communications. These are all well understood and do not raise difficult issues about how to get the balance right.

Principles

Beyond outputs and processes, I tend to see good regulatory practice in terms of principles, for example:

- that regulation focuses on areas of strong market power and opportunities to leverage that market power;
- as a corollary, that regulation should be restricted to the portion of an industry where it is genuinely needed (with only general competition policy applying elsewhere); and
- that the need for and scope of regulation be reviewed from time to time, and

not just by the regulator.

The principles of **independence** and **accountability** are linked. Let me say a little about independence.

Effective regulation requires the ability to make decisions that are unpopular in some quarters, to stand up to powerful interests and to take a measured view. This cannot be done consistently without independence from government. Despite their not infrequent desire to become involved in the day-to-day work of regulators, governments just as frequently find it advantageous to be at arm's length from regulatory action.

Independence is something that has to be constantly fought for and defended. Partly this is a question of stakeholder management. That sounds, at least to me, a somewhat cynical term suggesting manipulation. But it is necessary to recognise that there are many different categories of stakeholders, such as small business and big business, city and rural consumers, access providers and access seekers, established firms and new entrants. These groups are likely to form moving alliances on issues with which the regulator deals.

Clearly the regulator should not seek to curry favour with any one group. Even consumers are likely to oppose some of the regulator's positions, for example if it seeks to make cross-subsidies more transparent or reduce them. It may even be a measure of success that the regulator upsets every interest group at some time, but not always in the same way and not always the same groupings. This is not a matter of adjusting decisions to make them more acceptable to particular groups, but rather of trying to control the agenda – the subject matter and timing of decisions – so that no group is consistently on the wrong end of the regulator's decisions and no group is seen to be unduly favoured.

One part of setting objectives is finding out what stakeholders expect. How will they measure the regulator's success? Of course, a regulator will also seek to influence stakeholders' expectations and criteria for success rather than accept them passively.

The regulator's performance against both output and process objectives will be reflected in its **reputation**, and the regulator should also have aims that relate directly to that reputation. Is the regulator seen as credible in the sense that its announced intentions and forecasts are believed? Is it trustworthy in the sense that firms can rely on advice it gives them about its approaches being adhered to? Is it seen to have integrity? Does it have a reputation for not shirking difficult issues? Is it considered fair? Is it respected? Is it feared, and, if so, by wrongdoers or by all who have dealings with it?

Perhaps most tellingly, is the regulator seen to be successful? The reason this is important – beyond its impact on morale, and staff recruitment and retention – is that such a reputation aids in future performance. It helps in getting compliance with legislation and in achieving good market outcomes.

Organisational skills and culture

I have emphasised the need for a regulator to set itself objectives. Now I'd like to suggest some elements that go towards building and sustaining an organisation that is capable of setting and achieving objectives.

A key element is bringing together and managing people with the right skills. It's not just a matter of finding those with the intellectual quality and appropriate academic disciplines. Personal styles and approaches matter.

Staff with tenacity, drive and even cunning are required in dealing with large corporations with huge resources.

On the one hand, a regulator needs people who can give careful and cautious advice that will keep it out of trouble. On the other hand, there are times when you need someone who – rather than advising against a proposed course of action because of all the difficulties – can find a way to make things happen.

This need for complementary skills – thinkers, doers and even dreamers, those who are cautious and those who crash through, introverts and extroverts, reactive people and proactive people – extends across all subject matters and disciplines.

The balance between these different sorts of skills partly determines the regulator's organisational culture. Are thinkers or doers in the ascendant? Is the general approach cautious and risk averse or does the regulator stick its neck out and seek to open new frontiers, to push the envelope? Moderation in all things is probably a sensible approach, but culture often follows from a leadership style.

Developing a reputation for over-caution will severely hamper a regulator's effectiveness, but the other extreme – shooting from the hip – is equally unwise.

As suggested earlier, a useful aspect of organisational culture – which like other aspects must be reinforced by the leader's example – is a welcoming of scrutiny. Secretiveness breeds trouble, for eventually secrets tend to be revealed.

Although a strong culture – one in which staff share values – is usually a strength, it can be dangerous if it leads to groupthink, where everyone in the organisation approaches issues in such a similar manner that changes in the external environment, and new and better ways of doing things, are ignored.

For example, it is useful for regulatory staff to believe strongly in the rightness of what they do, to be determined to pursue the public interest and not let the wool be pulled over their eyes. This can often lead to a sceptical and aggressive approach to businesses. This is all right if not taken to extremes, manifesting itself in unfair treatment, a breakdown of relations, public sniping, and so on. It is up to the regulator's senior management to encourage such determination and commitment while maintaining their own receptiveness to other points of view than those commonly expressed internally.

A regulator necessarily deals with the same firms more or less daily, year after year. While an adversarial relationship may develop, both sides also need cooperation as there are likely to be ongoing information flows in both directions.

Moreover, a regulated industry often involves a series of bilateral relationships between a dominant firm such as an access provider and a series of smaller access seekers-cum-competitors. The regulator may be required to intervene in these bilateral relationships. It may be difficult in those circumstances to maintain a focus on the process of competition rather than the viability of individual competitors.

Conclusion

I conclude with a few simple thoughts.

Fairness is of course a requirement of the regulator's behaviour when it comes to how it interacts with all its stakeholders, particularly regulated firms and users of those firms' services. Fairness includes things like providing all parties with equal access to the regulator's thinking, reasonableness in information demands, presumptions of good faith unless proven otherwise, and sensitivity to the impacts of decisions, timing of decisions, and so on. In other words, the regulator's processes for dealing with stakeholders – perhaps especially regulated firms – need to be fair.

But fairness is not an appropriate concept in thinking about regulatory outcomes. That means that unfairness is also not the right way of thinking about regulatory outcomes. The idea is not to share the pain, or share the delights of regulation. The objective of the economic regulator is to seek to improve market outcomes by increasing economic efficiency and the interests of consumers over the long term.

It's all about increasing the size of the cake for a given set of ingredients, ie making the best use of the community's resources, not deciding how they are shared.

Or at least, if we want good market outcomes from economic regulation, that's what it should be about. But if the regulator is given multiple objectives, then economic efficiency will be compromised. I think it is better if the regulator is able to seek economic efficiency within given constraints, such as a USO, rather than trying to find a way through multiple objectives by some kind of optimising of regulatory outcomes.