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**‘Exploring the latest
issues in regulation’**

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INTRODUCTION

Today I would like to provide you with my views as to some of the ACCC's current and up-coming regulatory challenges.

I would also like to provide some context to our work. Not so much in the technical or forensic sense but in the broader sense of our regulatory approach.

The area for which I am responsible comprises a portfolio of regulatory branches and groups. These include energy, communications, water, transport -including airport monitoring, post and fuel monitoring.

The regulatory groups also provide advice to government and to departments, when requested, on issues of policy, regulatory frameworks and competition issues arising from activity in their respective sectors.

I am going to start with a somewhat brave assumption – that is, that we take the current rationale for economic regulation as given.

Natural monopoly characteristics, externalities, network effects and associated “market failures” are more often than not given as the underlying rationale. That is, without some type of government intervention the service provider would have little constraint on the charges it applies, consumers would be worse off and the economy would operate at a lower level of efficiency.

Also, regulation is often said to be necessary to address issues of long term commitment, especially in regard to infrastructure owners’ investments.

Regulation shouldn’t change at the whim of governments or policy makers. Long term commitment issues also arise with customers and regulation can be considered as protecting them, as well as operators, from politically driven decisions.

One of my colleagues, Dr Darryl Biggar, an independent consulting economist, has hypothesised that regulators around the world should see

their role in terms of long term contracts. In fact, he argues, that is fundamentally how regulators have been acting in their determinations.

This entails a view as to the regulator protecting the sunk investments of both suppliers and users and to an extent the regulatory contract between the regulator, government and the businesses. From the long term contracting perspective will come insights into the regulatory role and the way in which we undertake our tasks.

Regulation should provide confidence to investors and address concerns around political risk that may otherwise greatly reduce incentives and/or result in much higher returns being demanded from investors.

OBJECTIVES

The legislation that we operate under, while providing for different regimes, essentially start from the premise that economic regulation should be applied only where there is no effective competition.

Across our regulated areas we can identify two basic or fundamental objects reflecting policy makers' views and guiding regulatory approaches.

The regulator should promote the economically efficient operation of, use of, and investment in infrastructure; and in turn, promote competition in dependent markets and the long term interests of end users.

Again, these objectives are premised to a large extent on the belief that the sectors regulated have market power arising from control of bottleneck or essential facilities and that under a laissez faire scenario we would expect the simple, text book monopolist's decision making. That is, contraction in supply resulting in higher prices or poorer quality of service. Or a lazy monopolist with a quiet life.

Either way, the result would be a reduction in welfare to the detriment of society.

EFFECTIVE REGULATION

Effective regulation is not just about technical competence. Nor is it static. It requires judgment and careful, considered use of discretion. The best practitioners acknowledge the need to make choices.

The work we do entails art as well as science. Or as Malcolm Sparrow, the British policeman turned Harvard guru on regulation, would say – it is a craft that must be learned to be practised skilfully.

Regulation is meant to facilitate the market discovery process, not to replace it. Regulatory responsibility does not mean that the regulator makes all the decisions. The regulator in a perfect world would remain in the background.

Regulators do need to understand context and to take a leadership role in regulatory discussion and debates. We need to be able to reconcile competing demands.

Increasingly these demands include social policy imperatives as well as those of economic efficiency and the market and political power considerations of traditional regulation.

In a number of instances we are being asked to reconcile notions associated with justice and equality.

Mark Jamison from the Florida Public Utility Research Centre (PURC) is one experienced practitioner, academic and trainer who points directly to the changing role of regulators associated with their need to guide policy and help stakeholders adapt.

Technical and analytical competency is no longer sufficient. Adaptive leadership is becoming a core skill.

What are the front page issues that are taking so much of the attention of the media and the community?

- The National Broadband Network;
- Climate change debates;
- Water with its controversial and emotive social, environmental and economic aspects.

These issues have and will continue to have significant impact on the work of the ACCC/AER.

Similarly the business pages of our newspapers dwell upon issues regarding convergence, especially in the communications industry and of the likely impact of structural changes in different markets.

Again these are fundamental issues for the ACCC/AER and in the decisions we make we have to understand these changes and sometimes make a call, as best we can, about the direction of these changes.

The ACCC rarely escapes being named when community alarm is raised about any pricing issue. Currently energy prices are at the forefront and given the regulatory role of the AER this is right within our watch.

More broadly, when cost of living pressures (manifesting themselves as higher prices) breakout in any part of the economy there is a nod to the ACCC to get involved and find solutions.

Even when there are price reductions some members of the community look to the ACCC. Our commissioners are keeping abreast with the reported concerns about low prices in milk, bread and even potatoes.

There are times when we must acknowledge that price changes are the result of fundamental changes to the evolution of a market and action is well outside our legislative powers.

At other times they are a result of whole of supply chain regulatory decisions where we only have legislative command over parts of that chain – the ARTC Hunter Valley Rail Access Undertaking is just such an example.

However, we will always rigorously assess concerns to ascertain whether or not conduct in question is in breach of our competition and consumer protection laws.

CHALLENGES

There are interesting, complex, and difficult industry specific challenges in every sector we regulate. However, I would now like to point to some of the challenges I see that are more general in nature and arise in all the sectors we regulate.

The ACCC/AER is a unique beast in the world of regulatory, competition and consumer protection enforcement agencies.

It is unusual in many respects to have competition and consumer protection under one roof. If you then add product safety and the full suite of regulatory roles then we do indeed stand alone. Only New Zealand, Barbados and to a

lesser extent the Netherlands, as far as I am aware, come close to the Australian model.

This structure in itself raises a number of challenges that while often faced by other agencies, are magnified and made more complex in our case.

There are long running debates as to the most effective institutional arrangements for regulatory bodies. If they are industry specific – say focussing on water would this not be a better way to develop staff expertise and get a real understanding of the industry amongst those people given the heady job of making decisions?

Alternatively, concern about “capture” – that regulators will become so involved with an industry that they will be unable to make independent decisions - is sometimes raised to highlight a weakness of industry specific regulation.

UNCTAD (the United Nations Committee on Trade and Development) has been considering trends and features of regulatory and institutional frameworks in one of its expert working groups. The issue of multi-sectoral regulation is one that is being considered at UNCTAD as well as being debated in some European Regulatory circles.

There are obvious challenges arising from the Australian model, including the basic management of a diverse institution.

The positives as I see them relate to consistency across sectors in terms of regulatory approach; less opportunity for regulatory capture; much better coordination; and the benefits that a competition culture can bring to the traditional regulatory approach.

A multi-sectoral competition and consumer protection institutional structure should encourage a positive pro-competitive approach to regulation and a focus on integrated and consistent regulation across infrastructure areas.

Along with the benefits, this model brings significant challenges requiring strong guidance to maintain focus and clarity in the agencies goals and objectives.

We also need to be vigilant in respect to the size of the task so that we don't lose industry expertise in a more generalist body.

We need be able to manage and balance the differences in the various regulatory regimes under which we operate while maintaining the core economic and legal consistency required of an effective economic regulator.

Governance and decision making needs to be provided in a framework that manages the various risks inherent in a multi-sectoral body such as the ACCC. We have a series of Committees with overlapping Commissioner and staff representation to provide this oversight and management.

In addition a number of operational measures have been taken across the Division to ensure consistency and rigour in staff assessments of the various regulatory proposals.

These include a financial modelling group to consider and advise on Division wide financial issues and the Regulatory Development Branch (RDB). RDB has Division wide responsibilities in regard to advising the various groups and branches on a broad range of regulatory economic considerations.

(A recent paper, *Exploring Trends and Variations in Agency Scope* by Jacint Jordana and David Levi-Faur, examines the issue of multi-sectoral regulators in some detail.)

Our work is occurring in the context of a dynamic external environment characterised by significant economic events and rapidly evolving technological and often structural change.

Stability and change, Jamieson's so-called paradox.

Traditionally, stability has been viewed as a core attribute of a regulator and its regime. However, the rapid changes we face sometimes put the regulator in the position of being the change agent – a position that doesn't always sit easily with views as to the separation of the regulatory role and policy development.

Rod Shogren, a former ACCC Commissioner and a member of the Australian Competition Tribunal, has stated that the agency with the experience in administering legislation invariably has valuable knowledge of the shortcomings of the regime it regulates. It is also well placed to suggest improvements.

In making our recommendations to decision makers we and they must be aware of the context within which we operate. We need to understand where advocacy, policy and the regulatory role intersect – and understand the limits!

There is also a challenge for the ACCC in its role as what can be termed a “myth-buster”. That is, to be able to present to the public its expert and well researched views on particular issues of concern to the community. I would point to our role in petrol in which we have undertaken substantial work including many public pronouncements, speeches and a very comprehensive petrol monitoring report to try to explain to the Australian public the drivers behind petrol prices most of which are international in origin.

We will continue to ask how do we balance pragmatism, independence, and due process and market imperatives.

There are demands for the organisation to be more commercial and to make greater efforts to understand the businesses we regulate – to understand what drives business and their stages of development.

Technological change also poses numerous challenges: how do we manage regulatory consistency without stifling technological innovation?

Of course, regulatory practices also have to change to keep up – more on this later.

We must deal with competing incentives and demands and with the grey areas that often accompany our work.

This is especially so when social and/or environmental objectives are added to the more traditional ones. As mentioned, there is a real risk that intractable conflicts emerge that can well distract from the agencies core objectives.

Balancing policy imperatives with an effective regulatory regime is a challenge. How do we build in some of the broader less “economic” based objectives into what are essentially economic efficiency based regimes?

And as social imperatives (or at least less economic based objectives) come to the fore how do regulators ensure that they maintain their independence?

This issue of the independence of regulators is one of the enduring regulatory challenges.

Another challenge that confronts all regulators is the need to overcome any pre-conceived notions. We need to be careful not to bring any biases to our analysis. Long term regulatory relationships are like any other, fraught with

risk and can often descend into personal battles rather than to remain focused on the issues at hand.

At the same time we need to build relationships that allow us to understand and appreciate the commercial reality facing the business we regulate while managing this relationship in an “arms length” way. The customers of those businesses also have to be treated in a comparable way.

The continuing need for analytical rigour and intellectual honesty are always going to be a challenge for regulators.

This is most obvious where decisions have a political impact and can be manipulated by opponents to undermine the independence of the regulator.

Complementarity between Regulation and Competition Law is another challenge. This has been a bigger issue in the EU but it is also something we need to be aware of. We need to be able to link these two “disciplines” in order to achieve the best outcomes.

We have to be willing and able to bring our experience and analysis to bear in trying to bring a competition focus to demands for regulatory solutions to many problems facing the broader economy and society.

After all, this was identified in the Hilmer Report as one of the key benefits of having the regulatory role within the competition agency.

THE FUTURE

Our regulatory regimes are being constantly tested and questioned by a changing world. I spoke of the challenges arising in circumstances where the regulator is acting more as a change agent in addition to its more traditional regulatory operational role.

Perhaps the most important question that we can ask ourselves is, are we doing the job right? Following Hilmer and all the expectations arising from what was indeed revolutionary in the context of competition and regulatory law and practise we should ask: is this where we expected to be?

The following are a few of the concerns being voiced and some ideas about possible areas for attention by policy makers and regulators. The commentary is based in part on work done by Dr Biggar, ACCC staff, other economic regulators and interested commentators.

I would note that the following are my views, and not necessarily representative of those of the ACCC or AER Commissioners.

Looking from my side of the regulatory fence there is no doubt that we are using more and more of our limited resources to assess regulatory proposals.

Decisions are getting longer, taking longer, and becoming more complex, more technical and more difficult to understand. The proposals are likewise increasing in size, complexity, technical argument and so forth.

We need to look closely and honestly at our regulatory processes and outcomes and determine if we have the right balance. This will involve the regulator and regulated entities along with policy makers coming to grips with what may well be difficult alternatives or changes.

One particular area that I am especially concerned with is the debate around the cost of capital and its parameters.

The never ending search for numeric certainty has led to intense debate and litigation. These debates and the associated litigation seem to disregard the fact that we are dealing with a theory, not a pure, scientific or mathematical fact that can be proved unequivocally.

Imprecision in estimates of parameters and regimes like the National Electricity Law that allow challenges to individual parameters, leave plenty of room to challenge the various thetas, gammas, betas and so forth.

The potential rewards for businesses are high and the costs low or non-existent. In many cases the worst outcome is that the regulator's ruling is reinforced with costs of the challenge past through to users.

From my viewpoint, the ability for businesses to judicially cherry pick through the regulator's decisions coupled with the regulator carrying the burden of

proof, creates the very real risk that overall outcomes are likely to be too weighted in favour of the regulated entities.

The context or breadth of the decision is ignored in favour of highlighting the individual aspects of the decision.

On another level, there have been growing calls for increasing the role and responsibility of consumers in the regulatory process. Professor Stephen Littlechild, the well known UK regulatory expert, has long argued for an increased role for consumers in the regulatory process.

This is a very significant challenge. How can customer groups be given greater responsibility and be part of the decision making process? Consumer and user groups in Australia are often poorly resourced, focused on specific cohorts and lacking the economic skills base to ensure their voices are adequately represented in the debate. Regulation is very complex and we are certainly aware of how difficult it can be to get the right level of expertise to bring insight to these issues.

This issues not unique to Australia as Professor Littlechild's work attests. Internationally a number of countries have put in place programs to tackle the issues of consumer involvement. The establishment of say an *Office of the Consumer Advocate* either within or outside the regulator is one idea and is a solution that has been taken-up by a number of US states. Australia has been at the forefront of regulatory change but this is one area where we could well look to international experience for ideas.

When building a regulatory regime policy makers are inevitably faced with the issue of regulatory discretion. All enforcement and regulatory bodies along with their agents encompass some degree of discretion.

Regulators need the flexibility to learn, develop and adapt. This learning and maturity must be able to flow through to the regulators' operations and decision making.

When policy makers respond too rigidly to concerns in the market about the independent regulator's discretion and decision making we can end up with potentially dysfunctional results.

I would suggest that the overly prescriptive nature of the electricity law, for example, leads to a regime that encourages disputes.

There are growing concerns that the rules, and their highly prescriptive nature, can allow businesses to target individual aspects of a decision and to undertake appeals that do not necessarily take into account the overall regulatory decision. The issue of context I mentioned above.

A simple attack on the averaging period in the NSW and Tasmanian electricity network decisions led to an additional 2b in revenue which flows directly to consumers in increased prices. I would note that this is just one component of one parameter of a number of parameters that make up the cost of capital

in what I have already noted is still a theoretical construct. I reiterate my view that this search for certainty is highly problematic.

The regulator in the energy framework faces a significant evidentiary burden when it decides to challenge a proposal. The burden of proof favours the regulated firm.

To date the AER has found itself in the Australian Competition Tribunal on a regular basis being second guessed on what are essentially technical matters generally left to the independent expert.

There may be legitimate cause to question a regime that appears to place little weight on the expert judgement of the regulator and that appears to view the regulator as just another party in a dispute rather than as an independent arbiter over diverse interests including those of consumers and those of the regulated firm.

This issue is not just about energy of course. We need policy makers, courts and tribunals that understand the need to stand back and rely on broad incentives to achieve desired outcomes. Approaches that allow “cherry picking” to change the way decisions are made run the risk of preventing the achievement of overarching regulatory incentives.

We see in many areas our staff making what are essentially engineering assessments of firms’ proposals. We should be allowing economic incentives

to operate to the extent possible. The regulator will never match the businesses when it comes to engineering assessments.

Andrew Reeves, the chair of the AER, refers to the danger of our staff moving away from being economic regulators of engineering businesses to being economic engineers second guessing what we will never be the experts at. We will, therefore, forever end-up relying on duelling consultants to achieve any outcomes.

This refers to the regulatory regimes more generally and is not limited to the AER group. One just has to look at the time taken to determine the ARTC undertaking and the range of issues that the regulator is faced with to see this risk.

Rate of return, loss capitalisation, network path determination, capacity framework, efficient train configuration and pricing (one of my personal favourites) trading, assessment of the true up test and so on – is all part of the evaluation process.

When we pass our eye over our communications area we are again met with intellectually and technically difficult decisions, made even more so by the level of public dispute.

Having come this far in terms of industry structural change and seeing for the first time the very real possibility of fulsome competition and all it promises we would be quite remiss not to maintain our focus on developing competition.

We are faced with ensuring the industry structures that emerge are capable of promoting competition. We need again to be active in providing our views to government and others as to what we see are the competition impacts of emerging markets and technologies.

Issues such as equivalence; transitional regulatory arrangements; new regulatory arrangements; length of undertakings; how much or how little flexibility; and how do we maintain our processes at the high level of integrity the world has come to expect of us while under very real timing pressures are all challenges that need to be taken into account.

This whole area also highlights an extremely difficult issue for us. How do we ensure that we adapt to the new market realities and balance these changes and the pressures they are exerting on current market participants with an effective interim regulatory presence?

We cannot ignore the possibility of competitive and consumer detriment during that interim period. Thus an eye must be kept to the enforcement and adherence of the current regime, with our strengthened regulatory powers, while at the same time recognising that the development of an NBN specific

regime is likely to create another quite different world in communications regulation.

I would like to finish with a quick reference to what I consider to be certain essential attributes of a good, effective regulator.

We have to adhere to our fundamental tenets of predictability and consistency, confidentiality, transparency, fairness and timeliness. We must add to these tenets a high level of rigour in our economic, financial and commercial analysis.

All up, we need to ensure we are regarded as a highly professional institution.

All this needs to be considered in the light of the fundamental need for independence. We must be and be seen to be an independent regulator acting to support the public interest in achieving the goals and objectives in our legislative mandate.

We need, therefore, to have well defined goals that are clearly communicated; we need to be strategic in the way we undertake our work; we should focus on building a problem solving culture, rather than referencing “busyness” as the sign of effectiveness; and we need to be willing to evaluate our work, and where necessary adapt.

All this has to be accomplished within the context of an agency that engages with the many stakeholders that are affected by our decisions.

The agency needs to have a collective willingness to learn and adapt and to be open in its dealings with all stakeholders to the extent possible.

The full benefits of liberalisation and economic reform cannot be realised without an effective regulatory regime and institutions. Many of these benefits rest with a regulator that acts in accordance with the precepts I have briefly mentioned above.

So as our staff come into work in the morning they have to have in their mind this myriad of needs about communicating complex ideas, fostering innovation, providing strong, consistent messages – that is regulatory certainty – while at the same time being flexible and responsive to a changing and challenging environment.

This is our great regulatory challenge.