Understanding the Political Economy of Economic Regulation

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Key Political Economy Distinctions I

The main political economy functions involved in utility activities are:

(i) Policy making for the sector
(ii) Regulation
(iii) Commercial operation

In some circumstances, the three factors are totally combined with all major decisions taken by a small group of government members and senior decision makers.

This happened in 1940s Britain and France, 1950-85 Central and Eastern Europe.

Key Political Economy Distinctions II

- Post-1950, utilities in Western Europe developed more independence in commercial operation but …
  - Regulation of investment and prices was still run by government departments

- Separation of regulation from policy making only arrived in Western Europe after 1980 … and is still a fuzzy line
  - Most governments still try to retain some control over investment and (especially) retail prices

- The issue of what regulation covers and what is covered by policy is difficult and changes under successive governments
  - Laws can define what is regarded as ‘regulation’ but they cannot do so for ‘policy’
  - Only governments can define where the boundary between policy and regulation is located

Separation of Powers

Effective independent regulation requires substantive institutional separation between: (a) policy makers, (b) regulators and (c) regulated companies.

This separation – and the number of specialist staff required – can be difficult to achieve in small countries, especially newly established small countries

Particular problems can arise with local enterprises and a local regulator. Bigger problem for water industry than electricity or telecoms

– key role for national co-ordinating regulatory body

Economic Regulation as a “Game”

Economic regulation is a game involving 3 sets of players:

(i) The regulatory agency

(ii) The regulated enterprise(s) … and

(iii) The Government - which defines sectoral environmental and other policy

But, the Government makes the rules of the game and can change them … as well as being a player in the game.

Relations between Regulator and Regulated Company

- The regulated company <u>always</u> knows much more about its strengths and weaknesses than the regulator
  - hence, the focus on “asymmetric information” as the key problem for regulation

- Economic regulation is a “game” in the formal sense – a repeated non-zero sum game (c.f. bargaining games between Coca-Cola and Pepsi-Cola)
  - Repeated price setting means that regulators and regulated companies are regularly involved in bargaining games
  - These repeated games can lead to destructive strategic behaviour or to trust-creating signalling and

- There are no clear solutions to repeated non-zero sum games – the outcomes depend critically on the reputation of the parties … particularly whether and how far they build up trust in one another

Investment and Affordability

- The most critical issue in the political economy of utility reform is whether new investment requires significant retail price increases.

- More reform programmes fail for this than for any other reason - especially water and sewerage reform programmes
  - There is always great resistance to paying significantly more for an essential service that is already being supplied

- Many cash-starved systems have major maintenance backlog which, if left to worsen, can seriously threaten public health
  - For water, there are major public health externalities (See Annex slide)
  - The development of safe drinking water systems has probably saved more lives than all the doctors in history

- Combining proper maintenance standards with new investment while preserving affordable water prices is what all countries aim at but is <u>extremely</u> difficult and may be impossible
  - Much harder if Government tax support and/or exteranl aid unavailable or limited
  - Easier if (a) good collection rates on company bills. (b) high metering rates for households

Republic of Ireland Water I

- The Irish Water Industry is in major crisis.
  - In 2010, commercial water charges covered only 24% of operating costs as well as 100% of investment costs – rest financed out of taxation (and postponed maintenance)
  - Even for charged (non-household) customers, arrears are very high – 52% in 2010
  - Households have paid nothing for water and sewerage since 1997, implying no incentive at all to cut inessential use of water – and there are no household meters
  - Water shortages in Dublin area because of very high leakage rates

- Irish macro-economic crisis has forced change because tax revenue no longer available to meet financing gap
  - All local water companies being brought together in “Irish Water”, an independent, publicly owned subsidiary of Bord Gais (the Irish state-owned gas company)
  - Regulation by CRE, the Irish Energy regulator based on a single RPI-X revenue cap
  - A similar route is proceeding in Ireland as in Scottish water reform from 2000 onwards

Republic of Ireland Water II

- Key questions in Irish Water Reform

1) How will the regulator improve efficiency among the 1,500 public water schemes (also around 1,800 small private schemes)?
   - Efficiency and standards currently vary very considerably between suppliers – efficiency benefits crucial to keep price increases down
   - Likely to need strong internal benchmarking of Irish Water local suppliers

2) Will it be politically possible to install household meters and charge prices that meet significantly more than 24% of operating costs?
   - Major discussions going on about relief for low income householders – but what about <u>average</u> income householders?

3) Reform exercise being done very professionally by CER as regulator, but a very difficult exercise – in political economy even more than in technical regulatory terms

Concluding Comments

1) At best, in practice, regulatory agencies work with "legally bounded autonomy" rather than full independence
   - ➢ To be successful, they need to establish a reputation for good and predictable decisions and transparent, participatory processes
   - ➢ … and have strong external support from consumers and companies

   [Note problem of Third Party Opportunism in local area regulation for instance: incentives for opportunistic public scrutiny by political and commercial opponents (Spiller 2009 and 2011)]

2) In all regulatory systems, the Government has the final word.
   - ➢ If necessary, it can usually change the regulatory decision makers or amend the law to get its way.
   - ➢ Affordability of retail prices is usually the key breakdown point

3) If 'independent' economic regulation fails, the fallback is state/local authority regulation combined with company operation and arbitrary regulatory rules on prices and investment …
   - ➢ … as in 1940-80 Britain and France, pre-1990 Central and Eastern Europe.

ANNEX

Infrastructure Industries and Need for Regulation

Industry	**Rate of Demand Growth**	**Rate of Growth of Technical Progress**	**Potential for Competition** **(Including competition in products and competition between networks)**	**Degree to which Assets are Sunk**	**Externalities** **(including social benefits and relative costs of achieving them)**		**Overall Importance of Effective Regulation**
Electricity	Low	Low	Medium	High	High		****
Natural Gas	Medium	Low	Medium	High	Medium		***
Telecoms	High	Very High	High	Medium	Low		**
Water & Sewerage	Low	Low	Very Low	Very High	Very High		*****
Railways	Very Low	Low	Low	Very High	Medium		*****