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# Who is really regulating us?

**Introducing competition into regulated parts of the economy, or, where this is not possible, trying to mimic the competitive outcome, has been the dominant policy for utilities and infrastructure over the past 40 years. Fod Barnes and Mike Toms argue, however, that recognising when we have reached the end of this road towards more competition may be the key to getting the future of utilities and infrastructure right**

When Margaret Thatcher entered Downing Street in 1979, Britain was heartily sick of failed attempts by bureaucrats to determine what should be produced, how much it should cost, and who should get it. She brought a new message—don't plan, let the market decide. Competition would deliver the best outcomes for the individual, and for the country. This was a raw political position, but it was rooted in the generally accepted economic principle of efficient markets. Although Mrs Thatcher is long gone from government, her approach is still at the core of regulatory thinking, not just in the UK but worldwide. In all the main regulatory sectors, we have seen regulators, helped by legislation, competition authorities and courts, unbundling their industries to reduce the number of areas where they have to make pricing and investment decisions, preferring to let the market decide on all areas where competition can be introduced. It is not difficult to understand why—no regulator really wants to take responsibility for big, long-term national investments, nor indeed the minutiae of huge capital programmes. Much better to leave it to the hidden hand of the market. Or is it?

## Competition is clearly good, but is it enough?

In the rush to replace regulation with competition, it is easy to forget that the economic theory predicts that only perfect competition produces perfect outcomes. Perfect competition is based on the following preconditions:

- a homogeneous product;
- a sufficiently large number of buyers and sellers such that no single participant is able to influence prices;
- quick and costless entry to and exit from the market;
- the consumer pays for the product. If someone else is paying, a principal/agent issue is likely (a misalignment of incentives between those paying and those on whose behalf the payments are made);
- the absence of externalities—that is, there should be no material costs and benefits experienced by third parties that are not reflected in prices; and
- perfect information, not only on what the market can deliver now but also on all the possible futures that could exist.

In practice, the textbook preconditions of perfect competition are nearly always breached, and in many cases massively so. The outcome of the competitive process when the conditions are a long way from perfect competition is often far from perfect, and in any case there is actually significant intervention in those markets that are considered to be (relatively) free. The legal system underpinning the process of buying and selling is but one system of government intervention that is an essential feature to get markets to perform efficiently, even when the goods or services being bought and sold approximate the required characteristics as specified in the textbooks.

## Planning (but not the planned economy?)

In addition, however, there are very large interventions in this fundamental fabric of the market economy, particularly for important goods or services whose characteristics are a long way from the perfect conditions of the textbooks. The statutory town planning system, on its own, is a huge distortion of the property market and of how society produces the infrastructure needed to underpin the economy. The planning system imposes major constraints on what

Fod Barnes, Senior Adviser, and Mike Toms, Non-executive Director, are Oxera's 'grey beards' with 60 years of practical experience of regulation between them. The views expressed in this article are their own.

infrastructure capacity can be built, where and when. In the UK, this is to be compounded by the National Policy Statements for key sectors, which are expected to prescribe where the government will or will not approve major developments.[1]

There are good economic reasons why planning legislation exists—in this case, infrastructure projects usually have the characteristic that they distribute costs quite acutely to those users located near them, but the benefits accrue to a different section of society (often more diffuse), either as users or owners of that infrastructure. As these costs are not usually imposed on users, the precise location of infrastructure projects can redistribute significant wealth in ways where, under pure market conditions, those affected have little say or influence.

In addition, infrastructure projects often have economies of scale or density, so that provision of the same facility twice is very expensive.[2] If infrastructure is to be provided by the market, there are both intrinsic and imposed conditions that will make that provision far from perfect.

## Or imperfect competition?

The consequence of relying on imperfect competition is that the outcome may be imperfect. For instance, barriers to entry can result in underproduction and overpricing; external costs can lead to overproduction and underpricing. This problem is well recognised in the theory of 'second best' (extending to nth best). Regulators wishing to escape responsibility for ensuring that society gets the infrastructure it needs tend to play this down—they argue that what is needed is 'effective' or 'workable' competition, evidenced by 'rivalrous' behaviour by producers, for unregulated outcomes to deliver what consumers want. But the tests for 'effective' rivalry are not rigorous. In practice, there has been a remarkable absence of analysis by policy-makers and regulators of the differences for consumers between the results of perfect markets, and the results of the workable markets that policy-makers and regulators accept as substitutes. Case studies show few structured assessments of the gap in outcomes between 'first best' and the 'second (or nth) best' that are actually implicit in regulatory decisions.

Even where markets are efficient, they do not necessarily meet the public policy objectives of government. The energy market does not, on its own, price in the desirability of security of supply. The market cannot deliver efficiently the different levels of security of supply that different consumers would consider, for them, to be 'optimal'. Similarly, the airports market does not price in benefits to the economy of connectivity between the regions and London.

At least on good days governments understand this. While they support the discipline of the market, they also try to specify the outcomes they 'require' the process of 'competition' to produce. This inevitably leads to tension with regulators, who are supposedly independent of government, and may believe either that outcomes should be left to the market (in which case they are not responsible), or that they are to be responsible, in which case the government's preferred outcomes are not the right ones, or that, even if the desired outcome is the right outcome, they do not have the means to achieve it by 'competition' (and perhaps even by any other means).

## Or muddling through?

So far, this tension has been dealt with by a system of muddling through, in which there appears to be an unspoken understanding between regulators and government about the real limits to regulatory independence and the real limitations of what can be achieved by the regulatory instruments available (including 'competition'). This has been successful in avoiding outright conflict, but the results have fallen short of producing the outcomes governments have wanted, and, most likely, if the proper analysis were done, have not produced in a particularly efficient way the outcomes that have arisen.

Again, on good days, the current coalition government appears to have recognised that this confusion discourages investment and raises the cost of capital, which in turn raises final prices and produces less infrastructure than would be optimal. In April, the Department for Business, Innovation and Skills (BIS) published a statement of 'Principles for Economic Regulation' intended to clarify the relationship between competition and planning, and between regulators and government.[3]

## Or a coherent policy?

The BIS statement starts boldly. Paragraph 2 of the introduction says 'Competitive markets are the best way in the long run to deliver ... services'. But by paragraph 4 the regulated companies are being set a required outcome of 'delivering the majority of the £200bn of planned infrastructure investment over the next five years'. Sadly, the intervening paragraph does not provide an estimate of how much investment would have resulted from the operation of competitive markets.

Chapter 1 of the statement sets out the government's principles for economic regulation. The second of these principles is focus, the first element of which is to ensure 'the operation of well-functioning and contestable markets', and the second is that regulators should be 'focussed on outcomes rather than specified

inputs or tools'. Chapter 2 then applies the principles, in which commitment 2 preserves the independence of economic regulators, but commitment 3 commits the government to 'put in place, for each regulated sector, strategy and policy statements for the individual regulators to provide context and guidance about priorities and desired outcomes'.

Regulators, and more importantly investors, could be forgiven for being confused about who is in charge, and what they want. Is the government specifying the outcome it wants, with the regulator managing the industry to achieve this? Or is the competitive process what drives the outcomes, with the regulator making sure that competition is maximised? Or something else entirely?

If, as is likely given the economic characteristics of particular markets, competition does not deliver what, in the widest sense, customers need, then someone other than 'the market' has to specify what outcome is actually wanted; and then, almost by definition, unconstrained competition is unlikely to deliver it.

## There is a real impact

It is vital that the sector strategy and policy statements are sufficiently clear, specific and explicit about what outcomes are to be achieved, and what duties are to be placed on regulators to achieve them, beyond a general obligation to promote competition. If not, we will end up in the situation faced by the Civil Aviation Authority in 2006,[4] when it made clear that, in setting airport charges, it had no duty to follow government policy on investment in runways, and then produced a price determination that played a material part in undermining this policy—after BAA had spent more than £100m trying to implement the policy.

This is but one, easily measurable, example, but in reality this general problem arises frequently.

- We want drug companies to sell drugs at a low price in poor countries—which is incompatible with the free trade of those drugs between countries.
- We want water companies to 'fix the leaks'—but do not want the rise in prices to pay for them to be fixed.
- We want green energy (so are in favour of high feed-in tariffs to underpin the investment), but we do not want the high prices needed to pay for this.
- We want hospitals to compete for us as patients (patient choice), but do not want our local hospital to close when we choose to be treated elsewhere.
- We want to get from A to B quickly and easily, but do not want the new road/railway near our house.
- We want local (community) control of development ('not in my back yard'), but we also want development ('it has to be in someone's back yard').

The parts of the economy which even approximate the textbooks are remarkably small, but an approximately good outcome through imperfect competition has proved to deliver the best outcome (at least so far). But when the market conditions are a long way from perfect, relying on competition can deliver very expensive and very inefficient outcomes. Recognising when this occurs is critical to getting a UK infrastructure that is fit for purpose in the 21st century. The muddled thinking in the 'Principles for Economic Regulation' may not be the example that other countries should necessarily follow.

**Fod Barnes and Mike Toms**

[1] The 2008 Planning Act introduced a new planning system covering applications for major energy generation, railways, ports, major roads, airports and water and hazardous waste infrastructure. Under this system, national policy on Nationally Significant Infrastructure Projects is set out in a series of National Policy Statements.
[2] An example would be building two parallel railway lines between London and Brighton to ensure competition between Network Rail and another provider.
[3] Department for Business Innovation and Skills (2011), 'Principles for Economic Regulation', April.
[4] Civil Aviation Authority (2006), 'Airports Review Policy Update', May 15th, para 3.50.

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