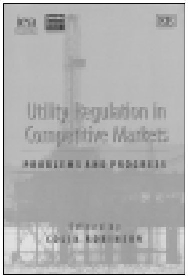
Book review

Utility regulation in competitive markets: problems and progress



Colin Robinson (ed)

Reviewed by
Dr Puneet Chitkara

Hardbound
237 pp
ISBN 978-1-84720-202-4

International Journal of Regulation and Governance **7**(2): 207–210

The book *Utility regulation in competitive markets: problems and progress* puts forth a case for competition, minimizing the role of traditional regulation and government intervention in energy, telecommunications, rail, and posts. The edited book contains chapters written by experts drawn from academics, regulatory bodies, and consulting firms. Chapters on each topic are followed by comments from regulators, competition authority chairmen, and other experts in the relevant fields.

‘Beyond regulation’ by Stephen Littlechild brings together the evidence from world over in favour of the competition in electricity generation and distribution. The paper also argues, citing evidence from Australia, that the risk of market failure embodied in ‘merchant transmission’ is much less than the regulatory risk in ‘regulated transmission investment’. The evidence to the contrary, however, could be provided by citing the experiences with regard to transmission investment in the New York Pool and other markets in the US, where there is gross underinvestment in transmission. There is a huge literature – both theoretical and empirical on the subject by Hogan on one side and Joskow and Tirole on the other – which has not been referred to. Also, what is important here is not only the mechanism by which the transmission assets are created but also how they are priced. India is an example where there has been inadequate transmission investment despite a regulated rate of return. The ‘gold plating’ argument in favour of overcapacity (as in the case of Australia) does not seem to have worked. The paper talks about the role of consumer participation in regulatory negotiations, which is again very well documented in the literature (Becker, Stigler). Hence, the concept of 'beyond regulation', as discussed in this chapter, could have been bolstered by including the role of transmission pricing, and the behaviour of electricity traders and the literature on pressure groups by Becker and Stigler.

Spectrum allocation has been revisited in the light of Ronald Coase's famous paper on social cost where he discovered a 'simple model of human action'. Professor Thomas Hazlett in this chapter asserts that the government should just allow competition for the market by auctioning licenses to the highest bidders with well-defined rights. The market should thereafter be left to the market forces, and the government should limit its role to defining the regulations and rules of the game and acting as referee. The chapter makes a case for adoption of the optimal policy regime for radio spectrum proposed by Ronald Coase—which is technology neutral and as valid today as it was in 1959.

Energy sector practitioner Jorge Vasconcelos discusses the regulatory challenges in integrating supra-national energy markets. He points to the urgency of the implementation of the European Union legal framework for energy. Among many issues that prevent market integration, as Philip Lowe commenting on the paper points out, are increased interconnection capacity, transparency about access to networks, inherent concentration in gas markets because of the nature of contracts, and the link between gas and oil prices.

Paul Joskow argues that there is no inherent conflict between the liberalization of electricity and gas sectors and reasonable supply security goals as long as the appropriate market, industry structure, market design, and regulatory institutions are developed and implemented. Joskow clearly explains why in the 1990s it was economical to build CCGTs (combined cycle gas turbines) in the UK, which replaced old coal-fired power plants. Now, however, the environmental concerns have introduced uncertainty and the incentives for capacity addition in generation, which were prevalent in 1990s, no longer exist. Following the underlying theme of the book, Joskow urges that the government keep its 'hands off the generation market' but develop strategies to tackle market failure (if it is observed). In both the UK and the US, the author points out the need to expand LNG (liquefied natural gas) import facilities to meet the 'supply security' challenges. Joskow refers to the importance of issues pertaining to improvement in wholesale and retail market design, unbundling, horizontal and retail restructuring, and incentive regulation of transmission and distribution network in electricity sector, which are important for bolstering energy security. These issues are, however, very important in the context of the chapter on 'Beyond regulation'. In fact, the issues raised and the direction given by Joskow could have provided useful inputs for Chapter 1 also.

In Chapter 5, Glynn and Stubbs probe the problem of 'postal exception', which means the delay in postal reforms as compared to other network industries. They suggest a model for ending the postal exception. The model essentially talks about (1) regulation of third party access prices to Royal Mail's essential facilities, (2) retail price deregulation, and (3) universal service obligation and its impact on efficiency of prices. These issues are similar to the issues that the regulators in the electricity and telecommunications sectors grapple with. Therefore, while the authors help acquaint the readers with postal markets in Europe and the UK, this chapter could have made more concrete proposals for reforms based on the various models for efficient access prices proposed by Mark Armstrong and Laffont and Tirole for the telecommunications market.

Chris Bolt assesses the future of rail regulation, following the rail review and the Railways Act, 2005. The author assesses whether the changes made following the review can indeed be expected to help deliver a more efficient and better-performing railways that would meet the needs of its users more effectively. While the author agrees that London Underground PPP (public-private partnership) has brought benefits for the rail industry and its customers, he believes that a lot needs to be done by the ORR (Office of Rail Regulation) in terms of short term objectives like integration of economic and safety regulations and longer term development in the regulatory framework to ensure adequate resource mobilization.

Cost of capital always remains a central concern in various regulatory mechanisms, be it cost plus regulation or a fixed price regulation. The nature of regulated utilities is such that the costs of going wrong are very high. In a price cap regulation, which is reviewed after a given period (as in the case of Ofwat), the regulated firms can participate by either levering up or moving the projects through time to obtain a higher price cap. The regulator thus needs to concern himself/herself with the leverage of the regulated firm. Though CAPM (capital asset pricing model) is the most widely used model for determining the cost of capital, Julian Franks feels that CAPM is not 'the holy grail' and the regulators should use the Fama-French three-factor model as a cross-check on the CAPM. The author also very rightly notes that different costs of capital should be used only when (1) the businesses are different, (2) there are prima-facie differences in risks, and (3) the differences are significant. This chapter is an excellent insight into an issue that concerns regulators across sectors, in both the developing and the developed countries.

In the final chapter, in his review of fixed link telecommunications, Ed Richards discusses the issue of open access to bottleneck assets being controlled by BT by ring fencing the operation of such assets. The success of these mechanisms is yet to be seen though. The chapter very lucidly explains that broadcasts in the analogue age had the characteristics of being both non-excludable and non-rival. However, now in the age of satellite and cable, while the broadcasts are non-rival in consumption, the non-payers can be excluded. The author argues for a case of public service broadcasting though it rests more on 'broad citizenship benefits' than on traditional market failures. With regard to spectrum, the author discusses the pros and cons of the 'individual rights approach' and the 'commons approach'. Richards supports the Hazlett's views (Chapter 2) that spectrum be allocated on a basis, which is as technologically neutral as possible. The author highlights the scope for convergence and evolution of communications network to increase competition and deliver benefits for consumers.

On the whole, the book does a great justice to the central theme and makes a strong point that across a host of network industries, greater social benefits could be reaped by reduced government intervention and light-handed regulation. Having said this, there are a few chapters, as pointed above, which could have further enriched our understanding of the nature of solutions to problems faced in the regulation of network industries.