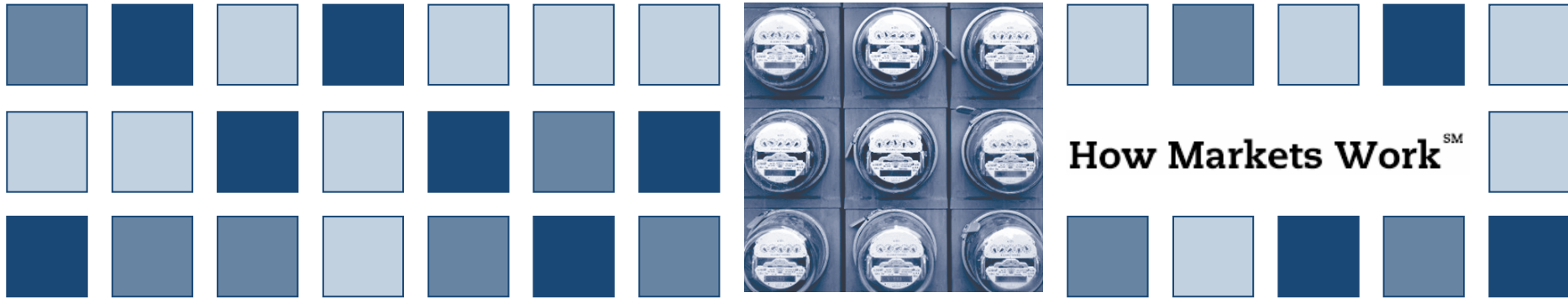


# NERA

Economic Consulting



**How Markets Work<sup>SM</sup>**

## Incentive Regulation and Implementation To Index, or Not?

---

Greg Houston, Director, NERA  
ACCC Seminar, Melbourne  
8 May 2003



# The Regulatory Problem Statement

- In the face of information asymmetry, regulation involves a *'basic trade-off between incentives and rent extraction'*
  - Laffont and Tirole, *Competition in Telecommunications*, MIT Press, 2000
  
- Cost-reimbursement or low powered incentive schemes breed inefficiency
  
- High powered incentive schemes give rise to large profits or losses
  - Large profits or rents are difficult to sustain politically
  - Big losses force regulators to raise prices to keep operators alive
  
- Strong incentives to reduce costs create a concern for quality





# Populist Goals of Economic Regulation

- **The rent efficiency trade-off implies some ‘populist’ goals of economic regulation can never be fully achieved, eg**
  - **Allocative, productive and dynamic efficiency**
  - **De-linking prices from an individual firm’s own costs**
  - **Mimicking the outcomes of a competitive market**





# Indexed vs Building Blocks?

- **Critical questions for the design of regulatory schemes are**
  - **How strong should the incentives be?**  
*or*
  - **What rents are we prepared to tolerate?**  
*and*
  - **What steps can be taken to reduce the rate at which these objectives must be traded off?**





# Indexed vs Building Blocks?

- **The Indexed vs Building Blocks debate:**
  - Doesn't address the question of 'how strong' incentives should be
  - Is based on the potentially false premise that building blocks provide lower powered incentives

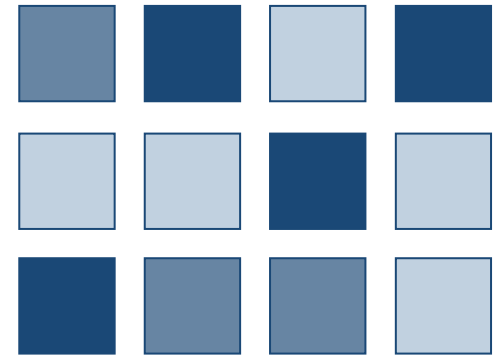




# Are they really so different?

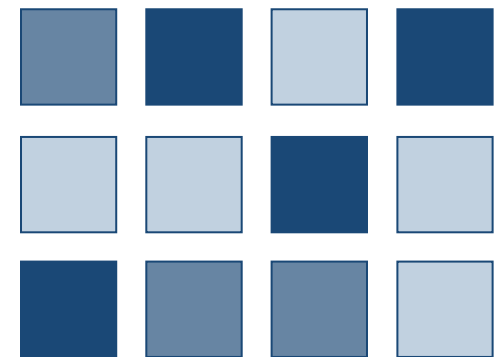
- **In practice**
  - All US-based TFP plans start by applying building blocks, or with the *option* of doing so
  - Some TFP-based price cap plans with narrow off-ramps look very similar to rate of return regulation
  - Building block based price caps could easily be set for longer periods, eg, ten years
- **The substance of the debate lies in choices at the implementation stage**





# NERA

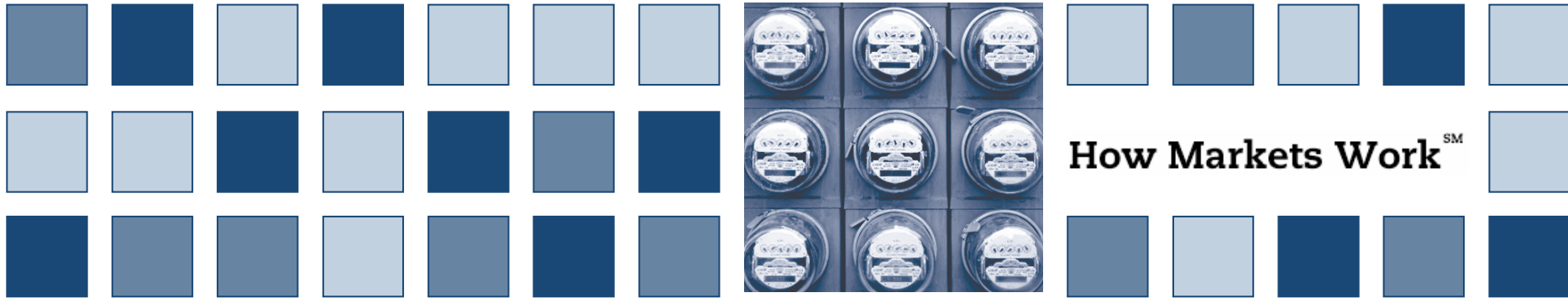
Economic Consulting



How Markets Work<sup>SM</sup>

# NERA

Economic Consulting



**How Markets Work<sup>SM</sup>**

## Incentive Regulation and Implementation To Index, or Not?

---

Greg Houston, Director, NERA  
ACCC Seminar, Melbourne  
8 May 2003





# The Regulatory Problem Statement

- In the face of information asymmetry, regulation involves a *'basic trade-off between incentives and rent extraction'*
  - Laffont and Tirole, *Competition in Telecommunications*, MIT Press, 2000
- Cost-reimbursement or low powered incentive schemes breed inefficiency
- High powered incentive schemes give rise to large profits or losses
  - Large profits or rents are difficult to sustain politically
  - Big losses force regulators to raise prices to keep operators alive
- Strong incentives to reduce costs create a concern for quality

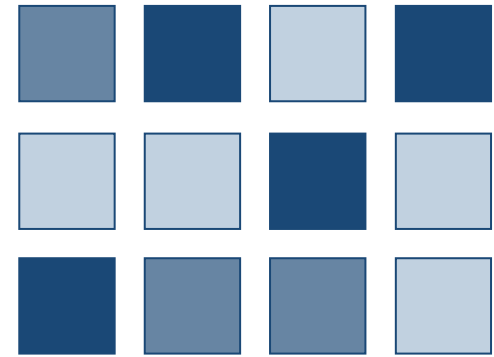




# The Regulatory Problem Statement

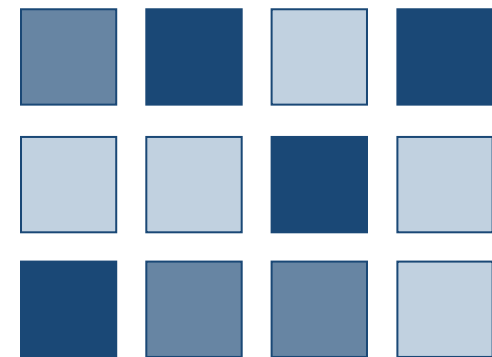
- In the face of information asymmetry, regulation involves a *'basic trade-off between incentives and rent extraction'*
  - Laffont and Tirole, *Competition in Telecommunications*, MIT Press, 2000
- Cost-reimbursement or low powered incentive schemes breed inefficiency
- High powered incentive schemes give rise to large profits or losses
  - Large profits or rents are difficult to sustain politically
  - Big losses force regulators to raise prices to keep operators alive
- Strong incentives to reduce costs create a concern for quality





# NERA

Economic Consulting



How Markets Work<sup>SM</sup>