*Neither service provider nor customer be**

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The Essential Services Commission is Victoria's economic regulator of the Victorian water industry. Its regulatory remit covers the State's water and energy sectors; it has a range of functions in relation to the ports and freight rail infrastructure, and various other transport and insurance services. The Commission also undertakes inquiries into a range of referred matters. In this brief note, Dr Ben-David examines some of the challenges facing economic regulation. He argues that economic regulators must satisfy two conditions if the current model of economic regulation is to succeed — namely, overseeing regulatory arrangements that (i) promote the creation of value for customers; and (ii) clearly delineate the responsibilities of the regulator from those of regulated service providers.

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* The opinions expressed in this presentation are those of the author alone. They do not represent the views of the Essential Services Commission, its staff or the Victorian Government. The author takes full responsibility for any errors, omissions or conjectures made herein.

There is an emerging sense of unease with-and-within that part of the regulatory community that deals with something broadly called ‘economic regulation’ — something with which the four panellists are intimately involved.[1]

At the moment, this unease is most prominently manifested in the heightened interest in the regulation of energy prices: with seven related reviews or inquiries currently underway. This heightened interest is also present in other areas of economic regulation; for example, in the urban water industry.

I would like to suggest that, perhaps, at least some of this unease can be traced to two causes. First, an inability to provide a satisfactory definition for the term ‘economic regulation’ — one which adequately distinguishes it from other forms of regulation; and second, a policy environment that is increasingly losing sight of what was intended by making particular sectors subject to so-called ‘economic regulation’.

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Often our various governing statutes provide us with an objective centred on promoting or protecting the “long term interests of consumers”.

But this is very broad — far too broad, in fact — for definitional purposes.

No doubt, many regulators would claim they exist for the purpose of upholding this objective — whether-or-not it appears in their legislation; and whether-or-not they see their primary focus as being “economic”.

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Sometimes, we are referred to as *infrastructure* or *network* or *utility* regulators — while variously true, such definitions only refer to 'who' or 'what' we might regulate. They tell us nothing about 'why' or 'how' we regulate . . . and of course, 'economic' is an adjective, so definitions based on 'who' or 'what' would seem to miss mark.

Other definitions have been ascribed to what we do.

These definitions may centre on notions such as: essential services; market power and natural monopolies; competition and anti-trust; efficiency and dead-weight loss; or 'sunk investment' and 'hold-up' theories.

While each seems reasonable, none seems sufficient in its own right.

Perhaps we should just concede Wittgenstein's point that, at least in this case, 'meaning is use'.

So although we may not to be able to pinpoint the definition of 'economic regulation' as neatly as we might like, we can probably accept that at least some of us know it when we see it; and we 'see it' because there are certain *resemblances* among economic regulators that draw from a finite set of objects, rules, conventions and behaviours (each of which, in turn, draw on its own set of *resemblances*).

Almost twenty years after the Hilmer Review, it is becoming evident that the policy community is losing sight of the imperatives that drove the competition reform agenda kick-started by that landmark Review. In other words, the policy foundation for economic regulation as a central feature of modern government and modern governance is gradually fading from memory.

No doubt, there are any number of explanations for this apparent inattentiveness — at least one of which may be the current imperative among various governments of wanting to be seen to be reducing the regulatory burden; that is, ‘cutting red tape’.

To be clear, this is self-evidently a worthwhile endeavour that, when properly conceived, complements the objectives of economic regulation and is entirely consistent with the conceptual proclivities of most economic regulators. But when cutting red tape becomes an ‘ends’ in its own right, then its natural sympathisers (in the community of economic regulators) become its prey. Moreover, those who ought to be supporting and advocating for their economic regulators, actually turn against them in pursuit of ‘easy’ but ill-conceived reductions in, so-called, ‘red tape’.

This may be a passing fugue; indeed, let us hope so. But if economic regulators are to avoid contributing to their own downfall during this amnesic phase of the policy cycle, then we must acknowledge the existential peril that surrounds us; and we must rise to this challenge.

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I submit that economic regulators will only rise to this challenge if they satisfy, and continue to be seen to be satisfying, two necessary conditions. The first involves the pursuit of ‘value’, while the second involves upholding clear lines of responsibility.

Turning to the first of these necessary conditions:

Elsewhere, I have written about the need for economic regulators, and the entities they regulate, to demonstrate they recognise the difference between the three very basic concepts of: cost, price and value.[2,3]

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[2] Ben-David, Ron (2012) *Economic regulation and the water industry: Between a rock, a hard place and a precipice*. Water Services Association of Australia (13 February 2012)

This observation may sound self-evidently true, indeed, almost trite, but look at where all the effort goes in current regulatory processes. It would seem that regulated entities invest vastly more time and effort in constructing their cost claims (and then reprosecuting those claims on appeal) than they invest in defining, creating and delivering new and greater value for their customers. At the same time, we find regulators are building evermore complex and intricate methodologies to identify the 'efficient' price for the services they regulate.

This has led to, what others have called, an "arms race" between the regulat*or* and the regulat*ed*. In the case of energy regulation, this 'race' has seen regulatory decisions double in length with each cycle. And that's just the formal decision document. If we include: the companies' submissions to the regulator, plus all the consultant reports, as well as all the legal advice and court documents, then I have previously speculated that the number of pages generated is probably increasing by a factor of ten-or-more with each cycle.

And in all those pages, how much effort do we really believe has gone into creating and delivering greater value for customers?

If economic regulators do not rethink their approach, then the cost of economic regulation — the regulator's costs as well as those of regulated parties — will continue to increase with no upper limit. Yet there may be very little commensurate increase in the 'value' being delivered to the customers who typically end-up bearing the costs of this arms race.

Another way of looking at this problem is to realise that, on current trends, it may not be too long before the time required to run a regulatory process actually approaches the length of time covered by a regulatory decision. And if that occurs, then we ought to keep in mind the fate of the one cent coin which,

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[3] Ben-David, Ron (2010) *Governance and the water industry: The challenge of defining, creating and delivering value.* VicWater 2010 Annual Conference (2 September 2010)

in 1992, was withdrawn from circulation when it started to cost more than a cent to mint a cent (and maintain it in circulation).

The second necessary condition that economic regulation must satisfy if it is to continue to operate successfully, pertains to a clarity of roles and responsibilities. While this issue is more germane in situations where the subject of economic regulation is a public entity (or should we say, *another* public entity), this is not exclusively the case.

Last year, I presented on this theme to the water industry by drawing on a poem in which William Butler Yeats asks: "How can we know the dancer from the dance?"[4,5]

I suggested that, if the water industry was the dancer, then its 'dance' represents the services delivered to its captive audience (that is: customers). In this metaphorical flourish, I likened the regulator to a theatre critic. It is not the role of the critic to tell the dancer which dance to dance or what price to charge the audience. The *dancer* is responsible for choosing the dance and the price it charges. The role of the critic is to assess whether the price represents 'fair value' for the pleasure of watching the dancer's performance.

What this means back in the real world is this: That despite the repeated claims by regulated industries to the contrary, regulators do not 'set' prices. We do not 'determine' prices. We do not even 'approve' prices. Approval would imply that we commend an industry's prices and the reasons for them.

Faux management must never become the role of the economic regulator. There must be *no* suggestion that anyone other than the relevant service providers are responsible for identifying the value desired by their customers

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[4] William Butler Yeats (1865-1939) *Among School Children*

[5] Ben-David, Ron (2011) *Economic regulation of the water sector. How can we know the dancer from the dance?* VicWater Annual Conference (8 September 2011)

or the investments required in order to deliver that value. Industry makes these decisions; not the regulator. They are responsible for their prices because they are responsible for their planning and for the delivery of the services valued by their customers. It is their dance, not ours.

Conclusion

Economic regulation faces two conditions that it must satisfy or risk falling into a regulatory abyss.

The first condition involves ensuring the regulatory regime is very clearly focussed on delivering the services that customers value and for which they are prepared to pay. This can only be achieved by:

- creating obligations for regulated parties to engage genuinely with their **customers** in order to identify what those customers value;

and by providing regulated entities with incentives to:

- pursue operational **efficiencies** (technical and dynamic) through their investments and better practices;
- undertake good long-term **planning** and provide their customers with as much information as possible about the future; and
- pursue product **innovations** in order to better reflect customer preferences and requirements (which also provides the opportunity to increase the regulated entity's profitability).[6]

[6] In this context, 'product innovation' also encompasses new and varied price (or tariff) offerings.

The second condition demands that clear lines of responsibility are maintained between the regulator and the regulat*ed*. Any notion that regulators are responsible for pricing must be repudiated. Regulated services providers must never be absolved of their responsibilities for service delivery by transferring responsibility for pricing to the regulator.

And what if these two conditions are not satisfied?

Then a regulatory abyss awaits: a state of regulatory free-fall in which no-one is properly in control and no-one is properly responsible. Management and regulators tussle over operational decisions. The ‘system’ becomes largely inattentive to the needs of customers. Well-organised sectoral interests come to dominate. Appeal to political patronage re-emerges as the way of ‘doing business’.

And even though no-one will quite remember what ‘economic regulation’ really meant, they will wonder how we ever lost sight of its purpose.

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