WHAT IS ECONOMIC REGULATION?

In recent times, the role of economic regulation seems to have become confused and conflated with other forms of regulation. This short essay sets out what economic regulation is, what it is not, and why it is important.

Long term interests of consumers

Since the Hilmer Review in 1994, it has generally been accepted that, wherever possible, the interests of consumers are maximised by having goods and services provided through competitive markets. These competitive markets ensure resources are directed towards producing those things consumers value most and at the lowest possible cost (often referred to as allocative and productive efficiency, respectively). As firms compete for customers, they lower their prices till they reflect their genuine production costs. Competitive tension also ensures that firms are rewarded when they invest in innovation that results in improved and valued good and services for consumers (dynamic efficiency).

In the absence of any barriers to doing so, markets will efficiently coordinate the actions of countless individuals for their mutual betterment. The economist and philosopher Adam Smith referred to the self-coordinating power of competitive markets as an 'invisible hand' guiding production and consumption decisions throughout society. The 'invisible hand' obviates the need for any form of external control over those decisions (that is, regulation).

In certain circumstances, markets may not effectively (or efficiently) maximise the interests of consumers. The presence of such 'market failures' (specifically natural monopoly, externalities, and network effects) gives rise to the traditional textbook rationale for economic regulation. For example, in the case of natural monopoly, where there is no competitive market to curtail the market power of the monopolist, economic regulation can help ensure that the prices paid by consumers are reasonable and reflect the efficient costs of providing on-going and reliable services.

A modern definition for economic regulation: an enabler

There are various explanations for economic regulation. A survey of the literature indicates that it can refer to creating or influencing markets; or it can mean the institutions for the setting of prices and service standards. Other explanations argue that it is a form of government-imposed restriction on a firm's decisions regarding price and quantity in the market. More novel variants will argue it is about protecting the sunk investments of service providers and consumers.

A more modern explanation sees economic regulation being less about *correcting* for market failures and more about *enabling* markets to work more effectively. That is, where the disciplines of competition are weak or absent, an economic regulator acts as a 'visible hand' seeking to guide service providers towards outcomes (eg. in terms of price, quality or both) that would have occurred had the market been subject to those competitive disciplines.

This shift in emphasis towards 'enabling' rather than 'correcting' means economic regulators' aims have also evolved over time. Modern economic regulators seek to improve economic efficiency by introducing incentives for service providers *and* customers to respectively produce and consume at levels that would have been observed had they been able to trade (or negotiate) their way towards a mutually desirable outcome.

As economic regulation has evolved so too has the role of the Essential Services Commission. Whereas once we were primarily responsible for determining and imposing price and service outcomes, now we seek ways to facilitate market driven solutions. Even in those areas where we continue to be responsible for authorising prices and service standards, our frameworks seek to promote market-like outcomes. This involves requirements that regulated entities engage closely with their customers to identify what is wanted, when it's wanted and the price that the parties are willing to bear.

Our approach is broader, more ambitious and less interventionist than the standard or traditional form of utility or infrastructure regulation — with its focus solely on setting prices, reviewing costs and monitoring service standards of monopoly service providers. Because our approach is focussed on 'economic enabling' rather than imposing outcomes, the Victorian Government has seen the Essential Services Commission as a valued source of advice in a range of areas that are not utility in nature but which might benefit from applying greater market-like discipline.

Not just a compliance exercise

Enabling markets to work is not simply about enforcing compliance with regulatory obligations. Nor is it about perpetuating economic regulation for economic regulation's sake. After all, economic regulation is only a second best solution to effectively functioning competitive markets. It is always preferable to let a competitive market emerge if possible. Of course, what is possible can change over time due to changing patterns of consumption, technological developments or both. It might also change as customers become more adept at dealing with less-than-competitive market conditions.

Our role as an economic enabler sees us regularly reviewing our regulatory frameworks and standing ready to advise Government to modify or withdraw our functions where competitive markets have matured sufficiently to meet the interests of consumers without our involvement.

What economic regulation is not

Economic regulation must also be distinguished from other forms of regulation. At its core, economic regulation focuses on the pursuit of economic efficiency — typically defined in terms of price, service quality and upholding competitive outcomes wherever possible. In contrast, social regulation is ultimately focussed on addressing risks. That is, the risk of harm to: individuals (eg. health and safety), property (eg. financial), community (eg. discrimination) or future generations (eg. environment). In so doing, social regulation defines acceptable standards and outcomes whereas economic regulation focusses on efficient production (and by implication, consumption).

In recent times, the discipline of economic regulation has also been applied in sectors where services are provided by public sector entities. In such instances, economic regulation must be distinguished from governance *of* those sectors (by government) and governance *in* those sectors (by government appointed Boards). Governance is not a substitute for economic regulation. Likewise, economic regulation does not displace or compete with the need for good governance. Governance is about the processes for making and implementing decisions. Good governance processes should always exist. Economic regulation is about providing an assurance to customers who must bear the price of those decisions that those prices are indeed fair and reasonable. When services are provided by a public sector entity, economic regulation and good governance serve as complements in driving organisational performance and efficiency in satisfying customer requirements.

Making economic regulation effective: Independence and accountability
The effectiveness of economic regulation depends on the institutions and rules that facilitate it. Throughout Australia and internationally, economic regulators have been established at arms-length from the day-to-day operations of government. Theory and experience shows that such independence has been a central design feature in upholding confidence in those areas of the economy — that is, confidence by consumers, incumbent businesses and new entrants, and upstream and downstream industries looking to make their own investments. Economic regulation provides this confidence by creating a stable and predictable environment for investment. Such independence is, and always should be, limited in its scope. For economic regulators to be effective they need statutory guidance regarding their tasks. In general, an economic regulator operates under the authority and constraints of legislation which sets out its objectives, powers and procedural obligations. In so doing, the legislation rightly defines the scope and scale of an economic regulator's independence.

We are established as Victoria's independent economic regulator by the *Essential Services Commission Act 2001*. Our legislation requires us to take a long term view when exercising our regulatory powers. Maintaining our focus on long term outcomes ensures a stable and predictable investment environment for regulated entities and their customers. This does not preclude change to the way in which we exercise our regulatory powers but it means that any such change must proceed in a measured and reasonable manner.

The flipside of independence is accountability.

While the Commission is independent from the day-to-day operations of government, we exercise our powers and discretion within the limits of the law and under the supervision of the bodies to which we are accountable, including Ministers and the Parliament. Importantly, we are also accountable to those people for whom our decisions have unavoidable implications, namely, regulated entities and their customers. Our accountability is manifested in the transparency required in our decision making by our Act. It is also demonstrated in our organisational commitment to open and inclusive processes. In the case of our regulatory decisions we typically publish an initial issues paper outlining relevant matters, which is later followed by draft and final decisions that explain how we reached our decisions. We also publish statements about how we conduct ourselves, our consultation processes and our work program.

Open and constructive engagement with stakeholders (eg. industry, consumers, policy makers and other regulators) is fundamental to the transparency of our decision making. It helps ensure parties have the opportunity to scrutinise and contest the reasons for our proposed decisions or actions. As an essential failsafe, our statutes provide for the right for our decisions to be challenged through appeal mechanisms. The potential for appeal imposes a very powerful discipline in all our regulatory decisions or actions.

Conclusions

Independent economic regulation is a powerful tool in policy-makers tool kit in promoting the long terms interests of consumers. It does so by creating incentives — rather than directives — for service providers to engage fairly with customers and to operate their businesses efficiently. While economic regulation provides an enabling framework, there is one thing that should never be in doubt. Service providers and not the economic regulator are responsible for delivering services that meet their customers' expectations and financial outcomes that satisfy their shareholders' commercial requirements. The Essential Services Commission clearly understands this distinction.