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Regulatory reform: An introduction

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Regulatory reform has been high on the policy agenda in Sweden as well as many other countries over the past 10-15 years. These reforms have affected a number of industries, among them some previously state-owned and state-governed "natural" monopolies, i.e., industries characterised by strong economies of scale. These economies of scale are often caused by the fact that a network, which is prohibitively costly to multiply, is an essential input. Examples are electricity generation and distribution (networks involving high-power national grid as well as local distribution to consumers), telecommunications (copper wires for local distribution), and rail and airline passenger transport (railways and airports).

One common characteristic of the reforms undertaken is the ambition to limit monopoly power and thus to allow, and to some extent encourage, entry. This liberalisation is a response to EU pressure, but also a result of the growing doubt about the ability of a state monopoly to efficiently manage business. The development is reinforced by the fact that in some industries, e.g. telecommunications, technological change has reduced the entry costs and the economies of scale, and thereby weakened the argument for monopoly. Similar developments have taken place in other countries both within and outside the European Union, notably the United Kingdom, Norway, the United States, and New Zealand.

Any major change of the regulatory structure in a traditional state monopoly tends to be preceded by a considerable debate about the expected benefits and whether they outweigh the disadvantages. Since not everyone will benefit from the change, there will also afterwards be disagreement about whether the reform was successful or not. It might then appear that the obvious task for the economics profession is to clarify if a particular reform did or did not achieve what was expected, or if perhaps it was beneficial (or not) even if things did not

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work out as expected. A Swedish example is the removal of price and entry regulations in the taxicab industry in 1990, which was widely expected to lead to lower prices. Post-reform studies could confirm the general observation that prices did not fall overall, and could also explain that this was related to the fact that the previous queues at busy times disappeared. The absence of queues that followed from free entry seems to be generally accepted as such a serious benefit that there are now no calls for the taxicab industry to become re-regulated.

If investigations should point to serious problems with a recent regulatory reform, the information could be used to avoid mistakes in other cases. It is, however, not probable that an unsuccessful reform will be reversed and the industry returned to its original regulatory structure. One argument for the non-reversibility of regulatory reform is that it entails institutional change, another that each reform was probably carried out in response to some problems with the initial state of affairs. More likely, dissatisfaction with the results of a reform would be met by a search for improvements of the regulatory design with the aim of eventually realising its potential benefits. A productive approach to the study of recent change in the governance structures of previous natural monopoly industries is then to ask what problems are left to solve, and what new challenges have arisen since the reform was enacted.

With this in mind, the Economic Council of Sweden invited researchers in the field to a one-day conference on the theme "Regulatory reform: Remaining challenges for policy makers". The conference took place in Stockholm on June 10, 2002, and was organised in cooperation with the Swedish Competition Authority (Konkurrensverket). This issue of *Swedish Economic Policy Review* presents the eight papers from the conference, together with comments written by the discussant of each paper.

In the first paper, *David Newbery* discusses regulatory challenges to European electricity liberalisation. One question is how to avoid a California-style electricity crisis. Newbery concludes that at the moment, Europe does have enough spare capacity in electricity generation, but that recent low prices have reduced the reserves. To ensure future quality and safety, governments need to provide incentives for investment, which is inherently risky in this industry. Newbery also suggests that European regulators may neither always have sufficient information and experience to know when and how to intervene, nor the power to do this effectively.

The paper by *Lars Bergman* discusses experiences from the Nordic electricity market. In this market, water-generated power makes up a large part of total capacity. This feature implies large potential variations in available generation capacity between "wet" and "dry" years, but also provides some short-run flexibility in adjusting generation to variations in demand. Bergman argues that there is an important role for policy in maintaining sufficient competition in the industry, particularly in view of entry barriers in generation as well as retailing. He also points to a need for sector-specific regulation of e.g. transmission capacity between countries, and tariffs in distribution.

Mats Bergman has written the third paper in this issue. His article deals with the relationships between competition law, competition policy, and deregulation. Bergman discusses whether the existing competition law can be thought to be sufficient for liberalised markets, or whether there is also a need for specific regulation of each liberalised industry. His conclusion is that competition policy and sector-specific regulation are complementary in that they serve different purposes, and that there is a need for them both, at least in network industries.

Sector-specific regulation has been used with some success in the telecommunications industry, for example to encourage entry by cutting the access charges to the local distribution (copper-wire) network. The paper by *Lars Hultkrantz* on telecommunications liberalisation in Sweden argues that due to the growth of the ADSL broadband market, access to the copper-wire network remains an important issue for regulators. Another important issue concerns measures to avoid consumers being "locked in" with one seller. Hultkrantz also discusses the universal service requirements which are traditionally important in natural monopoly utilities industries. His suggestion is that universal service should be procured, rather than prescribed (as was the case in the recent "beauty-contest" for allocation of Swedish 3G UMTS licences).

In his paper on price-cap regulation, *Simon Cowan* discusses the incentive-directed method increasingly used in sector-specific regulation, particularly in the United Kingdom. The argument supporting the use of price-cap regulation in that part of the old natural monopoly that remains a monopoly, i.e. the network services, is that it gives incentives for cost efficiency. However, there is a potential long-term problem in that price-cap regulation does not seem to give sufficient incentives for investment. Price-cap regulation differs from (old US-

style) rate-of-return regulation in not automatically providing a guaranteed return to investment, which makes substantial investment a risky project.

The last three papers in the volume deal with two large non-private passenger transport industries, airlines and railroads. *Frode Steen* and *Lars Sørgard* investigate the difficulties of deregulating the air transport industry in Norway. They identify the promotion of new competition as the key issue, and argue that this new competition will have to come from the so-called low-cost-no-frills carriers. To encourage entry, there is a need for regulation of frequent flyer programs and charges for transfers between carriers.

It seems to be a phenomenon in many countries that the rail industry is pronounced to be in need of large government subsidies. Both in Sweden and the UK, the rail industry has gone through major regulatory reform, while financial problems remain. In the paper by *Jan-Eric Nilsson* on the restructuring of Sweden's railways, it is suggested that low fees for track usage have been motivated from a static efficiency viewpoint, since there has been excess capacity. However, excess capacity should lead to long-run reductions in the size of the network, which appear difficult to achieve. Government investment policy instead promotes large projects with relatively small social benefits.

Chris Nash presents the experiences of regulatory reform in the British rail industry in the final paper in this issue. In the UK as in Sweden, the management of the rail tracks and the running of passenger services were separated, but a crucial difference is that the British tracks company was privatised, although it was recently renationalised due to severe financial difficulties. Nash makes the case that the advantages of privatisation in terms of cost pressures were outweighed by the disadvantages that emerged, most importantly a lack of long-term planning in developing the network. He points to problems such as investments yielding small safety benefits at large cost, and excessive track usage charges.

All in all, the papers in this issue give a very useful overview of regulatory reform in several industries, the problems that exist and the options for addressing them. Although increased competition has the potential of bringing substantial benefits to consumers, it is clear that regulatory reform is not a trivial task. Several papers have emphasized the need to monitor long-term investment in capacity. Capacity investment can be too small, as in electricity generation, or too large, as

in rail transport. This probably has something to do with local pressure groups being quite willing to have a new railroad built nearby, or an old one maintained, but unwilling to have a nuclear power plant, or a river dam (instead of a river). The large cost and the accompanying risk of these investments, as well as industry-specific externalities, suggest that capacity investment in most network industries will need continued public attention.

Several contributors have also singled out competition as a potential source of future problems. The difficulty of establishing and maintaining free entry of new firms is one problem. In some cases, entry is deterred by incumbent firms, for example by restricting the access to an existing network. Promoting competition in the network industries could be a joint task for the sector-specific regulator and the competition authority. It is clear that competition does not automatically follow upon liberalisation.

Finally, it is worth recognising that increased product market competition can have important general equilibrium effects. For example, there is a presumption that more competitive product markets will bring about higher employment. More intense competition should lead to increased output and employment at given wage costs and, in addition, employment may rise as a result of indirect effects operating via wage determination; enhanced product market competition is conducive to wage moderation by making labour demand more sensitive to wage changes. An attractive feature of product market deregulation in this regard is that it may be politically easier to accomplish than labour market deregulation, which is bound to raise a number of distributional issues.