

Regulatory errors

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Regulatory difficulties

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1. Asymmetric information.
2. Regulatory capture and political pressures.
3. Technological change.
4. The direct cost of regulation.
5. The indirect cost of compliance with the regulatory process.
6. **Mistakes** in the regulatory framework.

Object of the talk

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3. The telecommunications sector, etc

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Example

Chilean private health insurance system and excess contributions.

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Objective: To increase competition in the telecomms sector.

- ▶ CTC had the local monopoly, was strong in long distance and analog mobile.
- ▶ The main competitor, ENTEL, is in trouble if it does not obtain at least one frequency band.
- ▶ In that case, there will be no competition in the market (Subtel's objective).

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Penalty for not operating on promised day is US\$55MM.
- ▶ Auction mechanism is a beauty contest.

Results

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In September, new regulator. On 31st December, on some locations, there is no signal.

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- ▶ Subtel sends document to Comptroller for advice. Comptroller accepts document and Subtel likewise.

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- ▶ Smartcom (which won the last auctioned frequency band) opposes the agreement.

The process continues ...

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- ▶ Antimonopoly commission decides the frequencies must be auctioned.
- ▶ Process gets bogged, as 15Mhz are useless for independent companies.
- ▶ In the end, 30Mhz to CTC, 15 to BellSouth, little competition and government gets US\$6MM.

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3. Use of beauty contests.

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- ▶ In electric regulation, there are compensations in case of long term supply failures.
- ▶ Received by agents whose consumption falls in **rationing** periods.
- ▶ Energy not delivered is paid at rationing cost, five times the usual cost.
- ▶ Provides **correct** incentives to increase supply and reduce demand. An elegant solution to the problem of energy scarcity, except for ...

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- ▶ Incentives to invest in hydro power.
- ▶ Lower prices in normal years.
- ▶ Less supply security.
- ▶ The choice of a poor country.

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- ▶ Legal loopholes imply it has **never** been paid.
- ▶ **Worse:** The regulated price is not defined under extreme droughts ⇒
 - ▶ No demand reduction.
 - ▶ No supply increase.
- ▶ In fact, the regulated price fell under the 98-99 drought.

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- ▶ Supply to regulated consumers is reduced and transferred to clients with unregulated contracts.
- ▶ In April 99, unregulated clients increased their consumption while cities were suffering blackouts.

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The choice of a wealthier country.

Rate setting for water utilities.

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1. Provides incentives for efficiency.
2. Hard for the regulator, who has little information.

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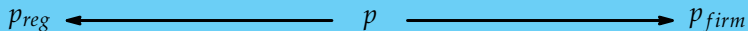
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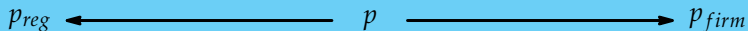


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Method produces **no useful information**: differences of up to 150%.

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In water, three arbitrators decide: only one of which is independent.

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- ▶ In one case, panel had to decide 400 discrepancies.
- ▶ Advantages of final offer arbitration are lost.
- ▶ Leads to averages, which leads back to the initial problem.

Conclusions and recommendations

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Theory must be applied with care!