

IS IRISH UTILITY REGULATION FAILING CONSUMERS?

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1. Introduction

Europe's energy and telecommunications industries have undergone major changes over the past decade. EU Directives required Member States to open up their national markets to competitors from other Member States in successive stages.¹ This has resulted in changes in the regulatory environment and the establishment of independent regulatory agencies for these industries. Introducing competition in monopolised industries should increase productive efficiency, leading to lower prices, and lead to a greater alignment between prices and costs, thereby enhancing allocative efficiency. The present article argues that such increases are due to a combination of inadequate structural reforms and shortcomings in the regulation of such industries in Ireland. The article considers some possible solutions to these problems.

The energy and telecommunications sectors share certain common characteristics, notably the fact that they combine natural monopoly and potentially competitive activities. At the same time there are significant differences between them. Rapid technological changes mean that natural monopoly may no longer be an issue in telecommunications. There is some debate as to whether final delivery constitutes a natural monopoly in postal services. The electricity industry, in particular, has certain unique features, which make competition and regulation of that industry particularly complex. While the current article essentially seeks to provide a broad overview and analysis of policy across the various sectors, it recognises that policy solutions may need to be tailored to address the differences that exist between the utility industries.

The balance of the article is structured as follows. Trends in Irish energy and communications prices in recent years are described in

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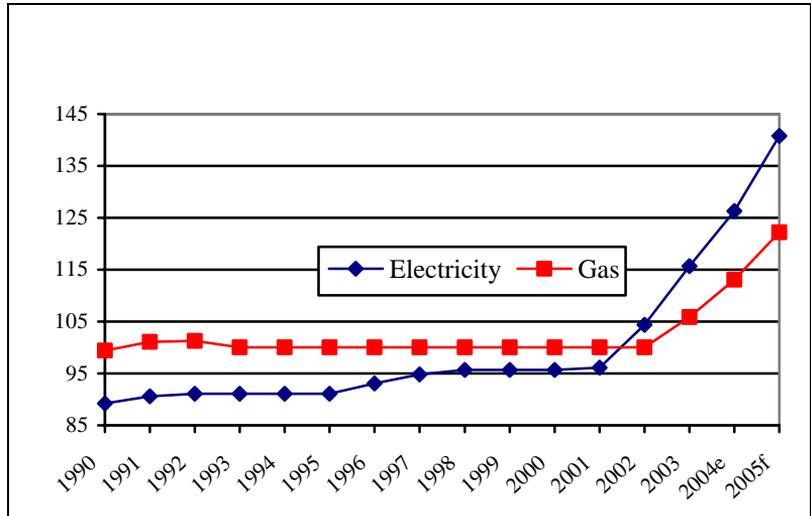
¹ Telecommunications was fully liberalised in 1998, full liberalisation of gas and electricity markets for smaller customers is scheduled to take place early in 2005, while liberalisation of the postal service is at a much earlier stage.

2. Trends in Irish Energy and Communications Prices

the following section. This is followed by a review of the economic literature on regulation along with a broad description of regulatory reforms in other countries. Subsequent sections then analyse Irish regulatory reforms, beginning with a review of the overall policy approach which is then followed by an assessment of decision making under the new regulatory regime. A number of suggestions for reform are then outlined.

Electricity and gas prices have risen by 40 per cent and 22 per cent respectively since December 2001² (see Figure 1). Rising oil prices only partly explain the sharp rise in electricity prices. The National Competitiveness Council (2004) reported that Irish industrial electricity prices were among the most expensive in the EU even before a 9 per cent price increase in October 2004.³ UK electricity prices were 40 per cent lower than in Ireland for firms consuming 10 GWh.

Figure 1: Irish Gas and Electricity Prices
(December 2001 = 100)



Notes: The 2004 estimates are based on Central Statistics Office (CSO) data up to August 2004 and incorporate price increases for gas and electricity which took effect on 1st October 2004. The 2005 forecast includes a further 3.5 per cent increase in electricity prices scheduled to take effect on 1st January 2005 and assumes no further price rises.

Source: Central Statistics Office and Compecon estimates.

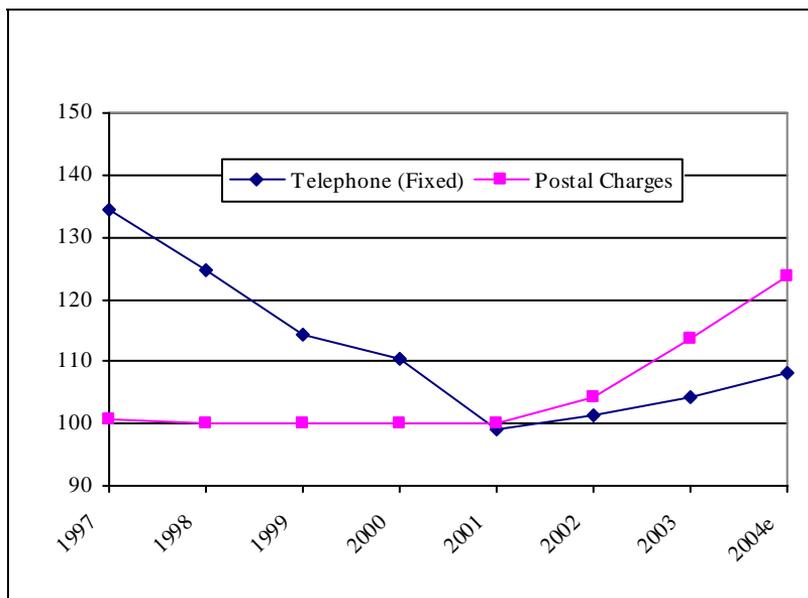
Fixed line telephone charges declined by over 30 per cent between 1997 and 2001 but have risen by 9 per cent over the past three years (see Figure 2). Eircom's line rental charges are double the

² This takes into account a 3.5 per cent increase in electricity prices due to take effect on 1st January 2005.

³ Ireland was second most expensive out of ten countries for firms purchasing 10GWh; 3rd most expensive (out of nine countries) for firms purchasing 25GWh and 3rd most expensive (out of eight countries) for 70 GWh.

European average.⁴ Although ComReg refused An Post's request for a further 7 per cent increase in the price of a standard postage stamp in November 2004, postage rates have risen by 24 per cent in three years. Senior (2004) reports that the standard price of a postage stamp in New Zealand, which has fully liberalised the postal sector, was unchanged on its 1989 level of NZ45c (€24c).

Figure 2: Irish Fixed Line Telephone and Postal Changes
(December 2001 = 100)



Notes: The 2004 estimates are based on CSO data up to June projected forward, i.e. assuming no further price increases this year.

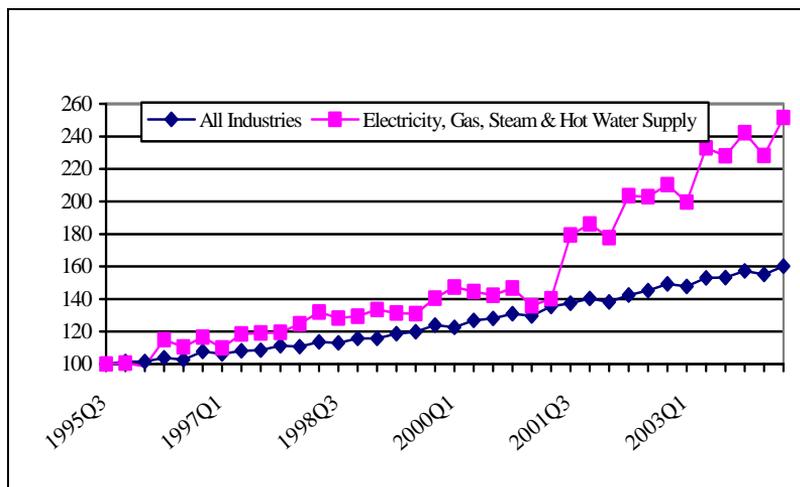
Source: CSO and Compecon estimates.

ESB profits before interest and tax in 2003 amounted to €354 million, with 61 per cent of this attributed to the transmission and distribution network. Pay levels in the electricity industry have risen sharply relative to those in other industries since mid 2001 (see Figure 3). Employment in the ESB has fallen, as past overmanning has been reduced. Such employment declines seem to have translated into higher earnings for those remaining with no evidence of cost savings being passed on to customers. Average weekly industrial earnings in the electricity, gas, steam and hot water supply sector in June 2004 were €1,157.47, more than twice average weekly industrial earnings which stood at €560.60. According to newspaper reports, more than one ESB board member “is understood to have commented at a board meeting that the company was doing very well out of the regulation process”.⁵

⁴ *Sunday Business Post*, 12 September, 2004.

⁵ *Irish Independent*, 2 October.2003, “Why Regulation is Good for ESB”.

Figure 3: Average Weekly Earnings of Industrial Workers
(1995q3 = 100)



Source: Central Statistics Office.

Not surprisingly such price increases have led to growing resentment among consumers and businesses. IBEC claimed that the energy market was not working and that a new approach was needed to ensure security of supply at a reasonable cost.⁶ The NCC (2004, p. ii) stated bluntly that:

Better regulation is needed in sectors such as energy, telecoms and professional services to ensure more vigorous competition and drive down the cost of doing business in Ireland.

3. Regulation – What Have we Learned?

Traditionally, gas, electricity and telecommunications were regarded as natural monopolies which had to be regulated to prevent the abuse of monopoly power. In Ireland, as in many European countries, state ownership was viewed as a way of ensuring these industries were operated in the public interest.⁷ (Hotelling, 1938). In the US such industries were generally privately owned with the scope for abuse of market power regulated by profit or rate of return regulation.

During the 1970s and early 1980s, there was a growing realisation that traditional forms of regulation were ineffective. The economic literature highlighted regulators' inability to achieve first-best outcomes due to information asymmetries, which enable the regulated firm to set price above cost and extract socially-costly rents from its activities. (See Laffont and Tirole, 1993 and Laffont, 1994). Nationalising such industries creates highly centralised organisations in which information is asymmetrically distributed in favour of

⁶ *The Irish Times*, 9 February, 2004.

⁷ Electricity and telecommunications were historically state monopolies, while the gas industry consisted of a small number of largely privately owned local urban monopolies. With the replacement of town gas by natural gas in the 1980s, the old town gas companies were acquired by the state owned BGE.

4. Promoting Competitive Markets

management, making it difficult to exercise effective public control (Schick, 1993).⁸ Regulatory agencies are also prone to bureaucratic capture resulting in an inherent bias towards increasing their activities. Such considerations resulted in a major reappraisal of public policy towards the energy and communications industries, beginning in the United States and Britain in the early 1980s and subsequently spreading to other countries.

It was recognised that, while the transmission and distribution networks in gas and electricity are natural monopolies, other activities are potentially competitive. The reform programmes introduced in most countries generally had two broad characteristics.

1. Measures to permit competition in potentially competitive segments of utility industries, reflecting a view that competition was superior to regulation; and
2. In natural monopoly areas, where regulation remains necessary, attempts were made to devise more effective regulatory tools designed to reduce the risk of regulatory capture.

In potentially competitive sectors, regulation has frequently been seen as a necessary temporary measure “to hold the fort” until competition develops. (Littlechild, 1999).

New entrants in gas and electricity must be able to access the natural monopoly network if they are to compete with the incumbent provider. A vertically integrated incumbent has obvious incentives to deny access to the network or to grant it on unfavourable terms. It is extremely difficult for a regulator to establish the true costs of providing access and vertically integrated incumbents have an incentive to overstate them.

The pricing of access to essential facilities can be complex even when their ownership is separate from competitive activities, but it is especially controversial when there is vertical integration. (Vickers, 1998, p.34).

In contrast, the unintegrated owner of a transmission network would never have an incentive to refuse to deal unilaterally. Vertical separation of the natural monopoly elements from the potentially competitive segments of the gas and electricity industries greatly simplifies the task of regulating access charges and is thus more effective at fostering competition.⁹ (See, for example, Armstrong *et al.*, 1994; Littlechild, 2003; Newbery, 2001; OECD, 2001; and United States Federal Trade Commission, 2000). Accounting separation is not enough, as it is very difficult for a regulator to ensure that costs are correctly apportioned between different business activities.

The issues in telecommunications are somewhat different to those in gas and electricity. Rapid technological change and the

⁸ Lawson (1992) describes how, in the UK, the CEBG misled successive Governments about the true cost of nuclear plants, something which only emerged on the eve of the UK electricity privatisation.

⁹ International experience indicates that the potential gains from competition outweigh the loss of economies of scope that result from vertical integration.

5.
Dealing
with
Information
Asymmetries

growth in rival mobile networks mean that the natural monopoly problem may no longer arise (Ricketts, 2004). Littlechild (2004) nevertheless argued for the vertical split up of BT, pointing out that, whereas price regulation had been removed in UK gas and electricity markets it remained in place for telecommunications.

The incumbent will typically have inherited a dominant position as a result of its former protected monopoly status and this may also stymie new entry. In the case of electricity Bergman *et al.* (1999, p.229) concluded that “competitive outcomes cannot be reached without sufficient dispersion of the ownership of generation assets.” Nuttall (2000), Newberry (2001) and Littlechild (2003) all stress the importance of horizontal restructuring in electricity generation.

Price cap regulation attempts to overcome the information asymmetry problem by encouraging the regulated firm to reveal accurate information about the potential for cost reductions. The price cap is supposed to provide a strong incentive for the regulated firm to achieve greater cost savings than those set by the regulator, since this will increase its profits. This in turn provides more accurate information to the regulator about potential efficiency gains when the price cap is due for review.¹⁰

Regulation is a repeated game which provides scope for strategic behaviour by the regulated firm. It will recognise that, while it can retain additional efficiency gains in the short run, such gains will lead to tighter price caps in the future (see Laffont and Tirole, 1993). Giulieti and Waddams-Price (2000), in a study of the effects of price caps in UK utilities, along with airports and telecoms in the US, found “little evidence that firms had moved towards more efficient pricing structures” under price cap constraints. They reported evidence of considerable gaming around the time of price reviews in an attempt to get price caps raised as much as possible. In contrast they report a move toward cost reflective pricing where competition had been introduced.

Noll (1995) pointed out that, in both the US and UK, when price capped public utilities earned high profits regulators acted to reduce them in response to political pressures, thereby reducing the incentive effects of price caps.

It was originally claimed that price cap regulation would be simpler to operate, and less vulnerable to producer capture than traditional rate of return regulation. Littlechild (1986) subsequently conceded that “...rate of return considerations are necessarily implicit in setting and resetting x ”. Price capping is, therefore, a highly complex process involving considerable information requirements and assumptions about cost and demand, as well as

¹⁰ Setting price caps for a basket of products simplifies the task of the regulator and allows the firm flexibility to adjust prices in response to changes in costs and increase profits. Provided the price cap ensures that consumers, as a whole, are not worse off as a result of such price increases, the result is increased social welfare. Flexibility also enables the firm to unwind any cross-subsidies which may exist.

6. Why Regulation Isn't Working

predictions as to future changes in cost and demand. Pollitt (1999) notes that poorly constructed incentive regulation may negate many of the positive benefits from reform. Laffont and Tirole (1993) and Laffont (1994) also question the efficacy of price-cap regulation.

Massey and O'Hare (1996) pointed out that price capping assumes that firms are profit maximisers and relies on the incentive to increase profits to induce firms to reveal information to the regulator. It is designed to apply to private sector firms. Dodgson (2003) argued that price capping was unsuitable for regulating the UK Post Office for similar reasons.

The EU Directives on opening up energy and communications markets only set out certain general principles and left Member States considerable scope to decide how such measures should be implemented. As Waverman and Sirrel (1997, p. 115) noted:

Experience in many countries shows that the devil is in the detail and that competition does not arrive overnight.

Cave and Prosperetti (2001, p.111) describe "the appalling record of some Member States in implementing [telecommunications] directives." Littlechild (2003) has criticised France and Germany for failing to introduce competition in their respective electricity markets. The then EU Commissioner for the Internal Market described liberalisation of the energy market as "still incomplete because two big players, Germany and France, lag behind." (Bolkenstein, 2004, p.126). Helm (2003) has criticised various merger decisions by the EU Commission for allowing the emergence of an oligopolistic structure in the EU electricity industry.¹¹

In both voice telephony and electricity Ireland sought and obtained a two year derogation from implementing the relevant EU Directives, suggesting a certain lack of enthusiasm for competition. In arguing for the derogation for voice telephony the Government claimed that ICTU had threatened to withdraw from national pay agreements if the telecommunications sector was liberalised.¹² Similar threats were made in response to proposals to introduce competition in airports and bus services. Massey (1991) warned that social partnership could obstruct regulatory reform and impose significant hidden costs on the economy.

To date little attempt has been made at restructuring the gas or electricity industries to promote greater competition.¹³ BGE remains vertically integrated. It was proposed that responsibility for control of the electricity transmission network would be transferred to a new independent company known as Eirgrid but ESB was to retain

¹¹ French and German utilities, sheltered from competition in their domestic markets, have emerged as the major players across the EU.

¹² Commission Decision of 27 November 1996, 1997 OJ L41, 12 February 1997, p. 8. The telecommunications derogation was subsequently waived 13 months early apparently due to concerns that foreign direct investment was threatened by the lack of competition in telecommunications.

¹³ The Government has taken a rather different approach to airports by breaking up Aer Rianta.

ownership of the network and be responsible for building additional capacity and maintenance work. Eirgrid's establishment has been delayed for a number of years, apparently because ESB National Grid staff are reluctant to transfer to the proposed new company. Arguing for more radical structural reform the managing director of the ESB National Grid observed:

*If these structural decisions cannot be taken, some other decision must be found that does not depend on markets and recognises that competition will not play a major role in the allocation of resources in the industry.*¹⁴

The CER, in a letter to the Minister in December 2003, conceded that the proposals for separation of ownership and control of the electricity grid were flawed. It recommended that Eirgrid be abolished and that the transmission system should be owned and controlled by a wholly-owned ESB subsidiary. It pointed out that, while some commentators would advocate full separation, the EU Directives did not require this.¹⁵

In a subsequent published report, however, the CER (2004) conceded that "...a comprehensive structural approach would... largely but not completely, address ESB's market dominance" but then argued:

1. It did not have the authority to order a break-up and so could not rely on such a solution. – It could recommend such an approach to the Government as being in the best interests of customers.
2. Structural change takes time – hardly a good reason for rejecting it.
3. The large size of some ESB power plants mean some market power problems would remain. As Borenstein *et al.* (1999) argued "...even with some market power present in the electricity industry the result is likely to be an improvement on traditional regulation."

The CER announced that it was "...not ruling out future structural changes to ESB, but will develop a regulatory approach that will, in the absence of any structural reforms, ensure a market that works well and will achieve many, if not all market benefits." Regulation simply cannot deliver such benefits.

Governments and regulators do not know what market outcomes would be and so, in general they cannot simulate such outcomes. (Robinson, 2004, p. 191).

The CER subsequently announced that it was reviewing its proposals for new market arrangements for electricity (MAE).

Massey and Daly (2003) report how ComReg rewarded Eircom and An Post by allowing them to raise prices, in spite of evidence of serious inefficiencies. The latter firm had also failed to achieve service targets set by the regulator. If the regulator simply allows

¹⁴ Statement of Kieran O'Brien, MD ESB National Grid to Oireachtas Joint Committee on Communications, Marine and Natural Resources, 20 June 2004.

¹⁵ *Competition*, No. 13, Vol. 2, p.30.

8. Protecting Competitors

monopolists to pass on the cost of inefficiencies to their customers, which is what an unregulated monopolist would do, it begs the obvious question – why have a regulator?

In gas, electricity and postal services, the regulators have decided on price increases by analysing the cost structure of the regulated firms and allowing some provision for a profit margin. Such an approach ignores the fact that the regulator has insufficient information to decide whether costs are justified or not – it cannot prevent gold-plating – and provides no incentives for the regulated firms to cut costs. In such circumstances prices are unlikely to differ from what an unregulated monopolist would charge. The CER (2001) has sought to regulate prices at a detailed level.

As well as the overall increases in tariffs the Commission reviewed and determined the structure of each tariff.

By focusing on applications for price increases regulators have ignored the potential for reducing costs through increased productivity and reductions in overmanning. The ESB unions have reportedly sought a pay increase of 18.5 per cent. Either there are significant monopoly rents or the unions are better informed than the CER about the scope for efficiency gains.

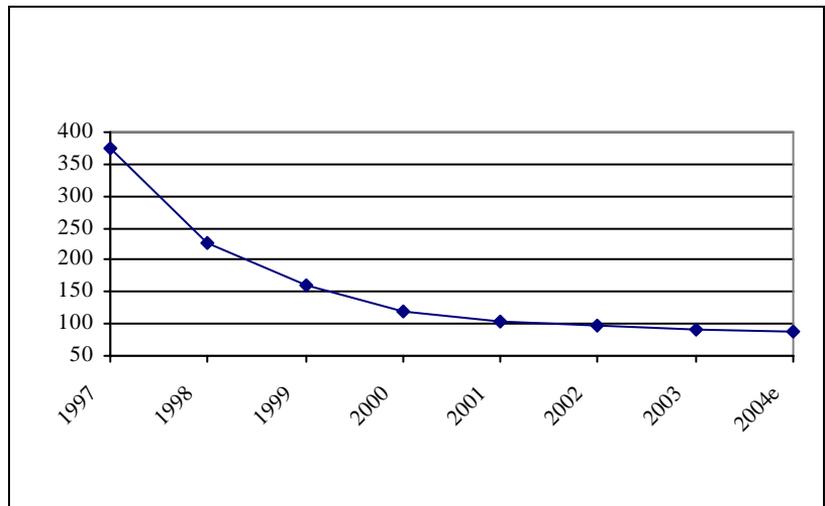
Regulation provides an incentive for firms to devote resources towards obtaining favourable regulatory treatment so that the regulator may end up protecting competitors at the expense of competition. Examples can be found in several decisions of the telecommunications regulator.

- The regulator opposed proposals to auction 3G mobile phone licences because firms might bid too high a price. This assumes that companies do not learn from mistakes and have to be protected from making poor commercial decisions.
- Eircom cannot offer high volume users lower prices than those approved by the regulator. McAvoy (1996) described how such price controls limit competition.
- The regulator has prohibited Eircom from approaching customers who switch to a rival provider for a period of three months, following complaints by rivals about aggressive approaches by Eircom to customers that had switched supplier.
- The regulator supported its decision to ease Eircom's price cap in 2003 by stating that other licensed operators had asked for this "so that they can achieve the increasing returns expected by their financiers." It went on to state: *From the point of view of competition, competitors in Ireland need some breathing room if they are to grow and in future provide increasingly sharp-edged competition to Eircom if users are to get what they need on a sustainable basis.* (ODTR, 2002, p.5).

Such measures are unlikely to foster "sharp-edged" competition.

Many commentators argue that the real risk in telecommunications is that regulation may prevent rather than promote competition. (See for example, Harris and Kraft, 1997; MacAvoy, 1996; Sidak, 2004). Crandall (2003, p.171) argues that “it is difficult to see how total deregulation [of telecommunications] could possibly reduce economic welfare.” Hausman and Tardiff (1997) cite the example of losses in consumer surplus because regulation delayed the introduction of voicemail in the US. Kiesling (2004) similarly argues that electricity regulation in the US has hindered the development of distributed generation in spite of its potential to discipline transmission prices.

Figure 4: Irish Mobile Phone Charges
(December 2001 = 100)



Source: Central Statistics Office.

Regulators nevertheless display a marked reluctance to relinquish control even when there is widespread evidence of effective competition. Figure 4 shows that Irish mobile phone charges have fallen dramatically with prices in 2004 at a quarter of their 1997 level. Massey and Daly (2003) point out that the regulator has nevertheless consistently argued that there is insufficient competition in mobile telephony. Waverman (2003) claims that regulators may be the only group that regards perfect competition as an ideal to be aimed at.

The EU has sought to move away from ex ante regulation towards a reliance on general competition law in telecommunications. Only firms deemed to possess significant market power (SMP) can be subject to ex ante regulation, where SMP is defined as being equivalent to the competition law concept of dominance. ComReg has decided, however, that all mobile phone operators have significant market power in respect of call termination on their own networks, although one of them had a 6 per cent share of the mobile phone market, while another has yet to

**10.
Counting
the Cost of
Regulation**

commence operations.¹⁶ The theoretical grounds for such a finding are somewhat mixed. (See Laffont, Rey and Tirole, 1998a and b and Dessein, 2003).

ComReg (2003) dismissed a 30 per cent reduction in call termination charges by the two largest mobile operators since the beginning of 1999 as being due to regulation rather than competition. It argued that consumers had no alternative to terminating a call on a given network and could not switch to an alternative. Yet ComReg requires that consumers making calls to another network receive a message informing them that this might involve a higher charge. ComReg also argued that Eircom’s decision to pass on the full reduction in mobile call termination charges to its customers indicated that it lacked countervailing buyer power and could not therefore exert a restraining influence on mobile termination rates. Such a response might suggest that Eircom lacked market power in the downstream market rather than indicate a lack of buyer power.¹⁷

Total expenditure by the CAR, CER and ComReg in 2002 amounted to €22.5 million. (see Table 1). This is roughly seven times the cost of the Competition Authority whose remit covers the entire economy. ComReg’s costs were more than twice those of the CER and four times those of the CAR. In February 2003 the Minister issued a formal direction to ComReg to keep its costs to a minimum under Section 13 of the Communications Regulation Act, 2002. Whether this will suffice to curb monopoly regulatory rents is a moot point.

Table 1: Regulatory Costs (€M)

	1999	2000	2001	2002
CER	1.25	7.16	4.67	5.98
ComReg	14.32	15.94	14.90	13.27
CAR			2.63	3.29
Total	15.57	23.10	22.20	22.54

Source: ODTR *Annual Reports*, CAR and CER *Financial Statements*, various years.

Direct regulatory costs represent only a fraction of the true cost of such a regime. The main cost of regulation is due to compliance costs, which are borne by the industry and for the most part are never even measured. In effect regulation suffers from a form of negative externality since the direct costs of regulation borne by the regulator are less than the cost to society resulting in an excessive level of regulation from society’s point of view.

Massey and Daly (2003) cite the example of the regulator setting higher next day delivery targets for postal services. Even a small increase in the next day delivery target may have significant marginal cost implications as postal services display peak loading

¹⁶ Regulators in several EU Member States have taken a similar approach.

¹⁷ Baker (2004) points out that even a monopolist will pass on a large proportion of any reduction in its variable costs. An inference that such cost pass-through indicates a lack of buyer power seems misguided.

characteristics. Thus there is a danger that higher costs may outweigh any benefits from higher delivery targets.¹⁸ As the regulator does not bear those costs it has an in-built bias towards setting higher targets which enable it to claim that it is trying to improve services for customers. Introducing a second class postage rate that would involve a lower charge in return for slower delivery, say 2-3 days as opposed to next day, would allow consumers rather than the regulator to decide the level of next day delivery required, while easing the peak load problem and reducing costs.

The existence of information asymmetries, combined with the fact that both incumbents and new entrants have an incentive to mislead the regulator, also has important cost implications. Incorrect regulatory decisions are likely to impose significant costs on the economy as investment decisions and competitive strategies of firms will be misdirected.

The CER invited the ESB to prepare proposals on how it should be regulated and then sought submissions on these proposals from third parties. Previously the CER sought comments on BGE's proposals for regulating the gas market. This effectively allowed the incumbent firms to set the regulatory agenda and raises serious questions about the extent of regulatory capture.

11. Regulatory Accountability

Regulators are themselves monopolies, which suggests that there is a need to ensure that they are subject to an adequate level of accountability. Levine (1998), however, claimed that

...the welter of information that the public receives about political issues from the media and the difficulties of organising to achieve political ends insulate regulators from monitoring and general interest pressures.

Westrup (2002) found that Oireachtas Committees had failed to properly oversee the activities of regulatory bodies because of a combination of inability; ignorance or partiality; and lack of interest. He observed that "...the Oireachtas has shown little enthusiasm for carrying out its scrutiny role" (p. 55) and described "...the apparent unwillingness of different Oireachtas committees to meet with the different regulators on even an annual basis is an indication of a reluctance to take seriously a scrutiny role". It appears that committees only take an interest in the activities of regulators when such issues become hot topics politically and present an opportunity for political points scoring. This of course does not permit for the sort of detailed and in-depth performance reviews that are necessary.

12. Getting the Market Structure Right

The lesson from other countries is that, where competition is possible, it is far superior to regulation at increasing efficiency and ensuring the lowest possible prices to consumers (Kahn, 1988). Policies which seek to limit competition, and rely instead on regulation to safeguard the interests of public utility customers are

¹⁸ An Post has announced plans to hire consultants to investigate whether the target is achievable at a reported cost of up to €500,000.

therefore misguided. As Stelzer (2001, p.7) observed with regard to UK regulatory agencies:

...it was somewhere between foolishness and wild optimism for the government to imagine that regulation is a process that can be performed by a few folks applying uncontroversial techniques to determine prices that will be fair to consumers and at the same time yield returns adequate, but no more than adequate, to attract capital in sufficient quantities to maintain service at acceptable levels.

Borenstein *et al.* (1999) point out market power problems may persist in electricity even when there are a number of competing generators, but nevertheless argue that competition is superior to regulation.

Equally it must be recognised that simply permitting entry will not lead to the emergence of competitive markets in gas and electricity. The objective of policy should be to ensure that, in five years time, regulation will only remain necessary in the case of the natural monopoly transmission and distribution networks. Achieving this aim is likely to require some restructuring in gas and electricity. The ownership and control of the transmission and distribution networks needs to be transferred to companies that are independent of ESB and BGE. In the case of gas, approximately 80 per cent of the market in volume terms is currently open to competition. While BGE still has 100 per cent of the household and small business market, horizontal restructuring of its supply business would appear unnecessary.

Electricity is more complex. The ESB (2003) has committed itself to reducing its market share of electricity generation to 60 per cent “to facilitate the entry of new competitors.” This is unlikely to result in an adequate level of competition, particularly as ESB would still have 100 per cent of the peak plants which effectively set the price for generation.¹⁹ Helm (2003) has suggested that the Republic of Ireland electricity market is too small to permit competition; although Littlechild (2003) reports that competition is being considered in countries with a total generation requirement of 1,000MW or less.

There are proposals for the creation of a single all island electricity market and for the construction of inter-connectors to Britain.²⁰ IPA (2001) concluded, however, that action would be required to tackle ESB’s dominance in generation even in the context of an all Ireland market.²¹ Helm (2003) indicates that restructuring would be viable with the construction of interconnectors to the UK. Borenstein *et al.* (1999) reported that in

¹⁹ Borenstein (1999) has shown that firms with much smaller market shares may be able to wield market power in generation.

²⁰ Bergman *et al.* (1999) describe how Sweden, Norway and Finland expanded their national electricity markets by integrating them in this way. Interconnection capacity between Scotland and England is being increased in response to a lack of competition in Scotland. See Ofgem (2001).

²¹ This need not involve privatisation of existing ESB plants. New Zealand, for example, privatised 40 per cent of its generating capacity but the remaining 60 per cent was split into three competing state companies.

13. Reforming Ireland's Regulatory Regime

parts of the US generators reduced the geographic size of the market by reducing output and causing congestion on the grid. Such experience suggests that increasing inter-connection capacity on its own might not suffice. Commenting on Swedish experience, Bergman *et al.* (1999, p.229) concluded, that "...it is better to rely on the redistribution of generation assets" whenever possible, because the benefits from market expansion "...are likely to be more uncertain and less immediate."

Consideration should also be given to faster liberalisation of postal services. There is some evidence that final delivery may constitute a natural monopoly. In the UK rival operators handle the collection, transport and sorting and pay the Royal Mail for final delivery at a rate of 13p per item. Such mail can be sorted down to the level of individual delivery routes. (Senior, 2004)

Structural changes in gas and electricity need to be accompanied by significant reforms of the existing regulatory regime. Sharp price increases for gas, electricity and postal services in recent years has contributed to a growing public disenchantment with the regulatory process in Ireland and created a mistaken impression that competition in these industries has not worked. In many instances regulatory decisions simply summarise submissions of various parties and set out conclusions. (See, for example, CER, 2004). Stelzer (2001, p. 105) has criticised such an approach in the UK.

This decision to establish a decision-making process that, to all intents and purposes, excluded consumers from participation relied on the very English notion that responsible chaps know what is best for the public.

There is a need for a properly resourced consumer body that is capable of undertaking the necessary research to present a counter case to the regulated firm. Greater transparency is required to restore credibility to price regulation. Future price reviews should be conducted by means of a public hearing. This would allow the arguments put forward by regulated firms to be challenged directly. It would also require those opposing price increases to present more rigorous arguments.²²

The existing regulatory agencies for energy, telecommunications and airports should be combined into a single regulatory agency. There would appear to be obvious economies of scale and scope suggesting that a merger would be beneficial, while such an agency might also be less prone to regulatory capture.

Massey and Daly (2003) describe the current *ad hoc* arrangements regarding appeals against regulatory decisions, with wide variations in the type of decisions by the different regulators that can be appealed and with appeals by customers against pricing decisions

²² Submissions from trade and business associations opposing the October 2004 price increase argued: Prices should not be increased because of a cumulative 28 per cent over the previous three years; price increases should be less than inflation because they are a significant cost to industry; and company's operating budgets included no provision for higher electricity charges. (CER, 2004)

excluded except in the case of the aviation regulator. Customers and customer groups should have a right to appeal decisions on prices and price caps with a single appeals panel responsible for considering appeals against regulatory decisions. An appeal by the major airlines, who are the customers, led to the CAR reducing price caps for airports. There is a concern that the appeals body would become the *de facto* regulator and that parties would not engage in the initial regulatory decision making process but preserve their ammunition for an appeal. Firms generally tend to want such issues decided speedily and it is not in their interests to act in such a fashion. In order to discourage vexatious appeals, appellants could be required to bear the cost of unsuccessful appeals.

Waverman (2003, p.144) argues that regulatory creep is endemic by its nature as the regulator's job is to regulate. "Hence blaming them for regulating is like blaming fish for swimming. There are only ways to restrain regulatory creep..." This is exacerbated by the fact that rivals have obvious incentives to complain to regulators about incumbent firms as they may benefit if the regulator restricts the ability of the incumbent to compete with them. He suggests that regulators should themselves be subject to a price cap while unsuccessful complainants should be required to bear the cost of investigations by the regulator. In Ireland's case a price cap of CPI – 10 per cent for the regulator(s) for five years would encourage moves towards developing effective competition and reducing the scope of regulation. The base point for the regulator's price cap should reflect ComReg's actual regulatory outlays rather than its revenue.

14. Conclusions

Little progress has been made to date in introducing competition in gas, electricity and postal services in Ireland. Arguably this is because too little consideration has been given to the introduction of measures necessary to bring about such competition. Policy has instead tended to favour regulation over competition. Such an approach is clearly misguided and will inevitably result in higher prices and a loss in allocative efficiency with consequent implications for industrial competitiveness. Greater emphasis must be placed on measures designed to promote competition, including restructuring in gas and electricity and a speeding up of measures to liberalise postal services. Such measures must be accompanied by policies designed to limit regulation to those areas that are genuine natural monopolies, something which regulators are unlikely to do if left to their own devices.

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