

# The transactional efficiency of long-term arrangements and the regulatory context

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## Outline

- From Organization of Coordination among components of the industry to Governance
  - The problem is often not the principle, but the implementation
  - Practical issue: impossibility to design perfect mechanisms i.e. able to address ex-ante ex post strategic manipulations & innovation
- LTC performances depends upon
  - Market infrastructure
  - Market structure
- Basic conditions in the electricity industry:
  - Fixed costs => Concentration
  - Complex interdependencies among providers (energy mix + plurality of objectives)  
=> Tight coordination needed to optimize
  - => Potential collusion (e.g. Wollak on New-Zeeland)
- ⇒ Necessity to combine Regulation (ex-ante) & Competition policy (ex-post)
  - Necessary second rank solution in a world of uncertainty (impossible perfect design)
  - What are the alternative organizations of regulation ?
- That said, the problem of capacity is a structural problem that cannot be fixed only within the current industrial framework only
  - (EU) Market integration to decrease specificity of investments => to invest in European transportation capabilities
  - Coordination with Demand through smart grids (+ new energy mix)

# Some basic economics of coordination mechanisms

- Key characteristics in contracting (Williamson)
  - Specificity of investment
  - Frequency
  - Uncertainty
- ⇒ These call for vertical integration in the electricity industry
- In addition systemic constraints: Optimizing energy mix in a context of high uncertainty of demand in the short and long run
- ⇒ Technical interdependencies: Potential externalities (Coase)
  - Market if clear property rights (or liability principle) and if transaction costs down to zero (i.e. no knowledge and information asymmetries): that said pbm of collusion in concentrated industry
  - Vertical integration: but how to regulate the monopoly

## Long term contracting

- Pbm:
  - by definition, long term contracting maintains independent entities, while limit competition (and then adaptability) => markets and organizational failures are not eliminated
  - LTC do not provide perfect guarantees: ex-post renegotiations
  - LTC are costly
  - ⇒ Generally speaking, performance of LTC depends upon
    - Market structure/concentration
    - Articulation with other mechanisms; e.g. spot markets (both because they complement LTC and discipline parties)
- With the government or among operators ?
  - Among operators
    - Joskow: combination of LTC and SpotMarket might allow optimal balance between adaptation and security//mutual reinforcement // in the same time ≠ context
    - Proliferation of contracts (transaction costs and systemic interdependencies/failures) & potential collusion
    - Strong need of regulation
  - With the government
    - Competition for the market rather than on the market
    - Winner curse effect + strategy
    - Performance depends upon Gvt capability
      - Ex-ante negotiation to enhance efficiency of ex-post auction (but control of corruption)
      - Ex-post negotiation and oversight of operation.
- Public oversight (at least) / Regulation is needed
  - As to set up any market (Brousseau & Glachant)
  - In this specific industry in particular : fixed costs + interdependencies = concentration + coordination needs

# Alternative in the Organization of Regulation

- Ostrom's self-regulation
  - Pros: "cultural" cognition and shared beliefs may help to deal with complex issues
  - Cons: high risk of collusion (this is not a common public good provision problem, since the commons is an asset aimed at producing commercial services)
  - In the context of the "KB economy"
    - Self-regulation is efficient in dealing with innovation, moreover it is sustained by ICTs capabilities
    - However, self-regulation might lead either to fragmentation, or to domination by gatekeepers that control interfaces and their evolution (see the Internet)
- Coasean markets + Competition policy
  - Pros: a consistent design of rights of access (property rights and permits) and a strong competition oversight can avoid the above mentioned capture (if transaction costs are not too high)
  - Cons: this coasean bargaining is efficient for professional markets. In mass-markets anti-commons/ transaction costs issues (+ pbm of consumers' skill)
  - In the context of the "KB economy"
    - Pbm of control over the design of the property right system in the case of permanent innovation. New use, new technology generate new opportunities and new interdependencies that generate externalities (or veto capabilities) that should be addressed by new property rights. Who is in charge? Especially in a context of permanent and incremental innovation: Reforms by the parliament are too scarce. Is the antitrust authority capable of doing so? (Nelly Kreuz said no because she is unable to design markets)
- Liability rule and judicialization
  - Pros: liability can be a substitute to the regulation and to the lack of knowledge of regulator.
  - Cons: , liability request the solvency of the players (pbm in case of systemic failure, or in case of "too big to fail" situation), and the ability or the "judge/regulator" to implement sanctions (which is magnified in an international context; see blackout in Europe; but also antitrust)
  - In the context of the "KB economy"
    - Judges can operate on a day to day basis to manage incremental evolutions leading to rule breaking or conflicts;
    - Pbm of assessment of damages in case of innovation. Lack of information and knowledge prevent the judge to easily evaluate damages. Lack of foreseeability of their decision, hence lack of deterrence. Deterrence works only for stabilized "technologies" (e.g. overbooking in the air transportation industry)

## Consequences for the Design of Regulatory Frameworks

=>Need to organize Arena (Public Posting to allow information sharing... and Common knowledge building)

- Pbm: traditional lobbying leads the regulator to access only to the information promoted by major stakeholders  
An arena should be open, which means empowering fringe and small stakeholders => better control of hidden information
- Pbm: uncertainty in matter of demand (usages) can lead to winners curse effect / An arena should allow to share the (lack of) knowledge / and to avoid winners curse by the building of "revisable consensus"

=> Consensus Regulation (Logic of the focal point = convergence of anticipations and facilitation of adoption of consistent/compatible behaviors; à la Greif/Aoki)

- Stakeholders interest have to be taken into account in the regulatory game => "Participation constraint" to the regulatory game // Regulatory change must be incremental [constraint]
- Public release of information allows to build possible futures (i.e. focal points) that allow regulating despite uncertainties // All players are aware that the regulatory framework is uncertain => Consensus on the need to revise it with the development of knowledge [opportunity]

# Systemic Solutions ?

- Smart grid=> to adapt consumption to supply & to rely on users capabilities (e-cars)
- Interconnexion=> reduction of specificity + reinforced competition (while of course pbm of complex coordination)

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## References:

Brousseau E. & Glachant J.-M., "Regulators as Reflexive Governance Platforms", *Competition and Regulation in Network Industries*, Volume 12, No. 3, pp. 194-209, 2011

Brousseau E. & Glachant J.-M.(eds.) *The Economics of Contracts : Theories and Applications*, Cambridge: Cambridge University Press, 2002