Director’s Take

Information Rules: Part 1

“What did the president know and when did he know it?” has been a popular question since it was first asked about 30 years ago. A similar question, “What does the regulator know and when does he know it?” is the key question in regulation because the decision “Should we regulate?” and the decision “How should we regulate?” both hinge on information. When it comes to making regulatory policy, information rules!

Let me explain. Suppose that the regulator knew as much as company managers about what customers want, what they are willing and able to pay, and the most efficient means of supplying the market. In such a world, the regulator could micromanage the company – telling the employees when to roll the trucks, buy PCs, advertise, etc. – because the regulator knows just as much as anyone else. Furthermore, by micromanaging the company, the regulator can ensure that the company achieves the regulator’s objectives. This is a clear win for the regulator.

But in today’s world, the regulator is not an expert on the best ways to diversify risk, choose technologies, advertise, negotiate contracts, fix software glitches, etc. Company managers are experts in these areas. This means that these managers have an information advantage over the regulator and this is what makes regulation challenging.

The regulator addresses this information advantage in three ways, by learning about the sector, introducing competition, and using incentive regulation schemes, such as price cap regulation. The regulator learns about the industries he regulates by reading the trade press, talking with industry managers and customers, studying financial statements, etc. More channels of communication and more time using them mean more information. However, the regulator can never absorb all of the knowledge embedded in a company, so competition and incentives remain key instruments for the regulator.

Competition has become a favorite tool for telecom regulators. In the best case scenario, it can completely overcome the company’s information advantage. Once competition takes hold, the telecom regulator can pretty much step aside, except to deal with market structure issues of interconnection, anticompetitive conduct, and the like. Of course, applying these instruments also requires information.

In water and energy, competition generally plays only a limited role, so incentive regulation schemes matter more in these sectors than in telecommunications. Incentive schemes reward company managers with extra profit when they improve performance – for example, by accepting lower prices, delivering higher quality, or expanding service. This overcomes the regulator’s need to know how to improve performance, but it comes at a cost to customers, namely higher profits for companies.

To sum up, one of the jobs of the regulator is to get customers the best deal possible. The regulator can do this by facilitating competition, but to do this well, the regulator needs to know how the industry works. The regulator can also get customers more bang for their buck through incentive regulation. The more the regulator knows, the better incentive regulation works. Information rules!

A more complete analysis of the role of information in infrastructure regulation is available online at www.purc.ufl.edu.

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