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MONASH BUSINESS POLICY FORUM

# Rationalising rustic regulators

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How should Australia's national economic regulators be reorganised?

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This paper has been prepared for the Monash Business Policy Forum by Rodney Maddock, Joe Dimasi and Stephen P. King. We would like to thank Brent Carney for his excellent assistance in the preparation of this paper.



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## Summary

Australia has implemented extensive microeconomic reform since the 1980s. Part of this process involved developing a suite of independent economic regulatory authorities. These institutions largely developed in an *ad hoc* manner, without an overarching framework to consider which functions and responsibilities should be located in which institution, and how these institutions should be organised. This paper provides such a framework.

The paper sets out some basic principles about the location of regulatory responsibility. When should functions be located in government departments, independent regulatory authorities, or dealt with through market interactions within the broad legal framework? The paper notes that the core benefits of arms-length regulation derive from improved decision making – better expertise and reduced sovereign risk. The paper recommends focusing independent economic regulation on four basic functions: market creation, market operation, market outcomes, and market failures. It develops a model to guide both the creation and review of independent regulators in these four areas.

The paper identifies a number of basic problems that need to be addressed in design of the suite of independent economic regulators. In particular:

- how to avoid regulators being captured by some party with vested interests,
- how to make sure regulators are not slack,
- how to prevent regulators from usurping policy functions,
- how to limit potential mission creep by regulators, and
- how to deal with changes in the economic environment that impinge on the relevance, responsibilities and requirement for particular regulators.

The paper develops a set of regulatory principles that aim to address these basic problems.<sup>1</sup> These are:

- to maintain regulatory relevance, make it hard to establish new regulators, and review each regulator once a decade,
- to give regulators clear and appropriate objectives and functions, and keep regulators separated from policy development,
- to establish clear regulatory independence and rotate Commissioners and senior staff,
- to make regulators accountable and transparent including through clear appeals processes, and
- to enhance regulatory efficiency by separating Commissioners from day-to-day management.

The paper then suggests how these principles might be applied in practice. It recommends that Australia consolidate its (national) economic regulators to just five:

- National Markets Commission
- Competition Commission
- Reserve Bank of Australia
- Consumer Protection Commission
- Essential Services Commission

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<sup>1</sup> Some of the points raised have been made recently by the Commission of Audit. See <http://www.ncoa.gov.au/>

## Introduction

Australia went through an important economic transformation in the 1980s and 1990s. This involved significant microeconomic reform, much of which focused on regulation.<sup>2</sup>

Broadly, the reforms involved shifting the locus of much economic decision making from inside government and government agencies, towards markets. Australia's reforms were part of a wider international movement away from central planning, and away from the assumption that bureaucratic decision making could replace and improve upon market decision making. These changes recognised that, in many situations, the information requirements for effective centralised intervention in markets (or replacement of markets) were simply too great.

The former Governor of the Reserve Bank of Australia, Ian Macfarlane put it this way when he was explaining why the dollar had been floated:

*I think politicians and key economic bureaucrats came to realize that the process of setting key financial prices ... was not working. It was just too difficult to do it properly.* (Macfarlane 2006, p. 45).

Government retreated broadly from direct provision of services in many areas during this economic transformation. Major businesses like the Commonwealth Bank, Telstra, Qantas, the Commonwealth Serum Laboratories, energy companies, airports and a wide range of other activities were privatised. In a number of other areas, such as the provision of water and the placement of the unemployed, new mechanisms were developed to make greater use of markets. In other areas, such as the introduction of compulsory superannuation, which was developed in an attempt to reduce reliance on the government to provide retirement support, reform spurred a whole new industry into existence.

The fact that government retreated from directly providing these services did not diminish the underlying political determination to influence the outcomes that were actually delivered.

The result was the emergence of a suite of new and expanded regulatory authorities. Rather than being a period of de-regulation and winding back of the state, the microeconomic reform era in Australia involved redesigning the boundaries of the state and experimentation by governments to improve service delivery in a range of areas. Independent regulation expanded.

So the move to free up the Australian economy and to render it more dynamic, created a boom time for regulation and regulators. Despite the best intentions of the Hilmer Report (1993), which provided an integrated view of the regulation of markets, Australia has proceeded in a disjointed and piecemeal manner both to construct new regulators and expand the scope of existing regulators.<sup>3</sup>

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<sup>2</sup> One of the seminal works of the period, and from which we have taken the title of this paper, was Ted Sieper's justly famous 1982 book *Rationalising Rustic Regulation* which put the case for reform of agricultural pricing in Australia.

<sup>3</sup> The Australian Competition and Consumer Commission (ACCC) provides a simple example. It was established in 1995 by merging the competition and consumer regulator (the Trade Practices Commission) and a price monitoring body (the Prices Surveillance Authority). It also gained some functions from the telecommunications regulator (Austel). Over time it has gained other permanent and ad hoc regulatory functions.

This is not likely to be optimal. It means that decisions about resource allocations and trade-offs made between functions are opaque and may not reflect either best-practice or what was intended by Government. Indeed, Australia's regulatory structures can be described as 'rustic'. They are rough, unsophisticated and ill suited to Australia's future development.

The purpose of this paper is to provide a stocktake of Australia's national economic regulators and to provide guidance as to how we might take the system forward.<sup>4</sup>

This type of review is critical to a successful economy. As society changes, many of the overarching objectives of government remain the same: better living standards, security and fairness are examples of lasting objectives. The issue for policy is how to devise structures that can help the society achieve some of its long-term goals, but are flexible enough to respond to change.

Social institutions may not simply lack the flexibility to adapt to change. They may actively oppose change. A challenge to a review of national economic regulators will be the vested interests embedded in existing structures. Mancur Olsen's *The Rise and Decline of Nations* famously sets out the problem to nations of institutional sclerosis. Structures and institutions can ossify and impede necessary adaptation. When reviewing and redesigning institutions, it is important to recognise the potential for existing institutions to impede or prevent necessary change.

Our approach in this paper is to step-back from existing institutions and provide a logical structure for thinking about what sorts of economic regulators are likely to work best in a range of different situations. The framework developed in this paper looks at underlying regulatory functions and considers how to devise institutions that match these functions, allowing for a commonality of objectives, skills and cultures within a specific regulator. In our opinion, the recommended structural changes presented in this paper will allow for more cohesive and transparent economic regulation, and better performance from our economic regulators.

## Government, law and regulation

The Australian political system delegates a wide range of decisions to the government. Once a government is formed, it has the ability to make these decisions subject to a variety of checks and balances.<sup>5</sup>

Government processes are separate from, but linked to, the legal system. The courts can make a wide range of judgements under common law. However, the courts are also called on to enforce statutory law passed by the parliament.

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For example the Australian Energy Regulator (AER) shares the staff, resources and facilities of the ACCC. While the AER three-member board is independent of the ACCC, it includes a member of the ACCC. The ACCC has also gained an on-going arbitration role under Australia's infrastructure access regime and had a temporary role monitoring price compliance when the goods and services tax (GST) was introduced on July 1, 2000.

<sup>4</sup> Kovacic and Hyman (2012, p.14) note that this type of "assessment and adjustment increases the likelihood that a jurisdiction will progress towards better (not best) performance and practice."

<sup>5</sup> For example, the federal government is constrained by the bicameral nature of parliament and the constitution. The government must also retain the confidence of the parliament to continue to govern.

While the courts can be used to implement government policy, government may also implement its decisions through regulations. The government can use two alternative approaches to regulation. First, the government can rely on bodies, such as government departments, that are directly answerable to the government on a day-to-day basis. Second, the government may use legislation to create a dedicated body that is tasked with implementing certain decisions and enforcing specific regulations. These independent statutory authorities are answerable to parliament but are not under the day-to-day supervision of the government. These authorities include arms-length economic regulators.

In different circumstances, these alternative ways to implement policy are either substitutes or complements.

For example, a person injured after being attacked by someone else's dog might sue the owner for damages through the courts. Alternatively, governments may use regulations to prohibit the ownership of certain breeds of dog deemed to be most likely to attack humans. These are alternative ways of achieving a particular social end. The *ex post* process through the courts is a substitute for the *ex ante* approach of regulation.

Alternatively, the government may establish rules against, for example, mergers between businesses that substantially lessen competition. The government may create an arms-length agency that is tasked with bringing such mergers before the courts. For example, in Australia, the Australian Competition and Consumer Commission (ACCC) is the only party able to seek an injunction from the courts to prevent a merger on the grounds that the merger will substantially lessen competition. The government has established a two-step process where an arms-length regulator and the courts complement each other.

Each alternative – regulation implemented through departments, arms-length regulators, and the courts – will be imperfect. This reflects the information limitations of the government, the courts and delegated authorities. Further, limitations in legislative drafting, legal interpretation and practical implementation will mean that, at best, actual policy imperfectly achieves its objectives. In the context of economic regulation, this does not mean that governments should not intervene in markets. However, it is important to recognise that, just as markets can fail, so too government policy can fail. When considering different government policy options, including the policy of 'doing nothing', the trade off is always between imperfect alternatives.

### Why use regulation at all?

Given the alternative of implementing policy through the courts, why do governments choose to use regulation at all?

Courts are entities that interpret law and adapt it to fit better with evolving social standards, providing some of the flexibility needed to respond to a changing society. There is, however, a key limitation with using the law to implement government policy. Once the law is in place, it tends to be relatively static, while the society to which it applies is constantly changing. The law is expensive to create and expensive to change, is built through the gradual accumulation of precedent, and is expensive and, often, slow to enforce through the court system. Consequently using the legal system to directly implement government policy can be slow and cumbersome.

Of course, these disadvantages are simply the mirror image of the benefits of using the court system. The passage of laws is relatively transparent, involving a very public, and potentially extended, period of debate and consideration, with merits evaluated in some detail. The system of precedent and appeals can provide certainty to private parties who are affected by the laws.

In contrast to legal processes, regulation can be cheaper and more agile. These are both desirable attributes for any social intervention. Delegating the rights to make decisions through regulation to a government department provides these advantages while allowing a minister significant control over the actions taken, and for the parliament to have substantial oversight of the processes. Thus, decision-making through a department may be more efficient than using the courts.

Nonetheless, using departments and regulation to implement government decisions can come at a cost. The process can be less public, less transparent and more subject to uncertainty than a court-based process. Determining the preferred approach to implementing any specific government policy will involve weighing up the benefits of the alternative approaches.

From the government's perspective, the delegation of decision making by a minister to his or her department provides some advantages, most particularly in regard to the scope and span of activities that a minister can manage. The departmental structure makes it possible for the minister to take responsibility for a wide range of activities, generally managed within flexible guidelines, while knowing that important decisions will be channelled to the minister.

Again, these benefits come at a cost. In a democracy, government is responsible for its decisions and subject to the final sanction of the voting public. While direct ministerial responsibility and control provides flexibility, it also provides political risk. As noted above, regulation is always imperfect and when a minister's department implements such regulation, the minister may face significant political pressure from vested interests that are adversely affected by the regulations. This may damage the minister and the government politically. It may also create incentives for the relevant minister to attempt to change the way in which the regulations operate, to gain a short-term advantage, even if this is not in the best interests of society in the longer term.

In contrast, the delegation of policy implementation to a court may reduce these political risks. The courts are usually seen as independent of government, so decisions by a court are not taken as a failure of any particular minister. However, the political risk of relying on courts to interpret policies after they have been embedded in law is that any problems become very obvious, very difficult to deal with politically and may persevere for a long time.

### **Why Ministers like independent regulators**

In this situation, where governments face a choice between two paths to implement policy, both of which have significant social and political costs and benefits, delegation to an independent agency can look very attractive.

The independence of the agency provides immediate political cover, allowing contentious decisions to be arbitrated and defended by reference to the specific expertise and authoritative

judgement of the specialist regulator. At the same time regulations can be altered as needs be at the discretion of the government.

Thus, independent regulatory authorities offer agility and flexibility, attributes which allow them to respond promptly to changing social circumstances. They can also make use of significant expertise which gives them a degree of authority. However they are usually less transparent than a court-based process, and they are at arms' length from the minister which provides political cover.

Further, delegation by ministers to independent agencies can help address the "Ulysses and the Sirens" problem. Ulysses knew that under the immediate seductive influence of the Sirens he would not be able to perform his long-term objective of delivering his ship to safety. He insisted on being tied to the mast to prevent him doing what seemed attractive in the short term.

Politicians too are often in situations where what they believe is best in the long term is in conflict with immediate political pressures. Like Ulysses they can establish mechanisms that stop them taking the short-term decision. Accordingly delegating a decision to another body, for example to an independent regulator, can prevent political short-termism. It allows politicians to say that they have no power to influence the decision and to protect themselves from the political consequences of making an unpopular decision.

### **Limiting the proliferation of regulators**

The temptation for politicians to push hard decision making off to independent regulators suggests that we are likely to see too many regulators being created.

Ministers will often want to create independent regulatory entities. They appear to offer an agile way of addressing changing circumstances, provide some ability to shape outcomes, but shield the minister from direct political responsibility. Does that mean we should let independent agencies proliferate?

The first argument against creating a multiplicity of regulators is the presumption of ministerial responsibility. Ministers are elected to make decisions, not to hide from them. Our democratic presumption should require us to be conservative in the creation of new regulatory bodies.

The second is administrative. There are two elements: (i) the entities themselves are expensive as they all involve set-up costs, and (ii) decision making becomes more expensive for everyone as they have to deal with and monitor the decisions of a widening range of regulatory bodies.

So from a social perspective, when is it desirable to 'allow' a minister to escape direct scrutiny for policy implementation, and to use the 'shield' of an independent regulator?

Society's broader interests and the government's political interests are aligned when dealing with a significant "Ulysses and the Sirens" problem. If political pressures push for intervention that is undesirable in the longer term, the protection of a minister from short-term pressure is both politically and socially desirable. These situations are most likely when there is a significant issue of sovereign risk.

For example, when private businesses are making large and often irreversible investments, and the environment within which the investment is made is subject to government whim, the investor faces such significant sovereign risk that, from a social point of view, too little investment will be undertaken. Investors will require a large return which compensates them for the risk, and absent such large returns, they will not invest. For example, this is one reason why firms are so reluctant currently to invest in Argentina.

There are two general solutions to this concern of sovereign risk.

First, the private party might enter a long-term contract with the government that is enforceable through the courts. This is the normal method we have used in Australia to manage investment in transport infrastructure.

Alternatively, the government can create an independent regulator who has control over the relevant decisions. This immediately explains the reason for providing independent regulation of the utility industries. In these industries, investments tend to be very large, very lumpy, very long lived and irreversible, making investment in those industries particularly susceptible to capricious decisions of government. Some of the justification for financial regulation derives from the same concerns.

In summary, governments' inclination to set up independent regulators to shield themselves from unpopular decisions should generally be resisted on responsibility, cost and efficiency grounds unless there is a significant and overriding efficiency issues such as sovereign risk.

## **So what is the downside with independent regulators?**

If it is desirable to establish an independent regulator, are there downsides or limitations to this approach?

Whenever delegation occurs between a 'principal' and an 'agent', there will be information problems. The whole point of delegation is to have an agent collect, distil, and act on relevant information. The principal must rely on the agent and, to the degree that the aims and objectives of the agent differ from those of the principal, delegation will only imperfectly implement the principal's wishes.

Further, even the best-meaning agents have to act on their interpretation of the desires and instructions of the principal. Mistakes may arise when the agent attempts to implement the parliament's intent.

This slippage is inevitable in all systems of delegation, and a central task of institutional design is to develop a structure which makes good choices most of the time about what actions the agent should take, the way that the agent acts, the information collected by the agent, the information passed on by the agent to the principal, and when the agent should refer decisions back to the principal.

The relationship between parliament, a minister/department and an arm's length regulator is a standard multi-level principal-agent problem. As such, it suffers from these information and incentive problems. Principals always struggle to provide the right incentives to the agent;

incentives which ensure that the objectives are being pursued as intended, and in a manner which is efficient and effective.

Like any principal-agent relationship, one of the other important concerns is how to renegotiate the arrangement when underlying economic conditions change.

## Capture

One standard concern with regulators is that they will be captured by some of the parties involved. There are many discussions in the US involving the extent to which regulators and the industry they regulate have become excessively close, and regulations have been interpreted to the advantage of the industry rather than the broader public interest.<sup>6</sup> There were clearly concerns recently in Japan that the energy regulator had been captured by the power industry.<sup>7</sup> The recent independent report into media regulation in Australia concluded that content regulation is inadequate and noted that common tools of regulation used in the area may be prone to ‘capture’.<sup>8</sup>

But this is not the only sort of capture. The entrants to an industry might capture regulators, particularly where a new market has been opened up. It is easy to see how the table might be tilted in favour of entrants relative to incumbents. When telecommunication markets around the world were being opened up to competition in the 1990s, some regulators worked to create an environment which helped new players relative to incumbents.<sup>9</sup>

Capture by particular groups of users of a service is also possible, so regulation might support consumers relative to producers.<sup>10</sup> The provision of public utilities in many countries may suffer because local regulators try to keep utility prices affordable (i.e. low) for consumers, and as a result investment in the system is squeezed, and service quality deteriorates.

A fourth form of capture arises when a regulator aligns with the interests of the whole industry against the broader public interest. Concerns have been expressed in Australia about an ‘industrial relations club’ which seeks to entrench a particular form of wage setting potentially against the interests of the unemployed and society more broadly.<sup>11</sup>

More recently regulatory decisions are starting to flow from international agreements that take little if any account of local interests. The Basel III financial arrangements have been criticised on these grounds.<sup>12</sup> This is another form of capture.

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<sup>6</sup> Dal Bo (2006) provides a theoretical overview of regulatory capture and summarizes the formal empirical literature applying to regulators in the United States.

<sup>7</sup> See Inajima, Adelman and Okada (2012).

<sup>8</sup> See Finkelstein (2012).

<sup>9</sup> For example, Dnes (1995), in the context of UK telecommunications, notes “the October 1985 decision to grant BT’s only serious competitor ... the right to interconnect with BT’s networks at advantageous access prices.” He notes similar regulatory decisions beneficial to entrants in the UK gas industry.

<sup>10</sup> For example, Helm (2006, p.175) notes “consumer groups and other NGOs also engage in capture expenditures. There are specific consumer interests, reflected in consumer bodies, which press for more regulation to protect special interests, and NGOs devote considerable resources to regulatory capture”.

<sup>11</sup> See Henderson (2013).

<sup>12</sup> For example, Moosa and Burns (2013, p.29) claim that “[a]ny justification for using internationally uniform capital standards is more like rhetoric than economic sense and substance”.

### *Tools for dealing with potential capture*

Governments have developed a number of tools for addressing the risk that a regulatory agency might be captured.

The most obvious is the appointment of commissioners to oversee the regulatory bodies and, in principle, direct the agencies towards achieving the intent to the statute(s). Appointing commissioners for a defined period, and appointing people of considerable expertise and standing, reduces the prospect of the entity involved being captured by any particular viewpoint.<sup>13</sup>

How effective this is will depend on the particular commissioners chosen. Inexpert commissioners may not be able to challenge expert opinion generated within the agency concerned. Importantly commissioners who spend too long at an agency may too become captured. Commissioners should not be appointed to ‘represent’ a particular group, such as small business. Such appointments will encourage, not prevent, capture.

A second level of defence involves requiring the regulator to make its decisions in a transparent manner. This could be by public hearings, by the issuance of discussion papers, or by the obligation to publish regulatory impact statements, all of which make it harder for the regulator to conduct its business in ways inconsistent with its mandate.

A third defence involves recourse to parliamentary processes including appropriation reviews, parliamentary questions and a range of inquiry options.

Fourth, clear, transparent appeals processes can be used to offset capture. If a regulator is captured, its decisions will be biased. Arms-length appeals processes can identify and correct such bias.

Finally, careful consideration of the range of functions covered by a regulator can reduce the potential for capture. A regulator that covers a range of areas dealing with multiple stakeholders is less likely to be captured by one or a small group of stakeholders. At the same time, as we discuss below, if the regulator’s remit is too broad and is inconsistent, this may reduce the effectiveness of the agency.<sup>14</sup>

### **Slack**

The second broad problem faced by any principal is ensuring the agent operates as efficiently as possible. It can be hard to monitor the effort the agent is putting into the job. The design of regulatory institutions should include processes and structures to deal with this potential for slack.

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<sup>13</sup> Kovacic and Hyman (2012, p.5) note the importance of fixed-term appointments for Commissioners as a part of ensuring a balance of regulatory autonomy and accountability.

<sup>14</sup> As Kovacic and Hyman (2013, p.19) note: “Another factor affecting an agency’s brand and credibility is its susceptibility to capture. In general, the broader an agency’s portfolio, the harder it is to capture, since all of the covered industries must bid against one another to capture the regulator.”

### *Tools for dealing with slack*

The problem of ‘slack’ is quite standard across many entities, and government has developed a number of tools to address it. Having to compete for budgets, tough scrutiny of annual reports, the requirement for efficiency dividends, and rigorous estimates hearings are some of the tools involved.<sup>15</sup>

Regulatory bodies escape much of this scrutiny if they have their own source of revenue. It is hardly surprising then that regulators seek to be funded by industry levies rather than out of general taxation.

From the point of view of managing slack, industry levies should be discouraged because they weaken the incentives for monitoring:

- they reduce the incentive on departments to monitor agencies;
- they encourage a cost-plus mentality;
- the levied parties may be disinclined to complain about their own regulators; and
- they are a hidden tax on all relevant competing business which is likely to be passed-on to consumers or other parties.

### **Information asymmetry in policy formation**

Both ‘capture’ and ‘slack’ are manifestations of an underlying problem of information asymmetry. The arms’ length regulator inevitably has more information about the industry and its own performance than does its principal.

An additional problem, which arises from the asymmetry of information, is that the government’s position as a policy maker is weakened. The normal allocation of roles is for the ministry concerned to make policy (as principal) and the regulator concerned to implement the policy (as agent). This distinction is clearly weakened when the regulator has the better information about the industry and hence about the likely impact of regulation.

### *Tools for dealing with information asymmetry in policy formation*

This problem is deep-seated and difficult to address. Making good policy requires having good information about the industry under analysis. To date, implementation strategies to deal with information asymmetry have not been a high priority. Nevertheless as the regulatory agencies age, the problem is like to become more serious.

There seem to be three fundamental steps governments need to take:

- recognise the problem and quite deliberately not delegate policy making to regulators nor allow regulators to take control of the agenda;
- implement an explicit and formal strategy of seeking expertise from outside the regulator in formulating policy quite possibly through the green paper and white paper process; and

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<sup>15</sup> “Accountability is usually established by giving the executive branch and/or the legislature direct control of the agency’s budget” (Kovacic and Hyman, 2012, p.5). Further, to ensure accountability, Kovacic and Hyman (2012, p.6) recommend that “an agency might be required to publish regular reports about the agency’s activities and operations”.

insist on independent regulatory impact statements being drawn up by an entity distinct from the regulator.

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In our opinion, this separation of policy design and implementation is key to effective regulatory agencies. However, in a number of countries, the roles are mixed, particularly for competition regulators who are expected to act as advocates for competition as well as enforce the relevant laws. Having these dual roles exacerbates information problems, confuses policy design with legal enforcement and undermines the independence and impartiality of the regulator.<sup>16</sup>

### Mission creep

Mission creep is another acknowledged problem with regulators. Over time, as new events arise, or as politicians ask regulators to consider new and different situations, regulators expand and find new applications for their regulatory tools. Part of this is a natural desire by regulators to seek to deal with interesting but important issues that are on the border of their remit. It can reflect pressure on politicians to find an agency to ‘deal with’ a problem in a short time frame and for senior members of a regulatory agency to seek to broaden their staff and enlarge their area of influence and control. However, the cumulative effect of small incremental steps in regulation can extend regulation well beyond what was originally intended or explicitly sanctioned by government.<sup>17</sup>

Mission creep can cause regulatory agencies to lose cohesion as they pursue multiple functions that may be unrelated or even inconsistent. This undermines regulatory performance. The “lifecycle hypothesis” of regulatory institutions suggests that over time regulatory agencies move away from being attuned to the public interest and become more captured and overly bureaucratized (Estache and Martimort 1999).

### *Tools for dealing with mission creep*

In theory, the department responsible for a regulatory agency should act to prevent the regulator from expanding its brief. While this should be one of the considerations for annual budget negotiations between the department and the agency, this protection, by itself may not be effective. There may be circumstances where the department is not unhappy with the expansion. Further, the department itself may initiate ad hoc expansion if there is political pressure to find an agency to ‘do something’ about a short-term issue.<sup>18</sup>

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<sup>16</sup> As Kovacic and Hyman (2012, p.9-10) note, if an agency has both a policy and an implementation role it risks becoming drawn in to the political process. The agency will be “seen as fair game by the ministers and legislators... [A]dvocacy entails forays into matters that elected officials regard as their policy domain”.

<sup>17</sup> The US Federal Trade Commission (FTC) provides a useful example of mission creep. The FTC is usually held up as the model of a multi-function agency. Its “mandate combines antitrust, a wide range of consumer protection functions (most notably, oversight of commercial advertising and marketing practices) and an increasingly important role as the principal U.S. data protection and privacy agency” (Kovacic and Hyman, 2013, p.1). However, this mix of functions was not designed. It is the result of mission creep. For example, “the original ambit of the FTC was antitrust law, and there is no evidence that Congress intended for it to play a role in consumer protection”. Its role in consumer protection was initiated by the agency then endorsed by Congress. (Kovacic and Hyman, 2013, p.7).

<sup>18</sup> Interestingly, the Australian Competition and Consumer Commission has only been directed to undertake two inquiries under Part VIIA of the (then) *Trade Practices Act* 1974. These inquiries, into petrol prices in 2007 and grocery prices in 2008, were largely driven by pressures on the relevant governments to ‘do something’ about these high profile issues.

A more structural solution is to subject all regulatory bodies to periodic review of their scope and operations. Such regular review will assist in refocussing agencies and paring back any mission creep.

## Economic change

While periodic fundamental reviews, say every decade, of regulators will be necessary, the underlying economic conditions that participants in a market face can change more rapidly. For example, in recently liberalised industries, a regulator's initial task might be establishing conditions for entry, and hence tilting the table against an incumbent.<sup>19</sup> But once the entry has occurred, the economic problem is more akin to balanced competition regulation.

There are many other examples. In telecommunications, the advent of wireless competition to wired services changes the underlying industry economics and seems likely to require a re-think of the principles of regulation. The rapid proliferation of sources of information has made many of the assumptions underlying media regulation redundant. Following the 2008 US and Europe banking crisis, the prudential regulation of banks has become more closely aligned with macroeconomic policy areas that are the domain of the Reserve Bank of Australia.

Thus regulators need to be sufficiently agile and flexible to deal with changing economic circumstances, while being tethered against mission creep and subject to appropriate checks and balances.

### *Tools for dealing with changing economic or technological conditions*

To ensure the correct balance of flexibility and accountability of regulators, the design of regulatory institutions needs to focus on the cohesion of each regulator. If regulators have clear responsibilities then this improves the internal focus and operations of the regulator. It also allows the regulator to have a credible image for both business and the broader community. As discussed above, it addresses a range of issues such as capture and mission creep.

However, the approach to regulatory design should be responsive to economic change. An adaptive and flexible regulatory framework will make regulatory responsibilities clear as new regulatory issues arise or existing issues change. Clear boundaries for regulators assist this task. In the absence of clear boundaries, regulators will tend to battle over regulatory mandates when circumstances change. In the extreme, this can lead to 'turf wars' among regulators as they attempt to extend their mandate.<sup>20</sup> Clear boundaries also make it easier for government to determine the relevant agency to deal with a particular issue of economic or political change. It allows the regulator to have the internal expertise to both foreshadow change and adjust to that change.

It might be argued that having focussed regulators with clear boundaries means that some areas of change 'fall between' different regulators. This is true. But in our opinion, this

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<sup>19</sup> For example, King and Maddock (1996) consider how infrastructure access may be used as a short-term tool to assist the development of competition in recently deregulated industries.

<sup>20</sup> As Kovacic and Hyman (2013, p.24) note, "[a]n adaptive regulatory framework would have clearly allocated regulatory authority over a particular area to a specific regulatory agency – instead of forcing personnel at multiple agencies to spend considerable time and effort disputing the allocation of responsibility".

represents the appropriate way to deal with economic and technological change. If change raises issues that have no ‘natural’ regulatory home, then the government, relevant ministers and departments need to consider both what regulations (if any) and what regulatory bodies (if any) are needed to deal with this change. Put simply, it imposes discipline on the regulatory process. In contrast, having broad overlapping regulators risks both regulatory inconsistency and the application of existing, but inappropriate, rules to changing areas of the economy.

## General principles to apply to Australian regulators

We see five basic principles that should apply to regulators and their operations in order to address concerns about their design and operation:

- Ongoing relevance
- Clear and appropriate objectives and functions
- Independence and clarity in decision making
- Accountability and transparency
- Efficient and expeditious processes

### Principle 1: Ongoing relevance

- *Make it hard to establish new independent regulatory agencies*
- *Seek solutions at the appropriate level of government*
- *Review the scope and operations of all regulators every ten years*

The central justification for allowing governments to set up independent regulators is where there is an important issue of sovereign risk that needs to be managed at arms’ length from government in order to allow investors to have confidence that the value of their investment will not be undermined opportunistically.

Following the Commission of Audit’s recommendations, and given the significant operating and governance costs of government bodies, we support the view that the creation of any new body should require Cabinet agreement. And in seeking this agreement a proposing minister should submit:

- The case for a new body;
- Compelling advice on why the function cannot be undertaken within the department or another existing body;
- Advice on how the cost of corporate functions will be minimised, including whether they will be provided by the department or a shared service provider;
- Advice on how the new body will interface with, but not duplicate, the activities of existing bodies; and
- A proposed termination date.

While the Commission’s reasons for this approach emphasised the cost of establishing regulatory bodies, it is also important to recognise that regulatory agencies build up their own momentum, and their own group of self-interested supporters. This makes them difficult to

abolish. Establishing a clear ‘sunset date’ for the current manifestation of any regulatory institution seems appropriate.<sup>21</sup>

The way in which our federation allocates roles and responsibilities among the states and between the states and the commonwealth creates a number of problems, some of which have been exacerbated by economic and technological developments. However the very process of trying to get agreement between all the parties is itself very expensive and should only be undertaken where the potential benefits are justified. We believe that national solutions, with associated broad national agencies, should only be pursued where necessary.

The general (subsidiarity) principle should apply so that entities should be operated as close as possible to the operations they are involved. This means that many activities, such as urban transport, planning, local water catchments and so on, should continue to be regulated at the state or local level as appropriate.

Of course, the states may seek to align regulation with peer governments either through mutual recognition, by simply recognising regulations made by other governments, or even by amalgamating regulators. However, there is no need for national approaches to many of these issues.

As our society continues to evolve, the institutional environment will also need to evolve. In particular, where the key justification for independent regulation is that the regulated firms need to be protected from sovereign risk, the proposition that the risk is still significant and that the protection involved is still appropriate needs to be tested periodically.

As discussed above, independent regulatory decision-making poses risks. The greater the discretion that is given to the regulator the greater the risk it can pursue its own objectives. The regulator can be captured by various interest groups, or pursue its own agenda even if this varies from the underlying intention of the legislation which established the regulator. The effectiveness of a regulator, and the cost to the regulated sector of a poorly performing regulator, can be difficult to measure in the short term.

The potential for capture, mission creep and other agency issues, makes it critical that all regulatory agencies are reviewed against their intended mission at least once a decade.

**Adoption of this Principle will help address the issues and concerns about having a regulator act as an agent for the government and will help to maintain regulatory relevance in the face of economic and social change.**

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<sup>21</sup> At a minimum, this forces a review of the agency’s functions as the termination date approaches and places the onus on those who want the agency to continue to argue their position.

## Principle 2: Clear and appropriate objectives and functions

- *Similar regulatory functions should be bundled into separate agencies*
- *Co-locate regulatory functions based on analytical proximity not industry*
- *Regulators should be explicitly excluded from policy development*

The Commission of Audit sets out two principles that address the scope of agencies:

- i. Organisations and bodies should capture economies of scale where possible, and
- ii. Bodies should have clear accountability and focus, with defined roles and performance management measures.

While these principles seem sensible individually, they are potentially in conflict. An omnibus regulator may be more likely to capture economies of scale in recruiting, accounting, and technology as well as in underlying analytical ability.<sup>22</sup> However, in the process, the omnibus regulator would lose institutional clarity of focus.<sup>23</sup>

There are two sorts of solutions. One would be for a group of agencies to share services in order to benefit from economies of scale and scope. At the administrative level much has already been done in Australia to achieve these efficiencies.<sup>24</sup>

However to achieve economies in the analytical part of the regulators' work, the shared service model is only likely to succeed if the functions are actually located within a single agency.

This suggests that we should be looking to co-locate regulatory functions so that either the underlying analytical approaches or the underlying industry knowledge is shared. In practice, do we put consumer-focussed regulators together, separate from network regulators, or do we co-locate all electricity regulators together, or all financial regulators?

In our opinion, there are good reasons to place priority on the colocation of regulatory functions by similarity of analytical approach rather than by industry. Colocation by industry increases the likelihood of capture. It creates regulatory inflexibility as 'industry specialists' rather than 'analytical generalists' dominate regulators. It risks the creation of a regulatory culture that views the particular industry that is the focus of regulation as 'special' and 'separate' from broader economic and social considerations. It promotes mission creep and a culture of 'market design'. After all, who is better to determine the future of an industry than the industry specialist regulator? It can lead to institutional defensiveness in the face of change that reduces the scope for regulation.

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<sup>22</sup> That said, the potential for economies of scale can be easily overstated. For example, "[w]hen discrete functions are combined in a single agency or department, the result is usually the creation of separate operating units for each function. ... Over time, this process results in units being staffed by personnel whose interests, training and, abilities focus narrowly on the work of their unit and have little understanding of the backgrounds and activities of other units underneath the same institutional roof" (Kovacic and Hyman, 2013, p.25).

<sup>23</sup> Kovacic and Hyman (2013) emphasize the importance of institutional focus and coherence. They note that organizational culture, policy coherence, credibility, branding and cohesion can all be adversely affected by grouping disparate functions into a single regulator.

<sup>24</sup> The introduction of shared services models in the Australian public sector has had mixed success. For example, see Economic Regulation Authority of Western Australia (2011). However, this is beyond the scope of this paper.

In contrast, regulators that are formed by grouping similar analytical approaches are less likely to be captured as they deal with a wider range of interest groups. They are likely to be more flexible in response to industry level change and are likely to have a more adaptable culture. Of course, there will be a trade-off as depth of knowledge in a particular industry is likely to be lower, but such knowledge can be ‘brought in’ to an agency as needed.<sup>25</sup>

In order to maintain focus on their regulatory tasks and to underpin both the independence and the standing of a regulator, it is important to separate regulators from policy development.

One fundamental issue with such a separation is that the agencies are inevitably in command of better information than the department, simply as a result of their day-to-day involvement with the entities being regulated. A formal separation of regulation and policy may be undermined by departments seeking informal policy advice from regulatory agencies and then lacking the internal expertise to evaluate that advice. While full separation may be impractical, if policy input is sought from an agency, it must be transparent and subject to public scrutiny.

Departments should actively seek alternative sources of advice and balance this against information provided by the regulatory agencies. The traditional structure of policy development using a green paper/white paper framework with public hearings can help to both separate regulatory agencies from policy development and allow departments to transparently gain a broad range of input.

**Adoption of this Principle should help address concerns about mission creep, capture, regulatory culture and, importantly, information asymmetry in policy formation.**

### **Principle 3: Independence and clarity in decision making**

- *Develop a clear protocol to protect Commissioners from Ministers*
- *Choose qualified and experienced Commissioners and give them space*
- *Limit tenure*

Ministers will want to influence decisions. As such, tension between ministers and independent commissioners is inevitable. There needs to be a clear strategy for managing such risk and the most obvious way is to establish a regulator through legislation as an independent body and to develop a suitable protocol between the relevant departments and the regulatory entity to manage this interaction. The regulator should be answerable to parliament, rather than the government of the day, for its performance.

Of course once regulators are given independence, parties other than the relevant ministers and departments can capture them. We have discussed principles to deal with capture above.

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<sup>25</sup> It is less efficient for a regulator to bring in analytical expertise from external providers because agencies need to retain enough internal expertise to evaluate contracted analytical work and to use such work as an input to regulatory decision making.

A key element to both regulatory independence and prevention of capture is to appoint commissioners for a limited period, to usually choose them from ‘outside’ the specific regulator, and to rotate them fairly often. Generally, this has been the standard practice in Australia and should be continued.

Turnover of commissioners raises the ‘poacher turned gamekeeper’ problem. Commissioners can be ‘rewarded’ for favourable regulatory decisions by lucrative private-sector positions when their term with a regulator finishes. This has not been a major problem in the past in Australia. Ensuring that regulators, where possible, cover a range of industries limits this problem.<sup>26</sup> There are also grounds for establishing formal cooling-off period of say two years after departure from a position as commissioner at a regulatory agency before subsequent employment at a business which was being regulated.

A complementary strategy involves rotating senior regulatory staff. If staff stay at an agency for long periods, while commissioners come and go, informal power over regulatory decisions is likely to shift towards the staff. The senior staff will have the ‘inside knowledge’ and can argue that ‘this is how it has been done in the past’. This puts the institution at serious risk of protecting its own prior decisions, and entrenching positions that are not necessarily the most appropriate. Staggered rotation of senior regulatory staff can improve regulatory flexibility while maintaining institutional memory.<sup>27</sup>

A process of rotation for senior staff will also lessen the risk of capture while providing the necessary degree of independence.

**Adoption of this principle addresses concerns about independence while reinforcing protections against capture.**

#### **Principle 4: Accountable and transparent**

- *Fund regulators from the budget, not from industry levies*
- *All regulation should be subject to appropriate appeals mechanisms*
- *Require transparent processes*
- *Establish a regulatory Code of Conduct*

It is important to ensure that independent regulators operate efficiently. This is a standard issue in any principal-agent problem where the agent has more information about the operation of the ‘business’ than its principal. Budget review provides an important check on operational efficiency.

Some regulators have proposed that their regulatory activities should be funded by a levy on the parties being regulated, by licence fees or similar industry charges. This should be resisted. It reduces the degree of budgetary scrutiny on the agency and undermines a key lever for regulatory accountability. Rather than having to fight for an allocation in the budget

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<sup>26</sup> Of course, if commissioners are appointed to represent a specific constituency, then they are captured before they start. This practice should never be followed.

<sup>27</sup> Senior staff rotation can also involve temporary posting with other regulators either in Australia or overseas. The aim is to broaden the perspective of staff members beyond their particular regulatory culture.

process, justifying spending to an expenditure review committee, a regulator funded by an industry levy is taxing the parties that it is regulating.

Requiring the regulated businesses to fund the regulator might seem appealing in that the parties ‘using’ the regulation are paying for it. But the structure means that regulated parties have very little incentive to complain about excessive charging or laxness by the regulator. They may indeed feel intimidated. It sets up a ‘customer-provider’ relationship between the regulator and the parties it is regulating, while at the same time reducing the accountability of the regulator to its actual principal – the parliament. Put simply, it creates the wrong incentives.

The need for appeals and the extent of any appeals depend on the structure of the Commission. All regulatory operations must be subject to the potential for judicial review on the basis of due administrative process. However, individual regulatory decisions may also be subject to merits review, where a tribunal or court can analyse the decision and, if it believes that the regulator has made an error, replace the decision in whole or in part. The need for merits review will depend on the structure of the regulatory authority. If commissioners are involved in running the agency on a day-to-day basis, then it is desirable to have a merits review. The commissioners are intimately connected in the evolution of the relevant determination and do not have a clear role of independent oversight. In contrast, if the Commission sits apart from the operation of the agency, then it may be possible to limit the appeal process to that of a judicial review. In such a situation, the commissioners take the role of reviewing the work of the regulatory staff at arms length.

Having regulators face the prospect of appeal is important in ensuring they pursue fair and transparent processes. In this sense, at least a limited merits review is often desirable. To avoid the court or tribunal starting from scratch and simply re-making the relevant decision, the appeal may be limited to the ‘papers’ before the regulator. The appeal body may also be required to give deference to the regulator’s conclusions on fact and/or interpretation of specific elements of the law (for example, what the term ‘appropriate cost’ means in a particular context). Multiple levels of appeal should be avoided and the appeals body should not be so limited that appellants are able to ‘cherry pick’ elements of a regulatory decision with the appeals body forced to draw conclusions out of context.<sup>28</sup>

While appeals promote transparency and accountability for regulatory decisions, the day-to-day operations of an independent regulator, and its interactions with relevant stakeholders, should be efficient and appropriate. A Code of Conduct should be developed that covers all economic regulators. This Code would cover issues such as the timeliness of regulatory decisions, the consistency of decision-making, the expectations for procedural fairness and the transparency of the process by which the regulator reaches its decisions.

The Code would reinforce the independence of the regulator in its day-to-day operations, making it clear that government, ministerial or department pressure on individual decision is inappropriate. It would also establish standards for media engagement by the regulator. Regulators may be tempted to ‘short cut’ due process by use of the media. However, this can inappropriately damage stakeholder’s reputations and should be avoided.

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<sup>28</sup> The Council of Australian Governments (COAG) Energy Council has recently considered a range of issues relating to energy regulation, including limited merits review.

**Adoption of this Principle helps to address the appropriate balance between regulatory independence and accountability.**

### **Principle 5: Efficient and expeditious**

- *Commissioners should operate a deliberative review function*
- *Commissioners should be isolated from day-to-day operations*
- *Commissioners should generally be part-time, not full-time*

Australia has experience of regulators operating under a range of different operational structures. These include regulatory agencies where commissioners act as hands-on executive managers, to models where commissioners act more like a board of directors, providing arms-length oversight and review of proposals developed by the executive.

If commissioners are intimately involved with the development of specific regulatory decisions then those same commissioners cannot provide objective oversight for these decisions. Agencies where commissioners are intimately involved in day-to-day administration and the progression of particular projects in effect have commissioners simply as senior staff members. While they may have final say on an agency's decision, it is unlikely that they will be able to separate out their roles in formulating the decision from their evaluation of the merits of the decision. In our opinion, such a structure undermines the role of commissioners. At a minimum, the decisions of such agencies need to be subject to fulsome merits review.

In contrast, commissioners may act as a deliberative body, reviewing proposed decisions but at arms-length to day-to-day operations that are managed through a CEO and senior staff. In such a situation, commissioners have an oversight role and merits review of decisions is automatic, through the Commission. The commissioners can quickly refer inconsistencies, lapses of process and errors back to the agency staff. However, the commissioners themselves are able to sit outside the specifics of any decision and to apply rigorous oversight.

In our opinion, an agency where commissioners take an oversight role is likely to be more effective than alternative agency models. It reduces the potential for both capture and agency slack as the Commission can review decisions for both capture and poor quality work. It is likely to improve regulatory decision making, as commissioners will expect alternative views to be presented.<sup>29</sup> Such a regulator is unlikely to require a process of merits review. Effectively, the role of the commissioners is to carry out such a review within the agency.

Having most (or all) commissioner roles as part-time positions enhances the deliberative role of commissioners. Part-time commissioners will necessarily bring an outside perspective to

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<sup>29</sup> It might be argued that commissioners are more likely to be poorly informed in such a model and will have to rely on the opinions of regulatory staff. This is unlikely if the commissioners themselves are appropriate experts in their areas. Arms-length commissioners, who have not been intimately involved in the design of submissions, are more likely to question submissions on the basis of their expertise and to bring 'fresh eyes' to the agency's proposed decisions.

their roles and are less likely to be drawn into the development of specific regulatory decisions.<sup>30</sup>

It might be tempting to consider a hybrid model, for example, where some commissioners are full time and some part time, or where commissioners (whether full or part time) specialise and become involved in specific regulatory functions. Unfortunately, such models conflict with the oversight role of commissioners.

For example, if a chief commissioner is also CEO, it becomes difficult for the other commissioners to oppose a view which has been developed by the staff under the direction of the chief commissioner. The same would apply if different commissioners took responsibility for policy in particular areas; a temptation that part-time commissioners would find easier to resist. Full time commissioners are likely to be drawn into day-to-day agency matters. For the commissioners to act as a board and sit in review, the members must refrain from trying to run the agency or its business.

**Adoption of this Principle will improve regulatory decision-making by allowing Commissioners to provide internal merits review and act as ‘intermediate’ principals. It will also limit the risk of slack, capture and mission creep.**

## Motivations for regulatory design

Different regulators oversee different types of regulations. We can distinguish between two different types of government actions, those designed:

- To enable the more efficient coordination of social activities by establishing standards and conventions such as driving on the left side of the road. In some sense these regulations are *neutral* between participants. In a regulatory context these might include rules such as the separation of water rights from land rights, thereby enabling separate markets to exist.
- To alter social and economic behaviour in ways which alter the outcomes which might otherwise emerge from market interactions, favouring some participants over others. We call these *motivated* actions. They might include regulations which require some groups of consumers to subsidize others, as in much telephony regulation.

The motivations behind these different sorts of policies are likely to be different:

- The aim of *neutral* rules is to establish a set of standards or procedures that assist the voluntary interactions between individuals. Most competition rules fall into this category. They represent a set of limitations on all market participants that are designed to assist the interactions between these participants. These type of coordination rules are also important as part of microeconomic reform, when new markets were being created from pre-existing government monopolies.
- The aim of *motivated* rules is to intervene in the interactions between individuals in a way that rebalances those interactions towards a particular individual or class of individuals. These rules require a political or economic judgement that society would be better served if some process or outcome were altered in favour of a particular party.

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<sup>30</sup> Of course, it is necessary to ensure that a commissioner’s outside roles do not conflict with his or her regulatory duties or promote capture.

When considering economic regulation, neutral rules fall into two distinct categories: regulation that aims at market creation and regulation that protects market operations. Similarly, there are two separate forms of motivated regulation: consumer protection regulation and market failure regulation. We consider each of these types of regulations below.

### Neutral regulation and market creation

As part of the microeconomic reforms in Australia, a significant number of regulators were established. Some of these regulators were charged with the joint tasks of establishing the rules that would allow a market to operate, and also for regulation of the market which emerged. For example, the Australian Energy Market Commission (AEMC) describes itself as the “rule maker for Australian electricity and gas markets”.<sup>31</sup> Among other things, the Murray-Darling Basin Authority manages “a water rights information service to facilitate water trading across the Basin”.<sup>32</sup> In general these government bodies, which also includes (among others) the National Competition Council (NCC), the Australian Energy Market Operator (AEMO), and Infrastructure Australia, were established in markets involving significant infrastructure to make rules, provide advice or administer various schemes on behalf of the government on either a transitory or permanent basis.<sup>33</sup>

In a federation such as Australia, it is sensible to have a forum where cross-jurisdictional issues can be discussed and managed without resort to the courts. This is a relatively specialised area where the core skills include matters of constitutional arrangements.<sup>34</sup>

### Neutral regulation and protecting market operations

In addition to establishing the rules for competitive markets to work, some regulatory bodies have been established to support the ongoing operation of markets and to prevent behaviours emerging that impede market operations.

Competition regulation falls into this category as it is focussed on behaviour which interferes with the efficient operation of markets. It prohibits behaviour that damages competition and prevents competition working effectively to produce efficient outcomes. Some of the provisions are directed at circumstances where competition is restricted and there is some degree of market power or where market power might be established, for example, through the formation of a cartel. Most competition regulation involves enforcement of rules that have been breached, to the detriment of market operations. The exception is merger laws, which apply *ex ante* to situations where mergers or acquisitions might threaten efficient market operations in the future.

An argument could be made that in the long run the market could deal with these issues. For example, cartels may break down in the long term due to ‘chiselling’ by members or new entry. However, such adjustment would be slow, transitional costs could be large, and the ramifications for related markets could be significant, for example, when investment patterns in other industries are distorted.

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<sup>31</sup> See [www.aemc.gov.au](http://www.aemc.gov.au)

<sup>32</sup> See <http://www.mdba.gov.au/about-mdba>

<sup>33</sup> The role of the ASX as a private body that is also a rule maker for the Australian Stock Exchange is somewhat unique.

<sup>34</sup> This function generally falls to the Council of Australian Governments (COAG) as the “peak intergovernmental forum in Australia”. See [www.coag.gov.au](http://www.coag.gov.au)

Financial market regulation shares some of these attributes of protecting market operations. The implementation of the recommendations of the 1997 Financial System Inquiry (the Wallis review) identified four types of potential failures in financial markets and with each regulated separately: anti-competitive conduct (ACCC), investor protection (ASIC), information asymmetry (APRA), and systemic instability (RBA). The ACCC and RBA roles are clearly directed at protecting market operations through neutral regulation.

### **Motivated regulation – consumer protection**

Market transactions can involve information asymmetries and taking actions to reduce these asymmetries can be costly. In such situations, transactions involve a degree of trust.

For example, you could ask to inspect the kitchens of the shop where you buy a sandwich for lunch. However, such direct monitoring is costly. As a result, most customers trust that the seller has appropriate hygiene standards and that the sandwich is not poisonous.

Even in the absence of direct regulation, such trust is not without foundation. There is a range of remedies directed to transactions that involve a breach of trust. These may be market based, such as a loss of reputation and a reduction in repeat sales for a party that misleads other market participants. In the absence of other regulations, private bodies may be formed to monitor transactions and communicate the past behaviour of a party to future market participants. Motoring organizations have long had this role in the automotive sector. More recently, software applications, such as TripAdvisor, enable consumers to directly interact by rating sellers.

Remedies may also be based in the common law. For example, a party harmed through a misrepresentation may sue the other party for breach of contract.

However, both the market-based and common-law-based remedies can operate slowly and may involve significant expense. In such a situation, there can be a role for regulation to ‘tilt’ the market towards those parties that lack relevant information. Regulation can seek to address the imbalance of information or power that might exist in the market place, and may impinge on the market activities of vulnerable groups, such as some consumers.

Where the users (and especially consumers) of the relevant goods or services are dispersed and litigation is expensive, regulation to protect consumers might be an efficient way of ensuring that markets can operate on the general assumption that products are being appropriately represented and are safe to buy and operate. Such *ex ante* regulation, for example, setting safety standards or preventing misleading advertising, can reduce the time needed to correct undesirable market behaviour and can help prevent unscrupulous operators from rebranding themselves with different identities to escape sanctions. Such laws also provide some protection to ethical operators who might otherwise be driven out of business by less scrupulous traders.

In this sense, a consumer protection agency is a motivated regulator. It explicitly represents the interests of consumers. It operates within a legal and enforcement framework that aims to pursue wrong doers and seek redress for consumers as expeditiously as possible. The culture, skills and operational requirements of such a body are very different to those of neutral regulators.

## Motivated regulation – market failure

Some markets operate under conditions that tend naturally towards monopoly outcomes, creating market power that favours some providers over other participants in the relevant markets. The concern is often loosely characterised as a natural monopoly problem. It is particularly prevalent in the utilities sector, but it is not restricted to that sector. The core problem is that in some industries the average costs of providing a key (or essential) service continue to fall as the quantity being produced increases so that there is naturally only one provider – it is always cheaper for the incumbent to provide additional volume to the market than it is for a new entrant to start up. These industries are typically those which involve very expensive upfront investment and quite low incremental costs.

The economic problem is that ‘natural monopoly’ firms would rationally extract unreasonable advantage by charging ‘excessive’ prices and providing less of the service than is in the public interest. The motivation for regulation in this case is to alter the market outcome towards one which is less favourable to the natural monopoly provider and more favourable to the other market participants.<sup>35</sup>

Intervention to deal with natural monopolies is a specialised area of regulation. It often involves setting minimum standards and maximum price levels for a natural monopoly business. In order to decide what is the appropriate price the natural monopoly should be allowed to charge, the regulator has to understand the cost of production of the service at different levels of output and the structure of demand for the product.

Private firms subject to natural monopoly regulation face high levels of regulatory risk. By deciding what the price should be, the regulator is effectively deciding how much profit the relevant firm should make. For a firm which has incurred the large up-front investment, there is always a risk that the regulator will set a price after the fact which undermines the original business case for the investment. It is easy to see the temptation for governments to set prices too low, satisfying the consumer demand for lower utility prices, at the cost of future investment. Effectively the government’s time horizon is shorter than that of regulated firm.

Independence of the regulator in this case is particularly important. It needs to tilt the table in favour of consumers but not to the extent that it removes incentives for ongoing maintenance and future investment.

The natural monopoly problem often arises in markets other than markets for final goods or services. Natural monopoly-type products can occur at other stages of production causing problems upstream or downstream. Regulation is not always appropriate. When a small number of parties are involved it may be possible to set up contractual arrangements which overcome the incentive problems.<sup>36</sup> However such private solutions face significant practical difficulties where there are many parties, where relevant future market participants cannot be

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<sup>35</sup> To see that such regulation is not simply driven by economic efficiency, note that utilities regulators often prevent price discrimination. However, price discrimination would often enhance economic efficiency, albeit with any gains accruing to the natural monopoly. Rather, regulators usually set revenues or prices to limit the seller’s profits. Such an approach focuses on distribution, not economic efficiency.

<sup>36</sup> For example, where a number of miners form a joint venture to establish shared rail and port facilities. These facilities might be a natural monopoly, but the miners have contractually dealt with this problem *ex ante*. At the same time, this solution does not deal with potential future entry and the joint venture partners may be able to prevent such entry by refusing access to the rail and port infrastructure.

identified ‘up front’ and where there is the potential for significant change. In such a situation there is a role for a regulatory contract to replace a market contract. We can think of the regulator’s role as akin to administering a long-term contract – it attempts to find the balance between giving certainty and having enough discretion to deal with changing circumstance.

The discussion above indicates that a key role of a utilities regulator is to be an arbitrator between competing interests. It needs to operate within a clear consistent framework. It needs to provide a high level of certainty for long-lived assets and it needs technical and industry expertise as well as economic and financial literacy for effective decision making. The regulator needs to be able to provide a high level of consistency and certainty although some discretion is required so that the industry can adjust to new information and circumstances. Given this discretion the regulator needs to be accountable through the courts.

## **Sovereign risk and economic regulation**

We have outlined four different categories of economic regulation, separated by two different motivations:

- Neutral regulation aimed at market creation and on-going rule-making;
- Neutral regulation aimed at protecting on-going market operations (competition or antitrust enforcement);
- Motivated regulation aimed at reducing the consequences of information asymmetry and to protect vulnerable market participants (consumer protection); and
- Motivated regulation aimed at reducing any natural monopoly power in infrastructure markets (utilities regulation)

What type of bodies should deal with this regulation? In particular, do these regulatory tasks require independent arms-length regulation or can they be dealt with by government departments?

As discussed above, a key criterion for the establishment of an independent regulator is sovereign risk. Ministers will have a natural inclination to delegate difficult decisions to independent bodies. But unless there is significant efficiency issue, such as sovereign risk, such delegation is not consistent with the objective of ministerial responsibility. Arms-length regulators are not a means for ministers and departments to avoid making decisions. Rather, they are a protection when ministers and departments face political pressures that may lead to poor decision-making. An independent regulator is needed when, like Ulysses, the minister needs to be ‘tied to the mast’ to avoid the call of the Sirens.

As noted above, there are significant issues of sovereign risk with utilities regulation. Utility pricing is a significant political issue and private investors face considerable risk. Arms-length utilities regulators are desirable to mitigate this risk.

The case for arms-length regulators is less obvious for the other three areas of economic regulation.

Because consumer protection is ‘motivated’ the argument for independent regulation is strongest in this area. If handled at a department level, businesses that deal with consumers or other potentially vulnerable market participants might face an ever-increasing burden. The department and relevant minister will face significant pressure to pro-actively address

potential problems and it is likely that the benefits from much of the regulation and regulatory enforcement could be outweighed by the cost to suppliers.<sup>37</sup>

Competition regulation around the world tends to be handled by independent regulators, with the Department of Justice in the United States and the Director General of Competition (DG Competition) in the European Union as the two notable exceptions. Given that two of the largest competition regulators in the world are not arms-length to government and that this includes the Antitrust division of the Department of Justice, which has been in operation for over a century, a case needs to be made by those supporting an arms-length competition regulator.

In our opinion, the potential for sovereign risk and the limitations this might place on business investment suggests that having an independent competition regulator is desirable. A competition regulator faces considerable discretion over the investigations it pursues. If a competition regulator is not independent then it will face considerable pressure to focus on ‘politically sensitive’ areas, even if these are not the most important for the overall functioning of the market economy.

Recent Australian experience highlights these risks. The grocery and petrol retailing sectors have been a focus of political pressure in the past decade. The independent ACCC, as competition regulator, has faced considerable political pressure in these areas. This includes being directed to hold inquiries into each of these sectors around the time of the 2008 federal election, being required to have a Commissioner identified as a ‘petrol commissioner’, being required to monitor and annually report on, retail petrol prices, and being required to establish a ‘grocery choice’ website that allowed consumers to compare prices between the major supermarket chains (and was later disbanded in part due to the conflict of interest this created for the ACCC).

Similarly, the banking sector has come under significant political scrutiny in the past decade. The Competition and Consumer Act was amended in 2011 to introduce new rules against price signalling and information disclosure. Regardless of the merits or otherwise of these amendments, they only apply to the banking industry.

These initiatives each reflect political pressure being brought to bear on the independent regulator. It is reasonable to conclude that, had the ACCC not been an independent regulator, political pressure is likely to have led to considerably greater intervention in the grocery and petrol retail markets and on the banking sector in the past decade. Having an arms-length regulator has not prevented opportunistic political activity. However, it has limited the damage such activity could have caused to the Australian economy.<sup>38</sup>

If, contrary to the views expressed in this paper, it was felt that competition regulation could be moved back to the relevant department, then, in our opinion, this would require a

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<sup>37</sup> In our opinion, the European Union provides an example of the potential for such risk. Consumer protection falls under the broad mandate of the European Commission and is guided by the European Consumer Agenda (EC, 2012). This document appears to place little if any emphasis on the potential costs of rules and regulations that aim to ‘protect’ consumers. Indeed, it appears to take any issue of market imperfection as a reason for intervention.

<sup>38</sup> It should be noted that we are not saying that these three sectors do not have issues that should be dealt with by the competition regulator. Rather, we note that political pressure led to attempted interventions that would isolate these sectors beyond standard competition laws and impose idiosyncratic restrictions on business behavior in these sectors that would be inconsistent with the general competition rules.

significant shift of the regulatory burden to the Courts. A department-based competition regulator would need to face strong appeal mechanisms through the Courts to avoid the type of sovereign risk that has been observed in recent years in Australia and discussed above.

Finally, should neutral market creation and rule-making regulation be at arms-length to the relevant department? The argument for independent regulation in this area based on sovereign risk is unclear. For example, the AEMC has an on-going rule-making function in electricity and needs to weigh up a range of vested interests when carrying out its activities. Given the nature of electricity investments, such rule-making functions can lead to issues of sovereign risk. In contrast, the Australian Energy Market Operator (AEMO) “plan, develop and operate markets” in electricity and gas in eastern Australia.<sup>39</sup> Its duties are generally functional and it is far from clear that these functions need to be at arms-length to the relevant department.<sup>40</sup>

In our opinion, the key reason for arms-length regulation at a national level for market creation and rule making rests, not on sovereign risk, but on the federated structure of Australia. The efficiency problem is the coordination of a number of jurisdictions. If a market is to be created that covers a number of states then it can be difficult for the regulator to be embedded in a single federal or state department. Rather, an independent regulator that stands apart from any specific government is best able to tackle a range of the constitutional and practical issues. In that sense, judgements about independent regulators in market creation and rule making are more likely to relate to jurisdictional and constitutional issues than issues of sovereign risk.

## Examples of regulatory structures

There is a range of different approaches to economic regulation, both in Australia and around the world. In this section we highlight four areas that illustrate the problems of current regulatory approaches, both in Australia and overseas.

We first consider the existing regulatory structure for consumer protection regulation in Australia. Regulatory authority in this area is dispersed across a range of regulators. The structure lacks clarity, involves overlap and is likely to harm the operation of markets.

We then consider the specific example of the Australian Communications and Media Authority (ACMA) just as one example of our method of analysis. We discuss how the existing structure of the ACMA violates many of the principles of good regulatory design. The same types of problems that exist for the ACMA also bedevil other Australian regulators such as the ACCC.

Third, we consider the overseas example of the UK, again to illustrate our mode of analysis. The UK has been chosen because Australian regulatory structures historically have often ‘mimicked’ the UK structures. We highlight the significant problems with the current UK regulatory structure and believe it does not provide a useful model for Australia.

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<sup>39</sup> See [www.aemo.gov.au](http://www.aemo.gov.au)

<sup>40</sup> Indeed, the argument for AEMO to be independent may relate to its role in coordinating functions covering state and federal levels rather than issues of sovereign risk.

Finally we consider whether competition and consumer protection responsibilities should be maintained in a single regulatory agency. The US Fair Trade Commission (FTC), an independent agency established in 1914, provides insight into a regulator with joint competition and consumer responsibilities. It is sometimes argued that these functions are best kept in a single regulatory authority, despite this leading the agency to deal with both neutral and motivated regulation.<sup>41</sup> In our opinion, the FTC highlights the problems with such a model. We note that the ACCC currently covers both competition and consumer regulation (as well as utilities regulation) and we consider that the ACCC's current structure is flawed.

### **The framework for consumer protection regulation in Australia**

The existing framework for consumer protection in Australia involves a hodgepodge of different regulators. Many regulatory functions overlap and it can be difficult to determine exactly which regulators are responsible for specific functions. Consumer protection laws are contained in a variety of different legislation including the Australian Consumer Law and industry and product specific legislation spanning everything from transport, to financial products, to pesticides. There is significant duplication between federal and state levels.

For example, standards setting and product regulation is handled by a variety of national regulatory bodies for specific industries, some of which coordinate different state bodies. They include the Australian Maritime Safety Authority, which deals with marine safety products and safe transport via sea, the Food Standards Australia & New Zealand that deals with food safety standards, the Therapeutic Goods Administration that deals with drugs and medical devices and the National Transport Commission, which co-ordinates safe transport of goods via road and rail.

Goods and services that fall outside specific product categories fall under the ambit of the ACCC and state and territory consumer protection agencies,<sup>42</sup> which monitor and oversee their safety. While these agencies do not check and regulate all consumer products, there are voluntary and compulsory rules that work to minimise risks, such as voluntary standards, bans and mandatory standards, and recalls.

The Australian Securities and Investment Commission (ASIC) licences most providers of financial services and products including financial advisers, superannuation trustees, general and life insurance companies, banks and other intermediaries such as insurance and stockbrokers. ASIC grants licences to financial services providers where they prove that they have the competency to comply with a range of obligations under the Corporations Act, put in place compliance arrangements, and join an ASIC approved dispute resolution scheme.

The Australian Communications and Media Authority (ACMA) and the Classification Board have responsibility for setting standards in broadcasting and telecommunications.

Similarly, monitoring, enforcement, advice and dispute resolution responsibilities fall to a variety of regulators.

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<sup>41</sup> For example see Bennett and Fingleton (2009) and Cseres (2013).

<sup>42</sup> ACT – Office of Regulatory Service, NSW – NSW Fair Trading, NT – Office of Consumer Affairs, QLD – Office of Fair Trading, SA – Consumer and Business Services, TAS – Consumer Affairs and Trading, VIC – Consumer Affairs Victoria, WA – Department of Commerce – Consumer Protection.

While the existing structure of consumer protection regulation in Australia reflects both historical structures and the transition to a national approach, it is a long way from best practice. In our opinion, reform is needed, at least at the national level, between the ACCC, ASIC and ACMA so that there is a single regulatory body dealing with general consumer protection issues at the federal level.

### **The Australian Communications and Media Authority**

The Australian Communications and Media Authority (ACMA) is an independent regulator that deals with a range of issues in communications and the media. In our opinion, however, the structure of ACMA is far from optimal and violates many of the principles of good regulatory design discussed above.

The ACMA covers a range of different regulatory tasks, with responsibilities extending into market creation, enforcement, equity, consumer protection, and policy advice.

- Market creation: ACMA has responsibility for planning, rule making and licensing of spectrum, where a market in tradable parcels of radiofrequency spectrum has been created.
- Market Operation: ACMA has responsibility for the licensing of radio communications equipment, primarily to manage interference between users. This activity is essential to ensure we can make functional use of the radiofrequency spectrum.
- Consumer protection: ACMA has rule-making responsibilities that span areas as diverse as billing and debt handling (via the telecommunications consumer protection code), the classification of broadcast content, and telecommunications wiring and cabling systems. The ACMA is also the consumer complaints body including broadcast radio and television content, spam, cabling compliance, and the “do not call” register.<sup>43</sup>
- Policy advice: The Government can seek advice from the ACMA on a range of issues. For example, the AMCA was extensively consulted on the development of an internet filtering scheme.

This range of issues span various objectives and functions. They include ‘neutral’ and ‘motivated’ regulatory functions. The skills necessary to regulate the radiofrequency spectrum are clearly different to those needed to develop consumer protection standards for cabling. The ACMA has a role in policy advice. The use of the ACMA for advice on policy formulation is clearly necessary given its expertise, but caution is necessary particularly when any new policy is likely to come under the ACMA’s expansive regulatory umbrella. Clearly ACMA does not satisfy Principle 2.

The ACMA is headed by a chair, deputy chair, and at least one, but no more than seven, other members who may be on a part-time or full-time basis. The chair acts as CEO, while the deputy chair and full-time members also sit on the executive team responsible for day-to-day operations. This is clearly at odds with Principle 5, as all full time members are involved in executive functions and the only ‘isolated’ review is via the part-time members, who will find it difficult to challenge proposals given their informational disadvantage.

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<sup>43</sup> Complaints relating to billing are handled by the telecommunication ombudsman.

The minister has strong powers of appointment and dismissal of members of the ACMA, beyond those for other independent economic regulators. These strong powers of appointment are complemented by strong powers of intervention. The minister may give written directions to the ACMA in relation to the performance of any its functions and the exercise of any of its powers. However, such a direction can only be of a general nature if it relates the ACMA's broadcasting, content and datacasting functions, unless there are powers under the Broadcasting Services Act (BSA) to the contrary. The minister's powers under the BSA allow him or her to intervene in:

- The allocation of commercial broadcasting licenses;
- The pricing system used by the ACMA for allocating commercial television and radio licenses;
- Local content rules for commercial radio; and
- The inclusion and conditions of offer for programs on the anti-siphoning list.

These ministerial powers clearly violate Principle 3. Indeed, they place doubt on the benefits of having the ACMA as an independent regulator rather than as part of the relevant department, under its current structure.

The roles of the ACMA and the ACCC overlap. The ACCC has a broad mandate over consumer protection, while the ACMA has a specific mandate in its areas. The ACCC also has specific powers in telecommunications. It has power to make certain communication services "declared services" for which the ACCC is required to set default prices and other terms and conditions of access. There are declared services for digital radio, broadcasting, mobile services and fixed line services. The ACCC also enforces specific competition rules for telecommunications under the *Competition and Consumer Act 2010*. This overlap of regulatory responsibilities violates Principle 2 for good regulatory design.

### **The institutional framework for regulated industries in the UK**

Australia is not alone in having poorly designed regulatory structures. The UK regulatory framework also fails a number of the principles outlined above.

The UK fails Principle 2 because it has both industry specific and general regulators. Further, the operations of these regulators overlap and are not clearly delineated.

The *Competition Act 1998* and the *Enterprise Act 2002* are the key pieces of legislation governing competition rules, enforcement, and delegation of powers in the United Kingdom. The Competition and Markets Authority (CMA) has responsibility for the economy-wide implementation, monitoring, and enforcement of these two Acts. However, in a process called 'concurrency' certain sectoral regulators (the "Regulators") have powers alongside the CMA to enforce some aspects of the *Competition Act 1998* in their respective industries.

Sectors where concurrency applies are the "regulated industries" consisting of communications and postal services, gas, electricity, healthcare services, railways, air traffic and airport operation services, and water and sewerage. Overlap occurs in competition laws dealing with collusion and abuse of market power.

To deal with this overlap, there are legislated requirements for cooperation between the CMA and the Regulators. Further the CMA acts as the peak body and has the power to decide

which body should lead on a case and the power to take over an investigation from a Regulator, even if the Regulator is already investigating that case.

The UK framework fails Principle 3. The Minister has considerable power to intervene in the activities of the CMA.

This can occur indirectly through legislative exclusion. A schedule of exclusions to Chapter I (anti-trust) and Chapter II (abuse of dominant position) is provided in the *Competition Act 1998*. Currently this only contains exclusions relating to the coal and steel industries, however, the Secretary of State has power to add to, remove, or amend the schedule of exclusions at any time.

Intervention may also be direct. The Secretary of State has powers to declare a merger to be in the “public interest”. In this case the Secretary of State will have the final say on a merger and if, after taking the advice of the CMA, he is of the opinion that a merger is adverse to the public interest, then he may take action he considers reasonable to remedy, mitigate or prevent any adverse effects resulting from the merger. This includes preventing the merger.

The UK framework also fails Principle 4. Regulators are required to raise their budgets from industry levies. The bodies regulating water, communications, and electricity each have the power to raise their own revenue through the licensee fees levied upon those they regulate. The regulators are responsible for ensuring that these fees are enough to cover their operating costs, however occasional grants-in-aid are provided by the Government to pay for activities for which no matching revenue stream exists, such as for ex-post competition investigations.

In summary, the UK regulatory framework, while recently reformed through the formation of the CMA, violates a number of best-practice principles for regulatory structures. In our opinion, it does not provide an appropriate model for Australia’s regulatory framework.

### **Should competition law enforcement and consumer protection activities be maintained in the same organisation?**

Competition laws and consumer protection laws are often viewed as ‘opposite sides of the same coin’. Both sets of laws have an ultimate aim of enhancing the efficient operation of markets. Indeed, in the United States, the FTC was originally founded as a competition regulator, but became involved in misleading advertising due to the potential anti-competitive effects that one business misleading customers can have on its competitive rivals. Congress later expanded the FTC’s authority to explicitly deal with unfair and deceptive business practices.<sup>44</sup>

Combined competition and consumer agencies are not unusual internationally. Kovacic and Hyman (2013, p.2) note, “more than thirty jurisdictions rely on a single agency to enforce antitrust laws and implement consumer protection statutes (especially measures that ban false advertising)”. That said, the number of combined agencies is well under the majority. As Kovacic and Hyman (2013, p.39) note, there are approximately 120 competition agencies globally.

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<sup>44</sup> Kovacic and Hyman (2013, p.7)

We consider that combining competition and consumer protection in a single regulatory agency is inconsistent with best practice design of regulatory institutions. Competition regulation is neutral. It aims to ensure the economically efficient functioning of markets. The regulator is an ‘umpire’ overseeing the day-to-day play in the markets.

In contrast, consumer protection regulation is motivated. Consumer protection regulation is aimed at rebalancing the market towards consumers, particularly where asymmetries of information can lead consumers astray. The regulator is, in many ways, a representative and an advocate for consumer interests.

Because of these different underlying roles, a regulator that attempts to combine these roles is likely to have internal divisions of culture. The regulator will not have a clear mandate and its role in each area risks being compromised by its involvement in the other area. Further, because the regulatory roles involve different skills and backgrounds, there is unlikely to be significant economies of scale or scope that can be achieved by joining competition and consumer protection functions within one agency.

Kovacic and Hyman (2013) note these issues when considering the FTC. The FTC has two internal Bureaus, one dealing with competition and one dealing with consumer protection. There are few if any economies between these Bureaus. “There is relatively little routine collaboration between the Bureau of Competition and the Bureau of Consumer Protection” (p.44). Indeed, the relationship between the two Bureaus is “more one of rivalry or indifference rather than cooperation” (p.56).

The combination of a ‘neutral’ role with a ‘motivated’ role can distort agency priorities and processes, thus, “[t]he desire to create broad awareness of an agency as a pro-consumer agency can affect, and distort, the agency’s allocation of resources” (p.45). Consumer protection matters can be used to raise the agency’s public profile to the detriment of competition enforcement. “Like the FTC, most dual-function agencies derive the highest levels of public recognition from interventions dealing with consumer goods and services. Competition matters generally do not diminish recognition of the agency’s consumer orientation, but they rarely reinforce it” (p.46).

Conflict between the two areas of regulation can arise at the senior staff level as neutral competition rules may be ‘bent’ in order to design market outcomes. “During the FTC’s deliberations over Google’s mergers, some Commission officials and staff advocated that the agency use the merger review process to exact concessions from the merging parties concerning their privacy policies and data protection practices” (p.55).<sup>45</sup>

Despite the long-lived status of the FTC, it does not provide a strong case for a combined competition and consumer regulator. Indeed, the strongest argument that appears to be raised for combining the tasks is that the ‘economic foundations’ of competition regulation can inform (and potentially restrain) the vigour of enforcement of consumer protection rules!<sup>46</sup> In our opinion, it is better to design an appropriate consumer regulator that is adequately resourced and has a legal framework that prevents it ‘tilting the market’ too far.

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<sup>45</sup> It should be noted that Kovacic is a former commissioner and chairman of the FTC.

<sup>46</sup> See for example Kovacic and Hyman, 2013 at p.58.

We note that the ACCC currently encompasses both competition and consumer regulation. This creates the potential for cultural misalignment within the ACCC or the creation of internal ‘silos’ of operation, as at the FTC. We consider that the current ACCC structure is fundamentally flawed.<sup>47</sup>

## **Rationalising the regulators: proposed structure**

In accordance with the principles set out above, we see the need for five independent regulatory agencies. For each regulator we have tried to align the analytical functions, core skills and cultural approach, in determining what fits best where. Grouping by analytical type both has the advantages mentioned above of making it less likely that regulators will be captured and also significant management advantages in terms of moving staff between functions. It is easier to move a staff member who has been doing electricity pricing to telephone pricing than it is moving someone from doing consumer protection to merger analysis.

### *Proposal 1: Neutral regulation and transitional market creation*

#### **Establish an Australian National Markets Commission**

There are a number of markets which potentially operate nationally but whose operations involve constitutional constraints. The fundamental analytical issues involved are interstate negotiations undertaken in the shadow of the constitution, and in many ways more involved with legal than economic expertise. The Australian National Markets Commission would have carriage of these issues.

This body would be a federal advisory body on rule making which affect industries that operate nationally but are potentially regulated by multiple governments. It would also give life to the Inter-State Commission as set out in the Constitution of Australia.

*s101. There shall be an Inter-State Commission, with such powers of adjudication and administration as the Parliament deems necessary for the execution and maintenance, within the Commonwealth, of the provisions of this Constitution relating to trade and commerce, and of all laws made thereunder*

The ANMC would replace the NCC and the AEMC.

### *Proposal 2: Neutral regulation protecting market operations*

#### **Establish an Australian Competition Commission**

This body would undertake the competition and market functions currently being undertaken by the ACCC and ASIC. It would not have consumer protection or utility regulation

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<sup>47</sup> This conclusion differs from that reached by the Productivity Commission (2008, Ch.4). In our opinion, a full restructuring of the regulators allows all consumer laws to be enforced by a single body rather than dispersed over different regulators. This approach means the synergies envisaged by the Productivity Commission can largely be achieved in a dedicated consumer regulator without the potential clash of methodology and culture associated with a ‘mixed’ regulator.

responsibilities. Its key role would be the investigation and enforcement of the competition law provisions in Part IV of the *Competition and Consumer Act*.

### **Retain the Reserve Bank of Australia**

The Reserve Bank is not a standard regulator. Rather, the government has decided to outsource monetary policy to an independent agent. This agent is the Reserve Bank. This is not a regulatory decision but an outsourcing of a core governmental responsibility.

There are two regulatory bodies that interact with the financial system, APRA and the Payments System Board. APRA has been allocated responsibility for ensuring a defined set of financial institutions is prudentially managed. It is an independent agency. The Payment System Board is part of the RBA and deals with a range of regulatory functions for the RBA.

Both the functions of APRA and the Payments System Board are essential to the operation of financial markets and to economic activity more broadly. They provide what are essentially regulatory functions. There are common skill requirements between APRA and the Board, and there are likely to be significant economies of scale in locating both regulators in one body. Further, the regulatory roles are complementary to the RBA's broader role of controlling risk in the financial system.<sup>48</sup>

Given the sunk costs invested in the Reserve Bank, it seems sensible to co-locate the other financial regulators within that structure. This would be a violation of the rule that regulators should not have an industry-specific remit designed to help prevent capture. The risk of capture means that the regulatory decisions taken within the RBA should be appealable (but not the policy decisions).

In recognition of the fact that these parts of the financial regulatory apparatus are regulatory, they should be operated under a separate set of Commissioners, and their decisions should be subject to the normal appeals processes which apply to other regulatory decisions.

### **Proposal 3: Motivated regulation consumer protection**

#### **Create an Australian Consumer Protection Commission**

As noted above, the existing structure of consumer protection regulators is poorly designed. A single Australian Consumer Protection Commission (ACPC) would pull together all nationally-regulated consumer protection activities within the one agency. This would both rationalise the current system and allow for a single body that could have a culture aimed at protecting vulnerable parties in the market economy.

A large part of the activity that would move to the ACPA is currently managed at a national level by the ACCC. The consumer protection functions of ASIC and the ACMA would also move to the ACPA. However, it would only deal with national issues. State-based consumer affairs would stay with the States.

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<sup>48</sup> These complementary relationships are reflected in the membership of the Payments System Board. The Governor of the RBA is Chairman of the Payments System Board and one other representative of the RBA is the Deputy Chairman of the Payments System Board. The Board also has a representative of APRA and up to five other members.

As discussed in Monash Business Policy Forum paper on national competition policy (2013), it may be desirable to extend the reach of Australia's consumer protection laws to cover vulnerable small businesses. If this is done, then the ACPA would encompass this expanded role.

#### *Proposal 4: Motivated regulation – market failure*

### **Establish an Australian Essential Services Commission**

The aim is to bring all utility regulators into the one agency, working on analytical issues mainly focussed around the pricing of and conditions of access to monopoly and quasi-monopoly services.<sup>49</sup>

The AESC would bring together the current regulatory functions of the ACCC, ACMA, the regulatory functions of the MDBA, and groups such as the Australian Energy Regulator (AER).

Such a body would be well placed to work with the state regulatory bodies and over time functions could be better aligned so that work relating to national industries that cross state borders would be undertaken by the national Commission while local issues would be retained by the state bodies. Industry specific regulators would not be established.

### **Concluding comments**

In this paper we have set out the principles for designing Australia's national economic regulators. A stock-take of Australia's regulators is well over due. Australia's microeconomic reform since the 1980s has been about changing regulatory structures rather than deregulation. These structures have not developed in a systematic and optimal way, as we highlight with our discussion of the ACMA and of consumer protection regulation. It is important to rationalise these rustic regulatory structures to ensure Australia's on-going growth and prosperity.

Policy makers who are considering regulation should always remember that they are dealing with a principal-agent problem. Designing good regulatory institutions requires structures that minimise the standard risks that arise in any principal-agent relationship. These features include separating regulators from policy development, choosing appropriate commissioners who are separated from day-to-day regulatory functions, designing regulators to maintain a consistent set of analytical skills and a unified culture, rotating commissioners and senior regulatory staff, having clear appeals processes and having regular reviews of each regulator.

At the same time, governments and ministers should not be able to establish independent regulators to simply avoid decision-making. Regulators should only be established when there are real issues of sovereign risk or, in a federal structure like Australia, where multi-jurisdictional coordination is essential. While regulators help government and ministers to avoid the 'Ulysses and the Sirens' problem, and improve decision-making, it should be hard to establish new regulators. Regulators should not be allowed to proliferate.

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<sup>49</sup> As noted above, this type of broad remit helps avoid capture. See also Kovacic 2013.

These issues of regulatory design are not unique to Australia, As the examples of the US FTC and the UK regulatory structure show, other countries also have regulators that fall well short of best practice. This is not, however, a reason to ‘do nothing’. Australia’s national competition policy of the 1990s was world best practice and has been used as the benchmark by a range of other jurisdictions. Australia has the opportunity to again lead the world, this time in reforming and optimising its regulatory structures.

The first step to this rationalisation is to reorganise our national economic regulators. The five regulators discussed above – the National Markets Commission, the Competition Commission, the Reserve Bank of Australia, the Consumer Protection Commission and the essential Services Commission – form an integrated structure that will ensure consistent, high quality economic regulation. This will underpin business investment and promote economic growth. It will allow Australia to move from rustic regulators to world best practice.

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