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Asymmetry of Information, Regulatory Lags and Optimal Incentive Contracts: Theory and Evidence: Discussion

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DISCUSSION

GEORGE R. HALL*: The paper by professors John and Saunders addresses a fundamental dilemma inherent in the conventional system of public utility regulation. The primary objective of public utility regulation is to limit the revenue of the regulated firm to a sum that will cover prudent operating expenses and interest on debt plus a fair return to equity. The dilemma arises because pursuit of the objective of limiting the firm's profit to the amount that would be earned in competitive markets substantially lessens incentives to reduce cost that are present in competitive markets.

Conventional regulation relies primarily on two techniques to address this dilemma. The first is the prudent investment doctrine which allows regulators to disallow unreasonable expenses incurred by managers of jurisdictional firms. This doctrine is only an ultimate deterrent for extreme cases. It creates the danger of regulatory "Monday morning quarterbacking." At best it is a negative force; it does not provide a positive incentive.

The other conventional regulatory inducement to cost reduction is the filed-rate doctrine, or as it is more often called by economists, regulatory lag. Public utilities are permitted to charge only filed rates and these are only adjusted periodically and prospectively. Utility rates are fixed for some period of time and are not true cost-plus prices. During the period the fixed rates are in effect, any realized cost efficiencies benefit the firm. However, efficiencies are likely to be reflected in the rates set whenever new rates are filed and approved by regulators. Thus, we must seek new and positive regulatory incentives for efficiency. To this end the paper before us proposes more use of incentive contracting between utilities and their suppliers.

Professors John and Saunders assume a world in which the key unknown with respect to incentive contracts is the amount of investment required to realize a cost reduction. They also assume an asymmetry of information between utility managements and suppliers. Within the narrow confines of this problem I believe their conclusions follow. However, within the broader context within which

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incentive contracts have to operate in practice, I have reservations about how much the use of this technique can be expanded without significant theoretical and regulatory breakthroughs.

There is great uncertainty about many vital variables for most major utility projects. Key unknowns include the general inflation rate, the safety and environmental regulatory requirements that will apply and the future actions of economic regulatory commissions. In such a world the use of incentive contracts is difficult and there is a great danger of motivating "game playing" to the detriment of consumers.

If there is a high rate of unanticipated inflation, manipulation of regulatory lag is likely to be counterproductive for consumers. If the "regulatory lag" concept merely recognizes the incentives inherent in the fixed-rate doctrine then regulatory lag may be regarded as a valid efficiency motivator. If, however, regulatory lag is used to justify dilatory action on rate applications by regulators in a period of significant inflation, such a policy is cynical and socially harmful. It violates the social compact inherent in regulation. It can lead to the financial peril of the regulated firms. Most important, it would greatly increase the regulatory uncertainty faced by public utilities and thereby increase the cost of equity capital. The result would likely be increases in the rates paid by consumers that far exceeded any potential rate reductions from induced cost reductions.

Professors John and Saunders conclude that dissemination of information about procurements will allow use of fixed price and incentive type contracts and that bidding by as many contractors as possible should be encouraged. Fixed price contracts are useful if and only if the product is defined with specificity and input prices are reasonably stable. In most large utility projects, such as nuclear power plants, the length of time required for construction and the plasticity of the regulatory requirements mean that these necessary conditions cannot be met.

Incentive contracts are possible if allowances can be made for general inflation and for changes in project specifications. Only if these allowances can be made, can measures be made of the productivity improvements reasonably attributed to management action. The definitional and statistical tasks are extremely challenging. More troublesome, if general inflation and change orders by the buyer are significant, opportunities arise for "games" and managerial "trade-offs" that will increase consumer costs relative to more conventional contracting arrangements. Competition among bidders would always seem desirable. However, if game playing and trade-offs are likely, who is the lowest bidder may be ambiguous. Also, if the final dimensions of the project are unclear, the relevance of any bid based on the initial configuration is questionable.

My remarks are not intended as a counsel of despair. They are a call for more attention by both scholars and policy makers to the practical aspects of applying incentive contracts in the face of general cost uncertainty and uncertainty about the final dimensions of investment projects. Until we solve these problems, in at least a rough and ready way, incentive contracting will remain primarily an intellectual curiosity rather than a potential solution to the central dilemma of public utility regulation.