UNIVERSITY COLLEGE LONDON

EXAMINATION FOR INTERNAL STUDENTS

MODULE CODE	:	**ECON7006**
ASSESSMENT PATTERN	:	**ECON7006A**
MODULE NAME	:	**Economics of Regulation**
DATE	:	**24 May 2016**
TIME	:	**2:30 pm**
TIME ALLOWED	:	**2 hours**

This paper is suitable for candidates who attended classes for this module in the following academic year(s):

2014/15 and 2015/16

2015/16-ECON7006A-001-EXAM-41

TURN OVER

SUMMER TERM 2016

ECON7006: ECONOMICS OF REGULATION

TIME ALLOWANCE: 2 HOURS

Answer ***question A1*** *in Part A and* ***TWO questions*** *from Part B. Each of the three questions is equally weighted.*

In cases where a student answers more questions than requested by the examination rubric, the policy of the Economics Department is that the student's first set of answers up to the required number will be the ones that count (not the best answers). All remaining answers will be ignored.

PART A

Question A1 is compulsory.

A1 *Theoretical papers and textbooks on the economics of regulation assume that a regulator's objective is to maximise economic welfare but that the regulator cannot reach the first best outcome because of information asymmetry between the firm and the regulator. In practice, regulatory objectives are more complicated than maximising economic welfare, but regulators strive to get better outcomes by reducing the information asymmetry between them and the regulated firms.*

Discuss this statement <u>in the context of one regulated sector</u> that you are familiar with. In your answer, you should compare the objectives of the economic regulator in the sector to the theoretical idea of maximising economic welfare. You should also explain why information asymmetry prevents regulators from reaching first best, both in theory and in practice, and discuss how the regulator in the sector makes efforts to reduce the scale of asymmetry.

PART B

Answer **two** questions from this section.

B1 *It is often noted that Margaret Thatcher considered the privatisation of Britain's railways to be a 'privatisation too far'. It required a change of government and Prime Minister (John Major) for the Railways Act 1993 to be passed and the privatisation programme to be implemented.*

Imagine you can go back in time and discuss railway privatisation in the UK with Margaret Thatcher. Given what you know about the experience of Railtrack's privatisation since 1993, and your knowledge of theoretical privatisation models:

- What arguments would you present to persuade her that there are potential welfare benefits to privatising a monopoly company that owns and operates the tracks and stations? You can assume that train services are provided by franchised train operating companies that pay an access charge to the monopoly track company.
- What advice would you provide to ensure that privatisation was carried out in a way that maximises the potential welfare benefits?

B2 Franchising can only improve welfare if there is effective competition during the tender bidding phase and effective regulation after the franchise is awarded.

Discuss this statement. You should explain why effective competition is important for the tender bidding phase and discuss how the party awarding the franchise can influence the extent of competition in bidding. You should also explain why effective regulation is needed after the franchise is awarded, considering the direct impact on outcomes and the effect on tender bidding.

B3 *In its review of energy network regulation between 2008 and 2010 Ofgem was looking for a regulatory framework that could deliver large-scale, uncertain and long-term infrastructure investment projects at a fair price to consumers. They opted to introduce RIIO instead of retaining RPI-X or switching to rate of return regulation.*

Assuming the only options were the RIIO framework, the building blocks approach to RPI-X and rate of return regulation, do you think that Ofgem chose the most appropriate model to deliver the required large-scale, uncertain and long-term investment projects at a fair price to consumers? Explain your answer.

B4 *According to Baron and Myerson (1982), when a firm's costs are exogenous and known to the firm but not known by the regulator, a regulator can reach a second-best welfare outcome if:*

- *the regulator can pay a transfer;*
- *the regulator has information on demand; and*
- *the regulatory contract is only negotiated once.*

Explain how the regulator in Baron and Myerson's model identifies the second best contract to offer the regulated firm and discuss whether and how the model provides insights for regulation of natural monopoly firms in practice.

B5 *Increasingly regulators involve consumers and other stakeholders in discussions on how to set the price control during price control reviews. There are potential benefits to this approach but also downsides.*

Discuss this statement. You should explain how regulators have increased the involvement of consumers and stakeholders in price control reviews, discuss the potential welfare benefits of this approach and consider the potential downsides for economic welfare. You should refer to concrete examples from at least two sectors in your discussion.