
CONTENTS

	FOREWORD	xvii
	ACKNOWLEDGMENTS	xxiii
	INTRODUCTION	1
1	The Regulatory Environment and Institutions	1
	1.1 Regulatory Constraints	1
	1.2 Regulatory Instruments and Incentive Schemes	6
	1.3 Simple versus Informationally Demanding Regulatory Rule	8
	1.4 Procurement versus Regulation	8
2	Commonly Used Incentive Schemes	10
	2.1 Procurement Contracts	12
	2.2 Regulatory Incentive Schemes in the Absence of Government Transfers	13
3	Received Theory and the Agenda for the New Regulatory Economics	19
	3.1 Marginal Cost Pricing	19
	3.2 Peak-Load Pricing	20
	3.3 Marginal or Average Cost Pricing?	23
	3.4 Balanced Budget and the Ramsey-Boiteux Model of Cost-of-Service Regulation	30
	3.5 Input Choices	33
	3.6 The Agenda of the New Regulatory Economics	34
4	Methodology and Overview of the Book	35
	4.1 The Controlled Experiment	35
	4.2 Overview of the Book	39
	References	47
I	PRICE AND RATE-OF-RETURN REGULATION	
1	COST-REIMBURSEMENT RULES	53
1.1	Some Background	53
1.2	The Model	55
1.3	The Two-Type Case	57
1.4	Continuum of Types	63
	1.4.1 Decentralization through a Menu of Linear Contracts	69
	1.4.2 Parameters of the Incentive Scheme and Performance	71
	1.4.3 Additive Noise and Linear Contracts	72
	1.4.4 The Two-Type Case and Nonlinearity of Optimal Contracts	73

1.4.5	Shutdown of the Firm	73
1.4.6	Compensation Caps and Cost Ceilings	75
1.5	The Main Economic Conclusions	76
1.6	Implementation: Relevance and Informational Requirements of Menus	82
1.7	Using Yardstick "Competition" to Reduce Informational Asymmetries	84
1.8	Adding Investment to the Model	86
1.8.1	Contractible Investment	88
1.8.2	Noncontractible Investment	91
1.8.3	Private Information on the Desirability of Investment: Rate of Return on Investment, Incentives, and the Averch-Johnson Model	93
1.9	Investment under Noncommitment	99
1.9.1	Rent Extraction Generating Underinvestment	100
1.9.2	Four Mechanisms Mitigating the Underinvestment Effect	101
1.10	Multiperiod Relationship under Commitment: False Dynamics	103
1.11	Risk Aversion	105
	Bibliographic Notes	106
	Appendixes	119
	References	124
2	PRICING BY A SINGLE-PRODUCT FIRM WITH AND WITHOUT BUDGET BALANCE	129
2.1	Some Background	129
2.2	The Model	131
2.2.1	Description	131
2.2.2	Full Information	133
2.3	The Two-Type Case	134
2.4	Continuum of Types	137
2.5	Delegation of Pricing to the Firm	139
2.5.1	An Introduction to Price Taxes	139
2.5.2	Using Historical Data to Construct the Price Tax	142
2.6	Two-Part Tariffs in the Absence of Government Transfer	145
2.6.1	The Optimal Two-Part Tariff	147
2.6.2	Optimal Cost-of-Service Regulation	149
2.7	Linear Pricing in the Absence of Government Transfer	151
2.7.1	Optimal Linear Prices as Sliding Scale Plans	151
2.7.2	Relationship to Monopoly Pricing and Price Caps	154

2.8	Concluding Remarks	155
	Bibliographic Notes	155
	References	164
3	PRICING AND INCENTIVES IN A MULTIPRODUCT FIRM	165
3.1	Some Background	165
3.2	Optimal Regulation	167
	3.2.1 The Model	168
	3.2.2 The Optimal Regulatory Allocation	169
	3.2.3 Linearity of Cost-Reimbursement Rules	171
3.3	Third-Degree Price Discrimination	172
	3.3.1 Ramsey Pricing	172
	3.3.2 Peak-Load Pricing	173
3.4	Second-Degree Price Discrimination	175
	3.4.1 Fully Nonlinear Pricing	175
	3.4.2 Two-Part Tariffs	176
3.5	Verifiable Quality	177
	3.5.1 A Procurement Example	177
	3.5.2 A Regulation Example	177
3.6	The Incentive-Pricing Dichotomy	178
	3.6.1 Necessary and Sufficient Conditions	178
	3.6.2 Example of Nondichotomy	180
	3.6.3 The Incentive-Pricing Dichotomy in the Absence of Government Transfer	180
3.7	Multidimensional Effort and Characteristics	181
	3.7.1 Effort Allocation: The Shared-Fixed-Cost Model	181
	3.7.2 Multidimensional Type	184
	3.7.3 Effort Allocation: The Shared-Marginal-Cost Model	186
3.8	Is Subcost Observation Useful?	187
	3.8.1 One-Dimensional Type	189
	3.8.2 Multidimensional Type	191
3.9	General Equilibrium Analysis: Foundations of the Shadow Cost of Public Funds and Taxation by Regulation	194
	3.9.1 Motivation	194
	3.9.2 An Imperfect Income Taxation Model	196
3.10	Concluding Remarks	200
	Bibliographic Notes	202
	Appendixes	206
	References	208

4	REGULATION OF QUALITY	211
4.1	Some Background	211
4.2	The Model with a Search Good	214
	4.2.1 Incentives to Provide Quality	215
	4.2.2 Incentives for Quality and Cost Reduction	217
4.3	Optimal Regulation under Asymmetric Information	219
4.4	Implementation of the Optimal Regulatory Mechanism	223
4.5	Concern for Quality and the Power of Incentive Schemes	225
4.6	Reputation Incentives for an Experience Good	227
4.7	Concluding Remarks	231
	Bibliographic Notes	233
	Appendixes	234
	References	243
II	PRODUCT MARKET COMPETITION	
5	COMPETITIVE RAMSEY FORMULAS AND ACCESS PRICING	247
5.1	Some Background	247
5.2	Pricing and Competition	249
	5.2.1 Regulated Competition	250
	5.2.2 Unregulated Competitive Fringe	251
	5.2.3 Unregulated Competition with Distorted Pricing	253
5.3	Access Pricing: Pricing in the Absence of Incentive Correction	255
5.4	Access Pricing and Incentives	258
	5.4.1 Common Network	259
	5.4.2 Network Expansion	263
5.5	Concluding Remarks	266
	Bibliographic Notes	267
	Appendixes	268
	References	271
6	BYPASS AND CREAM SKIMMING	273
6.1	Some Background	273
6.2	The Model	275
6.3	Optimal Pricing Rules and Optimal Incentive Schemes	276
6.4	Bypass and Cream Skimming	285
6.5	Some Further Considerations about Bypass: Redistribution and Budget Constraint	290

6.6	Concluding Remarks	295
	Bibliographic Notes	296
	Appendixes	298
	References	303
III	BIDDING FOR NATURAL MONOPOLY	
7	AUCTIONING INCENTIVE CONTRACTS	307
7.1	Some Background	307
7.2	The Model	309
7.3	The Optimal Bayesian Auction in the Two-Firm, Two-Type Case	310
7.4	The Optimal Bayesian Auction in the Continuum Case	314
	7.4.1 The Firm's Bidding Behavior	314
	7.4.2 The Optimal Auction	315
7.5	Implementation by a Dominant Strategy Auction	319
	7.5.1 Reduction in Transfer	320
	7.5.2 Equivalent Dominant Strategy Auction	320
	7.5.3 On the Revelation Principle in an Auction	321
7.6	Optimality of Linear Contracts	322
7.7	Auctions in Regulation	322
7.8	Concluding Remarks	324
	Bibliographic Notes	325
	Appendixes	337
	References	339
8	REPEATED AUCTIONS OF INCENTIVE CONTRACTS, INVESTMENT, AND BIDDING PARITY	341
8.1	Some Background	341
8.2	The Model	343
8.3	Optimal Regulation under Asymmetric Information	346
8.4	Learning by Doing	352
8.5	Assessment of the Model	355
8.6	Transferable Investment	356
8.7	Concluding Remarks	359
	Bibliographic Notes	360
	Appendixes	365
	References	370

IV	THE DYNAMICS OF REGULATION	
9	DYNAMICS WITHOUT COMMITMENT AND THE RATCHET EFFECT	375
9.1	Some Background	375
9.2	The Model	379
9.3	Ratcheting and Pooling in the Continuum Case	381
9.4	The Two-Type Case	387
	9.4.1 Characterization of Finite First-Period Menus That Induce the Upper Bound on Welfare	388
	9.4.2 Preliminary Analysis: Two-Contract Menus	390
	9.4.3 Comparative Statics of the Optimal Contract in an Example	397
	9.4.4 General Results	397
9.5	Concluding Remarks	401
	Bibliographic Notes	401
	Appendixes	415
	References	435
10	COMMITMENT AND RENEGOTIATION	437
10.1	Some Background	437
10.2	The Model	440
	10.2.1 The Commitment Framework	440
	10.2.2 The Renegotiation Game	443
10.3	Renegotiation-Proof Second-Period Contracts	443
10.4	Characterization of the Optimal Contract	447
10.5	How Much Pooling?	451
10.6	Continuum of Types	456
10.7	Commitment, Renegotiation, and Noncommitment	458
	Bibliographic Notes	460
	Appendixes	464
	References	471
V	THE POLITICS OF REGULATION	
11	REGULATORY CAPTURE	475
11.1	Some Background	475
11.2	The Model	480
	11.2.1 The Firm	480
	11.2.2 The Agency	480

11.2.3	Congress	481
11.2.4	Consumer Groups	482
11.3	Collusion-Free Regulation	482
11.3.1	Full Information	483
11.3.2	Asymmetric Information	484
11.4	Producer Protection	485
11.5	Multiple Interest Groups	488
11.6	Shutdown of the Regulated Firm	493
11.7	A Political Theory of Cross-subsidization	494
11.8	Concluding Remarks	498
	Bibliographic Notes	500
	Appendixes	506
	References	512
12	COST PADDING, AUDITING, AND COLLUSION	515
12.1	Some Background	515
12.2	The Benchmark (No Cost Padding, No Auditing)	517
12.3	Audit of Cost Padding	519
12.3.1	Benevolent Audit of Cost Padding	519
12.3.2	Collusion in Auditing	524
12.4	Monitoring of Effort	527
12.4.1	Benevolent Monitoring of Effort	528
12.4.2	Collusion in Monitoring of Effort	529
	Bibliographic Notes	531
	Appendix	532
	References	534
13	CARTELIZATION BY REGULATION	537
13.1	Some Background	537
13.2	The Model	540
13.3	Benevolent Agency and Incomplete Information about the Incumbent's Technology	544
13.4	Cartelization	546
13.5	Pro- and Anticompetition Agencies	550
13.5.1	Summary of the Argument	550
13.5.2	Agency-Entrant and Agency-Customer Collusion and Entry	551
	Appendixes	552
	References	557

14	AUCTION DESIGN AND FAVORITISM	559
14.1	Some Background	559
14.2	The Model	563
14.3	Optimal Auction with a Benevolent Agency	565
14.4	Collusion and Soft Information	568
	14.4.1 Description of Collusion	568
	14.4.2 Soft Information	569
	14.4.3 Indirect Bid Rigging	571
14.5	Asymmetric Collusion and Hard Information	572
14.6	Symmetric Collusion and Hard Information	573
14.7	Concluding Remarks	578
	Appendixes	581
	References	587
VI	REGULATORY INSTITUTIONS	
15	REGULATORY INSTRUMENTS, HEARINGS, AND INTEREST GROUP MONITORING	591
15.1	Welfare Foundations of Institutions	591
15.2	The Model	595
	15.2.1 Components	595
	15.2.2 Benevolent Agency Benchmark	599
	15.2.3 Collusive Agency	600
15.3	The Solution	602
	15.3.1 Average Cost Pricing	602
	15.3.2 Marginal Cost Pricing	604
	15.3.3 Optimal Institutions	604
	15.3.4 Subsidies for Intervener Programs	608
	15.3.5 Alternative Technologies	609
	15.3.6 Standards of Judicial Review	610
15.4	Choice of Watchdog	610
15.5	Concluding Remarks	612
	Appendixes	613
	References	616
16	COMMITMENT AND POLITICAL ACCOUNTABILITY	619
16.1	Some Background	619
16.2	Short-lived Regulators and the Optimal Constitution	621
	16.2.1 The Model	621
	16.2.2 Commitment	624

	16.2.3 Noncommitment	625
	16.2.4 Optimal Constitution	626
16.3	Short-lived Regulators and Complete Contracting	627
	16.3.1 Investment Induced	628
	16.3.2 No Investment	628
16.4	Elections, Career Concerns, and Commitment	630
	16.4.1 Commitment Constitution	631
	16.4.2 Noncommitment Constitution	632
	16.4.3 Flexibility-on-Commitment Constitution	633
	16.4.4 Campaign Contributions	634
16.5	Concluding Remarks	635
	Bibliographic Notes	636
	References	636
17	PRIVATIZATION AND INCENTIVES	637
17.1	Some Background	637
	17.1.1 Public Enterprise, Private Regulated Firm, and Unregulated Firm	638
	17.1.2 Conventional Wisdom about Privatizations	639
	17.1.3 Residual Rights Considerations	642
17.2	The Model	645
	17.2.1 Public Ownership	645
	17.2.2 The Regulated Private Firm	646
17.3	Optimal Regulation with Public Ownership	647
17.4	Optimal Regulation of a Private Firm	649
	17.4.1 Differentiable Equilibrium	649
	17.4.2 Nondifferentiable Equilibria	652
17.5	Comparison of Ownership Structures	653
17.6	Concluding Remarks	654
	Bibliographic Notes	655
	Appendixes	657
	References	658
	CONCLUSION	661
	REVIEW EXERCISES	671
	INDEX	695