Designing Energy Regulatory Policies:

The European Options

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Abstract

The incentive theory recommends the implementation of incentive mechanisms to regulate operators in networks industries (Laffont and Tirole, 1996), in order to reduce information asymmetries between local monopolies and the regulatory authority and prevent the operators from reflecting their rise in costs in prices. S. Littlechild proposed a price regulation based on a "price cap"[1] and implemented it for the first time for the case of *British Telecom*. However, in practice, we observe that the incentive theory's view is not always applied and for example in Europe we observe an important diversity among the regulatory mechanisms applied by the energy regulators (Joskow, 2006). On the one hand, cost plus regulation is still implemented in some European countries. On the other hand, for the countries providing incentives to energy operators, there are quite strong differences in the power of incentives applied and the scope of charges covered by the incentive mechanism. Therefore, it seems there is no unique way to regulate energy operators and to provide incentives for cost efficiency.

This diversity of mechanism can obviously be partly explained by the national structures of the industry. However, for those European countries which do not strongly differ in terms of industry structure, a high diversity of regulatory mechanism still remains.

The objective of this paper is to identify the determinants for the choice of a regulatory mechanism.

For this purpose, we analyze the regulation implemented for gas and electricity transmission and distribution operators in 6 European countries: Germany, Denmark, UK, The Netherlands, Italy and Spain. Besides the national objectives that can differ from one country to another, we take the institutional framework of each country into account. In this context, we mobilize the transaction cost theory in order to identify the costs of regulation.

We show that the combination of different industry structures, national objectives and institutional factors enables to understand the diversity of regulatory mechanisms implemented in Europe. This paper thus provides an analysis grid to explain the different choices made by the European energy regulators.

Keywords: Energy, Incentive Regulation, Transaction cost economy, Institutional framework.

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[1] Other hybrid forms of price regulation such as the "revenue cap", "sliding scale" or "profit sharing" are also developed in many countries. In the middle of the eighties, this new form of incentive regulation was introduced into the regulated segments of gas, electricity, telecommunications as well as water sectors, in countries such as Great Britain, New Zealand, Australia or the United States.