Regulation

- Given these drawbacks with MC pricing a different approach is **Average Cost Pricing**.
- Here the firm is forced to set the lowest price consistent with non-negative profits.
- This situation, where price=AC, is intermediate between marginal cost pricing and monopoly pricing.
- This is related to rate of return regulation, most often used to regulate utility companies.
- Specifically, prices are set to allow the firm to attain a "fair" rate of return on its investment.

Regulation

- This gives the regulated firm the wrong incentives.
- It will not want any cost reduction since prices will be lowered accordingly.
- This is what's referred to as low-power incentive mechanism.
- A the other extreme, price cap regulation is a high power incentive mechanism.
- Here, price is set beforehand and does not change even if costs change.

Regulation

- Competition is the best way of recovering allocative inefficiency in monopoly pricing.
- Regulation is only best in "natural monopoly" conditions competition is "not feasible".
- But who get's to say what's a natural monopoly?
- Suppose there are industries where there is competition in parts of the production process. (e.g. long distance telecommunications)
- A problem is these parts cannot exist independently from the part that is a natural monopoly.

Regulation

- What we have here is a monopolist selling services to firms in the competitive segment which in turn sell to consumers.
- Here we refer to the monopolists output as an essential facility.

- The regulation of essential facilities shares the same problems of monopoly regulation .
- It's often the case that the owner of the essential facility also competes "downstream".
- One concern is the "upstream" may use its monopoly power to extend it downstream.
- One regulator solution is to forced divestiture.
- An alternative is to allow the upstream firm to compete downstream but prevent it from discriminating against downstream competitors by regulating access pricing.