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.
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.
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 gets 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.
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.