MANAGING THE THREAT OF REGULATORY CAPTURE UNDER THE EUROPEAN ENERGY UNION

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Section 1: Overview

Operation or expansion decisions in the energy industry naturally have multiple spatial and temporal dimensions bridging commerce, governance, and community. Under the European Energy Union, legal directives at the European Union (“EU”) level are deployed as instruments for protecting or promoting the public interest. How to appease the perennial tension between public and private interests, a high ambition for any legal framework even in the best of times, probably requires a herculean effort in the context of the European Energy Union. If the design or implementation of legal instruments overseeing the EU energy industry is imprudently in the grip of regulatory capture, in essence, the sly substitution of public for private interests, the efficiency or equity of transboundary outcomes is likely harmed. The form of regulatory capture may look subtle or imperceptible, but its effects are usually prodigious. For example, captured regulation could a tad distort the investment signals for electric power generation or transmission, unduly altering the appropriate scale, location, timing, or technology of capacity additions, in one EU member state or across interconnected EU member states. Left to fester, such seemingly small distortions may unjustifyably cause benefits to be denied or delayed or costs to be imposed or advanced, a painful outcome for economically struggling regions in the EU, but barely noticeable for affluent ones.

There is thus a menace, where regulatory capture exists, that the disorderly construction or application of legal instruments leads to the wasteful or unfair distribution of gains or burdens over time or across locations. How, then, to alleviate an exposure to regulatory capture under the European Energy Union? Our objective in this paper is to build a framework for managing the threat of regulatory capture in the context of the EU energy industry. Our approach, drawing on the teachings of law and economics, is to investigate the propensities for inefficiency or inequity arising from regulatory capture in transboundary energy industries. Our paper is distinctive in the literature on cognate fields in regulatory law, industrial organisation, international economic law, public administration, or governance. It extends the law and economics concepts discussed by Macatangay at the 36th USAEE/IAEE North American Conference in Washington DC and the 35th USAEE/IAEE North American Conference in Houston.

Section 2: Approach

Our chief concern is whether or not the level of regulatory sophistication is fit for the purpose of limiting the susceptibility to regulatory capture. Capture is a “genuine threat” to regulation, and “the crucial question is whether capture, where it exists, can be mitigated or prevented.” A central thesis in the empirical literature is that “policymakers are for sale” and that “regulatory policy is largely purchased by those most interested and able to buy it,” and indeed there are various channels of regulatory capture, such as cultural capture, influence through expertise and information, corrosive capture, or the capture of scholars in academia. Cultural capture, pertaining to persuasion through “a set of shared but not explicitly stated understandings about the world,” seems to have an especially strong social aspect. Under its spell, regulators tend to support positions advocated by those whom they perceive as part of their “in-group” (identity); those whom they perceive as having higher social, economic, or intellectual standing (status); or those in their social networks (relationships). The higher the complexity or information requirements of an issue and the lower the regulatory capacity, the greater the tendency for cultural capture, and indeed one of the strategies for controlling cultural capture is to raise the scientific or evidentiary standards for decisions. There is evidence that regulators are more (less) disposed to authorise rate reductions (increases) if regulatory commissioners have long experience in office, there is a relatively large number of regulatory staff, or other regulatory agencies have made similar rate decisions or assessed operational penalties for the same utility. An improvement in informational flows, as it were, reduces the evidentiary costs of regulators in securing a rate reduction or debating a request for a rate increase.

Detestably, regulatory capture amplifies the inclination for manipulation or lack of transparency in regulatory proceedings. There is evidence that the settlement process during ratemaking proceedings is perverted into a spectacle in which the utility requests a large increase in revenue requirements or authorised returns, the regulatory staff balks at the high number, the utility and the regulatory staff negotiate to approximately half of it, and the PUC
approves it. In such a situation, the utility obtains an increase in profits, the regulator claims to serve the public interest, but consumers suffer. In complex rate cases with voluminous testimony on revenue or return calculations, “many investments can be deemed sufficient, prudent, and acceptable” reportedly because “all aspects” are susceptible to manipulation. If a PUC, without judicial oversight, can grant a wide range of utility requests, regulation is said to be “the very definition of arbitrary and capricious.” The empty show of a perverted ratemaking settlement sounds disconcertingly reminiscent of various practices threatening efficient or equitable outcomes in legal proceedings, such as an abuse of process, a pseudo-contract, or a robotic deference to Hornbook law.

**Section 3: Results**

We have three contributions. First, we show that the concept of regulation has to be affirmed as a meaningful exchange amongst adversarial parties to the proceeding in a persistent quest for contract. Regulation, in our estimation, is a process, in much the same way that the market tends to be characterised as a process. Meaningful regulation, going well beyond mere Hornbook law, is a series of purposeful articulations imbued with the normative pursuit of social welfare maximisation and spatial or temporal equity. Second, as a corollary to the precept of meaningful regulation, we further show that the analytical tools of law and economics enable the establishment of four foundational doctrines for mitigating the peril of regulatory capture in transboundary energy industries: the promotion of shared meaning in the regulatory process, a notion analogous to the avoidance of boilerplate or senseless text in a pseudo-contract; the indifference of the parties, given their respective claims, if each was in its adversary’s role; the use of cost-benefit analysis as a basis for transboundary compensation in international law; and the provision of non-arbitrary justification in the absence of a cost-benefit analysis.

Finally, as an empirical exercise, we show that the nuances of the electric power industry in the EU have profound implications for the danger of regulatory capture. Politics already looms large in energy industry regulation, but its salience in decision-making, in light of the forbearance inherent in the conveyance of money or non-money side payments, seems set to surge. A key feature of the ongoing energy transition is the presence of various politically-driven changes. Tellingly, the most significant policy challenges have to do with the regulatory and market arrangements and their distributional implications. “While not everybody may benefit from the energy transition in the short term, it will, if carefully managed, ultimately benefit the entire EU economy, by creating new job opportunities, bringing savings on energy costs or improving air quality.” In defending against the vulnerability to regulatory capture, how to contend with the nuances of the electric power in the EU? We focus on the potential inequities of energy market integration, the limited availability of locational pricing, and the delicate relationship between the signal for adding and the investment in transmission capacity.

**Section 4: Conclusions**

Regulation is ubiquitous, but the genuine threat of its capture could darken the horizon for efficient or equitable outcomes. Accounting for the idiosyncrasies of the electric power industry in the EU, the intellectual tradition of law and economics provides the diagnostic and prescriptive equipment to construct analytical barricades against the threat of regulatory capture.

**References**


