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Research Seminar Series

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Rational Bankruptcy in Regulated Utilities – A real problem, a credible threat and cheap talk

Abstract

A model is presented which predicts that it is rational for a regulated firm to create a positive risk of bankruptcy by excessively high levels of gearing, in order to extract a higher price (ie a price above Short run marginal social cost) than the official rules of the game allow. As such this is a model of capture with the (perhaps interesting) property that it is rational for the regulator to allow all three of these departures from the welfare optimum. One of the main predictions of the model is that issuing debt will prevent the regulator from acting opportunistically by reducing prices during a regulatory period. Equally, allowing the firm to issue debt, may be a commitment by the regulator not to reduce prices later. The intuition is that the regulator tradesoff static welfare for a dynamic gain of increased investment, which is otherwise underincentivised, in a risky, price capped environment. There are empirical phenomena in both the UK and California which suggests that such a model is timely. The paper concludes with certain indications of explicit empirical work which could usefully test its validity before any policy implications may be drawn.

Friday, April 13, 2001, 11 am–12:30 pm
Room 021, Anderson Hall, UC Riverside

Copies of the paper to be presented are available at `http://www.goldmark.org/livia/misc/regan.rtf` or from Prof. Lívia Markóczy, `Livia.Markoczy@ucr.edu`, Anderson Hall, Rm 221, 787-3908