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11 COUNTERARRANGEMENTS

11.1 INTRODUCTION

The case-study chapters and their analysis in the previous chapter show that strategic behaviour frequently occurs in infrastructure-based sectors. In many cases, strategic behaviour has serious consequences, not only for the configuration of the market, but also for market parties, end consumers and governments. Market parties can tell immediately by their corporate performance, final consumers are faced with higher prices or a less reliable service provision and governments find important policy targets being missed.

Strategic behaviour pays. This may be the foremost explanation for the ubiquity of strategic behaviour. What this behaviour will lead to and how it will be judged in the longer term is unclear yet, but these strategic winners do not always suffer negative repercussions in the longer term for their hard game. Memories are short and once the strategic game has been won, it is simply a matter of 'new round, new chances'. Strategic behaviour pays also because the counterforces tend to be weakly organised. Dixit [1996] has shown that the multiple principal problem leads agents to receive various incentives working at cross-purposes. This problem occurs especially in public sector environments and makes the strength of principal stimuli to agents extremely weak and the attainment of ideal outcomes out of reach. This does not imply that regulatory intervention is totally impossible, but economic theory has had very hard times to bridge the gap with practical organizational behaviour. (Joskon and Schmalensee [1986]; Lafont and Tinole [1993]) The complexity of administrative context is such that it has thus far been unfeasible to include this empirical wealth in the theory of institutional economics. The way in which price caps and sharing returns has been dealt with, has been patchy at best. We believe that our interdisciplinary approach has brought us a few steps closer to offering workable approach to fine tuning regulatory incentives against strategic behaviour, although optimality is an unachievable target in complex systems replete with transactions costs.

In this chapter, we describe five arrangements that are meant to either counter strategic behaviour or mitigate its effects. Henceforth, we will call these arrangements 'counterarrangements'. As we saw in the case-study chapters, strategic behaviour has both tangible and less tangible manifestations, which, besides, can merge diffusely. In view of this, it would not be recommendable to employ just one type of counterarrangement, with one clearly ordered structure. This would be ineffective because of the amorphous character of strategic behaviour. We will therefore discuss several counterarrangements, parts of which will overlap, or which may even be mutually exclusive. It may be expected that good results can only be achieved with the help of counterarrangements at different aggregation levels using diverse 'countering methods'.

In sections 2 to 4, we will deal with three well-known counterarrangements: competition engineering, skimming returns and consumer protection. Experience has now shown that the

effect of these counterarrangements is limited. In sections 5 and 6, we will introduce two new counterarrangements that may be more effective. They are an internal arrangement and an external one: hybrid governance and the regulator.

Hybrid governance is a special form of corporate governance. Corporate governance concerns the way an enterprise is governed and the way this governance is accounted for. The term hybrid refers to the hybrid legal design of corporate governance: not merely hard law, not merely soft law, but an intelligent mix of hard and soft law. The idea behind hybrid governance is that an enterprise's institutional design can moderate the incentives for strategic behaviour, can actively stimulate the safeguarding of public interests, while at the same time societal costs entailed by government interference can be avoided.

Although regulators in themselves are a familiar arrangement, the form we propose here to combat strategic behaviour is radically different from the way regulators fulfil their role in general.

11.2 COMPETITION ENGINEERING

The idea behind competition engineering as a counterarrangement is that competition can be influenced by government policies. Competition engineering can combat potential strategic behaviour because the more competitors there are, the fewer chances strategic behaviour will have.

Competition engineering has two variants. The passive variant is facilitating. This variant concentrates on realizing the optimum conditions within which competition can develop. In the active variant, competitors are actually put in the market.

11.2.1 PASSIVE VARIANT

The passive variant regulates the designing of a *level playing field*. Competition does not develop automatically. An incumbent has such an advantage over potential newcomers that, without further measures, these newcomers will rarely manage to gain a position in the market as serious competitors of the incumbent. This is why a *level playing field* needs to be created that offers better chances of fair competition. Regulators, supported by statutory rules, have to design such a *level playing field*. When creating a *level playing field*, the legislator and the regulator will seek, for example, to cut the ties between the incumbent and other relevant actors. Examples include the earlier mentioned opportunities, such as the self-evident access that incumbents have to bottleneck facilities and the relations between incumbent and relevant governments, such as departments, administrators and regulators.

The case studies show that vertical ties are not cut completely. The reason why they are not has undoubtedly to do with the position and efforts of the incumbent in the preparatory process for the institutional change. The incumbent is an established and deep-rooted party that, of course, will play its role in the consultation and negotiation process that should lead to the new institutional structure. (Emmons [2000]) It will realize that the more, and the more intensive, relations it maintains with other actors, the stronger its position will be in the new competition struggle. The incumbent will put forward in the debate that the desired quality of service provision demands a certain technical integrity. (Van Twist et al. [2000]) Radical severance of all vertical relations would take insufficient account of this need for technical integrity.

The incumbent's efforts tend to lead to a halfway result of this preparatory process. For example, the incumbent continues to form part of the holding company of which the other companies from the production chain also form part. Another possible outcome is that the incumbent continues to own important bottleneck facilities. Even if all these relations had been cut, there would be historically developed mutual relations between organizations and between people, preventing a complete separation.

The consequences of these ineffective outcomes of the decoupling process were clearly visible in the strategic games in the case studies. Although the close relations from the past have formally been weakened, in practice incumbents appear to be able to derive benefit from these historically developed links. Much strategic behaviour starts with exploiting these relations. Entrants do not have these contacts and thus have a serious disadvantage. Repeatedly, the *playing field* appears to be not level on this point.

If it is a given that incumbents cannot be decoupled completely from other organizations and from bottleneck facilities, then it is imperative to seek the realization of a *level playing field* in a different way. Rather than trying to sever the relations radically, it is imperative to seek to continue these relations on a certain level, with the entrants also entering into these relations. All competitors - both incumbent and entrants – then have these relations. Although the players will be bundled then, the *playing field* will be *level*. In concrete terms, for the institutional design of the bottleneck facilities this would mean that the companies that use these facilities own them and/or exploit them jointly. This also guarantees the technical integrity.

11.2.2 ACTIVE VARIANT

Although the *playing field* may be completely level, it remains to be seen whether any entrants actually show up that have the courage to start competing with the *incumbent*. A more active form of *competition engineering* is to not wait and see, but actually put a competitor in the market. Two variants are imaginable. In the first place, the incumbent can be split up into several organizations that start competing with each other. (Ten Heuvelhof and Van Twist [2001]) The splitting up of the American AT&T had elements of this. AT&T was cut up into seven *Baby Bells*, which were given the monopoly of local telephony and the new AT&T, which, in competition, would start operating on the market for long-distance telephony (see chapter 7). In retrospect, this split-up formed the prelude to a second wave of changes aimed at introducing market forces, meant to create competition also on the local networks. The idea was that local telephone companies would also gain access to the long-distance market and other local networks that clearly and irreversibly opened up their own, local markets. (Temin and Galambos [1987])

In the second place, a government itself can start enterprising, thus adding an extra competing company to the market. This creates the situation of the competing public organization. (Ten Heuvelhof and Van Twist [2000]) The form it is given requires a great deal of attention. In the first place, because a government is not accustomed to enterprising, certainly not in competition. In the second place, because a government is not only a party in a market, but also lays down the rules and is the regulator. This inevitably triggers a debate about the desirability of hybrid companies and the appearance of an entanglement of interests.

Although splitting up an incumbent and/or adding a competing public organization will increase the number of competing players, it will not end strategic behaviour. At best, these changes will steer the transition process to an open market into a new phase. For example, the market

configuration will shift from monopoly to a duopoly or perhaps an oligopoly, but it should be remembered that these configurations, too, are fertile breeding grounds for strategic behaviour. However, these changes offer opportunities for designing counterarrangements against strategic behaviour. These changes can be used particularly to make up for a part of the regulator's information disadvantage in comparison with the incumbent. The competing public organization can enable such a regulator to find out more about the minute details of the business operations and market developments in the sector. It becomes easier for the regulator to gather inside information. Armed with this information, it can intervene more effectively. The increase in the number of players also offers possibilities for introducing benchmarking systems that may incentivise companies in the sector to boost their performance.

11.3 SKIMMING RETURNS

Successful strategic behaviour improves a company's position. In some cases, the strategic behaviour immediately results in having fewer competitors or in the possibility of charging higher prices. The company may also be able to manoeuvre itself into a position that offers the prospect of a relatively easy future, for example a future without competitors or a future with a powerless regulator. Anyway, the advantages to itself that a company is able to realize will sooner or later pay off in higher returns. This assumption underlies all counterarrangements that follow from the financial parameters of the strategically behaving company. Where market forces fail to operate fully, strategically operating companies will succeed in realizing excessive profits. The knowledge that these will be skimmed anyway will act as a brake on this strategic behaviour.

Currently, these arrangements are used mainly in those links of the production chain where a (natural) monopoly survives after liberalization. Examples included the setting of tariffs for transport over the electricity networks. The arrangements can also be used in the links where there are excessively high prices because of the absence of sufficient competition.

11.3.1 RATE OF RETURN

This family of counterarrangements has two variants. The first variant is *rate of return regulation*. (Bos [1995]) This regulation determines a maximum return. The regulator establishes how much capital the enterprise has invested and indicates what it regards as a reasonable return on this capital invested. The enterprise then determines the price it has to charge its consumers to reach that return.

Two main drawbacks are attached to this counterarrangement. First, the company is left with hardly any incentives to produce efficiently, because all efficiency profit leading to a return higher than the established return will be skimmed off. This is a serious drawback, even more so because the aim of promoting competition is to create that incentive. The second drawback is caused by the fact that the regulator has to establish the invested capital. This is difficult for the outsider that every regulator will be. Here, the regulator has to pay for its information disadvantage in comparison with the company. We may safely assume that companies that are able to behave strategically because of their information advantage will succeed in pulling the wool over the regulator's eyes also on this point. At any rate, the company will lack the

incentive for sober investment, because all investments are taken into account to fix the permitted return. Instead, the company will feel an incentive to overinvest. The company may do so from the need to deliver perfect services, but it should always ask itself whether the extra costs warrant the reaching of the ultimate degree of perfection. (Breyer [1982]) Rate-of-return regulation deprives the company of the incentive to make such a trade-off.

11.3.2 PRICE REGULATION

The second variant is price regulation. The regulator fixes a *price cap*. If this *price cap* will be in force for a longer period, an automatic annual adjustment will take place for inflation, for example, and for a productivity increase that is considered reasonable. The advantage of *price cap* regulation over *rate-of-return* regulation is that the company continues to feel the incentive to produce efficiently, because all it manages to realize in cost price that is lower than the price it can charge will accrue to the company. However, also in this case the regulator will continue to have its information disadvantage, which makes it difficult to fix the right *price cap*. The company that wishes to use its information advantage strategically has more possibilities under *price cap* regulation than it has under a regime of *rate-of-return* regulation, because it is able to profit from its information advantage also in the process between price and return. A consequence of strategic behaviour that may arise in the event of *price cap* regulation is underinvestment. Once the regulator has fixed the *price cap*, the company will have an interest in keeping costs as low as possible, because all it manages to realise in cost saving will accrue to the company. In some cases, its information disadvantage will keep the regulator from discovering and preventing underinvestment.

11.4 CONSUMER PROTECTION

Conceivably, the adverse effects of the strategic behaviour will eventually affect the final consumers of the services and products. They either pay excessive prices or receive insufficient quality. This is even more problematic because the services provided are so vital to the consumers. This means, for example, that they do not have the option to buy nothing if they dislike the price/quality ratio. This is why the doctrine of consumer protection has been developed. Now that consumers cannot refrain from buying nor have the freedom, or have hardly any freedom, to choose other suppliers, they deserve extra protection, goes the basic idea behind consumer protection. To make consumer protection an adequate arrangement, three preconditions have to be met: the market must be transparent, the switch costs must be low and the legal protection must be adequate.

11.4.1 TRANSPARENT MARKET

First, it is important for the market to be transparent. This may seem obvious, but actually consumers in markets where they used to have no possibility of selecting a supplier themselves and where they do now, have a poor picture of the differences between suppliers. This is partly

due to the suppliers themselves, many of whom offer too much, irrelevant and hardly comparable information. The fact that not all consumers are equally well informed deserves special attention. The well-informed consumers are able to select suppliers in a way that serves their interest. However, the companies, in their turn, appear to be able to shift the disadvantages they suffer to their poorly informed consumers. (Boone and Potters [2002])

11.4.2 LOW SWITCHING COSTS

In the second place, low switch costs are necessary to allow consumers to benefit from the operation of market forces. It must be simple for a consumer to switch to another provider. This goes for any investments in equipment that a consumer needs to make, the length of notice periods and other obstacles.

11.4.3 ADEQUATE LEGAL PROTECTION

Finally, it must be possible to handle complaints procedures quickly and cheaply. If the length and the cost of a complaints procedure keep the consumer from turning to complaints agencies, it will be very unattractive to do so. This is especially true of minor problems and, consequently, minor complaints. A *small claims court* is an interesting idea in this connection. (Ybema [2002])

The attraction in the idea of consumer protection is that the arrangement fits in with the eventually envisaged level, i.e. the consumer. The disadvantage is that a good deal of strategic behaviour can no longer be traced when the service reaches the consumer. Much of the strategic behaviour takes place far upwards in the production chain and remains invisible to the consumer. A more structural protection of consumers would therefore be a good supplement. An interesting idea in this context is the possibility of *empowered public interest groups (PIG)*. (Ayres and Braithwaite [1992], p. 54 ff) PIGs are given a heavy, institutionalized position in the process of designing the operation of market forces. However, the design of these PIGs deserves a great deal of attention to prevent them degenerating into querulous and powerless little groups of dissatisfied users. It is necessary, for example, for a PIG to receive all the information exchanged between relevant organizations. (Ten Heuvelhof and Van Twist [2001], p. 4) This idea has been elaborated in hybrid governance, the internal arrangement discussed below.

11.5 HYBRID GOVERNANCE

11.5.1 HARD LAW AND ITS RESTRAINTS

Much is usually expected of the law as regards controlling strategically operating enterprises. The idea is that laws and regulations can enforce "decent" market behaviour and, for example, prevent cheating. Of course, this is not strange, because statutory rules are naturally and pre-

eminently meant to regulate behaviour. However, "regulation can make matters worse". (Noll [1989], p. 1262) Capturing by organized groups, e.g. the incumbent, may result in regulation that harms competition and provides opportunities for strategic behaviour. Owen and Braeutigam [1978] refer to many varieties of strategic behaviour in the regulatory process, e.g. the strategic use of information, strategic use of litigation, strategic use of innovation, etc. However, there is also empirical research showing that capturing may be overcome. (Derthick and Quirk [1985])

The fact that regulation may work out poorly also follows from an analysis at a deeper level. How do laws and regulations work? They affect behavioural alternatives of entrepreneurs and can limit these alternatives in such a way that undesirable behaviours are no longer an option. In the context of strategic behaviour, they are notably instrumental laws, laws aimed at realizing government policy, for example a particular economic order or social distribution. In the literature, this type of law is occasionally referred to as 'purposive law of the interventionist state'. (Teubner [1983], p. 240) This restraint can take place in several ways. Directly, by imposing a direct legal obligation. Examples would be the enterprise with 'substantial market power', which is subject to heavier requirements than its competitors, or the duty to negotiate with a competitor about access to crucial networks and facilities. Behaviour can also be restrained indirectly, i.e. by attaching binding rules to a licence, for example. Examples include the supply licence for electricity.

According to modern theoretical insights, instrumental legislation and regulation offer only very limited possibilities for influencing societal processes. (Nonet and Selznick [1978]; Teubner [1983], [1989] and [1992]) An important explanation for this is the self-referentiality of social systems. Examples of social (sub)systems are: society, the state, the church, the law, science, the economy and the political system. Self-referential systems are closed to the environment in their operation, with the result that realizing changes from the (political) environment is difficult. This self-referentiality causes social systems to reproduce themselves continuously: the system itself determines observation, the selection of what is relevant and the giving of meaning to information. The system thus proves itself and demonstrates the relevance of its own interpretation continually. However, this does not mean that social systems cannot change. Systems can vary their internal operation. They construct their environment by themselves and observe changes in it. They do not adapt themselves to objective changes in their environment, because their perception is subjective.

The only way external signals can enter the system is by offering the system elements for self-reproduction. An example will clarify this. Many companies are not spontaneously inclined to account for the adverse external effects they cause to their environment. The problem as such does not match the self-reference of the economic system. Only when levies affect the cost-benefit analysis are environmental problems observed in the economic communication. Another example concerns price and quality effects of a licence.

In a market sector, the customer should be central and the customer's wishes should determine the definition of quality. The interaction between demand and supply determines the quality to be realised eventually. The customer imposes requirements on quality, the providers react by offering a particular quality at a particular price. This leads to the trade-off between quality and price. Public-law instruments such as licences are not a substitute for this process, because the essence of a licence is that it is a unilateral legal act on the part of the administrative body that wants to bring about a legal consequence. The will of the applicant concerned does not matter. The essence of a market is that it facilitates a bilateral process between customer and supplier. This process results in agreements between customers and suppliers encompassing a trade-off between quality and price. Since the will of the licensor will not adequately represent the customer's will, an efficient allocation of resources – which the parties set out to achieve – is disturbed. Having customers themselves inform the provider of their wishes directly would achieve a better match with the market process. (Ten Heuvelhof and Stout [2005])

11.5.2 SOFT LAW AND ITS POSSIBILITIES

Evidently, the effects of instrumental legislation are limited. 'Soft law' might offer a solution. The term 'soft law' refers to quasi-legal instruments that do not have any legally binding force, or the binding force of which is somewhat "weaker" than that of traditional 'hard law'. A promising arrangement based on the model of soft law is the institutional anchoring of standards of decency, rules aimed at realizing values like fairness, openness, honesty, reliability; these are values that, if realised, keep the entrepreneur from strategic behaviour. (Stout [2007a] and [2007b])

The core of institutional anchoring is that intended values are realised, not with the help of compulsive rules of behaviour, but by the way the organization is designed. In other words, the point is that incentives should be built into the structure of the organization that help the organization to display desired behaviour or renounce undesirable (strategic) behaviour.

Of course, the arrangement must not be noncommittal. It should be prevented from eventually only involving good intentions. The arrangement should also have teeth and, if necessary, be enforced with the help of coercion. This requires having rules of soft law accompanied by rules of hard law. The application of rules of soft and hard law should be balanced and should alternate. Of course, the use of hard law should be limited to (tails of) processes, because setting material standards with the help of legal rules alone has proved to be useless. We speak of *hybrid governance* because of the combination of soft and hard law.

Institutional anchoring has the following advantages:

- It utilises the self-reflexive capacity of the organization instead of frustrating it in the way normal legislation does.
- It reinforces competition as a mechanism for promoting the efficient fulfilment of public duties.
- Institutional anchoring fits in with the growing tendency to anchor good conduct in the philosophy of corporate social responsibility.

The key question is how to arrive at adequate institutional anchoring. How can values and standards within a certain enterprise be reinforced in such a way that they lend support in preventing and combating strategic behaviour? We cannot give a general answer to this question. It depends on the legal structure chosen, which has been provided for in the legislation on legal persons, and this differs from one country to another. Each nation has its own specific corporate forms, with its own rules and restraints. It is therefore relevant whether we are dealing with, for example, the Dutch Naamloze Vennootschap (NV), the German Aktiengesellschaft (AG) or the British Limited Corporation (Ltd). To stick to these three examples, there are major differences between the institutional structure of a NV, an AG and an Ltd. They particularly concern the bodies of the enterprise and the way the tasks and powers within the enterprise are distributed over and between these bodies.

In spite of the differences, there are basic similarities. In addition to its legal personality, the modern business corporation has at least three other universal legal features: transferable shares (shareholders may change without affecting its status as a legal entity), perpetual succession capacity (its possible continued existence despite shareholders' death or withdrawal), and limited liability (including, but not limited to, the shareholders' limited responsibility for corporate debt).

The following arrangement for institutional anchoring is based on the Dutch Naamloze Vennootschap (NV), the common company structure for utility industries in the Netherlands.

Values and standards can be anchored at three levels: *the executive board, the supervisory board and the shareholders' meeting.*

- *Executive board level*
  Companies can establish a code for their own sector with the intention of committing the executive board to a number of rules of behaviour. This code should primarily contain rules with regard to processes (agents, subjects, methods). The crux of the matter is to set up a permanent consultative circuit in which stakeholders participate (government, supervisory directors, users and social organizations). A consultative circuit of this kind will be sufficiently dynamic and flexible to deal with the special nature of strategic behaviour. Through its participants, the consultative circuit will also exhibit a responsive capability and will be able to pick up social signals, an indispensable quality with a view to the dynamics of the debate. By virtue of its composition, the circuit is so transparent that its decision-making can be traced, which not only makes it possible to check outcomes but also legitimizes them to a certain extent. The way in which the rules come into being is in itself a good basis for compliance.
  The responsibility of companies in the public sector should not be limited to the creation of the code but should include its implementation. For example, the civil effect of the code can be realized by getting the board to report on compliance in its annual report. The obligation to report brings with it the obligation to explain why certain rules from the code have not been observed, for instance. It would then be up to the shareholders to form an opinion on this matter. After all, the general meeting of shareholders is the body to which the annual report is submitted for assessment. It could express its discontent about the report in terms of its willingness to approve the annual accounts, which means that the response to a failure in compliance need not be without a sanction.

- *Supervisory board level*
  The supervisory board should be composed of interests other than the company's profitability. How can this be achieved? Flexible, socially oriented arrangements are the most appropriate way of achieving this, such as an appointments policy geared towards recruiting supervisory directors from a wide spectrum of interests; wise men and women with a great many years of experience in social functions. This basic profile for a supervisory director can be laid down in the Articles of Association.

- *The level of the shareholders' meeting*
  The shareholders' meeting can play an important role in representing public interests. While it is true to say that shareholders are only interested in the profitability of the company and therefore in the share profit to be gained, the interests that shareholders represent, or believe they should represent, are determined by the shareholders themselves. Shareholders as individuals could choose to allow themselves to be led by more idealistic motives. Given that public interests are best represented by those who are directly involved, we propose that those with a vested interest in a public interest, i.e. private interest groups (PIGs; also see section 11.4.3) such as environmental or consumer organizations, should be given the opportunity to purchase shares. Since it is not realistic to suppose that non-commercial organizations have sufficient funds to purchase shares, companies should meet private interest groups part of the way in this respect. They might do so by issuing shares at reduced prices. This would enable the shareholders' meeting to grow into a forum for weighing up public interests and would allow socially acceptable trade-offs to be made between interests. Trade-offs that take place in this way are both public and transparent, and can therefore be verified. In this way, strategic behaviour that might harm public interests stands no chance of success.

  The process of making shares available to private interest groups in this way could also be laid down in the Articles of Association. This applies equally to the distribution of shares among the various categories of shareholders.

It is essential that the relationship between public-interest shareholders and private commercial shareholders should not be left to chance. The way the shares are distributed provides opportunities to incorporate incentives for efficiency. If the representatives of public interests were to be given 51% of the shares and the private shareholders 49%, this would kill two birds with one stone. The private influence would still provide an incentive strong enough to realise high efficiency, while the 51% public share would still safeguard the serving of public interests.

The above leads us to the following conclusion. As we saw in 11.5.1, traditional legal rules do not suffice to curb strategic behaviour. The only way external signals can enter the system is by offering the system elements for selfreproduction. This can be achieved with hybrid governance, with incentives built in into the governance of the enterprise in such a way that the enterprise, as it were automatically, refrains from strategic behaviour.

11.6 REGULATORS

Network-based industries in the USA have traditionally been organized as private enterprises, and private monopolies and oligopolies are common. In the US, regulators were brought in as a countervailing power. Within such settings, heroic battles were fought in the last century between private companies and regulators, e.g. in the telecoms sector (Temin and Galambos [1987]) and the aviation sector. (Vietor [1995]) In Europe, more or less parallel to privatization, regulators were recently set up following the American example to supervise private monopolies and oligopolies and safeguard public values at stake in these sectors.

Apparently, the institutional design, organization and working methods of these regulators are widespread concepts, but their effectiveness is disputed. More specifically, regulators should be strictly independent; they should apply clear rules laid down at the political level, and their working methods should be transparent. Independence, rule-based operation and transparency are undeniably part of a cast-iron democracy mantra, but it is doubtful whether these principles will automatically suffice to curb the excrescences of strategic behaviour in the network-based industries. Below, we will explore for each of these principles what risks are involved in interpreting them too literally. We will also explore reinterpretations of these principles that may be more effective, without affecting their essence.

11.6.1 INDEPENDENCE?

Independence allows for impartial action without reducing information asymmetry

A regulator should be strictly independent. (De Ru and Peeters [2000]) It should be able to make its decisions independently. Independence ensures that a regulator need not worry about a possible backlash of his decision against himself. Independence translates into a great distance from the players in the field.

But how effective is strict independence? To what extent does strict independence help to curb strategic behaviour? One of the main reasons why strategic behaviour is so rampant and proves to be so difficult to fight is the information disadvantage of the regulator vis-à-vis companies in the sector. The regulator has to familiarize itself with the capillaries of the companies; it has

to study cost-price calculations and decide whether the returns earned are reasonable. The regulator must have "state of the art" technical know-how, operate on at least the same level as the companies that have a potential advantage because of the commercial incentive they feel to build up and maintain a technological head start. In practice, this is rare if not impossible. (Ten Heuvelhof and Stout, [2003])

The regulator depends on other players for its information. Information is an asset. To acquire it, the regulator has to open itself up to others and give up its strict independence.

For example, in its day-to-day operations, OFTEL, the British regulator, actually proved to be highly dependent on other actors, also for obtaining information. (Hall, Scott and Hood [2000], p.8) OFTEL proved to be not only highly dependent on other regulatory actors, but on a large variety of industrial players with divergent interests including consumer organizations. In our case studies on Microsoft and AT&T, we observed similar phenomena for the European Commission and American regulators.

Reducing information disadvantage by intensive contact with the field

Of course, much information asymmetry can be removed by a statutory obligation to supply information. Supported by legislation, the regulator can oblige companies to provide the relevant information. However, this does not remove the asymmetry. The information that the regulator obtains in this way is 'need to know' information. In addition to that, there is 'nice to know' information. The regulator can only obtain this type of information by operating in the field and by seeking the vicinity of the important players. This is how the regulator can build up the required intelligence.

The opening up of markets offers a good starting point for a strategy to increase the regulator's knowledge. Although it is very difficult for the regulator to reduce its information disadvantage in the regulator-monopolist relationship, it has more possibilities available in a market that is open, however limited the degree of openness may be. Entrants faced with an aggressive defensive incumbent will be inclined to seek the support of the regulator. This support will be materialized by providing company information that is difficult to come by and by qualitative comment on 'need to know' information provided by the incumbent. For example, OFTEL proved to be less dependent on BT for its information when more companies appeared on the scene. (Hall, Scott and Hood [2000], p. 136 and 206) The European Commission was informed of Microsoft's strategic actions by its competitors and suppliers of complementary facilities.

In general, one can say that independence should be safeguarded in *structural independence*. At the institutional level, the regulator should be truly independent. But in policy and work processes, the regulator should adopt an outward focus and move into the field. Distance is a dangerous strategy and 'being there' a dire necessity. The regulator should work alongside the companies; they should be on committees together, do research together, carry out pilot projects together and conduct evaluations together. In short, *process bundling*. In these work processes, the information that the regulator needs to make up some of its disadvantage will flow freely.

11.6.2 RULES?

There are two reasons for having the regulator operate on the basis of, and within, clear rules established by politicians. The first is that the inspected companies have a right to know what is permitted and what is not. They make big investments and play the game with brinksmanship. This is fair only under the condition that the rules in force are clear. The second is that, in many cases, regulators have been given autonomy from political superiors. If these political overlords still want a grip, they will get it by fixing clear and detailed rules and ordering the regulator to

operate within the framework of these rules. This is how the minister can still deliver on his political responsibility.

Strict enforcement is hard to combine with negotiating and process bundling
Clear and detailed rules should be complemented by strict enforcement. The regulator should therefore supervise compliance with these rules and enforce them strictly in the event of non-compliance. However, the regulator as an enforcement machine is bound to provoke tensions. Hall et al. have convincingly demonstrated that much of the regulator's work takes place in bargaining processes. Negotiations will proceed more smoothly if they take place harmoniously. Strict enforcement that works out unfavourably for companies with which the regulator will have to negotiate again at a later stage will not improve the atmosphere in those negotiations. Likewise, the desired process bundling described above will be arduous if the regulator repeatedly spoils the atmosphere by strict enforcement. (Hall, Scott and Hood [2000], p. 203)

Enforcing rules requires a long lead time at odds with immediate effective action
Supervising compliance with rules and enforcement demands a long lead time. It usually takes some time for the regulator to establish an infringement of rules. The regulator will then first try to put the norm-deviant company back on the right track with mild measures. These will be followed by formal cautioning, which may eventually be followed by formal enforcement actions. Strategic behaviour of the norm-deviant company may considerably prolong this period. The company may at least lodge an objection and an appeal, which will take a few months. It will have even more possibilities of gaining time. For example, it may create the impression that it is willing to fulfil the requirements set by the regulator, whereas in reality it is not. Both the Microsoft and AT&T cases have shown this convincingly. It may also try to gain support among third parties for a somewhat more lenient treatment by the regulator.

However, companies are sensitive to quick decision-making, particularly in the transition period. New companies venture into the market and it is important for them to gain customers quickly. In transition periods, new products and services will be launched in the market. The market for these new products and services still has to be divided. Strategic behaviour that induces customers to choose one particular company instead of another pays off handsomely, especially during this period. A slow response to such behaviour makes it even more attractive.

Task competence for regulators
To enable regulators to operate more effectively, they need to be given more scope than the rules allow them. (Ten Heuvelhof and Stout [2003]) They should be given more possibilities of acting ex ante. Proactive action is not only desirable, but even necessary. The concept of task competence might be suitable here. The task description might be to guarantee proper competition. This will give the regulator great freedom of action, as long as it takes place in the context of its task performance.

11.6.3 TRANSPARENCY?

Transparency facilitates checks and creates certainty for norm addressees

Regulators should be transparent. (De Ru and Peeters [2000]) It should be clear to the outside world how regulators deal with the market parties, how they interpret the rules they have to enforce, what criteria they apply, what sanctions they impose and what their priorities are. Such transparency is necessary for two reasons. The first is that political authorities want to know how the regulator operates. The second is that the companies falling under the regulator want to know what they can expect. What does the regulator monitor? What does it take a grave view of and what does it turn a blind eye to? They can request this transparency to obtain legal certainty. (De Moor-van Vugt [2001], p. 5)

However, transparency hampers unexpected and surprise action

The question is to what extent transparency improves the regulator's position in the arena in which it operates. What matters to the regulator's position is its information disadvantage compared with the companies in the field. Although it is inevitable for a regulator to lag behind the companies as regards the whole of the available information, a regulator has a natural advantage on one point in the information portfolio: its own mode of thought and its actions. What does it focus on? What does it pay special attention to? It should cherish its advantage on this point. The question is therefore how desirable transparency is. The ultimate consequence of full transparency would be that the regulation no longer holds any surprises for the inspected companies. However, regulation should never be fully predictable, because complete predictability makes it very easy indeed for a strategically operating company to thwart the regulator and prevent it from making 'accidental discoveries'.

Transparency exposes the regulator to information disadvantage

The regulator can even undo much of the information disadvantage by not making clear what information it has actually available. It will be obvious to companies that the regulator knows less than they do. However, not knowing exactly how much less the regulator knows weakens their strategic advantage. If companies are uncertain, they will prefer to be safe rather than sorry and keep a safe margin about what the regulator knows. Transparency can all too easily undermine this, because it allows companies to find out exactly what the regulator knows and attune their actions accordingly.

It will be more difficult to repent and change course for organizations with maximum transparency than for organizations that feel less spied upon. Organizations with maximum transparency realise that their change of course will not go unnoticed by the outside world and that it will provoke criticism of the actions performed in the past. In the light of this change of course, it will be difficult to defend the old, abandoned course. The learning organization will at least suffer serious loss of face. In short, organizations are entitled to their own domain, screened off from the outside world. Some discretion towards organizations stimulates learning processes and eventually benefits the quality of the organization's operations.

Ex post accountability

The solution to the dilemma is to shift the emphasis from transparency to subsequent accountability, which, of course, involves a certain transparency. The regulator should be able to account at a later stage for its actions and its failure to take action, for its choice of priorities and posteriorities and for the criteria it uses. These accountability processes can be in line with two traditions. The first is that of enforcement under administrative law, in which the administration nearly always has some discretionary powers. The standard provision in administrative regulations is: "the board *can* ….". The point here is that the regulator is left some scope and that it may be asked afterwards to account for the way it used its discretionary scope. This rule should be coupled to the task competence suggested above to replace traditional regulations. The regulator would then be asked afterwards to account for the way it interpreted its task competence.

The second tradition is enforcement under penal law. Organizations that have duties and responsibilities in investigating criminal offences and prosecuting suspects have always had plenty of scope to operate and build up an information position. They are not obliged to provide maximum transparency beforehand and, as regards prosecuting in individual cases, they have many possibilities to follow their own line of action. Of course, they have to account for their actions afterwards, although this may be to a limited circle of authorities.

11.6.4 NEW REGULATION?

A regulator that is given the scope to operate in the way outlined above is better able to address strategic behaviour. Its being intertwined in processes enables it to gain information. This information helps it to make up for its information disadvantage. Although this will not completely undo the information asymmetry, it will reduce it. Allowing the regulator to operate in opacity reduces the effect of the remaining information disadvantage even further.

Containing the disadvantages of a regulatory risk

Although this may sound attractive, there is a downside to such changes that deserves to be mentioned. Without closer attention being paid to them, such changes would imply a regulatory risk (Parker [2003], p. 85-86) for the market parties. In addition to their 'normal' commercial uncertainties, companies now also face uncertainties arising from this regulatory risk. Like every other risk, this will put up costs. Regulation in the UK has been described as "a discretionary system where negotiations and personality are becoming its most important feature". It is turning into a 'game' between industry chiefs and regulators because regulation does not provide a clear and certain set of rules within which the industry can take economic decisions. Rather, investing in influencing regulators and changing the rules of the game are becoming an industry in themselves, consuming resources and increasing the burden of regulation. (Veljanovski [1991], p. 26) This regulatory risk is dealt with in the literature as something that should be avoided at any price. On the other hand, the lesson of this book is that 'any price' is too high a price. When deciding about a possible reduction of the regulatory risk, the government should weigh the extra cost of a certain regulatory risk for companies against the advantages of fewer possibilities for strategic behaviour. This will create a more balanced picture.

The government might allow the regulatory risk to continue to exist on a selective basis. This would be possible because the regulator uses these options only with respect to companies that behave strategically. It should apply the 'traditional' norms towards the other companies.

CONCLUSION

Strategic behaviour is difficult to catch. It cannot be proven clearly. In many cases, it can only be observed in the course of time, afterwards, when the 'picture is complete'. It changes rapidly and behaviours used in one form can be continued in a different form. If this were otherwise, it would probably not amount to strategic behaviour. This means that high demands are imposed on the counterforces. Strategic behaviour is typically the behaviour of intelligently operating actors that are reflective, act contingently and are able to hide their actions and underlying motives. Only actors that are equally intelligent, know the sector inside out and can, in turn, also be smart when they have to, are able to resist it. It is the regulator that has to realise the

promises of the operation of market forces and contain the strategic behaviour of the parties concerned. However, the case studies demonstrate that this is successful only to a very limited extent. This is why we have suggested two alternative types of arrangement in addition to the traditional counterarrangements of competition engineering, skimming returns and consumer protection. They are *hybrid governance* of 'hard law' and 'soft law', and regulators with higher degrees of freedom in their actions. We have briefly set out the advantages and disadvantages of using either of them. The use of these arrangements is unlikely to make all strategic behaviour a thing of the past and it is questionable whether that is desirable. The reason is that the great and many institutional changes that have taken place in these sectors were, and are, also meant to incentivize companies to start operating more cleverly and accurately. Offering room for strategic behaviour fits in with this, although strategic behaviour should not be allowed to take on forms that undo the advantages of the changes.

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