Price regulation in declining demand industries

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Abstract:

In many countries several regulated sectors, as for instance, electricity or traditional postal communications, have been through a process of declining demand in recent years. These processes have multiple causes (technological, consumer's preferences changes, etc) but general have in common the fact they are seen as irreversible and permanent. This raises crucial questions to regulators not only regarding the adequacy of the instruments traditional used to regulate prices (in particular rate of return regulation and price cap) but also regarding the need of price regulation. In this paper we compare, through a stylized theoretical model, the welfare consequences of two alternative regulatory approaches, regulating prices by price cap or not regulating prices, in a context of declining demand. We consider two alternative vertical market structures: one with an upstream monopoly and another with a downstream monopoly. We conclude that the effects of price regulation depend on the magnitude of the demand reduction. If it is expected a weak demand reduction, price regulation contributes to welfare enhance. On the contrary, if it is expected a strong demand decrease setting no price cap will lead to better welfare results. These conclusions apply to both vertical market structures.

Keywords: price regulation, declining demand, vertical market structure

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