

Abstract:

Time inconsistency and asymmetric information constrain regulators. We study how political ideology interacts with these two forces in the regulation of electric power distribution companies. More conservative political ideology of the state and party affiliation of regulators have a significant positive influence on the rate of return utilities earn on their equity. Systematically higher rates of return lead to higher levels of investment in the electric distribution system. At the same time, more conservative political ideology of the state and party affiliation of regulators have a significant negative influence on operational efficiency as measured by the amount of energy that is lost through distribution and transmission. We explain these empirical patterns in a model of an asymmetrically informed utility regulator who is unable to commit to future policies and a utility who invests and exerts unobservable effort. Increasing the weight a regulator places on utility profits relative to consumer surplus increases the rate of return granted to the utility and decreases the amount of unobservable effort exerted by the utility. Associating more conservative political environments with regulators who place more weight on utility profits than those in less conservative environments, we document an effective trade-off between strong investment incentives, which alleviates the problem of regulatory hold-up because of time inconsistency, and strong incentives for efficient operation, which alleviates the problem of asymmetric information.