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A Tune-Up Model of Regulation

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Regulators cannot continuously and perfectly monitor firms. An alternative considered here, related to "fire alarms", is "tune-up regulation:" the regulator sets a price at discrete, unforeseen, times. This paper assumes that marginal cost follows a stochastic diffusion process, but that the regulator may not be able to continually adjust the regulated price. I show that the optimal price may be less than or greater than the expected level of marginal cost, and that the regulated price should be higher the steeper the demand curve, the lower the discount rate, and the greater the variance of costs. I also consider the benefit of changing the price following a change in marginal cost. This benefit is usually greater if at the time price was set, marginal cost was low.