BOOK REVIEW

REVIEW OF REGULATORY FAILURE AND RENEWAL: THE EVOLUTION OF THE NATURAL MONOPOLY CONTRACT BY JOHN R. BALDWIN—A STUDY PREPARED FOR THE ECONOMIC COUNCIL OF CANADA, 1989

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Professor Baldwin's book *Regulatory Failure and Renewal: The Evolution of the Natural Monopoly Contract*, presents both an historical and theoretical analysis using principles of law and economics to assess why public enterprise has been preferred to regulation in controlling the provision of monopoly goods and services to achieve public ends in Canada as opposed to the United States where regulation has been preferred. Dr. Baldwin's work is built upon the premise that both public enterprise and regulation through independent tribunals are responses to the failure of the original instrument chosen to control and direct monopoly enterprises—the franchise contract.

The author's historical analysis covers the period between the mid-1800s and the 1930s. This time frame permits a review of the process of consolidation of privately-owned locally-oriented railways, energy suppliers and telephone companies into single firms serving much larger geographic markets, spanning provincial or state boundaries in many cases. According to conventional wisdom, this process of intercorporate consolidation in both Canada and the United States represents the evolution of "natural monopolies" in the provision of these basic infrastructure services.

Dr. Baldwin's explanation of why the original monopoly franchise concept was flawed and ultimately abandoned in both Canada and the United States is built upon the transactions cost analysis literature pioneered by Oliver Williamson, an approach which has often been employed by the antitrust law to assess the efficiency implications of vertical integration. Transactions cost analysis posits that transactions will be internalized within the firm if there is a failure in the development of workably competitive markets between arm's length parties for such transactions. One focus of transactions cost analysis is on the costs and imperfections in the market for information necessary to support efficient sales contracts.

By analogy, Dr. Baldwin contends that this approach can be used to assess the weaknesses underlying the original franchise transaction between public (as represented by the state) and the private developers of a utility service. As noted, transactions cost analysis identifies market failure largely based on examination of structural factors which prevent access to economic information by each side of the transaction to permit rational choices being made as well as the costs of generating information for weighing the marginal utility of the transaction to the potential parties. Factors contributing to transactions failure enhance internalization of transactions and can include lack of market transparency because a few bargains are struck, asset specificity and longevity, disproportionate control of knowledge by one side of the bargain, and market imperfections that result in few potential suppliers.

Dr. Baldwin emphasizes asset specificity and asset longevity as the principal reason behind the failure of the franchise approach to controlling emerging monopoly utilities. For these franchises, transaction internalization meant a shift in hands-on managerial control with respect to satisfying consumer expectations from an external contract (the franchise) to an ongoing government oversight situation.

Dr. Baldwin contends that the selection of independent regulatory agencies in the United States as the second best alternative to franchise contract was largely a result of constitutional recognition of the right of private property and the constitutional independence of the American judiciary. These factors created strong incentives against abrogation or expropriation, on unfair terms, of the monopoly franchisee's business by the state once the franchise began to fail due to increased utility monopoly power. Dr. Baldwin reasons that, without the threat of judicial intervention in Canada to prevent state confiscation of the franchise, Canada readily accepted the confiscation option, as indicated by its preference of "the public enterprise option".

Dr. Baldwin's study presents a radical but very useful departure of the traditional analysis of the United States preference for direct regulation of public utilities. The more traditional approach regards tribunal-based regulation as inconsistent with the theory of responsible government developed in the British unitary state. On this basis regulatory tribunals are regarded as primarily an American invention reflecting the checks, balances, and political tensions between the executive and legislative branches rather than a reflection of constitutional constraints against the exercise of state power. The traditional approach also embodies the presumption that goods and services provided by public utilities are more like public goods such as defence services which, because of their overall importance to the fabric of society and to the economy, should (absent compelling reasons otherwise) be provided by the state.

By emphasizing that both public enterprise and direct regulation are second best alternatives, at least in historical sense, to an express "social contract" between a consumer's representative (the state) and a producer, Dr. Baldwin has presented an intriguing construct under which options for moving away from both government ownership of business and direct regulation of business might be assessed. Specifically, the transactions cost analysis employed indicates that, to reverse the long-standing trend to government intervention in utilities, policy measures directed to overcoming information market imperfections in conjunction with institutional measures to establish a more politically acceptable social contract with the monopoly supplier might be worth examining as a less costly substitute to either form of business control.

The franchise concept of utility control has in fact re-emerged in the last few years. British Telecom is presently governed by renewable five year licenses established by its regulator. Under these licenses, regulatory controls, principally limits on price increases for service categories and policy and service undertakings, are established for each franchise period. The "regulator" is left with what is largely a monitoring and reporting role. Licence terms are "renegotiated" within the context of multi-apartheid regulatory proceedings involving various consumer interests and British Telecom with the regulator acting essentially as a contract arbitrator. Some U.S. state telecommunication regulators are also experimenting with longer term price and service commitments negotiated between the utility and consumer groups as a substitute for continuous "rate of return" and price regulation.

By emphasizing the legal and institutional dimensions to controlling monopoly power, Dr. Baldwin's analysis provides an element of sophistication concerning practical institutional reform missing in the economics literature of monopoly regulation which often offers only the option of complete deregulation where a formerly monopolistic firm is faced with potential competition. The economics literature to date has been unsuccessful in providing policy guidance on the more typical case where a multi-product monopoly utility retains dominance in its largest markets but is exposed to competition in newer, more technologically sophisticated product markets, or is exposed to greater purchaser sophistication and bargaining power.

The Baldwin analysis also suggests that the rationale for opting for public enterprise in lieu of regulation in the event of franchise contract failure should decline in Canada as a result of the establishment of the *Charter of Rights and Freedoms* and the development of a more interventionist stance by the courts in controlling

executive action under the *Charter* and under administrative law principles.

Finally, Dr. Baldwin has provided a useful framework for considering competition policy and enforcement measures as alternatives to direct regulation and state ownership. Judicially-backed consent orders can provide a detailed code of competitive conduct which embodies the same principle of social contract between producers possessing monopoly power and consumers as the original state/supplier franchise agreements examined by Baldwin in his study. For example, the ATT consent decree, which in 1982 settled a long-standing United States antitrust action against ATT for monopolistic pricing and other exclusionary tactics, established the principles for the regulation of ATT and the Regional Operating Companies. Since its implementation in 1983 it has become the principal instrument affecting the competitive evolution of the U.S. telecommunication services sector. In recent years, particularly since the adoption of the competition law reforms of 1986, Canadian prohibition orders, and more recently merger settlements, have also provided detailed supplier conduct codes. These requirements, which are subject to evolution through judicial modification as circumstances change, provide a minimum threshold of government intervention and a maximum amount of business flexibility for the parties involved.

The Baldwin approach to transactions cost analysis suggests that competition law measures could provide an adequate substitute for state enterprise or direct regulation where the rate of technological change in a domestic industry, increasing competition through international trade, or increasing prospects for entry in formally monopolistic markets, have increased buyer information, power, and sophistication, thus reducing the potential for information market failure in the industry. Under the Baldwin transactions cost approach, improved information market performance favours the substitution of one-shot negotiated controls over an industry in place of ongoing government intervention.

Regulatory Failure and Renewal provides a very important contribution to a reevaluation of the appropriate instruments for controlling business conduct in an increasing dynamic and competitive world in which many of the assumptions of micro-economic analysis, upon which natural monopoly economic justification of regulation or state ownership is founded, seem to bear less and less relevance.