REGULATORY REFORM

A HANDBOOK OF POSSIBILITIES

BY

RICHARD J. SCHULTZ

DEPARTMENT OF POLITICAL SCIENCE
AND
CENTRE FOR THE STUDY OF REGULATED INDUSTRIES
McGILL UNIVERSITY

PREPARED FOR

REGULATORY AFFAIRS BRANCH
BUREAU OF COMPETITION POLICY
CONSUMER AND CORPORATE AFFAIRS CANADA
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Introduction: Scope and Objectives

One of the most profound developments of the past decade has been the reassessment and restructuring of the relationship between states and their economies. This has been a phenomenon transcending geography, ideology, and the level of industrial and economic development. At the macro-level it has involved the rejection of once dominant central planning mechanisms and their replacement with market approaches. At the micro-level of specific institutions and techniques it has entailed variants of privatization or the sale of publicly-owned enterprises, and the reform of regulatory instruments for controlling economic behaviour.

The subject of this Handbook is the reform of economic regulatory instruments and techniques. Although all regulation has economic dimensions and consequences, the scope of this project is limited to reform in the regulation of what are commonly, and loosely, known as "public utilities" in North America -- namely, firms operating in the transportation, communications and energy sectors.

Economic regulation entails some form and degree of public control over both the structure of an economic sector and the behaviour of economic actors. The regulated behaviour may cover all or some of the following: entry into and exit from a

particular activity, the prices charged, the level of profits earned and the quality of service provided.

The restructuring and reassessment of regulation (and public ownership), associated as they are with attempts to place greater reliance on competition and market controls, have provoked considerable debate. This should not be surprising given the central role that regulation has played in North America for the attainment of public policies during most of the past century.

The debate thus far has polarized around two positions. On the one hand, for critics of regulation there is only one legitimate justification for its use: to correct for market failures. This position, which is favoured by most economists, bases its evaluation of existing regulation and its advocacy of reform on this single objective. Absent market failure, deregulation should occur. Other arguments that may be advanced to justify regulation are commonly dismissed as "pseudo-economic", and are perceived to be little more than attempts to disguise economic rent-seeking on the part of the presumed beneficiaries of government regulatory intervention.

On the other hand, there are the defenders of existing regulatory regimes who are wedded to the maintenance of those regimes as the only means for the attainment of existing policy goals, whatever the original rationale either for the goals or the introduction of regulation for their attainment. For those who

favour this latter position, advocates of regulatory reform, particularly in its presumably most extreme form -- deregulation -- are perceived to be little more than advocates of private monopolization, and "a return to the mean market mentality of the nineteenth century, to the elevation of private greed over the public interest" (Veljanovski, 1987, p.3).

Caught in the middle are those who believe that the goals pursued by regulation are more complex than its critics maintain. Furthermore, from this perspective, there may be public policies and instruments other than regulation that are more effective for their satisfaction.

One of the causes, and consequences, of this polarized debate is the widespread confusion over the definition and meaning of deregulation. Deregulation has been used as a generic term by both advocates and opponents to describe changes in regulatory roles and processes. Used in such a manner, the concept of deregulation has clouded, rather than informed, public debate and rational analysis of policy objectives and alternative instruments. The extent and implications of the confusion will be discussed below. For our purposes, the significance of the debate is that it underscores the value of this project which is to provide a survey of the range of possible reforms to regulatory regimes that could be introduced.

In this Handbook, we shall eschew the use of the term "deregulation" because it is largely a misnomer inasmuch as little actual deregulation has actually occurred in many sectors said to be deregulated -- such as, for example, American telecommunications (Crandall, 1990). Moreover, even when traditional regulatory instruments have been removed this has not lead to a situation, contrary to some critics, in which all government intervention, including other forms of regulation, has ceased to exist. In fact, as this Handbook will demonstrate, the normal, not the exceptional, development even when traditional regulation is removed is to introduce other regulatory instruments combined with other policies to attain traditional goals sought through the use of regulation.

The perspective of this Handbook is that regulatory reform is a more useful and embracing term to describe the process and the outcomes associated with the re-evaluation of government regulation. Regulatory reform can run the gamut from maintenance of traditional public goals while adjusting the means, in varying ways and degrees, for their attainment to fundamental redefinition and recasting of policy objectives and instruments. To build the case for a comprehensive appreciation of the possibilities for reform, it is necessary to analyse the alternative understandings of the function of economic regulation. The primary conclusion to be drawn from a review of the history of employment of economic regulation is that it has been justified on two broad grounds. In the first place, its original purpose was to act as society's

economic policeman to ensure that a regulated firm -- traditionally, in this case, a monopoly -- does not abuse its market power either to earn monopolistic profits or to discriminate among its customers. This form of regulation is usually described as behavioural regulation, with the specific behavioural aspects narrowly defined.

The second basis for the employment of regulation dates from the 1930s and the Depression era; society seeks to limit competition either to protect or promote the interests of the individual economic actors involved or to promote some presumed larger public purpose. In these instances, in the words of Kay and Vickers, "where competition is feasible but undesirable", regulation is used to restrict competition (1990, p.228). When regulation is so used, the types of regulatory constraints are expanded to include structural as well as behavioural regulation. Airline, highway transport and broadcasting regulation in North America represent examples of this type of regulation.

It must be emphasized that the preceding does not assume that society does in fact benefit from this type of regulation or, alternatively, that the social benefits are greater than those conferred on the regulated firms including their employees. Indeed, the evidence suggests that, in too many cases, the opposite is the result: regulated firms are the prime beneficiaries of the "private use of the public interest", to invert Schultze' phrase (Schultze, 1977). Our point is simply

that historically there have been cases where a broader positive objective than simple monopoly control has been pursued through the use of economic regulation.

Given that economic regulation has been employed in North America particularly for both the negative and positive purposes just described, it would seem appropriate to assume that regulatory reform initiatives would be introduced to deal with one or the other types of regulation. In other words, one should assume that the purposes of regulatory reform will be, at a minimum, as complex as the original justifications for the introduction of regulation.

In fact, as shall be seen shortly, there is an additional reason which emerges largely from the regulatory initiatives of those countries engaged in privatization. Regulatory reform in this case entails the modification of regulatory instruments, structural and behavioural, again for positive reasons: to promote the introduction and expansion of competition. This third type of reform has involved a mixture of the original regulatory instruments, namely, the prevention of abuse of monopoly or dominant market power, as well as creating conditions within which competitive markets can develop and flourish.

The regulatory reforms that are the subject of this study have occurred in two distinct but increasingly overlapping

contexts. The first is the almost exclusively North American context where economic regulation has long been an important instrument for the control of economic behaviour in a number of sectors. In North America, the past decade has witnessed the most serious and concentrated attempt since the 1930s to assess the appropriateness and effectiveness of regulatory instruments. Elsewhere, attention has been directed at regulatory instruments as a concomitant of privatization initiatives. One common characteristic of these initiatives is that they have resulted in the creation of private monopolies or, at a minimum, firms capable of dominating their markets. As a consequence, governments embarking on privatization have had to address the fundamental question of how to prevent the abuse of their market power by the newly privatized firms. This has led them in a search for appropriate regulatory and other instruments, but, in most cases, they have been loath to adopt traditional North American regulatory techniques. This reluctance to adopt those techniques reflects a number of causes, not the least of which is the increasing dissatisfaction with them found in North America.

As noted, these two contexts are no longer distinct inasmuch as North American attempts to reform their diverse regulatory regimes increasingly are drawing on new regulatory approaches developed in countries engaged in privatization. The most obvious, but not the only, example of this is the recent introduction in the United States of a price cap regulatory system for telecommunications at the federal level, a system that was

introduced a few years earlier in the United Kingdom following the privatization of British Telecom. The United Kingdom's regulatory initiative was a direct consequence of a belief that North American regulatory approaches were not desirable (Littlechild, 1983).

Although there have been a number of other studies of regulatory reform, they have been primarily sector or country specific, and have sought to analyse the process and consequences of reforms. Alternatively, some studies have sought to describe and evaluate the attributes and relative merits of individual reform proposals at a conceptual or theoretical level. This Handbook takes as its focus the Canadian experience with regulatory reform, with the purpose being to describe the major alternative techniques and instruments that have been employed in Canada. Where Canada does not provide examples of other substantial reform alternatives that have been introduced, the Canadian experience will be supplemented with examples drawn from other countries.

Although Canada is normally not thought to be one of those countries that has undertaken comprehensive regulatory reform, it could be said to have both a long and a short history of such reform. It has a long history because possibly the first major act of regulatory reform was introduced in Canada, in 1967, when the regulatory regime for railway pricing was fundamentally revised (Heaver and Nelson, 1977). Instead of the traditional

tariffing system, railway pricing after 1967 was subject to a form of banded or minimum-maximum pricing controls, with the railways given considerable freedom within these limits to set their own prices in response to their understanding of economic conditions. This specific reform was important not only because of its immediate and dramatic impact on the performance of Canadian railways (Caves and Christensen, 1978), but because the example clearly influenced subsequent American transportation regulatory reforms.

Canada, compared to some countries, has a relatively short history of regulatory reform in that most Canadian reforms were introduced only recently and largely follow the precedents set in the United States and elsewhere. Despite the recent nature of these reforms, however, it can be said that Canada is now experimenting with and employing a wide array of new and modified approaches to traditional regulation.

The assumption of this Handbook is that the Canadian experience offers some useful conceptual and design support for other countries in which regulatory reform is currently being contemplated. Canada's experience may also have a wider relevance and value due to its long tradition of combining economic regulation similar to that employed in the United States with public ownership, which has been the norm in many other countries. This tradition of combining regulation and public ownership has been, until recently, unique to Canada, and it is a major factor

in shaping both the development of Canada's use of regulation as a primary instrument of governing and its recent embrace of both regulatory reform and privatization (Schultz, 1978). Consequently, for those countries that are engaged in privatization, the Canadian experience may be instructive in aiding them to develop alternative forms of public control during the transition from monopoly to competition.

This Handbook consists of four parts. The first is a discussion of the purposes of regulatory reform which is presented in Chapter One. While these may be obvious to some readers, the ideological debate referred to above suggests that they cannot be taken for granted. Clarifying the purposes of reform will require a discussion of the range of purposes for which economic regulation has been employed and how those purposes may have become less relevant, less viable, or just as importantly, have been supplemented by additional goals.

One of the interesting aspects of the debate over regulatory reform is that it has caused a reconsideration and reassessment of traditional regulatory institutions as well as policies, techniques and methods. In particular, where separate, non--departmental regulatory agencies -- particularly those granted a significant degree of autonomy from political authorities -- have been primary instruments, one aspect of the debate over regulatory reform has been the appropriate nature of the political-regulatory relationship. Chapter Two describes

various macro-institutional reforms that have been introduced or proposed.

Chapter Three categorizes and describes the major reform alternatives in regulatory techniques and objectives that have been introduced in Canada, supplemented, as noted, with non-Canadian examples such as price cap regulation. One of the most important aspects of the debates over both the macro and micro components of reform has been the relationship between regulatory reform and the roles and responsibilities of competition/antitrust policy and authorities. Given that one of the central, albeit not the only, objectives of regulatory reform is to place greater reliance on market forces, such reform has obvious implications for competition policy and its instruments.

Chapter Four surveys the principal consequences of regulatory reform as it pertains to competition policy. In particular, it looks at both the enhanced role of regulatory reform and attempts to make regulation and competition policy co-exist and complement one another, as opposed to the traditional assumption of mutual exclusivity.

Chapter One: The Purposes of Regulatory Reform

The purposes of regulatory reform should be both obvious and easily summarized. Unfortunately, this is not the case as there is no general agreement on either the meaning of the term or its measurement. The debate referred to above over the nature, not to mention the merits, of deregulation is a clear indication of the controversies involved. The confusion about the purposes of regulatory reform, other than over a tautological statement of those purposes, should not be all that surprising given that there is a corresponding lack of agreement on the meaning of the most basic concepts i.e., economic regulation and deregulation. It therefore is important for the purposes of this Handbook to clarify this debate so that the full range of reform possibilities can be appreciated. Consequently, we shall start with an attempt to clear away some of the conceptual ambiguity surrounding it.

1.1 Definitions of Regulation

As previously stated, economic regulation has been subject to considerable academic and public scrutiny for more than a decade, especially in North America. Numerous studies have sought to describe and explain its introduction, evolution and, most importantly, its flaws and failures. What is surprising, despite this attention, is that there is little general agreement on the meaning of the central concept: economic regulation. The following is a partial collection of some of the definitions that

have been offered. It should be noted that even though some of them may appear to be definitions of a wider phenomenon than economic regulation, the context in which they are used is one that is primarily, if not solely, limited to what we have described as economic regulation.

> Regulation ... is any constraint imposed upon the normal freedom of individuals by the legitimate activity of government (Brown-John, 1981, p.7).
>
> Economic regulation (is) the imposition of rules by a government, backed by the use of penalties, that are intended to specifically modify the economic behaviour of individuals and firms in the private sector (Priest et al, 1980, p.5).
>
> Economic regulation ... is the imposition of rules intended to modify economic behaviour significantly, which is backed up by the authority of the state (Economic Council of Canada, 1978, p.15).
>
> Regulation is the public administrative policing of a private activity with respect to a rule prescribed in the public interest (Mitnick, 1980, p.7).
>
> Regulation exists to affect the relationships in and results of private markets (Trebilcock, et al, 1978, p.11).
>
> Regulation attempts to restrict people's behaviour.... (Needham, 1983, p.1).
>
> Regulation is what regulators do (Anon.).

1.2 Definitions of Deregulation

Turning to the definitions of deregulation, we find an equivalent range of meanings for the same term. The following is only a partial listing.

> Deregulation entails "a reduction or substantial elimination of regulatory constraints" (Peltzman, 1989, p.2).

> Deregulation is defined as the loosening of restrictions on the entry and exit from a market and on the setting of prices (Rubsamen, 1989, p.105).
>
> Outright deregulation means "the total removal of a set of regulatory constraints either at once or in stages" (Stanbury, 1987, p.508).
>
> Total economic deregulation: "the whole panoply of controls over price, entry, exit or the range of business in which firms may engage, may be removed and the industry left to be disciplined by competition and the forces of the marketplace" (Swann, 1989, p.11).
>
> Deregulation may mean a **complete** restoration of market mechanisms and withdrawal of government intervention (Stone, 1982, p.250, emphasis in original).

As the above list suggests, the various attempts to define economic deregulation, and with it, economic regulation, reflect a mix of intentions, consequences, objectives, tools, processes, targets and temporal dimensions. The problems that result are not simply semantic and definitional in nature. The fact that neither regulation nor deregulation are "uncontested concepts" (Cox et al., 1985) can result in considerable confusion inasmuch as individuals may not be referring to the same thing when discussing either of them. Breyer, for example, refers in a recent volume to the deregulation of telecommunications; he even introduces the concept of "pure deregulation". Crandall, in contrast, contends in the same volume that no such deregulation has taken place (Breyer, 1990 and Crandall, 1990).

A related problem, given the disparate meanings that can be assigned to the concepts, is that anything can be subsumed under them depending on one's objective. Tunstall, for instance,

argues that both the American Telephone and Telegraph Company (AT&T) divestiture and the American government's decision to end the antitrust suit against International Business Machines (IBM) are examples of deregulation (Tunstall, 1986). Others have used any and every example of the presumed negative consequences of deregulation or regulatory reform -- such as airport congestion and lost baggage in the case of U.S. airline deregulation -- to attack the policy. As Alfred Kahn has noted in this context, "the tendency to regard every real or imagined problem as just another escape from the box we Pandoras opened in 1978, however, is not only sloppy thinking, it interferes with the search for sensible remedies" (Kahn, 1988, p.22).

But the sloppy thinking is not only on the side of those opposed to, or critical of, deregulation and regulatory reform. Even the former does not and cannot entail the "total removal" of public controls or "complete restoration of market mechanisms and removal of governmental intervention". As Kay and Vickers have argued, such a suggestion is "misleading" because regulatory reform "as often as not" entails the creation or implementation of "new and generally more explicit regulatory structures" (1990, p.223).

1.3 Purposes of Regulation

One of the primary reasons for the absence of generally accepted definitions of regulation, deregulation and, by

extension, regulatory reform is that the definitional conflicts and the concomitant ideological battles represent a lack of agreement on the underlying purpose or function of economic regulation. Absent such an agreement, we argue that it is difficult to develop a generally persuasive case for an acceptance of the proposition that regulatory reform involves a broad range of possibilities and not simply the single case of deregulation, whatever that means.

To address this issue and to build the case for a comprehensive appreciation of the possibilities of reform, it is necessary to analyse the alternative understandings of the function of economic regulation. A useful starting point is the traditional economics paradigm which contends "that the principal justification for public policy intervention lies in the frequent and numerous shortcomings of market outcomes" (Wolf, 1988, p.17). Although many analysts include several specific types of market failures, including externalities, narrowly defined public goods and inadequate information, we suggest that the primary, if not the only, case of market failure that justifies economic regulatory intervention, according to the traditional paradigm, is natural monopoly. A related aspect of this focus on a market failure rationale for regulation is the presumed purpose of regulation. Sherman's statement of that purpose is not atypical of the economics literature: "Regulation seeks the same outcome that an ideally functioning market can achieve" (Sherman 1989, p.17). In short, according to the dominant economic paradigm,

economic regulation is a social response to a specific form of market failure and it is meant to be a substitute for competition.

1.4 Problems with the Market Failure Paradigm

There are several problems with this rather narrow explanation, and justification, for economic regulation. In the first place, as Charles Schultze has noted, it involves "the rebuttable presumption that the desirable mode of carrying out economic and social activities is through a network of private and voluntary arrangements -- called, for short, 'the private market'" (Schultze, 1977, p.13). But he goes on to ask, why should "we think of the public sector as intervening in the private sector, and not vice versa"? Richard Nelson provides a partial answer which is particularly germane to our understanding of the complexity and scope of regulatory reform:

> The market failure perspective on the appropriate roles of government also strikes me as hindering our ability to see the institutional complexity that marks modern mixed political economies....
>
> A case can be made that the "failure" language of firms in markets ... is not even a particularly good way to start on the question of appropriate governmental roles. It connotes that governmental programs are a last resort, put in place, as it were, to do necessary or wanted things that other institutions are not doing adequately. This implies that use of government is or should be exceptional.... [But] the influence of government is universal. Government sets the basic ground rules that define and delimit how other institutions are to operate. And governmental means are the natural ones to employ to achieve purposes widely regarded as public purposes. Government is not there so much because other institutions occasionally fail, but to set the stage so that they can work decently well in their assigned arenas of

> action, or as a chosen instrumentality in its own right for getting a job done (Nelson, 1987, p.544).

There are two other major objections to the "market failure" explanation for economic regulation -- one conceptual, the other empirical. The conceptual argument concerns the assumption that regulation is a substitute for competition, particularly in the formulation offered by Sherman (1989). If competition is presumed to be a means for promoting economic efficiency in all its forms -- technical, allocative and innovative -- as well as a control for X-inefficiency (Berg and Tschirhart, 1988, pp. 9-10), then it is erroneous to see regulation as a substitute. As Littlechild has noted, regulation "is essentially a means of preventing the worst excesses of monopoly; it is not a substitute for competition" (Littlechild, 1983, p.7). If the extensive economic literature on the limitations and imperfections of economic regulation tells us anything, it is how deficient such an institution is in promoting and fostering economic efficiency, whatever its record in controlling unacceptable monopolistic behaviour.

The third problem with the conventional economic understanding of the rationale for regulation is that it is empirically inaccurate. In this regard, the following comment by Litan and Nordhaus is as valid for Canadian as it is for American regulation:

> If society were interested in regulation primarily as a tool to correct the defects in a private market, one would expect

> that regulation would stimulate the most important feature of the market: the use of the "invisible hand" of price incentives, which encourages but does not command private actors to act in the broader social interest. That most regulation has instead taken the form of commands and controls and that market incentive experiments are few suggests that the use of regulation as a tool of government policy cannot be ascribed to a widespread desire to perfect the workings of the private market (1983, p.39).

Furthermore, although some economists are inclined to dismiss such attempts as being "pseudo-economic" or worse, poorly disguised rent-seeking, it is a fact that governments have introduced economic regulation to pursue positive goals comparable to those pursued though public ownership. Regulation has not been used solely or even primarily to police monopolists, but as an instrument for promoting and, indeed, planning economic activities (Schultz and Alexandroff, 1985, pp. 5-13). In Canada especially, but in the United States as well, economic regulation has been introduced on occasion not because markets could not work, but because governments did not want them to work. Canadian airline and broadcasting regulation cannot be understood without an appreciation of this fact. In both of these sectors, where European and other countries relied historically on public enterprises to meet public goals, Canadian governments for many decades employed a combination of public ownership and economic regulation for similar ends. To argue that this was inappropriate is to stretch the value and utility of economic reasoning farther than they can legitimately go.

1.5 Rationales for Regulatory Reform

It is important to discuss the major reasons for undertaking the reform of regulatory instruments because they can have an influence on the choice of specific reform initiatives. One commonly cited reason for reform is to address regulatory failure. Such failure occurs when regulation not only is unable to satisfy the underlying public goals justifying its introduction, but also imposes costs on society which exceed any public benefits. Regulatory failure is most often assumed to occur in those sectors where structural regulation has been employed to limit or prevent competition.

In addition to instances of demonstrable failure, regulatory reform may be introduced for a number of other reasons. One important one is a basic change in the structure of the market which transforms it, or has the potential to do so, from a monopolistic to a competitive one. There are several causes of such change. One is the emergence, as a consequence of technological changes, of alternatives or substitutes for the original monopoly service provider. The development of long-distance trucking as a challenge to railroads in many of their traditional markets is an example of this. In these circumstances, the justification for railway regulation to control against monopoly abuse may no longer be tenable.

A related cause involves regulated firms which produce multiple products or services. Traditionally, the policy assumption may have been that the entire sector exhibits monopoly characteristics. But this may prove to be invalid, for several reasons. The telecommunications industry, for instance, was presumed for much of this century to exhibit economies of scale, thereby justifying both a monopoly market structure and concomitant economic regulation in all three of its major sub-sectors: local and long-distance telephone as well as equipment. Subsequently, it was shown that this was an invalid presumption for both the equipment and the long-distance markets; it may eventually prove to be eroded in the local exchange market as well.

There are two additional reasons that may justify regulatory reform. One is that the public goals sought through regulation may have been met or are no longer considered important. The other is that, even if those goals remain valid, regulation may be found to be an ineffective or expensive policy instrument relative to the alternative. In the former case, the underlying policy rationale for the use of regulation may be eroded if the goals sought have been satisfied sufficiently. In these circumstances, existing controls on economic actors can be relaxed or removed. The level of development of Air Canada and the Canadian Broadcasting Corporation in the 1980s, for example, was such that the controls introduced in the 1930s and maintained for several decades thereafter had lost their relevance.

Related to this is the fact that regulatory controls imposed originally to protect specific firms or sectors may lose their effectiveness. In much of the literature on economic regulation, there is a concentration on the role of regulation in constraining the behaviour of the producers of goods and services. Insufficient attention has been paid to the attempts to use regulation to control consumer behaviour in such sectors. Indeed, regulation, as a result of technological change and other factors, may prove to be grossly ineffective in constraining or preventing consumers, be they corporate or individual actors, from escaping or "exiting" from the choices offered them. Canadian airline passengers escaped to U.S. airlines; Canadian shippers did the same to use American railways for East-West traffic; and Canadian corporations have begun to use U.S. telecommunication systems to meet their overseas communication requirements (Schultz, 1990).

The final reason for regulatory reform relates to the argument discussed earlier that the purpose of regulation is to provide a substitute for competition. Economic research over the past three decades has shown persuasively that regulation is at best a blunt, imperfect and ineffective instrument for fostering market efficiency, even when minimally defined. Rate of return monopoly regulation provides few incentives for efficient performance, and even when regulators may seek to pursue such an objective they can be easily evaded.

There are several observations that need to be made about the preceding reasons for regulatory reform. The first is that while some, indeed most, of the conditions justifying a monopolistic market structure may disappear, there may remain significant sub-markets that continue to demonstrate monopoly characteristics. In such circumstances, some public controls to prevent abuse will remain necessary. Secondly, when regulation has been introduced or extended to pursue more positive goals than simply the control of unacceptable monopoly behaviour, notwithstanding any changes in the market conditions eroding the potentially useful role of regulation, the validity of the public policies may remain. Universal telephone service or remote community transportation service are examples. In these instances, reform of regulation may require a package of measures to protect or foster the attainment of these goals.

Finally, the transformation of traditional monopoly sectors to competitive markets may involve transitional problems. One such set of problems arises in markets where the traditional monopolist operates in multiple markets -- some monopolistic, some competitive. The problem for public authorities in this situation is to devise an appropriate set of public policies and effective instruments that will protect the competitive markets from unacceptable anticompetitive behaviour, such as predatory cross-subsidization from monopoly customers. A second set of problems arises in newly competitive markets where incumbent firms have advantages that may be exploited to prevent the development of

competition. Control of access to bottleneck facilities offers one example of the potential for anticompetitive behaviour.

1.6 Conclusion

To summarize the principle points from the preceding discussion, economic regulation has had both a narrower and a wider role as an instrument of governing than has often been assumed. It has been used narrowly to control against monopoly excesses; it has also been used to limit the operation, indeed the existence, of competitive forces so as to satisfy positive public goals. Regulatory reform addressed to the former cannot be assumed to be the same as for the latter. If deregulation is not one-dimensional, then regulatory reform cannot be treated as synonymous with deregulation.

Furthermore, deregulation may only entail the removal of traditional public structural and behavioural controls, not the elimination of all public constraints. To the extent that traditional economic regulation has been employed to pursue positive ends, the analysis of regulatory reform must include a discussion of how these objectives are addressed in the reform initiatives. Are they simply removed along with the regulatory controls, or does the reform consist of a mix of removal, diminution and addition of new instruments? Finally, the analysis of reform initiatives must address the two problems of promoting and protecting competition where a traditionally regulated firm

operates in both monopoly and competitive markets or where it currently dominates a market that is potentially competitive. In both these situations, regulatory reform may involve the use of regulatory instruments to promote competition. The relationship between regulatory instruments on the one hand, and competition/antitrust policies and instruments on the other, will be crucial.

Chapter Two: Reforming Regulatory Institutions

In the Introduction, it was suggested that there were two broad categories of regulatory reform. One was described as macro reform, which addressed fundamental changes in the basic regulatory institutions; the other was at the micro level, that is, specific regulatory processes and techniques. Of course, this distinction collapses at that point where the objective of regulatory reform is to eliminate a regulatory agency in order to substitute other forms or mechanisms of public control. The abolition of the Civil Aeronautics Board in the United States is an example of this result. There is no comparable Canadian example.

Notwithstanding the potential overlap of macro and micro reforms, the distinction continues to be useful in analysing the alternative approaches to be employed to accomplish regulatory reform. In this section, the major attempts to reform or alter significantly the basic Canadian regulatory institutions are described. The related issue of substituting alternative public institutions such as competition authorities for traditional regulatory mechanisms or, alternatively, changing the relationships between the two sets of institutions, will be discussed as a separate set of reforms in Chapter Four.

2.1 Regulation by Independent Agency

Where economic regulation has been introduced in North America the basic institution has been the independent regulatory agency, such as the Civil Aeronautics Board in the United States or the Canadian Transport Commission (now the National Transportation Agency) in Canada. Use of this type of institution dates from 1887 at the federal level in the United States, with the creation of the Interstate Commerce Commission. In Canada, it dates from 1903 with establishment of an equivalent Board of Railway Transport Commissioners. The core attribute of these agencies is that their members are granted some degree of tenure so as to engage in independent decision-making, albeit relatively so. The original assumption justifying such independence was that economic regulation should most appropriately be undertaken through specialized, impartial agencies guaranteed some insulation from partisan political pressures.

Despite the attraction of such agencies as administrative solutions to the need for economic regulation in the first half of this century, in the past thirty years especially, they have come under increasingly negative scrutiny. Critics have argued that far from being society's economic policing agency they have been "captured" by the regulated and their purposes subverted. A more benign, but equally critical, perspective is that regulatory agencies cannot be effective policemen because they do not possess the resources necessary to

match or even approximate those of the regulated firms. A third criticism is that the utility of regulatory agencies is undermined by the highly cumbersome, legalistic adversarial process that is most commonly employed by such agencies.

There are two related defects that are presumed to flow from such a process. The first is that the parties affected by the decisions of regulators may not be represented adequately in the process, thereby tilting the outcomes in favour of the regulated firms. The second is that the process can be used by parties, the regulated, their customers and possible competitors, for strategic purposes as part of the "regulation game" (Owen and Braeutigam, 1978) to slow or otherwise influence the nature and direction of regulatory change.

The final two criticisms of traditional regulatory institutions are derived from their presumed lack of responsiveness to changing circumstances. One criticism is that, whatever the original rationale for, or prior record of, regulation, regulators are far too "regulation prone" to adjust or significantly reduce their role in changing circumstances. In particular, this criticism suggests that when the original circumstances justifying the introduction of regulation such as a monopoly market structure, are no longer tenable or desirable regulators are reluctant to leave the field. A related criticism is that the insulation and independence of regulatory agencies

affords them an opportunity and the means to frustrate the efforts of political authorities to redefine regulatory priorities.

2.2 Remedies for Independent Agency Defects

A number of remedies, some procedural, others more comprehensive, have been introduced in Canada to address these defects in regulatory institutions. To ameliorate the imbalance in regulatory representations, for more than a decade the Canadian government, through the Department of Consumer and Corporate Affairs, has funded the interventions of consumer groups before federal and provincial regulatory agencies. More recently, agencies such as the Canadian Radio-television and Telecommunications Commission (CRTC) have awarded costs to public intervenors, to be paid by regulated firms, when the public interventions have been judged to have made a contribution to the proceedings. In one instance, the federal Minister of Transport both appointed and funded the participation of a designated "consumer advocate" during a regulatory review of air transport policies. Finally, the mandate of the Director of Investigation and Research, Canada's primary governmental advocate for competition, was amended to grant him the statutory right to appear before Canada's federal regulatory agencies.

There have also been reforms of a more structural nature to address the relationship between political authorities and regulatory agencies. The power to amend or otherwise revise the

legislative mandates of regulatory agencies has always been an option available to governments and Parliament and, in fact, has been used recently in the transportation sector. New Canadian legislation places much more explicit emphasis on reliance and development of marketplace controls than did its predecessor. Significant legislative change, however, can be time consuming and may not always be timely. Moreover, once enacted, where authority is delegated to an independent agency such an agency can enjoy considerable discretion as to its implementation.

To address potential problems flowing from regulatory discretion, there are three other possible mechanisms that can be made available to political authorities. In Canada, one of the most common is the power conferred on Cabinet to alter or set aside a regulatory decision -- either on appeal from a third party or on its own motion. The existence of this "political appeal" mechanism is perhaps the most significant feature that distinguishes Canadian from American independent regulatory agencies. There have been a number of procedural and substantive criticisms directed at such a power. In terms of the latter, the major criticism is that any Cabinet change may only influence the specific decision and does not set an effective policy precedent to guide subsequent regulatory decision-making (Janisch, 1978).

To address this problem, there have been proposals that two existing controls which are currently only partially available should be generalized. One is that regulations developed by

regulatory agencies, particularly those presumed to contain a significant "policy element", should require prior political approval before taking effect. This is the norm in Canada, but it has not been the situation in either the transportation or telecommunications sector (Canada, Royal Commission on Financial Management and Accountability, 1979, p. 316). Recent transportation legislation corrected this anomaly so that now only the communications regulator possesses an independent regulation-making power.

The second proposal is that Cabinet should be given the power to issue general policy directives to regulatory agencies. The purpose of such directives would be to reduce the broad discretion conferred on the agency by its enabling legislation to develop and implement regulatory policy. Such a power already exists in the Canadian broadcasting and transport sectors. In the latter, more recently, as part of a fundamental revision of national transportation legislation, Cabinet was granted a general power to issue policy directions "concerning any matter that comes within the jurisdiction of the [National Transportation] Agency and every such direction shall be carried out by the Agency" (Canada, National Transportation Act, 1987, section 23(1)). Government policy statements have had an impact on regulators outside the statutory framework as well. For example, in 1984 air transport regulators were receptive to a Government policy statement recommending that existing entry controls governing the air sector should be relaxed. Similarly, in 1985 the regulator of

the natural gas pipeline responded with an open access policy to the Government's initiative to create a competitive natural gas market. More on this will be said later.

Canada has also experimented with another regulatory reform to ensure that regulatory agencies are sufficiently responsive to political authorities, and to their definitions and rankings of regulatory objectives. That reform is to employ non-independent agencies either within traditional departmental mandates or just outside them. In either case, the agencies are subject to far greater explicit and overt political direction than is permissible with traditional independent regulatory agencies. Moreover, such agencies permit far more flexible regulatory processes than those employed by independent regulatory bodies.

Examples of the use of "departmental-type" agencies with regulatory functions created over the past two decades are the Foreign Investment Review Agency (now Investment Canada), the Prairie Rail Action Committee, the Northern Pipeline Agency, the Grains Commissioner, the Petroleum Monitoring Agency and the Canada Oil and Gas Lands Administration. In addition, mention should be made that, in certain cases, licensing regulatory responsibilities have been assigned directly to specific ministers. The determination of the recipients of cellular radio telephone licences, for example, is the sole responsibility of the Minister of Communications and not an independent agency.

2.3 Comprehensive Institutional Reform

Finally, attention is drawn to one of the major institutional regulatory reforms undertaken by Canada. A major criticism of existing regulatory approaches in both Canada and the United States has been the absence of mechanisms for the continuous and systematic analysis of regulatory goals and instruments. The traditional approach was to "hive off" an area to be regulated, confer it on a specific regulatory agency, coupled possibly with a corresponding sector-specific department which might be granted an overlapping or monitoring responsibility.

The problems associated with such an approach in the United States, as identified by Litan and Nordhaus, are equally valid for Canada:

> In short, there exists today no mechanism or procedure that requires the systematic consideration of the cumulative impact of regulatory burdens on particular industries, how these impacts can be moderated without sacrificing progress toward worthwhile regulatory objectives, or how the objectives themselves can be balanced against one another (1983, p.49).

To address these problems, the Canadian government created the Office of Privatization and Regulatory Affairs, headed by a member of Cabinet. One of the first initiatives of this Office was to develop a statement of regulatory principles

together with a "regulatory reform strategy". For our purposes, the following six principles should be noted:

1. Regulation is and will remain a necessary and important instrument for achieving the government's social and economic objectives. But the government intends to "**regulate smarter**".

2. The government recognizes the **vital role of an efficient marketplace and a dynamic entrepreneurial spirit** in generating the ongoing economic growth needed to improve the standard of living for Canadians, and it recognizes that regulation should not impede those values without the most persuasive justification.

3. The government intends to **limit, as much as possible, the overall rate of growth and proliferation of new regulation**. It will proceed on a pragmatic basis with increased emphasis on economic efficiency but with continuing protection of the public wherever appropriate.

4. With regard to existing regulatory programs, priority is to be placed on **reforming ineffective or economically counterproductive regulation**, but there will be **no program of wholesale deregulation**. On a case-by-case basis, there will be reduced regulation where the practical interests of the economy and job creation call for it, just as there will be **improved and even intensified regulation where public protection requires it**.

5. Regulation entails social and economic costs, and the government will evaluate those costs to ensure that **benefits clearly exceed costs** before proceeding with new regulatory proposals.

6. **A Minister will be assigned specific responsibility for regulatory affairs**, including improved management of the system and overall implementation of the government's regulatory policy and reform strategy. Individual ministers with regulatory mandates will be responsible for implementing and exercising their responsibilities in conformity with the spirit and objectives of this policy (Canada, Office of Privatization and Regulatory Affairs, n.d., pp.4-5, emphasis in original.)

The final statement of principle is particularly significant given the above criticisms advanced by Litan and Nordhaus. It should be noted that in 1991, this Office was merged into another government department.

The Office perceives its role as combining a catalytic and what it describes as a challenge function. The catalytic function is to encourage and stimulate "the streamlining of regulation, with the objective of reducing government intervention". The challenge function is to ensure "that no new regulations or regulatory amendments are approved without a full assessment of their impact on society".

Recognizing that it is crucial to any regulatory reform program to go beyond the articulation of a set of principles, the Canadian government has also implemented a rigorous and comprehensive set of requirements that must be met by all departments and agencies exercising regulatory responsibilities. A "regulatory planning system" has been created which requires individual governmental regulatory authorities to submit "Annual Regulatory Plans" to Cabinet for scrutiny prior to their publication. As part of this scrutiny, Cabinet is committed to establishing overall priorities "for the consideration and approval of regulation". Regulators are also required to submit a "regulatory impact analysis statement" with each regulatory recommendation to Cabinet.

The new Canadian regulatory reform strategy also emphasises the important role that public consultation can play, and it consequently imposes more stringent public notification and comment requirements prior to the imposition of new regulations. As part of this process, draft and final regulations must be accompanied by a set of "explanatory notes" covering the following aspects:

- the policy objective of the regulation;
- the need for the regulation;
- the content of the regulation;
- changes from the existing regulation;
- the timing of consultation and implementation of the regulation;
- results of previous consultation;
- a summary of the impact analysis; and
- identification of contact person(s).

In addition to this more rigorous process for the introduction of new regulations, Cabinet also has announced a wide-ranging review of existing regulatory policies, programs and instruments. All existing regulations are to be reviewed over a seven-year period, while Parliament is to do the same for all regulatory statutes over ten years. Provision has also been made for both reviews to recommend "sunsetting" or timed abolition. In addition, Cabinet has promised to undertake periodic policy reviews of programs involving several departments or agencies with the objective being the removal of inefficient and overlapping programs. Finally, the new regulatory reform policy commits the federal government to evaluate all regulatory programs for efficiency and effectiveness at least once every seven years. An

example of its commitment to such evaluations is found in the 1987 National Transportation Act (s. 266) which mandates an independent, public review of that and related legislation, such as the Shipping Conferences Exemption Act and the Motor Vehicle Transport Act. This review will begin in 1992 and is to be completed within one year.

Chapter Three: Reforming Regulatory Policies and Instruments

To reflect the complexity of reform objectives and the variety of reform modalities, we propose to employ a three-fold categorization of regulatory reform possibilities. The first category includes those reform initiatives that are predicated on the continued validity of the centrality of the objective of controlling against unacceptable monopoly behaviour. This set of reforms is often described as lightening or streamlining regulation rather than altering its core function.

The second category addresses the issue of regulatory performance in promoting economic efficiency on the part of regulated firms. These reforms are similar to the first category of reforms in that they assume that the regulation of monopoly remains central, but want to expand the narrow objective of such regulation.

The third category of reforms covers the most explicitly deregulatory initiatives. These are associated with those sectors where the presumption of monopoly is thought to be no longer valid or where there is a search for other instruments to attain goals once sought through the use of regulation. This category includes those regulatory reforms introduced explicitly to promote competition as well as those reform components that address public policy goals traditionally pursued through regulatory means.

The three categories are not, however, mutually exclusive; there is considerable overlap among them. For our purposes, individual reforms are placed in the category which appears to represent best the basic objective of the reform. Others may disagree with this assessment. There is also a fourth set of reform initiatives which will be described in the next part of this Handbook. These include the initiatives that directly address the relationship between traditional economic regulation and its instruments and competition policy authorities and enforcement. As a primary goal of many advocates of regulatory reform is to reduce traditional regulatory constraints in order to substitute reliance on market forces subject to public policies governing the operation of such forces, the development of new techniques and new relationships between regulatory and competition authorities merits separate discussion.

3.1 Category One: Modified Monopoly Regulation

One of the most obvious reasons for undertaking the reform of regulatory instruments and processes derives from changes in the nature of the regulated sector. In particular, in those industries where economic regulation has been introduced in order to limit the potential for abuse of market power, changes may occur which call into question the need for total reliance on regulation for such a purpose.

One such change, as mentioned, is the development of alternative sources of supply, thereby providing a new check on market power. A second change involves multiproduct firms where competitive provision of some of the products emerges as a possibility, thereby calling into question the traditional monopoly abuse justification for regulation of the full range of products offered by the traditional monopolist. In response to changed circumstances such as these, a variety of alternatives to traditional regulation have been introduced. The key point in this regard is that the fundamental premises of monopoly abuse regulation are not challenged by their introduction. Instead, the objective is to adjust the scope of such regulation and supplement it with other methods.

3.1.1. Contract Pricing

One of the first examples of regulatory reform which has assumed even greater significance in recent years is a provision allowing a regulated firm to make a contract with individual customers to provide them services at stipulated prices. This type of pricing contract, originally called "agreed charges" in Canadian railway regulation, was a breach in the traditional requirement that there should be no unreasonable or undue discrimination amongst customers of regulated firms.

"Discriminatory" pricing by means of contract dates from the Depression in both the United Kingdom and Canada, and it

was introduced to permit railways to respond to the emerging competition from the trucking industry. The practice was subject to a degree of regulatory supervision, including publication, and by law it had to be extended in Canada to any shipper who was prepared to meet the same conditions as those in the original contract, such as a stipulated percentage of the customer's traffic for a period of time. Over time, this pricing practice became an important means by which the railways could respond to new forms of competition.

The significance of contract pricing in transportation, as an example of regulatory reform, derives from the reduction in the scope of traditional tariff regulation and the associated reliance on customer-provider relationships to control for abuse of power, subject, as indicated, to some safeguards. Such contracts have assumed even greater significance in both the American and Canadian railway industries as a result of their respective 1978 and 1987 regulatory reforms which allow agreements for confidential contracts between railways and their customers that would be subject to minimal regulatory scrutiny.

Contract pricing has recently assumed significance in other sectors as well. In telecommunications, for instance, as a result of the development of competition in long-distance markets and the AT&T divestiture, and in energy with the development of cogeneration alternatives, contract pricing is emerging as a major

response to the development of competition and the wish of regulatory authorities to introduce regulatory flexibility.

According to Phelan and Pitalis (1988, p.141), local exchange companies in the United States are increasingly providing telecommunication services to individual customers on a contractual basis. The primary purpose of these contracts, which usually involve a discount from the tariffed rate structure, "is the attraction, stimulation, and/or retention of customer demand for utility services, especially if the customer has alternative sources of supply" (Phelan and Pitalis, 1988, p.144). Electric utilities are also employing such a means to discourage customers from developing their own generation resources.

Recently, the United States Federal Communications Commission (FCC) authorized AT&T to offer similar "discriminatory" contracts to some of its customers. In contrast, it is worth noting that, in the United Kingdom, British Telecom has not been permitted to offer such contracts to its customers for fear that their use would reduce the potential for competition between that company and Mercury Communications (Beesley and Laidlaw, 1989, p.46).

3.1.2. Regulatory Prohibition

A second type of regulatory reform introduced to respond to changing economic circumstances is a prohibition on the

regulated firm from offering a particular service or entering into a sector. This type of regulatory constraint is not particularly novel inasmuch as it was employed as early as 1913 when, as part of an antitrust settlement, AT&T agreed not to acquire any more independent telephone companies.

More importantly, it was a central part of both the 1956 and 1984 antitrust settlements when line-of-business restrictions were placed on AT&T. In the former, AT&T was prohibited from entering the computer services business; in the latter, the firm could not enter the information services business for a specified period of time. Similar restrictions were placed on the divested regional operating companies, particularly with respect to equipment sales. Both Canada and the United States have imposed controls on telephone company ownership of broadcasting licences, particularly those involving cable telecommunications which are seen as a potential competitor.

While there are obvious reasons for introducing such prohibitions -- including the increased burden on regulatory authorities, and the potential for anticompetitive behaviour -- there are also concerns about their appropriateness. Some observers argue that they may distort technological developments and serve as an unjustified protection for incumbent firms in the restricted sectors. According to this latter line of argument, regulatory constraints are not the most effective instruments for the protection of consumers and the promotion of economic welfare.

3.1.3 Regulatory Forbearance

One of the most common techniques of regulatory reform applied in North America in response to the emergence of new service providers in traditional monopoly sectors is regulatory forbearance. This technique has been employed in a variety of jurisdictions, national as well as provincial/state in both Canada and the United States. Despite its popularity, however, it is difficult to give a precise definition of the concept. As Janisch and Romaniuk perceptively note:

> "Regulatory forbearance" is not a legal term of art, nor is it an expression of such common usage as to be capable of unambiguous interpretation. Instead, it is a broadly descriptive, if poorly articulated, concept generally capable of encompassing a variety of regulatory initiatives that have the effect of lessening, if not eliminating altogether, the constraints imposed on industry participants by existing, legislatively-sanctioned administrative practices, procedures and controls (1985, p.463).

Forbearance, for example, may represent a decision not to extend regulation to a new activity for any or all economic actors. Alternatively, it may involve the reduction or removal of specific forms of regulatory control, again for some or all actors. It is important to note that, just as the form of forbearance can vary, so can the justification or rationale used in the decision to forbear (Janisch and Romaniuk, 1985, pp.466-470).

One primary rationale that addresses the original justification for regulation is that no party may be in a position to exercise excessive or "dominant" market power. Consequently, the assumption behind regulatory forbearance is that consumers would be better served and protected through the operation of competition than by regulation. An alternative rationale is that the costs imposed by regulating the activity will outweigh the consumer and societal benefits. Janisch and Romaniuk provide the following list of costs that have been cited to justify regulatory forbearance:

1. the detrimental effect on the overall quality of regulation as scarce resources are pushed to their limits;
2. the fiscal burden on taxpayers;
3. a reduced willingness on the part of firms to undertake risk-laden investments;
4. an impairment in the ability of firms to react rapidly to changing market conditions;
5. the risk that "regulated competition (may become) cartel management" and hence result in the worst of both worlds;
6. the dampening of incentives to innovate; and
7. the sheer waste of resources attending the regulation of firms that have no market power to begin with (1985, pp.468-469).

In Canada, forbearance has been employed particularly in the telecommunications sector. When the attachment of customer-owned terminal equipment was permitted, the Canadian Radio-television and Telecommunications Commission (CRTC) opted not to

regulate equipment providers, except the dominant telephone companies who, as noted below, were limited to participating in this market through some variant of structural separation. Similarly when competitive provision of cellular radio-telephone was introduced, the CRTC decided not to regulate either the new national entrant or the telephone companies which would be granted one of the two licences in the individual service areas if they established structurally separate subsidiaries.

Forbearance has also been practised in the markets for enhanced services, earth station services, and in the resale and sharing of telecommunication services. When Teleglobe Canada, Canada's overseas telecommunications provider, was privatized in 1987, it was placed under the jurisdiction of the national regulatory authority, but its privatization legislation contained provision for the regulator to forbear from regulating those activities deemed to be subject to sufficient competition. Forbearance was also attempted in the switched long-distance private line markets for the non-dominant carrier, but the regulator was denied permission to forbear by the courts.

Finally, in Canada, forbearance is practiced in regard to small pipelines under the jurisdiction of the National Energy Board (NEB). These pipeline companies are required to file their tariffs with the Board, and they are then regulated on a complaint basis only.

3.1.4. Structural Separation

Regulatory forbearance is a useful reform initiative where no economic actor can exercise undue market power so as to subvert the operation of competition. However, where traditional monopolists operate in both monopoly and competitive markets, forbearance may permit them to exploit the monopoly market to the harm of both their monopoly customers and the competitive market. The fear is that revenues from customers of monopoly services may be employed to lower the prices in the competitive markets. The concern is two-fold. In the first place, if cross-subsidization occurs, it may mean that prices for monopoly customers are not "just and reasonable". Secondly, the competitive market may be subverted by anticompetitive pricing.

One regulatory solution to prevent this type of problem is to require that the monopoly and competitive portions of a firm operating in both kinds of markets be compartmentalized in separate structures. These could be either completely separate subsidiaries or, alternatively, a separate corporate division. Either way, they will require some form of monitoring to ensure that cross-subsidization does not occur.

Both of these approaches have been employed by the Canadian regulatory authorities. The CRTC's decision to forbear regulation of the new cellular radio-telephone market was predicated on the requirement that the cellular business

activities of the telephone companies be structurally separate from their regulated telephone activities. A completely distinct, arm's length affiliate was required before the telephone companies would be allowed to provide cellular services. In contrast, the regulator decided that something less than a separate subsidiary was required for the telephone companies to sell telephone equipment, and it consequently insisted only that such activities be carried out by a separate corporate division. It should be noted, however, that in this case, forbearance was not granted for the telephone companies and they must therefore obtain regulatory approval for the tariffs for such equipment.

In the Canadian energy sector, similar regulatory solutions have been applied. Following decisions to deregulate natural gas prices, both federal and provincial regulators recommended the separation of the marketing and transportation functions of the integrated service providers.

3.1.5. Cost Allocation Manuals

An alternative to structural separation as well as an additional regulatory instrument to address concerns about the potential for anticompetitive behaviour is to develop rules for the allocation of costs and revenues among service categories. Obviously, the most important categories are those for competitive and monopoly services and, as is often the case in such circumstances, that for common costs. The Canadian

telecommunications regulator, after more than a decade-and-a-half of effort, developed a costing methodology which has been in place for the past three years.

Structural separation and costing methodologies each have their merits, particularly when the goal is to lessen the degree of direct regulatory control over corporate behaviour, while protecting the interests of the customers of monopoly services. However, they also have their costs. Structural separation may impose inefficiencies on corporations, but costing approaches can be expensive, arbitrary and raise difficult compliance issues. Furthermore, contrary to the expectation that they will lessen regulatory intervention, they may actually increase it, especially if non-regulated competitors challenge specific filings on strategic grounds. As the Federal Communications Commission in the United States has noted, the positive results obtained from costing systems:

> ... (may come) at a high cost to society. This is so because a cost allocation system can present a strong deterrent to anti-competitive activity and, at the same time, be so detailed and rigid that it imposes on a carrier a complex and inflexible rate structure, one that may have little relation to consumer demand. If such a rate structure is deployed in a competitive environment, it may result in distorted consumption decisions, distorted production decisions, and distortions of the competitive process (1989, pp.18-19).

3.1.6. Automatic Rate Adjustment Formulas

One of the more common proposals for regulatory reform that emerged in the 1970s was for an automatic rate adjustment mechanism for regulated companies. A major justification for the introduction of such a mechanism, in the context of a highly inflationary period, was to provide for a process more expeditious than the usual rate of return proceeding to allow companies to increase their rates.

Canada has introduced an automatic rate adjustment formula for only one regulated sector: the cable television industry. In 1986, the CRTC established a formula to allow cable companies to increase their rates on an annual basis without regulatory scrutiny, subject to certain conditions. The most important was that, provided adequate public notice was given, individual companies could increase their rates by 80 per cent of the Consumer Price Index (CPI). In addition, they would be allowed to "pass through" certain incremental costs as well as a percentage of specified capital investments. Any rate increase above the amount allowed by the approved formula requires regulatory approval.

Two points need to be made concerning this case of applying an automatic formula. First, unlike the formulas and proposals to be discussed in the next chapter, the Canadian cable television rate increase formula was not intended to address or

involve a productivity issue. The increases were not predicated on productivity increases. This leads to our second point, which is that the formula was designed solely to "lighten the burden of regulation" imposed on the cable industry. The question of actual or potential competition for the industry was not an issue in the introduction of the formula. In 1990, after considerable public opposition resulting from the widespread perception that individual cable companies had abused the new formula to earn excessive profits, the regulator introduced amendments to limit the level of increases permitted and the automatic pass through of specific costs (Canada, CRTC 1990).

3.2 Category Two: Productivity Inducing Regulatory Reforms

As was already mentioned, while it is common to suggest that economic regulation is a substitute for competition, this overstates the potential role that regulation can play. Littlechild's comment, cited earlier, would appear to be far more accurate: "Regulation is essentially a means of preventing the worst excesses of monopoly; it is not a substitute for competition" (1983, p.7).

Over the past three decades, there has been an increased degree of attention paid to the deficiencies of economic regulation, even when understood as a control against monopoly excess. Numerous commentators have argued that regulation amounts to little more than a form of "cost-plus" social control and, more

importantly, that it is intrinsically incapable of monitoring and assessing all but the grossest forms of regulated firm productivity. From this has come the additional critique that regulation provides regulated firms few if any incentives to be innovative or to improve their economic efficiency.

Until recently, these criticisms had little impact on either the regulatory authorities or their charges. In the last decade, however, in large part because of the emergence of competition in some parts of the regulated firms' markets, there has been a heightened awareness of the flaws in economic regulation, and a search for credible ameliorative techniques. These techniques have at their core a desire to continue to protect monopoly subscribers from firm abuse, while at the same time providing incentives to regulated firms to become as efficient and innovative as possible.

Notwithstanding the CRTC's cable television rate adjustment formula discussed above, which does not address the productivity and efficiency concerns, there have been no examples of Canadian attempts to introduce productivity enhancing regulatory reforms. Consequently, to make this Handbook as comprehensive as possible, it is necessary to consider the experience of other jurisdictions such as the United States and the United Kingdom.

No attempt will be made, however, to provide either an exhaustive discussion of the analysis of regulatory imperfections or a detailed analysis of the range of alternative reforms. Both are readily available in the literature (See Littlechild, 1983; Johnson, 1989; Kruger, 1988; National Telecommunications and Information Administration, 1987; the Federal Communications Commission, 1987 and 1989; and the **Rand Journal of Economics** Symposium on Price Cap Regulation, 1989).

Although there are many alternative proposals to enhance regulated firm productivity and many authors use different approaches to categorizing them, we suggest that they can be grouped in two broad categories. The first is that set of proposals that provide incentives for efficiency gains without requiring them; the second includes techniques that make price changes conditional on improved productivity.

3.2.1 Social Contracts

In the first category of reforms are techniques such as the New York "Rate Moratorium and Incentive System," and the Vermont "Social Contract". The former established a moratorium on telecommunications rate increases for particular services for a specified period -- typically, those for monopoly customers -- and subsequently, a specified rate of return for the regulated firm. During the period when the agreement is in effect, if it can increase its productivity, New York Telephone would be allowed to

keep half of any extra earnings made above its prescribed rate of return. The other half would be distributed in some form to its subscribers. Other American jurisdictions have introduced variants of this approach which permit the firms to keep all extra earnings to a certain point, and then a percentage above that amount.

Vermont's "Social Contract" concept is more complicated, but the objective was essentially the same: to protect monopoly subscribers while encouraging the regulated telecommunications company to be as efficient as possible. Local residential and business rates were frozen for a set period, and then subject to a limited specified increase for the duration of the contract. In addition, the firm agreed to not discontinue service in any area where it currently operated and to invest a minimum amount for service and facilities improvements over the period of the contract. In return, rate of return regulation was suspended; the firm was given freedom to adjust its rates for all other services and was not subjected to profit controls.

3.2.2 Price Caps as Productivity Incentives

The second category of regulatory reforms that address the productivity issue includes those that make price changes conditional on productivity increases. They involve a shift in focus from profits to specific prices, more particularly, to prices for "baskets of services" with varying degrees of monopoly

provision. Although there have been a number of proposals for such an approach over the years, the current debate dates from the United Kingdom's privatization of British Telecom in 1983. Since then, the most important example has been the FCC's introduction of price caps for AT&T in 1989. Similar proposals are also under consideration for American local exchange companies.

Although oversimplified, the essential features of any price cap system, if it entails a productivity requirement, are four-fold. In the first place, services are divided into regulated and unregulated categories, with the latter not subject to regulatory control. Secondly, regulated services are subdivided into individual baskets according to some criterion, such as degree of available competition. Thirdly, the firm is given freedom to price the services within individual baskets subject to an overall cap or maximum annual increase on the average price of the services in the basket. The fourth characteristic is the most significant in that any increase is limited to the rate of increase in a designated rate of inflation, e.g., the Retail Price Index (RPI) for the United Kingdom or the Consumer Price Index (CPI) for the United States, less a specified annual productivity adjustment to reflect the gains in productivity for the telecommunications sector.

Although the British and American versions share some basic similarities, it is important to appreciate the very different circumstances which prompted their development. In the

British case, the formula was designed, in part, as a rejection of North American-style rate of return regulation, and to fit the circumstances of the about-to-be privatized British telecommunications firm. What must be recalled is that, with privatization, British Telecom was to lose its monopoly status. There was also a recognition that the development of full competition would take time, especially given that the British government wanted to maximize the selling price. This mitigated against an immediate and comprehensive embrace of competition. The government wanted to provide sufficient incentive for British Telecom to increase its productivity, while at the same time protecting its customers from any monopolistic abuse. Moreover, as Littlechild, the author of the British price cap regime, has noted, regulation:

> ... is a means of 'holding the fort' until competition arrives. Consequently attention has to be on securing the most promising conditions for competition to emerge, and protecting competition from abuse. It is important to ensure that regulation in general, and the profit control scheme for BT in particular, do not prejudice the achievement of this overall strategy (1983, p.7).

Apart from the obvious institutional and market structure differences, it is not clear that the FCC's adoption of price capping is premised, as was the case in the United Kingdom, on a transition to competition. It appears from public statements by the American Commission that the underlying goal behind its introduction is to improve both regulatory and regulated firm performance by relaxing traditional regulatory constraints and

adding a productivity incentive. This difference leads to consideration of a third category of regulatory reforms, those designed to promote competition and the free play of market forces.

3.3 Category Three: Regulatory Reforms to Promote Competition

In the preceding sections, different approaches to regulatory reform were described which were primarily concerned with improving regulatory performance in relation to its basic objectives. Although some of these -- such as forbearance, structural separation and social contracts -- had the goal of fostering competition, this was incidental to the primary objective.

The third set of regulatory reforms is comprised of those that seek to substitute competition, in whole or in part, for regulation as society's means for regulating economic behaviour. For our purposes, it is useful to divide this category of reforms into three sub-categories.

The first covers those reforms that are explicitly deregulatory in nature. The second subset of reforms include those that are explicitly, and perhaps paradoxically, are regulatory in nature. These are reforms that involve giving a regulator, other than competition law authorities, explicit responsibilities to use regulatory controls in order to promote

competition in those markets that are not yet fully competitive. The final set of reforms in this category has two purposes. One is to provide residual controls to protect the interests of some consumers against unacceptable forms of economic behaviour on the part of otherwise deregulated firms. The second is to introduce new instruments as part of a reform package or strategy to meet continuing public policy objectives that were traditionally pursued via regulation.

3.3.1. Deregulation

One of the most obvious methods of promoting competition is to remove or significantly reduce regulatory controls, particularly those that are designed as structural impediments. In both the Canadian air and the extraprovincial highway transport sectors, removal of existing entry controls has been undertaken. In the air sector, for example, regulation of entry through a fairly rigid "public convenience and necessity test" constituted a central part of Canada's regulatory regime dating from 1938. In a two-step reform procedure, the federal government had by 1987 largely removed such entry controls.

The first step came in 1984, when the Minister of Transport issued a non-binding but authoritative policy statement instructing the regulator to interpret its legislative mandate so as "to give much greater weight to the benefits of increased competition" when judging licence applications (Axworthy, 1984,

p.10). In addition, the regulator was ordered to remove existing licence restrictions on air carriers so that any carrier, new or existing, could apply to provide any type of domestic service.

The second stage in airline structural deregulation in Canada came in 1987, when new legislation was enacted. In place of the traditional "public convenience and necessity" test, the federal government substituted the much more minimalist "fit, willing and able" test. As significantly, constraints on withdrawal of specific services were largely removed. The continuing controls will be discussed in the last part of this section.

A more complex method was required to deregulate entry into the extraprovincial trucking industry in Canada because of the long-standing role of the provinces in this sector. Provincial regulatory agencies had been exercising federally delegated responsibility to regulate the extraprovincial aspect of trucking since 1954. Consequently, federal deregulatory proposals in this sector sought an accommodation with provincial regulation.

Provincial trucking regulation involved a "present and future public convenience and necessity test" which typically limited entry into the sector. Rather than moving immediately to a much more neutral -- in a structural sense -- fitness test, the federal and provincial governments agreed to a transitional period. During that period, the traditional entry test would be

replaced by a "reverse onus" test. Under this test, the responsibility is placed on those who object to a new entrant to prove why such entry would be deleterious to the public interest. At the end of the transition, extra-provincial licensing would be subject to fitness criteria stipulated by the federal Cabinet. A central component of the transition period was the creation of a tripartite monitoring committee comprised of representatives of federal agencies, including the Bureau of Competition Policy. The role of this committee was to undertake annual reviews of provincial licensing decisions to determine if they were consistent with the ultimate deregulatory objectives of the federal government.

Deregulatory reforms introduced to promote competition in the Canadian transportation sector also include changes in traditional behavioural or conduct constraints. Airlines, for instance, which were given considerable freedom from regulatory controls over pricing in the 1984 ministerial statement, had that freedom extended and entrenched in subsequent revisions to national transportation legislation (Canada, National Transportation Act, 1987). That legislation also allowed airlines to enter into confidential contracts to offer special fares and bulk discounts.

The reduction in the regulation of railway pricing introduced in 1967, was similarly extended in 1987, in large part, to encourage intramodal competition in addition to the earlier

goal of promoting intermodal competition. Two significant legislative measures are particularly noteworthy in this regard. First, Canadian railways lost their traditional right to engage in collective rate-making. As a result the Competition Act applies to rate-making activities that may unduly lessen or prevent competition. Second, the railways' freedom to price their services has been considerably enlarged by redefining the minimum and maximum constraints, and lessening the within-the-band controls.

Under the new legislation both prohibition against predatory pricing ("minimum" constraint) and regulation of potentially excessive pricing aimed at captive shippers ("maximum" constraint) are now subject to considerations beyond traditional cost concerns. Modelled on the competition policy, the regulator will now disallow a non-compensatory rate, i.e. below cost, only if that rate has the effect or tendency of substantially lessening competition or significantly harming a competitor. A new imaginative means of protecting captive shippers against potentially excessive pricing, the competitive line rates, is discussed in more detail in Section 3.3.3. Finally, the railways were given authority to enter into non-regulated confidential contracts with shippers.

Behavioural controls have been removed or lessened in other sectors as well. In the oil and gas sectors, for example, regulatory controls on pricing have been eliminated, and are now determined by direct buyer-seller negotiations (Canada, Western

Accord, 1985; and Canada, Agreement on Natural Gas Markets and Prices, 1985). The creation of the conditions for a competitive natural gas market has been facilitated in the Canadian environment by the NEB adopting a policy permitting open access for competitors of the pipeline monopoly-owner in its capacity as a dominant marketer of natural gas. Existing controls on oil exports to the United States have also been largely removed.

3.3.2. Alternative Pro-Competitive Regulatory Reforms

Although removal of regulatory price and entry controls may be sufficient in some sectors to transform them into competitive markets, in others, such reforms in themselves will be presumed to be inadequate. Additional measures may be required, especially if the sector has an incumbent firm with monopoly power or existing firms in the market are capable of exercising significant, anti-competitive power. Three types of regulatory pro-competitive reforms have been introduced or extended in Canada

In Section 3.1.1, reference was made to the introduction of confidential contracts as a means of permitting an incumbent firm to respond to the emergence of competition within a regulated environment. We suggested that these contracts were designed to stimulate intramodal competition in a deregulated environment. Such contracts can also be employed as a way of promoting competition where deregulation may not be feasible. A case in point involves Canada's reform in 1987 of legislation governing

the operations of shipping conferences in Canada. Recognizing that Canada could not unilaterally abolish such cartel arrangements because of their international nature, the 1987 reforms sought to provide a regulatory framework that could promote as much competition as was possible (Anderson and Khosla, 1988).

One such reform involved the establishment, by statute, of the right of individual conference members to offer rates that are different from those agreed to in conference authorized tariffs. This right was reinforced by making an exemption from the purview of the Competition Act conditional on the existence of such a right. As Anderson and Khosla note, the "effect of this right is to legitimize and facilitate a form of price competition within the conference" (1988, p.6). They also contend that the extension of this right, particularly as it is also available under comparable American legislation, "will serve as an important check against the possibility of excessive pricing by cartels."

A related reform was to permit confidential contracts between users and conference members. These contracts which, as indicated, were permitted as part of the general revision of national transportation legislation, were also extended to the shipping conferences so as to allow private negotiations to establish the terms for the transportation of cargo outside of conference tariffs.

A subsidiary reform included in the legislation was to stipulate that conference members could not insist that users commit themselves to shipping all of their goods before they could avail themselves of confidential contracts. These reforms, particularly as they were tied to related actions to be discussed below involving the role of the Director of Investigation and Research and exemptions from the provision of the Competition Act, provide excellent examples of the use of regulatory controls to promote or facilitate competition.

A second, more general, type of pro-competitive regulatory reform dates in Canada from the 1967 transport reform initiatives (Canada, National Transportation Act, 1967). One of the central objectives of that legislation was to ensure that the regulator took due regard in its decision-making for the promotion of intermodal competition. This was accomplished by including a statutory injunction that the policy objectives of:

> ...an economic, efficient and adequate transportation system ... are most likely to be achieved when all modes of transport are able to compete under conditions ensuring that regulation of all modes of transport will not be of such a nature as to restrict the ability of any mode of transport to compete freely with any other modes of transport (National Transportation Act, 1967, section 3).

The fundamental revision in 1987 of Canada's transportation policy went even further in reinforcing the statutory obligation to place a priority on competition over regulation as a control device by extending the obligation to

include intramodal competition. While using introductory language similar to that contained in the 1967 legislation, the 1987 National Transportation Act instructed the regulatory authority in sections 3(b) and 3(c) that competition and market forces are, wherever possible, the prime agents in providing viable and effective transportation services, and that:

> ... economic regulation of carriers and modes of transportation occurs only in respect of those services and regions where regulation is necessary to serve the transportation needs of shippers and travellers and such regulation will not unfairly limit the ability of any carrier or mode of transportation to compete freely with any other carrier or mode of transportation (National Transportation Act, 1987).

Statutory instruction to a regulator to be biased in favour of competition over regulation is not an insignificant regulatory reform. In Canada, for example, the telecommunications regulator continues to be governed by a traditional statute for regulating monopoly behaviour. Consequently, in the many proceedings over the past decade where the issue of competition has been addressed, the regulator has regularly reminded participants that "under the existing legislation, it has no mandate to favour either the monopoly or the competitive supply of telecommunications services per se" (CRTC, 1985, p.11).

Finally, recent British regulatory developments have carried this type of pro-competitive regulatory reform even further in the various sectors where privatization has occurred and a regulatory authority established. In telecommunications,

for instance, in addition to having the traditional responsibility to protect consumer interests, Oftel is given the explicit responsibility to promote competition. In its enabling legislation, the regulator is required in exercising responsibilities to take due regard to:

> (d) the desirability of maintaining and promoting effective competition between persons supplying telecommunications services or telecommunications apparatus in the United Kingdom; and
>
> (e) the desirability of maintaining and promoting competitive activity in markets outside the United Kingdom on the part of persons supplying telecommunications services, and persons producing and supplying telecommunications apparatus, in the United Kingdom (reproduced in Littlechild, 1983, p.4).

As Beesley and Littlechild note, in both telecommunications and gas "the regulators have taken seriously their duty to promote competition" (1989, p.466). They have done so through the use of their powers to licence new entrants, determine terms of interconnection and place constraints on the dominant firm's conduct, especially its pricing decisions in particular markets. It is worth noting as well that recent reforms to Australian telecommunications policy and regulatory structures impose a responsibility to facilitate and promote competition on the new telecommunications regulator (Cunliffe, 1990).

3.3.3. Residual Regulatory Controls and Supportive Policies

In the debates over regulatory reforms, especially those involving deregulation, where it is often assumed that this will

entail the complete removal of public controls on corporate behaviour, two particular concerns have been articulated. The first is a fear that, notwithstanding the attractiveness of competition as the economic regulator of the overall sector in question, some customers will not be adequately protected. According to this argument, deregulated firms will be in a position to abuse their dominant position vis-a-vis selected customers. The second concern arises from the use of regulation to pursue particular public policies. The concern here is that the legitimacy of the policy objectives remains, although the withdrawal of regulation may undermine them. One of the lessons of regulatory reform in Canada and elsewhere, however, is that these concerns can be and have been imaginatively addressed without sacrificing the overall reform objectives.

In the case of potential abuse of continuing market power, a number of alternatives have been developed to prevent this or, in the event that it occurs, to provide remedial relief. In the Canadian energy deregulation program, for instance, the transportation of oil and gas were subjected to continued regulatory oversight in part because of its non-competitive nature, and in part because the financial requirements for facilities construction called for continued scrutiny on prudency grounds. The issue of access to pipeline facilities remains critical from the perspective of the creation and maintenance of the competitive produce markets. This is especially true in reference to natural gas. As has already been stated, an open

access policy practised by the National Energy Board has been instrumental in facilitating competition in the natural gas markets.

Perhaps the most imaginative development of new approaches to regulatory control for those limited areas where they may be required are found in the Canadian transportation sector. Responding to the concern that some shippers may not have an effective choice in railways or, alternatively, to encourage Canadian railways to compete with one another, the deregulatory, pro-competitive proposals that resulted included a variety of relevant provisions. One was to expand the access of shippers to more than one railway by extending the limits for the interswitching of railway cars from one railway's line to another's from 4 miles (6.7km) to 18 miles (30 km.) The earlier limit dates from over eighty years ago. In addition, not only is the designation of interexchange locations no longer solely at the discretion of the railways, but the national regulator can even extend the limit if it rules that a shipper is at a competitive disadvantage. Finally, Cabinet was given the power to impose joint track usage on railways if it deemed that this would improve "the efficiency and effectiveness" of Canadian transport.

In addition, a new regulatory instrument was created in the rail sector, namely, competitive line rates, to protect the interests of those shippers not able to take advantage of the extended interswitching rights. If a shipper can negotiate a rate

with one railway to which it does not have direct access, it can then approach the railway to which it does have access to set a rate to carry its traffic to an interchange point. If the latter railway does not offer an acceptable rate, the shipper can apply to the regulator to impose a rate. According to one analyst, even if such competitive line rates are never used, they will "by providing competitive access alternatives, induce local carriers to be more responsive to their captive shippers" (Rothstein, 1988, p.30).

Two final innovative aspects of the new Canadian transportation regulatory regime are, first, the provisions for regulatory mediation and, second, final offer arbitration. Under the traditional regulatory system, while informal mediation was undoubtedly available, in the event of a dispute or complaint filed with the regulator, the only decision-making process was a regulatory investigation including a possible public hearing. Under the new system, if the parties to a dispute are willing, they can request the National Transportation Agency to provide mediation services. In the event that such mediation does not resolve the issue, a shipper may request that the Agency arbitrate the dispute. The process available also provides for final offer arbitration, with each party required to submit an offer to the arbitrator who must choose one of them within strict time limits. To facilitate the process, the legislation does not require the traditional written reasons for decisions unless all parties ask for them.

Another example of continued, albeit circumscribed, regulation in the Canadian transport sector involves new entry into the northern air market. The distinction between northern and southern air markets involves judgements that the former "is thin, highly dispersed and relatively fragile" (Transport Canada, 1986, p.6). Consequently, unlike for the southern market, the presumption was that a continued degree of economic regulation remained necessary to ensure essential service to small communities. As a result, while incumbents cannot argue against entry in the southern portion of the market, in the North, opponents can do so but they must persuade the regulator that any such entry will cause "a significant decrease or instability in the level of domestic service." Finally, there is a provision for consumers to initiate complaints against air carrier basic rate increases for both monopoly routes and generally for northern Canada.

To address concerns that deregulation will undermine continuing legitimate public policies, experience in both Canada and the United States provides examples of new initiatives introduced as part of regulatory reform packages. For instance, in Canada, in both the air and rail service sectors, provision has been made for public subsidies, if necessary, to protect against the loss of air service to remote communities or the abandonment of rail lines.

It is worth noting the specifics of the relevant legislative provisions. In the first place, in the case of air service, it is the responsibility of the Minister of Transport, and not the regulatory agency, to recommend to the federal government that a community served at the time of the new legislation requires financial assistance to continue essential air service. Secondly, the Minister is generally required to "ascertain by public tender the most economical and efficient method by which the service can be provided" (Canada, National Transportation Act, 1987, section 85).

It is also worth noting that American air deregulation was also accompanied by a subsidy program. Initially, this was to be only for the ten years following deregulation, but when that period expired, the program was extended for an additional ten years.

With respect to railway branch line abandonment, the 1987 Canadian legislation sought to balance the interests of railways and affected communities. Unlike previous legislation, the new law stipulated a maximum percentage of the mileage of a railway that could be abandoned for each of the first five years following the enactment of the legislation; subject to this limitation, however, its intent is to make abandonment easier. For example, the regulatory agency is required to order a line abandoned if the railway can establish that it is uneconomic. But the federal government can order retention of service subject to

the provision of a public subsidy if it deems such retention to be in the public interest. To make abandonment more acceptable, the legislation also provided for subsidies to shippers to obtain alternative transportation services for a maximum transitional period of five years.

The question of targeted subsidies has also been addressed in the American telecommunications market. A central feature of traditional telecommunications regulation has been the cross-subsidization of local residential rates from long-distance or toll rates. Consequently, one of the major fears surrounding the introduction of competition and potential deregulation of telecommunications in North America has been the presumed threat this would pose to universal service at affordable rates. The American experience demonstrates the potential for alternative, non-regulatory responses to this concern. Targeted subsidies have been designed to assist low-income subscribers to maintain telephone service by directly subsidizing their monthly bills. Directed subsidies have also been provided to allow low-income households to obtain telephone service through reduced connection charges which may be paid over an extended period. Finally, special assistance is provided to designated areas which incur particularly high costs in order to ensure that companies operating in these areas can continue to offer acceptable service at reasonable rates. The result of these programs, introduced at both federal and state levels, has been that telephone service, far from being threatened by the introduction and spread of

competition, has actually become even more widely available in the United States (Schultz, 1989).

Chapter Four: Regulatory Reform and Competition Policy

In Chapter Two, changes to regulatory institutions were described as constituting one of the basic categories of regulatory reform. Exempted from that discussion was reform or changes in the relationship between traditional regulatory agencies and competition policy institutions and authorities. This part of the Handbook addresses these relationships and highlights reforms that have been undertaken in Canada and elsewhere.

4.1 Interface Between Regulation and Competition in Canada

Competition laws are laws of general application. They apply to all industries, and to all forms of business transactions and behaviour, except where their application is either expressly exempted by a relevant statutory provision to that effect or foreclosed by the so-called "regulated conduct defence" (Romaniuk and Janisch, 1986).

One example of the statutory exemption is contained in the previously discussed Canadian legislation dealing with operations of shipping conferences, namely, the Shipping Conferences Exemption Act. Characteristic of the thrust of the regulatory reform which brought about this statutory enactment, this exemption is not without bounds. In the first place, any exemption for collusive agreements between conference members and non-conference carriers was removed so as to "ensure that non-

conference carriers serve as a genuine competitive alternative to conference lines" (Anderson and Khosla, 1988, p.5). Secondly, the legislation made it explicit that there would be no omnibus exemption, and particularly, conference members who engage in predatory pricing would not be exempted. The legislation also required agreements to be filed before an exemption was granted. A further condition was to remove the conference exemption from negotiations with inland carriers. Here, again, the competitive thrust of such a change is obvious. Finally, the right of an exemption from the Competition Act was made conditional upon members of a conference being granted the right to negotiate individual, "independent action" tariffs with users. If a conference does not permit its members to do so, it loses its exemption.

The "regulated conduct defence" is a doctrine that has developed in the jurisprudence as a result of a series of Canadian cases challenging either the application of the predecessor of the Competition Act, the Combines Investigation Act, or similar provisions in the Criminal Code. It is important to understand that this defence does not apply to a given industry as a whole or to every activity in an industry simply because of the mere existence of regulation. Only the conduct subject to regulation may be subject to the "defence". Briefly stated, the defence provides that where a specific activity or conduct is regulated pursuant to valid legislation and the regulator has exercised its authority in the public interest, such activity or conduct cannot

be found to be in violation of the criminal provisions of the Competition Act. An unresolved issue is whether the defence would apply with respect to the civil provisions of the Competition Act, e.g., mergers, abuse of dominant position, exclusive dealing and refusal to deal, in view of the fact that the jurisprudence is fundamentally based on the prosecution of criminal offences.

It is with this background that the role played by the competition authorities in Canada in influencing regulatory reform may best be appreciated. It consists of three discernible components: first, influencing the government's decision-making process; second, making representations before regulatory agencies; and third, enforcing the law itself.

4.1.1 The Bureau's Policy Role

The Bureau of Competition Policy is part of Consumer and Corporate Affairs Canada. Its head, the Director of Investigation and Research, acts in a dual capacity as chief enforcer of the Competition Act and Assistant Deputy Minister on broad policy matters. The Director's policy role enables him or her to influence the federal decision-making process by way of actively contributing to the work of other departments involved in the design of economic policies. This takes a variety of forms, including participation in interdepartmental committees, commenting on other departments' policy initiatives and initiating his or her own projects.

One of the indications of the enhanced role that the competition officials can play is found in the ongoing annual reviews of provincial highway transport regulatory agencies' progress in implementing the transitional "reverse onus" test in the licensing of motor carriers. These reviews are undertaken by a tripartite committee comprised of officials from the National Transportation Agency, Transport Canada and Consumer and Corporate Affairs. Development of such a monitoring role for competition advocates can contribute to the overall process of regulatory reform because it means that explicit and enhanced recognition can be given to competition policy considerations in the development and implementation of regulatory policies.

4.1.2 The Bureau's Representation-Making Role

Since 1976, the role of the Bureau's Director vis-a-vis traditional regulatory agencies has been enshrined in what is now section 125 of the Competition Act. It reads as follows:

> The Director, at the request of any federal board, commission or other tribunal or on his own initiative, may, and on direction from the Minister shall, make representations to and call evidence before the board, commission or other tribunal in respect of competition, whenever such representations are, or evidence is, relevant to a matter before the board, commission or other tribunal, and to the factors that the board, commission or other tribunal is entitled to take into consideration in determining the matter.

An earlier ambiguity that foreclosed the Director from making representations before provincial boards has now been statutorily rectified. Section 126 of the Competition Act permits the Director to make representations, similar to those to federal boards, to provincial agencies subject to their request or consent. Both sections 125 and 126 of the Act have been important to the promotion of pro-competitive positions before regulatory agencies. (See Romaniuk and Janisch 1986, pp.630-32 for examples.)

A potentially-widely relevant change that could augment the role of competition advocates, comparable to granting them automatic status to intervene before regulatory tribunals, is found in the revisions to the shipping conference legislation discussed at several points in preceding sections. The relevance of these revisions here is that the 1987 legislation not only established a new procedure for the filing of complaints with the National Transportation Agency, it also explicitly designated the Director of Investigation and Research as a person with authority to apply for remedial measures. It is important to note that this provision "is intended to supplement rather than supplant ... recourse to the provisions of the Competition Act, which remain applicable in respect of all matters that are not explicitly exempted in section 4" of the Shipping Conferences Exemption Act of 1987 (Anderson and Khosla, 1988, p.7).

4.1.3 The Bureau's Enforcement Role

The impact of effective enforcement of competition laws on regulatory reform cannot be overstated. With regulatory edict ceding to the laws of the marketplace, the effective operation of the latter must be subjected to a regime capable of delivering results which support the original intent of the reform. In this regard, the two complement each other, each being a cause and an effect at the same time. In this light, it is not surprising that regulatory reform brought about significant changes to the Canadian competition laws; it is also likely that the latter's strength and effective implementation will further influence the course of the former.

The new Competition Act, passed in 1986, contains significant changes in comparison with its predecessor, the Combines Investigation Act. First, a purpose clause stipulating a basic purpose has clarified the overall objective of the new legislation. The law seeks to "maintain and encourage competition in Canada in order to promote the efficiency and adaptability of the Canadian economy...." Second, former merger and monopoly provisions, whose criminal nature made them virtually unenforceable in the past, have been decriminalized and totally redrafted. Moreover, consistent with the purpose clause, efficiency has been accorded determinitive significance in their application. Third, a specialized body, the Competition Tribunal, has been established to deal with non-criminal matters, including

mergers and a modern version of monopolies -- abuse of dominant position. Finally, of all the other changes aimed at strengthening the Act, subjecting the commercial activities of Crown corporations to its application warrants special mention.

4.2 Overlapping Regulation and Competition: The British Model

There are two other examples of regulatory reforms in other countries that address directly the relationship between continued regulation and competition policies and authorities. It will be recalled that in both the United Kingdom, for four of the five recently privatized sectors, and in Australia in the telecommunications sector, the newly created regulators have been given a statutory responsibility to promote competition as one of their primary objectives. Both of these countries have sought to reinforce this responsibility by forging unique relationships between the new regulators and competition authorities.

The United Kingdom, for instance, has opted for what might be called an "overlapping model", wherein both the regulator, e.g, Oftel, and the Office of Fair Trading share jurisdiction over non-regulated or other business activities of otherwise regulated firms. Even more important is the relationship between the regulator and the Monopolies and Mergers Commission. The latter can be an arbitrator between the regulated firm and the regulator in cases of disputed licence changes. In addition, the individual regulators can refer questionable

practices relating to competition to the Monopolies and Mergers Commission (Beesley and Littlechild, 1989, pp.465-466).

4.3 Merging Regulation and Competition: The Australian Model

Australia, in contrast, has adopted what may be described as a "merged model" for the relationship between its telecommunications regulator, AUSTEL, and its competition authority, the Trade Practices Commission. In the parliamentary debate creating the new regulator, the sponsoring minister stated that "AUSTEL was intended to develop close links with the Trade Practices Commission 'in order to assist both bodies in their **respective** roles of ensuring that the carriers do not misuse their monopoly powers in competitive markets'" (Cunliffe, 1990, p.251, emphasis in original). To accomplish this objective, the Australian government appointed the Chairman of AUSTEL as a part-time member of the Trade Practices Commission, and one of the part-time members of the latter was to be an associate member of AUSTEL. The first cross appointment was made subject to the condition that the member could participate "only in those matters before the (Trade Practices) Commission which relate directly or indirectly to the telecommunications industry, any sector of that industry or any participant in that industry" (Baxt, 1990, p.275, Footnote 1). Finally, the authorizing statutes for both bodies permit them to refer matters to the other for comment and decision.

Concluding Remarks

It would be inappropriate, given the purposes of this Handbook, to attempt to offer any specific conclusions. The objective has been to describe, in a fairly summary fashion, the range of possibilities that regulatory reform can embrace. Our starting assumption was that, under the general rubric of reassessing the relationship between the state and the economy, there are many possible alternative reforms. Some of them involve a fundamental restructuring of that relationship while others are more modest.

The diversity of the institutional alternatives across different governments argues against offering any specific recommendations to individual countries. Moreover, the novelty of many of the reforms that have been undertaken suggests that it is probably too soon, in all but a few cases, to attempt an evaluation of their utility. What can be said is that, if sufficient appreciation is given to both the diverse reasons for existing regulatory regimes and the equally diverse justifications that can be advanced for reform, the regulatory reform process is replete with possibility. In searching for reforms that can meet the needs of individual circumstances -- which can vary tremendously across countries and economic sectors -- those who would seek to introduce reform should consider the following advice from an experienced and perceptive observer of both regulation and competition:

> The right mix of regulation and competition is not easily determined. What works for one industry may not work in another. What works well at one point may not work well at another. Thus, when antitrust principles are applied to markets that are -- perhaps of necessity -- partially regulated, the application must be done with care....
>
> Good policy decisions turn more on common sense than on the unthinking transference of precedents. Certainly emotional attachments to either free markets or to regulatory processes stand in the way of good policy decisions. The most sagacious of us will err, and it is well that we occasionally acknowledge mistakes and plot new courses (Phillips, 1990, p.675).

It is hoped that this Handbook offers some useful guidance on the full range of possibilities for "new courses" of the reform of regulation.

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