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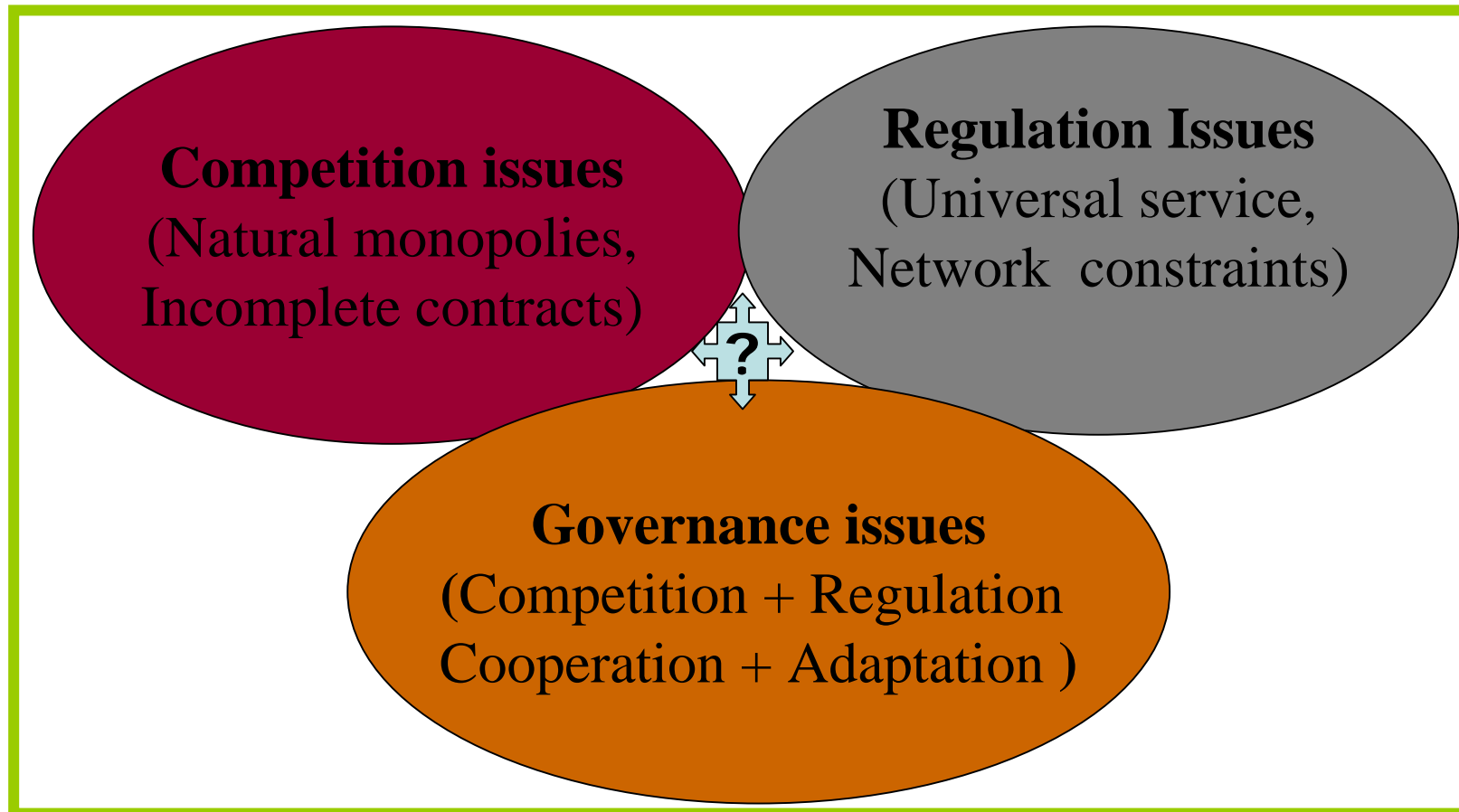
Florence School of Regulation

Regulatory Governance of Network Industries: Experience and Prospects

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The network industry experience: Competition, Regulation and Governance



In an Institutional Environment Frame

The rational structure emerging of experience: a four step problem

- Classical market failures got a new remedy: Ex Ante “Market reDesign”
- Market design failures lead to Long term “Market Building” Ex ante & Ex Post
- Market building failures lead to complementary fix: “Institutional Building”
- However Institutional building capability is bounded by “Institutional Endowments”

1. “Market Design” for market failures

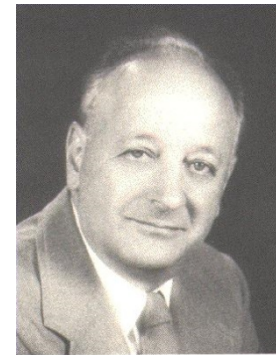
- the traditional “all public” solution questioned by new-institutional economics
 - The role of the Coase theorem: Market Failures can be fixed
 - *by market redesign (then Law) enabling private contracting
 - **or Law + public regulation

*R.
Coase*



→ Hence the “franchise bidding” solution by Demsetz (1968)

- Introduce market friendly mechanisms to redesign network industries
- Auctions to award “franchise contract “→ competition *for* the market as a substitute to competition *in* the market
- Market mechanisms based on new contractual arrangements to involve greater private participation



*H.
Demsetz*

- “Market Design” for market failures revisited as a strong “contracting issue” (NIE 2nd generation)
 - 1976: Goldberg & Williamson
 - Which key problem of natural monopoly: pricing problem or contractual issue?
 - Quality concerns, long term use of specific investments, adaptation of transactions through industry chain restructuring ...
 - Introducing “market mechanisms” may not be as simple as it seems...



O. Williamson

“Market reDesign” as Ex Ante remedy to market failures?

- “Market design” is mainly ex ante
- “Market building” is long term adaptation being ex ante & ex post in an explicit regulatory governance frame

2. “Market building” as remedy being “long term market design adaptation”

- 3 core principles of “*market building activity*”:
 - Competition where possible; with regulation around
 - Hence “restructuring” of industry and transactions based on modularity
 - Sequentiality of these reforms (various successive steps through “reform packages”)

- Competition where possible
 - Relates to setting boundaries between market and non market mechanisms
 - “Network activity” notably to be separated from “final services”
 - Yes... but where should the boundaries between market / network activities be set?
 - And how to define the interfaces managing the boundaries?

- Reforms become a process of successive steps and packages
- Hence sequencing of decision matters
 - Newberry (2002): Choosing the right reform strategy is more challenging than early optimists claimed
 - Definition of the reform strategy
 - Privatization decision
 - Defining powers & resources of regulator(s)
 - Bundling / unbundling across industry activities
 - Initial design of modularity in the industrial chain
 - Further deeper reform of these modules
 - Mutual adaptation of former & new modules

- Reform steps create new set of interests & stakeholders with new decision rights on market and non-market activities
- Market building is redefining rules and rights of industry players and consumers in a frame of diverging institutions: regulatory authority + government (controlling access to executive power and new Law) + competition authority + judicial review by courts
- Market Building becomes “Regulatory Institution Frame building”

3. “Institutional Frame Building” for market building governance adaptation in the long run

- Regulatory governance is an implementation structure for “rights” and safeguards
 - Governance adaptation deals with “**defining, allocating and implementing new rights**” within a nexus of **existing rights** protected by other institutional guaranties (Pagano, 2000, 2002)
- The perfect governance structure is then a dream, because various private & public institutions or the governance structure will be “**sequentially**” called **to intervene ... in the long term implementation of the reform**

- ... and they have to **interact** in the process of **discovering sequentially** how & by whom some rights are limited by rights of others and evolve through their actual implementation (Prosser, 2005)
 - ◉ The “governance structure” can change through transformation of the **veto power of players**
- Such “transformation of rules of play” raises problems unexpected or unforeseen while being due to characteristics of the **institutional endowments** ...

4. “Institutional Building” within institutional endowments

- Institutional Endowment basis
 - “Existing institutional environment makes it impossible to redesign all existing rights ‘at the start’ to begin market building in a perfectly designed institutional frame of governance”

Basically you can not do all what you want with rights (Weingast, North).

- “Strong government can change all the rules”
- problem of discretion, hence stability and long term credibility of the regulatory frame
- “Fragmentation and dispersal of power” leads to policy delay, gridlock, and immobilism (Tsebelis)
 - problem of adaptation and evolution of the regulatory frame

- Is “institutional endowment” a hard constraint?

Yes
If numerous veto
players cannot
negotiate

“Path-dependent
orientation” on purely
voluntary basis

No
If dominant veto
player

Or numerous veto
players can negotiate
or “enjoy” a “window
alignment for reform”

→ Decentralized and centralized countries are not equipped to easily converge on the same “re-design” because of their institutional characteristics and distribution of veto players.

Conclusion

Modularity, sequencing or **institutional endowment** of countries matter as much as “*Attractivity, Feasibility, and Credibility*” in competitive reforms of network industries

1. “**Market design**” cannot be robust since the very beginning
2. “**Market building**” is achieving (Step 1.) in a very long period of time –one to two decades–
3. “**Institution building**” is needed to provide a robust framework to (Step 2.) in the long run
4. (Step 3.) can be achieved only within the existing “**Institutional Endowment**” which is resisting to intentionally rational policy (von Hayek: *French Disease*; here: *Mandatory Liberalism*)