

University of Chicago Law School

Chicago Unbound

Journal Articles

Faculty Scholarship

1969

Natural Monopoly and Its Regulation: A Reply

Richard A. Posner

Follow this and additional works at: https://chicagounbound.uchicago.edu/journal_articles



Part of the [Law Commons](#)

Recommended Citation

Richard A. Posner, "Natural Monopoly and Its Regulation: A Reply," 22 Stanford Law Review 540 (1969).

This Article is brought to you for free and open access by the Faculty Scholarship at Chicago Unbound. It has been accepted for inclusion in Journal Articles by an authorized administrator of Chicago Unbound. For more information, please contact unbound@law.uchicago.edu.

Natural Monopoly and Its Regulation: A Reply

Richard A. Posner*

I shall reply briefly to the main points made in the comments, and I shall then address two additional issues, which were not adequately developed in my original article.

Professor Comanor devotes a major part of his comment to a discussion of an empirical study of the effect of regulation on electricity rates, by George J. Stigler and Claire Friedland, that I had relied upon in my article.¹ I cited the study for the proposition that “profit regulation may have little actual effect on monopoly prices and profits”²—a cautious assessment that I stand by. Professor Comanor is of course free to quarrel with the statisticians’ measure of significance in empirical work. And I find no fault with the method by which he reinterprets some of the Stigler-Friedland data as actually supporting the hypothesis that regulation has an effect on price after all. However, a finding that regulation probably has *some* impact on price should give scant comfort to the supporters of regulation if, as both the Stigler-Friedland study and a later study unfortunately not yet published³ indicate, that impact is slight. Comanor’s own results, showing price effects ranging from one to ten percent, are hardly decisive, especially given the limitations of the statistical procedures employed.

Comanor ignores, moreover, an important finding of the Stigler-Friedland study that casts grave doubt on whether regulation does affect price: The relationship of industrial to residential electrical rates was the same in the states that had regulation as in the states that did not.⁴ Since there is competition for industrial sales of electricity, regulation should reduce the spread between industrial rates (normally competitive) and residential rates (normally monopolistic); but apparently it does not.

The other part of Professor Comanor’s comment presents a formal model of the relationship between the benefits and costs of regulation. The model implies that a large reduction in price due to regulation is likely to be offset by a much smaller increase in the regulated firms’ costs induced by

* A.B. 1959, Yale University; LL.B. 1962, Harvard University. Professor of Law, The University of Chicago.

1. Stigler & Friedland, *What Can Regulators Regulate? The Case of Electricity*, 5 J. LAW & ECON. 1 (1962).

2. Posner, *Natural Monopoly and Its Regulation*, 21 STAN. L. REV. 548, 596 (1969).

3. E. Ewing, *Some Measurements of the Effects of Electric Utility Regulation by State Commission*, May 31, 1968 (M.I.T., Dep’t of Economics).

4. Stigler & Friedland, *supra* note 1, at 9.

regulatory control, at least if the effects of the price decrease on the distribution of income are ignored. However, in the absence of information concerning the elasticity of demand for the regulated service, the costs of regulation, the effects of regulation on rates, and the incomes of affected parties, the model provides no concrete guidance for policymakers. Even on the formal level it is incomplete, since it contains no method of balancing the distributive effects of price controls against their efficiency effects.

Mr. Swidler never joins issue with the points made in my article. From his discussion about treating citizens "as human beings, and not merely as statistical fodder,"⁵ I infer that he agrees with me that the economic case for regulating even a natural monopolist is weak; but if there is another case, he has not presented it. Granted that it offends (or should offend) Americans—or for that matter Tasmanians—"that monopolies based on public franchise should be free to charge whatever the market will bear,"⁶ it follows not that monopolies should be regulated, but that they should not be franchised. It is precisely regulation that, by limiting entry into the markets of monopolists, confers the "special privilege" of which Swidler complains.

He is also on shaky ground in shifting discussion from the regulation of natural monopoly, which presents the strongest case for some public controls, to the regulation of natural-gas producers.⁷ The Supreme Court's analysis of the industry in the *Permian Basin Area Rate Cases*,⁸ which he quotes, could be persuasive only to one unfamiliar with the scholarly work of Paul MacAvoy and Edmund Kitch, nowhere cited by Mr. Swidler.⁹ But then, as Swidler, formerly chairman of the Federal Power Commission and presently chairman of New York State's utility commission, says: "It is stultifying to be responsible for administering a statute unless one can accept at least its fundamental purposes, and there is little reward in public service unless one can believe in the value of one's work."¹⁰

Swidler shares with Professor Shepherd a misconception of the role that I assign antitrust policy in the control of the natural monopolist.¹¹ I have nowhere suggested that antitrust is an alternative to public-utility regulation. The article's discussion of antitrust was explicitly limited to the problem of controlling predatory practices in which a monopolist might engage, such as selling below cost in order to drive a competitor out of business.¹²

5. Swidler, *Comments on the Case for Deregulation*, 22 STAN. L. REV. 519, 521 (1970).

6. *Id.* at 521.

7. *Id.* at 522-23.

8. 390 U.S. 747 (1968).

9. P. MACAVOY, *PRICE FORMATION IN NATURAL GAS FIELDS* (1962); Kitch, *Regulation of the Field Market for Natural Gas by the Federal Power Commission*, 11 J. LAW & ECON. 243 (1968).

10. Swidler, *supra* note 5, at 525.

11. *Id.* at 523-24; Shepherd, *Regulation and Its Alternatives*, 22 STAN. L. REV. 529, 534-36 (1970). See text accompanying notes 22-25 *infra*.

12. Posner, *supra* note 2, at 588-89.

I maintained that the antitrust laws provided an adequate remedy against such abuses and that regulation was in this respect superfluous. Of course, the antitrust laws provide no answer to the problem of the monopolist's inadequate output; I am on record as stating that the control of a monopolist's profits is not a proper antitrust function.¹³

I am not clear what Professor Shepherd's quarrel with my position is, or whether there is a quarrel. He is correct that the costs of regulation cannot at present be proved to outweigh the benefits, due to the absence of the necessary quantitative data. But I had not thought I was arguing a contrary position, or making "quantitative" judgments. My purpose rather was to examine the case for regulation in its most favorable context, where the regulated firm is a natural monopolist; to expose the weakness of the assumptions that underlie the decision to regulate such a firm rather than to leave it alone; and to argue the appropriateness of (a) experimenting with some relaxation of regulatory controls and (b) declining to extend regulation to new areas of alleged natural monopoly, such as cable television and certain computer services. I do not understand Professor Shepherd to disagree with these fundamental points. And where he takes issue with me on specifics, his comments, generously viewed, are quibbles. He attacks me for recommending "a policy of leaving monopolists' profits as high as those elsewhere" in the economy in order to assure an efficient allocation of resources.¹⁴ That is a parody of my position. I pointed out that forcing the prices of some firms down to average or marginal cost might worsen rather than improve the allocation of resources, depending on price-cost ratios in other industries.¹⁵ But of course it does not follow that natural monopolists must be permitted to have the same profit rate as other firms; differences in risk alone might well require a lower rate for a natural monopolist. All I wished to claim was that the beneficial effect of regulatory profit controls could not be taken for granted.

Shepherd also accuses me of an "eccentric evaluation of part of the recent empirical literature"¹⁶ concerning the effect of monopoly on innovation. It is his comment that is eccentric: He cites in support of his assertion a recent survey of the empirical evidence that concluded (as I stated in my article, citing the specific pages where the conclusion is announced) that the evidence to date indicates "no clear relationship between technological progressiveness and any particular kind of market structure."¹⁷

13. Posner, *Oligopoly and the Antitrust Laws: A Suggested Approach*, 21 STAN. L. REV. 1562, 1597 n.95 (1969).

14. Shepherd, *supra* note 11, at 533.

15. Posner, *supra* note 2, at 559-61, 604-05.

16. Shepherd, *supra* note 11, at 531.

17. Posner, *supra* note 2, at 583, citing E. MANSFIELD, *THE ECONOMICS OF TECHNOLOGICAL CHANGE* 215-17 (1968). In Mansfield's words, "there is no statistically significant relationship between the extent of concentration in any industry and the industry's rate of technological change . . ." *Id.* at 217.

Shepherd questions my statement that a monopolist "has every incentive to be ingenious in anticipating and responding to consumers' wants"¹⁸ by remarking oracularly that "this is a matter of choice, not of survival, and other incentives [not specified] may come into play."¹⁹ What incentives? Suppose a firm obtains a monopoly of a previously competitive market. It can obtain a monopoly return either by raising the price of the good or service while keeping quality constant or by reducing quality or service while keeping price constant. Which course yields greater profits depends solely on consumer preference. Other than insisting upon the monopoly return, the monopolist—assuming that he is rational, a profit maximizer, and reasonably well informed—will treat consumers just as would a competitive firm. He has no incentive to treat them differently, which is all I said.

Shepherd challenges—but only in conclusional and unspecific terms—my contention that the possibilities of significantly improving the regulatory mechanism seem slight. He laments that "forceful regulation has rarely been tried" and urges "greater staff resources and legal powers to establish criteria and penalize slow management."²⁰ (Actually, most regulatory commissions have ample legal powers to institute the kind of regulation that Shepherd would like to see.) He states, but again without explaining, that "regulation could do many more penetrating things, in analyzing trends, establishing criteria, evaluating performance, and applying cost-benefit analysis to alternatives" and that "there are many new experimental regulatory devices that could be tried, including public holding of utility shares under a variety of conditions, excess-profits taxes, provisional franchising, and deliberate regulatory lag."²¹ The enumeration, without discussion, of possibilities, coupled with an unexplained assertion that regulation *could* do better, is a facile reply to my specific reasons, not mentioned by Shepherd, for believing the suggested reforms are impractical or otherwise undesirable.²²

Shepherd is perhaps most critical of my discussion of "alternatives" to regulation, and discusses two at some length: antitrust and public ownership. The first branch of his discussion is irrelevant in the present context. Like Shepherd, although for different reasons, I believe that the existing level and thrust of antitrust enforcement leave much to be desired;²³ but that is neither here nor there. The antitrust laws can in no event provide a solution for monopoly in markets that can support only one firm, and I

18. Posner, *supra* note 2, at 585.

19. Shepherd, *supra* note 11, at 532.

20. *Id.* at 530, 537.

21. *Id.* at 537.

22. Posner, *supra* note 2, at 625–35. I spoke favorably, however, of the excess-profits approach. *Id.* at 639–40. I do not see why Shepherd takes me to task for having ignored it.

23. This is developed in my paper, "A Quantitative Analysis of Antitrust Enforcement," forthcoming in the *Journal of Law and Economics*.

have never suggested that they could. As for the second branch, I offered reasons, which Shepherd characteristically ignores, for doubting that public ownership is a fetching alternative to regulation or *laissez faire*:²⁴ Under public ownership there is no profit incentive to assure efficient operation; the discipline of the capital market is removed; there is no threat of corporate takeover; there is an affirmative danger of political influence; above all, there is the danger that a public enterprise would be intolerant of competition, even if changes in demand or cost made competition feasible. That these are real dangers is attested by our postal system and—a point not mentioned by Professor Shepherd, although he is a student of the British nationalized industries—by Great Britain's.²⁵

The quality of Professor Shepherd's argumentation is fairly indicated, I believe, by his apparent endorsement of "a change in emphasis toward loosening entry and profit controls while tightening supervision of efficiency and price structure."²⁶ There is confusion in this view. The level of the monopolist's price remains the heart of any reasonable objection to unregulated monopolies. Were there no limitations on the level of monopoly profits, regulation would indeed be difficult to justify. Not only are there no persuasive or well established grounds for believing that an unregulated monopolist would incur excessive costs or adopt an arbitrary structure (as opposed to level) of rates,²⁷ but if the history of regulation offers any lesson, it is that regulatory agencies are incapable of effective control or surveillance over the management and operations of regulated firms, or of designing and enforcing economically rational rate structures. These are not only the weakest links of regulation, but, for the reasons stated in my article, strengthening them involves seemingly intractable problems of practical administration.

All three comments are critical of my unfavorable view of the possibilities for either justifying or improving regulation. I should like now to suggest two reasons not adequately discussed in my original article that support such a view. *First*: The article states that concern with the output of an unregulated monopolist is justified but that the magnitude of the restrictive effect is uncertain and possibly not great. Among the other reasons advanced in the article to support this proposition, I would now particularly emphasize the possibility that consumers, by suitable contractual arrangements, may be able, in advance of taking service, to prevent a monopoly

24. Posner, *supra* note 2, at 636-38.

25. For partial documentation of this assertion see Coase, *The Postal Monopoly in Great Britain: An Historical Survey*, in *ECONOMIC ESSAYS IN COMMEMORATION OF THE DUNDEE SCHOOL OF ECONOMICS 1931-1955*, at 25 (J. Eastham ed. 1955).

26. Shepherd, *supra* note 11, at 535.

27. See Posner, *supra* note 2, at 557-84, 606.

supplier from charging the monopoly price. For reasons that would take us too far afield to explore here (and that are the subject of a forthcoming paper on state and local regulation of the cable-television industry), the common objections to the contract solution, objections based on consumers' alleged lack of bargaining power and on the durability of the assets involved in providing utility services, seem rather unimportant. Instead, three factors are critical.

The first is whether other firms can serve the market in question. If so, then initially there will be a possibility of competition *for* (rather than *in*) the market. The second factor is how long it would take another firm to enter the market in the event that the seller who wins the initial competition to serve charges a monopoly price. That period defines the first firm's ability to charge a monopoly price in the absence of contracts with customers requiring it to sell at a lower price. The third factor is the cost at which the consumer could protect himself in advance against being charged a monopoly price during the vulnerable period by a suitable contract with the supplier.

These are empirical questions and they have never been carefully studied. It is thus an open question whether the so-called natural monopolies would in fact be sources of substantial market power, were it not for regulatory barriers to entry. We take too much for granted in these areas.

Second: It is of course possible to conceive, as does Professor Shepherd, of a regulatory system that would lack the conspicuous deficiencies of the present one. Proposals for reform are in fact old, and with an important exception relating to rate-of-return determination,²⁸ the recent proposals add little that is new. There are two plausible reasons why proposals for incentive regulation and other reforms have not been adopted. As explained in some detail in the article,²⁹ they are not good proposals. But as I would particularly emphasize were I writing the article anew, the deficiencies of regulation seem inherent in the nature of the undertaking rather than merely accidental. To state baldly and insufficiently a thesis that I have developed more extensively elsewhere,³⁰ the controls or incentives governing regulators are inadequate to protect the public interest. Like other men, regulators are surely actuated to a large degree by selfish ends. This would not be troublesome if the output of a regulatory agency—let us call it “good regulation”—were sold in a market, if all the costs of regulation were internal to the agency, and if the regulators bore the risk of loss and were entitled to the profits. When these conditions are approximated, as they are in most private mar-

28. I hereby retract footnote 171, *id.* at 625, where I confused Myron Gordon's very promising approach to determination of the cost of capital with the quite different, and in my opinion unpromising, earnings-price-ratio approach.

29. Posner, *supra* note 2, at 625-35.

30. See Posner, *The Federal Trade Commission*, 37 U. CHI. L. REV. 47, 84-87 (1969).

kets, we permit momentous economic decisions to be made by private individuals. None of these conditions, however, is even remotely fulfilled in the design or operation of regulatory agencies, and the void is not filled by waving a wand called "public service." It has proved impractical to specify rules of conduct or performance that would preclude other than the grossest departures from the public interest in furtherance of the regulators' self-interest. As a result, while society can perhaps largely prevent bribery and other conspicuous derelictions of duty, it cannot otherwise equate the regulators' self-interest with the public interest. Regulators remain largely free to use their office to promote their private ends. There is no effective social control of regulation.