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Franchise bidding for natural monopolies—in general and with respect to CATV

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The orthodox attitude among economists toward regulation is one of "disdain and contempt." The general reputation is not undeserved, but it fails to discriminate among different economic activities and different types of regulation. An effort to distinguish between those circumstances in which regulation, in some form, is immanent from those in which market modes can be made to work relatively well is needed.

Discriminating assessments of regulated industries (extant and proposed) will be facilitated by examining transactions in much greater microanalytic detail than has been characteristic of prior studies of regulation and proposed alternatives thereto. My examination of franchise bidding for natural monopoly discloses that this mode suffers from much more severe contractual disabilities than have hitherto been acknowledged. Faced with both technological and market uncertainties, CATV, circa 1970, does not appear to be among the circumstances for which unassisted franchise bidding can be expected to work well.

1. Introduction

■ The limits of regulation are manifold and, in a general way at least, have been examined elsewhere by others. Merely to show that regulation is flawed, however, does not establish that regulation is an inferior mode of organizing economic activity. For one thing, the disabilities of regulation are apt to vary with both the type of activity regulated and the form of regulation attempted. Secondly, before regulation is supplanted, there is an obligation to assess the properties of the proposed alternative—not only in general, but also specifically with respect to the activity in question. If the proposed mode is flawed in similar or different respects, the purported advantages of shifting out of regulation may be illusory.

The present paper is primarily concerned with the efficacy of

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franchise bidding schemes as an alternative to regulation in the provision of public utility services in circumstances in which there are nontrivial economies associated with monopoly supply. Granting that regulation is highly imperfect, assessed in terms of an abstract ideal, what are the conditions under which franchise bidding is a vastly superior solution to the supply of "traditional" public utility services?[1] In particular, should public utility regulation be extended to cover community antenna television systems or should franchise bidding be used instead (Posner, 1969, pp. 642–643)?

My assessment of franchise bidding for the supply of CATV services, *circa* 1970, is that it differs mainly in degree, rather than in kind, from the regulation that such bidding is intended to supplant—though this does not deny that franchise auctions may sometimes have attractive properties for the supply of natural monopoly services (see Section 5). In circumstances, however, where franchise bidding predictably and actually converges toward regulation, the purported advantages of franchise bidding as compared with regulation are problematical.

I attempt here to examine franchise bidding issues in somewhat finer microanalytic detail than has been done previously. My emphasis on contractual detail is to be contrasted with that of Richard Posner, who argues that "[t]o expound the details of particular regulations and proposals . . . would serve only to obscure the basic issues" (1972, p. 98). I submit, however, that the strategy employed elsewhere to study the employment relation (Williamson, Wachter, and Harris, 1975) and vertical integration (Williamson, 1971) has general application. In both instances, it was necessary to examine the contracting process in greater detail than had been done previously to discern the types of difficulties which market mediated exchange encounters and, relatedly, to establish in what respects and why internal (collective or hierarchical) organization offers an advantage.

It is of interest in this connection to observe that what Posner has referred to as the "economic approach to law" (1975) is characteristically deficient in microanalytic respects. The economic approach which Posner favors traces its intellectual origins, in antitrust respects at least, to Aaron Director and his students (Posner, 1975, p. 758, n. 6). As I have observed elsewhere, this tradition relies heavily on the fiction of frictionlessness and/or invokes transaction cost considerations selectively (Williamson, 1974a; 1974b). However powerful and useful it is for classroom purposes and as a check against loose public policy prescriptions, it easily leads to extreme and untenable "solutions."[2] What Arthur Leff has referred to as a "legal approach to economics" (1975), in which transaction costs are more prominently

[1] By traditional natural monopoly services I mean electricity, gas, water, and telephone. See Joskow (1975, p. 18) and Jorden (1972, p. 154).

[2] Posner regards Ronald Coase's classic paper "The Problem of Social Cost" (1960) as the entering wedge to the "new law and economics field" (1975, p. 760). It is noteworthy that this important and influential paper is in two parts: the first part features frictionlessness; the second qualifies the earlier discussion to make allowance for frictions. Much of the follow-on literature, including franchise bidding, is largely or wholly preoccupied with frictionlessness or deals with frictions in a limited or sanguine way.

and systematically featured, is, I think, a necessary supplement to (and sometimes substitute for) the Director-Posner tradition.[3]

My assessment of the problems of supplying natural monopoly services suggests that there are no friction-free alternatives. Choice among alternative modes nevertheless has to be made. Among the relevant factors to be considered in evaluating alternative modes of organizing natural monopoly are the following: (1) the costs of ascertaining and aggregating consumer preferences through direct solicitation; (2) the efficacy of scalar bidding; (3) the degree to which technology is well developed; (4) demand uncertainty; (5) the degree to which incumbent suppliers acquire idiosyncratic skills; (6) the extent to which specialized, long-lived equipment is involved; and (7) the susceptibility of the political process to opportunistic representations and the differential proclivity, among modes, to make them. (Of special relevance in this last connection is the tendency for regulation, once put in place, to assert ancillary powers, thereby to expand its jurisdiction, often with dysfunctional consequences. Although it is beyond the scope of the paper to assess this issue here, creeping "ancillariness" is one of the more severe disabilities to which regulation is subject.) The more confidence one has in contracting and in the efficacy of competition—both at the outset and at contract renewal intervals—the more one tends to favor market modes. Conformably, regulation, in some form, is relatively favored when one is dubious that incomplete contracting will yield desired results and when competitive processes are prone to breakdown.

It should be noted in this connection that variants within both market and regulatory modes exist. Discriminating assessments within as well as between modes are accordingly indicated. Also, a once-for-all verdict with respect to the supply of a particular natural monopoly service is unwarranted. The better mode at an early stage of an industry's development may no longer be better later on when a lesser degree of uncertainty prevails. To the extent that difficult transition problems are apt to be posed in shifting from one mode to the other, this should be acknowledged and taken expressly into account at the outset.

More intensive study of the abstract properties of alternative modes at successive stages will be needed before a more confident matching of modes with activities can be accomplished. Considering the primitive state of comparative institutional analysis, however, more than abstract study is needed. Microanalytic examination of a number of *individual cases* will also be instructive. Among the cases that might be selected for examination, the "study of extreme instances often provides important leads to the essentials of the situation" (Behavioral Sciences Subpanel, 1962, p. 5). Subject to the conditions that only gross inferences are to be attempted and that the system is observed to respond to disturbances in a coherent way, such observations offer a relatively economical way by which to secure insights into the properties of a complex organization. The case study reported here is used only for gross inference purposes,

[3] For an important contribution to the contracting literature, of which I became aware only recently, see Macneil (1974). The "relational" contracts described by Macneil are examined in a regulatory context by Goldberg (1976), whose treatment of the issues is independent of, but in a spirit that is consonant with, that developed here.

appears to satisfy coherence requirements, and introduces a hitherto missing element of reality testing into the evaluation of franchise bidding for natural monopolies.

Franchise bidding under steady state conditions is treated in Section 2. The more interesting issues relating to the efficacy of franchise bidding do not appear, however, until uncertainty is introduced. These are developed in Section 3. The Oakland, California, experience with franchise bidding for CATV is then described and evaluated in Section 4. Concluding remarks follow in Section 5.

2. The simple franchise bidding scheme

■ Partly out of a sense that the defects of regulation are so serious that patching it up is not worth the effort and partly out of a conviction that market solutions have not been given a fair chance to deal with the problems for which regulation has been devised, numerous proposals have appeared recently suggesting that market modes be used more imaginatively. Many of these suggestions are traceable, directly or indirectly, to what has come to be known as the economics of property rights literature.[4] Ronald Coase's study of the Federal Communications Commission (1959) is an early and classic example. A more recent issue to come up for consideration is the organization of community antenna television (CATV) systems, of which Posner's study (1972) is an illustration.

Posner's evaluation of CATV franchising relies in part on Harold Demsetz' earlier treatment of the question, "Why regulate utilities?" (1968). Demsetz contends that even though efficiency considerations may dictate that there be only one supplier in a natural monopoly industry, the unregulated market price need display no elements of monopoly.

□ **The basic argument.** Conventional analysis is flawed by a failure to distinguish between the number of *ex ante* bidders and the condition of *ex post* supply. Even though scale economies may dictate that there be a single *ex post* supplier, large numbers competition may nevertheless be feasible at the initial bidding stage. Where large numbers of qualified parties enter noncollusive bids to become the supplier of the decreasing cost activity, the resulting price need not reflect monopoly power. The defect with conventional analysis is that it ignores this initial franchise bidding stage.

Franchise bids which involve lump-sum payments should be distinguished from those where the franchise is awarded to the bidder who offers to supply at the lowest per unit price. Awarding an exclusive franchise to the noncollusive bidder who will pay the largest lump-sum fee to secure the business effectively capitalizes the monopoly profits which thereafter accrue. But the product or service for which such a franchise is granted will be priced on monopolistic terms. To avoid this outcome, the franchise award criterion of lowest per unit price is favored. George Stigler, among others, evidently finds the argument persuasive (1968, pp. 18–19; 1974, p. 360).

Demsetz illustrates the argument by examining a hypothetical example in which the state requires automobile owners to purchase

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[4] For a survey of this literature, see Furubotn and Pejovich (1972); for a selection of readings, see Furubotn and Pejovich (1974).

automobile license plates annually, where the plates in question are produced under decreasing cost conditions. To simplify the argument he strips away "*irrelevant complications*, such as durability of distribution systems, uncertainty, and irrational behavior, all of which may or may not justify the use of regulatory commissions but none of which is relevant to the theory of natural monopoly; for this theory depends on one belief only—price and output will be at monopoly levels if, due to scale economies, only one firm succeeds in producing the product" (1968, p. 57; emphasis added).[5] Provided that there are many qualified and noncollusive bidders for the annual contract and that the contract is awarded to the party that offers to supply at the lowest per-unit price, "the winning price will differ insignificantly from the per-unit cost of producing license plates" (Demsetz, 1968, p. 61).

Demsetz and others evidently believe, moreover, that the argument is not vitiated when the simple case is extended to include such complications as equipment durability and uncertainty. Equipment durability need not lead to wasteful duplication of facilities since, should a potential supplier offer superior terms, trunk line distributional facilities can be transferred from the original supplier to the successor firm (Demsetz, 1968, p. 62). Whether regulation is warranted as a means by which to cope more effectively with uncertainty is met with the observation that "[l]ong-term contracts for the supply of [nonutility services] are concluded satisfactorily in the market place without the aid of regulation" (1968, p. 64).

The dominant theme that emerges, occasional disclaimers to the contrary notwithstanding,[6] is that franchise bidding for natural monopolies has attractive properties. It is a market solution that avoids many of the disabilities of regulation. Demsetz' concluding remarks, in which he registers his "belief that rivalry of the open market place disciplines more effectively than do the regulatory processes of the commission" (1968, p. 65), are plainly in this spirit.

□ **Some objections.** *Marginal cost pricing.* Lester Telser takes issue with Demsetz' treatment of natural monopoly on the grounds that franchise bidding gives no assurance that output will be priced efficiently on marginal cost terms (Telser, 1969, pp. 938–939):

> [Demsetz] leaves readers with the impression that he is content with a situation in which the firm is prevented from obtaining a monopoly return and he does not raise the question of efficiency. Hence he implies that direct regulation of an industry subject to decreasing average cost is unnecessary if it is prevented from obtaining a monopoly return. . . . This misses the point. The controversy concerns regulation to secure efficiency and to promote public welfare. It does not concern the rate of return.

Another way of putting it is that Demsetz does not identify the relevant social welfare function or evaluate his results in welfare terms. Failure to do so, coupled with the prospect that franchise

[5] To the extent that Demsetz' treatment of natural monopoly is limited to a critique of elementary textbook discussions, the argument goes through. Plainly, however, Demsetz and others also contend that it has real world relevance. The "irrelevant complications" referred to in the text are conspicuously present when this latter application is attempted. As will be apparent, the purported superiority of franchise bidding is a good deal more difficult to establish when these conditions are present.

[6] Demsetz is somewhat more cautious about the merits of franchise bidding and highlights the qualifications to his argument in his reply to Telser's critique (Demsetz, 1971).

bidding will not lead to efficient marginal cost pricing, is, in Telser's view, a critical shortcoming of Demsetz' approach.

Demsetz has responded to these criticisms by observing that marginal cost pricing was of secondary importance to his paper (1971, p. 356). Although a complete treatment of the natural monopoly problem would require that efficient pricing be addressed, his original article did not pretend to be complete (1971, p. 356). He furthermore considers it doubtful that regulation leads to more efficient pricing than an appropriately elaborated bidding scheme (1971, pp. 360–361).

I suggest, for the purposes of this paper, that the marginal cost pricing issue be set aside and that the frictions associated with franchise bidding, which are glossed over in previous treatments, be examined instead. To the extent that filling the *lacunae* in Demsetz' "vaguely described bidding process"—which Telser mentions (1971, p. 364) but does not investigate—involves the progressive elaboration of an administrative machinery, the advantages of franchise bidding over regulation are uncertain. If, despite such machinery, the price-to-cost tracking properties of regulation are arguably superior to those of franchise bidding, the purported advantages of franchise bidding are further suspect.

Irrelevant complications. The irrelevant complications to which Demsetz refers—equipment durability and uncertainty—and dismisses in the context of his automobile license plate example are really the core issues. To be sure, steady state analysis of the type he employs sometimes yields fruitful insights that have wide reaching applications. I submit, however, that the interesting problems of *comparative institutional choice* are largely finessed when the issues are posed in steady state terms. Frank Knight's admonitions to this effect, although expressed in a different institutional context (1965, pp. 267–268), have general application. The basic argument, which applies both to Knight's interest in whether internal organization matters and to Demsetz' concern with market modes of contracting, is this: Rates of convergence aside, any of a large variety of organizing modes will achieve equally efficient results if steady state conditions obtain.[7] In circumstances, however, in which the operating environment is characterized by a nontrivial degree of uncertainty, self-conscious attention to both the *initial* and *adaptability* attributes of alternative modes is warranted.

Demsetz' treatment of franchise bidding emphasizes the initial supply price aspect and, as developed below, treats the matter of adaptability in a rather limited and sanguine way. As will be apparent, franchise bidding for public utility services under uncertainty encounters many of the same problems that the critics of regulation associate with regulation; as Victor Goldberg (1976) argues, the problems inhere in the circumstances.

[7] Consider in this connection whether, from an allocative efficiency point of view, it really matters if franchises are awarded on the basis of a lump-sum fee rather than a lowest supply price criterion. I submit that the monopoly distortions commonly associated with the former mode of contracting will tend to vanish if steady state conditions obtain. The reasoning here is that steady state conditions facilitate low cost price discrimination, in which event the marginal customer is supplied on marginal cost terms, and/or that customers can more effectively organize their side of the market and bargain to an efficient result.

3. Franchise bidding under uncertainty

■ It will be useful to examine franchise contracts of three types: once-for-all contracts, which appear to be the type of contract envisaged by Stigler; incomplete, long-term contracts, which are favored by Demsetz; and recurrent short-term contracts, which Posner endorses.

□ **Once-for-all contracts.** Stigler's views on franchise bidding are limited mainly to an endorsement of Demsetz' prior treatment of these matters. He observes simply that "[n]atural monopolies are often regulated by the state. We note that customers can auction off the right to sell electricity, using the state as the instrument to conduct the auction, and thus economize on transaction costs. The auction . . . consists of a promise to sell cheaply" (1968, p. 19). Since he gives no indication to the contrary, Stigler apparently intends that such bidding be regarded as a serious alternative to regulation under actual market circumstances—which is to say under conditions of market and technological uncertainty. Failure to refer to recurrent bidding also suggests that the bidding scheme proposed is of the once-for-all variety.[8]

Once-for-all contracts of two types can be distinguished: complete contingent claims contracts and incomplete contracts. The former require that each prospective franchisee specify the terms (prices) at which he is prepared to supply service now and, if price changes are to be made in response to uncertain future events, the conditional terms under which he will supply service in the future. It is generally appreciated that complete contracts of this kind are impossibly complex to write, negotiate, and enforce (Radner, 1968). The underlying transactional disabilities have been set out elsewhere (Williamson, 1975, Chap. 2; Williamson, Wachter, and Harris, 1975).

Given the infeasibility of complete contingent claims contracts, incomplete once-for-all contracts might be considered. Contractual incompleteness, however, is not without cost. Although incomplete once-for-all contracts are feasible in the sense that bounded rationality constraints are satisfied, such contracts pose hazards by increasing the risk of opportunism. The problems here are substantially those discussed below in conjunction with incomplete long-term contracts.

□ **Incomplete long-term contracts.** Demsetz evidently has in mind that franchise awards be of a long-term kind in which adaptations to unanticipated developments are accomplished by permitting renegotiation of terms subject to penalty clauses (1968, pp. 64–65). Such renegotiation would be unnecessary, of course, if the parties to the contract could agree, at the outset, to deal with unanticipated events and to resolve conflicts by employing a joint profit maximizing decision rule, thereafter to share the gains of the resulting adaptation. General agreements to this effect are not self-enforcing, however, unless the profit consequences are fully known to both of the parties and can be displayed, at low cost, to an impartial arbitrator. Absent this, each party will be inclined, when the unanticipated events occur, to manipulate the data in a way that favors its interests (Williamson, 1975, pp. 31–33, 91–93).

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[8] Possibly, however, Stigler intends that Demsetz' discussion of renegotiation and/or rebidding should apply. Demsetz' treatment of these matters appears below.

To be sure, aggressive self-interest seeking of a myopic kind is attenuated both by the existence of informal sanctions and by an appreciation between the parties that accommodation yields long-run benefits (Macaulay, 1963). But the hazards of opportunism scarcely vanish of these accounts. Among the problems to be anticipated when incomplete long-term contracts are negotiated under conditions of uncertainty are the following: (1) the initial award criterion is apt to be artificial or obscure; (2) execution problems in price-cost, in other performance, and in political respects are apt to develop; and (3) bidding parity between the incumbent and prospective rivals at the contract renewal interval is unlikely to be realized. Consider these several conditions *seriatim*.

(1) *Artificial or obscure initial award criterion.* The promise to "supply cheaply" is scarcely a well-defined commitment unless the quality of service is well specified and scalar valued bids possess economic merit. Posner recognizes the former and proposes that subscriber preferences regarding quality be ascertained by a preaward solicitation. The mechanics involve (1972, p. 115):

> . . . an "open season" in which all franchise applicants were free to solicit the area's residents for a set period of time. This would not be a poll; the applicants would seek to obtain actual commitments from potential subscribers. At the end of the solicitation period, the commitments received by the various applicants would be compared and the franchise awarded to the applicant whose guaranteed receipts, on the basis of subscriber commitments, were largest. In this fashion the vote of each subscriber would be weighted by his willingness to pay, and the winning applicant would be the one who, in free competition with the other applicants, was preferred by subscribers in the aggregate. To keep the solicitation process honest, each applicant would be required to contract in advance that, in the event he won, he would provide the level of service, and at the rate represented, in his solicitation drive.

The comparability problems that would otherwise be posed if both price and quality were permitted to vary at the final competition stage are thus avoided. The preaward solicitation not only prevents the quality level from being set by a political body, but also relieves the need to choose among disparate price-quality mixes, on grounds that are uncertain, at the final competition.

However imaginative this preaward solicitation process of Posner, it is not obviously practicable. For one thing, it assumes that subscribers are able to assess quality-price packages abstractly and have the time and inclination to do so—which poses a bounded rationality issue.[9] For another, it aggregates preferences in a rather arbitrary way.[10] Finally, it assumes that subscribers will demand that winners

[9] To observe that "customers face and overcome [such problems] daily in choosing among products that differ in quality as well as price" (Posner, 1972, p. 115) is scarcely dispositive. Issues peculiar to the supply of natural monopoly services are not even raised. For example, quality variability of electricity supply is apt to entail voltage variations or prospective supply interruptions, the implications of which are apt to be difficult to assess. Secondly, variable load pricing issues, with which most consumers have little familiarity, may be posed. Third, collective choice issues which do not appear for most consumer goods must be faced in deciding on electricity supply. Fourth, long-term interaction effects between electricity price and substitutes and complements are rather strong, albeit difficult to sort out in the context of hypothetical solicitations.

[10] Thus, if price-quality package A wins the competition, on Posner's criterion, over price-quality mixes B, C, D, and E, where A is a high price, high quality mode and B through E are all variants on a low price-quality mix, does it follow that package A is socially preferred?

provide the level of service at the rate represented or can otherwise obtain satisfaction for failure to perform. This poses execution issues and is discussed in (2) below.[11]

If, additionally, the prices at which service is supplied are to vary with periodic demands—a measure which often has efficient capacity rationing properties for public utility services—a complex variable load pricing schedule, rather than a single lowest bid price, must be solicited. Vector valued bids clearly pose award difficulties.

The upshot is that, although franchise awards can be reduced to a lowest bid price criterion, this is apt to be artificial if the future is uncertain and the service in question is at all complex. Such awards are apt to be arbitrary and/or pose the hazard that "adventurous" bids will be tendered by those who are best suited or most inclined to assume political risks. Again, this gives rise to execution issues, to which we now turn.

(2) *Execution problems.* Even if contract award issues of the kinds described above either were absent or could be dismissed as *de minimis,* we would still have to face problems of contract execution. It is at the execution stage and in conjunction with contract renewal that the convergence of franchise bidding to public utility regulation is especially evident.

I assume, for the purposes of this subsection, that there is a strong presumption that the winner of the bidding competition will be the supplier of the public utility service over the entire contract period. Only in the event of egregious and persistent malperformance would an effort be made to replace the winning franchisee.

The assumption is supported by the following considerations. First, the award of a long-term contract plainly contemplates that the winner will be the supplier over a considerable period. A leading reason to make the contract long term is to provide the supplier with requisite incentives to install long-lived assets.[12] If any slight failure to perform in accordance with the franchisor's expectations would occasion rescission of the franchise, the long-term contract would be a fiction and its investment purposes vitiated.

The prospect of litigation delays and expenses also discourages an effort to displace a franchisee. Moreover, even if such an effort were successful, nontrivial transition costs would be incurred. (These are discussed further in (3) below.) Finally, franchise award agencies, like other bureaucracies, are loath to concede or be accused of error. As Eckstein puts it, publicly accountable decision makers "acquire political and psychological stakes in their own decisions and develop a justificatory rather than a critical attitude towards them" (1956, p. 223). Since displacement may be interpreted as a public admission of

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[11] Similar problems arise with respect to the matter of who in the community is to be supplied service and at what connection costs: Connect everybody who requests it at a flat charge? Only those who live in areas where connected service exceeds some threshold? Anyone who bears his own incremental costs? Although a single standard can be stipulated by the contracting agency, is this optimal and ought such a connection standard to remain fixed for the duration of the contract?

[12] The short-term contracting procedure favored by Posner contemplates the transfer of long-lived assets from the winning franchisee to a successor firm. Appropriate investment incentives would thereby be realized. For the reasons developed in (3) below, I am skeptical of the properties of the asset transfer procedure described by Posner.

error, franchise award agencies predictably prefer, when faced with malperformance, to negotiate a "compromise" solution instead.

Price-cost relations. In circumstances in which long-term contracts are executed under conditions of uncertainty, fixed price bids are apt to be rather unsatisfactory. If the environment is characterized by uncertainty with respect to technology, demand, local factor supply conditions, inflation, and the like, price-cost divergences and/or indeterminacies will develop.

To be sure, some of these divergences can be reduced by introducing price flexibility by formula (Fuller and Braucher, 1964, pp. 77–78; Goldberg, 1975, p. 19). Adjustment for changes in the price in response to some index of prices is one possibility. This, however, is a relatively crude correction and unlikely to be satisfactory where there is rapid technical change or where local conditions deviate significantly from the index population. More precise tracking of prices to costs will be realized if, instead of fixed price contracts, cost plus (or cost sharing) contracts are negotiated. All of the difficulties associated with the execution of defense contracts of the cost sharing kind then appear, however (Scherer, 1964; Williamson, 1967). Problems of auditing and of defective incentives are especially severe. (These, it will be noted, are disabilities associated with regulation. Franchise bidding is designed to overcome them.)

Other performance attributes. A lack of specificity in the contract with respect to the quality of service and a failure to stipulate monitoring and accounting procedures accords latitude to franchisees during contract execution. Despite *ex ante* assurances to the contrary, franchisees can rarely be made to fulfill the spirit of an agreement if net revenues are enhanced by adhering to the letter of the contract only (CTIC, 1972a, p. 11). Moreover, technical standards, by themselves, are not self-enforcing; enforcement requires that a policing apparatus be devised (CTIC, 1973, p. 7). Since individual consumers are unlikely to have the data or competence to evaluate the quality of service in a discriminating way (Goldberg, 1976) and since both setup cost and specialization of labor economies will be realized by assigning the quality evaluation function to a specialized agency, centralization is indicated. But again, the convergence toward regulation should be noted.[13]

It may not be sufficient, moreover, merely to specify a common quality standard for all bidders. Thus, suppose that one bidder proposes to achieve the specified quality target by installing high performance, long-lived equipment, that a second proposes to have backup equipment ready in the event of breakdown, and that the third claims that he will invest heavily in maintenance personnel. Although only one of these may fully satisfy the requirements, both subscribers and the franchising agency may lack the *ex ante* capacity to discern which. Granting the franchise to the low bidder only to discover that

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[13] The Cable Television Information Center expresses the issue as follows (1973, p. 7):

> [T]echnical standards do not enforce themselves. Enforcement requires testing the system, evaluation of the tests, and deciding upon corrective actions required. These activities add to the administrative burden of regulation. A franchising authority should not adopt standards unless it is willing to shoulder the burden of enforcement.

he is unable to perform as described is plainly unsatisfactory. Although penalty clauses in contracts can help forestall such outcomes, it is often the case—as the history of defense contracting suggests—that successful bidders are able to have terms renegotiated to their advantage.

Accounting ambiguities coupled with the disinclination of franchising agencies to allow winning bidders to fail permit franchisees to use accounting data in a strategic way—to include the threat of bankruptcy—during renegotiations. The introduction of monitoring and accounting control techniques can prevent such outcomes, but this measure then joins the winning bidder and the franchising agency in a quasi-regulatory relationship.

Politics. In circumstances in which renegotiation is common and perhaps vital to the profitable operation of a franchise, political skills assume special importance. Prospective suppliers who possess superior skills in least cost supply respects but who are relatively inept in dealing with the franchising bureaucracy and in influencing the political process are unlikely to submit winning bids.[14] To the extent that political skills override objective economic skills, the advantages of franchising over regulation are placed in question.

Indeed, if franchisees are subject to less stringent profit controls than regulated firms (where the latter are subject to rate of return constraints), it may well be that franchising encourages greater political participation. The argument here is that the incentive to invest private resources to influence political decisions varies directly with the degree to which the resulting advantages can be privately appropriated—and that franchised firms have an appropriability advantage in this respect.[15]

(3) *Lack of bidding parity during contract renewal.* Lest meaningful competition at the contract renewal interval be upset, participation in contract execution should not place winners of the original competition at a substantial advantage over nonwinners. As discussed generally elsewhere (Peacock and Rowley, 1972, p. 242; Williamson, 1975, pp. 26–35), however, and as expressly developed in the context of CATV in the following subsection, there are reasons to believe that bidding parity at contract renewal intervals will not obtain.

□ **Recurrent short-term contracts.** A leading advantage of recurrent short-term contracting over long-term contracting is that short-term contracts facilitate adaptive, sequential decisionmaking. The requirements that contingencies be comprehensively described and appropriate adaptations to each worked out in advance are thereby avoided. Rather, the future is permitted to unfold and adaptations are introduced, at contract renewal intervals, only to those events which actually materialize. Put differently, bridges are crossed one (or a few) at a time, as specific events occur. As compared with the

[14] Note that a merger between parties who possess economic qualifications and those with political skills yields private and probably social gains in these circumstances. Such a merger actually occurred in the case study reported in Section 4.

[15] This assumes that regulation is not a farce and that management engrossing is strictly limited under regulation. Note also that the argument assumes that the *marginal* net gains of influencing the political process are greater under the franchise mode. For a discussion of politics and regulation, see Alfred Kahn (1971, pp. 326–327).

contingent claims contracting requirement that the complete decision tree be generated, so that all possible bridges are crossed in advance, the adaptive, sequential decisionmaking procedure economizes greatly on bounded rationality.

Additionally, under the assumption that competition at the contract renewal interval is efficacious, the hazards of contractual incompleteness which beset incomplete long-term contracts are avoided. Failure to define contractual terms appropriately gives rise, at most, to malperformance during the duration of the current short-term contract. Indeed, recognizing that a bidding competition will be held in the near future, winning bidders may be more inclined to cooperate with the franchising authority, if specific contractual deficiencies are noted, rather than use such occasions to realize temporary bargaining advantages.[16] Opportunism is thereby curbed as well.[17]

The efficacy of recurrent short-term contracting depends crucially, however, on the assumption that *parity among bidders at the contract renewal interval is realized.*[18] Posner faces and disposes of this issue (1972, p. 116):

> [T]he fact that the cable company's plant normally will outlast the period of its franchise raises a question: Will not the cable company be able to outbid any new applicant, who would have to build a plant from scratch? And will not the bargaining method therefore be ineffective after the first round? Not necessarily: in bidding for the franchise on the basis of new equipment costs, new applicants need not be at a significant disadvantage in relation to the incumbent franchisee. For example, once a new applicant is franchised he could negotiate to purchase the system of the existing franchisee, who is faced with the loss of the unamortized portion of his investment if his successor builds a new system. Insofar as the economic life of a cable plant is considered a problem when the franchise term is short, it can be solved by including in the franchise a provision requiring the franchisee, at the successor's option, to sell his plant (including improvements) to the latter at its original cost, as depreciated.

I find these views overly sanguine. For one thing, equipment valuation problems are apt to be rather more complex than Posner's remarks suggest. Secondly, Posner focuses entirely on nonhuman capital; the possibility that human capital problems also exist is nowhere acknowledged. To be sure, human asset benefits which accrue during contract execution and which give incumbents an advantage over outsiders will, if anticipated, be reflected in the original

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[16] This assumes that winning bidders are not fly-by-night operators, but instead are interested in remaining in the business on a continuing basis. Other things being equal, the franchising authority can be expected to continue with the current supplier or shift to a new supplier at the contract renewal interval depending on its experience with the current winner during the contract period.

[17] Similar considerations have a bearing on the performance of the franchising agency. Posner puts the argument as follows (1972, pp. 115–116):

> [If] the duration of the franchise . . . is long, the parties may not have foreseen all of the circumstances that might require modification of its terms. Although this is a problem common to all contracts, the peculiarity here is that one of the contracting parties is not a true party in interest but a public body charged with overseeing the interest of the other parties (subscribers). Experience with regulatory agencies suggests that one cannot assume such a body will represent the consumer interest faithfully. When the cable company asks for a modification of the contract by virtue of an unforeseen change in circumstances, the public body may react ineffectually or perversely.

With short duration contracts, "no modification of . . . terms need be entertained" (Posner, 1972, p. 116), in which event the distortions referred to are avoided.

[18] For prior discussions of bidding parity and its absence at contract renewal intervals, see Peacock and Rowley (1972, p. 242) and Williamson (1975, pp. 26–35).

bidding competition. But "buying in" can be risky and the price tracking properties of such strategies are easily inferior to average cost pricing in resource allocation respects. The upshot is that recurrent bidding (at, say, four-year intervals) is riddled with contractual indeterminacies.

Concern over plant and equipment valuation is, of course, mitigated if the investments in question are relatively unspecialized. I conjecture that this is the case for Demsetz' automobile license plate example. If, with only minor modifications, general purpose equipment (for the cutting, stamping, painting, etc.) can produce license plates efficiently, then a franchisee who fails to win the renewal contract can productively employ most of this same equipment for other purposes, while the new winner can, at slight cost, modify his own plant and equipment to produce the annual requirement efficiently.

Alternatively, concern over plant and equipment poses no problem if its useful life is exhausted during the contract execution interval. As Posner's remarks suggest, however, and as is generally conceded, it is inefficient to install utility plant and equipment of such short duration.

Unlike Demsetz' license plate manufacturers, moreover, most utility services (gas, water, electricity, telephone) require that *specialized* plant and equipment be put in place. The same is true of CATV. Since the construction of parallel systems is wasteful and since to require this to be done would place outside bidders at a disadvantage at the contract renewal interval, some method of transferring assets from existing franchisees to successor firms plainly needs to be worked out.

Posner contends that this can be handled by stipulating that plant and equipment be sold to the successor firm, at its option, at the original cost less depreciation of the predecessor franchisee. Consistent with his emphasis on fundamental policy choices, Posner declines to supply the details. Unfortunately, however, the details are troublesome.

For one thing, original cost can be manipulated by the predecessor firm. For another, even if depreciation accounting procedures are specified under the original franchise terms, implementation may still be contested. Third, original cost less depreciation at best sets an upper bound—and perhaps not even this, since inflation issues are not faced—on the valuation of plant and equipment. The successor franchisee may well offer less, in which case costly haggling ensues. Finally, even if no disputes eventuate, Posner's procedures merely provide a legal rule for transferring assets. He does not address the economic properties of the procedures in investment incentive and utilization respects.

Whether the accounting records of original costs can be accepted as recorded depends in part on whether the equipment was bought on competitive terms. The original franchisee who is integrated backwards into equipment supply or who arranges a kickback from an equipment supplier can plainly rig the prices to the disadvantage of rival bidders at the contract renewal interval. Furthermore, and related, the original cost should also include the labor expense of installing plant and equipment. To the extent, however, that the allocation of labor expense between operating and capital categories

is not unambiguous, the original winner can capitalize certain labor expenses to the disadvantage of would-be successors. Auditing can be employed to limit these distortions, but this has the appearance of regulation. Even if carefully done, moreover, the results are apt to be disputed. Inasmuch as information on true valuation is asymmetrically distributed to the disadvantage of outside parties, the burden of showing excess capitalization falls heavily on the would-be new supplier.

Reaching agreement on depreciation charges, which are notoriously difficult to define (especially if obsolescence is a problem and maintenance expenditures can be manipulated in a strategic manner), poses similar problems. Therefore, costly arbitration, for both original equipment valuation and depreciation reasons, is apt to ensue.[19] Rate base valuations of a regulatory kind thereby obtain.

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[19] The City of Los Angeles anticipated such difficulties in its ordinance on franchise award and execution (Ordinance No. 58,200). The ordinance stipulates that the City has a right to purchase the property of a franchise or find a purchaser therefore and further provides that

. . . in the event said franchise shall expire by operation of law, said city shall have the right, at its option, declared not more than one (1) year before the expiration of the franchise term as herein fixed, which right an option is hereby reserved to said city, to purchase and take over the property of such utility, and in the event that said city shall so exercise its right under such option the said city shall pay to the said grantee the fair value of the property of such utility as herein provided.
(d) The term "fair value" as used herein shall be construed to mean the reasonable value of the property of such utility having regard to its condition of repair and its adaptability and capacity for the use for which it shall have been originally intended. The price to be paid by the City for any utility shall be on the basis of actual cost to the utility for the property taken, less depreciation accrued, as of the date of purchase, with due allowance for obsolescense, if any, and the efficiency of its units to perform the duties imposed on them; no allowance shall be made for franchise value, good will, going concern, earning power, increased cost of reproduction or increased value of right of way or allowance for damages by reasons of severance.
(e) That the valuation of the property of such utility proposed to be purchased upon the termination of said franchise as herein provided, or otherwise, shall be determined by a board of three arbitrators of whom one shall be appointed by the city, one by the grantee, and the third by the two arbitrators so appointed. Said arbitrators shall be appointed within thirty days after the declaration by the city of its option to purchase said property of such utility, or to find a purchaser therefor. In case said arbitrators fail to make and file an award within the time hereinafter limited, a new board of three arbitrators shall be appointed as hereinbefore prescribed. The board of arbitrators shall immediately upon the appointment of its members enter upon the discharge of its duties. Any vacancy in the board of arbitrators shall be filled by the party who made the original appointment to the vacant place.
(f) In the event the grantee shall fail to appoint an arbitrator within thirty days after the declaration by the city of its option to purchase the property of such utility or to find a purchase therefor, or in the event of the death or resignation of such arbitrator so appointed and such grantee, its successors or assigns, shall fail to appoint an arbitrator to fill such vacancy within ten (10) days thereafter, or in the event the two arbitrators appointed by the city and grantee, as hereinbefore provided, shall fail to appoint a third arbitrator within sixty (60) days after the declaration of the city of its option to purchase the property of such utility, or to find a purchase therefor, then upon application made either by the city, or by said grantee after (5) days' notice in writing to the other party, such arbitrator shall be appointed by the presiding Judge of the Superior Court of the State of California, in and for the County of Los Angeles, and the arbitrators so appointed shall have the same powers and duties as though he had been appointed in the manner hereinabove prescribed.
(g) The award of the arbitrators must be made and filed with the City Clerk of said city within three (3) months after their appointment, and a majority of the arbitrators who agree thereto may make such award.

Indeed, the valuation of physical assets is predictably more severe under franchise bidding than under regulation. For one thing, earnings in the regulated firm are a product of the rate base and the realized rate of return. Clearly, the regulated firm can be conciliatory about the rate base if in exchange it receives allowable rate of return concessions. Additionally, the regulatory agency and regulated firm are prospectively joined in a long series of negotiations. Errors made by either party on one round are less critical if these can be remedied at the next rate review interval (or if, in a crisis, interim relief can be anticipated). More is at stake with asset valuation under franchise bidding, since degrees of freedom of both rate of return and intertemporal kinds are missing. Accordingly, more contentious bargaining leading to litigation is to be expected.

A related difficulty with Posner's physical asset valuation scheme is that it merely sets an upper bound. Inasmuch, however, as procurement on these terms is left to the successor firm's option, there is little reason to expect this figure to prevail. Without stipulating more, the successor firm would presumably offer to buy the specialized plant and equipment at its value in its best alternative (nonfranchised) use. This will normally be a small fraction of the depreciated original cost. Predecessor and successor firms thus find themselves confronted with a wide bargaining range within which to reach an exchange agreement. Since competitive forces sufficient to drive the parties to a unique agreement are lacking, additional haggling (which is a social cost) can be anticipated. Albeit vexing, the details, which are neglected by Posner, nevertheless matter; the frictionless transfer on which he appears to rely is simply not to be had on the terms described.

Conceivably superior asset valuation and franchise bidding schemes can be devised which mitigate these problems.[20] It is patently incumbent, however, on those who believe that large numbers competition can be made effective at the contract renewal interval to come forward with the requisite operational details. Without such specificity, one must consider dubious the contention that low cost reassignment of physical assets can be effected at the contract renewal interval for franchised services which require specialized and long-lived plant and equipment to be installed. Rather, nontrivial haggling and litigation expenses appear to infect Posner's proposal.

Moreover, human asset problems, which Posner and Demsetz fail even to mention, also need to be faced. Again, the matter of fungibility arises. To the extent that the skills of operating the franchise are widely available or, alternatively, that employees of the incumbent firm deal with rival bidders and the incumbent's owners on identical terms, no problems of this kind appear. If, however, nontrivial spec-

For a discussion of franchise valuations of a similar kind in connection with New York City's award of CATV franchises, see CTIC (1972a, pp. 16–17).

[20] One possibility is for each willing bidder, at the contract renewal interval, to indicate his asset valuation at the time he enters his bid on the quality and price of service. The problem here is that asset valuations and service bids are not independent. Franchisees will be prepared to pay dearly for assets if in the process they can charge a high price.

Other schemes might be explored (see note 19, *supra*) and possibly some can be shown to have attractive properties. It is plainly the case, however, that a good deal of hard thinking about the mechanics of the asset valuation process is needed before the rebidding scheme can be considered complete.

ialized skills and knowledge accrue to individuals and small groups as a result of on-the-job training and experience, the first of these conditions is violated. If, additionally, employees resist transfer of ownership in the bidding competition, rivals are put to a disadvantage.

The matter of nonfungibility of labor has been discussed elsewhere by Friedrich Hayek (1945, pp. 521–522) and Jacob Marschak (1968, p. 14) and has been addressed in the context of task idiosyncracy by Peter Doeringer and Michael Piore (1971, pp. 15–16) and by Williamson, Wachter, and Harris (1975). The thrust of this literature is that significant differences sometimes develop between experienced and inexperienced workers in the following respects: (1) equipment idiosyncracies, due to highly specialized or incompletely standardized, albeit common, equipment, are "revealed" only to experienced workers; (2) processing economies of an idiosyncratic kind are fashioned or "adopted" by managers and workers in specific operating contexts; (3) informal team accommodations, attributable to mutual adaptation among parties engaged in recurrent contact, develop and are upset, to the possible detriment of group performance, when the membership is altered; and (4) communication idiosyncracies evolve (with respect, for example, to information channels and codes), but are of value only in an operating context where the parties are familiar with each other and share a common language.

As a consequence, it is often inefficient fully or extensively to displace the experienced labor and management group that is employed by the winner of the initial franchise award. Familiarizing another group with the idiosyncracies of the operation and developing the requisite team production and communication skills are costly. Accordingly, incumbent employees, who alone possess the idiosyncratic knowledge needed to realize least-cost supply, are powerfully situated to block a franchise reassignment effort.

The cost disadvantage referred to will obtain, however, only insofar as incumbent employees deal with the current ownership and outside bidders differently. The strategic advantage which they enjoy in relation to inexperienced but otherwise qualified employees is one which can be exercised against both the current owner and his bidding rivals alike. The issue thus comes down to whether current and prospective owners are treated differently at the contract renewal interval.[21] I conjecture that they will be. The main reason is that *informal* understandings (with respect to job security, promotional expectations, and other aspects of internal due process) are much

[21] Relevant in this connection is the following issue: Why have incumbent employees failed to exploit fully their idiosyncratic advantage over inexperienced employees during the contract execution period—in which event there is no unliquidated idiosyncratic gain to be differentially awarded at the contract renewal interval? A distinction between moving equilibrium and discrete bargaining behavior is relevant in this connection. For one thing, there may be adjustment lags in the system which are tolerated during the operating period but for which correction is possible at the contract renewal interval. For another, collective action is necessary to appropriate the idiosyncratic gains. Enterprise owners may work out a *modus vivendi* with managers and labor representatives in which management and labor, in exchange for ownership support (including job security, emoluments, etc.), consciously decline to absorb the full idiosyncratic gain. Out of recognition that the "leadership" is in this together, a reserve of unliquidated idiosyncratic gain has strategic advantages.

easier to reach and enforce in familiar circumstances than in unfamiliar ones.[22]

This is not to say that employees cannot or will not strike bargains with outsiders, but rather that such bargains will be more costly to reach, because much more attention to explicit detail will be required, or that there is greater risk associated with an informal (incompletely specified) agreement with outsiders. Where additional detail is sought, outsiders will be at a disadvantage in relation to insiders, because the costs of reaching agreement are increased. If, instead, employees are asked to trust the outsider to behave "responsibly" or, alternatively, the outsider agrees to accept the interpretation placed on incomplete agreements by the employees when unanticipated events not expressly covered by the employment contract develop, the implied risks are great and corresponding premia will find their way, directly or indirectly, into the bid price. As a consequence, idiosyncratic employment attributes coupled with the inability of outsiders to reach equivalent agreements at equal expense place original franchisees at an advantage at the contract renewal interval. Thus, human capital considerations compound the bidding difficulties which physical asset valuation problems pose. To contend that bidding parity can be expected at the contract renewal interval is accordingly suspect for this reason as well. Put differently, if original winners of the bidding competition realize nontrivial advantages in informational and informal organizational respects during contract execution, bidding parity at the contract renewal interval can no longer be presumed. Rather, what was once a large numbers bidding situation, at the time the original franchise was awarded, *is converted into what is tantamount to a small numbers bargaining situation* when the franchise comes up for renewal.

Contracting schemes which avoid these risks, which have superior price tracking properties, and which do not experience offsetting disabilities are plainly to be preferred. Since both the risk bearing and price tracking properties of regulation are arguably superior to those of franchise bidding, and if franchise bidding in practice is, in most other respects, difficult to distinguish from regulation, the net gain of franchise bidding over regulation is not transparent.[23]

It might be argued, of course, that the incumbency advantage will be anticipated at the outset, in which event discounted certainty equivalent profits will be bid down to zero by large numbers competition for the original award. This is not, however, an entirely satisfactory answer. For one thing, to come in at a price below cost for the initial award (perhaps even a negative price) and to set price at the level of alternative cost at contract renewal intervals easily result in resource utilization of an inferior kind. Additionally, buying-in

[22] For a sociological discussion of some of the problems of succession, see Gouldner (1954). Macneil observes that "the elements of trust demanded by participant views of relations make identity important, and simple transfer therefore unlikely" (1974, p. 791).

[23] A distinctive limitation of regulation, to which franchise bidding is presumably less subject, is the proclivity of regulators progressively to expand the reach of regulation to include "ancillary" activities. More generally, the greater autonomy and degree of specialization associated with regulation, as compared with franchise bidding agencies, may have unfavorable long-run rigidity consequences. In particular, regulatory authorities are apt to resist vigorously anything which threatens their demise.

strategies are risky. The alternative supply price can be influenced by the terms the franchisor sets on subsequent rounds, including terms that may obsolete the learning by doing advantages of incumbents.

☐ **A summing up.** Once-for-all bidding schemes of the contingent claims contracting kind are infeasible and/or pose execution hazards. Incomplete long-term contracts of the type envisaged by Demsetz alleviate the first of these problems but aggravate the second. A whole series of difficulties long familiar to students of defense contracting and regulation appears. The upshot is that franchise bidding for incomplete long-term contracts is a much more dubious undertaking than Demsetz' discussion suggests.

Posner's proposal that franchise terms be kept short is designed to overcome the adaptability problems associated with incomplete long-term contracts, but his discussion is insufficiently microanalytic and/or critical of the disabilities of short-term contracts to expose their shortcomings. The fundamental limitation of the argument is that, despite Posner's procedural stipulations (1972, p. 116), bidding parity at the contract renewal interval between the original winner and rival successor firms cannot safely be presumed. To the contrary, there are reasons to doubt such parity, in which case the adaptability and price to cost properties that Posner associates with recurrent contracting[24] are not to be had on the frictionless (or low cost) terms he describes.

To be sure, some of the difficulties which infect the Posner proposal can be mitigated by introducing an extensive regulatory/ arbitration apparatus. Assessing plant and equipment installations, auditing related accounting records, and arbitrating disputes between incumbent and rival firms over physical asset valuations are illustrative. But then franchise bidding and regulation differ only in degree.

It is perhaps unsurprising, in view of the foregoing, that Posner's recurrent bidding proposal has not been widely adopted. Rather, most CATV franchise awards are for ten to fifteen years, and contractual incompleteness has been handled by progressively elaborating a regulatory structure (CTIC, 1972c, pp. 9–12)—a result which conceivably reflects a desire by CATV operators to insulate themselves from the rigors of competition. I submit, however, that the drift toward regulation is also explained by performance defects associated with CATV franchise awards which are caused in part by contractual incompleteness (CTIC, 1972c, p. 9).

Still, the contractual incompleteness defects described above might conceivably be remedied by progressively refining CATV awards in the future. Stipulating appropriate penalties for unsatisfactory performance and setting out complex conditional responses to contingent events may serve to promote efficient adaptation and mitigate haggling expenses. Elaborating the contract in these respects is not costless, however, and franchising agencies often lack the resolve to exact penalties as prescribed.[25] Although times have surely

[24] The basic argument is that "[e]ach bidder would submit a plan of service and schedule of rates. As long as there was more than one bidder and collusion among the bidders was prevented—conditions that ought not to be insuperably difficult to secure—the process of bidding subscriber rates down and quality of service up would eliminate monopoly pricing and profits" (Posner, 1972, p. 115).

[25] Note, moreover, that not only are contract remedies "among the weakest of

changed for the better, it is sobering to note that the limits of franchise contracts were described some 70 years ago as follows (Fisher, 1907, pp. 39–40):

> Regulation does not end with the formulation and adoption of a satisfactory contract, in itself a considerable task. If this were all, a few wise and honest men might, once in a generation supervise the framing of a franchise in proper form, and nothing further would be necessary. It is a current fallacy and the common practice in American public life to assume that a constitution or a statute or a charter, once properly drawn up by intelligent citizens and adopted by an awakened public, is self-executing and that the duty of good citizens ends with the successful enactment of some such well matured plan. But repeated experience has demonstrated—what should have been always apparent—the absolute futility of such a course, and the disastrous consequences of reliance upon a written document for the purposes of living administration. As with a constitution, a statute, or a charter, so with a franchise. It has been found that such an agreement is not self-enforcing. . . . [Moreover, the] administration may ignore or fail to enforce compliance with those essential parts of a contract entrusted to its executive authority; and legal proceedings . . . are frequently unavoidable long before the time of the franchise has expired.

At the risk of oversimplification, regulation may be described contractually as a highly incomplete form of long-term contracting in which (1) the regulatee is assured an overall fair rate of return, in exchange for which (2) adaptations to changing circumstances are successively introduced without the costly haggling that attends such changes when parties to the contract enjoy greater autonomy. Whether net gains are thereby realized turns on the extent to which the disincentive effects of the former (which may be checked in some degree by performance audits and by mobilizing competition in the capital market forces (Williamson, 1972)) are more than offset by the gains from the latter. This is apt to vary with the degree to which the industry is subject to uncertainties of market and technological kinds.

4. A case study

■ Although the case study reported below cannot claim to be representative, it does reveal that many of the franchise concerns discussed in the previous section are not purely imaginary.[26] The study both

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those the legal system can deliver, [b]ut a host of doctrines and techniques lies in the way even of those remedies" (Macneil, 1974, p. 730). Until franchisers and the legal system can be persuaded to behave otherwise, it is fatuous to contend that franchisees can be induced to behave in ideal ways by the introduction of a complex set of penalty clauses.

[26] It is also noteworthy that many of the franchising concerns reported by the Cable Television Information Center are consonant with those set out in Section 3. Among the concerns and recommendations of the CTIC are the following (CTIC, 1972a):

(1) The renewal period has proven to be a period of great pressure on the city, with the cable operator often threatening to discontinue service immediately unless renewal is promised (p. 16).
(2) The franchising authority will . . . want to include buyback provisions as part of its effort to insure continuity of service. The provision should include . . . a method of evaluation or termination (S. 4, p. 6).
(3) [The] right of transfer should be limited at the initial stages of the systems' development, and perhaps flatly forbidden before construction, to avoid trafficking in franchise awards (p. 17).
(4) Results of system performance and tests should be submitted periodically to ensure the system's quality (p. 24).
(5) [Day to day regulation involves] considering consumer complaints and passing on requests for rate increases (p. 25).
(6) Once a procedure has been developed for considering rate changes, the proposed

indicates the importance of evaluating proposals to scrap regulation in favor of market alternatives in more microanalytic terms and discloses that, in practice, franchise bidding for CATV (and presumably other public utility services) has many of the qualities of regulation.

□ **The Oakland CATV experience.** On June 19, 1969, the Council of the City of Oakland, California, passed a city ordinance which provided for the granting of community antenna television franchises. The main features of the ordinance, for the purposes of this paper, were:[27]

(1) the franchise award was to be nonexclusive;
(2) the franchise duration was not to exceed twenty years;
(3) the City was authorized to terminate a franchisee for noncompliance after thirty days' notice and a public hearing;
(4) the franchisee was directed to supply a complete financial statement to the City annually and the City was given the right to inspect the franchisee's records;
(5) the City had the right to acquire the CATV system at the cost of reproduction;
(6) the City Manager was authorized to adjust, settle, or compromise any controversy that might arise among the City, the franchisee, or subscribers, although aggrieved parties could appeal to the City Council;
(7) failure to comply with time requirements of the franchise were grounds for termination;
(8) inasmuch as failure to comply with time requirements would result in damages that would be costly to assess, an automatic fine of seven hundred and fifty dollars per day would be imposed for each day beyond the three-year target completion date that the franchisee took to install the system;
(9) any property of the franchisee that was abandoned in place would become the property of the City;
(10) a surety bond of one hundred thousand dollars was to be obtained by the franchisee and renewed annually;
(11) property of the franchisee was to be subject to inspection by the City;
(12) the CATV system was to be installed and maintained in accordance with the "highest and best accepted standards" of the industry.

Operationalizing the bidding process. The above constituted the basic legislative authority and ground rules. Rather, however, than solicit bids immediately, the Department of General Services engaged instead in a set of preliminary discussions with prospective franchisees.[28] Simultaneously, community groups were requested to advise the City on the types of services to be offered. The resulting

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changes are to be measured against the standard of what is fair to the system and to the subscribing public (p. 30).

(7) One of the most neglected areas in ordinances has been enforcement. Mechanisms such as arbitration, provision for leaseback, and the ability to seek court action will aid in achieving the type of Cable system the community wants (p. 45).

[27] City of Oakland, Ordinance No. 7989 C.M.S., June 19, 1969.

[28] The dialogue period was described to me by Mark Leh, Assistant Manager of Electrical Services of the Department of General Services, Oakland.

dialogue was intended to elicit information regarding cost, demand characteristics, technical capabilities, etc., and would help define the "basic service," which would then be stipulated in the contract. Comparability among bids for a standardized service would thereby be facilitated.

Ten months later, on April 30, 1970, the City of Oakland apprised five applicants that the City would receive their amended applications to construct, operate, and maintain a nonexclusive CATV system franchise within the City. The main features, for the purposes of this paper, of the invitation to bid were:[29]

(1) Two systems were to be provided:
   (a) System A, which is the basic system, would permit the subscriber to receive the entire FM radio band plus twelve TV channels distributed as follows: nine local off-the-air channels; one or more newly created local origination channels; and one channel assigned to the City and School District. Payment of a monthly charge of "*X*" plus connection charges (see items (5) and (6), below) would permit the subscriber to receive System A.
   (b) System B would provide special programming and other services. The mix of programming and other services were left unspecified, however. The charges for System B were to be determined later by the franchisee with the approval of the City Council.
(2) All areas within the city limits of the City of Oakland were to be served.
(3) Franchise duration was set at fifteen years.
(4) The franchisee was to make annual payments to the City of 8 percent of gross receipts or $125,000, whichever was greater.[30]
(5) Connection charges for each of four customer classes[31] were stipulated, and thus common for all bidders. It was further stipulated that no additional fee be charged to the subscriber for switches or converters needed to receive System A.
(6) The basic bid consisted of designating the monthly fee "*X*" which would be charged to each subscriber for the first TV and FM outlet connected in his living unit, with an additional monthly charge of $0.2X$ to be paid for each additional outlet in his living unit. This would entitle the subscriber to receive System A.
(7) The franchisee was to provide the City and School District with certain free connections and services, including studio facilities for originating programming for up to twenty hours per week.
(8) The system to be installed was to be a dual cable system, and

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[29] City of Oakland, "Invitation to Submit Amended Applications for a Community Antenna Television System Franchise," April 30, 1970.

[30] The $125,000 figure was built up in successive $25,000 annual increments, starting with zero in 1970 and reaching $125,000 in 1975, thereafter to continue at this level.

[31] The four customer classes were: noncommercial housed in buildings with less than four living units; noncommercial housed in multiple unit apartments, motels, hotels; commercial; and special, including low density users. The installation charge was $10 for noncommercial subscribers housed in buildings with less than four living units.

each of the cables was to be capable of carrying the equivalent of thirty-two video channels. A series of minimum technical specifications concerning signal quality, cable characteristics, installation methods, automatic controls, etc., were stipulated.

(9) Service requirements were described in general terms. The details were to be defined by the franchisee subject to Council approval.

(10) The system was to be 25 percent complete within eighteen months of franchise acceptance, with an additional 25 percent being completed in each succeeding six month period, so that the system would be fully completed in three years.

(11) Proposals to raise rates to subscribers could be submitted annually. (No indexing or other criteria were offered in this connection.)

Bid acceptance. Bids were made on July 1, 1970, the lowest being the bid of Focus Cable of Oakland, Inc., which stipulated an "*X*" (see items (1) and (6), above) of $1.70 per month.[32] The next lowest bid was by Cablecom-General of Northern California, which set a rate of $3.48.[33] The TelePrompTer Corporation bid was $5.95 (Libman, 1974, p. 34).

Focus Cable apprised the City at the time of its bid that Tele-Communications, Inc. of Denver, Colorado, whose participation had been vital to the qualification of Focus as an applicant, had elected to withdraw from the Focus Cable proposal.[34] Focus Cable reorganized the corporation under the laws of California and included a copy of the Articles of Incorporation, dated July 1, 1970, with its bid. Inasmuch as Focus had entered the lowest bid (by a factor of two), was the only local bidder, and represented an ethnic minority,[35] the City was reluctant to reject their bid for lack of financial capability and technical qualifications. However, awarding the franchise to Focus plainly posed hazards.

It appeared that these were greatly mitigated when TelePrompTer Corporation proposed on July 16, 1970, to enter into a joint venture with Focus Cable to construct and develop the Oakland franchise. As a part of the joint venture, TelePrompTer agreed to provide all needed financing for the project.[36] Why TelePrompTer was prepared to do this at a monthly charge less than 30 percent of its own bid was not disclosed. Presumably, however, the prospect of earning substantial returns on System B was a contributing factor.[37] Focus Cable

[32] Amended Application for a Franchise to Construct, Operate and Maintain a Community Antenna Television System within the City of Oakland submitted by Focus Cable of Oakland, Inc., July 1, 1970.

[33] Memorandum from the City Manger to the City Council, dated September 28, 1970, p. 3.

[34] See note 32, *supra*.

[35] Minority group involvement in cable—in ownership, employment, and programming respects—is prominently featured in the CATV literature (CTIC, 1972c, p. 13). The FCC requires cable operators to establish affirmative action plans (CTIC, 1972a, p. 34).

[36] Letter from Leonard Tow, Vice President of TelePrompTer, Inc., to Harold Farrow of Focus Cable, dated July 16, 1970.

[37] The rate on System B was not included in the original bid but was to be negotiated later. As things worked out, and probably ought to have been anticipated, most subscribers elected to receive System B—at a considerably higher rate than System A.

advised the City of Oakland, in a letter dated July 21, 1970, that "the proposed financing of Focus by TelePrompTer can and will provide the ideal marriage of local investors, CATV expertise, and over-all financial strength to best develop the CATV franchise in Oakland."[38] The Focus contribution to this ideal marriage was its local investor attributes.

The agreement between Focus and TelePrompTer provided that each should have equal ownership at the outset but that TelePrompTer would convert this to a majority interest immediately and could exercise options after the first year which gave it ownership of 80 percent of the capital stock outstanding.[39] The joining of TelePrompTer with Focus was thought to warrant completing the negotiations. A report to the City Council from the City Manager and the City Attorney, dated September 28, 1970, concluded as follows:[40]

> Part of the concept of Systems A and B in the specifications was, by competitive applications, to obtain a rate sufficiently low on System A which would encourage the early development of System B. It is staff opinion that the low rate submitted by Focus would motivate such a development. Also, the low rate will assure the widest utilization of System A by families of all economic means.
>
> Focus is the applicant which has submitted the lowest basic monthly subscriber rate. The question has been raised as to whether Focus meets the specifications due to changes in its organization. From a legal standpoint, the organizational change does not disqualify Focus from further Council consideration. It is staff opinion that the proposed agreements between Focus and TelePrompTer, with the additional guarantees by TelePrompTer, will result in a useful combination of initial local representation with one of the largest and best qualified CATV firms in the United States.

Focus Cable and TelePrompTer Corporation entered into a Subscription Agreement on September 21, 1970, in anticipation of being awarded the franchise. Two hundred shares at ten dollars per share were to be paid for by the organizers of Focus.[41] Additionally, the Agreement provided:[42]

> The Corporation shall purchase equipment and products from TPT [TelePrompTer] for use in its business in preference to other sources to the extent that the quality and workmanship of such equipment and products are comparable to such other sources. If TPT shall sell any such equipment or products to the Corporation, the price to be charged shall not exceed an amount which would be reasonably comparable to the charge for like equipment and products if obtained from an independent supplier dealing on an arm's length basis.

The Subscription Agreement also set out the TelePrompTer option to acquire an 80-percent ownership position at an option price per share of $10.[43] The purchase of eight hundred shares at ten dollars per share would thus give TelePrompTer an 80-percent ownership position for an outlay of eight thousand dollars.

The Council of the City of Oakland awarded the CATV franchise to Focus Cable on November 10, 1970.[44] Focus Cable accepted the franchise on December 23, 1970.[45]

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[38] Letter from Focus Cable to the City Manager of Oakland, dated July 21, 1970.

[39] Stock Transfer Restriction and Purchase Agreement, dated September 21, 1970, Appendix A to Focus Cable of Oakland, Inc., Subscription Agreement.

[40] See note 33, *supra*.

[41] See Subscription Agreement, note 39, *supra*, p. 2.

[42] *Ibid.*, p. 12.

[43] See note 39, *supra*, p. 6.

[44] City of Oakland Ordinance No. 8246 C.M.S., November 10, 1970.

[45] Statement from Leonard Tow, Treasurer, Focus Cable of Oakland, to City of Oakland, dated December 23, 1970.

Execution of the franchise. A rate for System B of $4.45 per month was requested by Focus Cable on March 10, 1971, and was approved on March 11, 1971.[46] The combined rate for System A and System B thus came to $6.15 per month.

Construction, which was due to be completed on December 28, 1973, did not go so quickly as the franchise specifications called for, fewer households subscribed to the service than anticipated, and costs escalated. Focus Cable appealed to the City to renegotiate the terms of the franchise. A reduction in the penalty period and the penalty fee was sought; a stretch-out of the construction period was requested; and a downgrading of the cable requirement was proposed. The Staff of the Office of General Services summarized the requested changes as follows:[47]

> Focus is requesting that: further construction be limited to a dual trunk/single feeder cable configuration; a two-year construction extension be granted; only 90% of the households be served at the end of the two years with the remaining 10% to be served only under specified conditions; activation of the dual cable system be deferred until adequate demand develops; damage payments for construction delays be waived; rates of $1.70 for basic services and $6.15 for extended services continue but that additional set rates be increased; extended service subscribers be reduced from 38 to 30 channels; and that reductions be made in the city and school spectrum allocations.

The Staff then considered four alternatives: (1) insist that the terms of the original franchise be met; (2) negotiate a revised agreement with Focus; and terminate the franchise, in which event (3) proposals from other commercial cable operators would be invited, or (4) shift the franchise to public ownership. The first was rejected because it would require great effort by the City "to obtain a satisfactory result from a recalcitrant operator. Citizen complaints about service will proliferate and require enormous effort to resolve. Litigation may result."[48] The third was rejected because other operators were thought unlikely to provide any more than the "minimum requirements of the 1972 Cable Television Report and Order"—"28-Channel capacity, some two-way capacity, three channels for local use, and 'significant' local programming"—offerings which were characterized as "significantly less than would be provided by Focus' recommended plant revisions."[49] Furthermore, public ownership was rejected for philosophical and financial reasons.[50] The second alternative, which the Staff characterized as the compromise solution, was accordingly proposed.[51]

In the course of reviewing Focus Cable's problems, the Staff reported that Focus claimed to have invested $12,600,000 to date and that Focus estimated that this would increase to $21,400,000 if the dual system were to be completed. The Staff disputed these figures and offered its own estimate of $18,684,000 as the completed capital cost of the dual system. The original Focus estimate, by contrast, was $11,753,000. The Staff attributed the increase over the initial estimate to "possible mismanagement of construction activities; inflation,

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[46] Oakland City Council Resolution No. 51477 C.M.S., dated March 11, 1971.

[47] Inter-Office Letter from Office of General Services to Office of the City Manger, dated April 5, 1974, p. 1.

[48] *Ibid.*, attachment, p. 4.

[49] *Ibid.*, attachment, p. 5.

[50] *Ibid.*, attachment, p. 5.

[51] *Ibid.*, attachment, p. 8.

which was compounded by Focus' not meeting the original construction schedule; and an underestimate by Focus of the mileage and unit costs necessary to build the Oakland system."[52]

Since 437 miles, or 55 percent of the system, were already completed and furnished with dual cable, the Staff recommended that the system be completed as a dual cable system. The second cable, however, would not be energized until a later date. Since only the one cable was to be energized, a reduction of channel capacity on System B resulted, and a reduction of city and school spectrum allocations was proposed. The subscriber to the extended service (now designated A/B) would receive 12 channels on System A and 18 channels on System B.[53] Also, the Staff was agreeable to the proposal that a construction extension of two years be granted and that only 90 percent rather than 100 percent coverage be attempted.[54] Additionally, the Staff recommended that Focus pay the City $240,000 for lost revenues, due to the delay, during the period 1973 to 1976 and that any delays beyond December, 1976, be assessed at the rate of $250 rather than $750 per day.[55] Finally, the Staff recommended that the monthly rate for the initial System A connection remain at $1.70 and that the initial System B connection remain at $4.45 (so that System A/B remained at $6.15), but that the monthly rate on additional outlets for System A be increased from $.34 to $1.70 and that the rate for additional System B outlets be set at $3.00.[56]

The "compromise" that finally emerged and was approved by City Council had the following provisions:[57] (1) A shift from the dual to a single cable system was permitted with the understanding that additional transmission capacity would be put in place within one year after it was ascertained that the "additional transmission capacity will attract sufficient revenues to provide a per annum rate-of-return on the gross investment required, over a 10-year period, equivalent to ten percent."[58] (2) The minimum franchise fee was increased by $25,000 in 1974 and each year thereafter. (3) Damages were assessed at the rate of $250 per day from December 18, 1973, until the first reading of the amended franchise—which resulted in a penalty of $36,000—rather than $750 per day for the entire period from December 18, 1973, until system completion—a penalty which would have been greater by a factor of 20 or more and which might have precipitated bankruptcy. (4) A deferred construction schedule was approved. Finally, (5) the monthly rate on additional connections was increased from $.34 to $1.70 per month on System A and was set at $3.00 per month on System B.

The City passed an ordinance on May 30, 1974, to reflect most of these changes.[59] Attorneys for Focus forwarded Letters of Accep-

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[52] *Ibid.*, attachment, p. 8.

[53] *Ibid.*, attachment, pp. 10–11.

[54] *Ibid.*, attachment, pp. 8–9.

[55] *Ibid.*, attachment, pp. 11–12.

[56] *Ibid.*, attachment, pp. 12–13.

[57] Memorandum from Office of General Services to Office of City Manager summarizing actions taken by the City Council at work sessions concerning Focus Cable, dated April 22, 1974.

[58] *Ibid.*, attachment I.

[59] City of Oakland, Ordinance No. 9018 C.M.S., Amending Ordinance No. 8246 C.M.S., and Ordinance No. 7989 C.M.S., Relating to the Community Antenna Television System Franchise, dated May 30, 1974. The only significant exceptions from the

tance by Focus and TelePrompTer on June 14, 1974, and sent a check from TelePrompTer Corporation made payable to the City of Oakland in the amount of $36,000.

Focus Cable filed a progress report on November 15, 1974, which showed that 11,131 subscribers were connected. Of these, 770 took the basic service at $1.70 per month (of which 206 had additional outlets), and 10,361 had the extended service at $6.15 per month (of which 974 had additional outlets). This represented an overall penetration rate of 36 percent.[60] The Office of General Services recommended that Cable Dynamics, Inc. of Burlingame, California, be retained as consultants to "devise and perform tests to establish the degree of compliance" with technical requirements of the franchise.[61] Cable Dynamics estimated that the costs from Autumn 1974 to June 1976 would be approximately $10,750.[62] Focus agreed to reimburse the City for these costs up to an amount not to exceed $10,750.[63]

☐ **An evaluation.** The franchising procedures employed by the City of Oakland, especially at the initial reward stage, are not without merit. As compared, for example, with those in New York City, which awarded noncompetitive, 20-year contracts to Manhattan Cable TV and to TelePrompTer to supply CATV in Manhattan,[64] the Oakland exercise had the appearance of a genuine bidding competition. Franchise specifications were standardized and, with respect to System A at least, carefully described. Bidding competition in terms of a simple promise to sell cheaply (by designating the value "X" at which System A services would be supplied) was thereby facilitated. However, numerous problems, many of which were anticipated in the discussion of incomplete long-term contracts, developed. Thus, consider each of the previously described disabilities which sometimes infect franchise awards: (1) the artificiality or obscurity of the initial award criterion, (2) the development of execution problems in price-cost, other performance, and political respects, and (3) the absence of bidding parity at the contract renewal interval.

(1) *Initial award.* Awarding the franchise on the basis of the lowest bid of "X" to supply System A service simplified the award criterion, but the promise to supply cheaply proved to be specious. The lack of attention to System B (which was treated as a futuristic service and, except for capacity requirements, was left relatively undefined) in both quality and price respects may well have contributed to "adventurous" bidding on the part of Focus. Trafficking in the franchise award quickly ensued.

To have regarded System A, which essentially supplies improved off-the-air signals, as the "basic system" was misguided. Over 90 percent of the subscribers took the combined A/B service, although the additional service thereby obtained was relatively mundane

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compromise described in the text are the following: the additional connection rate for System B was set at $1.30 per month and it was stipulated that System B should provide not less than 18 video channels.

[60] Attachment to City of Oakland Inter-Office Letter from Office of General Services to City Manager, dated November 20, 1974.

[61] Letter, *ibid.*, p. 2.

[62] Attachment to letter, *ibid.*

[63] Letter, see note 60, *supra*, p. 2.

[64] *New York Times*, July 29, 1970, p. 1.

(mainly the import of distant signals). The rate on the combined service, however, was three-and-a-half times as great as the basic System A service. Surely a more careful effort to assess subscriber preferences at the outset would have revealed that System A lacked appeal. Indeed, inasmuch as most of the prospective franchisees were experienced in supplying CATV services in other areas, it is difficult to understand the preoccupation with System A services during the extended precontract discussion between the franchisor and the prospective franchisees. The possibility that the Staff was gullible and deliberately misled during these precontract discussions cannot be dismissed.[65]

Whatever the case—given the demand and technological uncertainties associated with CATV (CTIC, 1972c, pp. 5, 12) and the complexity of the service, in quality and product mix respects—reducing the award criterion to the lowest bid price for System A resulted in a strained and perhaps bogus competition.

(2) *Execution difficulties. Price-cost relations.* Whether the Focus bid of $1.70 per month for System A can be regarded as close to "per unit production cost" is doubtful in view of the following factors: (1) the disparity among bid prices raises a question as to whether an economically meaningful competition was conducted; (2) System B prices, which appear to be the more relevant dimension, were negotiated subsequent to the bidding competition; and (3) true cost levels are difficult to ascertain—partly because the vertically integrated supply relation obscures these, partly because inflation rates during the construction period have been abnormally high, and partly because the Staff lacks an auditing capability. What is evident is that Focus and the Staff of the Office of General Services are, together with the City Council, involved in a long-term bargaining relationship over prices and costs in which political interests, bureaucratic interests, and franchise viability all play a role.

Other performance attributes. The stipulation that the CATV system be installed and maintained in accordance with the "highest and best accepted standards" of the industry coupled with technical specifications did not yield a well-defined quality outcome.[66] Sufficient customer complaints over quality have been registered with the Staff of the Office of General Services[67] that the Staff, unable itself to assess the quality of service, has arranged for a consultant to test the degree of compliance of service with technical requirements.

Politics. Whether the winning bid by Focus involved "buying in" is uncertain. An inference that buying in did occur is supported by the following considerations. (1) The next lowest bid was double the Focus bid while the TelePrompTer bid was more than triple the Focus bid. (2) The timing and nature of the Focus reorganization

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[65] As Posner surmised, it is hazardous to permit a public agency by itself to declare subscriber preferences for service.

[66] Partly this may be because "[a]n initial high signal quality may, over time, slowly degrade to the point where the signal quality is not acceptable" (CTIC, 1973, p. 9); partly it is that signal quality is multidimensional and varies with the capability of the system to receive off-air and microwave signal as well as headend and cable attributes (CTIC, 1973, pp. 19-24).

[67] The existence of customer complaints regarding quality of service was disclosed in an interview with Mark Leh (see note 28, *supra*).

suggest a foot in the door strategy—the object being that, once in, the franchising authority would be inclined to work with Focus and its affiliates in an accommodating manner. (3) Focus' local bidder status was affirmatively regarded by the franchising authority and evidently supported politicking.[68] Finally, (4) the extensive renegotiations undertaken by Focus, with evident success—the Staff acceded to most of Focus' requests and the City Council approved a "compromise" in which energizing of the second cable was deferred (with a cutback in System B services to 18 channels); the annual franchising fee was increased slightly; damages were reduced drastically; construction deadlines were extended; and rates on additional System A and B connections were increased—reinforce this judgment.

(3) *Frictionless takeover or transfer.* Although the enabling ordinance provided for buying up of the plant and equipment of the franchisee, the City was plainly not prepared to upset the original award. The reasons appear to be that incumbents are strategically positioned to bargain—both in terms of service interruptions and the litigating and other expenses which franchise termination would entail—and, relatedly, because franchising agencies lack resolve. This lack of resolution appears to be attributable to the reward structure in bureaus. Unable to appropriate the gains that reassignment of the franchise would prospectively yield and unwilling to concede error, the bureaus favor "accommodation" whenever contract execution difficulties appear.

The interruptions and expenses which franchise termination would experience are presumably explained, in part at least, by physical and human asset problems of the kinds discussed in Section 3. Absent rules for valuing the CATV plant and equipment that are at once rational, unambiguous, and inexpensive to employ, physical asset valuation problems predictably arise.[69] Inasmuch as such rules had not been devised (and, realistically, perhaps could not have been devised) for the Oakland franchise, litigation expenses and delays would attend any effort to take over the physical plant in question.

The risk of service interruptions and related malfunctions would

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[68] Libman (1974) reports that the award of the Oakland CATV franchise to the Focus group, despite its lack of expertise and adequate financing, and the subsequent implementation of the franchise appear to have been influenced by political considerations. A more spectacular and unambiguous case is afforded by the CATV competition in Johnstown, Pennsylvania, where Irving Kahn, the former chief executive and chairman of TelePrompTer, the nation's largest operator of cable TV, was tried and convicted of bribery and perjury. Kahn has also admitted bribing public officials in Trenton, New Jersey, to secure their votes. Politics appears also to have been a decisive factor in the award of CATV franchises in New York City. (See note 64, *supra.*) Whether this holds for CATV awards in large cities more generally is uncertain. The incidence of corruption with respect to franchise awards for other types of services is also an open question.

[69] Indeed they did arise. Witness that the completed system estimate by Focus exceeded the Staff's estimate by almost three million dollars. Note also that it is ill-advised to permit the franchisee to become affiliated with a firm that supplies equipment and products for the construction of the plant. The risk here is that the procurement costs of these items will be overstated, thereby to build up the rate base of the franchisee and improve its bargaining position during rate negotiations. Despite claims that equipment will be procured on competitive terms, this is costly to check and violations are difficult to prove conclusively. The Oakland Staff suspects unwarranted equipment cost escalation in the estimates by Focus of plant valuation, but admits that it has no definitive proof.

be compounded if the human assets associated with the franchise had acquired, in a learning by doing process, nontrivial task idiosyncracies. Given that the Staff lacked qualifications in the CATV area and was evidently unwilling to solicit bids from other experienced CATV operators (possibly because the Staff was unwilling to accept the risk of embarrassment should the new operator also prove to be deficient), the transfer of human assets would need to be worked out if City ownership were to be attempted. The incentive to displace the original franchisee would be attenuated to the extent that a frictionless transfer of such human assets could not be anticipated.

The upshot is that, good intentions to the contrary notwithstanding, *unassisted* franchise bidding for CATV conducted and executed under conditions of uncertainty has dubious properties. The franchising authority that assumes an accommodating posture is merely legitimating monopoly, while a concerted effort to exercise control requires the agency to adopt a regulatory posture. The purported dichotomy between "regulatory controls" on the one hand and "natural economic forces" on the other is accordingly strained. It confuses the issues to characterize market solutions as "natural" where these are actually supported by an administrative apparatus of considerable complexity.[70]

5. Concluding remarks

■ That franchise bidding for CATV, *circa* 1970, has superior properties to regulation is not transparent. Microanalytic assessments of franchise bidding, both as an abstract exercise and in the context of a specific case study, suggest a mixed verdict. Not only is simple franchise bidding for CATV beset with numerous transactional difficulties, but the institutional infrastructure that predictably develops to check dysfunctional or monopoloid outcomes has many of the earmarks of regulation.

Surely no one would dispute that "[t]he correct way to view the problem is one of selecting the best type of contract" (Demsetz, 1968, p. 68). But one also needs to be instructed on how to proceed. Although it may be possible to disallow some contracting modes on static allocative efficiency grounds,[71] the more interesting cases, I submit, involve an examination of the efficiency properties of alternative contracts executed under conditions of uncertainty. Contrary to normal practice, attention to transactional detail is needed if the real issues are to be exposed. Additionally, a check on the operational properties of abstract contracting modes is usefully made *by examining one or more actual cases* in which different modes are being employed.[72] As P.T. Bauer and A.A. Walters observe, "the com-

[70] Posner employs this dichotomy in his 1969 discussion of natural monopoly, in which he urges that "even in markets where efficiency dictates monopoly we might do better to allow natural economic forces to determine business conduct and performance subject only to the constraints of antitrust policy" (1969, p. 549). He declines, however, to handle the CATV issue in this way but instead favors the market assisted bidding scheme described in Section 3, the administrative problems associated with which are formidable.

[71] For example, awarding a franchise to the bidder who will pay the largest lump-sum amount will serve to capitalize the monopoly profits but, at least transitionally, will lead to a higher price and lower output than will an award of the franchise to the bidder who offers to supply at the lowest price.

[72] To be sure, one swallow does not make a spring, and a single case study does not settle the franchise bidding for CATV issue. It is thus to be hoped that more such

plexity, instability, and local variation of many economic phenomena imply that the establishment or understanding of relationships requires that analysis be supplemented by extensive observation, and also that the inquiry must often extend beyond statistical information to direct observation and use of primary sources'' (1975, p. 12). The case study of CATV franchising in Oakland, California, as reported in Section 4, is in this spirit. The complexity of this contracting problem exceeds that of Demsetz' automobile license plate example by several orders of magnitude. That a different understanding of franchise bidding obtains is not, perhaps, unsurprising.

The ''appropriate'' level of transactional detail is not well defined and may vary with the circumstances. The following proposal is advanced as a means by which to get at the transaction cost issues: Progressively refine the degree of detail until contractual problems are plainly exposed. Then ask the question, ''Do these issues have comparative institutional significance in the context of the specific problems at hand?''

The level of detail that I have found useful in studying related transactional phenomena is what might be called a semimicroanalytic level of detail. Given the infeasibility of complex contingent claims contracting for the services in question, the properties of incomplete long-term and sequential spot contracts need to be assessed. When unassisted market processes prospectively or actually founder—because the hazards of incomplete long-term contracts are severe and sequential spot contracting is beset with indeterminacies and/or distortions—alternatives to autonomous contracting, of which regulation is one, plainly warrant consideration.

It is relevant in this connection to note that there are striking regularities among the incentives to organize internal labor markets (Williamson, Wachter, and Harris, 1975), the incentives for vertical integration (Williamson, 1971), and the incentives to regulate (or otherwise substitute an administrative apparatus for unassisted market exchange). The particulars differ, but the disabilities of recurrent market contracting which give rise to each of these nonmarket or market assisted modes are substantially the same. To the extent that the organizational failures framework set out elsewhere has generality (Williamson, 1975), such commonalities are to be expected.

Lest the argument appear unsympathetic to the franchise bidding approach, I should point out that there are circumstances where I suspect that regulation or public ownership can be supplanted by franchise bidding with net gains. Local service airlines and, possibly, postal delivery are examples.[73] The technology for both is well developed, demand is likewise well defined, and idiosyncratic skills appear to be negligible. Furthermore, displacement can be made without posing serious asset valuation problems—since the base plant (terminals, post offices, warehouses, etc.) can be owned by the government and other assets (planes, trucks, etc.) will have an active second-hand market. It is not, therefore, that franchise bidding is

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studies will be performed. In the meantime, I submit, the Oakland experience gives occasion for pause.

[73] A careful microanalytic assessment of both is needed, however, before the franchise bidding mode is introduced. Disabilities that are not apparent on the surface may be disclosed.

totally lacking in merit,[74] but that those who have favored this mode have been insufficiently discriminating in their endorsement of it.

An unbiased assessment of the abstract properties of alternative modes will be facilitated by examining the transactional attributes of each in microanalytic detail.[75] It will be useful for this purpose to regard rate of return regulation as a highly incomplete form of contracting in which the prospects for windfall gains and losses are strictly limited and, in principle and sometimes in fact, adaptations to changing circumstances are introduced in a low cost, nonacrimonious way. The frequency and extent to which such adaptations are required and the differential ease with which these are effectuated by alternative modes are important in making an informed comparative institutional choice.

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[74] Not only might franchise bidding be usefully introduced in some cases where regulation is now employed, but it should continue in circumstances in which it is plainly efficacious. The award of gas station franchises on turnpikes is an example of the latter.

[75] As Donald Dewey has observed, "[T]he disdain and contempt for regulation [by economists] is nearly universal" (1974, p. 10). Although much of regulation is indeed contemptible, I submit that *some* of the problems for which regulation has been devised are really intractable—in the sense that *all* of the feasible modes of organization are beset with difficulties. Arguments favoring market modes in which these difficulties are not squarely faced should accordingly be regarded with skepticism.

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