Comments on

"THE NEW TELECOMMUNICATIONS ACT AS A REGULATORY FRAMEWORK"

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It is indeed possible that new technology will make competition with the existing telecommunications system easier. We should not forget, however, that the current telecommunications system is a legal monopoly; although, perhaps, if the legal monopoly were repealed we would find a natural monopoly. Further, there was a good deal of competition at the time that it became a legal monopoly. In this respect, it is like most of the other so-called natural monopolies. Water supply, sewage removal, and electricity all started as competitive businesses and then became monopolies by government action.

In the case of water, sewage, and gas, this happened a long time ago, and I have not seen any studies about them at all. (I once visited a very prosperous Athenian suburb which had a competitive water supply using trucks. It was notable that not only was the water available at a competitive price but you could buy different qualities of water, depending on whether you were drinking it or watering your lawn.) With respect to electricity and telephones, the story is better known. In both cases, the providers were important

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forces in getting the service monopolized; in fact, AT&T has recently been boasting about that in their advertisements. In both cases, monopolization led to an increase in their profits. In the long run, it may have hurt them, but the executives who pushed for the development of regulation at the time no doubt were right for the present discounted value of the entire income stream.

As far as electricity is concerned, there are some places in the United States with competing electric companies; Primeaux's studies have shown that in these places prices are low and service is good, all of which would seem to say that the natural monopoly explanation is not a very good one. (See for example his "An Assessment of X-Efficiency Gained through Competition," *Review of Economics and Statistics* 59 (February 1977); 105-108.)

I should also like to point out that the natural monopoly explanation has been used in almost every area where the government is regulating and preventing competition. You will find people alleging that airplanes were a natural monopoly 10 or 15 years ago; railroads were alleged to be natural monopolies at the time that they were regulated, although the basic problem facing the railroads at the time was destructive competition. I remember, when I was in college, being told that milk delivery was a natural monopoly.

I do not wish to allege that there are not any natural monopolies. I do not even wish to allege that the telephone company is not a natural monopoly. Indeed, my *a priori* assumption is that the telephone *is* an example of a genuine natural monopoly. What I wish to point out, however, is that if there are natural monopolies, there is absolutely no reason to have a law prohibiting competition. All the laws that guarantee monopolies should be repealed; we can then find out whether the monopoly is indeed natural. If it is, regulation would be called for. If it is not, we can let the market proceed. In the particular case of the telephone, repealing the laws against competition should be supplemented by a law requiring AT&T to interconnect at reasonable terms with private local companies. It is, of course, being compelled to do this for long-distance calls now, and I do not think there is any obvious reason why it would be difficult to do it locally. After all, AT&T is now interconnected with a large number of very small companies. (There is one not far from where I live with 115 subscribers.) There is no reason why it cannot be required to interconnect with people who want to directly compete

with it. My own personal investment plans do not involve attempting to set up a competing small telephone company, but I see no reason why anybody who wants to should be told that he will go to prison if he does.

So much for warnings about the government not taking action. I should now like to discuss the type of government action which, when I was in college, caused a great deal of inconvenience to me whenever I used the Chicago elevated railroad, and which I fear is going to cause the destruction of our current electric and telephone systems. The Chicago El was a private company, regulated of course, and the prices were not high enough to cover the cost of operation. As a result, slowly, over a long period of time, the El deteriorated. During almost all the time I had contact with it, it was steadily running down and had been doing so for some time. Equipment was poorly maintained, it was uncomfortable, the personnel were sparse and only rarely competent and, in general, it was dying.

The reason it was dying was, of course, that the regulatory commission had set the prices far too low. The result was that eventually, after the price of the El had fallen far enough, it was purchased by the government and immense increases in fares were immediately put into effect. (The fare increases went through a number of increments and were so extreme that they actually got into the elastic part of the demand curve and reduced total revenue, and a fare cut had to be instituted to get back to the revenue maximizing point.) With these immense increases, the salaries of the (unionized) employees were raised and equipment and service were improved. I fear a similar prognosis for our telephone and electric utilities.

Traditionally, the regulated industries have been regulated by a simple but unstated rule. This is that the return should be high enough to permit them to sell their securities on the market at a reasonable interest rate. In general, this has led to an interest rate that is at least a trifle higher than the absolute minimum needed to meet that goal. If you give too low a return, companies have difficulties selling their securities and you observe it. If you make it a little too high, then what used to be called "gold plating"—now called the "Averch-Johnson effect"—takes place and the industry gets excessive capital. The only real regulatory function that a Com-

mission has here is to try to prevent this "gold plating" or "Averch-Johnson effect" from becoming too great. Nevertheless, I agree with the studies of regulated industries that indicate that they are currently overcapitalized. The case that is usually cited is the extremely high reliability that is built into the electrical system although now, with the regulatory climate less favorable, this is beginning to vanish.

The problem here is that with an excess of capital the industry as a whole can go for a number of years consuming this excess capital without new capital. Further, a number of allegedly pro-consumer groups have been pressing hard to prevent regulatory commissions from giving the kind of rate increases that they usually give. Under the circumstances, it seems quite possible that the Chicago El story will be repeated. Failure to give increases will lead to nonreplacement of equipment. This will not be visible at first because there is presently too much equipment, but eventually it will become visible in poor service. Poor service will then be used as an excuse for attacking the company, not for increasing its rates. Service will deteriorate further, public support for the companies will vanish, and eventually they will be taken over by the government, which will promptly raise the prices very sharply.

Having said that I fear this will happen, I regret to say that I have no recipe for avoiding it. It will take great political skill and adroitness on the part of the lobbies for the telephone and electric companies to avoid this problem, but I think economists should—right now—begin calling it to public attention.

Consider first the strong plea from the states that the settlement's restrictions on the BOCs be dropped. Some of the state regulators may be taking this position because they fear the loss of substantial economies of integration. But I wonder whether it isn't also possible that that argument is being made with such passion because state regulators see an opportunity to extract money from competitive markets and transfer it to the regulated area. Such cross-subsidies would hold down local telephone rates and thereby shield the regulators from the wrath of the ratepayers.

In the long run, of course, this approach works only if the BOCs are allowed into the competitive environment *and* if other companies are excluded. Thus, if the Consent Decree is changed and the BOCs are allowed immediately into all markets, we will then see an effort by regulators in many states to extend the boundaries of public utility regulation to or beyond their logical limits, so they can regulate entry and rates. The degree to which states can take that kind of action varies from market to market, depending on the jurisdiction they are given by individual state laws and on the economic and political vigor of those already in the markets.

Against that backdrop, let us focus on Geller's argument in favor of letting the BOCs into all markets. Geller makes two arguments: first, that there are economies of scope here, and second, that competition will be increased, net, if the BOCs are allowed in. The first point is plausible in some cases, but it is not obviously correct in all cases; it requires a market-by-market analysis. As for the second, we must set the increase in competition against the danger of anticompetitive behavior by the BOCs. One must consider the dangers of cross-subsidy and of discrimination in network access, design, and pricing—all the problems that we know so well from the last 15 years.

To pursue this equation, measuring costs and benefits, we must descend into the tedious process of market-by-market analysis. Specifically, one must examine each market the BOCs might enter to ask whether the states do or could regulate it (i.e., has the FCC preempted state regulation?); whether BOC entry would produce significant economies; and how the competitive advantage of BOC entry would compare with the loss of existing and potential competitors.

Let me give you some examples of how I would approach this assessment. First, letting the BOCs into equipment manufacturing

and interexchange transmission offers significant benefits and minimal danger. The largest competitor in those markets is AT&T, and it has little to fear from BOC entry because the BOCs are hardly likely to drive Long Lines and Western Electric out of business. As for state regulation, Congress and the FCC have pre-empted it, except for intrastate interexchange transmission. Thus, the overall risk of letting the BOCs into those markets is low. On the other hand, the gains—in terms of increased competition, and, perhaps, efficiency—may be quite large.

Provision of information content offers a different equation. (I should point out here that one of my firm's clients, the American Newspaper Publisher's Association, has an argument like the one that follows.) Note that I have in mind information publishing, rather than data processing; the Consent Decree covers both concepts under "information services."

The danger of letting the BOCs provide content for electronic publishing services is that electronic publishing is a new, small market in which all providers depend on the local exchange to reach customers. If the BOCs become electronic publishers, they will have the incentive and the opportunity to discriminate against fragile competitors who depend on their transmission facilities.

As a result, it is at least plausible that letting the BOCs provide electronic publishing content over their monopoly facilities would discourage entry and reduce competition. On the other hand, exclusion of the BOCs from content probably would not significantly hurt competition, because electronic publishing is a service with low capital requirements and many potential entrants. Any economies of integration from BOC entry seem to be fairly small. Finally, FCC pre-emption of state regulation in this field seem particularly vulnerable to legal challenge, making the dangers of extended state regulation particularly significant. (Congress can pre-empt, of course, but it is less likely to deal with this area if Judge Greene himself lifts the restrictions. The continuing need for a *legislated* telecommunications policy is one reason why the Judge should not try to solve all the problems by rewriting the settlement.)

In the long run, I have no doubt that the BOCs will be allowed into all markets. After all, in the long run, cable, microwave, cellular radio, and other technologies are likely to introduce substantial competition into the presumed BOC monopoly of local exchange

service. Judge Greene, however, must deal with the short run. And, in today's environment, a weighing of the costs and benefits of the restrictions on the BOCs is not a simple process leading to an obvious answer. Rather, it requires a messy series of guesses market-by-market—the kinds of decisions Congress, not antitrust courts, is best suited to handle.