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A Comment

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By *Ray Rees*

There is virtually nothing in this stimulating and wide-ranging paper with which I disagree, and so my comments will mainly be concerned with adding my own observations on some of the main points Ingo Vogelsang has made.

The underlying nature of tastes and technological possibilities in the telecommunications markets of the European countries and the USA in the 1970's was inherently similar. What differed hugely was the economic organisation of these markets, and this is what made the USA the leading source of innovation. The PTT structure of the leading European telecommunications markets was a major obstacle to progress. Starved of the investment funds required to expand services and carry out technical innovations by the forced cross-subsidisation of inefficient and highly labour intensive postal services, organised as public bureaucracies rather than commercial enterprises, the telecommunications suppliers in Europe lagged seriously behind those in North America. Perhaps the most profound single innovation in the USA was the introduction of competition in the long distance telephone market. The cosy assumption that telecommunications was a natural monopoly in all its markets was invalidated at a stroke.

In the UK in the late 1970's, more so than in the other major European countries, attempts were being made to change the structure and organisation of telecommunications supply to remedy the situation, but problems were still created by subjection to public sector borrowing constraints. Then came privatisation. Privatisation was a central element in the ideological position of the new Thatcher government, part of the general commitment to "roll back the public sector" and break the power of the Trades Unions. By those concerned with trying to reorganise telecommunications supply, it was seen as the way to solve the funding problems of telecommunications as well as to create a modern and dynamic enterprise, while the privatisation policy itself derived strength and impetus from the existence of such a suitable and relatively unproblematic candidate.

At this point US experience again exerted an important influence, but this time in terms of what *not* to do. There was a considerable US literature on the perverse incentive effects of “Rate of Return regulation”, the problems of capture inherent in the American regulatory system, and its generally adverse effects on economic efficiency. Thus the price cap regulation system was devised (largely by Steven Littlechild) in a conscious attempt to achieve something better. It was to provide positive incentives for cost reduction, maximise the possibilities of the development of effective competition, and minimise the dangers of capture.

Ingo Vogelsang’s paper talks of economists being “fooled” by the public interest theory of regulation, but in fact this theory receives quite a good deal of support from the formulation of the price cap regulatory system. As conceived by Littlechild, it was not the outcome of some interest group equilibrium, but an attempt to provide an economically efficient framework of regulation. Of course, something like this was required to “sell” the privatisation policy to a doubtful electorate. Moreover, there is an interesting difference between the system as Littlechild conceived it, and the one that was actually implemented, which may give Chicago some comfort and is relevant for the rest of the story. Littlechild proposed that long distance markets would be exempt from the price cap regulation, since they would be subject to competition, and regulation was only required for markets where there would be no competition. That is, long distance services should not be included in the basket of charges to which a price cap was to be applied. In fact, they were included, and this had important implications, both for the profitability of the newly privatised concern, and for the issue of “re-balancing”. British Telecom was able to meet competition in the long distance market, while maintaining overall profitability, by raising prices sharply in the local domestic market, in a way that would not have been possible if the local charges alone had been subject to the price cap. This meant that the problem of “re-balancing”, or reducing the large cross subsidies from long distance to local services, a problem which still bedevils telecoms pricing in the USA, was solved relatively quickly and comprehensively in the UK. Since on efficiency grounds such re-balancing is certainly defensible, it must be counted as a welcome achievement of price cap regulation, though it probably had more to do with concern for BT’s profitability than for economic efficiency as such.

In the US context, “universal service provision” seems to be code for the rebalancing problem, i.e. the provision of local telephone services to virtually all domestic consumers at highly subsidised prices, while in Europe it means something quite different. Here it means the provision of access to telecommunications services in sparsely populated rural areas, or to low-income consumers, and the provision of public call boxes, at prices less than cost. In short, forms of income redistribution which could just as well be achieved by explicit subsidies from the public purse, except that governments prefer that the true costs are buried in the accounts of the enterprise and the true nature of the income redistribution involved is thereby hidden. Vogelsang’s comment that the costs of this to BT are negligible would certainly be disputed by them, and probably rests on a study by the regulator (Oftel) which purported to show that. It was only able to do this, however, by setting the costs against such dubious benefits as the advertising value to BT of rural telephone boxes, or the gratitude felt by currently low income subscribers who eventually would become higher income and would repay BT by loyally buying its services, regardless of how its prices compared to those of its competitors. The root problem is of course that of cream-skimming, i.e. that competitive entry takes place only into profitable markets, leaving the incumbent to finance loss-making services from a shrinking profit base. The Oftel study was essentially an attempt to avoid having to find a way to deal with this problem, at least for the time being.

European consumers should be grateful for the impact developments in the US have had on the structure and performance of their telecoms markets, just as European taxpayers, at least those in the UK and Germany, should be grateful for the example provided by the American spectrum auctions. It is not so clear to me, even accepting the example of price cap regulation, that so very much has flowed in the opposite direction as to warrant use of the term cross-fertilisation. But Ingo Vogelsang's attempt to make the case for that has made very interesting and informative reading.