Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

Telephones and Computers: Uncrossing the Wires

TO THE EDITOR:

William Baumol and Robert Willig ("Telephones and Computers: The Costs of Artificial Separation," *Regulation*, March/April 1985) have done a commendable job explaining why major changes in the Federal Communications Commission's *Second Computer Inquiry* rules are in order. Those rules essentially require AT&T and the regional Bell companies to separate their regulated "basic" from their unregulated "enhanced" service offerings through separate arm's-length subsidiaries. The rules were designed for a company—the unified Bell System—that no longer exists. They have been kept in place chiefly because AT&T's competitors find change inconvenient.

But the article understates the calamitous consequences of this and related regulatory regimes, particularly for U.S. communications trade. In addition, the authors are far too sparing when it comes to proposing relief. Not only AT&T but a number of other companies similarly constrained should be freed from this regulatory bondage.

Regulators of multi-product firms face a perennial problem: by misattributing costs, a company can use monopoly rents to subsidize enterprises that compete on the open market. In the early seventies, the FCC embraced the notion that requiring companies to maintain separate subsidiaries was a sort of universal panacea for these cost-accounting problems. The 1934 Communications Act, however, gives the FCC explicit authority to prescribe industry accounting practices. Accounting is one of the chief glues that holds our economy together; as a group, accountants manage to reap some $14 billion in revenues annually, which suggests that what they do has some merit. But for years the FCC has held the view that in telecommunications, accounting just will not work.

At the same time, rooting out and eradicating any chance of cross-subsidies has become something of an FCC obsession over the years. Now, as a practical matter, cross-subsidies pervade American business life quite as much as stock options, worries about Japanese competition, white wine, and aspirin. Probably no company ever earns precisely the same return on each part of the repertoire of services it provides. Indeed, to require every service from the outset to float on its own fully distributed cost bottom would be an effective way to suppress new offerings.

Not all the things people worry about, however, are necessarily rational. Pre-revolutionary Chinese peasants worried about the people who might be trespassing on their land—from below, on the other side of the world. Businessmen faced with price competition often worry just as much about the possibility that their competitors might be cross-subsidizing. Thus many of the telephone industry's competitors, as well as the FCC itself, react to the mention of possible cross-subsidies as if one had tossed an especially realistic rubber tarantula onto the policy-making table.

If the FCC's requirement of separate subsidiaries was ever justified, however, it is hard to see how it makes much sense today. This sort of official handicapping of established telephone companies has the obvious result of shielding such firms as IBM from competition by new entrants.

Consider, moreover, how these and related rules affect international trade. In practice, the effect of the present FCC requirements is to force all "intelligence"—capabilities beyond simple telephone service—out of the national telephone network and into the switching and other equipment located on a subscriber's premises. Since foreign vendors supply a far larger share of customer-premises equipment than of network equipment, they greatly benefit from this arrangement.

The trade statistics tend to bear this assumption out. In 1982, the year that the AT&T divestiture was announced and a little more than two years after the FCC's computer rules became effective, the United States ran a $200 million trade surplus in telephone equipment. Thereafter we ran a deficit of $419 million in 1983 and $1 billion in 1984. In the broader category of "electronics-based products," things were considerably worse. Between 1982 and 1984 our trade balance shifted from a surplus of $4.9 billion to a deficit of about $6.2 billion. If one uses the semi-official multiplier by which every $1 billion in electronics trade supports about 25,000 high-tech workers, this means that in only about two years, we lost some 278,000 American jobs.

FCC restrictions obviously were not the sole cause of this small national calamity. Regulations imposed by the Justice Department's Antitrust Division and a stronger American dollar also contributed. Unless we want to see our "sunrise" telecommunications sector eclipsed, however—before it has even risen—we are going to have to do something to reduce the level and intensity of domestic regulation of our telephone industry generally.

Which brings me to my second point. It is not simply AT&T that should be allowed to compete more effectively both at home and abroad. The same is true of the seven regional Bell holding companies, which at present are not only subject to the FCC's *Second Computer Inquiry* rules, but must also contend with the severe restrictions that the Antitrust Division is enthusiastically enforcing as it administers the AT&T consent decree. Then there is the GTE Corporation, the second largest phone company. Although largely exempted from the FCC's rules, GTE is subject to yet another Antitrust Division consent decree, one effect of which is to hobble *this* possible competitor.

AT&T presumably finds this situation not unattractive because it hampers most of that firm's large potential competitors. But why is it in the national interest for the government to ice down fully half our telecommunications industry at pre-

cisely the time that the international competitive challenge is highest?

The policy of the past decade seems to rest on the assumption that America's telecommunications companies are so large, their resources so great, that they can put up with pretty much anything that the federal bureaucracy wishes to visit upon them. We ought to wake up, however, to the obvious fact that the U.S. industry no longer stands like some economic Gulliver astride a world of communications Lilliputians. The more burdens and impositions placed on American telephone companies, even for the most commendable of reasons, the less likely it is that the industry will be able to provide efficiently the future jobs and investment opportunities that the country needs. In breaking up AT&T while retaining outmoded regulatory restrictions and adding new ones, we may, in effect, have simply swapped the "dead hand of monopoly" for the dead hand of excessive federal regulation. That exchange does not do the country any good in the long run.

Kenneth Robinson,
National Telecommunications and Information Administration

Comparing Kiwis and Oranges?

TO THE EDITOR:

I was disappointed that *Regulation* gave so much space to Thomas Lenard and Michael Mazur's attack on citrus marketing orders ("Harvest of Waste: The Marketing Order Program," May/June 1985). In this imperfect world, I believe those of us who are truly concerned about government interference in our lives should direct our energies to where the harm is most egregious and where established relationships can be dismantled without excessive harm to innocent parties. Citrus marketing orders are *de minimis* as a form of government control. They do not even use tax dollars. They merely permit the citrus industry to estimate the amount of fruit that can be absorbed by consumers each week and then "prorate" each grower's share of the amount shipped, so as not to glut or short the market.

Under the marketing-order system, consumers have enjoyed a steady supply of fresh fruit at relatively stable prices that at times have been lower than the prices of potatoes or onions. In the last thirty years the total navel orange crop has increased from 29,000 rail carloads (a carload is 1,000 40-pound cartons) to an anticipated 57,700 carloads this year. During the same period, domestic fresh shipments more than doubled and exports nearly tripled. Although the size of the crop has been as small as 15,300 cars in the 1961–62 freeze year and as large as 84,200 cars three years ago, California and Arizona citrus farmers are thriving at a time when most American farmers' livelihoods are being undercut by spiraling production costs and declining market prices.

As it is, the present system is remarkably close to the free market. In the first place, the market is always competitive in that the price is never fixed and the handler must hustle to find a produce buyer. Although the system evens out returns to growers over time, it guarantees them nothing in the way of profits —which, of course, depend on each grower's costs. Some growers have gone out of business historically and some will go out of business in the future because *in the long run* marketing orders operate similarly to the free market with respect to the allocation of resources.

Getting rid of marketing orders would not take citrus growers much closer to the benefits of the free market than they are now. Growers would be forbidden by antitrust law to band together to establish their own prorate—a prohibition that is contrary to the basic philosophy of free enterprise. In addition, they would still face any number of departures from the free market in the form of agricultural labor laws, environmental legislation, tax provisions, immigration policies, foreign restrictions against imports, and a host of other rules that interfere with individuals' ability to make their own judgments and act on them (without force or fraud, of course).

There is absolutely no doubt that in the absence of marketing orders many small farmers, who are not inefficient but who simply lack economic staying power during times of rock-bottom prices, would go out of business. The reason is that farmers are not part of the negotiations on the price of the crop. It is the handlers who negotiate the price; the return the farmers receive depends on the price that the handlers receive.

With a drop in the number of producers, orange prices would go up—and oranges are not a luxury fruit like kiwis or cherimoyas but one of the three fresh-fruit staples in the American diet (the other two being apples and bananas). After four-plus decades of marketing orders, consumers have gotten used to having fresh oranges all year round at reasonable prices. If foreign citrus came into the U.S. marketplace to fill the void, consumers would not only have to accept an inferior product (California eating oranges are of the very highest quality) but would be dependent on foreign sources for both bananas *and* oranges. Many Americans who defend the Jeffersonian view that there is value in being a nation of small farmers do so because they feel uncomfortable at the thought of having staples of our food supply in the hands of an American oligopoly or foreign sources.

The optimistic predictions that orange prices to consumers would drop if marketing orders were lifted have turned out to be based more on theory than reality. When the Department of Agriculture suspended the prorate volume restrictions on navel oranges in January of this year, the price to the grower dropped by almost 30 percent in five weeks, but there was little or no change in the price consumers paid for oranges at the local supermarket.

Lenard and Mazur's article contains many inaccuracies. I will cite just three.

(1) In discussing the fresh-fruit and juice markets, they say that "identical products are sold for different prices." Wrong. It is the less attractive fruit that goes to juice. The best is sold for eating fresh.

(2) They say "oranges are diverted to juice when consumers would rather enjoy them fresh." This makes no sense because it does not tell us under what circumstances and at what price consumers manifest this preference. It also makes no sense since the growers push to sell to the fresh market where returns are higher. There is virtually no incentive to put navel oranges into juice since, in almost all years, all can be sold at the higher fresh-market price.

(3) The authors say, "prorate and market allocation provisions are used in good and bad years alike—suggesting that their purpose is simply to raise prices, not smooth them out." Orange prorates do not attempt to smooth out prices from one year to the next, but only during a given season, whether for navels or for valencias. In fact, prorates are among the most sensitive of the instruments imaginable for this purpose:

• The amount that goes to market each week is set in simple response to demand. So if a supermarket produce buyer wants to do an orange promotion, he can easily convey that information and get the additional fruit he wants.

• Shippers faced with an unusual opportunity to sell more fruit than their allowance can borrow against future allotments.

• There are no limits on the amount of fruit that can be sold fresh for export or for juice or given away as charity.

• Every season the prorate is suspended when 85 percent of the crop has been sold. The suspension of the prorate in January because of short supply was based on a similar rationale.

Citrus marketing orders, far from being the villain Lenard and Mazur make them out to be, have served both producers and consumers. The system has worked so well that some agricultural economists are considering marketing orders as a replacement for the costly and unworkable subsidies, acreage allotments, price supports, and other schemes that characterize much of the rest of U.S. agriculture.

Clytia M. Chambers,
Hill & Knowlton, Inc.
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MICHAEL P. MAZUR responds:

My article with Thomas Lenard argued that citrus prorates encourage overproduction, raise prices and restrict supplies to consumers of fresh fruit, artificially expand sales to processors, lower the average quality of fruit, and lead growers to abandon crops in the field. All of these distortions will occur in the long run as well as the short. Our article suggested that these effects are costing the U.S. economy more than $100 million a year. Yet Clytia Chambers says that prorates are a "*de minimis*" deviation from the free market. I wonder what she would consider a major deviation.

Chambers believes that it is consistent with the basic philosophy of the free market for sellers to collude to restrain competition among themselves. This is obviously a point on which we differ. In any event, marketing orders do permit conduct that if engaged in by sellers elsewhere in the economy would land them in prison under the antitrust laws, and to that extent they are consistent with her views. Marketing orders go further than just suspending the antitrust laws, however, since they effectively give a majority of growers the legal authority to compel the unwilling minority to participate in their scheme.

The data do not support Chambers's assertion that there was little or no change in consumer prices of navel oranges after the prorate suspension announced in January and put into effect on February 7, 1985. According to the Bureau of Labor Statistics, the average retail price for navel oranges declined from 52.6 cents per pound in January to 52.5 cents in February and 50.5 cents in March, a decline of 3.8 percent from the last month entirely under the prorate to the first month entirely under the suspension.

Concerning the three alleged inaccuracies, I would observe the following:

First, our article indicated that the fruit sent to the fresh market is of better quality on average than that sent to the juice market. Our point is that fruit of a given quality sells at a higher price in the fresh market than identical fruit can fetch on the juice market.

Second, *in the absence of prorate* there would indeed be very little incentive to put navel oranges into juice and most would probably be sold to the fresh market. As a result of the prorate, however, more than 30 percent of navel oranges marketed during the five seasons between 1978 and 1983 were sold for processing.

Third, proponents of marketing orders often attempt to defend them as devices to stabilize prices from year to year as well as from week to week. Our article addressed both contentions. The argument that federal regulations must mandate the amount shipped to market each week, lest growers ship too much one week and too little the next, ignores the fact that the free market gives growers ample incentive not to act that way. That the market actually works is demonstrated by the shipping performance of other citrus crops not subject to prorate. Moreover, a recent statistical analysis by the Economic Research Service of the U.S. Department of Agriculture found that week-to-week variability in prices and volumes shipped was no greater during the 1985 suspension of the navel orange prorate than during the preceding five years under the prorate.

On a different matter, I am happy to report that our article was overly pessimistic about the prospects for reform of the hop marketing order. On July 1 the Department of Agriculture announced that it would terminate that marketing order, effective December 31 of this year.

Competition in Transatlantic Satellites

TO THE EDITOR:

Peter Cowhey and Jonathan Aronson's intriguing analysis of the controversy over separate transatlantic satellites ("The Great Satellite Shootout," *Regulation*, May/June 1985) incorrectly concludes that "both Intelsat and Orion have won." In fact, the Federal Communications Commission's (September 3, 1985) decision to allow new satellites may have left both Intelsat and Orion losers while dealing the winning cards to European governments.

Intelsat might claim that the decision was a victory in that the U.S. government did acknowledge its legal obligations under the Intelsat agreement and consequently banned switched-network (telephone system) use of the new satellites. It also imposed a one-year minimum lease restriction on separate satellite systems. However, it placed no limit on the number of systems that could be licensed, the types of services separate systems could offer, the degree to which multiple related or unrelated users could share a given system's facilities, or the minimum capacity that could be allocated to any one user under such a sharing agreement. And even if the FCC's minimal restrictions effectively shield a "core" of switched services from the competition of separate satellites, Intelsat will come under across-the-board pressure in that area too because of the FCC's unrestricted licensing of new transatlantic fiber-optic cables.

The FCC urges Intelsat to respond to this pressure by increasing its efficiency and reexamining its capacity plans. To heed this call for more "business-like" operations, Intelsat will have to reexamine and modify its nondiscriminatory pricing structure, its broad-beam technology aimed at linking a maximum number of earth stations through a single satellite, its user-cooperative model capital structure, and its complex international-organization management system.

Unfortunately, the factors that inhibit Intelsat's competitive poten-

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tial are the same ones that create its unique political benefits. If Intelsat tries to placate U.S. deregulators by taking a competitive posture, it may both forfeit any future claim to U.S. restrictions on its potential competitors and lose political support from less developed countries where the consortium's politically dictated market vices are considered virtues. On the other hand, if Intelsat continues to adhere to its nondiscriminatory rates, broad interconnection policy, and cooperative-style organization, U.S. authorities may feel obliged to leave existing restrictions in place even while they chafe under the consequent limitations on the efficiency of separate system operations. In either case, an Intelsat that has lost the U.S. political backing that made it a unique vehicle for global sharing of space technology can hardly be considered a winner.

Intelsat's loss is not necessarily Orion's gain. The decisions of U.S. regulators may have turned Orion into a potential bride with a valid, blank marriage license and no dowry. Orion still needs foreign consent if it is to operate its separate system, and neither the FCC decision nor the senior interagency group's white paper presents any plan for how to secure that consent. The restrictions on interconnection with switched systems prevent Orion from offering to integrate its operations with existing European facilities, while the FCC's threat to revoke Orion's license should that firm agree to procurement set-asides for foreign firms prevents Orion from appealing to European industrial-policy interests. Whether European governments will be willing to permit new services that bypass their existing facilities or to permit competitive pricing of separate system services that could disrupt their existing tariffs is an open question. What is clear is that, without such permission, Orion too will have lost.

The European governments, in contrast to Intelsat and Orion, have been placed in a "no-lose" position. They are free to reduce their dependence on what they have historically perceived as U.S.-dominated Intelsat facilities while putting the political onus for Intelsat's decline on the United States. European governments, which will be negotiating with multiple U.S. licensees in a situation where there will inevitably be pressure on the U.S. authorities to make separate systems "succeed," may press for revenue-sharing, reciprocity, elimination of previous U.S. restrictions on using cable circuits disproportionately to satellites, and "voluntary" procurement concessions. At a minimum, it seems unlikely that the current scenario will give the U.S. the leverage to dissipate the traditional market power of European postal-telephone agencies by establishing truly competitive end-to-end satellite services. Thus, as Cowhey and Aronson ultimately recognize, the issue of competition in international telecommunications markets is far from resolved. There is a significant risk that a more diverse but less efficient international system will emerge and that no U.S. interest will fairly be deemed a winner.

Bert W. Rein,
Wiley & Rein

JONATHAN ARONSON and PETER COWHEY respond:

We do not see how either Orion or Intelsat have lost the political battle. Bert Rein argues that Orion and other entrants have won only a Pyrrhic victory because they have not yet had to confront the European governments. This argument was widely circulated in Washington during the debate over the Orion application and largely depends on the analogy of the opening of the North Atlantic airline market to competition, an analogy that we reviewed in our article.

As for Intelsat's future, Rein raises useful questions about the meaning of some of the terms of the FCC decision (which came out after we completed our paper). However, he shows a lawyer's predisposition to treat the precise wording of the decision as if it were the substance of the policy. We view the decision instead more as a setting out of preliminary guidelines on acceptable competitive strategies and as an implicit forecast of the foreseeable balance of commercial power.

Rein did not mention a recent congressional action of critical importance. Our article spoke of the conditions laid down by the executive branch for competition, which among other things protect Intelsat from loss of its core market for "switched" service (such as telephones). Not only did the FCC decide that any new satellite systems would have to comply with these strictures, but Congress has now buttressed them further by requiring (in the State Department's authorization) that they be met by any foreign country that is to do business with Orion. The two actions give Intelsat a strong basis to fight against U.S. regulatory decisions that might endanger its most important market.

We think the FCC recognizes that the total share of the market commanded by the new systems will ultimately not be large. There are several reasons to expect this outcome: the requirement that entry avoid "significant harm" to Intelsat (which effectively puts a loose cap on the number of new entrants), competition from new fiber optic cables, Intelsat's inevitable restructuring of its rates and services, and intense political attacks in Europe on new satellite systems. However, potential entry by competitors can be as economically beneficial as actual entry.

The test for policy makers is to make sure that the benefits of liberalized entry are not dissipated by additional handicaps on the new systems. The FCC's decision to set no limit on the number of competitors and to allow customers to share the use of privately leased satellite circuits (a move that significantly raises the number of potential lessors) is correct. While the new systems are testing the marketplace and the political milieu, it makes little sense to set prior limits on their room for experiments.

We agree that the U.S. government has not yet worked out a convincing diplomatic strategy. However, Rein's fears that Europe will emerge with a dominant bargaining position are misplaced. The FCC has already used its regulatory powers to prevent a similar problem in the area of international telex and telegram service, and its staff has produced lucid suggestions on how to do the same in this case. But we concur with Rein that the impasse between the U.S. government and Intelsat on how that consortium should reformulate its competitive program could both gravely damage Intelsat and impede efficient competition. Because the feud extends up to the offices of Intelsat's president and the U.S. Undersecretary of State responsible for Intelsat policy, it will take a very high level of political attention to work out a solution. Wouldn't this make an interesting mission for Walter Wriston, who is Secretary Shultz's personal advisor on international telecommunications policy? ■