Alfred E. Kahn
Luncheon Remarks
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Following receipt of an award for
"Lifetime Achievement in Antitrust"
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If this were this fall, rather than summer, and I had passed my 86^{th} birthday, I think I would cry.

I think you should understand that in John's case his entire encomium was really an exercise in self-justification, because I am quite certain that the reason I was offered the chairmanship of the CAB was John's influence in the Democratic Party in Virginia. For that, John, and for your friendship over the years, my profound thanks; and for yours and Irwin's distinguished careers in antitrust over the years, my profound admiration.

As for Irwin, all I need do is ask you to read the last paragraph of the preface to my two volumes. After pointing out that my daughter Hannah used to lecture me about the misuse of the word "literally"—such as when people say "I was literally *dead*," or "There were literally *billions* of beans in my plate"—my last sentence was, "Irwin Stelzer, without whose help and constant encouragement and criticism I would not have possibly been able to finish this book"—and I added, "literally." I thank my two old, treasured friends.

I express thanks also to Josh Gottbaum for assembling all these old friends from our days of trying to fight inflation, lacking control over monetary policy. Without minimizing the importance of our successful deregulations of surface as well as air transportation, I suspect my major contribution to the conquest of inflation was to agree with Paul Volcker when he told me, "Fred, what you're doing is just not working. I have the only weapon in town that anybody has that could really bring this inflation under control, and sooner or later I'm going to have to use it." To which I sadly agreed. (I should give Michael Blumenthal, just previously Secretary of the Treasury, credit for consistently advising the President, "get your recession over early in your term." That's what Paul Volcker ultimately did—for the benefit of President Ronald Reagan.)

When Bert asked me to receive this honor and participate at this occasion, I expressed deep appreciation but protested that I had not been actively engaged in antitrust work since something like 1975. True, my first job, before I actually finished my Ph.D., was at the Antitrust Division of the Department of Justice. And I was working for Myron Watkins and Joe Borkin and Charlie Welsh when all the disclosures of the German chemical cartels, particularly, were appearing, and I eventually assisted Myron and George Stocking in preparing three chapters of their *Cartels in Action*. I'm also the only person in this room, I'm quite certain, who ever saw Thurman Arnold take his pants off—as he was doing when he asked me why the hell I was asking his permission to testify before a senate committee on international cartels. But that was in the early 1940s. And of course Joel Dirlam and I did our work on antitrust, eventuating in my "Standard for Antitrust Policy," and our book, *Fair Competition*. Bert responded—convincingly to me!—that my more recent work in contributing to the deregulation of air and surface transportation has contributed significantly to genuine antitrust triumphs; and my intensive work over the last several years, although involving much more complicated issues, has of course been directed to the same end.

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To be sure, deregulation has most definitely not displaced the antitrust laws. On the contrary, the truism is that it makes antitrust more important rather than less: and if only the FCC would deregulate I would think that might be true also in telecommunications. I'll come back to that only briefly, and with no intention of arguing with Jonathan Rubin, whose brief or draft piece for *Trinko* seems to me excellent. I'll come back briefly to explain why I hope, nevertheless, that he is mistaken!

It was perfectly predictable that deregulation would be a bonanza for the antitrust bar. What is perhaps less obvious to all of you is that it's been proved to be an even greater bonanza for the regulatory bar. The membership of the Federal Communications Bar grew 78 percent between 1994 and 1998, with the Telecommunications Act of 1996 in between. That was four years ago, so I had somebody check with the Federal Communications Bar Association, and they were happy to assure them that the employment remains at that level. And I'll give you some suggestions about why that is so and why I regard the continued pervasive *regulated* deregulation of telecommunications, *with no end in sight*, as not only an employment bonanza for the Federal Communications Bar but by *any reasonable judgment* an *abomination*. And of course, if the Supreme Court listens to Jonathan Rubin, as I fear it will feel constrained to do, I fear we'll have a similar flowering and indefinite extension of work for the antitrust bar and regulated deregulation forever.

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Over the last half year or more I have been attempting to assess the implications of the recent financial meltdowns of the airline and telecommunications industries. One obvious inference might be that it's because the airline industry was deregulated that it is in such terrible shape. It's a little hard to attribute that same blame to deregulation in telecommunications because they *haven't* been deregulated!

The airline industry has always been very susceptible to fluctuations in the economy at large. When there were calls for re-regulation in the early 1990s, after the industry had lost something like $13 billion, the answer that prevailed was that the companies had succumbed to over-optimism in their purchase of aircraft in the preceding years, and that when the economy recovered, they would recover as well. And of course they did, and they did very very well in the late '90s.

But of course September 11th and the Iraq war produced more than an ordinary recession. Moreover, those catastrophes appear to have come on top of what appears to be a structural change in the industry, a partial reversal of the likewise largely unpredicted apparent triumph of hub-and-spoke operations in the '80s and '90s.

The efficiency advantages of hub-and-spoke are easily illustrated. Assume, for example, that you have nine planes spaced north and south on the east cost and nine planes on the west coast, and you set them off in a bank of transcontinental, nonstop flights, you have 18 origins and destination, 18 routes—nine this way and nine that way. Put a hub in the middle, and you have 198 flights that you can offer, origins and destinations, east to west and west to east, respectively.

Those extremely efficient network operations proved quite early to be unsustainable unless they could practice price differentiation, both reflecting differences in incremental costs and true discrimination, as the only means of recovering the huge fixed costs involved in them. In exchange, travelers were offered a wide range of fare options, reflecting their differing evaluations of the service (including torrents of highly discounted fares, at which the overwhelming majority of them traveled), and direct and indirect connections all over the world.

The obvious antitrust concern was that this preponderant form, with its necessity of extreme price discrimination, be subject to competitive restraint, in particular to protect the demand-inelastic travelers from unreasonable exploitation. And that meant the importance of preserving competitive entry by the other form of operation, exemplified by Southwest Airlines—which, however, had much less at that time than 5 percent of the market.

As William J. Baumol and his collaborators have demonstrated (and I suggested in my *Economics of Regulation*, in general terms), the proper economic ceiling on rates to customers being discriminated against is the cost of serving them on a stand-alone basis, the best guarantor of which would be free entry, particularly by relatively uniformly low-cost, low-fare carriers. But this in turn—along with the very low short-run marginal cost of aircraft operation in the presence of excess capacity—raises the possibility of predatory responses by incumbents. That was where antitrust had or should have had an important role, until the courts became convinced that there is no such thing as predation.

The other aspect of antitrust that has become increasingly applicable is of course the consequences of 9/11 inducing attempts to combine their operations. I remember testifying only three years ago against the proposed merger of United Airlines and US Airways, let alone the really outrageous agreement that emerged thereafter between United and American to divide up USAir, and by so doing in effect to divide up the entire East Coast market: you may recall they were proposing even to operate the East Coast Shuttle together. One of what I thought was my telling arguments in opposition to the merger was my recognition that United might need a hub in the Northeast, and covet US Air's very valuable Pittsburgh hub. The competitive way for it to do so, I contended, would be by constructing its own, competitive, hub. But that of course was before that option became totally unrealistic, in consequence of the recession, 9/11 and its aftermath.

The catastrophic declines in traffic led the industry to ask the Department of Justice for antitrust exemption, in order to permit them collectively to curtail their operations to the manifestly shrunken demand, which I believe the Antitrust Institute and Department of Justice were justified in rejecting: my first teacher, Myron W. Watkins, taught me permanently that the *Appalachian Coals* decision was an abomination.

That leads me to the more recent proposed mergers and then code-sharing alliances, about which I must confess divided feelings.

The alliances do *clearly* attempt to preserve, even extend, economies of scope achieved by network operations in a shrinking environment. I struggle, therefore, to draw a line between *Appalachian Coals* and attempts by code-sharing to preserve economies of scope in such an environment.

Specifically, now that the Continental/Delta/Northwest Airlines alliance has been approved, the relevant question is the sufficiency of the conditions attached to its approval by the Department of Justice. The most important of these seem to be the prohibition of direct fixing of prices or division of revenues on routes in which the parties are direct head-to-head competitors on a non-stop basis—most obviously between their respective hubs.

For whatever interest it may have, I continue to be concerned about how agreements between major hub carriers to put passengers on one another's flights, with their own flight identifications, can avoid involving also agreements to suppress horizontal competition, actual or potential, and—particularly troublesome to me—the exclusionary effect on equally efficient smaller competitors of a merging of frequent-flier benefits—a brilliant competitive innovation but nevertheless rewards for exclusive patronage.

The ultimate question is of course the sufficiency of residual competition. In this connection, it is of some considerable significance that independent carriers have now roughly doubled their market share, from something like 10 to 20 percent nation-wide. In this connection, I had a particular look at the Boston/Phoenix market, just because Julius Maldutis used it ten years ago to illustrate the compatibility of dominating hub-and-spoke operations with travelers they offered a rich variety of competitive alternatives—all seven major hub-and-spoke carriers offering travelers one-stop flights between Boston and Phoenix, over their respective—some 19—separate hubs. The situation today is essentially unchanged, except that, in addition, Southwest Airlines has now set up large competitive operations in Providence and in Manchester, New Hampshire. I'll return to the consequences of this oxymoronic interpretation.

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Telecommunications deregulation continues to reflect in its present form the classic—chronic—antitrust problem of distinguishing the preservation and advancement of competition from the protection and/or subsidization of competitors—a disposition fortified in this case by the desire of regulators to produce benefits highly visible to consumers.

I have developed and expounded my criticisms of this tendency, particularly of the Federal Communications Commission in its administration of the 1996 Telecommunications Act, so many times it would be an abuse of your patience for me to do so here once again.[1] I will attempt to confine myself to explaining the controversies that have roiled Commission actions during the past year that produced, in one essential respect, a split 3-2 decision, overriding its new chairman, Michael Powell, and perpetuating this deplorable policy insofar as the politically most sensitive basic service to residential customers is concerned.

It has always been widely conceded that if competition in the provision of local service were to be introduced, entrants would have to be able to make use of some facilities of the historical local franchised monopolists—prototypically their wired copper networks providing ubiquitous service to residential customers, which cannot economically be duplicated. The 1996 Act set a standard for defining the unbundled network elements that the local companies were to be required to make available to competitors that was intended to be considerably more

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[1] See Kahn, *Lessons from Deregulation: Telecommunications and Airlines after the Crunch*, AEI-Brookings Joint Center for Regulatory Studies (in press); Whom *the Gods Would Destroy, or How Not to Deregulate*, AEI-Brookings Joint Center for Regulatory Studies (May 2001); *Letting Go: Deregulating the Process of Deregulation*, Michigan State University Institute of Public Utilities (July 1998). See also Kahn, "The Deregulatory Tar Baby: The Precarious Balance Between Regulation and Deregulation, 1970-2000 and Henceforward," *Journal of Regulatory Economics*, 21:1, January 2002, pp. 35-56.

liberal than the strict essential facilities as defined under antitrust, inviting the FCC to impose the requirement when the elements were "necessary" to competition or would "impair" the quality of the competitive offerings. The FCC went beyond and required the incumbent local companies (ILECs) to make available any elements that could feasibly be connected with competitors. For this it was rebuked by the U. S. Supreme Court, by an 8-1 vote, and with a classic concurrence by Justice Stephen Breyer, requiring the Commission to give some substance to the "necessary" and "impair" standards.

Beginning around 1999, the FCC expressed its willingness to permit state commissions to require the ILECs to make available, among the "unbundled network elements," the so-called "UNE-Platform," the *combination* of lines and switches necessary to produce service.

The other essential element of the continuing controversy—and basis for my bitter criticisms of the FCC—is the method for determining the price of the UNE. The Act provides that it be set at "cost," including, permissibly, a reasonable profit. The FCC, in its omissions, decided instead that it should be the cost that would be incurred by a hypothetically most efficient new entrant, writing as it were on a blank slate (with an important qualification of taking the existing wire centers of the ILEC as given). That sets levels typically, so far as I know, far below the actual costs of the incumbent, whether reckoned in book or historical or incremental terms.

The combination of the UNE-P and the TELRIC pricing formula—confined by the FCC's decision of last February to residential service—is that state commissions have now and have continued to be free to set the wholesale price, at which the local companies must make complete services available to competitors for resale—all they need do is put on their own brands and handle the marketing and billing—at prices designedly below the actual costs of the incumbents, however calculated.

Accepting this invitation, within the last two years, Michigan, California, New York, Illinois and the District of Columbia have decided to require their local companies to provide UNE-Ps at rates between 25 to 45 percent below the previous levels.

Intensifying the irony of this policy, most American states (and the FCC) several years ago abandoned cost-plus for rate cap regulation—in order to give the companies stronger incentives to improve their efficiency indexing the rates to economy-wide inflation and incorporating a prescribed annual reduction to reflect achievable improvements in productivity—four-and-a-quarter percent per year, in real terms, in the case of Illinois.

The mandated reduction in these wholesale rates—in the case of Illinois from something like $20 to $12 a month—produced the desired result: AT&T and MCI have become major competitors of the local companies via resale, using the latter companies' facilities and simply undertaking the retailing, taking advantage of the close retail margins in the 40 to 60 percent range to offer residential customers service packages, along with their long-distance operations, at substantial discounts. "*Some* competition"!

This turbulent history, hastily summarized, returns me to the irony I see in *Trinko*. It's clear that the requirements imposed on the carriers by the Telecommunications Act, particularly as interpreted by politically sensitive commissioners—including, most prominently, the 3 to2 decision by the FCC at the end of February, means continued litigation, at federal and state hearings. It's in those circumstances that I wrote the response to Bert about the *Trinko* case: "Oh my God, I've spent the last seven years at least involved in endless administrative proceedings under sections 251 and 271, and under state regulations statutes before that, mainly on behalf of Baby Bells—I want to make sure you understand that—in the latter of which they had to satisfy the FCC of their compliance with the highly detailed provisions of the Act to qualify for lifting the interLATA long-distance exemption. The notion of the companies now having to re-litigate those complex issues before juries I think would give any reasonable person nightmares."

Having said that, I have to say I don't find anything that I can disagree with in your excellent brief. So that's why I am constantly reminded of the difference between a psychotic and a neurotic. A psychotic thinks two and two equal five. A neurotic knows that it equals four, but can't stand it. With respect to the *Trinko* case, I *think* you may well be right, but I can't stand it!