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THE THEORY AND APPLICATION OF REGULATION

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I thought I could count on Don Flexner to quote to you from the *Report on Regulatory Reform* by the ABA Antitrust Section Industry Regulation Committee, since he was its Chairman. That would have saved me at least five minutes to talk about other things. Despite his delinquency, I am merely going to assume that you are all familiar with the eternal verities it contains. By simply endorsing them one hundred percent, I will have taken care of half of my assigned subject—the theory and application of regulation.

That will free me to concentrate on the other half—the theory and practice of deregulation—in recognition of the fact that the five years or so of experience we have now had is worth decades of speculation about its probable consequences. I will quickly survey that record, in order to explain why I think that deregulation, not merely in airlines but in most of the other industries that have been subjected to it, has produced something like ninety percent of the results we expected. I will then spend the major portion of my time exploring with you the very difficult problems that remain in the case of industries in which neither you nor I nor the Antitrust Section Industry Regulation Committee have been able to articulate a clear-cut case for total deregulation, or to sell it politically—notably telecommunications and the electric and gas utilities.

I cannot claim that when I set out to deregulate the airlines—a certain respect for history requires me to point out that the Ford Administration had already endorsed airline deregulation before I came on the scene, and that my predecessor, John Robson, had already taken some very important initial steps—I cannot claim that when I became Chairman of the CAB, in the spring of 1977, that I had a clear-cut blueprint in mind of how we were going to proceed or, indeed, how far we were going to go; very few people in Congress or the Executive Branch did,

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either. I had a clear conception of the direction, but I determined to move gradually and deliberately, partly out of intellectual caution; partly because I thought an industry that had lived in a protectionist hothouse for forty years needed time to adjust itself to the cruel world of competition; and partly out of political sensitivity.

It was only after a period of months that I discovered that moving partially and gradually, and attempting meanwhile to run a regime of partial deregulation, created more problems than it solved—more distortions, more legitimate complaints—so that, in fact, the process took on a momentum of its own. And I think eventually the industry itself—and by "eventually" I mean nine months, and by "the industry" I mean some of the industry—not Delta Airlines; I was once introduded as, "Fred Kahn; Delta Airlines was not ready when he was"—came to see that a regime of partial deregulation was the worst of all possible worlds. And, as I say, to a large extent the process of deregulation actually got out of my hands.

Still I think it is clear, as your Industry Regulation Committee *Report* points out, that over the decades of the 1960s and the 1970s there had already developed something close to unanimous opinion among disinterested academic students—from which I exclude the airline pilots—that, most obviously in transportation but also elsewhere, regulation had produced several undesirable effects: it had suppressed innovation. It denied the public the variety of price and quality options that a competitive market would have provided; encouraged competition in wasteful cost-inflating ways—thereby illustrating the economic principle that, in a structurally competitive industry, if you do not let competition push prices down to marginal cost, competition will push marginal costs up to prices, and the same thing would be true in the intermediate or long run of average total cost of efficient supply. Regulation produced monstrous resource misallocations—consider the consequences of the overpricing of long distance telephoning and the underpricing of crude oil and natural gas; sheltered and encouraged inefficiency in the production of the services and in its distribution among competing modes—most obviously in transportation. And regulation encouraged the wage/price spiral that in a certain sense was the microeconomic component of our national inflation problem, with which I struggled so unsuccessfully when I became the latest living embodiment of the Peter Principle.

The clearly indicated prescription was something like total deregulation, wherever it appeared that competition, actual or potential, would be even imperfectly effective in protecting consumers from monopolistic exploitation. And if there were time, I would give you my two-hour rather than my three-minute talk, documenting my contention that the prescription has indeed been abundantly successful. The unleashing of competition has gotten prices to track costs much more closely than before; this alone has produced billions of dollars of additional consumer welfare. It has provided consumers a much wider range of price/quality options—consider the fact, cryptically put, that Charles Schwab is the People Express of the brokerage business, for example. It has exerted powerful pressures to improve efficiency. It has imposed very healthy downward pressures on inflated wages: in most of these industries labor, organized in strong unions, had become the principal beneficiaries of the government's thoroughgoing suppression of competition. All of this has not been at the expense, in general, of quality of service. On the contrary, in most instances the quality—and especially the variety—has sharply improved.

I'd like to expand on that last assertion in the case of the airlines only because there is such a strong popular impression that air safety has deteriorated. So far as the available facts show, that is simply incorrect: the safety record *of the part of the industry that we deregulated* has improved markedly. Do not be misled by the terrible accidents involving Japan Air Lines or Air India or Mexicana Air or the charters of Arrow and Galaxy Airlines. We never regulated the charters. And, obviously, we did not deregulate Japan Air Lines or Air India. If you look at United States carriers alone, in both domestic and international scheduled service, you will find that in every important respect—number of accidents per million flights, number of fatal accidents per million flights, number of fatalities per million flights—we have experienced something like a thirty-five to thirty-eight percent decline.

In telecommunications, in contrast, although deregulation has been in process for twenty-six years—the *Above-890* decision[1] opening the above-890 megaHertz spectrum to private microwave systems, goes back to 1959—even today, we still suffer from considerable uncertainty about how far to go, how fast, and how to get there.

I think the direction in which we are going is probably the correct one: deregulation is producing a lot of the benefits that I have already characterized it as having produced in the other industries; and, in any event, I suspect it was technologically inevitable.

Still, a more than plausible case could be made that we have drifted into deregulation in communications largely through inadvertence.

[1] Allocation of Frequencies in the Bands Above 890 Mc., 27 F.C.C. 359 (1959), 29 F.C.C. 825 (1960).

That is not true of our deregulation of customer premises equipment. That is a manufacturing industry, with none of the characteristics of natural monopoly: there was absolutely no reason not to permit independent entry, and to allow subscribers to attach their own answering machines, interior wiring, telephones, switchboards, and computers.

But our deregulation of the long distance business was surely inadvertent. The *Above-890* decision was intended to permit only private systems. Next, it seemed logical to permit MCI, then other "specialized common carriers" to offer the same specialized service to smaller users. But the FCC thought all this time it was restricting entry to the provision of private, dedicated service; it had no intention of letting the competitors encroach on the monopolistically-controlled, integrated switched network; and it prohibited them from offering switched service.

These individual steps, however, taken together, laid the basis for a direct challenge to the core of AT&T Long Lines' monopoly. Any subscriber could simply dial MCI through the local exchange office; MCI could switch the calls over its long-distance lines to its office in the vicinity of the call's destination, which could, through a local call, complete the transaction—and voilà, MCI would be offering long distance service, in universal competition with AT&T. When the circuit court of appeals, in the *Execunet* decision,[2] overturned the FCC's attempt to prohibit MCI's offering of this service, we were off to the races.

And then, when AT&T's reaction to these competitive incursions appeared to violate the antitrust laws, it set in motion a separate, largely autonomous process that, along with the preceding discrete steps, produced the present situation, which, I suspect a public opinion poll would demonstrate most people consider a catastrophe. Whether or not that assessment is fair, there must be precious few people responsible for telecommunications policy over the last twenty years who can honestly say this is the result they intended.

There are a number of reasons for our lack of clear vision of the proper regulatory or deregulatory future for telecommunications. First, even today, we still do not know to what extent large parts of the telephone business may be natural monopolies. In the interexchange business, none of the new entrants appears to be making any money, and most of them are importuning the FCC to continue to put constraints on AT&T's competition with them, often using the arguments that you

[2] MCI Telecommunications Corp. v. FCC, 561 F.2d 365 (D.C. Cir. 1977), *cert. denied,* 434 U.S. 1040 (1978); MCI Telecommunications Corp. v. FCC, 580 F.2d 590 (D.C. Cir.), *cert. denied,* 439 U.S. 980 (1978).

and I would translate into "this is really a natural monopoly, and if we let AT&T compete with us they are going to wipe us out." That, I hasten to point out, is not a sufficient characterization of their position: AT&T does enjoy competitive advantages that are merely a legacy of the regulation days; and it may yet turn out that, given a fair opportunity, some of these competitors may succeed in demonstrating their entitlement to survive.

Ironically, however, our greatest hope for the survival of competition in the interexchange business may turn out to rest on the other AT&T offspring, the regional holding companies.

At the local level, as well, the competition we are witnessing does not necessarily demonstrate this is not a natural monopoly. The widespread bypassing of the facilities of the local exchange companies is clearly motivated, in important measure, by the desire to avoid the inflated charges those companies are being forced to impose on long-distance companies for access to the local networks; and the spreading construction of "smart buildings" by real estate developers—using their own switchboards to provide local calling within their confines, as well as a great variety of other services—may be the simple consequence of the regulatory handicaps limiting the ability of the telephone companies to meet or forestall that competition.

Second, there remain large bodies of consumers whom we still think we have to protect—mainly residential subscribers to local service. And so, we find ourselves in the terribly difficult situation of trying to run a system part regulated and part competitive—trying to make arrangements that will permit free competition in the unregulated markets, while preventing cross-subsidization of that competition at the expense of the captive customers.

Finally, there continues to be the fear that the regulated monopolists, mainly the operating companies, will use their control over the bottleneck facilities to deny rivals, dependent on those facilities, a fair opportunity to compete. So we have all sorts of restrictions—themselves in a real sense anticompetitive—on their ability to enter whatever businesses they please, even where that entry might make perfectly good sense technologically.

So regulatory commissions all over the country, in the purported interest of protecting the monopoly customers and the preservation of competition, are imposing all sorts of handicaps on the Bell Companies. They alone must sell under tariffs; and those tariffs get tested against full allocations of embedded costs, determined in traditional public utility regulatory fashion, which have no relationship whatever to marginal cost or, therefore, to their efficiency relative to that of their rivals in serving the public. They are also being forced, still, to sell to their various customers and in their various geographic markets at average costs, even though the actual cost of serving them may vary enormously, which leaves them prey to competition pinpointed at the low-cost, high-priced markets. You do not see the MCIs and the Sprints of the world begging for the opportunity to hook up a hundred million households, or real estate developers planning smart buildings in rural areas.

And the restrictions on the markets in which they may compete and the ways in which they may do so—only through fully separated subsidiaries, for example—may systematically interfere with their exploitation of the economies of scope.

Now, this may be the best we can do in an impossible situation, running a marriage of partial deregulation and partial regulation. Its result, however, is that we have no way of knowing whether the system is efficient, whether the competition that we see is or is not economically legitimate, and what services we may be deprived of because of the restrictions on what the various players are permitted to do.

Ultimately, I suspect that what we have to hope for is full deregulation of the competitive operations; sooner or later we have to get regulators out of the business of handicapping the process. That means we have to find ways of protecting captive customers, to the extent we think they continue to require protection, in ways that divorce their rates totally from the revenues that the regulated companies get in their competitive operations, and without perpetually restricting the kinds of activities those companies are permitted to undertake. One possible method of separating the two is the way the British regulate British Telecom's rates: changes in its average bundle of regulated prices cannot exceed the consumer price index minus three points, and in its prices to residential customers, the consumer price index plus two points. The particular indexation formula is to some extent arbitrary, but it does establish a kind of pragmatic protection, to the extent ceilings on some prices are considered needed, while enabling them to free the competitive prices without fear that the latter will be cross-subsidized at the expense of the former.

Now, it is far less generally recognized, except by the companies directly affected, that all these same developments, giving rise to all the same problems, are beginning to appear in electric utilities generally and in the transmission of natural gas.

It is important to recognize at the outset that some of what is being labeled by regulatory commissions and consumerists as deregulation is actually expropriation. Some commissions, operating on an original cost/ prudent investment system but suddenly, embarrassingly, confronted with some high-cost plants, have decided to "deregulate" those plants, but only them: "We'll let you get for them whatever the market will allow," they tell the companies—knowing full well that the market will not allow the costs actually incurred—"but on these other plants, whose book costs are far below the current cost of reproducing the service, we are going to continue to hold you to original cost regulation." Or, "we will set the rates for the power coming from the high-cost plant at avoided costs—i.e., competitive levels—but the rest of your power you must continue to sell at original costs." That's not deregulation, it's expropriation; it's heads we win, tails you lose.

At the same time, genuine deregulation is also in process—partially. Industrial uses of power and gas are demanding—and many times getting—the right to buy from the lowest-cost supplier rather than their local franchised utility—an adjoining or distant power generator, or gas pipeline or producer in the field—and having the power wheeled or the gas carried to them by the local electric company or previous pipeline supplier. Local distribution companies—particularly municipally owned distributors and co-ops—are similarly seeking the right to shop around, rather than be limited to buying from the franchised distributor or pipeline that used to have—indeed, continues to have—the obligation to serve them.

Similarly, by requiring the electric companies to buy power from cogenerators and from other independent small-scale generators at avoided cost, PURPA (the Public Utility Regulatory Policies Act) has legally sanctioned competitive generation and assured it access to the market.

Is all this unequivocally desirable? Should your Industry Regulation Committee applaud it?

I cannot supply an adequate answer. It is necessary to recognize, however, that here is another case of a mixed system, about whose efficiency or desirability we simply cannot be sure. The utility companies' prices are still regulated on an embedded cost basis. The competitive decisions—whether to self-generate, or to buy from *B* rather than *A*—are being made on the basis of a comparison among those economically meaningless regulated prices, or between them and competitive prices and economically meaningful costs. There is, therefore, no assurance that the consequent decisions are socially rational or economically efficient.

Moreover, the regulated companies continue to be subject to an obligation to serve all comers. That means an obligation to incur long-term cost commitments, constructing capacity (or contracting for supplies) in advance of demand so as to be in a position to fulfill the obligation. What happens under a mixed system, in which some companies continue under those obligations but buyers within their franchise territories no longer have an obligation to pay those costs? What if the buyers are in a position to say, "I demand that you install the capacity necessary to serve me today, but if I see an opportunity tomorrow to buy at a competitive price below your artificially set, embedded cost rate, I want to be free to shift and I want you to wheel the power for me; and if three days after that I find that arrangement unsatisfactory, I expect you to be in a position to serve me again?"

And how are the regulatory commissions supposed to respond when, their big industrial or wholesale customers having departed, the utility companies turn to them and ask for recovery of their stranded investment costs—prudently incurred in order to fulfill their obligation to serve—from their residential customers, who do not have those competitive options available to them?

I am not attempting to throw cold water on the deregulation enthusiasm—which I share—but only to observe that where we do not have so clear-cut a vision of our ability to go all the way, it is conceivable that the world of partial deregulation, part competition/part regulation, may be the worst of all possible ones.