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"Deregulation Revisited: A Tribute to Fred Kahn"
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Prepared Remarks (Introduction of Fred Kahn)

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I first met Fred Kahn almost 35 years ago, in early 1974, shortly after his appointment as Chairman of the New York State Public Service Commission. At the time I was weighing an offer to return to DC. Fred suggested that I might want to stick around to learn more from him about the economics of regulation, which he intended to apply systematically as Chairman of the Commission. If I regarded economics as the "dismal science" it had been labeled, Fred indicated that his approach to regulation would be anything but dismal. What an understatement that turned to be! Fred introduced an entirely new way of thinking about utility regulation, accompanied by an infectious enthusiasm and a quick wit. He educated, energized and stimulated the imagination of the agency's staff.

As a result mainly of his star turn at the Civil Aeronautics Board, opening the airline industry to competitive entry and pricing, Fred has often been called the consummate "deregulator." That description is a bit misleading. Fred has always maintained that economic deregulation must be accompanied by strong antitrust regulation. His support for antitrust regulation is exemplified well by the role he played as Chairman of the New York Commission in facilitating competitive entry into what once was a tightly closed retail telephone terminal equipment monopoly.

Fred's analysis of this market dates to 1956 when, as a member of staff to the Council of Economic Advisors, he wrote a memo to Arthur Burns criticizing as anticompetitive the FCC's original decision in the *Hush-a-Phone* case. In that case, the FCC initially affirmed the right of AT&T – the old, fully-integrated monopoly Bell System AT&T, not today's "new AT&T" – to outlaw an attachment to the telephone utility supplied instrument. The attachment was no more than a plastic cup attached to the speaking end of the telephone that protected the caller against eavesdroppers. The Hush-a-Phone was in wide use and admittedly had not compromised the safety or integrity of telephone service. Nonetheless, AT&T claimed the right to ban this "alien" attachment and asserted that the company would provide such a device if there were a "general public demand" for it.[1] As Fred later wrote: "Big Brother said he would provide best – even in the face of clear evidence that 100,000 people thought he did not."[2] The FCC's decision was later reversed by the D.C. Circuit Court of Appeals,[3] which held that the old AT&T's prohibition was unlawfully discriminatory.

In the 1960's, Fred was serving on the old AT&T's board of economic advisors when the FCC issued its landmark 1968 *Carterphone* decision,[4] which held that AT&T could not prohibit by tariff direct interconnection to the telephone network of competing, non-telephone company supplied terminal equipment that would not harm telephone service. Fred advised the company to remove unreasonable tariff restrictions and welcome the competitors, in return for sufficient relief from rate regulation to compete on price against them. The old AT&T's then

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1 *In the Matter of Hush-a-Phone Corporation,* 20 FCC 391, 397 (1955).

2 Kahn, A.E., *The Economics of Regulation,* Vol. II at 141 (John Wiley and Sons, 1971).

3 *Hush-a-Phone v. United States and Federal Communications Comm'n,* 238 F.2d 266 (D.C. Cir. 1956).

4 13 F.C.C. 2d 420, *recon. denied,* 14 F.C.C. 2d 571 (1968). The dispute over interconnection of the Carterphone began as an antitrust suit against the old AT&T that was referred to the FCC under the primary jurisdiction doctrine. See *Carter v. AT&T Co.,* 250 F.Supp. 188,190 (N.D.Tex.), *aff'd,* 365 F.2d 486 (5th Cir. 1966), *cert. denied,* 385 U.S. 1008 (1967).

Chairman, H.I. Romnes, seemed to embrace Fred's advice. In *The Economics of Regulation*, Fred quotes what Romnes wrote at that time: "we want to make the connection of such equipment as easy as possible, and the rules and regulations as few as possible."[5]

However, Romnes' successor at the old AT&T, John deButts, chose a different strategy. When independent equipment suppliers complained that they were unfairly handicapped in their ability to compete because they were required to incur the cost and delays of expensive and cumbersome Bell System supplied and installed "protective connecting arrangements" (otherwise known as "BS/PCAs" or simply "PCAs"), whereas telephone company-supplied equipment was not burdened with such requirements and costs, the FCC proposed to replace the PCAs with a simpler, cheaper, non-discriminatory FCC certification program for telephone terminal equipment, regardless of supplier. But the old AT&T vigorously opposed the FCC's proposal. When it became clear that the old AT&T would not prevail at the FCC, the company asked Congress to preserve, in effect, its PCAs in a bill entitled the "Consumer Communications Reform Act of 1976," which proposed to take the issue away from the FCC and put it in the exclusive hands of state commissions.

The old AT&T waged what was, in essence, a fear campaign. It claimed that without the PCAs the public would suffer a disastrous decline in telephone service quality and safety (which at times included the sensational charge that telephone line workers could be electrocuted), and that subsidized basic telephone service rates would skyrocket as the Bell System lost lucrative terminal equipment business to competitors.[6] These arguments would likely be more persuasive to state commissions, who were responsible for regulating the rates for and quality of basic

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5 *See,* Kahn, A. E., *The Economics of Regulation,* Vol. II at 145 (John Wiley and Sons, 1971).

6 *See, e.g.,* Oversight Hearings on Domestic Telecommunications Common Carrier Policies before the Subcommittee on Communications of the Committee on Commerce, Science, and Transportation, United States Senate (95th Congress), First Session, March 21 and 22, 1977 (Part 1) (Serial No. 95-42), at 288-291 (Statement of John deButts), hereafter referenced as "*Senate Hearings*".

telephone service. Many state commissions could thus be expected at least to preserve the PCAs, or otherwise inhibit terminal equipment competition (as several had already attempted to do).[7]

Speaking as the Chairman of the New York State Public Service Commission before the Subcommittee on Communications of the House of Representatives, Fred called the Consumer Communications Reform Act of 1976 an "abomination" – courageously, "soberly, and regretfully," fully recognizing that in doing so he ran the risk "of giving offense to the many eminent Congressmen and Senators whose names appear[ed] as its sponsors."[8] He further testified: "The customers in a state such as New York, which may well be expected to pursue a liberal policy of interconnection, cannot be indifferent to the prospect that any manufacturer who comes forward with a new idea may be able to sell his product in some states and not in others, or may have to adopt markedly different product specifications or marketing arrangements from one state to another."[9] He was the only state regulator to present testimony to the Congress in opposition to this bill. In doing so, he directly contradicted the position of the national association of state regulators, which joined the old AT&T in support of the bill, and even chose as its spokesperson a member of Fred's own commission![10]

Fred was also the only state regulator to present probative evidence on the alleged public safety need to maintain the PCAs. More specifically, he provided evidence from the results of a liberalized terminal equipment interconnection program that the New York Commission

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7 See *North Carolina Utils. Comm'n v. FCC*, 552 F.2d 1036, 1043 (4th Cir.), *cert. denied,* 434 U.S. 874 (1977).

8 See *Senate Hearings* at 578-594, where Fred's prepared testimony on this bill before the Subcommittee on Communications of the U.S. House of Representatives is reproduced.

9 *Id.* at 584.

10 See *Senate Hearings*, Second Session, March 23 and March 28, 1977 (Part 2) at 936-1035. (Statement of Edward P. Larkin for the National Association of Regulatory Utility Commissioners).

approved for use in a large independent telephone company service territory in 1972, and which had been allowed to proceed by the old AT&T (perhaps unknowingly at first) as an exception to its interstate tariff provision that required PCAs. The FCC, at the specific request of the New York Commission, did not preempt this program because it was more welcoming to competition than the PCAs.[11] The principal source of network protection under this plan was inspection and certification of the design and performance of the equipment, similar to what the FCC had proposed but was unable to implement fully as yet. As of mid-1976, there were 2,794 lines with interconnected customer-provided equipment under this plan.

The relevant excerpt from Fred's testimony before a committee of the United States Senate reads as follows:

> After three years of experience under that plan, our staff has reported the following three remarkable facts to us. First, trouble reports on those lines have been lower, and in most cases significantly lower, than for the company as a whole. Second, there has been a steady decline in the percentage of total trouble reports on those particular lines that proved to be attributable to the customer-provided equipment – . . . [down to] 13 percent in the last quarter of the third [year] . . . . Third, according to a recent analysis of the New York [Bell] Telephone Company's comparable experience, the proportion of that Company's trouble reports attributable to terminal apparatus provided by the Company itself was 30 percent ![12]

First the committee heard the Bell System essentially speculate that public safety would be harmed if customer-provided terminal equipment were subject to certification rather than PCAs; then it heard Fred provide *empirical evidence to the contrary*.

Fred responded to the old AT&T's additional claim – that it would lose terminal equipment revenues it was using to subsidize basic telephone service – with this statement of principle: "I do not believe in setting up monopolies and giving them the opportunity to exploit consumers in one market in order to achieve some presumed social advantage in other markets.

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[11] See *In the Matter of Telerent Leasing Corp.,* 45 F.C.C. 2d 204 (1974).

[12] *Senate Hearings,* First Session, at 510-511 (Statement of Alfred E. Kahn).

My concern is for the welfare of consumers in this country in the aggregate; that welfare is served by keeping open to competitive enterprise all markets that are not natural monopolies. And terminal equipment is not a natural monopoly."[13]

Fred's testimony followed that of Mr. deButts on behalf of the old AT&T, and the Senate committee was clearly impressed with Fred's policy analysis and evidence. In a classic understatement, Senator Hollings said to Fred: " To say the least, you are well informed. . . . I am going to provide, of course, your statement to Mr. deButts and see what rebuttal he has to that, and you can provide whatever rebuttal or critique you might make of Mr. deButts' statement, as you did on the House side."[14] Mr. deButts filed rebuttal, essentially trying to distinguish the New York program results on the grounds that certification was performed by a telephone company (albeit an independent one) rather than the government, and ignoring the fact that the relevant percentage of trouble reports on lines with customer-provided terminal equipment was lower than that on lines with Bell System terminal equipment![15] On June 9, 1977, Fred wrote to Senator Hollings advising him that he had been nominated by President Carter to chair the CAB. Fred attached to that letter a lengthy point-by-point answer to AT&T's rebuttal,[16] and shortly thereafter left to assume his duties in Washington.

The old AT&T's Congressional campaign against competitive entry failed and the FCC was soon able to implement its equipment certification program fully. In 1982, in his consideration of a settlement of the Department of Justice's antitrust suit against AT&T, in which the BS/PCAs played a prominent role because of their exclusionary effect on

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13 *Id.* at 594.

14 *Id.* at 502.

15 *Id.* at 513-516.

16 *Id.* at 516-539. Fred's answer was later followed by a staff submission on June 21, 1977. *Id.* at 539-578.

competition, Judge Harold Greene found that after the FCC's certification program went into effect " the telephone network – AT&T's predictions to the contrary notwithstanding – did not cease to function in its customary fashion. Indeed, AT&T was unable during the trial to prove *any* actual harm to the network from the elimination of the PCAs."[17] (That is what the evidence Fred presented five years earlier had implicitly predicted.)

Although Fred needs no formal introduction because he is so famous, he nonetheless deserves one at this conference in his honor to remind us of all he has accomplished in his career. He is the former Dean of the College of Arts and Sciences and Robert Julius Thorne Professor *Emeritus* of Economics at Cornell University. He is the former Chairman of the New York State Public Service Commission and the Civil Aeronautics Board. He is the former Chief Advisor on Inflation to President Jimmy Carter. He is the author of the now classic two-volume text, *The Economics of Regulation, Principles and Institutions*, as well as many other influential books and essays analyzing economic and regulatory policy issues, some of which have been discussed today. He is a subject of the book *The Prophets of Regulation,* winner of the 1984 Pulitzer Prize in History. Throughout his long association with National Economic Research Associates, he has been a consultant to and expert witness for private and public clients far too numerous to mention; and, in the vernacular of litigators, has often hit more "home runs" in a *year* (many for one of my clients in the late 1980s) than Ruth and Gehrig hit in their combined *careers*. (As a boy, Fred *saw* Ruth and Gehrig play at Yankee Stadium.)

He is a man who has greatly influenced public policy over a professional career spanning seven decades, and more directly influenced the lives and careers not only of his immediate and wonderful family, but of literally countless former students, assistants, associates and colleagues, some of whom (including me) still seek his personal counsel, which he invariably and generously provides. Last, but certainly not least, his leadership in the opening of the airline

[17] *United States v. American Tel. and Tel. Co.*, 552 F. Supp. 151, 163 (D.C.D.C. 1982).

industry to competitive entry and pricing, in less than two years as head of the CAB, brought airline travel within the grasp of millions of people of modest means, many of them students [including, I have been asked to insert here, my daughter Jessica], who as a result traveled and studied abroad in droves. We can reasonably expect dividends in the future from their wider exposure to different cultures and their additional education. To borrow from but amend Winston Churchill's famous phrase, never was so much owed by so many to one economist from Paterson, New Jersey (which is where Fred was born – our everlasting thanks to his parents – in 1917). With great personal affection, it is my honor and privilege to give you now for his closing remarks my mentor and dear friend, Fred Kahn.