



Bells Stand to Benefit From New FCC Chairman's Neutrality, Economists Say

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Even before the Bush administration brought its deregulatory bent to Washington, the telecommunications business was a steep challenge for those competing against the Baby Bell companies - the regional giants that dominate local telephone service. In the five years since Congress allowed new companies to compete, they have captured a mere 8 percent of the nation's local telephone lines.

Now, as upstart carriers land in bankruptcy, suffocated by a critical shortage of capital, some say the promise of competition is dying. Despite such warnings, the new chairman of the Federal Communications Commission, Michael K. Powell, is staying true to his guiding philosophy: He is standing aside and allowing market forces to determine the outcome.

"I am not the grand master chef of competition," Powell said in an interview last week. "The government can create the conditions and the environment for private entities to compete. We don't come out and start a phone company in your neighborhood."

But a growing chorus of economists claims that anything short of regulatory intervention amounts to tacit approval for the monopolistic grip of the Bells. To reach their customers, the new entrants must have access to the local telephone wires that connect to homes and businesses. But since those wires are controlled by their rivals - the Bell companies - it won't happen without strict rules, they argue.

"Any local operating company has a lock on local service. That's why they're regulated in the first place," said Lawrence J. White, an economist at New York University's Stern School of Business and a former chief economist at the Justice Department's antitrust division under President Reagan. He is a reliable proponent for fewer regulations. "This is an exception. I even half-choke on the words as I say them, but there's got to be regulatory intervention. Otherwise, the whole issue of local competition is truly a joke."

Those who control the credit on Wall Street say they cannot justify new investments in the upstart carriers. Tens of billions of dollars have already been lost on such ventures. Investors are reluctant to surrender more - especially given the growing view that the regulators are working against the new entrants.

"Investors need to feel like there's a firm regulatory foundation beneath their feet before they feel comfortable enough to invest," said James H. Henry, managing general partner at Greenfield Hill Capital LLP, a New York investment fund focused on telecommunications. "They don't feel that way. Certainly, the regulatory issue is one that's foremost in people's minds."

Powell bristles at the suggestion that telecommunications competition is somehow in his hands. He is troubled by the bankruptcies, he says, "because it means that the future that we are hoping for has been

set back." But he adds, "I just reject the fundamental premise . . . that if they're failing, it's my responsibility to have a plan for their recovery, as if I'm a bankruptcy court."

He also rejects the notion that he should make policy with an eye toward encouraging investment.

"It is a dangerous thing to suggest that the commission ought to pursue things solely to stimulate a perception of favoritism to a community in order to incent capital flow," he said. "I am not in a position to play Alan Greenspan."

But Powell's lack of action has thus far been taken as strengthening the Bell companies while weakening their competitors. Under his direction, the FCC has passed rules phasing out payments Bell companies now must make to rival carriers when the upstarts connect calls - a change expected to save the Bells as much as \$3 billion a year. The agency allowed Verizon Communications - the dominant local telephone carrier from Virginia to Maine - into the long-distance business in Massachusetts, despite complaints that the company was overcharging rivals for access to its wires.

Powell has vowed to enhance and expand the agency's enforcement efforts, but the upstarts say some complaints have gone unaddressed.

At the same time, the new chairman of the House Commerce Committee, W.J. "Billy" Tauzin (R-La.), is pressing legislation that would immediately allow the Bells into the long-distance market for Internet traffic in every state. His bill would undo rules aimed at forcing the local giants to first open their local markets to competition.

Tauzin argues his proposal would unshackle the Bell companies and jump-start competition. He dismisses most of the Bells' competitors as fundamentally unsound, because they rely on access to the Bell networks. "That's a business plan doomed to failure," Tauzin said.

In the Tauzin view, no telecommunications company is a monopoly, because technology has produced so many different ways to deliver services. Cable television systems are being upgraded to deliver telephone and high-speed Internet connections along with satellite systems. The telephone wire is simply one pathway.

But economists say that vision is flawed because most of the alternative networks are still being built. Satellite systems may compete with cable for television services. Cable companies are slowly rolling out telephone links. But, for basic phone service, the Bells and a handful of rural companies still control all but 3 percent of the market.

"They're deregulating a market that's not sustainable for competition," said Lawrence J. Spiwak, president of the Phoenix Center of Advanced Legal & Economic Public Policy Studies in Washington. "If you want to move from monopoly to competition you can't get there without more firms."

Now, the firms are being winnowed. E-spire, a Herndon-based provider of local telephone and Internet links, has filed for bankruptcy. So, too, ICG Communications and WinStar Communications Inc. NorthPoint Communications Group Inc. has gone bust as well, eliminating high-speed Internet connections for 100,000 customers in major markets around the country.

The list of the deceased is expected to grow. According to Aryeh B. Bourkoff, an analyst at UBS Warburg Fixed Income in New York, only one-third of the competing carriers have sufficient funds to continue through the end of the year. "The regulatory climate has been one of the impediments to

generating positive returns," he said.

The demise of the so-called competitive carrier industry eliminates more than expanded choices for service: It means the loss of revenues for equipment manufacturers such as Cisco Systems and Nortel Networks and the rest of the technology production chain. The upstarts have been hungry customers as they have erected their networks. When WinStar filed for bankruptcy last month, it scorched the bottom line at equipment giant Lucent Technologies Inc.

To be sure, far more than regulatory uncertainty goes into explaining the disaster met by the so many telecommunications entrants. After Congress adopted the Telecommunications Act of 1996, giving competitors the right to connect to the Bell networks, exuberant investors poured some \$60 billion into the industry. Many companies chased growth at any cost, amassing enormous debts. So many new companies were minted that prices for many services plummeted. Even the "winners" of market share could not profit.

Indeed, the meltdown in the competitive carrier industry began months before Powell and Tauzin assumed their new positions. Moreover, some economists see the unraveling as healthy - a necessary stage to producing a more rational business climate.

"What we're seeing is a fairly natural shakeout," said Bob Atkinson, former deputy chief of the FCC's common carrier bureau and now executive director of the Institute for Tele-Information at Columbia University. "In a sense it's nothing lost."

But the new policy tone in Washington has deep-frozen already chilly capital markets. "For anybody to invest again, the field of play probably has to be tipped" toward the upstart carriers, said Jeffrey Williams, a partner at Greenhill & Co., a New York investment banking firm founded by Bob Greenhill, a former president of Morgan Stanley & Co. "So many people have lost so much money."

Instead, the field seems to be tipping the other way. When Bush named Powell - son of Secretary of State Colin L. Powell - to head the FCC, the financial world widely interpreted it as a signal that the Bells were gaining an advocate. He brought a reputation as a believer in the benefits of looser markets and fewer rules on businesses. He had been critical of his Democratic predecessors for attaching conditions to major mergers in the name of fostering competition.

At his first news conference, Powell alarmed the upstarts by implying that he would allow Bell companies to expand into the long-distance business more quickly. Under the Telecom Act, the Bells may enter long-distance only after persuading regulators that they have opened their local markets to competition. Rivals have used the long-distance approval process as a key vehicle for extracting concessions from the Bells. Powell signaled that he would ease their path.

"I do not believe deregulation is like a dessert that you serve after people have fed on their vegetables and is a reward for the creation of competition," he said. "Deregulation is instead a critical ingredient to facilitating competition, not something to be handed out after there is a substantial number of players in the market."

Too much was made of that comment, he now says. "I bristle a little bit at the suggestion that people read into some vague quote that that signals a very dramatic bias to one industry segment," he said.

But industry lobbyists and analysts say real policy has since confirmed the force of Powell's rhetoric. And the upstart carriers now are watching closely to see how Powell addresses two arcane but

significant proceedings at the heart of competition policy. The Bell companies have petitioned for a roll-back of rules requiring that they lease their wires to the new entrants. At the same time, the agency must update rules that specify where precisely within the Bell network they have the right to connect.

Anything that deprives the upstarts of access to telephone lines "will be the end of the competitive carrier industry," said Gina Keeney, a former Republican chief counsel for communications on the Senate Commerce Committee. "This is going to be on his watch. What what he does or doesn't do will greatly affect competition and growth in the telecommunications sector."

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