

Break Up the Bells

It's The Best Way to Boost High Technology And Help Pull the U.S. Economy Out of Recession

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More and more Americans are asking a simple question: Why on earth can't I get a high-speed broadband connection to the Internet with hassles and with a decent price?

Only one in 20 U.S. homes has broadband, and most of those get poky speeds – 450 kilobits per second is better than a dial-up modem at 56K, but it is not fast enough for downloading high-quality video, and video is undoubtedly the future of Internet commerce. As a result, businesses that were started with the intention of using broadband to connect with consumers – firms in education, entertainment and health care, for example – have gone out of business or languished. Others never started at all.

The prices of computers have been driven down by well over 90 percent, when you adjust for quality, over the past decade. You can now get a PC with more power than a 1980s mainframe for less than \$1,000. You can order it over the Internet to your specifications and have it

delivered the next day. You can install it yourself in a few minutes.

Long-distance telephone rates are now just pennies a minute. It wasn't long ago that you paid \$2 or more for a three-minute call.

A study by Brookings Institution fellow Charles Ferguson, a longtime scholar of the tech industry, found that the ratio of price to performance for Bell broadband services has been falling at, at most, 10 percent annually. That compares to 30 percent to 40 percent annually for most other information-technology products.

The technology for fast broadband exists; thousands of miles of fiber-optic cables have been laid. What's the problem?

It isn't technology. It's public policy.

Consumer choice, innovation, low prices, high quality – all of those benefits have a single source. Competition.

Without competition, AT&T, prior to its breakup in 1984, had little incentive to offer consumers anything other than a black, rotary-dialed telephone. Without competition, the Bell companies had little incentive to roll out DSL technology, which could speed up the signal traveling along copper wires. The Bells were getting great rates from T-1 lines, and consumers were buying highly profitable second and third lines for their slow-motion modems and their fax machines, so the Bells kept cheaper DSL on the shelf for a decade.

With little public attention, a ferocious battle is raging now in Washington and the states to change public policy in telecom. Broadband is critical to a high-tech revival, so

the stakes are huge. But, incredibly, the answer that the House of Representatives may soon vote on would move telecom AWAY from competition and toward the certain entrenchment and extension of the monopoly of the Bells companies.

Competition is the real answer.

That's what the Telecommunications Act of 1996 -- acclaimed by liberals and conservatives -- was supposed to produce. Instead, the seven Baby Bells merged into four Mega Bells (Verizon, SBC, Bell South and Qwest -- with Verizon and SBC by far the biggest), prices rose, service deteriorated, and deployment dawdled.

The source of the impasse is the Bells' grip on the "last mile" -- the wire that connects every home and office to the greater outside telecom network. Any firm that wants to offer DSL must travel over that last mile, which was built with federal protection and subsidies over a century.

The 1996 law required the Bells to allow competitive local exchange carriers (CLECs) to connect -- for a price -- anywhere on their system. But as Karen Kornbluh of the New America Foundation notes, the CLECs are like "the Gingerbread Boy of the fairy tale, riding across the river on the nose of the fox. Their sole means of transportation has every incentive to do them in."

Or, as Aaron Goldberg of Ziff-Davis Market Experts put it: "It's as if the trucking companies owned the road and allowed only their own trucks to run on it."

In a paper that is available on the TechCentralStation website, Robert Hall, the distinguished Stanford economist, writing with telecom expert William Lehr of MIT, made

the point that a company cannot be expected to both cooperate with other firms and compete against them. Cooperation and competition are inherently contradictory. The Bells have simply not cooperated – despite the requirements of the act – mainly because regulators have let them gotten away with non-cooperation, and much, much worse.

Through regulatory and legal footdragging, the Bells have forced many upstarts out of business. While Verizon and SBC alone have been fined over \$400 million, with billions at stake, that's a pittance. The Bells maintain control over 91.5 percent of local lines.

Yet, with incredible chutzpah, the Bells got friends in Congress, including the chairman and ranking member of the Commerce Committee, Reps. Billy Tauzin (R-La.) and John Dingell (D-Mich.), to produce a bill to kill off the CLECs altogether. The Tauzin-Dingell bill would: 1) stop CLECs from connecting at key points on their networks, 2) let the Bells into the lucrative data long-distance market without first opening their local lines, as the act requires, and 3) limit the power of regulators, both federal and state, to encourage competition. They say this will let them build out broadband. Instead, it will put the CLECs out of business.

By the way, another tale the Bells have been telling is that the CLEC industry is dead anyway. It is not. I recently completed a study of 15 publicly traded CLECs that found that more than half of them have enough cash and other quick assets to stay alive, even at current burn rates, for at

least another two years – much longer if the economy, as expected, picks up next year.

Smart investors like Ted Forstmann of Forstmann Little & Co. are putting more money into CLECs like XO and McLeod. And Covad, one of the larger CLECs, recently announced a restructuring with a significant cash infusion. Still, as a study that I conducted this summer with Prof. Lehr found, the CLECs have been bleeding market cap as a result of the delaying tactics of the Bells – and the Tauzin-Dingell bill itself, hanging over the CLECs' heads, has had the predictable effect of drying up capital.

Congress wisely has shown little enthusiasm for the anti-competitive approach of Tauzin-Dingell, and the bill languished for two years. Until now. Suddenly, Speaker Dennis Hastert, perhaps tired of fighting his Commerce chairman and distracted by the aftermath of the Sept. 11 terror attacks, has said the legislation could come to the House floor in early December.

The Bells have a powerful lobbying machine. SBC has named as its president William Daley, former Al Gore campaign chairman, who, as the San Jose Mercury News put it last week, “is no expert in telecommunications” but “is a master of politics.” That SBC would name Daley as its number-two executive shows how important it considers the Tauzin-Dingell bill to be.

More evidence of desperation: In their latest attempt to get the bill passed, the Bells now have seized, cynically, on terrorism.

In a speech soon after the Sept. 11 attacks, Verizon co-CEO Ivan Seidenberg told a Goldman Sachs conference,

“We need to rethink security. We’ve got people running through our buildings with FCC permits, and we don’t even know who they are.” Those “people” are CLEC employees, doing what the 1996 act lets them do. Meanwhile, the Boston Globe reported Verizon’s other co-CEO, Charles Lee, said that the lesson of Sept. 11 “is that the nation needs phone giants like the Baby Bells to be as strong as possible, even if it means policies that accelerate the demise of smaller competitors.”

Verizon is even using the Sept. 11 attacks to forestall cuts in wholesale rates charged to CLECs in New York. The cuts, recommended by a state Administrative Law Judge in May after two years of investigation, would increase competition, helping lower prices for consumers. But Verizon has petitioned for a delay, arguing it must keep rates high to restore its damaged network. That’s nonsense; the real aim is to squelch competition. CLECs now must pay Verizon \$25 a month to lease Bell technology they need to serve a single consumer, whom they can charge only \$30, leaving no room for profit after their other costs. New Jersey’s phone regulators, in similar circumstances, recently ordered Verizon to slash wholesale rates by 40 percent.

To be fair, Verizon lost employees in the attacks and responded well after severe damage to its central office. But security concerns are no reason for Congress to let the Bells extend their monopoly to broadband, and possibly long distance. Monopolies act predictably -- they reduce supply, raise prices, and have little incentive to invest in new technology.

Finally, high-tech companies that have been hurt badly by the lack of low-cost broadband for consumers, are at last waking up to the real villains. In October, I attended a high-level tech conference in Scottsdale, where resentment against the Bells exploded. The story was related in a piece in the Nov. 12 issue of Fortune by reporter David Kirkpatrick with the headline, "Great Leap Forward: Techies vs. Telcos: With morale in the tech industry even lower than its stock prices, leaders are looking to lay the blame. Their favorite culprit: those controlling broadband access to the Net."

Kirkpatrick wrote that the high-tech firms are increasingly pointing their fingers at the Bells: "Bob Metcalfe, the legendary network pioneer, took the stage and summed up the undertone of discontent, when, on a panel about networks, he described the big regional telephone companies as 'scumbags.' Nobody objected or disagreed."

The Fortune reporter also wrote, "The telecom critics make a strong case that these companies are going slow on broadband in order to maintain monopoly pricing on their primary services – voice calling and video distribution."

The Bells like being monopolies. Who wouldn't? There are three modes of business: Being an unregulated monopoly, which is what the Bells aim at through Tauzin-Dingell, is best. Being a regulated monopoly is second-best. Then far, far down the list is being a firm in a competitive marketplace. The Bells aren't used to such a mode of business, and they will do anything to avoid it.

As Metcalfe said in Scottsdale: "The core competency of the regional phone companies has become lobbying and litigation."

While Tauzin-Dingell is sold as deregulation, it will inevitably lead to MORE regulation, as Lehr and I showed in our July paper, also on the TechCentral website. The reason is simple: Congress will not sit by and allow the Bells to create an end-to-end telephone monopoly, from local to broadband to long distance. Instead, they will increase regulation.

That's exactly what happened in the Commerce Committee, which tacked on an amendment saying that the Tauzin-Dingell had to spell out a timetable for the rollout of broadband. No timetable is needed for the sale of sweaters or computers or monitors or network hardware. Why not? Those markets are competitive. Congress, like all America, knows that in competitive markets, firms supply what consumers demand. But monopoly markets are very different.

A great deal is at stake. In an editorial on Friday, the San Jose Mercury News, the largest newspaper in Silicon Valley, stated: "No question: The faster the deployment of broadband, the better especially for Silicon Valley. High tech companies would roll out new services; networking companies would sell new systems. Consumers would upgrade computers."

But Tauzin-Dingell is not the answer. It is, said the Merc, "the wrong way to encourage broadband or help consumers... Tauzin has it backward."

If Tauzin-Dingell is not the solution, what is?

To give consumers low-cost broadband choices and better service, either regulators need to get serious about enforcing the law or, better yet, the Bells themselves need

to be broken in two. “Structural separation,” or divestiture, is an idea gaining momentum on both left and right. At the Agenda conference, such a solution was favored by Metcalfe, as well as many tech industry veterans, including Dan Bricklin and Bob Frankston (creators of VisiCalc, among other innovations). I think structural separation is the obvious answer. The only serious criticism I have heard is that it is not politically feasible, but it could be.

Structural separation would split each Bell monopoly into two companies – one wholesale and one retail. Bell shareholders would own both, but each firm would be a separately managed legal entity. The wholesale company would own the last mile, and, since all its income would come from leasing access to that mile to retailers, it would have a big incentive to cooperate with all of them – including the retail Bell arm, which could enter any line of business. Retailers could then compete to offer consumers the best service at the lowest price.

Structural separation is not new. It was used by Judge Greene in 1984 with AT&T itself. The giant Bell System was broken up into a long-distance company, open to vigorous competition, and seven regional Bell companies to handle local service, each still regulated. Now it is time to apply the same kind of separation in local service.

AT&T’s own break-up created a competitive market for long distance, and breaking up the Bells offers the best hope for broadband. The U.S. economy would be the biggest beneficiary. The Bells are right about one thing: the Telecom Act is not working. But their Tauzin-Dingell solution – trust the monopolist – is a cure far worse than the disease. Instead, trust competition.