

The Post-Merger World: A Market Assessment And Survival Guide

Jim Blaszak and Hank Levine

Now that the FCC has approved SBC's acquisition of AT&T and Verizon's purchase of MCI, enterprise customers need a "going forward" strategy. Waiting for the next shoe to drop is *not* a strategy—it's a prescription for frustration and higher telecom costs.

When thinking about the implications of the mergers, enterprise customers should consider the near term, mid term and long term. For our purposes, near term means the next six months, mid-term is the 18 months after that (mid-2006 until the end of 2007) and long term is 2008 and beyond. This article gives our view of likely industry behavior during those periods, and what that means for enterprise customers about the strategies they should pursue.

The Near Term

Personnel in the merged entities, particularly account teams, are anxious about their futures because modern mergers are almost invariably accompanied by reductions in head-count—through reductions in force (RIFs), "packages," and layoffs. Consolidation of back-room operations and networks are also virtually certain, especially in the case of Verizon/MCI. For the third or fourth time in a decade, enterprise customers will see reduced and potentially less qualified support. Account team changes could affect provisioning, invoice review and disputes, application of credits and, of course, service repair and restoration.

But while enterprise customers are anxious about loss of support, account teams do not want to lose business and desperately want to impress their new bosses and keep their jobs by booking new deals. That, and the desire of senior executives at the newly merged companies to impress their peers (and Wall Street) with quick wins, makes the near term a good time for enterprise

customers who can do so to put telecom business out for bid.

Moreover, negotiating a deal in the near-term will likely be easier than it will be after the "Bell heads" take control and impose policies in the name of simplification and best practices that make it harder for customers to get what they want and need—even if what they want and need is both reasonable and consistent with what those customers have gotten for the past 15 years.

New contracts executed in the "near term" have to take account of some of the uncertainties created by the mergers. One such concern, already mentioned, is the adequacy of account support and other aspects of customer care. Enterprise customers and carriers have historically solved provisioning, maintenance and invoice/payment problems informally because account teams knew how the "system works." That may not be the case in a post-merger environment, when both the carrier account teams and the "system" change. Enterprise customers cannot assume that informal solutions to customer care issues will survive, and this makes detailing support in a contract much more important than it has been.

A second risk is the loss of carrier redundancy in the old SBC and Verizon territories. A customer fortunate enough to have dual diversity in Houston, with dedicated links to both SBC and AT&T, will now receive service from a single vendor. Contract clauses can protect against a loss of vendor diversity for those who care, by generally requiring that the merged carrier continue to provide the level of diversity inherent in the contract at the rates, terms and conditions set forth in the contract—but only those customers who ask for such terms will get them.

By far the greatest near-term uncertainty arises from not knowing the corporate structure under

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which the merged entities will provide service to enterprise customers. If the merged entities opt to provide long distance service through an integrated corporate structure, as seems likely, we do not know whether regulatory authorities will consider the offering as one made by a “dominant” or a “non-dominant” provider.

That matters to enterprise customers because under the current regulatory regime, long distance carriers who are structurally-separate RBOC affiliates, and as well as those who are not affiliated with RBOCs at all, are considered non-dominant and may *not* offer interstate long distance service through tariffs. Instead, they provide service through contracts.

RBOCs, on the other hand, are deemed dominant carriers and may only offer interstate service under tariff. Which model will apply to SBC/AT&T and Verizon/MCI? We do not know; but no sensible enterprise customer would want to return to the era of tariffs controlling the rates, terms and conditions under which carriers offer long distance service. Tariffs are invariably one-sided, carrier friendly documents—furthermore, under a long line of Supreme Court cases, they trump inconsistent contracts (i.e., in instances where the tariff and the contract conflict).

The concern over tariffs versus contracts is most acute with respect to special access, which accounts for one-third or more of most enterprise customers’ telecom budgets and will continue to do so in a converged world of IP-based networks. Almost all enterprise customers buy special access (except for the occasional SONET ring) through their long distance carriers—they pay less than they would if they bought directly from the RBOCs. That’s because of volume and term contracts between the RBOCs and AT&T and MCI that allow AT&T and MCI and the other long distance carriers to pass on some of the savings to significant customers. Moreover, enterprise customers avoid substantial, and infamous, Access Coordination Function (ACF) and Central Office Connection (COC) charges if they buy special access through their long distance carriers. Finally, when enterprise customers buy special access from long distance carriers, they buy it under contracts, i.e., at negotiated rates, terms and conditions, rather than under the “take-it-or-leave-it” BOC tariffs.

Would the FCC allow SBC and Verizon to offer special access off-tariff if this was done through separate affiliates? What will be the ground rules if SBC, (i.e., the new AT&T), and Verizon offer

long distance services and special access not through separate affiliates, but rather through integrated corporate structures?

Certain contract provisions, if properly crafted, can offer you some protection. For example, you can include in the contract an obligation to tariff all material elements of that contract, if such tariffing would be necessary to make those elements enforceable, and a right to terminate without liability if efforts to make the carrier file such tariffs prove unsuccessful. For complicated reasons associated with the “filed rate” doctrine and changing market conditions, it just isn’t clear that contract provisions alone will accomplish their intended purpose in contracts with the new AT&T and Verizon/MCI.

Given these uncertainties, readers may be asking, “So why would we want to do a deal now with AT&T or MCI?” There are two answers. First, resolution of these regulatory and legal issues will take some time, and for the next two

and a half years, relatively favorable special access rates should continue to be available to entities buying special access from AT&T and MCI under the volume and term contracts negotiated by AT&T and MCI with the BOCs. Second, matters may get worse.

The Mid-Term

Once the post-acquisition dust settles, the new owners of AT&T and MCI will have to decide whether to use the RBOC-monopoly or IXC-competitive-market model when dealing with enterprise customers. The problem for customers is that the people who will control these merged carrier companies have a long history of acting like monopolists, and they like that model.

When buying long distance services, enterprise customers are accustomed to negotiating service contracts with a fair amount of give and take. RBOCs are different. One, for example, insists that its customers remain contractually liable for minimum financial commitments even when the commitments are missed because the RBOC has materially failed to honor its obligations under the contract. It takes this position because it can. And now it will control one of the major long distance carriers. There is cause for concern, because competitive pressure on the RBOCs is not likely to increase, and may decrease, in the post-acquisition world.

Enterprise customers should therefore be prepared during the mid-term for difficult contract negotiations. The best hope in many cases will be

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seriously to consider moving business to entities other than SBC/AT&T and Verizon/MCI, because while SBC/AT&T and Verizon/MCI will continue to respond to genuine competitive pressure for high-value customers, it will be more difficult to create such pressure. Enterprise customers who resist using a competitive procurement because of entrenched relationships or because “it is just too hard” to change suppliers should not expect the kind of deals they have enjoyed to date.

The Long Term

In the long term, a serious threat of duopoly may (or may not) be offset by the emergence of alternative technologies that offer hope for a competitive telecom environment for enterprise customers, even if the FCC does not require major reductions in tariffed special access rates.

Despite the new mega-carriers’ public posturing, enterprise customers should not assume that over the long term, SBC/AT&T and Verizon/MCI will compete with each other vigorously. The RBOCs essentially control the provision of special access service, an essential input for enterprise customers. As a result, special access already is grossly overpriced—SBC, for example, reported a rate of return of more than 70 percent on its interstate special access offerings.

RBOCs can use their market power to squeeze other service providers who must lease dedicated circuits in order to serve enterprise customers. In contrast, when an RBOC itself provides special access circuits and long distance services in its own region, it does not face the same cost pressures, because it does not actually pay the premium price it charges others for special access circuits—the money simply moves from one corporate pocket to another. Over the long term, that suggests that the best strategy for an RBOC is to compete vigorously in its own region, raise special access rates to line its pockets and squeeze the competition, and compete less vigorously outside its own region. In other words, it won’t take a conspiracy to get to Bell West and Bell East—a bad outcome for enterprise customers.

The price squeeze problem can be avoided if the FCC uses its regulatory authority to require substantial reductions in tariffed special access rates. Although the issue of excessive special access rates has been before it for several years, the agency must accelerate its ongoing special access rate investigation. Enterprise customers should support efforts, such as the one being spearheaded by the Ad Hoc Telecommunications Users Committee (a group represented by the authors’ law firm), to persuade the FCC to compel reductions in special access rates. Enterprise customers may also hope that SBC/AT&T and Verizon/MCI will find certain customers attractive enough to pursue aggressively even if a substantial portion of the customer’s business is out of region.

The best hope of long term competition rests

on the emergence of new technologies that are not controlled by the RBOCs. If WiMAX becomes available from suppliers other than in-region RBOCs, it could (over time and to a degree) offer an alternative to BOC special access service, and with a realistic alternative will come pressure on prices and competition. But remember that the commercial deployment and broad availability of new technologies often takes longer than press hype suggests, and new technologies are often not as reliable or easy to deploy as anticipated. For that reason alone, enterprise users must keep the pressure on the FCC to reduce interstate special access rates.

Strategies For Creating Competition

Enterprise customers should also consider strategies that increase the value of their transaction and perhaps encourage competition where it might not otherwise emerge. Bundling wireless, Web hosting and other services with basic transport services is one such strategy. The downside to bundling is that it tends to involve access and management consolidation, which make customers more dependent on fewer vendors—demand becomes “stickier”—and more vulnerable to carrier-wide service failures. In other words, a bundled transaction has to be significantly more attractive than the alternatives if it is to merit consideration.

Whether or not transactions are bundled, enterprise customers should reconsider the mechanisms used to adjust rates during the term of the contract. “We’ll talk” provisions, i.e., provisions in which a customer has no remedy (and therefore no leverage) if it cannot reach agreement with its carrier on rate reductions, have very little value. Commitment reduction—a common way for large enterprise customers to put teeth into rate review clauses—also may not work in the new world, particularly in MPLS-type networks when more and more applications converge. Other approaches, such as third-party benchmarking and “baseball arbitration,” may have to be revived to cope with a two-carrier market dominated by converged services.

In the post-acquisition era, significant rate reductions year after year will become harder to realize. Enterprise users should coldly assess the telecom market, consider their procurement options, try to make their telecom procurements as creative and competitive as possible, and last, but not least, participate in efforts to persuade the FCC to reduce the RBOCs’ special access rates □



**Long term,
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Companies Mentioned In This Article

AT&T (www.att.com)

MCI (www.mci.com)

Verizon (www.verizon.com)