

# The Market A Year After The Mergers

**W**e're honored that *BCR* has asked us to take over the "back page" on Dick Kuehn's retirement. Dick's wisdom and curmudgeonly good sense are legendary, and like many of you we learned a lot from him over the years.

Like Dick, we work the customer side of the street—in our case, mostly Fortune 100–200 enterprise customers and comparable public sector clients. We'll try to be fair to our carrier friends—as we never cease to remind them, customers and their representatives are the loyal opposition, not the enemy—but this column will continue to reflect customer interests. We are confident that we can match Dick's curmudgeonry, but equaling his wisdom will be another matter altogether.

It's been just over a year since the mergers of SBC and AT&T (now at&t) and Verizon and MCI (now Verizon). Of course, at&t has also gobbled up BellSouth during this period, making it even bigger. With a year of experience, it's time to review the industry's behavior in the wake of the mergers.

## Oligopolies In The Making?

When the mergers were announced, some—including one of us—were concerned that Verizon and at&t would geographically segment the market. Many—including both of us—were fearful that they would soon assume the mantle of oligopolists. While the Justice Department and regulatory authorities were considering the mergers, SBC and Verizon consistently dismissed such fears. They argued that one of the big motivations for buying AT&T and MCI was to gain access to the global enterprise customer market so that they could compete more effectively for the largest customers. But would they in fact compete for

enterprise customer business both in and out of region?

A principal reason for concern about the anticipated behavior of the merged entities sprang from grossly inflated special access rates. Special access is essential to medium and large businesses, and makes up 30–50 percent of the cost of connecting business customers to the network and each other. Except in the (very) few buildings served by facilities-based CLECs, out-of-region providers must buy special access from the in-region incumbent local exchange carrier to serve customers located in the incumbent's territory.

Incumbents can use high-priced special access in combination with aggressive retail pricing to squeeze competitors, making it unprofitable for out-of-

region services providers to compete for businesses located predominately in the incumbent's region. Incumbent providers are not hurt by high special access prices—to them, it's just a matter of moving money from one corporate pocket to another. High special access prices in New York might make it unprofitable for at&t to compete for the business of enterprise customers in Verizon's territory, even as high special access prices in Texas or California could make it unprofitable for Verizon to compete there. Needless to say, providers such as Sprint could really be hard pressed to compete anywhere. And without effective competition (which in our view requires at least three strong competitors in a market), the declining cost of providing telecommunications would show up in higher carrier profits, not lower prices to customers.

FCC Commissioners Michael J. Copps and Jonathan S. Adelstein insisted that the FCC address the price squeeze problem before they



**The two mega-carriers are competing strongly for enterprise business—at least for now**



**If special access rates are controlled, the carriers will have an incentive to compete aggressively**

would vote to approve the SBC/AT&T, Verizon/MCI and at&t/BellSouth mergers. To gain approval of the mergers, the applicants agreed to freeze some special access prices. But the freeze is temporary. Before it ends, users can only hope that the FCC will have ordered a reduction in interstate special access rates, which currently generate annual profit margins in excess of 80 percent every year. Special access rate stability will facilitate, but not motivate, out of region competition. The distinction is an important one.

The good news is that so far, at&t and Verizon seem both able and motivated to compete for national enterprise customer business. The two may eventually conclude that their profits will be maximized by not competing aggressively for business that is predominately out of region; special access price squeezes could induce such behavior, but so far we have not seen it. At this point, special access may be yielding huge profits for the two largest carriers, but it is not choking competition for business customers.

#### **Competitive Prospects**

As long as special access rates are appropriately controlled, we believe that at&t and Verizon will have an incentive to compete for enterprise customer business throughout the country. Verizon and at&t need to replace eroding local service revenue—forecasts show local exchange carriers losing up to 20 percent of their residential voice business to cable telephony by year-end 2009, and wireless and non-cable VOIP providers are also a threat.

The major carriers plan to get substantial revenue from new video services, but it isn't clear that those services will prosper. Financial analysts have been unhappy with the cost of Verizon's FiOS platform; some have asserted that Verizon's cost per subscriber is many times that of the cable industry. at&t's Light Speed platform is less costly, but some analysts have questioned whether technical problems with its current design will force at&t to make expensive upgrades. As long as their core business is under assault and special access rates can't be used to stifle competition, we think that the telcos will continue to compete vigorously for enterprise customer business.

Some of the behavior we have seen since the mergers does suggest a rigidity characteristic of oligopolists. But we believe that the culprit in many cases is confusion as managers assume new positions, systems are consolidated, and everyone copes with the force reductions that followed the mergers (Verizon and at&t didn't lay off anyone, but they did "synergize" thousands of people, including some of their best). We believe these factors lie at the root of widespread frustration and dissatisfaction with account support, to cite one example. It also accounts for the significant turnover we have seen recently in the teams charged with negotiating deals with large enter-

prise customers, and the frustration customers feel when personnel who are new to such negotiations react to their own uncertainty by tenaciously defending stock positions (even indefensible ones) rather than seeking to solve problems in a commercially reasonable way.

Finally, we all need to remember that the state of competition in the market for business customer telecom service relationships could change. The market will be less competitive if the FCC does not act to control interstate special access rates appropriately before the merger-related rate freezes end. New technologies may help on that count; we all hope (and some of us expect) that Wi-MAX will compete with wireline special access, but despite its promise, Wi-MAX is not yet a marketplace reality.

We also hope that cable television companies will opt to configure their networks to provide competitive access arrangements to business customers as well as Internet access to the mass market, but thus far their initiatives in that "space" have been, well, modest. If these options are widely deployed, reliable and available at attractive prices, business customers will use them—initially for backup and redundancy, but soon thereafter for core applications.

For the last 20 years, the market for business telecommunications has been marked by service advances and ever lower prices. The recent mergers could change the direction of the market, but so far that has not happened systematically. New technology provides hope for the future.

In the meantime, we'll try to continue to give you our best advice, whether or not you want to hear it □

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#### **Companies Mentioned In This Article**

AT&T ([www.att.com](http://www.att.com))

Verizon ([www.verizon.com](http://www.verizon.com))