

PROTECTING ENTERPRISE CUSTOMERS AFTER THE TELECOM MEGA-MERGERs

By Hank Levine and David Rohde

Telecom industry consolidation is now officially well under way. No sooner had Sprint hooked up with Nextel than SBC bought AT&T and Verizon walked off with MCI. This article seeks to answer the questions enterprise customers are asking about telecom competition after the SBC/ATT and Verizon/MCI deals and what steps customers can take to protect their interests in the new telecom marketplace.

The Mergers and the Market

The mergers are likely to be approved by the requisite state and federal regulators. That will take at least a year, however, and will probably come with conditions designed to protect/stimulate competition. For a long time it was “unthinkable” for a regional Bell operating company to buy a major long distance carrier. But the consumer long distance market is *unconcentrated* as a result of the growth of wireless, cable entry, and the entry of the RBOCs. And while the large user interexchange market is more concentrated, the RBOCs’ share of that market is small. The principal effect of the mergers is therefore largely a loss of potential competition rather than actual competition, and this makes it unlikely that regulators will kill the deals on antitrust grounds.

A more interesting question at the moment is what will happen to the carriers that are without a partner – Sprint, Qwest, and BellSouth. BellSouth has been conservative, cautious, and profitable, but it will be hard to continue as a major player when its largest growing asset is a minority interest in a giant wireless company and it lacks sophisticated nationwide capabilities. Sprint is the logical mate, but because of its wireless assets it is almost too expensive to buy, even though it is subject to the same price pressures as the others in the enterprise segment. Sprint’s management has been de-emphasizing the wireline part of its business, especially since the announcement of its deal to merge with Nextel, which raises the intriguing possibility that Sprint will sell its enterprise wireline business to BellSouth. Alternatively, BellSouth could sell its 40% stake in Cingular to SBC (which owns the other 60%) and use the proceeds to buy Sprint (with Nextel). Stay tuned.

All of this matters to enterprise customers because *de facto* duopolies (of the kind that will exist if we end up with Bell East and Bell West) inevitably end up offering second class service at first class prices – think of cellular service when there were only two participants in each market. When there is a third reasonably strong entrant the temptation to “cheat” on the oligopoly becomes much stronger, and competition is more heated – which benefits customers. The question is where the third strong competitor will come from. At the moment, there is lots of speculation but no clear answer.

Sprint is currently a strong third in the IXC wireline market, but its status is questionable as it becomes relatively smaller and deemphasizes enterprise wireline services. Qwest has aspirations, but without MCI they are likely to remain just that. We can say with some confidence that the second tier IXCs (companies like Global Crossing, Level 3 and Broadwing) are not the answer. All have more debt and/or less cash than MCI, and are at more short- to intermediate-term risk. Many have undergone financial restructurings, and you have to wonder about their fate when MCI faced a challenge getting bought, and the most likely prospective buyers – the RBOCs – want market share, which these companies don’t have. There is nothing wrong with using these carriers, but not to run a company’s core network, and only under a flexible contract with a very low commitment.

The disappearance of AT&T and MCI as independent corporations will also have significant second order effects in the regulatory arena. Telecom regulation is intensely political and it takes a strong player to battle the efforts of those with market power who want to exploit that power to the detriment of customers. AT&T has long supported enterprise customer groups working to keep a lid on RBOC special access pricing. It did that for its own reasons – it had to buy most of its dedicated access from the RBOCs and didn’t want to pay exorbitant prices or take the blame for installation delays. Whatever its motives, in recent years AT&T was often aligned with enterprise users before the FCC, and their joint efforts have recently started to pay off – in response to pressure from enterprise customers and AT&T, the FCC started a new proceeding less than a month ago to examine the rules and pricing for dedicated access services such as T1s, DS3s, OCns, etc. Unfortunately for its allies, AT&T’s contribution to this effort will now come to a screeching halt, leaving large users to fend for themselves.

Doing Business with the Major Carriers

Regulatory fears aside, the first concern of large users in the wake of the recent mergers should be layoffs and account team turnover. Both are likely, although the situation may play out somewhat differently in the two deals. SBC may well follow its purchase of AT&T with a large layoff of its *own* customer-facing

personnel, a move that Verizon made in late 2003. By contrast, Verizon is known to be concerned that MCI is not organized or operated efficiently. MCI gets about 1/3 less revenue per employee than AT&T because its many mergers were never rationalized and it continues to run multiple networks and billing platforms. Some within Verizon are reluctant to abandon that carrier's own Enterprise Advance long distance initiative, notwithstanding MCI's stable of Fortune 100 clients and global IP network. So while SBC's post-merger cuts may well be made first on the SBC side of the house, Verizon is likely to concentrate on slimming down MCI.

After service and account support, the first question on enterprise customer minds is whether to rush to cozy up to their principal RBOC, e.g. by signing an **interexchange contract** with SBC and Verizon. As a general matter, the answer is no. If anything, the very fact that two of the RBOCs are proposing to buy two of the Big 3 IXCs illustrates why one should be careful about switching interexchange business to an RBOC at this point. Under the SBC/AT&T deal, AT&T will become the long distance division of SBC, which means that SBC will use AT&T's infrastructure to provide interexchange services. The same is likely under the Verizon/MCI deal. The risk is therefore not that a large enterprise customer will have to migrate *from* AT&T – it is that it will sign a deal with SBC and then be forced to migrate *to* AT&T.

A related issue is the advisability of executing a **local service agreement** with AT&T or MCI in the near future. For reasons that mirror those just given, again the answer is generally no. One of the regulatory conditions that may well be placed on SBC would involve divesting AT&T's local service facilities in SBC's ILEC territory. The same reasoning would logically lead to Verizon's sale of MCI's local service assets in Verizon territory, though MCI's local network is less extensive than AT&T's. AT&T is well-equipped to provide local telephone services (to some large office buildings, though not as many as it sometimes led customers to believe) and high-bandwidth connections such as Accu-Ring (in most major metropolitan areas); it would be disruptive and expensive to discontinue these services precipitously where they are being used. At the same time, the RBOCs are likely to migrate customers off of the AT&T and MCI local platforms, shutting them down even as they shut down their own interexchange platforms. These concerns should make prudent enterprise telecom managers wary of giving new local business to AT&T or MCI.

It is also likely that the management teams of the merged companies will not make **global services** a high priority, particularly given the pressure they will be under to meet the financial goals set by and for Wall Street. AT&T did a reasonably good job of building out its international network in the wake of the Concert debacle, but that build essentially stalled after reaching the 50 or so most important overseas locations and there is no reason to believe AT&T's ever-shifting strategy would have soon produced the global one-stop shop it periodically announced. MCI also had a fairly strong global network, but sold many of these assets (including its stake in Infonet) while in Chapter 11. There is

no reason to believe that international service will become a higher priority after the mergers, and good reason to believe the opposite.

At the same time, BT is buying Infonet from the grab-bag of overseas national carriers that own it, and France Telecom is purchasing the shares of Equant that it doesn't already own. These developments will stabilize Infonet's and Equant's strategic positions, and will encourage network managers to maintain or even step up their contracts with those entities. In short, while the SBC/AT&T and Verizon/MCI mergers are unlikely to advance the day when you can go to one carrier for all of your worldwide needs, other industry developments are pointing in the right direction.

The upshot of all of the various service considerations is that large users should continue to offer bid opportunities at least to the traditional Big 3 interexchange carriers, plus one of the second-tier carriers and the RBOC serving its headquarters/principal locations. The consolidation process is only beginning, and it would be unwise to game the system by arbitrarily throwing out one or more first-tier carriers.

Contract Terms

Industry upheaval breeds uncertainty, and enterprise customers can use that uncertainty to their advantage by noting (and leveraging) carrier anxiety even as they continue to request bids. The purchase of AT&T and MCI and other carriers' debt or cash flow problems are challenges, but they are also opportunities that can (and should) also be used to drive commitments down and obtain favorable terms.

The cost-cutting and account team turnover that will follow the mergers threaten project implementation, provisioning, optimization and provider responsiveness on SLA compliance and related issues. To mitigate these and other concerns, large users should consider either supplementing their RFPs with items like those listed below and pressing for them in contract negotiations.

Account Team Support: Large network services contracts should specify a list of key personnel positions, describe the job functions and relevant expertise for each, and require the vendor to allow the customer to interview and have input on candidates for those positions. ("veto" rights are difficult to get, and you should check with your employment specialists to make sure that such rights would not create liability as a co-employer.) Large users may also want to insist that the vendor not replace key personnel without customer consent for reasons other than illness, bona fide promotion, termination of employment or other circumstances beyond the vendor's control. The contract should require the carrier to use all reasonable efforts to ensure a smooth transition if key personnel are reassigned. Finally, while the vendors will want the right to eliminate key personnel positions in the future, customers may want to either prohibit that or require advance notice and cooperation to minimize adverse impacts.

Service Levels: The sale of AT&T and MCI increases the importance of service levels, especially “soft SLAs” that focus on the vendor's responsiveness (as opposed to “hard SLAs” like latency or network availability). Pay particular attention to SLAs for installation delays, time to restore/mean time to repair, and remedies for chronic interruptions (with a definition of “chronic” that is consistent with a customer’s business needs). Also, many vendor contracts condition a customer’s right to credits on unreasonable requirements that the customer report outages and submit written requests for credits within specific periods of time. Good account teams protect customers by doing the necessary paperwork, but if the amount (or quality) of account support declines, provisions like these will leave customers unable to enforce the SLAs. Finally, consider shifting the emphasis away from SLA credits (which are usually small) to making the vendor accountable for correcting problems in a timely manner through mandatory meetings of the parties’ project managers and necessary support personnel when problems go uncorrected, and the right to reduce commitments or terminate services if overall performance suffers for a specified period of time.

Change in Control / Assignment: A change in control provision that permits the customer to terminate the contract without liability if the provider is acquired is extremely rare; AT&T's and MCI's contracts with large users are one of their principal assets, and such provisions severely compromise the value of that asset. But more limited alternatives may be available. A customer might, for example, seek a provision permitting it to terminate the contract or reduce its commitment in the event of a material degradation of service after the acquisition closes, with “material degradation of service” being defined to include loss of account support. Other triggering factors large users may want to pursue include the sale of the vendor to a competitor of the customer, or a loss of vendor diversity – if a large user was obtaining a T1 from Verizon and a T1 from MCI to serve a particular location, it will have to pull one of those circuits to maintain diversity. And make sure that the assignment clause provides that the vendor remains liable for the performance of its obligations under the contract in the event of a permitted assignment.

Contract Flexibility: The best protection against the problems that will likely accompany RBOC acquisition of AT&T and MCI is contract flexibility. A short contract term serves that objective; two years with a one or two year renewal right (at the customer’s option) is reasonable in the current market. Customers should also make sure that their minimum annual revenue commitments are no more than 50%-60% of projected spend – carrier demands for more on the grounds that without it excellent pricing is somehow unavailable are baseless. Preserving an adequate cushion is the easiest way to maintain the flexibility to award new business to other vendors, and the leverage to renegotiate rates as needed.

Tariffing: Finally, in the wake of AT&T's sale to SBC and MCI's sale to Verizon interstate dedicated access purchased from AT&T or MCI may well have to be purchased on a tariffed basis; local services purchased from these carriers may

also fall under the more stringent regimes that currently govern the RBOCs. The SBC/AT&T and Verizon/MCI dedicated access tariffs will not be customer-friendly, so clauses designed to protect customers against the adverse effects of the filed tariff doctrine will become more important than they have been since IXC services were detariffed almost four years ago. The vendor should agree to file customer-specific tariffs (if required) that accurately reflect the terms of any contract. And after the contract is signed, the customer should make sure the required filings are made -- under the filed rate doctrine, the tariff will take precedence over the contract if they conflict or if the contract entitles the customer to greater rights than the tariff.