



Telecom Industry Consolidation –

Where It's Going and What It Means for Enterprise Customers

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With the SBC/AT&T merger now a done deal and the Verizon/MCI merger preparing to close, enterprise users are voicing a number of concerns. Moreover, the uncertainty that flows from the mergers cannot be separated from the risks surrounding the carriers' relative investments in wireline vs. wireless networks, and their ongoing technology migrations in the corporate data networking arena. Here are our answers to some of the key questions enterprise customers are asking about the telecom mega-mergers, their effect on national and global enterprise contracts, and the future of the industry.

Q. When do the mergers close? What happens immediately thereafter?

With all the federal regulators having approved the mergers, SBC decided to close its acquisition of AT&T right after the California Public Utilities Commission gave its approval on Nov. 18. The company is changing its name to AT&T, even though this was an acquisition by SBC, and SBC's old management will be firmly in control. Verizon and MCI have a few more states to get through, partly because their merger process began later. But the key states of New York and New Jersey have approved the deal, and the merged company, named Verizon, will likely debut by January. It's unclear whether MCI will survive as a trade name – it has value, but Verizon has put a lot of resources into building its brand recognition since its predecessors, Bell Atlantic and GTE, merged in 2000.

It will take some doing for everyone to get used to the three biggest enterprise carriers being called “AT&T, Verizon and Sprint” and for “AT&T” to be a Bell company again. **For the remainder of this document, we have used the legacy names of the merged companies as we analyze the effects on customers of the pre-existing enterprise carriers.**

Entering the mergers, the enterprise market was robustly competitive and, aside from personal distraction on the part of negotiators and account teams worrying about their futures, there is no reason to believe that deals in process will be materially affected as they happen to cross the merger closing dates. SBC and Verizon are buying a number of things – networks and capabilities and, in SBC's case, a famous name – but more than anything else they are buying you, the enterprise customer (or, from their point of view, account control). The effects we see are going-forward considerations that one should plan for regarding support under your current or in-process contract, your carrier choices for the next procurement, and the technologies you must be prepared to consider.

Q. I heard there were conditions and divestitures that the regulators put on the merging parties. What are these about? Will they affect my negotiations for voice and data services?



A. There are two sets of conditions, one imposed by the Justice Department, the other by the Federal Communications Commission. The Justice Department announced that both merger groups must “divest” certain fiber entrances into commercial buildings on the theory that AT&T-built local fiber in SBC territory and MCI-built local fiber in Verizon territory could lose their competitive status. The chance that this will affect you is remote, even if you currently buy AT&T or MCI local services.

First, only 750 buildings are affected – 0.1% of the office buildings nationwide. If a building is not on the list, nothing is divested, no matter what the competitive situation actually is. Second, at each building, AT&T or MCI must divest either 8 fiber strands or half their unused fiber, whichever is more, to a new party. MCI together with Verizon have publicly indicated that they have enough unused fiber that current customers should not be affected. SBC and AT&T haven’t explicitly indicated that, but have publicly minimized the effect of the conditions. Also, remember that services like AT&T Accu-Rings are often actually provided over RBOC facilities, which aren’t affected by the conditions (though in the long term they may be affected by the post-merger landscape).

Nevertheless, if you have AT&T or MCI local services now, or are negotiating a deal that includes these services, it’s a good idea to check whether you have any sites that match the affected building list. Send an e-mail to Michaelen Terrana at mterrana@lb3law.com for the lists. If there is a match, ask your account team to check whether there’s an issue of carrier change of control, just to be sure (and to keep them on their toes, which is always a good idea).

Q. And the FCC conditions? What is their effect?

A. The key issue for the FCC in the mergers was the price of dedicated access lines. As you may know, compared to other rate elements it can be difficult to gain price concessions in an enterprise contract for T-1 and other dedicated access into branch offices, stores and other corporate network sites. Partly as a result, the FCC got SBC and Verizon to commit not to increase their “interstate special access tariffs” within their own regions for 2½ years. Those are the *basis* of the rates that have been charged through pre-merger AT&T, MCI and Sprint as they develop their dedicated access offers to you. So the benefit may be indirect – remember, national carriers are often expected to present simplified access pricing deals to enterprises based on an amalgam of the prices at which *they* have to obtain these access links from local carriers around the country.

Another provision of the FCC conditions does require SBC and Verizon not to raise prices to *customers* for 2½ years specifically on local T-1 and T-3 lines provided *directly* by pre-merger AT&T and MCI via their own local services (for example, in AT&T’s local tariffs for TCG, an alternative fiber provider it bought in the 1990s). That’s a specific price protection for some customers, but these circuits are more the exception than the rule. If an enterprise buys T-1 access to 500 branches or stores around the country, for example, most will really be riding on the local carrier’s facilities even if the deal is coming from a national carrier.

So how will this all shake out? Taken together, these provisions require some knowledge on your part to really secure any advantage. The more you’re aware than SBC and Verizon can’t raise their basic access prices in-region to anyone (regardless of whether the national carrier holding



the primary account relationship with you now will be part of the same company or not), that can help in negotiations. But beware: Account teams, borrowing a term from analogous conditions in state-regulated telephony “rate cases,” may characterize access rates as “frozen” where their own company becomes the incumbent local provider, thus turning what is supposed to be a price ceiling into a price floor. In addition, BellSouth and Qwest are not subject to the new rules and could (and probably will) try to get more for the dedicated access they provide to the mega-merged carriers. To get the benefit of these mergers, you should be prepared to state that you know that nothing in the merger approvals prevents *any* of the Bell companies, whether merging or not, from *lowering* their rates; that you expect to receive bids on a supply-and-demand basis; and that there should be a benefit from the fact that your carrier (unless it’s Sprint) now controls access in a significant number of states.

Q. Speaking of Sprint, should we be concerned about the fact that it just merged with Nextel, and its wireline enterprise business seems to be getting little mention?

A. The entire industry restructuring is taking place against the background of an accelerating network migration in the long distance segment. Each of the carriers has to decide not only how much to invest in wireless, but also how long to emphasize (or even support) traditional frame relay/ATM services –as opposed to “converged” IP-based networks and related services such as Multi-Protocol Label Switching, or MPLS. But perhaps because of the wireless tilt of its overall business, Sprint has been the most aggressive of the carriers in pushing customers off of wireline frame relay. If you sign a contract with Sprint that extends beyond 2007, expect the carrier to give itself the right to require you to migrate onto an MPLS platform – or at least its alternate frame relay interface onto to a secure IP network with a tunneling protocol – or before the expiration of the contract.

How this affects Sprint’s vigor in competitive bidding situations may depend on who you are. If any-thing, Sprint is becoming more aggressive in trying to win business at the nation’s largest companies, believing (rightly or wrongly) that its combination of IP and wireless assets (including spectrum that will be usable for WiMax services when these come to market next year) will be appealing to these enterprises. At the other end of the spectrum, medium-sized businesses with a legacy 56K port/0 CIR branch office frame relay network – once a core Sprint constituency – may see the carrier’s interest wane. After all, unless it can bypass the RBOCs’ last-mile monopoly, Sprint’s dependence on the new mega-carriers for dedicated wireline access puts it at a particular disadvantage for lower-speed network connections whose cost is largely a function of the cost of that access. In sum, Sprint remains a viable candidate for national enterprise RFPs – and could be a big winner if WiMax emerges as a viable alternative to wireline T-1’s and T-3’s – but its role and focus are changing.

Q. How will the other carriers handle the migration to MPLS? Will there be a forced timetable?

A. For corporate data networks, it’s inevitable that AT&T and MCI will soon emphasize an IP/MPLS network over their product set for the past decade – an ATM-based network most commonly sub-scribed to via frame relay. Even AT&T’s original MPLS effort, which leveraged the “multiprotocol” part of the technology to run label-swapping of IP traffic over an ATM switching core, is now giving way to a true IP/MPLS global network strategy. The question is whether AT&T’s and MCI’s new owners will force the move as quickly as Sprint. Perhaps



paradoxically, it appears that the mergers may initially retard this movement for anywhere from 6-18 months. AT&T and MCI are now pre dominantly business carriers, meaning that they are bringing little consumer business to the mergers that SBC and Verizon couldn't get anyway. The last thing the new owners want to do out of the gate is to rile up the enterprise installed base, because without it they really haven't bought anything.

That said, the financial logic of both mergers – especially Verizon/MCI – depends on significant net-work rationalization. History suggests that, like past legacy services, frame relay and frame-to-ATM interworking will survive in some form – especially at SBC/AT&T – for some time. But Verizon is under pressure to optimize MCI's disparate networks and operations quickly, perhaps tolling the bell for traditional frame relay at that carrier by the end of this decade. And remember that carriers have a tried-and-true method to discourage renewals of legacy services: making them more expensive. Finally, all the carriers, merging or not, face the challenge that Cisco is no longer enhancing its ATM switching family, which forces the carriers to migrate to the successor product line. This particularly bears watching at AT&T, which even within its MPLS family has had a set of managed and unmanaged offerings with differing terms and conditions due to product migration challenges. So while right now frame and ATM deals appear “easier” to extend with AT&T and MCI than with Sprint, a year or two into the mergers that may no longer be true. Now is as good a time as any to socialize within your organization a clear timetable to MPLS and/or managed Internet services, and to make sure that whatever IP service you choose is the one to which your carrier is really committed.

Q. Should we be concerned about more layoffs and account team turnover in the merged companies?

A. Yes, although the situation may play out somewhat differently in the two mergers. We believe that SBC may use its purchase of AT&T to justify a layoff of some of its *own* customer-facing personnel, a move that Verizon made in late 2003. By contrast, Verizon is more likely to lay off lower and mid-level MCI personnel because of concerns that MCI's slim margins (well below AT&T's) are the result of poor organization and inefficiency.

But at a broader level these mergers heighten the importance for all large users of contract provisions in areas such as account team input and change of control protection. And like other unsettling industry news, they highlight the importance of contract flexibility, especially the need to keep dollar commitments well below projected spend. This is a good time for enterprise users to pull out their contracts and consider their rights and the carriers' obligations. Look for (1) good performance specs, especially in “soft” areas like reporting and response to outages (as opposed to raw network performance, which is pretty standard); (2) the extent to which there is committed account support and customer control/influence over account team selection; (3) billing and reporting requirements; (4) provisioning and maintenance intervals; (5) optimization reviews, and (6) responsibility for maintaining administration plans. If you believe that service or account support is slipping, document your concerns in internal notes and emails to the carriers, regardless of whether your carrier is part of the industry consolidation.

Q. What other forces will affect prices after the mergers?



A. Over the last decade the telecom industry has waded through legislation, court battles, mergers, bankruptcies and accounting scandals. The price of telecommunications services, old and new, has continued to fall throughout this period.

There are two key variables in projecting pricing trends – the rest is noise. One is the number of viable, full-featured national carriers with their own facilities that can service the entire range of enterprise customer requirements. The other is underlying transport costs. In and of themselves, the two mergers do not change the number of capable enterprise carriers with a national reach. The RBOCs had been nipping away at AT&T, MCI and Sprint in roughly the same manner as previous generations of “second-tier” national carriers, albeit with more money and better name recognition.

The main risk is therefore not the mergers *per se*, but rather a change in the strategic allocation of carrier resources and the loss of the potential competition that would have been created had SBC and/or Verizon become major interexchange carriers through organic growth or by buying carriers that were not among the Big 3. But the RBOCs ultimately were not interested in buying national carriers who could not bring them premium market shares, no matter how advanced their networks.

Much of this dynamic was at work when, just before merger closing, AT&T CEO David Dorman was asked by a Wall Street analyst whether the impending consolidation was crimping competition or pulling prices up. He responded: "No, I think that the market remains very competitive with or without the mergers. I don't really perceive it as a pre-merger kind of thing at all. In fact, if anything, we continue to see ourselves and MCI fighting out every deal in a very vigorous way, and SBC and Verizon independently bidding on most of the bids that we're in, particularly if it's in their footprint."

But note the end of Dorman's comment. Over time there is a risk that SBC and Verizon could try to divide the market along lines that correspond to their home territories, as the result of economic incentives if not conspiracy. Think about it: When AT&T buys overpriced local access in Texas, it is overpaying its parent; when it buys overpriced access in New York, it is overpaying Verizon. Where do you think it is more likely to put in an aggressive bid? That makes it particularly important that, if your headquarters and/or major operations happen to be in the territory of the RBOC that is acquiring your principal carrier, you engage the other mega-carrier in a serious way. Going forward, most major enterprises should probably endeavor to have some business with both SBC/AT&T and some with Verizon/MCI, and for many of them at least one other carrier.

Remember that individual carrier performance, customer service, and negotiating flexibility ebb and flow in unpredictable ways. And individual customer leverage – lost or won through a mix of term, commitment and other factors, such as willingness to change carriers – remains the single most important factor in determining the ability to secure aggressive pricing in any given contract. Locking your company into contracts with a commitment that is close to 100% of anticipated traffic robs you of leverage (which is why the carriers push so hard for this) and virtually ensures that your pricing will not remain competitive over several years. It's much better keep the carriers uncertain with regard to your relationship with them, current or prospective.



Q. What are BellSouth and Qwest going to do now?

A. BellSouth has long been discussed as a buyer of either Sprint's wireline long distance business (Sprint is already selling off its wireline local business) or Qwest. More recently, a number of Wall Street sources have been hyping an SBC acquisition of BellSouth. Our best indication at this time is that BellSouth will continue to wait and see. It's in a unique position of being the default access carrier in the Southeast for all of SBC and Verizon's new customers. And BellSouth is well aware that taking on one of the remaining long distance carriers would give it no better than a No. 3 position in the national enterprise market in exchange for likely new restrictions on dedicated access pricing – probably not a trade-off it finds appealing. The lack of a long distance partner hasn't hurt BellSouth in the financial markets; its stock outperformed all of the other RBOCs during the first 11 months of 2005.

Qwest, on the other hand, cannot stand still forever. Its attempt to buy MCI earlier this year revealed that the financial markets prefer that it do something – anything – to spread its \$16 billion in debt over a broader revenue base. Qwest's stock price rose even when it clearly proposed to overpay for MCI (mathematically, its offer would have required Qwest to create savings by mixing and match MCI and Qwest long distance POPs, a potential nightmare for users), and its stock price dropped when MCI shareholders ultimately said no and went with Verizon's lower offer. Qwest merging with another Bell company, splitting its long distance operations, or other moves are all conceivable. Nothing is certain, but it's unlikely that Qwest will look like it does today at the end of 2008.

Q. What's the status of the other significant wireline carriers?

A. The second-tier long distance carriers (companies like Global Crossing, Level 3 and Broadwing) have all undergone financial restructurings. But these restructurings tend to leave them with either too much debt or relatively low levels of cash. In more than one case, the restructured carrier is beholden to a single owner that has accumulated rights to both equity and debt, which grants them power to sell off assets or make other moves with little regard for the effects on customers. Generally, these carriers could be bought for very little money, but the most likely prospective buyers – the RBOCs – wanted market share, and these companies don't have it. And at the moment, there do not appear to be other, new buyers of these carriers (except for each other, as witnessed by Level 3's current move to buy WiTel from a firm that's not otherwise involved in telecom). Generally we continue to counsel using these carriers, but only under very flexible contracts with no (or very low) commitments, and in no case under a contract that expires beyond the maturity of the carrier's major debt.

Q. How will the mergers affect global network services?

A. One problem with U.S. consolidations is that the management of a merged company is unlikely to make global networking its No. 1 priority, given the pressure it will be under to meet the domestic financial goals set out for Wall Street. AT&T did a reasonably good job of building out its international network in the wake of the Concert debacle, but European and Asian carriers, including Chinese carriers, are coming on strong to compete for U.S. multinationals business with their pan-regional networks. For its part, MCI's international position weakened during the WorldCom bankruptcy and the sale process – for example, it sold off most of its Latin American



assets. Yet necessity is the mother of invention – pre-merger MCI has reported that MPLS service demand (under its trade name Private IP Service) was so strong that it created MPLS points of presence in several new markets as ports in service worldwide grew 51% during the first half of 2005.

At the same time, users with significant international requirements should be aware of two positive events affecting global telecom: BT earlier this year bought Infonet from the grab-bag of overseas national carriers that owned it, and France Telecom purchased all of the shares of Equant that it didn't already own. These developments will stabilize Infonet's and Equant's strategic positions and should provide a jolt to competition. BT in particular has learned that its way of doing business in the U.K., based on deals that rarely went beyond tariffed rates, terms and conditions, doesn't work in the rest of the world. Where BT once was unwilling to provide market-competitive pricing or to commit to levels of support beyond its standard offering, outside of the UK Infonet is very competitive and much more creative and flexible in its deal structures.

France Telecom's absorption of Equant hasn't proved as beneficial yet, and some users have complained that Equant, although a leader in promoting global MPLS service, is no longer as willing to negotiate price and puts onerous requirements on the customer to qualify for MPLS service level credits (never mind that it almost refuses to bid on frame relay and stand-alone voice anymore). In fact, the lawyer who led deal negotiations at WorldCom during its worst period of overreaching and inflexibility left post-bankruptcy MCI last year and went to Equant, which predictably affected its deal culture. Still, Equant remains an important player in a multi-faceted world of global and pan-regional carriers. Provided you remember that it is virtually impossible to have a single carrier (especially a U.S. carrier) really be your one-stop shop for global networking, the competitive situation for global networking current looks promising.