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Free the Photon! Emancipate the Electron!

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Let Telecom Markets Follow the Logic of Physics, Not the Lawyers

Under new Chairman Michael Powell, the FCC has already taken constructive steps to promote true competition and to end the regime of artificially subsidized competition that Powell's two immediate predecessors created after passage of the Telecom Act in 1996. Liberalizing long distance entry will help pave the way for fair competition. Though the FCC deserves praise, more needs to be done.

Blocking competition is regulatory resistance to rapid industry restructuring. There is, of course, a long history of such efforts.[1] The Bell System break-up segmented the local and long distance markets to promote long distance competition. Prices fell, and the experiment was widely pronounced a success. In reality, long distance prices have fallen steadily since 1915, and indeed fell slightly faster in real terms between 1915 and 1960, as compared to the period between 1960 and 1990. From 1990 to 1996, prices actually rose for smaller customers. It was not until 1997—as the Internet became a factor and access charges were reduced – that prices began to drop again.[2]

The 1996 law, coming during the period when long distance prices actually rose, expressly established the so-called Section 271 prerequisites for regional Bell company entry into long distance. One way of entering long distance, however, was short-circuited by Section 271: mergers. Thus, in 1997 the FCC stepped in when it heard that AT&T was about to bid for SBC Communications (the new name for the combination of the old Pacific Telesis and Southwestern Bell, which later added Ameritech). Calling it "unthinkable," FCC Chairman Reed Hundt killed the deal in 24 hours, accusing them of using merger to avoid competing. A year later AT&T instead bought TCI. Hundt's successor as FCC chairman, William Kennard, allowed two deals merging local and long distance to go through, Qwest and Verizon, but only on condition that the local and long distance operations remain separate pending state-by-state long distance entry. In effect, Kennard allowed what might be called "non-merging mergers."

A Market Structure at Odds With Economic Logic, as Well

Many sponsors of the 1996 law agreed with Hundt's stance. They too envisioned the law fostering head-to-head competition, without stimulating mergers. But the response of telecom management—proposing mergers—was in fact understandable. Getting from 19 major firms (eight local carriers, seven cable MSOs—Multiple System Operators, and four long distance carriers) to a number most industry observers believe the market can sustain (three to five) can happen in one of two ways: a winnowing competition or a series of mergers.

The first option would have essentially entailed placing at high-risk under-depreciated network plant built to meet regulatory requirements, not those of the marketplace. That telecom executives were not eager to do that was no doubt a welcome relief to their shareholders. Instead the merger option was taken by telephone and cable companies alike, only to run afoul of onerous FCC conditions that effectively undermined many benefits sought by merging firms.

Five years later the telecom landscape is a financial mess, with debt-laden firms facing declining residential consumer revenues and lagging broadband markets. Most of the competitive local exchange carriers (CLECs) are nearing bankruptcy, with diminishing opportunities to profit from artificial regulatory arbitrage. Few in the industry seriously believe that more than half of today's large firms can survive the next five years. A second round of restructuring is needed.

Logically this would entail merging existing long distance companies with local telephone or cable companies. Comcast's bid for AT&T's broadband assets has put the company "in play"; AT&T's pieces will likely all be sold sooner or later. WorldCom's recent decision to spin off MCI's consumer operations makes it an attractive acquisition prospect as well.

The Structural Legacy of Regulation

Allowing cross-industry mergers of the AT&T-SBC variety that Hundt stopped cold four years ago could have broken the structural logjam, had the FCC applied more reasonable standards to the Section 271 process. The FCC chose instead to impose onerous conditions on the SBC/Ameritech and Bell Atlantic/GTE deals and block vertical consolidation. In doing so the FCC frustrated the deregulatory design of the 1996 law, just as the Justice Department's deregulatory design for divestiture was frustrated by the FCC, which kept AT&T hamstrung until late 1995.[3] (The FCC's serial defeat of deregulatory designs brings to mind Karl Marx's famous dictum that history repeats itself, first as tragedy, then as farce.)

Against this it will be argued that a competitive free-for-all is the American Way, and if that's good enough for Wal-mart it should apply to telecom firms. The difference is that Wal-Mart evolved from its inception under vigorous competition. Sam Walton built his company by choosing markets to enter, whom to serve, and what products or services to provide. Not so with telecom and cable companies, who operate under franchises and were historically monopolies. As for AT&T's advocacy of separating the wholesale local loop from retail, as the Progress and Freedom Foundation's Jeff Eisenach notes, this is the bright idea that California had with electric deregulation: A telecom instant replay sounds no better.

The result of monopoly heritage is embedded investment vastly greater than would have been made under competition. Asking these companies to engage in what would amount to a financial demolition derby in shareholder asset value is thus not reasonable. Further, perpetuation of the artificial distinction between the local and long distance markets impedes development of end-to-end competition. No firm is eager to build a fresh nationwide long distance network, given the current mega-glut of fiber-optic cable already laid.

Act Sooner Rather Than Later: Allow Rapid Vertical Integration

It is time for the federal government to end micro-management of industry structure and markets, and allow realistic industry economics to drive structure. Better to have vigorous (ultimately, end-to-end) competition among three to five companies than to force a competition that will leave the winners shattered as was France after World War I, with service inevitably deteriorating. Far better to have three to five healthy carriers than twice as many sick ones.

The CLEC collapse of the past year is a prime example of what happens in a market overstuffed with competitors whose entry was underwritten by regulatory largesse. A proper pricing regime would have fostered entry by fewer, stronger carriers, based upon market economics rather than regulatory fiat.

The lawyers' creation, dividing local and long distance segments, has lived long enough.

Photons and electrons do not know from jurisdictional boundaries, nor do they know local from long distance. In today's data networks digital bits travel in packets, with a single data call disassembled at the point of origin, split among numerous network nodes en route, and re-assembled at the point of termination.

It's time to return to networks structured by how best to harness the behavior of photons and electrons, and let customer demand drive market evolution.

1. Concern that AT&T might acquire Western Union and all independent telephone companies led the Justice Department to press AT&T to issue a letter, the 1913 Kingsbury Commitment, agreeing not to do so. Congress effectively repealed Kingsbury with passage of the Willis-Graham Act in 1921. The Radio Act of 1927 made clear that Bell would not be allowed to acquire broadcast interests. In 1956 Justice secured a consent decree barring AT&T from the computer industry, and requiring spin-off of Western Electric. And then in 1982, in a modification of the 1956 consent decree (MFJ), AT&T agreed to divest its local operating companies. The 1996 law repealed Willis-Graham and replaced the MFJ with section 271.

2. A ten-minute telephone call from New York to San Francisco cost $69 dollars in 1915, when the average hourly wage was 23 cents. Put another way, in 1915 an average wage earner would have needed to work 300 hours to pay for the call. At today's $1 cost the call would require a few minutes of average-pay work. Source: Edwin S. Rubenstein, Hudson Institute.

3. The late William Baxter, who as antitrust chief negotiated the consent decree for the Justice Department, later lamented that had he known how long regulation of AT&T would persist he would have been "horrified." MacAvoy, Paul, The Failure of Antitrust and Regulation to Establish Competition in Long-Distance Telephone Service, pp. 23-24 (AEI Press & MIT Press 1996).

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