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Local and Long Distance: Déjà Vu All Over Again?

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WorldCom's spectacular implosion seems to have caught many regulators by surprise. They missed it partly because they were unable to see that the core voice business of the long distance industry was collapsing. Long distance managements were loudly trumpeting the Internet Age, when data revenues would rise so steeply that voice could be free. That vision likely will come true—eventually. But data revenues in recent years did not grow fast enough to replace losses in voice revenues; this made inevitable WorldCom's bankruptcy.

Part of the reason regulators—and virtually the entire telecom industry as well—missed the boat on data growth was, it now emerges, that WorldCom was not satisfied with cooking the financial books. It cooked the Internet traffic figures as well. As the largest router of Internet traffic, WorldCom's UUNet subsidiary was deemed authoritative as a source: Its claim that traffic was doubling every quarter was true for 1994 to 1996, but beginning in 1997 the annual growth figure was around 100 to 150 percent. Industry, pundits, government all sang from the same (cooked) hymn book, and surely many tens of billions were invested on the assumption that Internet growth was running at the higher figure.[1]

That traffic fraud could be successfully perpetrated and sustained for several years strikes a deadly blow at the culture of trust for which the Internet has been so celebrated. And if that is not bad enough, the next shoe to drop on the industry after WorldCom's Chapter 11 filing may well be what regulators might do in an effort to ensure continuation of service to WorldCom's spun-off MCI consumer division, which serves some 20 million LOLITAs (telecom industry-speak for Little Old Ladies in Tennis Apparel). Political pressure is being directed at the Federal Communications Commission to press local carriers to rescue the MCI LOLITAs. The pressure comes from the usual suspects: regulation-minded members of Congress, consumer groups, and anti-Bell industry folks.

FCC Chairman Michael Powell recently signaled receptivity to a Bell rescue of WorldCom, despite a philosophy pithily summed up in an interview last fall: "I am not the grand master of competition."[2] WorldCom and other long distance firms have lost market share in states where Bells have been permitted to enter—e.g., Verizon has gained over thirty percent of long distance customers in New York since winning permission to enter there in January 2000.[3]

A further source of temptation is WorldCom's role in national security and Internet communications, which CEO John Sidgmore emphasized in a Washington talk: It handles about one-third of defense communications and one-half of domestic Internet backbone traffic. (WorldCom has, however, only eight percent of the Internet physical backbone.[4]) Defense Secretary Rumsfeld splashed cold water on Sidgmore's warning, saying he did not fear loss of service.[5]

Rumsfeld is not worried, but Powell is. Describing the telecom industry as being in a state of "utter crisis" he warned that the government "ought to be very, very careful about adding to the circumstances that might collapse the company…. This is a significant company whose assets are critical components of the entire network. It would be messy if they became unavailable."[6]

At this point, Mr. Powell said, WorldCom's officials and lenders have given assurances that the company would continue to fully maintain its voice and data networks.

Powell added:

> It's going to be a tricky situation because there will need to be a major restructuring of the company or its assets that doesn't lead to service outages. We're watching closely, but for now both the company and the banks believe that keeping the networks running is in everyone's best interest.[7]

He concluded: "things are becoming more acute by the day."[8] His agency does, however, have running room, as FCC regulations prohibit any carrier from terminating services for 30 days after filing for bankruptcy, a deadline the agency has discretion to extend. On July 26 Powell went further: "The FCC will not permit a cut-off of a customer's service in the wake of WorldCom's bankruptcy filing. The FCC has regulations in place to protect consumers' telephone service, and we will vigorously enforce these rules."[9]

Origins of Today's Competitive Segmented Industry Structure

The structure of the telecom industry today arose out of the end of the longtime relationship between regulators and phone companies: regulated monopoly. The "regulatory contract" endured for nearly a century[10]—common carriers offer service for hire to all customers at a non-discriminatory rate, in return for an exclusive franchise. Regulators unilaterally abrogated the compact in 1984, with the Bell break-up and open entry.

Except that AT&T and its former local Bell offspring were still saddled with their service obligations, even as their businesses were progressively opened up to competitive entry—subsidized entry, at that. MCI and Sprint were simply the early beneficiaries of this regulatory largesse. And ironically, it is the now-moribund MCI consumer division of WorldCom that may become, if regulators yield to the temptation (as well they may), the latest beneficiary as well.

Contractual default by a private party normally entitles the other party to suspend performance under the agreement; not so with opportunistic post-Ma Bell regulators. They got to abrogate their end of the bargain and still hold their captive companies to their end—a classic "have your cake and eat it" two-step. Thus, AT&T waited nearly twelve years for the reduced regulation it bargained for, whilst its prime competitors continued to enjoy discounted access.

What makes the tale especially rich is that the government, having dishonored the original regulatory contract, now may impose a new one on the very local companies who were victims of the original unilateral default.

A Forgotten Vignette from the Not-Too-Distant Past

What will happen if regulators succeed in pressuring Bells to buy up MCI to save LOLITAs the hardship of having to search for a new long distance carrier? Find it hard to imagine? You shouldn't: In 1997, immediately upon announcing its deal with MCI, WorldCom, having indiscreetly disclosed its intention to jettison MCI's residential consumers, was forced to retract within twenty-four hours, by a Washington scandalized by the thought that the new company would continue to target business customers only. That numerous CLEC entrants were at that very moment doing exactly the same thing did not trouble them in the slightest.

A limited parallel is so-called "social contract" regulation: regulators allow regulated firms to enter new markets in search of higher returns if the companies agree to provide utility-type service to the LOLITAs. But this masks what in effect is a confiscation of assets for the benefit of competitors not similarly obligated.

Perhaps a bailout can be made to work if the Bells get something in exchange for agreeing to do it. Relief from TELRIC might be a starter. But that hardly suffices as a basis for buying a company whose core business—commodity voice service—is imploding, with no turnaround in prospect. Betting on LOLITA broadband demand to more than offset migration losses would pay, if at all, after quite some time. Meanwhile a Bell-MCI balance sheet would resemble Baghdad the morning after a visit by American warplanes.

Acquiring a common carrier with an imploding core business may, if regulators are not careful, become a growth industry all its own. Saddling carriers with mounting service obligations as their workforces contract; restricting entry into new markets; aiding poachers on their networks; and punitive do-it-or-else rules will merely drive local carriers toward an MCI-like ending. And who will bail them out? Indeed, local carriers are already writing down WorldCom losses.

The Public Network Is Not Going out of Business -- Yet

After WorldCom's implosion, what happens to Internet traffic? Slowdown and poorer service, but probably not complete breakdown. Data traffic is managed differently than voice calls. A voice call travels over a completed end-to-end circuit connection. Because the public-switched voice telephone network is engineered to carry about ten percent of voice callers simultaneously, if more than that share of the total tries to call the excess callers above the ten percent limit simply do not get on the network. Lost calls are dropped and the caller must wait and try again.[11] This is what happens on Mother's Day.

Data calls work differently. Data is sent via individual packets, each of which may be routed by a different route and re-assembled at the call destination. Capacity overload does not generally cause data calls to be dropped; rather, they are merely delayed. Some calls may be lost due to transmission errors, which are more likely in times of high volume (but can happen anytime).

Post-default WorldCom's assets will be transferred to and managed by a trustee in bankruptcy until re-emergence, or until the assets are sold at their post-bankruptcy market value. Bankruptcy is merely a financial reorganization that decides how much on the dollar creditors receive of the debtor's remaining assets. Stockholders, who own equity, get nothing, because liabilities (debts) exceed assets. Eventually the company emerges with a fresh balance sheet, debts discharged (not all, some debts survive bankruptcy). Will the Bells step in?

The Bells have an imploding customer base, vast capital investment, a labor squeeze, and financial woes—sound familiar? Your friendly (airline) skies: an industry whose margin for years has been some one percent—the same as for the Bells.[12] Like the airlines, telecom may crash, creating a telecom world where the customer is as happy with phone service as with airline service.

Regulators can help prevent this by adopting sensible deregulatory measures that enable telecom firms to become once again attractive

investments—market pricing, allowing vertical and horizontal mergers, undoing Clinton-era rules and deregulating broadband. Pushing bum deals upon local carriers is not the answer. Allowing MCI and other long distance carriers to go through bankruptcy allows revaluation of assets to market. As bankruptcy does not terminate service, it is not necessary to force shotgun marriages to protect LOLITAs.

Can "Déjà vu" Be Averted?

So how will the local carriers feel a couple of years from now? Still firmly in the regulatory embrace, for sure, but perhaps less regulated. However, LOLITAs are the telecom industry's AARP, the ultimate killer political constituency. Regulators have historically genuflected to them and their desire above all for low monthly rates, above all other considerations.

Perhaps the worst will not happen. Local carriers might be allowed to vertically re-integrate with long distance network assets of their own choosing. This might mean buying a single network, or putting together parts of several.

The FCC needs White House heft to resist pressure to intervene. Without White House support, Congress could push harder and the FCC may yield. Large phone companies are not regarded fondly by many constituents, even in the best of times, let alone in the midst of a telecom meltdown and spreading scandal. But keeping failed carriers alive will only prolong the telecom debacle.

The stage is being set for vertical re-integration, on better or worse terms, beginning sometime in 2003. Economics and investment attractiveness demand it, but regulators will set the terms. Integration on economic terms means that long distance carrier assets are revalued per market yardsticks, and re-incorporated into local companies. Regulators could, however, go the airline bailout route. The result would be to perpetuate economic dislocation, and the ultimate losers will be consumers and shareholders who desire a vibrant, productive telecom industry.

[ET CETERA]

The New ARPANET? The original Internet was the ARPANET, a defense packet-switched network incubated by DAPRA, the Defense Advanced Research Projects Agency. Under the far-sighted leadership of networking legend Robert Kahn (who with Vinton Cerf authored the first TCP/IP protocol that became the lingua franca of the Internet), DARPA became the model for public/private cooperation. The CIA is tapping private industry to help search for terrorists, through a savvy outfit called In-Q-Tel.[13] One company has created software that aims to track people through no less than thirty degrees of separation; considering that everyone is purportedly within six degrees of separation from everyone else, this is quite a feat. The idea is to find obscure relationships between far-flung terror cells.

Airport Follies: "Stop Us Before We Kill Again!" Airport screeners missed one in four weapons in a test of their screening acumen (indeed, they missed forty-one percent at LAX, site of July 4's terror attack).[14] Perhaps if they spent less time hassling ex-Vice-Presidents, elderly Medal of Honor winners, and America's soccer moms they might have more time to look for dangerous stuff. The latest terror threat to be neutralized -- as Dave Barry says, "I am NOT making this up!": Mother's milk.[15]

Air Crew Moles. Burglaries of airline uniforms and IDs are increasing, with terror suspects feared as the perpetrators. At Northwest Airlines, union officials warned personnel to be on the alert for "Mideastern-looking males and females" conducting surveillance of air crews.[16] If the government will not profile, at least the union is showing common sense.

FAA Becoming a Progressive Force? A pilot program starting in August will enable FAA employees to gain trusted access to their workplace, a possible prelude to a "trusted traveler" program.. Identifiers will include name and security clearances, and later on biometrics. Some officials fear that "sleeper terrorists" could obtain such cards and escape detection. Such advocates seek perfection, a standard by which not one single defense system would have been deployed, ever, as there is ALWAYS a potential counter-measure.[17]

Jack Who? The Blair government has announced a plan to require compulsory ID cards for all, in order to police immigration and welfare benefits. However, the government will assay public reaction over the next six months, so stay tuned.[18]

Look At Who is Now Second in Global Web Traffic. According to consulting firm WebSideStory, it is none other than China, with 6.63 percent of Web traffic, a distant second to the US figure of 42.65 percent. Next in line are Japan at 5.25 percent, Great Britain at 3.94 percent, Canada at 3.93 percent and Germany at 3.64 percent. Neilsen NetRatings estimates that 56.6 million Chinese homes have Internet access, also second to the US.[19]

[1] "The Power of WorldCom's Puff," *The Economist*, p. 60 (July 20, 2002).
[2] "FCC Leaves WorldCom on Hold," washingtonpost.com, 7/4/02.
http://www.washingtonpost.com/wp-dyn/articles/A22054-2002Jul3.html
[3] Id.
[4] Gilder, George & Swanson, Bret, "Unleash Broadband," wsj.com, 7/8/02.
[5] "Bankrupt WorldCom Called a Security Risk," washingtontimes.com, 7/3/02.
http://www.washtimes.com/business/20020703-30793748.htm
[6] "FCC, Faced With a Telecom Crisis, Could Let a Bell Buy WorldCom," wsj.com, 7/15/02.
http://online.wsj.com/article/0,,SB1026696580457716480,00.html?mod=home_whats_news_us
[7] Id.
[8] Id.
[9] "Federal Communications Commission Assures WorldCom Customers Concerning Continuation of Phone Service," FCC News Release, July 26, 2002.
[10] The first regulation of phone rates was imposed by the state of Indiana in 1885: $3 per month maximum basic rate charge. It was repealed in 1888. Brooks, John, Telephone, p. 82 (Harper & Row 1975). Federal regulation of telephone companies as common carriers began with passage of the Mann-Elkins Act of 1910, placing rate regulation under the jurisdiction of the Interstate Commerce Commission (formed in 1887). Huber, Kellog & Thorne, *Federal Telecommunications Law*, sec. 3.2.2, p. 214 (Aspen Law & Business 2nd Ed., 1999).
[11] Callers who fail to reach the network get a fast busy signal, whereas callers who reach their intended party get a slow busy if the called party is busy (or the called party's phone is out of order). In the second case the caller is not stopped by network overload. In some cases, a party fails even to get dial tone, but can wait and eventually may get connected. This happens in earthquakes. Callers queue up to get the electronic dial-tone, which comes when a circuit is closed between the phone company central office and the caller's handset.
[12] "Bad Connection," *Forbes*, p. 84 (Aug. 12, 2002). For 1998-2002: Bell 1% ROI on $140 billion.
[13] "In-Q-Tel, Investing in Intrigue," washingonpost.com, 7/1/2002.
http://www.washingtonpost.com/wp-dyn/articles/A5577-2002Jun30.html
[14] "Airport Security Failures Persist; Simulated Weapons Slip By 1 in 4 Times," usatoday.com, 7/1/02. http://www.usatoday.com/usatonline/20020701/4237377s.htm
[15] http://www.nypost.com/news/regionalnews/54312.htm
[16] "Terrorists Stealing Airline Uniforms and Credentials, Pilot Group Says," worldnetdaily.com, 7/3/02. http://www.freep.com/news/latestnews/pm9952_20020703.htm
[17] "FAA Employees to Get Security Bypass Cards," washingtontimes.com, 7/3/02.
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[18] "UK Proposes Compulsory ID Cards," upi.com, 1:25Pm, 7/3/02.
http://www.upi.com/view.cfm?StoryID=03072002-121925-9331r
[19] "China Second to US in Web Traffic: Study," smh.com, Aug. 1, 2002.
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