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Dumber than "Dumb and Dumber": Saving WorldCom

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Always Look at the Bright Side

Near the end of his tenure as WorldCom CEO, John Sidgmore told a trade association audience: "If you get away from the debt and fraud, this is a tremendous company with tremendous asset [*sic*]. It needs to be saved and it will be."[1] And if you get away from the terrorism and mass murder, al-Qai'da is a transnational affinity group, right?

A recent speech by FCC Chairman Michael Powell expressed views that, if adopted as agency policy, would seem to throw cold water on Sidgmore's hopes that debt and fraud could so lightly be tossed aside for a fresh start. He first stated that government and industry must "ruthlessly root out corporate fraud." Powell advertised his intention to break with the FCC's policy of protecting preferred competitors. Then, after noting that government policy aimed to create local competition and accelerate its advent by conferring entrants with "extraordinary advantages," Powell issued a stern warning:

> Government policy also explicitly and implicitly signaled that it would protect these new entrants from failure. No matter how weak or shoddy the fundamentals or poor business models were, and no matter how irresponsible the debt levels or exaggerated the growth expectations were, policy promised that all competitors could be salvaged and sustained in the name of competition.
>
> It is here where the government's pro-competitor industrial policy cracked. It could not possibly protect against these shortcomings.[2]

The scary thing is, the powers that be in the telecom world appear to be mulling over trying to do just that—taking away the debt and the fraud, and leaving WorldCom. Major telecom carriers will hit the financial skids in greater numbers than if WorldCom is allowed to disappear, because the number of carriers will be artificially inflated by the firm's survival. Like much that is good politics, this is awful policy. It will postpone the ultimately inevitable vertical re-integration of long distance with local telecom markets that is a predicate for full sector recovery. If that happens, then *Playboy* magazine's freshly-minted "Women of WorldCom" pictorial will likely be followed with "Babes of Bandwidth Bankruptcy."

The desire to "save" WorldCom reflects the age-old preference for "the devil we know"—hence George Bush Sr.'s famous "Chicken Kiev" speech in 1990, urging the Ukraine to stay part of the all-too-familiar Soviet Union. And this latest "save" idea is no better than its predecessors. Failed firms, like failed states, need restructuring and regime change.

Of Three Roads, Only Two Lead to Rome

Broadly speaking, there are three ways policymakers can address WorldCom's bankruptcy and its aftermath: (1) allow bankruptcy to go forward, without propping them up with continuing subsidies from currently solvent carriers; (2) revoke WorldCom's radio licenses—if the Supremes will allow it—and redistribute them to solvent, fully-qualified carriers; (3) bail out WorldCom to keep it afloat, by any means necessary. The first two are defensible; the third, by perpetuating the financial squeeze in the telecom sector, would be disastrous.

Allowing financial reorganization to proceed, as with any other business, would seem to be the market-determined course that an administration committed to market-based solutions would prefer to follow. Bankruptcies filed by Competitive Local Exchange Carriers ("CLECs") after the meltdown offer clues to how perpetuating failed firms harms markets. Further complicating resolution of telecom financial woes is the tangled NextWave case, one of the greatest public policy train wrecks in memory. The full tale runs Russian-novel length, so highlights will have to suffice. Start first with the CLECs.

CLECs: Local Precursors of Long Distance Collapse?

A study recently released by the Progress and Freedom Foundation provides a coherent portrait of a market segment collapse.[3] Of more than 300 CLECs that sprouted after passage of the 1996 Telecom Act (some of which pre-dated the Act), only some 70 survived by late 2002. From a market valuation peak in 1999, CLEC capitalization fell 60 percent in 2000 and another 80 percent in 2001, a cumulative decline of 92 percent.[4]

The authors studied a sample of 24 CLECs who raised $3 billion during 1996-2001, of which 17 had either declared bankruptcy or been acquired, and only one of which turned a profit. The study concludes that competition grew despite CLEC failures, and that CLEC failures occurred despite this market growth.[5] Key findings of the study follow.

The sampled CLECs, as a group: (1) never came close to generating net cash from operations, nor were they headed in that direction; (2) failed to make an economic return on $25 billion in capital expenditures; (3) attracted a higher investor premium (sixfold) than other groups (doubling for the S&P 500, fivefold for other technology stocks and a doubling for established local and long distance carriers), despite no earnings, negative cash flows and that unlikelihood of turning a profit over the short- to medium-term.[6]

The authors found no evidence that adverse regulation caused the CLEC collapse, and suggested investigating whether in fact regulation encouraged excessive entry. They offered several reasons for the massive CLEC mess: (1) pressure from investment bankers for aggressive entry strategies; (2) failure to allow for the large number of competing entrants; (3) failure to learn how to operate a local telephony business. These factors made a meltdown "inevitable."[7]

The authors are, if anything, too conservative in their conclusions. Regulation clearly tilted toward encouraging entry, and by forcing incumbent carriers to sell network access at prices well below true cost, discouraged investment in separate facilities. Such "Potemkin competition" damaged not only the incumbents, but also those CLECs that took the substantial market risk associated with new facilities investment. Dividing a market among hundreds of companies weakens all entrants. A small number of facilities-based entrants could have made a stronger run at long-term local market survival.

Now an analysis of the NextWave mega-debacle, a case that should become a business school classic on how not to conduct federal agency public policy.

Spectrum Follies: The 'C' Block Auction

In 1993 Congress allocated 200 MHz of new spectrum for private use, tasking the FCC with allocating radio licenses by auction. Included in the law, however, was a provision directing the FCC to set aside a block of spectrum for "designated entities"—firms owned by women, minorities or small business. The Supreme Court struck down the gender and race categories as unconstitutional, leaving mom-and-pop providers as the sole survivor.

In 1996 the FCC auctioned off the "C" Block of spectrum, with NextWave posting a winning bid of $4.74 billion for one license. The bid was made with a nod to the 1995 FCC announcement that after auctioning "C" spectrum, auctions for Blocks D, E and F would follow, albeit no specific date was set.

To facilitate NextWave meeting the financial requirements of winning bidders—timely payment for licenses, failing which bidders would forfeit their licenses—the FCC permitted "C" Block winners to pay by annual installments spread over ten years. NextWave made the first payment, but could not raise the second one, despite a thirteen-month payment deadline extension granted by the FCC.

NextWave filed for bankruptcy protection, and (no surprise) litigation ensued. NextWave cited a provision of the 1998 revised bankruptcy statute that prohibits agencies from denying bankrupts licenses, solely due to their financial distress; the FCC cited its motivation as regulatory—freeing up spectrum—rather than punitive, and claimed that thus the bankruptcy protection provision did not apply.[8]

Before litigation was complete—perhaps earlier than "C" Block bidders anticipated—the FCC re-auctioned the NextWave spectrum, and Verizon won with a $16 billion bid. To make a long story shorter, an appeals court ruled that the FCC had to return the spectrum to NextWave. Negotiations between the parties failed to settle the issue, and the case went to the Supreme Court, which heard oral argument October 8, 2002.

It is famously hazardous to predict how the Supremes will decide any case. This observer heard the argument, and believes that NextWave will prevail. This would put the NextWave license back in the hands of a company that could not find funding in the far more felicitous financial climate of 1998-1999, and surely will not do so now. So, as happened with the cellular lotteries in cellular's first decade, unqualified winners will reap a financial windfall by "flipping" their licenses. And barring a change of the law by the next Congress, bankrupt firms will be able to keep licenses regardless of communications policy implications.

Which brings us back to Square One: WorldCom. If the firm discharges most of its debts in bankruptcy it will then have a huge cost edge over its long distance rivals. AT&T and Sprint could follow WorldCom into Chapter 11. They may well do so anyway, but this will hasten the process. The long distance carriers could then be acquired—quite possibly by the surviving local companies. There are sound reasons for letting this happen—long distance is truly no longer a stand-alone business, and thus vertical re-integration makes economic sense.

Should Bad Behavior Be Rewarded?

A second viable alternative, suggested by American Enterprise Institute resident scholar J. Gregory Sidak, is for the FCC to take WorldCom's radio licenses away for violation of the "good character" requirement imposed on all licensees. Massive financial fraud, and deliberate over-hyping of Internet traffic volume, would seem to provide sufficient basis for the agency to do so. When multi-million dollar fines are levied against Bell companies for failing to provide precise parity of equal central office access to their competitors—a far lesser offense by any reasonable calculus—punishing WorldCom seems appropriate.

Apparently, the Feds Say Yes

But that runs counter to certain sentiments in Washington. Rather, "saving" WorldCom is front and center stage. This means perpetuating certain sustaining subsidies without which the carrier might be auctioned off in pieces. This would preserve the familiar "Big Three" long distance market, at least, for a time. It is also the worst possible policy option by far. Propping up failed carriers siphons traffic away from currently solvent carriers. This is precisely what happened when the FCC propped up CLEC entrants with an artificially low local central office access pricing regime, vastly inflating the number of new entrants into local telephony, and injuring the few solid entrants who tried to build new facilities.

The bankruptcy court is a key actor, allowing WorldCom to suspend payment of $750 million per month to local carriers for interconnection services.[9] Thus the Bells are now bankers. Bankruptcy courts need not take into account the state of competition in telecom markets; helping the bankrupt settle with creditors takes precedence over telecommunications policy. And therein lies danger. Flawed short-term settlements can have a baleful long-term impact on market evolution.

Saving WorldCom: Cui Bono?

Winners: WorldCom management and bankruptcy attorneys, either in a re-organized WorldCom or as part of existing firms without WorldCom's negative brand name value. Losers: telecom industry investors, and the national economy, which needs a revitalized telecom sector to accelerate economic growth. Indeed, if policymakers are not careful, this one has the potential to be a much bigger train wreck than was NextWave, hard though it is to imagine.

NextWave, after all, ties up one segment of radio spectrum, until a qualified buyer builds new facilities; or else, no one enters a bid for it—given the saturation of wireless markets, with many having at least five entrants already—and NextWave pays the price of its refusal to settle on reasonable terms with Verizon. But the WorldCom mess, if perpetuated by saving the company, can cripple the long distance market for years by impeding economically desirable market consolidation, which in turn will hamper future Internet broadband traffic growth as well.

What about the "Too Big to Fail" Doctrine?

There are, of course, precedents for bailing out firms. Notable in recent decades were the bailouts of Lockheed and the auto companies. But these were different cases. Lockheed was a major producer of top-quality military hardware, such as the Stealth program. And the automotive industry was, twenty years ago, still the heart of the old economy, with the new economy yet to emerge.

A recent report from a consulting outfit, Eastern Management Group, argues strongly that WorldCom's demise would not sink the telecom sector, the economy, or leave Granny without access. In this view, WorldCom is a company less like a department store than a shopping mall, with easily separable product lines. Thus, it can be acquired in parts by several different carriers, without disrupting industry service.

The report goes further, by contradicting the oft-cited 50 percent figure for WorldCom's share of Internet traffic, citing a report that pegs WorldCom's true share at 15 percent (rather than 50); that number is in turn estimated as fractionally less (i.e., a difference smaller than one percent) than a similar 15 percent traffic share held by AT&T, while AT&T revenues reportedly lag slightly.

According to Eastern Management, 95 percent of Chapter 11 bankruptcies result in asset liquidation. WorldCom's 126 voice and 30 data switches in major markets would thus be put up for auction. WorldCom, Eastern notes, is not ranked first in any of its business. Its much-touted data service is strongest with medium-sized business customers (100 to 500 employees), while its residential base (20 million) is essentially MCI's old customers.

None of this has swayed the federal government, which recently awarded yet another major government contract to WorldCom. By contrast, New Jersey has shown refreshingly higher standards, having taken away from WorldCom the management of the state's electronic EZ-PASS network.

Eastern concludes that "the chances that WorldCom's demise will cause harm to the telecommunications sector are non-existent"; rather, customers will be "guaranteed the same level of, if not superior, service." Eastern may be optimistic, but the experience with the 1984 Bell System break-up suggests that disruptions will be short-run, and eventual equilibrium reached (which does not mean that divestiture was a good idea—in this writer's view it was an awful one). Indeed, customer and market dislocation in 1984 was surely vastly more severe than anything that one might reasonably expect from sundering WorldCom and auctioning its parts.

Bring on the Silver Cross and Wooden Stake—Now!

Count Dracula must be stopped before he sucks the financial blood out of the core of the telecom industry. The cost structure of the industry must be rationalized for market forces to work. Either let WorldCom go bankrupt, forcing the downward revaluation of other long distance carriers, or take away WorldCom's radio and operating licenses, as the first step in an industry re-structuring that must take place if growth is to resume. But under no circumstances should the FCC or the bankruptcy court artificially prop up WorldCom so as to preserve, for a time, the world of the familiar. Doing so not only harms healthier carriers, but would severely impede the vertical re-integration that is essential to recast the telecommunications marketplace in accordance with technological and economic realities.

[ET CETERA]

A Handshake for the History Books. The world's first trans-oceanic "handshake" was attempted Tuesday, October 29, 2002 by sending touch sensations over 5,000 kilometers of fiber-optic cable. Tactile sensation is created through a "haptic" interface, in this case touching a special pencil-type device to a computer screen. Participating are scientists from MIT and University College, London.[10]

Yesteryear's Retort? Henry David Thoreau was not impressed with the telegraph or cable. In *Walden* he wrote of the telegraph: "We are in great haste to construct a magnetic telegraph from Maine to Texas, but Maine and Texas, as it may be, have nothing important to communicate."[11] (The Bush clan, one suspects, might disagree.) The great cable fared no better: "We are eager to tunnel under the Atlantic and bring the Old World some weeks nearer to the New; but, perchance the first news that will leak through into the broad, flapping American ear will be that Princess Adelaide has the whooping cough."[12]

Bankruptcies are a painful, if necessary, part of economic life. Averting one, if it causes others that might be avoided, is no recipe for market stability. The feds should resist the temptation to save the company which perpetrated the worst fraud in financial history, and did more than any other firm to amplify the magnitude of the catastrophe that befell the telecom industry. Far from being "too big to fail," WorldCom is too big NOT to be allowed to fail.

[1] "WorldCom CEO Defines Challenges, New World of Business." Infoworld.com, October 18, 2002. < http://www.infoworld.com/articles/hn/xml/02/10/18/021018hnsidgmore.xml >

[2] Remarks of Michael K. Powell at the Goldman Sachs Communicopia Conference, New York City, pp. 3-4, October 2, 2002. < http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-226929A1.pdf >

[3] Darby, Larry F., Eisenach, Jeffrey A., Kraemer, Joseph S., "The CLEC Experiment: Anatomy of a Meltdown," Progress on Point Release 9.23, September 2002). < http://www.pff.org/publications/POP9.23CLEC.pdf >

[4] Id., p. 1.

[5] Id., p. 2.

[6] Id., pp. 12-15.

[7] Id., pp. 16-20.

[8] NextWave argued that by auctioning off the D, E and F blocks so soon after the C auction, the FCC destroyed the value of NextWave's licenses. But NextWave knew about the impending auctions, and took the risk that they would happen sooner rather than later.

[9] Estimate provided by Walter B. McCormick, Jr., President & CEO, United States Telephone Association, at Progress and Freedom Foundation's Aspen Summit 2002, August 20, 2002.

[10] "MIT and London Team Report First Transatlantic Touch," MIT News, October 28, 2002. Hand-to-brain signals take 30 milliseconds, whereas signal propagation delay in the oceanic link currently run 150-200 milliseconds; reducing the delay will improve the "feel" of the interaction. < http://web.mit.edu/newsoffice/nr/2002/touchlab3.html >.

[11] Gordon, John Steele, A Thread Across the Ocean, p. 70 (Walker & Company 2002).

[12] Id.

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