

**Testimony of Michael J. Price  
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Industry and Broadband Deployment”  
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**The Telecom Mess: How did we get here and how are we going to get out of it?**

My name is Michael Price and I am Vice Chairman at Evercore Partners a private equity and advisory firm based in NY and LA. We have 2 private equity funds that invest in growth capital and one venture capital fund. Our advisory business focuses on strategic corporate services and restructuring. I have spent 20 years in the investment banking and telecom industries. In 1987, I joined Lazard Freres and ran their global telecom and technology practice. While there I was responsible for the sale of McCaw Cellular to ATT, SBC’s acquisition of PacTel, the breakup of US West into Media One and US West, and the sale of MCI to WorldCom. In 1998 I left Lazard Freres to start FirstMark Communications Europe and raised \$600 mm to build a competitive carrier in Europe.

As an active participant, I have firsthand experience in the dramatic growth of this industry, as well as its contraction. I have watched the power shift from the incumbents to the upstarts, and now back to the traditional participants, the RBOC’s and the cable companies. However, the current state of affairs is more dire than it has ever been. We are simultaneously fraught with excessive competition, fragile balance sheets, regulation which is constraining investment, declining profitability and bankruptcy laws, which recycle assets and allow them back to be competitive with those companies that have not restructured.

Furthermore, technology is finally creating alternatives for consumers to feast on. Wireless is an effective substitute for the landline telephone. Satellite is an effective substitute for cable TV, broadband internet may one day be a substitute for the cinema as video on demand takes off. These dislocations change the power of the participants.

Today I would like to present you with my views on what led to the current telecom meltdown and highlight three observations about industry structure that need to be addressed and one legislative proposal for you to consider, which in my view, will lead to a more rapid recovery of this sector.

**First, how did we get here?**

The Telecom Act of 1996 created unbridled enthusiasm about the opportunities available to new

telecom competitors. Unfortunately, it also created a consumer friendly frenzy that is economically unsustainable. It has destroyed the profitability, and balance sheets of some of America's most important companies. In essence, we have too much competition, particularly in wireless, and backbone transport.

Early successes like MFS and Teleport proved that investors could make money supporting competitive telcos. Extrapolation of early successes in the marketplace ignored the difficulty in gaining significant numbers of customers and assumed little competitive response from incumbents. In the late 90's, we believed that telecommunications was a rapid growth industry, as early internet growth was estimated at 100% per quarter for several quarters. This forecast gave proof to the capital markets that demand was indeed boundless. Following the closure of Napster and the rapid achievement of high internet penetration, internet growth returned to a much more normal pace. However, the future perceived "demand" curve of that moment in time in 1999, dictated the capital budgeting commitments for the next 18 to 24 months. At the same time, dense wave division multiplexing (DWDM) and other next-generation technologies multiplied available capacity, leading to the massive oversupply with which we are now faced. These points we chronicled in last Thursday's Wall Street Journal.

Wall Street responded enthusiastically to the "Telecom Growth Opportunity" raising over a trillion in capital and spending in this industry dramatically increased with North American telco equipment capital expenditures rising from \$28 billion to \$123 billion from 1990 to 2000. While capital expenditures in this industry dropped to \$110 billion in 2001 and is expected to drop to \$78 billion in 2002, this is still above inflation adjusted 1990 numbers of \$39 billion. Thus, if we return to pre-wireless, pre-hype spending levels, Nortel, Lucent, Corning and Motorola will see their sales decline further.

### **Bankruptcy Laws Are A Problem**

The good news about telecom deregulation is that it was extraordinary successful in bringing new entrants to the market and creating new choices for consumers. The bad news is that it created too many competitors who did not have customer bases and this has resulted in stranded capacity, like the railroads of the 1880's, which will take years to disappear.

Normally the free markets eliminate capacity, however, our bankruptcy laws allow companies to be reorganized. In Europe, assets are liquidated. In the United States, management teams that have overextended themselves, get to wipe out their debt in Chapter 11, and start with a cost advantaged capital structure relative to those that have managed their businesses prudently. This means capacity does not go away.

In an industry where we have fundamental oversupply, we have a structural flaw, which in fact encourages the perpetuation of this oversupply. This recycling of assets, with their debt free capital structures will put pressure on the "still" strong balance sheets. Thus, the complete "capitulation" is still some years away. Chapter 11 is a path to liquidity, not a path to capacity reduction.

My first point is that our bankruptcy laws will actually lengthen the time period for this industry to

recover, and this needs to be appreciated when prescribing ‘fixes’ for this industry.

### It’s all about Industry Structure

My second point is that we have too many competitors, particularly in the overcapitalized wireless industry. Michael Porter provides a framework for evaluating industries structure in terms of the power of buyers and suppliers, the barriers to entry and exit and switching costs. The below chart summarizes the competitive nature of the telecom industry as compared to the airline industry.

	Wireless	Local Wireline	Cable	Airlines
Power of: -Buyers -Suppliers	High Medium/Low	Medium Medium/Low	Medium Medium/Low	High High
Barriers to: -Enter -Exit	High High	Medium High	High High	High High
Switching costs for consumers	Low	Medium/High	Medium	Low
Number of competitors per market	6-8	Residential: 1-4 (UNE-P, cable and RBOC, wireless)  Business: many (Multiple CLEC’s, IXC’s, RBOC)	1 - 3 (satellite)	1- 4 (per route)
Key Industry Issues	Excess competition, low switching costs, lack of product differentiation	Competition from wireless and cable, regulation (what is the true cost of UNE-P?)	Competition from satellite providers, leverage with media companies, balance sheet leverage	Labor unions, low product differentiation, supplier concentration

Using this analysis, the attractiveness of the wireless industry is only slightly better than the airline industry due to the airline's labor and concentrated equipment supplier issues. However, the larger number of (currently) well-financed wireless competitors may make its prospects worse. It is important to remember when thinking about this comparison that the cumulative net profitability in both the airline and US wireless industry is negative.

The wireline industry is entering a battle with cable. While the intramural broadband wars have begun, and are painful for the ILEC which lose money on each DSL line sold, the real fight, over residential voice, has not yet begun. The outcome of this fight will determine the fundamental shape of the industry for the next generation.

So where do we go from here?

### **Wireless:**

Six, seven or eight competitors are too many for a maturing, capital-intensive industry, where the switching costs for the consumer are near zero. Recently, US wireless penetration reached 50%. While minutes of use have grown dramatically in the last three years (447 per month for 2002 vs. 171 for 1999) and total revenues have grown materially (\$65 billion in 2001 vs. \$33 billion in 1998), we are entering the final stages of this industry's growth. We may be entering a phase where the elasticity of demand for voice services approaches one, i.e., increasing number of minutes leads to flat or negative revenue. When this condition occurred in the long distance industry in the late 90's competition became cutthroat. Furthermore, the industry is not yet suffering from the churn caused by number portability.

The wireless industry's capital structures are under tremendous strain due to next generation upgrades and marketing costs. In 2002, the wireless industry is expected to have \$0 in free cash flow (EBITDA less capital expenditures) while it struggles under \$84 billion of net debt.

A recent report indicated that for the wireless industry to earn 10% return on invested capital, given the existing invested capital base, and the current profit per subscriber, the industry would have to double the number of subscribers, without investing any additional capital, and with no pricing degradation. Since this is unlikely, and as capital needs a return, only two conclusions can be made — consolidation must occur (to share the invested capital plant), or competitors need to leave the industry.

The European wireless market provides evidence that the existence of 3 or 4 competitors still maintains a high degree of competition. In Europe, wireless competition remains fierce and penetration has reached 87%.

My view is that the same competitive environment would exist in the US if there were 3 or 4 competitors. Remember that in the late 1990's, in the highly concentrated long distance industry where three players - ATT, MCI and Sprint, had 80% market share - competition was intense.

The long distance industry, like the wireless industry, has no switching cost.

Beyond allowing consolidation, the government should give wireless carriers additional spectrum at little or no cost. In an engineering context — spectrum is a substitute for capital. We can strengthen the remaining carriers if we allow them to have 60-70 mhz of spectrum each, and make it available at low cost. This will allow the remaining strong carriers to be a truly effective alternative to the landline communication network and provide other broadband connectivity options. It will also lead to the RBOC's competing with each other, which ought to be a broader public policy objective.

### **Wire Line: They Are Not as Strong as They Seem!**

With huge cash flow, EBITDA margins over 40% and relatively strong balance sheets, the RBOCs appear to be the stalwart of this industry. However, this trend is changing.

Aggregate access lines at SBC are down 4% from last year but retail access line growth was down 6%, the difference being low/no profit wholesale access lines. It is clear that the RBOCs are facing stiff competition from the wireless and cable companies.

With the improvement in coverage in the wireless services, home phones are becoming optional. Several providers, including Leap Wireless and MetroPCS are pursuing a strategy of landline replacement. Leap estimates that in some markets 26% of its customers have dropped their home phone. According to USA Today, one of 5 Americans think of their cell phone as their primary phone.

Further, the cost advantage of the cable plant is an emerging reality. Coax cable technically has more capacity for a given level of technology expenditures than a copper loop. The average charge for high-speed internet service by the telcos (DSL) is \$51 per month and the average cable internet service is \$45 per month, and \$10 per month less if you are already a video subscriber. This pricing advantage allows cable to capture 2/3 of all broadband customers.

DSL is a transitional product, which has less capacity than coax cable plant. Eventually, the RBOCs will have to spend billions up upgrade their networks to fiber just to compete. Nationwide, the estimate is \$100 billion to bring fiber to every home. If they do not have the profits from existing services they will be unable to afford the fiber upgrade.

Cable's cost advantage is also due to its lack of regulation. It was effectively freed from price caps 6 years ago and cable operators now have upgraded their plant to provide high speed internet and digital cable. In 2 to 3 years cable telephony will be implemented using voice over IP at very low incremental costs to the cable TV provider. This points to the benefit of regulatory freedom.

The so-called cable triple play (voice, video and high-speed data) will allow it to offer all of the

services of the RBOC, plus video, for a lower total cost.

When I recently surveyed a group of telco executives and asked which they would give up first, their home phone or their cable TV, the answer was unanimously the home phone.

The residential voice business traditionally had one strong competitor — the RBOC, a monopoly. Today, facilities based alternatives to residential voice, include six wireless competitors, with at least one of these wireless competitors offering a landline quality product. In the near term, the entry of the cable company into residential voice will add additional facilities based competition. Furthermore, UNE - P's are allowing ATT and MCI to capture local customers.

In this regard, the Telecom Act is an apparent success. We have both facilities and non-facilities based competition. While the RBOC's still have 80-90% market share in residential voice, Verizon Wireless the largest wireless company has only 25% market share in wireless, and the telco industry has only has 33% market share in high-speed internet. So, in the "next gen" platforms, the monopoly is waning, and either the rest of market, in the case of wireless, or cable in high-speed internet access has the dominant share. But in the historical monopoly business — residential voice — competition is here today, before cable launches VOIP.

The question for this Committee, and the FCC, is if facilities based competition has become a reality, when should the regulatory environment be changed.

### **The Need for Broadband:**

We are in a telecom and technology depression. With 500,000 telecom jobs lost, hundreds of bankruptcies and two trillion dollars of wealth lost, the effect of telecom bust have been wide spread. The trend of recycled bankrupt assets becoming economically viable again, will only serve to hurt the strong players of today in the years to come. Just as the 1930's economy needed a "New Deal", today, we need a Technology New Deal.

My proposal would be a subsidy paid to the provider to stimulate broadband demand. The problem with broadband is that it simply costs too much. At \$20 per month, America has over 60% narrowband internet penetration. Bill Gates has suggested broadband should cost \$25 per month — it currently costs 60-100% more. Broadband penetration in Korea is 60% as the cost of broadband (\$22) is almost the same as narrowband (\$20). America will fall behind other nations if we do not have pervasive residential broadband.

To foster broadband penetration, I would suggest a \$300 per subscriber subsidy be paid to the provider, if the provider agrees to provide high-speed service (defined as 384 kbs or greater) for under \$30 per month for a three-year period of time. The payment would be made on the basis of net adds so the carrier would receive no benefit for churn. If we created this incentive for the 20 million new broadband homes the cost would be \$6 billion, probably over 2-3 years.

The secondary consequences would be dramatic. Tele-medicine, e-learning, tele-commuting, and e-commerce would be more pervasive. Software, hardware, equipment companies and cable and telcos would all benefit. With a large enough installed broadband base, Hollywood will be forced to solve the digital rights issues that will eventually enable entertainment content to be broadly available over the internet. This will be the killer-app that will massively stimulate further broadband demand.

The Korean market benefits from greater density (more apartment buildings, smaller cities), which has led to the lower cost to provide broadband and thus spurred its adoption. An American company ON2 is currently selling VOD using DSL in Korea. It cannot find a market here in America. Once broadband penetration reaches 30% (up from 10% today) the cost structure of the entire industry will decline and these prices will be able to be maintained, eliminating the need for any possible extension of the subsidy.

### **Conclusion:**

Without a change in the regulatory environment, there will be no catalyst to revive investment in wired and wireless networks. The equipment manufacturers will not survive the cutbacks the carriers are making in their capital budgets. Lucent and Nortel have reacted by partially reducing their spending in next-gen technology. If this continues, the US will lose competitiveness. Already Nortel has cut back its investment in its world leading optical technology. How much longer do we expect Lucent, which is projected to lose \$3.5 billion this year to fund Bell Labs and where would this country be without Bell Labs?

Without a rebound in carrier spending within 24 months, Corning, Lucent, and Nortel will either be bankrupt or become subsets of their current capabilities.

### **I leave this committee with 3 observations and the aforementioned proposal:**

1. Our current bankruptcy laws, which allow stand-alone restructurings, will perpetuate the over-capacity that will plague this industry for years to come by maintaining excess capacity and creating “low cost competitors”. WCOM without its \$30 billion debt burden may now really have a lower cost structure than ATT.
2. The wireless industry resembles the airline industry and needs to be consolidated and, GIVEN more spectrum. If they cannot earn an acceptable rate of return on new equipment due to overcapacity — they will not innovate new services and continue to invest.
3. The historical regulation of telcos needs to be reexamined in light of the changing competitive environment, cable’s superior technology plant and the increasingly quality of wireless offerings. Their current regulatory regime may be appropriate in a monopoly context, but the RBOC monopoly is rapidly waning.

4. No matter what constructive action this Government could take to the previous three issues, it will not solve the industry's problems for a meaningful time to come and thus this industry needs a Technology New Deal to stimulate broadband demand.

When considering the need for economic stimulus, I ask this committee to consider this proposal in the backdrop of our overall economy, where the airline industry is deeply troubled, the consumer is becoming weary even before a possible war, and the auto industry may be "stuffing" the channel, with unsustainable free financing. In fact, the auto industry today, reminds me of what Nortel and Lucent did for their customers in the late 90's in financing purchases they cannot afford.

Without some "HELP" the technology and telecom markets have little prospect for recovery until 2005. My hope is that with a broadband stimulus bill we can enliven the broader technology, media, telecom and entertainment sectors by creating a new pervasive communication medium called BROADBAND.

Thank you Chairman Hollings and members of this Committee for inviting me to share my views.