House Committee on Financial Services
Subcommittee on Domestic Monetary Policy,
Technology and Economic Growth

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Mr. Chairman and members of the Subcommittee:

It is my pleasure to discuss with you issues related to capital formation in the telecom market. As a vice president at Schwab Capital Markets Washington Research Group, I work with a staff of analysts that examine the regulatory, legislative and political factors affecting investments in various industries, including telecom, technology, energy, health care, financial services and international trade. We work with institutional investors to address their concerns in these areas.

It was only a couple of years ago that the telecom and technology markets were ablaze. Equity values soared and capital investment was flowing into these sectors.

But as we all know, telecom and technology have suffered a meltdown. Telecom carriers, pursuing a land rush mentality, assumed substantial amounts of debt to build and expand the reach of their networks. The bursting of the Internet and dot-com bubble undermined a major portion of

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the customer base for telecom service providers. A slowing economy exacerbated the situation. Despite optimistic projections of data growth, the supply of capacity from multiple long haul providers fostered a disruptive pricing war in the core of the network. Revenue struggled to keep up with debt service obligations. We have seen numerous bankruptcies and threats of more to come.

Regulators struggled to promote a climate hospitable to the objectives of the 1996 Telecom Act. The Act offered to promote local competition by requiring incumbent phone carriers to open their networks to competition, primarily by allowing the resale of local services or the leasing of network components on a wholesale basis. In return, the Regional Bell Operating Companies would be allowed to enter the long distance market. But litigation ensued as the FCC's authority to administer key parts of the Act, particularly the Commission's authority to adopt rules governing the establishment of wholesale rates, created regulatory uncertainty. The FCC's authority here was sustained but it took several years to resolve. Meanwhile, the competitive carriers and incumbents battled over the conditions, terms, quality and timing of access to incumbent networks. Delays in providing service meant delays in the collection of revenues needed to cover operating costs and debt service.

The investment community obviously suffered along with the telecom carriers. They were enthusiastic about the promise of telecom competition and the migration to new and exciting data

services over upgraded networks. To a great extent, investors believed that expanding telecom networks to allow flexible configuration of services to customers in all major metropolitan areas offered the greatest potential upside in the new telecom environment. But building networks in all major cities required the assumption of huge amounts of debt. The Association for Local Telecommunications Services reports that competitive local exchange carriers (CLECs) invested over $56 billion in new networks between 1996 and 2000. By some estimates, from 1996 to 1999, phone carriers raised more than $80 billion in below-investment grade debt to finance construction of networks. Capital expenditures for the industry rose steadily from 1996 through 2000 but have declined since then.

A variety of factors pressured the revenue growth of upstart telecom service providers. Competition for high volume business customers led to disruptive pricing as carriers attempted to achieve revenue targets regardless of profitability. Internet service providers struggled and went out of business, disconnecting service or cutting back demands for service. Regulatory actions cut back projected revenue from reciprocal compensation, the fees carriers charge other carriers for bringing calls to Internet service providers. The economic slowdown worsened a difficult situation. The expansive revenue growth anticipated from new data services failed to materialize. Meanwhile debt burdens continued to squeeze upstart carriers. Investors pulled back, refusing to invest additional money in telecom service providers. Suddenly, the emphasis was on cash flows rather than the reach of a provider's network.

As illustrated by the last couple of years, it is difficult to make a business work when it requires massive upfront investment and entails substantial customer acquisition and retention costs. Severe price competition among multiple carriers, particularly in the long haul space, presents another factor that further undermines the ability to generate sustainable revenues and service debt. High debt levels impair the ability to acquire additional financing or generate cash flow for investment in new services or business growth. Ongoing regulatory battles between incumbent and competitive carriers have increased regulatory uncertainty in the sector. At this time, there is little growth in the telecom industry. Without profit growth, there are few incentives to invest.

But despite the downturn in the industry, there is room for optimism. A necessary shakeout will mean inevitable consolidation and the survival of carriers with the most sustainable business models and financial structures. New data services and other offerings will continue to leverage upgraded telephone, cable and wireless networks.

But the healing process will take time. Carriers are reluctant to assume additional debt, a factor discouraging industry consolidation. Meanwhile, the burden of maintaining networks and upgrading them to add capacity or provide new services remains a costly exercise at a time when adoption rates for new services lack visibility. But technology is forcing the migration to new

service models. Telephone carriers face competitive pressure from wireless substitution, IP telephony and instant messaging. Broadcast and cable operators face a fragmented audience among numerous video offerings that pressures traditional advertising models. Commercial wireless service providers are making critical investments in data services. Although futurists may be excited about today's telecom opportunities, reluctant investors fit the "once burned, twice shy" characterization. They want to see "killer apps" that drive penetration rates for new services. The pendulum has swung from irrational exuberance to abject pessimism. History teaches, however, that we tend to overestimate change in the short run, but underestimate change over the long run.

As Washington considers legislative or regulatory proposals to jump-start the telecom economy, some level of caution is warranted. Major initiatives lead to the inevitable legal challenges in federal court and the results are unpredictable. The resulting uncertainty can actually discourage capital investment. Moreover, legislative and regulatory actions cannot force changes in human behavior. As noted above, there is genuine excitement about the potential of new technologies and high bandwidth services. What is not clear is how consumers will embrace these new capabilities over wireline and wireless networks. What is the value proposition for these services? We don't need 100 Mbs for e-mail. Consumers and business are struggling with this question today. We must be realistic in our expectations of what government policy will accomplish.

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