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**MAKING MONEY AS A TELEPHONE COMPANY
RISKS, OPPORTUNITIES AND LIKELY FAILURES**

John F. McLaughlin
Executive Director
Program on Information Resources Policy
Harvard University
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Good evening.

I am here to talk to you tonight about a subject which I assume is close to your hearts, "Making Money in the Telephone Industry."

Before I go too far, I think I should warn you that this is a negative view of the subject. I expect to stand here and close more doors than I open! As a long-time bureaucrat and academic, I can assure you that I am much more proficient in telling you about strategies that probably will not work than those that will. If I was great at predicting things that will make money, I would be relaxing on a tropical beach with my wife at the moment, not singing for my supper here!

Smart people, however, do not avoid negative advice simply because it is negative. The essence of education is to learn from accounts of the experiences of others so you do not have to suffer their mistakes personally.

Two other preliminary warnings are in order:

I have cut the cloth of my ideas to fit the time available this evening. As a result, I will be making some highly generalized statements. Sweeping and as grating as they may sound, I assure you there is a lot of analysis backing up the conclusions.

A lot of my remarks concern the Regional Holding Companies. I am sensitive to the differences between the RBOCs and independents, but I think most of my comments apply to the entire industry, not least because the fate of the RHCs will do much to determine the fate of everyone else in the industry.

In the rapidly fleeing years since the famed "1/1/84," I have spent a lot of time with people in the telephone industry. I have tried to work with them to identify strategies that had a chance of flying in their markets and their public policy arenas, and strategies that did not stand a prayer. Here is how I see things at the moment.

THE PROBLEM FOR TELCOS

Let me start with the observation that the American telephone industry is largely a victim of its own success. In little more than a century since its birth the industry created what most people would agree was the best, most

efficient and most equitable telephone system in the world. This progress was achieved as a result of an historical "deal" between the telephone industry and the State, "the State" in this case meaning both federal and state governments. The essence of this deal was that the industry would invest lots of capital to wire up the nation, and also do lots of price averaging to encourage universal access to telephony. In return, the State promised the industry protection from competition. The State also promised the opportunity to earn a fairly healthy and predictable return based on your invested capital. It was a deal that seemed to work well for a long time, but it started to collapse in the 1970s.

The historical telephony deal dissolved for many reasons, but I would like to cite two:

1- "Universal service" became, for the most part, a realized ideal. Between the efforts of telephone companies and the regulators (via Lifeline services and welfare allowances for telephone service), just about everyone who wanted telephone service in the U.S. got it.

The result is that the State has a lessened interest in providing "universal service." For all intents and purposes, it has been achieved. That is what I mean about the industry being a victim of its own success. It is worth noting that this achievement was facilitated by the coincidental depopulation of many rural areas which highlights a second reason for the collapse of the historical deal between the industry and the State.

2.- To a great degree state regulated tariffs, the Ozark Plan for separations and settlements and the REA Rural Telephone Program reflected our rural, agrarian, and populist past. Politically powerful rural interests could extract subsidies from urban centers to provide low cost services to rural areas. The Supreme Court's 1962 decision in *Baker v. Carr*, commonly known as the "one person, one vote" decision, accompanied by drastic demographic changes, altered the political landscape for such urban-to-rural subsidies. As political representation increasingly reflected the demographic realities of American life, politicians, quite gradually, have shifted their votes. The Postal Reorganization Act of 1970, airline and trucking deregulation legislation (1978 and 1979), eased regulations for rail line abandonment and a host of other state and federal actions over the past 20 years reflect the political and demographic realities of modern America. The drastic "re-regulation" of our telephone industry during the 1980s has been one part of a larger political and social change.

As it happens, I do not think that our political representatives meant to harm local exchange companies as they started this process of re-regulation. The LECs were left with their local franchises and the Rate-Based/Rate of Return system that has served them well over the years. I think that our state and local politicians meant to leave the local operating companies in place, but I suspect that some of the pols wanted to force some reasonable productivity and rate improvements by allowing the door open to some competition around the edges of the franchise. Wittingly, or not, the re-regulation of the past decade has exposed LECs to two important vulnerabilities:

1.- Public policy has allowed, even encouraged, competition for business traffic within the local exchange franchise. This competition threatens to siphon away the "cream" of LEC revenues. I am talking about IntraLATA competition, competition among CPE vendors, competition among Inter Exchange Carriers with their proliferating Points-of-Presence, and the growth of alternative local carriers like Teleport and Metropolitan Fiber Systems. LECs may be guilty of crying "wolf" too early and too frequently, but the "bypass" monster is a real and growing threat.

2. Technology is undermining earlier assumptions about the value of the local franchise. Telephony was once a scarce good. Providing it to most users entailed building a capital-intensive infrastructure, entailing, in turn, a monopoly franchise and a high likelihood of a fairly certain return on investment. This situation led to Rate-Based/Rate of Return Regulation (RB/ROR) which made a lot of sense when communications infrastructure was expensive. Technology has changed. An ESS5 or a DMS 100 today costs half as much as either did only three years ago. The capital requirements of maintaining a high quality voice network, and expanding it to meet natural growth are now declining, not growing. This means, effectively, that LECs have ever-less justification for investing capital to maintain and expand their systems, which means, in turn, that their earnings, based on RB/ROR, are fated to long term decline. LECs can grow their businesses, but if they cannot justify ever larger capital investments, they cannot grow, or even maintain, their earnings.

To summarize the current environment: I would say that LECs are faced with increasing competition for current revenues and declining opportunities to harvest profits when existing or future revenues are based upon capital investment requirements fated to decline by technological realities. This looks like the proverbial rock and hard place!

FOUR STRATEGIES THAT PROBABLY WILL NOT SOLVE YOUR PROBLEM

A lot of LEC, RBOC, or RHC executives sensed or understood this problem early in the game, and pursued one or more of the following solutions:

1- We Will Make Money in "Unrelated" Businesses.

Some telco managers viewed their earlier telco franchises as straitjackets, not gifts. They believed "deregulation" or "reregulation" would give them license to make unlimited profits in unregulated ventures, ranging from retail computer stores and real estate management to software houses and vehicle fleet management.

Results in this area have been predictably bad. Most telco executives, having trained and matured in the regulated monopoly world of telephony, lacked both the knowledge and the instincts to thrive in new competitive worlds. Any entrepreneur or economist would have been pleased to tell these executives that there are not multi-billion dollar businesses lying about unexploited in a market

economy.

2- We Will Make Money in "Unregulated" businesses.

The two major "unregulated" businesses of most telcos are mobile cellular and yellow pages and it is pretty debateable whether the yellow pages business is really unregulated in most jurisdictions. While both cellular and yellow pages show that telephone companies can make money in fields related to their core telephone business, it is very hard to see new growth in either of these businesses proving to be a financial promised land for telcos.

Yellow pages probably will continue to contribute nicely to earnings, but everyone has been pushing rate increases, sales, book redesign and operating economies pretty hard for the past five years. It is hard to see the same growth rates continuing for yellow pages in the next five years. Besides, if earnings look too rich, you will be back on the mat with the regulators wanting "their" share.

The growth prospects for the cellular business look great, but it is difficult to see that being translated into mega-profits for telephone companies. The existence of a second carrier in every major market presumably will keep prices competitive and thereby limit profit margins. If the current duopoly does not result in price competition, I suspect we might see Washington emulating Mrs. Thatcher's approach of granting more and more mobile licenses until sharp price competition does result.

3- We Will Make Money in the "Prohibited Businesses," After We are Allowed In.

I continue to be perplexed by the number of telephone executives who are anxious to lose money in the three areas forbidden the RHCs by Judge Greene. As far as I can tell, there is not enough business around for those who currently manufacture CPE, switches, transmission equipment and other telephone related hardware. An RHC might bring something to some small niche market, but I do not see any goldmines created by removal of the manufacturing prohibition.

"Information services?" Maybe there is something there, but it is more smoke than fire for the foreseeable future. There are markets for voice store-and-forward, for gateways and for CLASS services, but these are markets requiring long term development and, they all are shared with many actual competitors.

Then there is Inter Exchange Carriage. Somehow I find it difficult to believe that many players will make much money if seven RHCs go charging into a highly competitive IXC market where prices have been plummeting for years. Seven RHCs in the IXC market would create a new definition for the term "bloodbath."

I do not believe that Judge Greene envisioned himself as a grand protector of RHC stockholders when he barred the RHCs from these three areas, but the stockholders should bless him every day because he did.

4- We Will Make Money by "Glassing America."

This brings us to the technocratic visionaries and their solution for all of your problems: Fiber optics to every home. The Electronic Highway. Information Infrastructure. The Information Utility. Brrroad Band!

As a financial solution to telephone company problems, fiber optic cable to homes ranks right up there with the magic Kool-Aid of James Jones. If you still have people in your companies selling this particular panacea, you should bundle them off to a techie Siberia where they should be incarcerated forever along with the Bell Labs and BellCore people who perpetuate this form of madness.

Crank a few numbers. The only tangible market for broadband services to the home is for video entertainment. In 1988 all of the CATV system operators in the U.S. generated \$13.4 billion in revenues from all sources. That includes basic and pay subscriptions, installation fees, advertising revenues and home shopping commissions.

A lot of analysts see future growth of CATV revenues as highly constrained. With cable now passing 85% of U.S. homes, there are fewer new potential subscribers being added to the base each year. There is increasing political resistance to price increases for basic cable service, while the availability of VCRs and cheap video rentals has cooled the growth of pay services.

Assuming that the telephone industry were allowed to compete for this market through deployment of fiber optics, the estimated entry price ranges from 150 billion dollars up to 400 billion dollars. And that is the price to compete with cable operators who have political friends, who know the business and who have plant in place today. If we assume that capital investment costs are at the lowest point in the range -- \$150 billion -- and, if we assume that you eventually captured half of the total CATV revenues -- about \$7 billion in 1988 dollars -- we are talking about gross return on invested capital of less than 5% per year. ($\$7/\$150 = 4.67\%$) And that totally ignores operating costs.

I do not know of any industry where numbers like these would invite entry.

WHERE TO NEXT?

I said I would try to shut some doors this evening. Perhaps I have been unduly harsh in my appraisal of these four frequently discussed strategies, but

I think some perspective is needed. In 1988 the average RHC had revenues of 10.6 billion dollars and net profits of almost 1.3 billion. Acquiring a neat little software company with annual profits of 10 million dollars does not do much for an RHC's earnings, especially if you are looking at declining profits in the regulated areas that produce 90% of RHC revenues.

All of the foregoing leads me back to my opening. Telephone companies traditionally made money because of their "deal" with the State. The lion's share of any telco's assets and expertise is invested in the regulated telephone sector. Making and keeping more money means leveraging those assets and expertise. And that means cutting a new deal with the State. If there is a single major solution to telcos' financial woes, it lies here.

I know that many companies have tried and are trying to craft new deals under a variety of labels. But I also would contend that few telcos have given the new deal-making activity a priority commensurate with its financial importance to the companies in the industry. Few have given the regulated core telephone business the same imagination and top management attention that they have been willing to invest in unrelated industries or overseas experiments. Too many telephone company executives still do not recognize the importance and urgency of coming to new terms with state regulators and other state and federal politicians that write the rules of the game.

Telecommunications is a business enjoying vast growth rates, and most telecommunications is local. You are local telecommunications companies. I think that if I were in your shoes, I would be spending about 90% of my management time and attention working with my regulators to come up with some new rules that allow my company to make money, and allow the regulators to look like winners, too. If you and your colleagues cannot envision such new arrangements, then I would suggest that top management devote most of its time to figuring out how one drastically down-sizes a telephone company. I suspect that is the remaining option.