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FCC En Banc Hearing on
Steps Toward Recovery In The Telecommunications Industry

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Introduction.

Good afternoon, Mr. Chairman and Commissioners. My name is Robert Konefal, and I am a Managing Director of Moody's Investors Service. On behalf of Moody's, we are pleased to appear before you today at your request regarding steps toward recovery in the telecommunications industry. We appreciate the opportunity to share our views with the Commission regarding the current state of the industry and the near-term outlook under the existing framework. As a rating agency, we do not take opinions on particular policy issues but instead we analyze the current and long-term ability of companies to service their debt. With respect to our assessment of the ability of telecommunications companies to meet their debt obligations, we believe that a distinction should be made between the long distance, local, and wireless subsectors because there are notable differences in credit quality and outlook.

Let me start by discussing Moody's and its role in the financial markets and then provide our views on the outlook for ratings of telecommunications companies over the next 12 to 18 months.

Moody's Investors Service is owned by Moody's Corporation, which is traded on the New York Stock Exchange. Moody's is the oldest rating agency in the world. Our roots can be traced to 1900, when John Moody & Company first published Moody's Investor Service focused on rating railroad bonds. As early as 1924, Moody's was rating nearly every bond in the U.S. bond market.

I will give a brief overview of what we do. Although Moody's rates a wide range of debt obligations, the heart of our service lies in rating long-term bonds, for which we have nine primary debt rating categories. Investment-grade ratings range from a high of Aaa, down to a low of Baa. Speculative grade ratings range from Ba to C. Overall, Moody's ratings are designed to provide a relative measure of risk, with the likelihood of credit loss increasing as the rating decreases.

It's equally important to note what our work at Moody's does *not* include. A rating is neither a buy nor a sell recommendation, nor is it a seal of approval. Rather our ratings reflect Moody's opinion of the relative creditworthiness of a fixed income security. Furthermore, just as we do not insure the bonds we rate, we do not audit the financial information provided to us.

As part of Moody's commitment to predictive ratings, we review the relationship between defaults and our ratings. We publish a study annually, which we call our "default study," which consistently shows that higher-rated bonds default less frequently than lower-rated bonds, although the rates of default vary over time. Our default studies show the predictive nature of our ratings. Put simply, as a forward-looking opinion, ratings effectively distinguish bonds with higher credit risk from bonds with lower credit risk.

Moody's strong record in evaluating relative creditworthiness is due in large part to the availability of reliable information. In order to analyze a company's ability to meet its debt obligations, Moody's analysts rely on a variety of information sources, including publicly available information that is filed with regulatory authorities or is otherwise available in the market; audited financial statements; third-party analyses of the company and the industry sector; and information provided by the company directly to our analysts. Although we do not have investigative authority, our analysts are encouraged to exercise skepticism with respect to an issuer's claims and promises.

We are constantly striving to enhance the quality of our ratings process. For example, we assign ratings by committee. Rating committees vary in size and generally include several senior analysts and one or more Managing Directors. A Credit Policy Committee and credit standing committees under the control of a Credit Policy Committee review ratings practices and policies internally. We continuously look at ways to ensure the rigor of our ratings process.

Outlook for Telecommunications Sector:

Now, let me turn to Moody's analysis of the telecommunications industry, which I am presenting based upon Moody's press releases and other publicly available information. It will likely not surprise the Commission that our outlook for the next 12 to 18 months for all segments is negative. However, we see the degree of negative pressure as most severe for long distance carriers and more modest for local exchange carriers and wireless companies. In the past year, we have downgraded companies with large long distance businesses -- such as AT&T, WorldCom, Sprint, and Qwest -- by multiple notches. AT&T and Sprint are now rated low investment grade, Qwest is rated speculative grade, and WorldCom, of course, defaulted. Looking at local carriers, we recently placed the Bell Companies -- SBC, Verizon and BellSouth -- under review for downgrade. However, the magnitude of the downgrades will be modest. As for wireless, most of the large operators carry negative outlooks, but are not under review. Near-term, we expect the Bell Companies and other ILECs to remain the highest-rated companies in the sector by a significant margin.

The question hanging over this hearing is: "What steps can the Commission take to put the telecom sector on the path to recovery?" That is an important topic and I am confident that others will have specific, although perhaps conflicting, policy recommendations to accomplish that goal. But it is important to realize that a number of forces acted together to put the industry in its current state. Clearly, for an industry as heavily regulated as telecom, government decisions have a significant impact. It should be no surprise that the emergence of a raft of new competitors, which were able to raise capital despite incredibly high risk, would have a negative impact on the large incumbents. This has happened in other industries. But technological advances have also had a profound effect, prompting massive capital investment by all carriers and contributing to the current capacity glut. Lastly, the telecom sector is not immune from the larger forces affecting the economy, which spawned the first recession in a decade. We believe that these forces all have a role in the future of the telecom industry.

Moody's notes a number of current concerns for the sector. One is weak capital markets, which makes debt refinancing more challenging. Another is disappointing performance, resulting in poor returns on the huge capital outlays for networks and acquisitions. Also, competition is fierce not only within segments, but across them as wireless substitution is becoming an increasing factor affecting local and long distance service. Finally, free cash flow generation is marginal or negative for many operators in relation to their debt loads. While free cash flow may be helped by capital expenditure cutbacks, such reductions in investment could compromise service quality or delay new product introductions.

Before I address each of the telecommunications industry segments, I want to reiterate that Moody's makes its predictions based on information it knows today. To the extent market factors and other information change, our rating assessments also may need to be modified.

Also, I want to underscore our role in the financial markets. Moody's does not advocate policy positions nor does it have a preference on the outcome of a rating, or on a particular regulatory issue or marketplace event. As a neutral evaluator, our job is simply to evaluate a company as best we can with available information, and if that information materially changes, then to reevaluate the company for a possible rating change.

With that caveat in mind, now I will address specific industry sectors:

Long Distance.

Looking first at the long distance sector, the future is not bright. We expect further declines in revenues and operating income. Increased competition has had a profound impact on market shares and prices. The market share losses by the big 3 long distance carriers will continue due to the entry by the Bell Companies and increased wireless substitution.

The weakness in the debt and equity markets is most pronounced for long distance companies and was exacerbated by the WorldCom meltdown. After a period of extensive investment, carriers are cutting back investment in infrastructure dramatically. The impact of WorldCom's bankruptcy is not clear. WorldCom customers may move their business and benefit stronger carriers like AT&T and Sprint. Pricing, after years of sharp decline, may stabilize, although RBOC entry into long distance is likely to keep the pressure on. We believe the prospects for consolidation are low. With so much excess long haul capacity, a horizontal merger does not make sense. A long distance/local combination makes more sense, if permitted, but the performance and debt problems of long distance carriers may prove to be a deterrent. Of course, we recognize that permitting a long distance/local combination would probably help the two companies involved but would have a negative impact on competing carriers.

Incumbent LECs.

Next, we turn to the ILECs. Our outlook for this sector is brighter, but still one that we rate as modestly negative. ILECs remain dominant in their markets despite access line losses. Their revenues and operating income trends are flat to slightly down. Free cash flow is positive, but the trend is flat and would be negative if not for reductions in capital expenditures. The key development is that UNE-P, resale, cable competition, and wireless substitution are now having a notable impact on the RBOCs' performance.

Looking out over the next 12 to 18 months, we expect a continued flat trend in revenues, operating income and free cash flow. We believe ILECs will suffer a further decline in market share to AT&T and possibly CLECs coming out of bankruptcy. We also expect the ILECs will continue to invest heavily in new facilities, focusing on DSL and long distance. As Section 271 approvals are granted, we expect the Bells to achieve a significant share of the consumer long distance market and a smaller but meaningful share of the business market.

Competitive LECs and Cable Industry.

It is perhaps telling on the state of the CLECs that Moody's has withdrawn coverage of many of them because they have defaulted, filed for bankruptcy, and are not issuing debt. But there is a question as to what happens when CLECs emerge from bankruptcy with their debt loads dramatically reduced. None of them attained the critical mass to become profitable, so that challenge remains. They also need new capital, which will be very difficult to obtain. However, some CLECs built substantial facilities-based networks and could still be a legitimate threat in certain cities.

Another competitive force is the cable industry. To date, cable companies have focused on upgrading their networks to offer digital video and high-speed Internet access and are winning the battle against the ILEC's DSL product, a lead we expect cable to maintain for some time. Longer-term, we believe cable represents a threat to the ILECs in voice telephony. Only AT&T Broadband and Cox are actively offering it now, but others may do so in several years as IP technology improves. The larger, stronger cable companies are nearing completion of their upgrades, experiencing growth in video and data, and should start generating free cash flow, which could help support a telephony strategy.

Wireless.

Turning finally to wireless, the outlook for this sector is also modestly negative. In their favor, subscriber growth is still strong, resulting in solid revenue and operating income growth. However, the rate of subscriber growth is decelerating. Also, most operators have negative free cash flow because investment needs remain so high. While average revenue per user has been relatively stable, pricing plans are granting subscribers more and more minutes, which affects network and spectrum usage and, ultimately, capital expenditures.

As the Commission is well aware, wireless operators spent heavily to build digital 2G networks. These investments have not yet generated a positive return on invested capital. Now they are investing heavily in 2.5G and 3G platforms, which limits their ability to generate positive free cash flow in the near-term. In our view, the CDMA operators Verizon and Sprint have the less expensive, less complicated migration path, while TDMA operators AT&T Wireless and Cingular face a more challenging and expensive migration path that requires an overlay of GSM technology. Furthermore, the success of 3G services is far from assured and may not justify the large capital investment. Finally, as subscriber growth slows, there is the possibility of more aggressive price competition. In the long run, we do not believe that markets can support six operators, and would anticipate either consolidation, if permitted, or attrition.

Conclusion.

We respect that the Commission is well aware of the state of the industry, and we thank you for allowing us to share our views on the various industry subsectors. As the environment affecting the industry changes in a material way, we will review all available data regarding ratings of debt instruments to determine whether any changes are warranted.

Thank you Mr. Chairman and Commissioners. I am happy to answer any questions.