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The Capital Markets Perspective on Competition In Telecommunications

Capital Markets infused a significant amount of capital into telecom industry from 1996-2001
Over $1 trillion dollars of capital was invested
Cable Industry alone spent $80B in past 6 years just in capex

- "Build It And They Will Come" was a popular saying during that time
- Networks were constructed and facilities-based competition emerged

Capital Markets Also Forgot Basic Finance - We Did Not Assess Risk and Thus Capital Was Effectively Free

- We focused on the supply side of the model and assumed the pie was dramatically expanding. We forgot to check the demand side of the model
- Corporations were increasing telecom spending 3% per year
- Consumer spending on subscription communications services remained at approximately 3.5% of overall household spending
- Wholesale market was really fueling the growth as it chased the traffic of ISPs, web hosting, and other new services all aimed at servicing the seemingly endless growth of the internet
- Trends were also masked by potential inappropriate company reporting

Result: We overfinanced the market because we did not appropriately consider risks. This was not the fault of policy makers

Today, stocks are down at all time lows for both telecom and cable. What you see is market anticipating impending head to head competition with a more critical assessment of risk - maybe overassessment

- Cable stocks are down due to satellite competition
- RBOC stocks are down due to cable and wireless and IXC competition
- IXC stocks are down due to wireless and RBOC competition
- Wireless stocks are down due to competition among themselves

It's fair to ask what has changed. These threats of competition existed before. The difference is the markets show me mentality

- Market unwilling to believe in future cash flow streams from new services until they appear
- Market therefore believes little to no expansion of industry pie
- All industry players are incumbents in at least one service therefore all have something to lose
- Consequently competition is viewed as a zero sum game

So how can the FCC assist in improving the situation

First in terms of the stock prices,

- I think it is important to recognize that your goals of introducing competition run contrary to market wishes. The market generally does not like competition introduced into a regulated industry because it many times threatens returns in the short term. The lack of certainty has only exacerbated the situation as the market listens to the rhetoric of both sides and tries to determine the winner. Certainty as soon as possible is important

Second, in terms of the balance sheets,

- The problem today is that the Investment Cycle is Stalled. The market has put the industry on a proverbial "diet".
- Nothing, in my opinion that the FCC can do. The market fueled the excess and now is taking it away

- Leaves one alternative for players. Find operational efficiencies or cut back on investment to fuel free cash flow to pay down debt. Once the debt is repaid, the market will once again provide capital if the opportunities are there

That leads us to the final question, which is how to encourage investment and return to growth

- **The UNE-P debate has hit a nerve in this area as it allows competition with limited investment in facilities** - although one should not underestimate the level of investment required to market, provision, care, and bill a consumer customer regardless of whether one owns the underlying network.
- **I believe the real question is whether the goal is competition today or facilities based competition** down the road. I can't tell you which one makes sense, only that the timing will be dramatically different. The market, in my opinion, will be reticent to fund any additional capital for facilities based competition. In addition, for cable at least, any free cash flow generated must be used to pay down debt. Some MSOs will be repaying debt for the next 4-5 years. Those that have free cash flow are waiting for IP telephony to reach scalability, which appears to be at least 2 years away. In addition, even with excess capital, the cable operator must make a choice as to whether to invest in telephony to fuel growth or defend their core video business, which is under attack. I believe it will be years before cable telephony is really beginning to be deployed in scale across the U.S.
- Having said that, I believe that if UNE-P rates are set too low, it will thwart facilities-based competition period by the cable industry. Today, however, IXC entrants are charging similar rates to cable telephony providers, which suggest returns for all. The real question is whether pricing competition develops.

So in summary, what the market needs is certainty and the ability to see the resulting competition proceed in the market and judge the results versus being buffeted by the rhetoric and projections of all companies involved today. So the challenge for the FCC in the eyes of the market is to provide some certainty, let the companies compete, and let the market determine which management teams innovate and survive.