

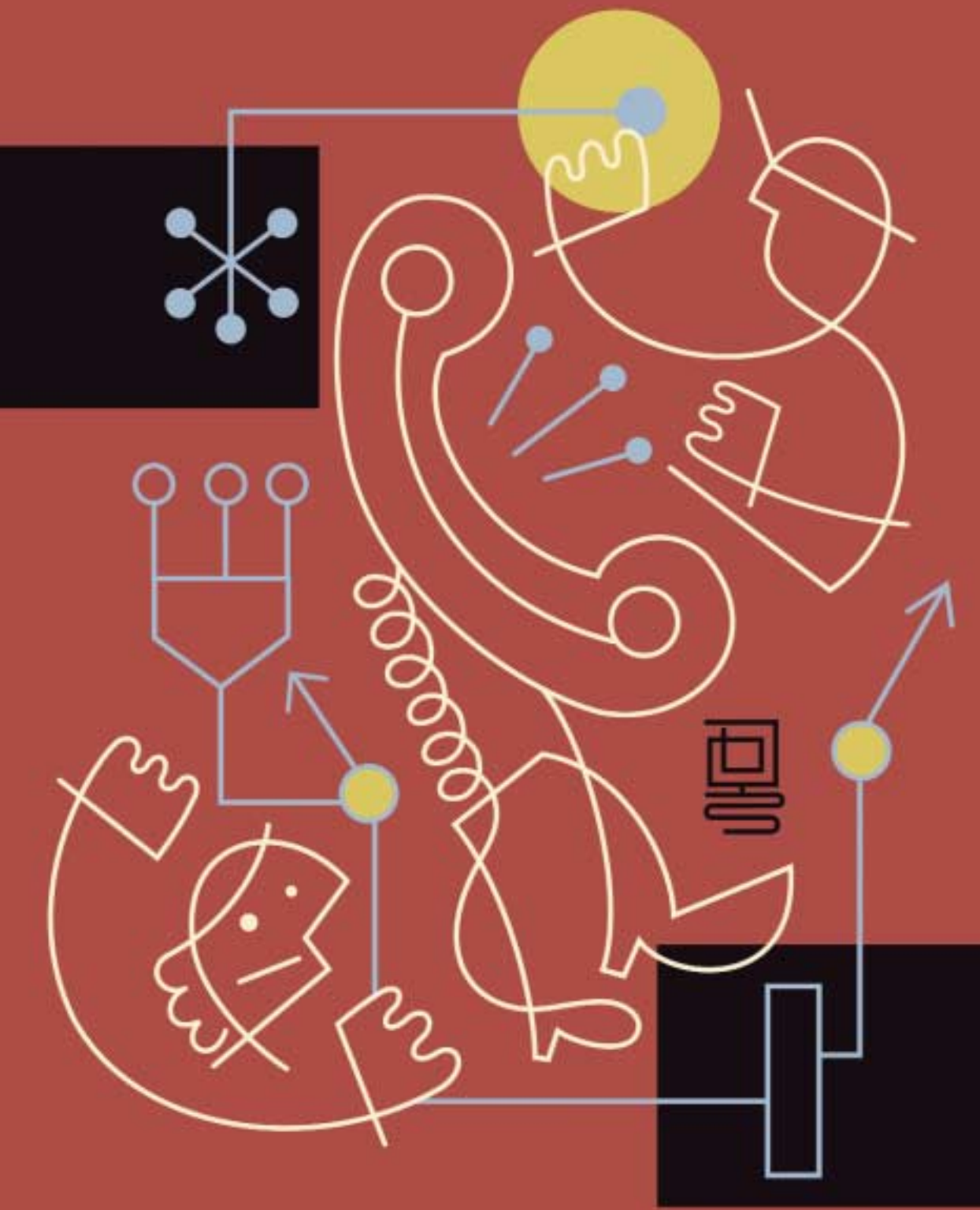
Weathering telecom's **dark and stormy** night

Rita Koselka

Reed Hundt, former chairman of the Federal Communications Commission, explains why the future still looks good for the telecommunications industry.

Deregulating US telephone services has been the holy grail of free marketers for decades. In the wake of a stock market bust that has hit telecommunications stocks particularly hard, *The McKinsey Quarterly* talked to Reed Hundt, a McKinsey adviser and recent chairman of the US Federal Communications Commission (FCC), about the future of the telecommunications industry and how to make deregulation work.

Hundt took over the FCC chairmanship in 1993, under President Bill Clinton, after a career practicing law. The biggest event of his four-year tenure was the passage of the 1996 Telecommunications Act, the first major legislative reform of the industry since the 1934 Communications Act, which made AT&T a regulated monopoly and established the principle of universal coverage (see sidebar, "Opening up the market," on the next spread). Hundt and the FCC designed the regulations to implement this reform and to translate its procompetition goals into reality.



Reed's revolution



Reed Hundt

Vital statistics

- 53 years old
- Born in Washington, DC
- Married with 3 children

Education

- Graduated in 1969 with history degree from Yale College
- Graduated from Yale Law School in 1974

Experience

- A partner at Latham & Watkins, Washington, DC (1980–91)
- Senior adviser to Clinton-Gore presidential campaign and subsequent transition team (1991–93)
- Chairman of the Federal Communications Commission (1993–97)
- Currently serves on board of directors for—among others—Intel and Novell

Fast facts

- Befriended former Vice President Al Gore in high school and former President Bill Clinton in law school
- Regards as his most important success a 1996 Telecommunications Act amendment that requires all schools to be attached to the Internet and provides government funds for that purpose

The Quarterly: What do you think about the telecommunications industry today and about the progress of deregulation?

Reed Hundt: Looking at the industry right now reminds me of Snoopy, when he writes the first line of his novel in the cartoon strip *Peanuts*: “It was a dark stormy night.” The big companies are burdened by debt; the new competitors are starved for capital; the equipment providers are on thin ice; and the component providers are seeing their revenue expectations unmet. It’s a brand-new experience for communications companies, which have been protected from downside risk as well as denied the upside of growing markets and rewards for innovation. But that’s our brave new world: now the old communications companies are supposed to face more competitive pressure and to become more innovative and efficient as a result.

The Clinton administration, Congress, and the FCC supported the 1996 act in order to increase

competition and to promote investment in the most important activity of the country, the information sector. This part of the economy was then about 7 percent of the whole, and five lanes of the information highway ran toward the future: broadcast, cable, wire, wireless, and satellite. Since the passage of the 1934 Communications Act, these had been legally separate industries; for the most part, none was permitted to compete with any of the others. Each was regulated so as to work well and to earn steady but unspectacular profits. FCC rules drew the dividing lines and kept the monopolies intact. The 1996 act busted this old world apart.

The Quarterly: That increased competition has made for some rough sledding. ICG Communications, Iridium, NorthPoint Communications, and Winstar Communications, for example, are in bankruptcy and others might follow. If the whole industry goes bust, it’s not good for anyone.

Reed Hundt: I'm not sure that's true. For the most part, the boom in building data networks will benefit the entire economy for years to come, but maybe not all shareholders. The bust might not be good for those who were in the industry before, but it will be good for those who shape the industry next. This sort of evolution has happened many times before. And the whole industry is far from bust, although I do think we need to see capital providers stepping up to the plate for new companies that are innovating and developing new technologies. The cable companies have upgraded their cables for broadband; the Bells have invested in DSL.¹ Those are new services to consumers, at low prices. The Bells' share of business customers—the most lucrative market—has dropped. The new competition is forcing the Bells to respond. There was a burst of investment in telecom infrastructure and research. Hundreds of billions were spent on IT in only a few years. This was great for the country, even if not all those ideas panned out.

Technologically, we have made vast improvements and discoveries. Don't forget that the coincidence of new technologies and a procompetitive legal framework caused the information sector to double its share of the total US economy from 1992 to 2000, even after the bursting of the dot-com bubble. Some companies may have managed their investments poorly or overinvested, but now there are countless miles of fiber that have been laid, and tower sites on hills, and satellites up in the sky that will be useful assets for decades. That's what competition was supposed to do. I think the markets and the public have been too negative. The US telecommunications

Opening up the market

In the 1980s, after a lengthy antitrust action, AT&T was broken up, leaving the US local telephone market split up among the seven Baby Bells and forcing Ma Bell to compete in the newly deregulated long-distance market. The 1996 Telecommunications Act was intended to open up the massive local telephone market and to stimulate competition among the Baby Bells, which could now enter each other's markets, as well as competition with companies pioneering new communications technologies, such as wireless telephony and the Internet.

The statute offered the Bells the right to compete in the long-distance market as well if they first opened their local wired markets to competitors. In the wake of this legislation, new companies, such as the competitive local-exchange carriers (CLECs), emerged and became stock market stars—ICG, Teligent, and Winstar among them. The 1996 act also promoted universal access to the Internet and spurred huge investments by cable, Digital Subscriber Line, and other companies trying to hook up customers to the World Wide Web.

¹Digital Subscriber Line.

market is the biggest, best, and most competitive telco market in the world. We are connecting through more means and passing more information more efficiently than ever before, and it's only getting better.

The Quarterly: If you were to do things again, would you have tried to insist on another factor to get the former Bell companies to open their local markets, in addition to the “carrot” of entry into the long-distance market?

Reed Hundt: If you want competition in a hurry, you should minimize litigation. The 1996 legislation was written vaguely because Congress wanted to please everybody. There was nothing I could have done about that. As it

was, instead of giving the national regulatory agency the power to set interconnection prices, the statute was ambiguous, so the authority of the FCC to determine the prices for new competitors to interconnect with the Bell local loops was chal-

‘The only real question is whether government **procompetition** policies will remain consistent’

lenged. Twice this issue has gone to the Supreme Court; the first case was over whether the FCC could set any national rules. The FCC won, but the case took two and a half years. The second case is about the methodology the FCC is using to set prices at a forward-looking incremental cost. I don't expect the case to be resolved for 18 months. This cost methodology is the same policy the United States has argued for in trade negotiations globally. In fact, it's easier to convince France than Mississippi, easier to get 69 countries to agree to a WTO² treaty than to get 50 states to accept FCC rule making.

In any case, the market is getting more competitive, at about the rate the government predicted. Long distance is the best example. Deregulation was started in the early 1980s, when AT&T had the entire market. By the mid-1990s, AT&T's market share was down to less than 50 percent in the enterprise market but still 70 percent in the consumer market. That's what we are seeing in the local communications market: competitors are now making inroads in the enterprise space. Verizon is down to 80 percent in New York. Nationally, the Bells are down to 95 percent, from practically 100 percent, and they've entered the long-distance market in a few states.

But deregulation stories are relatively drawn out and require constant regulatory attention. The only real question is whether government procompetition policies will remain consistent. For instance, the spectrum auction decision³ may or may not be good law, but it's bad policy. We need the spectrum in use, not in court.

²World Trade Organization.

³In the NextWave Telecom case; see next page.

The Quarterly: What do you mean?

Reed Hundt: The appellate court ruled that NextWave still owns the spectrum it bought in auction from the federal government but hasn't paid for. I don't want to debate the merits of that decision. But the fact is that the spectrum, which was auctioned by government and freed up for competitive uses, has been slow to be put into use and to offer customers more choices, such as different types of wireless communications devices, because the companies involved are mired in litigation. Auctions are currently on hold. The federal government has to make the rules very clear and then enforce them. It needs to get more spectrum in the hands of innovative companies.

I am also concerned about the growth and development of the Internet. One of our primary policy goals when I was in government—and also a goal of my successor as FCC chairman, Bill Kennard—was to have the Internet become a mass-market phenomenon. That has happened with narrowband connections, but I'm not sure the current policy makers have the same commitment to making broadband universal. I think it would be a major mistake and a cause of great regret if we didn't make the commitment to low-cost, high-speed Internet access that is always on, for everyone and everywhere in this country.

The Quarterly: Some might call that more of a luxury than a right.

Reed Hundt: A right to information is essential, especially when it may determine whether a person becomes a skilled and active member of the information economy. It is not unusual for a new medium to be embraced by government so that the medium will become universal. It's what the government wanted for broadcast television between 1945 and 1955. It was the same thing the government wanted for radio in the 1920s and for telephone in the 1900s. The 1934 Communications Act wrote down in law the commitment to have telephone service available to everyone, everywhere. Bell Labs was set up, in part, to work on making universal service more affordable.

In fact, it is this work that led to the invention of the transistor in 1947. Bell Labs was funded partly to develop new low-cost methods to extend telephone access. Transistors were developed to replace vacuum tubes as part of the research seeking an electronic switch to replace manual or mechanical switching in telephone systems. Telephone switches are, in concept, the same as computer switches: they move electrons. It is ironic that the transistor, which grew out of research into improved telephone switching, eventually spawned the Internet, which will overturn the Bell companies' local monopoly. But the point is that a government policy ensuring universal coverage

forced innovation that was of benefit to everyone, including the many businesses that sprung up as a result of the policy. This is good economic policy as well as social policy.

The Quarterly: Although the 1996 act didn't mandate universal Internet access.

Reed Hundt: It wasn't mandated, but we tried to make the Internet universal in two ways. Number one, let's put it in every classroom where the next generation will be trained on it, using government money. The country went from 3 percent of classrooms with an Internet connection in 1994 to 77 percent today. It's been the fastest-growing innovation in education since chalk. Second, we wanted competition to rule the Internet. By promoting competitive ISPs,⁴ we kept the price of Internet access low. For example, ISPs don't pay interstate access charges or universal charges. That was all calculated on the part of the government to make the Internet cheaper, to make it a mass-market phenomenon, to drive competition. Today everyone thinks it's a God-given right to be on the Internet. In my view, that's great. I'd like everyone to have the same view of broadband—because that would spur massive investment, job creation, productivity gains, and, I hope and believe, advances in health care and education.

An OECD⁵ study came out this spring that said the United States has the lowest Internet access charges in the world. We have 55 percent household Internet penetration—twice that of Europe and three times that of Asia. Yet this version of the Internet is like black-and-white TV compared with color TV. This is narrowband; broadband is next.

The Quarterly: Does government have a role in sponsoring broadband?

Reed Hundt: Broadband will take off and enable new content, new revenue streams. We don't know where it will go. The same thing happened when television started. It was essential for the development of black-and-white TV that the government sponsored it, making every local market have its own broadcaster, thereby developing local businesses and advertising markets. The government granted licenses in every city and limited how far a station could broadcast. As a result, networks became necessary—to pool programming costs and develop national advertising markets—but enough value was transferred to local stations to drive the rapid development of local broadcasting businesses. This was a pretty good idea and it produced a very rapid expansion of a universal medium. This was one of the most adventur-

⁴Internet service providers.

⁵Organisation for Economic Co-operation and Development.

ous, risk-taking enterprises of the 20th century, and it wouldn't have been so successful if government policies hadn't supported it.

We have 5,000 Internet service providers today because we, at the FCC and in the rest of the government, rolled out the red carpet for them. There are the big ones like AOL and Juno, but there are also lots of mom-and-pop ISPs. Billions of dollars have been invested in connecting people to the Internet. Not all of the ISPs will keep going, and there will be a lot of consolidation.

In the end, it will be like the radio stations: thousands of individual stations are now owned by only a few big, efficient companies. That's the way innovation works. Given time, broadband will be universal

because we jump-started this compe-

tition. You might not want to be a shareholder in any one of the ISPs, but at least a handful will be, or already are, winners. The whole process has been good for the economy and the population at large. And the Internet created a platform for fantastic experimentation with business models. Not all of them work. It's like laboratory experiments; some of the animals die and some live. Broadband is going to be the same but more so. Given time and leadership from government, Wall Street, and business, it will be universal.

The country went from 3 percent of **classrooms** with an Internet connection in 1994 to 77 percent'

The Quarterly: Some critics say that it doesn't look as if we're going to have a world where every home and business has two wires attaching it to voice or data networks to give it a real choice. Market share for high-speed Internet access is being divided among incumbents, such as the Bell companies with DSL and the cable companies.⁶ New entrants such as Covad Communications, NorthPoint, and PSINet are failing.

Reed Hundt: There is some competition in the broadband space. If you look at the marketplace as your test, telcos and cable companies are competing at similar price points. DSL is running behind cable in market share but is provisioning at a faster rate.

This is my prediction: cable is going to deliver broadband, telcos will deliver DSL, but there will be a third source of high-speed network access. When the capital markets get over their self-induced depression, they will fund another generation of providers. I'm talking about wire-based technologies that would be compatible with wireless technology in the home or local-area networks. These are greenfield builds, involving new fiber-optic cables going

⁶See "Pipe war," *The McKinsey Quarterly*, 2001 Number 1, pp. 178–93.

in around the country, that are being put together by companies such as Gemini, Western Integrated Networks, WOW, and Carolina BroadBand. These companies exist, but they are underfunded. Given the bandwidth these guys are installing, they will be able to deliver voice, video, and data and to compete for voice traffic with the Bells. I've been meeting with these new companies, and I believe they will provide a catalytic third force.

The Quarterly: There are two pieces here: the connection, or pipe, to the consumer and the content that goes through it. The US Justice Department insisted on an in-house adjudicator at AOL Time Warner to assure that other Internet content providers were not disadvantaged. Is this enough to ensure competition on the content side?

Reed Hundt: I think having open access to Internet content from other providers is something that most cable companies will volunteer to do because they will want to have the largest possible audience. However, there will be a trend toward consolidation on the content side. There are so many providers of digital content, and the number will grow when broadband becomes ubiquitous. But I don't think the market is at great risk of anticompetitive consolidation resulting from an attempt to keep a vertical lock⁷ on customers through proprietary content. There is enough competition among content providers, and they have enough money and market power to keep battling each other. Think of Disney.

The role the FCC played in the AOL–Time Warner merger was very positive, as it has been historically. The FCC has never rejected a merger that the Department of Justice has approved. What the FCC has sometimes done is to change its regulations to accommodate an approved merger or to mitigate potential negative consequences, as it did in this case. If the FCC were in the business of rejecting mergers after they were approved, it would be a real problem because it would be a true double gate. It wouldn't be right to block a merger that the DOJ⁸ has approved. However, *putting conditions* on mergers that the DOJ or the FTC⁹ has approved is a different matter in my view.

The Quarterly: Would you regulate cable more closely, in retrospect?

Reed Hundt: If I had been the “master of all,” I would have passed the Satellite Home Viewer Act in 1992 instead of the 1992 Cable Consumer Protection Act. When the satellite act was passed in 1998, it allowed, in effect, satellite companies like EchoStar and DirecTV to include local broadcast

⁷Through the combination of content and connections, as opposed to a horizontal combination uniting all content developers or all connections.

⁸Department of Justice.

⁹Federal Trade Commission.

stations and to compete more effectively with cable. For both regulatory and technological reasons, that hadn't been true before, so viewers who wanted to watch their local news had to get a cable hookup as well as a satellite dish. It would have been good in the beginning of the '90s to say that "we want satellite to compete with cable" and "we want the satellite firms to have all the content they need to compete." That would have made home-TV access prices lower through competition, not through regulation. We've never found anything that works better than competition to set prices.

The Quarterly: Telecommunications stocks are down as a group by 70 percent, and the bankruptcy courts are crowded with failed new entrants. Can or should the government do anything to restore the industry and to keep competition and innovation moving?

Reed Hundt: It is ugly out there. Right now, the government should encourage a return to normalcy in the investment markets. Investors are denying capital to good companies. There are a lot of concrete things government could do to encourage business building and to shape the information sector in the long term. It could exercise more leadership and implement some

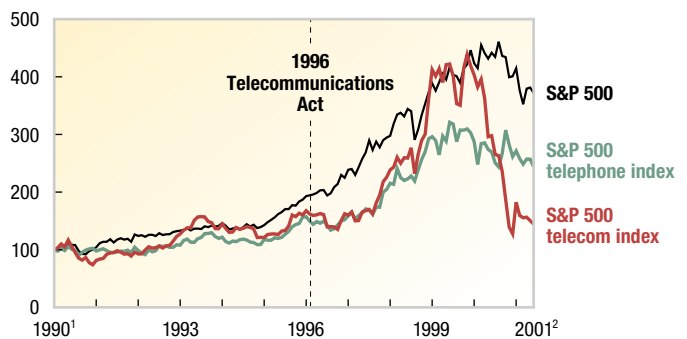
national directives. One example is that the utility companies own telephone poles, and they charge an arm and a leg to anyone, like those third-wave companies I mentioned, to put a line on those poles. I think it's in the national interest to regulate the pricing of pole access at very low levels, so that new entrants in the high-speed Internet-access area can attach their wires cheaply. The government has done it before. In the 1970s and 1980s, cable companies could not get going, because they could not get pole-attachment rights, so the FCC stepped in, since it wanted cable to compete with broadcast television.

To stimulate investment in telecommunications, the FCC also could deregulate depreciation schedules for the telcos. Telcos should be able to write down their investments as fast as they want to, but no one in state government is

EXHIBIT

A rough ride

Index: Share price = 100 in 1990



¹ January 31, 1990.

² Through June 30, 2001.

Source: Bloomberg

interested in this, because state governments want to keep prices down. Depreciation is an expense. If it were increased, the rates the telcos are allowed to charge customers—rates based on the telcos' costs—would go up. So state regulators have kept depreciation schedules slow and depreciation amounts low. If this were changed, it would make a huge difference. Prices might go up by a modest amount, but in my opinion prices should be set by competition, not by regulators. The important thing is that more realistic depreciation schedules would unleash billions of dollars of investment. To do this, the FCC should lean on the states. If you're into federalism, you don't want to do that. If you're into proinvestment competitive policies coupled with deregulation, it's the right thing to do. *MQ*

Rita Koselka is a *McKinsey Quarterly* contributing editor based in McKinsey's San Francisco office. Copyright © 2001 McKinsey & Company. All rights reserved.