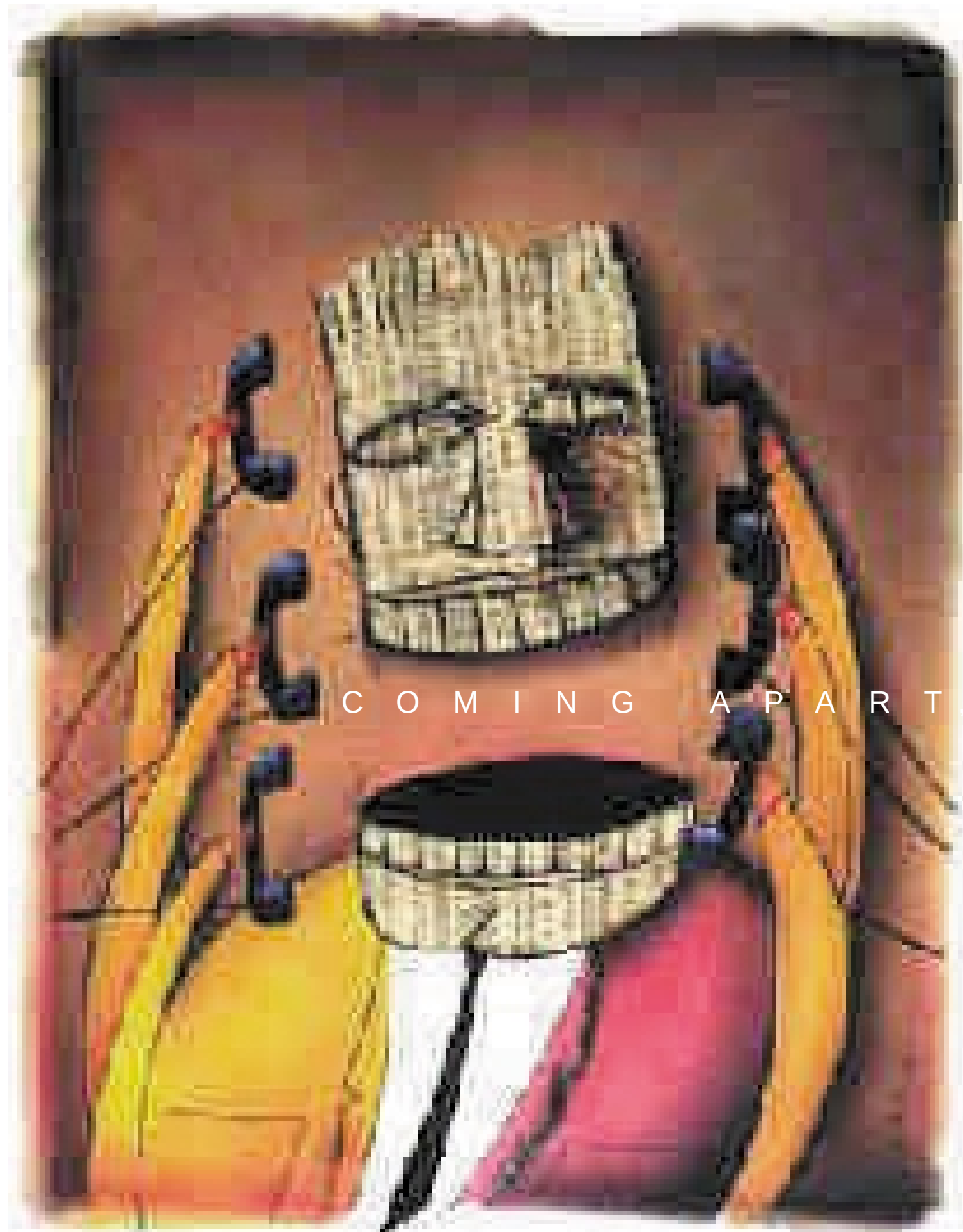




In the past year, the stock prices of telecommunications companies have fallen sharply. Indeed, the shares of telephone companies, once regarded as boring but dependable, have of late displayed the volatility more common among software companies and Internet retailers. For example, AT&T, once the ultimate widows-and-orphans stock, lost half its value in 2000. Just two years after investing in cable TV assets, CEO C. Michael Armstrong is now planning to break AT&T into several parts.

COMING TOGETHER: THE AT&T BREAKUP (ROUND THREE) AND THE REMONOPOLIZATION OF TELECOMMUNICATIONS

By Nicholas Economides

In the meantime, a series of mergers by local telephone companies – the Baby Bells created after the 1980s government-mandated break-up of AT&T – has led to a substantial remonopolization of the telecommunications sector. Add in the cross-media AOL-TimeWarner merger, the rapid growth of the Internet, and the stratospheric bids for European spectrum to be used for wireless telecommunications, and the telecommunications landscape is

both confusing and treacherous to investors.

Why are these once-reliable companies seeing their fortunes shift dramatically? And why have so many shrewd investors been caught unawares by the plummeting stock prices?

At the most basic level, the stocks of some telecommunications companies fell sharply in 2000 because the Internet- and technology-related investment bubble was finally pricked. As investors realized

that early expectations for Internet growth were much higher than justified, stock valuations were appropriately adjusted.

But the deeper answer to why AT&T is breaking up while its former offspring are acquiring each other lies in an understanding of the new market dynamics created by advances in technology, and of successive government attempts to stimulate competition through the enactment of new regulatory schemes.

First, a bit of history. For the



past four decades, rapid technological change in computers and transmission technology has consistently driven production costs of telecommunications services steeply downwards. At the same time, the regulatory environment, which was established to protect consumers from monopolistic abuses, instead kept most of the benefits of technological change from reaching consumers. For decades, in fact, telecommunications services price decreases have been much slower than cost decreases. In other words, companies did not exactly rush to pass on the full benefits of rapid technological change to their customers in the form of lower prices.

The 1981 government-imposed breakup, which created Seven Baby Bells to provide local service and left parent Ma Bell (AT&T) as a long-distance provider, was intended to remedy this state of affairs. By allowing companies other than AT&T to compete in the then lucrative long-distance market, the breakup did indeed create huge benefits to consumers. The advent and growth of long-distance players like MCI (later WorldCom) and Sprint lowered rates, to the point where residential and business customers now pay long-distance rates that are a small fraction of the 1981 price.

However, the AT&T breakup had another effect that was less beneficial for consumers. For it fossilized

the monopoly status of the seven local telephone companies that were carved out of AT&T: Ameritech, Bell Atlantic, Bell South, NYNEX, Pacific Bell, Southwestern Bell, and US West. To be sure, prices did fall dramatically for long-distance rates. But they didn't fall quite as much as

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technological change and competition would imply. That's because the local telephone companies – the so-called Baby Bells – were allowed to charge “access fees” that were as much as ten times greater than cost to let long distance calls travel the “last mile” along their lines to the consumer. As part of the 1981 AT&T breakup, local telephone monopolies were barred from entering the long distance market since their huge access fees would have given them the ability to undercut long distance prices and easily drive the long distance providers out of business.

Fifteen years after the AT&T break-up, the government again tried to remedy the competitive situation through a sweeping action. The Telecommunications Act of 1996 was supposed to level the playing field by allowing competition in local markets. Once that happened, the local monopolies could compete with their former parent in offering long distance service.

However, things haven't quite worked out as intended. Five years after the passage of the landmark legislation, less than four percent of the local telecommunications market belongs to new entrants. Instead, each of the eight large local monopoly telephone companies at the AT&T 1981 breakup – the seven Baby Bells plus GTE – continues to control more than 96% of its market. As important, these firms have consolidated with one another, to the point where there are now only four large local telecommunications monopolies: Bell Atlantic, NYNEX, and GTE merged to form Verizon; Southwestern Bell, Ameritech, and Pacific Bell got together to form SBC Communications; U.S. West was acquired by Qwest, and Bell South remains independent.

The Telecommunications Act of 1996 ordered the local telephone companies to lease parts of their network to new entrants, so that competition would take place in local markets. But the local telephone companies have failed to do so. And this has led to the sub-

stantial failure of the Telecommunications Act of 1996, as well as to the demise of the hopes of long distance companies to become major competitors in local markets. It does appear likely that local telephone companies such as Verizon may eventually be permitted to offer long distance service – as Verizon already does in New York State – and therefore be able to sell both local and long distance service to the same customer. But it seems very unlikely that long distance companies will be able to capture significant market shares in local markets by leasing parts of the local telecommunications companies' networks.

This state of affairs helps explain AT&T's strategic moves of the past few years. Facing great difficulty in entering local markets under the terms of the Telecommunications Act of 1996, AT&T CEO C. Michael Armstrong decided two years ago to get into the local telephone markets through broadband cable television connections. In other words, it would offer local service through the high-capacity coaxial cables that run into millions of American homes. Thus, AT&T spent billions of dollars acquiring cable television companies TCI and MediaOne, as well as a stake in TimeWarner. With a deep-pocketed and aggressive firm on the scene, and with the ability to offer telephone service over cable wires, it appears likely there could now be substantial competition in local telephone service. As an added benefit,

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the cable TV connection gives AT&T the possibility to sell high capacity Internet service and other broadband services, such as interactive video.

Given this set of circumstances, it may seem contradictory for AT&T to even consider divesting its cable television and wireless assets. Has the company lost its nerve and vision? I think not. AT&T's divestiture plan was formed in response to pressure from financial markets and large institutional shareholders. Despite its strategic moves and large investments in cable TV assets, financial markets apparently continued to value AT&T stock as if it were only a long distance telephone company. Moreover, long distance prices have been under tremendous pressure because a great deal of network transmission capacity was built up by several competitors over the last three years due to rampant Internet growth in the United States.

Thus, management came to believe that the value of AT&T as a sum of the values of its independent parts (cable-broadband, wireless, business services, and residential

long distance) is indeed higher than the present value of the unified AT&T.

But if it makes good financial and strategic sense for AT&T to break itself into several parts once again, what is driving the seemingly contradictory mergers of the local telephone companies that emerged from the 1981 AT&T breakup?

At the 1981 AT&T breakup, the local telephone companies were allowed to remain monopolists in the local markets. The 1996 Telecommunications Act attempted to create competition in local markets and failed. Presently the local telephone companies are poised to enter the long distance market without significant decreases of their market shares in local markets. Looking forward to the time when they will be allowed to sell long distance services, local telephone companies have merged to expand their customer base footprint and become stronger competitors in the next battle among carriers that sell both local and long distance services. Twenty years after the government broke up the longstanding MA Bell monopoly, the remonopolization of telecommunications is almost here.

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For more on these issues, see Prof. Economides' Economics of Networks website, <http://www.stern.nyu.edu/networks/>, which has been ranked by The Economist as one of the top five economics sites on the Internet.

