COMMENT & ANALYSIS: Too weak to compete

By Eli Noam
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Astench of scandal is hanging over the telecommunications industry. But to focus on individual misdeeds is to miss the fundamental structural problems of telecoms economics and policy. These problems will not go away with corporate reforms or criminal sanctions.

For telecoms to recover, the corporate strategies and public policies of more than two decades have to change radically. The basic policy, spreading from the US and the UK to become the new orthodoxy, has been to force the traditionally monopolistic markets open. After a period of protection for new entrants, competition would take hold and the role of government would wither away.

Wherever one looks, however, telecoms companies are drowning in red ink. The cumulative debt of the seven largest European carriers is greater than Belgium's gross domestic product. In the US, most of the new entrants into local telecoms have gone bankrupt. All big long-distance carriers are bleeding. Across the sector, stock market valuations have dropped dramatically. Performance has been poor in such a large number of companies and countries that one cannot simply blame specific management teams.

Although growth is unlikely to return to the levels of the boom years, the present downturn is probably only temporary. Yet the real problem for the industry is that it has entered a period of chronic volatility in which boom-and-bust patterns will become a common occurrence rather than an aberration.

One cannot really blame a drop in consumer demand for this instability. Telecoms usage has kept growing at a rate that would make most other industries proud.

The problem is not low demand but low prices, based on oversupply. During the late 1990s, the network companies over-optimistically projected their market shares over the long term. This was aggravated by the tendency of analysts to value a company's progress by physical measures of its infrastructure, such as cell sites and fibre miles. In consequence, capital expenditures grew enormously, in the US by an annual rate of 29 per cent.

A related factor was that while the cost of building a network is high, the incremental costs of serving a customer are low. Hence, competitive prices dropped dramatically, 54 per cent annually for transatlantic circuits and 43 per cent for trans-Pacific ones. Business plans based on higher prices became worthless.

Technological and economic obsolescence will gradually take capacity out of circulation. But disinvestments take time. For Texas office space, it took more than a decade to dissipate the excess supply. Another strategy would be to stimulate a substantial growth in user demand, probably from video over the internet. But this, too, will take time. And when it arrives, it will stimulate another boom-and-bust cycle.

In the meantime, what will telecoms companies do? The textbook responses are to cut costs and prices. But these strategies will quickly be matched by competitors and will leave everyone even worse off.

The main strategy will therefore be to raise prices above competitive levels, reducing competition and the commodification that lowers profitability and future investments. To do so this requires market power, or at least collaborative cartels or oligopolies within market segments, both among telecoms companies and with related platforms such as cable operators and wireless carriers.

Such market power is highly valued by investors. In the US, rural phone companies maintained their value much better than those active in competitive markets.

The problem with any cartel is its instability. Hence, government will become engaged in the process. Historically, government has often been recruited as an enforcer of cartels to stabilise vital industries whose competitive equilibrium was not sustainable. In the US, airline and railroad competition was, and to a certain extent still is, reduced by government regulatory bodies. In telecoms, for many decades the Federal Communications Commission and the state utility commissions played a similar role.

It will not be easy for politically sensitive regulators to hold off from stabilising the industry when the downturn persists, when essential service providers falter, when service quality deteriorates and employment drops.

For governments to moderate competition in favour of stability would require a fairly radical departure in regulatory philosophy. For a generation now, liberalisation, deregulation and competition have been the keystones of telecoms policy.

One business cycle later, competition is giving way to consolidation and, soon, co-operation. Thus, the traditional system of regulated market power will return. This scenario, unfortunately, will look more like the old telecoms than the new, but we must face reality rather than engage in denial.

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