ENCOURAGING CAPITAL FORMATION IN KEY SECTORS OF THE ECONOMY

HEARING

BEFORE THE

SUBCOMMITTEE ON
DOMESTIC MONETARY POLICY, TECHNOLOGY,
AND ECONOMIC GROWTH

OF THE

COMMITTEE ON FINANCIAL SERVICES

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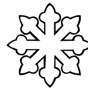

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CONTENTS

Page

Hearing held on:
April 18, 2002 1
Appendix
April 18, 2002 33

WITNESSES

THURSDAY, APRIL 18, 2002

Alexander, Anthony J., President and Chief Operating Officer, FirstEnergy Corporation 5
Glenchur, Paul, Vice President, Schwab Capital Markets, Schwab Washington Research Group 18
Kuhn, Thomas R., President, Edison Electric Institute 4
Levin, Blair, Managing Director and Telecommunications and Media Regulatory Analyst, Legg Mason Wood Walker, Inc. 20
Mitchell, Bryan J., Chairman and CEO, MCG Capital Corporation 13
Trabandt, Charles A., Vice President, Charles River Associates, Inc. 7

APPENDIX

Prepared statements:
Alexander, Anthony J. 34
Glenshur, Paul (with attachment) 86
Kuhn, Thomas R. 39
Levin, Blair 93
Mitchell, Bryan J. (with attachment) 72
Trabandt, Charles A. 52

ENCOURAGING CAPITAL FORMATION IN KEY SECTORS OF THE ECONOMY

THURSDAY, APRIL 18, 2002

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY,
TECHNOLOGY, AND ECONOMIC GROWTH,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 10:00 a.m., in room 2128, Rayburn House Office Building, Hon. Peter King, [chairman of the subcommittee], presiding.

Present: Chairman King; Representatives Oxley, Grucci, Capito, Biggert, J. Maloney of Connecticut, C. Maloney of New York and Clay.

Chairman KING. The hearing will come to order. Today, the Domestic Monetary Subcommittee continues its work which began last year to examine economic growth issues and the steps that Congress can take to help facilitate that needed growth.

I would like to welcome our distinguished guests from the energy and telecommunications sector. Clearly, the segments of the economy you represent drive a very large percentage of U.S. industrial capacity and are catalysts for a variety of other business activities.

I recognize that because your respective industries are identified as critical infrastructures for purposes of national security, much of your post 9–11 focus has been on security and fail-safe systems. That, added to the climate brought about by the most recent corporate failures, has surely raised some degree of uncertainty, which is generally not conducive to capital formation.

Because you have driven so much of the economic growth in the past decade, in this critical recovery period, I believe the relevant question in the context of encouraging growth is what hurdles your respective industries face that detract from your ability to raise capital and, in turn, spur growth in your sectors. I look forward to receiving your testimony and any recommendations you may make to help Congress better understand what it can do to break down existing barriers to capital formation and improve investor confidence.

With that, I would now like to recognize the Ranking Member of the subcommittee, who works very closely with me, my friend from New York, Ms. Maloney, for any remarks she may have. And the Chair would also note that your full statements will be included in the hearing record, without objection.

Thank you.

Mrs. Maloney.

Mrs. MALONEY. I thank the Chairman, my colleague from the great State of New York, for calling this hearing. We are meeting today in this subcommittee today to discuss capital formation and the unique challenges facing the energy and telecommunications sectors, specifically.

During the 1990s, our Nation enjoyed an unparalleled period of economic prosperity that included exploding values in the equity markets. Investment in the internet and telecom greatly increased as staples of the new economy. However, in the past few years, the sector has become a poster child for the dot-com collapse and the devaluation of the Nasdaq.

While it is appropriate to review Government policies that affect these two sectors, my belief is that clearing up the questions about the accounting practices of these two sectors and the recovering economy will have the most significant impact in pumping investment back into them. The SEC is currently conducting inquiries into the accounting practices of a number of energy and telecom companies. Given the explosion of Enron and Global Crossing, we can hardly expect investors to rush back into these sectors until these issues are resolved.

While capital raising in the entire economy has waned in the past 2 years, the economy in general is now improving faster than many had anticipated. Economists can rightly point to the resiliency of consumer spending for preventing a harsher period of recession.

In the fourth quarter of 2001 alone, new data indicates that the GDP grew 1.7 percent, powered by a 6.1 percent increase in consumer expenditures. Spending by business on fixed capital dropped for the fourth consecutive quarter, this time by 13.8 percent. However, business spending on computers and computer related devices increased for the first time since the end of 2000.

While preliminary estimates will not be available until the end of the month, forecasters believe that economic growth continued to increase during the first quarter of this year. The recovery has produced little evidence that the excess capacity of communications equipment has substantially narrowed to the point that demand will increase substantially anytime soon.

Capital formation also continues to be affected by adverse long-term interest rates. The Fed reduced interest rates 11 times last year, after raising them the previous 2 years. But long-term interest rates remain high, partly as a result of the return of massive Government deficits.

The Congressional Budget Office's projection of the baseline budget surplus for 2002 through 2011 was $5.6 trillion a year ago. But it has dropped to just $1.7 trillion in the last report, a drop of nearly $4 trillion. The president's recent budgetary proposals would further reduce the projected surplus to less than $500 billion over those same 10 years and would result in a projected deficit of almost $200 billion in 2002 through 2006.

There is little doubt that this return to deficits will have a major impact on all aspects of the economy, including energy and telecom. I think all Members need to keep these grim statistics in mind as we vote on the issues before us.

Chairman KING. Thank you, Mrs. Maloney.

I now recognize the Chairman of the Full Committee, the gentleman from Ohio, Mr. Oxley.

Mr. OXLEY. Thank you, Mr. Chairman.

I welcome our witnesses to today's hearing, which is really about the health of the U.S. economy. Capital investment is the fuel that feeds America's economic engine, and while consumer spending has been cited as the recent hero, ultimately, it is capital investment by business that drives our economy, allowing companies to grow and innovate.

One of the early goals I set as Chairman of this committee was to use our unique forum to promote overall economic growth. Capital formation has been a long-standing interest of this committee.

Last year, the Oversight and Investigations Subcommittee held a hearing on regulatory barriers to capital formation, and today, the Domestic Monetary Policy, Technology, and Economic Growth Subcommittee turns its attention to two specific industries, energy and telecommunications. These are two capital intensive sectors that traditionally have saved a rebounding stock market. But this time, they seem to be lagging behind.

We have seen investor confidence shaken by the dramatic fall of companies like Enron and Global Crossing. Enron cast a shadow over the electric power industry, even though retail customers were virtually unaffected by its collapse. As for the telecom and technology sectors, by all accounts the current state of investment is quite grim.

What I believe has gone unnoticed is that Enron and Global Crossing are not representative of their industries as a whole. After all of the media coverage of recent months, it is time to bring back balance to the picture. Congress also needs to identify ways that it can promote growth in these markets, because that is what attracts capital.

I believe the CAARTA bill passed by our committee this week is one key to enhancing investor confidence. Why should people care about what Congress does about capital formation? When capital becomes more expensive for utility companies, costs go up for consumers. When telecommunications firms cannot raise adequate capital, the market becomes less competitive, and consumers are denied choice.

We have seen this happen in the telecom sector. In fact, lately, many companies have found that even the commercial paper market is extraordinarily stingy which leads to higher financing costs.

We have two excellent panels to discuss the state of capital formation in their industries. I would particularly like to welcome the President of the Edison Electric Institute, Thomas Kuhn, an old friend; the President and Chief Operating Officer of FirstEnergy, Tony Alexander, who comes to us from Akron, where FirstEnergy's headquarters is based.

I look forward to this morning's testimony, Mr. Chairman, and I yield back.

Chairman KING. Thank you, Chairman Oxley.

I would like to now welcome the witnesses who are here this morning. As Chairman Oxley said, we have Mr. Thomas Kuhn, the President of Edison Electric; Mr. Anthony J. Alexander, the President and Chief Operating Officer of FirstEnergy Corporation; and

Mr. Charles A. Trabandt, the Vice President of Charles River Associates.

We will start with Mr. Kuhn. I would ask each of the witnesses to try to keep their statements to approximately 5 minutes. We are not going to be banging gavels on people, but we would like to keep the statements to roughly 5 minutes, and your full statement will be, without objection, included in the record.

Mr. Kuhn.

STATEMENT OF THOMAS R. KUHN, PRESIDENT, EDISON ELECTRIC INSTITUTE

Mr. KUHN. Mr. Chairman, Congresswoman Maloney, Chairman Oxley, and Members of the subcommittee, I am Tom Khun, President of the Edison Electric Institute. EEI is the association of U.S. shareholder-owned electric companies and industry affiliates and associations worldwide. I very much appreciate the opportunity to testify before you today on this very, very important subject with respect to capital formation in the electric utility industry.

The electric utility industry is one of the most capital intensive industries in the country. Our $872 billion worth of assets represent about 9 percent of the assets of all businesses in this country.

Electric companies have been through an enormous change over the last 10 years as they make the transition from vertically integrated regulated monopolies to diverse companies operating in competitive markets. The past year brought additional financial challenges for the electric industry, starting with the California electricity crisis, continuing with the terrible events of September 11th and the resulting economic downturn, and ending with the collapse of Enron.

Enron has brought much greater scrutiny to the energy industry. But I would like to emphasize that Enron's collapse was a financial story, not an energy story. Electricity supply and delivery were not disrupted and prices remained stable. Nevertheless, Enron did deal a blow to investor confidence that, at least in the short term, has affected the cost of capital for energy companies.

More generating capacity is definitely needed to meet the demand for more electricity. Electricity and the economy grow on almost a one-to-one basis.

Congress can remove a tax impediment to building more generation by shortening the depreciable lives of generation facilities. Other barriers to investment in generation are the Public Utility Holding Company Act and uncertainty in environmental policy.

Competitive wholesale and retail electricity markets place more demands on a transmission grid that was not designed for such purposes, resulting in dramatically increased congestion in the transmission area. According to the Federal Energy Regulatory Commission, transmission bottlenecks cost consumers more than $1 billion over the past two summers alone. Yet largely due to regulatory uncertainty and inadequate returns, investment in transmission is decreasing rather than increasing.

Transmission investments in 1999 were less than half of what they had been in 1979. Maintaining transmission adequacy at its

year 2000 level would require a quadrupling of transmission investments during the current decade.

FERC should be given authority to help site new transmission lines with appropriate State participation. PUHCA should be repealed, because it acts as a barrier to the formation of interstate independent transmission companies. And financial incentives, including higher rates of return and other appropriate innovative pricing mechanisms, are needed to attract capital to fund investments in transmission expansion.

Congress should shorten the depreciable lives of property used in the transmission and distribution of electricity. To efficiently meet our Nation's energy needs, the electric industry requires the same ability that other industries have to more rapidly depreciate assets for Federal income tax purposes.

As part of H.R. 4, the energy bill, the House last summer approved a reduction in depreciable lives for gas distribution facilities to 7 years. Facilities in other capital intensive industries, such as pulp and paper mills, steel mills, automobile plants, and even cigarette manufacturing plants, are depreciable over 7 years. All this is in stark contrast to the 15 or 20-year depreciable lives for electric generation, transmission, and distribution facilities.

The Federal tax code also should be amended to defer taxes on the sale, and eliminate taxes on the spin-off, of transmission facilities for transmission-owning companies that seek to join FERC approved regional transmission organizations, as contained in H.R. 4, the energy bill that passed this summer. In this time of historic change in the electricity industry, it is critical that Congress continue to pursue measures that will promote capital investment in the electric industry, which will encourage the development of badly needed generation and transmission facilities.

Thank you again for allowing me the opportunity to testify today. I will be glad to answer any questions you might have after the other panelists have finished.

[The prepared statement of Thomas R.. Kuhn can be found on page 39 in the appendix.]

Chairman KING. Thank you, Mr. Kuhn.

Mr. Alexander.

STATEMENT OF ANTHONY J. ALEXANDER, PRESIDENT AND CHIEF OPERATING OFFICER, FIRSTENERGY CORPORATION

Mr. ALEXANDER. Good morning, Mr. Chairman and Members of the subcommittee. My name is Tony Alexander, and I am president and chief operating officer of FirstEnergy, based in Akron, Ohio.

FirstEnergy is a registered public utility holding company. Our seven electric utility operating companies comprise the Nation's fourth largest investor owned electric system, based on serving 4.3 million customers in Ohio, Pennsylvania, and New Jersey.

Encouraging capital investment in the Nation's electric system is critically important, because maintaining an affordable, reliable supply of electricity with a strong network to produce and deliver it is essential to our economic growth. With the development of competitive electricity markets, utility companies no longer have the obligation to build generating capacity and recover those costs through utility rate-making.

Instead, the competitive market will determine if and when capacity is built. This fundamental change in the manner in which electricity supplies will be developed has a significant impact on capital formation in the industry.

Investments in the energy industry, particularly in generation assets, must now compete with every other capital requirement in the market, and that means it is essential that regulatory, tax, and other burdens do not discourage investment in this sector. In fact, generating facilities should be treated like other competitive businesses.

I believe there are several ways to encourage needed investment in this segment of our industry. First, Government should provide more favorable tax treatment for generation assets. Shorter depreciation periods would free up capital for reinvestment in energy markets and make those markets more attractive to new investors.

The current 20-year depreciation periods for generation assets are outdated and far longer than for other capital intensive industries. It makes sense that electric generating facilities have tax treatment similar to other capital intensive industries. Tax credits are another way to attract capital to the energy industry.

Second, the industry needs a greater degree of certainty with respect to future environmental regulations governing generating facilities. Potential investors in generation need to know what the regulatory future holds. Without good prospects for solid returns, they will not tie up capital for new or expanded facilities.

Third, the Government needs to support competitive energy markets by allowing those markets to develop unimpeded. That includes ensuring that wholesale electricity prices are market based. Artificial price caps or pricing subject to refund will only serve to stifle competition and create barriers to investment.

In addition to generation, the competitive electricity market also depends on an adequate transmission system. Even though transmission is still regulated, utility companies are being required to turn over control of their transmission assets to third parties.

There are limited options available that will encourage investments in assets over which the owner will have no control of operations, pricing, or expansion. One way, however, is to remove barriers to divestiture by reducing the current tax liabilities for the sale of transmission assets.

Another is through so-called participant funding, which requires that new investment in transmission be paid for by the party requesting the expansion. And, finally, rate-making allowances that produce sufficient returns will allow the owner to make needed investments in the transmission network.

In order to create and support the kinds of markets that were envisioned when States and the Federal Government promoted competition, we first need to ensure that the steady and growing capital requirements of the electric industry are met. Only with an adequate supply of electricity produced from diverse sources that include coal, nuclear, natural gas, and renewables and the proper system to deliver it can customers be assured of reliable and reasonably priced electric service.

Thank you for the opportunity to share my views on this important topic. I would be more than willing to answer any questions you might have after the other panelists have spoken.

[The prepared statement of Anthony J. Alexander can be found on page 34 in the appendix.]

Chairman KING. Thank you very much, Mr. Alexander.

Mr. Trabandt.

STATEMENT OF CHARLES A. TRABANDT, VICE PRESIDENT, CHARLES RIVER ASSOCIATES, INC.

Mr. TRABANDT. Good morning, Mr. Chairman, Congresswoman Maloney, and Chairman Oxley. Thank you for the opportunity to testify before the subcommittee today on this important subject of capital formation in the energy industry.

My testimony reflects my experience as Vice President of Charles River, advising electric utilities recently, as well as 8 years as a Managing Director in the energy and power group at Merrill Lynch's investment banking division, where I worked on capital formation for energy and utilities around the world, and 8 years as a commissioner at the FERC, working on these similar issues.

At the outset, I would commend this subcommittee and the full Financial Services Committee for bringing a specific focus to the critical capital formation considerations in the context of the ongoing congressional debate about our national energy policy and the reactions to the Enron situation. I have been asked to testify today about the impact of recent developments in the electric power industry, including the situation in California and the collapse of Enron, and my prepared testimony provides some considerable detail on those matters.

I generally support the recommendations made in Mr. Khun's testimony and also Mr. Alexander's testimony with regard to action that can be taken by Congress to facilitate capital formation. As Tom's testimony demonstrates, there is a critical need for capital investment in the Nation's electric infrastructure, which requires both investor confidence and assured access to capital markets going forward.

The Federal Energy Regulatory Commission, FERC, in Order 2000 sought to address that need by providing structural and regulatory flexibility for independent for-profit transmission companies or so-called transcos. That flexibility has spawned a new generation of proposed transcos in every region of the country with participation by investor-owned utilities and some public power entities, including Mr. Alexander's FirstEnergy Company, which has provided considerable leadership in that area.

It is clear from a business and financial perspective that a properly structured for-profit business model could access capital markets for equity from financial and strategic investors and for investment grade debt to maintain, upgrade, and expand the transmission infrastructure. I cite in my testimony a deal between the Alliance Transco LLC with National Grid USA as the proposed managing member as one example of the types of commercial business arrangements that can be negotiated with significant infrastructure investment.

FERC policy initiatives should be formulated in a manner to facilitate such arrangements in the emerging energy markets. FERC also has initiated an ambitious program for establishing four or five regional transmission organizations across the country which will implement a uniform market design now under development on a national basis. This effort is intended to materially advance competition in wholesale electricity markets over the next 2 years and will be a significant response to the difficulties in California.

The recent Supreme Court decision in the Order Number 888 case is seen as solidifying FERC's authority under the Federal Power Act to pursue the new policy. And just yesterday, the chairman of the Tennessee Valley Authority announced an agreement with major southeast and midwest utilities to support a seamless eastern electricity market that would run from the Atlantic to the Rockies and from the Gulf Coast to the Canadian border. That is a big step forward in the FERC plan and should advance the wholesale markets.

While FERC pursues a more robust competitive wholesale market under Federal law, State authorities still maintain predominant jurisdictional control of State retail competition policies and programs. As a practical matter, the nationwide drive toward retail competition at the State level, which New York was one of the pioneers of, has stalled precipitously as a result of regional differences, the events in California, and Enron.

Seventeen States now have some form of competition for retail customers while other States have essentially slowed significantly or stopped all together movement toward retail competition. Perhaps the best hope for supporters of retail competition would be FERC's success in advancing truly competitive wholesale markets across the country, as they have set out to do over the next 2 years.

The competitive wholesale market has continued to function reasonably well despite the Enron collapse, with no interruption in physical supply and with no excessive price volatility or spikes, albeit it during a winter season of very mild weather and with very low demand on both the industrial and commercial sides as a result of the economic slowdown.

Nonetheless, the many issues surrounding Enron have negatively affected a number of our energy companies and caused a loss of investor confidence that must be addressed to assure needed access to capital markets for infrastructure investments. Many companies have already taken decisive action in the form of comprehensive recapitalization plans now being implemented to respond to credit quality and accounting challenges.

Somewhere in the vicinity of about $10 billion has been raised over the last couple of months as part of those recapitalization plans. But, as Mr. Oxley said in his opening statement, some companies have also experienced great difficulty in obtaining capital because of credit quality concerns and because of the reticence of many investors today.

But assured access will only be restored when there is a greater degree of regulatory certainty regarding the Enron related issues. This committee's leadership on accounting reform legislation which you reported Tuesday is a positive step forward, and, hopefully, other committees in Congress will follow your example to take

measured and carefully considered action with regard to the going-forward practices in the industry.

I would respectfully urge Congress, the Administration, and Federal regulatory agencies to strive to complete the Enron reviews in a timely manner and adopt any clearly needed reforms with carefully considered and measured actions which will support competitive energy markets. At the end of the day, greater regulatory certainty in all forms of regulation and an increased degree of stability for the industry will be required for assured access to capital investment for the critical national energy infrastructure needs that Tom Kuhn laid out.

Thank you, Mr. Chairman, for this opportunity to testify. I look forward to questions.

[The prepared statement of Charles A. Trabandt can be found on page 52 in the appendix.]

Chairman KING. Thank you, Mr. Trabandt.

We will have votes coming up on the floor in several minutes. With that, I will yield my time right now to the Chairman of the Full Committee, Mr. Oxley.

Mr. OXLEY. Thank you, Mr. Chairman. I appreciate that courtesy.

Mr. Kuhn, the Financial Services Committee just recently passed our legislation addressing accounting and appropriate disclosure issues raised by Enron. Just in general, what are your thoughts in terms of the approach that our committee took? There were folks who were less than enthusiastic about our approach, in the media, for example, and I am wondering, from your perspective, what tone you would recommend that the legislation take.

Mr. KUHN. Mr. Chairman, I think basically what I have pointed out on Wall Street and elsewhere—and I think there is a general consensus—is that Enron was a business and a financial situation, not an energy situation. So I commend you and the committee for approaching the Enron situation from an overall business perspective and looking at it from the standpoint of accounting practices and disclosure rules that would apply to all businesses. I think that is the approach that definitely should be considered and looked at.

There are some specific issues in the accounting area with respect to the energy industry that we are addressing with FASB and with the SEC and with the rating agencies and with Wall Street. We have a very aggressive program at EEI right now to bring our companies together to review all our accounting practices and disclosure practices, to look at best practices, and to deal with these things on a going-forward basis.

But I believe your approach was right on target in terms of looking at the situations from a broader based business standpoint, from doing things that make sense to do as a starting point. I know there are thousands of ideas out there that are very regulatory in nature, and I would just urge you to cautiously, as you have done, make sure that they are addressing the problem, the absolute problems, and not re-regulating in a way that I would think would hurt competitive markets or hurt financial markets in general.

Mr. OXLEY. Well, Chairman Greenspan testified here last month, and one of the things that he emphasized was the ability of the capital markets to fix problems within its system. And you pointed

out the fact that your member companies are re-examining a number of issues, including their auditing and their accounting procedures.

That is obviously happening all over the corporate world, because it is demanded by the shareholders and by the boards of directors. So you could be congratulated for your leadership in that area. I think it is critically important.

Let me turn to Mr. Alexander. I know that the repeal of PUHCA, which has been an issue that has been around for, I guess, as long as I have been in Congress—some say that because of Enron, PUHCA should be retained, maybe even strengthened, even though the SEC continues to support conditional repeal.

I know what you are going to say, but I need to hear you say it, anyway, in regard to PUHCA and what effect it would have on FirstEnergy, specifically.

Mr. ALEXANDER. The industry position, obviously, is that the Holding Company Act has outlived its usefulness in connection with the way the industry is going right now. It is a very highly regulatory driven Act being applied to an industry that is trying to deregulate.

And as such, it really does not fit, and it is an impediment to some of the things that the industry would like to do, and it tends to slow down your ability to raise capital in a timely way if you are a holding company. Those things need to get addressed, either by the SEC in the way it applies the Holding Company Act, or by repealing the Act and finding other means to maintain some regulation over the parts of the industry that require it, generation not being one of them any longer.

Mr. OXLEY. Let me ask you this, then. If we assume that the status quo maintains, and that is at the end of the day, Congress is unable or unwilling to repeal PUHCA, is it your testimony that the SEC could, on its own initiative, amend or change the PUHCA to make it more realistic in today's world?

Mr. ALEXANDER. I do not think the SEC can amend it. They can apply it in a way that allows transactions to be completed in a more timely way—financing transactions—instead of perhaps a year or longer—or mergers, instead of being the last one to go, they could start addressing the regulatory side to try to speed up their processes so that, yes, it is a regulatory burden, but as long as that burden does not delay transactions from being completed or financing from taking place in a timely way so you can take advantage of market opportunities, then that is something the agency can deal with and should be dealing with today.

Mr. OXLEY. Thank you.

Mr. KUHN. Mr. Chairman, if I could add to that——

Mr. OXLEY. Yes.

Mr. KUHN. Obviously, with an interpretation by the SEC and a great deal more work from lawyers, sometimes you can get to the same conclusion. But, basically, what the existence of PUHCA does is it discourages a lot of investment in generation and transmission from companies that do not want to become subject to the Holding Company Act, also.

So you have players that might want to make investments in generation or transmission that otherwise will not make them.

That impedes capital investment that is critically needed in the industry right now.

Mr. TRABANDT. Mr. Chairman, I would also add that the Circuit Court of Appeals recently reversed an SEC decision in the AEP merger case, specifically because it found that the SEC had been too loose in its interpretation of the law. And I think that is a good example of where repeal is probably not only the best solution but the only really good solution for purposes of allowing financial transactions to go forward.

Second, I would offer that as an investment banker, I actually went out to recruit investment in a major transmission company that FirstEnergy and 9 other utilities were trying to form. And we were repeatedly told by both strategic partners and financial investors that they were unwilling to make the investment, which would translate directly into infrastructure development, because they would become subject to PUHCA's requirements.

And on Wall Street, those requirements are a major disincentive and PUHCA it does have a material effect on the ability to raise capital from these types of industrial undertakings.

Mr. OXLEY. Speaking of raising capital, obviously, the whole issue with competitive markets has put a strain on transmission. Let me just ask all of you, in your view, is investment in upgraded transmission systems keeping pace with demands being placed on our system?

Mr. KUHN. Mr. Chairman, the very simple answer is no, it is not, and transmission is the most vulnerable part of our system. Under wholesale competition, the number of transactions that are occuring on the transmission system are growing exponentially.

Basically, the transmission system was built to interconnect neighboring utilities. So you might almost make the analogy that it was kind of a country road.

Now we want to create with competition a super highway, and the transmission system definitely needs to be upgraded to deal with all these additional transactions on the transmission system. Last year, the Federal Energy Regulatory Commission study showed that more than $1 billion was lost by consumers over the last two summers because of congestion in the transmission system.

We desperately need additional investment in the transmission system. We need higher returns on investment for transmission. We need to decrease the depreciable lives of transmission assets. I think these things would help greatly in terms of getting much needed investment in the transmission area.

Mr. OXLEY. Mr. Alexander, what has been your specific situation with FirstEnergy in regard to transmission?

Mr. ALEXANDER. Well, Mr. Chairman, we have obviously continued to invest in our transmission system, although it is more and more difficult to make business decisions, because you do not really control the asset ultimately. Ultimately, this asset is going to be controlled by someone else, and they are really making the capital investment decisions that are going to have to be made when we actually get into operating regional transmission organizations.

Transmission across the entire system needs to be improved and upgraded to allow for these literally thousands of transactions that

the system was not designed or built to accommodate. And as long as we are going to continue down the path of deregulated competitive generation business—now, years ago, when a utility built a power plant, it built its power plant and then it built its lines to get that power into its system. Now, you can go to a power plant, any place you choose, and someone else's responsibility is to build those lines, and you might not be building it to the area where those lines are primarily directed. They may be directed to some other market.

So the entire spectrum of transmission has to be looked at totally differently as we move more and more toward competitive generation markets. And the system is just not there on the transmission side at this point to allow for all of the transactions that people would like to make.

There are thousands of transactions that are made on a daily basis. Let's not discount the transmission system we have today, because it is a very good system. It allows for a lot of transactions, but not all of them.

Mr. OXLEY. Thank you.

Mr. Trabandt, you have had, obviously, some experience on Wall Street. You were at FERC. You were a consultant to the energy industry. What is your take on this whole issue regarding transmission?

Mr. TRABANDT. I think it is very important, Mr. Chairman, in that regard to focus on something that Tom's testimony pointed out, and that is we need an enormous amount of new generation in the country. Much of the financing that is being done now is to connect new power plants to the grid, rather than to deal with the issues surrounding the upgrading and improvement and reliability of the existing system as it is today, which, as Tom said, is not designed for a market operation.

So we really do have what is tantamount to a potential crisis in that part of the industry today that needs to be addressed. I think what is very important—and I think our respective testimonies focused on this, perhaps in somewhat different ways—is that regulatory policies at FERC definitely need to establish incentives in terms of the rates, terms and conditions that are going to be established for transmission service so that there is a proper return for investment.

Today, there is not an incentive to invest in transmission as a general matter. We have a couple of examples where there were investments in so-called merchant transmission lines, but so far, no one has successfully built one of those because of the inherent concerns with the returns and the financing associated with them.

So, I think that it is quite important that regulatory policies, the tax policies, and the general overall energy policy maintain a focus on this. I think it is important that Mr. Bush's national energy policy that was released last year really did highlight this issue. The issue has tended to be overtaken by California, Enron, and other things. But I think capital formation for investment in the transmission sector is critically important for the country.

Mr. OXLEY. Thank you.

Thank you, Mr. Chairman.

Chairman KING. Thank you, Chairman Oxley.

Ms. Maloney has had to leave. She does have a series of questions which we will submit to the witnesses in writing, and if you could get back to her within the next week or 10 days, that would be greatly appreciated.

As for my own questions, actually, everything has been answered. Your statements are comprehensive, and your dialog with Mr. Oxley has really touched on all the questions I would have asked.

We have to go vote. We will be in recess until about 11:10.

Mr. Chairman, unless there are further questions, I think we can excuse this panel at this time.

So I want to thank you for taking the time to be here. We certainly appreciate your cooperation and your assistance, and you are excused. Thank you for being here.

The hearing stands in recess until 11:10, at which time we will have our second panel.

[Recess.]

Chairman KING. The hearing will come to order. I want to welcome our second panel today and thank them at the outset for taking the time and trouble to come down here and give us the benefit of their knowledge and wisdom and their insights.

I would like to welcome Mr. Bryan Mitchell, the Chief Executive Officer of MCG Capital; Mr. Paul Glenchur, Director of Schwab Capital Markets; and Mr. Blair Levin, Managing Director of Legg Mason. I would ask each of you to make an opening statement. If you can possibly keep it to roughly 5 minutes, that would be appreciated.

We are not going to be pulling the plug on anyone, but if you could keep it to 5 minutes, it would be appreciated. In any event, your full testimony will be incorporated into and made a part of the record.

So, with that, I would ask Mr. Mitchell to make his opening statement.

STATEMENT OF BRYAN J. MITCHELL, CHAIRMAN AND CEO, MCG CAPITAL CORPORATION

Mr. MITCHELL. Thank you, Mr. Chairman. I appreciate it and thanks for giving me the opportunity to express my thoughts in front of your subcommittee.

I wanted to give you a brief description of the background of our company so you can put into context our comments. Our company is a publicly traded solutions-focused financial services company that works with high growth small private companies. We assist those companies in prioritizing their opportunities and managing their risks of growth.

We apply an expert activist investment philosophy to these companies, and we do that by focusing on very specific industry sectors in which we invest. We develop financial, operational, and regulatory expertise in these marketplaces, and we actively apply that knowledge to support these companies.

The basic investment thesis of our company is to trade upside for a less speculative, more stable path to value creation, and it is that bias that we bring to the discussion today. As a bit more background, our company has an investment portfolio today of about

$675 million. A little over 25 percent of that investment portfolio is in the telecommunications industry, and the remainder is in media, information services, and technology.

Our company, in the fourth quarter of last year, completed a $240 million IPO and issued $265 million worth of investment grade bonds to support our investment activities in the telecom sector and technology sector. And we have had our basic investment philosophy validated, in our view, by the capital markets by completing those capital transactions in December of 2001 in a very difficult capital market environment.

I think the last point I would make around our background is that we have been active in investing in telecommunications for over 10 years, and we have deployed over $2 billion of capital and over 200 transactions in that time period. And our basic approach is to assess the fundamentals of growth markets and identify the path to cash flow and profits, which ultimately create significant enterprise value.

It is the assessment of that critical path to cash flow and profitability that I would like to focus on as it relates to assessing capital formation in the telecommunications industry. Our focus in the space has been really in a range of different service providers, long distance, niche markets, prepaid services, conference calling, the hospitality industry, integrated services such as the local long distance data bundling models that are out there and messaging models, and, ultimately, and I think most importantly, for the purpose of this testimony today, is in the UNE-P CLEC area.

The basic framework that we have brought to bear as it relates to investing in telecommunications companies is identifying companies that are able to acquire customers that have high net present value. And inherent in the telecommunications business is a cost to acquire a customer, the marketing, the provisioning costs, that is in excess of the current period, that current month's revenue stream. It is inherently a negative cash flow investment proposition.

So what we look to identify is the predictability of the future revenue streams of that customer and the gross profit margin in fulfilling the particular service that that customer procures that generates positive cash flow in the out periods, that when discounted to a present period, exceeds the cost of acquiring that customer. And I think in this framework, as you build that critical mass of customers, you can then look to take the next step in terms of stepping up the return on investment curve by building facilities in which the gross profit margin increases as you push forward.

Now, when we initiated our activity, in particular, in the local services marketplace, we did that based on what we deemed to be a very favorable regulatory environment related to the Telecom Act of 1996, a significant price-value proposition for a very large universe of consumers, where the greatest value proposition of deregulation was to the advantage of small businesses and residential customers, of which there are very many. The basic belief was that smaller competitors can significantly out-perform by being better at the basics, as it relates to what a customer sees, the customer service, the billing clarity, the pricing policies, the provisioning elements of the business.

And, lastly, we felt that the Telecom Act of 1996 provided a terrific framework for encouraging innovation. I think within the context of the Telecom Act of 1996, the Act really provided for three basic entry strategies for competitive telephony.

The first was a total service retail model, which essentially was a retail minus, the regional Bell's price minus a percent. And, essentially, your new entrance came in as marketing and billing agents for the incumbent providers of telephony.

The facilities model, which is also obviously one more, involved a significant PP&E investment, very sizable capital expenditures, and essentially made use of some elements of the public switch network. The last model which we have focused in on is the UNE-P or network elements recombined.

If you think about the basic framework of the Act, it was designed to allow the key elements of completing a phone call to be unbundled and procured by the competitive infrastructure. In the three components, there is really sort of seven specific components, but they basically roll up into access, switching, and transport of a telephone call.

What the UNE-P model represents is a cost-plus approach rather than a retail-minus, and it is that cost-plus approach that allowed those entrants to generate a reasonable return on capital that could facilitate additional flows of capital into that marketplace. Now, each one of those components that were envisioned by the Act has a very significant and meaningful position, and, clearly, the Act was very well thought out in that regard.

The total service resale model presents a low-cost entry strategy. Your investment capital is primarily to acquire customers.

The sort of customer acquisition model is a critical element in that regard, and there is a fairly low gross profit margin which creates a long timeframe for return on investment. In other words, you burn money to build a pool of customers, you get this critical mass of paying customers, and then you go about the capital expenditure investment to generate a profit margin. That is a fairly long path, given the lack of return on capital while you are acquiring the critical mass of customers.

The other model, which has been obviously very notorious for its impact on sort of the trouble in the markets, is a sort of build it and they will come—the facilities based model. Now, obviously, there are significant entry costs. There is a significance reliance on favorable access terms, which I think is very important and was expressed effectively in the Telecom Act of 1996.

There is, however, also a very long scaling timeframe. There is high gross profit margins upon reaching scale, but you have got to get your plants built, and then you have got to acquire those customers. Both of those cost a lot and do not throw a lot of return back on the capital that you invest. And as you ultimately load your network, that is when the gross margins begin to kick in.

And, lastly, I think the facilities framework is really designed to serve the higher margin larger users out there, the large corporate users or the very concentrated, from a population density perspective, users in the market.

The last entry element, UNE-P, really does present to some extent the best of both, with a little bit of extra. We think it provides

a low-cost market entry point. It is a customer acquisition entry model.

It has a much shorter payback on customer acquisition, because there is sufficient gross profit margin associated with buying the network elements at a cost basis rather than a retail-minus basis, so that you can generate a gross profit margin with about 20,000 or 25,000 access lines. That allows you to continue to propagate with profitability new customer acquisition, which ultimately allows you, I believe, to step into the facilities framework.

The capital expenditures associated with this model typically focus on customer centric issues. Most customers in the marketplace do not feel that the existing infrastructure is not effective at completing their calls. They feel more along the lines of "my bill is confusing; the pricing mechanic does not make sense; I need service and it takes a long time; I call customer service and I do not get that."

So from our perspective, the basic building blocks of building a competitive framework involve serving those sort of front and center customer issues up front, and we think that this framework is supportive of that.

And then, lastly, by being able to unbundle the network and then recombine those network elements, it gives innovative firms that have built a critical mass and are generating returns the opportunity to create product and service innovations by bundling hardware and software with the existing network elements to create enhanced services, things like unified messaging or follow-me calling or enhanced conference calling services or enhanced voice mail services. And this innovation, which has been really lacking from the incumbents, is really the biggest promise of telecom deregulation.

Then, lastly, I think what UNE-P represents is the stepping stone to the higher margin facilities based business model. So as I look at what Congress did in 1996, I think there was an enormous amount of brilliance embedded in the Act.

But, I think it is essential that Congress continue to support all three elements of the Act, the resale model, which creates ubiquity in the marketplace; the UNE-P component, which allows for a stepping stone to profitability through quicker cash flow and quicker profitability, which at this point is really what the capital markets are looking for—they do not like that long-term horizon of capital burn before they begin to see a return on their capital, and I also think it creates a very effective service platform for the average customer, the small user, the person who has eight lines in his business or 12 lines in his business rather than the large Fortune 500 companies—and then, lastly, the facilities strategy to serve the most complex customers and generate the highest margins.

I think the three together will facilitate capital formation. And I think that leads to someone sort of saying, "Well, boy, it all seems to be so well thought out and works so well—what happened?" It sort of begs the question: Why are we in the position that we are in?

I think that one of the strengths and one of the weaknesses of the economy is its willingness to speculate for gain, to drive lots

of capital into circumstances to create the upside. And I think the capital market simply went for the brass ring.

If you think about it, it is a $200 billion-plus revenue marketplace, and to secure 20 to 30 percent of that from the monopoly market to a competitive market represents $40 billion to $60 billion at a two to three times multiple on revenue. That is $180 billion of market cap that was available to be created. There was a pent-up gold rush into that market cap model, and everyone went for the highest margin business model, the facilities based model.

I think the capital markets ignored a bit a more rational step framework that was established in the Act through total service resale, UNE-P, and then facilities based advocacy. So I guess the question is what sort of point of view do I have as it relates to how we perpetuate or reinvigorate capital formation in the space.

The question is, also, is there still a reason to force the incumbents to keep open all three entry strategies, and we believe very emphatically yes. We think it is a central theme to capital formation in the marketplace, and we think through the FCC's triennial review proceedings, which are underway, the results of that will really, I think, determine the outcome.

From a public interest perspective, we do not think people are going to build the Novo networks to serve the small guy. And competitive telephony, as it is configured today, will allow all to benefit as each strategy has an opportunity to flourish over time.

I think my second point would be that what Congress can do to facilitate flows of capital is to continue to hold the incumbents to cost studies that allow for buy rates on the public switch network elements that can support margin and that will perpetuate capital inflows.

Then, lastly, I would say that enforcement is a critical issue. And, in fact, rather than lessening the terms of the Act, I think the terms of the Act need to be more fully embraced. It is important to note, in my view, that old monopolies die hard, and as such, enforcement mechanics should not be undermined.

I think the Tauzin-Dingell bill appears to create a protected safe harbor for the Bells to invest in next generation networks that will not be subject to open access as provided for in the Telecom Act of 1996. And I think that would be a dangerous precedent and deleterious to capital formation in the telecommunications industry.

Again, I would like to thank you for the opportunity to speak before the subcommittee, and I would be pleased to entertain any questions anyone might have.

[The prepared statement of Bryan J. Mitchell can be found on page 72 in the appendix.]

Chairman KING. Thank you, Mr. Mitchell.

The subcommittee has been joined by Congressman Grucci, who does have a particular expertise in this area, and he will be asking questions later. But now, I would like to ask Mr. Glenchur to give his opening statement.

STATEMENT OF PAUL GLENCHUR, VICE PRESIDENT, SCHWAB CAPITAL MARKETS L.P., SCHWAB WASHINGTON RESEARCH GROUP

Mr. GLENCHUR. Thank you, Mr. Chairman and Members of the subcommittee. It is my pleasure to discuss with you issues related to capital formation in the telecom market.

As the vice president of Schwab Capital Markets, Washington Research Group, I work with a staff of analysts that examine the regulatory, legislative, and political factors affecting investments in various industries, including telecom, technology, energy, health care, financial services, and international trade. We work with institutional investors to address their concerns in these areas.

I would like to say at the outset, however, that today's comments and views represent my own, not those of Charles Schwab and Company or Schwab Capital Markets.

It was only a couple of years ago that the telecom and technology markets were ablaze. Equity values soared and capital investment was flowing into these sectors.

But as we all know, telecom and technology have suffered a meltdown. Telecom carriers, pursuing a land rush mentality, assumed substantial amounts of debt to build and expand the reach of their networks.

The bursting of the internet and dot-com bubble undermined a major portion of the customer base for telecom service providers. Revenue struggled to keep up with debt service obligations. We have seen numerous bankruptcies and threats of more to come.

The investment community obviously suffered along with the telecom carriers. They were enthusiastic about the promise of telecom competition and the migration to new and exciting data services over upgraded networks.

To a great extent, investors believed that expanding telecom networks to allow flexible configuration of services to customers in all major metropolitan areas offered the greatest potential upside in the new telecom environment. But building networks in all major cities required the assumption of huge amounts of debt.

A variety of factors pressured the revenue growth of upstart telecom service providers. Competition for high volume business customers led to disruptive pricing as carriers attempted to achieve revenue targets regardless of profitability.

Internet service providers struggled and went out of business, disconnecting service or cutting back demands for service. Regulatory actions also were involved in affecting the projections of competitive local exchange carriers.

The economic slowdown worsened a difficult situation. The expansive revenue growth anticipated from new data services failed to materialize. Meanwhile, debt burdens continued to squeeze upstart carriers. Investors pulled back, refusing to invest additional money in telecom service providers. Suddenly, the emphasis was on cash flows rather than the reach of a provider's network.

As illustrated by the last couple of years, it is difficult to make a business work when it requires massive up-front capital investment and entails substantial customer acquisition and retention costs. Ongoing regulatory battles between incumbent and competi-

tive carriers also have increased regulatory uncertainty in the sector.

At this time, there is little growth in the telecom industry. Without profit growth, there are few incentives to invest.

But despite the downturn in the industry, there is room for optimism. A necessary shakeout will mean inevitable consolidation and the survival of carriers with the most sustainable business models and financial structures.

New data services and other offerings will continue to leverage upgraded telephone, cable, and wireless networks. But the healing process will take time.

Carriers are reluctant to assume additional debt, a factor discouraging industry consolidation. Meanwhile, the burden of maintaining networks and upgrading them to add capacity or provide new services remains a costly exercise at a time when adoption rates for new services lack visibility. But technology is forcing the migration to new service models.

Telephone carriers face competitive pressure from wireless substitution, IP telephony, and instant messaging. Broadcast and cable operators face a fragmented audience among numerous video offerings that pressures traditional advertising models. Commercial wireless service providers are making critical investments in data services.

Although futurists may be excited about today's telecom opportunities, reluctant investors fit the "once burned, twice shy" characterization. They want to see killer apps that drive penetration rates for new services. The pendulum has swung from irrational exuberance to abject pessimism.

History teaches, however, that we tend to overestimate change in the short run, but underestimate change over the long run. And, hopefully, the melt-down represents the first part of that equation.

As Washington considers legislative or regulatory proposals to jump-start the telecom economy, some level of caution is warranted. Major initiatives lead to the inevitable legal challenges in Federal court and the results are unpredictable. The resulting uncertainty can actually discourage capital investment.

Moreover, legislative and regulatory actions cannot force changes in human behavior. As noted above, there is genuine excitement about the potential of new technologies and high bandwidth services. What is not clear is how consumers will embrace these new capabilities over wireline and wireless networks.

What is the value proposition for these services? We do not need 100 megabits a second for e-mail. Consumers and business are struggling with this question today. We must be realistic in our expectations of what Government policy will accomplish.

Thank you, Mr. Chairman.

[The prepared statement of Paul Glenchur can be found on page 86 in the appendix.]

Chairman KING. Thank you, Mr. Glenchur.

Mr. Levin, please.

STATEMENT OF BLAIR LEVIN, MANAGING DIRECTOR, TELECOMMUNICATIONS AND MEDIA REGULATORY ANALYST, LEGG MASON WOOD WALKER, INC.

Mr. LEVIN. Thank you very much, Mr. Chairman, Ranking Member Maloney, Members of the subcommittee. I am Blair Levin, Managing Director of Legg Mason. I am an analyst, and in that role, I advise institutional investors about the impact of Government policy on telecommunications and media companies.

Let me start by saying that I think the telecom situation is different than the energy situation in a very critical aspect. Telecommunications went through an historic change in the last 5 or 6 years.

Every industry that has gone through an historic change has seen a cycle of over-investment and then a retreat from the market. This was true of the railroads in the 1800s, and it was true of the auto industry in the early 1900s, and it was true of the computer chip industry and the computer industry.

That does not mean that these industries, all of which are critical to the success of our economy, are fundamentally flawed. It just means that when you have change, you have enormous investment, because, as the first speaker mentioned, there was a brass ring to be grabbed, and now the market is obviously retreating.

I think as an indication of the fundamental health, but the problem of the industry—the revenues in the telecom industry last year grew at a rate of 7.5 percent, ranking as one of the highest among industries. But the profits of the industry dropped about 52 percent, and that is obviously very problematic.

Mr. Chairman, I think you asked the right question by asking what are the hurdles that need to be overcome so you get the appropriate level of investment. Let me say I think that first, there are three preconditions to investment in the telecom industry.

The first is competition, because without the opportunity for competition, you do not have investment in new entrants. Also, traditionally, the incumbents do not invest as much, and, certainly, there are a lot of examples which I cite in my written testimony that as competition starts to come online, you have both investment in competitors as well as more investment by the incumbents in upgrading our networks.

Second, I think there needs to be a growth opportunity in both revenues and profits. Mr. Glenchur talked about that, and I think that is absolutely right. None of us in this room are going to invent those killer apps, but, nonetheless, we have to make sure that the companies realize they can get the benefits of inventing those killer apps.

Third, there has to be, as Chairman Oxley mentioned, innovation in the marketplace. There have to be new kinds of goods and services. And here, there is a particular problem in telecommunications, because there is a tension between innovation in the networks themselves and innovation at the edge of the networks. I think we have to make sure that the delicate place is balanced, so that both investments kind of make sense, because that is what really drives the kind of innovation that increases consumer welfare gains as well as the economy.

In making sure that those preconditions are met for investors, I think Government itself faces three challenges, first, to make sure that there is a balanced policy. All the policy debates center around the question of what are good incentives for investments.

But it turns out there is a lot of tension between facilities based investors or those who want to lease networks, between certain kinds of facilities based investors. It is much easier to say than to do, but the simple truth is—and my written testimony goes into some examples of this—we need to make sure that all different kinds of investors have an opportunity to see revenues and profits, because otherwise, we will not get the kind of competition and innovation that America needs.

Second, we need to rationalize the revenue streams in telecom. One of the things that makes telecom different than these other sectors—which I noted earlier as going through historical cycles—is that it is very heavily regulated. And we need to, when possible, have the market sending the right pricing signals.

In my testimony, I talk a little bit about the problems of retail rate setting and universal service and the very complicated Federal-State jurisdictional battles that still, I think, give the market problematic signals and lead the market to underinvest in the sector, because they cannot tell where the market really is and where the growth is going to be and whether they should invest in a company who, unfortunately, may really depend on a regulatory regime for their profits.

The third thing is we need speed and certainty in decisionmaking. The others have talked about that, and my written testimony goes through some examples. But again, I think the Congress did a very good thing when it passed the 1996 telecom act by telling the FCC to get a number of decisions made within a very short period of time.

But we have the ironic situation where the Congress asked the FCC to establish the pricing rules within 6 months, which it did. And now 6 years later, the courts have still not finally addressed the question of what is the appropriate pricing regime. So I go into some concrete proposals for how to speed up that decisionmaking and how do you make it more certain.

There is a limit to what Government can do. Obviously, as Mr. Glenchur mentioned, consolidation and other market forces are going to return this sector to a greater sense of profitability and make it more attractive to investors.

But, nonetheless, I thank the subcommittee for giving me this opportunity to testify, and I think that the Government does have a very critical role to making sure that capital formation in the telecom industry improves over the next 3 years.

Thank you very much.

[The prepared statement of Blair Levin can be found on page 93 in the appendix.]

Chairman KING. Thank you, Mr. Levin.

I want to thank each of the panelists for their testimony. I have one question I will ask at the start, and then I will turn it over to Mrs. Maloney and then to Mr. Grucci.

I will ask the three of you to comment on this. To what extent do you see the issue of access lines being a capital deterrence, and how does this issue affect the decisions of Wall Street analysts?

Mr. LEVIN. Could you just clarify on the question of access lines? I am not sure I know what you mean.

Chairman KING. Actually, the last mile, basically, we are talking about.

Mr. MITCHELL. Oh, OK. I will start. I think that having open access to last mile is absolutely critical and essential to building any kind of a competitive framework. And the buy rates on that last mile need to be constructed in a way that the companies that are competing can generate a reasonable profit margin so they can cover their costs and generate a return on capital.

So capital will form up to acquire customers and create—the first part of the competitive infrastructure, in my view, is a critical mass of customers to make prudent ROI judgments on, in terms of investing in expanded facilities.

Mr. GLENCHUR. The last mile is obviously the whole critical part of this debate, and in terms of what we ought to do to reform telecom regulation. Whether it is for phone connections or it is for broadband connections, it is the great advantage that incumbents have, whether it is the Baby Bells, the incumbent phone carriers, or cable operators, having that direct connection with the customer.

Unlike the infrastructure for long distance, the barriers to entry in terms of coming into the local market are pretty substantial. It is much more costly to invest in the local infrastructure to solve the last mile problem or to offer competitive alternatives. And that is why we have seen so many of the telecom meltdowns that we have seen and the bankruptcies and the pending bankruptcies. So this is a very, very difficult challenge.

I would also say that beyond just that connection, you are looking at a lot of advantages that incumbents have in terms of brand identity, constant contact with the customer, and entrenched customer relationships, which has raised the acquisition cost for a lot of upstart carriers or those who would enter this market to try to offer that alternative. And it takes time to try to overcome those hurdles, to find the right business model and financial model to make a business case for entering this market. But it is the great challenge, and it is really at the heart of the difficulties the industry faces today.

Mr. LEVIN. I would certainly echo that. I think it is notable that a great deal of the investment that occurred in the post–1996 environment went into the long-haul side, and prices have dropped dramatically, performance has improved dramatically in the long haul networks. But we did not see the same kind of investment or improvements in price and performance in the last mile.

On the other hand, I think that more and more, there are beginning to be last mile substitutes, whether it be on the wireless side—I think we are going to see more cable CLECs in the efforts over the next year. So, obviously, we want to see more improvements in the performance of that last mile, but I would be cautious about making any dramatic changes in the policy at this point in time, because I think that could hurt investment into the last mile at this point more than help it.

Chairman KING. Mrs. Maloney.

Mrs. MALONEY. I just would like to ask the panel to react to what Mr. Kuhn said earlier. In his statement, he made a point that he was trying to distinguish Enron's practices from those engaged in by other energy companies in order to restore investor confidence in the whole industry.

But several other energy companies, including counter parties to Enron, have announced that the SEC has opened inquiries into their accounting practices. So, basically, the point is we are trying to get more investor confidence into energy companies and telecom companies. But how can we get that investor confidence when all of this is being announced, whether it is Global Crossing or Enron or whatever.

Global Crossing was a telecommunications company, was not it? It was not in energy. It was in telecommunications.

So as long as that cloud is out there with Global Crossing and alleged accounting practices in other telecommunications companies, for then Enron—that was totally an energy company. How can we get investors to come back with confidence and put their capital there when this cloud is out there?

Mr. GLENCHUR. I think that is right. It is another burden to have to overcome at a very difficult time in the industry. They are burdened with substantial debt, and we have seen the bankruptcies, and we are probably going to see more of those. What is positive is some of the companies are working out of bankruptcy, and that is favorable.

But if you look in the telecom industry, it is not just Global Crossing. You have seen questions raised with respect to WorldCom, Qwest. You have seen the SEC opening an inquiry in Adelphia, a cable company, now, raising questions about off-balance sheet debt.

And these are problematic, because it increases the due diligence that one must perform with respect to potential transactions in this sector, in terms of what kind of debt you are going to assume in doing a deal, as well as whether you have a good sense about the scope of the burdens that you may be taking on. It actually may have somewhat of a chilling effect on the ability to see consolidation take place that might ease some of the troubles in the sector.

Mrs. MALONEY. Well, energy projects are often financed and held through special purpose vehicles, the so-called SPEs, that do not appear on the books of the sponsoring companies. How frequently is this type of financing vehicle used in the telecommunications industry? Doesn't the telecommunication industry use these SPEs in their accounting practices?

Mr. MITCHELL. From my perspective, there is not nearly as much frequency in that regard. The sort of accounting issues that, I think are more prevalent in the telecommunications industry are sort of bartering arrangements and sort of income recognition issues more so than moving things off of the balance sheet so they cannot be seen.

I think that this kind of issue of accounting policy and accounting framework tends to be highlighted in industry sectors where there is a lot of growth, which creates a lot of investor interest and creates an opportunity for people to engage in perhaps less savory

activities. But I think, to some extent, it is a separate and distinct issue to the underlying construct of profitable business models.

Is there the ability to develop, and is there a supportive framework from a regulatory perspective for the formation of profitable business models. And, you know, I think telecom is plagued with its share of accounting issues, but I think the bigger issue in telecom is companies that investors invested in that did not make money, and they knew it did not make money when they invested in it. And the task of making money was so extended that it created investor indifference and, ultimately, investor dissatisfaction, which then created a lot of pressure on the leverage side of the houses, as was mentioned by Paul.

Mrs. MALONEY. I think the first and best thing that we could do as a Nation to get people to invest capital in telecommunications is to restore confidence that the businesses are well managed. When someone reads about a Global Crossing, it is not fair to say that every company is the same. It certainly is not. Most companies are honest, hard working, and doing a great job.

But we need to restore investor confidence. I think that is probably the biggest thing we could do to get people to start investing capital back into telecommunications.

So I would like to ask what the industry is doing to assure investors that these off balance sheet entities do not conceal additional liability or losses. And what is being done by the industry to weed out overly aggressive or misleading practices?

Obviously, the best thing that could happen for telecommunications is that there is not another Global Crossing, there is not another scandal, you could say, of sort of misleading investors. And Government is trying to do their role. We have had extensive markups on bills that increase oversight. The SEC is trying to do their role. But what is industry doing to weed out aggressive or misleading practices?

Mr. LEVIN. I would like to answer that with two comments. First, I think we need to make a distinction between misleading investors in what one might think of as a conscious way, where you do not reveal information you should reveal—clearly, this was the case in Enron. Based on press reports—and I want to emphasize based solely on press reports, it appears to be that Adelphia was engaged in off book accounting.

But that is very different from what I think is the major problem facing telecom, which is the business models did not live up to expectations, primarily because of mis-estimations of supply and demand. So there were a number of companies that went into the long-haul business. The demand did not increase as much as they had anticipated. There was much greater supply. Prices dropped. That is a more normal problem, but I think that that is more of the problem in the telecom sector than some kind of misleading.

And, second, let me say to the extent that there is misleading, I have got to tell you that the market reacts just like Washington. In other words, when there is an issue, everybody goes and focuses on that issue. And I can assure you that as soon as Adelphia came out with their statement that they had been borrowing money that had not been revealed, every single cable company was imme-

diately asked by every single analyst, OK, tell us what you have too.

So I think that the market is self-correcting in some ways. That is not to say there is no further Government role necessary. But the market is now, I think—well, Mr. Glenchur stated that we have gone from irrational exuberance to some kind of over-pessimism.

We have also, as analysts—it used to be that the job of the analyst was to search for the great new thing which would bring huge upside. Now, I think analysts are very focused on what is the missing thing that actually I can discover that reveals that there is enormous downside. So I think the marketplace is reacting by searching for those kinds of problems.

Mrs. MALONEY. Well, then, what can we do to help you? What, specifically, could Government do to help with capital formation for telecommunications? I mean, I see it as investor confidence. You say that is adjusting. When all these scandals are out, investors pull back. But if that is adjusting, and that is not a problem, then what could be done?

Mr. MITCHELL. I think the first step is private capital formation. I think you need to distinguish sort of private equity and large institutional funds that invest in companies separate and distinct from the individual investors maybe through their mutual funds or whatever.

From my perspective, I think there was great brilliance in the Telecom Act of 1996, and I think that it would be a mistake to sort of throw the baby out with the bath water. We have to recognize that frequently, in the economy, particularly around substantial growth sectors—and I think Blair mentioned that telecommunications revenue growth is still up substantially—there is a proclivity to over-invest, to create speculative fervor around these growth sectors.

I think when that happens, the markets do correct themselves, and what we do not want to do is over-respond from a regulatory perspective. Let's look at the brilliance of the stepped business models toward inevitable profitability that was established in the 1996 Act, and let's make sure we enforce those provisions and hold people, particularly the incumbents, to the critical metrics of reasonable buy rates and open access and do not find ways for them to avoid open access on the data side and keep it open on the voice side, because at the end of the day, data and voice are the same thing. It is bits and bytes. And so it is just sort of voiding the old monopolies' desire to protect themselves and make sure we stay true to the original framework of the Act.

Mr. GLENCHUR. I think that Blair stated this pretty well, that the investment community will be a disciplinarian for the market, and you are seeing companies having to respond to that. The "build at all costs" model has been discarded, and now you will see competitive carriers with tighter geographic focus, more customer segmentation.

You have seen the models adapt to the change in the capital environment. The capital markets are brutal, and they are forcing discipline on the market.

At the same time, we still have a very, very expensive infrastructure build-out ahead at a time when we really, again, do not know how fast or how deeply these new services that will be offered and enabled by this infrastructure investment will be taken up by consumers, which still makes it speculative and risky. But I think it is good now that we are seeing the hype come out of the market, the concept investing come out of the market, and fundamentals like cash flows and profits are reemphasized, and that is painful.

But that process did self-correct, and I think it is good to let that begin to run its course from a financial and business standpoint. There are broader policy issues that I know Congress has debated that regulators are looking at that affect various regulatory incentives in the market, and those are worthwhile debates to have. But I think that, in general, we are seeing the healing process, and we need to make sure that nothing is done to interfere with that.

Mr. LEVIN. I would just echo those comments again to the extent that there are folks who are deliberately not revealing information that they should have revealed or that we need to change the rules to make sure they reveal that information. That is certainly an appropriate role for the Government and the SEC with the capital markets.

Mrs. MALONEY. Isn't it a criminal offense not to reveal the information that you have debt that you are not really—to lie, basically, to lie to your auditor? Isn't that a criminal offense?

Mr. LEVIN. I am not an SEC lawyer, and I think there are always questions—obviously, there are a lot of questions about what needs to be revealed and what is not. And I think that that is at the heart, obviously, of a lot of the investigations of Andersen. I think those are very legitimate and important questions for this subcommittee and, really, the entire Government to look into.

But I do make a distinction, and I think it is an important distinction, between those players who were withholding information and those players who simply guessed wrong. They did not guess wrong because they were not smart and did not work hard. They guessed wrong because markets are unpredictable. So I want to make sure we do not punish them, because if we punish them, then people will not invest in new innovative companies that, I think bring a lot of value to this American economy.

Mrs. MALONEY. Thank you.

Chairman KING. Thank you, Mrs. Maloney.

Congressman Grucci.

Mr. GRUCCI. Thank you, Mr. Chairman. It seems to be a New York issue here. We have all New York representatives.

My question goes along the lines of competition and bringing competition into the marketplace. How can we encourage young upstart companies to get into the telecom industry, and can they access capital to do so? How can we help in creating the environment for capital to grow so that it can be accessed by these new startup companies?

I guess we will go down the line. If anyone wishes to answer that first, that is fine with me.

Mr. MITCHELL. Well, Congressman, that is exactly what my company does. We are in the business of financing private companies with $5 million to $25 million of capital to support creation of what

we hope to be, in the long run, a larger and ultimately perhaps public companies.

And from our perspective, our company has been rewarded by this fundamental cash flow discipline that we have applied to investing in this space to our ability to raise over $500 million in December of 2001 to re-deploy back into this market, so that the capital market, sort of on a wholesale basis, had, I think, a firm step-by-step process of building moderately profitable to very profitable businesses with good visibility on profits and cash flow. And I think the Act has built a framework for that, and I think continued access to the network elements on an unbundled basis is a very important part of constructing a profitable business model and a business model that will then perpetuate innovation.

I think the first issue is is there a framework that you can go out and negative spend to acquire customers in the context of near-term profitability as you gross up your customer base. And the facilities build model, straight up, does not provide that.

The amount of capital you need to spend to get the facilities and the amount of negative burn that needs to occur to get the customers puts profitability so far off that the capital markets have said, "I just do not have the tolerance for that long view of things, in terms of return on investment."

My personal view is I think that the Act has developed a good framework for that, and it is sort of making sure the buy rates make sense and making sure you can get those individual network elements for the facilities guys for access, for the UNE-P guys for access, transport, and switching, and, ultimately, for resale guys a reasonable access to the overall network at a reasonable price.

Mr. GRUCCI. Does anyone else wish to answer?

Mr. GLENCHUR. Yes, I would just say briefly that, again, I think that the competitive market for telecom services, the competitive carriers and the upstart carriers—I mean, they are trying to overcome a very difficult financial climate, and the capital markets are generally not open to them at this point, at least not as much as they were. I think a lot of the hype and the concept has come out of the investing, and there is discipline being imposed on the market as they explore the kinds of models that will work and the kinds of financial structures that will be sustainable, and that is a good process.

Eventually, as you see the consolidation and the shake-out, some players emerge who have the right approach, as the third or fourth generation competitive local exchange carrier going forward. So I think that healing process is critical here, because that will be something that all investors will want to know about and will have questions about and will demand answers, in terms of what kind of model a carrier has to compete, given today's climate.

I also think it is important for the FCC to continue to enforce the rules that Congress has established, provisions for competition—the FCC implements and enforces them. As the commission explores changes in this area, obviously, that creates some uncertainty in the market, and that is another difficulty to overcome.

But to the extent that the rules——

Mr. GRUCCI. Congress starting to go on, and I want to get a second question in, and we will start with Blair, if he wishes to answer this.

Chairman KING. Congressman Grucci, you can have as much time as you want.

Mr. GRUCCI. Thank you, Mr. Chairman.

The next question I wanted to ask is are there restrictions and impediments that put the smaller companies at a disadvantage over the bigger companies? Is there some kind of regulatory relief or regulatory assistance that might make it more appetizing to invest in a small company if, indeed, they had access to that kind of help?

Second, the Tauzin-Dingell bill was designed to bring competition into the field. I would like to hear all of your responses as to whether or not you are seeing that. Do you think that will grow, and do you believe that we ought to bring the cable companies into that loop where they are also covered under the Tauzin-Dingell bill?

Blair, why don't we start with you?

Mr. LEVIN. I suspect Mr. Mitchell could answer the question about small companies better than I, but let me make a couple of quick observations and then talk about your other question. I think there is a distinction between—telecom is really a big player game, and when you are talking about running these huge networks, huge data pipes, huge voice pipes, you really need scale.

There are a number of small telecom companies in this country that are in, geographically, generally rural areas. And I think there are certain things that Congress is considering in terms of regulations to limit the restrictions on them. But that is different than saying that a small CLEC can arise in Long Island or in New York and really compete with the big guys.

Going back to your earlier question, after the 1996 Act, we saw hundreds of new companies form. In some sense, they acted as an enormous success in terms of generating a lot of interest in telecom, and a lot of capital was invested. But what we have seen is that it is a big player game, and we just have to accept that that is the economics of the business.

On the other hand, a lot of the best things that have happened have been at what we think of as the edge of the networks, with new applications and innovations. And I think it is important that the people who—whether they be things like e-mail or instant messaging or file sharing or whatever—that those folks have access to the networks, so that they can make money off of bringing those innovations into the marketplace.

On the other hand, we want to make sure the big guys have incentives to invest in faster and faster networks. And that is the tension which I talk about in the written testimony, but I think it really calls for a certain kind of balanced policy where you really have to get into the weeds of the details of the policy. But that is the goal that we ought to shoot for, where everybody has an incentive to invest in all parts of the network.

In terms of the Tauzin-Dingell bill, I do not have any particular comments to make as to whether it is a good or bad idea. I think it goes to an earlier point I made, which is, yes, it is about invest-

ment, and, very frankly, if the bill were to pass, I would say the obvious thing to investors, which is invest more money in Bells, invest less money in CLECs and IXCs.

I do not think the bill will, in at least the short and medium term, affect the fundamental competition between cable and DSL, because that competition, in my opinion, has a lot more to do with the fundamental economics of providing broadband services, and that goes to the economics of the networks. And I have read a variety of different studies, but just roughly speaking, I think the cost for the Bells to provide a DSL services is, in rough order of magnitude, 30 to 50 percent more than the cable companies providing a cable modem service.

You can really play with the numbers, because so much depends on how many people you are serving. But my point is there are economic reasons that cable is beating the Bells that really have nothing to do, in my opinion, with regulation.

So I would just make that obvious observation, that it really depends on where you want the investment to go. But if you take the point——

Mr. GRUCCI. If you wanted the investment to bring competition into an area, how would you encourage that to happen?

Mr. LEVIN. Well, I think there are a number of things. For example, I think that one of the constraints on competition today is that a lot of cities have regarded their rights of way as a money-making opportunity. So they either tax or have some kind of fees on companies that, in my opinion, hurts competition.

If a new CLEC wants to come in and put in pipes under the ground, obviously, the city has a right to get reimbursed for direct costs, and, obviously, there are problems for cities of digging up streets. I am not saying the cities have no rights here.

But on the other hand, if the city is essentially saying, "We have a scarce resource, a right of way, which we should treat—and we should kind of, shall we say, auction it off, or we should try to make money here," I think that is an impediment to competition. I am delighted to see that a number of people, such as the NTIA director, Nancy Victory, have recently said that this is a big problem.

Also, several States have taken action to prevent local Governments from using the rights of way in that way. But, frankly, a State-by-State approach is much too slow, and I think Federal action may well be warranted to make sure that all facilities based competitors have a right to the right of way.

Mr. GRUCCI. Just on that issue, I used to be the supervisor of a township of 450,000 people, and we did have franchise agreements with a cable company on Long Island. I almost shudder to use this word in this town, but it is an infinitesimal amount of revenue that came to the municipality as compared to what the gross revenues of the cable company were.

For our municipality, it was probably less than $2 million a year in franchise agreements, and I know that they made tens of millions of dollars in gross receipts from just my township alone. While that may certainly add to the cost of the final product, which is what the consumer pays for, I do not believe that is driving away competition, because anybody would have the rights to that area.

The lease agreements would be open to anyone who wishes to come and lease that space, the right of way.

I am concerned with these giant companies coming in, and if you are saying that we have to accept the fact that this may only be a game for the big players, then what happens when, as in the accounting industry, the big eight went to the big six which went to the big five which is going now to the big four. I mean, what do we end up with, one cable company throughout the entire country, one telecommunications company throughout the entire United States?

I do not think that would be good for the consumer. They would end up paying the brunt of all of that.

Mr. GLENCHUR. Well, fortunately, the FCC is in the process now of looking at how consolidation in telecom and in media—well, primarily in media—will impact the idea of having all voices brought down to a small number, and whether it has impacts on the diversity of viewpoints and localism and the extent to which, historically, the FCC's effort to protect that has worked, and they are looking at that very issue. And I think maybe by the end of the year, we will have a better sense about how this kind of consolidation, as we go to fewer players and larger players, will affect those very issues.

Mr. GRUCCI. The issue that I am concerned with is how it affects the consumer. Let me just say locally—because that is the issue that is the topic of today—we have really one cable company that provides access to the TV stations, other than a dish or an antenna, and a dish is the real small guy in the marketplace trying to be a player.

There is a war going on now between the two top guys in the Yes network and cable company, and as a result, the consumers are being denied the ability to watch Yankee baseball games. And while I am not a huge fan of sports—I enjoy watching it—there are those who are, and they cannot access that unless they now go out and get a completely different system for their homes. And that is my fear, that if you end up with one or two companies where the consumers can go for this kind of service, they are ultimately going to bear the high cost of that new service.

Mr. MITCHELL. Well, I think your point, Congressman, is right on—and I would suggest that, in fact, you can create a very viable business model around serving Long Island, Westchester County. I invest in companies that do exactly that—60,000 customers in Westchester County, and why those customers come to work with my little CLEC that does not have enormous levels of facilities and all this pipe and what-not—they come because we have clearer bills, which might be less expensive.

When they call to get another line put in their house, we respond on the phone immediately. We come out and provision that line in 5 days in a very reliable fashion.

Basic consumer facing service improvements are enough for a lot of customers to make a decision to change from the regional Bell to a competitive player. And that basic initial building block, if you can do it profitably, will allow you to build the cluster of customers, like one of my companies that has 60,000 customers in Westchester County, and then we can take a look at whether or not we should,

in fact, be investing in additional facilities that allow us to bring more innovation, broadband services, and other things.

We have got a profitable cluster of customers, and that makes me, as a capital investor, much more anxious to look at making additional investments of capital into that company. I think the Act has a provision for that, and I think what we have to be very careful about in the Tauzin-Dingell bill is the opportunity for the entrenched historic monopoly businesses to find a safe harbor in data and broadband, which actually can serve as sort of the next generation voice network as well, and sort of leave behind to that small customer service innovator that wants to become a product innovator an antiquated system or an antiquated methodology.

And if you give them the safe harbor, they will take it. There is absolutely no doubt about it, and——

Mr. GRUCCI. Isn't that what happened with the cable companies? Didn't they find a safe harbor in the Tauzin-Dingell bill?

Mr. MITCHELL. I am less able to speak to the issues in Tauzin-Dingell relating to cable than I think—and telecommunications. But I think the same concept applies.

Mr. LEVIN. Could I just real quickly give the——

Mr. GRUCCI. Sure.

Mr. LEVIN. The question about media ownership, in particular, I think is one that really needs to be on the radar, because the courts have significantly undercut the FCC's ability to actually regulate in this area. But I think it is worth noting that this debate over the S network—there is a certain kind of—the marketplace is working to a certain extent. A cable company is not carrying it, one satellite company is not carrying it, but the other satellite company is.

In fact, in the most recent quarterly results of Direct TV, they had a big increase in subscribers, and a lot of people think it has to do with the fact that a number of people chose to get the S network, and they want to do it. I think that, you know, it is an interesting question, which I am sure the folks at the Department of Justice and the FCC will look at. If you allow the two satellite guys to merge, then what happens to that competitive dynamic for programming?

So that is a very important question. I generally tell investors what I think will happen in the world, whether or not it is a good thing or a bad thing. You obviously have to worry about what is being served in the public interest here.

I would just say that I think these issues of ownership are incredibly important and deserve an awful lot of study. And we have to be very careful, because, in fact, I think both the telecom industry and the media industry have delivered an awful lot of benefits to American society, both in terms of providing a diversity of viewpoint as well as economic growth.

Mr. GRUCCI. Thank you, Mr. Chairman. I appreciate your indulgence and your generosity with the time.

Chairman KING. Thank you, Mr. Grucci. I think you went a bit overboard, though, in being such a strong advocate for the Yankees, especially since the Mets are doing considerably better than the Yankees lately, and I think your constituents, even

though they elected you, are still too enlightened to get that excited about the Yankees when the Mets are the proper alternative.

Ms. Capito, do you have any questions?

Ms. CAPITO. Thank you, Mr. Chairman. I have no questions.

Chairman KING. We have votes coming up in the next several minutes. Do any of you want to comment on any of the points that your fellow panelists made this morning? I am not trying to look for a fight, but is there anything you want to add or amplify on a point that was made by one of your fellow panelists?

Mr. GLENCHUR. I would only say, again, that with respect to what we need to do, in terms of Tauzin-Dingell or any other regulatory efforts to modify the competitive landscape, the rules that players will compete under, that we just be very, very cautious about how much unpredictability that can create and how expectations about the future have to adjust and whether it actually deters investment in the sector. I think that those are not easy questions to answer, but I think that we do need to be cautious about that.

Chairman KING. I want to thank the witnesses for their testimony. You have gone above and beyond the call of duty. We greatly appreciate it, and I speak for myself and the Ranking Member, Ms. Maloney, and the other Members of the panel.

I also want to note that a number of Members may have additional questions for the panel, and, without objection, the hearing record will remain open for 30 days for Members to submit written questions to witnesses and to place the responses in the record. So ordered, and, with that, the hearing stands adjourned.

Thank you very much.

[Whereupon, the hearing was adjourned.]

A P P E N D I X

April 18, 2002

Anthony J. Alexander

President and Chief Operating Officer

FirstEnergy Corp.

Before the Subcommittee on Domestic Monetary Policy,

Technology, and Economic Growth

Financial Services Committee

U.S. House of Representatives

"Encouraging Capital Formation in Key Sectors of the Economy"

April 18, 2002

Testimony of Anthony J. Alexander

Good morning Mr. Chairman and members of the subcommittee.

My name is Tony Alexander and I am president and chief operating officer of FirstEnergy, based in Akron, Ohio. FirstEnergy is a registered public utility holding company. Our seven electric utility operating companies comprise the nation's fourth largest investor-owned electric system, based on serving
4.3 million customers in Ohio, Pennsylvania and New Jersey.

Thank you for the opportunity to discuss the issue of capital formation as it relates to the energy industry.

Encouraging capital investment in the nation's electric system is critically important because maintaining an affordable, reliable supply of electricity – with a strong network to produce and deliver it – is essential to our economic growth.

With the development of competitive electricity markets, utility companies no longer have the obligation to build generating capacity and recover those costs through utility ratemaking.

Instead, the competitive market will determine if and when capacity is built.

This fundamental change in the manner in which electricity supplies will be developed has a significant impact on capital formation in the industry.

Investments in the energy industry, particularly in generation assets, must now compete with every other capital requirement in the market – and that means it is essential that regulatory, tax and other burdens do not discourage investment in this sector.

In fact, electric generating facilities should be treated as any other competitive business facilities and should be freed of the burdensome regulations put in place when these facilities were operated as part of vertically integrated, fully regulated public utility companies.

I believe that there are several ways to encourage needed investment in this segment of our industry.

First, government should provide more favorable tax treatment for generation assets.

Shorter depreciation periods would free up capital for reinvestment in energy markets, and make those markets more attractive to new investors.

The current 20-year depreciation periods for generation assets are outdated and far longer than for other capital-intensive industries.

For example, oil refineries and steel mills have depreciation periods for their facilities that are 10 and 7 years, respectively.

It makes sense that electric generating facilities have similar tax treatment.

Investment tax credits are another way to attract capital to the energy industry. Tax credits for new facilities would bring down the cost and minimize the risk of investing, making electricity assets more attractive.

Second, the industry needs a greater degree of certainty with respect to future environmental regulations governing generating facilities.

Potential investors in generation need to know what the regulatory future holds. Without good prospects for solid returns, they will not tie up capital for new or expanded facilities.

Accelerated depreciation and other tax treatments for environmental systems also will help encourage investment, because they minimize the impact of making future environmental retrofits.

Third, the government needs to support competitive energy markets by allowing those markets to develop unimpeded.

That includes ensuring that wholesale electricity prices are market-based. Artificial price caps – or pricing subject to refund – will only serve to stifle competition and create barriers to investment.

In addition to generation, the competitive electricity market also depends on an adequate transmission system. Even though transmission is still regulated, utility companies are being required to turn over control of their transmission assets to third parties.

There are limited options available that will encourage investments in assets over which the owner will have no control of operations, pricing or expansion. One way is to remove barriers to divestiture by reducing the current tax liabilities for the sale of transmission systems.

Another is through so-called participant funding, which requires that new investment be paid by the party requesting the expansion. And, finally,

ratemaking allowances that produce sufficient returns will allow the owner to make needed investments in the transmission network.

In order to create and support the kinds of markets that were envisioned when states and the federal government promoted competition, we first need to ensure that the steady and growing capital requirements of the electric industry are met.

Only with an adequate supply of electricity produced from diverse sources that include coal, nuclear, natural gas and renewables – and the proper system to deliver it – can customers be assured of reliable and reasonably priced electric service.

Thank you for the opportunity to share our views on this important topic.

TESTIMONY OF THOMAS R. KUHN

PRESIDENT

EDISON ELECTRIC INSTITUTE

BEFORE THE COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON DOMESTIC MONETARY POLICY, TECHNOLOGY,

AND ECONOMIC GROWTH

U. S. HOUSE OF REPRESENTATIVES

"ENCOURAGING CAPITAL FORMATION IN KEY SECTORS OF THE ECONOMY"

APRIL 18, 2002

Testimony of Thomas R. Kuhn

Mr. Chairman and Members of the Subcommittee:

My name is Tom Kuhn. I am the President of the Edison Electric Institute (EEI), which is the association of U.S. shareholder-owned electric companies and industry affiliates and associates worldwide. I am pleased to have the opportunity to testify before the Subcommittee on encouraging capital formation in the energy industry.

The Growing Demand for New Capital Formation

Electricity drives America's economy. Modern technologies powered by electricity have been responsible for as much as half of the nation's economic growth since the 1930s. Electricity powers our homes, offices, industries, medical services, transportation, and computer and Internet activities.

The electric industry is one of the most capital-intensive industries in the nation. In the 1990s, electric generation, transmission and distribution assets together comprised nearly 9 percent of all U.S. business assets. In 1999, construction expenditures by regulated investor-owned electric utilities were $22.8 billion; data for 2000, the latest available, show an increase to $25.3 billion. With the growth of merchant generation and competitive wholesale markets, construction expenditures by unregulated power producers have also grown significantly, as have wholesale power trading revenues. Overall for the year 2000, total expenditures by investor-owned electric companies for generation, transmission, environmental and other purposes were approximately $45 billion.

Electric companies have been through enormous change over the last ten years, beginning with the passage of the 1992 Energy Policy Act that started us down the road to wholesale competition. The electric industry is in the middle of a sometimes painful transition from an industry composed of highly regulated, integrated utilities with monopoly service territories and cost-based pricing, to an industry with competitive power generation markets, market-based pricing and a wide diversity of market participants. New institutions are emerging, such as regional transmission organizations (RTOs). It remains our firm belief that market-oriented restructuring of the electric industry remains the best opportunity we have to provide consumer benefits and to develop reliable new sources of supply.

This past year brought additional financial challenges for the electric industry. 2001 began with severe problems in the California electricity market and ended with the collapse of Enron. The combined events of September 11 and the resulting economic downturn led to sharp declines in stock performance for businesses across-the-board. Even under these conditions, however, the electric industry fared better than most others. For example, the EEI index of utility stocks fell 8.8 percent, compared to the S&P 500, which fell 13 percent. The industry's financial results show growth in assets and revenues, and earnings that are stable. Total assets increased by 1.5 percent compared to 2000, rising from $860 billion to $872 billion. This follows significant growth of 20 percent in 2000. Total revenues increased by $128 billion, up 29 percent from 2000 and the fifth consecutive year of double-digit growth. Despite the impacts of the California electricity crisis, September 11, and the downturn in the economy, the industry's bottom-line, after all nonrecurring activity, was down a slight 1.3 percent.

The Uncertainty of Investor Confidence

Of course, the stunning collapse of Enron has brought much greater scrutiny to the energy industry. Enron is a major financial story, but it is not an energy story. Enron's failure is not an indictment of competitive markets or the fault of electricity competition. In fact, Enron's collapse has unfortunately, but clearly, illustrated the benefits of competitive markets. It has been widely acknowledged by the Secretary of Energy, the Chairman of the Federal Energy Regulatory Commission (FERC), and others that, even with the loss of such a major player, bulk power markets continue to function well. Electricity continued to flow. There were no shortages. There were no price spikes. There was no chaos in electricity or gas delivery. Markets are working the way they are supposed to.

Nevertheless, Enron dealt a blow to investor confidence that, at least in the short term, has affected the cost of capital for energy companies. Because Enron happened to be one of its leading participants, the unregulated power generation and trading sector has been especially hard hit by the fallout from the Enron bankruptcy. Analysts and investors have scrutinized these companies with extra care. Some companies have seen their ratings downgraded, and many have restructured their finances. All this has contributed to a rise in capital costs. A number of companies have cancelled generation projects.

EEI is leading a campaign to promote best financial practices in the industry, clear up many of the misconceptions surrounding the Enron situation, and distinguish Enron's practices from those engaged in by other energy companies, all in an effort to restore investor confidence in our industry.

FERC, under Chairman Pat Wood, is pursuing an aggressive agenda aimed at enhancing competition in wholesale electric markets and broadening the benefits and cost savings to wholesale and retail customers. Currently, the Commission is considering some rather far-reaching initiatives that are aimed at increasing certainty about market rules and cost recovery for greater investor confidence. But if these initiatives are implemented in a way that does not preserve a stable business climate, investors will perceive increased risk and uncertainty, which could affect the attractiveness of electric companies in the eyes of investors.

As we look ahead, capital formation will only become more important to our industry. The demand for power and the infrastructure needed to deliver it to consumers safely and reliably will increase as the economy continues its recovery. This will require massive infusions of new capital.

In addition, because of the critical nature of energy infrastructure, and the fact that electricity cannot be stored, more redundancy must be built into the system to enhance its ability to withstand potential terrorist attacks. This, too, will require significant capital investment.

I will now focus in more detail on some specific issues that affect the ability of companies to attract capital for investment in two key components of the nation's electric system: generation and transmission.

The Need for New Generation

Demand for electricity is growing rapidly as the U.S. becomes increasingly electrified. Between 1995 and 2000, U.S. electric demand increased by 13.8 percent, while total electric generation additions rose only 5.4 percent. This has resulted in a

decline in utility reserve margins. The Energy Information Administration (EIA) projects that 355 gigawatts of new electric generating capacity will be needed by 2020 to meet growing demand and to offset retirements of existing plants. Even with additional energy-efficiency improvements, EIA projects that electricity consumption will increase 43 percent by 2020.

The dramatic increase in electricity prices seen in California last year is proof of what happens when capacity does not keep up with demand. Responsible public officials must support the siting and construction of generating facilities to ensure reliable and adequate electricity supplies. Otherwise, it will be very difficult to attract investment in generation, and consumers will pay a very high price for electricity.

- **Federal Tax Code Impediments**

The ability to recoup investment costs, including the depreciation and amortization of generation assets, is of critical importance to the electric power industry's viability and the nation's access to reliable power. As I mentioned before, the electric industry is rapidly changing to one in which generation is becoming fully competitive at a time when there is growing need for new energy supply. However, the capital recovery rules that have applied in the past under the traditional regulatory framework are now inadequate.

To efficiently meet our nation's energy needs through adequate and reliable power, the electric supply industry requires the same ability that other industries have to more rapidly depreciate assets for federal income tax purposes. In stark contrast to the 15 or 20 year depreciation lives for electric generation assets, facilities for other capital intensive manufacturing processes, such as pulp and paper mills, steel mills, lumber

mills, foundries, automobile plants, shipbuilding, and even cigarette manufacturing plants are depreciable for federal income tax purposes over 7 years. Chemical plants and facilities for the manufacture of electronic components and semiconductors can be depreciated over 5 years.

There is no sound justification for these types of distinctions in today's competitive environment. For example, according to federal tax law, investment in pollution control equipment at other types of manufacturing facilities have shorter depreciable lives than at electric generation facilities. As the electricity industry evolves and becomes competitive, it is important for it to have the same types of tax incentives to encourage modernization and increase productivity as those available to other industries. We recommend that the federal income tax laws be changed to allow electric generation facilities to be fully depreciated over 7 years.

- **Constraints in Federal Law and Regulation**

Congress can facilitate the availability of adequate generation by removing federal roadblocks that hinder development of sufficient and affordable generation capacity. One of the most significant barriers is the Public Utility Holding Company Act (PUHCA). PUHCA is an outmoded 1935 statute that acts as a barrier to competition in power markets. By imposing a number of restrictions and regulatory burdens on the purchase and sale of securities and assets as well as other normal business activities, PUHCA restricts the flow of capital into energy markets and slows development of generation capacity. The Securities and Exchange Commission, which is responsible for administering PUHCA, has supported its repeal for over twenty years.

Because of multiple, uncoordinated, and overlapping existing and proposed air emission control requirements from federal and state agencies, and even neighboring countries, the electric power industry faces enormous uncertainty as it tries to develop appropriate plans to develop new generation capacity, upgrade plants and add pollution controls. In lieu of the current regime, EEI has long supported a reasonable, sound, and integrated multi-emissions strategy that would streamline the regulatory process through flexibility and certainty, accomplishing meaningful air quality benefits at a much lower cost, while protecting electric reliability and fuel diversity.

Regulatory certainty and stability are essential to attracting capital for air pollution control. Providing business certainty by establishing specific and reasonable emissions reduction requirements that remain unchanged for a definite period of time will facilitate capital acquisition at a price that allows for lower overall compliance costs. EEI seeks safe harbor provisions in clean air legislation that assure certainty through reasonable timeframes and the elimination of multiple regulatory requirements for SO_2, NO_x, and mercury.

New Transmission Must be Built

Having established the need for more investment in generation, I would suggest there is an even greater need for investment in the power delivery system. Without an adequate transmission system to deliver power to consumers, electricity will not get to where it is needed, no matter how abundant supply may be. Adequate transmission is absolutely necessary to make wholesale electric markets work, bringing lower energy prices to consumers.

Most of today's transmission systems were not designed to deliver large amounts of power over long distances. The grid—built originally to interconnect neighboring utilities—now is being used as a "superhighway" for electric companies.

The number of transactions on the grid has increased significantly because of competition. As a result, the transmission system is facing dramatic increases in congestion. Increased congestion on transmission lines threatens system reliability and increases costs to consumers. In fact, according to FERC, transmission bottlenecks cost consumers more than $1 billion over the past two summers alone.

Competitive wholesale and retail electricity markets place more demands on a transmission grid that was not designed for such purposes, making it imperative to increase the transmission capacity in the U.S. The grid is nearing the limits of its capacity because of the growing demand for power and the use of the grid to serve competition.

While the demand for electricity is increasing rapidly, transmission investments in 1999 were less than half of what they had been in 1979. In fact, transmission grid expansions are expected to be slow. According to the North American Electric Reliability Council (NERC), about 10,500 miles of transmission facility additions (230 kilovolt and above) are planned throughout North America over the next ten years—only a 5.2 percent increase in total circuit miles. As NERC testified before Congress last year, "The nation is at, or fast approaching, a crisis stage with respect to reliability of transmission grids." Most of this investment connects new generation to the grid, and does not upgrade the capacity of the basic infrastructure.

Maintaining transmission adequacy at its year-2000 level would require a quadrupling of transmission investments during the present decade. At a time when the transmission system is nearing the limits of its capacity, however, investments in transmission have actually been declining. We must turn this around.

As the electric industry makes the transition from one dominated by vertically integrated companies to one featuring more diverse players, stand-alone transmission companies are being formed. However, these companies can only survive and prosper if they can provide returns adequate to attract the significant amounts of capital investment needed to maintain and expand transmission systems.

Current rates of return on transmission infrastructure are too low to attract the significant amount of capital needed to finance and build new transmission facilities. According to one recent analysis, maintaining transmission adequacy at its current level might require an investment of about $56 billion during the present decade. However, it is estimated that only $35 billion will likely be invested.

The most severe choke points on our nation's transmission system are also by nature the locations at which an intentional physical attack on the system would cause the most widespread outages, an additional vulnerability that must be considered in the wake of September 11.

- **Current Law and Regulation Must be Changed**

The nation obviously needs to build new transmission facilities and upgrade existing facilities. Unfortunately, regulatory uncertainty and transmission ratemaking policies can create roadblocks that hinder investment in expansion of needed transmission facilities.

Policymakers can take several steps to help ensure that the transmission system will be able to meet the needs of consumers in increasingly competitive electricity markets.

FERC should be given authority to help site new transmission lines, similar to its long-standing authority to site natural gas pipelines, with appropriate state participation.

Financial incentives, including higher rates of return and other appropriate innovative pricing mechanisms, are needed to attract capital to fund investments in transmission expansion.

PUHCA should be repealed because it acts as a barrier to the formation of interstate independent transmission companies. Regional transmission organizations (RTOs) are expected to play a critical role in planning new transmission infrastructure in the future. RTOs are also a cornerstone of FERC's policy for the development of competitive wholesale electricity markets. However, PUHCA is an impediment to these efforts. An RTO could be required to become a registered holding company and subject to PUHCA restrictions and additional regulation. As investor-owned utilities attempt to raise financing for these newly formed RTOs, they are discovering that PUHCA's restrictions are a significant concern to Wall Street firms and a barrier to investment.

As mentioned before, FERC is pursuing an aggressive regulatory agenda that will shape wholesale electricity markets, including ownership and operation of the transmission grid, for years to come. Congress should seek to ensure that FERC's regulatory policies do not impede or discourage private investment in transmission infrastructure or operations. Encouraging FERC to implement performance based rates

and other innovative approaches are essential to enhancing the grid and creating a viable business climate for the formation of independent transmission companies.

- **Tax Law Considerations**

Current tax law is also a major impediment to the formation of independent transmission companies. In order to avoid tax liability while complying with FERC policy, transmission-owning utilities are forming corporate structures that have only passive ownership of transmission assets, with control of the lines being transferred to the RTO. However, attracting new investment capital to upgrade and expand the transmission system is extremely difficult for the utility (which owns but does not control the transmission lines) and for the RTO (which controls but does not own the system). Selling or spinning off the transmission assets to a separate stand-alone transmission company may be a better option for transmission-owning utilities. Yet they are discouraged from doing so because of federal tax law. In order to fix this problem, H.R. 4, the House-passed energy policy bill, amends the U.S. tax code to defer taxes on the sale, and eliminate taxes on the spin-off, of transmission facilities for transmission-owning companies that seek to join FERC-approved RTOs. The House should be commended for acting promptly on this issue by passing H.R. 4 last summer. The Senate should follow suit.

Congress also should shorten the depreciable lives of property used in the transmission and distribution of electricity. To assure upgrading and building of adequate transmission capacity, EEI recommends that new, and the resale of, transmission depreciable lives should have a cost recovery period of 7 years.

It is worth noting that the economic stimulus bill recently enacted by Congress includes a provision that should help encourage transmission additions. The bill includes a bonus depreciation provision that will permit electric companies to immediately expense 30 percent of the cost of certain "qualified property" placed in service in a three-year period, and extends the deadline for capturing the depreciation deduction until January 1, 2006. It also contains provisions that would apply the bonus depreciation provisions to repairs and reconstruction of property already placed in service. While primarily designed to promote transmission facility upgrades, the bill may also help promote some construction of new gas-fired generation, which can be brought online relatively quickly.

In addition to the demonstrated need for new capital formation for generation and transmission, our industry anticipates the need for new capital formation to upgrade and modernize our distribution infrastructure through the use of shorter depreciable lives.

Conclusion

The electric industry is one of the most capital intensive in the nation. The industry is undergoing significant changes, from vertically integrated companies with regulated monopolies to diverse companies operating in competitive markets. These changes, plus other recent events, have caused capital investment to lag. Therefore, it is critical that Congress and other policymakers continue to pursue measures that will promote capital investment in the electric industry, which will encourage the development of badly needed new generation and transmission facilities.

Testimony of Charles A. Trabandt
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Before the Subcommittee on
Domestic Monetary Policy, Technology,
and Economic Growth

of the
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Testimony

Thank you, Mr. Chairman, for the opportunity to testify before the Subcommittee on this important subject of capital formation in the energy industry. I have been asked to provide testimony with particular emphasis on the electric power industry in the context of recent developments, including the situation in California and events surrounding the collapse of Enron. I would note for the record that I am testifying today in my personal capacity and my testimony does not necessarily reflect the views of Charles River Associates, Inc. or any of its clients. My testimony reflects my experience as a Managing Director in the Global Energy and Power Group of the Investment Banking Division at Merrill Lynch & Co. My testimony is also informed by my prior service as a Commissioner at the Federal Energy Regulatory Commission (FERC) and as a Committee Counsel in the U.S. House of Representatives and the U.S. Senate.

As a high level, first principle, our national policy objective is to provide the American economy with an assured and adequate supply of energy at reasonable cost through a properly designed balance of (i) enlightened, forward looking and light-handed regulation of monopoly activities and (ii) operation of market forces in workably competitive markets subject to appropriate monitoring and oversight. Legislators, policymakers, and regulators have been confronted with a dizzying array of conflicting signals and market dislocations over the past twelve months as a result of California, the September 11th attacks and now Enron. The capital markets have also been challenged by the fast paced developments regarding the accounting adequacy, credit quality, equity valuations, financial disclosure, and future prospects of U.S. energy companies. Capital formation for much needed investment in the infrastructure of the energy industry could be affected negatively as a result of the pervasive uncertainty and increased risk perceived by investors today. Congress can provide critical leadership in the face of these factors by providing a carefully considered and appropriately measured response to any well-established and systemic

failures of law or regulatory policy affecting capital markets or electric power.

Let's turn briefly to California. The post-mortems on why the California turmoil occurred could fill a multi-volume encyclopedia. But, in general the primary causes are deemed to include:

- Retail rate freeze and absence of demand response under CPUC rules
- Lack of long term contracts and dependence on spot market
- Sharp rise in demand
- Existence of market power and absence of workable competition in certain markets at various times
- Record low hydroelectric production
- Record high forced outages
- Record high delivered gas prices
- Credit quality crisis and uncertainty about credit-worthy counter parties
- Restrictive and inflexible air emission regulation
- Major north-south transmission constraints
- De facto moratorium on power plant construction and transmission expansion
- Federal failure to act in timely manner
- State action to municipalize power purchasing under DWR

We all know the results in terms of the electricity price spikes, the bankruptcies, the consumer rate increases, the impact on the California economy, the fiscal cost to the State of California, the ongoing litigation and retroactive refunds, and the continued legislative debate about an eventual resolution. Regionally, the Pacific Northwest states have also experienced negative impacts on their economies, consumer rates and utility financial situations. The fallout from that experience has had significant impact on retail consumer attitudes, state deregulation

ılans, federal legislative initiatives, industry restructuring and electricity market development in he western region and across the country.

Ironically, the electricity markets in California and the western region today have returned to ι state of relative stability, but certainly not tranquillity by any means. As demonstrated in a ecent FERC analysis, prices at the hubs have converged and average around $30/mwh, while ıatural gas prices have fallen back to about $3.00/mbtu. A combination of very mild weather, nore normal hydroelectric reservoir levels, additional new generation capacity, reduced demand ınd demand elasticity, additional conservation measures, increased transmission capacity, more lexible environmental regulation and FERC price mitigation and more aggressive enforcement, ımong other factors, have led to a more stable market environment. Of course, the jury is still ıut on the longer term market forecast and the threat of recurring extreme price volatility or a eturn to rolling black outs, although analysts are more optimistic today than six months ago.

Other witnesses in this and other Congressional hearings have testified about the ncreasingly urgent need for investment in the nation's electric transmission infrastructure. nvestment by any measure has fallen just as the wholesale electricity market under open access ıolicies has grown dramatically. And, just as the electricity system moves toward Regional 'ransmission Organizations (RTO's), the stress and strain on the transmission infrastructure is ;oing to increase at an accelerating rate for several reasons.

Electricity demand nationwide has continued to grow and is projected to do so at a steady ate. Construction of new generation plants is underway at a record pace, requiring new ıterconnections and upgrades and increasing the demand for transmission services. Wholesale lectric transactions for existing generation, with associated transmission service requirements, ave increased several fold in recent years. Additionally, the system already is experiencing ıcreased congestion with growing costs and fast rising transmission curtailments. And probably

not yet well understood or fully appreciated, the existence of a new RTO and wholesale market structure with a standard design can significantly change the wholesale transaction structures and transmission service requirements to execute newly economic trades. In short, there is a critical need to provide investment to maintain the national grid, which undoubtedly will increase in the aftermath of the September 11th attacks and in the new context of homeland defense.

As a result of those relatively inevitable pressures on the electric transmission system, FERC in Order No. 2000 adopted a flexible approach to financing and structuring RTO's. FERC acted prudently to provide the electric industry with the opportunity to structure RTO's as independent for-profit transmission companies (transcos), as Independent System Operators (ISO's) or as hybrid ISO-transco organizations. Hybrid organizations could include an RTO structured as an ISO with one or more transcos as members, who also may provide various services to the RTO.

FERC also developed a transmission rate-making policy for RTO's which was intended to remove pricing disincentives for transmission owners to join RTO's and to help transmission companies become viable businesses. Under that rubric, FERC endorsed Performance-Based Rate Regulation (PBR) for RTO's to create incentives to make efficient operating and investment decisions, share benefits between customers and the RTO, protect system reliability, and prescribe rewards and penalties in advance based on benchmarks. PBR has been implemented for transmission services in Canada and the United Kingdom, in Federal regulation of telecommunications in the U.S., and by State Public Utility Commissions for retail electric, gas, and telecommunications service.

Consequently, while a novel concept at FERC thus far, the PBR approach is well established in regulatory circles. What is less apparent, however, is that it will take some time to collect the required data for the benchmarks for a new, non-power pool RTO. Nonetheless, the

PBR has substantial financial and regulatory appeal as an alternative to FERC's traditional transmission ratemaking policy.

In addition, FERC decided to consider innovative pricing proposals for RTO's, on a case-by-case basis, in response to its concern about continued under-investment in the transmission grid. The possible innovative pricing proposals include a formula rate of return, levelized rates, accelerated depreciation and incremental pricing for new transmission facilities. FERC also encouraged market approaches to congestion management as early as feasible. An RTO also can propose a rate moratorium for the period through January 1, 2005, and capture cost-saving benefits or increase leverage to increase earnings. Additionally, FERC will consider acquisition adjustments on a case-specific basis where there are measurable benefits to customers.

FERC also recognized that the IRS Code created a substantial disincentive for transmission owners to divest substantially depreciated transmission systems. As a result, passive ownership rules provide specific protections and rights for those owners who transfer control to the RTO (transco). Of course, the House-passed energy legislation would address the problem and mitigate or remove that tax disincentive.

Another disincentive exists in the context of registration requirements under PUHCA with the SEC. The multi-state nature of the larger proposed RTO's could trigger a registration requirement for the owner of a small active ownership interest, with relatively severe limitations and approval requirements for other business and financial activity. Several potential strategic partners and equity financial investors have indicated that they would be unwilling to accept registration as a condition of a strategic partnership or an active equity investment in an RTO. Legislative action by the Congress or administrative action by the SEC may serve to remove this financial disincentive at some point.

Not surprisingly, many possible strategic partners and equity financial investors are themselves directly, or are affiliated with, market participants, as defined by Order No. 2000. As such, those potential investors are limited by the FERC rules to a 5% ownership stake for 5 years, in order to ensure RTO independence, although they could make qualified passive investments. Thus, the market participant limitations do constrain the investment opportunity for many potential (and knowledgeable) investors and limit the universe for marketing transco private equity. But, it does not appear that FERC will amend Order No. 2000 to address this issue.

This overall regulatory flexibility has spawned transco proposals across the country, which could create the proper conditions for the nascent independent transmission industry. Transco's could support further development of the competitive wholesale electricity market by accessing capital markets to secure the much needed financing for sustaining capital expenditures, upgrades and expansion of the transmission infrastructure. As a general financial matter, transcos should become attractive as an equity investment to strategic partners, financial (private equity) investors, and the public market.

Strategic partners will be attracted by the opportunity to manage a significant asset base, share in the value creation potential ("gain sharing"), have specified rights with regards to the assets, and an acceptable projected return on the equity investment. There are indications that there are a number of potential strategic partners, however the probable requirement to register under PUHCA with the SEC remains an impediment today. Financial investors will require a well-defined and meaningful investment as a private placement with a subscription agreement, appropriate limitations on liability, an acceptable return and exit strategy, board representation, and other typical features. There are definitely financial investors interested in the transco

opportunity, provided that the specific transco structure can be formulated to satisfy their individual requirements.

Transcos also may become attractive to the public equity markets in the form of an IPO, a spin-off, or a tracking stock, each of which has differing characteristics and conditions. The IPO alternative probably will require, among other factors, a solid management track record of a couple of years, a good business plan and marketing story, sufficient size for liquidity, adequate projected growth and total return, well developed valuation, reasonable regulatory stability, and of course, a positive stock market environment. As a result, it is not likely that the new transcos under Order No. 2000 will be positioned for an IPO in the first or second year of operations. That factor suggests the importance of a strategic partner and/or financial investors in the initial transco financial plan.

Additionally, transcos should be capable of obtaining strong investment grade credit ratings, which will support financing by access to debt markets. Credit rating agencies have become more experienced with the transco concept and have developed a series of quantitative metrics and qualitative factors to assess the credit quality of a transco. A transco with transmission system assets should be able to achieve a solid investment grade rating with a capital structure having debt in the range of 60% to 65%, under reasonably favorable regulatory treatment.

The electric utility industry has moved with reasonable dispatch to capture the opportunity provided by the FERC regulatory flexibility. For example, the Alliance Companies (eight Midwestern utilities and Dominion Energy), Grid South (three investor-owned utilities serving the bulk of customers in North Carolina and South Carolina), SETrans (Southern Company and public power groups in Georgia, Alabama, and Mississippi with Entergy in Arkansas, Louisiana and Mississippi, Grid Florida (the three investor owned utilities which serve

the majority of customers in the state) and TransConnect (five investor-owned utilities in the Pacific Northwest) have proposed and committed resources in varying degrees to a for-profit Limited Liability Company (LLC) structure for their RTO. Utilities, such as First Energy, Detroit Edison and Consumers Energy, have created independent transmission subsidiaries to facilitate options for their systems. In addition, the American Transmission Company with investor-owned and public-owned transmission systems in Wisconsin already has, and the TRANSLink group, including Northern States Power, Mid-American, Alliant, NPPD and OPPD, is in the process of, forming independent transmission companies in the hybrid structure under the Midwest ISO-proposed RTO. Also, Arizona Public Service, Salt River Project, El Paso Electric, Public Service of New Mexico, Tucson Electric and Texas-New Mexico Power have announced a proposal for a new for-profit transco RTO, WestConnect, for the Pacific southwest region. Each of these initiatives will create the opportunity in one form or another to access capital markets for financing purposes.

Two recent developments highlight the opportunity for for-profit transcos. First, a new consortium, in July 2001, won a structured auction in Alberta and signed an agreement to acquire the TransAlta transmission system which supplies 60% of the Province's transmission requirements. The consortium is 50% owned by SNC-Lavalin, one of the leading engineering and construction firms in the world, 25% owned by the Ontario Teacher's Pension Plan Board, a large institutional investor in Canada (OTPP), 15% owned by Macquarie Financial Group of Australia, and 10% owned by Trans-Elect of the U.S. The consortium paid a premium for the TransAlta assets in a competition which reportedly included several other international strategic and financial investors.

SNC-Lavalin made the investment to capitalize on its international engineering and financing expertise, which when combined with the strengths of the TransAlta team, would

support high quality transmission services and much needed expansion of Alberta's interconnections with surrounding jurisdictions. OTPP concluded that Alberta wanted to make it attractive for investors to expand the electricity system, such that the TransAlta transmission business was a good asset to finance pensions. And, Macquarie also saw the acquisition as a good investment and its first of many infrastructure investments in Canada. While not directly on point in the context of U.S. RTO's, this consortium demonstrates that there are strategic investors, such as SNC-Lavalin, and financial investors, such as OTPP and Macquarie, who are prepared to make financial commitments in the transmission infrastructure under favorable financial conditions.

In August, 2001, eight of the Alliance Companies, announced that they had signed a Letter of Intent (LOI) with National Grid USA, by which National Grid USA would become the Managing Member of the Alliance Transco LLC. The transaction was the subject of definitive documents filed on November 1, 2001, pursuant to a detailed Term Sheet attached to the LOI and to a FERC determination that National Grid USA is qualified to be Managing Member. The eight Alliance Companies and National Grid USA made filings at FERC on August 28 seeking the requisite approvals for the joint Alliance Transco LLC. The Alliance RTO previously had been substantially accepted by FERC under Order No. 2000, but the Commission subsequently directed the Alliance Companies to consider a hybrid arrangement on other policy grounds in December.

Nonetheless, the Alliance-National Grid USA transaction is highly significant and well reflects the potential business, commercial and financial benefits of FERC's regulatory flexibility with regard to RTO structure under Order No. 2000. The strategic partnership would be beneficial to the Alliance Companies, National Grid USA and the customers of the Alliance Transco. National Grid USA's parent company has an excellent track record in the United

Kingdom for managing transmission assets effectively and ensuring reliable delivery of electricity. The deal commits National Grid to making $1 billion in specified investments in the Alliance RTO in exchange for a seven-year management contract and associated compensation. At the same time, the Alliance Companies are provided with significant incentives to divest their assets in the form of cash and attractive passive investments with financial benefits and assured liquidity in several forms.

For those companies which do not divest immediately, there would be various protections to ensure that National Grid USA as Managing Member fulfills it obligations in its functional control of their systems. Both divesting and non-divesting Alliance Companies would have approval rights over certain National Grid USA actions, while National Grid would have a right of first negotiation on any transmission asset sales by an Alliance Company to another party. In my judgment, the Alliance-National Grid USA deal is an excellent example of the types of commercially-based business and financial transactions which are possible under FERC's order No. 2000 and should be encouraged under enlightened energy policy.

Let's turn now to the wholesale electricity markets of the future. The new FERC majority has demonstrated by actions taken and initiatives proposed and discussed over the past several months that federal regulation would move to establish four or five large RTO's and regional wholesale markets over the next few years. Chairman Wood testified before Congress that such regional RTO's were not only required to support competitive markets, but now were imperative for a reliable national power grid as part of homeland defense. He argued that the cost of planning and executing the necessary level of security and infrastructure protection will be significant and will require expertise which only large region-wide organizations can provide.

A Northeast region could consolidate the existing Mid-Atlantic, New England, and New York ISO's. A Southeast region could include the areas in Grid South, Grid Florida, SETrans

(with the Southern Company and the Entergy service areas), and the TVA and public power territories. A Midwest region could include the Midwest ISO service territory, the Alliance service territory and The Southwest Power Pool. Finally, the Western region could cover the entire Western Interconnect, eventually including California, the Pacific Northwest and the Pacific Southwest.

The blueprint for these regional markets involves taking the RTO concept under Order No. 2000 and recrafting it from a transmission service provider in a large multi-utility service territory into a full-blown region-wide energy market with a nationally standardized market design and structure. FERC will set uniform rules for key market design and structural features, such as congestion management, cost recovery, market monitoring, transmission planning, business and reliability standards, the nature of transmission rights and the minimum forms of electricity products and services.

All of the key market functions and transmission services within a single RTO energy market eventually would be identical as IT systems, processes and procedures are eventually consolidated and integrated across an entire region, as contemplated in the Northeast business plan. There would be strong pressure to move to consolidation as soon as possible on a feature by feature basis to avoid sub-regional balkanization, reliance on internal seams arrangements, undue delay and the potential for stranded costs. In the Eastern Interconnect, there also would be strong pressure to accelerate and expand the ongoing inter-RTO seams negotiations with the end-game objective of eventually achieving a relatively seamless electricity market across the Northeast, Southeast and Midwest regions.

With regard to RTO structure, FERC clearly is reconsidering the inherent flexibility of Order No. 2000 in the context of the role of for-profit transcos and various incentives for their establishment. For-profit transcos under Order No. 2000 are required to meet a series of tests,

including independence of governance from market participants, in order to qualify for RTO status. The Commission appears inclined to the view that certain market-related functions of an RTO should not be provided by a for-profit transco, even if it satisfied the Order No. 2000 independence requirements. The expressed concern is that certain market sensitive functions should not be controlled by a for-profit entity with a fiduciary responsibility to shareholders. Rather, such functions should be under a "public spirited" entity with broader public interest responsibility for proper market operations.

At the same time, there appears to be a disposition to retain some form of a for-profit transco entity as a member of an RTO, which could be responsible for some functions and services. These RTO structural issues have been highlighted in the context of several pending cases in the Northeast, the Southeast and the Midwest. Decisions in those pending cases will establish the guidelines for transcos on a going forward basis.

The FERC road map to achieve the new vision of four regional energy markets under the reconstituted RTO concept is now taking shape. FERC has devoted the last few months to refine the overall vision, the regional RTO blueprint and the standardized features for a uniform national market design and structure. FERC plans to embark promptly on a series of generic rulemakings and case decisions to facilitate, conditionally mandate or require the establishment of the several regional RTO's and a systematic process for moving to operational status. That overall effort could take several years for final completion, but there is a disposition to proceed now with all dispatch and not allow the quest for the perfect to become the enemy of the acceptably good. And, in an effort to respond to sharp criticism and strong concerns from several states, FERC has moved to establish regional councils and provide a more active role in decision making for states. The bottom line is the distinct possibility of four highly integrated regional electricity markets by 2004.

Congressional action on electricity restructuring this year appears uncertain, but legislation in both houses could facilitate the new FERC vision. Pending bills provide various forms of express authority to FERC for uniform standards, jurisdiction over all transmission owners, requirements for open access and RTO participation, reliability responsibility, and conditional eminent domain authority for regional transmission siting. Legislation also includes repeal of PUHCA and amendments to the Internal Revenue Code, which could facilitate participation in RTO's by investors, IOU's, coops and municipal systems. Of course, pending legislation could also be used to constrain or refocus that vision if Congress does act on restructuring. In addition, the Supreme Court recently supported FERC's authority under the Federal Power Act to require jurisdictional electric utilities to provide non-discriminatory access to their transmission services and systems, which may provide additional legal support for Order No. 2000.

Turning now to retail electricity markets, the essential fact is that those retail markets will remain largely under the exclusive authority and control of the several states. In fact, Congress has abandoned any immediate disposition to mandate state-by-state retail competition in any form, in part because of California. And, also in part because of California, the progressive movement towards state retail competition has slowed considerably, if not stalled for now.

California has clearly raised the sensitivity of Governors, state legislators, and PUC regulators to somewhere between scaring them politically and persuading them that all of their worst fears about retail competition were well founded. And, both of those concerns have proven handy for opponents of restructuring. At the same time, the advertised benefits of retail competition-- lower prices and increased reliability-- have not generally been delivered to consumers, because of volatile wholesale markets and supply interruptions in various regions. As the *Wall Street Journal* characterized the situation, many individual consumers and now some

industrial customers have come to a simple conclusion about electricity competition: a big pain for a little gain.

One of the most obvious challenges under most state restructuring plans is that the incumbent utility provides an average cost-based and fixed-price default supply alternative which beats the competition. One federal regulator has bemoaned the existence of such default supply and consumer rate freezes as the Achilles heel of eventual retail competition. And yet, the California experience has made it politically more difficult for states to modify those policies. Pennsylvania, which has often been trumpeted as the most successful of the state restructuring initiatives, is an excellent case study in that regard.

In April 2000, 35% of all customer load in Pennsylvania was served by alternate suppliers, including a majority of industrial load and almost half of commercial load. As a result of an increase of wholesale energy and capacity prices in late 2000 and early 2001, and in the aftermath of the California turmoil, consumers in all classes dramatically swung back to the incumbent utility. The total load served by alternate suppliers dropped to under 10% last summer, and the number of alternate suppliers have gone from around 30 to under 10 today. Indeed, one Pennsylvania commissioner recently called for the adoption of a combination of price caps and variable rates in place of default supply service in an effort to rekindle retail competition in that state.

More generally, this once was anticipated to be the time frame when at least half the states with about 50% of U.S. population would have retail competitive services. Today, however, only fifteen states have real retail competition including the residential consumer. Seven states have acted to delay or revise their programs, fourteen states are continuing to study the matter, and thirteen states have rejected restructuring and have no pending plans. To be sure, many of those states in the latter categories were states, such as those with low cost supplies, which

already had made decisions prior to the California turmoil. Nonetheless, California has surely hardened the opposition at the state level, as well as making a federal mandate virtually impossible.

Perhaps, the best hope in the near term, for supporters of expanded, and eventually standardized, retail competition across the nation, is the new FERC vision. Large, integrated regional wholesale markets would eventually be in operation with relatively seamless interfaces between the regions. And, a more robust and competitive wholesale market could develop with appropriate market monitoring mechanisms to satisfy some, if not all, state concerns about retail competition. That result could in turn give electricity consumers more confidence that there is an actual gain for the perceived pain of consumer choice in a retail competitive market.

The previous discussion of California, FERC policy, competitive wholesale markets and state retail competition provides a useful framework for considering the impact of the Enron collapse on electricity markets, energy companies and capital formation for the industry.

The most striking aspect of the Enron collapse is that the wholesale electricity markets have continued to function remarkably well. There was considerable concern about potential impacts on the markets when the downward spiral began in early October, after the disclosure in the quarterly report of the large writedown and revised financial statements due to the off-balance sheet trusts. The primary concern was Enron's credit worthiness as the marketmaker on the Enron Online trading platform, which then handled about one quarter of the electricity and natural gas volumes traded nationwide. An additional concern was the potential impact on other market players who were counterparties of Enron in either primary arrangements or in hedging arrangements entered into for purposes of risk management, and who had financial or commodity exposure to any Enron problem as a result.

As the Enron downward spiral accelerated in late October leading eventually to the failed merger with Dynegy and the bankruptcy filing, other trading platforms, such as IPE, and other marketmakers expanded positions to provide liquidity and maintain efficient market operations. As a result, there was no disruption in the bulk power markets. There was no interruption in the physical supply of electricity or natural gas commodity. And, there was no extreme volatility and no significant spike in the prices in any regional market (albeit in the midst of slack demand due to September 11 and a very mild fall and winter). These results have confirmed for many analysts the relative robustness and strength of the wholesale competitive markets and the advisability of the Federal policies which support them.

The most immediately negative impact was on other energy companies with merchant power plant portfolios and energy marketing and trading operations. Many of these companies had once been highly valued by analysts and investors as growth plays with price-earnings ratios in the 20 to 30 range by comparison to the low to mid-teens of other companies in the sector. Mirant, NRG and Reliant had successful IPO's during that time in 2000. However, the events in California, FERC price caps in the West and the threat of refunds, coupled with slackening demand, fears of surplus production from new plants and already softening prices due to the developing recession led to downward pressures on the stocks of those companies. There also were developing concerns by the middle of 2001 that a number of the individual companies were committed to power plant development programs that were destined to become operational in a time of significant surplus capacity leading to a major supply bubble.

September 11th and then Enron placed additional negative pressure on those companies. Enron precipitated a perceptible loss of investor confidence in companies deemed to be potentially similarly situated as a result of a constant drumbeat of disclosures of perceived accounting irregularities and auditing failures. The widespread use of off-balance sheet financial

vehicles exacerbated concerns about the actual amount of debt liability borne by companies, triggers tied to falling stock prices and the accounting practices applied to them. The combination of these and related factors have led to reduced credit ratings, historically low stock prices, and higher costs of capital with increased collateral requirements for debt.

The deemed lower credit quality of the companies has led to rating reductions which have proven to be especially problematic, because of the pervasive use of credit rating triggers in commercial trading agreements and financial lending documents. Such triggers can expose a downgraded company to the risk of a termination of a deal or a requirement for additional collateral, both of which can be problematic for a highly leveraged company. The triggers have served to limit financial flexibility and to magnify the impact of deterioration in credit quality, with further negative impacts.

Many of the affected companies responded rapidly to the developing crisis of confidence, which has served to support continued stability in the markets. Most companies have announced major restructuring plans to improve their liquidity, reduce overall leverage (on and off the balance sheet), and strengthen the balance sheets to maintain or regain investment grade credit quality and obtain greater financial flexibility. The net effect has been a fundamental recapitalization of the competitive sector. The business plans and financing strategies have been substantially revised to accomplish those objectives. The revised plans have included a combination of asset sales (including power plants and natural gas properties), equity issuance, equity infusions from financial and strategic partners, and cancellations and deferrals of new power plants.

These actions have already reduced debt levels and enhanced cash flow and liquidity for improved credit quality for some companies. At the same time, there has been a commensurate downward adjustment in earnings projections for many companies. Analysts see a number of

broader ramifications flowing from these actions. The cancellation and deferrals could mitigate the likely boom and bust cycle that otherwise could result from a surplus capacity supply in the mid-decade time frame. Clearly, there also will be a substantial market for divested assets, which may result in a rationalization of asset valuations and prices. And, the recapitalization plans should significantly improve the credit quality across the industry. To be sure, there are many other companies who have maintained strong balance sheets and solid credit quality throughout the period, who are already well positioned to expand asset portfolios, enhance market positions and increase market share.

The financial community has provided a reasonably positive response to the recap plans with several billion dollars of new equity in the companies and restructuring or refinancing of existing debt (albeit with increased cost and tougher collateral requirements). The crisis in investor confidence has not thus far foreclosed access to needed capital investment, but the capital markets remain problematic in the near term. At the same time, increased disclosure, improved financial reporting and greater transparency should serve over time to restore investor confidence.

The Enron collapse already has added to concerns of state authorities reluctant to embrace retail electric competition. They and the public at large are reacting to the wide spectrum of on-going Enron-related policy reviews. Those include accounting standards (such as mark to market and other derivative/hedging issues); accounting practices (such as treatment of special purpose entities); the relationship between auditing functions and consulting services; pension fund rules for investments in the corporation's own securities; corporate governance and fiduciary responsibilities of senior executive officers and Directors; the potential regulation of energy commodity derivatives by the CFTC; potential electricity market manipulation in Western markets; and possible abrogation of power contracts in the West; among other pending matters. I

would respectfully urge Congress, the Administration, and Federal regulatory agencies to strive to complete the reviews in a timely manner and adopt any needed reforms with carefully considered and measured actions supporting competitive energy markets.

At the end of the day, the energy industry will require greater regulatory certainty in all forms of regulation and an increased measure of stability in order to have assured access to capital investment for the critical national energy infrastructure.

Thank you, Mr. Chairman.

U. S. House of Representatives
Committee on Financial Services
Subcommittee on Domestic Monetary Policy, Technology and Economic Growth

Capital Formation in Telecommunications

Presented By:
Bryan J. Mitchell
Chairman and CEO
MCG Capital Corporation

MCG's Background

- Solutions - Focused
  - Working with high growth, smaller private businesses
  - Assist in prioritizing opportunities and managing risks of growth
- Expert – Activist
  - Focus on specific sectors of the economy
  - Develop financial, operational and regulatory expertise
  - Actively apply to portfolio companies
- Fundamental Investment Thesis
  - Trade upside for less speculative, more stable path to value creation
- Current investment portfolio of $675 mm
  - 25% in telecommunications
  - Remainder in Media, Information Services and Technology
- Recently completed IPO and Bond Offering
  - Capital Markets validation of investment thesis
- Active investor for over 10 years
  - Deployed over $2B in capital in over 200 transactions since 1990

MCG's Investment Activities

- Fundamentals
- Growth
- Cash Flow
- Collateral Value

MCG's Telecommunications Investment Activity

- Long Distance
- Niche Markets
  - Prepaid; conference calling; hospitality
- Integrated Services
  - Local-long distance-data bundling; messaging
- Support Infrastructure
- UNE-P CLEC

MCG Investment Thesis

- High Net Present Value Customer Acquisition
- Predictable Revenues
- GPM that supports S, G & A and a return on capital within an appropriate time value of money framework
- Discernable ROI on facilities

Attraction of the Market

- Favorable Regulatory Environment
  - Telecom Act of 1996
- Significant Price/Value Proposition
  - Greatest value proposition to small business and residential customers; many customers
- Smaller competitors can outperform
  - Better at basics- customer service; billing clarity; provisioning
  - Innovation encouraged by competition

Telecom Act of 1996

Created Attractive Framework for Multiple Entry Strategies

- Total Service Resale – retail minus
  - new entrant as marketing and billing agent
- Facilities – significant PP&E investment
  - use components of public switched network
- UNE-P – network elements recombined
  - Cost plus that facilitates innovation

Total Service Resale

- Seemingly low cost entry strategy
- Investment capital to acquire customers
- Customer acquisition model is critical
- Low gross profit margin
- Long time frame to ROI

Facilities

- Significant entry costs
- Reliant on favorable access terms
- Long scaling time frame
- High gross margin upon reaching scale
- Target high margin; larger users

UNE-P

- Low cost market entry
- Shorter payback on customer acquisition
- Viable gross margins with moderate scaling
- Capital expenditures focus on customer
- Creates framework for product/service innovation
- Stepping stone to the high margin facilities

Brilliance of the Act

Have to support all three entry models:

- Ubiquity of resale
- Opportunity for innovation, effective service for average customer and more stable and visible path to profitability of UNE-P
- Facilities strategies to serve the most complex customers and generate highest margins

The three together will facilitate capital formation

What Happened?

- Capital markets went for the brass ring
  - Total market size and valuation creation opportunity created speculative bubble
  - Ignored rational stepped framework that was established in the Act
  - Don't throw the baby out with the bath water

What's Next?

Is there still a reason to force the incumbents to keep open all three entry strategies?

FCC's Triennial Review Proceeding will determine outcomes

Public Interest

- Nobody is going to build de novo networks to serve the small guy – competitive telephony as configured allows all to benefit as each strategy flourishes over time

Buy Rate

- The incumbents need to be held to cost studies so the buy rates on the public switched network elements can support a margin that perpetuates capital in-flows

Enforcement

- Old monopolies die hard and as such enforcement mechanics should not be undermined.

Tauzin-Dingell appears to created a protected safe harbor for the Bells to invest in next generation networks that won't be subject to open access as provided for by the Act

MCG Capital Corporation

Insights and Outlook

May 2001

Competitive Local Exchange Carriers

The Morning After: CLECs in 2001

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__MCG Capital Corporation__ is a solutions-focused private finance firm serving the communications, technology and content sectors within the United States. MCG Capital provides specialty finance, research and advisory services. MCG's lines of business combine to provide capital and comprehensive advisory and corporate development support with a focus on long-term value creation for our customers. MCG's expert activist investment approach is based on a philosophy that emphasizes a detailed understanding of market sectors and individual company operating dynamics within these converging markets. MCG has a ten-year track record of providing customized financing solutions with over $2 billion invested in over 200 deals.

The party was raging for CLEC players in the beginning of 2000. Publicly traded stocks were skyrocketing, venture capital was flowing and companies were raising huge amounts of debt. CLECs were building momentum to capture a meaningful portion of the local access market by 2002.

At some point in early 2000, perhaps as publicly traded CLECs reported more than $4 billion in 1999 losses, investors revisited their rationale for CLEC investments. Initially, the nascent status of CLECs left investment bankers with "inadequate" metrics to value these industry players. Plant, property and equipment (PP&E), as a hard asset base with an easily quantifiable value, emerged as a key determinant for valuation. Bankers reasoned that equipment deployed within a network was more valuable than the purchase price of the equipment. Following this logic, CLEC valuations became a multiple of gross PP&E plus the present value of long-term cash flows from network revenues. Therefore, the larger the size of the network footprint, the greater the valuation.

Rooting company valuations in PP&E created artificial incentives for CLEC players in search of capital. Instead of focusing on building viable businesses, CLECs concentrated on building out extensive networks. On the advice of bankers and equipment vendors, CLECs with a modest regional network plan and customer acquisition focus were

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The Morning After: CLECs in 2001

lured into aggressively expanding into national networks. These companies developed low ROI, capital-intensive business plans that involved large-scale national and global network build-outs. Hundreds of startups rushed to capture the capital flow.

This distortion of market forces by the capital markets and vendors resulted in a build-out of underutilized networks and promoted a build-it-and-they-will-come business model. This over capacity in the marketplace drove down the price of bandwidth and CLECs fell short of aggressive revenue milestones. As a result, despite CLECs making significant progress, the investment environment took a turn for the worse. Investors grew disillusioned with CLECs' insatiable appetites for capital and distant path to profitability. By the end of the year, the capital markets effectively closed the door on emerging CLECs, as addressable market, lines on the network and eventually positive cash flow replaced multiples of PP&E as key metrics for assessing the value of CLECs.

The changes in the capital markets created new and unforeseen impediments to CLEC expansion. Those CLECs with extensive under-funded expansion plans were forced to scale back. Others, counting on an endless supply of capital or too far down the overbuild road to switch gears, were forced to shut down. As a result, numerous CLECs filed for bankruptcy protection in late 2000 and early 2001.

While the party for CLECs in the capital markets winds down, their acceptance in the industry marketplace appears unhindered. In the past two weeks, approximately 20 publicly traded CLEC companies reported their first quarter results. These results support the thesis that the demand for competitively priced CLEC services in the marketplace remains strong. In our opinion, the shakeout in the CLEC industry is primarily a result of CLEC operators buying into the hype of the capital markets and vendors, not a result of an over estimation of the demand for the CLEC service/value proposition.

In the first quarter of 2001, as these companies refocused their efforts on acquiring customers, revenues grew an average of 100% over the first quarter of 2000. (See attached table for details.) Total EBITDA loss for this group fell to $200 million, improving from a loss of $380 million in the fourth quarter and $215 million in the first quarter of 2000. Improvements in EBITDA stemmed from increased utilization of networks and reduced marketing expenditures.

The majority of the earnings conference calls featured cautiously upbeat management teams channeling previous aggressive expansion efforts towards cash conservation and profitability. Managements' comments on the condition of the industry marketplace were consistent and indicated demand for CLEC services remained robust.

In addition to these solid first quarter results, FCC line share data also supports strong demand for CLECs. The percentage of local telephone lines in use through CLECs increased from 4.4% in December 1999 to 8.5% in December 2000. In total, CLECs accounted for 16.4 million local telephone lines at the end of 2000, out of approximately 194 million lines nationwide, an increase of 93% over the previous year. It is important to note that line share data differs from revenue share as a core CLEC value proposition is to provide competitively priced services.

While industry signs indicate demand for CLECs' services remain strong, other factors such as scaled-back expansion plans, tightened capital markets and bankruptcies affect the CLEC industry's revenue market share gains from RBOCs.

First and foremost, capital constraints have reigned in the publicly traded CLECs' market expansion plans. Almost universally across reporting public CLEC companies, capital expenditures fell significantly from previous levels as companies struggled to conserve cash. In the aggregate, capital expenditures from the first quarter of 2001 fell to $1.4 billion, down 124% from fourth quarter levels. Capital expenditure savings resulted from both closing of facilities in existing markets as well as slowing the rollout in new markets. Many companies made significant downward revisions to future expansion plans. Some companies planning notable reductions in capital expenditures include XO Communications and McLeod. XO cut $2 billion from its budgeted

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The Morning After: CLECs in 2001

investment in capital expenditures and McLeod trimmed $300 million.

In addition to the decelerated expansion plans of existing players, the closing down of troubled CLECs decreases competition within specific markets and affects overall industry growth. In the past six months, 10 CLECs have filed for bankruptcy protection including Winstar Communications, Net Tel and e.Spire. The likelihood of CLECs receiving additional funding is low given the intolerance of the capital markets for capital-intensive network build-outs.

The recent bankruptcies and the resulting service disruption to subscribers are a black eye to the entire CLEC industry and caused some fallout with consumers. In our opinion, this drop in consumer confidence is not an insurmountable challenge, but rather one that can be overcome in the long run. Several privately funded CLECs, with modest expansion plans and reasonable capital requirements, continue to expand their sales and network deployment investment plans in 2001. These smaller CLECs managed to avoid the lure of easy money and built businesses focused on niche markets. Over the past two years, these companies focused on developing customer acquisition programs and back office systems. These players, in combination with the surviving public CLEC companies, hold the promise for the future of the CLEC industry.

As a result of fewer players in fewer markets the overall growth of the industry will slow. While the decline in competitors represents negatives for overall industry growth, it offers some positives for established players. We are seeing isolated pockets of reduced competition resulting in less pricing pressure and the pickup of customers from financially troubled competitors. Also, recruiting for key sales and technology positions is easier due to the easing of the employment market in some areas.

Past projections of revenue market share for CLECs anticipated that these companies could capture 15% to 20% of the local market in the next couple of years. Under current conditions, these revenue levels appear unrealistic. To estimate CLECs' revenue market share gains in 2001, we aggregated the revenue guidance given by the companies we followed this quarter. Overall these companies expect to post $5.1 billion in revenues - a 66% aggregate year-over-year increase over 2000 levels.

Using this group of CLECs' fourth quarter reporting season as a proxy, MCG estimates CLECs' market share could reach between 8% and 10% of the estimated $110 billion domestic local service market in 2001. In reaching this estimate, we assumed that our followed group of publicly traded companies represents approximately 50% of the entire CLEC market. (See attached table for details.)

CLECs with forward-looking operators continue to find the $110 billion domestic local service market attractive and the incumbents susceptible to market share loss. While RBOCs are large entities with deep pockets and the all-important ownership of the PSTN, they historically are slow to respond to customers and competitors. Perpetuation of this monopoly mentality makes them vulnerable to nimble competitors with extensive product offerings and an overwhelming desire to please the customer.

The current risk-adverse capital market is just one of a number of uphill battles facing the CLECs. The industry faces operational, technological and regulatory challenges. While these challenges add a degree of uncertainty to the growth of CLECs, the long-term outlook for this industry remains positive. Over the long run, CLECs should garner a significant share of the local service market.

This report is intended for informational purposes only. MCG is not soliciting that any action be taken as a result of it. Although the information contained herein has been obtained from sources believed to be reliable, its accuracy and completeness cannot be guaranteed Opinions expressed are our current opinions as of the date appearing on this material.

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CLEC Operating Results

As of the First Quarter 2001

numbers in millions excluding percentages

Company	Ticker	Fiscal Year End	Revenues			Revenue Growth		EBITDA			Net Income (Loss)		
			1Q01	4Q00	1Q00	Sequential (3)	Annual (4)	1Q01	4Q00	1Q00	1Q01	4Q00	1Q00
Allegiance Telecom	ALGX	Dec	105.9	95.4	47.3	11.0%	123.9%	(28.8)	(26.6)	(21.4)	(96.3)	(86.2)	(61.3)
Choice One	CWON	Dec	34.9	29.5	6.8	18.0%	413.3%	(23.0)	(40.1)	(77.5)	(65.1)	(62.1)	(81.7)
CTC (1)	CPTL	Mar	67.6	59.4	46.6	13.8%	45.1%	(9.0)	(13.5)	(5.4)	(28.9)	(32.8)	(18.7)
Electric Lightwave	ELIX	Dec	62.6	63.0	56.8	(0.6%)	10.3%	3.3	(33.8)	(6.7)	(37.7)	(33.8)	(35.1)
FairPoint Communications	FRPT	Dec	75.9	72.7	44.9	4.4%	69.0%	19.5	(26.2)	(3.7)	(59.0)	(42.8)	(18.2)
Fastnet	FSST	Dec	3.7	3.2	3.0	13.0%	20.8%	(2.2)	(12.0)	(2.8)	(4.0)	(13.5)	(4.2)
Focal	FCOM	Dec	67.4	67.4	45.3	0.0%	48.6%	3.8	(4.4)	(4.0)	(33.5)	(34.2)	(20.8)
ITC^DeltaCom, Inc.	ITCD	Dec	102.2	98.6	75.7	3.7%	35.0%	12.1	11.2	9.9	(29.8)	(26.0)	(15.8)
McLeod USA (2)	MCLD	Dec	361.3	339.2	218.9	6.5%	65.0%	(32.6)	(38.0)	(28.2)	(173.2)	(140.9)	(58.5)
Mpower	MPWR	Dec	46.6	44.6	25.5	4.5%	83.0%	(71.6)	(52.7)	(22.5)	(98.5)	(75.6)	(25.3)
Net2000	NTKK	Dec	24.5	21.4	10.6	14.5%	131.1%	(20.3)	(21.9)	(14.8)	(32.8)	(29.6)	(23.0)
Pac-West	PACW	Dec	40.1	39.0	30.8	2.9%	30.2%	10.2	12.4	10.6	(0.5)	(0.8)	2.3
Talk America	TALK	Dec	137.8	131.5	156.0	4.8%	(11.7%)	0.5	(27.6)	15.5	(10.1)	(39.6)	13.4
Time Warner Telecom	TWTC	Dec	173.1	134.3	100.1	28.9%	72.9%	33.9	32.1	23.5	(28.7)	(3.4)	(2.9)
US LEC	CLEC	Dec	38.1	33.6	25.4	13.3%	50.0%	(5.3)	(5.8)	(1.7)	(15.1)	(55.1)	(39.6)
XO Communications	XOXO	Dec	277.3	253.1	105.8	9.6%	162.0%	(77.1)	(97.5)	(72.1)	(443.5)	(491.6)	43.2
Ztel	ZTEL	Dec	75.0	69.2	14.0	8.4%	436.9%	(13.6)	(24.4)	(14.4)	(17.6)	(26.4)	(15.5)
Total			**1,694**	**1,555**	**1,014**	**9%**	**67%**	**(200)**	**(369)**	**(216)**	**(1,174)**	**(1,194)**	**(362)**

Source: Company Reports, MCG Estimates and Bloomberg

(1) CTC's numbers are based on the calendar year, not the company's fiscal year.

(2) McLeod's revenue and EBITDA numbers exclude revenues and cash flow from the company's publishing business.

(3) Sequential revenue growth indicates the percentage increase from 4Q00 to 1Q01.

(4) Annual revenue growth indicates the percentage increase from 1Q00 to 1Q01.

CLEC Operating Results

As of the First Quarter 2001

numbers in millions excluding percentages

	Capex			Capex Growth		Balance Sheet Data			Revenue		
Company	**1Q01**	**4Q00**	**1Q00**	**Sequential (3)**	**Annual (4)**	**Cash**	**PP&E**	**Debt**	**2000**	**2001E**	**Growth**
Allegiance Telecom	120.5	101.8	102.5	18.3%	17.5%	510.1	846.8	576.3	285.2	549.0	92.5%
Choice One	19.6	30.6	20.4	(35.9%)	(4.0%)	130.8	312.6	447.0	68.1	195.0	186.3%
CTC (1)	20.2	24.3	15.5	(16.9%)	30.3%	47.1	204.3	186.8	170.4	315.0	84.9%
Electric Lightwave	20.3	18.1	25.4	12.5%	(20.0%)	10.0	834.4	912.6	244.0	459.4	88.3%
FairPoint Communications	36.0	58.3	10.5	(38.3%)	243.8%	NA	NA	NA	246.3	303.8	23.3%
Fastnet	0.5	1.7	1.4	(70.6%)	(63.5%)	17.3	20.1	11.0	12.7	67.0	427.6%
Focal	22.0	82.0	52.3	(73.2%)	(57.9%)	107.2	558.2	578.9	234.1	378.5	61.7%
ITC^DeltaCom, Inc.	60.5	78.0	54.3	(22.4%)	11.4%	78.7	697.1	711.7	363.7	475.0	30.6%
McLeod USA (2)	347.0	362.8	239.4	(4.4%)	44.9%	1,049.0	3,154.0	3,498.0	1124.6	2000.0	77.8%
Mpower	17.0	58.7	33.6	(71.1%)	(49.3%)	438.0	467.2	483.4	146.9	205.0	39.6%
Net2000	10.2	18.9	22.0	(46.3%)	(53.8%)	12.1	162.0	102.9	61.8	147.0	138.0%
Pac-West	20.0	20.9	11.6	(4.4%)	72.3%	80.1	215.3	150.0	139.1	163.0	17.2%
Talk America	1.2	4.97	9.78	(75.9%)	(87.7%)	22.5	NA	NA	544.6	597.4	9.7%
Time Warner Telecom	95.6	107.5	62.3	(11.0%)	53.4%	550.0	1,656.0	1,066.0	487.3	767.0	57.4%
US LEC	15.9	22.3	14.4	(28.6%)	10.2%	70.0	187.9	130.0	115.0	158.0	37.4%
XO Communications	593.0	526.9	194.7	12.5%	204.6%	1,898.0	3,362.0	5,188.0	723.8	1450.0	100.3%
Ztel	8.7	8.5	9.2	2.4%	(5.4%)	31.587	63.233	20.0	177.7	322.5	81.5%
Total	**1,408**	**1,526**	**879**	**(124%)**	**60%**	**5,053**	**12,741**	**14,063**	**5145**	**8553**	**66%**

Source: Company Reports, MCG Estimates and Bloomberg

(1) CTC's numbers are based on the calendar year, not the company's fiscal year.

(2) McLeod's revenue and EBITDA numbers exclude revenues and cash flow from the company's publishing business

(3) Sequential capex growth indicates the percentage increase from 4Q00 to 1Q01.

(4) Annual capex growth indicates the percentage increase from 1Q00 to 1Q01.

SchwabCapitalMarkets

Washington Research Group

House Committee on Financial Services
Subcommittee on Domestic Monetary Policy,
Technology and Economic Growth

Statement of Paul Glenchur
Vice President, Schwab Capital Markets
Schwab Washington Research Group

April 18, 2002

Mr. Chairman and members of the Subcommittee:

It is my pleasure to discuss with you issues related to capital formation in the telecom market. As a vice president at Schwab Capital Markets Washington Research Group, I work with a staff of analysts that examine the regulatory, legislative and political factors affecting investments in various industries, including telecom, technology, energy, health care, financial services and international trade. We work with institutional investors to address their concerns in these areas.

It was only a couple of years ago that the telecom and technology markets were ablaze. Equity values soared and capital investment was flowing into these sectors.

But as we all know, telecom and technology have suffered a meltdown. Telecom carriers, pursuing a land rush mentality, assumed substantial amounts of debt to build and expand the reach of their networks. The bursting of the Internet and dot-com bubble undermined a major portion of

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the customer base for telecom service providers. A slowing economy exacerbated the situation. Despite optimistic projections of data growth, the supply of capacity from multiple long haul providers fostered a disruptive pricing war in the core of the network. Revenue struggled to keep up with debt service obligations. We have seen numerous bankruptcies and threats of more to come.

Regulators struggled to promote a climate hospitable to the objectives of the 1996 Telecom Act. The Act offered to promote local competition by requiring incumbent phone carriers to open their networks to competition, primarily by allowing the resale of local services or the leasing of network components on a wholesale basis. In return, the Regional Bell Operating Companies would be allowed to enter the long distance market. But litigation ensued as the FCC's authority to administer key parts of the Act, particularly the Commission's authority to adopt rules governing the establishment of wholesale rates, created regulatory uncertainty. The FCC's authority here was sustained but it took several years to resolve. Meanwhile, the competitive carriers and incumbents battled over the conditions, terms, quality and timing of access to incumbent networks. Delays in providing service meant delays in the collection of revenues needed to cover operating costs and debt service.

The investment community obviously suffered along with the telecom carriers. They were enthusiastic about the promise of telecom competition and the migration to new and exciting data

services over upgraded networks. To a great extent, investors believed that expanding telecom networks to allow flexible configuration of services to customers in all major metropolitan areas offered the greatest potential upside in the new telecom environment. But building networks in all major cities required the assumption of huge amounts of debt. The Association for Local Telecommunications Services reports that competitive local exchange carriers (CLECs) invested over $56 billion in new networks between 1996 and 2000. By some estimates, from 1996 to 1999, phone carriers raised more than $80 billion in below-investment grade debt to finance construction of networks. Capital expenditures for the industry rose steadily from 1996 through 2000 but have declined since then.

A variety of factors pressured the revenue growth of upstart telecom service providers. Competition for high volume business customers led to disruptive pricing as carriers attempted to achieve revenue targets regardless of profitability. Internet service providers struggled and went out of business, disconnecting service or cutting back demands for service. Regulatory actions cut back projected revenue from reciprocal compensation, the fees carriers charge other carriers for bringing calls to Internet service providers. The economic slowdown worsened a difficult situation. The expansive revenue growth anticipated from new data services failed to materialize. Meanwhile debt burdens continued to squeeze upstart carriers. Investors pulled back, refusing to invest additional money in telecom service providers. Suddenly, the emphasis was on cash flows rather than the reach of a provider's network.

As illustrated by the last couple of years, it is difficult to make a business work when it requires massive upfront investment and entails substantial customer acquisition and retention costs. Severe price competition among multiple carriers, particularly in the long haul space, presents another factor that further undermines the ability to generate sustainable revenues and service debt. High debt levels impair the ability to acquire additional financing or generate cash flow for investment in new services or business growth. Ongoing regulatory battles between incumbent and competitive carriers have increased regulatory uncertainty in the sector. At this time, there is little growth in the telecom industry. Without profit growth, there are few incentives to invest.

But despite the downturn in the industry, there is room for optimism. A necessary shakeout will mean inevitable consolidation and the survival of carriers with the most sustainable business models and financial structures. New data services and other offerings will continue to leverage upgraded telephone, cable and wireless networks.

But the healing process will take time. Carriers are reluctant to assume additional debt, a factor discouraging industry consolidation. Meanwhile, the burden of maintaining networks and upgrading them to add capacity or provide new services remains a costly exercise at a time when adoption rates for new services lack visibility. But technology is forcing the migration to new

service models. Telephone carriers face competitive pressure from wireless substitution, IP telephony and instant messaging. Broadcast and cable operators face a fragmented audience among numerous video offerings that pressures traditional advertising models. Commercial wireless service providers are making critical investments in data services. Although futurists may be excited about today's telecom opportunities, reluctant investors fit the "once burned, twice shy" characterization. They want to see "killer apps" that drive penetration rates for new services. The pendulum has swung from irrational exuberance to abject pessimism. History teaches, however, that we tend to overestimate change in the short run, but underestimate change over the long run.

As Washington considers legislative or regulatory proposals to jump-start the telecom economy, some level of caution is warranted. Major initiatives lead to the inevitable legal challenges in federal court and the results are unpredictable. The resulting uncertainty can actually discourage capital investment. Moreover, legislative and regulatory actions cannot force changes in human behavior. As noted above, there is genuine excitement about the potential of new technologies and high bandwidth services. What is not clear is how consumers will embrace these new capabilities over wireline and wireless networks. What is the value proposition for these services? We don't need 100 Mbs for e-mail. Consumers and business are struggling with this question today. We must be realistic in our expectations of what government policy will accomplish.

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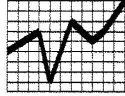

Symbol	AEYS
Shares Outstanding(est.)	9,000,000
Float (est.)	2,000,000
3-6 Month Target	$.80
12-18 Month Target	$1.50

Rating: Strong Buy
American Energy Services, Inc.
(OTC BB: AEYS)

OTCBB: AEYS Delivers Celebrates Market Success

Congratulations to those of you who heeded our past to recommendations; OTC BB: THCR and OTC BB: BBJE. Both stocks increased in value 50% to 100% within one week of each recommendation. **Good Job!** **Our current feature company** is one that you have seen here before at Market News Alert. American Energy Services (OTC BB: **AEYS**). Have you seen this stock trade lately? AEYS had declined to a support level of $.15 and then dramatically rose to $.49 just after recent news of the company's market success. We believe that only good things are in store for this Houston based, old line energy service company.

The Company
Founded in 1987, American Energy Services Inc. (OTCBB:AEYS) designs, engineers, manufactures, markets and services over 300 standard and specialty valves of varying sizes and pressures used to regulate the movement of liquids, gases and solid materials. AES is a licensed API monogram holder and its valves are manufactured according to the specifications of the American Petroleum Institute (API) and are ISO 9000 approved. The company markets its products in over 31 countries on six continents to a broad range of industries including petrochemical, plastics, energy, utility, engineering, construction and power generation. The company's clients include manufacturers, producers, processors, transporters and refiners of oil and natural gas, mining and mineral processing, plastic and petrochemical processing and power generators. The company owns three patents and has three trademarks AEV, AES and AES Accuse 500. For more information, visit the company's Web site http://www.aesvalves.com

Market News-HOUSTON, May 1, 2002 -- American Energy Services Inc. (OTCBB:AEYS) announced today that significant progress has been made on its plan for debt restructure. AES President Pat Elliott said, "We are 70% into final negotiations with major lenders and creditors. We feel confident that we can complete these negotiations by late May to mid-June." This restructure, by significantly reducing the debt, will assist AES in attracting the necessary capital for executing on its acquisition strategy, which will be in keeping with the plan of growth by accreted acquisition.

On the market front, Elliott noted that AES' increased bidding activity with the United States Department of Defense (DOD) has begun to bear fruit. "We have been notified by the U.S. Navy that AES is the successful bidder on a number of DOD valve requirements," commented Elliott.

AES is proud to participate in these highly technical, precision products that serve our nation's needs, such as acoustically modulated noise abatement valves (ARDBall(TM)) for the U.S. Navy; high pressure exotic alloy flow control valves; and aluminum bronze, titanium-lined corrosive application valves.

Investment Opportunity
Recent developments coupled with an exciting trading rally make AEYS a great opportunity. AEYS could conceivably see another rally over the short term and if the good news continues a long term $1.50 trading range is almost eminent.
Don't miss this one!

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WRITTEN STATEMENT OF

BLAIR LEVIN,
MANAGING DIRECTOR
AND
TELECOMMUNICATIONS AND MEDIA REGULATORY ANALYST
LEGG MASON WOOD WALKER, INCORPORATED

ENCOURAGING CAPITAL FORMATION IN THE TELECOMMUNICATIONS SECTOR

BEFORE THE
HOUSE SUBCOMMITTEE ON DOMESTIC MONETARY POLICY,
TECHNOLOGY AND ECONOMIC GROWTH SUBCOMMITTEE

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

APRIL 18, 2002

Chairman King, Ranking Member Maloney, and Members of the Subcommittee:

Thank you for inviting me to testify on the critical subject of encouraging capital formation in the telecom sector.

By way of background, I practiced law for 10 years in North Carolina, largely as a corporate lawyer. Among my principal work during that time, I served as outside General Counsel to a rural wireless company that raised over $200 million in equity and debt and grew to service 26 markets. I also served as a securities lawyer on municipal finance offerings in North Carolina. In 1993, the Chairman of the Federal Communications Commission appointed me Chief of Staff, a position I held for 4 years. After leaving the FCC, I served as a consultant to a number of telecom and media concerns. In January of 2001, I began my current job as an analyst with Legg Mason where my principal mission is to evaluate the impact of government policy on telecommunications and media companies for institutional investors.

Today I would like to briefly discuss the state of the telecom industry. Then I will outline what I see as the three critical dynamics affecting investment in telecom and the three principal challenges facing the government as it seeks to encourage investment in what is clearly a critical sector for generating economic growth and consumer welfare gains for all Americans.

I. State of the Industry

For consumers and the economy, enormous gains...

For the American economy and consumer, the state of the telecom sector is far better than it was prior to the '96 Act. In wireless, choices have expanded, use is way up and prices are way down. The opportunity to communicate electronically through e-mails and instant messages, a phenomenon in its infancy six years ago, is now utilized by tens of millions daily. Long distance and international rates are down. The ability of businesses to send increasing amounts of data has skyrocketed as prices for long-haul transport have plummeted. Today, the majority of web surfing is done over broadband Internet access, a service that was only on the drawing board in 1996 A growing number of residential and small business consumers now have a choice of local telecom providers – with nearly 8 million now taking service from new competitors with millions of others substituting wireless for wireline.

Even with the price cuts in a number of sub-sectors, increased use has meant that telecom has enjoyed what other industries would consider a healthy growth in revenues. Telecom revenues are increasing as a percent of the GDP, still growing at approximately a 4 percent annual rate. Residential telecom spending as a percentage of disposable income is rising as consumers take advantage of new opportunities. From 1991 through 2Q 2001 the market capitalization of telecom services grew at a compound annual growth rate of 21% and for computing and communications components and equipment it was 23%. According to Fortune magazine, even last year, a year universally regarded as the worst ever for telecom, telecom enjoyed 7.5% growth in revenues, the 12th best out of 48 sectors Fortune measured.

...For investors, the most difficult times

But for investors in the sector, it is the worst of times. More than 100 start-up telephone companies have gone bankrupt in the United States in the last two years. I have seen estimates that the meltdown in the telecom sector has resulted in losses of over $100 billion in contributed capital and $2 trillion in stock market value. And the same Fortune magazine survey that had telecom in the top 12 in revenue growth had telecom 38th in profit growth, with a decrease in profits of 52.9%. And last week, a number of blue-chip companies in the sector, from RBOCs to cable, hit historic lows.

It is important to remember that this boom and bust cycle is similar to other cycles of investment in periods of massive growth and change. A similar boom and bust characterized investment in a number of critical industries in our country, from railroads in the mid-1800s to cars in the early part of the last century to the more recent cycle involving PC's and computer chips. Michael Milken recently recalled that in 1967 Merrill Lynch published a report "correctly predicting that the computer industry would be one of the great growth stories of the next generation. The report listed 25 leading companies in the hardware and software business. Industry revenues, of course, have grown tremendously since 1967 yet remarkably, 24 of the 25 companies disappeared or stopped selling computer and software products."

Telecom is likely to follow a similar pattern. It is of cold comfort to investors, but the telecom revolution, like earlier technology revolutions, is likely to yield far greater benefits to the general economy and consumers than it will to many investors. As George Gilder recently wrote "[l]ike the railroads that bankrupted a previous generation of visionary entrepreneurs and built the foundations of an industrial nation, fiber optic webs, data-centers, and wireless systems installed over the last five years will enable and endow the next generation of entrepreneurial wealth."

I agree. While we cannot expect to see the kind of extraordinary investment in telecom that characterized the first five years after the Telecom Act, the growth potential is still exceptional. Our country needs an appropriate level of investment to continue so that the economy and consumers can continue to benefit from improved communications networks and services. Therefore it is critically important that the government examine the question that you are raising today: how to encourage investment in the sector.

II. Key Telecom Investment Drivers: Competition, Growth Opportunities, and Innovation

Competition the greatest single investment catalyst

The simple, but sometimes forgotten, answer is that the most important way to encourage investment in the sector is to assure a competitive market. One of the best things the Congress ever did for the media sector was to pass the Program Access rules. Those rules enabled Direct Broadcast Satellite companies to gain access to a key input and therefore compete with cable. Subsequently, cable operators invested over $55 billion to upgrade to digital and, as Robert Sachs, President and CEO of NCTA, recently noted, "[w]hat prompted this massive upgrade was competition from DBS."

The telecom sector is no different. In the four years prior to the passage of the '96 Telecom Act, regional Bell investment declined 2.4% annually. After the Telecom Act, there was an explosion of investments into new entrants, starting with $5 billion in 1997 and increasing to $22 billion by 2000. The Bells responded by increasing their own capital expenditures by nearly 11% annually during that period. And in 2001, when the CLECs' investments declined, so did the Bell investments.

Wireless similarly demonstrates how competition drives investment. When the 1994 spectrum auctions broke up the existing duopoly, investment by both incumbents and new entrants soared.

So any policy to encourage investment must recognize the need for competitive markets with a sufficient number of healthy competitors in order to succeed. Moreover, it is far too early to write off competition in telecom as an economic impossibility. For all the publicity over CLEC failures, competition has also had some notable successes. In Anchorage, Alaska, CLECs serve over 40% of the local market. In New York State, almost 20% of the lines are served by CLECs. In Texas, it's 18% of the lines.

Investment also requires opportunities for revenue and profit growth

But investment is also a function of the business growth opportunity. And here, the fundamental problems are in the market, not in government. The biggest problem in the sector is lack of new drivers of growth in revenues and profits. After the great data and wireless explosion of the 90's, the sector lacks a similar engine now. Further, the availability of wireless and data has cannibalized revenues that used to be the unchallenged province of the wired voice network. While that creates consumer welfare and business productivity gains, it creates an unappetizing picture for investors.

There is a limit to what government can do. None of us in this room is going to invent a killer application that will bring new revenues to the telecom networks and, in turn, lead to a new round of investment. Nonetheless, government can act to assure that when the opportunities are developed, investment will not be stifled.

Innovation drives biggest improvements in consumer gains but there is a tension between investment in innovations in the network and innovations at the edge of the network

While price competition gets the lion's share of the attention, and falling prices are often used as a measurement of whether there is competition, I believe that a greater source of economic and consumer welfare gains arises from product innovations that offer new services that inevitably provide competition to incumbent offerings. The data networks and wireless networks were not developed to provide direct price competition to the incumbent wired voice network but the new networks have had an enormous competitive affect.

Innovation is not limited to new entrants but history has demonstrated that incumbents need a competitive threat to deploy innovation. And if we look at the great innovative applications of the last decade -- email, web browsing, streaming audio and video, file sharing, instant messaging, e-commerce – none was invented by an incumbent. But it is also true that we could not take advantage of such applications if incumbents and others had not invested in network upgrades to speed the transport of the bits.

This tension between the need to invest in upgraded networks and the benefits of investing in innovations at the edge of the network is at the core of an important paper, written by two distinguished telecom thinkers, David Isenberg and David Weinberger, called "The Paradox of the Best Network." They point out that from the point of view of society and consumers, the best performing network would be one that delivered the most bits at the fastest speeds, was most open to new communications services, closed off the fewest futures, and promoted the most innovation. They note, however, that that kind of network is the hardest kind of network to make money running since its design reduces the transport function to a commodity while the real high-value added services are in the bits and the services at the edge of the network.

The authors suggest a variety of policy remedies, such as the forced separation of content and conduit, which I personally would not advocate. The paper, however, serves an important role in describing what I think is a tension between the different kinds of investment that the government needs to encourage: investment by large incumbents in maintaining and upgrading their networks and investment by a wide variety of companies -- from start-ups in garages to large international phone companies -- in innovations that will drive great leaps forward in terms of economic growth and consumer welfare gains.

This tension has, in my view, raised the technological risk factors for all telecom investments and is one of the reasons why all telecom stocks have plummeted, notwithstanding that the underlying growth in network traffic, as well as productivity gains due to new network efficiencies, remain robust. Investors are understandably nervous about investing in more and improved pipes in the ground whose value can be reduced by new innovations. But unless there are investments to upgrade the pipes, the benefits of other innovations will remain unrealized by our society. Government policy should not seek to eliminate this tension, which is simply a demonstration that the Schumpeter economics of creative destructive has arrived in telecom. Rather, policy should try to reflect that tension by balancing the needs to encourage innovation in and at the edges of the network.

In short then, the path to investment requires policies that encourage competition, allow for revenue growth and protect innovation in all parts of the network. This is easier said than done. Given its history, telecom is not a classic free market. Given economics dictated by huge fixed costs, minimal marginal costs and significant network effects, it will be more difficult for a truly competitive free market to develop in telecom compared with markets where large, initial capital investment is less critical.

III. The Policy Challenges Ahead

Government can help encourage investment if it faces up to three fundamental challenges: developing and implementing a balanced policy, rationalizing revenues, and making timely and certain decisions that the market can rely on in making its investments.

1. The Challenge of Developing and Implementing a Balanced Policy

In developing telecom policy in the Congress and at the FCC, the debates often revolve around the question of what policy will provide the most incentives for investment. But it turns out that the debate is not so much about investment as it is about who will have the incentives to invest: the incumbents or the new entrants; facilities-based providers or those

who integrate parts of existing networks and new networks; those who own transmission pipes or those who want to run applications and services over the pipes.

The truth, simple in concept but complicated is practice, is that a telecom sector that is healthy for the economy, consumers and investors requires that a broad spectrum of competitors have investment incentives. A policy that shuts out any part of the telecom value chain is a policy that will short-change our country.

Equality in regulation is not the primary goal; rather the goal is enable market forces that eliminate the need for regulation

Some suggest that a balanced policy requires equality in regulation. I do not think this is correct. This country often regulates similar services differently. Satellite and cable companies both offer multi-channel video but both are regulated differently. RBOCs and rural ILECs both offer local phone service but are regulated differently. AT&T and MCI in the 1980s and early 1990s both offered long distance service but were regulated differently. Moreover, the search for regulatory equality, in my opinion, distracts us from our primary goal, which is to create market forces that eliminate the need for regulation.

Policy needs to apply equal vigor to policy concerns of multiple parties

To help assure that those market forces exist, I believe that in any policy evaluation, we should make sure that we apply equal vigor in addressing the policy concerns of the whole spectrum of potential competitors. For example, the FCC has undertaken a series of inquiries that have at their core the question of whether existing regulations on the RBOCs and other incumbent LECs can be lifted. A significant rationale for these inquiries is that removing such regulation will create greater incentives for facilities-based competition.

There is nothing wrong with asking questions and determining if regulations can be lifted. But regulators should understand that asking questions is not an academic exercise. There is a cost created by the uncertainty in raising questions about major changes in policy. The market penalizes regulatory uncertainty, and the presence of open questions, even if well meaning, has the affect of deterring investments in the market.

Moreover, there is something wrong if we don't also remove regulations that create disincentives for new facilities-based providers. For example, as NTIA Administrator Nancy Victory correctly noted recently, "constraints on accessing public rights-of-way and tower sites may be inhibiting or least delaying broadband network construction." Some states, such as Michigan, Kansas and Missouri, have adopted rules to reduce local government regulation of rights-of-way. A state-by-state approach to this issue, however, is time consuming and is not the most efficient way to encourage new investment.

Policy has to accommodate a ramp up strategy by new entrants

Further, there must be an understanding that the market is not going to fund facilities-based competitors on a "build it and they will come" basis. To attract capital, one now has to have customers. Therefore, regulation must accommodate a ramp-up period in which new entrants have some ability to use parts of the existing networks to attract customers as they built out their own. This was the clear policy of the 1996 Act. It was based on a correct understanding of history. To create competition in long-distance, the government allowed AT&T's

competitors to use extensive parts of the AT&T network to win over customers and as they did so, they used the revenues to build their own facilities, which also created the collateral benefit of more wholesale opportunities. This successful effort to introduce competition in a previously monopolized market would not have been possible without a ramp-up strategy for new entrants. So to encourage investment, the policy has to provide the right balance for new entrants who need, at least temporarily, to use existing networks and incumbents who understandably want to capture the lion's share of value of their new investments in the network.

2. The Challenge of Rationalizing Revenues

A simple way of characterizing the central dilemma facing investors in telecom is that, for the past few years, too much money has been invested in the opportunity to collect too little revenues. Most of this, as noted above, relates to a historically typical pattern of over investment in a new field where supply and demand are both uncertain.

But in the telecom field, investors face an additional problem -- that a material portion of the revenues is regulated in a bewildering array of federal and state rules, accounting formulas, universal service requirements, and retail price regulation. Investors are nervous about investing in a sector where pricing signals are so often set in complicated proceedings in multiple forums. This multi-layered approach, a legacy of the deal struck almost a century ago between the U.S. Government and AT&T to assure universal service, has had the positive impact of driving up penetration and keeping rates low for local phone service. But in today's market, it has, in my opinion, lead to a system that depresses competition and innovation.

Retail rate regulation deters investment and if wholesale regulation works, retail regulation is unnecessary

I recognize that there are complex legal, political and economic issues involved here. But I also think the inexorable march of wireless and data should lead us to at least ask the question of whether it is time to begin eliminating all retail phone regulation over some period of time. Today we regulate in detail both wholesale services (including unbundling and interconnection) and retail services. If we are doing the right job on the wholesale level, (and the recent announcement of WorldCom that it will be able to compete in the local market in at least 32 states may provide an example of how wholesale regulation can work to generate retail competition) the retail regulation is at best duplicative and at worst, counterproductive. Eliminating the retail regulation would, in my opinion, encourage investment in competitive providers and would, over time, lead to enormous productivity and consumer welfare gains. We should be clear that such deregulation might also in the short-term in some areas lead to higher prices. Over time, however, I think that such price increases would lead to increased investments in new service providers and that competition will lead to improved services for consumers.

I would note that we as a country pre-empted state retail regulation of wireless phones in the mid-90's and resisted calls to regulate the retail rates of data service. Both those sectors have enjoyed greatly improved service and price cuts. It is critical to note, however, that in both cases government policies and market forces had created vibrant competition. We should be exploring whether we are approaching that point in wired services.

Universal service reform is critical to giving market the transparency necessary for efficiency and investment

A necessary component to any such rationalization would be universal service reform. Obviously, there needs to be a restructuring of the method for distributing funds for universal service to make sure that the vast majority of Americans, including in high-cost rural areas, stay connected, as they are today. There needs to be a simpler way to determine where subsidies need to go, and in what amounts. There are clearly parts of the country where subsidies (whether implicit or explicit) can be reduced and rates increased without any reduction in subscribers. This would create a better business investment climate in these markets, with the business case structured less by regulation and more by market forces.

There also needs to be a simpler and more sustainable way to collect the funds. The FCC is currently reviewing whether to replace the current method of collecting a percentage of each carrier's net interstate and international telecom services billings with an assessment on connections to the network. Without commenting on a number of details that need to be thought through, I would note it is likely that such as system will become even more important in the future. We believe that service providers will increasingly bundle numerous products. Assessments applied against a service will be difficult to account for and will create incentives to engage in accounting manipulations that ultimately hurt the market. Assessments applied against a connection, on the other hand will give the market the kind of transparency that leads to more efficient markets and an improved investment climate.

III. The Challenge of Making Timely and Certain Decisions.

It is a simple but critical truth that a decision delayed is investment denied. Further, any decision has to be considered final for the financial markets to invest on the basis of that decision.

Giving the FCC deadlines works

One of the best things Congress did in the '96 Act was something that at the time I thought was one of the worst things: it set very strict and certain time limits on how long the Commission had to finish the scores of rulemakings Congress mandated. I frankly thought it would be impossible to meet those deadlines. But the Chairman made it very clear to the other Commissioners and the staff that he would not tolerate missing any of the deadlines. The staff responded with a great spirit of professionalism and public service, a spirit that has long characterized the FCC and continues today. In those months immediately following the Act's passage, the staff worked extraordinarily hard and as a result, the Commission met every deadline.

The Judicial Process, where possible, should be expedited

Unfortunately, the FCC was only part of the equation. Every major Commission decision was appealed, as should be expected whenever the Commission decides a contentious issue with millions, and sometimes billions, of dollars at stake. And the courts are under no mandate to render their decisions within any set period of time. So today, some of the key issues Congress correctly wanted decided quickly are still unresolved. For example,

Congress gave the FCC six months to decide the critical question of how to define "cost" for the purposes of determining the price at which incumbent phone companies would be required to sell its unbundled network elements. The FCC economists and the rest of the staff poured through thousands of pages of dense economic analysis and came out with the Commission's answer within the six-month deadline. Appeals immediately followed, and now, more than six years after the Act's passage, the Courts have still not finished their determinations of whether the Commission's decision was correct under the law.

And it is not just the FCC decisions that were subject to appeal. Almost every, if not every, major state Public Utilities Commission decision was also appealed.

This judicial process ultimately led to great confusion and uncertainty in the marketplace as to what the rules are concerning pricing. While there were many things that contributed to the collapse in investor interest in the telecom sector, the ongoing battles over what the rules are did not help encourage investment and were among the many contributing factors to investors' disillusionment.

We do not have to sacrifice our commitment to due process or our belief in a federal system to improve the current system. Just as Congress should not be afraid to give the FCC strict timetables, it can take actions to improve the timeliness and certainty of key decisions. For example, it could, as it did with appeals of the FCC decisions on RBOC in-region long-distance applications, put all the appeals of Commission decisions in the Court of Appeals for the D.C. Circuit, thus limiting forum shopping and providing a more consistent and experienced administrative law perspective on Commission decisions.

Resolve competitive disputes faster

A second example of how delay hurts investment is the treatment of disputes between competitors and incumbents. The Commission is to be commended for setting up a "rocket docket" that expedites resolution of such disputes. And the current Chairman, Michael Powell, is clearly correct in his view that the current limit on the amount of fines for failure to comply with the law is not a sufficient incentive to discourage unlawful behavior. But problems persist. Let me provide an example to illustrate the problem. A facilities-based provider was having problems enforcing the reciprocal compensation terms of its interconnection agreement with Verizon South (formerly GTE) in Virginia. The competitor began a proceeding in June 2000. In September, the proceeding was split into a liability phase and a damages phase. The parties completed their briefings on the liability phase on July 20, 2001. If the competitor is successful at that phase, then it will have to go through a damages phase, with further discovery and briefing. In short, the new entrant will have to wait at least two years before it has any chance of recovering the disputed amounts and even then, it's subject to judicial review.

While we must provide due process to all parties, we must recognize that such a playing field creates enormous disincentives to invest in new competitors, including facilities-based competitors. There is a better way. As an example, let me note the process agreed to by Covad and SBC as part of a litigation settlement. The parties agreed that rather than pursue disputes at the FCC or state PUCs, the parties would follow a specified executive escalation process and if that is not successful, a binding arbitration process. The decisions are binding across SBC's entire region. As a result, disputes that could take years in a dozen forums are resolved within a matter of months in one forum.

Don't let a process tie up investment capital

A third example of delay hurting investment is the NextWave case. This is not the time to review the long, tortured Odyssey of that spectrum, an Odyssey likely to take as long as the voyage of Homer's hero after the Trojan War. And I believe there are a lot of legal reasons to be glad that the Supreme Court will decide the important questions raised in the litigation.

But from an investment perspective, we face a ludicrous and painful situation. We have a critical industry, wireless, that is starved for capital to invest in capital upgrades for new and improved services. While the FCC recently took the appropriate action and returned most of the down payment money, we essentially still have $16 billion in potential capital for the wireless industry will likely be tied up for several more years. This is no small thing. S&P, for example, said that despite the down payment being returned, it was keeping the same credit rating and outlook status for Verizon, "because of the uncertainty regarding Verizon's ultimate obligation to pay the total $8.7 billion it bid in the auction."

If this were a private contract dispute, I could understand the government taking the position that the auction "winners" (and I use that term in the technical sense only) must stay on the hook for their prior commitments until the end of the litigation. But from the perspective of encouraging wireless companies to invest in improved service and technologies, what public purpose is served by tying up billions bid in 2001 for spectrum that the government is unlikely to be able to deliver to the companies until 2004, or beyond?

I'm sure there are many other tales of decisions delayed that have led to investment denied. In fact I am quite sure that every industry in the telecom sector, would have its own story.

I think the bottom line is clear: don't hesitate to give FCC deadlines; deal with judicial problems by limiting venues, use alternative dispute resolution to speed up competitive disputes and don't allow a process to tie up investment capital.

Conclusion

Again, let me thank the Committee for investigating investment in the telecom sector. The telecom sector has made enormous contributions to our economic performance. If government develops a balanced policy to encourage investment in all parts of the network, rationalizes regulation to allow more market based signals and facilitates faster decisions, it will encourage investment and the sector will again make great contributions.