

Profile: Pac-West Telecomm

Few carriers offered as clear a view of both edges of the regulatory sword as Pac-West Telecomm. It took full advantage of the reciprocal compensation opportunity, but faced hard times when reciprocal compensation was later limited.

Like Talk America, Pac-West began its life as a long-distance reseller in 1982. Eventually it installed and operated its own long-haul switching infrastructure and carved out a successful niche selling to small and medium-sized businesses, particularly ISPs, with operations in California.

California's telecommunications market is different from the other intra-state markets. California is the most populous state and one of the largest states by area, resulting in the largest intra-state, inter-LATA telecommunications market in the U.S. It is also one of the few states that has a significant presence by more than one RBOC. The original Bell company in California, Pacific Bell was acquired by SBC in 1997. GTE was the second-largest phone company in California. Formerly the largest independent (non-Bell) ILEC, it was acquired by Bell Atlantic (now Verizon) in 2000, so it is now part of the RBOC family.

California is also home to Silicon Valley, a cradle of high-tech entrepreneurial activity. One of the first links on the ARPANet, predecessor of the commercial Internet, ran between Stanford University in Silicon Valley and the University of California in Los Angeles.

In this environment of much demand for telecommunications services and no dominant carrier, Pac-West saw an opportunity in 1996 with the passage of the Telecommunications Act. It decided to become a CLEC and offer local service to its clients in addition to long-distance. Pac-West, like the long-distance companies and the RBOCs, wanted to be fully integrated carriers, offering their customers a one stop shop for all telecommunications services (or at least most of them).

Whether by design or by accident, Pac-West discovered that the new rules surrounding reciprocal compensation had a huge loophole. The original rules and the inter-carrier agreements negotiated within those rules contemplated roughly equal amounts of network traffic flowing in each direction across the circuits that connected the carriers. The rules generally required the originating carrier to compensate the carrier that completed the call.

What was not originally considered was what would happen when traffic was significantly unbalanced, as was the case with calls directed toward dial-up modem banks for ISPs. Pac-West operated racks of modems, called dial concentrators, placed around the state in such a way that all of a given ISP's subscribers could reach the ISP by placing a local call (without incurring toll charges). Since it was expensive for each ISP to place modems so as to eliminate toll charges, several carriers placed large modem banks in distributed areas and offered a "managed dial-up access" service for use by multiple ISPs. UUNet was perhaps the largest nationwide carrier to offer such a service, supporting both AOL and MSN at one point. Pac-West offered managed dial access in the entire California market as well as each of the contiguous states: Oregon, Nevada, and Arizona.

Pac-West was successful attracting ISPs to use its dial network. It was also able to cut its prices since it could rely on reciprocal compensation from the ILECs that originated virtually all of the calls to the dial racks. More over, the dial racks never

generated any outbound traffic, so Pac-West didn't have to worry about owing reciprocal compensation on these lines.

In significant part because of this wrinkle in the new regulations, Pac-West saw its revenue increase along with interest in the Internet. Pac-West's revenue rose from \$30 million in 1997 to \$95 million in 1999 and to \$150 million in 2001.

Pac-West followed many of the new-age carriers of the time and went public in 1999. Its stock went from \$16.50 per share to \$18.44 on its first day of trading, a 12% increase. The stock continued to do well, trading at more than \$40 per share in March 2000. But once the bubble burst Pac-West couldn't retain investors' interest. Even though the company was profitable in 1999 and 2000, the stock dropped precipitously, closing 2000 at \$3.44 per share.

As it turned out, all of Pac-West's eggs were in one basket. In 2001, reciprocal compensation accounted for 42% of its revenue. Its ISP market (counting revenue from reciprocal compensation as well as, for example, circuit charges) accounted for 68% of Pac-West's revenue. The situation became even more difficult for Pac-West once the ILECs started disputing the reciprocal compensation bills. Revenue, when it showed up at all, was late and came at the cost of high legal bills.

The other shoe dropped when, in April 2001, the FCC finally decided that reciprocal compensation for ISP-bound calls would be wound down over time. In the interim, all calls beyond a set number were to be handled in a bill-and-keep manner, meaning the carrier on either end of the call would owe no compensation.

With the end of the reciprocal compensation party, Pac-West seemed doomed. It faced falling revenue, high interest payments from \$150 million of junk bonds taken on in better times, and an increasingly competitive long-distance market once SBC was allowed into the inter-LATA market in California (Verizon was already in). Pac-West was able to stay afloat only with one-time revenue items that trickled in (such as late payments on reciprocal compensation claims).

In October 2003, Pac-West negotiated a new financing arrangement to replace its high-interest-rate bonds and, potentially, live within its means. The prospect of making it through the Telebomb sent Pac-West's battered stock to heights not seen since the end of the boom. More on Pac-West's stock performance is in Chapter 10.