

By Lawson AW Hunter, QC

The new competitive reality in communications

Message to regulators: Understand the power of broadband, and fundamentally rethink economic regulation of the entire industry

We are now a little over a decade from the beginning of dramatic changes in the competitive landscape in the consumer telecommunications business. So what have been the main drivers of change over that past decade, and what are the results as we presently see them?

The drivers have been pretty clear. First, the competitive changes have been largely driven by technological change: the move to digital; the inexorable change to internet protocol as the basis of most systems; and the growth of the internet as the most important product in the home. These changes allowed an expansion of the products being offered by service providers who once were stuck in a “voice” silo or a “video” silo. Finally, there is the profound and growing impact of wireless.

The must-have sector?

Perhaps the best news for the sector, is that, even in these difficult economic times, products offered by the industry are at the top of “must haves” in a recent survey in Canada.¹ At the top of the list of the services least likely to be dropped was home internet service, something I doubt would not have been even on such a list a decade ago. The second and third most valuable (or least discretionary) services were DVD rentals and mobile/wireless phones. And perhaps, surprisingly, the fourth most valued service was good old home voice products.

If you distill this information and the trends we have seen over the past decade, it leads to the conclusion that the key to the supplier/consumer relationship is now, and increasingly will be, the broadband connection to the home. In other words, the broadband connection to the home will be the key driver of competitive activity for the next period of time.

This is not to diminish the importance of wireless. But, at least for the next while, broadband services offered

over a fixed line network will be the key competitive differentiator of services offered to the home.

But in mentioning the key drivers of change, I did not mention the role of regulation. That was quite deliberate. In my view, the regulatory environment over the past decade has most often, in both the United States and Canada, misread or misunderstood, the fundamental changes taking place in the marketplace.

More often than not, regulators adopted policies that prevented necessary change, or promoted forms of competition that were not sustainable. The emphasis on CLEC competition, certainly in the United States, and to an important degree, in Canada, did not promote facilities-based competition, and as a result, retarded capital investment in the network by the incumbent telephone companies.

It also created a dependency regulatory environment that governments too often create, and too seldom exit, even when it is obvious that it is not achieving the intended objectives. I should add that when I comment on the regulatory environment, I am focussing on the United States and Canada because it is those two jurisdictions that have the luxury of having two, almost ubiquitous, fixed networks into the home.

And it is those two networks, owned by telcos and the cablecos, that are the foundation of the current and future competitive consumer environment.

State of play

So what is the current state of competition and who has the momentum as a supplier to the broadband home? In my view, for a number of reasons, the cablecos have the momentum and the advantage. There are several reasons why the cable industry is better positioned than the incumbent telephone companies.

First, they have a cost advantage. They particularly have a cost advantage as they enter the bread and butter product of the telcos, namely the local voice market. And this is for the simple reason that their voice product is simply an application on their IP network, whereas the cost of the telcos switched product is much higher.

¹ See discussion of the Solutions Research Group Report in Grant Robertson, “Internet, cellphone: the new essentials: Belt-tightening consumers are more likely to cut back on movie tickets, DVDs, and top-tier cable, study finds”, The Globe and Mail” (23rd October 2008) B3

Indeed, the cablecos, in Canada, when they entered the home voice market, were profitable almost from day one. They were profitable with a minimal number of subscribers, and at very healthy margins.

The second reason the cable industry has an advantage is their broader product mix. They have a voice product. They have a video product. They have a high speed product. The telcos are clearly playing catch-up on the product side in video, and it is unclear whether they will ever reach ubiquity over their networks with a competitive video product.

The third advantage the cablecos have is a technology advantage. Their coaxial cable network offers more bandwidth at higher speeds than most of the telcos high speed offerings. This is particularly true of DSL. And the demand for bandwidth will only increase as video moves to high definition, and consumers increase their usage of video and other applications over the high speed network.

The fourth reason the cablecos have an advantage is that they are growing in the telcos highest margin product, local voice, but are not facing similar competitive pressure in their core product, video, which has a lower margin than the historic margins in voice, in any event. So they can apply pressure to the telcos, while not facing similar pressure in their core market.

Finally, the telcos face the issue of wireless substitution or wireless-only homes in their core voice market. This is not an issue for most cable companies who, with the exception of Rogers in Canada, have never entered the mobility market.

Cablecos may have the momentum...

This is not to say that the telcos do not have strengths of their own. They have the scale, customer relationships and the business and wireless markets that can work to their advantage. But they are also saddled with a legacy technology that is difficult to adapt to the new IP world. Their switched products face a truly disruptive technology.

Furthermore, it is not scale, or financial results, that are the best indicators of the state of competition in this marketplace. Historical market share is practically of no use in assessing the strength of competition. The real measure is whether competitors have the capacity to offer competing services, and whether the consumer has a real and meaningful choice. And the answer, of course, is that

that capacity and choice exists in the marketplace today.

US and Canadian trends

There are clear trends in both Canada and the United States in the incumbent telcos home voice market. What is clear in both countries is that the loss of market share in this market is essentially a straight line. In fact, in the United States, some research reports, particularly those coming from Bernstein, believe the losses are actually accelerating.²

The situation in Canada is a little choppy, but it also seems to be heading in the same direction. An interesting question is: will there be an equilibrium point in this market? It is often the case that when new entrants enter a market they capture a certain proportion of the market, but ultimately the market shares stabilize.

The history to date in the home voice market does not indicate that we have reached such an equilibrium point. The unanswered question is whether there will, indeed, be an equilibrium point in this market.

There are similar if less dramatic trends in the high speed home internet market, but data shows that the cable industry seems to have the advantage. In both countries, their share of the overall high speed market is increasing, and is at least 55% in both countries.³

Also, if one looks at the recent North American trends in net additions of high speed subscribers, the cablecos are capturing the biggest share of new customers. And there is probably a strong correlation between the telcos loss of home phone share, either to cable offerings or wireless substitution, and their declining share in the high speed market. This is a point that Bernstein makes with the added comment that as the telcos sell "naked" DSL, its comparison to the competing cable internet product becomes more obvious.⁴

A third area is the importance of video in the new competitive reality, and although the picture

- 2 See, for example, Bernstein Reports, "US Telecom: Wireline Limbo - how low can you go?" in US Telecommunications, Wireline Unplugged, June 2008, page 21
- 3 See Bernstein Reports "US Telecom Cable and Satellite: A Consumer Scorecard...Who's Winning the Wars", 27th May 2008, page 13; CRTC, Communications Monitoring Report 2008, page 206
- 4 Bernstein Report, "US Telecom, Cable and Satellite: Value Migration Accelerates", 3rd September 2008, page 13



is somewhat mixed and harder to analyze, it seems clear that having a competitive video product is an important factor affecting the household decision for the other two products in the bundle. Certainly, the evidence in the US is that in areas where Verizon offers FiOS they are doing much better in retaining or adding high speed customers and they are making good progress in attracting video market share – FiOS TV sales penetration jumped to 19.7% in the third quarter of this year, up from 15.2% in the same quarter last year – and AT&T is similarly having some success with their Uverse product.⁵

Perhaps the best demonstration is the two Canadian provinces of Manitoba and Saskatchewan. The incumbent telcos in these provinces have been offering a video product in their major urban areas for a few years now. They both report that they have strong video penetration in those centers, with the product in Saskatchewan gaining more than 25% of the market and the product in Manitoba gaining over 30%.⁶ And when you analyze their losses in the local voice market, as well as their share of high speed internet, they are doing relatively well in their territory. There, may, of course, be a number of reasons for this, one of them likely being the loyalty customers' show to the local provider.

But at the end of the day, consumers will migrate to the best price and the best product. It will be necessary to offer competitive services in order to win in the market ultimately. The role of satellite also deserves a comment. In the US, it appears

to have helped the incumbent telcos to some degree.

But it is not a high margin product, since the incumbents are merely acting as distributors to the real service provider. In Canada, Bell has offered a video satellite product for some years. Although it, too, has helped to some degree, the fact that it runs on a completely separate platform means that it is harder to get the margins the cable companies can obtain by offering all products over the same platform.

Implications

So what are the implications for public policy and the market if my analysis is correct?

First, the continuing role of economic regulation is highly questionable. At a minimum, the need for symmetry, or a level playing field, between the incumbent telcos and the cablecos is ever more important. In Canada, the telcos are still subject to more regulation than the cable companies competing with them.

The telcos have a continuing price cap on their standalone voice product. There is an asymmetry between wholesale access for the telcos compared to the cablecos. And, of course, the universal service obligation continues to exist for the telcos. I am not an expert on the US regulatory environment, but I suspect a similar situation exists at the federal and state level in the United States as well.

What this calls for, in my view, is a fundamental review of all of the existing economic regulations of the industry, applying principles similar to those enunciated by the Telecom Policy Review Panel in Canada and adopted by the Federal Government in its directive to the CRTC. Those principles were the following:

⁵ Verizon Communications, Investor Quarterly, 3Q 2008, page 6

⁶ Bruce Johnstone, "Sasktel to get a \$118 million update", Regina Leader-Post (30th January 2007); MTS Allstream, Annual Report 2007, page 23

- » The regulator must rely on market forces to the maximum extent possible;
- » Regulation must be efficient and proportionate;
- » When regulation is necessary, the least intrusive means must be used; and
- » Regulation must not deter economically efficient entry nor promote economically inefficient entry.

These principles, if legally binding and properly applied, would bring about a dramatic change in the extent, scope and nature of economic regulation of the telcos. And it would produce healthier companies and more effective competition for consumers.

But two infrastructures..?

A second implication of my analysis I raise more as a question. Given the significant capital cost involved in building a network that will meet current and future demands in the broadband home, are two fixed infrastructures into the home sustainable or realistic?

First, we are on the eve of an all digital, high definition market in the United States, with Canada a couple of years behind. Also, the increasing demand for bandwidth to provide competitive products, even ultra high speed products, seems inevitable. And finally, it highlights the importance of the capacity of the network in such an ultra high speed environment.

This, of course, leads into the network neutrality debate. Some of the leading academic supporters of network neutrality principles, particularly Professor Benkler in his book "The Wealth of Networks"⁷ somehow manage to ignore the capital requirements to build the brave new world they discuss, and the need for private sector players to make a decent return in order to justify the investment. Perhaps, in their "commons" world they would prefer that governments own the network, although I suspect that is unlikely in the current economic situation.

In my view, we need to be forward looking and practical in discussing network neutrality,

including the sustainability of a competitive market structure.

The third implication I want to raise is also more of a question. That is how will enterprise markets be affected by the changes I discussed in the consumer market, and the decline of the incumbent telcos' position in that market. Many of the telcos' costs in serving the consumer, SME, enterprise, and even wireless markets, are common. As such, they are allocated or shared by the various customers/business divisions and this has an impact on the ultimate price in the marketplace.

But if the consumer market, and probably the SME markets, of the telcos decline, more of the network or common costs will be loaded onto the enterprise business. And here, of course, the incumbent telcos are the main suppliers. The cablecos have never seriously entered this market. There have been some attempts in Canada which have been largely uneventful.

Credit crunch impact

Will the current financial and economic crisis affect regulation in areas outside of the financial sector? This is a serious concern, and we are very likely moving into an era where government/regulation is seen as better and business/markets are seen as worse.

Lawrence Summers, in a recent article in the London Financial Times, stated:⁸ "All of these considerations suggest that the pendulum will swing – and should swing – towards an enhanced role for government in saving the market system from its excesses and inadequacies".

His article was largely focussed on the market failings in the credit and financial markets, but the question is whether it will spread to a concern about reliance on market outcomes in other areas of the economy as well.

And no less an authority than Alan Greenspan, in appearing before Congress in late October this year, stated:

"...those of us who have looked to the self-interest of lending institutions to protect shareholders' equity (myself especially) are in a state of shocked disbelief".⁹

7 Yochai Benkler, "The Wealth of Networks: How Social Production Transforms Markets and Freedom" Yale University Press, New Haven and London, 2006

8 Lawrence Summers, "The pendulum swings towards regulation", Financial Times, 26th October 2008

9 Testimony of Dr Alan Greenspan, Committee of Government Oversight and Reform, 23rd October 2008

He was mainly speaking about financial markets, but pointed out that the market, which he so believed in, was not immune from failings or shortcomings.

On top of these issues, the political environment has changed dramatically in the United States, and to some degree in Canada. There seems to be a trend towards populism and consumerism, the likes of which I have not been seen in Canada since the 1970's. Although I am no expert on the US political environment, the Democratic Platform tends in this direction as well. This could have serious implications for issues like network neutrality, for example. In Canada, although we have re-elected a Conservative Government, it still has a minority in Parliament. And the Opposition Parties are more center, or left of centre, than the Government itself and will push any legislation before Parliament in that direction.

In any event, the Conservative Government itself, both before the election and after, will continue to move to the center in its search for a majority. The Conservative Platform had a number of populist/consumer friendly measures and I am advised that the Government intends to implement its platform as articulated. It is, however, possible that the timing of implementation will be affected by the economic climate.

Conclusion

With this background, what do sectors like the telecommunications sector do to prevent counter-productive new regulations of their business.

First, it will be necessary to insist on hard-headed, factual analysis, sector by sector. One size does not fit all sectors of the economy and, particularly, the real economy. There are aspects of the financial sector which require a type of regulation usually not required in the real economy, prudential regulation in particular. And the psychological aspects of financial markets are more significant than in most other sectors of the economy.

Second, it will be necessary to have clear objectives, a theory if you will, as discussions unfold about new regulatory measures. Fuzzy headed "fairness" regulation is not a theory and it is not a substitute for analysis.

Third, it will be important for the supply side of the communications industry to avoid the regulatory gamesmanship it has exhibited in the past. Now, more than ever, telcos and cablecos have a common interest, even if they are vigorous competitors. There is a need for clear alignment in the industry. This should happen regardless of the current economic situation and its implications for public policy.

It is time the supply side of the market got its act together, recognized common objectives and spoke with one voice. To have credibility for this position, it may well be that the sector should advocate vigorous antitrust enforcement as a way to avoid sector specific and more intrusive regulation.

The mantra of the industry, in my view, should be "what's so special about telecom"? The need for sector specific regulation, particularly economic regulation, in an industry as demonstrably competitive as this one diminishes daily. The industry itself should not get trapped by the "historic accident" of the industry, with its natural monopoly characteristics, if it is to avoid more intrusive regulation than is desirable for either the industry or consumers.

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