

### **BELL TELECOM UP, CABLE COMPANIES DOWN ON CAPITOL HILL**

In 1996, the Clinton Administration and a Republican Congress finally updated the nation's telecommunications laws which had changed little since the Great Depression. Or so they thought. Looking back, it is clear that the federal government had little idea what was about to happen. The dominant theme of the 1996 Act was that it was time to permit local telephone companies, the "baby Bells," to compete against AT&T, MCI, and Sprint in the long distance telephone market once the FCC had certified that the baby Bells faced competition in their local markets. As a result, the law was hundreds of pages long, but the word "Internet" appears only eleven times, and the word "broadband" appears only once.

In 2016, will we look back also with a wry smile to see how far off our national leaders were in 2006 in anticipating changes in the communications industry and in writing helpful laws to guide this dynamic industry forward? This report card can be published years from now, but in a matter of weeks, we will get the Congress' ideas on what should be done now to modernize laws in the information age. **As of today, it appears that Congress thinks that what was once old is now new; any bill that become law this year should favor the two larger Bell telecoms, AT&T and Verizon.**

Before the end of March, the House Energy Commerce Committee is expected to unveil a bi-partisan draft that addresses at least two burning topics:

- Under what terms should the nation's largest telecom companies, AT&T, Verizon, BellSouth, and Qwest enter the cable market?
- What limits should be placed on broadband builders – principally AT&T, Verizon, Comcast, Time Warner, and Cox Communications – when they negotiate with content providers who are expected to use very large amounts of bandwidth when they roll out new services, such as Google, Yahoo!, Microsoft, and Amazon?

The answers to the first question will determine how much market share the cable companies lose in their traditional line of business in the next five to ten years, and how much money communications equipment makers will make when the owners of these two large communications platforms compete by modernizing their systems. The answers to the second question will determine whether the owners of national broadband "pipes" or popular content providers become the tech darlings of Wall Street.

The Senate Commerce, Science and Transportation Committee should unveil its own ideas soon after the House Committee acts. It is expected to unveil answers to these questions in

April. Committee Chairman Stevens (R-AK) has made the optimistic prediction that his Committee's bill will be considered by the full Senate just after Easter.

### **The Bell Telecoms are Winning on Capitol Hill**

When the cable industry was newborn, it had to negotiate franchise agreements on a municipality-by-municipality basis. This meant negotiating with the nation's 30,000 mayors and town councils, one at a time. The process was laborious and expensive. Each city wanted a fee in exchange for granting rights of way over its public territory as well as "add ons" unique to each location, such as setting aside channels dedicated to broadcasting city council meetings, or to assist teachers. Many jurisdictions also demanded that cable companies "build out" their systems so that any citizen that wanted service could get it, even if the capital outlay needed to serve him made his service unprofitable.

The Bell telecom companies want to enter the video market, but avoid the time consuming and expensive process that the early cable monopolists endured; Congress is likely to grant their wish. Specifically, both the House and Senate are likely to support "video franchising." Under video franchising, the telecoms will petition the FCC for a national video license. Once granted, a Bell telecom will have the right to enter any municipal market it chooses. In return, the municipal government will receive 5 percent of the Bell telecom's local video revenues, which is the rate now charged most cable companies, and also they can require them to set aside some room for public, education, and government programming, just as cable companies now do. However, the basic terms are set from the outset, permitting the telecoms to enter the video market as rapid as their capital budgets and marketing strategies dictate.

How important is video franchising to the Bell telecom video rollout? Verizon wrote the FCC last week complaining about delays in getting local franchises saying, "... nearly 80 percent of those negotiations pending 15 months ago are still not complete, and of the few that are complete, half of them took 15 months or more." AT&T told the Senate Commerce Committee last month, "And delay is just one of the problems inherent in the current system ... We faced a range of demands that would have rendered our plans uneconomic, including fees that exceeded the limit under federal law, extensive build-out requirements, as well as more outlandish requests, such as for the construction of fire stations or recreation centers."

If video franchising becomes law, as seems likely, many of those reading this ten years from now probably will watch Superbowl L courtesy of AT&T or Verizon. You may not have this option, however, if you live in an area where it is expensive to reach you. The telecoms apparently have won the fight in the House, and are on track to avoid "build out" requirements.

The telecoms also appear to have won another boon from the House Committee; until the telecoms achieve a 15 percent market share, the cable incumbents will not be permitted to price discriminate by area. Thus, if Verizon begins to market and to wire part of a town, Comcast will not be permitted to drop its prices to match Verizon's offering unless it does so for the whole town until Verizon has gained a major foothold. It would appear that the Committee is about to

guarantee that a fifteen percent market share will go to the Bell telecoms since the cost of challenging them on price would be prohibitive. Who would want to give up gross margins on a book of business three times as large or more, just to enter a dog fight?

### **It Won't be Your Father's Cable, Either**

The telecoms' video service, they insist, will not be "standard cable." For example, the equipment maker Alcatel told Congress it had been selected by AT&T to provide "ultra-high speed broadband service to 18 million households by 2008," describing the service as two-way interactive, allowing:

- Subscribers to ship home movies
- Parents to screen out objectionable programming
- Sports viewers to shift camera angles at will

Ultra-high speed broadband also will make telemedicine feasible. Patients need not be physically present to meet with their doctors.

### **Equipment Makers Will Win as Bell Telecom and Cable Companies Face Off**

The cable industry can not afford to let the Bell telecoms have a free hand in the fight to sign up broadband customers nor risk that the Bell telecom's new video products will have a "killer application." Therefore, they are making plans to expand their bandwidth as well and to develop new applications that can take advantage of it. When country A and country B fight a long war, the thing that seems most certain is that the arms suppliers to both countries will prosper. In this case, broadband equipment makers should benefit as Bell telecom and the cable industry open their wallets to pay Adtran, ADC Telecommunications, C-Cor, Harmonic Inc, Cisco, Alcatel, Siemens, Lucent, Motorola, and NEC.

### **Video, a la Carte**

While Congress considers reforms that bring new competition into cable/satellite markets, some members are also questioning the practice of making consumers pay for channels they do not watch. One feature that irks many cable and satellite video customers is that they have to pay for a bundle of channels to get any channels at all. Furthermore, some of the bundled content is inappropriate for children. The Congress is weighing whether this practice should end. Sometime soon, they may, spurred on by a recent FCC study that found that "a la carte" pricing would lower consumer bills, by "up to 13 percent." If consumers can choose to pay for only the channels they want, such a requirement likely would apply to all video platforms – cable, satellite, and Bell telecom.

At least two influential players think that a la carte pricing is the way to go. Senator McCain (R-AZ) has long championed the issue and the House Appropriations Subcommittee Chairman Frank Wolfe (R-VA), who oversees the FCC, recently told Kevin Martin, the FCC

Chairman, “ I think you have made such a powerful case for a la carte it will be shocking if this Congress does not deal with this issue,” during Martin’s testimony before the Subcommittee on March 1, 2006.

### **Is “Net Neutrality” Just Another Name For Cyber-Squatting?**

Who should pay to build and maintain the new high capacity broadband network that will be deployed soon – the retail customers of Internet service providers or the companies that use the network to send retail customers content? Until now, it has been retail customers who have footed almost all of the bill for repaying prior Internet builders. AT&T and Verizon want to change the rules for the largest content providers, and they will unless Congress or the FCC stops them. Here are the quotes company leaders recently gave:

- “Now what they would like to do is use my pipes free, but I ain’t going to let them do that because we have spent this capital and we have to have a return on it. So there’s going to have to be some mechanism for these people who use these pipes to pay for the portion they’re using.” – AT&T Inc. CEO, Edward Whitacre Jr.
- “The network builders are spending a fortune constructing and maintaining the networks that Google intends to ride on with nothing but cheap servers. It is enjoying a free lunch that should, by any rational account, be the lunch of the facilities providers.” – John Thorne, Verizon Communications Senior Vice President

The telecoms are making their move now because they know that Google, Yahoo!, Amazon, Microsoft, and others are planning to roll out bandwidth intensive products that will use up a disproportionate amount of their capacity, such as GoogleTV, multi-player, virtual reality, real-time gaming, and video web browsers. Maybe they think they can get away with it, since even the Internet’s most profitable companies have little choice but to use local the cable/Bell telecom duopoly to reach their customers.

“Net neutrality” means different things to different people. However, the dominant concept is that things should remain as they are: content providers pay almost nothing to ship their material over the Internet while retail ISP customers pay almost everything, with some paying more if they wish more bandwidth. If Comcast can extract significant rent from Google, then analysts may have to rework their earnings estimates for Google and others who now “ride for free.” There is a rumor that Google is sufficiently worried about this problem that it is exploring becoming a telco broadband provider itself.

### **The Future of VoIP**

A second “net neutrality issue” involves service discrimination by broadband providers. How Congress and the FCC address this issue may decide the fate of independent VoIP companies and other highly time-sensitive broadband applications like multiple person, remote game playing. For example, if it chose to do so, AT&T could program its routers to give lower

priority to shipping the data packets of Vonage, the leading independent VoIP company. Whenever there was congestion on At&T's broadband lines, customers of Vonage might experience noticeable delays, and perhaps jerkiness, in the flow of conversation. Meanwhile, AT&T's wire line and wireless customers could use AT&T VoIP service smoothly. There is a layman's description on the mechanics of net discrimination at [www.freedom-to-tinker.com](http://www.freedom-to-tinker.com) prepared by Princeton University professor Ed Felten.

### **Congress is Unlikely to be Neutral Toward Net Neutrality**

CAN anticipates that any bill Congress clears will allow Bell telecom and the cable companies to try to extract revenue from high bandwidth content providers like Google. Such a policy is, in fact, current law, so Congress would have to overturn existing law to stop them. It may not be lost on the politicians that if Microsoft has to pay more to build out high capacity broadband as a dominant future content provider, perhaps their constituents can pay less.

### **Legislative Timing**

Communications lobbyists are swarming on Capitol Hill now, trying to influence the draft bills they expect the House and Senate Commerce Committees to develop before Easter. If there is a consensus among this anxious crowd, it is that two outcomes are likely this year: either a video franchising bill reaches Bush by year-end, with perhaps a net neutrality section that prohibits the worst kinds of abuses, or that Congress will not complete action on any bill this year, and the job of finishing the bill will fall to the next Congress. We should know the answer by September.

---

For further analysis or information, contact Capitol Analysts Network, Inc. at:

4405 Bradley Lane  
Chevy Chase, Maryland 20815  
website: [www.capitolanalysts.com](http://www.capitolanalysts.com)

Phone: 301-951-9161  
Fax: 301-652-5831  
Email: [capnet@xecu.net](mailto:capnet@xecu.net)

© 2006 Capitol Analysts Network, Inc. All rights reserved

**Disclaimer:** This report is based on material we believe to be accurate and reliable; however the accuracy and completeness of the material and conclusions derived from said material in this report are not guaranteed. Capitol Analysts Network, Inc. makes no recommendation as to the suitability of such investment for any person.

Capitol Analysts Network, Inc. employees or officers may have long or short positions or holdings in the securities or other related investments of companies mentioned herein.