News Item #2


Discussion:

This news article shows the important role switching costs play in the competition for market dominance.

The world’s two largest telephone companies, AT&T and Verizon, are making inroads into the television business, which has been traditionally controlled by cable operators, in the hope that they could catch up with the latest ride of building “one-stop shop” for customers to obtain television, telephone, and Internet services from the same provider. All the players in this battle know very well that the more services they could bundle and sell, the harder it would be for customers to defect to their competitors.

Cable operators have the first mover advantage in the television business because they control a large installed base of customers. Telephone companies attempt to persuade the customers to switch by offering extensive channel selection, broadband interactive features and relatively low pricing. Cable companies have responded by providing aggressive discounts and broadening their services to discourage customers from switching. One big challenge for the telephone companies is how they can keep prices low while still making a profit. They will incur very high infrastructure costs and are likely to pay premium prices to content providers at the early stage of new market expedition. However, content providers do have an incentive to cooperate with the telephone companies, because more competition in the television business will reduce the bargaining power of cable operators. It is interesting to watch how the balance of power would play out as the battle continues.
Calling Out the Cable Guy

By LORNE MANLY and KEN BELSON

TERRY DENSON and Dan York are not exactly boldface names in entertainment industry circles, but perhaps they should be. After all, nearly $30 billion and the future of two Baby Bells hang in part on whether these two refugees from the television programming world find success in their new jobs.

Mr. Denson, who works for Verizon Communications, and Mr. York, his counterpart at AT&T, are playing starring roles in their companies' risky forays into the TV business. In the latest twist in an accelerating technological free-for-all, the Baby Bells are trying to shore up their flagging fortunes by muscling their way into what was until just a decade ago the bailiwick of cable companies. Rarely competitors in the past, cable operators and telephone companies are now scrambling to be the one-stop shop that will gladly accept your monthly payments to watch television, use the phone and have high-speed Internet access.

Executives at both Verizon and AT&T, which last week officially changed its name from SBC, hope that the extensive selection of channels, whiz-bang features and low pricing of their video offerings will sway television viewers around the country to switch. Although cable and satellite have spent billions upgrading their delivery systems to accommodate a future in which all forms of entertainment are digital and perhaps interactive, the Baby Bells contend that bandwidth is destiny.

When they're done spending their billions, the phone companies say, they will surpass their rivals. They promise a seemingly infinite number of channels, many in crisp high definition, and plenty of interactive tie-ins, like the ability to check e-mail messages or screen incoming telephone calls on the TV set.

But as the Baby Bells know better than most, talk is cheap and the challenge is daunting. The capital expenditures are staggering. Holding little leverage with the content creators, they also end up paying more for programming than cable companies and satellite operators, who already hold the accounts of 92 million consumers and are rapidly making inroads into the telephone companies' own business of phone service.

What's more, the Baby Bells aren't expected to reach consumers in meaningful numbers anytime soon. Verizon began its Fios service in its first town, Keller, Tex., only two months ago, and AT&T will not roll out a service until later this year or next year. That means that the cable operators will have had
years to solidify their relationships with customers for all their television and telecommunications needs.

"It's awfully difficult to see how a late entrant operating at a dramatic cost disadvantage and employing a strategy of charging less for more has any shot at earning acceptable returns," said Craig E. Moffett, a cable and satellite analyst at Sanford C. Bernstein & Company.

The phone companies, of course, cannot be discounted. The newly combined AT&T, with $90 billion in revenue, and Verizon, with $71 billion, dwarf the biggest cable operator, Comcast, with $20 billion. The phone giants have about 50 million local phone lines each and their service representatives communicate with many customers each day, offering prime opportunities to sweet-talk them into buying their television services.

The Baby Bells are not strangers to television, either, but that history is one that they would just as soon forget. During the mid-1990's, when the cable companies had the playing field to themselves, telephone companies formed two groups that tried - and failed - to establish TV programming services. Bell Atlantic, Nynex and Pacific Telesis, whose names have mostly been lost to the industry's mania for mergers, worked on Tele-TV, but that consortium's reliance on wireless technology proved its undoing. The other group, called Americast and made up of Ameritech, BellSouth and SBC, never got off the ground.

But the Baby Bells could be forgiven for acting distracted. The landmark Telecommunications Act of 1996, which deregulated the industry and allowed the Baby Bells to jump into the long-distance phone market, offered what seemed like a far cheaper and potentially more lucrative alternative to taking on the cable industry.

Things haven't worked out so swimmingly, however. Nearly 10 years later, the core business of the Baby Bells - renting phone lines - is under attack as never before, shrinking by an average of 4 percent each year over the last three years. Nearly 13 million people are forgoing land lines, relying entirely on cellphones instead, according to CTIA, a wireless-industry trade group. While the erosion has been minimized by the ownership stakes that Verizon, AT&T and BellSouth have in Verizon Wireless and Cingular, the cable companies and small independent concerns like Vonage and SunRocket are picking off thousands of customers a day with their Internet-based phone lines.

In just two years, the cable industry alone has persuaded about two million households or businesses to forsake the phone company. Cablevision has signed up more than 600,000 customers. Time Warner Cable is nearing one million accounts. And Comcast, the country's largest cable operator, with 21.5 million customers, has finally turned its marketing machine on the phone business, meaning that the pace of defections is likely to quicken.

The Baby Bells "see their land-line business as an ice cube melting in the sun right now, so they need to become a purveyor of content," said Todd Dagres, a partner at Spark Capital, a venture firm focused on media and technology.
The formidable task of acquiring that content and taking on the cable operators and satellite companies has fallen to Mr. Denson and Mr. York. The two men share more than a job description. Mr. Denson, 39, and Mr. York, 42, have both worked in midlevel positions on two sides of the television business equation - for the programmers and the cable companies.

Mr. Denson, vice president for video programming and content marketing and strategy at Verizon, toiled at ABC and MTV Networks before moving to Insight Communications, the country’s ninth-largest cable operator. Mr. York, executive vice president for programming at AT&T, spent 13 years at HBO and then switched to In Demand, a venture of three cable companies that carries pay-per-view movies and subscription sports packages. They both took their new gigs for similar reasons, attracted by the opportunity to create something new on a large, blank canvas.

And both came into the negotiating process with the upper hand firmly held by the folks across the bargaining table. Content providers like the Walt Disney Company, Viacom and Time Warner charge a per-subscriber fee for their cable networks and demand carriage of some of their smaller cable channels in return for the right to carry the broadcast networks. Few television viewers will scurry to sign up with Verizon or AT&T because they prefer those companies' network architecture.

The prime responsibility of Mr. Denson and Mr. York - buying content at a reasonable price - will be a determining factor, at least until newfangled features like the ability to choose multiple camera angles for a sporting event or to view digital photos become reality.

Facing entrenched competitors, the telephone companies can ill afford not to match or surpass what cable and satellite offer. That imperative has led many analysts covering this converging world to estimate that the content providers will be able to wrest a hefty premium - as much as 25 percent - from Verizon and AT&T, meaning that profitability for the Baby Bells' television services may be years, perhaps decades, away.

Mr. Denson and Mr. York cautioned against accepting too readily the conventional wisdom. "Obviously, we're not negotiating Comcast rates," Mr. Denson said. But those estimates, he said, were off the mark.

Besides, they say, Verizon and AT&T are not entirely lacking in the clout department themselves. "We're not a mom-and-pop start-up cable system," Mr. York said. "We are one of the largest communications companies in the world and partners with some of the content providers already."

Indeed, Verizon and AT&T control the two biggest cellphone companies in the country in Verizon Wireless and Cingular, and content providers searching for new outlets are frantically striking deals with wireless companies to carry their programming. And the two phone giants just happen to be among the biggest advertisers on the media conglomerates' cavalcade of broadcast and cable networks. Annoy them too much, and they could take a chunk of their advertising elsewhere. Companies like Disney, Viacom and NBC Universal, a unit of General Electric and Vivendi Universal, know better - most of the time -
than to push too hard and jeopardize a gushing revenue source.

"Don't assume they're paying a big premium," said Sean R. H. Bratches, executive vice president for sales and marketing at ESPN and ABC Sports, both of which are divisions of Disney. Mr. Bratches was the lead negotiator for the parent company's recent deal with Verizon.

Another motive keeps Disney, Viacom and other content providers from exacting too many pounds of flesh. "We are enamored of the fact there will be more gatekeepers in the marketplace," Mr. Bratches said. The more fragmented the industry offering television service, content providers say, the harder it will be for the biggest players, like Comcast, to push back against the annual increases in programming fees that content companies desire and demand.

But the programmers are certainly reaping benefits. For example, all of the cable channels of Disney and Viacom - including relative newcomers like ESPNU, an all-college sports network, and MTV Desi, a music-video-centric channel for South-Asian Americans - reside on Verizon's extended basic tier rather than on a more limited, more expensive digital tier. Disney and Viacom do not have similar deals with any cable operator or satellite provider.

The benefits for the content companies are substantial. They are paid a per-subscriber fee for a lot more people. And getting their newer channels in front of more viewers often translates into higher ratings and more advertising revenue.

VERIZON will even be a partner on promotions, as it was recently for ESPNU in Keller, Tex.: during a Friday night football game, the company was a co-sponsor of a halftime kicking contest, complete with Randy White, the former Dallas Cowboys star. Disney has also created a whole new revenue stream by persuading Verizon to pay a fee for each of its 4.8 million high-speed Internet subscribers to receive Disney's selection of proprietary broadband Web sites, including ESPN 360.

While Verizon lacks the leverage of cable and satellite companies with their millions of subscribers, it hopes to wow consumers with extra channels and diverse programming. Cable operators have regularly struggled with the capacity constraints of their systems, forced to limit the number of channels so they can deliver innovations like video-on-demand and high-definition channels. "We don't have to make that trade-off or compromise," said Mr. Denson, because Verizon's network is more advanced.

That explains why Verizon and AT&T have agreed to carry on their extended basic tiers truly niche networks like the Soundtrack Channel, a four-year-old offering devoted to - yes - movie soundtracks, with a healthy dollop of entertainment news and features. "Because they are new to the marketplace themselves, their appetite for channels like ours - that will help differentiate their offerings - is far greater," said William Lee, the channel's chief executive.

But just how much prospective customers care about receiving hordes of niche channels - like the Gospel Music Channel and Blackbelt TV - remains unclear.
"There's also too much of a good thing," said Joseph Laszlo, an analyst at Jupiter Research. "If Verizon added the Lint and Dust Channel, they would just end up with a program guide that is difficult to navigate."

The Baby Bells are under no illusions that smaller channels will persuade people to jettison their current providers. "Are we going to get two, three, four percentage points because we have the Black Family Channel?" said Mr. Denson, referring to gains in market share. "No, we're not."

But they will do everything they can to reinforce a message of serving the customer's needs in all aspects, including service, something that the cable industry has struggled with for decades.

In Keller, Tex., about 30 minutes north of Fort Worth, Verizon is doing just that. With its new fiber lines, Verizon can sell multiple phone lines and broadband connections that are six or more times as fast as the cable company's. Verizon's lowest-priced television service charges $39.95 a month for 180 channels. The most similar offering from Charter Communications, the local cable company, provides 260 channels for $52.99.

"The first thing that got me was price. When you're a dad, that's what it's all about," said Tony Rodges, a Keller resident who switched to Verizon's Fios service from Charter. "But then the little things kick in, like the picture, the sound, the channels."

MR. RODGES also marveled at the eagerness of the Verizon technician. "The guy jumped through hoops" for the installation, he said. "I didn't feel he was going to leave me hanging like the cable guys."

Verizon's decision to run fiber-optic cable all the way to customers' homes is a calculated - and expensive - risk, and a counterpoint to AT&T's television strategy. Verizon will spend an estimated $22 billion through 2010 burying high-capacity cables, according to Sanford C. Bernstein research. But that substantial investment gives Verizon the flexibility to add data-hungry high-definition programs, faster broadband speeds and other features that customers like Mr. Rodges are already enjoying. Though costly, these fiber connections are seen by Verizon as the only way to reliably leapfrog the competition. By the end of 2006, the company expects to make these fiber-based services available to six million homes in its territory, including Fairfax, Va., and Huntington Beach, Calif.

By contrast, AT&T is installing fiber cables only to within 3,000 feet of homes and using compression technology to make sure that television, phone and broadband signals can travel the rest of the way over older and narrower wire already in the ground. That will save billions of dollars in construction costs and help AT&T start selling television faster. Sanford C. Bernstein estimates that AT&T will spend more than $7 billion through 2010; the company has said that it will spend about $4 billion through 2008.

But there are hiccups. The software that Microsoft is installing for AT&T has rarely been deployed on such a large scale. And while AT&T says that it will start selling television this year or early in 2006,
only one market - the company's home base in San Antonio - is expected to get the service initially. AT&T hopes to make its television service available to 18 million homes by the first half of 2008.

As the Bells rumble into action, cable companies are aggressively selling discounted bundles of television, broadband and phone services. They are also offering many of the services that the Bells expect to provide. Comcast, for instance, now gives away nearly 3,800 hours of on-demand movies and programs to some subscribers. Time Warner Cable and others offer a raft of free interactive features like video games and home shopping and are leasing powerful digital video recorders.

That will not only generate more revenue but will also make it harder for Verizon and AT&T to lure away cable customers. According to Jonathan Schildkraut, an industry analyst at Jefferies & Company, customers who buy at least two products from one company are half as likely to switch carriers than if they had just one.

Mr. Rodges, for example, is already hooked on Verizon's bundle of services, and he is unlikely to switch back. But he is one of the few who have the option of buying television from a Baby Bell.

Brian L. Roberts, the chairman of Comcast, is careful not to count out the phone companies, with their millions of customers, billions of dollars in cash and long history of fighting back. He also knows that the cable industry unwisely laughed off satellite companies when they entered the television market a decade ago. Now, he must wrestle with the likes of DirecTV, which is part of Rupert Murdoch's media empire.

EVEN SO, Mr. Roberts figures that the Bells have too many hurdles - financial, technical and cultural - to make a serious dent in his business. "I don't understand their economic model; I don't understand how that pays off," he told investors recently. "It didn't work when Bell Atlantic did it. It didn't work when Tele-TV did it. And it didn't get cheaper to do in 2005 and 2006."

How the Baby Bells will fare may be subject to debate, but one outcome can be reliably predicted, said Nicole Browning, president of affiliate sales and marketing for MTV Networks and BET. "It means more choice and more recourse," she said, "when you're not satisfied with what you're getting."