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EDITORIAL COMMENTARY

Let Freedom Ring

The Internet is a powerful force for telephone deregulation

By **CHRISTOPHER WHALEN**

BACK IN FEBRUARY, two Democrats and a Republican on the Federal Communications Commission carried the day in a widely publicized but rarely understood 3-2 vote not to deregulate the telephone market. FCC Chairman Michael Powell was embarrassed, and took to spinning. He told Congress that the stunning defeat of his plan actually was "a substantial step in our broadband agenda -- focusing on new infrastructure investment in the traditional last-mile telephone network."

In fact, it was part of a typical Washington regulatory deal, engineered by the major phone companies, who promised to boost investment in broadband infrastructure in return for delay in opening the different pieces of the telephone network to competitors. Regulation once again protected entrenched monopolies.

Since then, the communications industry and the markets have been waiting for the FCC staff to write the rules implementing the commission vote. Whatever emerges is certain to be confusing and contradictory, and intended to delay the day when full competition hits the telephone industry, but even three FCC commissioners cannot stop the revolution created by unlimited bandwidth.

The real opportunity for investors lies in the part of telecommunications that operates via the Internet without fear or favor generated by the government. The rapid growth of this unregulated industry demonstrates that communication markets do not require regulation or subsidy, and suggests that the aging switched telephone network is dying a natural death.

Just Another Service

As John Patrick, IBM's former Internet guru, told Eric Savitz of *Barron's* earlier this year, "The telecom industry thinks of the Internet as one of the things you can do with telephony services, but it is exactly the opposite. Telephony is one of the many things you can do with the Internet."

This vision of Internet telephony has been or should have been the cause of nightmares for executives from major long-distance telephone companies, such as Sprint, AT&T and MCI, and the big local phone companies such as Verizon, Bell South, and SBC. Now it is

coming to reality in the clear light of day, bearing the title Voice Over Internet Protocol, or VOIP for short.

One provider of Internet telephony is Vonage, a private telephone company located in Edison, N.J., that provides telephone service covering all of the U.S. and Canada via the Internet for a flat rate of less than \$50 a month. Such offerings are disrupting the economics of the telecommunications monopolies and will reduce the tax revenues and "user fees" that subsidize the existing industry. Technological innovation, once again, outflanks artificial regulatory limitations. The effect of VOIP was summarized years ago by George Gilder: Bandwidth utilization will go up and revenue for the telephone monopolies will go down as they lose "retail" business and individual customers, leaving only fees from providing flat rate Internet connections.

Gilder and other seers have predicted the advent of VOIP for years, but the commercial reality is slow in arriving. But in the past 12 months, companies like Vonage have begun the broad rollout of Internet Telephony in earnest. While VOIP marketers like Vonage currently cannot always move a phone number, new FCC rules on portability that take effect in November mean consumers will get to keep their phone numbers when they switch carriers. The move to VOIP will then become a rush.

Cisco Inside

The Vonage service is based on a clever technical solution designed by Cisco Systems that comes in a box the size of a double CD case. Harry Homeowner simply plugs in his Cisco Analog Telephone Adapter into his home network router (something many families buy right after the cable modem) and within minutes he is making flat-rate calls. The sound quality is quite good and the service includes Web-enabled features easily comparable to those found on switched phone networks.

Vonage has its roots in the VOIP service that vendors like Cisco, Avaya, and Alcatel now offer to businesses. The VOIP vendor replaces the PBX box in the office telephone closet with a network interface carrying software that lets the new phones work like the old phone system. Now every business customer can have the switching capability of a small telephone reseller and VOIP telephony at cents on the dollar compared with traditional switched voice services.

The key term here is "service." Both directly to business and indirectly to consumers via resellers like Vonage and the local cable companies, Cisco and the other equipment makers are providing hardware and a new type of voice service that competes directly with the existing telcos. By routing calls over the customer's broadband Internet connection, Cisco and others are quietly winning business from the incumbents, who often don't even know when they've lost a customer.

Unlike a toll call that goes through a switch at Verizon or another local telephone switch, the VOIP telephone call avoids much (though not all) of the high-price legacy phone network. VOIP is not subject to many of the taxes, fees and surcharges that governments add to the cost of everybody's telephone bill. Carriers like Vonage do pay federal surcharges on services they buy wholesale from local carriers to complete calls, but because they are not regulated as telecommunications carriers, they are not obligated to pass these fees and surcharges along to customers. They are free to eat the taxes and

compete on price. The cumulative result of the VOIP technology and the lack of taxes is huge savings to the consumer.

By no coincidence, earlier this year Cisco acquired Linksys, the leading provider of wired and wireless networking equipment for homes and small businesses. More routers in more locations mean more ways to proliferate the use of VOIP and wireless networking technology. Cisco isn't keeping its brand and 60% gross margins safely in the business channel; just look at the Vonage box with its Cisco logo. CEO John Chambers is going retail. (What that means for Cisco's margins and profits remains to be seen.)

The next wave of the VOIP revolution includes wireless VOIP-enabled mobile phones and computers. Cisco and other makers such as Motorola are already planning handsets that will enable customers to choose whether to make a call via a wireless carrier or via the free 802.11 Wi-Fi networks available in offices, homes coffee shops and hotel lobbies. As in the case with VOIP service over land lines, a wireless handset with VOIP will take the switching role away from the incumbent carrier and give the choice and the savings to the consumer.

VOIP-based services offer features and options at a cost that the major telcos cannot match -- even with the variety of federally mandated fees and subsidies to support the cost of maintaining their networks. As VOIP spreads via resellers such as Vonage and the cable companies, the relevance of the switched network will fade, until the VOIP network becomes the predominant provider of call and data volume.

The implications for the traditional telephone carriers are ominous - at least so long as Congress and the regulators stay out of the marketplace. In the short term, incumbent long-distance providers are being forced to embrace unlimited, flat-rate calling plans to respond to the VOIP challenge, but in the long run they cannot compete without eliminating costly infrastructure. Happy news for the American consumer, bad news for the shareholders of the dinosaurs.

Competition Pays

In a guest editorial on this page in 1994, Jeffrey Michael Freedman described the benefits of competition in the British telephone market. He noted that when the government allowed cable companies to become phone companies and to interconnect freely with other service providers, the result was to push the U.K. telephone industry years ahead of its counterparts in America. He wrote: "The success of the cable TV industry in Britain -- or anywhere else -- depends on minimizing government regulation and control. Private competition can generate opportunities for investors and consumers alike."

What was true in the U.K. a decade ago is even truer in the U.S. today. Government ought not be in the business of deciding the results of commercial competition. Congress and the FCC should leave the evolving telephone marketplace well enough alone and shun calls to regulate or tax the Internet. Adding rules or costs will hurt all consumers.

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