

Time to Bid Goodbye to Fat Cable Margins

By John Dizard, The Financial Times

There is about \$90 billion of equity and Dollars \$62 billion of debt in the US cable industry, and the value of all that capital is going to take a big hit.

While the cable companies have been congratulating themselves on taking most of the market share for broadband to the home, a disruptive technology with powerful sponsors has been winding its way through development projects and the regulatory maze. This fall, it is going to burst out like one of those "Alien" creatures into cable companies' nightmares.

The technology is "broadband over power lines", or BPL. The idea is to use the electric utilities' distribution system to send data, including voice and video, over the existing lines to homes and workplaces.

For a long time it was one of those perpetual technologies of the future, but engineering advances, along with a push from the Bush administration and other politicians, have brought it to the fore.

Technical problems slowed the implementation of BPL. Power lines, unlike cable, are not shielded from radio frequency emissions, so it has taken the Federal Communications Commission and other agencies a long time to agree on which parts of the radio spectrum need to be blocked off from use by the utilities. Now only the Coast Guard and the amateur radio enthusiasts need to be satisfied, and the FCC seems to believe all this can be wrapped up by October or November.

A few utilities have had pilot and development BPL projects, of which the largest is Cinergy's in Cincinnati, which has 15,000 homes passed. While the low pricing for broadband data is bad enough for the cable companies, worse news for them is what it costs the utilities to deliver the service, and the prospect of the electric companies selling video as well as data and voice.

David Shpigler, whose Shpigler Group is a BPL partner with several utilities, says: "The cost of BPL per home passed in suburban areas is about \$100-\$150. Then the customer premises equipment is another \$100-\$200. Most of the time the CPE is plug-and-play, so you don't need a truck roll." Translation: you don't need to wait around for someone like Time Warner Cable to show you mercy and send a technician. How long would it take the electric companies to deploy BPL? According to Shpigler, whose estimates agree with others' in the industry, a utility can install two devices an hour on overhead lines, and four an hour for underground lines (which have above-ground equipment pads). There are usually five or six homes connected to a single transformer, so that's 20-35 homes per hour.

Once an electric utility decides to roll out the service at a modest pace, it would take perhaps two to three years to cover half the service territory, and five to seven years to complete the build-out.

The problem for the cable companies is that their systems are capitalized in the markets at more than three thousand dollars per customer, while the electric utilities could provide a competitive service for one tenth of that market cap. We are not talking big promises from underfunded start-ups. The giant electric industry is here, and most of the equipment is installed.

To make matters worse for the cable companies, part of the cost of the BPL buildout will be covered by electric utility bills, since part of the function of BPL is to provide for automated meter reading and better control of the distribution system.

The chipsets and equipment available for BPL can provide two to three megabits per second to the home, which is short of the four to five megabits needed to deliver video. But new chipsets and equipment will be available in 12 to 18 months that will provide enough bandwidth to the home to fully substitute for cable. The utilities can team up with satellite vendors to package a video, broadband and voice service.

What are the prospects for the cable companies' defense against this assault? "Pretty small," says Jason Bazinet, an analyst with JP Morgan Chase. "Comcast has about \$990 of debt per video customer, Cox has \$1,060 of debt per customer, and Cablevision has \$3,300 of debt per subscriber." That's a hurdle of inflexible, capitalized goodwill that's built into their pricing.

"The other problem," says Mr. Bazinet, "is that while they're getting price increases, most if not all of that is going to the content providers. The only increase in cash flow the cable companies themselves are getting comes from broadband. They're getting \$40-\$45 of revenue per month, which costs them perhaps \$15 per month. That's why they still have such lofty valuations."

Initially, the electric utilities, with or without the satellite companies, will seek to hold pricing to a level just below what the cable companies are charging. But with the phone companies gradually installing fiber to the premises, we are looking at a vicious price war. Not vicious for the consumer-voter of course. Did I use the term "goodwill" in referring to cable companies? That is the wrong word for consumers' feelings about those high charges.

Sayonara, cable margins.