

## ***Dealing with a Changing Market Dynamic***

*UTelcos pondering entry - or continued expansion – into the telecommunications market face a number of challenges*

By David Shpigler

In 2001, UTC Research profiled UTelco trends in North America, providing a snapshot of a business segment at the intersection of the telecom and utility industries that appeared to be ripe for growth. Capitalizing on core utility assets, dual deregulatory trends (in the electricity and telecom spaces) and the projected “hockey stick” growth in the demand for telecommunications and IT services and applications, the 2001 report chronicled a line of business that seemed to hold tremendous possibilities for the utilities that were able to navigate demands of traditional risk management, a well-funded and sophisticated array of competitors, and what seemed to be limitless opportunities for growth.

In the period of time since the last report, the telecommunications industry has suffered one of the most dramatic reversals of financial fortune in industrial history. All told, the “telecommunications meltdown” of the last few years has cost private investors billions of dollars and has winnowed the number of service providers aiming to compete with the former Bell monopolies – CLECs or Competitive Local Exchange Companies – down from a few hundred to a few dozen key players.

Meanwhile, the North American utility sector has experienced troubles of its own. Suffering from the ill effects of a global economic recession, major Investor-Owned Utilities (the 100+ electric utilities that comprise the ranks of publicly-traded energy companies) hit a new low by February 2003, featuring an overall market cap drop of 29% from one-year before and a drop of 49% in value from two years prior. While current pricing levels have been restored to at least 2002 levels, the painful experience of the last several years has been a sharp contrast to the relative stock price stability within the sector of the past.

As a result, utilities pondering an entry into telecommunications or how to position further telecom activity going forward must face a number of issues, including:

- What is the future of electric market reform/deregulation?
- What is the effect of the “bandwidth glut”?
- What is the effect on competition in the telecom sector?
- How will the development of new technologies affect the market?
- How will market conditions drive the decision-making process of utility executives?
- How will system reliability requirements affect the UTelco sector?
- How will regulatory pressures within the telecom sector affect utilities?
- Is there a cost of “doing nothing”?

## The Rationale for UTelcos

Utilities and critical infrastructure (CI) enterprises are fundamentally network-based “pipes and wires” businesses. By their very nature, utilities have large bases of infrastructure and diverse assets that can be exploited at various levels moving up the value chain from leasing assets to providing fiber-based services to providing retail services to customers and even as far as to providing content. As a general rule, as the companies move up this value chain, the need for expertise in the telecom field grows and the likelihood of partnering rises, as does the risk and potential for greater profits.

In large part, utilities have been drawn to the telecom sector for three principal reasons:

- *Access to Infrastructure* – Telecommunications ventures need it; utilities have it. The development of telecom networks requires significant expenditures in infrastructure in order to thrive. In fact, a careful study of the telecom industry shows that, by and large, facilities-based service providers tend to be among the strongest market operators. However, the cost associated with building the network can be prohibitive and can often be financially crippling in the long term. Meanwhile, utilities have access to many of the same kinds of infrastructure that many providers covet – fiber, towers, poles, rights-of-way, etc. As a result, it is often easier for UTelcos to enter the market than for traditional telecom providers.
- *Possession of Capabilities* – When considering the reasons ventures fail, it typically can be found in the inability to overcome one of three key risk factors: (1) technology risk, (2) market risk, or (3) execution risk. By far, the most dangerous of the three is execution risk, as poor execution of a well-laid strategy will often doom a business. For telecommunications providers, the application of execution failure can manifest itself in one of several areas. Poor marketing, substandard customer service, provisioning problems, inability to contain key cost elements – all are areas of potential pitfalls. However, while many of these factors can plague a UTelco as well as a pure-play telco, there is one other operational factor in which UTelcos typically receive a “free pass”. In the area of network construction and system management, UTelcos can leverage the cumulative experience of the parent utility to construct and maintain networks – typically better than any traditional telecom player ever could. As a result, utilities may expect to find at least one less risk factor that could doom a business case.
- *Access to Capital* – For sure, the last several years have been difficult to all industries, albeit at varying levels. For the telecom sector, sharp reductions in market value have meant that the ability to finance new network construction using stock as currency is severely reduced. Furthermore, the ability to attract venture dollars in a financially distressed market has been more of a challenge, resulting in fewer network builds than market demand levels might suggest. As a result, some undeveloped market opportunities do exist, given the right market approach. At the same time, utilities have taken a hit, with economic challenges

not limited only to the telecom industry. However, while challenges have been present within the utility sector, they pale by comparison to the telecom market, resulting in a greater ability to tap into select market opportunities. Furthermore, while conservatism may suggest a lack of willingness to enter into the telecom market, should the desire be in place, the capital is likely to be as well.

## **Investor Owned Utilities**

Many investor owned utilities were among the first entrants into the fiber-based, large-scale UTelco enterprises. Drawn to the market during the growth of the “telecom bubble” toward the latter half of the 1990s, IOUs sought to leverage network assets – typically fiber networks – to build extensive metro networks. Many of these endeavors grew in scope and size and became leading telecom service providers – either keeping to the wholesale sector, or in other cases moving into retail applications. However, the “bursting of the bubble” has hit utilities hard, and many UTelco enterprises have been shut down while others have been scaled back significantly. Today, key IOU UTelcos are struggling with how to operate in a competitive and quickly moving telecom arena while still tied to a more conservative utility parent.

Investor owned utilities are refocusing efforts, with many featuring a “back to basics” strategy approach. As telecom once appeared to be a tremendous source of value and growth, many utilities that took very aggressive market approaches wound up suffering the same fates as other telecom ventures. Going forward, we see some key trends emerging for IOUs:

- *Decreasing Aggressiveness* – While many of the early stage UTelco ventures began to aggressively engage in “land grab” strategies, we expect to see a more conservative growth approach going forward.
- *Focus on Strategic Assets* – We expect to see fewer investments in financially oriented M&A activities and more of a focus on leveraging strategic assets. As a result, networks will become tighter and become reoriented toward the strengths they possess.
- *Shifting Wireless Strategies* – In the past, wireless infrastructure business lines were viewed as stand-alone business lines. However, changing dynamics in the wireless industry have suggested greater opportunities to bundle services and offer truly differentiated services. For one, we expect to see a movement toward offering a service to wireless carriers that combines wireless attachments, engineering services, and fiber backhaul facilities. In addition, we also see a movement to develop wireless antenna business lines as more of a product owner rather than only as a leaser of vertical real estate.
- *Broadband over Power Line* – As the BPL market continues to mature, we expect to see increased interest in the technology. With additional trials and commercial deployments, we expect to see numerous utilities exploiting this opportunity – some as passive landlords and others as active service providers.

## **Municipal Utilities and Electric Cooperatives**

Unlike many IOUs that are shying away from entering into the telecom market – or in some cases are exiting markets previously entered into, municipalities and coops are becoming more involved in the development of needed communications infrastructure. The levels of involvement for any given municipal entity are often varied and reflect options depending on the dynamic of the needs of the community. However, while IOUs view telecom as a potential source of profit – and choose not to participate without a threshold of profitability being realized – municipal utilities and coops often focus on a much lower threshold, one that is supported by the ability to support economic development within the communities they serve.

While many IOU UTelcos are retrenching, municipalities and electric cooperatives are becoming more aggressive. Recognizing the opportunities that exist within the communities they serve, many that have already entered the market are now exploring growth opportunities and new service strategies. Those that have been waiting on the sidelines are increasingly becoming intrigued with market entry strategies. Overall, we envision the following trends:

- *Increasing Aggressiveness* – Driven by the appetite to support increased communications within the community, we see more networks coming on line in the muni and coop sector.
- *Deeper Networks* – While IOUs have largely focused on the metro, munis and coops have sought to bring service to the end customer. We see this trend continuing, with deep networks including FTTH builds and focused wireless deployments becoming more prevalent.
- *Joint Coop Initiatives* – Not only are networks becoming deeper, they are growing in aggregate size as well. We see a trend among coops to join forces with other nearby coops to sponsor extra-regional network builds.
- *Funding Option Variability* – Funding for network construction will come from a variety of sources. Revenue bonds and federal funding from sources like RUS will increase in number as many utilities will seek to build networks that will fall outside of the ability of the community to build using existing financial resources.

## **Two UTelco Markets**

The UTelco industry in 2004 is truly divided into two markets. For investor owned utilities, challenges are present that suggest that a full-scale return to the glory days of the 1990s is unlikely. However, a well-defined strategy that accomplishes the original targets for UTelcos – namely leveraging core assets and capabilities – can be very successful and accomplish key financial objectives. Specifically, we see an emergence of strategies based on creative implementations of bundled solutions for wireless carriers, focused metro fiber builds, and BPL efforts that are based on key operating partnerships with industry specialists. On the other hand, the days of far-reaching speculative

buildouts may find continued challenges – from both the marketplace as well as from utility boardrooms.

Meanwhile, there is a completely different story among municipal and coop utilities. We expect to see more growth in the sector in 2004. Builds will be deeper, farther-reaching, and increasingly focused on the end user. Economic development opportunities will become more of a focus and government agencies seeking to spur broadband activity will become involved in these types of initiatives.

At the same time, there are a number of other key industry participants that should pay careful attention to developments within the UTelco sector. For one, the telecom equipment vendor segment is one that has held increasing interest in the sector. Key issues for vendors include clearly delineating key benefits of systems in economic terms rather than purely in terms of “features and functionality” and investing in the overall segment to support “word of mouth” sales. At the same time, there are also opportunities for service providers seeking to establish partnerships with utilities in the telecom arena. Opportunities to work with utilities often involve a symbiotic relationship leveraging utilities’ strong abilities in network construction and management with telcos’ experience in operating competitive telecom ventures.

For sure, we expect to see continuing shifts in the UTelco marketplace. All those involved in the sectors – utilities and associated players – should stand ready to take advantage of shifts in the industry as they occur.