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SBC's Price Cuts Re-Shape US Broadband Competition and Force the Hand of Cable Operators

Snapshot

SBC's recent decision to offer DSL service priced at only $14.95 a month will take broadband competition to a new level in the United States. By making broadband available at rates lower than those charged by many dial-up services, SBC will achieve its most immediate goal: sustaining the robust DSL subscriber growth it has enjoyed in the last year. The move also increases pressure on the telco's cable competitors, and helps shift investor attention away from obstacles facing SBC's move into IP-based TV services. At a higher level, SBC's price cuts will have a ripple effect, forcing cable operators to reduce prices as well, and enticing millions of consumers to upgrade to broadband sooner than they may have planned.

Analysis

On June 1, 2005, SBC Communications, the second-largest broadband service provider in the US, announced it would offer new customers a discounted rate of $14.95 a month for its SBC Yahoo! DSL Express service. This rate breaks new ground in the US, where consumers have historically paid rates ranging from $20 to more than $40 a month for DSL or cable modem service.

SBC's promotion is available only to new subscribers who sign up for service online, and requires that they also use the telco's All-Distance calling plan for wireline telephone service. More significantly, the offer requires customers to commit to a one-year contract, after which monthly rates may be increased. And the maximum downstream speed delivered by the service is 1.5 Mbps, lower than the 3-5 Mbps speeds available from higher-priced DSL or cable modem packages. The new offer comes just three months after SBC launched a similar promotion priced at $19.95 a month.

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No other telephone or cable companies have matched SBC's new $14.95 price point -- yet. On June 13, however, Verizon, the country's second-largest DSL provider, launched a promotion offering new customers three months of service at $19.95 a month, a ten-dollar reduction from its standard rate of $29.95.

The terms and timing of the SBC announcement reflect immediate challenges the company faces in the broadband market, as well as wider strategic goals for related services such as IPTV. SBC's top priority in the consumer market is to maintain its new momentum in broadband. As we noted in our recent forecast and analysis of the North American broadband market ("Broadband Internet Services in North America: Market Outlook and Analysis," June 2005), DSL growth has finally become a key strategic goal for SBC and fellow regional operators Verizon, BellSouth and Qwest. After trailing their cable counterparts for years, the telcos now see broadband as their last chance to maintain connections with consumers who are disconnecting conventional telephone lines at an alarming rate. During 2004 the number of primary consumer access lines served by SBC fell three percent, slipping from 23.9 to 23.2 million.

Unlike the cable operators, whose early lead in broadband has allowed them to maintain higher prices and profits, the RBOCs are willing to sacrifice DSL margins in order to deter access line losses and regain share. So far this strategy has worked: since mid-2003, when telcos began lowering DSL prices, their quarterly subscriber growth has outpaced that of most major cable multiple system operators (MSOs) (see Exhibit 1). DSL's share of the total US broadband subscriber base has also risen significantly, moving from 36 to 39 percent in 2004.

Exhibit 1: Quarterly Broadband Subscriber Growth by Company, 2004-2005

SBC	**Q1-04**	**Q2-04**	**Q3-04**	**Q4-04**	**Q1-05**
Total DSL Subscribers	3,962	4,277	4,679	5,104	5,608
New Subscribers	447	315	402	425	504
Growth Rate	13%	8%	9%	9%	10%
Verizon	**Q1-04**	**Q2-04**	**Q3-04**	**Q4-04**	**Q1-05**
Total DSL Subscribers	2,664	2,944	3,253	3,559	3,994
New Subscribers	345	280	309	306	435
Growth Rate	15%	11%	10%	9%	12%
BellSouth	**Q1-04**	**Q2-04**	**Q3-04**	**Q4-04**	**Q1-05**
Total DSL Subscribers	1,618	1,738	1,872	2,096	2,349
New Subscribers	156	120	134	224	253
Growth Rate	11%	7%	8%	12%	12%
Qwest	**Q1-04**	**Q2-04**	**Q3-04**	**Q4-04**	**Q1-05**
Total Cable Modem Subscribers	744	853	955	1,036	1,121
New Subscribers	107	109	102	81	85
Growth Rate	17%	15%	12%	8%	8%

Comcast	Q1-04	Q2-04	Q3-04	Q4-04	Q1-05
Total Cable Modem Subscribers	5,678	6,005	6,554	6,994	7,408
New Subscribers	394	327	549	440	416
Growth Rate	7%	6%	9%	7%	6%
Time Warner Cable	**Q1-04**	**Q2-04**	**Q3-04**	**Q4-04**	**Q1-05**
Total Cable Modem Subscribers	3,421	3,548	3,716	3,913	4,122
New Subscribers	193	127	168	197	209
Growth Rate	6%	4%	5%	5%	5%
Cox	**Q1-04**	**Q2-04**	**Q3-04**	**Q4-04**	**Q1-05**
Total Cable Modem Subscribers	2,150	2,246	2,431	2,571	2,750*
New Subscribers	161	96	185	140	179
Growth Rate	8%	4%	8%	6%	7%
Charter	**Q1-04**	**Q2-04**	**Q3-04**	**Q4-04**	**Q1-05**
Total Cable Modem Subscribers	1,653	1,711	1,820	1,884	1,978
New Subscribers	125	58	108	65	94
Growth Rate	8%	4%	6%	4%	5%
Cablevision	**Q1-04**	**Q2-04**	**Q3-04**	**Q4-04**	**Q1-05**
Total Cable Modem Subscribers	1,129	1,179	1,259	1,353	1,441
New Subscribers	72	50	80	94	88
Growth Rate	7%	4%	7%	7%	7%

* Estimate

Company Reports, Strategy Analytics, 2005

While SBC executives have acknowledged their willingness to trade profits for market share, we believe that the new price cuts also serve several other purposes. First, they put pressure on the cable companies by forcing them to lower their own prices or face sharper declines for cable modems. With cable stocks already out of favor on Wall Street, either option creates problems for top operators such as Comcast, Time Warner, Charter and Cablevision.

At the same time, good news on the DSL front also helps SBC offset bad news about its ambitious plans to offer multichannel IPTV service to millions of homes over the few years. Just days before the new DSL promotion was announced, legislators in SBC's home state of Texas failed to pass a bill that would have allowed the company to offer multichannel TV statewide without applying for franchises from individual towns and cities. The bill's failure is not only a major setback for SBC locally, but suggests that similar laws proposed in other states are also unlikely to succeed. Elsewhere, SBC's IPTV plans have been dampened by news that a planned IPTV launch by Swiss incumbent Swisscom, which uses the same Microsoft software platform as SBC, has been delayed until 2006.

Implications

- **VOIP and Bundling Are Cable's First Response.** With telcos reiterating their focus on price, cable's first line of defense will be a vigorous offense built around VOIP and bundling. Comcast and Time Warner are both in the process of launching VOIP service on a wide scale, and are counting on low-cost phone service to accelerate telco line losses. To help avoid direct comparisons between cable modem and DSL prices, these operators should follow the example set last year by Cablevision, which offers a triple-play package of digital cable, broadband Internet access and telephony priced at $90 a month for the first year of service. While Cablevision's low-cost bundle has been criticized for being too inexpensive, it has allowed the company to quickly overtake nearly every other operator in penetration of all three services, and will help blunt future attacks from local rival Verizon.

- **But Price Cuts Will Also Be Necessary.** Even with these weapons, we believe cable operators will also be forced to introduce lower-priced broadband products of their own. In the two years since telcos began cutting DSL prices, cable has responded by raising access speeds and positioning cable modems as a premium broadband platform worth paying a few dollars more for. Comcast and other large MSOs have also helped justify prices by bundling premium services such as music subscriptions and video e-mail with broadband. But with DSL packages like SBC's now priced at roughly half the cost of many cable modem services, making this argument becomes much harder for the MSOs -- especially to price-sensitive customers upgrading from dial-up. As a result, we expect major operators to lower prices for entry-level service tiers with the same speeds as DSL, while continuing to increase speeds for customers paying higher prices.

- **Overall broadband adoption will grow more rapidly.** Our current broadband subscriber forecast for the US (issued just weeks before SBC's announcement) projects that 8.3 million households will adopt broadband this year, down slightly from the 8.8 million new customers recorded in 2004. If other major service providers follow SBC by introducing lower-cost services of their own, this figure may be revised upward.

- **Lower prices could also lead to higher churn.** While price reductions should help sustain subscriber growth, one unintended side effect may be higher churn rates in the future, as new customers attracted by low-cost promotional offers seek out better deals as they become available. This is particularly true for time-limited price packages like SBC's, which may expire after a year. SBC hopes to deter churn by requiring customers to also use their phone services, but this may not be sufficient if cable operators also lower prices and make VOIP widely available.

- **Consumer perceptions of broadband will change.** With about a third of US households now using some form of high-speed Internet access, broadband is already evolving from a premium technology product for advanced PC users into something closer to a utility like telephone service or even electricity.

If prices fall to the same levels as those of the dial-up services already used by over 40 million homes, the perception of broadband as a premium service is bound to change. The next great challenge for service providers will be to convince consumers that although broadband access may be a low-cost commodity, broadband services – especially IPTV, advanced VOIP services and home networking products – are worth paying a premium for.

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