

Telecommunications Update:

Finally, a positive turning point for incumbent Telcos in Canada

Event

Last week, Industry Minister Maxime Bernier announced the deregulation of access-independent Voice over Internet Protocol ("VoIP") services offered by the incumbent Telcos. This marks the first time since 1988 that the federal cabinet has overruled the Canadian Radio-television and Telecommunications Commission ("CRTC") on a telecommunications decision.

Background

In 2006, the Liberal-appointed Telecom Policy Review Panel ("TPRP") recommended that the CRTC should be less involved in the regulation of telecom services and that a greater reliance should be put on market forces. By overruling the CRTC VoIP decision, Maxime Bernier reinforces this belief in less regulation. ***While we don't expect much to change in the short-term, over the longer term, the move towards deregulation will provide Bell (BCE-TSX) and Telus (T-TSX) with much needed flexibility and incentive to effectively compete against the cable VoIP competitors.***

Short-Term Impact

With last week's announcement, the incumbent Telcos are no longer required to file tariffs for their VoIP services provided over a broadband connection. They are now free to price and bundle their access-independent VoIP service as they so desire. ***However, for the residential market, we believe that Bell and Telus are in a quandary because any sharp reduction in the price for VoIP residential service would cannibalize their existing local line business. Thus, we don't foresee a wide-scale competitive response from either Bell or Telus. (At present, Telus doesn't have a residential VoIP offering).***

Longer Term Consequences

The importance of the decision is that it signals a first step in removing competitive restrictions that have been imposed by the CRTC on Bell, Telus and the other Telcos that have limited their ability to invest and compete. While we believe that the actual deregulation steps will be gradual, the pronouncement allows the Telcos to see "the light at the end of the tunnel." ***In addition, the increasing regulatory freedom provides the Telcos with a clearer justification to accelerate investments in lower cost, next generation IP networks that carry both fixed and mobile voice and data traffic.***

The Telcos have seen a steady decline of their local line business for some time now, and we believe that a continued loss of valuable customers to lower priced VoIP competitors will eventually force them to respond. In order for the Telcos to compete effectively on price and features, a fundamental change in operating structure will be required - the kind that will only come about from the rebuilding of the network to eliminate the inherent inefficiency of circuit-switched technology. Current cost cutting measures that focus on process improvements will not be sufficient.

The Shift to an IP Network

Most of today's voice traffic runs over digital circuit-switched networks which are expensive to maintain and upgrade and have limited flexibility in introducing new products and services. In contrast, the Telco of the future will merge voice and data networks into a single Internet Protocol ("IP") network. This new IP network will allow the Telcos to quickly and cost effectively launch new services, merge their fixed and wireless networks and lower operational costs. It will also use soft switches that can handle wireline, wireless, and data services. (A single IP soft switch can replace approximately ten digital circuit switches.)

By adopting an emerging international standard called IP Multimedia Subsystem ("IMS"), companies will be able to quickly rollout advanced features such as personal single numbers, presence, and other novel capabilities. Under its 21st Century ("21 CN") initiative, British Telecom is moving to such a network beginning in 2007, and plans to have all its customers migrated to this new network by 2011. As a result, the company is forecasting a £1B per annum savings in operational costs.

We believe that Maxime Bernier's announcement will come to be viewed as a turning point for the incumbents just as the 1988 ruling by Mulroney's Conservative Government that allowed Call Net to remain a long distance reseller triggered telecom competition in this country. This time, however, the focus for the incumbents will be a total transformation of their networks to enable quadruple play, fixed mobile convergence, and new service capabilities along with significant operational cost reduction.

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