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Identity Crisis; Internet Services Challenge Definition Of 'Phone Company'

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As if the telephone companies didn't have enough problems, the cable companies are coming after them with Internet phones.

The phones look and behave like regular phones, but the service generally costs less. The main difference is that voices get chopped into digital packets, which travel over the Internet and are reassembled at the other end.

So is an Internet phone the same as a phone? That's what regulators across the country are bickering over as they struggle to figure out what the emerging technology known as voice over Internet protocol (VoIP) might mean for consumers and the heavily regulated phone industry. Though Internet and traditional phones serve similar purposes, current regulations treat them differently.

A federal judge in Minnesota ruled this month that the state's Public Utilities Commission could not regulate Internet phone companies. Since they send calls over the Internet, they are more properly classified as "information services," U.S. District Judge Michael J. Davis said in an opinion released last week.

"Congress has expressed a clear intent to leave the Internet free from undue regulation so that [its] growth and exploration may continue," Davis wrote. "State regulation would effectively decimate Congress's mandate that the Internet remain unfettered by regulation."

The issue is now front and center -- after a decade of fits and starts -- because Internet telephony finally appears ready to go mainstream, with improvements in the technology and a recent push from start-ups and cable operators. The upshot, according to analysts, may be lower costs for consumers and brutal price competition for phone companies.

Businesses are embracing the technology the fastest. Nearly 10 percent of businesses have replaced their old systems with some form of VoIP, and that transition is accelerating, said Vijay K. Bhagavath, a telecom analyst at Forrester Research Inc.

Most major cable operators hope to sell Internet phone service to their residential customers, bundled with television programming and Internet access. Cablevision Systems Corp. started selling Internet phone service in Long Island last month, offering unlimited local and long-distance calling for \$35 a month. Time Warner Cable Inc. has signed up 5,500 customers for a similar Internet service it rolled out five months ago in Portland, Maine. Comcast Corp., the largest cable company, is testing a version with 200,000 homes in Coatesville, Pa. Cox Communications Inc. is running a test in Roanoke.

Newcomers such as Vonage Holdings Inc., 8x8 Inc. (also known as Packet8), Free World Dialup and Skype also are selling Internet calling plans, at prices ranging from free to about \$40 a month.

Even traditional phone companies -- the ones most threatened by VoIP -- are using the Internet to reduce their transmission costs, because it doesn't require expensive routing equipment. Also, a call takes up more space on a traditional network than it does in its chopped-up format on an Internet network. Verizon Communications Inc. and AT&T Corp. use a version of the technology to transport calls within their networks. BellSouth Corp. has gone further; it recently started selling Internet phone service to businesses and plans to offer it to residential customers next year.

Phone companies can't afford to ignore the trend, analysts say, because they're racing with cable companies to sell bigger bundles of digital services to homes and businesses. If they don't innovate to match the cable companies, it could leave their main business vulnerable, some say.

"When you get the nation's largest cable companies, like Time Warner and Comcast, going after the phone business, it's going to put significant pressure on the Bells" to reduce prices, said F. Drake Johnstone, a cable analyst with Davenport & Co.

But Verizon, the largest phone company, says cable operators face an uphill climb trying to take Internet phones to the masses. "They're entering a very competitive market, and if they think it is a magic bullet for them, they're wrong," said Verizon spokeswoman Bobbi Hensen.

Local phone companies are at a disadvantage, some say, because they are required to pay tariffs and provide public services that Internet phone companies have so far avoided. But regulators in about a dozen states are considering imposing some of the same rules on Internet phone services.

In the Minnesota case, Vonage, an Edison, N.J., start-up up with 56,000 Internet phone subscribers, challenged the state's right to regulate its technology.

"Let the industry grow up a little bit, and let Congress and the industry write regulations specific to this service," said John S. Rego, Vonage's chief financial officer.

Public utility commissions in California and Wisconsin, meanwhile, are still attempting to require Internet-based phones to comply with existing rules.

"We very much feel that this is a telecommunications service, and we feel it should be regulated as such," said Carl Wood, a member of the California Public Utilities Commission. "If it looks like a duck and walks like a duck and quacks like a duck, that's what it is."

In a letter sent Tuesday, Vonage rejected the California commission's request that it certify as a telephone company with the state, asserting the state lacks jurisdiction over the service. The letter said that "transmission of audio signals does not necessarily make it a 'telephone' service."

The issue appears headed for the Federal Communications Commission, which plans to hold a hearing this fall. FCC Chairman Michael K. Powell recently said he sees the debate as "a manifestation of a bigger challenge" -- deciding which services should be regulated and which should not as Internet services merge with older technologies.

"We think pretty quickly there's no reason why virtually any communication service" won't be Internet-based, Powell said.

In the next few weeks, Verizon plans to weigh in on the subject for the first time with the FCC, arguing for minimal regulation that gives neither side a disadvantage, said Eric Rabe, a Verizon spokesman.

Skeptics say VoIP technology still faces significant hurdles.

"The telephone business is so unbelievably complicated. These technologies tend to be much more expensive than you anticipated," said Susan Kalla, an analyst with Friedman, Billings, Ramsey & Co. Kalla was speaking on an Internet phone, which abruptly dropped the call. Problems like that -- interruptions and clipped sound -- probably will keep the technology in its infancy for a while and drive up costs more than cable companies expect, she said.

Good Internet phone service depends in large part on a speedy connection, which is why businesses are adopting it faster than individuals, most of whom still have slower Internet links at home. Call quality also is affected by traffic congestion, which in turn can depend on whether a call is traveling over the public Internet or through private cable networks.

Also, unlike regular phones, most Internet phones lack their own electrical power sources, so if power goes out, so does the phone. Calls are harder to trace, too, posing problems for emergency workers accustomed to pinpointing the location of calls to 911.

Free Internet phone services have additional limitations. Skype and Free World Dialup each connect only to other users of the same service, like instant messaging. They require people to download their software, plug headsets into their computers, and then connect by typing users' names or numbers instead of dialing.

"That is the Achilles' heel of [some] services. The value of the phone network is that you can call anybody," said Charles S. Golvin, a senior analyst with Forrester. "These types of closed services don't work until you open it to everybody."

Vonage and the cable companies are more open, allowing customers to call any phone number using regular phones. Users simply plug a phone into an adapter, which plugs into an Internet connection.

"It's great, because I can program the phone to do what I want," said Ashim Roy, a Potomac resident who switched his second home line to a Vonage phone in June and estimates he's saved 20 to 30 percent on phone charges. His phone goes out when he loses his cable connection, but Roy said that if the service becomes more reliable, he probably will move all his home and business lines to the Internet.

In the long run that could be bad news for Verizon, even though the number of Internet-based callers today is minuscule compared with its traditional customer base. The regional phone giant, however, has a plan to leapfrog the cable companies by replacing copper wires in all the homes and offices it serves with high-capacity fiber-optic cables.

"Is [cable telephony] a huge threat? No. But do I take cable companies seriously? Yes, I do," said Bruce S. Gordon, president of retail markets for Verizon. "Do they have the potential to take market share? Sure."

Gordon said Verizon is testing its own version of VoIP and can match cable firms in both price and service. "We are prepared to compete," he said.

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