This Little Piggy Went to Market

You, too, can learn trader lingo. Here's how to sell and trade bandwidth as a commodity.

By Rick Muscoplat

Commodity. It strikes fear in every marketer's heart. It's a word so powerful that its use is banned in sales meetings. Middle managers and executives are warned never to offer up, "Our product has become a commodity" when asked to explain why sales revenues are falling.

Value added. That's where it's at. It's the cure-all for a competitive market, the antidote to a commodity perception. Any marketing book will tell you that a company whose product has become a commodity has failed to differentiate, failed to add value, failed to understand that toasted oats fetch a higher price than regular oats. Once a product has become a commodity, it's no different than oats, or wheat, or beans – or pork bellies.

Moos and Modems

Farming is one of the closest examples of pure competition. Grade A soybeans are Grade A soybeans, no matter which one of the many thousands of farms they come from. The farmers' ability to add value to their beans (if they could) disappears once a grain inspector stamps Grade A on them.

Some farmers sell their soybeans directly to soy sauce companies. But most soybeans pass through a series of brokers, traders and grain exchanges before landing on your table as a flavor-devoid soyburger.

Some argue that telecommunications and bandwidth producers are selling a commodity. If it's a commodity, they argue, then producers must accept the fact that it can be bought and sold as such. However, the Value-Adders believe that as long as they can add value to minutes and bandwidth, they can avoid the commodity trap.

Value-Adders point to three market factors to support their stance.

- First, we have no universal standards of quality when it comes to minutes and bandwidth, no worldwide organization like the USDA to write the specifications for a Grade A point-to-point connection between New York and São Paulo.

- Second, we have little price transparency. You can easily follow the going rate for spring wheat futures. But with our current system, in which each major fiber provider negotiates one-on-one deals with individual carriers, no one can see the prevailing price, let alone price differentials between minutes and bandwidth.

- Finally, they argue, we have few market fluctuations. Reprovisioning can quickly ease spot shortages, and excess capacity seems to be gobbled up by mushrooming voice and Internet Protocol (IP) demand, at least into the foreseeable future. Thus, the market has built-in price stability. See? Telecommunications capacity and bandwidth are not commodities after all.

Whoa, Nellie

We can believe that telecom capacity and bandwidth aren't commodities only so long as we're willing to ignore the stampede of new fiber providers and trading exchanges. Electric utilities, galloping to win the fiber daily-double, have already demonstrated considerable skill in the art of trading and switching power and gas. It's logical for them to move into the communications sector, according to Neil Chakkera, assistant vice president of U.S. Bancorp Piper Jaffray Portfolio Strategy Group Research. The growth rate for traditional electric utilities is 2% to 3%. Integrated natural gas companies fare a little better, at 6% to 8%. However, communications services are growing at 8% to 13% with data and international services increasing at significantly higher rates.

"All else being equal, higher growth rates would usually translate into higher stock valuations," says Chakkera.

The communications business provides valuable diversification benefits to an energy utility's portfolio. "Besides, adds Chakkera, "utilities already own valuable rights-of-way that make it easier, cheaper and quicker to provide access to business and retail customers."

They also possess strong cash flow and significant debt capacity – invaluable characteristics a company as a company contemplates the large upfront investments required to lay fiber and build switched networks.

By selling capacity and bandwidth through in-house wholesale mechanisms, third-party brokers and exchanges, and their existing retail customer base, utilities are quickly becoming serious competitors to the traditional long distance carriers and bandwidth providers.

In Chakkera's opinion, Williams Cos., Enron Corp. and Montana Power Co. (Touch America) are best situated to take advantage of the opportunities. They are members of the FTV Communications LLC consortium and have wholesale and retail strategies to sell capacity and bandwidth to interexchange carriers (IXCs), competitive local exchange carriers (CLECs), incumbent LECs (ILECs) and Internet service providers (ISPs), as well as small- and medium-sized businesses and residential customers. The three utility powerhouses already control over 53,000 miles of fiber.

When all factors are considered, "energy utilities have the motive, the means and the opportunity to continue their penetration into the communications market," says Chakkera.

Going to Market

No matter which side you're on, one thing is clear: These little minutes and bandwidths have to get sold if someone's going to make money. But sales costs can be a considerable factor in fiber profitability. How best to reduce those costs? Enter the new kids on the block.

In just two years, three different firms have emerged to facilitate the sale of minutes and bandwidth to carriers and users. They are:

- Third-party Internet-based exchanges, clearinghouses and dealing rooms – These are Web sites that facilitate trades between providers and carriers. They charge brokerage fees for facilitating the trade. Sales terms, provisioning arrangements and payments are made between buyers and sellers, or by paying an extra fee to the exchange for settlement and switching services. The exchange usually assumes no credit risk. This market model changes daily as players add new services to add value.

- Wholesalers – Generally third-party bulk purchasers and resellers. Wholesalers own the minutes of bandwidth and profit on the differential between cost and sell price. The wholesaler assumes the credit risk.

- Lead generators – Matchmaking services that court inquiries from end users and forward those inquiries to carriers. The lead generator does not participate in the negotiation process, assumes no credit risk and is paid a lead generation commission for the life of the contract.

I'd Gladly Pay You Tuesday for a Hamburger Today

Except for spot shortage buys, most exchange transactions are in forward or futures contracts, swaps and, most recently, derivatives. An exchange facilitates a forward contract by listing sellers' capacity and buyers' needs – a matchmaking service, if you will. Once matched, the parties generally write their own contracts and arrange for provisioning and settlement, although the provisioning and settlement elements may also be provided by the exchange for an additional fee.

Depending on the policies and services offered by the exchange and the desires of the parties, identities may or may not be disclosed before bid acceptance and contract formation. When a futures contract is transacted, however, anonymity is usually maintained throughout the entire deal. Parties exchange net payments through the settlement service of the exchange, if provided. Provisioning is usually arranged by a third party.

Players in this category include Arbinet Global Clearing Network, Band-X Switched, ITXC Corp., InterXion Virtual Dealing Room, RateXchange RTBX, TransNexus' Internet Communications Clearinghouse, Cape Saffron, and Min-X: The Minutes Exchange.

Arbinet Selected International

Origination: New York

Destination Dialing	Answer Seizure Lowest Ratio	Delay	Post Cost $
Australia	69%	7	0.048
Canada (Toronto)	62%	7	0.031
China	60%	5	0.180
France	69%	7	0.034
Germany	48%	7	0.037
Hong Kong	75%	10	0.032
India (New Delhi)	56%	9	0.435
Japan	71%	6	0.054
Pakistan	30%	12	0.474
Philippines	38%	11	0.197
Singapore	52%	10	0.080
South Korea	70%	10	0.064
Taiwan	65%	10	0.075

United Kingdom	68%	7	0.024

Buy Low, Sell High

Wholesalers have virtual loading docks, forklifts and trucks to switch and deliver owned minutes and bandwidth from producer to buyer.

AIG Telecommunications LLC (AIGT), a member of American International Group Inc., is one such wholesaler. It also is one of the largest players in this category.

AIGT facilitates trading and delivery of capacity by providing access to a worldwide series of nodes to interconnect the various telecommunications networks. By purchasing and owning capacity and bandwidth in bulk and then reselling in smaller increments, AIGT maintains anonymity between the provider and AIGT’s customer. "Carriers prefer it that way," notes AIGT’s Eric Raab.

Key to the company’s success is its unique concept of Standard Telecommunications Units (STUs), says Raab. The STU defines a measure of connection time or bandwidth that conforms to defined standards of circuit quality and relevant performance criteria.

"The providing carriers like to play games, providing excellent routes for testing during the negotiation phase," notes Raab. "But once the deal is done, your connection sounds like you’re talking from the bottom of a bathtub."

If you’re a smaller customer and you contracted directly with the carrier, you have little squeak. AIGT monitors carrier quality on a regular basis, and because it purchases in such large quantities, it has roar with the providing carrier. Thus, the STU becomes a meaningful warranty to the end user-purchaser.

What's in a Name?

David Morken is an attorney and former Marine with no prior experience in telecommunications. Years ago, in a moment of foresight, Morken possessed the wisdom to register and trademark the domain name, Bandwidth.com. At the time, he had no idea what he would do with it. But he figured that someday it would bear fruit.

Contacted by MCI, Morken was quickly brought up to speed on the commission opportunities available to him as a lead generator. He built his Web site to include a user-friendly lead form. Potential buyers, carriers, ISPs and IT managers from small- and medium-sized businesses complete the form, indicating their upcoming needs. At the click of a mouse, the bid request form is forwarded to a host of participating carriers. Morken’s list of participating carriers grows daily.

The carriers contact the potential customer directly and provide pricing information and terms. By using Bandwidth.com, the customer receives multiple competitive bids by filling out a single form. Morken’s firm does not involve itself in contract formation between carrier and customer, nor is it involved in switching or settlement. Bandwidth.com receives a referral fee from the selling carrier of 10% of the sale up front, or 2% to 5% of the deal’s monthly revenue.

As with most Internet ventures, the key to attracting business is being "discovered" among the maze of competing search engine finds. With a name like Bandwidth.com, Morken has upped his odds.

Putting Lipstick on Farm Animals

All claiming to be the first of their kind, most exchanges started out as nothing more than Internet-based electronic bulletin boards where buyers and sellers could post their offers and bids. Today, claiming to be "first" adds little to no value for exchange participants. Who cares who was first? What have you done for me lately? That’s what providers and buyers want to know.

So exchange operators have been recreating themselves to offer more professional (and risky) exchange-type services. At the same time, they’re trying to "dress up" the commodity perception of the minutes and bandwidth that pass through their doors – which is a little contradictory, because doesn’t a product cease to be a commodity the instant you create differentiation in the mind of a buyer?

You can put lipstick on your entire herd of USDA Choice Holsteins, but they won’t fetch a penny more at auction as long as all of the other USDA Choice Holsteins are equally as good looking. Fatten them up and turn them into USDA Prime, and all you’ve done is jump to a higher category.

Telecom and bandwidth are no different. Even if a competitors’ exchange quality ratings were equivalent – which they’re not – the exchange can do nothing to add value to the basic commodity.

So it comes down to service. Because of the complexity of providing switched minutes and bandwidth, many exchanges have invested heavily in physical switching capabilities. With that goes the responsibility of translating between voice and data standards such as ISDN, IP, VOIP, SS7 and C7 protocols. Exchanges also are offering the ability to switch traffic on the basis of a multitude of parameters, including time of day, price, capacity in ports, capacity in minutes, latency and, of course, available credit.

As they compare themselves to traditional exchanges such as Nasdaq, the Web-based players find they must do their homework on those who offer and those who bid. What good is a "done deal" that vaporizes before the dollars change hands? In this regard, exchanges range from guaranteeing the buy/sell transaction to publishing a blacklist of bad-boy players. Talk about closing the barn door after the escape: blacklists save on overhead but offer minimal value to the exchange participants.

Rating the quality of minutes and bandwidth is a neat trick. Exchanges tout their diligence in rating providers' quality. If buyers do business with a specific exchange over time, they can gain a feel for the reliability of that particular exchange's ratings. But without an international equivalent of the USDA and the Securities and Exchange Commission (SEC), a "comparable" buy from another exchange may prove as risky as buying a round-trip ticket on some new, unsinkable ship.

In Real Time

This brings us to the issue of real-time trading. Spotting an attractive offer to sell, you respond with an equally appealing bid. It's accepted right away. Congratulations; you're engaged. But don't start making honeymoon plans; this deal isn't as real-time as you think. Many deals take from 36 hours to several weeks to complete before the switch is thrown. Larger contracts may require face-to-face meetings.

So who's buying from these firms? Certainly, carriers, ISPs and VOIP operators. But as overcapacity continues to grow and IT managers discover the lower prices posted, plan to see more online buys and even more arm-twisting with Tier 1 carriers. Wholesalers and lead generators also will see a huge increase in sales to small- and medium-sized businesses which are heeding the call of crashing prices.

Is it just like Nasdaq? Not quite – at least not for the next few years. The ground is still trembling from the stampede of all the new entrants. And just as with real Wall Street firms, consolidations, mergers and acquisitions are blowing in the wind.

Exchanges, wholesalers and lead generators can perform a valuable service. They can force down the prices of minutes and bandwidth. But as much as these firms like to compare themselves to Wall Street exchanges, they are not regulated by the SEC. Some are privately funded or operating with recent IPO money.

If an exchange melts down, either physically or financially, and it was providing switching and settlement services for you, will you be left with nothing but screaming customers? Better to check into financial stability and equipment redundancy before you click on the dotted line.

Remember that, when it comes to trading commodity futures and especially when dabbling in derivatives, some little piggies do get to eat roast beef, but it’s just as true that others cry wee, wee, wee, all the way home. The moral? Don’t go hog wild, and don’t bet the farm.

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