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ONE BIG BAD BABY BELL

The company that just bagged AT&T is gunning for even bigger game: It wants to revolutionize the television business. But does **SBC'S ED WHITACRE** have what it takes to compete against Rupert Murdoch and cable's Brian Roberts? BY STEPHANIE N. MEHTA

WHEN SBC COMMUNICATIONS CEO Ed Whitacre strode into the ballroom of the Plaza hotel in New York City to explain his phone company's $15 billion acquisition of AT&T, the assembled shareholders and analysts appeared to stand at attention. A 63-year-old Texan whose flinty features make him look perpetually grim, Whitacre is a no-nonsense guy whose presence seems to signal that it's time to get down to business. Yet on this rainy February day, he did no such thing. Instead he smiled for photographers, warmly greeted reporters, and walked the floor making small talk and shaking hands. Longtime SBC watchers could scarcely believe their eyes: Was tough, old Ed Whitacre actually working the room?

WHITACRE MAY well be honing his schmoozing skills for his newest—and unlikeliest—role: aspiring media mogul. In a few short months, SBC will unveil what it hopes will be the ultimate weapon in the war between cable and the Bells—a high-tech TV service that Whitacre insists will offer viewers as many channels as they currently receive from regular cable and then some. SBC has anted up $4 billion just to get its network ready to offer the service, known as Internet protocol TV, or IPTV, and it will spend additional hundreds of millions to acquire TV content. But much more is at stake: SBC's future as a major player.

For as big as SBC is, cable companies have been invading its 13-state territory. The cable companies have made huge investments to ready their systems to offer phone service, and many, such as Cox Communications, have wooed large numbers of SBC customers in key locations like Orange County, Calif. The fight will only intensify: Comcast, the nation's largest and most powerful cable operator, says it will deliver phone service to its entire customer base—it reaches 40 million homes—by the middle of next year. Time Warner Cable (like FORTUNE, part of Time Warner) is testing whether to add cellphones to its bundle of television, telephone, and high-speed Internet.

SBC must counter them or deal with the consequences of the inevitable decline of its phone business. But Whitacre isn't satisfied to simply play catch-up—he wants to leapfrog his cable competitors by deploying cutting-edge Internet technology. If Whitacre can deliver on his grand plan (and he doesn't doubt for one minute that he can), SBC will be the first American company to offer Net TV on a mass scale and usher in long-awaited convergence, which promises to be as big an improvement as color was over black and white, or cable was over broadcast. It will transform the TV set into a full-fledged computer: a smart device that is linked to all the other gadgets on a home network and that viewers can use to grab all kinds of rich and interactive content they normally get on PCs.

Whitacre, who started his career as a facility engineer for Southwestern Bell back in 1963, is an unlikely media visionary, to be sure. But in recent years he has emerged as the guy to watch in telecom. It was Whitacre who predicted almost a decade ago that the telecom industry would whittle itself down to three or four giants offering a full range of services. A few years ago he struck up an unlikely friendship with Yahoo co-founder Jerry Yang and formed a groundbreaking SBC/Yahoo joint venture to sell DSL service. And SBC was the first major American phone company to embrace IPTV, a platform that Microsoft has been developing for six years. (Verizon, which may prove to be SBC's biggest rival if the two Bells ever decide to compete for consumers outside their home territories, also recently said it will embrace Microsoft's IPTV platform.)

So even though shareholders on that gray February day had ostensibly gathered to talk about SBC's purchase of its former parent and the extension of its phone business into national and business markets, the real deal transforming the $40-billion-a-year Baby Bell is its push into video. That push takes it into exciting—and scary—new territory, and the challenges Whitacre faces are daunting, to say the least. Not only must SBC assemble a full suite of entertainment content—all the usual cable channels that consumers expect plus a whole lot of stuff they can't get anywhere else—but it must also figure out how to persuade its customers to buy TV shows from their phone company, all in time for a year-end launch. What's more, SBC must convince Wall Street that its video gambit—sure to eat into its reliable flow of cash and profits—is a good idea. So far, investors seem unimpressed: SBC recently traded at $24 a share, roughly the same price as a year ago.

THE AIR IS FILLED WITH new-carpet smell and the effluvium of freshly plugged-in computers and television sets. Dozens of people are crammed into SBC's exhibit at the Consumer Electronics Show in Las Vegas—a hastily assembled home of the future—to get a closer look at IPTV, which Microsoft chairman Bill Gates highlighted in a presentation the previous night. What the onlookers see and hear is a videophile's dream come true: four simultaneous video streams, including one in high definition, of Major League baseball games framed by stats pulled from the Internet, all on a single television screen; plus the ability to program the system to record shows remotely from the office or the road via an Internet connection or cellphone.

For all the razzle-dazzle of that Las Vegas demo, however, SBC doesn't plan to offer anything radical when it first rolls out the service market by market. Nor does the company intend to break the mold on pricing. What Whitacre has in mind is a package of telephone (via voice over Internet protocol, or VOIP), video, and Internet services for about $100 a month, $10 more than Cablevision in New York currently charges as an introductory rate for a similar package. "When we roll it out, it will be a product in terms of programming that is very comparable to cable TV," Whitacre says. "But every quarter you'll see a new feature rolled out." Not that Whitacre is likely to be a big consumer of the services he's touting. It turns out that his bold embrace of the new doesn't extend to his personal life. "The only thing I watch is sports," he tells me in his distinct deadpan drawl between meetings in Las Vegas. He pauses to consider the many things he might be able to do with IPTV but won't. "I'm not going to call from my cellphone to program my DVR."

Whitacre might not, but he's sure hoping his future customers will. And those features just scratch the surface of what IPTV can do. IP takes digital content—e-mail messages, data, and even phone calls—and transmits it in little packets that get reassembled at its destination point. Because video is treated just like any other stream of data, IP makes it very easy for the carrier to customize channels and programming for each customer. In fact, IP could allow carriers to offer an all on-demand viewing experience, turning the entire broadcast model on its head. Today, consumers essentially customize their viewing by scrolling through video guides and taping the programs they like. But with IP, you could make your preferences known to your media company upfront, so that it might push only mystery dramas, say, to your set-top box. And IPTV has a browser-like ability to collect intelligence about a household's viewing and surfing habits—think cookies—enabling advertisers to deliver very targeted messages and entertainment providers to suggest other programs or sites a viewer might enjoy.

The convergence of phone, television, and Internet will enable some other cool stuff too: a service, say, that lets you see caller ID information on your TV screen or alerts you if you get an urgent e-mail in the middle of your favorite show. Want to chat onscreen with other Chicago Bears fans while you watch the game on Sunday? Done.

Enabling users to mix and match video and data to suit their needs is where SBC partner Yahoo comes in. The pair are developing a special onscreen guide that directs users to TV programs, movies, and select online content such as photos and music. As viewing options proliferate, Yahoo will have a key role in helping consumers manage their IPTV experience. "I'm not so sure that in a world of unlimited channels we'll actually sit there with a clicker," says Yahoo CEO Terry Semel. "How does Yahoo help? It's called search."

Of course, all this raises the question—If IPTV's so great, why isn't someone offering it already?

So far, cable companies may have been slow to embrace IPTV for the same reason that SBC and others initially resisted Internet telephony: It threatens the status quo of their business, which in the case of the cable companies means broadcasting an ever-growing array of channels to customers. It also would require new set-top boxes and other equipment upgrades on top of the $95 billion the industry already has spent to ready networks for broadband and phone services.

As outsiders in the video game, telcos like

Whitacre won't simply play catch-up—he wants to **LEAPFROG HIS CABLE COMPETITORS** by using cutting-edge technology.

SBC have nothing to lose by going with IPTV. SBC has no existing advertiser relationships that could be jeopardized by an all on-demand service, for example. And crucially it believes it has (mostly) figured out how to surmount three of the biggest barriers to new entrants: cost of the physical network, regulation, and technological know-how.

Instead of replacing the so-called last mile of copper wires it has strung to 36 million homes with the fiber needed to carry IPTV, SBC is spending a mere $4 billion to replace only some of that copper with fiber (IP's compression capabilities will allow SBC to push video and other digital content over the remaining few hundred feet of copper wire). "The whole economic proposition changes," says SBC operating chief Randall Stephenson. "What would have been a $40 billion investment became a $4 billion investment."

Meanwhile, telecom laws designed to spark local phone competition require the Bells to lease their phone networks to others at deep discounts, but SBC didn't want to share a spanking-new fiber network with any of its competitors. Together with its Bell brethren, it argued that investments for new video and data services should be exempted from the rules; last fall the Federal Communications Commission finally said yes.

Third, the technology for IPTV has already been proven to work and is in use in Hong Kong, Canada, and even some small pockets of the U.S. In Hong Kong, where PCCW launched IPTV more than a year ago, about 400,000 homes have signed up for the service, which offers 12 channels—all other programming is sold à la carte. However, it hasn't been without its glitches, and one of the demonstrations in SBC's suite at the electronics show seemed a bit slow, as if too many software programs were running at once. Certainly SBC, which doesn't even have a customer trial running yet (the first is planned for this summer), can ill afford the kinds of mistakes that plagued its early rollout of DSL.

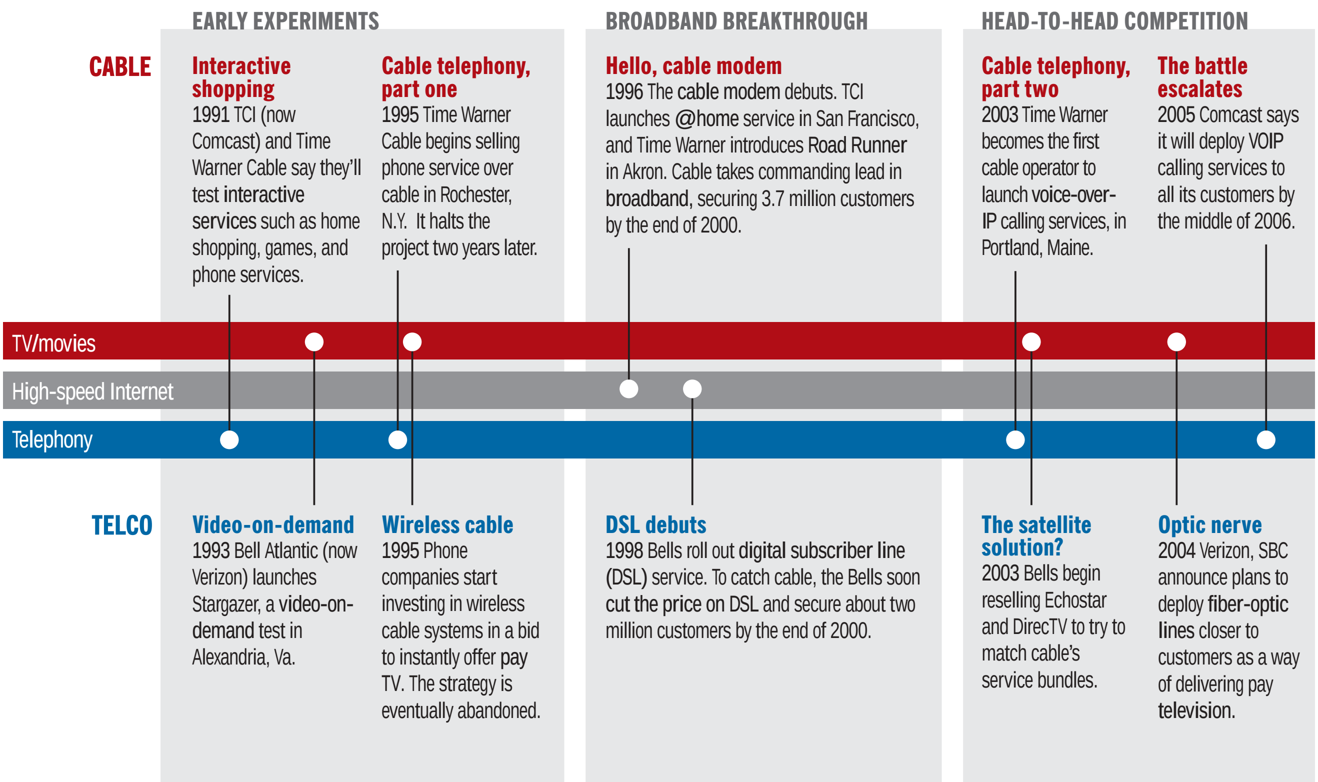
Now comes the hard part. It's not regulation or technology that worries Wall Street; it's the need to fill the new system with shows that people want to watch. "You can always get the service to work," says Rich Nespola, CEO of the Management Network Group, a telecom consultancy. "The question is whether any telco can negotiate successfully with the entertainment industry."

THAT'S WHY WHITACRE hired Dan York, a former HBO executive, to sit across from creative types (well, their lawyers and financiers) and acquire content for SBC at the best terms possible. York, an amiable 41-year-old, spends his days shuttling between New York City and Los Angeles, introducing SBC to media guys and evangelizing IPTV. "We are in talks with all of the professional sports leagues—NFL, MLB, NBA, NHL—as well as the leading sports networks," York says. "The same is true of the Hollywood studios, the news and information providers, and major national television network groups."

In theory, cutting deals should be a snap. Content providers small and large are happy to see another distributor for their programming. A big telco like SBC offers networks another revenue stream and can help keep giant cable companies such as Comcast from wielding too much power at the bargaining table. But here's what makes York's job tough: Content owners are not going to cut SBC any breaks on price. Distributors that deliver the most viewers pay the lowest unit prices, and so far SBC can't offer any viewers at all. (Its plan initially calls for wiring up 18 million of its customers. The remaining 18 mil-lion, many

CABLE GUYS AND PHONE GEEKS: BUTTING HEADS FOR 15 YEARS

High costs and low returns stunted true competition between phone and cable companies—until now.



FORTUNE GRAPHIC / SOURCES: NATIONAL CABLE & TELECOMMUNICATIONS ASSOCIATION; THE YANKEE GROUP; THE COMPANIES of whom may prove to be too expensive to reach with fiber, are being offered EchoStar's satellite TV service instead.) The need for content to support IPTV's sexiest features, such as a user's ability to view multiple camera angles of the same game, adds a layer of complexity to York's negotiations. He also wants permission for IPTV users to access their favorite shows on other gadgets, like their cellphones and computer terminals.

Though SBC has yet to announce a single content deal, no one who knows the TV business doubts that it'll get the programming it needs—for a price. UBS Warburg analyst John Hodulik guesses SBC will probably end up paying somewhere between $20 to $28 a month per subscriber for programming—well above Comcast's estimated $17.70 a month in costs but not a whole lot more than what the satellite players pay. And York isn't saying whether SBC is willing to spend the extra bucks to amass high-end sports programming (à la DirecTV's supersized football sports package, *Sunday Ticket*) or first-run movies.

SO WHY ON EARTH would anyone buy TV service from a telco? An accomplished marketer for a phone company, SBC knows it's facing a tough sell. The beauty of hawking phone service is that everyone gets it intuitively—you don't need to tell a consumer why he needs a phone. IPTV, on the other hand, is complicated. "We have to figure out a way to tell the story," admits Scott Helbing, a Dell veteran who joined SBC almost two years ago to head consumer marketing. "We will rely heavily on advertising, but we'll also have to go door-to-door; we'll have to be very guerrilla-like in our approach." He's open to anything: long-form commercials (TiVo has used infomercials to explain its video recorder), kiosks in malls—and he recently turned a storefront in SBC's home base, San Antonio, into a demo center for consumers to test-drive some of its new technology.

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Helbing's biggest asset, however, remains SBC's huge size. In addition to billing 30 million homes each month, it has customer service and marketing reps who talk to a staggering nine million customers a month. Every conversation is a selling opportunity. Lately SBC has applied its marketing skills to the job of reselling EchoStar's satellite television service. In nine months the phone company sold 323,000 satellite subscriptions. "We never even advertised it," Whitacre says. "When you let our big distribution channel loose, we think we can put really big numbers on the board."

Whitacre's going to have to deliver those big numbers to convince Wall Street. Some shareholders worry that SBC will be too aggressive in its quest to win customers—while others worry that SBC will lose ground to cable by not being aggressive enough. And then there's the matter of digesting AT&T, which involves finding ways to integrate networks and cut some $15 billion in costs, and which could easily prove a distraction to SBC management. All that uncertainty seems to be built into SBC's stagnant stock price. "Doing something in video certainly is better than doing nothing," says UBS's Hodulik. Not exactly a ringing endorsement. By Hodulik's math, SBC will be spending $6 billion—$5 billion on building the network, plus another $1 billion when it enrolls customers. The move will help boost its top line by $7 billion over the next six years, he calculates, but it will also drain free cash flow by $7 billion over the same period.

SBC says a big portion of its bet on IP technology represents investments it would have had to make anyway to modernize its network and boost efficiency. "It's the ability to deliver multiple integrated IP-based services over a single broadband pipe that makes this project so exciting and important," says Lea Ann Champion, the SBC executive who runs all of the company's IP operations. "But the network efficiencies are significant."

NOT SURPRISINGLY, TV executives are skeptical. "It is hard to imagine tougher competitors than Rupert Murdoch and Charlie Ergen," says Steve Burke, president of Comcast Cable, referring to the chairmen of News Corp. and EchoStar, respectively, which have seized 25% market share from cable operators. "Anyone who thinks they can come into the video market and gain customers easily will find it is very competitive and very crowded already." The cable guys are quick to point out phone companies' past failed efforts to get into the video business (see chart). Indeed, each foray seemed more disastrous than the last, culminating with AT&T's acquisition and subsequent divestiture of about 13 million cable lines.

All the while, the cable companies will continue to ramp up the pressure. They already have the lead in the battle to provide consumers with communications bundles—a more than $200-billion-a-year opportunity when you consider what American consumers spend on local, long-distance, wireless, high-speed Internet, and cable television services. And of course, cable companies will eventually be able to deploy their own version of IPTV if consumers demand it—they already use a version of the technology on the high-speed Internet and voice services they offer. In fact, Bill Gates is banking on that. "This next-generation digital network with IPTV is a huge opportunity for both cable companies and telcos," Gates wrote in an e-mail to FORTUNE.

But these are still early days. Cable's three million telephone customers, for example, represent less than 3% of households with phones in the U.S. Whitacre reckons he'll have that many TV customers and more by the end of 2007. Besides, if anybody in the phone business has the grit to go up against the likes of Brian Roberts and Rupert Murdoch, it's Ed Whitacre. When Whitacre really wants something—and all signs indicate he badly wants video—he usually gets his way. "SBC doesn't kid around," says Yahoo's Semel, who knows a thing or two about video from his days running the Warner Bros. studio. "When they plant a stake in the ground and say they want to do something, I've seen them succeed time and time again."

As in all mass-market battles, it is the consumer who will ultimately decide. One way the cable vs. telco contest may play out: People will buy bundles around the services they covet most. A road warrior who needs reliable wireless service may be inclined to buy video and data services if approached by her cellphone provider. A rabid online gamer who loves his cable modem may take local and long-distance service from his cable company if it throws in a few more megs of bandwidth free. As competition takes hold, households are bound to be bombarded with offers for more services for less money. "The next few years are going to be fun," Whitacre says, a sly smile easing across his face. "It's really all good for the consumer, though, isn't it?" F