Analysis - Consolidation = Improved Vertical Competition & Universal Service

By Keith Mallinson Saturday, July 23, 2011

Carrier consolidation will help counterbalance the rising competitive strength of Apple and Google across the entire mobile ecosystem and extend mobile broadband universally.

Debate on the proposed acquisition of TMobile USA by AT&T focuses on what antitrust lawyers and economists call horizontal competition issues among wireless carriers. What choice do consumers have, how many wireless carriers are competing locally, nationwide and how will this affect prices for basic services in voice minutes, texts and megabytes of data?

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Until quite recently, vertical issues – in supply chain competition between carriers and their handset vendors, operating system suppliers and applications providers – have never figured much in discussions on telecom carrier mergers, despite the fact that major U.S. wireless carriers had significant sway over their supply ecosystems.

The FCC's Fourteenth Annual Commercial Mobile Radio Service (CMRS) Competition Report, published one year ago, "examined, for the first time, competition across the entire mobile wireless ecosystem, including an analysis of the "upstream" and "downstream" market segments, such as spectrum, infrastructure, devices, and applications." The Fifteenth report, published this past June, follows the same analytical framework. Nevertheless, the FCC "makes no formal finding as to whether there is, or is not, effective competition in the industry." This is a crucial question – including horizontal and vertical considerations – for the FCC and DOJ in evaluation of the proposed merger.

DEVICE ECOSYSTEM PROVIDERS PREVAIL

Today's competitive landscape is very different and changing rapidly with balance of power moving towards certain players in the broader ecosystem. Apple has an increasingly strong competitive position versus carriers on the one side, and against mobile applications developers and content providers on the other. The iPhone company is extracting a lion's share of total ecosystem profits. Similarly, Google, with its increasingly popular Android operating system and OEMs and applications developers in tow, is also a powerful competitive counterbalance to the aspirations of wireless carriers in value-added offerings above and beyond connectivity services.

Such is the increasing vertical competition from Apple, Google and over-thetop providers such as Skype, and with wireless carriers increasingly dependent on efficiency-based competition in commoditized connectivity services, there is increasing justification to allow relatively small and insufficiently profitable players, such as T-Mobile USA, to merge or be acquired by larger players. The increased heft of combined carriers, such as an even larger AT&T, would be a more effective foil to increasing vertical competition.

The Wall Street Journal recently reported that the Justice Department has concerns about

Apple as a prospective purchaser of patents, including those for wireless technologies from bankrupt Nortel. Apple was subsequently given the permission to bid. Google is under antitrust investigations in Europe and by the Federal Trade Commission in the U.S. These are likely to be broad reviews into the business practices of the world's most popular search engine used on fixed and mobile devices.

NATURAL OLIGOPOLY

The U.S. approach of licensing wireless on a narrow, geographic market-by-market basis, as opposed to the national licensing adopted in virtually all but a few of the very largest nations worldwide, ensured many competitors at the outset. However, that in itself does not make for a stable situationfrom an economic or competitive standpoint. On the contrary, there are many factors that make wireless a distinctly national marketplace, as reflected in U.S. calling plans, and significant consolidation was inevitable.

Telecommunications remained a natural monopoly everywhere worldwide until 30 years ago. There are massive economies of scale in constructing telecommunications networks. Costs for just one, let alone two or more, service providers are prohibitive in serving a small but significant proportion of subscribers in rural and remote areas. Vertical integration with equipment supply and carrier services was also commonplace. For example, AT&T made its own network equipment until it divested the business which was renamed Lucent. Despite many shortcomings, monopolies built networks and provided services on a widespread and affordable basis.

Competition – both horizontally and vertically – has been the watchword ever since, but fixed communications at the facilities level has remained a monopoly, or duopoly with cable in some nations, for most consumers worldwide. Market forces and government agencies have yet to determine the number of competitors in wireless services on a long term and stable basis with the dramatic shift to mobile broadband, and with new and increasing expectations that this will bridge the digital divide to those not yet served by high-speed Internet access. Simple economics suggest remote locations will be best served with just one provider because this saves duplication of infrastructure where costs are highest.

Wireless is not the natural monopoly there ever was in fixed telecom, but there is a balance to be struck between the number of competitors and economic efficiency. Roads, electricity, water, sewage and natural gas distribution remain monopolies almost everywhere. It is inconceivable we will ever revert to the national wireless monopolies most nations had in the 1980s, but consolidation to a couple of wireless carriers taking the large majority of market share with other subscribers being serviced by a variety of much smaller and more specialized players would be an economically efficient outcome.

Telecom market growth and competition has been dramatic in many ways, but there have also been market failures and significant value destruction with the decline in fixed carrier voice revenues, the millennial telecom sector bankruptcies and financial restructurings. No business will sustain unprofitable operations indefinitely. Some will soldier on in the expectation of selling out, without any realistic hope of long-term independent viability. The U.S., in particular, with its large land mass and very low population density in comparison to many other advanced nations, presents economic challenges in supporting multiple suppliers to all locations or more than a few truly nationwide carriers. In contrast, many other nations insist wireless carriers enter unproven and questionable partnerships among competitors with network sharing, to maintain competition at the service provider level, while prohibiting full-blown consolidation.

Forcing continued uneconomic fragmentation upon wireless carriers will imbalance competition across the broader ecosystem and further strain the challenging business case in establishing universal mobile broadband with widespread access, including remote locations.

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