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Wireless Markets: No Longer "Effectively Competitive"?

The FCC recently released its 14th annual report on Commercial Mobile Radio Service (CMRS) competition – an annual summary of the wireless marketplace and report to Congress. This new edition is similar to past CMRS reports, providing coverage maps, industry statistics, and narratives about the industry. But one aspect of the current report represents a major departure from any of the previous releases in this series: The Commission having repeatedly *declared* the US wireless market to be "effectively competitive" in each of the first thirteen *CMRS Reports*, that pronouncement is nowhere to be found in the 2010 version.

To be fair, the Commission doesn't expressly reverse its previous conclusion by declaring that effective competition is absent from the wireless marketplace. Rather, the *Report* simply acknowledges that there is a lot of data out there, and a very comprehensive review will be required in order for it to make definitive determinations as to the actual level of competition. While the *Report* does not explain what would need to be shown to demonstrate that the CMRS market is "effectively competitive," it does contain specific data that sheds light upon the status and direction of competition in the wireless industry. Indicia such as market share, profitability and contract terms and conditions all suggest that the FCC is on the right track in refusing to declare victory – i.e., that widespread "effective competition" is now present in all wireless sectors.

Market shares

Despite the breakneck pace of adoption of wireless services in the US, competitive entrants have generally had a difficult time establishing themselves. Smaller companies have either folded, or more often, have been acquired by a larger carrier. At the outset of the 2000 decade, the wireless market was made up of six nationwide competitors and a mix of strong regional carriers (often the only ones serving rural areas). Although the national carriers unsurprisingly held the lion's share of total US subscribers, market shares were reasonably distributed, both among multiple competitors and as between RBOC-affiliated and independent wireless companies.

At the beginning of 2000, there were eleven major wireless carriers each serving more than one million subscribers, and dozens of others offering service in regional footprints. Now, at the end of that first decade of the 21st century, the complexion of the wireless market looks very different. The mergers of Bell Atlantic and GTE and their partnership with Vodaphone's US properties combined to create the largest nationwide carrier – Verizon Wireless. In 2001, SBC and BellSouth quickly partnered to form Cingular Wireless, then the second largest US carrier.

Despite these consolidations, the marketplace still seemed capable of supporting numerous competitors. By the end of 2003 Verizon Wireless served 24.8% of US wireless phones, while the top four companies together held a 65.7% market share. The two RBOC-affiliated companies (Cingular and Verizon) combined had a lower market share than the independent companies (AT&T Wireless, Sprint, T-Mobile, and Nextel). Regional carriers Alltel and US Cellular had respectable shares of the total US market at 5.3% and 2.9% respectively, and of course higher shares within their specific regions.

However, the mergers and acquisitions did not stop in 2003, and the market dynamics have shifted dramatically. The latest *CMRS Report*, providing data as of 2008, reveals that on a *pro forma* basis (reflecting Verizon's January 9, 2009 acquisition of Alltel) concentration in the US wireless market, as reflected in the market shares held by the largest firms, has risen sharply. Verizon, together with Alltel, served nearly 32% of all US wireless subscribers. AT&T Mobility (the combination of Cingular and AT&T Wireless) was a close second at just under 30%. Together, these top-two carriers, both RBOC-affiliated, controlled 61% of the US market. The top-four companies (Verizon, AT&T, Sprint, and T-Mobile) together controlled a whopping 89% share – even with Sprint's *loss* of 3% share from the prior year. The largest regional player, US Cellular, also lost share relative to its 2007 level. The rumored combination of T-Mobile and Sprint would further reduce the number of active wireless competitors serving US customers.

Profitability

It should come as no surprise that wireless profitability has been on the rise consistently during the 2000s as market concentration increased over the decade. Profit can be measured in many useful and interesting ways, although the data necessary to examine wireless profitability on, for example, a service-by-service basis is generally not available in the public realm. The FCC examines overall profitability as measured by EBITDA margin (earnings before interest, taxes, depreciation and amortization). While comparing year-over-year EBITDA data can be tricky (as accounting rules can cause fluctuations in earnings unrelated to actual profits), long term trends in EBITDA make the growth in profitability abundantly clear. From 2002 to 2009, Verizon Wireless increased its EBITDA margin from 39.5% to 46.3%. T-Mobile grew its margins from 9.1% in 2002 to 33.1% in 2009. AT&T Mobility

moved from 31.1% in 2005 (the earliest data point available from the FCC) to 38.3% in 2009. Upstart MetroPCS grew its EBITDA margins from 28.9% in 2005 to 30.5% in 2009.

MetroPCS's entry, as it turns out, serves to demonstrate the limited role small firms play in constraining the market power of the dominant incumbents. According to the *CMRS Report*, MetroPCS's market share (as of the end of 2008) was only 2.05%. The carrier has introduced several very aggressive pricing plans – for example, it currently offers a $40 plan providing unlimited voice, texting and data, with the $40 monthly charge *inclusive of taxes, surcharges and fees.* This price point is substantially below the corresponding unlimited voice/data/texting plans offered by Verizon, AT&T, and Sprint, which vary between $99.99 and $119.99 *plus taxes and fees*. Notably, the major carriers apparently have not felt compelled to match or otherwise respond to MetroPCS's pricing initiative, suggesting that they view the small, single-digit share loss to MetroPCS as having a much smaller financial impact than an across-the-board price cut to match MetroPCS's $40 price point. The growing profit levels coupled with the lack of corresponding price reductions on the part of the dominant incumbents demonstrates the ever-decreasing level of competition in the wireless marketplace as concentration and consolidation escalate.

***Contract Terms: Two Year Contracts and Early Termination Fee*s**

Landmark class action lawsuits were brought against Sprint, T-Mobile, AT&T and Verizon, in each instance alleging that flat rate Early Termination Fees ("ETFs"), assessed when a subscriber terminated a long-term contract prior to its fulfillment, constituted unlawful liquidated damages penalties. T-Mobile, AT&T and Verizon all settled these cases (while a California jury awarded plaintiffs $299-million against Sprint) resulting in the carriers ending the practice of charging flat rate ETFs. The lawsuits did not address the fundamental anticompetitive nature of locking subscribers into long-term contracts that would likely be difficult or impossible to impose in a robustly competitive marketplace.

Despite this outcome, the carriers continue to lock subscribers into long term contracts and charge ETFs when the contract term is not fulfilled. The FCC notes that the current (post-settlement) ETF regime imposes a pro-rated charge that declines over the life of the subscriber's contract. Although this change of practice is undoubtedly a step in the right direction, analysis of the current ETFs, along with new increased ETFs for advanced devices, casts further doubt as to the level of competition actually present.

Both AT&T and Verizon now charge $350 pro-rated ETFs for smartphones, a move that Verizon describes in a letter to the FCC as reflecting the higher costs of providing these more expensive devices at "attractive prices" as well as what Verizon characterizes as the added risks associated with broadband network build out. The specific linkage that Verizon seeks to draw as between ETFs and its overall broadband build-out are indirect at best.

First, so-called "handset subsidies," to the extent they actually exist for any specific wireless phone, turn out to be considerably smaller than the major wireless carriers claim as the basis for their ETFs, when properly viewed in terms of the carrier's out-of-pocket wholesale cost rather than its often-inflated "retail price." Moreover, much of the "subsidy" is recovered immediately via up-front "activation fees" and by the nominal purchase price collected at the point of sale. During the ETF litigation, ETI calculated the average handset subsidy for 2006 at only $14.33.

Second, any handset subsidies being offered are a part of the carrier's marketing plan to induce customers to subscribe to the wireless service and thus result in a stream of recurring revenue to the carrier. Evidence introduced in the ETF lawsuits demonstrated that the average revenue over the service life of a customer was many multiples of any up-front "subsidies," even when early terminations are included in such average revenue calculations. Firms in any number of industries have adopted a strategy of sacrificing profits on sales of a "platform" product in order to stimulate demand for an aftermarket product whose ongoing purchase results in a recurring revenue stream. Examples of such practices include razors (which create sales of blades), ink-jet printers (which create sales of proprietary ink cartridges), and Polaroid cameras (which created sales of Polaroid film). In none of these cases was the purchaser of the "platform" product required to make any specific commitment to a minimum purchase of the secondary product.

The FCC acknowledges that the ETF is "...probably the largest quantifiable cost to consumers who wish to switch service providers." Term contracts and termination penalties unquestionably increase switching costs for consumers, which makes them less available to rival wireless providers. The persistence of term contracts with termination penalties is itself evidence of a less-than-competitive market – particularly in light of the fact that the large established carriers continue to require contracts and impose penalties even though many smaller entrants, such as MetroPCS, do not.

All of this is not to suggest that there are no competitive forces acting in the wireless market. The FCC seems to correctly acknowledge that some areas have become more competitive, while competition elsewhere has diminished. But with concentration on the rise and additional consolidations in the offing, it may still be quite some time, if ever, until the Commission can truly declare victory in its ongoing efforts to foster competition in this key telecom sector.

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FCC denial of Qwest's Phoenix Forbearance Petition highlights new focus on carrier market power

Earlier this summer the FCC released what many hope is a precedent-setting Order denying a Qwest Petition for regulatory forbearance from most of the Commission's remaining Title II regulations in the Phoenix metropolitan statistical area (MSA). This was Qwest's second attempt at gaining full deregulation in Phoenix and for the second time it was unable to make a viable case for deregulation. More noteworthy than the Commission's rejection of what can most charitably be described as an over-aggressive deregulatory Petition was the FCC's analysis underlying the denial: the June 22, 2010 *Qwest Phoenix II Order* represents a dramatic departure from the competitive analyses the

FCC has been employing for the last decade. Earlier forbearance rulings had been premised upon a theoretical and factual foundation that "predicted" competitive growth, drawing upon anecdotal competitive evidence, rather than any formal quantitative analysis of the carrier's market power. In the *Qwest Phoenix II Order*, however, the FCC has now laid out and applied an antitrust type of "analytical framework" involving a comprehensive market power analysis with a strong emphasis upon market definition, market share, and other quantitative indicia of actual competition. This rigorous approach can be expected to form the basis for review of future ILEC Forbearance Petitions as well as for other regulatory reviews – most notably the FCC's ongoing Special Access investigation.

Shoring up prior Orders denying forbearance

In crafting the *Qwest Phoenix II Order*, the FCC was clearly mindful of the outstanding DC Circuit Court of Appeals remand of its earlier denials of Verizon's Forbearance Petitions for broad deregulation in six MSAs (Boston, Providence, Philadelphia, Pittsburgh, Baltimore and Norfolk/Virginia Beach) and Qwest's original Petition for Forbearance in four MSAs (including Phoenix as well as Minneapolis, Denver and Seattle). The Court had questioned why the FCC had not evaluated the impact of "potential competition" (the market disciplining effect that the threat of competitive entry would have upon a service provider) in the Verizon and Qwest MSAs (a criterion it had employed in approving earlier Forbearance Petitions in Omaha, Anchorage and Terry, Montana), and remanded the decisions back to the FCC on that narrow issue. In the *Qwest Phoenix II Order*, the FCC addresses the issue of potential competition head-on, finding that in order for "potential competition" to reduce an incumbent's market power the "potential" needs to have a realistic and probable basis.

Using a supply-side analysis of the ability of competitors to respond to Qwest throughout the Phoenix MSA, the FCC concluded that "potential competition" did not diminish Qwest's market power in the Phoenix MSA and that earlier FCC decisions that had included the impact of "potential competition" substituted "predictions" of future competition for a rigorous analysis of the "potential" for competition, noting that the *Qwest Phoenix II Order* corrects that error. It would be surprising if this same quantitative justification does not form the basis for analysis in the outstanding remand orders in response to the DC Circuit Court of Appeals.

Repudiation of the careless results-driven deregulatory decision-making of the past

In some of its earlier forbearance and other deregulatory orders, the FCC mixed and matched market evidence from the enterprise and residential, retail and wholesale markets (just as the carriers requesting the elimination of regulatory constraints had done in their filings), only nominally defining separate product markets. Using the analytical framework it now lays out, the Commission here separately examines each of the various product markets (enterprise and residential, retail and wholesale), and concludes that effective competition does not exist in any of them in Phoenix.

The FCC also openly criticizes some of its own earlier prediction-driven deregulatory decisions. In a discussion of the ILECs' failure to continue to provide competitors with wholesale inputs at fair and reasonable prices (after the Commission had forborne from requiring them to do so), the Commission now concedes that this result should not have been surprising, noting that "assuming that Qwest is profit-maximizing, we would expect it to exploit its monopoly position as a wholesaler and charge supracompetitive rates, especially given that (absent regulation) Qwest may have the incentive to foreclose competitors from the market altogether."

Renewed recognition of the importance of wholesale markets for enterprise services

The FCC's analysis of the enterprise services product market placed particular emphasis upon competition at the wholesale level. Examination of the data filed by a variety of parties in the proceeding led to a finding that wholesale competition for the kinds of services utilized by enterprise (large business) customers is almost nonexistent. The finding of a lack of competitive alternatives at the wholesale level is of particular importance here because, in addition to its adoption of a quantitative analysis, the FCC re-embraces its earlier interpretation of the 1996 federal Telecommunications Act as supporting the development of local competition through both facilities- and non-facilities-based entry.

To emphasize its findings that competitors rely upon Qwest's wholesale services to compete, the FCC quotes extensively from orders that pre-date the Powell/Martin Commission, in which the FCC had identified formidable entry barriers. The Commission reinforces its theoretical analysis with empirical findings regarding the status of competition, including the finding that even the largest CLECs rely upon ILEC last-mile facilities to connect to the vast majority of their enterprise customers; that ILECs have not continued to provide competitors with wholesale inputs at fair and reasonable prices; and that intermodal competitive services (such as fixed microwave for enterprise customers) have not emerged or are not available to near the level necessary to constrain the ILECs' market power.

Use of the Qwest Phoenix II Order "analytical framework" in ongoing and future FCC proceedings

In a concurrently issued *Public Notice*, the FCC has indicated its intention to apply the same "analytical framework" to other forbearance proceedings. Not specifically addressed is the range of ongoing and future proceedings in which the FCC is examining the status of competition and the consequences of its deregulatory policies of the past decade, such as its long-running Special Access Investigation (CC Docket No. 05-25). ETI's own Dr. Lee Selwyn, invited by the FCC to participate at an "economists workshop" on the appropriate "analytical framework" to use in evaluating the speical access market on behalf of large enterprise customers, members of the Ad Hoc Telecommunications Users Committee, recommended that the Qwest Phoenix framework be directly applied to special access. (See article below.)

A wide range of findings with far reaching implications

Many of the *Qwest Phoenix II Order* 's findings relative to market power and competition clearly have implications far wider than the Phoenix MSA. Of particular note, the FCC found that the expansion of facilities by cable companies to mass market customers is not predictive of new entry by other competitors that lack cable's existing infrastructure platform, thus supporting a conclusion that a "duopoly" market structure is likely for many local telecom markets. Further, the FCC also found that "[t]he move

from monopoly to duopoly is not alone necessarily sufficient to justify forbearance" and "economic theory holds that firms operating in a market with two or a few firms (i.e., an oligopoly) are likely to recognize their mutual interdependence and, unless certain conditions are met, in many cases may engage in strategic behavior, resulting in prices above competitive levels." It would seem that the FCC now understands that there is indeed a continued role for regulation.

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ETI urges FCC to extend its use of quantitative market-power based analysis to the special access market at FCC economists workshop

More than a decade after introducing "pricing flexibility" into the ILECs' special access market, the FCC appears to have re-engaged in its investigation of the impact that this deregulatory policy has had over this period. In support of this effort, the FCC is currently in the midst of an investigation of the proper "Analytical Framework" for evaluating the functioning of the special access market as part of its long-running Investigation (CC Docket No. 05-25) into the effectiveness (or, as many believe, the harmfulness) of its deregulatory initiatives. Dr. Lee Selwyn, ETI's president, was asked to participate in an "economists workshop" on this issue, which was held at the FCC on July 19. Dr. Selwyn's participation was on behalf of some of the country's largest enterprise customers that comprise the Ad Hoc Telecommunications Users Committee. In keeping with positions long advocated by ETI in a number of expert submissions and white papers presented at the FCC, at the Canadian Radio-Television and Telecommunications Commission, and at many state public utility regulatory agencies, Dr. Selwyn urged the FCC to forego its past reliance upon "predictive judgments" and often superficial anecdotal evidence of isolated instances of competitive entry in favor of a formal antitrust type of quantitative analysis of the incumbent carriers' market power with respect to special access services. Dr. Selwyn noted that this was precisely what the Commission had done in its recent action rejecting Qwest's Phoenix MSA forbearance petition (see companion article above), and stressed the importance of applying this same approach to special access.

Dr. Selwyn also explained why the Commission could not rely upon its use of price cap regulation as a backstop means for limiting pricing excesses in pricing flexibility areas. He noted that most of the protections against excessive ILEC pricing and profits that had been engineered into the FCC's original ILEC price cap plan – adopted back in 1990 – have long since been abandoned by the Commission. These measures had included periodic reviews intended to evaluate both the ongoing workings of price caps as well as a determination as to whether its specific price adjustment elements had been correctly specified. In the original price cap plan, realized rates of return were relied upon as indicia of a properly functioning regulatory system, and excessive earnings were subject to "sharing" with consumers (to assure that any efficiency gains realized under incentive regulation would be flowed through in lower prices) and, if earnings exceeded a specified upper bound, downward adjustments in rates would be automatically implemented. With each and all of these features now gone, what remains of price caps is incapable of assuring just and reasonable rate levels without additional regulatory involvement.

Dr. Selwyn defended the use of rate of return analysis in evaluating price levels against RBOC critiques and FCC uncertainty – citing AT&T's own use of the identical type of earnings and regulatory accounting data its recent complaint regarding NECA switched access price levels. While maintaining his long held view as to the usefulness of regulatory accounting and rate of return data as a valid basis for identifying the presence of excessive ILEC prices, Dr. Selwyn also supported the use of alternate benchmarks, such as the use of UNE prices or TELRIC-based costs in place of one based upon realized earnings.

Dr. Selwyn also explained that the collocation-based triggers that form the basis of the FCC's pricing flexibility rules were flawed from the outset and never offered any useful insight as to the actual level of competition extant in the special access market – particularly the market for last mile channel terminations. Introducing the only empirical evidence to make its way into the debate, Dr. Selwyn presented data showing that even if, *arguendo*, the triggers were useful at the time they were implemented, the FCC rules did not provide any mechanism for reviewing and reversing pricing flexibility if the trigger status changed. Citing Verizon data from a 2001 New Jersey regulatory proceeding, Dr. Selwyn demonstrated that in the year following the FCC's initial grant of pricing flexibility to Verizon in certain New Jersey MSAs, the number of collocations declined by more than 60%, and further noted that some portion of the remaining 40% likely belonged to MCI before it was absorbed into Verizon in 2006.

The workshop was conducted as a facilitated debate led by Dr. Jonathan Baker, the FCC's Chief Economist, with questions also asked by Dr. Donald Stockdale, Deputy Bureau Chief/Chief Economist of the FCC's Wireline Competition Bureau. Two of the four economists invited to participate in the workshop represented enterprise customer and competitive carrier interests (Dr. Selwyn and Dr. Bridger Mitchell of CRA International). The other two supported RBOC positions relating to Special Access pricing (Dennis Carlton of Compass Lexecon and William Taylor of NERA).

A video link to the FCC debate will be available on the ETI website as soon the FCC makes the feed available.

For more information on this subject, please contact Dr. Lee Selwyn directly at *lsewyn@econtech.com* .

About ETI. Founded in 1972, Economics and Technology, Inc. is a leading research and consulting firm specializing in telecommunications regulation and policy, litigation support, taxation, service procurement, and negotiation. ETI serves a wide range of telecom industry stakeholders in the US and abroad, including telecommunications carriers, attorneys and their clients, consumer advocates, state and local governments, regulatory agencies, and large corporate, institutional and government purchasers of telecom services.