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REMONOPOLIZING LOCAL TELEPHONE MARKETS: IS WIRELESS NEXT?

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FEDERAL AND STATE ANTITRUST OFFICIALS SHOULD SAY NO TO THE CINGULAR- AT&T WIRELESS MERGER

The exit of AT&T Communications, the largest competitive local exchange carrier (CLEC) and provider of long distance service to residential customers, from the residential market is the strongest evidence to date that the decision of the Federal Communications Commission (FCC) and the White House not to defend the Triennial Review Order spells the end of landline competition for local residential telephone service. The political decision of the Administration and the business decision of AT&T place an immense amount of pressure on competition from other technologies – wireless and voice over the Internet. To date, these technologies have done little to end the Baby Bell monopoly. Wireless is widespread but has not eroded Bell market shares much to date. VOIP is nascent, at best. Whether these technologies can provide effective competition for basic telephone service is uncertain at best.

Ironically, the FCC and the Bush Administration are immediately faced with another huge decision that could undermine the potential for cross-technology competition. The Cingular/AT&T Wireless merger is currently being reviewed by the FCC and the Department of Justice (DOJ). Since SBC and Bell South are the owners of Cingular, which is seeking to become the largest wireless carrier in the nation by buying up AT&T Wireless Inc, this merger represents another anticompetitive blow to consumers. It removes the largest unaffiliated competitor from the wireless market and transfers it to local phone companies that dominate about half the country. In light of recent developments in local telephone markets, this merger requires very careful scrutiny.

This paper shows that if antitrust authorities take a close look, they will conclude that the merger is anticompetitive from every angle. The merger will harm consumers, is not in the public interest and should be blocked or subject to extensive restructuring if it is approved.

Wireless competition will be dramatically reduced by the merger, whether one views the wireless market as a national or local market. The merger would make SBC and Bell South the dominant wireless providers by far in highly concentrated local and national markets for wireless service.

- SBC and Bell South would be the dominant carrier in virtually every one of the markets in which they are the dominant local phone company.
- Nationally, Cingular would be 50% larger than Verizon and dwarf the few other national wireless carriers.
- Because SBC and Bell South also still have over 90 percent of residential local landline services in their home territories, the merger allows them to bundle local landline and wireless together, which makes it especially difficult for stand alone wireless companies to compete.
- In their home territories, SBC and Bell South control access to the local network on which competing wireless providers depend to complete calls. They have the ability to make it difficult or expensive for competitors to gain access to the local telephone network; the larger their market share becomes, the stronger their incentives and the greater their ability to undermine competition.

The merger would dampen cross-technology competition between wireless and landline local service.

- SBC and Bell South as the dominant wireless and landline providers will have little incentive to migrate customers off of landline service.
- The merger increases the incentive to raise prices for wireless (since that takes pressure off of landline prices).
- The merger severely impacts the likelihood of effective competition between wireless and landline high-speed data service. The merger would remove the spectrum licensed to AT&T as a potential, independent competitor for high-speed Internet service, in a product space where there are, today, only two facility-based providers (cable and telephone companies).

WIRELESS MUST BE ANALYZED AS A LOCAL PRODUCT

Wireless is sold as a local product. On the demand-side, consumers buy and use wireless as a local product. When a customer visits a local store in Dallas for wireless, they expect a local account. They want a local number to call and give out.

- Approximately 70 percent of wireless calls and 60 percent of wireless minutes are intralata. Approximately 80 percent of all wireless calls and 70 percent of all minutes are intrastate (Industry Analysis and Technology Division, Wireline Competition Bureau, *Trends in Telephone Service* (Federal Communications Commission, Washington D.C., 2003, 2004), Table 11-4).

The pattern of market penetration demonstrates the local nature of the service. Firms are less likely to market where they do not have spectrum. They control customer acquisition through advertising and marketing efforts. Firms have different success rates in local markets and act like spectrum is a local resource. Market shares in and out of region vary sharply in the wireless industry (based on top 50 markets for SBS/BS/VZ)

- The Baby Bells, as Incumbent Local Exchange Carrier (ILEC) are the number one wireless provider in almost 3/4 of home service areas (pre-merger).
- Market shares for wireless firms affiliated with ILECs are 50 percent higher in the home territory, than outside.
- Market dominance of ILEC is likely to be larger in smaller markets.

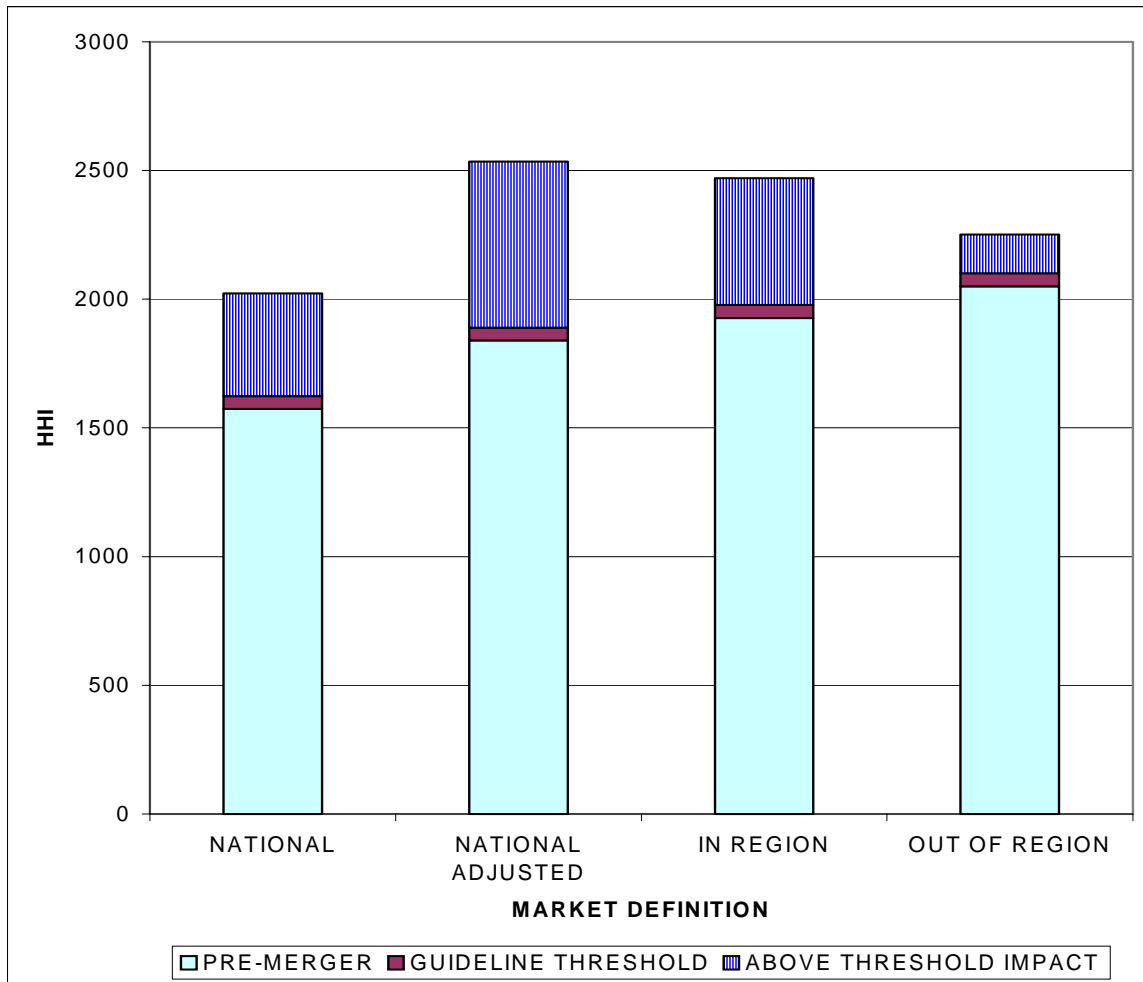
THE MERGER WILL SEVERELY REDUCE WIRELESS COMPETITION

The Department of Justice and Federal Trade Commission *Merger Guidelines* (1997) single out highly concentrated markets for special concern. The *Guidelines* define a highly concentrated market as one in which the concentration ratio (HHI) is greater than 1800. Mergers in such markets that increase the HHI by 50 points or more “potentially raise significant competitive concerns” because they are “likely to create or enhance market power or facilitate its exercise.”

No matter how the market is defined, the Cingular-AT&T Wireless merger violates the *Guidelines* by a substantial margin. Figure 1 shows market concentrations before and after the merger based on customer accounts. Even if regulators were to view this as a national service, they would have to reject the merger. This is a merger between a number two and a number three firm in a market that is already moderately concentrated. The post-merger market would be highly concentrated and the increase in concentration exceeds the merger guidelines by a very substantial margin.

Moreover, while Cingular points to six national carriers and a set of regional carriers, a close look at the data shows that in eighty-five percent of the top 100 markets, at least one of the national competitors is absent or none of the major regional carriers is present. More importantly, looking at the major cities where the parents of Cingular are the dominant incumbent local exchange carriers, we find an even more troubling outcome. In two-thirds of the SBC/BellSouth local markets where both Cingular and AT&T wireless are present today, at least one of the national/regional wireless entities is not present.

Figure 1: Increases in Concentration Violate the *Merger Guidelines* by a Wide Margin



Source: *Declaration of Richard J. Gilbert*, p. 5; Local data base.

Looking at local markets in region, we find highly concentrated markets that will suffer a very large increase in concentration. Impacts in the home regions of the Baby Bell owners of Cingular will be especially large.

Although the HHI guidelines are only a screen to trigger scrutiny, the magnitude of the increase in concentration is so great that antitrust authorities frequently challenge mergers that have this large an impact on markets. Other evidence supports this view of the merger.

- The merger eliminates about half the top 50 markets where the ILEC is not the dominant wireless carrier.
- The merger eliminates a competitor in 87 of the top 100 markets.

- Estimates of potential price increases resulting from the merger are large enough to raise the red flags that traditionally get the attention of antitrust authorities. (Phoenix Center for Advanced Legal and Economic Public Policy Studies, *Higher Prices Expected From The Cingular/AT&T Wireless Merger*, May 26, 2004).
- Econometric evidence indicates that demand elasticity is low and margins are high, suggesting market power could be abused

SPECTRUM IS A SCARCE LOCAL RESOURCE

On the supply side, spectrum is a local input. The last mile transmission medium is the core of the network. The last mile is the gateway through which all services flow. It sets the pace of competition. One cannot sell wireless service to a customer in Dallas with spectrum in New York. Spectrum in Dallas is necessary to make the “last mile” connection in Dallas. To the extent that competing regional and national carriers must rely on roaming to deliver service where they do not hold a license to spectrum, they must rely on making a deal with a holder of local spectrum.

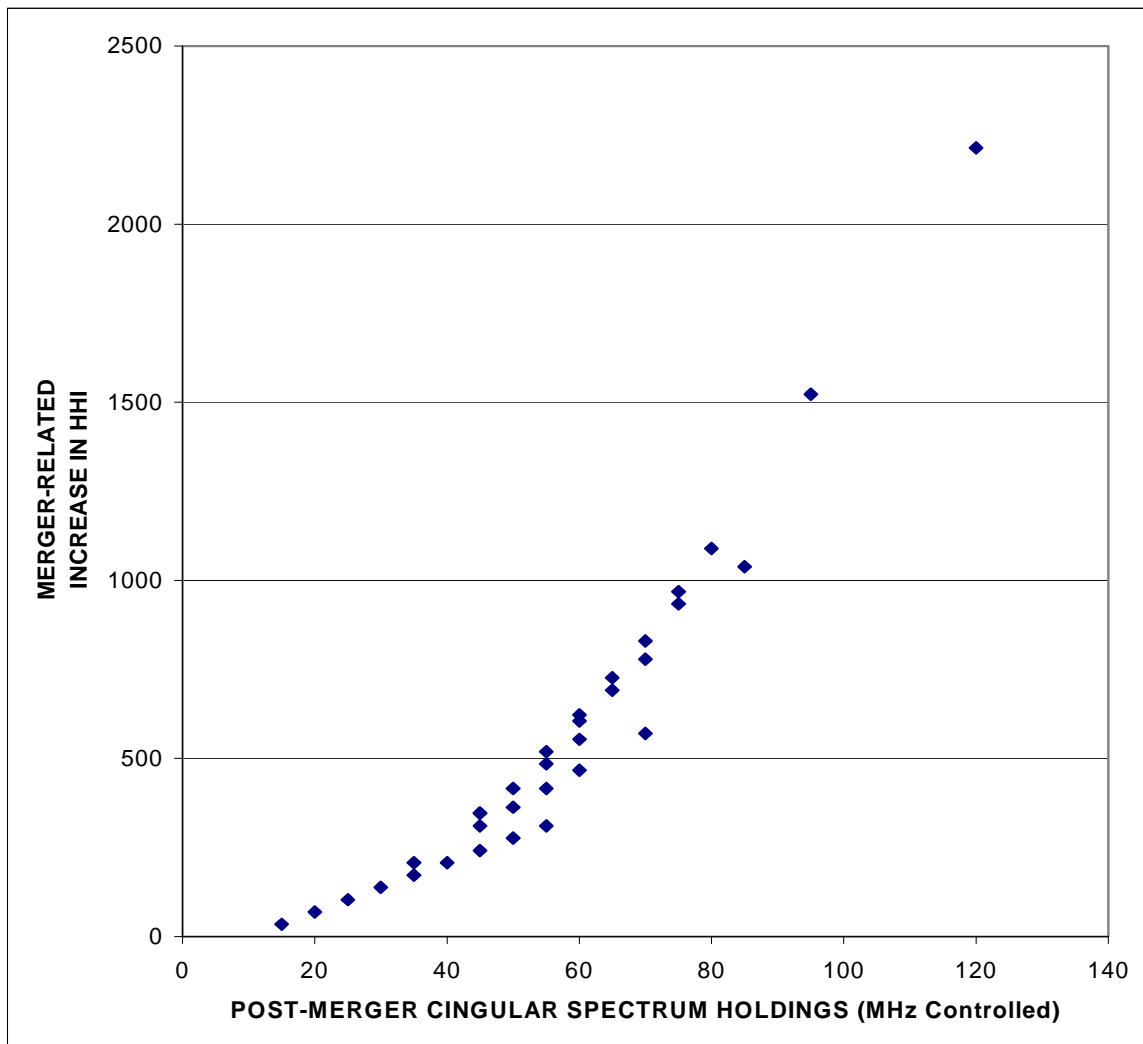
The merger raises severe concerns about the long-term competitiveness of wireless markets because of the scarcity of spectrum and the huge holdings the Cingular/AT&T Wireless combination would create.

- Separately Cingular and AT&T Wireless have more spectrum today than many of the other wireless license holders.
- Combined they will have a dominant holding of spectrum in many markets.
- At the level of spectrum that Cingular claims to need for a full service offering (80 MHz), local markets will support at most 2 to 3 full service wireless networks today.
- If firms are allowed to hold licenses to significantly more than 40 MHz, the spectrum available would support only three full service competitors.

Figure 2 shows the market concentration based on spectrum. It plots the increase in the HHI resulting from the merger against the post-merger holdings of Cingular. This analysis still underestimates the advantage the Cingular would have. As the holder of cellular licenses, its spectrum provides better coverage. (AT&T Wireless Services, Inc., Transferor, and Cingular Wireless LLC, Transferee, Applications for Transfer of licenses and Authorizations, WT Docket No. 04-07 (hereafter Application), p. 15)

- Anywhere that Cingular holds more than 40 MHz, post-merger; the spectrum market is above the moderately concentrated threshold.
- The merger increases the concentration by 175 points or more. For many markets the increase much larger.

Figure 2: Spectrum Concentration Resulting from the Cingular-AWE Merger



Source: AT&T Wireless Services, Inc., Transferor, and Cingular Wireless LLC, Transferee, Applications for Transfer of licenses and Authorizations, WT Docket No. 04-07 (hereafter Application), Attachment 8.

- The merger would require divestiture of spectrum in a majority of the markets where these companies serve.

While future spectrum might become available, exactly when is uncertain and its ability to discipline the market power created by this merger is highly speculative.

- The likely impact of future spectrum on the market is well beyond the time frame normally used by antitrust authorities in evaluating mergers.
- In any case, this merger will afford Cingular an enormous first mover advantage.

- At the level of spectrum that Cingular claims it needs, substantial new spectrum would be required to sustain vigorous competition, much more than is likely to be made available any time soon.

THE MERGER RAISES SEVERE, ANTICOMPETITIVE CROSS-TECHNOLOGY AND CROSS- PRODUCT PROBLEMS

To the extent that other telecommunications product markets are considered, the anticompetitive picture becomes even more ominous. Because Cingular would be the dominant holder of spectrum licenses and the parent companies are the dominant providers of landline access in the service territories, the merger raises significant cross-technology and cross-product concerns.

The largest impact would be in the markets where the parent companies of Cingular are the incumbent local exchange carriers (ILECs). As the dominant local exchange carrier SBC and BellSouth still have an 85 percent share of local lines and over a 90 percent share in residential markets. If the basis is the ownership of facilities, the figure is probably above 95 percent for the residential market. Thus,

ILECs dominate local markets (post-merger)

Landline market share	~ 90%
Wireless market share (in region)	~ 35%
Long distance market share (in region)	~ 30%
High-speed Internet access	~35%

(Industrial Analysis Division, Wireless Competition Bureau, *Local Telephone Competition: Status as of December 31, 2003*, *High-Speed Service for Internet Access: Status as of December 31, 2003* (June 2004); UBS Investment Research, *Wireline Postgame Analysis, 7.0*, June 1, 2004; Local data base)

With the recent exit of the largest CLECs and long distance carriers from the residential market, the Baby Bells are likely to hold onto their landline monopoly for local service and increase their market share in long distance. To the extent the wireless competes either with local or long distance service, allowing the dominant landline company to expand its control over wireless will significantly reduce the competitive pressures in the residential telephone market.

In the voice market the companies are schizophrenic about wireless-landline competition. In this proceeding they have produced a witness who claims that wireless and landline are not substitutes. In virtually every other proceeding the parent landline companies maintain that they are substitutes. If they are viewed as substitutes, the merger eliminates a facilities-based last mile competitor in a market with few such competitors.

If wireless and landline are combined into a market for “local telephone connectivity,” then Cingular and its parents would have such a dominant position in the local connectivity market that the merger between AT&T wireless and these dominant ILECs would violate the *Merger Guidelines* by a mile.

- The market for local connectivity is highly concentrated (HHI just under 4000).
- The merger would raise the HHI by about 800 points, more than 15 times the threshold.

These concerns extend with even greater force to wireless data services. Cingular would control substantially greater spectrum than its competitors in many of its markets. The parent companies of Cingular are, at present, one of only two ubiquitous, high-speed data last mile facilities available. The DSL facilities are somewhat limited in capacity. Allowing the merger puts one of the more promising new entrant high-speed Internet access facilities into the hands of one of the current last mile owners. In this market, the prospects for numerous competitors are less promising than in the voice market.

- The HHI for this market is over 4000, indicating a duopoly. One of the duopolists is the incumbent local exchange carrier. Preserving potential competitors in this market is critical.

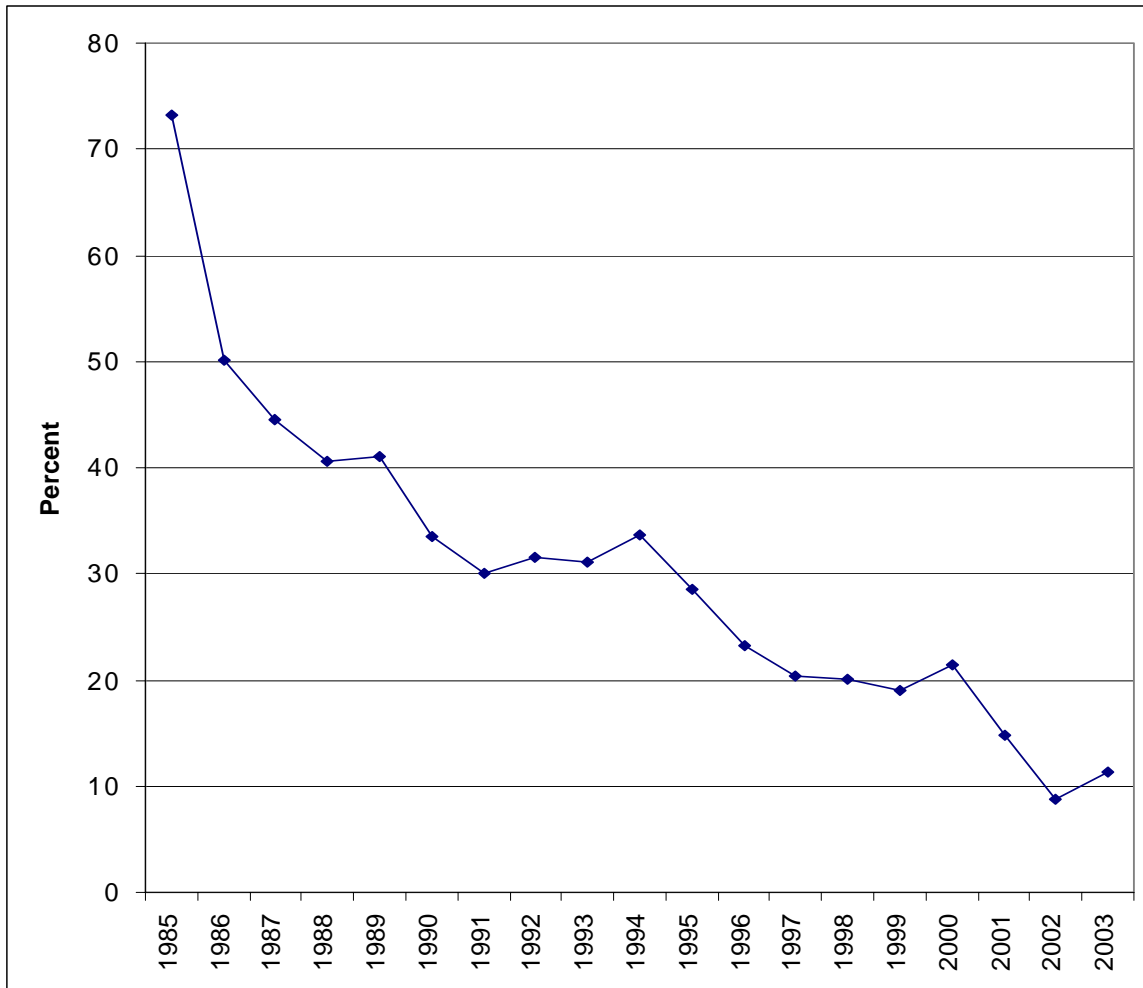
THE WIRELESS INDUSTRY IS A TIGHT OLIGOPOLY THAT PROVIDES NO UNIQUE PROTECTION AGAINST THE ABUSE OF MARKET POWER

The merger takes place in an industry that has matured, is already a tight oligopoly and is typified by significant barriers to entry. In other words, claims that the unique fluidity of the wireless market will protect consumers from the anticompetitive effects of this merger must be rejected. Contrary to Cingular’s claim, all of the evidence points to an industry that has substantial barriers to entry. Indeed, exit seems to be the watchword, rather than entry.

Over the past several years the shares of regional firms have diminished sharply (Federal Communications Commission, *Annual Report and Analysis of Competitive Market Conditions with Respect to Commercial Mobile Services*, various issues; UBS Investment Research, *Wireless 411* June 23, 2004)

- The top six, national firms have increased their market share from 55% in 1997 to 85% today.
- New subscribers have declined sharply in the past several years (see Figure 3).
- Moreover, since the industry moved to uniform pricing, market shares and industry rankings have become quite stable (See Figure 4).

Figure 3: New Subscribers as a Percent of Year-End Total Customers

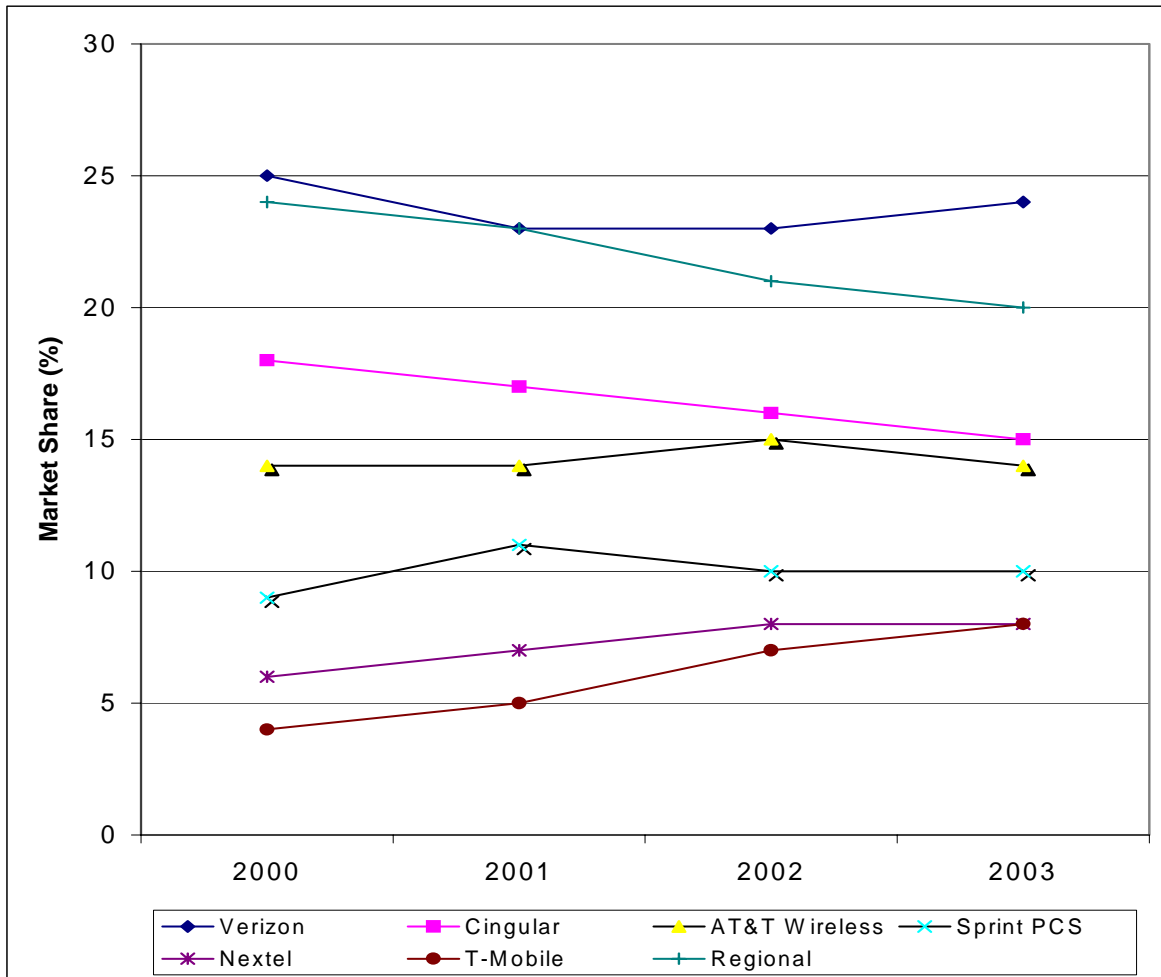


Source: Eight Annual Report, CTIA 2003 Report.

Barriers to entry are substantial. Spectrum is scarce. Infrastructure is a substantial sunk cost. Dealing with incumbent ILEC for network access is a challenge. Cingular’s double talk on barriers to entry must be rejected.

Cingular asserts that infrastructure costs are not a barrier to entry for competitors who “include licensed PCS providers who have not yet built out in a particular area (for whom barriers to entry are low and consist mainly of the costs to build out or lease infrastructure and market the network in that area).” (**Opposition** of AT&T and Cingular, AT&T Wireless Services, Inc., Transferor, and Cingular Wireless LLC, Transferee, Applications for Transfer of licenses and Authorizations, WT Docket No. 04-07 (hereafter Application), p. 16, note 55). Yet, for Cingular, these very same costs and activities become a major hurdle because “a company must find a tower location with the right coverage and then address zoning,

Figure 4: Market Shares Since National Pricing



Source: Source: *Declaration of Richard J. Gilbert*, p. 5.

environmental, and political issues concerning the tower. This is both time-consuming and costly.”(Application, p. 6)

Competitors are encouraged to purchase spectrum that might become available in future auctions. (Opposition, p. 12) Yet, Cingular never acknowledges the possibility that its needs could be met in this manner.

Similarly, while Cingular claims roaming agreements will be easy to reach (Opposition at 47), it has failed to do so in many markets (Application at 20-21). While Cingular is a net payor under roaming agreements today (Opposition, p. 48.) that will likely change when Cingular doubles its subscriber base and expands its coverage. With Cingular being 50 percent larger than its nearest rival and three to five times as large as the other national players, it is

almost certain to shift from being a net payor in reciprocal roaming agreements to a net receiver and have the incentive to increase roaming charges.

The merger would create a duopoly in the national market – six of seven Bell operating companies plus major independents – GTE, SNET, Continental and more than half of all wireless subscribers would be concentrated in two regional giants.

- SBC/BS/Cingular will be a dominant vertically integrated firm, controlling large share of local wireless and landline markets, as well as national markets.
- Verizon is a similarly integrated firm, although about one-third smaller.
- With their regional dominance they would easily avoid competing with each other, as they have since the passage of the Telecommunications Act of 1996.

This is a crucial merger that will define the market structure. By creating a dominant firm that dwarfs others, it will ignite a merger wave.

- The remaining stand-alone firms would be dwarfed. Combined, the three national wireless carriers that are not affiliated with an ILEC would be smaller than Cingular.
- Antitrust authorities would be hard pressed to stop other mergers.

Cingular – AT&T Wireless Mergers Compared to the Next Possible Mergers

	Post Merger Market Share	HHI	HHI Change
Cingular	30	2023	449
Verizon-Sprint	33	2525	502
Nextel-T-Mobile	18	2626	101

THE MERGER RAISES SERIOUS CONCERNS ABOUT VERTICAL INTEGRATION AND CONGLOMERATION

The dominant position of the incumbent local exchange companies integrated into wireless gives them the incentive and ability to dampen competition in their home territories. The parent companies of Cingular could bundle all wireless and landline, voice and data and substantially reduce competitive pressures. This reflects both the fact that they control the facilities to deliver and especially large bundle, while competitors must act as CLEC to achieve a similar bundle. Stand-alone wireless competitors are at a severe disadvantage.

- They are dependent on the vertically integrated competitor for critical local inputs like special access to transport and access to central offices. The parent companies of Cingular have made CLEC life miserable in gaining access to their facilities.
- ILECs can withhold landline functionality to gain an advantage.
- Raising CLEC costs is the central strategy being pursued by the Baby Bells today.

To the extent that Cingular is the dominant spectrum holder, it has an incentive to withhold access to these inputs or to raise the cost for its rivals. Cingular profits doubly from such a strategy, once from the increased revenues and once from the ability to raise prices for its own service, should the competitors feel compelled to pass through increased roaming charges.

The larger their market share, the more incentive and ability they have to execute these anticompetitive strategies. Size matters in determining the profitability of discrimination and anticompetitive efforts to raise rivals costs. The larger the size of the firm instituting an effort to raise rivals costs, the more likely it is to succeed, as competitors have fewer options.