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AT&T And T-Mobile: Duopoly Deja Vu?

Law360, New York (April 1, 2011) -- As corporate deals go, it is not the biggest. But in terms of potential impact, AT&T Inc.'s proposal to acquire T-Mobile USA Inc. is perhaps the most significant telecom deal since the breakup of AT&T in 1982 and AT&T's later acquisition by SBC in 2005. Whether it will be permitted, over vociferous objections by competitors and some public interest advocates, is more questionable.

Let's start with the basics. Under the proposal, AT&T would pay Deutsche Telekom, T-Mobile's owner, $39 billion in cash and stock. In the process, the nation's second-largest wireless carrier would acquire the fourth largest. Put another way, with 95.5 million subscribers today, AT&T would add T-Mobile's 33.7 million subscribers.

The combined entity would emerge with 129.2 million subscribers, 35.1 million more than the current largest operator, Verizon Wireless (which had 94.1 million at year-end 2010). And between the two, AT&T and Verizon would reportedly control some 70 to 75 percent of all post-deal wireless customers in the U.S.

The transaction is contingent on regulatory clearance by the U.S. Department of Justice and the Federal Communications Commission. In the event approval is not obtained, AT&T has agreed to pay a $3 billion breakup fee and turn over certain spectrum rights to T-Mobile. If approved, Deutsche Telekom would end up as AT&T's largest stockholder with an 8 percent equity interest and a seat on AT&T's board.

The deal continues a dramatic consolidation in the cellular marketplace. In the late 1990s, there were more than a dozen major cellular providers. If the acquisition is approved, there would be just three national carriers with the third, Sprint, being a distant third at that. It is for reasons such as this that Sprint and other critics have characterized the deal as "re-creating the cellular duopoly" which existed when the service was first authorized in the 1980s.

AT&T argues that the deal would help implement the Obama administration's objective of deploying high-speed broadband Internet access to hard-to-serve rural areas (i.e., would expand its 4G network to 95 percent of the population, instead of 80 percent without the merger); would enable it to improve capacity (and service) by adding T-Mobile's spectrum and cell sites in congested markets; and would realize some $40 billion in efficiencies and cost savings.

AT&T also suggests that the DOJ has analyzed telecom mergers for antitrust purposes on a local market basis — the rationale being that cellular usage is largely in or near the consumer's home city. In most major local markets, there are typically at least four other carriers, such as Cricket, Leap Wireless, ClearWire and Metro PCS. Indeed, AT&T notes that in 18 of the 20 top markets, there are five or more other carriers.

The antitrust issues presented by the proposed acquisition are not that simple, however. The purpose of a free market is to encourage price competition. In the wireless space this is epitomized by T-Mobile and Sprint, both of which utilize flat-rate and unlimited wireless pricing schemes well below the prevailing rates of either AT&T or Verizon.

By removing T-Mobile as a competitor, consumers could experience a significant rate increase or, at least, a diminution in the aggressive price-cutting that has characterized U.S. wireless services for years. Furthermore, much of local market competition appears to be for prepaid customers, rather than the more lucrative post-paid customers typical of the national wireless providers, and is provided by smaller, regional carriers which in many locations operate on a resale basis, do not control their own networks and are accordingly less influential for price competition purposes.

From the spectrum standpoint, it is well-known to the point of satire that AT&T has been plagued with service problems in major markets like New York and San Francisco. This is due in large measure to the exponential growth in mobile data traffic associated with the iPhone, other smartphones and digital devices. According to AT&T Mobility's CEO, Ralph de La Vega, the carrier has experienced an 8,000 percent growth in data traffic over the past four years.

Conversely, AT&T's control over the present T-Mobile spectrum, if approved without conditions, could impede the ability of a new entrant to build or expand a competing wireless network. These sorts of quasi-regulatory barriers to entry (because spectrum allocation and assignment is ultimately a matter on which the government is in charge) could prove very significant in both the DOJ and FCC reviews of the deal.

While the regulators struggle to identify additional spectrum — an essential prerequisite for meeting demand — there is little relief on the immediate horizon. The FCC's plan to allow a voluntary auction by TV broadcasters requires congressional legislation, and the prospects of that happening this year appear to have diminished. Thus, in some respects the AT&T deal represents a private market solution to the spectrum crunch facing the U.S. wireless industry.

Traditionally, the FTC-DOJ merger guidelines and past enforcement cases (such as United States v. Oracle (PeopleSoft)) suggest that while four-to-three mergers are better than three-to-two mergers, the former are still troubling in concentrated markets. And of course, the AT&T/T-Mobile deal exceeds the merger guidelines' "HHI" index criteria for governmental challenge — on a national basis, and likely in at least some local markets as well — by a wide margin.

That is not the end of the matter, however, because Clayton Act merger analysis is always fact-specific and because the ultimate point is a prediction of future competitive effects. There is a plausible argument that, given the continued presence of Sprint and regional carriers, coupled with the huge subscriber "churn" rates endemic in wireless services, price competition may not be affected substantially.

And given the increasing substitution of wireless for landline phone services (nearly 30 percent of the population is now wireless only), "market definition" could prove exceedingly difficult in today's environment; if traditional telephone companies are considered competitors, the concentration impact of the deal is far less of concern.

Assuming AT&T can get over the antitrust threshold with the DOJ, spectrum and/or subscriber divestments are likely, as they would address and ameliorate the barrier to entry issue. One can also predict with relative certainty, especially in light of its recent actions in the Comcast-NBCU acquisition, that there are additional, "voluntary" conditions the FCC will want AT&T to accept, such as enhanced data roaming and wireless network neutrality obligations, as the price of

regulatory approval. Indeed, the deal anticipates that significant divestitures may be required.

Yet the reality is that in some ways, perceptions matter more than actual facts in the highly political and visible process of federal government merger review. AT&T clearly wants to close the acquisition and, like Comcast, will be under substantial pressure to make concessions to both the DOJ and the FCC in order to get it done.

The regulatory agencies prefer to settle merger proceedings with negotiated consent decrees rather than prolonged court battles. And the Obama administration to date has been particularly sensitive to the telecom policy objectives promoted by public interest advocates, some of whom have already pronounced AT&T/T-Mobile as dead on arrival.

We think that assessment is overstated. The AT&T/T-Mobile deal may be closer to Chrysler's purchase of AMC in the 1980s, a four-to-three transaction involving a second-tier competitor that had little or no negative impact on the automobile market in the U.S.

But then again, in wireless services there is no possibility of foreign competition — while Toyota, Nissan and Subaru more than made up for the loss of AMC — and with spectrum presenting both the largest barrier to competition and a major pro-competitive justification for the AT&T deal, the impact of governmental spectrum policy, amorphous at best, could be a dispositive factor. What we do know with certainty is that there will plainly be protracted and hard-fought regulatory proceedings over this watershed deal. Arbitrageurs beware!

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