The Mobile Price War of 2014[1]

On December 26, 2012 CEO John Legere announced that T-Mobile would eliminate mobile handset subsidies, moving completely to a new form of pricing, called "Value" plans. It thus would be the first American carrier to drop the requirement that customers agree to long-term contracts in exchange for subsidies on their mobile phone purchases. This seemed like a small pebble indeed in an ocean of contract pricing plans ranging from mobile networks to cable television networks, DSL services, and satellite providers all requiring contracts just to get lower rates. Under T-Mobile's new pricing model, consumers could pay full price for the smartphone, or they could pay in monthly installments until the device is paid off (zero down, zero percent financing). "Either way, it's a more transparent way to operate and doesn't allow the carrier to justify higher rates throughout the life of the contract," said technology analyst Roger Cheng.[2]

T-Mobile had to do something. The fourth-largest mobile network lost $7.8 billion for the third quarter 2012 (compared to a $332 million profit the same quarter a year earlier), on sales of $4.9 billion (down 6 percent year over year).[3] It had lost 492,000 contract customers, causing a drop in its average revenue per user (ARPU) to $42.78, a decline of 7 percent year over year. At the same time, T-Mobile had gained 365,000 new prepaid (non-contract) customers, up 44 percent from the

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[1] This case was prepared by Professor Gerald Smith, Carroll School of Management,

[2] Roger Cheng, "On T-Mobile killing the subsidy: It's about time," C|NET, December 7, 2012 5:40 AM PST.

[3] T-Mobile also reported an $8.1 billion non-cash impairment charge for the third quarter 2012 relating to the decision made by its parent company, Deutsche Telekom, to merge T-Mobile USA and MetroPCS.

year-ago period, resulting in $450 million in revenue, a 38 percent increase year over year, while its ARPU rose by 12.5 percent, to $27.35.[4]

A year later, Legere, now dubbed "the most dangerous man in wireless," announced that T-Mobile was killing roaming fees and slashing per-minute and text charges for international calls. "The cost of staying connected across borders is completely crazy," Legere, said in a statement. "Today's phones are designed to work around the world, but we're forced to pay insanely inflated international connectivity fees to actually use them."[5] T-Mobile continued pressing, announcing that its customers could now trade in their phones for a new one every six months rather than every year.

By the end of 2013 the mobile carrier business was trying to figure out how to deal with T-Mobile's sudden change in pricing posture, called the "uncarrier" strategy. Verizon Wireless and AT&T accounted for roughly two-thirds of the US subscriber base, with Sprint and T-Mobile in the number three and four positions, and other competitors trailing far behind. See Exhibits 1-5 for recent subscriber data trends. "What's interesting is that despite T-Mobile's aggressive value-enhancing actions, rivals have not reacted by slashing prices," said blogger Rafi Mohammed. "It's actually common for companies with varying value propositions to co-exist peacefully. Consider the airline industry. Southwest Airlines generously offers free baggage and a liberal flight cancellation policy — great enhanced value. But this has not provoked a price war. A lesson to managers of all companies — it's less threatening to compete on value than price."[6]

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[4] Zack Whittaker, "T-Mobile USA loses 492,000 contract customers in Q3," C|NET, November 8, 2012 3:19 AM PST.

[5] Jose Pagliery, "T-Mobile drops international roaming charges," CNNMoney, October 10, 2013: 1:18 PM ET.

[6] Rafi Mohammed, "T-Mobile Hasn't Incited a Price War…Yet," HBR Blog Network, January 13, 2014 1:02 PM.

In 2014, however, competitors began to agitate. On January 3, AT&T made a direct attack on T-Mobile customers, saying switch to AT&T and get $450: T-Mobile switchers were offered a $200 credit per phone line, plus the chance to trade in their smartphones for up to $250.[7] "AT&T declined to say how long the $450 offer would last, citing competitive reasons," said industry observer Jose Pagliery. "The company wouldn't say how many customers it expects to gain from the pitch -- or how much it would cost. T-Mobile did not immediately respond to requests for comment. But CEO John Legere addressed rumors of the AT&T offer Thursday night [January 2] on Twitter. 'I guess we are making AT&T a bit nervous,' he wrote."[8]

"Investors had hoped AT&T and market leader Verizon Wireless would be able to shrug off T-Mobile's moves, since they already control about two-thirds of the market," said industry analyst Sinead Carew. "AT&T had previously said that T-Mobile's efforts only concerned the most cost-conscious customers, who are not its or Verizon's primary targets. AT&T stayed on the sidelines for months in the face of public criticism of its services from T-Mobile's outspoken chief executive officer, John Legere. Now that the company is fighting back, even industry leaders could face tighter margins, say analysts. 'The most disappointing thing is that AT&T is reacting to T-Mobile,' said Jefferies analyst Michael McCormack. 'How long is it before Verizon reacts?'"[9]

The brewing hostility between AT&T and T-Mobile was getting personal. The two companies previously had been best of friends, agreeing on March 20, 2011 that AT&T would purchase T-Mobile USA. It was a perfect fit, "since they use the same

[7] Jose Pagliery, "AT&T offers T-Mobile customers $450 to switch," CNNMoney, January 3, 2014: 12:04 PM ET.
[8] Ibid.
[9] Sinead Carew, "Price war in U.S. mobile market raises fear of profit hemorrhage," Reuters.com, Sat, Jan 11 2014.

technology [and] it is simple for customers to switch between services."[10] But the US Department of Justice announced they would seek to block the takeover in August 2011, and AT&T abandoned the bid on December 19, 2011.[11] As T-Mobile's posture became more provocative during 2013 their "battle got more personal at the Consumer Electronics Show in Las Vegas when AT&T kicked Legere out of its party, a concert featuring rapper Macklemore. At T-Mobile's own event, Legere, sporting his customary pink company tee-shirt under a leather jacket, took to the stage to make fun of AT&T and its executives in a profanity-sprinkled speech."

"Roe Equity Research analyst Kevin Roe sees the 'unhealthy market dynamic' getting worse, since he is not convinced AT&T's incentives to T-Mobile switchers will end there. 'There's more to come, and it will continue until AT&T has market-share stability,' said Roe, who believes the carrier will keep going until it can ease customer losses to T-Mobile."[12]

Less than a week later, on January 8, T-Mobile retaliated broadly, announcing "killer 2013 subscriber numbers and making a new $650 offer to poach competitors' customers. The company [had] added 4.4 million customers in 2013 -- its biggest growth in eight years. The company [said] it's proof its "uncarrier" strategy -- aimed to upend the mobile industry -- is working after only 8 months."[13] The deal: "Cancel your contract and we'll pay your termination fees up to $650. That deal includes a maximum of $350 per line and $300 per phone . . . You must trade in your old phone and buy a new one from T-Mobile, and you can transfer your current number."[14]

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[10] Ibid.
[11] "Attempted purchase of T-Mobile USA by AT&T," Wikipedia.
[12] Carew, Price War in US Mobile.
[13] Jose Pagliery, "T-Mobile will pay you $650 to switch over," CNNMoney, January 9, 2014: 2:03 PM ET.
[14] Ibid.

CEO John Legere said “"We will become famous for this in 2014. We're going to force the industry to change. I want every customer to have a complete choice. It's going to be a healthier industry."[15] Chief Technology Officer, Neville Ray, took the case further: “T-Mobile can now claim a faster network than AT&T in some cases. [And] Legere joked that he might pull another media stunt by sending AT&T, which frequently claims to be the fastest, a cease-and-desist letter along with a camera crew to tape it.”[16]

In fact, T-Mobile reportedly has a smaller 4G network, currently serving "254 markets versus Verizon’s and AT&T’s 4G service in 500 and 488 markets, respectively, and many customers value a large 4G network,” said Rafi Mohammed. “Due to this perceived inferiority, only a sub-segment of Verizon’s and AT&T’s (the largest and second largest U.S. wireless operators) customers will consider switching. So instead of an across-the-board price war cut, it’s better for rivals to deal with at-risk-of-defecting customers individually. This will lead to what I call a private price war, which is less threatening to margins. When customers intent on switching to T-Mobile attempt to cancel service, their current carrier will offer an inducement — say a $100 or $200 credit — as an incentive to stay.”[17]

Still, the prospect of full escalation into a broader price war appears increasingly possible. The number three wireless carrier, Sprint, 80 percent-owned by Japan's SoftBank Corp, lost customers last year because of technical problems from a network overhaul. It may feel compelled to compete for customer acquisition to win customers back, especially in the fluid market of 2014 where customers are in play. Some investors note that SoftBank has hopes of merging Sprint with T-Mobile, which would provide another very strong competitor and dampen price

[15] Ibid.
[16] Ibid.
[17] Mohammed, T-Mobile Hasn’t Incited a Price War.

competitive forces. "[Sprint] may make a bid for T-Mobile as soon as this year," said Sinead Carew. "But many Washington industry experts see regulators blocking such a deal: The government rejected AT&T's earlier attempt to buy T-Mobile on the grounds that the market needed four national operators. Since T-Mobile has become stronger, that decision seems to have been justified."[18]

Meanwhile, through all of 2013 Verizon appeared unbothered. On January 7, the day before T-Mobile made its latest offer, "executives at Sprint and Verizon brushed off questions about the AT&T move. 'You don't really buy loyalty that well in my view, and those customers will switch back,' Verizon Communications CEO Lowell McAdam said during a webcast of an investor conference on the sidelines of CES. At the same event, where he announced his own company's new promotions, Sprint CEO Dan Hesse also suggested that his rivals' moves to buy customers would be fleeting."[19]

But by January 21, there were signs that Verizon was indeed getting nervous. ""The competitive environment has changed again here in the fourth quarter [of 2013], and you can expect us to respond accordingly,"[20] said Verizon chief financial officer Fran Shammo on an earnings call. Shares in Verizon were down about 3%, wiping about $4 billion off its market value, despite solid quarterly results. "Shammo said he doesn't think [T-Mobile's simplified value plans] are that much cheaper overall, just that costs of a device and wireless access are being shifted around. 'Really when you do the math, there really isn't much of a price decrease here. It's just a shift of how it's marketed into the consumer market.' But T-Mobile's recent move to pay customers' early termination fees of up to $350 (and a further

[18] Carew, Price war in U.S. mobile market.
[19] Ibid.
[20] John McDuling, "Verizon just hinted that a full blown price war in wireless might soon be upon us," Quartz January 21, 2014.

$300 for a traded-in device) if they switch over from another carrier is a different matter entirely."[21]

Analysts at Macquarie Equities estimated how many customers had switched from Verizon, AT&T and Sprint to T-Mobile. See Exhibit 6. But of course these estimates did not capture customer switching since T-Mobile's latest offer of up to $650 in termination fees and incentives. "Verizon's whole strategy has been built on having the best network, and charging the most for it," said John McDuling. "Shammo's words about a change in the 'competitive environment' on this morning's call might signal a shift in its strategy, which would alter the telecom landscape dramatically. Consumers are likely to benefit—but not anyone owning telecom stocks."[22]

How should industry players judge the profit impact of these competitive moves? The profit margins of wireless mobile carriers are especially affected by the growth of smartphone usage. "Increasing smartphone penetration is helping drive postpaid [contract] ARPUs, as smartphone users are usually heavy data users as well . . . but [smartphones] are also very expensive due to the huge subsidies that carriers provide in return for long-term contract plans."[23] A basic new iPhone costs around $650 for carriers who then subsidize it heavily to sell the handset to consumers for $199. Other non-iPhones cost less, around $350 for average models that usually sell for about $99. The impact of the subsidy can be seen in mobile carriers' gross margins. For example, in a recent holiday buying season with very strong smartphone sales, analysts estimated that the subsidy caused Verizon's wireless gross margins to decline by close to 500 basis points. Then after the holiday

[21] Ibid.
[22] Ibid.
[23] "Verizon Dials Up $42 As Margins Recover And LTE Picks Up Steam," Forbes 4/23/2012 @ 12:07PM.

buying season, Verizon's wireless gross margins improved 440 basis points in the following quarter.[24] Because of the subsidy most industry players had adopted two-year contract plans, requiring customers to pay over at least 24 months. But often customers became lazy or loyal and continued with their plan longer. Estimated current gross margins for the major carriers are shown in Exhibit 7.

The Pricing Decisions

1. Were T-Mobile's pricing moves good decisions? Was AT&T's pricing decision wise? How should Sprint and Verizon react to these moves?
2. What are the roles of the players in the industry, and how does this affect your thinking?
3. How can the industry avoid falling into an all-out price war?
4. Using pricing breakeven modeling, should competitors react to T-Mobile and match its promotional incentive for switchers. What do your calculations suggest?

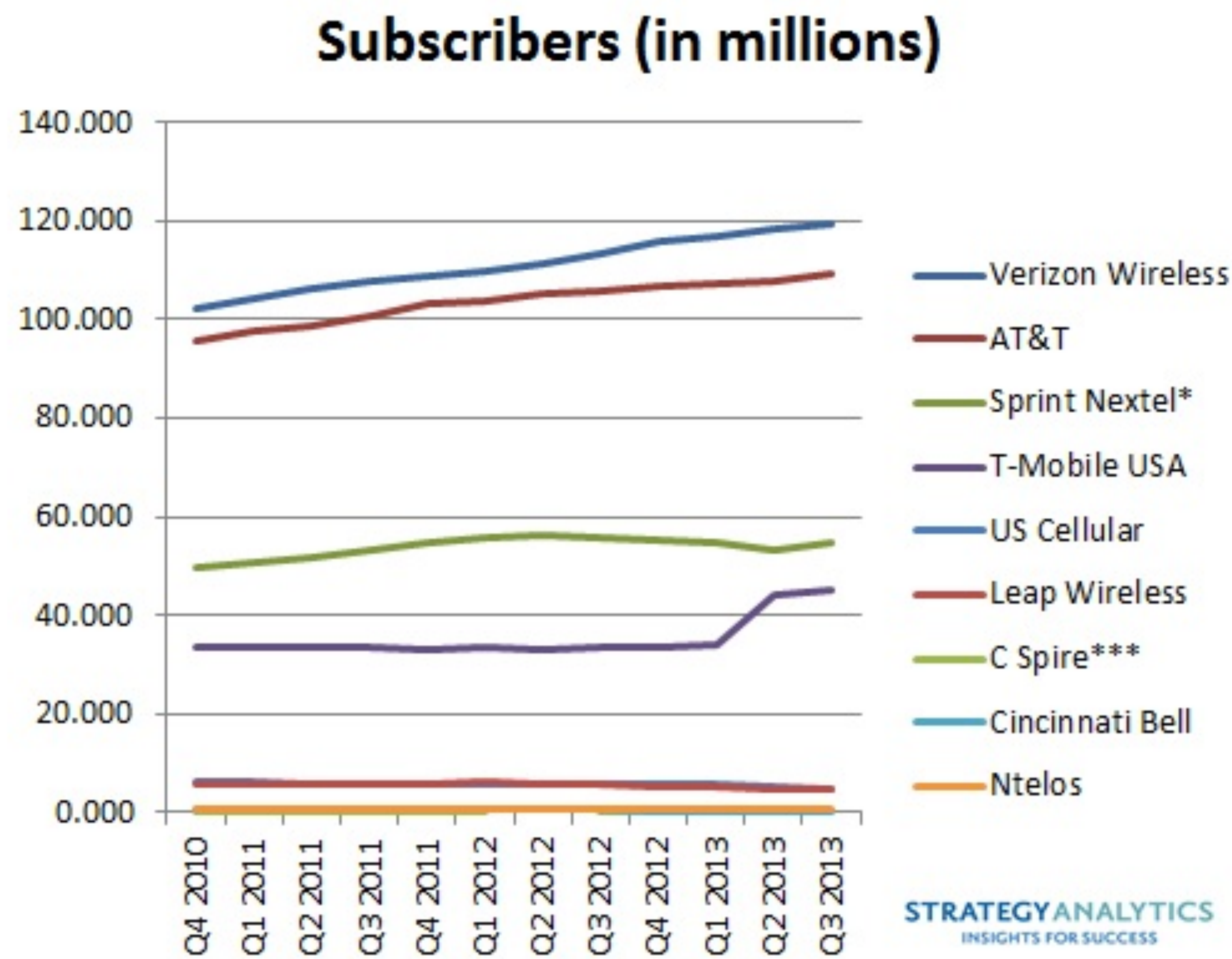
[24] Ibid.

Exhibit 1

Top US Wireless Carrier Metrics Q3 2013 (ranking by subscribers, retail + wholesale) STRATEGY ANALYTICS INSIGHTS FOR SUCCESS							
	Carrier	Subscribers (millions)	Net Adds (millions)	Churn (Avg Monthly)	Data % of Service Revenue	ARPU
1	Verizon Wireless*	119.450	1.291	1.28%	48.8%	$55.57
2	AT&T	109.460	0.989	1.31%	47.4%	$47.49
3	Sprint**	54.572	-0.317	2.71%	n/a	$51.50
4	T-Mobile US	45.039	1.023	3.10%	42.0%	$45.38
5	U.S. Cellular	4.875	-0.093	2.22%	n/a	$58.36
6	Leap Wireless	4.643	-0.196	4.00%	n/a	$45.45
7	C Spire***					
8	Ntelos	0.457	0.002	3.1%	41.2%	$54.29
9	Cincinnati Bell	0.355	-0.015	3.93%	40.1%	$41.41

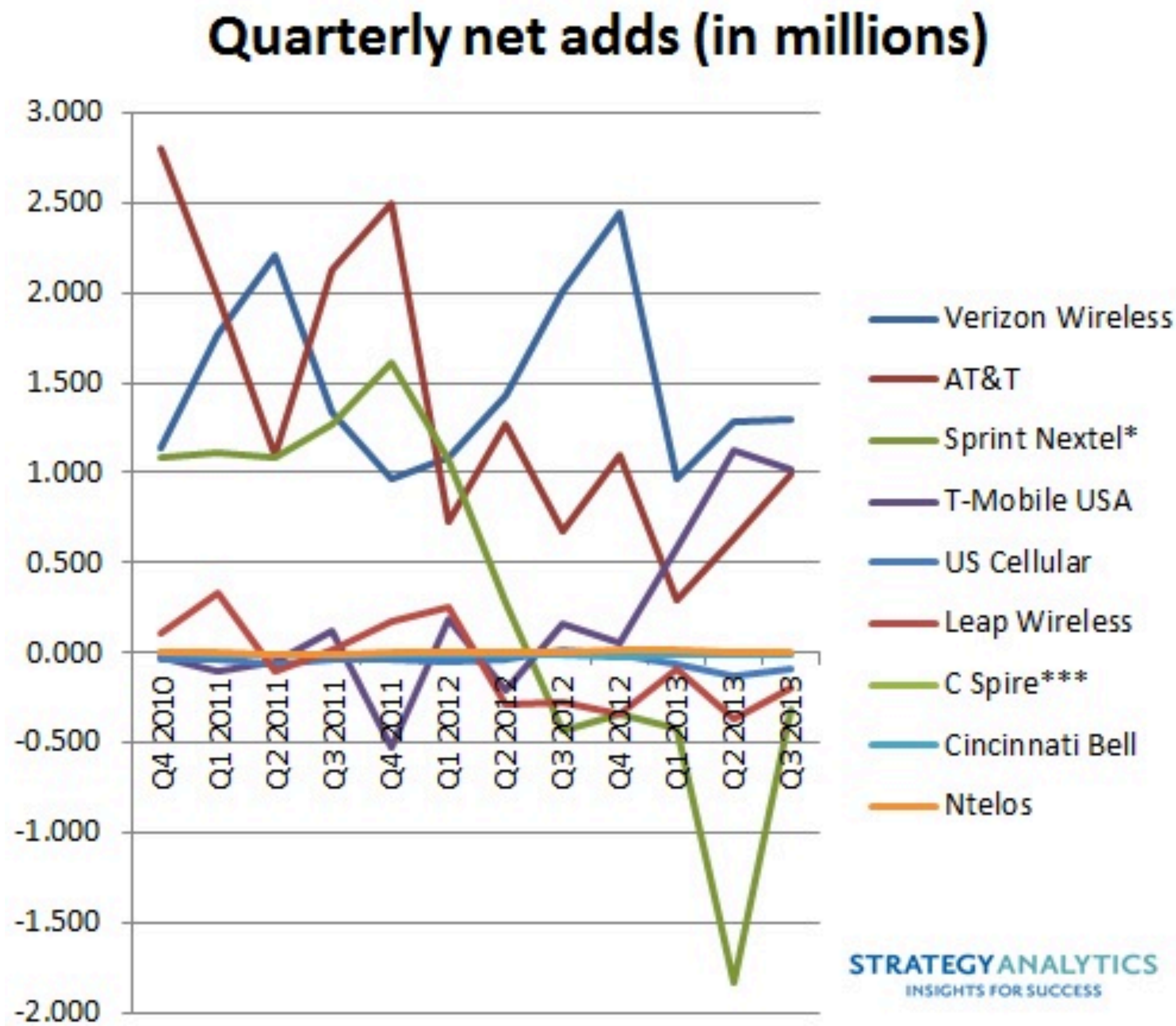
Source: “Grading the top U.S. wireless carriers in the third quarter of 2013,” FierceWireless, November 18, 2013.

Exhibit 2



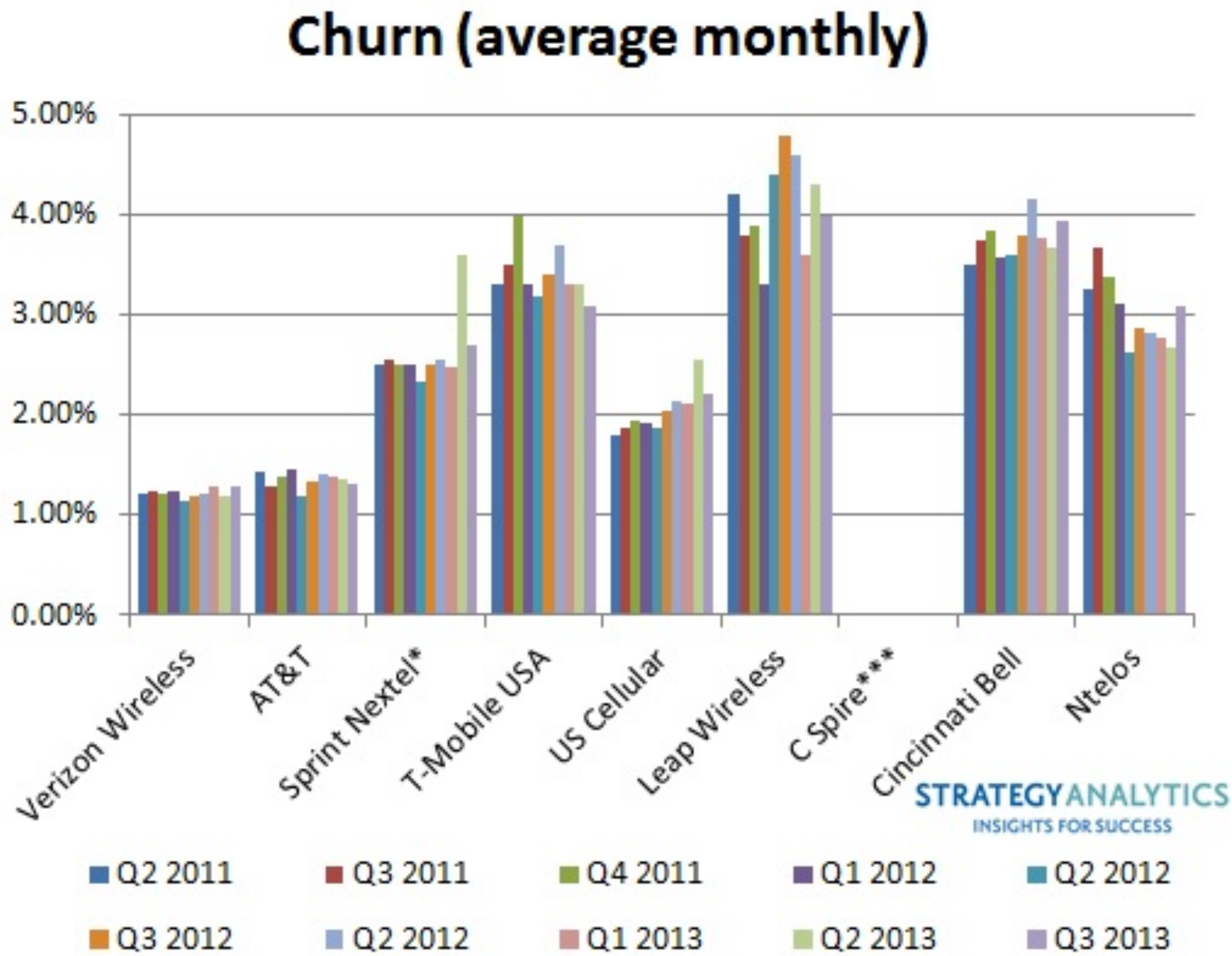
Source: "Grading the top U.S. wireless carriers in the third quarter of 2013," FierceWireless, November 18, 2013.

Exhibit 3



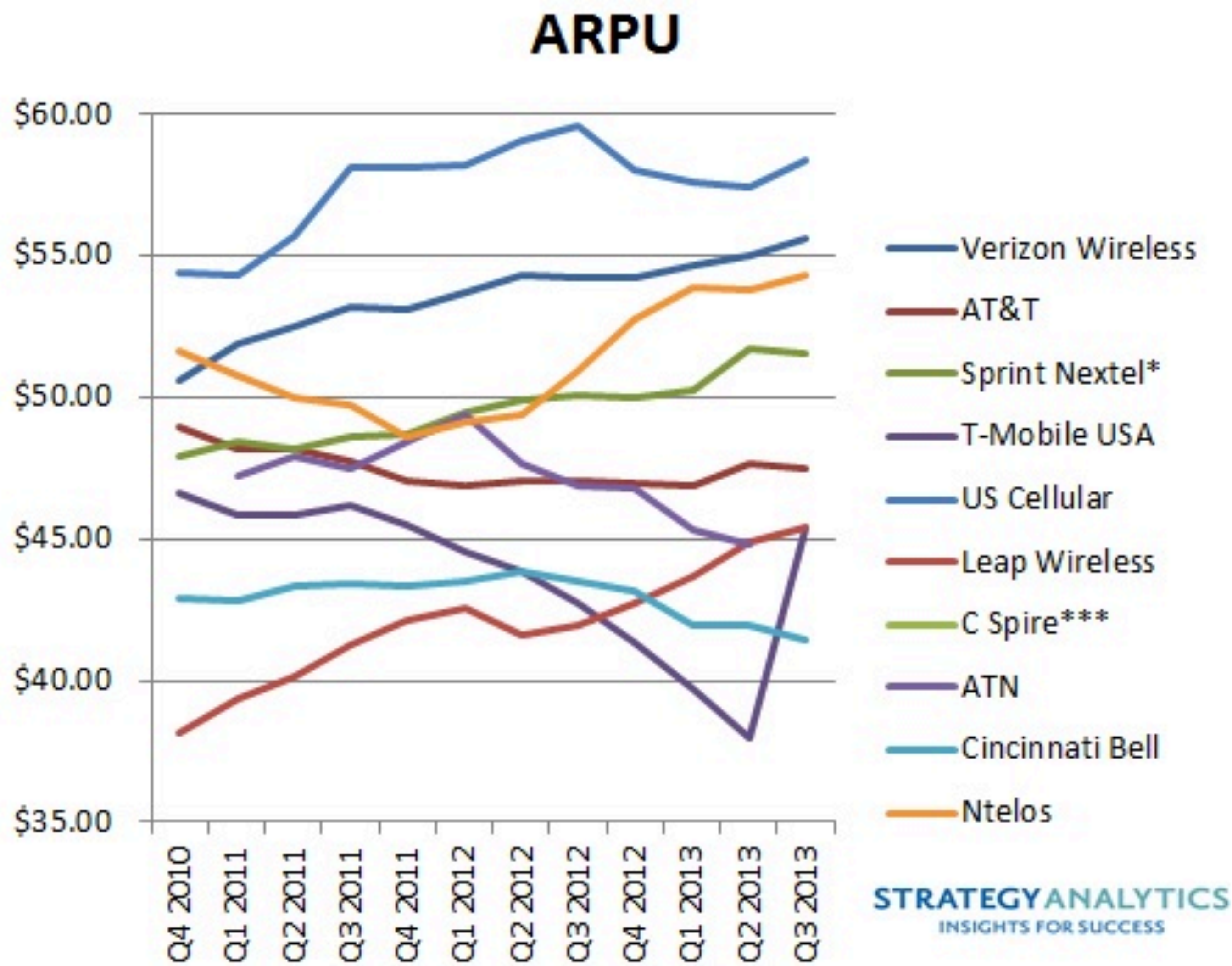
Source: "Grading the top U.S. wireless carriers in the third quarter of 2013," FierceWireless, November 18, 2013.

Exhibit 4



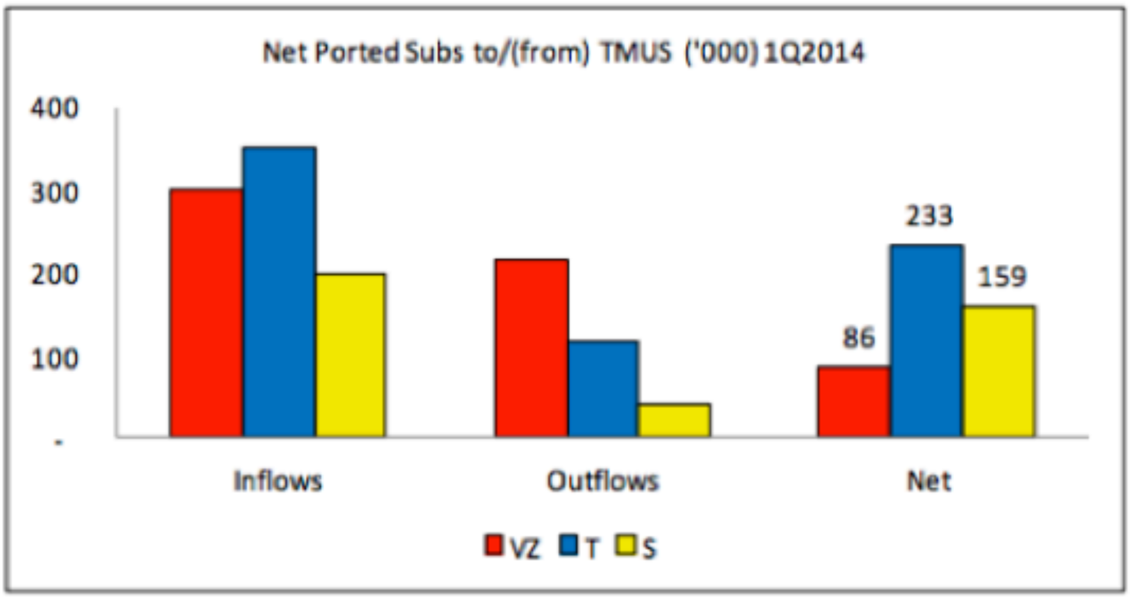
Source: “Grading the top U.S. wireless carriers in the third quarter of 2013,” FierceWireless, November 18, 2013.

Exhibit 5



Source: "Grading the top U.S. wireless carriers in the third quarter of 2013," FierceWireless, November 18, 2013.

Exhibit 6



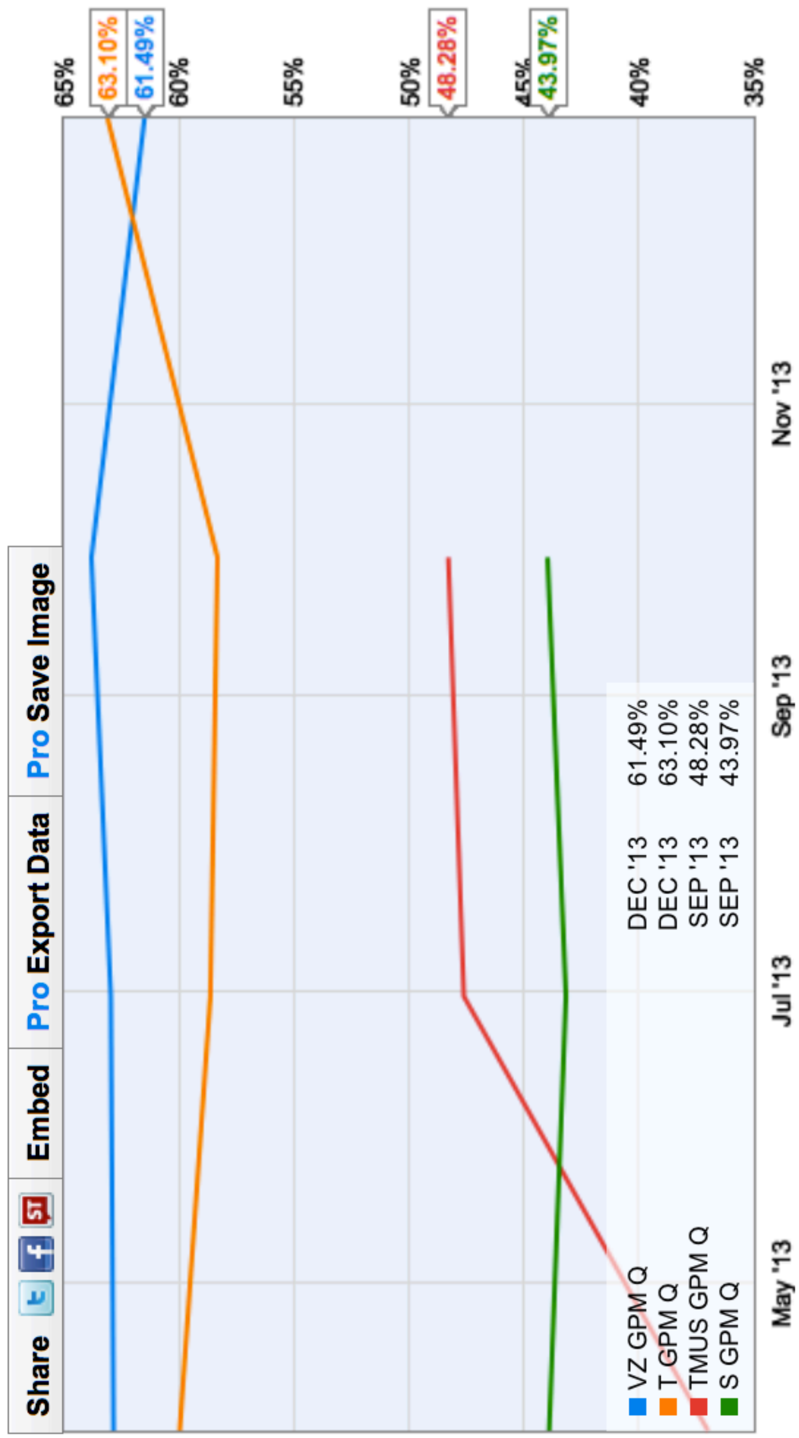
Source: Company data, Macquarie Capital (USA), January 2014

Source: John McDuling, "Verizon just hinted that a full blown price war in wireless might soon be upon us," Quartz January 21, 2014.

Exhibit 7

Gross Profit Margins By Quarter

Verizon (VZ), AT&T (T), T-Mobile (TMUS), Sprint (S)



Source: YCharts, January 30, 2014, 06:32AM ET