AT&T's iPhone dilemma

Peter Burrows

If Apple widens the circle of iPhone carriers beyond AT&T, those new partners will grab a highly profitable slice of customers.

To some, AT&T's agreement to sell iPhones seemed ill-advised at first. Apple (AAPL) CEO Steve Jobs set some exacting demands in exchange for granting AT&T the sole U.S. rights to the iPhone. U.S. carriers had always maintained nearly complete control over the devices on their networks. But Jobs wouldn't even let Ma Bell affix its logo to the handset. He also insisted AT&T (T) surrender a hefty chunk of the monthly service fees it would collect and only Apple could decide what software would be used on the device. In exchange, AT&T got a multiyear deal to be the exclusive network to carry the device.

So far, that bet looks brilliant. Since the first iPhone came to market in mid-2007, AT&T has signed up more than 7 million subscribers who wanted the device—more than 40% of them from other networks. In the quarter ended on Mar. 30, roughly 70% of AT&T's new wireless subscribers signed up to get an iPhone. And while AT&T's rivals sling high-end devices from Research In Motion (RIMM), Nokia (NOK), and others, none has approached the allure of the iPhone. "It's the only one that has made people say, 'I'm willing to change networks for that,'" concedes David Owens, a marketing executive at Sprint Nextel (S).

But now AT&T is having to contemplate life without that iPhone exclusive—and it's bound to be a difficult adjustment. Should Apple widen the circle of iPhone carriers, those new partners will take a slice of iPhone customers, who are not only numerous but highly profitable; they pay an average of $85 in wireless charges per month, roughly double the average. Also, AT&T will no longer be able to lean on Apple's marketing muscle, and it will have to face the long-term impact of ceding so much authority—and brand equity—to Apple. With every iPhone it sells, AT&T becomes known that much more as Apple's partner. "AT&T made a devil's bargain with Apple" that brought short-term gains and long-term problems, says one high-ranking telecommunications executive.

Apple needs broader reach

In the short run, AT&T could still negotiate another exclusive. That's because Verizon Wireless and Sprint Nextel, the next-largest carriers, use a cellular technology called CDMA that will likely be phased out by 2012. "CDMA is a dead technology," says UBS telecom analyst John Hodulik. More likely, Apple would wait to create a phone around the so-called LTE (Long Term Evolution) next-generation cellular standard that AT&T and Verizon Wireless both plan to support. Many analysts say the Verizon Wireless LTE network won't be ready for widespread use until 2012.

Still, AT&T's reliance on the iPhone puts Apple in an excellent negotiating position. Already, AT&T covers roughly $400 of the $600 or so that Apple receives for each iPhone, which customers buy for $200 or $300, says Avian Securities analyst Mark Thornton. While AT&T earns this subsidy back through two-year contracts, the up-front payments can be tough to swallow. And AT&T has no other exclusives that could approach the iPhone's success. It aggressively promotes devices such as RIM's BlackBerry and recently began selling Nokia's e71x, a huge seller in Europe, but others offer comparable devices, too. Sprint, meantime, has the exclusive on the one device that might invite iPhone comparisons: Palm's (PALM) Pre, expected to hit shelves in June.

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