

TESTING THE "WATERBED" EFFECT IN MOBILE TELEPHONY

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Abstract

This paper examines the impact of regulatory intervention to cut termination rates of calls from fixed lines to mobile phones. Under quite general conditions of competition, theory suggests that lower termination charges will result in higher prices for mobile subscribers, a phenomenon known as the "waterbed" effect. The waterbed effect has long been hypothesized as a feature of many two-sided markets and especially the mobile telephony industry. Using a uniquely constructed panel of mobile operators' prices and profit margins across more than twenty countries over six years, we document empirically the existence and magnitude of this effect. Our results suggest that although regulation reduced termination rates by about 10%, this also led to a 5% increase in mobile retail prices. We also provide evidence that both competition and market saturation, and most importantly their interaction, affect the overall impact of the waterbed effect on prices. (JEL: D12, D43, L5, L96, L98)