Economic and Business Dimensions

Is the Internet a Maturing Market?

If so, what does that imply?

Two concerns dominate the current debates over U.S. Internet policy. The first is the relatively low level of U.S. broadband adoption. Although the U.S. once ranked 4th among industrialized nations in the percentage of residents subscribing to broadband, it has currently slipped into 15th place. Concerns that the U.S. may be losing its leadership position in this key industry have spurred a series of governmental initiatives to address the problem. The stimulus package enacted during the initial days of the Obama administration dedicated $7.2 billion for new investments in broadband infrastructure. It also required the Federal Communications Commission to prepare a national broadband plan, which the agency released to much fanfare this past March. The plan is designed not just to ensure that broadband is available and affordable to all Americans, but also to devise ways to address the fact that a surprising number of households are not subscribing to broadband even when it is available.

The second is the debate over network neutrality. Network providers are experimenting with a variety of new business arrangements. Some are offering specialized services that guarantee higher levels of quality of service to those willing to pay for it. Others are entering into strategic partnerships that allocate more bandwidth to certain sources and applications. Interestingly, management literature exists suggesting that both developments may simply reflect the ways the nature of competition and innovation can be expected to evolve as markets mature. If applicable to the Internet, this literature has the potential to provide new insights into how to craft broadband policy and what steps business managers might take to prepare for the future.

Demand-Side Considerations: Product Life Cycle Theory

The best-known theory of market maturation is known as the product life cycle. A central feature of every leading marketing textbook, product life cycle theory examines how the pattern of demand growth affects the nature of competition over time. Empirical research has confirmed that many, if not most, markets follow the pattern predicted by product life cycle theory.

The predominant version posits that new product markets pass through four distinct stages shown in the prod-

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uct life cycle figure here. During the introduction stage, the product’s novelty dictates that sales are small and grow relatively slowly. If a market for the new product develops, this initial stage gives way to the growth stage, during which sales grow rapidly. Over time, market saturation causes the product to enter the maturity stage, during which sales growth flattens. Eventually, the product enters the decline stage, as technologically superior substitutes emerge. The nature of competition changes as the market advances from one stage to the next.

Internet usage over the last two decades fits comfortably into this pattern. During the introduction stage of the broadband Internet during the mid-to-late 1990s firms focused on inducing early adopters to try the product, as the theory predicts. Early adopters tend to be technologically sophisticated, risk tolerant, and price insensitive, which describes the typical Internet user circa 15 years ago. This focus in turn caused firms to emphasize cutting-edge technological features and to deemphasize product quality and price, once again, as theory predicts.

As the market transitioned into the growth phase, firms began to target the mass market and to compete to attract new customers who are not yet being served. Price and quality took on greater importance. In order to keep production processes simple and to make the product easy for customers to understand, firms typically offered a single product designed to appeal to the broadest possible audience.

After enjoying an extended period of rapid growth, there are some indications that the market is on the cusp of entering the maturity phase. U.S. Internet penetration has leveled off at approximately 75%. When one focuses solely on broadband, data collected by the FCC suggests that the growth curve has passed the inflection point marking the transition from growth to maturity. As the market enters the maturity phase, revenue growth no longer depends on attracting customers who are not yet in the market. Instead, firms focus on finding ways to deliver greater value to customers who are already in the market.

According to this theory, there is nothing surprising about the prevalence of offering a more complex array of services and price points. These firms are trying to increase revenue in their primary market and set themselves up to offer new services that generate more revenue. That also explains why industry leaders such as Yahoo, Google, Apple, and Microsoft are becoming more aggressive about invading territory traditionally controlled by other leading firms. It is a natural outgrowth of maturity and the natural increase in rivalry that results when firms compete in a market that is no longer growing as fast as it once did.

Supply-Side Considerations: Dominant Design Theory

A parallel line of research in this framework explores the supply-side of market maturation. Called dominant
design theory, it posits that when a technological breakthrough first occurs, uncertainty fosters lack of product standardization, which provides little incentive to invest in advanced production processes. At some point the basic product features and technological characteristics coalesce into a dominant design. Innovation becomes less driven by trial and error and instead becomes more systematic and incremental. Other scholars have extended this analysis, suggesting that technological guideposts or paradigms emerge that direct research along particular avenues or trajectories. These technological trajectories frame the way each field determines which problems are worth solving and which technological solutions are likely to be the most promising. This impetus toward certain trajectories becomes more pronounced if a technology is embedded in a web of interdependent technological processes. The presence of such a design hierarchy establishes a technical agenda that channels subsequent innovation along particular lines. It also obstructs innovations that are inconsistent with the existing architecture and can delay or prevent new architectures from evolving.

What does that have to do with the Internet? A growing number of technologists have noted the core architecture of the Internet, built around TCP/IP and its many extensions, is several decades old. They suggest the new demands being placed on the network are creating the need for fundamentally different design architecture. And as this theory would predict, they are finding that the standardization on a certain approach combined with the interconnected nature of the technologies comprising the architecture is limiting the Internet’s ability to evolve to meet these new demands.

**Significance for Internet Policy and Business Strategies**

The implications are myriad. The transformation of the Internet from an experimental testbed into a mass-market platform has made major architectural change more difficult, just as design hierarchy theory would predict. The flattening of revenue growth inevitably gives network providers incentive to experiment with increasingly specialized equipment, both to lower costs and to offer services targeted at particular subgroups of customers, just as product life cycle theory would predict. The desire to provide greater value to customers is creating greater interest in facilitating content providers’ long-standing interest in monetizing content streams. At the same time, market maturation is causing firms to place greater emphasis on capturing a bigger fraction of the dollars that are available.

This theory also suggests that policymakers should be careful not to lock the Internet into any particular architecture or to reflexively regard deviations from the status quo as inherently anticompetitive. Such measures would reinforce the obstacles to architectural innovation that already exist. Instead, they should focus on creating regulatory structures that preserve industry participants’ freedom to experiment with new solutions and to adapt to changing market conditions. Any other approach risks precluding the industry from following its natural evolutionary path and rendering the obstacles to architectural innovation that already exist all but insuperable.

Applying market maturation theory to the Internet comes with a number of limitations. Although the pattern of sales growth predicted by product life cycle theory is the most common, empirical research indicates that other patterns exist as well, which leads some to question the theory’s generalizability. Others condemn these theories as self-fulfilling prophecies, as their widespread acceptance leads firms to manage their products in ways that cause these patterns to come true. Moreover, while key turning points are easy to identify in retrospect, they have proven quite challenging to anticipate far in advance.

Even if it is not always possible to anticipate precisely how the nature of competition and innovation will change, that both will change over time is a given. The real question is not if the nature of competition and innovation will change, but rather how and when. Business managers and IT professionals must not take for granted that the competitive dynamics and the technology underlying the industry today will still be in place tomorrow. Instead, they should look for indications that the market may be reaching saturation and plan for how their strategy and those of their customers and competitors are likely to change as these phase transformations occur.

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