DOES APPLYING MERGER CONTROL ANALYSIS GIVE SOME USEFUL INSIGHTS INTO THE 'LEGAL SEPARATION' OF BT AND OPENREACH PROPOSED BY OFCOM

This article examines Ofcom's plans to partly separate BT Group from its internet and infrastructure subsidiary Openreach. It asks whether such a partial separation goes far enough to address what Ofcom believes to be a lack of incentives on Openreach to invest in, develop and operate the UK's fibre broadband network. The article considers what insights can be gained from merger control analysis on the nature and quality of corporate control into the legal separation being put forward by Ofcom and whether Ofcom's proposal is an effective solution to the competition concerns that it has raised.

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RESOURCE INFORMATION

RESOURCE ID

w-004-8339

RESOURCE TYPE

Article

PUBLISHING DATE

6 December 2016

JURISDICTION

United Kingdom

Ofcom has announced that it will notify the European Commission of its plans to partly separate BT Group from its internet and infrastructure subsidiary Openreach. The proposals stop short of the full separation that is being urged by some of BT's competitors and consumers.

National regulatory authorities including Ofcom must conduct a consultation on their proposed regulatory measures. The European Commission directorate general for communications DG Connect can recommend that they amend or even withdraw the planned measures. Ofcom believes that an overhaul of the relationship between BT Group and Openreach would bring greater regulatory certainty and that, once it is independent from BT, Openreach would be better placed to invest in broadband infrastructure.

Ofcom's *July 2016 statement*, announcing its proposed model for reform of the arrangements governing Openreach's independence, had said that Openreach would become a separate company from BT with an independent board. Ofcom's *latest statement*, of 29 November 2016, maintains the position that a full structural separation could entail materially greater costs and risks than a partial one and could affect BT's pension scheme. This is therefore not being pursued by Ofcom at present.

More fundamentally, the proposals raise a question about what can be achieved through a partial separation to address what Ofcom believes to be a lack of incentives on Openreach to invest in, develop and operate the UK's fibre broadband network including in the interests of the wider telecoms industry as well as end users. If, ultimately, Ofcom's goal is to reduce but not completely remove the control and/ or influence that BT Group currently has over Openreach's activities it may be asked whether Ofcom's proposal goes far enough. Putting it another way, does the post-separation structure provide the optimum environment to promote investment that is in the interests of consumers, while ensuring that competitors who depend on Openreach's network can secure access on fair terms?

This article considers what insights can be gained from merger control analysis on the nature and quality of corporate control into the legal separation being put forward by Ofcom and whether Ofcom's proposal is an effective solution to the competition concerns that it has raised.

APPLICATION OF THE EU MERGER REGULATION TO CONCENTRATIONS THAT HAVE A UNION DIMENSION

The EU Merger Regulation applies to 'concentrations' (typically mergers or acquisitions) that have a Union Dimension. (The test for whether there is a 'Union Dimension' is based on turnover - in very broad terms the Regulation only applies to very large concentrations with an EU cross-border dimension.)

A concentration shall be deemed to arise where a change of control on a lasting basis results from:

- The merger of two or more previously independent under-takings or parts of undertakings; or
- The acquisition, by one or more persons already controlling at least one undertaking, or by one or more undertakings, whether by purchase of securities or assets, by contract or by any other means, of direct or indirect control of the whole or parts of one or more other undertakings. (Article 3(1), EU Merger Regulation).

A concentration will also arise where there is a durable **change in the quality or nature of control** of an undertaking. Thus, for example, there will be a concentration where a party with joint control of an undertaking moves to a position of sole control.

Similarly, there may be a concentration as a result of changes in the number of shareholders that jointly control a Joint Venture (JV) undertaking following the withdrawal or entry of one or more controlling shareholders.

The establishment of a JV undertaking will give rise to a concentration where the following conditions are met:

- **Joint control:** Two or more parents must together exercise decisive influence over the JV undertaking, (for example through rights of veto over strategic matters such as the adoption of annual budgets or the appointment of senior management).
- **Autonomy:** The JV must have sufficient personnel, facilities and resources to enable it to perform the functions normally carried out by other undertakings operating on the same market.
- **Durability:** The JV must be established on a "lasting basis".

APPLICATION OF UK MERGER CONTROL TO A RELEVANT MERGER SITUATION UNDER THE ENTERPRISE ACT 2002 (EA2002) AS AMENDED BY THE ENTERPRISE AND REGULATORY REFORM ACT 2013

UK merger control will be triggered where a "relevant merger situation" has been created or arrangements are in progress or in contemplation which will result in a relevant merger situation if they are carried into effect. The relevant thresholds are triggered where either:

- A target company's UK turnover exceeds GB£70 million; or
- The transaction results in the creation of, or increase in, a 25% or more combined share of sales or purchases in (or in a substantial part of) the UK, of goods or services of a particular description ("share of supply test").

Unlike the situation under EU merger control, notification is voluntary and there is no requirement to notify the Competition and Markets Authority (CMA) of a relevant merger situation. However, if a transaction meets the jurisdictional thresholds and the parties do not notify, the CMA can open an investigation on its own initiative. If a transaction raises substantive competition issues a decision not to notify carries the risk that the CMA will adopt interim orders preventing any further action that may prejudice or impede its investigation.

A relevant merger situation arises when two or more enterprises cease to be distinct, or will cease to be distinct, as a result of being brought under common ownership or control (*section 26, EA2002*).

Section 26(3) of EA2002 provides that the CMA may treat material influence (and indeed 'de facto' control) as equivalent to 'control', for the purposes of establishing whether enterprises have been 'brought under common ownership or control'. A stepping up in the quality of control such as a change from material influence to de facto control or legal control, or from de facto control to legal control, can constitute a new relevant merger situation.

The term 'enterprise' is defined in section 129 of EA2002 as the activities, or part of the activities, of a business. Given the wide definition of an enterprise in section 129, compared to that of a full function JV in Article 3 of the EU Merger Regulation, a joint venture may qualify as a relevant merger situation in the UK in circumstances where it does not qualify as a concentration under the EU Merger Regulation. In the case of a 'start-up' joint venture, the question under the EA2002 will be whether the activities transferred to the joint venture by one or more parents (or acquired from a third party) are sufficient to constitute an enterprise (*Mergers: Guidance on the CMA's jurisdiction and procedure, CMA2, page16, footnote 25*).

OFCOM'S MODEL OF LEGAL SEPARATION

If Ofcom was proposing divestment to a new owner, that could give rise to a concentration or merger situation in the form of an acquisition of sole or joint control by the new owner(s), depending on whether the relevant EU or UK domestic turnover (and in the case of the UK the alternative share of supply) thresholds are triggered. However, what Ofcom is proposing is legal separation, but ***not*** a formal 'divestment' to a new owner.

"Ofcom's proposed model, announced on 29 November, 2016, is for:

- **Openreach to become a distinct company.** Openreach should be a legally separate company within BT Group, with its own 'Articles of Association'. Openreach - and its directors - would be required to make decisions in the interests of all Openreach's customers, and to promote the success of the company.
- **Openreach to have its own Board.** The new Board should have a majority of non-executive directors, including the Chair. These non-executives should not be affiliated to BT Group in any way, but would be both appointed and removed by BT in consultation with Ofcom.
- **Executives accountable to the new Board.** Openreach's Chief Executive should be appointed by, and accountable to, the Openreach Board - not BT Group. The Chief Executive would then be responsible for other executive appointments. There should be no direct lines of reporting from Openreach executives to BT Group, unless agreed by exception with Ofcom.
- **Greater consultation with customers.** Openreach would be obliged to consult formally with customers such as Sky and TalkTalk on large-scale investments. There should be a 'confidential' phase during which customers can discuss ideas without this being disclosed to BT Group.
- **Staff to work for Openreach.** Ofcom's principle for the new model is that people who work for Openreach should be employees of the new company, rather than BT Group. This would prevent any real or perceived conflict of interest, and allow Openreach to develop its own distinct organisational culture.
- **Openreach to own assets that it already controls.** Openreach should own its physical network. This would allow the Openreach Board to make decisions that depend on investing in, and looking after, Openreach's assets. There may be costs in transferring assets or people to Openreach, which would need to be mitigated.
- **A separate strategy and control over budget allocation.** Openreach should develop its own strategy and annual operating plans, within an overall budget set by BT Group.
- **Independent branding.** Openreach should have its own brand, not affiliated with BT Group, to help embed the organisational culture of a distinct company".

"This model would provide Openreach with the greatest degree of independence from BT Group that is possible without incurring the costs and disruption - to industry and consumers - associated with separating the companies entirely".

"It is designed to ensure that Openreach acts more independently from BT Group, and takes decisions for the good of the wider telecoms industry and its customers. If it cannot achieve this, Ofcom will reconsider whether BT and Openreach should be split into two entirely separate companies, under different ownership". (Source: *Plans to make digital communications work for everyone, ofcom.org.uk, 26 July, 2016*.)

ANALYSIS OF OFCOM'S LEGAL SEPARATION MODEL UNDER MERGER CONTROL PRINCIPLES

Although there are some similarities in the jurisdictional tests under the EU Merger Regulation and under UK merger control, this article considers them separately.

The 'change of control' criteria should be considered more carefully whether the relevant criteria is "decisive influence" (EU Merger Regulation) or "material influence" (EA2002).

At the outset it should be noted that, given the domestic focus of Openreach's activities, in the absence of the introduction of a new shareholder(s) with significant EU operations it is unlikely that the EU merger control turnover thresholds would be met. However, it is useful to consider how a structural separation of the type planned by Ofcom would be treated for EU merger control purposes when compared with UK merger control, in particular in terms of the nature and quality of control that would need to be satisfied to trigger merger control jurisdiction.

ANALYSIS OF OFCOM'S SEPARATION MODEL UNDER THE EU MERGER REGULATION

It appears that there are at least two main possibilities in terms of how the proposed arrangements could be treated from a control perspective:

- **Option 1**: A change in sole control (decisive influence) currently exercised by BT to control by (an)other undertaking(s).
- **Option 2**: A shift from sole (BT) to joint control with (an)other undertaking(s) in the form of the creation of a new, jointly controlled, full function JV.

> "Ofcom's current view
>
> "Our current view is still that an effective and robust form of legal separation, ***with Openreach as a wholly-owned subsidiary of BT***, is likely to achieve the greatest improvements for everyone in the shortest amount of time. Therefore, this is the approach with which we are minded to proceed". (Source: *Update on plans to reform Openreach (29/11/16), ofcom.org.uk, 4 October 2016*.)"

Ofcom states:

However, the fact that all the shares will be owned by BT does not appear to be determinative in the context of the proposed operation, because the shareholding will not apparently confer 'decisive influence' over (Future) Openreach.

Article 3(2) of the Merger Regulation, provides:

> "Control shall be constituted by rights, contracts or any other means which, either separately or in combination and having regard to the considerations of fact or law involved, confer the possibility of exercising decisive influence on an undertaking", in particular by:
>
> Ownership or the right to use all or part of the assets of an undertaking.
>
> Rights or contracts which confer decisive influence on the composition, voting or decisions of the organs of an undertaking."

In the present case, the four criteria mentioned by Ofcom that will affect decisive influence are:

- **Element 1:** Openreach to become a distinct company – "Openreach should be a legally separate company within BT Group, with its own 'Articles of Association".

- **Element 2:** Openreach to have its own Board – "The new Board should have **a majority of non-executive directors, including the Chair**. These non-executives should not be affiliated to BT Group in any way, but would be both appointed and removed by BT in consultation with Ofcom. (Emphasis added.)

- **Element 3: Openreach's Chief Executive should be appointed by, and accountable to, the Openreach Board** - not BT Group. The Chief Executive would then be responsible for other executive appointments. There should be no direct lines of reporting from Openreach executives to BT Group, **unless agreed by exception with Ofcom**. (Emphasis added.)

- **Element 4:** Openreach to own assets that it already controls. Openreach should own its physical network. **This would allow the Openreach Board to make decisions that depend on investing in, and looking after, Openreach's assets.** (Emphasis added.)

As regards the criteria of 'decisive influence', element 1 seems not to add anything to the situation of an ordinary wholly owned subsidiary. On the other hand the combination of elements 2, 3, and 4 are seemingly intended (**whether they would in practice have that effect or not**) to create, contractually and/or by regulatory decision, an independent company within the BT Group which would have an autonomous power to use the assets of the (Future) Openreach. Decisive influence over the entity would appear to be exercised by a combination of BT, Ofcom, and the (Future) Openreach Board.

A valid conclusion appears to be that no one single undertaking would have decisive influence over a (Future) Openreach ruling out Option 1 (change in sole control) above.

As to Option 2 (creation of a full function JV), arguably the wide powers given to Ofcom in section 1 of the 2003 Communications Act (CA2003) mean that it could conceivably act as an 'undertaking' (an economic entity carrying on activities of an economic nature) in certain circumstances. However, in the present case, irrespective of turnover, it seems plain that Ofcom is acting in its statutory regulatory capacity under section 3(1) of CA2003, which sets out its principal duty:

- To further the interests of citizens in relation to communications matters.

- To further the interests of consumers in relevant markets, where appropriate by promoting competition.

This appears to rule out a conclusion that a (Future) Openreach could be treated as a full function JV between BT and Ofcom.

Similarly, an analysis in terms of a jointly controlled full function JV between BT and the Board is fraught with difficulty even before considering whether there can be attributed to the Board relevant turnover for EU merger control jurisdictional purposes. The majority of the Board including the Chair of (Future) Openreach are to be non-executive directors. That necessarily implies that they will be natural rather than legal persons. It is not known whether the individual members will have control over other economic activities meaning that they might qualify as relevant undertakings in their own right. They are to be appointed and removed by BT **in consultation with Ofcom**. Presumably what that means is that BT will propose - but Ofcom can object - to each particular appointment.

The (Future) Openreach CEO is to be appointed by the Board not by BT and he or she is to '**be responsible for**' other executive appointments. Presumably the purpose is to make the CEO appointment (and removal) one step removed from BT because BT will 'appoint the appointers' of the CEO, in consultation with Ofcom. The Board will clearly have an important role in determining the future commercial strategy of Openreach. However, it is not yet plain from Ofcom's proposal just who will have veto rights over strategic commercial decisions that is the hallmark of decisive influence and whether that party will be a relevant undertaking for EU merger control purposes.

That might appear to be the (not so illuminating) end of the analysis, namely that no undertaking(s) will have decisive influence post-separation over (Future) Openreach. But it does beg the question of what sort of legal or commercial animal (Future) Openreach will be and whether there are 'change of control': (...) "rights, contracts or

any other means which, either separately or in combination and having regard to the considerations of fact or law involved, confer the possibility of exercising decisive influence on [that] undertaking".

ANALYSIS OF OFCOM'S SEPARATION MODEL UNDER UK MERGER CONTROL

A key difference in the UK and EU merger control jurisdictional tests is that for UK mergers the relevant control test includes **material** influence which is a lower level of influence than that applicable for EU mergers – where (as discussed above) the test is **decisive** influence.

For present purposes, this article focuses only on the question of whether under Ofcom's proposals there would be a relevant change in the quality of control that would give rise to a relevant merger situation.

One potential analysis is that post-separation BT's level of influence would be reduced to material influence, namely an ability to materially influence another enterprise's policy. The concept can therefore clearly catch transactions that would not be caught by the EU Merger Regulation and can arise at relatively low levels of shareholding, perhaps as low as 10 to 15%. Other factors such as board representation, industry standing and contractual relationships between the enterprises involved may also be relevant. *The Court of Appeal has upheld* a finding that BSkyB's acquisition of a 17.9% stake in ITV gave rise to material influence in the circumstances of the case. Given BT Group's industry standing and historic links with Openreach it would be reasonable to assume that its influence over the latter would not disappear overnight. It is further noted that its shareholding will not be reduced.

As noted above, a stepping up in the quality of control such as a change from material influence to de facto control or legal control, or from de facto control to legal control, can constitute a new relevant merger situation. However, UK merger control does not bite on a reversal of this process (a stepping down in terms of the level of control) unless it results in a new merger situation where a new controller would have a relevant level of control over Openreach.

This analysis puts into sharp focus the concerns of competitors that, while the proposals may be a step in the right direction (by mitigating the incentives of Openreach to favour the interests of the wider BT Group in its investment strategy): yet it may not go far enough to prevent anti-competitive behaviour that hampers future optimal development of the UK's fibre network.

CONCLUSIONS

The above analysis raises questions about how effective the (Future) Openreach Board can be within the proposed structure:

- First, because it highlights the possibility of tensions between the CEO and executive team and the Chair and (majority) non-executive Board Members.

- Second, because the CEO will be responsible to, but may not consult, his shareholder BT (without Ofcom's say so.)

- Third, because (Future) Openreach looks potentially rudderless, BT may retain a measure of influence amounting to *material* influence but no combination of the rights, contracts or other means involved looks to clearly confer *decisive* influence over the company, on either the CEO and executive team, Ofcom, the Chair and/or the (majority) non-executives.

A further point that emerges from the analysis is the extent to which the appointment of the Chair will be absolutely crucial. Ultimately if Openreach is to own and administer the (crucial network) assets that it already controls it has to be critically examined whether the Ofcom proposals will deliver robust management of the company in the interests of consumers. Ofcom recognises:

> (...) "the critical role that digital communications play in people's lives, and the importance of the steps Ofcom is taking to deliver better telecoms services for people and businesses". (Source: *Update on plans to reform Openreach, ofcom.org.uk, 29 November 2016*.)

The authors of this article suggest that the concerns about the proposed structure mentioned above raise important questions about its potential effectiveness. At the same time, Ofcom remains prepared to consider structural separation in a second stage:

> "If Ofcom's monitoring suggests that legal separation is not delivering sufficient benefits for the wider telecoms industry and its customers, we will return to the question of structural separation - fully breaking up the companies". (Source: *Update on plans to reform Openreach, ofcom.org.uk, 29 November 2016*.)

Arguably, therefore, it may be better to bite the bullet now, rather than generate two sets of costs by arriving at separation as a solution to Ofcom's competition concerns in two stages:

- Stage 1: "In response to our consultation, BT told us that our proposed model [i.e. legal separation] would trigger ***substantial* costs**", (...).

- Stage 2: "Responses to our consultation also make clear that structural separation **could generate *materially greater costs* and risks** compared to models based on legal separation". (*Source: Update on plans to reform Openreach, ofcom.org.uk, 29 November 2016*.)

Or is this to misread the proposal by taking it at face value? Is Ofcom, perhaps, trying to make BT's life so uncomfortable that the (Future) Openreach shareholder will reach the independent conclusion that it should 'do a British Gas'. (It will be recalled that in 1997 British Gas plc split (demerged) to form three separate companies: Centrica plc, BG plc and Transco plc.)