EU telecoms consolidation

When Three is not enough

*by **Suzanne Rab****

The European Commission (Commission) decision to block the merger between CK Hutchison's Three and Telefónica UK's O2 mobile businesses was widely expected (M.7612). The transaction would have created the largest mobile network operator (MNO) in the UK by combining the second and the fourth players with influence over the totality of UK mobile network infrastructure. The prohibition bucks the trend of recent clearances of mobile mergers in other member states that have reduced the number of operators from four to three. This has led some commentators to suggest that it is indicative of a toughening in the Commission's stance towards in-market mobile mergers and may even be a death knell to similar deals in the future. While the Commission has flatly disclaimed that there is a magic number of operators needed to sustain healthy competition, the case provides a lens through which to examine some old and new trends in EU mobile mergers and the competition issues they present.

Consolidation in the mobile industry

It is worth taking a step back with a brief reflection on how EU telecommunications and mobile markets in particular have developed and the attitudes to them by the authorities. Readers already immersed in this evolving market and regulatory landscape may want to skip this section.

Consolidation in the EU telecommunications sector has been characterised by four broad development phases, which can be distinguished in terms of their economic drivers and the underlying competition and policy thought. The first phase was characterised by industry reshaping as a result of regulation and market liberalisation. As regards mobile, the UK was the first EU country to award GSM licences in 1989 with most others following in the 1990s. The licensing rounds in the EU resulted in between three and five MNOs in each member state by about 2000.

The second phase from about the late 1990s was characterised by rapid innovation across almost all communications markets and financial incentives to consolidate. Mobile markets experienced consolidation both domestically and cross-border. Geographic expansion was a feature of such notable acquisitions as Vodafone/Mannesmann (M.1795) and Deutsche Telekom/One2One (M.1669). Mobile operators also entered into joint ventures across other markets. Transactions such as Vivendi/Canal+/Seagram (M.2050) were reflective of the phenomenon of technological convergence which blurred product and service boundaries and the rigid distinctions between telephony, media content, internet and TV.

The 21st century saw yet a third phase of consolidation characterised by the quest for economies of scale as companies sought measures to reduce costs in the altered economic environment after the dotcom crash. Consolidation occurred between fixed and mobile operators to create scope for geographic and service differentiation (eg KPN/E-Plus (M.2726) and Telenor/Vodafone Sverige (M.4034)). These transactions tended to attract rather less regulatory concern, mainly due to the lack of material horizontal overlaps, although vertical issues were examined as well. The mobile sector also grew increasingly consolidated within member states, including Austria, Denmark, Finland, Germany, Italy, the Netherlands, Portugal and Sweden.

Since about 2010, a fourth phase of consolidation appears to be emerging but where the drivers of value creation are far less clear. Perhaps in recognition that the scope for further cross-border consolidation remains more limited, these transactions are focused on in-market combinations. Examples include T-Mobile/Orange (UK) (M.5650); Hutchison 3G Austria/Orange (Austria) (M.6497); Hutchison 3G UK/Telefónica (Ireland) (M.6992); and Telefónica/ E-Plus (Germany) (M.7018).

The regulatory reviews of these transactions suggested that in-market mergers would be tolerated provided that the parties would be prepared to offer both structural and behavioural remedies. For example, the Hutchison 3G UK/Telefónica Ireland merger combined the second and the fourth largest MNOs in Ireland with approximately 40% of the retail mobile market. The Commission found competition concerns in the retail mobile telecommunications market in Ireland, as well as in the Irish wholesale market for network access and call origination. Hutchison agreed to sell up to 30% of the merged company's network capacity to allow entry by two mobile virtual network operators (MVNO) and to divest five blocks of spectrum. It also committed to continue a network-sharing agreement on improved terms with Eircom. The Telefónica Deutschland/E-Plus merger raised similar concerns in relation to the German mobile markets. Telefónica agreed to sell up to 30% of the merged company's network capacity to up to three MVNOs in Germany, and to divest radio spectrum and certain assets. It also committed to extend its existing wholesale agreements and offer wholesale 4G services.

Enter Three and O2

Hutchison's proposed acquisition of Telefónica's O2 is representative of the fourth phase of industry consolidation focused on in-market consolidation, which is likely to attract greater regulatory scrutiny than cross-border mergers. When BT announced its plans to acquire EE in February 2015, it was not surprising that other operators would evaluate their position in the UK market.

The merger between Hutchison's Three and O2 was announced in March 2015. Whether this was a defensive move or not, the scale that the combination offered made sense for two mobile-only operators in a market increasingly characterised by multiplay offerings. The move was also consistent with Hutchison's growth across Europe in recent years, most notably with its acquisitions in both Austria and Ireland.

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The transaction would have created a new market leader with over 30 million customers and leaving only two MNOs, Vodafone and EE, as independent competitors. The Commission's competition concerns were threefold. First, it found that the merger would lead to less competition, higher prices and reduced choice and quality for consumers. The merged entity would have a 40% share of the mobile retail market. The Commission found that the merger would eliminate competition between two strong players. In particular, it saw that Three as the latest entrant would be lost as an important driver of competition.

Second, the Commission had concerns that the future development of UK mobile network infrastructure would be hampered. It found that a Three/O2 combination would have consolidated their interests in the two network-sharing arrangements owned, respectively, by Three and EE and Vodafone and O2. The Commission did not view this situation as healthy for competition as the merged entity would have had full visibility over the network plans of the two remaining competitors, EE and Vodafone. The Commission considered that having a foot in both network infrastructure camps risked the roll-out of next generation 5G technology to the detriment of UK consumers.

Third, the Commission raised concerns that the transaction would reduce the number of MNOs effectively willing to host MVNOs on their networks. Since MVNOs rely on access to infrastructure to provide services to their customers, the Commission was concerned that the reduction in the number of host networks would leave MVNOs in a weaker bargaining position in respect of wholesale access.

No magic number of mobile operators

The Commission has rejected any mantra that four mobile operators are needed to maintain a competitive market. There are already precedents for allowing consolidation from four to three players, most notably in the Commission's own decisions in the Hutchison transactions in Austria and Ireland noted above. National authorities have also given their consent to 4:3 transactions, for example KPN/Telfort (2005) in the Netherlands. Against these precedents and the Commission's desire to create a more cohesive approach to pan-European telecommunications regulation, it would have been hard to block the transaction outright purely on the basis that the move to three players in the UK was a step too far. However, the decision makes interesting reading when set against the conditions set by the UK communications regulator Ofcom that the 4G auctions were predicated on the basis that there would be four major networks. Perhaps the reconciliation lies in the fact that any such conditions were requirements at the time of the auctions and not fixed stipulations for the future.

No remedial solution

Hutchison offered a package of remedies but none of these were acceptable to the Commission. To address the Commission's first concern relating to loss of competition between Three and O2, Hutchison proposed measures that were designed to strengthen the development of existing and prospective MVNOs. These included granting network capacity to up to two MVNOs, divesting O2's interest in Tesco Mobile and offering a wholesale agreement for a share in Hutchison's network capacity to MVNO Virgin Mobile. To address the second concern relating to UK network sharing, Hutchison offered behavioural remedies including promises to invest to strengthen network coverage, reliability and data speeds. Finally, to address the effect of the merger on MVNOs, Hutchison offered measures aimed at granting MVNOs access to 4G and future technologies.

The measures aimed at supporting existing or future market entry of MVNOs were not deemed sufficient to counterbalance weakened wholesale and retail mobile market competition. A feature of these remedies was that the merged entity would retain its interests in the network-sharing agreements. The Commission rejected the concessions as falling short of effective solutions to the structural concerns raised by the consolidation of interests in the two and only UK network-sharing agreements. The Commission deemed the behavioural measures to be "commercially unattractive" to MVNOs and considered that they gave rise to significant uncertainty over their definition and problems with implementation and monitoring.

Remedial action in mergers involving mobile operators has tended to focus on structural remedies combined with behavioural remedies in pursuit of infrastructure, as opposed to service level competition. The remedies offered did contain structural elements in the form of the offer of a share in the network and divestment of the Tesco Mobile stake. Forcing the opening up of the network to MVNOs might also have provided opportunities for others including Sky (which was apparently interested in a perpetual share) to access the mobile market and to compete with BT and Vodafone. However, as a note of caution, it is worth noting that MVNOs come in many forms and while some are mass-market in their offering, others target narrower customer segments so do not offer such direct competition to the MNOs.

The remedies offered are arguably more extensive than those accepted in the Austrian, German and Ireland cases, which begs the question as to why they were not adequate to allay the competitive concerns that the Commission identified. However, the outcome is not entirely out of kilter with other cases. In the 2015 case TeliaSonera/ Telenor/ JV (M.7419), the parties were proposing to form a joint venture involving the second and third largest MNOs in the Danish market (a market with only two other MNOs) with a combined market share of 40%. The transaction was abandoned by the parties after they failed to offer remedies that fully addressed the Commission's concerns (in particular, the Commission was seeking the creation of a fourth competitor in the market).

The Commission's insistence on an MNO remedy merits a more detailed treatment. Hutchison apparently pursued this possibility but it appears that the lack of sufficient available spectrum meant that there were no takers. This returns to the feature of the UK mobile market where there are only two network-sharing arrangements and the merged entity would have been present in both. A debate could be had about the comparability of both networks and hence the risk that involvement in both would constrain strategic network development. However, even if the Commission could be satisfied that the risk of anticompetitive spillover effects could be overcome, this would not address its quandary over the need for an effective independent MNO with access to and the ability to control sufficient capacity.

Ultimately, the Commission concluded that the remedies offered would not have been able to avert the negative effect on prices, quality of service and innovation. There is an ongoing debate about whether prices in the mobile sector are the result of recent mergers that were blessed by the Commission. While some studies have shown price rises (for example, in Austria) the complexity of pricing in the mobile sector raises questions about the comparability of data across markets and packages.

The elusive search for efficiencies

The Commission rejected Hutchison's efficiency claims based mainly on the integration of the Three and O2 networks as uncertain to materialise. It found that such efficiencies would only manifest themselves years after the merger and may take longer to be achieved in full. In dismissing these efficiency claims, the Commission remains wedded to its focus on short-term price effects rather than embracing arguments based on dynamic efficiencies. In its horizontal merger guidelines (part VII), the Commission articulates its approach to efficiencies in merger review. The parties must establish that the efficiencies directly benefit consumers, that they are merger-specific, substantial, timely and verifiable and thereby counterbalance the adverse effects of the merger on competition.

The analysis of efficiencies in the Commission's assessment thus contrasts starkly with the US approach. The reluctant approach of the Commission, for example in comparison to that of the Federal Communications Commission (FCC), can be illustrated by the case of the mobile telephony market. While the Commission swiftly rejected any efficiency claims to be merger-specific, verifiable and timely in Three/O2 and in T-Mobile Austria/tele.ring (M.3916), the FCC has conducted an in-depth analysis by considering efficiencies leading to enhanced quality of services, operational efficiencies, lower marketing costs, billing costs and IT costs (eg Sprint Corp/Nextel Communications, FCC 05-63).

In the coming years, a key challenge for merger control review in the telecommunications sector will be to identify and appraise and balance a merger's potential for innovation leading to efficiencies and its potential harm. So far, the recognition of efficiencies as the basis for sanctioning an otherwise problematic merger has proved to be the holy grail of European merger control. In the current economic climate, it is perhaps understandable that merging parties would lay claim to such efficiencies to support a more moderated view of a merger between the larger players. It is also understandable that regulatory authorities will continue to want to be assured that such efficiencies are clearly substantiated by robust economic evidence and argument.

The wider policy and regulatory agenda

The licensing of mobile frequencies on national lines also partly explains why mobile mergers tend to be reviewed on the basis of national geographic markets. This may be set against the Commission's desire to create common and stable conditions for EU telecommunications competition. This tension between the wider EU policy agenda and ostensibly national markets also underlies the reluctance of the Commission to cede review of telecommunications mergers to the national authorities, even where their deal logic is not geographic expansion.

The Commission refused a request from the Competition and Markets Authority (CMA) under article 9(2)(a) of the EU Merger Regulation (EUMR) to review the transaction. Although the Commission accepted that the merger affected retail and wholesale mobile telecommunications markets in the UK, the Commission concluded that it was better placed to deal with the case. This was on the basis of the Commission's experience in considering mergers in the telecommunications sector and the need to ensure consistency in the application of merger control rules in the sector across the EEA.

Even where the Commission reviews a transaction under the EUMR, the national sector regulator is not redundant. Such authorities may be consulted informally and will invariably have a voice along with the national competition authority on the issue of whether to cede jurisdiction to the Commission or support referral back. Historically, Ofcom has been a prominent player in the assessment of UK telecommunications transactions subject to the EUMR (eg T-Mobile/Orange).

The CMA urged the Commission to block the Three-O2 tie-up unless the parties were required to sell off at least one network's infrastructure and spectrum. The CMA chief executive Alex Chisholm in a letter to the Commission, though polite in tone, was unequivocal in stating the CMA's view that, without such remedies, "the only option available to the Commission is prohibition". Sharon White, head of Ofcom, was also opposed to the merger. While it is normal for national authorities to engage with the Commission as part of the merger consultation, this was nevertheless a bold show of face, which can be expected to have been a factor in Vestager's decision to seek structural remedies. The CMA and Ofcom have publicly stated their view that the final decision is the right outcome for consumers.

Back to the future of EU mobile mergers

The UK has a history of aggressive mobile competition, prompting commentators to speculate that if a four-to-three merger cannot be approved here, then the hopes for similar consolidation elsewhere may now be more limited. Rejecting any implication that the prohibition raises the bar for future clearances, Vestager has been at pains to emphasise the number of specific characteristics that distinguish the case from previous approval cases, not least the concentration that would have resulted in the two network-sharing arrangements. Those who are expecting the published decision to yield greater insights may be disappointed, as the commissioner claims that it contains "nothing new".

What then of the prospects for other in-market mobile mergers taking place against the inevitable need for operators to continue to finance their investments and compete with multiplay offerings? Hutchison is focusing on the Commission's review of its proposed joint venture with VimpelCom, another four-to-three transaction currently in the middle of a Phase II review (M.7758). It has also said that it is considering its options for challenging the prohibition decision. In these circumstances, one can probably say that the prohibition leaves EU telecommunications merger policy somewhat murkier and not clearer. One can probably say, though, that talking about four-to-three mergers may be less helpful as a label to demarcate which mobile transactions will be likely to pass the test for clearance and those which will not.