



Response to Provisional Findings in *BT/ EE*

Redacted version

November 2015

1 Introduction

1.1 This submission forms TalkTalk's response to the CMA's Provisional Findings, notified on 28 October 2015 and published in full on 30 October 2015, regarding the proposed merger of BT and EE. TalkTalk is grateful to the CMA for the chance to respond, and in particular for the additional transparency created by the CMA [X].

1.1 The impact of the transaction on the UK communications sector

1.2 Although this submission focuses on harm to competition in the wholesale mobile market, TalkTalk urges the CMA to consider the negative impact the merger will have on the future of the UK communications sector more broadly. It is imperative the CMA consider carefully the fact that this decision takes place not in a vacuum, but against a backdrop of dwindling competition across the industry. TalkTalk believes the implications for customers, innovation and investment will be far more serious and lasting than those currently contemplated by the Provisional Findings. The prospect of foreclosure of wholesale access to mobile capacity is just one of several consequences of this re-concentration of the market. Not only will this foreclosure result in reduced choice for consumers of mobile services, but it will, in turn, reduce the incentive for companies like TalkTalk to invest in upstream networks, further protecting BT's very profitable upstream network business.

1.3 The privatisation of BT 30 years ago was forcefully resisted, and eventually achieved only by an exceptional display of political will. It was predicated upon the belief that no state monopoly business could deliver the service, investment and innovation of a privatised company. Local loop unbundling was also vigorously opposed by BT, along with a multitude of other policies designed to boost market access and drive choice, quality and value for customers. The benefits of competition have been hard won, and TalkTalk perceives a real and manifest risk today of them being usurped by stealth by an organisation even larger and more dominant than the pre-privatisation BT.

1.4 With a 47% share of mobile spectrum, 37% share of retail mobile customers, a 36% share in retail broadband customers, and continued 100% ownership of the national telecoms infrastructure network, a combined BT/EE will have both the means and the motive to permanently lock future competition out of the market. As TalkTalk has previously emphasised, BT's fixed line dominance relies upon competitors being restrained from making their own infrastructure investments, and thus being forced to use the ageing copper network. Fixed-mobile bundling provides a potentially lucrative source of growth, and therefore investment capital, for players seeking to

break this historic constraint. However, a strong fixed-mobile offering relies on the ability to purchase wholesale mobile, an ability which BT would be both motivated to foreclose, and capable of foreclosing, should the CMA's provisional ruling stand. Nothing in the CMA's provisional findings demonstrates that this is not a logical and highly likely outcome.

- 1.5 TalkTalk believes the CMA has a responsibility to seriously reconsider the impact of its decision in the wider context of the real and significant threat of a re-monopolisation of the UK telecoms sector. With 30 years of competition at stake, nothing less than full certainty should suffice.

1.6 Summary of TalkTalk's detailed concerns

- 1.2 The body of this response primarily deals with the CMA's analysis of the wholesale mobile market, as contained in Chapters 13 and 14 of the Provisional Findings document, and in Appendices H, I and J.
- 1.3 The final section of this paper sets out TalkTalk's view on the errors the CMA has made in its assessment of the mobile backhaul market.
- 1.4 In summary, TalkTalk considers that the Provisional Findings contain serious errors, both of omission and analysis, and that the CMA has erred in the process by which it has reached its decision.
- 1.5 The main errors contained in the Provisional Findings are the following:
- *Inappropriate counterfactual*: the counterfactual set out in the Provisional Findings is inappropriate because it is based on an error. The effects of the merger have been assessed against the pre-merger conditions of competition, because these are the conditions that would prevail if H3G/O2 were prohibited or abandoned, or the same "to any material degree" as the conditions that would prevail if H3G/O2 were cleared on the basis of commitments. This second proposition is an error. The standard against which the European Commission assesses proposed commitments is whether the merger as modified would result in a significant impediment to effective competition. Accordingly it must accept commitments which leave some impediment to effective competition, so long as this is not significant. This means that the European Commission may accept commitments which result in a change to the market situation against which the impact of wholesale mobile input foreclosure should be assessed, as long as it considers that the diminution of competition is not significant.
 - *incorrect application of the burden and standard of proof*: the assessment in the Provisional Findings contain a number of errors. In particular it:
 - apply the balance of probabilities test to each step in its vertical analysis, rather than cumulatively, in direct contradiction to the approach set out by the Court of Appeal;

- fail to consider whether the theories of harm it analysed, *taken together*, would meet the balance of probabilities test, as its guidance requires;
 - do not reflect the CMA having made reasonable enquiries to arm itself with the evidence needed to make an informed assessment; and
 - fail to address the extent and consequences of the uncertainties inherent in the assessment and whether the standard of proof is nevertheless met.
- *takes insufficient account the strategic incentives of BT to exclude*– TalkTalk has previously submitted to the CMA that the merged firm may have strong incentives to exclude firms such as Sky, Virgin Media and TalkTalk from providing fixed-mobile products because, by doing so, it will decrease the profitability of them rolling out alternative infrastructures that will compete with Openreach and so reduce the amount of investment in alternative infrastructures undertaken. TalkTalk considers that this provides a meaningful additional incentive to foreclose fixed-mobile competitors.
 - *incorrect analysis of the asymmetry in bargaining power between MNOs and fixed-line operators*– the Provisional Findings do not reference TalkTalk's submissions that the importance of fixed-mobile bundles is asymmetric between fixed line operators and MNOs. There are several times more mobile connections in the UK than there are fixed line connections.¹ As such, fixed operators could easily be excluded from the market if they do not obtain an MVNO agreement. This means that there remain low incentives on MNOs to grant MVNO agreements solely to obtain access to the market for fixed-mobile bundles. The bargaining position of MNOs will therefore be much stronger than that of fixed-mobile MVNOs, contrary to the finding of the Provisional Findings.
 - *the Provisional Findings do not adequately reflect the withdrawal of Vodafone from the wholesale mobile market, other than for self-supply*– the Provisional Findings treat Vodafone as an active participant in the wholesale mobile market. This is incorrect. Vodafone is no longer an active participant, has entered into no new MVNO contracts in the recent past, and has not [X].
 - *the Provisional Findings do not provide sufficient detail on the basis for the panel's findings in the wholesale mobile market to allow TalkTalk fully to respond to these*– although the CMA panel has split 2:2 on whether there is a significant lessening of competition ('SLC') in the wholesale mobile market, this is dealt with cursorily in three paragraphs at the end of section 14. This is inadequate fully to understand the panel's reasoning and to permit TalkTalk to respond in full on the panel's views.
 - [X]

¹ Ofcom (2015), *Communications Market Report*, p.255. Ofcom reported that at the end of 2014 there were 23.7m fixed line broadband connections, compared to 83.7m mobile connections.

- 1.6 As a result of these errors, the wrong conclusion has been reached regarding whether the proposed BT/ EE merger will create an SLC in the wholesale mobile market. Once these various errors and omissions are corrected, TalkTalk considers that any revised analysis will necessarily lead to the conclusion that there will be an SLC caused by the proposed merger of BT and EE, unless suitable remedies are adopted.
- 1.7 In addition, the Provisional Findings also reveal a misunderstanding of the manner in which regulation of Openreach operates. As a result, an incorrect assessment is made of the incentives on BT to exclude its competitors through gaming regulation of its mobile backhaul products. This results in an incorrect conclusion that there will not be an SLC created by the impact of the merger on the mobile backhaul market.
- 1.8 TalkTalk considers that these errors are so severe that they vitiate the Provisional Findings. TalkTalk therefore requests that the CMA withdraw its Provisional Findings document and reissue an alternative document which amends for these errors, in particular the inappropriate counterfactual and the lack of detail on the dissenting members, both of which will tend to prevent TalkTalk from sensibly responding to Provisional Findings. The merging parties and third parties would then be able to comment on this amended statement of Provisional Findings.

2 Inappropriate counterfactual in relation to the merger between H3G and O2

- 2.1 The proposed BT/EE transaction takes place against the background of potential major MNO consolidation occurring on an almost identical timescale – H3G’s proposed acquisition of Telefónica’s UK business (**‘H3G/O2’**), currently under investigation by the European Commission.
- 2.2 The Provisional Findings address the consequences of H3G/O2 at Section 7 (pp. 76-79). However, in doing so critical errors of fact and logic have been made, resulting in the economic analysis in the subsequent Sections, and especially Section 14 on the wholesale mobile market, proceeding on an incorrect basis.

2.1 The analysis in the Provisional Findings

- 2.3 At §7.6 the Provisional Findings note that there are three possible outcomes from the European merger control process: unconditional clearance, prohibition, or the transaction proceeding with remedies.

- 2.4 At §7.10 the Provisional Findings state that:

Given that it is difficult to characterise any one of the three outcomes listed in paragraph 7.6 by itself as resulting in the 'most likely' scenario, we have considered to what extent there would be foreseeable similarities and differences between the conditions of competition resulting from the different scenarios.

2.5 At §7.11, the Provisional Findings goes on to state that:

Although the conditions of competition would not be identical as between the scenarios of prohibition and conditional clearance, the intended basis of any commitments that the Commission might accept to remedy any concerns it found in relation to the H3G/ O2 merger would be to restore the level of effective competition in the markets to which the commitments relate. Thus, competitive conditions in any market to which the commitments relate should to any material degree be equivalent to those absent the H3G/O2 merger. In any other affected market, it would also follow from the Commission's assessment that there would be no significant impediment to effective competition. It is not possible to say which markets would be the subject of remedies and which would not.

2.6 The CMA therefore seeks to group together scenarios with similar competitive consequences for the BT/EE transaction, and consider which group *collectively* is the most likely outcome of the European Commission's review, thus avoiding the need to identify a single most likely outcome.

2.7 In applying this approach the CMA makes a significant error of fact and logic. It suggests that in any market in which remedies are accepted, the competitive conditions post-merger will be "*to any material degree*" the same as pre-merger conditions.

2.8 This misunderstands the nature of the European Commission's legal powers and obligations, which are in this respect different from the CMA's. Under the Merger Regulation, when commitments are offered, the Commission's task is to decide whether the concentration, *as modified by the commitments*, meets the SIEC test (see Recital 30 and Art 8(2)). Accordingly, it has no power to require that pre-merger competitive conditions are restored, only that the remedied merger does not cause a significant impediment to effective competition.

2.9 Changes to the competitive conditions, while not in themselves leading to a SIEC, can nevertheless change the competitive dynamics of the market, increasing the likelihood that a subsequent merger will have a significant impact. A five firm market in which sequential mergers occur provides a useful example. The first merger reduces the number of firms from five to four, which may not raise significant competition issues. The second reduces it further from four to three, which is much more likely to have a significant impact. Yet the logic of the CMA's position is that it would treat the four to three merger as having an identical competitive impact as the five to four. This is irrational and unreasonable.

2.10 In the present case, remedies aimed solely at addressing the horizontal issues raised in H3G/O2 may very well have minimal or no impact on the vertical issues raised by BT/EE. A plausible outcome of the Commission's review in H3G/O2 would be to replicate the commitments accepted in *Hutchison 3G UK / Telefónica Ireland*, another four to three MNO consolidation reviewed by the Commission in 2014. In that case the Commission accepted commitments from the merged group to offer two scale MVNO contracts, with an option to purchase spectrum at any point over a ten year period. The commitments did not seek to remedy any concentration caused by the merger at the wholesale level.

- 2.11 If such similar commitments were accepted in H3G/O2, this would not have the effect of replicating the competitive conditions present in the market pre-merger, and it is quite plausible that they could have no constraining effect whatsoever on the incentives and ability of BT/EE to foreclose fixed line MVNOs:
- there is no reason why either of the MVNO contracts would be awarded to a fixed line operator (and indeed even if both were, this would not secure capacity for all three);
 - the terms of any MVNO offer may not be sufficiently commercially attractive to provide a guarantee of take-up;
 - those fixed line operators which did not secure one of these contracts would face a reduced choice of providers for wholesale access (four to three, even assuming Vodafone is actively competing, which it is not). If BT/EE ceases to supply on competitive terms the choice reduces to two firms (again incorrectly assuming that Vodafone competes actively); and
 - it is speculative whether either of the beneficiary MVNOs would choose to take up the option of spectrum, or if they did whether they would have any incentive, or indeed the ability (for example, sufficient spare capacity) to supply fixed line MVNOs. Even if they did so, this may not be until well into the 10 year period stipulated in the commitments, at which point material damage would have been done to the nascent market for bundled fixed-mobile products and the ability of fixed line providers to invest in fixed line infrastructure.
- 2.12 Accordingly, the CMA's proposed approach is flawed. It is both analytically incorrect and, at a practical level in the present case, clearly wrong to argue there is no material difference in the competitive conditions absent H3G/O2 and those likely in the case where H3G/O2 proceeds conditionally. Those two outcomes must be distinguished if the CMA's analysis is to proceed on a sound footing.

2.2 Alternative approaches

- 2.13 The concurrent mergers arising in this case raise very particular, and as far as TalkTalk is aware unique, challenges for the authorities concerned. If different outcomes in H3G/O2 have different consequences for BT/EE, and the approach currently adopted by the CMA is inappropriate, these issues must be faced head on.
- 2.14 **The CMA cannot credibly argue that the outcome of the Commission's review is unforeseeable.** At several points in its analysis, the CMA refers to the difficulties in predicting the outcome of the European Commission's review.

- 2.15 However the CMA is not required to predict *with certainty* the actual outcome of the European process, only to identify the *most likely* outcome from among the set of potential outcomes.²
- 2.16 Nor is the CMA confined to counterfactual assessments where the answer is ascertainable with little effort. The CMA’s guidelines point to the need to give detailed consideration to the most likely counterfactual: “*When [the CMA] considers that the choice between two or more scenarios will make a material difference to its assessment, the [CMA] will carry out additional detailed investigation before reaching a conclusion on the appropriate counterfactual.*” (Merger Assessment Guidelines (CC2), §4.3.6).
- 2.17 The outcomes of merger reviews are not unforeseeable: they are designed to be predictable to allow merging parties to plan their affairs. The economic framework for review is well settled and clearly set out in the Commission’s guidelines. In the present case there are no fewer than three recent analogous decisions containing substantial analysis (all cited in the Provisional Findings). Further, it is reasonable to expect that H3G also has a good understanding of the position and is unlikely to abandon the transaction in light of the likely remedies required for clearance.
- 2.18 The outcome of the European Commission’s review is more predictable than the types of assessments the CMA regularly has to address in its counterfactual analysis, such as the likelihood of exit by a third party over the medium term (*BOC/Ineos*) or the short and medium term strategy of the government in dealing with a failing bank (*Lloyds/HBoS*).
- 2.19 Accordingly it is simply not credible to suggest that the outcome of the Commission’s review is too uncertain to be taken into account in the CMA’s analysis.
- 2.20 **The CMA cannot rely on the “inappropriateness” of second guessing the European Commission to avoid assessing the counterfactual:** TalkTalk notes the CMA’s comment that it is not “appropriate” for the CMA to predict the most likely outcome of the Commission’s investigation (§7.9). Nevertheless, in the very particular circumstances arising in this case the CMA has *no choice* but to do so.
- 2.21 **The CMA cannot ignore H3G/O2 because it was notified later or to a different authority:** The Merger Assessment Guidelines state that “*the [CMA], when assessing a merger, cannot ignore a parallel transaction on the grounds that it has not been notified to the [CMA], or was notified after the merger under review.*” (Merger Assessment Guidelines (CC2), §4.3.26).
- 2.22 The CMA must therefore address itself to the question of what is the most likely outcome of the European Commission’s review.

² Indeed even once it has done that it remains able to give consideration to other potential outcomes (see the Court of Appeal in *BSkyB*).

2.3 The most likely outcome and options for dealing with uncertainty

- 2.23 It is not particularly difficult to identify the most likely outcome of the European Commission's review. All three of the precedent cases (*Hutchison 3G / Telefónica Ireland, Telefónica Deutschland / E-Plus, Hutchison 3G Austria / Orange Austria*) involved a remedy similar to the Irish remedy discussed above, involving scale MVNO contract(s) and options to acquire spectrum under various terms. In all of the last three cases decided by the European Commission, there was a reduction in the number of active MNOs. If the CMA believes the Commission will adopt a different approach it should set out what approach it believes the Commission will adopt, and set out why it believes the Commission will differ in this instance from recent precedent.
- 2.24 If the Commission accepts similar commitments to those it has accepted in previous mergers, the consequence for the BT/EE transaction is clear. In particular, the Commission is unlikely to secure a functioning and competitive wholesale market for the fixed line operators to compete effectively to provide bundles. It is instead likely that the number of available wholesalers will reduce by one, enhancing the ability and incentive of BT/EE to foreclose fixed line providers.
- 2.25 As noted above however, the CMA is not required to fix upon a single counterfactual at the start of its analysis and ignore all others. While we believe the most likely outcome of the Commission's review is one consistent with previous decisions, it is also possible that the Commission will require different commitments to be made.
- 2.26 This possibility does not prevent the CMA proceeding on the basis of the outcome it finds most likely. The CMA has ample opportunity to reassess any remedies it requires in the event that the Commission comes to a different conclusion.
- The CMA's duty to remedy anticompetitive outcomes allows it to take into account material changes of circumstance arising in the period before the remedy is implemented. Based on current timetables, the CMA would not be required to implement its remedies until the Commission's decision was actually known. It therefore has the opportunity to adjust its approach.
 - Even if the timetables do not permit this, the CMA has the ability to review remedies that it has imposed in light of changed market circumstances. The CMA therefore always has the option to step back from remedies which, in the light of events, are more intrusive than necessary.

2.4 Conclusion

- 2.27 The CMA's approach to the counterfactual, as set out in the Provisional Findings, proceeds on an incorrect basis of fact and logic, undermining the subsequent economic analysis assessing the impact of the merger on competition.
- 2.28 The Commission has taken a consistent approach in three previous cases. The CMA must either adopt a counterfactual for the Commission's decisions consistent with

these cases, or explain what alternative approach it believes the Commission will take. If necessary, the CMA has the tools to adapt its approach if the Commission alters its position from the one adopted by the CMA as most likely.

- 2.29 TalkTalk considers that the errors in the counterfactual presented by the CMA are so serious that they vitiate the entirety of the Provisional Findings. We therefore consider that the CMA should withdraw its current Provisional Findings document and issue a new Provisional Findings document for comment by the merging parties and interested third parties, on the basis of a new counterfactual where the CMA has met its legal obligations.

3 Incorrect application of the burden and standard of proof

- 3.1 The Provisional Findings do not address the burden and standard of proof applicable to the CMA's assessment. This causes a number of key legal errors that in turn lead to the CMA adopting incorrect conclusions.
- 3.2 In this section, TalkTalk focuses on the consequences of these errors in the wholesale mobile assessment (Section 14) but many of the points made apply across other sections of the Provisional Findings.

Failure to apply the balance of probabilities test at the "endpoint"

- 3.3 In *BSkyB*, the Court of Appeal considered how the CMA should apply the balance of probabilities test to a theory of harm relying on a sequence of hypothetical events:³

"The essence of Mr Flynn's point on the standard of proof is that each element in the sequence of hypothetical events which leads to a conclusion that there is an ability to exercise material influence has to be established separately on the balance of probability..."

It is not necessary for the Commission to isolate each step in the analytical process and to apply the balance of probability separately at each stage. The standard of proof applies to the Commission's conclusion on the points which it has to decide, namely first whether the Acquisition gave Sky the ability materially to influence the policy of ITV, and then whether this would cause an SLC. It does not have to be applied separately to each element in the analysis which is used to reach a conclusion on each of these points."

- 3.4 The wholesale mobile theory of harm is just such an instance: the analysis proceeds by reference to a sequence of steps: ability to foreclose, incentive to foreclose and effect on competition.

³ British Sky Broadcasting Group Plc v The Competition Commission & Anor [2010] EWCA Civ 2 (21 January 2010)

- 3.5 Yet the CMA proceeds in precisely the manner rejected by the Court of Appeal above, stating that it must be satisfied *separately* as to each step of the analysis if it is to make an SLC finding:

“9.15 For a vertical theory of harm to be established, we will typically frame our analysis by reference to the following three questions:

(a) Ability: Would the merged entity have the ability to harm its rivals by engaging in the foreclosure strategy?

(b) Incentive: Would it have the incentive to engage in that strategy?

(c) Effect: To the extent that the merger creates or enhances the merged entity’s ability or incentive to engage in the strategy, would the effect of any action by the merged entity be sufficient to reduce competition in the affected market to the extent that, in the context of the market in question, it gives rise to an SLC?

9.16 Whilst these questions are to an extent interrelated, all three must be answered in the affirmative for the theory of harm to hold and must be of an order of magnitude likely to give rise to an SLC (that is, the legal test at phase 2).”

- 3.6 It is clear that this error was more than theoretical. The CMA’s analysis of the mobile wholesale theory of harm relies at several points on uncertainty.⁴ It is precisely in those circumstances that the distinction made by the Court of Appeal in *BSkyB* is likely to make the difference between an SLC finding and a finding that no SLC may be expected to occur.

- 3.7 It is essential that the CMA directs itself properly as to the applicable standard of proof and carries out a fresh assessment of the evidence relevant to wholesale mobile.

Failure to apply the balance of probabilities test to the merger as a whole

- 3.8 The CMA’s own guidance makes clear that it is not required to be satisfied on a balance of probabilities that any one theory of harm will result in an SLC: its conclusion may be based on the sum of probabilities of different theories (provided these are not mutually exclusive):

“4.2.6 ...The [CMA] will determine whether an SLC arises or is expected to result from a merger, having considered one or more theories. It need not determine this in respect of each of the theories considered and its overall expectation of an SLC may be based upon one theory only or upon its composite view of multiple alternative theories.”

- 3.9 This guidance is echoed in the Provisional Findings at page 86, where the CMA sets out its intended approach.

- 3.10 However, when overall conclusions on the merger are drawn (Section 23) there is no evidence of any such consideration. At §23.1 the CMA provisionally concludes that

⁴ See for example §14.28, §14.115, §14.122, §14.136, §14.143, §14.146, §14.179, §14.182, §14.250, §14.265, and §14.274.

“the merger is not expected to result in an SLC within any market or markets in the UK, including the retail mobile, wholesale mobile, mobile backhaul, wholesale broadband and retail broadband markets which have formed the focus of our inquiry.” There is no mention of a conclusion relating to these markets together.

- 3.11 This is no mere omission or misuse of language. If there had been any robust consideration of the composite effect of the impact of the merger across markets, then some discussion would be expected to be evident in the Provisional Findings. It is inconceivable that the CMA have actively considered the question and yet not included any discussion of it within the Provisional Findings.
- 3.12 Again, TalkTalk submits that it is essential that the CMA carries out a fresh assessment taking into account this critical aspect of its statutory duty.

Failure to conduct reasonable enquiries

- 3.13 As noted above, the CMA’s analysis is punctuated by references to uncertainty or lack of evidence, or to a lack of evidence in the possession of the CMA. In some cases the CMA appears to have failed to acknowledge that the burden is on *it* to obtain evidence on which to base its conclusions. TalkTalk notes that there are many areas where the CMA could, with reasonable ease, have sought to obtain evidence itself (for example, by conducting consumer surveys to obtain revealed preference information), but did not to do so. These choices amount to a failure to conduct reasonable enquiries to enable it to make a rational decision, and further undermine the validity of the (provisional) conclusions reached.

Failure to specifically consider the balance of probabilities test

- 3.14 Finally, the CMA at no point refers to the balance of probabilities test or its meaning in a forward looking assessment in a dynamic market. In such circumstances, “uncertainty” is inevitable. It does not follow that the standard of proof is not reached. It is incumbent on the CMA to address the *extent and consequences* of the uncertainties that it faces, and whether the standard of proof is nevertheless met. It has not done so.

Conclusion

- 3.15 In summary, the CMA has failed to address itself to the burden and standard of proof underlying its assessment, and therefore makes critical errors, leading to conclusions which are unreliable and unlawful.

4 Insufficient analysis of BT’s strategic incentives to exclude

- 4.1 In its response to [§], TalkTalk set out that a key rationale for such exclusion would be to reduce the profitability to TalkTalk, Sky and Virgin Media of rolling out fixed

line networks into areas where we currently do not own fixed line infrastructure. For example, we stated at §1.6 of that submission that:⁵

[redacted]

4.2 This analysis was set out in detail in the body of the document at section 2.1.1.

4.3 The only reference to this argument in the Provisional Findings is at §14.171 which states:

TalkTalk argued that damage to its ability to offer fixed-mobile bundles would reduce the return on its proposed investments in its fixed infrastructure (and therefore put them in jeopardy), and also damage TalkTalk's economies of scale which relate, for example to advertising.

4.4 The Provisional Findings then summarise all of the submissions on the potential for investment to be damaged as follows:

As to damaging investment in other services, we note that in the case of TalkTalk and Virgin Media, mobile revenue constitutes between [redacted] of the companies' total revenue ([redacted]). While it has not been possible to assess the constituent profit levels of mobile services alone, our review of mobile margins (see [redacted]) supports the case that the mobile business is not likely to have contributed more than [redacted]% of the fixed-MVNOs operating profits. Therefore, even if the merged entity can render MVNOs' mobile services less profitable, we would not expect this to have a large effect on the ability to finance investments in other aspects of their services.

For these reasons, and considering the greater degree of uncertainty that would be attached to such an indirect strategy, we considered that any additional merger-related incentive to engage in such a long-term strategy is likely to be limited.⁶

4.5 As such, the CMA focusses on the ability to fund investment. This is not the relevant issue. TalkTalk's submissions do not mention the ability to fund investment– given that all major fixed line operators are large firms listed on major securities exchanges, access to funds is not an issue.

4.6 What is relevant is the incentive of TalkTalk and other operators to invest in infrastructure which would compete with Openreach. For example, as set out at §2.7 of TalkTalk's submission on the [redacted]:

[redacted]

4.7 The core argument being made by TalkTalk, as set out in our previous submission, is as follows:

- by foreclosing in the wholesale mobile market, the merged BT/EE would be able to increase the costs of offering mobile for TalkTalk, Sky and Virgin;

⁵ TalkTalk comments on [redacted], September 2015

⁶ Paragraphs 4.174-4.175.

- increasing the costs of providing mobile would be passed through into TalkTalk, Sky and Virgin's pricing of fixed-mobile bundles;
- given the increasing consumer demand for fixed-mobile bundles, an operator which sets a higher price in fixed-mobile bundles will have a lower number of fixed line customers than in a counterfactual where that operator sets a lower price for fixed-mobile bundles;
- a reduced number of fixed line customers will reduce the profitability to an operator of rolling out fixed line infrastructure in new areas, as the average cost of roll-out per active consumer will be higher;
- reduced profitability of rolling out fixed line infrastructure will result in potentially profitable infrastructure investments becoming unprofitable, and thus not being rolled out. This will reduce competition in fixed line infrastructure.

4.8 In short, therefore, by raising rivals' downstream costs of offering fixed-mobile bundles, BT will reduce these rivals' total demand for fixed line products, and this will reduce incentives for rivals to invest in infrastructure.

4.9 The Provisional Findings do not address this argument. They neither provide an assessment of whether this argument is correct in principle, the scale of the incentive to foreclose, nor the scale of consumer harm that might result from lower roll out.

4.10 TalkTalk believes that [X].

4.11 The issue of the potential loss of Openreach margins from other fixed-mobile providers gaining market share is addressed briefly in Appendix I to the Provisional Findings, but only as regards Virgin Media. TalkTalk has been unable to find any reference to long-term strategic incentives to exclude, based on the possibility of fixed line operators expanding their access infrastructure, permanently reducing Openreach's profits.

4.12 When investing in infrastructure, fixed line operators have to consider the profitability of that infrastructure over its whole lifetime. Even if the market has not fully moved to fixed/ mobile bundling at the time the infrastructure investment is being considered, future market moves towards bundling, and the possibility of foreclosure of those bundles, will be taken into account when looking at the expected profitability of the project.

4.13 The CMA's approach fails to reflect the vital importance for the UK of investment in telecoms infrastructure by a range of parties, rather than the failed and outdated approach of all spending being channelled through a single monopoly (i.e., BT). By ignoring investment by other operators, the CMA risks supporting BT's dominant position in fixed-line infrastructure, rather than seeking to use the window of opportunity created by the nascence of ultrafast broadband to move to a much more competitive market structure, where different networks compete with one another on their merits across the UK.

5 *Incorrect analysis of the asymmetry in bargaining power between MNOs and fixed-line operators*

5.1 At §14.164 and §14.167 of its Provisional Findings, the CMA states as follows:

... if fixed-mobile bundles become important and begin to affect retail competition for mobile services, Vodafone may, given its [X], also have an incentive to serve one or more fixed-MVNOs (at least in the medium term), in order to improve its access to that segment of customers that has a preference for buying fixed and mobile from the same operator.

... in a scenario where a high proportion of people wished to purchase fixed and mobile services from the same supplier, and in response to a price rise would rather purchase a bundle than unbundle, Telefónica and H3G would both have strong incentives to provide services that allowed them to earn wholesale or retail revenues from customers of this type. A failure to do so would involve foregoing substantial amounts of revenue.

5.2 This argument appears to be at the core of the CMA's analysis of the incentives of MNOs other than BT/EE to provide wholesale mobile capacity to MVNOs following the merger.

5.3 However, this argument omits a key point, which is the substantial difference in incentives between fixed network operators and MNOs to ensure that they are able to offer fixed-mobile bundles. This asymmetry stems from the different number of customers in each market.

5.4 Ofcom data sets out that at the end of 2014 there were 23.7m fixed line broadband connections in the UK, and 83.7m mobile connections— there were over three times as many mobile connections as there were fixed line connections.⁷ In general, TalkTalk would expect that [X].

5.5 Given the disparity in the number of fixed and mobile connections, it is clear that fixed-mobile contracts are likely to be considerably more commercially important to fixed providers than to mobile providers, as they will represent a greater proportion of the overall customer base. This is set out in Table 5.1 below, which provides hypothetical scenarios for the number of fixed-mobile bundled customers, on the basis of one mobile connection per bundled contract, and then determines what proportion of the fixed and mobile base this is (based on 24m fixed line customers and 84m mobile customers).

⁷ Ofcom (2015), *Communications Market Report*, p. 255

Table 5.1: Relative importance of fixed-mobile bundles to fixed and mobile

Number of fixed-mobile customers	Proportion of fixed base	Proportion of mobile base
4m	17%	5%
6m	25%	7%
10m	42%	12%
15m	63%	18%
20m	83%	24%

5.6 As can be seen from this table, fixed-mobile bundles rapidly become a significant proportion of the fixed base as the number of bundled fixed-mobile customers rises. On the other hand, they are a much less important part of the mobile base.

5.7 This asymmetry between the proportion of the fixed and mobile bases represented by fixed-mobile bundles will in turn create a difference in the bargaining power of MNOs and fixed-mobile MVNOs. When a meaningful number of customers are looking to take fixed-mobile bundles (for example, 6m or more), they will represent such a large proportion of the fixed line base that fixed operators will have to be able to address that market, or will lose significant scale and see an increase in the average cost per consumer. Conversely, MNOs will not only have less need to enter into deals which involve fixed-mobile bundles (as they are a smaller proportion of total mobile market demand), but will know that fixed-mobile MVNOs are unlikely to be able to walk away from wholesale access negotiations altogether and will have to take up one of the offers (as long as there are any such offers) made to them.

5.8 This has two corollaries:

- when fixed-mobile MVNOs are negotiating with MNOs, they are likely to obtain worse terms than if there were a credible threat to walk away from negotiations and not take any contract, or where both MNO and MVNO would suffer equally from failure to reach agreement.
- excluding fixed-mobile MVNOs by not granting them an agreement to supply wholesale mobile capacity is a more credible threat than if MNOs were equally harmed by any refusal to deal.

5.9 TalkTalk considers that the CMA must take this into account when determining the wholesale price increases that fixed-operators would face if BT/EE withdrew from the wholesale MNO market. The CMA's analysis implicitly assumes that the incentives to enter into wholesale mobile contracts are symmetric, or close to symmetric, between MNOs and fixed-mobile MVNOs, and thus that MNOs would have a high incentive to deal with fixed-mobile MVNO's at a reasonable price. It does not reflect the disparity in bargaining power likely to be seen in practice.

6 The CMA has not adequately reflected the withdrawal of Vodafone from the market

6.1 TalkTalk has provided evidence to the CMA, in both our oral and written submissions, that Vodafone has withdrawn from the wholesale mobile market. The

Provisional Findings do not take this adequately into account, and as a result reach the erroneous conclusion that Vodafone currently acts, and will continue to act, as a viable competitor in the wholesale mobile market.

- 6.2 TalkTalk has previously submitted to the CMA our direct experience of [REDACTED].
- 6.3 As part of our May 2015 submission we also set out our understanding that Vodafone had served notice on Sainsbury's to terminate its MVNO agreement.⁸ This was denied by Vodafone at the time, with their statement that they would continue to offer MNO services to Sainsburys.⁹ However, it has now been publicly reported (on 14 October) that the commercial relationship between Vodafone and Sainsbury's has been terminated, with services due to cease on 15 January 2016. [REDACTED]
- 6.4 Both of these examples provide a clear indication of [REDACTED].
- 6.5 The extent of Vodafone's withdrawal from the MVNO market can be seen by reference to Figure 2.4 of the Provisional Findings document. Figure 2.4 sets out that Vodafone offered, at the time the Provisional Findings were concluded, MVNO services to only three MNOs of the eighteen major MVNOs considered by the CMA:
- Sainsbury's, which (as set out above) is a contract which has been terminated [REDACTED];
 - Talk mobile, which is not an independent MVNO, but rather a sub-brand of its 100% owner Vodafone. It is therefore in no sense a competitor to the main Vodafone brand;
 - Lebara.
- 6.6 Effectively, therefore, of the 16 independent MVNOs tracked by the CMA, from the end of January, Vodafone will support only one, compared to at least three for all other MNOs.¹⁰
- 6.7 The last remaining meaningful independent MVNO on the Vodafone network is Lebara. TalkTalk understands that [REDACTED]. We have been unable to find any evidence that [REDACTED]. We also do not know if [REDACTED]. We consider that [REDACTED].
- 6.8 In any case, the situation of Lebara is very different from that of TalkTalk. TalkTalk considers that TalkTalk, Sky and Virgin Media are all 'mass-market' MVNOs, which aim to attract a broad range of customers, and which will therefore compete with MNOs across the range of their product offering. This makes mass-market MVNOs a relatively close substitute for the MNOs, and means that they will primarily abstract

⁸ Section 3.1 of that submission

⁹ See, for example, <http://www.mobilenewscwp.co.uk/2015/10/26/vodafones-mvno-future-unclear-after-failure-of-sainsburys-partnership/>

¹⁰ Of the 18 MVNOs detailed by the CMA, Talk mobile is a subsidiary of Vodafone, while giffgaff is a wholly owned subsidiary of O2. Neither is an independent competitor from its parent MNO. TalkTalk considers that the presence of giffgaff and Talk mobile in Figure 2.4, without an associated note that these MVNOs are mere subsidiaries of MNOs, is highly misleading.

demand from other operators, rather than growing the market overall. In contrast, Lebara is a niche MVNO which targets a very different group of customers from the MNOs— as the CMA notes in its Provisional Findings document, where Lebara is listed as a 'International Focus' MVNO— and will tend to grow the overall mobile market with a relatively lower proportion of customers abstracted from the MNOs.

- 6.9 The status of Lebara as a niche MVNO means that Vodafone will have much greater incentives to provide Lebara with capacity than to provide fixed-mobile MVNOs with capacity. As such, even if Vodafone remains committed to Lebara, this is irrelevant to Vodafone's incentives (or lack thereof) to supply mass-market MVNOs such as TalkTalk, Sky or Virgin.
- 6.10 The CMA should thus [X].
- 6.11 TalkTalk also considers that the CMA's analysis at §§14.83-14.84, in which it argues that there are incentives on Vodafone to offer service to fixed-mobile MVNOs in a situation where fixed-mobile bundling grows in importance, is incorrect, as set out at section 5 above.
- 6.12 Overall, therefore, TalkTalk considers that the CMA's position that Vodafone is a currently active competitor in the wholesale mobile market is not consistent with the available evidence. There is no evidence adduced in the Provisional Findings that would be sufficient for the CMA to make its case. The CMA should therefore amend its findings to set out that Vodafone is no longer an active competitor in the wholesale mobile market.
- 6.13 In a similar way to the errors in the counterfactual, the CMA's position on Vodafone is likely to lead to the CMA underestimating the wholesale price rise that would be caused by BT/EE withdrawing from the market.
- 6.14 Given that there are currently four MNOs that could in principle offer wholesale access to MVNOs, and given that there are considerable doubts regarding the willingness of some of these MNOs to provide wholesale access, a refusal by any MNO to provide wholesale access is likely to have a significant impact on the degree of competition at the wholesale level.
- 6.15 In the case where all four MNOs are initially active at the wholesale level, withdrawal by BT/EE amounts to a reduction in the number of active MNOs from four to three. We consider that a more likely counterfactual is that only two (and at most three) MNOs would be active at the wholesale level. In particular, if Three and O2 merge and Vodafone continues to be inactive at the wholesale level, the only remaining players are EE and the merged Three/O2. In such a case, the refusal of EE to provide wholesale access would amount to wholesale prices increasing to monopoly levels. The risk of this happening is considerable and the likely impact would be highly significant.
- 6.16 In addition to a reduction in the number of MNOs active in wholesale supply, leading to each remaining MNO bidding less aggressively, there is a reasonable chance that, for a given MVNO, EE was the preferred supplier due to non-price differentiation

between the MNOs. In the case where EE withdraws from wholesale provision, such an MVNO would not only have to switch to a supplier that is bidding less aggressively, but also to a supplier that was second-best already prior to the price rise. While this is most likely to be the case for MVNOs currently contracted with EE, such as Virgin, it may also apply to TalkTalk in future contract negotiations.

- 6.17 Both of the above effects are well known in auction theory. In particular, the degree to which a bidder bids above cost is a decreasing function of the number of bidders, and the more bidders there are the lower will be the expected cost of the lowest-cost bidder.¹¹

7 The Provisional Findings do not provide enough detail to permit TalkTalk to comment in sufficient detail

- 7.1 TalkTalk considers that the CMA is under a duty to set out its views in sufficient detail that third parties such as TalkTalk can comment in full, and are able to respond to the entirety of panel members' views on the issues which are determinative for the merger.
- 7.2 In particular, we consider that the CMA has failed in its duty to provide sufficient detail on the views of the dissenting members of the panel. The entire section detailing the views of these members is as follows (§§14.277-14.279 of Provisional Findings):

Two group members did not provisionally agree with the view that the merger would not be likely to give rise to an SLC in one or more markets.

These members considered that the merged entity would have the incentive to harm fixed-MVNOs, either by refusing to supply them, or, more probably, by restricting the range and quality of services offered. They believed that fixed-mobile bundles would likely become increasingly prevalent and that the merged entity would not wish to assist major competitors by giving them access to a high-quality mobile service and thereby extinguishing any competitive advantage they might enjoy from EE's network and other assets. The MVNOs, for their part, would be reluctant to risk their long-term security of supply by being hosted by their main rival in mobile and fixed telecom markets.

These members did not believe that such foreclosure, and the consequent reduction of competition in the wholesale mobile market, would be neutralised by the other three MNOs offering better terms either out of a desire to play a part in fixed-mobile bundling or in any event. Rather, they expected EE's total or partial withdrawal to lead to higher prices and/ or reduced quality in MVNO contracts. They believed that this in itself established an SLC in the wholesale mobile market, irrespective of the effects downstream, which were harder to assess. They

¹¹ See for example Krishna, V. (2009). *Auction theory*. Academic press. The results also apply to a procurement setting. For details see Paarsch, H. J., & Hong, H. (2006). *An introduction to the structural econometrics of auction data*. MIT Press Books, 1.

nonetheless thought it likely that there would be adverse effects downstream as a result of reduced rivalry in the upstream market.

7.3 This is very limited analysis compared to the 276 paragraphs preceding them describing the view of two panel members as to why there is no SLC. It is unclear precisely which of these 276 paragraphs were the views of all panel members; which were the views of three members; and which were the views of only two members. It is incumbent upon the CMA to set out this level of detail so that respondents such as TalkTalk can determine the views of the individual panel members in cases where the panel is split.

7.4 In particular, the presentation of the dissenting views by the CMA does not set out:

- whether the dissenting panel members did, or did not, believe that Vodafone is an active competitor in the wholesale mobile market;
- what the dissenting panel members' views were on whether there would be scope for partial foreclosure by the merged firm, through bidding at increased prices;
- what is meant by the dissenting panel members believing that 'fixed-mobile bundles would likely become increasingly prevalent'. All market participants appear to believe that fixed-mobile bundles will become increasingly prevalent; the question is how much more prevalent they will be. The CMA provides no detail on this;
- what the dissenting members' views were on the extent of unbundling likely by customers of fixed-line operators unable to offer fixed-mobile bundles (see §§14.145-14.158);
- whether the dissenting members agree that mobile operators without fixed services will have strong incentives to enter into agreements with fixed line operators to be able to provide fixed-mobile bundles (see §§14.167-14.169);
- whether the dissenting members consider that there will be harm to Virgin Media through the merged firm using the scope available within its contract with Virgin to degrade the quality offered, for example by delaying the transition to a full MVNO or hindering the launch of 4G services.

7.5 This is a prohibitive lack of clarity for TalkTalk in responding to the Provisional Findings, on issues which are clearly material to a finding of whether there is likely to be an SLC. In light of this failure adequately to explain its reasoning, TalkTalk considers that it is imperative that the CMA withdraws its Provisional Findings document and reissues it with considerably greater detail regarding the views of the dissenting members. TalkTalk will then be able to respond fully to the actual views of the panel members.

8 Other errors and omissions

8.1 The preceding six sections have dealt with TalkTalk's most significant concerns regarding the CMA's Provisional Findings document. These errors and omissions are

very serious, and undermine the factual and logical basis of the provisional decision. Indeed, they are so serious that the CMA must withdraw its Provisional Findings document until it has remedied the various errors sufficiently to bring it back within the CMA's legal obligations, and allow respondents to comment on a rationally arguable document.

8.2 This section briefly deals with a number of further errors and omissions made by the CMA in its Provisional Findings. These errors are less serious than those outlined above— in particular, all can be reasonably responded to by TalkTalk without the CMA needing to reissue its Provisional Findings document— but remain issues which, in TalkTalk's view, the CMA should carefully reconsider, and upon which it should amend its findings.

8.1 **The CMA has mistakenly considered that the merger would not change the gain from harming mobile-only MVNOs**

8.3 The second bullet of §14.135 states as follows:

the merger... would not change the gain to be made by harming mobile-only MVNOs and so would be unlikely to change the merged entity's incentives to supply these MVNOs as compared to EE's incentives absent the merger

8.4 This is incorrect, as it ignores the existence of BT's downstream mobile business. The incentives to engage in vertical foreclosure of mobile-only MVNOs depend upon, amongst other things:¹²

The merged entity's recapture rates... ie the proportion of customers that choose to leave the MVNO that are recaptured by BT/EE

8.5 Prior to the merger, EE would only have taken into account diversion of customers to EE's retail brands when mobile-only MVNOs were refused supply. In contrast, following a merger with BT EE will have to consider diversion of customers to both EE's retail brands, and BT's retail mobile brand. As it should be expected that there will be a positive diversion ratio from any MVNO and BT's retail mobile offer, the merger will increase the proportion of customers recaptured by BT/EE, compared to EE alone.

8.6 As such, the CMA's statement at §14.135 is demonstrably incorrect, and should be amended. The merger would necessarily increase the gain to be made from harming mobile-only MVNOs. The CMA should therefore assess how large this additional harm would be (which would likely vary from MVNO to MVNO) and then determine whether this increased incentive to foreclose would lead to an SLC.

8.7 There is also a second factor which the CMA has failed to take into account. At §9(b) the CMA notes that some customers will choose to unbundle their demand for fixed and mobile products in response to being unable to obtain a bundled product from a

¹² Paragraph 9(d) of Appendix I

particular provider. The same will also be true in reverse: if there are fewer MVNOs which do not engage in fixed-mobile bundling, then more customers will take a bundled product, which will lead the merged firm to have a greater number of customers taking fixed-mobile bundles. As customers taking fixed-mobile bundles have [X] those on fixed-only products, this will increase the profits of the merged firm relative to a counterfactual where there was greater competition from MVNOs. This provides a further incentive to foreclose mobile-only MVNOs. The CMA should investigate how large this incentive is.

- 8.8 TalkTalk is concerned that the CMA may not have contacted smaller mobile-only MVNOs to determine their views on the proposed merger. In the absence of such consultation, it is not reasonable to provisionally conclude that there will be no harm to mobile-only MVNOs from the proposed merger.

8.2 The CMA fails to consider the specificities of TalkTalk

- 8.9 Throughout its document, the CMA states its position as if Virgin, Sky and TalkTalk were broadly homogeneous to one another, and all are therefore approximately equally effective competitors, with the same ability to withstand foreclosure. For example, at §14.173, the CMA states that:

Even if the quality of the mobile offering suffered, each of the fixed-MVNOs have particular strengths and differentiators – in particular, for Sky, its pay TV service and for Virgin Media its broadband service. We would not expect mobile to be a key differentiator for any of them even in the counterfactual.

- 8.10 This comment from the CMA clearly omits TalkTalk. [X] As such, we are the closest pure competitor to BT/EE and particular weight should be given to our concerns of foreclosure.

- 8.11 It is clear to TalkTalk that the incentives to foreclose fixed-mobile operators are firm-specific. There will be a different incentive to foreclose (say) Virgin Media than TalkTalk, given our different customer bases, product offerings, customer price sensitivity, and so forth. However, the CMA treats all competitors to BT as being the same. TalkTalk therefore considers that the CMA should [X] and change its conclusions accordingly.

- 8.12 [X].

9 The CMA's analysis of the mobile backhaul market is incorrect

- 9.1 Although TalkTalk's primary concern regards the wholesale mobile market, TalkTalk has also briefly reviewed the Provisional Findings regarding the impact of the merger of BT and EE on the mobile backhaul market.

- 9.2 TalkTalk considers that the Provisional Findings misunderstand certain aspects of the effect of regulation in the telecoms sector, and in particular whether regulation eliminates the incentive and ability of BT to discriminate against and foreclose competitors.

9.1 Price discrimination

- 9.3 Sky and Vodafone raised concerns around various forms of price discrimination. For example at §16.33(a):

Vodafone submitted that the merged entity might still be able to increase the costs to rival MNOs by altering the relative prices of EAD and EAD LA (included in the same basket) in such a way that the overall cost to MNOs would increase.

- 9.4 The CMA concludes that this is not a concern (at §16.34).

In relation to Vodafone's concerns, we provisionally found that this was not likely to occur, as it would be a breach of the SMP condition of non-discrimination Appendix D, paragraph 61b and could result in enforcement action being taken by Ofcom on its own initiative or by an MNO taking a formal dispute to Ofcom.

- 9.5 This conclusion is not sound. Ofcom in its recent Business Connectivity Market Review has found that Openreach had engaged in exactly this type of behaviour in respect of EAD-LA and EAD standard products¹³. EAD-LA and EAD-standard are Ethernet variants. External CPs use relatively more of EAD-standard than does BT internally. Ofcom found that BT had inappropriately¹⁴ raised the price of EAD-standard (offset by reductions in the price of EAD-LA) to raise rivals' costs. Notably it would be very difficult for rivals to detect this behaviour (and bring a dispute) since it would require knowledge of the underlying cost differences between EAD-LA and EAD-standard— data which is not published.

- 9.6 Sky raised other price discrimination concerns (at §16.33(b)):

Sky submitted that the merged entity could discriminate against rival MNOs, in terms of pricing, by:

(i) calibrating a volume-based discount scheme that afforded limited opportunity for rival MNOs to benefit from the largest discounts, but allowed EE to benefit in line with its level of demand...

- 9.7 In the Provisional Findings the CMA said (§16.35):

...In relation to the first of Sky's concerns, we provisionally found that this strategy was not likely to result in higher prices to other MNOs. This was because a discount that only EE could get would not harm rival MNOs since payments between EE and Openreach would constitute internal transfers and so such a discount would give EE no competitive advantage.

¹³ BCMR May 2015 §10.18ff

¹⁴The price difference should reflect the LRIC cost difference. However, the price difference was far greater than the LRIC cost difference.

9.8 The Provisional Findings conclusion misunderstands how wholesale Ethernet products (which include mobile backhaul products) are regulated. Wholesale Ethernet prices are regulated within a basket. The regulation that Openreach has to comply with requires that they reduce prices (on average) within the basket by a certain amount each year. Therefore, they can 'rebalance' prices, offsetting relative price reductions on some products with relative price rises on others. This mechanism allows Openreach the opportunity to discriminate. For example:

- as Sky pointed out a volume discount for EE (only) would harm competitors since the prices that rivals pay could rise to reflect the reduction in the imputed payments from EE;
- the EAD-LA / EAD-standard example discussed above is another example of this form of gaming;
- Openreach has also engaged in this type of pricing behaviour with other products. For instance, charges for MPF variants of products such as new provide, cease, and right when tested were systematically higher than the equivalent WLR variants. BT uses WLR not MPF.

9.9 More generally, BT can price discriminate against competitors by raising the prices of Ethernet products (including mobile backhaul) above their true cost. BT has been able to do this by manipulating cost attributions and loading (according to Ofcom) over £250m of excessive cost onto regulated products¹⁵.

9.2 Non-price discrimination

9.10 We discuss below a number of areas of non-price discrimination.

9.11 The CMA considers that there will be 'limited, temporary and localised' degradation of service quality (§16.23) since, in part, SLGs are in place which deter degradation. At §16.23(d), the CMA states that:

An SLG direction has been in place since 2008 that requires that Openreach pays compensation for non-delivery and fault repair on a proactive basis.

9.12 The mere existence of SLGs is insufficient to create incentives for efficient and non-discriminatory quality levels. The effectiveness of SLGs depends on many factors such as such as the level of SLGs (e.g. the value of compensation per day of delay), what services the SLGs apply to, at what point SLGs become payable, the ability of BT to avoid paying SLGs (for example, via the deemed consent mechanism¹⁶) and exemptions. All of these elements are currently not set by Ofcom in the SLG Direction but rather are set through commercial negotiation. Openreach has

¹⁵see Ofcom Cost Attribution Review Second Consultation November 2015 Table 1.3

¹⁶Deemed consent is a mechanism whereby BT is able to unilaterally modify/delay a delivery date under certain circumstances the effect of which is that SLG payments for late circuit delivery can be avoided

significant power in these negotiations as Ofcom recognised in a recent market review:

we recognised that Openreach, as the SMP provider for services in fixed access markets, naturally holds a more powerful negotiating position than other CPs¹⁷

- 9.13 As a result Openreach is able to impose unreasonable terms. For example Openreach has been able to impose deemed consent rules to avoid paying SLGs in a wide range of inappropriate circumstances¹⁸. The existence of a dispute mechanism has not neutralised Openreach's power – see below.
- 9.14 Notably, Ethernet delivery service performance has been 'unacceptable' over the last 4 years¹⁹ which implies that the SLG regime is ineffective.
- 9.15 Regarding innovation the Provisional Findings conclude that Openreach is unlikely to discriminate in respect of innovations and product developments in large part due to the ability to 'appeal' (or dispute) an SOR rejection to Ofcom:
- Finally, CPs have the right to appeal to Ofcom if they think they have been discriminated against in the treatment of an SoR. Ofcom has so far received only two formal complaints, and has dismissed both of them.*
- 9.16 The Provisional Findings are not correct in saying that these formal complaints had been 'dismissed' by Ofcom. One of the examples is the single jumper variant of MPF (known as SJ-MPF) which would materially lower the cost of the MPF product. BT's rivals use MPF whereas BT does not use it itself (in any material volume) – this creates an incentive to discriminate by raising the costs of MPF. In its dispute resolution decision in 2014, Ofcom concluded that SJ-MPF was not (at that point in 2014) worth developing since due to low future MPF growth it would not be cost effective. However, Ofcom accepted that Openreach had been aware of the cost saving in 2008. Further, if SJ-MPF was launched in 2008 it would have resulted in costs savings since there was high growth in the number of MPF lines in that period. This example highlights the weakness of the SOR regime – Openreach is able to delay the process so that, in this case, new product developments are no longer viable.
- 9.17 The Provisional Findings conclude that BT could not discriminate against competitors by rolling out fibre in ways that favour EE (§16.76(c)):
- The deployment of fibre infrastructure in a way that directly discriminated against rival MNOs would be considered a breach of the EOI requirement Openreach is subject to. MNOs could then bring a formal dispute to Ofcom.*
- 9.18 We are not aware of any EOI requirement (or provision in the Undertakings) that would prevent this type of discrimination. Further it is notable that in its response to

¹⁷Business Connectivity Market Review May 2015 Consultation §1.38

¹⁸Ofcom has proposed to change some of these in proposals in the Business Connectivity Market Review. For instance, it is proposing that deemed consent can apply in much fewer circumstances. However, the final regulations which will be applied by Ofcom are currently unclear.

¹⁹Business Connectivity Market Review May 2015 Consultation §13.256

Ofcom's Digital Communications Strategic Review, BT highlights that a benefit of its vertical integration is the ability to coordinate and favour its downstream businesses:

functional separation does not eliminate the coordination benefits that vertical integration can bring, or the over-arching ability of the BT Group plc Board to adopt an 'end-to-end' perspective in setting Group-wide strategy.

Thus, integration would provide Openreach with enhanced incentives to introduce new or better quality services, and to do so more rapidly, where this will allow a boost to the downstream business' retail proposition²⁰

9.3 Effect of disputes

9.19 The Provisional Findings sets out its views that disputes could be an effective method for disciplining Openreach to prevent price and non-price discrimination (at §16.34):

In relation to Vodafone's concerns, we provisionally found that this was not likely to occur, we it would be a breach of the SMP condition of non-discrimination Appendix D, paragraph 61b and could result in enforcement action being taken by Ofcom on its own initiative or by an MNO taking a formal dispute to Ofcom.

9.20 The Provisional Findings make a similar point at §16.36:

...pricing strategies that discriminate between CPs would be a breach of the non-discrimination condition and MNOs could bring a dispute to Ofcom.

9.21 The Provisional Findings are correct in that competitors, such as TalkTalk, can refer disputes to Ofcom if they consider BT is not complying with SMP obligation such as non-discrimination. However, the existence of the dispute resolution regime does deter BT from discriminating. This is for two main reasons:

- A dispute might not be brought by a competitor since they have to detect the discrimination (which in the case of product development, for example, is very difficult) and also develop and bring a dispute to Ofcom which can be difficult and costly particularly given the lack of transparency.
- Even if the competitor 'wins' the dispute there is limited downside for BT. The worst that can occur for BT is that the overcharge is backdated or in the case of a product development that BT need to develop the product in future. No fine is imposed even though BT will have benefitted from the weakening of competition in the period up to resolution.

9.22 Therefore, from BT's perspective even with the risk of disputes there is little or no commercial downside from discriminating – if a dispute is brought the worse that can happen is that some (not all) of its gains are removed. Accordingly, BT has a strong incentive to act anti-competitively.

²⁰ Report for BT by RBB Economics : Vertical integration of Openreach – the impact on competition and investment, 7 October 2015 §68 and §89

9.23 The reality of regulation including dispute provisions is that whilst it attempts to prevent discrimination it does not. It is because there is continuing discrimination that Ofcom is considering structural separation of Openreach to remove the incentive and ability of Openreach to discriminate.