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CONSOLIDATION IN THE TELECOMS SECTOR: WHAT'S NEXT?

A report on a seminar jointly held by Jones Day and HSBC in London on 6 December 2011

On 6 December 2011, Jones Day and HSBC brought together four leading experts to discuss their perspectives on recent developments in international telecoms merger control.

The event was attended by leading investors, telecoms companies and other significant participants in the telecoms industry, who provided a broad spectrum of views and thoughts on key issues facing lawyers, analysts and regulators today.

A LAWYER'S PERSPECTIVE

Francesco Liberatore
Antitrust & Competition Associate,
Jones Day London

From a practitioner's perspective, three broad trends emerge in international telecoms merger control today: new consolidation through high value deals in the US and in the EU, convergence in the way in which US and EU agencies approach the substantive review of these deals, and procedural challenges arising out of the parallel application of different rules.

First, despite uncertain financial markets, last year the telecoms sector accounted for 15.9 per cent of high value "mega deals" globally. This new wave of consolidation is driven by a combination of economic, technological and regulatory changes. In response to these changes, firms are restructuring themselves in various forms. At one end of the spectrum, there are outsourcing deals and contractual joint ventures. These are relatively quick to implement and offer a high level of commercial flexibility. At the other end of the spectrum are mergers, acquisitions and full function joint ventures. Their legal structures require more work, but tend to be more stable and need less legal intervention going forward. Unsurprisingly, these latter are also the deals that are more likely to result in competition filings, if they meet certain thresholds, and to attract the interest of competition agencies.

Second, although under different legal frameworks, there is convergence in the way in which key jurisdictions, such as the EU and the US, amongst others, assess consolidation in the telecoms sector. For example, both EU and US agencies have cleared the majority of the notified deals unconditionally. However, in some cases, commitments have been imposed on the parties to remedy alleged anti-competitive effects resulting from the proposed merger such as commitments to sell frequencies and assets to competitors with lower market shares (e.g. in the EU: *T-Mobile/Orange*; in the US: *Verizon Wireless/Alltel*). In other cases, the vertical relationship between the parties to the transaction was examined (e.g. in relation to internet content or international roaming). In the majority of such cases, the transaction was cleared without commitments, taking into account the efficiency of the regulatory framework in preventing anti-competitive behaviour that would otherwise occur as a result of the transaction. However, in other cases, regulatory conditions were imposed to make up for the shortcomings of the existing sector specific rules, in addition to more traditional divestment conditions (e.g. in the EU: *Telia/Sonera*; in the US: *Nextel/Clearwire*). Often the sectoral regulators have been entrusted with the role of monitoring compliance with these conditions (e.g. in the EU: *Telia/Sonera*; in the US: *AT&T/Bellsouth*). In other instances, the parties abandoned the deals when faced with insurmountable objections from the competition agencies (in the EU: *MCI Worldcom/Sprint*; in the US: *AT&T/T-Mobile*).

Third, despite this potential for substantive convergence, lawyers are likely to face procedural challenges. EU and US agencies increasingly coordinate their parallel reviews of transatlantic deals on timing, collection and evaluation of evidence, remedies and settlements (e.g. *Level 3/Global Crossing*). Within the EU itself, there is a complex system of referral of deals from and to the European Commission and the EU Member States' competition agencies which may delay the review process, if not managed carefully (e.g. *Cisco/Tandberg*, *Orange/T-Mobile, LibertyGlobal/Kabel*). Finally, over 90 jurisdictions now have merger control regimes, with China and India being notable additions in recent years. It is a list that continues to grow. Many regimes take a similar approach to key jurisdictional questions; for example, they assert jurisdiction based on the parties' local turnover. However, there remains a lack of clarity on key issues; for example, whether turnover should be allocated to the country where a call terminates or where a call originates. Given the strategic importance of telecoms for governments and consumers alike, it is likely that each agency will use either of the two approaches that grants it jurisdiction.

It therefore becomes ever more important for practitioners to coordinate EU and US merger control filings with those in other jurisdictions, in particular in terms of timings, substantive assessment and remedies if necessary.

AN ANALYST'S PERSPECTIVE

Stephen Howard
Head of HSBC Global Telecoms,
Media & Technology Equity Research

Consolidation poses the question: what kind of telecoms market do we want? Historically, the focus has been on delivering the lowest priced services to consumers, but clearly this approach is not delivering the optimal level of infrastructure investment. Larger scale operations will facilitate network upgrades and create the optimal level of infrastructure investment. However, at this moment, it is not clear if merger regulation will reflect this.

One example of this is that fixed-line telecoms remains a market with formidable barriers to entry. By and large it has not proved economically feasible to duplicate pre-existing telecoms networks. To sidestep this problem, regulatory agencies have forced the sale of incumbent networks at, or beneath, their cost. However, this creates its own set of issues, particularly that this undermines the case for all players in the market to invest in infrastructure.

To counter this aversion to infrastructure projects, which has been the inevitable result of regulatory policy, the European Commission has started to encourage next generation access upgrades to the telecommunications network. As a consequence of this, there is a possibility that the pendulum will swing back in favour of scale.

If the regulatory authorities do not continue to also encourage infrastructure investment and development in relation to mobile capacity then there is the possibility of "capacity crunch", as there will come a point when demand will outstrip the capacity provided by the operators. It is hoped that merger control regulation will accommodate these scale dynamics. The logical response to these developments is direct consolidation, which will enable parties to pool infrastructure and spectrum resources. Lower profile alternatives include network sharing and mutual network outsourcing. Due to this capacity pressure it would be advantageous if the regulatory authorities recognised the legitimate economic arguments driving consolidation.

However, mergers and acquisitions in any sector remain controversial for investors. There is currently an inclination towards deleveraging, which is reinforced by the difficulties of accessing credit. The market remains highly sceptical about the justification for cross-border deals.

In conclusion, scale and capacity issues are conducive to investment, but regulators need to recognise the specific market challenges facing the telecoms sector. Ambitious policy goals can be achieved by facilitating mergers that will lead to larger operators. The inevitable result of the mobile spectrum capacity crunch is concentrations. All this should point to regulators appreciating the specific challenges facing the sector and acting accordingly.

A REGULATOR'S PERSPECTIVE

Sheldon Mills
Director of Mergers,
UK's Office of Fair Trading (OFT)

In the light of the OFT's recent telecoms experience, four factors are particularly relevant to telecoms merger control: early pre-notification contacts; increasing focus on closeness of competition in complex cases; cross border cooperation between agencies; and interface with sectoral regulators, such as Ofcom in the UK.

Of these, the most important is arguably the first issue of pre-notification and the accompanying jurisdictional issues. Pre-notification of potential mergers is vital in the telecoms sector because of its global importance for commerce and consumers. The inevitable result of this is that antitrust and regulatory agencies will take a keen interest in consolidations involving telecoms firms at all levels of the supply chain. As such, it goes almost without saying that notification of a pre-merger or joint venture is essential. Although the EU operates a "one stop shop" policy for merger notification, that does not mean that the national competition and regulatory authorities of the Member States will not be involved. Member States tend to take an active interest in telecoms mergers; either formally through making a request for referral, or informally through active discussions with the Commission's case team.

Whether or not a merger will fall under the jurisdiction of the European Commission or the Member States is dependent on the circumstances of each case. If a deal has wide cross-border impact then it will almost certainly be dealt with by the Commission in Brussels. However, if the deal has primarily local impact on the Member State(s) then the merger is likely to be considered at the national level. Even if a merger does not have a "Community dimension", i.e. does not fall within the Commission's jurisdiction, Member States may make a request that the Commission does in fact take responsibility for the merger investigation.

To consider how telecoms mergers are substantively assessed it is worthwhile looking at the *Orange/T-Mobile* case, as it highlights a number of significant areas which apply to telecoms mergers. *Orange/T-Mobile* really brought to the fore the interaction between the Commission and the Member States. For instance, the OFT requested a partial referral on the basis that Hutchinson "3" could be weakened as a competitor, and because the transaction could have impacted upon the 4G spectrum of cellular wireless standards in the UK. The OFT later withdrew their request for a referral, once adequate commitments had been agreed by the parties. This highlighted the need to consider remedies and commitments early on in the merger process.

The substantive analysis of the *Orange/T-Mobile* case can be considered a new approach by the Commission. The two parties had a combined market share of 30-40 per cent in the market for retail mobile services. But the Commission focused on the closeness of competition in the market as well as the parties' combined market share. The Commission found that O2 and 3UK were the major beneficiaries of Orange's customer churn, and that Orange was the primary beneficiary of T-Mobile's customer churn. 3UK was identified as the "maverick" in the market.

In contrast, in its review of the proposed merger between AT&T and T-Mobile's US operations, the US Department of Justice also looked at market shares and closeness of competition. However, it found that the parties would control more than 90 per cent of the US territory and that US T-Mobile was the maverick. Therefore, the deal was strongly opposed and ultimately abandoned.

In *Level 3/Global Crossing*, the OFT liaised closely with the US Department of Justice. The deal brought together two worldwide IP transit providers. The deal rationale was to invest in infrastructure in order to improve internet traffic backbone. The OFT considered that IP transit was distinct from peering. However, despite the parties' combined strong position in peering, the OFT concluded that the merger entity would continue to face competition from other Tier 1 and some local Tier 2 providers. The information exchanged with the US Department of Justice, aided by waivers from the merger parties, was key for the OFT to arrive at these conclusions.

Telecoms mergers may raise complex issues and therefore pre-notification contacts with the regulators are essential. In particular, the merging parties and their advisers may need to pay particular attention to local impacts and differences, network infrastructure issues, sector specific regulations and inter-agency cooperation.

CLOSING REMARKS

Bernard Amory
Partner-in-Charge, Jones Day Brussels, who also oversees Jones Day's Antitrust & Competition Practice in Europe

From an industry policy point of view, it is understandable that all stakeholders would ask regulators to soften their merger control approach and allow national champions to grow in order to be able to better compete in a globalised world economy, and to reach the scale required to invest in new network technology, such as broadband. This would be consistent with the EU's own telecoms policy, that is to allow the deployment of new infrastructure in the long term.

However, from a legal point of view, policy objectives may have limited practical impact on the substantive review of mergers. EU merger control is a well-oiled machine which draws on many years of experience. The assessment of proposed deals is largely based on the level of the combined market shares of the parties, the concentration ratios and other technical and economic factors, such as barriers to entry and closeness of competition. Although the current regime allows the European Commission to consider efficiencies that would outweigh any anticompetitive effects resulting from high combined market shares of the merged entity, there is no precedent to date where this efficiency-based defence has been successfully applied.

Therefore, in the years to come, a key challenge for practitioners, analysts and regulators will continue to be to work together to disentangle a merger's potential for efficiency and innovation from its potential for foreclosure and excessive market power, on the basis of the rules and purposes of international merger control regimes which are converging in some respects, but still diverging in others.

CONTACTS

For more information about the seminar and its contents, please contact:

William Saunders
Jones Day London
+44 (0) 20 7039 5182
wbsaunders@jonesday.com

Francesco Liberatore
Jones Day London
+44 (0) 20 7039 5221
fliberatore@jonesday.com

Caroline Birch
Jones Day London
+44 (0) 20 7039 5400
cbirch@jonesday.com