



**Response to the CMA's Preliminary Invitation to Comment on
proposed BT/EE merger**

TalkTalk submission

Non-confidential version

March 2015

1 Summary

- 1.1 This submission responds to the CMA's Preliminary Invitation to Comment, issued 4 March 2015, on the proposed merger between BT and EE.
- 1.2 TalkTalk welcomes the CMA taking the innovative step of launching a preliminary invitation to comment on this proposed merger prior to its filing by the merging parties, and we are delighted to respond.
- 1.3 TalkTalk is a significant participant in many of the markets impacted by the proposed transaction. We compete with both BT and EE in retail mobile communications markets and in fixed line broadband, triple and quad-play markets. We are also one of BT's two largest customers, via our purchases of wholesale products from BT's Openreach division; and we are a major purchaser in the market for MVNO services. There is almost no aspect of TalkTalk's current product offering which is not impacted by this transaction as either competitor or customer. The views expressed in this submission cover both our position as a customer and as a competitor of the merging parties.
- 1.4 Overall, TalkTalk considers that the proposed merger of BT and EE will cause a substantial lessening of competition in a wide range of markets, resulting in harm to consumers. This substantial lessening of competition arises due both to the horizontal overlaps between BT and EE and the vertical links between the two companies.
- 1.5 TalkTalk does not consider the current competitive conditions in the market are the most suitable counterfactual for the CMA to use in its merger assessment, for two main reasons: BT and EE have each recently announced intentions to enter each other's markets; and there is an ongoing parallel transaction between Three and O2. The CMA should reflect these factors in its counterfactual to the merger.
- 1.6 The CMA has asked us to specify concerns we have in respect of the supply of a number of services¹. We have concerns in relation to several of these:
 - *Wholesale mobile services to mobile virtual network operators (MVNOs).* TalkTalk expects that EE's wholesale mobile service offering will be at least partially withdrawn from the market by BT post-merger, given that BT has the commercial and strategic incentive to do so. In combination with the proposed merger of O2 and Three, a withdrawal of EE's wholesale mobile service offering would reduce the number of potential suppliers of MVNO services from four currently to two for any company planning to offer quad-play bundles. [Redacted]
 - *Retail mobile voice and data services.*

¹ These areas are identified in an email from Ronan Scanlan of the CMA to Simon Pilsbury of TalkTalk on 4 March 2015.

- *Personal customers.* BT has publicly stated its intention to begin supplying retail mobile voice and data services and has acquired a block of 2600MHz spectrum to facilitate such entry. TalkTalk understands that BT would enter using a combination of ‘femtocell offload’ utilising the 2600MHz spectrum, and a national roaming agreement elsewhere. This innovative technology would allow BT to operate a mobile network with a very different cost base to incumbent mobile providers, disrupting the existing market and potentially driving costs down for consumers. TalkTalk anticipates BT will abandon this planned strategy as a consequence of the merger.
- *Business customers.* BT and EE both supply mobile voice and data services to business customers. BT has an MVNO agreement with EE that enables it to offer such services. The proposed transaction will decrease the number of independent providers in the market, thereby reducing choice for consumers in a market which is already concentrated. It will also reduce the competitive pressure from EE on BT's triple-play offering to SME businesses.
- Broadband services:
 - *The supply of superfast broadband ('SFBB') to residential customers.* The proposed transaction will combine two scale providers of superfast broadband to residential customers in a market with high entry barriers and few other scale providers. While BT has been slower than Virgin in converting standard broadband customers to SFBB, it is now rapidly increasing its customer base. The transaction will further entrench BT's market leading position, harming consumers.
 - *The supply of standard broadband ('SBB') in areas which have not been subject to unbundling.* Few providers currently offer standard broadband services to consumers in deep rural areas (where there is little unbundling). The transaction would combine two of the three main retail providers of ‘off-net’ services to customers, thereby harming consumers.
- *Triple-play and quad-play packages.* The impact of triple- and quad-play residential bundles is to magnify the impact of any detriments to competition caused by prospective exclusionary behaviour in other markets. A competitive detriment caused in any one of the elements of the bundle (for example, mobile) can impact sales of other elements of the bundle.

1.7 In addition, we have concerns regarding the impact of the vertical relationships that will be created between BT's Openreach division and EE, and the potential for BT to use the transaction to raise costs for competitors in BT's downstream markets:

- *Increased incentives to drive up competitors' prices for wholesale local access ('WLA') products.* EE is the only major ISP other than BT to use BT's Wholesale Line Rental ('WLR') product as the primary wholesale product for serving customers. Both TalkTalk and Sky use BT's alternative MPF product. Post-merger, BT will have an increased incentive to drive up the costs allocated to its MPF product compared to its WLR product.

- *Impact on VULA margin testing.* By acquiring EE, BT will shift its cost structure for offering mobile elements of packages from being primarily variable cost (under an MVNO deal) to primarily fixed cost (under ownership of an MNO). This will make it easier for BT to game the recently introduced VULA margin regulation for quad-play SFBB bundles.
- *Increased ability to drive up competitors' costs.* As a consequence of the transaction, BT's cost structure (and its regulatory financial statements) will become even more complex. [Redacted].

1.8 TalkTalk is not a significant competitor for, or purchaser of, mobile backhaul or retail voice-only products. Notwithstanding this, there appears to be scope for the proposed merger to lead to consumer detriment in these markets.

1.9 Finally, TalkTalk is concerned about the prospect of integration and a softening of competition between EE and BT prior to completion of the proposed merger. We are writing separately to the CMA on this issue to outline our concerns more fully. We believe the CMA needs to give serious consideration as to whether steps are required to prevent such integration and to prevent a deterioration in competition between BT and EE while its review is ongoing; for example, the use of its interim order powers or the appointment of a monitoring trustee.

1.10 The remainder of this submission sets out the concerns above in greater detail. TalkTalk looks forward to further discussions with the CMA on these matters during the course of its consideration of the merger.

2 Relevant counterfactual to the merger

2.1 TalkTalk does not consider the currently prevailing competitive conditions in the market are the most suitable counterfactual for the CMA to use in its merger assessment for two reasons.

2.2 First, BT and EE have each recently announced intentions to enter into each others' markets. In February 2013, BT acquired blocks of 2600MHz spectrum in the 4G spectrum auction, with the stated intention of using this spectrum to serve '*business and consumer customers*'. EE launched its pay-TV offering in October 2014, which competes directly with the pay-TV offering of BT, as well as the larger pay-TV platforms operated by Sky, VM and TalkTalk.

2.3 Second, the BT/ EE merger takes place at the same time as the anticipated Three/ O2 transaction, which affects some of the same economic markets. On 23 January 2015 Three announced its intention to acquire O2, merging two of the four major UK mobile network operators ('**MNOs**'). This merger has the potential to reduce or otherwise impact competition in some of the markets where BT/ EE may raise concerns, particularly the wholesale MVNO market, the consumer mobile market, and the business mobile market.

2.4 Regarding mobile products, in the February 2013 auction for 4G spectrum, BT paid £186m for 2 x 15MHz and 1 x 20 MHz blocks of 2600MHz spectrum. The acquisition of this spectrum effectively committed BT to entering into the UK market for retail mobile products. BT's commitment to enter the UK retail mobile market has been further supported by its comments to investors and press about its intentions regarding mobile products. For example, at the time of acquisition of the 4G spectrum, BT informed the markets that:²

BT has secured a licence for 2x15MHz of FDD and 20MHz of TDD 2.6GHz spectrum, the company confirmed today. This spectrum, which can be used to provide fast 4G connectivity, will enable BT to provide its business and consumer customers with an enhanced range of mobile broadband services, building on its existing strength in wi-fi.

2.5 BT has supplemented this 4G spectrum with a national roaming agreement with EE to offer service in areas which are outside BT's 4G coverage on its own network. TalkTalk understands that the 4G spectrum was to have been used by BT to provide a femtocell based service for its subscribers, offloading some demand onto its own network, and resulting in lower costs to consumers. This approach is possible due to the combination of BT's 2600MHz spectrum with the large number of BT subscribers with wi-fi routers in their homes, routers which could be switched to ones including femtocells, allowing them to provide mobile broadband and voice services to customers across a broad swathe of the country.

2.6 BT's approach is one with the potential to be very disruptive to incumbents in the mobile market, by adopting an approach with a potentially lower cost structure and potentially a different customer experience.

2.7 Moreover, by engaging in an MVNO deal with high offload, and the ability to market to its existing fixed-line subscriber base, BT has the scope to grow its mobile business organically over the next few years. This would provide a subscriber base which would make it more profitable for BT to bid for other tranches of spectrum in future auctions, increasingly using its own network (rather than its MVNO partner) to carry traffic.

2.8 We consider that, particularly in phase 1 consideration of this merger, it would be appropriate for the CMA to adopt a conservative counterfactual in order to ensure that no competitive concerns are missed; the appropriate counterfactual can then be considered more thoroughly by the panel in a phase 2 review. Such an approach is in line with that set out in the joint OFT/ CC (now CMA) Merger Assessment Guidelines, at §§4.3.25-4.3.27.

2.9 We believe the appropriate counterfactual should therefore be:

- BT is an active competitor in all markets (such as retail mobile products) where it has stated its intention to enter;

² <http://www.btplc.com/News/Articles/ShowArticle.cfm?ArticleID=1933E628-6973-4835-AF50-5548CD979649>

- EE is an active competitor in all markets (such as retail pay-TV) where it has stated its intention to enter or recently entered; and,
- the Three/ O2 merger has already been completed without any remedies.

2.10 The remainder of this submission will be based on the counterfactual set out in §2.9.³

3 The BT/ EE merger raises serious competition concerns

3.1 This section sets out the serious competition concerns raised by the proposed BT/ EE merger. These concerns come in two broad categories: horizontal concerns, which generally result from the combination of EE and elements of BT Consumer in a single company; and vertical concerns, which generally result from the combination of EE and BT Openreach in a single company.

3.2 The subsections dealing with the various competition issues raised are as follows:

- section 3.1 considers the impact of the transaction on the supply of SFBB products;
- section 3.2 considers the impact of the transaction on the supply of SBB products in 'Market A' (rural) areas;
- section 3.3 considers the impact of the transaction on the supply of retail mobile products;
- section 3.4 considers the impact of the transaction on the supply of wholesale mobile capacity to mobile virtual network operators;
- section 3.5 considers the impact of the transaction given the vertical relationships which exist between EE and BT; and
- section 3.6 covers off other areas of interest to the CMA set out in its preliminary invitation to comment.

3.1 Horizontal overlaps in the residential SFBB market create an SLC

3.3 The proposed merger of BT and EE combines two of the five largest providers of SFBB products to residential consumers. Both BT and EE offer SFBB products based on BT's Generic Ethernet Access ('GEA') product overlaid onto WLR. For the purposes of this section (and in line with Ofcom's approach) a customer is considered to be taking SFBB when they are purchasing a product with a headline speed at, or in excess of, 30Mbps.

³ If the CMA does not treat BT as an active competitor in the retail mobile market, the CMA should instead treat BT as an actual potential competitor in this market when conducting its analysis of whether there is an SLC caused by the proposed merger.

- 3.4 The UK market for residential SFBB has only five participants of significant scale: Virgin Media, TalkTalk, Sky, BT and EE. 32% of purchasers of any broadband product were determined by Ofcom's *UK Fixed-Line Broadband Performance November 2014* to be taking a product with a headline speed at or above 30Mbps; for a total market size of 23.4m broadband lines, this implies that approximately 7.5m connections were SFBB. TalkTalk's estimates of market shares in Q4 2014 are set out in Table 3.1 below.⁴

Table 3.1: Estimated market shares in consumer SFBB, Q4 2014⁵

[Redacted]

- 3.5 Static current market share measures may give a misleading impression of the competitive dynamic. BT's market share has already been growing in this market. In Q4 2013, BT Retail had around 1.9m SFBB customers, out of a total market size of 5.6m, giving it a 34% market share (therefore a 3% increase year-on-year). BT's market share is likely to grow more quickly than its historic trends over the next two years, as VM has already upgraded around 3.8m of its 4.5m customers to SFBB (up from 3.2m a year ago); VM is unlikely to be able to sustain a further 600k net SFBB additions per annum. As such, BT's current market share likely understates its competitive strength in this market.
- 3.6 Moreover, the market shares set out in Table 3.1 may overstate the extent to which Virgin Media imposes a competitive constraint on BT. Virgin only covers 45% of the UK with its network, while the Openreach SFBB network currently encompasses around 75% of UK premises. As such, less than half of BT's SFBB customers are likely to be living in areas where they could switch to VM; outside VM areas, both BT and EE are likely to have much higher market shares, and be relatively more important in imposing competitive constraints on one another.
- 3.7 EE should be considered as one of the few major competitors in the UK SFBB market which could be capable of placing a competitive constraint on BT's offering. [Redacted]⁶ [Redacted]⁷ Consequently, the competitor set for SFBB appears to TalkTalk to be no wider than five firms: BT, Virgin, Sky, TalkTalk and EE.
- 3.8 The SFBB market exhibits significant barriers to entry. All of the operators listed in Table 3.1 have achieved their market shares by upgrading customers from SBB; there are only five operators with a market share in excess of 1% in SBB, the same five operators with a market share in excess of 1% in SFBB. There has also been no substantial new entry into the SBB market in the past five years, and even before that time operators such as TalkTalk and Sky entered and/or expanded by acquiring

⁴ The data are sourced from various companies' releases, and reconciled to Ofcom's estimate of the overall market size. Estimates are used where precise figures are unavailable. TalkTalk's figure is exact for end November 2014; BT Retail is exact for end December 2014.

⁵ Sources: TalkTalk accounts, BT quarterly KPIs, Ofcom UK Fixed Broadband Performance November 2014, TalkTalk estimates.

⁶ [Redacted]

⁷ [Redacted]

incumbents (AOL/ Tiscali/ OneTel and easynet respectively), rather than on a greenfield basis. [Redacted]

- 3.9 Given BT's substantial existing market share, the trend towards BT increasing its market share over time, the differences in competitive intensity between different geographic areas, the small number of competing firms in the market, and the high barriers to entry into the SFBB market, BT's purchase of EE is likely to lead to detriment to consumers of SFBB, through some combination of loss of choice, price increases, and reductions in quality of service.

3.2 Horizontal overlaps in the SBB market in rural areas create an SLC

- 3.10 The SBB market differs on an exchange-by-exchange basis. The key determinants of competition are the number of different operators which have unbundled an exchange, and whether Virgin Media has a network presence in the area covered by the exchange.
- 3.11 There is a significant difference in the level of competition from exchange to exchange because:
- TalkTalk no longer sells to new customers at exchanges where we have not unbundled; and,
 - Virgin has disposed its off-net base (to TalkTalk) and no longer sells to new customers other than via its cable network.
- 3.12 Effectively, therefore, there will only be three operators of meaningful scale willing to sell to new residential broadband customers in exchanges that have not been unbundled (generally rural exchanges): BT (including Plusnet), Sky (although Sky does not advertise that it is willing to sell off-net), and EE. In exchanges which have not been subject to any unbundling, the proposed transaction will be combine two of the three significant existing suppliers of SBB services in such areas.
- 3.13 Although no figures are publicly available, BT is likely to have a very high market share – in excess of 50% – in areas which have not been unbundled, due to the absence of both TalkTalk and Virgin, and Sky not actively selling. In the presence of such a high market share, any acquisition of further market share, particularly where it eliminates one of the few remaining competitors able to exercise a competitive constraint on BT, is likely to lead to a substantial lessening of competition.
- 3.14 The lack of competition BT faces in market A areas (approximately, those which have been unbundled by no more than one competitor, and where Virgin is not present) already allows BT to engage in geographic price discrimination via its Plusnet brand. Plusnet charges different prices depending upon which WBA market the customer is in– customers outside 'low cost areas' (i.e., areas with multiple competitors to BT)

are charged £7.50 per month more than customers in low cost areas.⁸ BT is therefore amending its pricing strategy based on the number of competitors it faces (and therefore the extent of market power it holds) in a given area. As it states in Plusnet's FAQ:⁹

There are 3 different categories for UK telephone exchange areas - Market 1, Market 2 and Market 3.

*Which one of these categories your area falls into determines the price you pay for broadband. **Where there's more competition in an exchange between different providers, we can offer you better pricing.** This is known as a 'low cost area'. [emphasis added]*

- 3.15 Removal of one of the last scale competitors to BT in areas not subject to unbundling will merely worsen this situation, providing scope for BT to increase retail prices even further above the levels prevailing in more competitive areas.

3.3 Loss of a credible entrant into the mobile market

- 3.16 Historically, the UK mobile market had five incumbent MNOs active within it. In 2010 this was reduced to four MNOs due to the merger of T-Mobile and Orange to form EE. EE became the largest MNO in the UK; the other three remaining MNOs are Vodafone, O2 and Three. As set out in section 2, Three and O2 are currently proposing to merge.
- 3.17 As set out in section 2 above, the appropriate counterfactual is one which takes into account BT's widely announced plans to launch a retail mobile product, given BT's acquisition of spectrum, MVNO deal with EE, and strong growth prospects. As such, the CMA should base its analysis on the counterfactual where BT enters the mobile market and, leveraging its estate of routers and ability to cross-sell, rapidly expands within this market.
- 3.18 The proposed merger between BT and EE will eliminate this competition:
- there will be much lower incentives for BT to adopt a disruptive strategy based on its router estate than if BT does not purchase EE. If BT is a stand-alone company, it does not have to write off any costs by choosing to adopt a femtocell based strategy, as it has not incurred any costs of building macro-cells, purchasing lower frequency spectrum, or building masts. This difference in previously sunk costs will mean that a merged BT/EE will have much reduced incentives to engage in (costly) roll-out of femtocells across its fixed-line estate.

⁸ See http://www.plus.net/support/broadband/products/low_cost_areas.shtml. BT does not appear to have updated this webpage to reflect Ofcom's move from defining markets 1, 2, and 3 (the system prior to the 2014 WBA Review) to defining markets A and B (in the 2014 WBA Review). However, we understand that Plusnet's pricing is now based on markets A and B.

⁹ <https://www.plus.net/home-broadband/faqs/general/#low-cost>

- whereas BT would have had incentives to price aggressively, including using bundles, in order to expand its share of the retail mobile market, a merged BT/EE will have much lower incentives to do so. While a stand-alone BT has no existing mobile margins to cannibalise by adopting an aggressive pricing strategy, EE is the largest mobile provider, and would experience a serious risk of margin loss across its existing base if it chose aggressively to target additional customers with discounted offers.

3.19 Other full MNO entry is unlikely. While there are other competitors in the retail mobile market which are able to supply customers using MVNO deals rather than acquiring spectrum and launching as an MNO, these operators tend to be much smaller and are best seen as a competitive fringe rather than major players in the market. Even the largest MVNO operator (Virgin Media) has never achieved more than 10% of market net adds in a quarter, and remains a relatively minor competitive force.¹⁰ Furthermore, as set out at section 3.4 below, the merger will itself also impact on the wholesale MVNO market.

3.20 Such a reduction in the number of competitors, relative to the counterfactual, will tend to increase prices to consumers, as the market becomes more concentrated. Consumer welfare losses from any higher prices will be in addition to the loss of consumer welfare from reduced consumer choice.

3.3.1 Loss of direct competition in the SME mobile market

3.21 At present, BT directly competes with EE in the market to offer mobile voice and data services to SMEs. Mobile communications are vital for a large proportion of SMEs, some of whom buy their mobile products as part of a bundle with fixed line services, and some of whom buy fixed and mobile products separately.

3.22 As the largest mobile communications provider in the UK, EE will have a large share of the market to provide mobile services to SMEs, although the precise market share is unclear. Some of this market share will be direct; while another proportion will be through the various reseller and MVNO deals that EE has entered into.

3.23 BT is the market leader in fixed line communications services for SMEs, with a market share in the region of 45% (precise market shares in SME markets are very unclear). This market share is at least an order of magnitude higher than any other provider of fixed line communications to SMEs; there are no other scale operators. BT also offers mobile services to SMEs; historically it has done so through an arrangement with Vodafone, but in 2014 it shifted to an MVNO deal with EE. As such, BT will almost certainly already be the largest provider of triple-play communications bundles to SME customers, as well as the largest provider of internet-only and voice-only products to SMEs.

¹⁰ See Enders Analysis (2014), *UK Mobile Market Q3 2014*, December 8, at page 6.

- 3.24 The combination of EE and BT will therefore substantially weaken competition in the markets to provide communications services to SMEs. BT will acquire one of its largest rivals, a competitor well-placed to push out from offering mobile communications services to becoming a major player in triple-play bundles. The potential for EE to win market share from BT is likely to have acted as a constraint on BT's pricing of triple-play bundles. Moreover, by acquiring EE, BT can potentially convert customers which previously took separate mobile service from EE and fixed line services from BT to taking a single triple-play bundle. This will tend to lower rates of switching for such customers (as they risk a switching failure leaving them without any communications, so that they cannot temporarily use mobile and fixed lines to substitute for one another); lower rates of switching tend to make markets less competitive and thereby raise prices or reduce the quality of products offered.
- 3.25 As a result of this, the CMA should undertake a full analysis of competition in the SME mobile market(s) and, in particular, the extent to which BT and EE place constraints on one another.

3.4 The proposed merger will create an SLC in the wholesale MVNO market

- 3.26 The only suppliers in the wholesale MVNO market are MNOs who have sufficient spectrum in order to be able to supply third parties, generally with full national coverage. Short-term entry into this market is impossible, as it would involve both the acquisition of spectrum (which generally only occurs at Ofcom spectrum auctions) and the time-consuming and costly roll-out of a national mast network.
- 3.27 The CMA should not consider there to be any horizontal overlap in this market due to the proposed BT/ EE merger. This is because, despite BT's forthcoming MNO launch, BT is unlikely to be in a position to compete effectively in the wholesale MVNO market in the next two years, as it will be unable to offer national mobile coverage on the basis on the blocks of 2600MHz spectrum which it has previously acquired.
- 3.28 However, EE has been an active player in the MVNO market. [Redacted] EE has previously also entered into MVNO agreements with both BT and Virgin Media.
- 3.29 Following the acquisition of EE, BT will have both the commercial and strategic incentive and the ability to partially withdraw EE's wholesale MVNO product from the market. TalkTalk envisages that this withdrawal would be targeted at companies who may use the MVNO agreement to supply quad-play bundles in competition with BT's downstream arm, such as TalkTalk, Sky and Virgin Media.
- 3.30 BT's willingness to act on these incentives can be seen in its policy of attempting to leverage upstream market power into gains in retail market share. BT has shown

itself willing act anti-competitively in order to attempt to raise rivals' costs and foreclose them.

- 3.31 [Redacted]¹¹ [Redacted]
- 3.32 [Redacted]¹²
- 3.33 [Redacted] BT's unwillingness to enter into a reciprocal agreement for Sky to supply Sky Sports to BT, and BT to supply BT Sport to Sky appears to be the *prima facie* reason for BT's CA98 complaint to Ofcom regarding sport.¹³
- 3.34 TalkTalk expects that if BT acquires EE [redacted]. In effect, we would have no prospect of obtaining supply from BT/EE, and would have to attempt to source supply from other MNOs.
- 3.35 Taking into account the O2/Three merger, this would leave effectively two competitors (Three and Vodafone) to supply Sky, TalkTalk and Virgin with MVNO agreements. We think that two competitors is unlikely to be sufficient to secure effective competition, particularly since Vodafone's incentives may also be clouded by its own proposed move into fixed line products.¹⁴[Redacted]
- 3.36 Furthermore, with only two competitors in such a market, there is the prospect that there may be coordinated effects as well as increased unilateral market power and the potential for foreclosure. Many of the conditions for coordinated effects are present:
- the oligopoly will be 'tight' following the merger, as there will be only two providers, and no scope for market entry until such a time as more spectrum is auctioned;
 - there will be broad symmetry between Three and Vodafone in terms of their costs of supplying MVNO products to customers, due to their reliance on similar network structures and similar network coverage obligations;
 - the likely potential quality of service that could be offered by Three and Vodafone will be similar;
 - there will be a high degree of transparency as to which operators are seeking MVNO contracts, and to which of Three and Vodafone has won MVNO supply contracts with each purchaser of wholesale MVNO agreements.
- 3.37 In light of these factors, it is plausible that there could be coordinated effects in the MVNO market that result from the transaction. The CMA should therefore investigate in detail the potential for coordination in this market.

¹¹ [Redacted]

¹² [Redacted]

¹³ Case CW/01106/05/13, opened on 14 June 2013.

¹⁴ <http://www.telegraph.co.uk/finance/newsbysector/mediatechnologyandtelecoms/media/1146557/2/Vodafone-targets-November-launch-for-internet-pay-TV-service.html> sets out for recent media reporting of Vodafone's expected entry.

3.38 The merger has the potential to significantly increase the costs of TalkTalk and others from competing in both the retail mobile market, and the potential market for quad-play packages.¹⁵ This has the potential to harm both consumers taking mobile packages from TalkTalk (who will experience higher prices as costs are passed on to consumers) and consumers taking mobile packages from other operators (who will experience lesser competitive constraints, and therefore set higher prices than in the counterfactual). In the extreme case, we may be foreclosed from the market entirely, maximising consumer welfare loss.

3.5 Using vertical relationships between BT and EE to raise rivals' costs

3.39 The fifth major source of competitive harm from the proposed merger of BT and EE is the increased ability that it provides to BT to game its regulatory system to the detriment of its downstream customers (who will also generally be competitors of BT Retail), generating an increased risk of regulatory failure.

3.40 The regulation of BT is a complex task, much hindered by the vertical integration of BT's Openreach and Consumer divisions. This vertical integration provides incentives for BT to use its strategic control over Openreach to attempt to raise its downstream rivals' costs, and even to attempt to exclude these rivals from the market.

3.41 Historically, BT has engaged in regulatory gaming in a number of ways including:

- through its control of the Regulatory Financial Statements ('RFS') it has loaded costs onto regulated products which are purchased by its downstream rivals, and reduced the costs allocated to products which are mainly bought by BT Retail;
- where price regulation is on a basket basis, rather than on a product-by-product basis, BT has tended to reduce the prices Openreach sets for products consumed by BT Retail, and increase the prices Openreach sets for products provided to downstream competitors of BT Retail.

3.42 Gaming of BT's regulatory system will become easier to undertake following a merger of BT and EE:

- BT's RFS will become considerably more complex. The costs of EE – a very large business itself – will have to be incorporated into the RFS. This will likely reduce Ofcom's understanding of the RFS, at least until it gets a full grasp on EE's cost structure, and will also add many cost categories which have not been considered before. Both of these will provide additional scope for BT to game the RFS.
- It will be more difficult for Ofcom to identify the relevant costs that it should include in its margin calculations for the purposes of testing VULA margins under the regulation announced on 19 March 2015. BT will go from paying an

¹⁵ See section 3.6.1 for a brief explanation of the impact on the quad-play market.

identifiable external price for its MVNO product to making an internal transfer payment to EE. This will provide scope for BT to game the margin regulation for quad-play SFBB bundles.

- BT will be purchasing the sole significant external user of its wholesale line rental ('WLR') product. EE exclusively uses WLR to supply its customers; TalkTalk almost exclusively uses the LLU-based MPF product (and is divesting its remaining residential WLR base) and Sky now serves the vast majority of its fixed line customers through MPF. This will increase BT's (already strong) incentives to allocate costs towards MPF and away from WLR, increasing external revenues while at the same time raising rivals' costs and therefore the risk that regulation will be ineffective in preventing distortions to competition.

- 3.43 TalkTalk considers that Ofcom, despite its efforts to ensure effective regulation of BT, will be unable to prevent BT from engaging fully in such behaviour. This would almost certainly increase the costs faced by TalkTalk and other similar competitors relying on BT infrastructure, and so weaken competition. In the extreme, TalkTalk may be foreclosed from supplying customers in certain markets or offering complete bundles.

3.6 Other areas referred to by the CMA

- 3.44 This section sets out TalkTalk's views on additional areas of interest to the CMA: mobile backhaul, retail fixed voice, and triple- and quad-play packages.

3.6.1 Mobile backhaul

- 3.45 At the present time, TalkTalk does not consume mobile backhaul, as our mobile business is still a white label Vodafone reseller. Even under a full-function MVNO [redacted], we will still not be a direct consumer of mobile backhaul.
- 3.46 As such, TalkTalk does not have detailed day-to-day knowledge of the mobile backhaul market, [redacted]. However, we are concerned by the ability of BT to construct its mobile backhaul product set to benefit EE at the expense of other mobile operators; this may have detrimental impacts on consumers, through reductions in competition, as EE's rival suffer a relative competitive disadvantage. This could also result in higher costs or a lower level of service offered in the MVNO market, potentially harming TalkTalk as a customer of wholesale MVNO services.

3.6.2 Retail fixed voice

- 3.47 The standalone residential fixed voice market (i.e. voice-only) is increasingly a niche market. The majority of customers in the UK take at least a dual-play package including broadband and voice together. [Redacted]¹⁶ [Redacted]

¹⁶ [Redacted]

- 3.48 The only firm with a meaningful residential voice-only market share is now BT, as all of Sky, TalkTalk, VM and EE have moved away from offering this product to new customers. [Redacted].
- 3.49 EE does not appear to offer voice-only fixed line products to new customers; as such, it is not clear that the transaction combines competing suppliers for fixed-line voice products.
- 3.50 BT is therefore the only scale provider of fixed line voice only products. Any existing constraints on BT's pricing of voice only packages are being provided by mobile operators, rather than other fixed line providers. EE is by some distance the largest mobile operator, and therefore is likely to impose a greater competitive constraint on BT than other mobile providers.
- 3.51 There is thus a strong case for the CMA to investigate the extent of competitive constraints imposed on BT's voice only packages by mobile operators, and in particular EE, as if there are strong constraints from EE on BT, this could lead to price rises for customers when EE's constraint is eliminated by its absorption into BT.

3.6.3 Triple- and quad-play packages

3.6.3.0 Triple- and quad-play packages for consumers

- 3.52 In this section, triple-play packages are defined as those which include all of fixed voice, fixed broadband and pay TV services, in a single bundle purchased from a single provider; quad-play packages are defined as those which include all of the elements of a triple-play bundle, plus mobile in addition.¹⁷
- 3.53 All of BT, Sky, TalkTalk and VM are active in the supply of triple play packages at present.¹⁸ In addition, EE, TalkTalk and VM are active in the supply of quad-play packages, while all of BT, Vodafone and Sky have announced plans to commence supply of quad-play packages in the near future.
- 3.54 [Redacted]
- 3.55 Overall, TalkTalk considers that the ability to offer quad-play packages will become increasingly important over the next few years. The UK is behind many other European countries in the proportion of customers taking quad-play; [redacted].
- 3.56 At present, much of the competition in SBB and SFBB markets is driven by triple-play customers. [Redacted]

¹⁷ As such, this section does not cover the (currently unusual) bundle of fixed voice, fixed internet, and mobile services.

¹⁸ EE does not offer triple play as defined in this section, although it does offer a bundle which contains voice, broadband, and mobile.

- 3.57 The move towards triple- and quad-play packages means that it is particularly important that competition is maintained in each market making up the quad play bundle (voice, broadband, TV, mobile). Vertical concerns are likely to be particularly important: the inability to offer an effectively competitive product in (say) the mobile market may have knock-on effects into other related markets (e.g., broadband), increasing the benefits of exclusionary strategies.
- 3.58 At this stage, TalkTalk considers that it is most appropriate for the CMA to review each of the markets within the quad-play bundle separately. However, it should be aware that even mild competitive impediments in a single market may have their effects magnified through the move towards quad-play.

3.6.3.1 Triple-play packages for SMEs

- 3.59 Triple-play packages for SMEs are covered as part of the SME mobile market analysis at section 3.3.1, above.