



## **Response to the CMA's Issues Statement**

*TalkTalk submission*

*Redacted version*

**August 2015**

## 1 Introduction

- 1.1 This submission responds to the CMA's Issues Statement in the *BT/EE* merger. TalkTalk is pleased to have the opportunity to respond in this way. The points that we make in this letter should be taken alongside those that we have made in our earlier submissions, our questionnaire responses, and our oral hearing with the CMA. It deals with the various areas considered by the Issues Statement in the order in which the CMA makes them.
- 1.2 Where TalkTalk has not commented on a particular issue in this submission, this should not be taken as implying that TalkTalk holds any particular view on the issue. Where we have previously commented on such an issue, our previous comments on that topic should be taken to stand. TalkTalk would be happy to expand further on any of the points made in this submission if the CMA would find it helpful.

## 2 Market definition

- 2.1 TalkTalk considers that business and domestic customers should be considered to be in different markets. This is reflected in the organisational structure both of TalkTalk (which has separate TalkTalk Business and TalkTalk Consumer divisions) and of BT (which has split BT Consumer from BT Business). Moreover the competitor set and market structure differs radically between business and consumer markets— notably, Sky are not active in business markets, while BT holds a much higher market share, one which could be consistent with a dominant position, in business markets.
- 2.2 With regard to quadplay, TalkTalk considers that the market is currently in a dynamic state in which market definitions are changing over time.<sup>1</sup> At present, the market definition is probably best seen as being one where there are individual markets for TV and mobile, along with one or more markets in fixed line. Quadplay (and other bundles) operate in multiple markets, change the competition dynamic in those markets, create demand-side and supply-side synergies between the markets. However, with the expected rapid growth of quadplay packages, TalkTalk's view is that there will be a separate market for quadplay bundles in the near future, with the potential for an operator with market power successfully to impose a SSNIP, to the detriment of consumers, even where it faces effective competition from different operators in each and all of fixed, mobile, and TV markets.

## 3 Counterfactual to the merger

- 3.1 The most important element of the counterfactual for the CMA to consider is the prospective merger of Three and O2. This is a merger which directly impacts the same set of markets being considered by the CMA in *BT/EE*, and which appears likely

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<sup>1</sup> We refer to “quadplay” to cover all bundles of services that include fixed and mobile. The vast majority of the arguments related to quadplay would also relate to triple-play bundles of fixed voice, fixed data, and mobile.

to be considered by a different competition authority (DG COMP). In advance of DG COMP's review, it is not possible to definitively determine the relevant counterfactual to the merger.

- 3.2 However, DG COMP has recently reviewed three mergers in the European mobile sector, in Austria, Germany and Ireland. All of these mergers involved (as *Three/O2* will) the consolidation of the mobile sector from four competing firms in the wholesale MNO market to three. In all of these mergers DG COMP has applied some remedies. However, in all three cases the remedies have failed to recreate four competing firms in the wholesale MNO market; rather, they have tended to focus on the creation of one or more additional MVNO operators. As such, if similar merger remedies were imposed in *Three/O2* they have had no impact on TalkTalk's key concern with *BT/EE* – that it will lessen competition for the supply of wholesale mobile capacity to MVNOs seeking to use that capacity as part of the supply of a quadplay bundle. The CMA should therefore assume that the counterfactual to the merger of BT and EE is that only three MNOs exist in the UK: *Three/O2*, EE and Vodafone, of which only two (*Three/O2* and EE) would be willing to provide capacity to MVNOs.
- 3.3 The counterfactual to the merger of BT/EE in the retail mobile market should be taken to be that within 2-5 years BT would be either the largest, or the second largest, MVNO operating in the UK.<sup>2</sup> This is consistent with the 5-10% market share which BT indicated in its submission to the CMA that it planned to obtain in the mobile market; 5-10% would imply a user base of between 3 and 6 million customers.<sup>3</sup> BT becoming one of the two largest MVNO operators reflect some of BT's unique advantages, including:
- unrivalled ability to use femtocell offload, due to BT having the largest fixed line base in the UK;
  - BT's ownership of 2600 MHz spectrum, improving the quality of service available using femtocells and providing the ability to use picocells and metrocells;
  - better ability to offer metrocells than any other operator providing mobile services, due to BT's large portfolio of cabinets and other street furniture;
  - BT's strong, well-trusted brand; and,
  - substantial ability to cross-sell mobile due to BT having the largest fixed line base in the UK.
- 3.4 Crucially, BT should also be considered in the absence of the merger to be a maverick mass-market operator, not an MVNO catering to a niche segment. BT will aggressively seek to use offload of mobile traffic to lower its costs of operation, with that mobile offload coming initially through the use of femtocells based on BT's 2600

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<sup>2</sup> This element of the counterfactual is independent of whether or not Three and O2 complete their proposed merger.

<sup>3</sup> BT submission, §4.2 of section D.

MHz spectrum, but increasingly also to metrocalls based in BT's street furniture. This would enable BT to achieve a much higher proportion of offload than [REDACTED].

## 4 Wholesale mobile services

- 4.1 TalkTalk considers that there is a separate wholesale market for MNOs supplying agreements to MVNOs. That is, self-supply of network capacity by MNOs to their own downstream retail mobile businesses should not be included in the relevant market. The different market reflects that self-supply of MNO capacity would in no way prevent a hypothetical monopolist over the supply of wholesale capacity to MVNOs from imposing a SSNIP. This is supported by TalkTalk's practical experience of competition in this market, as set out both in our earlier submissions and below.
- 4.2 Furthermore, a clear distinction needs to be made between the wholesale market to supply MVNOs who target particular customer segments with only mobile services, such as Lebara, and the wholesale market for MVNOs who provide quadplay bundles such as Virgin, TalkTalk, BT, and Sky (we refer to these as quadplay MVNOs). Most mobile-only MVNOs, targeting particular segments, do not compete strongly with their host MNO.
- 4.3 The merger probably does not have a particularly significant impact on MVNOs aimed at specific segments since BT/EE will have a very similar incentive to serve them after the merger as before.
- 4.4 However, given the increasing demand for quadplay bundles and development of a separate quadplay market, as well as quadplay MVNOs' installed fixed base and their potential to use femtocell offload, potential quadplay providers are credible mass-market MVNOs who would compete directly against MNOs. The merger between EE and BT substantially changes the merged firm's incentive to provide capacity to quadplay MVNOs:
- Quadplay MVNOs may win business from both EE and BT. Prior to the merger EE would only care about its own loss of customers and margins but if the merger is consummated will care about both losses to itself and to BT. This would substantially decrease the merged firm's incentive to trade with quadplay MVNO providers.
  - The presence of quadplay MVNO providers able to offer quadplay products including femtocell offload would risk creating significant extra competition in the market, given the cost reductions that femtocells would allow, and undermining the benefits of any femtocell deployment that BT may choose to undertake.
  - [REDACTED]; and
  - Because of the importance of quadplay in the consumer sector (however defined), such foreclosure would lead to higher prices for consumers.
- 4.5 The operation of a wholesale market for mass-market MVNOs is already very fragile, even before the proposed merger. [REDACTED].

- 4.6 [REDACTED].
- 4.7 [REDACTED].
- 4.8 [REDACTED].
- 4.9 TalkTalk considers that, prior to the proposed mergers of BT and EE, and Three and O2, [REDACTED] are active competitors in the market to supply agreements to MNOs. We expect that the merger of BT and EE, if passed without suitable remedies, would lead to [REDACTED].<sup>4</sup> In addition to the incentive reasons given above, this [REDACTED].
- 4.10 If the merger of BT and EE is allowed to proceed, therefore, [REDACTED].<sup>5</sup>
- 4.11 On the other hand, if the Three/ O2 merger [REDACTED].
- 4.12 As such, regardless of the counterfactual that the CMA assumes, there will be harm to consumers due to the impact of *BT/ EE* on the market for wholesale mobile services.

## 5 Mobile backhaul services

- 5.1 TalkTalk considers that it is vital that the CMA carefully assesses the impact of the merger on mobile backhaul. Even though TalkTalk is not a supplier of mobile backhaul [REDACTED] and is not a direct customer of mobile backhaul products, we and our customers are still affected by competitive conditions in mobile backhaul, as price changes will be passed on to us via our MVNO agreement.
- 5.2 It is important that the CMA 'looks through' the ongoing business connectivity market review ('**BCMR**') and does not take into account any remedies that may, or may not, be imposed in that market review until the review is finalised. Ofcom has yet to finalise its views on remedies in the BCMR. There can therefore be no guarantee that any of the proposed remedies will be introduced, or of the form in which they will be introduced, and the CMA should proceed on the basis that the current regulatory regime continues in place, as a reasonable assumption. It is likely that even if a dark fibre remedy is imposed that it will take 3-5 years for it to be fully operationalised and have an impact on the market particularly since there is no obligation on BT to use the product itself. It is in BT's incentive to delay the product from being fully operationalised in order to maintain its monopoly rents from leased line products. Therefore a dark fibre remedy is unlikely to remedy any anticompetitive effects caused by the merger of BT and EE within a suitable time period.

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<sup>4</sup> In this sense, withdrawal would include presenting commercially unviable terms which made it effectively impossible for an MVNO to compete vigorously for [REDACTED].

<sup>5</sup> TalkTalk does not consider that the forthcoming 2300/ 3400 MHz spectrum auction will permit entry into the wholesale mobile market, given the low quality of the spectrum, the limited amount of spectrum being auctioned, and other barriers to entry including the need to acquire or construct a mast network and the need to acquire customers.

## 6 Retail mobile

- 6.1 TalkTalk's view on the relevant counterfactual to the merger in the retail mobile market is, as set out above, that BT would have successfully entered the mobile market, growing rapidly within that market, as set out in our response on the counterfactual above. It would have taken at least 5-10% of the UK retail mobile market within the next few years.
- 6.2 Such rapid growth by BT would have necessarily reduced the market share and demand facing incumbent MNOs, and to a lesser extent MVNOs. BT would likely have impacted the market share of MNOs more than MVNOs due to its expected strategy of targeting mid-market households using bundled packages including both fixed line and mobile elements. It would therefore have had a greater effect on mass-market MNOs than on MVNOs which have generally tended in recent years to focus on lower end consumers.
- 6.3 This reduction in demand would have been perceived by incumbent MNOs as an increase in their elasticity of demand. On a purely unilateral basis, a firm facing a higher elasticity of demand will cut the price which it charges to consumers, as it will increase its profitability to do so. This effect will be particularly pronounced since BT, with its ability to offload a substantial proportion of its demand using femtocells and metrocalls, and the economies of scope which come from selling a bundled fixed/mobile product, would likely have set a very disruptive price in the market. As explained in our oral hearing with the CMA, we launched our All-in SIM as a pre-emptive reaction to BT's expected aggressive pricing in, and promotion of, its mobile proposition. In the absence of the proposed merger with EE, we would have expected BT to have supported its mobile business with heavier advertising, and to have grown much more strongly than it has in practice.
- 6.4 As such, the direct impact of the merger is to increase prices to consumers due to competitors' reactions to perceiving stronger consumer demand for their products. This impact will be exacerbated by the indirect impact of the merger in making the MVNO market less competitive through quadplay providers such as TalkTalk, Sky and Virgin having to pay higher prices for wholesale mobile capacity. This impact will be felt not just by consumers of the impacted MVNOs; rather, the 'umbrella effect' of their higher prices will raise prices for customers of all operators. This will occur due to the unilateral actions of mobile operators, which will perceive themselves to be facing higher demand due to the lack of switching to these MVNOs, and will therefore set a higher price to maximise their profits.
- 6.5 Future spectrum releases will not change the unilateral impact of this merger. The 2300 and 3400 MHz spectrum due to be auctioned by Ofcom will not affect the change in competitive conditions caused by the loss of BT as an independent competitor. Moreover, as outlined above, it will also be insufficient to restore competition to the MVNO market, and so the merger will continue to lead to price rises in the consumer mobile market due to the indirect effect of changes in competitive conditions in the wholesale mobile market.

## 7 Wholesale broadband input foreclosure

- 7.1 TalkTalk's primary concerns regarding the merger's potential to cause foreclosure of the wholesale broadband input market is that by acquiring EE, BT will gain greater ability to game its regulatory system. Its incentives to frustrate the aims of regulation will be unchanged, as BT always had significant incentives to engage in such gaming.
- 7.2 BT's ability to game will be enhanced in two ways:
- First, BT will be able to game its regulatory financial accounts when EE is integrated. Under its current regulatory structure, BT has significant control over the manner in which its regulatory accounts are constructed, and therefore the manner in which costs are allocated to various products. Allocation issues are particularly significant for Group central overhead costs; Ofcom has recently determined that BT has been allocating around £220m in excess Group central overhead costs to its regulated products. This demonstrates that even before a merger with EE, BT has both the incentive and the ability to game its cost allocation. By adding EE, a large firm with significant overheads, BT's regulatory accounts would become more complex and the total of Group central overhead costs in the business would increase, giving BT greater ability to game its regulatory system. In particular, BT might game its system through [redacted]. BT has previously gamed its regulatory system in exactly this way [redacted] which led to [redacted]. Preventing such regulatory gaming is likely to be difficult [redacted].
  - Second, the merger will make Ofcom's recently introduced margin squeeze regulation of superfast broadband ('SFBB') products more difficult. Ofcom's margin squeeze test was originally proposed before BT launched either BT Sport or proposed to merge with EE. At that time, BT paid well-defined incremental prices for most of the inputs to its SFBB products, as they were based on regulated products from Openreach (such as WLR and VULA) or were based on variable MVNO or wholesale pay-TV charges. However, the launch of BT Sport using acquired sports rights provided a major element of SFBB inputs that was not based on an incremental charge, but rather on a large fixed cost which needed to be allocated in some manner across different products. The complexities of this required substantial separate attention in Ofcom's margin testing document which is now under appeal. Recently, Ofcom has had to issue supplementary guidance to deal with the launch of BT Sport Europe.
  - Prior to the proposed merger with EE, BT's quadplay SFBB bundles would have been built on a mobile element using BT's MVNO agreement with EE, which would specify prices for voice calls, SMSs and data. This could have been built into Ofcom's margin testing relatively easily, as there would be few fixed or common costs to allocate. However, after purchasing EE there will no longer be a well-defined incremental price for mobile usage. Rather, costs will need to be allocated to customers in some way: these costs will predominantly be fixed and common, including costs for spectrum, masts and mobile backhaul. This will considerably increase the difficulty of

regulation, as with such fixed and common costs there is no single 'correct' allocation method. Rather, there is likely to be a drawn out process of disagreement between BT and other operators regarding the costs to be allocated to SFBB products, and a need for further supplementary guidance and consultations by Ofcom. TalkTalk considers that BT is likely to propose an allocation to its SFBB products which effectively permits it to [X] would be unable to [X] and the consequent [X].

- 7.3 Overall, therefore, TalkTalk considers that the proposed merger of BT and EE will significantly increase the difficulty of regulating BT effectively, leading to detriment to the consumers of TalkTalk and other wholesale customers of Openreach.

## 8 Retail broadband in market A1

- 8.1 TalkTalk is no longer active in the supply of broadband in the market where only BT is present at the wholesale level (i.e., those areas where Virgin Media is not present, and where no firm has unbundled the local exchange – the CMA refers to this as market A1). TalkTalk withdrew from these areas through the sale of our customer base in these areas to Fleur Telecom earlier this year.
- 8.2 As set out in our earlier submissions, we withdrew from these areas because we had not unbundled the exchanges in these areas, increasing our costs of service and restricting the product range we can offer in these areas.
- 8.3 In these areas, with TalkTalk and Virgin Media not present, there are few competitors to BT, which (including its Plusnet subsidiary) will hold a market share well in excess of 50%. The primary competitors are likely to be EE and Sky, although Sky do not actively sell in these areas. BT already price discriminates against these areas by charging a higher price for Plusnet products than in areas where there is greater competition for customers. EE is likely to be one of the key constraints preventing BT from further increasing prices in these areas, most likely by further increasing Plusnet's prices or even withdrawing Plusnet products in these areas. If EE is not acting as a constraint on BT in these areas, then it is unclear which competitors would be doing so, given the lack of other major competitors interested in serving customers in market A1, and [X]. Unless BT is charging the full monopoly price already pre-merger, then some firm must be acting as the binding competitive constraint on BT. The CMA should investigate which competitor is the closest constraint on BT, for example by undertaking survey analysis of diversion ratios in these areas.

## 9 Superfast broadband

- 9.1 TalkTalk considers that SFBB is no longer subject to competitive constraints from standard (copper-based) broadband products, but forms a separate retail market. In fact, the most appropriate market definition is likely to be asymmetric, with fibre broadband acting as a competitive constraint on copper-based products, but no

constraint from copper products on SFBB products. This reflects TalkTalk's view [8], that once customers switch to SFBB products they tend not to switch back unless it is unavoidable.<sup>6</sup> TalkTalk therefore considers that there is no constraint on SFBB pricing from copper-based products.

## 10 Entry and expansion

- 10.1 TalkTalk wishes to reiterate its points made in its response to the CMA's questionnaire that barriers to entry and expansion in the relevant markets for this transaction are sufficiently high to prevent entry other than by acquisition or regulatory intervention. Moreover, given the low rates of switching in the various markets affected by the transaction, expansion to become a scale operator is slow, even for incumbents in related markets who would have advantages over 'pure' greenfield entrants.

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<sup>6</sup> For example, moving house to an area which is not SFBB enabled.