CMA
Competition & Markets Authority

ANTICIPATED ACQUISITION BY BT GROUP PLC OF EE LIMITED

Summary of hearing with Sky on 4 August 2015

Overview of Sky's concerns

1. Sky stated that it was primarily known for its Pay-TV services. However, it stressed that the outcome of the merger inquiry was still very important for it. It generated [✂] revenue from telephony and fixed broadband. It had entered the fixed market ten years ago and, from a standing start, with five million customers, was now the second biggest broadband provider in the UK behind BT and the fastest growing broadband provider. It had achieved this by investing £1 billion in its network infrastructure.

2. Sky stated that it had three primary concerns in relation to the merger. First, it was concerned with the impact of the merger on the hosting of mobile virtual network operators (MVNO). [✂].

3. [✂] Sky emphasised that forming a partnership between the MNO and MVNO was key for the success of an MVNO arrangement, in which it is important that the two sides are aligned. [✂].

4. Sky stated that its second major concern with the merger was around fibre. It estimated that BT earned around [✂] more a month per customer, if that customer was a retail customer as compared to a wholesale customer. As a result, Sky stated that there was a profound incentive for BT to use the fixed infrastructure that it owned in a way that favoured its own downstream operation. Regulation in this area acted as damage control and it was unable to influence the incentive issue. It submitted that the extent to which regulation in standard broadband and superfast broadband regulation had been effective had varied. Regulation of standard broadband had been reasonably successful and the market was very competitive with low prices. On the other hand, superfast broadband was not regulated and the only constraint that BT currently faced today on the way it priced superfast broadband was the new virtual unbundled local access (VULA) margin squeeze test. It said that this test was extremely complex and subject to significant challenge. BT had stated that it was going to appeal the whole decision to impose the VULA margin squeeze test. Sky submitted that post-merger BT would have an increased incentive to favour its own downstream business. Further, the VULA margin squeeze test would become completely ineffective as the scope

of BT to move costs around its business would be increased. Sky submitted that effective regulation was important to it because it required some degree of certainty that the regulated products it relied on would be supplied at prices that it could compete on.

5. Sky submitted that its final concern was in relation to mobile backhaul, which was an important determinant of quality of service. It submitted that mobile backhaul would increase in significance as data became more important. [✂]. It stated that as a result of the merger, many of the problems that were seen in fixed services, would now be seen in mobile services. BT would have a large mobile business, EE, and possess fixed infrastructure that every single mobile operator relied upon. It submitted that BT would use this control to assist EE and that there was no regulation in place to control this. Most products that were bought for mobile backhaul by operators were supplied by BT Wholesale. There was regulation in place for BT Openreach, but not BT Wholesale. Sky was concerned that post-acquisition BT Wholesale would raise backhaul costs [✂].

6. [✂]

7. With regard to the rationale behind launching its MVNO network, [✂].

Fixed/mobile bundles

8. Sky stated that its product offerings enabled customers to pick between different options that varied in price and content. It offered in the region of three different broadband packages, two different telephony packages and 12 TV packages that its customers could choose form. [✂]. [✂] Sky believed companies would cross sell into their customer bases. It submitted that BT would focus on cross selling BT products into the acquired EE customer base and vice versa. [✂] Sky said that the take up of fixed-mobile services in the UK had been low until now as only Virgin had the ability to offer such a package. [✂] It said that fixed-mobile bundles had been successful elsewhere in Europe and that in countries such as Spain and France the market had developed quickly in this area. This was also becoming the case in the UK, as once BT had announced it was to offer all components of a quad-play bundle other communications providers (CPs) such as TalkTalk, Vodafone and EE also began to offer these services and saw quad-play as the future. It stated that the market was dynamic and that in the way it had developed towards consumers expecting triple-play offerings from communication providers, it was also likely to evolve to a market where there was an expectation from consumers that quad-play offerings could be purchased from a single CP.

9. Sky stated that [✂].

10. Sky stated that [✂].

Small cells

11. [✂]

12. [✂]

Wholesale mobile

13. In relation to wholesale mobile hosting, [✂].

14. [✂]

15. Sky believed that [✂].

16. Sky stated that [✂].

17. If the BT/EE merger were to go ahead, Sky believed that EE would be ruled out as a potential MVNO host not only for Sky, but also for Virgin Media and TalkTalk, as BT would be unlikely to give attractive MVNO rates to those it was competing with in TV and other elements of quad-play bundles. In particular, Virgin Media would be affected, as when BT loses a customer to Virgin Media, it loses all of its revenue. [✂]

18. [✂]

19. Sky stated that the move by CPs towards convergence of fixed and mobile offerings would be led by the combined BT/EE entity being able to offer the biggest network of fixed and mobile services. Sky believed that BT would put all of its marketing and offers behind promoting it.

20. Sky gave the example of BT's TV offering. Although BT Sport was available on a stand-alone basis, consumers received more favourable terms if other services were purchased from BT alongside the TV component. Sky also stated that cross selling both fixed and mobile offerings successfully could be achieved with ease by BT post-merger, as it would look to contact those customers who took broadband from BT currently and mobile from EE, and offer a contract for both services that would tie them in for two years or longer at a discounted rate, essentially locking the customer in. This was in essence the same as BT's approach when it launched its BT Sport offering.

21. Sky stated that this might not even need to take the form of a discount in order to incentivise customers to take an additional component of a bundle and sign a new contract. Sometimes it was possible for customers to be offered gift cards or new equipment such as a router or TV box to secure an agreement for additional services. [✂]. As a result of BT locking customers in to contracts for multi-play contracts, there would be fewer customers for other CPs to compete for in the marketplace.

22. Sky considered that quad-play penetration would go from 4% to double digits within a couple of quarters driven by the merged entity. It noted that BT had acquired 5 million BT Sport customers in only two years.

23. [✂]

24. [✂]

Retail mobile

25. [✂] Sky thought that growth in retail mobile would have been important to BT, also from a shareholder perspective, as it had been in relation to BT Sport and fibre. Sky referred to analyst reports which had indicated that BT would have grown to represent 8% of the market over five years. BT had the ingredients to succeed – spectrum, ability to add femtocells to routers, street furniture, cabinets, poles, exchanges, places to put small cells (where no one else could, for example in street cabinets). BT Openreach had not allowed any other CP to put small cells in cabinets. Small cells needed power so exchanges and cabinets were important places. Small cells would also need backhaul so BT would have been at an advantage there also (insofar as backhaul costs were sunk costs to BT).

26. Sky said that ultimately it was an unknown how successful BT would have been in retail mobile, absent the merger. [✂]

27. In terms of branding, Sky estimated that around 50% of BT's broadband base had never been with another supplier, which suggested some brand loyalty (as well as some inertia). BT could cross sell to that base. The heritage of the BT brand was incredibly powerful.

28. BT had been trying to revitalise its brand with the BT Sport campaigns. Sky thought that BT would have invested similar amounts of money in mobile as it had done in other areas (eg 'billions in fibre, billions in sport'). BT's marketing machine had enabled it to acquire millions of customers in fibre and sport so that same machine could have enabled similar gains in mobile.

29. Sky thought a lot of what would have made BT successful in retail mobile was because it would have been a 'super-MVNO', with spectrum. It was partly about femtocell in the home but moreover the ability to put small cells outside the home and on the street cabinets and exchanges, and free backhaul, would have enabled BT to offer high speed data and lots of data capacity without having to pay the partner MNO. The economics would have been much better than a traditional MVNO. However, that strategy would have relied on evolving technologies and therefore entailed some execution risk. There were mixed views about the role of femtocells in the industry. There may also have been technology developments in Wi-Fi but innovations would be expected first in femtocells and then in Wi-Fi up to two years later.

30. Sky said that [✂].

31. Sky thought that [✂].

Wholesale broadband

32. Sky had seen BT investing a significant amount in fibre but not necessarily copper. BT didn't provide a good quality of service in copper and this impacted Sky's customers. Over 90% of BT's provisioning lead times were over ten days whereas 90% of Sky's was under ten days [✂].

33. Sky also thought there were similar problems in the business-to-business segment (although it was not active there) and that BT had been underinvesting in that space in favour of consumer offerings. It considered that the acquisition of EE would further divert BT resource from investment into the copper network in favour of mobile.

34. This was a big issue for Sky in the local-loop unbundling (LLU) space since all of BT's capital expenditure and marketing was focused on fibre. It was still selling Digital Subscriber Line (DSL) and a lack of investment was causing the copper network to be degraded. Poor investment and customer service in copper was disproportionately affecting Sky and TalkTalk as compared to BT Retail which were focussed on selling fibre.

35. Sky had put the quality issue to Ofcom, which had been sympathetic and was considering quality of service as part of its next review. However, Sky noted that establishing and enforcing effective quality of service regulation was very difficult.

36. Sky thought that the merger effect was twofold. The incentive for BT to favour the downstream was already profound but would become greater because each customer of broadband would be a potential customer of EE mobile. Sky

thought that BT would be aiming to sell mobile to [✂] of its fixed base, which would be a sensible product attachment rate. Therefore the economics of having a broadband customer with BT Retail versus Sky post-merger would be [✂] more attractive. Instead of making a margin of [✂] or so as BT does now, it would achieve more like [✂] or [✂]. But Sky recognised the incentive was already profound so the issue was more around capex and the further degradation of the copper network, which would become even less of a priority post-merger.

37. In relation to the VULA margin squeeze test, Sky considered that the number of assumptions that would need to be made, post-merger, by Ofcom, in applying that test to a substantially larger entity would be highly complex.

38. Sky said that there was already a dispute around the VULA regulation and how the structure of the test could create leeway for gaming, even pre-merger. The merger could create additional headroom potentially in the implementation of the test because of the way that BT could potentially shift costs out of the cost stack or, for example, benefit from the additional profit margin made from the mobile component to enable it to pass the test at a given price while increasing the VULA price to third parties. Sky thought that the merger might enable BT to increase rivals' costs in this way whilst passing the VULA test.

39. Sky considered that the merger would make policing the VULA margin test even more difficult. It would increase BT's ability and incentive to raise costs. There was already a 'massive incentive' for BT to increase the VULA price but it was currently bound by regulation. The merger would increase that incentive further, but the key issue was that it would also increase the ability of BT in this respect.

40. Sky believed that regulation and the ability to regulate would be what was damaged by the merger such that regulation could not be relied upon by the Competition and Markets Authority to address this concern.

41. Sky said that if every BT customer were to take fibre and mobile, that would result in a very large margin that could be averaged out across its customers. BT could then increase the price of VULA to 'soak up' this margin on mobile. If a competitor had a similar customer mix this might be okay but competitors without mobile customers might no longer be able to sell VULA competitively. The only competitors that could compete in the same way would be those with the same mix of customers and exactly the same margin on each of the products. No one would have the same margin. What would happen was that the merger would essentially allow the VULA price to be increased and Sky thought that that was simply not right.

42. Sky noted [✂].

43. Sky said that BT was expert at moving around costs without detection.

44. Sky said that BT did not like selling wholesale inputs that enabled competitors to unbundle cabinets or exchanges, as this forced BT to be more transparent about the costs of the different elements of the inputs and also made it easier for competitors to compete with BT. BT preferred to sell active wholesale broadband products, which made it more difficult for competitors to differentiate themselves from BT and compete. An extreme example of BT setting high wholesale prices for unbundled products was BT's sub-loop unbundling product. If Sky rented the sub-loop (the copper from the customer's home to the nearest cabinet), this was more expensive than renting the local loop (the copper from the customer's home to the nearest exchange, which was much further than the cabinet). This was an example of how BT played with costs and discouraged competition.

45. Sky said that BT also used delaying tactics (ie 'Let us take our time to look at it') over years rather than months. This had happened with VULA. This had also happened when BT had been asked for a single jumper Metallic Path Facility (MPF) together with TalkTalk (which together accounted for more than 50% of BT's copper base). Nothing had happened because BT didn't consume MPF but did consume shared MPF.

46. When Sky wished to create a new product, it would put in a request or 'statement of requirements'. BT tended to take on the ones that suited itself rather than competitors. [✂]. BT was very good at doing the things that worked for itself and didn't work for other CPs.

47. Sky noted that in the mobile space, everyone had different demands – different towers in different places, customers in different places, different products to customers. There would therefore be much scope to discriminate and this would be very hard to identify in law since BT had to prioritise its investments. This was deeply frustrating to Sky.

48. Sky explained that [✂].

49. Sky noted that whether or not an alternative cable provider had a ring in place would not make a big difference with fibre to the home roll-outs. The costs would not be very different as the provider would still need to dig to reach individual customer's homes. The lack of a ring was not a barrier.

50. [✂]

Retail broadband

51. In relation to standard broadband, [✂] Sky's competitors were BT and TalkTalk (before it had withdrawn) and more recently EE. The only remaining competitors would be those that took BT's IP Stream everywhere (ie BT and EE). Sky sold its broadband either through its LLU network (like TalkTalk) or its 'Connect' customers (in off-net ones).

52. Sky believed that EE used fibre and used BT's IP Stream in non-fibre areas.

53. Sky thought that [✂].

54. In relation to superfast broadband (SFBB), Sky said that BT sold about 80% of Openreach's GEA lines. This compared to around 40% of Openreach's DSL lines.

55. In relation to market segmentation, Sky said that there was certainly a group of customers which would be unlikely to switch from SFBB to standard broadband. Some might, if they had moved to an area without SFBB or if they were trying to save money. But for those with the option, it was unlikely that they would switch back. Sky noted that all of Virgin Media's base and a very big proportion of BT's base were SFBB. Sky compared it to customers using the Sky+ box and that it would be unlikely that those customers would revert back to a normal tuner.

56. [✂].

57. In terms of Sky's pricing proposition, unlimited DSL was £7.50 and unlimited fibre was £20. [✂]. Sky did not think that BT Retail really acted like it was paying its costs. Whilst in theory BT Retail would have to pay the same as Sky to Openreach, it didn't really add up.

58. It was no question that standard broadband was still large but preferences were shifting towards SFBB, because of the experience. The constraint may therefore be asymmetric. So whilst some might move back to standard, it was not usually price driven. The sense was that standard did not constraint SFBB. There were around 8 million SFBB customers now in the UK, which was a little less than half the total broadband customers.

59. In relation to EE's presence in SFBB, Sky observed that EE's total market share was quite small but that it was currently third in net adds, after Sky and BT. In the last quarter, Sky had done 90,000, BT had done 85,000 and EE had been consistent at around 40,000. Virgin Media had been going backwards and TalkTalk had been flat/going backwards. EE's market share was quite low.

Hybrid network services

60. Sky had raised concerns around the notion of 'hybrid network services'. It could mean small cells and femtocells complementing the macro cells. So fixed and mobile could be used together to replace each other or as a form of resilience to each other. For example, a hybrid solution could be used to increase the bandwidth at a customer's home which was located too far from the nearest exchange. You could potentially combine the bandwidth using an LTE SIM on the mobile network to increase the overall speed to that customer's home. Another example would be to use the LTE as a backup to the fixed connectivity. A further alternative would be where you did not have enough capacity on the mobile network because coverage in that area was poor. So it could be possible to offload traffic on to the fixed network. In Sky's view these were all illustrative of two worlds converging, which might give an MNO an advantage as compared to an MVNO or other MNOs.

61. Sky essentially considered that the roll-out of small cells could enable an MNO to have a network that was so much better than any other MNO's. This was something that BT might attempt to do post-merger. Sky considered that BT would have a substantial advantage over its competitors in small cells, given the fact that backhaul costs would represent 'wooden dollars' to BT. Sky considered that BT would also have huge scale in terms of the number of customers. BT would also have the ability to put small cells on cabinets, exchange buildings and poles, where there was electricity. The addition of the BT spectrum which was contiguous to the EE spectrum would create a lot of flexibility in how the merged entity would manage and use capacity.

62. Sky was concerned with whether the other MNOs could do something as compelling as BT post-merger, in a world where people wanted increasing amounts of data. [✂]. So the merged entity would be able to do something that the two companies could not have done independently. [✂]

63. Sky believed that this could be bad for customers because in the counterfactual BT would have priced competitively and offered a high quality product. If the merged entity had the best network and no other company could compete, the benefits might not be passed on to customers and may just result in BT having lower costs. Its concern was one of dynamic competition and whether the merged entity could dampen long-term dynamic competition. Its concern was not that competitors would withdraw but that there would be some sort of delay or less ability to compete. It could result in some MVNOs exiting the market. It recognised that from one point of view vertical mergers could have great efficiencies. But the concern was that there might be parallel incentives to slow down the ability of others to catch up and preserve that competitive constraint.

64. Sky was concerned that the merger would effectively combine the ownership of assets that were tightly complementary. So the Competition and Markets Authority should not separate one theory of harm from another as these assets were relevant to competition in a number of places. The cumulative effects gave Sky real concern.

65. Sky considered that BT would be able to put small cells on a cabinet in a way that meant there was no room for anyone else – ie a ‘first mover advantage’. This was what had happened with VULA – there was no space for another player to put in the kit. It gave the example of MIIS and noted that in future BT might be incentivised to create solutions that clearly favoured EE rather than all MNOs.