The European Commission´s Decision in Telefónica Deutschland/E-Plus[°]

by

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Abstract

The article critically examines the European Commission's decision in the four-to-three merger between Telefónica Deutschland and E-Plus. Despite the explicit recognition of the importance of vertical effects in the telecommunications sector more generally as exemplified by the European Commission's past antitrust enforcement record also held up by the European Courts and as also explicitly acknowledged in the context of the Telefónica/E-Plus transaction itself, the decision does not contain any vertical effects analysis. Only the examination of possible vertical effects such as raising rivals cost or vertical foreclosure would have allowed assessing the transaction in line with the Commissions own merger guidelines. That the Commission recognizes the importance of vertical effects in the decision but then provides no analysis of these effects is an omission reminiscent of Schneider/Legrand.

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Keywords: *mobile telecommunication, EU merger control, Telefónica Deutschland, E-Plus, four-to-three merger, clearance decision, Schneider/Legrand*, raising rivals cost, vertical effects, foreclosure, MVNO remedy, MBA remedy

[°] Disclaimer: The authors work for 1&1 Internet AG, a third party in the Commissions' proceedings. Frank Maier-Rigaud has previously worked for the European Commission on many merger cases, including in the telecoms sector. The views reflected in this article are the authors own and not those of the European Commission.

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On July 2nd 2014 the European Commission decided to clear the Telefónica Deutschland/E-Plus transaction after a phase II investigation and a turbulent advisory committee hearing, where, in the words of the Commission, "*a plurality of Member States disagree[d], an equal plurality of Member States abstain[ed] and a minority of Members agree[d]*"[1] with the conclusion that the transaction must be declared compatible with the internal market. The provisional non-confidential version of that decision was finally published on the Commission's webpage on Friday 13th of March 2015, months after the merger was consummated and the merging parties had started to integrate their networks. The decision clears the merger between Telefónica Deutschland and E-Plus under what essentially are mere behavioural remedies.[2] This decision adds to the list of telecoms merger cases ultimately cleared on the EU level despite sceptical national competition authorities and is the first telecom merger case in which the European Commission rejected a referral request from a national competition authority.[3]

The decision raises several fundamental issues ranging from the role of behavioural remedies in merger control and the comprehensiveness of economic analysis to legal questions concerning the rights of defense in light of the publication date of the decision. It also creates renewed interest in the role of political intervention in EU merger proceedings and the role of National or European champions in the digital agenda.[4] In the following the focus will be on the absence of any vertical effects analysis in the decision.

Despite the horizontal nature of the transaction, i.e. the reduction of vertically integrated mobile network operators (MNO) from four to three, the analysis of vertical effects, in particular the possibility of the new entity to raise rivals', that is, mobile virtual network operators' (MVNO) cost[5] is a crucial element in the assessment of potential anticompetitive

[1] See Opinion of the Advisory Committee on Mergers given at its meeting of 18 June 2014 regarding a draft decision relating to Case No COMP/M.7018 – Telefónica Germany/E-Plus, available at http://ec.europa.eu/competition/mergers/cases/additional_data/m7018_5501_3.pdf. See also Financial Times (2014), "Regulators revolt against Telefónica and E-Plus merger", published 20.06.2014, available at http://www.ft.com/cms/s/0/d10483aa-f8a0-11e3-befc-00144feabdc0.html#axzz3bRvp1K9r.

[2] The decision foresees essentially three different remedies, the MNO remedy, the MBA MVNO remedy and the Non-MNO remedy. Regarding the MNO remedy, the only unambiguously structural remedy envisioned, the Commission notes, that it "considers that the MNO component of the Final Commitments is unlikely to be implemented and is therefore also unlikely to alleviate the competition concerns raised by the proposed transaction." (paragraph 1382). On the role of structural remedies and the distinction between behavioural and structural remedies see for example Maier-Rigaud, Frank (2015) Behavioural versus Structural Remedies in EU Competition Law, in: Philip Lowe, Mel Marquis and Giorgio Monti, eds., European Competition Law Annual 2013: Effective and Legitimate Enforcement of Competition Law (Oxford: Hart Publishing.) forthcoming.

[3] The latest four to three mergers cleared by the European Commission took place in Ireland (Case M.6992 Hutchison 3G UK / Telefónica Ireland) and Austria, (Case M.6497 Hutchison 3G Austria / Orange Austria). Noteworthy is also the five to four merger of T-Mobile and Orange UK (Case M.5650 -T-Mobile/ Orange). Just as the Federal Cartel Office in the Telefónica case, the Office of Fair Trading not only had serious concerns, but also initially requested the case. For a more general discussion of the EU merger enforcement record, see for example Maier-Rigaud, Frank and Kay Parplies (2009) EU Merger Control five years after the Introduction of the SIEC Test: What explains the drop in enforcement activity? European Competition Law Review, 11, 565-579.

[4] See for example "Merkel backs EU telco consolidation" by Daniel Thomas, Alex Barker and Jeevan Vasagar, Financial Times, 8 May 2014.

[5] See the European Commission's non-horizontal merger guidelines or the seminal article by Steven C. Salop and David T. Scheffman (1983) Raising Rivals' Cost, American Economic Review, 73(2), 267-271.

effects. This is recognized by the Commission in paragraph 104 in the section on affected markets: "*The German retail market for mobile telecommunications services and the German wholesale market for access and call origination on public mobile telephone networks are also vertically affected*". The concerns regarding vertical effects resurface in paragraph 790 of the decision where the Commission rather clearly states that "*these likely anti-competitive effects on the market for wholesale access and call origination will compound the anti-competitive effects of the proposed transaction on the retail market for mobile telecommunications services. As the ability of MVNOs and Service Providers to compete with MNOs crucially depends on the access conditions that they obtain at the wholesale level, a deterioration of these conditions following the proposed transaction will also have an impact on the retail level*."

Nevertheless, and despite recognizing vertically affected markets for call termination and international roaming and establishing vertically affected markets also in a number of Member States, no vertical effects analysis was carried out. This is particularly surprising as the European Commission is of course aware of the importance of vertical effects not least through its own margin squeeze cases that demonstrate not only the particular set of incentives at work in such a vertical structure but also the potential magnitude of such effects.[6] Furthermore the Commission's own non-horizontal merger guidelines, which focus almost entirely on input foreclosure concerns, clearly stipulate a whole set of economic analyses that would have been crucial to undertake in the context of the E-Plus/Telefónica case.[7] In assessing the likelihood of an anticompetitive input foreclosure, *"the Commission [normally] examines, first, whether the merged entity would have, post-merger, the ability to substantially foreclose access to inputs, second, whether it would have the incentive to do so, and third, whether a foreclosure strategy would have a significant detrimental effect on competition downstream."*[8]

In the following it will briefly be demonstrated why it is insufficient to consider the effects of the transaction on the wholesale and retail level separately at the detriment of a comprehensive analysis taking the vertical link between the upstream wholesale access market and the downstream retail market explicitly into account.

An analysis that does not take vertical effects into account, implicitly assumes that the *wholesale and retail market operate completely independently* of each other. The Commission analyses the merger as if it were a merger between two multiproduct companies producing unrelated products such as coffee and tires where an entirely separate analysis of the coffee and the tire market would be appropriate. The wholesale and the retail market are, however, linked, as the demand for wholesale access by MVNOs is clearly

[6] See for example Case COMP/C-1/37.451, 37.578, 37.579 – Deutsche Telekom AG, OJ L 263, 14.10.2003, upheld by the Court of First Instance in Case T-271/03 on 10 April 2008 and by the European Court of Justice (C-280/08) on 14 October 2010. See also Case COMP/38.784 – Wanadoo España V. Telefónica, OJ C 83, 2.4.2008, upheld by both, the General Court (Cases T-336/07 and T-398/07) and by the European Court of Justice (Case C-295/12P).

[7] See Guidelines on the assessment of non-horizontal mergers under the Council Regulation on the control of concentrations between undertakings, Official Journal C 265 of 18/10/2008.

[8] See Guidelines on the assessment of non-horizontal mergers under the Council Regulation on the control of concentrations between undertakings, Official Journal C 265 of 18/10/2008, paragraph 32.

derived from the prospect of retail market sales. Even more importantly, assuming independence implies that when an MNO gives access to its network on the wholesale level, such access is granted myopically, that is, without any regard to the repercussions of granting such access to its own position on the retail level. In other words, an MNO will offer access to an MVNO and to service providers (SP) without taking into account that the said firms will be directly competing with the MNOs own sales division on the retail market. In reality, however, an MNO will behave strategically and will take into account the trade-off between the profits generated by giving access to an MVNO or SP and the losses such an access generates in terms of cannibalized sales on the retail level.

If post transaction, the market shares of the merged entity on the wholesale and retail level are increased, this implies that wholesale access prices will increase and the incentive to grant access on the wholesale level will be reduced. First of all, the merger gives rise to an upward pricing pressure for access prices on the wholesale level, i.e. the access costs of independent downstream firms increase, which translates into an incentive for the MVNOs to increase prices on the retail level. The impact that this increase in access cost on the wholesale level has on the downstream retail market depends on the importance of the input for the final output, i.e. mobile telephone services, and on the degree of competition in the downstream market. If the costs of the input form a large part of the overall cost of the independent downstream competitors and if competition is intense, the increase in marginal cost will be passed-through almost in full. This, in turn, allows the retail division of the MNO to increase its prices above and beyond the increase in price that would anyhow result from the elimination of E-Plus as a competitor in the retail market. In addition, the increased marginal cost for the MVNOs results in a less favourable competitive position as compared to the merged entity or other MNO's much alike to a margin squeeze. Secondly, the impact of the merger on the retail market changes the incentives to grant access on the wholesale level. Assume for instance that an MNO has only a 1% market share on the retail level. If that MNO grants access to its network and allows a new MVNO to make attractive offers on the retail market, that MVNO will gain market share. As the MNO itself only holds 1% of the retail market, the impact on the MNO granting the access will be limited. Assuming for instance that the MVNO gains 10% market share on the retail market and assuming a proportional diversion of demand, the MNO will itself only lose 10% of its sales, i.e. 0.1% of its market share whereas other retail operators will on aggregate lose 9.9% market share (10% of their 99% market share). As the profits generated by an MNO from selling network access to an MVNO that subsequently gains a 10% retail market share remains the same independently of the retail level market share of the MNO, it follows immediately that the incentive to sell is directly and negatively affected by any increase in that MNOs retail level market share.

Having recognized the importance of vertical effects explicitly, it is an omission of Schneider Legrand[9] proportions that the Commission has not conducted any analysis of vertical effects

[9] See Judgement of the Court of First Instance in Case T-310/01 (and Case T-77/02) Schneider Electric SA v Commission. The annulment of the Commission decision was in particular due to the Court finding several obvious errors, omissions and contradictions in the Commission's economic reasoning (c.f. paragraph 404) and gaps in the assessment of the impact of the transaction (c.f. paragraph 407f. and 410). For a brief overview see Press Release No 84/02, available at: http://curia.europa.eu/en/actu/communiques/cp02/aff/cp0284en.htm. In Telefónica, however, the omission does not consist in an imprecisely targeted analysis as in Schneider

in the decision in particular in light of a host of margin squeeze cases in the telecoms sector that clearly exemplify the importance and potential magnitude of vertical effects in that industry. With a proper, by the book, analysis of vertical effects, the Commission would never have cleared the transaction, at least not on the basis of the behavioural remedies imposed.

Legrand but in the complete absence of an analysis of vertical effects, nevertheless recognized as relevant in the decision itself.