Completed acquisition by O2 UK Limited of the Link Stores Limited

The OFT's decision on reference under section 22 given on 10 October 2006. Full text of decision published 27 October 2006.

Please note that square brackets indicate figures or text which have been omitted or replaced with a range for reasons of commercial confidentiality.

PARTIES

1. **O2 UK Limited (O2)** is a vertically integrated Mobile Network Operator (MNO)[1]. It provides telecommunication services at the wholesale level and also sells connections, handsets and accessories via tied outlets at the retail level. O2 is a subsidiary of O2 plc which operates mobile telecommunications networks in Germany, Ireland and the Isle of Man. O2 plc is ultimately controlled by Telefonica S.A. which is a global communications group present in Europe, Latin America and Africa.

2. **The Link Stores Limited (The Link)** is an independent retailer of mobile connections, handsets and accessories through 292 retail outlets in the UK. The turnover of The Link for the year ended 30 April 2006 was £323 million.

TRANSACTION

3. Prior to the transaction, O2 (UK) owned 40 per cent of the share capital of The Link. Through this transaction O2 has acquired the remaining 60 per cent from DSG Retail Limited (DSG) and therefore legal control of The Link. The parties completed the transaction on 16 September 2006.

4. On 20 July 2006 the parties submitted an Article (4)4 referral request to the European Commission by way of a Reasoned Submission. On 18 August 2006, the European Commission approved the Article 4(4)

[1] MNOs are awarded a licence by the Government to run mobile telecommunications networks and provide mobile telecommunications services to customers through their own mobile network. This involves providing access (via a connection) to a mobile network to make and receive calls. It also involves the provision of other services such as billing and customer support services. Mobile Virtual Network Operators (MVNOs) on the other hand do not have their own network, but provide services using the network of an MNO. MNOs provide wholesale mobile network access to MVNOs, but both MNOs and MVNOs compete to provide mobile telecommunications services to end users.

application and referred the transaction to the OFT. The transaction was notified to the OFT on 18 August 2006. The 45 working day statutory deadline is 20 October 2006.

5. The agreement between the parties restricts DSG from operating dedicated mobile retail outlets within the UK for a period of two years from the date of completion of the transaction. The parties have asked the OFT to consider whether the restrictions qualify for ancillary status.

6. Restrictions that are directly related and necessary to the implementation of the merger agreement (ancillary restrictions) may be assessed under the Enterprise Act 2002 and excluded from scrutiny under the Competition Act 1998.[2] When assessing the ancillary status of a restraint, the OFT will generally follow the European Commission's Notice on restrictions directly related and necessary to concentrations.[3] In this case the restraint is a non-compete obligation. Such clauses, if properly limited, are generally accepted as essential if the purchaser is to receive the full benefit of any goodwill and/or know-how acquired with any tangible assets.[4] In order for restraints to be considered ancillary, account will be taken of whether the duration, subject matter and geographical field of operation of the restraint are proportionate to the overall requirements of the merger.[5] In this case, the geographical scope of the non-compete obligation is limited to the UK and the duration of the restriction is limited to two years, such that the restrictions are to be considered ancillary.

JURISDICTION

7. As a result of this transaction, O2 and The Link have ceased to be distinct. The UK turnover of The Link stores exceeds £70 million, so the turnover test in section 23(1)(b) of the Enterprise Act 2002 (the Act) is satisfied. The OFT therefore believes that it is or may be the case that a relevant merger situation has been created.

RELEVANT MARKET

Background

8. At the wholesale level, mobile phone connections and after-sales service (such as billing and customer service) are supplied by MNOs and mobile virtual network operators (MVNOs). In the UK there are numerous MNOs and MVNOs.[6] Both MNOs and MVNOs sell mobile phone connections to end users (personal and corporate users) via a number of retail channels. It

[2] Schedule 1 Competition Act 1998
[3] OFT Mergers Substantive Guidance para 11.13
[4] OFT Mergers Substantive Guidance para 11.20
[5] OFT Mergers Substantive Guidance para 11.20
[6] In addition to O2, the UK MNOs are Vodafone, T-Mobile, Orange and Hutchison 3 G. The main MVNOs are Virgin Mobile, BT mobile, EasyMobile and Fresh.

is the retail level which is affected as a result of the transaction. The retail level can broadly be subdivided into:

a. Tied specialist retailers - these are retail outlets owned by an MNO/MVNO, for example, Orange, Vodafone and Virgin which sell connections, handsets and accessories.

b. Independent specialist retailers - these are independent retailers selling connections, handsets and accessories for a number of MNOs and MVNOs in return for a commission. Examples of independent specialists include Phones 4U, Carphone Warehouse, small chains and other independent single stores.

c. Generalists - these sell mobile connections and/or handsets and accessories as a small proportion of their overall sales of other products, for example, Comet, Argos and Woolworths.

d. Internet retailers - these may sell handsets, accessories and connections to one or a number of networks over the internet but are not present in the high street.

Product scope

9. The parties overlap in the retail supply of pre- and post-pay mobile phone connections, handsets and accessories to end users in the UK.

10. There is also a small overlap between the parties in relation to the supply of broadband connections to end users. However, the parties' combined share of supply would appear to be less than one per cent and there are a significant number of alternative and larger providers present in the market. On this basis, competition concerns are not considered to arise in this sector. Therefore, it will not be considered further.

Sale of handsets, connections and accessories.

11. The parties claimed that the sale of mobile handsets is driven by competition between MNOs and MVNOs to sell mobile telecommunications services. Although it is possible to purchase mobile phone connections separately from handsets and vice versa, both pre- and post-pay connections are generally offered in conjunction with subsidised handsets. There is very little demand for the sale of connections separately from handsets or the other way round, as purchasing the products separately would mean forgoing a substantial handset subsidy. The parties submitted that in 2005, about one per cent of the handsets sold through O2 stores and about 1 per cent of those sold through The Link were sold without a connection. Given that all the main mobile phone retailers regularly bundle handsets and connections together and it is difficult to separate the price

of the connection separate from the price of the bundle, it is considered to be appropriate to consider these products together.

12. The parties also argue that sales of accessories should be assessed by reference to sales of handsets and connections as demand for accessories is derived from demand for these products. Accessories range from fashion accessories such as mobile phone covers to black accessories (car chargers, batteries) and are sold by all specialist retailers, a number of generalist retailers and, in some instances, retailers who do not sell mobile phone connections. Given the large number of retailers who sell these products, and the ease with which competitors could begin to sell such products, it has not been necessary to conclude whether they should be considered separately or together with mobile connections, as under either approach no competition concerns are considered to arise.

Pre-pay/post-pay

13. It was considered whether the sale of pre-pay connections should be distinguished from the sale of post-pay connections.[7] Some retailers stated that it would be hard to sell post-pay connections (as opposed to pre-pay), given the higher in-store service levels and IT equipment required to provide the necessary credit checks and to issue a post-pay contract. On the demand-side, while it appears pre- and post-pay connections may appeal to different types of end user, retailers stated that were the price of post-pay to increase by 5-10 per cent, then customers would switch. This is supported by evidence collected by OFCOM which indicated that 45 per cent of mobile phone owners would consider switching from pre-pay to post-pay and the other way round. OFCOM[8] also found there were no significant structural barriers to switching. This would tend to suggest that pre- and post-pay connections provide a competitive constraint on one another and therefore should be considered together. However, it is not necessary to conclude on whether pre- and post-pay are in the same market for the purposes of this decision as concerns do not arise in either segment.

Business/general customer sales

14. Previous European Commission decisions[9] have considered whether there was a distinction between the market for mobile telecommunication

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[7] Post-pay customers sign a contract with a mobile operator and pay on a monthly basis. Pre-pay customers do not enter into a contract with the mobile operator and merely pay for airtime in advance on a top-up basis.

[8] OFCOM Consultation document 11 April 2003.

[9] In Decision of 12 April 2000 Comp/M.1795- Vodafone Airtouch/Mannesmann, the European Commission considered it premature to further segment the market between business/residential customers. This was supported in Case Comp/M.3245 Vodafone/Singlepoint 16 September 2003. Decision of 24 September 2004 Comp/M.3530 Teliasonera AB/Orange AS.

services to (i) corporate customers and (ii) individuals given that corporate customers require a level of account management far superior to that required for individuals. However, customers can choose from a wide range of tariff packages and information provided by OFCOM[10] identified that if corporate tariffs were to rise above the competitive level, corporate customers would switch to tariffs for individuals.

15. The OFT has in previous decisions taken a similar approach,[11] considering that suppliers of mobile telecommunication services to individuals could quickly and easily switch to provide services to corporate customers. In addition, the range of services offered to corporate and individual customers was similar. No representations were made by third parties that would suggest the OFT should adopt a different approach.

Segmentation by retailer type

16. The OFT considered whether independent specialist stores (whether part of a chain, such as Carphone Warehouse, or a local independent) and tied specialist stores possess similar offerings. Both offer almost identical services, with the only difference being that tied stores only sell connections with the mobile operator concerned, whereas independents offer connections to a variety of mobile operators thereby allowing customers to compare the tariffs of different mobile operators within one single store. O2 argued that this is not a relevant differentiation as independents are paid commission in return for connections sold and therefore will encourage customers to take connections with the mobile operator which pays them the most generous commissions. However, as independent retailers can use part of the commission they receive to subsidise the handsets and charges paid by end users, they could still offer a differentiated service/product to end users.

17. With regard to generalist retailers, these retailers focus on selling a wide range of products and dedicate a small proportion of their energies to selling mobile phones and connections. Generalist stores are likely to exercise a stronger constraint in the supply of pre-pay connections than of post-pay connections, as many generalist stores only sell pre-pay packages. However, there are already a number of generalists, e.g. Comet, which do supply some post-pay packages, albeit in a more limited range than independent specialist stores. In addition, as many generalist stores already have the necessary structures to process post-pay contracts (e.g. IT and credit checking facilities) there would appear to be relatively few barriers to expanding their post-pay range in the event of a price increase by the merged entity.

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[10] OFCOM Consultation document 11 April 2003.

[11] Anticipated acquisition by Vodafone Group plc of Project Telecom plc, 18 September 2003.

18. Internet retailers also sell a range of pre- and post-pay mobile phones and connections. O2 argued that internet retailers provided a strong competitive constraint on the prices offered in shops, with one fifth of all new connections in 2005 being made online. O2 provided evidence to show that over half of all customers use both channels (internet and high street) before deciding on their purchase. However, it would appear that, even though end users use the internet for comparing prices, most purchases are still made through physical/high street stores. One third party stated that online retailers do not generate as many sales as 'physical' stores, and considered that this was probably because the majority of customers prefer to handle the phones and take advice on their functionality before purchasing. Nonetheless, given end users have demonstrated a willingness to shop and compare prices online, this would be expected to exert some constraint on the pricing behaviour of the high street retailers.

19. Overall, based on the above evidence, it is considered that all retailers provide varying degrees of competitive constraint on the parties; however, it is recognised that the specialist retailers – tied and independent – are likely to provide the strongest competitive constraint on the merged entity.

Conclusion

20. Given the factors outlined above, for the purposes of this assessment, the OFT considers the relevant product frame of reference to be the sale of pre- and post-pay mobile connections and handsets to end users in the UK.

Geographic scope

21. The parties argued that the geographic scope of the sale of mobile connections and handsets is national as competition on the retail market is driven by competition between MNOs and MVNOs at the wholesale level for the provision of mobile telecommunications services. The latter is a national market given that customers are only able to obtain mobile telecoms services from licensed network operators and licensing takes place on a national basis.[12]

22. The parties also claimed that mobile tariffs are set and marketing and advertising is undertaken by MNOs and MVNOs at a national level, therefore mobile operators do not differentiate between customers on the basis of their geographic location. Third party responses were broadly consistent with this view.

23. Nevertheless, while there are elements of competition occurring on a national basis, evidence from third parties also suggests that competition also occurs at the local level, with MNO/MVNOs engaging in some local

[12] Case Comp/M.3245 Vodafone/Singlepoint 16 September 2003.

marketing activities. This is also supported by the fact that retailers regard the location of their stores as very important[13] and customers value browsing in a store locally where they can pick up and try a mobile phone before buying it. On this basis it would appear appropriate to examine the effects of this transaction at both the national and the local level, recognising that the most intense competition comes from competitors located in the same shopping area.

COMPETITIVE ASSESSMENT

Competition at the national level

24. At the national level, the parties jointly accounted for approximately [15-25] per cent (increment [5-10] per cent) of all new connections in 2005. By contract type, the parties' combined share was [20-30] per cent (increment [5-10] per cent) for pre-pay connections and [15-25] per cent (increment [5-10] per cent) for post-pay connections.

25. We analysed whether the removal of The Link as an independent supplier of MNO/MVNO connections could lead to a substantial lessening of intra-brand competition. Data provided by O2 demonstrated that The Link accounted for less than [5-15] per cent of all new connections and less than [5-15] per cent of pre-pay and post-pay connections in 2005. MNOs confirmed that a small proportion of their sales were accounted for by The Link. Post-merger there will still be a number of other independent retailers, particularly Carphone Warehouse and Phones4U, which are both independent specialists with a larger share of sales than The Link. In addition, internet retailers and generalist retailers will still be present. Therefore, post-merger these remaining retailers would be expected to provide a strong constraint to tied retailers and offset any loss in intra-brand competition.

26. We also considered whether the removal of The Link could lead to a substantial lessening in inter-brand competition, that is, competition between the different MNO/MVNOs for new connections. Any effect will be dependent upon The Link's role in promoting such competition as an independent retailer of all mobile phone brands. As The Link accounts for less than [5-15] per cent of all MNOs/MVNOs sales, this role would appear to be small. Furthermore, there will still be two large independent specialist retailers present post-merger, along with tied specialists; generalist retailers and internet retailers, all of whom can continue to facilitate inter-brand competition post-merger.

[13] The parties told us that they choose where to locate stores according to RCR listings or 'goad centres'. The RCR index is a widely used index in the retail field. RCR provides a ranking for 2,392 retail centres across the UK. Shopping areas are ranked on the basis of a combination of quality of retail outlet and the quantity of outlets in that location the pull of the centre. The catchment area or pull of a centre is also factored in to give the RCR index for a retail area.

27. Post-merger at the national level, there remain two large independent specialists and numerous tied specialists. These have a comparatively large proportion of MNO and MVNO's sales, and the have larger shares of sales than The Link. In addition, a wide range of smaller independent retailers and generalist stores as well as many internet retailers will continue to exert some competitive pressure on the merged entity in both the pre- and post-pay segments. On this basis, competition concerns do not arise at the national level.

Competition at the local level

28. At the local level, the OFT considered whether the reduction in the number of retail outlets (and in particular specialist retail outlets) would lead to a substantial reduction in choice for the consumer. The parties identified 240 RCR or 'Goad' centres where O2 and The Link stores overlapped. The parties submitted an analysis of local competitors in all overlap areas by reference to competitors located within a geographic radius of 3 miles for market and provincial towns and 1 mile radius in city centres from the O2 store, and by reference to the boundaries of shopping centre sites.

29. Based on the parties' data, the OFT identified 26 areas where there would be four or fewer tied or (chain store) independent specialist retailers present post-merger. In all 26 areas however, there were numerous generalist retailers such as Argos, Virgin, Woolworths, Comet and Littlewoods as well as smaller independents and internet retailers. This collective constraint from the range of existing competitors, combined with low barriers to entry at a local level (see below) together leads the OFT to consider that no competition concerns arise in any of these 26 areas.

BARRIERS TO ENTRY AND EXPANSION

30. The parties maintain that barriers to entry and expansion in the sale of mobile connections and handsets at the local level are low.

31. The parties claimed that the main barrier to entry at the local level was access to suitable retail locations. Third parties stated that the minimum size necessary for third parties to compete effectively was approximately 500 square feet. Turnover of shops of this size in the type of shopping area where mobile retailers locate is high such that suitable premises become available on a regular basis. This is evidenced by the rate of expansion of some retailers over the last few years. Given the small amount of space required and the absence of any planning restrictions, barriers to entry or expansion at the local level are considered to be low.

32. Some third parties suggested that barriers to entry and expansion for the sale of post-pay connections were higher, as specialist IT equipment would

need to be bought in order to carry out credit checks and to connect customers to the network for post-pay connections. The parties submitted that such checks can be carried out on the telephone or by fax, and indeed many generalist retailers already carry out their own credit checks on customers, for example, Comet and Littlewoods. The parties also claimed that the costs of entry are recoverable within a short period of time. Third parties responses supported this view. Further, product knowledge and training is provided to sales staff by the MNOs and MVNOs.

33. Barriers to de novo entry and expansion at the national level may be higher, however they are not considered to be significant. In particular entry by a retailer with an existing national brand may be easier given it already has an established retail network of outlets which it can use to sell mobile phones. The parties also stated that advertising is not a barrier to entry at the national level or local level as market growth is driven by competition between MNOs and MVNOs. MNOs also provide direct marketing support to smaller stores wishing to expand and smaller specialist independents also benefit from nation-wide advertising campaigns of the MNOs and MVNOs. The parties pointed to Hutchison 3G and Virgin Mobile as recent entrants on a national level. In addition, the parties cited Marks & Spencer as a generalist new entrant in the sale of handsets and connections. Concessions within department stores are also considered to be an alternative way to enter, for example, Hutchinson 3 G has outlets within certain Superdrug and Virgin within WHSmith stores.

34. Based on the evidence supplied, it is considered that barriers to entry and expansion into the pre-pay and post-pay sectors at the local level are at present low. At the national level, entry and expansion may be less straightforward. However, it has not been necessary to conclude on barriers to entry at the national level as no competition concerns arise.

VERTICAL ISSUES

35. O2 operates on the market for mobile telecommunications services, which is vertically linked to the retail market for the sale of handsets and connections. The OFT does not consider, however, that the merger will foreclose access to the market for other MNOs and MVNOs given that The Link's share of sales of new connections is both low and significantly less than that of the other two large independent specialist retailers, Carphone Warehouse and Phones4U. The removal of The Link as an independent supplier of several MNO/MVNO connections will not affect the ability of MNOs and MVNOs to switch to different retailers should they wish to. The other MNOs are strong competitors and will continue to have access to customers through Carphone Warehouse and Phones4U, through their own tied retail outlets and through sales via generalists and the internet. On this basis, no vertical concerns are considered to arise.

THIRD PARTY VIEWS

36. A few third parties expressed concern about further concentration in this sector. Some third parties were concerned about the vertical issues addressed above.

ASSESSMENT

37. At the national level, given the parties' low shares of supply on a national level as well as the presence of numerous strong competitors, the acquisition does not give rise to any national issues. On a local level, the acquisition does not give rise to concerns given the continued presence of numerous competitors, the constraint posed by internet retailers and the low barriers to entry and expansion at the local level.

38. Consequently, the OFT does not believe that it is or may be the case that the merger has resulted or may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

DECISION

39. This merger will therefore not be referred to the Competition Commission under section 33(1) of the Act.