Anticipated acquisition of Chelys Limited (owner of the Energis Group) by Cable and Wireless plc

The OFT's decision on reference under section 33 (1) given on 25 October 2005. Full text of decision published 3 November 2005.

Please note that square brackets indicate information excised, or exact figures replaced by a range, at the parties' request.

PARTIES

1. Cable & Wireless (**C&W**) is an international telecommunications company. In the United Kingdom (UK), its principal operations are in the business-to-business market: fixed lines telecoms services; data and Internet Protocol services and managed hosting solutions.

2. Chelys Limited is the ultimate parent company of the Energis group of companies (**Energis**). Energis provides telecommunication services to businesses in the UK and Ireland. It includes basic telephony, advanced voice and data and Internet related services. Its turnover for the financial year ending 31 March 2005 was £745 million.

TRANSACTION

3. C&W proposes to acquire the entire issued capital of Energis.

4. A satisfactory submission was received by the OFT on 16 August 2005. The OFT's administrative deadline is 20 October 2005.

JURISDICTION

5. As a result of this transaction, C&W and Energis will cease to be distinct. The UK turnover of Energis exceeds £70 million, so that 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 arrangements are in progress or

contemplation which, if carried into effect, will result in the creation of a relevant merger situation.

RELEVANT MARKET

PRODUCT MARKET

6. The parties overlap in the business segment of the telecommunications sector.

7. The European Commission defined a series of specific retail and wholesale electronic communications markets in the Commission Recommendation on relevant product and service markets within the electronic communications sector.[1] These have been reviewed and to some extent revised by Ofcom in a series of market reviews carried out in 2003.

8. In view of its expertise in relation to the UK telecommunications sector and the fact that it has conducted detailed market analyses so recently, the OFT has adopted as its starting point the approach to market definition taken by Ofcom in its market reviews. In addition the parties have proposed two frames of reference for sectors not covered by the above approach – wholesale carrier voice and business data communications. These are discussed separately below.

9. The parties overlap in a number of areas but, on the basis of market shares and third party comment, there are only four segments where there were preliminary competition issues meriting closer consideration: wholesale carrier voice services; wholesale and retail number translation services (here called 'Telebusiness'); national leased lines; and retail business data communications.

10. Wholesale carrier voice services comprise a number of services provided by network operators, of which the most important elements are: interconnect voice services; and wholesale indirect access services (IDA). Wholesale IDA services are provided across the operator's network, in particular to retailers offering Carrier Pre-Selection services (CPS). CPS services enable a customer connected to a BT line to obtain its call from another operator. Interconnect voice services includes the inputs that are needed to deliver an end-to-end telephone call (origination, inter-tandem conveyance or termination, – ie carrying the call over the trunk network and delivering to or collecting it from the end user at either end of that network).

11. Telebusiness consists of the provision of non-geographic numbers or Number Translation Services (NTS) (0800xxx, 0845xxx, 0900xxx, etc.) to businesses

enabling them to provide voice and fax based services to their customers. Ofcom has subdivided this segment into NTS termination and NTS hosting services.[2]

12. Leased lines are point-to-point connections with capacity dedicated to the customer's exclusive use. Ofcom segments this sector into low, high and very high bandwidth.[3] The most common bandwidth delimitation distinguishes bandwidth of (i) up to 8 Megabits per second (Mbps); (ii) between 8 Mbps and 155 Mbps; and (iii) above 155 Mbps.

13. The European Commission considered business data communication in Telia/Telenor.[4] These services involve the transfer of often large quantity of data, securely and quickly, nationally and internationally. There are different technologies currently available to provide these services: packet switches (x.25), Frame Relay and Asynchronous Transfer Mode (ATM). More recently, a further alternative technology has emerged - IP-VPN[5] - which uses the internet network to allow companies to interconnect their sites without incurring the costs associated with building a data network based on leased lines, ATM or Frame Relay. For the purposes of this assessment it is not necessary to conclude as to whether different methods of provision constitutes separate frames of reference as there are no differences in the outcome however these markets are defined.

Geographic market

14. The role of regulation in the telecommunications sector suggests a frame of reference that is national in scope and the OFT has received no convincing evidence to suggest that a narrower frame would be more appropriate in relation to any of the product segments identified above.

HORIZONTAL ISSUES

Wholesale carrier voice

15. According to the parties, BT has a substantial share of supply of wholesale carrier voice services as whole (65 per cent). In contrast, the parties' combined share is only [10-15 per cent] with an increment of less than 5 per cent. These shares are reflective of the respective positions of BT and the parties in the narrower interconnect voice services segment and this is therefore not considered further.

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[1] OJ L114, 8.5.2003, p.45.

[2] Ofcom Consultation Document: Number Translation Services - Call Termination Market Review

[3] Ofcom Review of the Retail Leased Lines, Symetric Broadband Origination and Wholesale Trunk Segments Markets

[4] COMP1439 - Telia/Telenor

[5] Internet Protocol- Virtual Private Network

16. In relation to the wholesale IDA segment, share data reveals a substantially less concentrated picture, with pre- and post-merger HHI figures of between [1000-1800] (increment [in excess of 100]) respectively.[6] While C&W would have the leading post-merger share (estimated at around 30 per cent, increment [10-15 per cent]), it would face five other active suppliers with significant shares – Opal (15 per cent), MCI (10 per cent), Thus (10 per cent), Kingston (10 per cent) and Gamma (10 per cent). These share estimates by value provided by the parties are broadly corroborated by data from other industry sources.

17. The weight of evidence available to the OFT, including from Ofcom, indicates that provision of wholesale IDA capacity is largely a commodity business based on high fixed costs which suppliers seek to defray by maximising capacity utilisation - in other words, by winning voice call volume business from CPS operators. This is achieved when a supplier wins a wholesale IDA contract from one of (typically several) rivals invited by a CPS operator to bid for its volume. Accordingly, the uncommitted capacity of an IDA supplier will be a significant driver of how aggressively that supplier bids in competition for the next contract. Such opportunities are relatively frequent, as contracts are short-term: typically only two years in length. If the share distribution is any guide, a substantial number of suppliers - from among the six post-merger competitors identified above – have historically had sufficient capacity to gain a significant share of overall business and may reasonably be assumed to be credible bidders at any given opportunity. The lack of competition concerns expressed to the OFT from the majority of market participants - including Ofcom - reinforces this view.

18. Two customers, however, argued that they would be unable to resist price increases imposed by C&W post-merger when a particularly large-volume opportunity arose. Their argument, in essence, is that the merger transaction would merge the two lowest-priced bidders for previously tendered large-volume IDA supply contracts, thus demonstrating that other rivals would not be sufficient competitive constraint post-merger. Indeed, one customer supported this contention with clear evidence that in a recent large contract, the merging parties had offered the two lowest-priced bids. There are no suggestions of coordinated interaction among suppliers from the complainants or otherwise, so the theory of harm considered by the OFT is purely one of unilateral effects: is there a realistic prospect that by eliminating bidding competition between the parties, C&W would win a substantial number of such contracts at post-merger prices materially higher than if the two merging parties continued to bid against one another?

[6] This figure indicates that the market is in the 'concentrated' (1000-1800) rather than 'highly concentrated' (>1800) range. See further OFT Mergers Substantive assessment guidance, para.

19. For such a strategy to be profitable for C&W depends on the assumption that bidding competition between C&W and Energis is an important competitive dynamic; that each took the other into account as rival bidders in large-volume contracts; and that absent such constraint, the post-merger C&W will bid in a more relaxed (higher priced) manner - based on the calculus that it will lose substantially fewer such contracts to competitors than in a situation where Energis had remained a rival bidder.

20. This incentive for C&W to raise price (i.e., bid less aggressively) depends on the profitability of the calculus that rivals other than Energis are sufficiently capacity-constrained such that they are <u>not</u> a credible alternative to which the customer could award a large contract. In other words, C&W's judgment would be that rival bidders either simply lack the actual capacity to cater for such a large-volume contract, or that by factoring in capacity expansion costs, this would render their bid uncompetitive, thus providing latitude for C&W to raise price - relative to that with Energis present - and still win such contracts.

21. In order to gain a more representative understanding of bidding dynamics - beyond the two examples supplied by complainants - the OFT sought bidding data from the parties. Although the parties do not systematically retain bidding data or win/loss records, they were able to provide details of 'large volume' bids of over £10 million made during a six month period. This data set is obviously limited to opportunities in which at least one of the merging parties bid, and does not purport to represent the universe of such bidding opportunities. Within this set, the data revealed that the parties bid against each other relatively frequently - [] of the time - with BT the only identified other party bidding with a similar frequency. The data was insufficiently detailed, however, to establish a particular dynamic of competition between the parties, e.g., that prices were lower when both bid that when only one party was present. The parties believe that pre-merger on average there were four bidders for these contracts and data from customers suggests on average five were invited to bid.

22. The available bidding data does not, therefore, reinforce the snapshot provided by the single bidding example provided by a complainant, though certain suppliers did indicate that capacity constraints would deter them from competing for <u>sole</u> supply of large volume contracts. A substantially greater body of evidence, however, compels the conclusion that rivals would not be excluded from successfully competing with the merged entity.

23. First, certain rivals appear to have large amounts of uncommitted capacity, the ability to expand or (in the case of Opal) have publicly confirmed a commitment to substantial capacity expansion of a magnitude that would appear easily to handle the volume of the largest existing contracts.

24. Second, it would be inappropriate to take too static a view of suppliers' ability to react to demand, and too modest a view of customers' ability to discipline the merged entity by facilitating credible alternative bids. A sample of switching data provided by the parties in relation to contracts worth between £1 million and £5 million suggests there are at least three alternative suppliers regularly finding enough capacity to win a contract of this size from the parties. Moreover, the parties have succeeded in winning contracts by starting off as small scale suppliers within a multi-sourced contract and incrementally increasing capacity, thus allowing them to displace rivals; it is also widely agreed within the industry that there is a large amount of unused network capacity across the telecommunications sector as a whole and that the majority of customers which let large contracts multi-source.[7] Accordingly, customers with large volume needs can react to higher post-merger prices from C&W by shifting allocation of their demand in favour of rivals, who - alone or in tandem - appear to be credible alternatives in such circumstances.

25. Third, there are examples of wholesale IDA suppliers competing by vertically integrating with a CPS retailer in order to maximise use of available capacity, or acquiring the networks of bankrupt operators to provide wholesale services.

26. Fourth, it appears that BT has frequently bid, if not very successfully, particularly in relation to large contracts. This may be a reflection of a disincentive to undermine its retail voice business with low cost wholesale IDA offerings for the CPS retailers with which it competes. However, the recent changes in regulation by Ofcom may increase BT's incentive to grow the wholesale business and make it a more effective constraint in this sector.

27. Finally, these large contracts account for a substantial proportion of any supplier's revenue (other than BT) and suppliers, as noted, operate under fixed cost economies which generates an appetite for volume to fill unused capacity. As such, bidding from even a relatively small pool of bidders appears to generate outcomes that sufficiently satisfy customers' competitive needs; in other words, these factors do not suggest that the elimination of one bidder, given the remaining number, raises significant competition concerns.

28. Overall, therefore, the theory that C&W has the post-merger incentive to bid with prices higher than absent the merger is unsupported by the weight of the evidence available to the OFT.

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[7] Although the parties each supply around [ ] largest CPS retailers, which is twice their nearest rival, more than [ ] multisource and all of Energis's customers do so.

Wholesale and retail Telebusiness

29. According to the parties, the merged entity will have a [20-25 per cent] share of supply of the total Telebusiness market in the UK (with an increment of [5-10 per cent], behind BT with a share of supply of 30 per cent. While other sources suggest that the parties will be the largest supplier within the NTS call termination segment with a share of supply of 35 per cent (increment 10 per cent), most competing networks offer these services and there will remain several competitors with similar shares to Energis. Again, there is evidence of multisourcing in this segment and it appears that customers often change provider since barriers to switching are low - regulation provides that operators must have processes in place to allow customers to switch NTS providers at low costs.

30. The concern raised by one third party was that the merger would reduce the few providers who had the geographic coverage, the ability to deliver complex technical solutions, financial standing and price it required. However, bidding data supplied by the concerned third party suggests that several other bidders will remain post-merger and no evidence was forthcoming to support the proposal that this group of other bidders was further reduced by the number able to satisfy the criteria outlined above.

National leased line bandwidth below 8 Mbit/s

31. The parties and other industry sources estimate the merged entity will supply around [10-15 per cent] of leased line of 8 Mbit/s and below. BT has an estimated 65 per cent share of supply of the whole UK market; MCI has a similar share to the parties.

32. A third party suggested only BT and the parties could provide low bandwidth national leased lines at a distance of 100km outside London. However, there is no evidence to suggest that Energis has a greater geographic coverage than other networks, or strength in a particular region.

Business data communications

33. The parties have a share of supply of [15-20 per cent] (increment [around five per cent]) of the wider business data communications sector, placing it second to BT with a share of supply of around 60 per cent. Third parties, including Ofcom, were unconcerned except one. The concerned third party argued that the parties' position was particularly strong in IP-VPN, although it was unconcerned about the merger as a whole. An examination of bidding data for IP-VPN contracts suggests that even in those bids where the parties overlap, the majority had more than five

bidders. Barriers to switching appear low and contracts are short, with customers generally being sophisticated.

VERTICAL ISSUES

34. The merger does not give rise to substantial vertical issues.

THIRD PARTY VIEWS

35. Extensive third party comments were received. The majority were unconcerned or saw the potential pro-competitive effects (speeding up the investment in next generation infrastructure, strengthening competition, innovation and sustainable competition) resulting from this transaction as outweighing any concerns they had. A minority had concerns relating to specific sectors, which are addressed above.

36. Ofcom expressed no competition concerns about this merger.

ASSESSMENT

37. The parties overlap in the supply of a number of wholesale and retail telecommunications services to the business sector. In most of these the parties have low shares and no concerns were raised by third parties. The four exceptions are: wholesale carrier voice services; wholesale and retail number translation services (Telebusiness); national leased lines; and, retail business data communications.

38. Within the wholesale IDA segment of wholesale carrier voice services, the merger will create a market leader with a share of supply of around 30 per cent but there are several other competitors with shares of 10 per cent or more. Nevertheless, two customers argued that for larger contracts the impact on competition would be greater than these shares of supply might suggest as only a few providers had sufficient capacity to meet their needs and offer an acceptable price. An examination of the parties' bidding data in relation to large contracts revealed that there would remain on average three bidders post-merger, and, as large contracts represent a substantial proportion of most suppliers' revenue, customers appear to have sufficient choice from among the pool of post-merger bidders so as to discipline a price rise by the merged entity. Although there was one recent bidding example from one complainant to support the argument that the parties' were each other's closest competitors, the notion that this was a good guide to future post-merger competition was outweighed by the body of evidence that rivals are credible alternatives, with either available capacity in the near future, or the ability to expand incrementally to serve customers needs. Finally, competition may be

further boosted by deregulation and a change in bidding incentives on the part of BT.

39. As regards the other three segments where third parties identified the merger as giving preliminary cause for concern, the evidence showed that in all but one (Telebusiness), the merged entity will have a share of supply of no more than 20 per cent, compared to BT's share of around 60 per cent. In the Telebusiness segment, the merged entity may, on one view, be the largest player with a share of supply of [20-25 per cent] but there will remain a number of significant players and customer switching appears to be widespread. In all three segments, the particular concern raised by the third party was not substantiated by evidence.

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

DECISION

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