Telecom Services

JEF U: Expert Call Recap "A Wind Shift in the EU Merger Regime for Telcos"

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Key Takeaway

In our expert event on EU merger policy for telcos, our speaker suggested that the upcoming ruling by the EU Court of Justice on the Commission's O2 UK / Three prohibition decision, annulled by the General Court in 2020, creates a pivotal moment both for the Commission and the industry. A rejection of the appeal would invalidate the EC's recently developed stricter line on horizontal in-market consolidation. A ruling might be expected in 2022.

EU merger review framework. EU merger reviews revolve around the question whether the concentration will lead to significant impediment of effective competition in relevant markets. The relevant law (EUMR) remains unchanged since 2004 but leaves substantial leeway to the Commission (EC), not least through the definition of relevant markets, the assessment whether impediments to competition are significant, as well as remedy design. Following a period of relative "leniency" with the telco industry until about 2014, the EC has taken a tougher stance. The limits of the EC's discretion are set by judicial review, but the EC has suffered few defeats in court on substantive (rather than merely procedural) grounds.

O2 / Three UK case creates a pivotal moment. The EC's 2016 prohibition of the O2 UK / Three merger was overruled in May 2020 by the EU General Court (EGC) who found a series of material errors in the EC's argument. The EC appealed, and a ruling by the European Court of Justice (CJEU) is pending. Our expert suggested that the outcome is pivotal for EC merger practice. If the appeal is rejected, the EC's strict line on unilateral effects would be invalidated and the threshold for further merger prohibitions would increase significantly.

Timelines and outcomes. Our expert took the view that the appeal ruling might well be issued during 2022. The outcome is difficult to predict, but the large number of contested points suggests the CJEU might confirm some but not all elements of the EGC ruling and send the case back to the EGC. The EGC would then take about two years to decide. However, it is also possible that the CJEU decides the entire matter directly.

In the meantime... Our expert rejected the idea that the industry might benefit from the current phase of uncertainty. In his observation, the EC is following a path of "keep calm and carry on" while waiting for the decisive CJEU ruling. This means the industry's opportunity to attempt more consolidation with horizontal in-market mergers would arise only following a CJEU ruling supportive of the EGC.

Change to merger law less likely. On the idea that the EC might react as in 2004 when merger rules were changed in reaction to court rulings overturning several EC merger prohibitions on substantive grounds, our expert took the view that this is less likely to happen again. A change of the EUMR would involve the Council of the EU, potentially opening the process to other demands such as moving powers back to member states.

Merger policy not influenced by industrial policy intent. Industrial policy intent as visible in the EC's sector regulation (EECC) is unlikely to show as a material shift in merger policy, in our expert's view.

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Robert Klotz is a partner in the Antitrust & Competition Practice Group in the Brussels office of Sheppard Mullin Richter & Hampton LLP. He has more than 25 years of experience in EU and German competition and regulatory law.

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Sector-wise he has a particular focus on network industries, such as energy, telecommunications, post and transport. This is based on his previous role, in which he served for a decade as an official of the European Commission in DG Competition, dealing with high level antitrust cases the same sectors.

In addition to his client work, Robert teaches EU law in several LL.M. programs in Germany and is a frequent speaker at international conferences. He is the managing editor of a standard treatise on EU competition law (ed. NOMOS, in German) and of CoRe, a quarterly review covering competition and regulatory law (ex. Lexxion, in English).

Ulrich Rathe: Hello everyone. And thank you for joining this Jefferies expert call on the EU merger regime for Telecom Services. My name is Ulrich Rathe and I'm an analyst on the European Telecom Services team. My colleague Jerry Dellis will join shortly.

Why are we having this call? We find ourselves increasingly debating telecom mergers with investors, both scenarios and announced deals. EU merger policy is invariably a key question in this conversation and that's relevant. Last time we had meaningful consolidation in 2013-15, the sector rerated 45% relative to the market. And it is not just relevant but also timely. In 2022, the upcoming appeal ruling in the 3/O2 UK merger case could be a trigger moment. So that's what we want to explore today.

I'm delighted to announce our expert speaker, Robert Klotz. Robert is a partner in the Brussels office of Sheppard, Mullin, Richter & Hampton. He has more than 25 years of experience in EU and German competition and regulatory law. He advises clients in cartel and abuse of dominance cases, merger control, and state aid. Sector wise, he has a particular focus on network industries, and that is based on his previous role in which he served for a decade as an official of the European Commission in DG competition, dealing with antitrust cases.

I'll pass over to Robert in a minute, but before I do, a word on the format of the call. We have some core issues that we will be covering with Robert up front in a fireside chat setting. We would very much welcome any questions you may have or thoughts you would like to share. Please raise your hand on Zoom or alternatively send an email to me and I'd be happy to read out your question after the initial fireside chat is over. So, with no further ado, I'm delighted to welcome Robert. Hello Robert, thank you for joining us.

Robert Klotz: Hello Ulrich, thank you for inviting me. It's my pleasure to be here for fireside chat on the spring day, actually. So, why don't we go ahead?

Ulrich Rathe: Right. In-market mobile/mobile or fixed/fixed consolidation is the holy grail for investors in European telecoms. And whether such mergers close and under what conditions is determined by the European Commission for the larger deals that actually matter. Could you describe the legal parameters guiding EU merger decisions and how those have evolved more recently?

Robert Klotz: Yes, certainly. So the legal starting point for assessing mergers is Article 2 of the EUMR which was last reviewed in 2004. And the key test is whether the deal leads to significant impediment of effective competition, the so called SIEC test. Under the old merger regime, SIEC was always found or coincided with the creation or strengthening of a dominant position. While this factor has not gone away in the current EUMR, it is not decisive alone. It is only a starting point. So the Commission when reviewing a merger will not just look for the creation or strengthening of a dominant position, but consider a number of factors as well.

So what are these? This depends on the nature of the merger. We have horizontal mergers between parties active in the same market, where the Commission will focus on non-coordinated unilateral effects. They're often found in oligopolistic markets and here the Commission will review market shares of the parties, concentration ratios measured by HHI, and many other factors in conjunction, like the number of competitors, the closeness of competition, ease of market entry and the like. So, it is not in any way a quantitative but more a qualitative assessment of non-coordinated unilateral effects. And this is the common scenario in telecoms mergers.

The Commission can also look for coordinated horizontal effects. This comes closer to tacit collusion, but it's more rare. The Commission can also look into vertical effects if the parties are active up- or downstream from each other. This is generally seen as a

little less critical than horizontal effects. And finally, the Commission can also review conglomerate effects, with merging parties active on different markets, whether related or not. This is generally even less critical than the others, but certain theories of harm can be relevant here, like bundling, portfolio effects, or spill over effects.

These parameters have not evolved materially since 2004. The legal criteria have remained the same. But it is fair to say that they have been applied in a different manner over time. In telecommunications, for instance, they have been applied in a stricter manner in the past few years. First, there was a fairly lenient line on telecoms mergers, when we saw second phase approvals without remedies, for instance, the EE JV in the UK, or with remedies in Austria, both in 2012. This more lenient line came to a culminating point in 2014 with the German Telefonica/E-Plus merger, when a 4-to-3 consolidation was approved, although the maverick was taken out of the market, with light behavioural remedies, which were much criticised and legally contested.

Since this case we have seen a turning point with a tougher stance being taken by the Commission. This materialised in the abandoned Danish mobile merger, to pre-empt a prohibition in 2015, and the Italian Hutchison/VimpelCom merger, only approved with an upfront buyer of the divestment spectrum, enabling the market entry of Iliad. And finally, the reason why we're here today, the UK prohibition in 2016. So, a stricter line was built up by the Commission while the legal criteria remained unchanged.

Ulrich Rathe: Right. That's a good introduction, and takes us very quickly to the core of the discussion. Let me ask you on this shift. From the outside, it looks very much as if this is tied to personalities. This turning point that you described with the abandoned Danish deal happened to be, of course, the moment at which Margrethe Vestager came in as Competition Commissioner. So is it really the case that there's top down industrial policy intent expressed here on the basis, as you say, of an unchanged law? Would you agree with that? And how would you describe the current mood in Brussels on that front?

Robert Klotz: Well, observing what has happened in telecoms mergers over the past 10 years can only lead you to agree that policy makers do shape the way enforcement goes. To pin this down a little bit into what is legally permitted and what may be overstepping the boundaries, it is fair to say that there is no mathematical rule for applying the SIEC test. The Commission has discretion in applying all relevant elements of the SIEC test. And that obviously creates room for political views to be expressed or to materialise in individual cases. These can be part of competition policy – how liberal or strict competition policy should be. But increasingly we also see the inflow of industrial policy and even other factors like more recently climate change or foreign policy. All these can come together one way or another, even in individual cases.

Now, how does this work in practice? The discretion that the Commission has in applying the SIEC test already starts with the way markets are being defined. Whether you consider them as national or as broader-than-national or even global, this changes the entire assessment of the case. So market definition is the entry point, and it comes with some discretion.

The discretion obviously increases in the substantive assessment because what you consider as “significant impediment” will be shaped by the political preferences, beliefs, convictions of the enforcers and their leaders. There's also discretion in the design and the assessment of remedies, structural versus behavioural remedies, the Commission having a stated preference for the former. It is in the hands of the Commission to decide whether they are sufficient or not. And likewise, the Commission can accept or refuse to review such remedies later on. Upon special request by the parties, merger remedies can

indeed be phased out or modified. This has occurred a number of times and is always subject to a new decision by the Commission.

This discretion finds its limits only in the judicial review by the EU courts. But the judicial review is limited when it comes to the Commission's complex economic assessments, such as in these types of mergers. The courts will not replicate the entire assessment of the case by the Commission. They will only review procedural infringements, which are the most frequent cases and can often be fixed afterwards by the Commission, or substantive manifest errors of law. These are more rare. We have seen one in Ryanair/ Aer Lingus, for instance, and we have O2 UK / Three, of course, where the EGC found several manifest errors of law.

And what's the current mood? Well, I would call it "keep calm and carry on." I think the Commission is currently caught between different objectives. On the one hand, trying to be a little bit more courageous, more daring, but on the other hand, anxious to see the outcome of the Court case. Unproblematic telecoms mergers get approved, like T-Mobile Austria / UPC in 2018, Iliad / UPC Polska just recently in March, others only with behavioural remedies, like Vodafone Italia / TIM in 2020. Others seem more difficult to approve, like the recently announced Orange / MasMovil merger in Spain. This very much underpins the traditional line of the EU, but could change substantially depending on the outcome of the court case.

Ulrich Rathe: So the court case came up several times, so let's dig into that. Just to lay out the picture a little bit, back in 2016 we had Commissioner Vestager rejecting the proposed merger for O2 and Three in the UK. And that was, as you said, subsequently overruled by the EU General Court. Now we are aware that the EC has appealed this, and what we are seeing on our end is that some management teams of telecom operators ascribe great importance to the outcome of this appeal. Can you put the relevance of the decision into context for us?

Robert Klotz: Yes. In my view, this matter is highly relevant – not just for the telecom sector, but for the entire future of EU merger policy. It can be seen as a potential leading case, only comparable to a few others 20 years ago which led to a reform of the merger regulation and the review process. The Commission has a long track record in mergers and has had very few defeats in front of the courts. Many of the Commission decisions were not contested, and when they were, most of them were confirmed by the Courts. The courts generally accept wide discretion for the Commission and are not replicating the investigation.

Commissioner Vestager welcomed Court reviews recently and stated that even annulments are important feedback for her policy, because they improve the overall enforcement level and predictability. This is good, but I also believe that the Commission prefers to avoid any annulments by the Courts. Because these defeats can have significant impact on their policy going forward.

20 years ago, the Commission saw an unprecedented wave of three annulments of merger prohibitions within six months. That led to wide-ranging reforms of the EUMR, with the SIEC test being opened up for more economic assessment, moving away from the more legal test. The chief economist team was also set up as a consequence of these judgments.

The Telefonica / E-Plus conditional approval in 2014 was a borderline case I think. It might have been annulled on reasons of law, on substantive grounds, upon third party application before the court. But unfortunately, all these third parties withdrew their applications for different reasons before the ruling, and so the case ended there. The O2 UK / Three merger is a potential game changer in my view, because the Court found not

just one but a whole series of material errors in the substantive test, e.g. the Commission assumed too easily Three as an important competitive force, likely price increases and the disruption of network sharing agreements, among others.

If the Court of Justice confirms the General Court ruling and rejects the Commission's appeal on all grounds, the prohibition decision will fall apart, and the EC's strict line on unilateral effects will be invalidated. The parties can renotify the merger, but I guess that's unlikely to happen. A new review upon new notification would have to take the two rulings fully into account. More important, I think, is the impact on future mergers. They could benefit from such a ruling, because the threshold for further prohibitions might significantly increase.

If the Court, however, follows the Commission's appeal and overrules the General Court, either on all grounds, or on some, or even on one, the case may be sent back to the General Court for a new assessment of the prohibition decision in light of the Court ruling. In such a case, there is a high likelihood that the EC prohibition decision will ultimately prevail. However, when overruling the General Court, the Court of Justice may also decide directly on the entire matter, including whether the EC prohibition stands or falls, all or in part. This is in the Court's discretion. This does not occur very often, but it has happened.

Ulrich Rathe: That's very clear. Now, what sort of factors does the appeals court have to take into account on both sides of the argument?

Robert Klotz: There's a short answer to that, the Court has to apply the rule of law. In this case we have very bold grounds of appeal put forward by the Commission. They literally say that the General Court made serious mistakes, and this basically reflects the ruling of the General Court, which said the same about the Commission decision. So who was right and who got it wrong? This is first and foremost a matter of the Court applying the rule of law based on the EUMR, the relevant Commission guidelines and the precedents, to determine whether what the EGC stated meets or does not meet the required legal standards.

Either the Commission or the General Court will not like the outcome of the Court ruling. I think the defeat would be harsher for the Commission than for the General Court. A Court being overruled by the higher instance is basically business as usual. The Commission as an enforcer is more directly under the public radar and exposed to the business world. My best (albeit purely speculative) guess as of today is that the Court of Justice might confirm the General Court ruling on some grounds, not completely dismissing the Commission's appeal, and refer the case back to the General Court.

Ulrich Rathe: Okay, we should explore that maybe in the Q&A at the end. That's interesting. But one thing I wanted to tie down first, which is really front and centre of what investors are talking about in this context, is what is the timeframe for this appeal process? We've heard late last year at least one management team in the sector saying that from what they've heard it would be mid-year 2022, and then we've heard other people saying "no, this is really something for 2023, because it's not even on the docket yet." What's your view on the timing?

Robert Klotz: So, the appeal was submitted mid-2020. We've seen a procedural order issued mid last year, but we do not yet have public record of an oral hearing. This suggests that this case may take a bit longer to be decided than average. The average time to ruling is currently 15 months. This case is a bit delayed, probably due to its complexity, but I would expect it to be issued before the end of this year. And if it's being sent back to the General Court this would then take us into 2024 for a final ruling.

Ulrich Rathe: Got it. Let's leave the discussion of this particular case and its potential impact for now. As I said, might be interesting to explore what you just said on the most likely outcome at the Q&A, but let's switch gears. There is this question whether there's a linkage between merger reviews and telecoms with the EC's digital platform effort – very crudely said, the attempt to get Google and Facebook under control. One might construe that if digital platforms increasingly do snap up value in the value chain, then letting the telco operators consolidate might produce a local European counterweight. Is that conceivable thinking on the side of the antitrust authority or is that wishful thinking from the point of the industry?

Robert Klotz: It is indeed much discussed what role the DMA, the Digital Markets Act, will play, and what effect it will have on antitrust enforcement. So, the DMA is a step change for tackling anti-competitive conduct, mainly by digital gatekeepers, but not the "telcos". So it's meant to hit big tech, on their conduct, but does not change much for the merger reviews. The DMA contains a mere duty to inform the EC about transactions below the EUMR thresholds, with no further obligations attached.

So, will this have an indirect knock-on effect for telecoms mergers? Rebalancing the playing field, maybe, if notified mergers and the new DMA merger tool would reveal such a need? Commissioner Vestager alluded to such a possibility in the European Parliament last week for the first time, to my knowledge. In a DMA-centered debate, she said she would be ready to discuss more consolidation in Europe, so the link with mergers was confirmed by herself. But at the same time, she attached this to pan-European consolidation, adding that this is not what the telcos want for now. So in doing that, she left it to the companies to operate this change, and then her policy might react to that. On the other hand, more leeway for purely national consolidation, I think, cannot be deducted from what she said and cannot be expected as a direct outcome of the DMA. So this, for me, would be wishful thinking indeed.

Ulrich Rathe: Got it. Okay, that's a clear answer on that question. And then I had another one in a slightly different direction again. There is an argument we've heard recently that modularizing technology, such as software defined networking, virtualization, and 5G network slicing, all naturally dismantle the competitive power of network owners. Is that an active debate in merger policy?

Robert Klotz: I haven't seen this as an active debate, at least not among competition authorities. It sounds to me more like an issue for national regulators and possibly BEREC in an attempt to define narrower markets, which I think would lead to some form of deregulation under the EECC. Defining narrower markets has been a goal pursued by many incumbents over the years in the field of ex-ante regulation. Which does not mean that it cannot play a role in future mergers, because when such a trend is sufficiently advanced, merging parties will put this forward in their notifications as part of the definition of relevant markets. And when this is sufficiently convincing, it may contribute to the Commission accepting more fragmented markets, which might allow more consolidation.

Ulrich Rathe: Okay. I wanted to return back to the main thrust of the discussion, picking up earlier comments you made about remedy design. Obviously, these merger decisions aren't just about blocking or passing deals, but also how the remedies are designed. The German consolidation, I think you mentioned, came with behavioural remedies, but they unfolded maybe not quite along the lines that the EC originally intended. Still, you already highlighted cases where the EC still went for behavioural remedies. How do you see the EC's approach towards remedies evolving based on the experience they're having with behavioural remedies three, five, 10 years after the fact?

Robert Klotz: I don't see a major change. The Commission's approach to remedies has been fairly stable over the years. There is a general preference for structural over behavioural remedies, but obviously not every case lends itself to structural remedies. Remedies must be suited and appropriate for them to be imposed. However, the Commission is not able to choose the remedies itself. They depend, in the first place, on what parties propose, and if they're not willing to go further, the Commission can only threaten to prohibit, but cannot enforce different remedies at its own discretion.

So, I would say the current line of the Commission, they're somehow stuck in a trial-and-error process. The weakness of the Austrian and the German mobile merger remedies are well understood. They led to price increases. Which is what third parties predicted would happen, so they were right. The stricter line worked out for the Commission for some time but was momentarily stopped by the General Court in the UK case – although it was not a remedy case. The remedies choice is not the subject of the pending court case, but the expected ruling will have an impact on when and what kind of remedies can be imposed in future mergers.

Ulrich Rathe: Okay, great. Let me repeat something I said to the audience earlier. If you wish to ask a question, please raise your hand on Zoom or email me, and I'm more than happy to read it out.

I have one last question that I wanted to address in this format here, before we get to the open Q&A, which is: it seems to us that the latest EC regulatory framework, the EECC, broadens the regulatory toolkit in at least partial recognition of an industrial policy issue in Europe. I guess that's a fancy way of saying the EECC allows national regulators to incentivise operators through light-touch regulation in a way that wasn't really possible previously. Do you agree with that, first of all? And then the real question is, if you agree, do you believe that such a shift on the side of the EECC, which is more the remit of DG CONNECT, that such a shift in policy would be mirrored at the European antitrust authorities?

Robert Klotz: Well, it is not my reading of the EECC that it's a major shift towards industrial policy or towards deregulation. I think the incumbents expected much more from the Commission in terms of deregulation. In my view, the EECC is a strong signal towards keeping *ex-ante* regulation of SMP operators in place, because competition generally is not yet sufficiently sustainable. The main industrial policy element which I see in the EECC is the co-investment option for next generation network operators. So, it's now possible for operators to get relief from third party access obligations if, instead of investing alone, they go with a partner. Then they can reserve this infrastructure for themselves, but this is subject to very strict conditions and a very difficult approval process, and it's definitely not something for the antitrust authorities.

At the same time, it is true that industrial policy is making its way up on the EC's general policy agenda, so it's definitely recognised to be more and more important. But somehow, it does not, in my view, directly translate into the substance and procedures of competition law enforcement. So, we don't see major changes in merger policy or antitrust, to allow for more industrial policy considerations in exchange for less competition in Europe to promote Europe as a whole. That however is not easy to implement under the current rules. It would for instance take a change of the merger rules to do that. Just look at the Siemens-Alstom prohibition, which was made against very strong claims for a more lenient route to promote a European champion. Still, the Commission remained strict and forcefully defended its prohibition. So this leads me to believe that industrial policy is probably better pursued with other, more sector-specific policies, and maybe with State aid rather than merger control.

Ulrich Rathe: Got it, great. In terms of questions, I see a hand raised, but I also have an emailed question which is actually quite relevant I think. So let me start with this one. On the Three / O2 UK appeal, there are essentially two theories what this means for operators looking to do deals. One is that we have to wait for the ruling, and if that goes against the EC, then we might have a wave of test cases. Another one is that there's a window of opportunity now, in the time of maximum uncertainty before the ruling, because EC might not want to reject big cases that get thrown out later in an embarrassing way. So essentially the argument is they're a bit gun shy. What is your view on this question? Do we have to wait for the ruling or is now the time to notify mergers, because the EC is a bit restrained?

Robert Klotz: As lawyers we often take the cautious route. I think I would recommend to wait for the ruling. I don't really see the window of opportunity before the ruling because any decision taken now could also be appealed by parties or third parties, and would not escape the judicial review, including the impact of the expected Court ruling.

Ulrich Rathe: Got it, okay. I see a raised hand here from Alex.

Alex: Hi, thanks for taking the time today and for taking my question. Please, could you provide your reasoning behind your educated guess on the likely outcome of the O2 / Three appeal, please?

Robert Klotz: It is my purely personal view that this seems to be the most likely outcome, mainly because of the number and weight of the errors of law found by the General Court, combined with the fact that the Court of Justice would have to overrule the General Court on all these points to confirm the Commission decision. From reading through the different grounds of appeal, it seems to me that it's rather likely than not that at least one of these grounds may be dismissed by the court.

Alex: Okay. Thank you.

Ulrich Rathe: Can I follow up on that? I appreciate you put a view out there on the potential outcome which is very difficult to do, I understand. But one thing I'm not quite clear about is what the implications of that would be. Would we just be in a big muddle of the whole issue being entirely up in the air and it's all about half the points go back to the EGC and the other half don't go back. Is this ultimately a scenario where uncertainty, very fundamental uncertainty about the EC's antitrust policy would continue for the next two, three, four, five years? Or would this be a scenario where minor aspects around the margin get need to be clarified, but we know essentially where the EC's policy has to change or not change. Or practice, not just policy, but practice of merger review has to change or not?

Robert Klotz: I can't really speculate about the outcome of each individual ground of appeal, but if only one of them will be dismissed by the Court, then definitely there is an open issue which will have to be decided upon referral by the General Court, unless the Court decides on this right away. The latter would be beneficial to the predictability that I think is relevant for you and your group and many others. Whether this happens or not depends on how many grounds it will uphold, how many it will dismiss, and what their relative weight will be within the overall appeal.

Ulrich Rathe: Understood. I have one more email coming in here, which I also thought ties quite nicely into this. Let's say the Hutch / O2 appeal goes against the EC, could the EC not just turn around and say, "Okay, then we just change the legislation." What is their room for manoeuvre? You started to discuss that a little bit during your earlier comments, but I think the question really is about whether the EC could not just recreate

the *status quo ante* by just changing the rules because they're executive and legislative at the same time.

Robert Klotz: The EUMR is a Council Regulation and so the Commission cannot change it single-handedly. The Commission can only change the implementing guidelines, which might not permit a step change to overcome a significant defeat in front of the Court. A change of the EUMR could only be proposed by the Commission and would have to be adopted by the Council, so by the Member states. And that, I think, is something that may trigger other requests from Member states, potentially reducing the Commission powers. So I don't think a fundamental change of the merger rules is very likely to happen soon.

Ulrich Rathe: Robert, thank you very much for making time. This was a fascinating debate, it certainly taught me something. Hope we can repeat that at some point in the future. And thank you everyone for attending.

Robert Klotz: Thank you. It was my pleasure.

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Investment Recommendation Record

(Article 3(1)e and Article 7 of MAR)

Recommendation Completion	April 1, 2022 , 10:26 ET.
Recommendation Distributed	April 3, 2022 , 19:00 ET.

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Distribution of Ratings						
			IB Serv./Past12 Mos.		JIL Mkt Serv./Past12 Mos.	
	Count	Percent	Count	Percent	Count	Percent
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