

## Anticipated acquisition by SBC Communications Inc of AT&T Corporation

The OFT's decision on reference under section 33(1) given on 23 August 2005. Full text of decision published 30 August 2005.

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**Square brackets indicate information removed or replaced for confidentiality reasons at the parties' or third parties' request.**

### **PARTIES**

1. **SBC Communications Inc. (SBC)**, a Delaware corporation, provides voice and data telecommunications services, primarily within the 13 U.S. states in which SBC is the incumbent local exchange carrier. In the EU, SBC supplies business application software and services (via its subsidiary Sterling Commerce) and also derives revenue from European mobile phone operators (via its 60 per cent ownership of Cingular Wireless) for roaming services provided in the United States. SBC's EU-wide turnover in 2004 was approximately [ ].
2. **AT&T Corporation (AT&T)**, incorporated in New York, provides long distance and international telecommunications services for the business and government sector. In the EU, AT&T provides international telecommunications services to large multinational companies and government agencies; its UK affiliate is AT&T Global Network Services (UK) B.V. AT&T's UK turnover in 2004 was [in excess of £70 million].

### **TRANSACTION**

3. SBC proposes to acquire the entire issued share capital of AT&T.

### **JURISDICTION**

4. SBC and AT&T will cease to be distinct. AT&T's relevant UK turnover exceeds £70 million. Accordingly, arrangements are in progress or contemplation which, if carried into effect, will result in the creation of a relevant merger situation for the purposes of s 33(1) of the Enterprise Act 2002 (the Act).

## PROCEDURAL CONTEXT

5. The transaction has its centre of gravity in the United States, where it is the subject of ongoing merger review by both the U.S. Department of Justice (DoJ) and the Federal Communications Commission (FCC). In Europe, the transaction has received merger clearance in all jurisdictions in which it was notified (Germany, Austria, Norway, Estonia); it has also been cleared in several other jurisdictions.
6. The parties did not initially notify the transaction under the UK's voluntary filing regime. However, in light of complaints received about the merger, the OFT opened an investigation. The OFT's 40-working day administrative deadline expired on 9 August 2005.
7. In light of the international dimensions of the case, the OFT requested, and the parties provided, comprehensive waivers permitting the exchange of information confidential to them between the OFT on the one hand, and the DoJ and the European Commission (Commission) respectively, on the other.
8. Certain substantive issues considered below relate to the alleged impact of the transaction in tandem with the proposed acquisition of MCI Corporation (MCI) by Verizon Communications, Inc (Verizon). That transaction is also subject to U.S. review by the DoJ and the FCC, and will be reviewed by the Commission under Regulation 139/04 (the EC Merger Regulation, ECMR).
9. Two complainants urged the OFT to transfer jurisdiction to the Commission by making a request pursuant to Article 22(1) ECMR.<sup>1</sup> After careful consideration, the OFT decided not to make such a request.

## SUBSTANTIVE ASSESSMENT

10. The parties' activities do not overlap specifically within the UK. SBC's UK revenues were [very small], derived in roughly equal part from software services via Sterling Commerce, and U.S. roaming charges levied on UK mobile phone operators. AT&T, meanwhile provides international telecommunications services to business and government.
11. However, the OFT has received complaints from three sources asserting that the merger will harm competition, all for similar reasons.
12. The OFT's duty to refer under s 33 of the Act applies only to mergers that may substantially lessen competition 'within any market or markets in the United Kingdom'. Accordingly, the following focuses on those theories of harm to competition advanced by complainants that, taken at face value, could plausibly have a foreseeable impact in the UK, rather than merely extraterritorial effect. These relate to alleged anti-competitive

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<sup>1</sup> This provision permits the OFT to make such a request where the transaction affects trade between EU Member States and threatens to significantly affect competition within the territory of the UK.

effects in the respective global markets for global telecommunication services and internet backbone connectivity, with consequent effects in the UK.

13. Market definition is not contested in this case, as the parties and complainants largely adopt positions previously taken by the Commission and the DoJ. In the absence of evidence to support a different approach, the following has therefore had close regard to relevant Commission and DoJ analysis.

## **Global Telecommunications Services**

### Market definition

14. In January 2005, the Commission considered the global telecommunications services (GTS) sector in the context of BT's acquisition of the U.S. GTS player, Infonet.<sup>2</sup> In that case, the Commission defined GTS as follows:

'telecommunications services linking a number of different customer locations, generally in at least two different continents and across a larger number of different countries. They are generally purchased by MNCs [multinational corporations] with presence in many countries and a number of continents. The services provided are enhanced services – going beyond the provision of simple services such as basic voice and fax – to provide customers with package solutions including virtual private networks for both voice and data services and advanced functionalities.' (para 8)

In the same case, the Commission identified a single product market for GTS, despite some suggestions that it might be appropriate to segment the provision of GTS by type of service or industry sector.

15. As to geographic market definition, supply and demand for GTS services is, as the terms suggests, global in scope. These considerations underlie the Commission's indication as such in *BT/Infonet* (para 13).

### **Share data and market conditions**

16. AT&T estimates its GTS market share at [between 5 and 15 per cent]. The most recent independent industry report (Forrester, May 2005) estimates AT&T's GTS share at around 12 per cent. An earlier industry report (Ovum, 2004) indicated a share of 33 per cent, but itself suggests that this figure is inflated.<sup>3</sup> The Forrester report may therefore be the best independent guide on the issue.

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<sup>2</sup> Case COMP/M.3641 – *BT/ Infonet*, 25 January 2005.

<sup>3</sup> The Ovum report was cited by the relevant parties and in turn the Commission in COMP/M.3641, note 5. However, that report acknowledges that its data for Cable & Wireless and AT&T 'includes significant amounts of non-MNC business' (p. 22). As GTS customers are typically MNCs, this suggests a significant overstatement of AT&T's GTS share.

17. Moreover, the Commission noted in *BT/Infonet* (para 16) that market shares are of less probative value given the evidence that GTS is a bid market, where the number of credible bidders may be a better guide to customers' options and the relative position of suppliers. In this regard, the decision identifies at least seven current telecoms rivals to AT&T available to bid for GTS contracts: T-Systems (Deutsche Telekom), MCI, Cable & Wireless, BT Infonet, Equant (France Telecom), Global Crossing and Colt (para 13).
18. That list of competitors may not be exhaustive. Indeed, in that case, BT and Infonet argued that GTS provision is 'highly competitive' and that competition has significantly increased due, *inter alia*, to the entry of so-called virtual operators and systems integrators and IT companies (e.g., IBM) (para 15). AT&T endorses this view in the present case, and the Forrester 2005 report provides independent support, assigning a combined 37 per cent share to system integrators/IT outsourcers. No customer or other third party suggested a more limited pool of GTS bidders than the above suggests.
19. Complainants' GTS theories of harm rest in part on the proposition that AT&T already has market power in GTS given its '30-40 per cent' share. The above evidence indicates that its share is considerably lower than that, and in any event that GTS provision is dynamically competitive.

### **Horizontal issues**

20. At least one complainant raised horizontal concerns, contending that SBC is either active, or a significant future entrant, in GTS. SBC denies this, and the OFT could not confirm this contention from any other source. The OFT cannot therefore conclude that SBC is active in GTS or a potential entrant. Even if it were a potential entrant, however, the loss of one potential bidder in GTS – when there are more than seven existing bidders other than AT&T – would not appear to raise significant competition concerns.

### **Vertical issues**

#### Overview

21. SBC is the incumbent local exchange carrier (ILEC) in the 13 U.S. states in which it owns the Regional Bell Operating Company (RBOC; or so-called 'Baby Bell'<sup>4</sup>). As the ILEC, SBC owns substantial local 'last mile' network infrastructure, which it is obliged to provide to other telecoms firms pursuant to 'special access' regulatory provisions. Local access, wherever required globally, is a component in the provision of GTS.
22. Through its acquisition by SBC, AT&T will effectively integrate back into ILEC-scale local infrastructure. Vertical integration characterises numerous other GTS providers, with substantial local network infrastructure due typically to their origins as monopolist

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<sup>4</sup> One of the seven local telephone companies formed upon the break-up of AT&T in 1984: NYNEX, Bell Atlantic, BellSouth, Southwestern Bell, US WEST, Ameritech, and Pacific Telesis. Today's SBC is a merger of several of these interests.

incumbents in their 'home' country: notable European examples are France Telecom, Deutsche Telekom and BT,<sup>5</sup> whose network covers significant GTS locations such as Paris, Frankfurt and London. However, vertical integration to the 'last mile incumbency' level appears not to be a pre-requisite to being a credible GTS bidder. In this respect, the parties cite as examples three players identified by the Commission in *BT/Infonet* – AT&T itself, as well as MCI and Global Crossing, none of which are local access incumbents – as well as Sprint and Vanco.

23. Competitors have previously alleged foreclosure effects in the context of GTS mergers, including recent ones involving BT (*BT/Infonet*) and France Telecom (*FT/Equant*) though, unlike here, those cases were not purely vertical – there were also horizontal overlaps in GTS. The Commission cleared each case despite the expression of such concerns.<sup>6</sup> In this case, two GTS competitors provided confidential complaints to the OFT, followed by a recent complaint from CompTel, a U.S. industry body.<sup>7</sup>
24. Notwithstanding vertical integration of other players, the complainants in this case assert that SBC's 'home market', and thus local access within it, has particular GTS significance. The 13 'SBC states' include major U.S. metropolitan areas – such as Chicago, Cleveland, Dallas, Detroit, Houston, Los Angeles, St. Louis and San Francisco – and are said to feature the headquarters of 220 of the 'Fortune 500' of top global MNCs, and as such will contain many actual or candidate customer sites requiring GTS connections.
25. The foreclosure theory advanced is essentially as follows: SBC will have the ability and incentive to provide preferential local access charges for SBC locations to its newly-acquired GTS business, AT&T, at the expense of GTS rivals. AT&T could thus undercut rivals with a lower total bid price,<sup>8</sup> and rivals could also suffer degraded service quality where this depends on SBC, thus distorting competition for GTS customers. As rivals become less effective, bidding less often or vigorously or indeed exiting GTS, the competitive constraint on AT&T's post-merger pricing and other terms to GTS customers would allegedly be relaxed.
26. As to SBC's ability to favour AT&T at rivals' expense, complainants assert that neither regulation (U.S. special access rules and non-discrimination provisions) nor FCC oversight will prevent such conduct. A complainant also asserts that a threat by rival

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<sup>5</sup> See further, e.g., Case COMP/M.3641 (paras 17-18) and Case COMP/M.2257 – *France Telecom/Equant*, 21 March 2001.

<sup>6</sup> Case COMP/M.3641 (paras 17-18); Case COMP/M.2257 – *France Telecom/Equant*, 21 March 2001 (para 49). See also case COMP/M.3695 - *BT/Radianz*, 22 April 2005 (paras 43-44).

<sup>7</sup> This complaint is available at <[http://www.comptelascent.org/public-policy/international/documents/2005/ukoft-mergercomments\\_july29\\_2005.pdf](http://www.comptelascent.org/public-policy/international/documents/2005/ukoft-mergercomments_july29_2005.pdf)> More detailed concerns analogous to those considered by the OFT have been raised publicly in the FCC review process; for greater detail, see <<http://www.fcc.gov/transaction/sbc-att.html>>

<sup>8</sup> The allegation also notes that this could occur through cross-subsidization: SBC would mask explicit preferential treatment on access charges (by charging AT&T the same rate as others) while AT&T would shift the savings to charge a lower amount on another cost component of the GTS bid, thus still undercutting the rival bid.

vertically-integrated GTS providers to retaliate against such anti-competitive behaviour would be limited by more effective telecoms regulation in other countries. The credibility of the allegations that U.S. regulation is ineffective must seriously be doubted. Moreover, the complainants' foreclosure theory is flawed in other respects.

27. In particular, the theory lacks sufficient evidentiary support in respect of several propositions as to SBC's post-merger ability and incentive to foreclose, as follows.

#### Potential for GTS rivals to circumvent SBC's market power

28. Complainants assert that SBC, as an ILEC, has market power, reflected in its charging of monopoly, or in any event supra-competitive, prices for special access to its relevant ILEC infrastructure. Overall, SBC does account for the majority [around 60-70 per cent] of lines to business customers in its region; in some areas within this region, AT&T also accounts for a material number of private lines. However, GTS customers, being multinationals, will tend to have higher capacity requirements than other, smaller, business customers and SBC's share by metropolitan area tends to fall as the relevant line capacity (bandwidth) increases (e.g., from so-called 'DS1' through 'DS3' to various 'OC' lines).
29. However, ILECs are subject to detailed U.S. regulation supervised by the FCC. Under statute<sup>9</sup> and FCC regulations, SBC is required to provide access under tariff and to interconnect with inter-exchange carriers on non-discriminatory terms. In previous rulings, the FCC has taken the view that the statute 'impos[es] a flat prohibition against discrimination' and 'recognizes that even a facially neutral practice may have an unlawfully discriminatory impact'.<sup>10</sup> In short, the law appears clear and the OFT has no reason to believe that the FCC, which is itself reviewing this transaction, is incapable of resolving any compliance issues such that U.S. regulation might be deemed 'ineffective'.
30. Beyond the constraint of regulation, competitive constraints may also exist, in tandem, on SBC. Evidence available to the OFT suggests that a variety of competitive local exchange carriers (CLECs) have developed access infrastructure that competes to a degree with that of ILECs such as SBC, including in certain major metropolitan areas (e.g., Dallas, Chicago, Los Angeles) where SBC is the ILEC, and which frequently feature GTS locations. Where such constraints exist, GTS rivals may have the option to bypass SBC via existing third party CLEC infrastructure in certain cases, without the need for the GTS supplier (or its third party partner) to build dedicated network infrastructure for that customer (although the parties suggest this could also be a cost-effective alternative to ILEC access in some cases). Complainants cite AT&T as a CLEC with a 'bypass threat' against SBC for GTS local access, but seem to suggest this would not hold true of other

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<sup>9</sup> See Telecommunications Act 1996, Pub. L. No. 104-104, 11 Stat. 56 (1996); Communications Act of 1934, as amended, and in particular 47 U.S.C. §272(e).

<sup>10</sup> See *Implementation of the Non-Accounting Safeguards of Section 271 and 272 of the Communications Act of 1934, as amended*, First Report and Order and Further Notice of Proposed Rulemaking, 14 FCC Rcd 21905, 21914, para 16 (1996); *AT&T Corp. v. BellSouth Telecommunications, Inc.* 19 FCC Rcd 23898 (2004) at 23904-05, para 19.

firms post-merger.

31. SBC's market power vis-à-vis GTS providers seeking special access therefore appears to be kept in check by regulation and certain competitive constraints. Indeed, a Teligen study suggests U.S. access costs are some of the lowest in the world.<sup>11</sup>

#### Significance of SBC-region access costs in bidding for GTS contracts

32. Assuming, however, that regulation were ineffective and that access from SBC itself were essential to bid viably for certain GTS contracts, the next issue is the potential for 'leveraging' of SBC's market power post-merger – namely whether raising costs to rivals for a subset of GTS contracts would enable the merged entity to gain market power in the GTS market as a whole (the OFT does not have reason to believe that AT&T already exercises market power in GTS: see above).
33. Each GTS customer will have a different profile of needs based on its worldwide distribution of sites, including the degree to which access is required in the SBC region at all, and relative to all other areas in which local access is required. Other firms, whether active in GTS or not, are of course the primary local access providers in Europe, the Middle East and Asia, and indeed in the 37 U.S. states outside SBC's territory, including almost the entire Eastern seaboard.<sup>12</sup> Setting aside the bypass threat from CLECs above, a hypothetical UK GTS customer with U.S. locations only in these 37 states would require no SBC access; conversely, one with a large U.S. presence in, say, Texas and California, may well require such access, though again, the significance of this will be relative, depending on the proportion of its total worldwide sites that are in this SBC region.
34. For the foreclosure hypothesis to be plausible, it would be necessary (but not sufficient) for SBC-area local access costs to be a significant proportion of costs of supplying GTS services for a substantial proportion of GTS opportunities: in this way, any unchecked market power of SBC's (but see above) might be leveraged into GTS. As each customer is differently situated, aggregating the proportion of costs into averages is only a proxy measure of the significance of costs of SBC access in GTS bidding. Nonetheless, in this connection, the following is relevant:
  - AT&T supplied information that actual SBC access costs represented a very low percentage (mean and median [less than 10 per cent]) of its total actual revenues from its top 30 GTS customers in 2004;
  - The OFT's best estimate on available evidence from the complainants is that the 'average' cost of SBC access would represent no more than around 10 per cent of the 'average' GTS contract price, based on aggressive assumptions;

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<sup>11</sup> Teligen, *Local Access Circuit Price Benchmarking for Key Asia-Pacific Countries vs. each Other, the European Union & OECD Countries* (2003).

<sup>12</sup> Major U.S. cities likely to contain GTS locations outside SBC's footprint include, for example: Boston, New York, the New Jersey corridor, Philadelphia, Pittsburgh, Washington, Atlanta, Memphis, Miami, Denver, Phoenix and Seattle.

- AT&T estimates that less than 19 per cent of all eligible GTS locations are in SBC's region.
35. In contrast, one complainant argued that 'up to' 40-60 per cent of GTS prices are attributable to the costs for local access for GTS, although this relates to worldwide, rather than SBC region, local access costs. It also provided modelling scenarios of 'typical' GTS contracts under various access cost scenarios. These purport to show that its EBIT<sup>13</sup> margins would fall from positive (at initial bidding) to negative (if AT&T's lower bid price were matched) for GTS bids where certain cost assumptions hold true. The inference it urges that the OFT draw from these models is that it would cease to bid for certain contracts post-merger under these assumptions, because it would not be profitable to match the lower AT&T bid. The assumptions used appear aggressive, and, unlike AT&T's evidence on actual GTS contracts, relate to hypothetical contracts.
36. In the light of all available evidence, it is the OFT's judgment that, at most, a small proportion of GTS contracts would meet the profiles advanced by the complainant, and therefore the GTS business it would arguably forego would similarly be relatively small. Accordingly, such 'exclusion' from a selected number of GTS opportunities would not amount to foreclosure in the relevant sense, as it does not relate to a substantial proportion of the market.
37. Taken together with other evidence, discussed below, this does not support the proposition that the merger might substantially lessen GTS competition in the UK.

#### Foreseeable impact on GTS rivals and UK customers

38. Where a merger is alleged to lead to foreclosure, the OFT seeks to test whether the alleged harm to particular rivals could amount to harm to competition. Competitive harm is understood as harm to customers, and ultimately consumers.<sup>14</sup> As noted earlier, the OFT's statutory remit focuses on the UK; accordingly, the key issue is whether there is a realistic prospect that UK customers of GTS will suffer harm as a result of a lessening of competition caused by this transaction. The OFT considers that this prospect is already unrealistic due to the above factors. However, further considerations reinforce this conclusion:
- *Multi-sourcing customers can and do split business regionally by GTS supplier.* There is substantial evidence that customers are prepared to multi-source GTS provision by using more than one supplier, often to cover different geographic regions (e.g., Americas, Europe, Asia). Indeed, one GTS provider asserted that it had in the past maintained a profitable European GTS business even when not present in the United States. Accordingly, there appears to be scope for continued competition from rivals

<sup>13</sup> Earnings Before Interest and Taxes (EBIT) is calculated by subtracting costs of sales and operating expenses from revenues.

<sup>14</sup> See OFT Substantive Assessment Guidance, May 2003 (OFT Guidance) para 3.7: a merger may be expected to lead to a substantial lessening of competition where the merger would 'weaken rivalry to such an extent that customers would be harmed'.

even assuming they were unable to compete for, say, the U.S. portion of a given GTS contract (e.g., if that contract were heavily weighted towards SBC's footprint, rather than, say, New York, Boston and Seattle and elsewhere in the 37 'non-SBC' states). This suggests that AT&T would gain no durable competitive advantage that would extend to foreclosure of rivals and consequent market power in GTS. For example, rivals undercut by the merged entity initially could re-bid even for the U.S. portion of a GTS contract if SBC were subsequently to raise prices. In any event, given multi-sourcing, UK GTS customers are not necessarily even losing a single bidder from their range of options.

- *Customers and GTS rivals do not appear to support foreclosure concerns.* In this case, no GTS customer, UK or otherwise, expressed competition concerns to the OFT. Given the visibility of this transaction, the public nature of GTS foreclosure complaints in the United States due to the FCC's public process, the public nature of the OFT's merger investigation, and the OFT's own inquiries of UK customers, it is reasonable to believe that any concerned customers have had sufficient opportunity to make their views known to the OFT. As such concern is conspicuous by its absence, it is reasonable to infer that these large, sophisticated multinational corporations do not perceive their interests in competitive GTS prices and terms as being put at risk by this transaction. Similar customer reaction was recorded by the Commission in its *BT/Infonet* and *FT/Equant* investigations.<sup>15</sup>
- In a similar vein, the large majority of GTS rivals did not make foreclosure concerns known to the OFT, which, as the 'front-line' victims of foreclosure, one might expect them to do if they regarded themselves as in danger of losing GTS business. In the absence of any corroboration from other market participants, it seems speculative to propose that rivals, and in turn customers, are vulnerable to foreclosure by the merged firm as a result of SBC's hypothesised favourable treatment of AT&T.
- *SBC's incentives to foreclose are questionable.* For the foreclosure hypothesis to be credible, the strategy must be profitable. One way of testing this is whether the profit gained by additional GTS business at rivals' expense would exceed the profit sacrifice in the form of lost local access revenues, which SBC would otherwise levy on the GTS rival. One complainant variously suggests that (i) SBC's local access margins are high (around 76 per cent); (ii) GTS margins are low; and (iii) local access can account for up to 40-60 per cent of GTS prices. However, even assuming the validity of complainants' figures, the lost local access profit, if indeed lost, would substantially exceed the gained GTS profit. Moreover, AT&T's downstream GTS share (the best independent estimate being 12 per cent; see above) is such that a strategy of foregoing actual, high-margin upstream revenues in the interim period in the attempt to gain durable downstream market power in the long run lacks compelling economic logic. This would apply even if AT&T's share of GTS were as high as '30-40 per cent', in circumstances of a bid market with multiple actual and potential suppliers, and sophisticated customers that can and do multi-source.

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<sup>15</sup> COMP/M.3641, para 16; COMP/M.2257, para 46.

## Coordination between SBC/AT&T and Verizon/MCI in GTS

39. One complainant advances a theory of ‘coordinated foreclosure’ by these two firms after their respective mergers: that by combining two ‘bottleneck monopolists’ in U.S. local access with two GTS bidders, the two firms will tacitly collude to foreclose other GTS suppliers (as above), but in a tandem rather than unilateral manner.
40. There are several difficulties with this theory. As noted, for a variety of reasons canvassed above, the OFT does not believe that SBC has the ability and independent incentive to foreclose GTS rivals on its own. Moreover, neither complainant nor any third party has alleged current, pre-merger coordination between any GTS bidders, let alone adduced evidence. In these circumstances, it is difficult to see how the two mergers would create a mutual ability and incentive to foreclose GTS rivals by the firms in question.
41. Indeed, the OFT is unable to reconcile this theory with the criteria for coordinated effects articulated in OFT guidance and established by the Court of First Instance (CFI) in *Airtours*.<sup>16</sup> In short, complainants assert that the two firms would not undercut each other’s special access prices, but, according to the foreclosure theory, would undercut all other bidders with a lower price. Given the dynamics of GTS provision and the above findings, the logic of such a scheme is not independently apparent to the OFT. Nor has it adequately been explained how such a scheme creates a mutual incentive, how terms of coordination would be agreed and monitored in actual bidding scenarios, and how punishment for deviations would work. Moreover, the customers and GTS rivals do not appear to share foreclosure concerns in this ‘tandem’ variant either, at least as far as the OFT’s investigation is concerned (the points made above at para. 38, second bullet apply).
42. In any event, the evidence does not establish any likelihood that the OFT’s third necessary condition for coordination is met: that the coordinated behaviour be sustainable in the face of other competitive constraints in the market.<sup>17</sup> Any attempt at a scheme of coordinated foreclosure in GTS would face disruption by two sets of market participants: numerous credible bidders on the one hand, and sophisticated multinational customers who can and do routinely multi-source and split their contracts on the other. As the risk for the colluding parties of losing business to credible rivals – rather than sharing in supra-competitive profits – appears substantial, this further undermines a hypothetical incentive to engage in tandem foreclosure at first instance. As such, the coordination theory cannot be supported on the evidence available to the OFT.

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<sup>16</sup> See OFT Guidance, para 4.12; see further, Case T-342/99, *Airtours plc v. Commission* 2002 ECR II-2585 (*Airtours*), para 62 (required conditions for collective dominance findings under the ECMR).

<sup>17</sup> See OFT Guidance, *ibid*, and cf. *Airtours*: ‘the foreseeable reaction’ of other market participants must not ‘jeopardise’ the fruits of coordination (para 62).

## Conclusion

43. For the duty to refer to be enabled, the OFT's belief under s 33 of the Act must be objectively justified by relevant facts. The OFT has carefully scrutinised the complainants' foreclosure theories in this case, but finds critical supporting facts and evidence to be lacking. Even if one were to ignore the views of other third parties and grant the (questionable) propositions that SBC is both able – unlawfully and in defiance of the FCC – to discriminate against GTS rivals with impunity, and has the incentive to do so, one complainant's hypotheticals, taken at face value, show merely that it would no longer be profitable for that one rival to bid for a number of GTS contracts, which, when checked against other evidence, would appear to amount to a small proportion of the total GTS market.
44. Thus, even if this one rival were to withdraw from bidding on a small number of contracts with a heavy SBC-region bias, it is speculative to suggest that it (and by implication others) would withdraw from GTS entirely as multi-sourcing and split bids allows suppliers to compete profitably for substantial portions of non-U.S. GTS business. Finally, the complainants' contentions must be weighed alongside the dearth of evidence at the OFT's disposal that other rivals or customers perceive their commercial interests to be at risk as a result of alleged foreclosure by SBC, alone or in tandem with Verizon/MCI.
45. As to the coordination theory, this view is of course limited to this transaction's impact in the UK, and is based on the facts and evidence available to the OFT at this time. These findings are without prejudice to the outcome of merger review of this or any other transaction in other jurisdictions.
46. Accordingly, complainants' theories of harm relating to GTS cannot sustain a belief on the part of the OFT, objectively justified by relevant facts, that the merger raises a realistic prospect of a substantial lessening of competition in the UK.

## Internet Connectivity

### Market definition

#### *Product market*

47. The parties overlap in the provision of internet connectivity in the United States, where both parties are internet service providers (ISPs).
48. The complainants allege that the parties may overlap in so-called 'Tier 1' internet 'backbone' connectivity, also referred to as 'top-level' universal internet connectivity. The internet is a hierarchical structure comprised of thousands of separate networks: as such, direct interconnections among such networks are impractical; instead, smaller networks are connected to one of the large backbone networks, with high-capacity long-haul transmission facilities, which are connected with each other. Internet backbone providers (IBPs) exchange data between each other either through 'peering' arrangements, which

are settlement-free agreements on exchange of all traffic, or 'transit' arrangements, whereby one IBP pays to route data through another IBP's network (but not *vice versa*).

49. The approach previously adopted by both by the Commission<sup>18</sup> and the DoJ<sup>19</sup> support the definition of a separate market for Tier 1, or top-level universal internet connectivity, which the DoJ defined as comprising those IBPs that 'typically maintain private peering relationships with all other Tier 1 IBPs on a settlement-free basis, as opposed to purchasing Internet connectivity (e.g., transit) from any other IBP'.<sup>20</sup> The Commission, meanwhile, defined top-level universal connectivity as a separate market on the basis that 'second-tier ISPs could not avoid continuing to buy transit from top level networks and second-tier ISPs could not provide a competitive constraint on prices charged by top level networks'.<sup>21</sup>

### *Geographic market*

50. The Commission has previously taken the view that the market for provision of Tier 1 internet connectivity is global in scope, on the basis that there is global demand for connectivity and that 'although the majority of top level network providers centre their operations in the US, they are the only providers that can provide transit to all parts of the internet'.<sup>22</sup>
51. In both prior Commission cases<sup>23</sup>, the relevant merging parties had argued that internet connectivity was becoming more regional in scope, in that the amount of traffic originating in Europe that was sent to the U.S. was decreasing, although at the time, even for larger European networks, flows transferred to the U.S. continued to be at around 50-80 per cent.<sup>24</sup> The parties in this case assert that this trend has continued and that in 2001, 71 per cent traffic originating in Europe stayed in-region; by 2007, one estimate of intra-European traffic is 85 per cent, with only 7 per cent destined for North America.<sup>25</sup>
52. In prior cases, the Commission noted that even with a change in traffic flows – which on the basis of the parties' data appears to have occurred – much of the traffic originating in Europe would continue to be sent to U.S.-based network provider affiliates in Europe, thus perpetuating dependence on (U.S.) top-level connectivity. In this case, a prudent

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<sup>18</sup> Case IV/M.1069 – *MCI/WorldCom*, 8 July 1998; Case COMP/M.1741 – *MCI Worldcom/Sprint*, 28 June 2000.

<sup>19</sup> See e.g., *United States v WorldCom Inc. and Sprint Corporation*, DoJ Complaint available at <<http://www.usdoj.gov/atr/cases/f5000/5051.htm>>.

<sup>20</sup> *Ibid.*

<sup>21</sup> COMP/M.1741, p.12.

<sup>22</sup> *Ibid.*, p.21.

<sup>23</sup> Cases COMP/M.1069 and COMP/M.1741.

<sup>24</sup> *Ibid.*, p.14.

<sup>25</sup> Source: Parties; and Probe Research, *Worldwide Internet Traffic Advisory Insight and Market Strategy report*, January 2003.

approach is to analyse the transaction's impact assuming a global frame of reference. There is no need to reach a definitive conclusion on this issue, however, as the evidence available does not support a realistic prospect of a substantial lessening of competition regardless of whether the relevant Tier 1 internet connectivity market in this case is global or European-wide.

### **Share data**

53. In *MCI WorldCom/Sprint*, the Commission identified AT&T as one of five key Tier 1 providers out of a total of 17 Tier 1 suppliers. The shares of the 5 key Tier 1 providers were estimated as follows: MCI WorldCom (32-36 per cent share); AT&T and Sprint (each 5-15 per cent); and Cable & Wireless and GTE (each 0-10 per cent). SBC's (lack of) Tier 1 status is addressed below.
54. As to evidence of share distribution among IBPs immediately post-merger, the U.S. review process has elicited competing estimates of SBC/AT&T's combined share, as well as that of a combined Verizon/MCI (relevant in particular to the coordinated effects theory, discussed below).
- The parties' data submitted to the OFT indicates a combined share of North American internet traffic of around 18 per cent (AT&T: 12.5 per cent; SBC: 5.8 per cent); the global figure would be lower; Verizon in the U.S. proceedings calculated the Verizon/MCI 2004 combined share as 19 per cent (down from 37 per cent at the time of the U.S. and EC *Worldcom/Sprint* investigations).
  - By use of certain 'extrapolation' techniques, complainants project 2004 figures of 22.8 per cent and 26.5 per cent for the merged SBC/AT&T and Verizon/MCI, respectively; projections for 2005 are 27.5 per cent and 26.5 per cent (two-firm total of 49.3 per cent in 2004; 54.0 per cent in 2005).
55. As discussed below, there is objective evidence in this case to suggest that irrespective of the 'true' share position immediately post-merger, this state will not necessarily persist over time and that the portrait conveyed by such data is unduly static.
56. In light of this consideration, and other reasons discussed below as to why the theories of harm advanced fail to ground the OFT's duty to refer, the OFT does not need to determine with precision which estimates are to be preferred.

### **Theory of loss of SBC as an actual or potential Tier 1 competitor**

57. The complainants assert that, since the decision in *MCI WorldCom/Sprint*, SBC has achieved Tier 1 IBP status, while Cable & Wireless has dropped below Tier 1; as such, the transaction is said to be a '5:4 merger' among key Tier 1 IBPs. However, the parties, and a third party, note that SBC is not even a Tier 1 IBP within the meaning of relevant Commission decisions, as it does not peer with most of the largest U.S. Tier 1 IBPs – AT&T, MCI, Sprint, Qwest or Global Crossing; rather, to obtain full connectivity, it

purchases transit from Sprint, enabling it to reach customers on those networks on which it is not peered. In the view of the OFT, the overall evidence does not support the view that SBC is a Tier 1 IBP under the Commission's past definition.

58. Complainants alternatively argue that SBC is a significant potential Tier 1 competitor, as it has aggressively expanded from Tier 2 status and reduced its dependence on transit (the alternative to peering). One complainant noted that it has been negotiating a peering relationship with SBC and anticipates that, absent the acquisition, SBC would have been in a position to gain peering in the near future. One complainant suggests that, by removing SBC as an independent source of transit, for customers that require it (i.e., those who do not peer), transit prices may rise.
59. In the OFT's view, even if SBC were a potential Tier 1 IBP entrant, customers could secure paid transit services from other providers such as MCI, Sprint, Global Crossing, Qwest, Level 3, Cogent, DT, FT/Equant, NTT/Verio, Savvis, Teleglobe, and Telia. Accordingly, elimination of a potential entrant in these circumstances would not substantially lessen competition, and thus fail to lead to higher transit prices or other forms of competitive harm.

### **Theory of global or targeted de-peering by the merged firm**

60. Complainants further assert that this transaction poses the same risk of harm as that motivating the Commission's and DoJ's intervention in earlier cases such as *WorldCom/MCI* and *MCI WorldCom/Sprint*.<sup>26</sup>
61. Those concerns derive from a theory proposed by Cremer, Rey and Tirole.<sup>27</sup> The theory is based on the premise that the creation of a leading IBP with a substantial size (i.e., internet traffic) margin over its nearest rivals would reverse pre-merger incentives to peer with other IBPs, as follows:
  - When an IBP is non-dominant, peering is beneficial to it as well as its (smaller) rivals: as the Commission has put it, 'a non-dominant network would need its competitors and their customer base too much to risk degrading the quality of its connectivity offering.'<sup>28</sup>
  - Once one firm gains a position of dominance, the theory posits that the merged firm may have the post-merger incentive to de-peer or degrade interconnection with all its rivals (referred to here as **global de-peering**) if it is credible to suppose that de-peering will harm rivals more than it harms the leading IBP and pose the risk of 'tipping' the global IBP market to the merged firm. In this particular case, both the

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<sup>26</sup> Case IV/M.1069, *WorldCom/MCI* – 8 July 1998; Case COMP/M.1746 – *MCI WorldCom/Sprint* – 28 June 2000.

<sup>27</sup> See further, Cremer, Rey and Tirole, 'The degradation of quality and the domination of the Internet', *Journal of Industrial Economics* 48(4), December 2000, 433-472.

<sup>28</sup> Case COMP/M.1746, para 154.

parties and the complainants seem to agree that the credibility of the incentive to globally de-peer depends on establishing, as per the theory, that in fact the merged firm accounts for a majority of traffic, with a share *above* 50 per cent.<sup>29</sup>

62. **Targeted de-peering** involves de-peering of some but not all of the merged firms' rivals and was also at issue in prior cases. Complainants also assert that a similar risk is posed here.
63. Complainants argue that SBC will favour AT&T for SBC's internet traffic derived from its ILEC region: SBC is an ISP provider for over 16.7 million U.S. subscribers and, complainants assert, SBC has a bottleneck monopoly in its RBOC region for special access to business customers requiring high speed connections such as T-1 and T-3 lines, while also rapidly building expanding fibre connections to millions of residential customers. By shifting these growing traffic volumes to AT&T, this is alleged to place AT&T further ahead of its IBP rivals, raising the risk of unilateral dominance through global or targeted de-peering.<sup>30</sup>
64. The parties submit that the necessary factual conditions are not met for either the global or targeted de-peering theories to apply in this case.
65. The OFT does not believe that unilateral de-peering concerns arise in this case. Even if SBC were in a position to route its entire backbone traffic to AT&T – an assumption that the parties dispute – the complainants' 'worst case' shares for SBC/AT&T post-merger (based on projections for 2004 and 2005 of 22.8 per cent and 27.5 per cent, respectively) are obviously well below the critical 50 per cent threshold agreed by both sides of the debate in this case, and in any event not suggestive of dominance in absolute terms, or relative to other providers in this case.
66. As a result, the Commission's finding – that 'a non-dominant network would need its competitors and their customer base too much to risk degrading the quality of its

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<sup>29</sup> In *MCI WorldCom/Sprint*, the Commission calculated the post-merger share as 'between [37-51] per cent based on traffic exchanged and [30-65] per cent based on revenue, with the next competitor 'never higher than 15 percent (COMP/M.1741 at para 123); the DoJ's complaint refers to a '53 per cent combined share of Internet traffic ... at least five times larger than that of the next-largest IBP' (Complaint at para 32).

<sup>30</sup> Complainants assert that incentives to de-peer will be heightened as the merged firm will have a high share of 'eyeballs' – individual internet users – who receive substantially more data (e.g., webpage contents) than they send; accordingly, rivals with greater 'content' business (i.e. hosting of commercial websites, etc) will suffer because the merged firm will be receiving far more traffic from the other IBP than it sends, breaching the relative parity rules that typically govern peering arrangements. As such, the merged firm will have incentives to de-peer because its rivals will suffer the greater harm, in part because the merged firm's 'eyeball' user base is 'stickier' – less likely to switch if some connectivity is lost (i.e., sites cannot be reached) than that of the rivals (i.e., a business customer of rivals will switch if its customers cannot access its website). The parties have provided credible responses covering the 'eyeballs' and 'content' distinction, the lack of merger effect on its peering ratios, et al. For purposes of this decision, the OFT does not intend to articulate this debate in detail given its overall finding at para. 65.

connectivity offering<sup>31</sup> applies to SBC post-merger. Indeed, the most active complainant acknowledges that '[g]iven that neither firm' – SBC/AT&T or Verizon/MCI – 'will be large enough to profitably degrade quality alone, neither of the merged entities could acquire dominance without coordination'. In other words, it concedes that the post-merger SBC is not dominant and could not profitably de-peer unilaterally.

67. As a result, there is no basis for concluding that a realistic prospect of a substantial lessening of competition arises in this respect.

### **Theory of coordinated de-peering between the merged SBC/AT&T and Verizon/MCI**

68. In later submissions, the complainants develop the argument that the parallel merger between MCI and Verizon (the ILEC for much of the U.S. Northeast and elsewhere) would create the same incentives for Verizon to route all of its traffic to MCI, creating a 'dominant duopoly' of two 'super-peers' which would peer with one another but globally de-peer their IBP rivals in tandem. (This coordinated effects 'extension' to the de-peering theories of harm was not raised in previous cases.)
69. In this respect, complainants submit that their projections (two-firm combined shares of 49.3 per cent for 2004; and 54.0 per cent for 2005) show that the putative 'duopoly' share of the two firms is within range of, or indeed exceeds, the 'over 50 per cent' threshold for global de-peering incentives to apply.
70. However, complainants' submissions prepared for the purposes of the OFT's inquiry do not articulate in any detail in line with the OFT's guidance criteria and the CFI judgment in *Airtours* as to how such a coordinated strategy would be feasible given both the theory at issue and present and foreseeable market conditions.
71. As noted, on the underlying theory's own terms, one of the necessary conditions for coordination is that the putative duopoly share of traffic volumes confers a sustainable position of joint dominance, thus preserving incentives to de-peer. It is far from clear on available evidence that the relevant post-merger two-firm combined share exceeds the 50 per cent level needed for theoretical global de-peering incentives to exist (and could be below 40 per cent). Even if the two-firm combined share were above 50 per cent, more critical is the issue of durability of this position given evidence of foreseeable customer reactions, as discussed below.
72. Stability of demand is generally recognised in economic theory as being an important ingredient for successful tacit collusion. This has also been endorsed by the European courts. The following extract from the CFI's *Airtours* decision is instructive:

'The Court observes in limine that, as the Commission recognises, economic theory regards volatility of demand as something which renders the creation of a collective dominant position more difficult ... (at para 139) ... [in the relevant market] the planning

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<sup>31</sup> Case COMP/M.1746, para 154.

process remains difficult, because each operator must anticipate ... how demand will evolve - demand being distinguished by its considerable volatility and thus entailing a degree of speculation (at para 142) ... it is not possible [for the alleged colluding post-merger firms] to make a precise forecast as to how the main ... [demand] variables ... will develop (at para 144) ... [such a firm] will ... find it difficult to interpret with any accuracy ... decisions taken by the other [firms] (at para 146) ... It follows from the foregoing that the Commission has failed to establish that economic theory is inapplicable in the present case' (para 147).

73. In this case, the parties submit that it is unsafe to regard post-merger demand as stable, because the vast bulk of U.S. broadband ISP services and in turn internet traffic volumes are in the hands of major cable companies (Comcast, Time Warner) and other RBOCs (Bell South, Qwest), and that these sophisticated customers are both able to divert their volumes to rivals of the merged firm(s) and would have no interest in facing the higher prices and less favourable terms that a dominant firm or dominant duopoly at the IBP level would impose upon them.
74. The parties' argument as to substantial demand instability – specifically, the ability and incentive of customers to disrupt coordinated behaviour – has been verified by third party inquiries.
75. Given such evidence, the 'duopolists' therefore face analogous difficulties to those identified by the CFI, including (i) anticipating how demand will evolve, i.e., how important customers will react, and where they will shift their business and the market share that goes with it; (ii) making precise forecasts as to their own and each other's share (which must persistently remain above 50 per cent combined for de-peering incentives to apply, per the theory); and (iii) in interpreting each other's decisions (e.g., which parties the other did or did not de-peer and why).
76. In addition, other than the two confidential complainants and CompTel, no customer or other IBP or ISP approached the OFT to voice corroborative concerns about coordinated global domination of Internet connectivity.
77. The OFT has also identified a number of potentially serious flaws with the contentions that the 'duopolists' have the incentives to enter into, maintain and enforce co-ordinated global de-peering. However, it is unnecessary to canvass these points at present, because:
  - Third party inquiries support the proposition that customers have the ability *and* incentive to switch their business in response to a coordinated effort to dominate global Internet connectivity; and
  - As such, it is reasonable to conclude that any attempt at coordination would be frustrated, even assuming sufficient incentives to try at first instance.
78. In terms of the OFT's guidance, therefore, the theory lacks a firm basis, as the third necessary condition for coordinated effects does not appear to be met: that the

coordinated behaviour be sustainable in the face of other competitive constraints in the market,<sup>32</sup> in this case, through the reaction of customers and rivals.<sup>33</sup>

79. Accordingly, on the evidence available to it, the OFT does not consider there to be a realistic prospect of coordinated de-peering such that a substantial lessening of competition would result in the UK.
80. Again, this view is of course limited to this transaction's impact in the UK, and is without prejudice to the outcome of merger review of this or any other transaction in other jurisdictions.

## ASSESSMENT

81. This merger has a relatively weak nexus with the United Kingdom because there are no UK-specific issues; the relevant markets appear to be global in scope. The OFT received no concerns from UK customers. Indeed, only three other parties submitted concerns, two competitors and one industry body. Moreover, this U.S.-centric transaction is subject to very detailed review by both the DoJ and FCC, and has been cleared by the four other European jurisdictions in which it was notified. The OFT has nevertheless carefully considered those theories of harm advanced that, were they sustainable, would imply a competitive impact in the UK.
82. As to foreclosure in GTS, the theory of competitive harm is speculative because the OFT could not elicit sufficient supporting facts and evidence from the complainants or other market participants. Weaknesses in the theory include the following. First, it assumes U.S. regulation is fundamentally ineffective; second, it ignores prospects of competitive bypass; third, the best data available suggest that SBC-access accounts for a small proportion of GTS costs, and that AT&T has no market power in GTS; fourth, other market participants do not corroborate such concerns; fifth, in these circumstances SBC's incentive to foreclose is doubtful. Finally, the coordination theory fails to establish necessary criteria for sustainable tacit collusion.
83. As to global domination of Internet connectivity deriving from de-peering strategies by the merged SBC: on any estimate, SBC's *unilateral* position post-merger is insufficient to engage the relevant theory on its own terms. As to the novel theory that SBC/AT&T and Verizon/MCI would de-peer *in tandem* to share in the fruits of joint dominance of global Internet connectivity: third party inquiries permit the OFT to confirm that large,

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<sup>32</sup> OFT Substantive Assessment Guidance, para. 4.12. The other OFT criteria relate to incentives to coordinate at first instance, and incentives to maintain coordination through monitoring and, potentially, punishment; see *ibid*.

<sup>33</sup> In the terminology of *Airtours*, the fruits of coordination would be 'jeopardised' by 'the foreseeable reaction' of other market participants (para 62).

sophisticated customers have the ability and incentive to switch their business to credible IBP rivals precisely to avoid the harm that such an outcome would visit upon them. As such, the OFT concludes that coordination in this respect, even if embarked upon, would be frustrated.

84. Accordingly, based on the weight of all available evidence to it, the OFT concludes that the theories of harm lack merit in this case, for a variety of reasons set out in more detail above. The OFT does not therefore believe there to be a realistic prospect of harm to competition, and hence to UK customers, that is objectively justified by relevant facts.
85. 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**

86. The merger will therefore **not be referred** to the Competition Commission under section 33(1) of the Act.