September 2008

RBB Brief 28

RBB | Economics

Sending the Right Signal

In September 2008 the Competition Commission (CC) accepted price control undertakings following the merger of Arqiva and National Grid Wireless (NGW), which had been cleared subject to undertakings by the CC in March 2008.[1]

The merger was cleared even though it was a merger to monopoly in the supply to broadcasters of managed transmission services (MTS). Whilst such findings would normally result in prohibition or a structural remedy, the CC accepted a package of behavioural remedies addressing the effects of the substantial lessening of competition (SLC) rather than the SLC per se. This was motivated by the efficiencies that were made possible by the merger and the recognition that a structural remedy would largely deny their attainment.

This Brief explores three interesting aspects of the decision. First, it evaluates the finding that customers with pre-existing long term contracts can nevertheless be harmed by a loss of rivalry. Second, it considers whether a merger to monopoly should ever be justified by efficiencies. Finally, it asks whether behavioural remedies that go beyond simply compensating customers for the SLC arising from the merger can sensibly be calibrated.

Site Access and Managed Transmission Services

Both NGW and Arqiva owned networks of masts for radio and television broadcasting transmission, including all of the largest masts.[2] Access to these large masts is essential for the broadcasting of television and for the broadcasting of non-local radio services.[3] However, broadcasters do not obtain site access directly, but generally appoint a provider of MTS, part of whose role is to secure access to all of the relevant sites. Prior to the merger this was almost always Arqiva or NGW.[4]

In most cases, some of the required sites would be owned by the appointed MTS provider (e.g. Arqiva) and some would be owned by the other party (e.g. NGW). The MTS provider would negotiate access to those masts it did not own within a regulatory framework set by Ofcom. As well as securing site access, the MTS provider would normally finance, source, install, maintain and repair the transmission equipment used at each of the sites.

In addition to their normal site access and MTS activities, the parties had also recently embarked upon a major re-engineering of all of their sites throughout the UK, in preparation for the phasing in of high-powered digital terrestrial TV in place of analogue TV, referred to as digital switch over (DSO) and due to be completed by 2012.

Merger to Monopoly

Since the scope to vary the mix of sites used for a particular customer is limited, there was virtually no pre-merger competition in the provision of site access. In effect, each mast was already a monopoly, with terms of access regulated by Ofcom. As such, the merger had no material impact on the market for site access.[5]

However, the CC found that Arqiva and NGW competed in the supply of MTS services to both television and radio broadcasters and were the only credible suppliers of those services (other than for small radio stations). The merger therefore represented a merger to monopoly in the supply of these services.

1
Completed acquisition by Macquarie UK Broadcast Ventures Ltd of National Grid Wireless Group: Notice of acceptance of final undertakings pursuant to section 82 of and Schedule 10 to the Enterprise Act 2002, Competition Commission, 1 September 2008.

2
Arqiva owned those masts that had previously been owned by the Independent Television Authority and NGW owned those masts previously owned by the BBC.

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Radio stations covering relatively small geographic areas can often use shorter masts, including those located on tall buildings.

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Some smaller radio stations used MTS providers other than Arqiva and NGW, but those MTS suppliers were generally viewed as too limited in their technical and geographic scope to be effective providers of MTS for television broadcasters and larger radio customers.

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It was suggested that the loss of one mast owner could make it harder for Ofcom to regulate mast access due to a loss of the ability to compare the performance of Arqiva and NGW. However, whilst recognising this possibility, the CC found that there were sufficient alternative sources of information to enable site access to be effectively regulated.

There were likely to be a small number of new radio MTS contracts arising in the next few years over which Arqiva and NGW might have been expected to compete and a larger number of expiring radio MTS contracts coming up for renewal. However, as a result of DSO there would be no new analogue TV MTS contracts for which the parties would have competed. Moreover, it was recognised that the MTS contracts for digital TV broadcast customers had already been competitively tendered and awarded for a period of about 25 years, with the earliest contracts expiring in 2031.

Harm under Existing Contracts

However, in addition to finding that loss of rivalry between the parties would lead to an SLC for new and renewing contracts, the CC found that harm may arise even under existing contracts. In other words, even though prices and service levels had been negotiated under competitive conditions and were specified in long term contracts, the CC argued that those customers nevertheless benefited from the existence of a rival to their current MTS supplier.

The parties argued that a rival provided no additional incentive to outperform their contractual obligations, and that contractual penalties would ensure that they had an incentive not to underperform. With price and performance contractually specified, customers could not be harmed by a merger. The CC disagreed on the grounds that a rival created pressure to keep costs down and improve service quality; that it gave credibility to the threat to terminate a contract; that it gave an incumbent an incentive to outperform contractual obligations so as to win future business; and that it gave an opportunity for customers to benchmark the performance of an incumbent.

However, these arguments are at the very least contentious. The threat to terminate a contract cannot be made credible by the existence of a rival if there are other fundamental impediments to termination. In this case, as the CC acknowledged, large relationship-specific investments and huge penalties for termination made termination extremely unlikely, with or without a rival. Indeed, the severe nature of the contractual conditions imposed can be interpreted as a direct result of the inability to switch during the life of a contract.

Furthermore, the incentive a rival gives an incumbent to outperform its contractual obligations so as to win future business and the ability it gives customers to benchmark the performance of its current supplier are only of relevance if the customer concerned has the option to switch to that rival at some point in the foreseeable future. If the expiry of an existing contract is 20 years away, the incentive on the incumbent supplier to over-perform in anticipation of renewal is negligible.

Moreover, the view of the CC that a rival materially benefited customers with existing contracts was not widely shared. For example, in its response to the provisional findings, Ofcom stated that it was "not aware of any occasion in which the existence of a potential alternative supplier in the current industry structure has led to an improved outcome in relation to service levels and innovation in the provision of MTS/NA under existing contracts with television or radio broadcasters."[6]

Given the paucity of new contracts and renewals, one can see why the CC wished to add weight to its SLC finding by arguing that customers under contract would suffer. However, the CC has set the bar dangerously low. In effect it is saying that regardless of the contractual protections enjoyed by a customer it will view that customer as reliant on the maintenance of effective competition. In markets where suppliers and their customers routinely commit to large relationship-specific investments in the context of very long term contracts, such an approach risks overstating the benefits of maintained rivalry, so distorting the trade-off that must be made between reduced competition and the attainment of efficiencies.

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Paragraph 15 of "Acquisition by Macquarie UK Broadcast Ventures of the National Grid Wireless Group. Response to notice of possible remedies dated 30 November 2007, non-confidential version." Ofcom, 20 December 2007.

A Credible Efficiencies Defence

The CC was nevertheless persuaded that the merger had the potential to generate efficiencies substantial enough to outweigh the, arguably exaggerated, loss of competition that it had identified. A large part of those efficiencies were of the type traditionally claimed for horizontal mergers, such as headcount reductions made possible by rationalisation of duplicated functions. However, significant weight was also given to the benefits of minimising the risks to DSO.

DSO requires detailed coordination between the parties. It is a priority project for the Government and the broadcasters, and delay would impose substantial costs from the continued use by analogue TV of valuable spectrum and the inability of consumers to enjoy the full benefit of investments in digital technology.[7] Moreover, the differences in the costs and benefits accruing to each of the merging parties from DSO meant that the incentives of the parties would not necessarily have been fully aligned.[8] The merger fully aligned their incentives and avoided the need for complex inter-firm coordination. As such, it was believed that the risk of a delay to DSO would be significantly reduced by the merger.

The CC recognised that the only plausible structural remedy – divestment of one of the overlapping businesses – would prejudice the attainment of most of the benefits of the merger, and in particular the de-risking of DSO. The CC instead opted for behavioural remedies designed to address the adverse effects of the identified SLC. This was done by ensuring pass-on of part of the synergy value generated by the merger to existing customers via price reductions available either immediately or upon renewal.[9]

Martin Cave of Warwick Business School has criticised the CC for what he terms its willingness to sacrifice competition for regulation.[10] However, his critique disregards that in this market there is only minimal future competition to be sacrificed and takes no account of the substantial nature of the benefits brought about by de-risking DSO. Since competition is simply a means to an end, it cannot be right to take the absolutist position that no efficiencies (no matter how large) can ever compensate for a loss of competition (no matter how small), even if experience suggests a strong presumption in favour of the maintenance of competition.

Behavioural Remedy

However, once a pricing remedy has been chosen the issue then becomes how the benefits should be shared between producers and consumers. One principle would be to set prices such that customers as a whole are no worse-off than they would have been absent the merger. A more stringent criterion might set prices such that no individual customer is worse-off. However, the remedies ultimately agreed go well beyond these benchmarks. For example, existing analogue TV customers would have lost nothing from the loss of a rival.[11] Any remedy benefiting such customers therefore places them in a materially better position than would have prevailed absent the merger.

If a behavioural remedy addressing the effects of an SLC is to go beyond that needed to compensate customers for any loss they may suffer how much of the net benefit of a merger should accrue to customers? One answer might be to give customers that share of the efficiencies they would have received had those efficiencies been achieved in the pre-merger competitive environment (i.e. had the efficiencies been achieved but without the SLC).[12]

However, it is far from clear how the cost savings created by the merger would have affected customers had competition been maintained. For example, many of the savings were fixed cost savings. Competition authorities' own guidance indicates a belief that fixed cost reductions will not generally get passed through to customers in the short run, and largely discounts them.[13] The situation becomes even more complex when common cost savings are involved, as these arise across several markets, not all of which were

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DTI and Ofcom have estimated the net present value of DSO at between £1.0 and 2.9 billion, and the cost of delays to DSO in the region of £250 to £300 million per annum.

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For example, Arqiva had won all of the third-party post-DSO TV MTS contracts and so had a stronger incentive to see DSO occur on time than did NGW whose revenue from analogue MTS would be lost on DSO.

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Prices for any new contracts that may arise in the future, for instance in relation to new services using spectrum freed up by DSO, will be based on cost-reflective benchmark terms approved by Ofcom.

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"Does the Competition Commission case enough about Competition", Martin Cave, Utilities Law Review, Volume 16 Issue 4.

11
Analogue TV customers' existing contracts have just a few years to run and would clearly not be terminated, retendered or renewed before their expiry on DSO in 2012. It is clear such customers would have obtained no cost reductions between now and then regardless of the extent of competition in the MTS market.

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As with the harm from the merger, it is doubtful whether customers with existing contracts would have received any of the benefit from merger cost reductions under pre-merger market conditions, other than those to which they were contractually entitled (and would receive in any event).

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"Efficiencies are more likely to be taken into account where they impact on marginal or variable costs, as such cost savings tend to stimulate competition and are likely to be passed more directly on to customers in terms of lower prices (because of their importance in short-run price setting behaviour). Generally, savings in fixed costs will not be given such weight as they often represent private gains to companies and are not so important in short-run price formation." See Mergers – Substantive Assessment Guidelines, OFT, footnote 27.

subject to the SLC found. In this case the merger created savings in parts of the merged business that serve both customers affected by the merger (i.e. broadcasters) and customers unaffected by the merger (e.g. wireless network operators).

Calculating how much (if any at all) of a common cost saving would be passed back to customers under competition and how that portion passed back would be divided between different customer groups is an extremely complex problem. The package of measures finally agreed gives customers more than they could reasonably have expected to have received had equivalent efficiencies been achieved in the absence of the merger. However, given the complexities involved in the setting of pricing remedies it is perhaps inevitable that the process became one of mediated negotiation between the parties and their customers over the split of the merger benefits, rather than the mechanistic application of recognised competition principles.

Conclusions

The three aspects of the Arqiva/NGW merger discussed in this Brief individually raise interesting issues. First, the implicit approach of the CC in this case was to view customers with long term contractual protection as nevertheless reliant on the maintenance of effective competition. In our view, this significantly exaggerates the benefits of continued rivalry in this case and, if applied in future cases, could similarly overstate the extent of the loss of competition from a merger in markets with relationship-specific investments and long term contracts.

Second, the extent of the efficiencies generated by the merger, relative to the extent of future competition, made the adoption of behavioural remedies a sensible option, despite the authorities' justified general preference for structural remedies (i.e. a preference for competition over regulation). While the impact of the merger on de-risking DSO appears to have played a major role in the decision to opt for behavioural undertakings, the unique nature of this process suggests that the CC's decision in this case is unlikely to herald large numbers of successful efficiency defences in other cases.

Third, the price reductions required by the CC go well beyond those required to leave customers no worse-off from the merger. By maintaining that existing customers with long term contracts derive some benefit from the existence of a rival the CC provided some rationale for granting them compensatory price reductions that in reality would have been extremely unlikely to materialise in any other way. Nevertheless, one is left with the impression that the calibration of the behavioural remedies was ultimately decided by negotiation between the parties and their customers over the savings liberated by the merger, albeit a negotiation conducted by proxy.

These issues share a common theme. Mergers that create net economic benefits for society should be permitted. If the CC were to adopt a policy which systematically overstated the loss of competition by undervaluing customers' contractual protections, they would necessarily bias the decision-making process against mergers, so risking the prohibition of potentially welfare enhancing deals. Worse still would be the adoption of an absolutist position that favoured structurally secured competition over behavioural remedies, regardless of the benefits foregone. Ultimately what matters is that transactions that enhance economic welfare are permitted. In this case, the efficiencies were secured, with both shareholders and customers better-off than they would be without the deal. If the ultimate division of the net benefits in this case was the result of a somewhat opaque negotiation, rather than the application of identifiable scientific principles, at least the process allowed the deal to be done.