O2

Tie-up hopes dashed for Europe's telecoms

Three-O2 merger block raises questions about network investment

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MAY 11, 2016 by: **Daniel Thomas**, Telecoms Correspondent

The telecoms sector has become the battle ground for commissioners and businesses in a battle between opposing visions of future industrial policy for the EU.

Brussels' decision to block (http://next.ft.com/content/32018c52-1695-11e6-9d98-00386a18e39d) CK Hutchison's £10.5bn acquisition of O2, the UK mobile operator owned by Telefónica, will spark a debate about how to nurture a globally competitive telecoms sector when investment needs to be made in next generation networks.

Central to the argument is whether the commission can find a balance between protecting its regional businesses and the consumers they serve.

In the case of telecoms, the two strands of policy are in conflict given the importance the antitrust regulator has put on the threat of price rises if businesses are allowed to merge.

This conflict is having a tangible — and costly — effect on a telecoms sector that has suddenly seen the chance to push for widespread consolidation evaporate. Companies will be left scratching around for new ideas to bolster businesses under pressure to deliver next generation infrastructure.

Kester Mann, an analyst at CCS Insight, says the collapse of the deal leaves both Three and O2 in a precarious position.

More broadly, he adds: “It also casts serious doubt over the future structure of a European telecoms sector that had banked on the tie-up paving the way to further consolidation.”

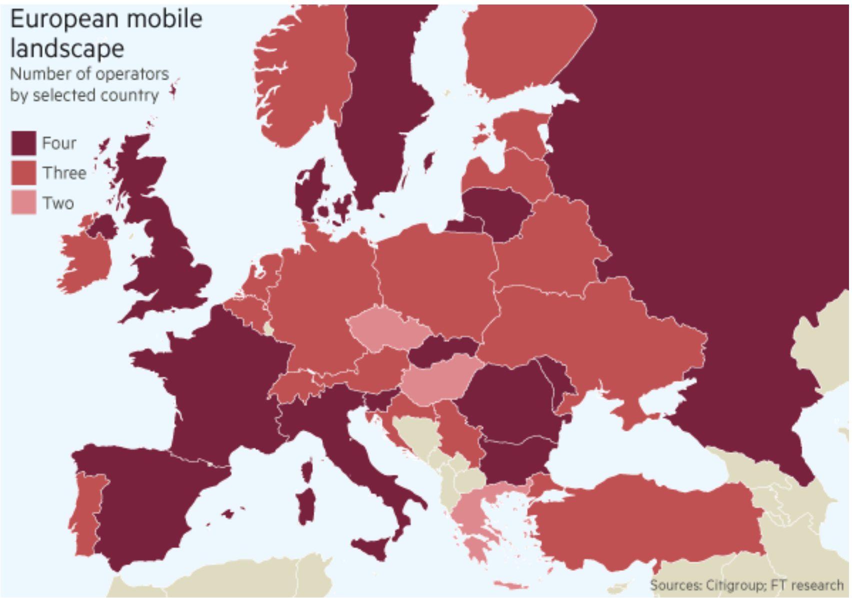
Chris Watson, head of technology, media and communications at law firm CMS, describes it as “a significant statement of change in macroeconomic policy” by Brussels.

The outlook for the telecoms sector had appeared much brighter just a year ago, given a shift to supporting big telecoms businesses felt in the industry.

Chief executives across the sector, including Orange’s Stéphane Richard and Tim Höttges at Deutsche Telekom, spent years telling regulators that Europe needed to help build a strong European telecoms market.

Prices — and revenues — have been falling as the need to invest in infrastructure such as 4G mobile and ultrafast fibre broadband has become critical.

The answer for telecoms executives was simple: merge their businesses within markets to create a company with greater financial firepower.



They pointed to the relative strengths of Asian and US telecoms companies that had been allowed to gain significant market power by building strong positions in their markets.

Brussels appeared to take heed of the calls.

In 2013, the previous commission introduced policies to create a digital single market aimed at encouraging investment across the continent. Commissioners talked loftily about creating pan-European telecoms giants that would champion regional technology innovations such as 5G.

But, more importantly for the telecoms sector, companies were finally given what they had long called for: an open door to consolidation.

Smaller mergers in Austria and Ireland were used to test the waters. Telefónica's 2014 takeover of E-Plus (http://next.ft.com/content/eebbbb7c-01db-11e4-bb71-00144feab7de) in Germany showed that Brussels could overrule national competition concerns to create larger telecoms groups.

Bankers, sensing an opportunity, dusted down their books of potential deals that had been considered impossible.

Deals in France, the UK and Italy were quickly proposed. Similar moves were discussed in Scandinavia.

But the opportunity was all too brief for telecoms executives. The change in the commission last year brought in a new, tougher competition regime.

The first warning shot from the commission was in Denmark, the home of the antitrust chief.

Ms Vestager had made sceptical noises about consolidation before, but her words were perceived by the industry as threats rather than a sign of what was to come. But when she opposed the merger (http://next.ft.com/content/c935224c-5853-11e5-97e9-7f0bf5e7177b) of the Danish units of Telenor and TeliaSonera, a clear marker was being laid.

Yet the industry took a while to see it as such. Denmark was a special case, executives argued, given that the merger would have created an unfairly large and dominant group in a relatively small market.

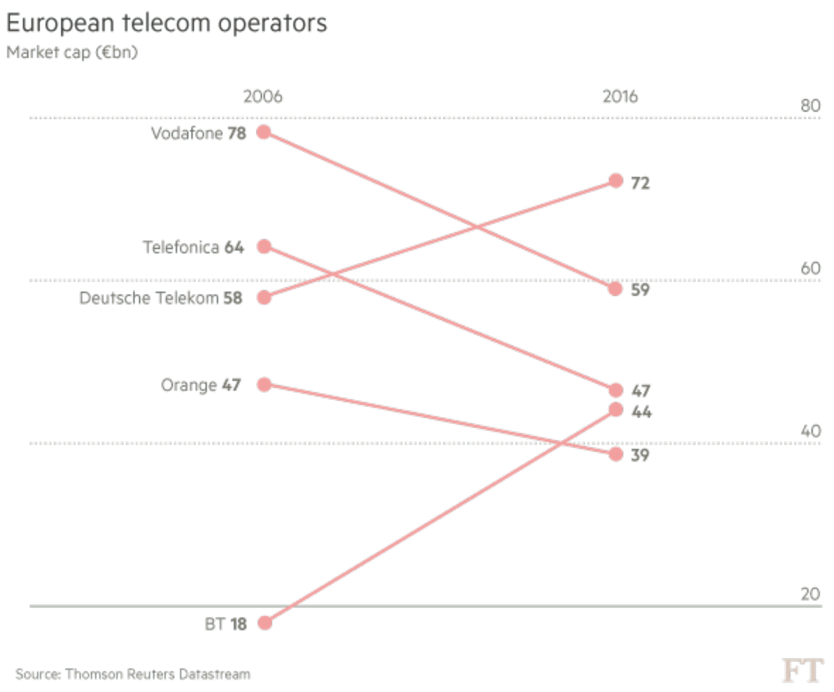
They thought other deals would be fine, and took comfort in Ms Vestager's assertion that each market would be judged on its own merits. Executives at Telefónica and Hutchison were still confident about the prospects of the deal as recently as a month ago.

The decision to block the UK merger of Three and O2 will send a chill wind over other attempts to make similar deals elsewhere. Hutchison will worry about the precedent set for a proposed €20bn deal to merge (http://next.ft.com/content/fec4e488-cd8d-11e5-831d-09f7778e7377) its Italian business with rival Wind. It will now weigh up whether to offer to create a fourth mobile group to meet commission requirements to approve such deals.

Whether or not that is a good result for the regional telecoms market is unclear, with arguments set to continue about the need for further in-market consolidation.

Hutchison continues to strongly believe that the merger would have brought major benefits to the UK by addressing the country's coverage issues, enhancing network capacity, speeds and price competition for consumers.

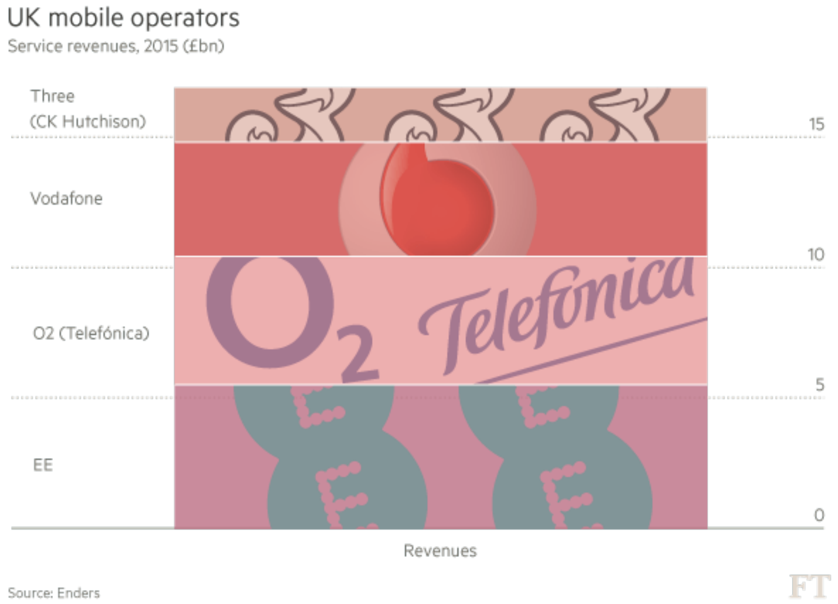
The commission asserts that less competition would lead to higher prices, and reduced choice and quality for consumers, as well as impairing the future development of the mobile network infrastructure and cut the number of mobile network operators willing to host virtual operators.



Nonetheless more deals are expected. Brussels will continue to champion cross-border deals — for example, should Deutsche Telekom ever make a bid for BT or KPN, the Dutch operator, or French groups Iliad and Vivendi for Telecom Italia — but executives are sceptical about the benefits to their own businesses.

Competition authorities have also flagged that deals between fixed and mobile groups would be allowed — such as with BT and EE — as well as with media groups. Liberty Global, the cable group, has already said that it may look at O2 (http://next.ft.com/content/6d0da158-16c4-11e6-9d98-00386a18e39d) in the UK.

However, given the precedent now set by Brussels, any move to cut the number of mobile groups within a country from four to three will prove difficult for the foreseeable future. The next phase of the UK market will be closely watched to see who benefits.



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