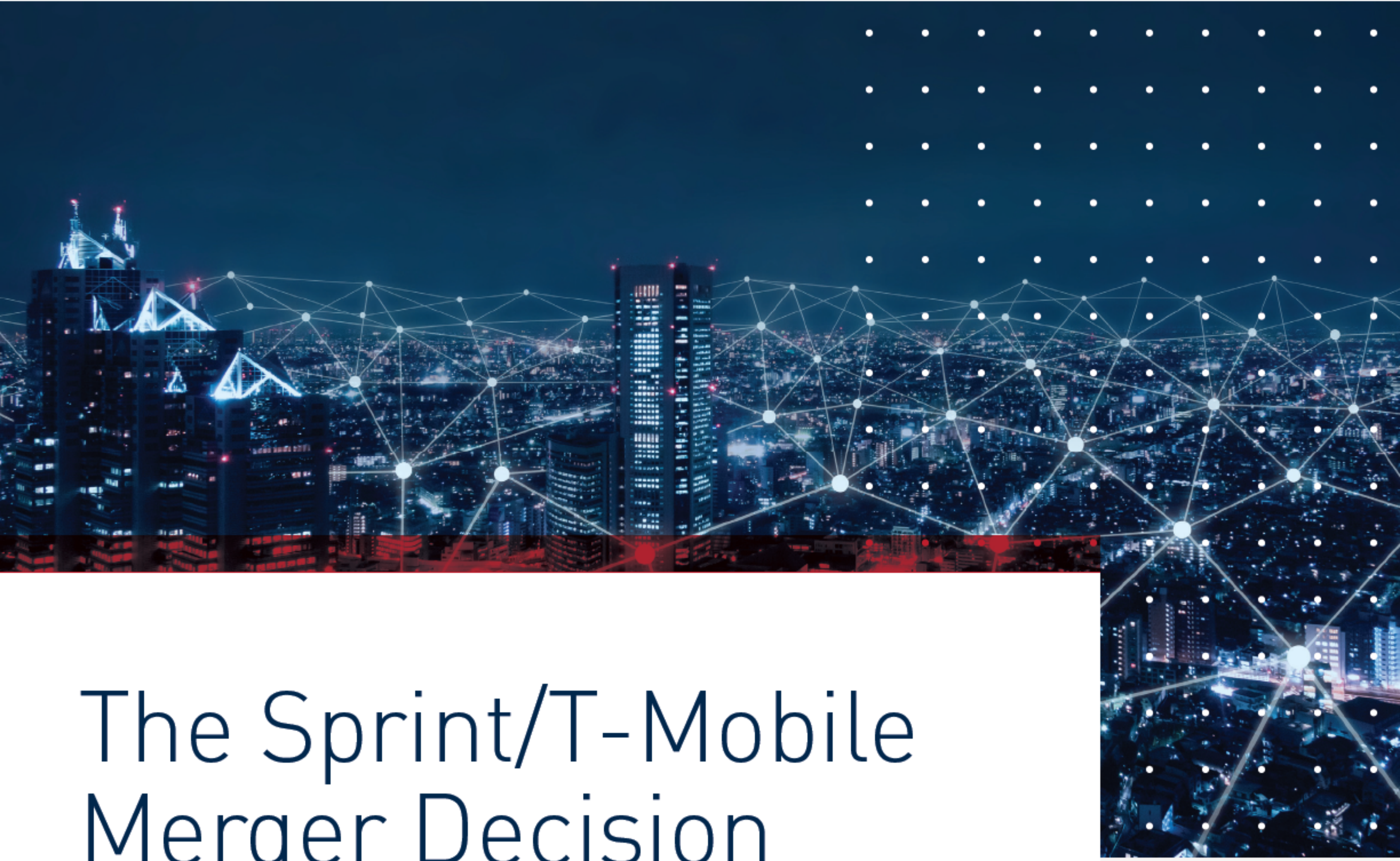

The Sprint/T-Mobile Merger Decision

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INTELLIGENCE THAT WORKS

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This brief highlights some key points in a court ruling earlier this year on the proposed merger between Sprint and T-Mobile, the third- and fourth-largest mobile network operators (MNOs) in the United States.[1] The merger had been approved by federal agencies, with conditions, but was challenged by a group of US states in federal court on the grounds that it was anticompetitive and ultimately bad for consumers.

The case was tried by Federal Judge Victor Marrero of the US District Court, Southern District of New York (the "Court"), who found against the states. The case was not appealed, and the merger has been allowed through.

Background

This merger is the latest in a series of deals over the past few years that has resulted in the consolidation of the US telecommunications market. It is not the first time these two operators have attempted consolidation. They first tried to merge in 2010. The following year, T-Mobile tried to merge with AT&T, the second-largest MNO in America, but this was abandoned after scrutiny from investors and regulators. Sprint and T-Mobile tried again in 2014, ended talks, and resumed them in 2017, only to see them break down again. They restarted in 2018 when new senior management at Sprint decided that a merger was the only viable option for the business.

The essence of the merging parties' rationale for the merger rested on two main claims. First, Sprint was already a distant fourth national competitor and showed no signs of being able to turn around its fortunes; absent the merger, Sprint would continue to fade into competitive irrelevance. Second, the merger would allow rapid deployment of 5G networks across the country.

The Federal Communications Commission (FCC) investigated the merger for a year before the trial, concluding that the merger would help 5G rollout but that conditions were needed to avoid anticompetitive harm. Sprint committed to divesting its prepaid business (operating under the Boost brand), and T-Mobile committed to providing the buyer of this business with attractive wholesale rates.

The US Department of Justice (DoJ) reviewed the proposed merger in parallel and reached similar conclusions. It saw benefit to consumers through more effective use of the parties' combined spectrum holdings, but proposed remedies in addition to those proposed by the FCC. Sprint had to divest its Boost business and all of its 800MHz spectrum holdings to DISH, a satellite TV operator, and the DoJ attached additional conditions to the wholesale arrangements between DISH and New T-Mobile[2] aimed at ensuring DISH's competitiveness in the mobile market. The DoJ also required DISH to agree to network rollout targets and penalties for missing them (a $2 billion fine and divestiture of $12 billion of spectrum).

Despite these conditions, a group of states sued to block the merger over concerns of harm to competition. This led to a federal trial in December 2019 with closing arguments made in January 2020.

1 *State of New York et al. vs. Deutsche Telekom AG et al.*, No. 1:2019cv05434 - Document 409 (S.D.N.Y. 2020) (hereafter, the "Decision"), available at: https://law.justia.com/cases/federal/district-courts/new-york/nysdce/1:2019cv05434/517350/409/

2 "New T-Mobile" is the term used to refer to the combined Sprint/T-Mobile business, post-merger.

Legal Framework

The case is judged primarily in the context of Section 7 of the Clayton Antitrust Act of 1914 which prohibits a merger if its effect "may be substantially to lessen competition in any line of commerce in any section of the country".[3] This requires a finding of "reasonable probability" of the impairment of competition rather than just the possibility that such an event might happen.

The Court's decision describes a three-stage "burden-shifting framework" under which these cases are considered.[4] This starts by establishing a prima facie case that the merger will significantly increase market concentration and thereby lead to a presumption that there will be a substantial lessening of competition in the relevant market. The defendant may then rebut this with evidence that casts doubt on the likely future effect of the merger on competition. Finally, the burden shifts back to the plaintiff to present a sufficiently convincing case that the merger will have an anticompetitive effect.

Presumption of a Significant Lessening of Competition

The product market in question is the retail mobile market,[5] and the parties were broadly in agreement about what was included in it. However, one point of disagreement concerned the way in which Mobile Virtual Network Operators (MVNOs) should be included in the analysis. The Court found that MVNOs could not be included in the market-share analysis in their own right, as they were, in effect, simply reselling the services of the MNOs and were therefore limited in the extent to which they could undercut the MNOs on price or introduce innovative services. They therefore did not provide a competitive constraint on MNOs and could not be considered as separate market players for the purposes of the market-share analysis.

3 Clayton Antitrust Act of 1914, §7.
4 Decision, §II, p. 35.
5 Referred to in the decision as the market for "Retail Mobile Wireless Telecommunications Services" or "RMWTS".

The next question related to the relevant geographical market. The parties agreed that there is a national RMWTS market but did not agree on whether there should also be subnational markets. It was agreed that MNOs set prices, and make key engineering and strategic decisions, on a national basis. However, the Court observed that MNOs also compete on non-price factors such as network quality and marketing which do vary geographically. The Court was of the view that, on the demand side, most consumer choices are made in relation to their local geographical market. For example, it noted that "it seems highly unlikely that a consumer in a locality like New York City could simply turn to anywhere else in the nation, such as California, to obtain wireless services".[6] The Court concluded that both the national RMWTS market and the Cellular Market Areas (CMAs), defined by the FCC for licensing purposes, were the relevant geographical markets.

Under US law, a consolidation is presumed to have an anticompetitive effect if it results in a significant concentration in a market. This can be measured in two different ways:

- A merger is presumptively anticompetitive if the merged firm would have more than a 30 percent market share.
- An HHI[7] increase of over 200 points and results in a "highly concentrated market" with a total HHI of greater than 2,500.

This merger passed both tests. Combined, Sprint and T-Mobile account for approximately 38 percent of the national market for mobile services, measured by subscribers (and approximately 34 percent by revenue). The merger would also cause the HHI to increase by 679 points to nearly 3,200. This underlines the asymmetric structure of the US market, sometimes described as a "2+2" player market rather than a four-player market. Verizon and AT&T are both very large, and T-Mobile and Sprint much smaller, although, pre-merger, T-Mobile had been growing rapidly.

Key Factors in the Court's Decision Not to Block the Merger

Despite the prima facie case that the merger would have an anticompetitive effect, the Court cleared the merger. Several factors were considered in reaching this decision.

THE COURT AGREED THAT THE MERGER WOULD CREATE EFFICIENCIES

The Court noted, "It remains unclear whether and how a Court may consider evidence of a merger's efficiencies",[8] but concluded that the trend has been for lower courts to recognise them, under certain conditions, as a procompetitive counterweight to potential anticompetitive effects. It also noted that that the DoJ and the Federal Trade Commission (FTC) tend not to challenge mergers when they believe that efficiencies will ameliorate potential anticompetitive harm.

The decision focused on the combination of the merging parties' spectrum as the primary source of efficiencies. The merger would allow it to be used by one network instead of being spread across two separate networks, as is currently the case. The merging parties' spectrum holdings also showed significant complementarities. Sprint possessed a large amount of 'capacity spectrum', which T-Mobile needed, while T-Mobile possessed 'coverage spectrum' that Sprint needed. Combining these spectrum holdings would result in gains in technical efficiency which would be complemented by savings on network costs from consolidating the two firms' networks.

The decision also emphasised the role of the excess capacity that would arise from the combination of the two merging parties' networks and spectrum holdings. The marginal cost of providing additional capacity to customers on the merged network would be lower than could be achieved by either MNO operating separately. This lower marginal cost would disincentivise price increases, incentivise price competition post-merger and reduce the likelihood of coordinated effects.

6 Decision, §II.A.2, p. 47.
7 Herfindahl-Hirschman Index.
8 Decision, §II.B.1, p. 57.

The Court also considered whether these claimed efficiencies were merger specific and verifiable.

Merger specificity

The discussion of merger specificity in the decision centres on whether Sprint and T-Mobile could achieve similar efficiencies in other ways; could either MNO realistically replicate the spectrum holdings of New T-Mobile in other ways? The Court also emphasised that when considering alternatives, they need to be, "practical in the business situation faced by the merging firms".[9]

The Court concluded that, although it might in theory be possible to achieve the same spectrum holdings as would arise from the merger through other means (i.e. auctions and private transactions), in practice this is unlikely, because auctions are infrequent, and their timing is unpredictable. Also, Sprint's ability to purchase significant amounts of spectrum was limited by its poor financial position. In view of this, the Court concluded that the efficiencies claimed by the merging parties were merger specific.

Verifiability

There is a strong emphasis on the "realness" of efficiencies claimed by the merging parties in both case law quoted in the decision and the Horizontal Merger Guidelines.[10] Section 10 of the guidelines also states that claims of efficiency that are supported by previous experience will be given more credit than others.

The estimation of efficiencies was done using network engineering models which compared the cost of easing congestion on the network following the merger with the costs of achieving similar outcomes with two stand-alone networks. The Court recognised the limitations of this modelling exercise but decided that it had value as part of an overall analysis. It also accepted the defendants' modelling of the economic benefit of higher speeds that would arise from the merger.

The Court concluded that the claimed efficiencies were verifiable and would lead to increased competition.

THE COURT AGREED THAT SPRINT'S ABILITY TO COMPETE WAS LIKELY TO DECLINE ABSENT THE MERGER

The Court placed considerable weight on the role that Sprint would play in the mobile market absent the merger, stating, "Evidence that a merging party is a 'weakened competitor' that cannot compete effectively in the future may serve to rebut a presumption that the merger would have anticompetitive effects".[11] The Court noted that this view is rare in the case law[12] but concluded that this merger was one of those rare cases. It emphasised Sprint's history of poor performance and inability to compete with the other players in the market.

The Court's analysis of Sprint's performance focused on its poor network quality and consumer perceptions; its financial difficulties; and the limited alternatives available to it to improve its performance, which the Court dismissed as either unlikely or too "speculative". The Court concluded that Sprint "does not have a sustainable long-term competitive strategy and will in fact cease to be a truly national MNO".[13]

9 Decision §II.B.1., quoting the US Merger Guidelines §10.
10 US Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines* (August 19, 2010), §7.1.
11 Decision §II.B. 2, p. 84.
12 Decision §II.B. 2, p. 85.
13 Decision §II.B.2.c, p. 100.

ROLE OF FEDERAL AGENCIES AND THE CONDITIONS ATTACHED TO THEIR APPROVALS OF THE MERGER

The decision noted that the approvals of the merger by the FCC and DoJ do not prevent the merger being litigated in federal courts but did ascribe weight to these processes and outcomes. The merger that the Court reviewed had already been scrutinised closely by specialist regulatory bodies, which had both attached conditions to it; and the Court concluded it should accord the views of these agencies "… some deference". [14]

The conditions that the FCC and DoJ imposed played an important role in the Court's assessment of how competition in the market is likely to evolve, post-merger. The Court focused particularly on the role of DISH as a new entrant, stating that the "DOJ's efforts to establish DISH as a fourth nationwide MNO and replacement for Sprint comprise the most prominent remedies that contribute substantially to rebutting the Plaintiff States' *prima facie* case".[15] It considered several key factors:

- DISH would have a spectrum portfolio worth approximately $22 billion (rivalling Verizon's in size) and including both low- and mid-band spectrum. This would satisfy one key requirement for any businesses wanting to build a national mobile network.

- The conditions would strengthen DISH's competitiveness. The Court noted that the divestiture of Boost would be a strong starting point for DISH because of Boost's success in the prepaid segment of the market, 9.4 million subscribers, brand, staff and retail outlet footprint. New T-Mobile would also have to provide DISH with access to its network for seven years at wholesale rates lower than those provided under a typical MVNO agreement. The Court believed that scepticism around DISH's ongoing reliance on New T-Mobile for wholesale services had been addressed by the DoJ's proposal to, among other things, appoint a monitor and apply a formula to ensure that the wholesale price paid by DISH to New T-Mobile would never increase. DISH also had made a series of proposals regarding its financing and technical capacity to roll out a competing network in a short period of time which the Court took seriously.

- DISH's stated desire to enter the mobile market was supported by evidence of the planning that DISH has already undertaken, hiring of staff and legally binding commitments that it has made to the FCC in relation to its use of spectrum and its network rollout.

- Finally, the Court also considered the likely timeframe over which DISH could become a viable competitor in the market. The Court noted that earlier versions of the Horizontal Merger Guidelines[16] did include a two-year timeframe but emphasised that what constituted a reasonable timeframe would necessarily vary between industries.

14 Decision §II.B.2.c, p. 103.
15 Decision §II.B.3.b, p. 106.
16 DoJ, 1997 Merger Guidelines.

THE COURT DISAGREED WITH THE PLAINTIFFS' ARGUMENTS CONCERNING ANTICOMPETITIVE EFFECTS

The plaintiffs' economic expert, Carl Shapiro, argued that the merger was likely to create *coordinated effects* and *unilateral effects*. Coordinated effects refers to the effects of a merger on the ability of remaining competitors to avoid direct or vigorous competition without either tacit or explicit agreements to do so. Unilateral effects refer to the direct impacts of removing a competitor from the market.

Coordinated effects

The Horizonal Merger Guidelines consider whether the relevant market is vulnerable to coordinated conduct and whether there is a "credible basis on which to conclude that the merger may enhance that vulnerability". Shapiro argued that it would do so, because of many of the characteristics of the US mobile market: a small number of large, roughly symmetric firms; consumer demand that is predictable and inelastic; high barriers to entry; and transparent pricing. In his view, the proposed merger would facilitate coordination around price increases or slower rates of price reductions than would be the case absent the merger.

The Court disagreed with this view. In its assessment, it indicated that the mobile market is complex and that operators compete on characteristics other than price which makes coordination difficult. The Court noted two further factors specific to the merger that would reduce rather than increase the likelihood of coordinated effects. First, the merger would create asymmetries in capacity between New T-Mobile and the other two remaining MNOs. Second was the prospective entry of DISH. The Court also placed considerable emphasis on the fact that, in its view, there had been aggressive competition in the mobile market for years and the merger would not change this.

Unilateral effects

Shapiro argued that the merger would generate upward-pricing pressure in the market because the merging parties were close competitors. The evidence for this was based on an estimation of the "diversion ratio" between T-Mobile and Sprint (i.e. the extent to which, pre-merger, customers of T-Mobile switched to Sprint in response to a T-Mobile price increase, and vice versa). The Court largely discounted this because of challenges to the validity of the underlying data and the difficulty of this type of analysis in what the Court considered to be a complex and fast-moving market. Instead, it preferred to rely on the history of T-Mobile as an aggressive competitor in the market combined with the anticipated decline of Sprint, absent the merger.

SECTOR DYNAMISM AND COMPLEXITY

Finally, the Court discussed at some length its understanding that the mobile industry is dynamic and complex. It noted previous decisions urging caution in markets that are characterised by rapid changes in structure, as well as high rates of innovation and technological development.

Conclusion

In conclusion, the Court noted that there was a clear prima facie case that the merger of Sprint and T-Mobile would have an anticompetitive effect, and that such a case might be sufficient to block the merger in other industries. However, in the Court's view, the specific characteristics of the RMWTS market in the US and the measures taken by the DOJ and FCC to facilitate the entry of DISH as a fourth player mean that it did not believe that the merger would lessen competition substantially. It therefore declined to the block the merger.

Commentary

The decision is long and contains considerable detail. Much of it is specific to the legal process in the US which is not relevant in other jurisdictions. However, a few notable points stand out from the Court's analysis and decision.

- ***Importance of spectrum.*** Spectrum plays a key role in the stated rationale for the merger and in the Court's assessment of its impact on competition. The impact of consolidating spectrum across a wide range of bands in one network was thought to be significantly more efficient than having it distributed (unevenly) across different MNOs. Spectrum also is an important factor in assessing the merger-specificity of the efficiencies (i.e. via the lack of realistic alternative ways of accessing spectrum) and the viability of DISH as a fourth entrant into the market.

- ***Sprint as an increasingly weak competitor.*** The Court considered the role of Sprint in the 5G market, absent the merger. It evaluated Sprint's performance post-merger announcement, compared to its business plan. The Court was convinced that Sprint would not have the capital needed to perform in a 5G world and set its analysis of the merger in this context.

- ***Market dynamism.*** The Court characterised the market as being highly dynamic with continuous innovation in technology, retail strategy, pricing etc. This was partly a function of mobile markets in general but also a feature of the operators in the US market, particularly T-Mobile.

- ***The role of DISH.*** Throughout the decision, the role of DISH in the market, post-merger, is seen as key. Concerns that might arise from a four-to-three merger were allayed, in the Court's view, by the fact that an aggressive new fourth player was expected to enter the market. This was also seen as likely to take place in reality, because critical conditions such as spectrum endowment, financing and a viable network strategy were already in place and would be supplemented by the conditions that DoJ and FCC had attached to the merger prior to the Court's review.

NOTE: BRG staff presented expert testimony in the case in support of the plaintiffs.

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Mark Williams is an economist with twenty years of experience in the economics, regulation and strategy of the telecoms, media and technology (TMT) sector. This has covered a range of specialist areas including regulation, litigation, cost modelling, spectrum, restructuring, financial analysis and business strategy.