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Where Economists Roam: Syniverse/MACH and contestability

On 29 May 2013, following a full Phase 2 investigation, the European Commission (the "Commission") announced its decision to approve the proposed acquisition of MACH by Syniverse, subject to conditions.[1] In this Brief we explore how the economic theory of contestable markets and the threat of self-supply by customers influenced the Commission to be more tolerant of high levels of market concentration, and we draw out some practical implications for the design of remedies in such cases.

The transaction combined the two largest providers in a number of roaming technology markets, most notably data clearing ("DC"), and financial clearing ("FC"). DC houses settle the usage records of subscribers that roam on mobile networks.[2] Mobile network operators ("MNOs") use these services to determine the wholesale payments they make to each other for the roaming of these subscribers, and to determine the retail payments subscribers must ultimately make for their roaming activities. FC services relate to the settlement of wholesale payments between MNOs in respect of roaming activity, which follows the data clearing activity.

The Commission market tested, and ultimately accepted, commitments submitted by Syniverse, which involved the creation of a new DC competitor by divesting certain European customer contracts, employees, hardware, software, and the MACH brand. This was considered sufficient to deal with competition concerns in the EU and world-wide, as further demonstrated by the fact that similar commitments were offered to CADE in Brazil, and were accepted as part of the first Merger Control Agreement signed under the new competition law.[3] Neither regulator required a remedy in FC.

The decision raises a number of important points.

First, in regard to DC, the analytical approach that runs through the substantive assessment, including the consideration of commitments, provides a compelling real world application of the theory of contestable markets, and marks a significant departure from an overly structural approach and a fixation on market shares. Specifically, the case illustrates the factors that are important in concluding whether just two effective rivals might be sufficient to maintain competitive outcomes, thus justifying the approval of a transaction that results in a significant increment in global market share, from a high starting point.

Second, in regard to FC, the transaction additionally involved the assessment of when self-supply by customers might form a significant competitive constraint. Although the Commission has shown limited support for this dynamic in other merger inquiries,[4] it played a key role in justifying the absence of remedies required in FC.

Background

In 2007 the Commission had cleared, unconditionally, Syniverse's acquisition of the BSG Group's wireless business, a transaction which, at the time, reduced the number of competitors active in Europe in the market for GSM DC services from three to two.[5] An important rationale for that transaction had been the combination of DC and FC services, as Syniverse had not previously had any FC capabilities.

1. *Syniverse/MACH,* case M.6570, 29 May 2013. RBB Economics provided economic analysis to support the parties throughout the investigations conducted by the European Commission and CADE. We also worked on the parallel filings before the relevant agencies in Argentina, Colombia, Jersey, Taiwan and the Ukraine.

2. Roaming is the sending and receiving of calls, SMS and data while travelling abroad.

3. Syniverse/MACH, merger approved on 22 May 2013, under new Law 12.529/11, which came into effect in May 2012.

4. For example the Commission decisions in Airtours/First Choice (1999) and TUI/First Choice (2007) in which the Commission was reluctant to accept the existence of a likely constraint from consumers "self packaging" the various elements that make up a package holiday, and the UK Competition Commission decision in Ticketmaster/Live Nation (2009) in which venue owners' ability to organise event ticketing in-house was largely dismissed as a constraint. A related situation is the exclusion of self-supply within vertically integrated firms, see for example the Commission decisions in Schneider/Legrand (2001), and Alcoa/Reynolds (2000).

5. Syniverse/BSG, case M.4662, 4 December 2007, http://ec.europa.eu/comm/competition/mergers/cases/index/m93.html#m_4662

In its 2007 clearance decision, the Commission noted that Syniverse and BSG had not exerted strong competitive pressure on one another, switching by MNOs between BSG and Syniverse had been very rare, and that BSG and Syniverse had faced, and would continue to face, strong competition from the market leader MACH. Moreover, their customers, the MNOs, would retain significant buyer power, *inter alia* through sponsoring new entry, by either non-European DC providers, or billing software providers.[6]

By 2012, when the Syniverse/MACH transaction was announced,[7] the parties collectively retained a *"virtual monopoly"* [8] share of GSM DC services globally.[9] Furthermore, the merger also combined the two largest providers of FC services.[10] A number of smaller outsourced service providers ("OSPs") provided each of DC and FC services, and, importantly, a significant number of MNOs chose not to outsource their FC services to specialist providers, such as the merging parties, but instead performed this service "in-house".[11]

Rules for a contest

The Commission raised initial concerns in respect of each of DC and FC, focussed on the very significant market shares that would result from the merger, both on an EEA basis and worldwide. The parties submitted that these markets were characterised by contestable Bertrand competition, a framework in which the presence of one other potential competitor would be sufficient to maintain competition. When applied to technology services markets such as these, in which tenders come up for renewal every two to three years, this framework might be considered at the level of individual customer tenders, such that one alternative OSP might be sufficient to discipline an incumbent to continue to offer competitive terms.

Several authors have discussed the necessary conditions for contestable competition.[12] Applied to this case, these are as follows:

1. Lumpy contracts and infrequent tenders increase the costs of losing a tender. This gives each OSP strong incentives to bid aggressively for new contracts, and makes coordination unlikely. MNOs create "winner-takes-all" bidding processes for 2-3 year contracts that represent a significant proportion of an OSP's revenue and profit.
2. Homogeneous products and no "lock-in" mean that the offering of one OSP is equivalent to that of any alternative OSPs, so there is no incremental customer benefit from having more than one outside option. Homogeneity arises principally from GSMA[13] standards for roaming services, and MNOs further standardise service levels within each tenders. No lock-in (and further GSMA standards mandating procedures for transitions between OSPs) places incumbents and recent entrants on an equal footing.[14] Easy and frequent switching, and significant price reductions on the renewal of contracts with incumbent OSPs (similar to the price reductions on switching to an alternative OSP), provided evidence of no significant lock-in.
3. Low barriers to entry and expansion mean that smaller competitors and potential entrants can pose competitive constraints that may be disproportionate to their market share (whether measured at the customer level or globally).[15] The recent entry of smaller competitors, such as Nextgen, and the rapid expansion of others, such as Comfone, provided some evidence of low barriers to entry and expansion, although we discuss further below whether these smaller entrants were seen as fully effective competitors.

The cumulative effect of these features would be a contestable market where the presence of one other actual or potential competitor would be sufficient to drive prices down to a competitive level. In such a market, prices would not be expected to vary together with traditional measures of concentration and a merger would not result in a significant impediment to effective competition despite high combined market shares, provided it did not itself pose a threat to that contestability.[16]

6. The Commission further noted the market characteristics which made coordination unlikely, including the dynamic nature of the market and the tendering process, by which large customers typically tender for new contracts infrequently.

7. http://www.syniverse.com/content.cfm?page_id=14&press_release_id=513&press_release_year=2012

8. See Commission Press Release: http://europa.eu/rapid/press-release_IP-13-481_en.htm?locale=en

9. In addition, Syniverse and MACH achieved similar shares in respect of another roaming technology market, Near Real Time Roaming Data Exchange ("NRTRDE"), a technology related to fraud detection in mobile roaming transactions. The analysis of NRTRDE was similar to that of DC, and so is not discussed separately in this Brief.

10. MLex "EC asks whether Syniverse, Mach tie-up will raise prices", 20 Nov 12 | 17:18 GMT. See also http://europa.eu/rapid/press-release_IP-12-1439_en.htm

11. "In-house" provision might include self-supply or outsourcing part of the activity to non-specialist providers.

12. See, for example, Baumol, WJ, Panzar, JC and Willig, R (1982) *Contestable Markets and the Theory of Industry Structure,* New York: Harcourt Brace Jovanovich, and Klemperer, PD (2005), *Bidding Markets,* Occasional Paper No.1, UK Competition Commission. (Also reprinted in Journal of Competition Law and Economics, 2007, and reprinted in Handbook of Competition Policy, P. Buccirossi (ed.) 2008).

13. The GSMA is an association that represents the interests of mobile operators worldwide.

It just takes two – the assessment of DC contestability

In regard to DC services, the Commission investigated this framework, and, affirming the logic of the earlier Syniverse/BSG clearance Decision, largely accepted that two effective competitors were sufficient to maintain competition. However, it retained doubts about the ease of entry and expansion that would be required for perfect contestability, so the merger specific inquiry then focussed on whether or not the small actual or potential competitors would continue to sufficiently constrain Syniverse post-merger.

Following its detailed investigation, the Commission was concerned that the smaller competitors were not credible, particularly for a small set of the largest "Tier 1" customers. The Commission considered that these customers in particular demanded quality and reputation, given that roaming activities were worth vast multiples of the fees actually paid to the parties for supporting services such as DC.

The parties performed a switching study, analysing the sourcing behaviour of substantially all MNOs globally, over a four year period. This showed that switching volumes were significant, and that smaller competitors had disproportionately won a majority of customers that switched providers, particularly in the most recent years.

Apart from the switching data, it was difficult to directly measure the strength of the competitive constraint posed by the smaller competitors due to the ubiquity of the two parties as at least potential competitors for nearly every tender. While the Commission and the parties undertook an extensive bidding study, there were too few examples of competition where only one of the parties had faced the smaller competitors alone, and too few actual switches by large MNOs, to persuade the Commission to clear the DC overlap without remedies.

Acknowledging the fierce competition between the parties, the Commission described the DC market within a differentiated products framework, with the parties as closest competitors, while smaller rivals only represented more distant alternatives, particularly for the largest customers. In support of this framework, the Commission cited customisation required by some MNOs, such as bespoke software interfaces, and service level agreements which specified customer-specific terms and conditions that any provider would need to meet.

The flaw in the Commission's differentiated products characterisation is that the differentiation in this case was between requirements of different customers, not between the offerings of competing providers for the same customer. Differentiated product competition typically involves rivalry between diverse offerings at the point of competition – in competing for a given customer's demand the difference between the products drives the analysis (e.g. a consumer choosing between two different brands of beer). In the case of DC services, any differentiation existed only between individual customer's requirements. Competition took place at the level of each individual customer, so that in a given tender all competitors were mandated to offer homogenous products to that customer.

A more appropriate way to consider this dynamic would be as contestable markets, subject to a qualification or credibility hurdle, such that only credible competitors would be capable of exerting a sufficient competitive constraint to ensure effective competition in the presence of only one actual or potential rival bidder for each tender.

14. While the condition of no lock-in is often stated as a standard condition for contestable markets, within the context of a merger assessment some degree of lock in, or switching costs, such that incumbents could enter into the re-negotiation of tenders with some degree of advantage, may result in a deviation from marginal cost pricing, although this deviation may not change as a result of acquiring a rival.

15. Strictly speaking one might consider those costs of entry or expansion that are non-recoupable on exit, i.e. sunk costs, which are associated with serving a new customer. Potential entrants would not bid as aggressively if they face the potential of being replaced after a short duration and losing those upfront investments. If contracts are sufficiently long, then sunk costs, or customer-specific investments are effectively underwritten by the customer over the course of the contract.

16. Buyer power, while an important framework for the discussion of the competitive assessment, is not considered explicitly in this *Brief*. It can be seen as complementary to the contestable dynamic described here. Sophisticated buyers may create market rules that more or less approximate these necessary conditions, including sponsoring expansion or de-novo entry; the contestable dynamic then involves those buyers playing alternative providers off against one another in order to achieve competitive outcomes.

A solution – targeted remedies in DC

The Commission concluded that a remedy was required to create a second DC competitor that would qualify as an alternative supplier to even the largest MNOs. On the parties' framework, that competitor need not comprise the entire MACH operation, nor even have substantial DC market share, but rather need only pass the relevant hurdle to qualify as a fully effective bidder in tender contests.[17]

The remedy ultimately included MACH's DC customers in the EEA, along with the necessary software, hardware and personnel to allow the purchaser to provide the relevant services.[18] The conditions require a suitable purchaser who would develop the divested activities at EEA and global level. Importantly, however, a second competitor was required only to have the necessary capabilities to compete effectively, it was not necessary for Syniverse to divest a large part of MACH's market share and global assets.[19]

CADE's decision underlines this reasoning. Although no Brazilian contracts were included in the Divestment Business, and the merged entity supplied almost all DC customers in Brazil, the commitments were also seen as effective in remedying similar concerns in respect of Brazilian customers. The divestment business would be credible for customers on a global basis, irrespective of its precise share in each region.

"In-house" supply as a constraint in FC

In regard to FC services, following the phase II investigation the Commission dismissed its initial concerns, despite the merger combining the two largest providers in Europe and globally. This was significantly attributed to the constraint from MNOs' ability to take FC services in-house and effectively self-supply. Although the Commission ultimately left open whether self-supply should be considered within the market or as an external constraint, its reasoning is interesting, given the distinction from previous cases where self-supply constraints have often been dismissed.[20]

In contrast to DC services, large numbers of customers currently choose in-house provision, and there has been significant switching between in-house and outsourced solutions over the past four years. In at least one case in-house FC solutions had been offered to third party MNOs.[21] Finally, FC services were seen as simpler than DC services, so in-house provision was considered a more realistic short-term alternative. This simplicity also enhanced the credibility of smaller competitors, and the constraint from potential entrants.

Conclusion

This case demonstrates how an upfront competitive assessment was able to provide an analytical framework within which to discuss and address the Commission's initial concerns.

In DC, the framework was used to target the necessary solution at the source of those concerns. It focussed on the need to create a second competitor with sufficient capabilities to overcome a credibility threshold, so as to be a fully effective rival in the market, rather than solving a market share concern. This case required significant preparation, not only in the analysis of market dynamics, but in the collation of datasets on specific market features which informed the substantive analysis and allowed the parties to move quickly to work with the Commission to find a solution. This ultimately resulted in commercially focussed remedies that directly targeted the Commission's residual concerns, even where a simplistic market share assessment might have suggested a far more onerous solution.

In FC, the Commission was prepared to wave through a high post-merger concentration on the basis of self-supply constraints that have seldom been found to be compelling in previous cases. This outcome was due to the application of a similar framework, allied to the efforts taken by the parties to demonstrate important and distinguishing industry facts.

17. On the Commission's "product differentiation" framework, a second competitor was required to compete sufficiently closely with the merged entity so as to provide an effective constraint.

18. http://europa.eu/rapid/press-release_IP-13-481_en.htm?locale=en#PR_metaPressRelease_bottom. Final commitments offered on 19 April 2013 (http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=2_M_6690)

19. The Commission's press release leaves open whether the geographic market is EEA-wide or global (http://europa.eu/rapid/press-release_IP-13-481_en.htm?locale=en).

20. In Google/Double Click, the Commission considered the in-house provision of ad serving tools imposed a constraint in two ways. First, publishers could switch to in-house provision in response to a price increase by third-party ad serving tool providers. Second, solutions developed in-house could be sold to other publishers (i.e. customers become competitors).

21. Telenor had taken FC services in-house by using code developed by another MNO, KPN (http://www.linkedin.com/groups/Successful-Financial-Clearing-new-roaming-3978270.S.187214164).