

# update

## **Cartel Office blocks KDG's Level 3 Cable Consolidation - Lessons to Learn for Future Szenarios**

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After KDG's attempt to consolidate all level 3 cable networks in Germany failed to get merger approval from the Federal Cartel Office (FCO), the German cable industry is again back to square one. This came as a surprise to many observers, who thought that after harsh criticism of the Liberty Media decision, regulators would not block another transaction which was announced as a crucial cure for Germany's cable disease. Nevertheless, despite massive lobbying and far-reaching commitments offered by KDG to digitalize networks and roll out broadband internet, the FCO took a very clear position against the merger. KDG did not even get close to obtaining approval and in the end withdrew the application to avoid an adverse landmark precedence.

How could this happen? How could KDG with its three prudent investors APAX, Providence and Goldman have been so misguided to lose significant time and resources in a proceeding it could not win? There are quite a few answers to this question and some of them will hopefully help to avoid similar failures in the future.

### ***The Underlying Facts***

Kabel Deutschland GmbH (KDG) is the major player on Germany's broadband cable market. It operates six of the nine regional level 3 networks and serves about 10 million of the 18 million cable homes in Germany; 1/3 directly and 2/3 indirectly via so-called level 4 networks. Independently owned level 4 networks traditionally control the lines between the street level and multi-family homes. In early 2004, KDG undertook to acquire the remaining level 3 network operators, ish, iesy and Kabel BW. In its statement of objections, the FCO indicated in August 2004 that it would not approve the merger. As a result, KDG withdrew its merger notification in September 2004.



*Broadband Cable Service Areas (Network Level 3)*

### **KDG's Argument: This is not the Liberty Media Case**

In 2002, the FCO blocked Liberty Media's attempt to acquire the six KDG networks on the grounds that it already owned some overlapping level 4 networks. The FCO found that this combination to eliminate potential competition, and viewed Liberty's vertical integration and its proprietary decoder approach critically. KDG now argued that this case was different from the Liberty Media case and presented the FCO with the following considerations:

- KDG and the target companies were no competitors and therefore the concentration would not mean an addition of market shares;
- KDG did not intend to vertically integrate any level 4 networks;
- KDG would establish an open, non-discriminatory digital platform without any proprietary decoder standards or exclusive end customer relationships;
- KDG was not involved in program content and therefore had no incentive to favor certain program providers over others.

### **Why the FCO Nevertheless Blocked the Merger**

However, KDG's strategy failed although there was no real doubt that this case was different from the Liberty case. In fact, combining the six KDG regions with the remaining three level

3 operators was considered to be even more detrimental to competition than the combination of Liberty's few level 4 networks with six level three networks.

### ***Relevant Markets***

Key to the FCO decision was the definition of the relevant markets. On this point, the FCO saw no reason to change the opinion it had clearly formed during the Liberty case.

Like the EU Commission, the FCO looks at the cable sector as a market separate from satellite, digital terrestrial and DSL television transmissions. According to the FCO, none of these other infrastructures is interchangeable with cable: Specific housing laws restrict households in rented homes in switching from cable to satellite, and DVB-T offers fewer programs and is not yet available nationwide in Germany. DSL does not yet offer the same quality, involves higher fees and only accounts for some 4 million users. And even if there were a greater degree of interchangeability between cable and other means of transmission, the single broadcasters would not have any influence on households to replace cable with other means of reception. Therefore, the FCO maintained its established viewpoint that every level 3 cable operator must be considered dominant in terms of the households connected to its network. These households constitute their own geographical market.

### ***Elimination of Potential Competition***

The FCO presented two major arguments why the proposed merger would strengthen KDG's existing dominant position in the cable market by eliminating potential competition.

- Firstly and based on firmly established case law in other network-based industries, the FCO insisted that the integration of two neighboring territorial monopolies always strengthens the dominant position of each of the affected regional monopolists. FCO argued that the proposed merger would eliminate potential competition between KDG and the remaining level three networks. Such competition could develop by ish building an overlapping infrastructure or using alternative infrastructure in order to access level 4 networks in KDG regions ore even the homes connected to KDG.
- Secondly, the FCO argued that the open network rules of the German Telecommunications Act also apply to cable networks. According to these rules, ish could request KDG to carry the ish signals to KDG homes ("Durchleitung"). This could become relevant in the digital world where capacities are no longer scarce. As a result, the KDG homes would be able to chose between subscribing to ish channels or to KDG channels, rather than being forced to rely only on the service of its regional cable operator. Such scenario would offer more choice not only to consumers but also to broadcasters and other content providers who could enter into carriage agreements with the cable operator offering the most favorable conditions. Through the inter-network carriage arrangements, the content/channels could nevertheless reach all German cable homes.

### ***Public Interest Test***

Under German law, a concentration which would strengthen a dominant market position may not be approved unless it provides for some positive competitive effects which would outweigh the negative impacts. In this regard, KDG argued that the proposed merger would

help to facilitate the digitalization of the cable network, including the roll out of cable broadband internet. KDG tried to convince the FCO that only the proposed merger would enable it to facilitate a nationwide digital cable roll-out. KDG further claimed it would become a serious competitor for the current de facto DSL monopolist, Deutsche Telekom. The FCO, however, refused to accept these arguments. It argued that a level 3 network consolidation would not be necessary to upgrade the networks. The FCO pointed to examples of a number of smaller cable network operators (including one of KDG's target companies, Kabel BW) which have made much greater progress in upgrading their networks than KDG, which is already the largest cable operator in the country. Rather than consolidating all level 3 networks, a credible network upgrade strategy would require arrangements to ensure that the level 4 networks would also be upgraded. In this respect, KDG had little to offer due to a tense relationship with level 4 operators who strongly opposed to the merger. As a result, FCO found KDG's whole roll out strategy dependent on reaching cooperation agreements with numerous level 4 operators. Conclusion: the enhancement of competition triggered by network upgrades was too uncertain to be considered in the public interest test.

### ***No Suitable Undertakings***

As a final effort to have its venture approved, KDG offered a number of undertakings to the FCO. In particular, it was willing to guarantee specific investments to upgrade its network infrastructure for broadband internet services. However, German law - as opposed to EU competition law - expressly prohibits the use of behavioral undertakings to justify mergers. The network upgrade undertakings and investment commitments proposed by KDG, though, would have required continuous monitoring by the FCO, which therefore considered these proposals to be inapplicable. Furthermore, the FCO claimed significant reason to doubt that KDG would actually implement such a upgrade strategy should the merger have been approved. In particular, some of KDG's internal financial calculations, indicating that KDG was indeed not as keen to invest into its network infrastructure as originally claimed to the FCO, became public during the proceedings.

### **Lessons to be Learned**

Although some may think differently, the Liberty case and KDG's failure to consolidate all level 3 networks do not mean that German cable mergers will always be blocked. Yet, once again it became clear that regulators will look at cable as a separate market in which the cable operators have natural monopolies in controlling access to their customers. A combination of neighbouring cable networks or existing large operators strengthens the existing monopolies as it eliminates potential competition.

Future approaches to consolidate cable will have to reflect this and consider the following:

- Consolidation of neighbouring level 3 networks or larger level 4 and level 3 networks will only win merger approval if the merger meets the public interest test. Economies of scale achieved through a merger do not matter much since network upgrades require a network by network approach anyway.
- Cable operators will have to establish why a merger will cause an enhancement of competition in the cable market or related markets, such as broadband internet. Investment undertakings alone are insufficient and cannot be considered by the FCO.

Rather, the roll out strategy for digital cable or broadband internet must be plausible and realistic, and with a view to the relationship between level 3 and level 4 network operators. This implies that mergers integrating overlapping level 4 and level 3 networks will have fewer problems to show credibly that such a merger is necessary to upgrade the - integrated - network.

- Overall size matters. As a result of KDG's level three consolidation, one player would have controlled the access to almost all German cable homes, nearly two thirds of all German TV households. Although there is no 30% ownership cap like in the U.S., such dominant player must be a concern to all other players in related markets, especially broadcasters, but also box manufacturers and level 4 network operators. Mergers of other cable operators, even of other level 3 operators, would not result in an entity controlling more than one third of the German TV households. They could argue that a merger could create a counterweight to KDG enabling the merged entity to effectively compete with KDG.

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