

Part II

Background and evidence

3 The companies and the merger situation

Contents

| | <i>Page</i> |
|---|-------------|
| Introduction | 31 |
| Cable & Wireless plc..... | 32 |
| History and activities..... | 32 |
| Profitability and performance..... | 33 |
| Balance sheets | 33 |
| Cable & Wireless Communications plc | 34 |
| History and activities..... | 34 |
| Profitability and performance..... | 35 |
| Balance sheet..... | 36 |
| NTL Incorporated..... | 39 |
| History and activities..... | 39 |
| Residential services | 40 |
| Business telecommunication services | 40 |
| Broadcast transmission, tower and other services | 41 |
| Profitability and performance..... | 42 |
| Balance sheets | 43 |
| Constitution and governance | 44 |
| The merger | 44 |
| Background and structure of the merger | 44 |
| Description of the transaction..... | 45 |
| Benefits and synergies from the merger | 51 |
| Other issues | 53 |
| Interconnection agreements between CWC and NTL | 53 |
| The Heads of Agreement..... | 54 |
| ConsumerCo traffic | 57 |
| NTL traffic (originating on the current NTL network)..... | 58 |
| Discriminatory terms..... | 59 |
| Roll-out of ADSL..... | 59 |

Introduction

3.1. In this chapter we present the financial performance of the companies involved in the merger situation, the merger terms and the reasons for the proposed acquisition by NTL, with support from France Telecom. We then go on to look at the impact of the merger on NTL and the justification for the offer price of some £8 billion. Finally we consider the synergies and benefits to be expected from the merger and other related issues. Appendix 3.1 shows the companies involved in the merger and other companies connected with the cable and telephony industries. Appendix 3.2 shows other companies involved in pay-TV and interactive services in the UK.

Cable & Wireless plc

History and activities

3.2. C&W is a UK company and the ultimate parent of a multinational group of companies (the C&W Group). The C&W Group is one of the world's larger international providers of telecommunications and multimedia communication services. The C&W Group's operating revenue was derived principally from public telecommunications, including international and domestic fixed line and mobile telephone services, data transmission services, and leased circuits. In the year ended 31 March 1999, the turnover of the C&W Group was £7.9 billion.

3.3. The predecessor to C&W was formed in 1929 through the merger of UK companies that had pioneered international submarine cable telegraph and radio communications. Following World War II, it became wholly owned by HM Government. Subsequently, through public offerings commencing in 1981, HM Government sold its entire interest in the company with the exception of a Special Share. This Share gives the Government the power to block any transaction over a certain value. C&W said that the share was more of a value preserver than an instrument to stop takeovers. The company's ordinary shares are listed on the London Stock Exchange and the Frankfurt Stock Exchange, and US depository receipts representing the ordinary shares are listed on the New York Stock Exchange. Its market capitalization at 14 February 2000 was £33 billion.

3.4. The C&W Group's principal operations are located in Hong Kong, the UK, the USA, the Caribbean, Australia and Japan. In the past, in the UK, the Group operated through its subsidiary, Mercury Communications Limited (Mercury), and now principally operates through Mercury's successor, CWC.

3.5. The C&W Group provides international and domestic telecommunication services both under exclusive licences (for example, in certain islands in the Caribbean) and non-exclusive licences (for example, in Europe, the USA, Japan, Australia and Hong Kong).

3.6. The C&W Group's Global Operations division comprises a number of key businesses designed to serve international telecommunication customers:

- (a) Through its subsidiary Cable & Wireless USA, the C&W Group owns and operates one of the world's largest and fastest Internet networks. C&W said that as a principal, or Tier 1, network service provider, Cable & Wireless USA is a leading innovator of integrated Internet solutions. It is an industry leader in developing Internet, voice, data and messaging solutions and offers a suite of integrated communications solutions. C&W told us that it was currently investing US\$670 million to develop a next generation high-capacity Internet network that will fully integrate Internet, data, voice and messaging communications.
- (b) Cable & Wireless Global Network (CWGN) directs the priorities and actions of the C&W Group in the wholesale international telecommunication market. CWGN focuses on four main business activities: international wholesale voice minutes; wholesale Internet provider (IP) backbone and managed IP services; and point-to-point connections. CWGN is also developing a global automatic teller machine (ATM) backbone network comprising gateway ATM switches located in the UK, the USA, Japan, Hong Kong and Australia and connecting national and regional distribution networks. It will also continue to develop its global Internet 'backbone' capability comprising regional hubs, agreements with other providers, and international connectivity. CWGN will continue to leverage and expand the C&W Group's presence in Europe, and aims to obtain licences and national interconnection agreements in all major European countries.
- (c) Cable & Wireless Global Markets services the communication needs of multinational corporations by establishing a dedicated account and service management team with each customer (acting as a 'single point of contact to ensure seamless, global service across all regions'), whilst integrating and directing the local and regional network and international connectivity expertise of other C&W Group companies and partners around the world. It also operates an industry-focused approach, providing expertise to the finance, information technology, logistics, oil and energy and automotive sectors.

- (d) Cable & Wireless Global Card Services provides calling card services to customers located throughout the world. It provides cards to multinational corporations and other business customers, as well as to individuals.

Profitability and performance

3.7. Table 3.1 shows a five-year summary of C&W's consolidated profit and loss accounts to 1999. Group turnover increased by 54 per cent from £5.1 billion in 1995 to £7.9 billion in 1999. During this period, group operating profits ranged between £1.1 billion and £1.6 billion. Earnings before interest, tax, depreciation and amortization (EBITDA) is a measure commonly used by analysts for many businesses as an indicator of the cash generative capabilities of companies. In the case of the C&W Group, EBITDA increased from £1.7 billion in 1995 to £2.7 billion in 1999. Group operating profit as a percentage of turnover increased from 22 per cent in 1995 to 25 per cent in 1997, and since fell to 20 per cent. This compared with EBITDA as a percentage of group turnover which increased from 33 per cent in 1995 to a level around 34 per cent in subsequent years.

TABLE 3.1 C&W: consolidated profit and loss accounts, 1995 to 1999

| | <i>£ billion</i> | | | | |
|--|-----------------------------|--------------|--------------|--------------|-----------------|
| | <i>Years ended 31 March</i> | | | | |
| | 1995 | 1996 | 1997 | 1998 | 1999 |
| Group turnover | 5.1 | 5.5 | 6.0 | 7.0 | 7.9 |
| Exceptional items charged to operating profit | (0.1) | 0.0 | 0.0 | (0.1) | 0.0 |
| Net operating costs | <u>(3.9)</u> | <u>(4.2)</u> | <u>(4.5)</u> | <u>(5.5)</u> | <u>(6.3)</u> |
| Operating profits on ordinary activities | 1.1 | 1.3 | 1.5 | 1.4 | 1.6 |
| Share of operating profits/(losses) in joint ventures and associates | 0.0 | (0.1) | (0.1) | 0.0 | 0.1 |
| Other exceptional items | (0.2) | 0.0 | 0.0 | 0.9* | 0.2 |
| Profit/(loss) on disposal of fixed assets | <u>0.0</u> | <u>0.2</u> | <u>0.1</u> | <u>0.1</u> | <u>0.2</u> |
| Profit before interest | 0.9 | 1.4 | 1.5 | 2.4 | 2.1 |
| Net interest (payable)/receivable | <u>(0.1)</u> | <u>(0.1)</u> | <u>(0.1)</u> | <u>(0.2)</u> | <u>(0.3)</u> |
| Profit on ordinary activities before taxation | 0.8 | 1.3 | 1.4 | 2.2 | 1.8 |
| Taxation charge | <u>(0.2)</u> | <u>(0.3)</u> | <u>(0.3)</u> | <u>(0.2)</u> | <u>(0.4)</u> |
| Profit after taxation | 0.6 | 1.0 | 1.1 | 2.0 | 1.4 |
| Minority interests | (0.3) | (0.4) | (0.4) | (0.7) | (0.5) |
| Dividends | <u>(0.2)</u> | <u>(0.2)</u> | <u>(0.3)</u> | <u>(0.3)</u> | <u>(0.3)</u> |
| Profit for the year retained | 0.1 | 0.4 | 0.4 | 1.0 | 0.6 |
| EBITDA† | 1.7 | 1.9 | 2.2 | 2.4 | 2.7 |
| | | | | | <i>per cent</i> |
| <i>Performance indicator summary</i> | | | | | |
| Group turnover growth | 9 | 8 | 9 | 17 | 13 |
| Operating profit as a percentage of group turnover | 22 | 24 | 25 | 20 | 20 |
| Profit before interest as a percentage of group turnover | 18 | 25 | 25 | 34 | 27 |
| EBITDA as a percentage of group turnover† | 33 | 35 | 37 | 34 | 34 |
| Average employee numbers (full-time equivalent) ('000) | 41 | 40 | 37 | 47 | 51 |
| Change in employee numbers (%) | - | -4 | -6 | +24 | +9 |

Source: C&W.

*Exceptional profits in 1997/98 were due to profits on disposal of telecommunication interests in Hong Kong totalling £1.2 billion, less reorganization costs of £200 million.

†EBITDA was reported in the accounts for 1998 and 1999. For earlier years, the figures were not included in the published accounts.

Balance sheets

3.8. Table 3.2 shows C&W's summary consolidated balance sheets for the five years to 31 March 1999. Tangible fixed assets (in use) increased from £4.4 billion in 1995 to £9.6 billion in 1999. Net

operating assets at March 1999 were around £8.9 billion, and the group had net debt of £4.0 billion. EBITDA as a percentage of average net operating assets was 40 per cent in 1995, increased to around 49 per cent by 1997, and since fell to 34 per cent.

TABLE 3.2 C&W: consolidated balance sheets, 1995 to 1999

| | <i>As at 31 March</i> | | | | | <i>£ billion</i> |
|--|-----------------------|-------|-------|-------|-------|------------------|
| | 1995 | 1996 | 1997 | 1998 | 1999 | |
| Tangible fixed assets (excluding assets not in use) | 4.4 | 4.7 | 4.9 | 7.5 | 9.6 | |
| Stock and debtors less creditors | (0.2) | (0.3) | (0.4) | (0.6) | (0.7) | |
| Net operating assets | 4.2 | 4.4 | 4.5 | 6.9 | 8.9 | |
| Tangible fixed assets not in use | 0.5 | 0.6 | 0.6 | 1.0 | 1.5 | |
| Intangible assets—goodwill* | 0.0 | 0.0 | 0.0 | 0.0 | 1.2 | |
| Investments | 0.1 | 0.3 | 0.2 | 0.2 | 0.5 | |
| Interest in net assets of associates and joint ventures | 0.6 | 1.0 | 0.7 | 0.6 | 0.2 | |
| Borrowings less cash (net debt) | (0.7) | (1.1) | (0.5) | (2.9) | (4.0) | |
| Provisions | (0.2) | (0.5) | (0.2) | (0.3) | (0.3) | |
| Net assets | 4.5 | 4.7 | 5.3 | 5.5 | 8.0 | |
| <i>Represented by</i> | | | | | | |
| Share capital and reserves (equity) | 4.5 | 4.7 | 5.3 | 5.5 | 8.0 | |
| | | | | | | <i>per cent</i> |
| <i>Performance indicator summary</i> | | | | | | |
| Net debt to equity | 16 | 23 | 9 | 53 | 50 | |
| Group operating profit as percentage of average net operating assets | 26 | 30 | 33 | 24 | 20 | |
| EBITDA as percentage of average net operating assets | 40 | 44 | 49 | 42 | 34 | |

Source: C&W.

*This represents goodwill amounts arising on the acquisition of US Internet assets and other Internet-related businesses, and Cable & Wireless Optus Limited which are to be amortized over 10 to 20 years respectively.

Cable & Wireless Communications plc

History and activities

3.9. CWC is an integrated communications business comprising a local loop network infrastructure in 47 cable franchise areas, a national trunk network covering about 10,500 km with direct fibre-optic connections to business customers and an extensive international network. It was formed in 1997 following the combination of Mercury with NYNEX CableComms, Bell Cablemedia and Videotron. A description of the services offered by CWC and its network features is given in Appendix 3.3. CWC said that the mergers were intended to allow the cable companies to derive economies and to give them the scale to be better able to compete with BSKyB and BT, which it described as the two dominant players in the pay-TV and telecommunication markets. It added that the mergers were followed by further consolidation by cable service operators, for example three operators that each passed roughly 1.1 million homes were acquired by NTL, and another which passed 1.3 million homes was acquired by Telewest. It said that it had not made any further acquisitions because this would have diluted its earnings, given that cable operators were loss-making. However, it told us that it had contemplated various acquisitions and arrangements with major cable operators, none of which had proceeded.

3.10. CWC's shares are listed on the London Stock Exchange and its market capitalization at 14 February 2000 was £16 billion. Its market capitalization at 20 December 1999 was around £12 billion. It is a subsidiary of C&W, which owns 52.84 per cent of its capital and voting rights. Bell Atlantic Corporation (Bell Atlantic) holds 18.59 per cent and the remaining 28.57 per cent is held by the public.

3.11. Until recently, CWC operated through four divisions: International & Partner Services, Consumer Markets, Corporate Markets and Business Markets (the latter two have now been combined into a single unit called the Business Team):

- (a) *International & Partner Services.* This division offers other operators and service providers telecommunication traffic carriage services to over 150 direct international routes, underpinned by bilateral agreements with telecommunication operators around the world. Customers include mobile operators, cable operators, other UK operators and Internet service providers (ISPs), and resellers.
- (b) *Consumer Markets.* CWC offers a range of telecommunication and pay-TV services directly via its cable network to homes in its 47 franchise areas. CWC also offers telephone-based services (including Internet access) indirectly via BT. CWC launched digital pay-TV services in the Manchester area in July 1999 and is in the process of extending this service to its other franchise areas, in particular London. Digital interactive services were also launched in the Manchester area in November 1999.
- (c) *The Business Team.* CWC serves approximately 150,000 businesses. These businesses range from small office operations to large companies. Customer needs are organized through five sectors: International Corporate, City & Media, Retail & Retail Finance, Public and Outsource. CWC said that it offers customers integrated business solutions by providing national coverage, a broad product portfolio and commercial flexibility, including applications such as managed network services, data and IP networks, outsourcing services, telebusiness, and ATM network solutions.

3.12. As a result of the merger, the Consumer Markets division of CWC, which C&W described as ConsumerCo, will transfer to NTL. In addition, a small proportion of the business customers which are directly connected to the cable network being sold will have to transfer to NTL (see paragraph 3.66). The International & Partner Services division and The Business Team will remain with CWC, which it described as DataCo. The split between ConsumerCo and DataCo can be represented diagrammatically as follows:

| | | | |
|----------------------|------------------------------|--------------------------|--|
| Before the merger | CWC Consumer Markets | CWC The Business Team | CWC International & Partner Services |
| After the merger | Enlarged NTL (ConsumerCo) | CWC (DataCo) | CWC (DataCo) |

3.13. CWC's head office, employing some 800 personnel, is located close to Watford.

Profitability and performance

3.14. Table 3.3 shows CWC's profit and loss account summary for the three years to 1999, since the combination of Mercury with the three cable companies. Turnover increased from £1.7 billion in 1997 to £2.6 billion in 1999, compared with operating profits which were £0.4 billion in 1997, and £0.3 million for the next two years. Results before tax were roughly breakeven for the three years. EBITDA was £0.7 billion for 1997, fell to £0.5 billion for 1998, and increased to £0.8 billion in 1999.

TABLE 3.3 **CWC: consolidated profit and loss accounts, 1997 to 1999**
£ billion

| | Years ended 31 March | | |
|--|----------------------|-----------------|-------|
| | 1997 | 1998 | 1999 |
| Turnover | 1.7 | 2.3 | 2.6 |
| Net operating costs | (1.3) | (2.0) | (2.3) |
| Operating profits on ordinary activities | 0.4 | 0.3 | 0.3 |
| Costs of fundamental reorganization | 0.0 | (0.2) | 0.0 |
| Profit before interest | 0.4 | 0.1 | 0.3 |
| Net interest payable | 0.0 | (0.1) | (0.2) |
| Profit/(loss) on ordinary activities before taxation | 0.4 | 0.0 | 0.1 |
| Taxation charge | (0.1) | 0.0 | 0.0 |
| Profit after taxation | 0.3 | 0.0 | 0.1 |
| Dividends | (0.4) | 0.0 | 0.0 |
| Profit/(loss) for the year retained | (0.1) | 0.0 | 0.1 |
| EBITDA | 0.7 | 0.5 | 0.8 |
| | | <i>per cent</i> | |
| <i>Performance indicator summary</i> | | | |
| Turnover growth | * | 30 | 16 |
| Operating profit as a percentage of turnover | 21 | 13 | 13 |
| Profit before interest as a percentage of turnover | 21 | 4 | 13 |
| Average employee numbers (full-time equivalent) ('000) | 7.1 | 12.1 | 11.5 |
| Change in employee numbers (%) | * | +71 | -5 |

Source: CWC.

*Not available.

3.15. Table 3.4 analyses CWC's turnover by activity for the two years ended 31 March 1999. The consumer activity showed turnover of £495 million from a total of £2.25 billion (22 per cent) for 1998, compared with £616 million from a total of £2.6 billion (23.5 per cent) for 1999.

TABLE 3.4 **CWC: analysis of turnover, 1998 and 1999**

| | £ million | |
|----------------------------------|----------------------|------------|
| | Years ended 31 March | |
| | 1998 | 1999 |
| <i>Consumer</i> | | |
| Direct telephony | 219 | 292 |
| Indirect telephony | 104 | 102 |
| TV | <u>172</u> | <u>222</u> |
| | 495 | 616 |
| Business Markets | 366 | 405 |
| Corporate Markets | 587 | 638 |
| International & Partner Services | <u>806</u> | <u>962</u> |
| | 2,254 | 2,621 |

Source: CWC.

Balance sheet

3.16. Table 3.5 shows a summary of CWC's balance sheets for the three years to 1999. At 1999, tangible fixed assets were £4.9 billion, being mainly network cable, plant and equipment. Its borrowings grew from a relatively small amount of £35 million in 1997, to £2.8 billion in 1999. The net assets were around £1.7 billion over the three-year period.

TABLE 3.5 CWC: consolidated balance sheets, 1997 to 1999

| <i>£ billion</i> | | | |
|--|--------------|--------------|--------------|
| <i>As at 31 March</i> | | | |
| | <i>1997*</i> | <i>1998</i> | <i>1999</i> |
| Tangible fixed assets | 2.0 | 4.6 | 4.9 |
| Stock and debtors less creditors | <u>(0.3)</u> | <u>(0.5)</u> | <u>(0.4)</u> |
| Net operating assets | 1.7 | 4.1 | 4.5 |
| Borrowings less cash | <u>0.0</u> | <u>(2.5)</u> | <u>(2.8)</u> |
| Net assets | 1.7 | 1.6 | 1.7 |
| <i>per cent</i> | | | |
| EBITDA as percentage of average net operating assets | † | 17 | 18 |

Source: CWC.

*CWC was incorporated on 3 December 1996 and acts as a holding company. The CWC Group was formed on 28 April 1997 from the merger of Bell Cablemedia/Videotron, Mercury and NYNEX CableComms.

†Not available.

3.17. The Chairman's statement on the 1998/99 accounts said that CWC was moving from a business of voice telephony into a business which provides valuable innovative services to its customers, based upon Internet technology with complete integration of voice, data, video and entertainment services. Given the demand for growth in non-voice services it intended to continue investing for long-term growth and to improve standards of customer care and support. In 1999/2000 its capital investment was forecast at £1.1 billion. The Chairman added that digital TV in particular was an investment for future profitable growth. In the short term it would reduce revenue growth in Consumer Markets in 1999/2000 as its customers switched from analogue to digital. In addition to ensure that digital TV was successful, it planned significant extra investment in marketing and customer services, which would cost around £60 million a year. The Chairman said that the success of digital TV would improve prospects for profitable growth in subsequent years.

3.18. Table 3.6 shows ConsumerCo's summary profit and loss accounts for the five years to 1999. Prior to 1997, as noted in paragraph 3.9, ConsumerCo did not exist and therefore the figures shown in the table are CWC's estimates of what ConsumerCo would have reported, had it been an integrated group. Turnover grew from £144 million in 1995 to £688 million in 1999, which compared with operating losses of £113 million in 1995, smaller losses until 1997, and operating profits of roughly £45 million in 1998 and 1999. After interest, the losses were £128 million in 1995, peaked at £157 million in 1997 and 1998, and then fell to £134 million in 1999. CWC said that its EBITDA for 1998/99 was £796 million of which ConsumerCo accounted for £180 million (23 per cent) and DataCo accounted for the balance of £616 million.

TABLE 3.6 CWC: ConsumerCo profit and loss accounts, 1995 to 1999

| <i>£ million</i> | | | | | |
|---|--------------|--------------|--------------|--------------|--------------|
| <i>Years ended 31 March</i> | | | | | |
| | <i>1995</i> | <i>1996</i> | <i>1997</i> | <i>1998</i> | <i>1999</i> |
| Turnover | 144 | 372 | 449 | 550 | 688 |
| Net operating costs | <u>(257)</u> | <u>(470)</u> | <u>(538)</u> | <u>(502)</u> | <u>(643)</u> |
| Operating profit/(loss) on ordinary activities | (113) | (98) | (89) | 48 | 45 |
| Other costs | <u>(2)</u> | <u>(7)</u> | <u>(5)</u> | <u>(84)</u> | <u>-</u> |
| Profit/(loss) before interest | (115) | (105) | (94) | (36) | 45 |
| Net interest payable | <u>(13)</u> | <u>(40)</u> | <u>(63)</u> | <u>(121)</u> | <u>(179)</u> |
| Loss on ordinary activities before taxation | (128) | (145) | (157) | (157) | (134) |
| <i>per cent</i> | | | | | |
| <i>Performance indicator summary</i> | | | | | |
| Turnover growth | * | 158 | 20 | 24 | 25 |
| Operating profit/(loss) as a percentage of turnover | (78) | (26) | (20) | 9 | 7 |
| Profit/(loss) before interest as a percentage of turnover | (80) | (28) | (21) | (7) | 7 |
| Loss before tax changes | * | 13 | 8 | 0 | (15) |

Source: CWC.

*Not available.

3.19. Table 3.7 shows ConsumerCo's balance sheets, summarized from 1995 to 1999. At 31 March 1999, its tangible assets totalled £2.9 billion, and it had incurred borrowings of £2.8 billion. Its overall net asset deficiency was roughly £0.3 million. As the value of the proposed acquisition by NTL was around £8.2 billion (see paragraph 3.54), under acquisition accounting the vast majority of the purchase consideration represented goodwill.

TABLE 3.7 CWC: ConsumerCo balance sheet summary, 1995 to 1999

| | <i>£ million</i> | | | | |
|---------------------------------|-----------------------------|--------------|----------------|----------------|----------------|
| | <i>Years ended 31 March</i> | | | | |
| | 1995 | 1996 | 1997 | 1998 | 1999 |
| Tangible fixed assets | 1,425 | 1,709 | 2,166 | 2,635 | 2,860 |
| Stock and debtor less creditors | <u>63</u> | <u>20</u> | <u>(268)</u> | <u>(339)</u> | <u>(328)</u> |
| Net operating assets | 1,488 | 1,729 | 1,898 | 2,296 | 2,532 |
| Intangible assets | 240 | 226 | 434 | - | 8 |
| Borrowings less cash | <u>(389)</u> | <u>(670)</u> | <u>(1,179)</u> | <u>(2,419)</u> | <u>(2,803)</u> |
| Net assets surplus/(deficit) | 1,339 | 1,285 | 1,153 | (123) | (263) |

Source: CWC.

3.20. Table 3.8 shows DataCo's summary profit and loss accounts for the five years to 1999. Turnover increased from £1.63 billion in 1995 to £1.93 billion in 1999, which compared with operating profits of £132 million in 1995, which increased to £286 million in 1999. Interest was a negligible cost on DataCo's activities, compared with ConsumerCo.

TABLE 3.8 CWC: DataCo profit and loss accounts, 1995 to 1999

| | <i>£ million</i> | | | | |
|--|-----------------------------|----------------|----------------|----------------|-----------------|
| | <i>Years ended 31 March</i> | | | | |
| | 1995 | 1996 | 1997 | 1998 | 1999 |
| Turnover | 1,634 | 1,555 | 1,599 | 1,704 | 1,933 |
| Net operating costs | <u>(1,502)</u> | <u>(1,351)</u> | <u>(1,280)</u> | <u>(1,460)</u> | <u>(1,647)</u> |
| Operating profits on ordinary activities | 132 | 204 | 319 | 244 | 286 |
| Other costs* | <u>(62)</u> | <u>-</u> | <u>9</u> | <u>(117)</u> | <u>(2)</u> |
| Profit before interest | 70 | 204 | 328 | 127 | 284 |
| Net interest receivable/(payable) | <u>3</u> | <u>-</u> | <u>4</u> | <u>-</u> | <u>(10)</u> |
| Profit on ordinary activities before taxation | 73 | 204 | 332 | 127 | 274 |
| | | | | | <i>per cent</i> |
| <i>Performance indicator summary</i> | | | | | |
| Turnover changes | † | (5) | 3 | 7 | 13 |
| Operating profit as a percentage of turnover | 8 | 13 | 20 | 14 | 15 |
| Profit before interest as a percentage of turnover | 4 | 13 | 21 | 7 | 15 |
| Profit before tax changes | † | 179 | 63 | (62) | 116 |

Source: CWC.

*Other costs in 1995 and 1998 were for fundamental reorganizations, and in 1997 and 1999 were the surplus/(loss) on sale of fixed assets and part of business.

†Not available.

3.21. Table 3.9 shows DataCo's balance sheets, summarized from 1995 to 1999. Its tangible assets totalled £2.0 billion over the period, and it had negligible borrowings compared with ConsumerCo. The overall net asset surplus ranged between £1.7 billion and £2.0 billion over the five years.

TABLE 3.9 CWC: DataCo balance sheet summary, 1995 to 1999

| | <i>As at 31 March</i> | | | | | <i>£ million</i> |
|-----------------------------------|-----------------------|-------|-------|-------|-------|------------------|
| | 1995 | 1996 | 1997 | 1998 | 1999 | |
| Tangible fixed assets | 1,974 | 1,998 | 1,966 | 1,983 | 2,016 | |
| Stocks and debtors less creditors | (164) | (223) | (289) | (368) | (46) | |
| Net operating assets | 1,810 | 1,775 | 1,677 | 1,615 | 1,970 | |
| Intangible assets | 1 | 16 | - | - | 7 | |
| Borrowings less cash | (16) | 70 | 35 | 100 | 32 | |
| Net assets | 1,795 | 1,861 | 1,712 | 1,715 | 2,009 | |

Source: CWC.

3.22. We note the estimates of future cash flows that CWC used to value ConsumerCo in its negotiations with NTL in paragraphs 3.60 to 3.63.

NTL Incorporated

History and activities

3.23. NTL is a Delaware company whose immediate predecessor, International CableTel Incorporated (CableTel), was formed in April 1993.

3.24. In the six years since its creation, NTL grew substantially by taking advantage of acquisition opportunities and organically through licence acquisition which has made it one of the three largest cable operators in the UK. It is also a significant broadband telecommunication provider. It delivers a range of communication services to homes, businesses and public sector organizations in the UK and abroad. Its franchise area covers 25 per cent of the UK's households, it employs approximately 11,500 people and has over 1.3 million customers. NTL (as CableTel) was listed on NASDAQ in 1993 and the EASDAQ exchange in Luxembourg in 1997. NTL told us that its market capitalization at 1 February 2000 was approximately \$13 billion (based on the value of its issued shares), and it was one of the top 100 NASDAQ companies by market capitalization.

3.25. NTL gave us information about its major shareholders as at 7 February 2000, both on a fully diluted basis (ie assuming that all holders of presently exercisable options, warrants, convertible bonds and exchangeable preference shares were to exercise their conversion rights) and on the basis of SEC beneficial ownership percentages. These are shown below:

| | % | % |
|-----------------------------|----------------------|---------------------------------|
| | <i>Fully diluted</i> | <i>SEC beneficial ownership</i> |
| France Telecom | 9.6 | 13.2 |
| Janus Capital Corporation | 6.6 | 9.6 |
| AXA Assurances | 6.6 | 9.6 |
| The Goldman Sachs Group Inc | 4.5 | 6.6 |
| Microsoft Corporation | 4.8 | 7.0 |
| Prime 66 Partners | 4.3 | 6.3 |

NTL told us that its directors and officers (15) held an interest of approximately 8.8 per cent, and other employees held a further interest of around 7.5 per cent on a fully diluted basis (9.4 per cent and 7 per cent on a beneficial ownership basis). NTL said that the SEC beneficial ownership figures did not represent a likely scenario, as it is assumed in the calculation that only the relevant shareholder, but none of the other holders of presently exercisable options, warrants, convertible bonds and exchangeable preference shares, exercises its conversion rights.

3.26. It said that a key step in its growth was the acquisition in 1996 of NTL Group Limited, the former IBA transmission business, which provides TV and radio transmission services and was floated by the Government in the 1990s. Following the acquisition, CableTel changed its name to NTL.

3.27. NTL has the following activities:

- (a) residential services including telephone and pay-TV delivered through its cable networks, PC- and TV-based Internet access and interactive services;
- (b) national telecommunication services, including business telecommunications, national and international carrier services, Internet services and satellite communications services; and
- (c) broadcast transmission and tower services including digital and analogue TV and radio broadcast services, wireless network management and tower site rental services.

These services are provided mainly in the UK. However, NTL has begun to expand its international activities, and recently acquired Cablelink, a cable operator in the Republic of Ireland; a cable operator in France ('1G' formerly owned by France Telecom) and since renamed as 'ntl France'; and the national broadcast transmission system in Australia.

3.28. NTL told us that in the telecommunication markets (ie local, long-distance and national fibre network services) it operated in competition with BT, CWC, Telewest, Energis, MCI WorldCom Limited, COLT Telecom Group plc, Torch, Thus, Racal, Global One, and European state-owned incumbent telecommunication companies (such as Deutsche Telecom and Telia). It said that it offers telecommunication solutions to large national organizations and local authorities. In TV broadcasting (comprising digital cable, digital terrestrial and digital satellite services) its main competitors were BSkyB, CWC, Telewest, ONdigital, Crown Castle and European state-owned companies. In Internet provision (comprising broadband access, national backbone, and portal services) its competitors included all the telecommunication groups noted above together with ISPs such as Demon, AOL and Freeserve.

3.29. NTL said that at 31 December 1998 it had invested £3.1 billion in its cable and transmission networks. It had built a state-of-the-art national fibre-optic cable network linking all of its franchise areas and extending to all major submarine cable landing points to handle international telecommunication traffic. NTL also had a network of approximately 1,300 transmitter sites across the UK providing satellite and broadcast links. NTL said that its strategy was to provide end-to-end services capable of carrying any kind of information, communication or entertainment services to any kind of customer in the combination of their choice. The advent of digital technology increased its opportunities to do this by increasing the speed and capacity of its networks.

Residential services

3.30. NTL said that it held 55 cable franchises in the UK which covered approximately 25 per cent of the UK households. It offers its customers in those franchise areas pay-TV, residential and business telephony and Internet access services. NTL emphasized its pioneering role in the concept of a simple pricing formula which offers the consumer, for the cost of a conventional telephone line, a combination of telephony (which includes the rental but not the cost of calls) and either pay-TV, Internet access or a second telephone line for a phone, fax or computer link. It added that its customers were not forced to take (and pay for) a large number of channels which they may not want and would be bundled in a larger package that included the attractive channels. It said that it offered a greater choice of basic packages of between six and ten channels, and a pay-TV customer must purchase a basic package before being eligible to purchase any premium channels such as sports or movies. We discuss in Chapter 4 the comparison of NTL's offerings of basic packages with BSkyB (see Table 4.8).

3.31. NTL said that it pioneered access to the Internet via the TV. The service is available to any customer with a telephone, both inside and outside NTL's franchise areas, and is offered as a package with indirect access telephony. [*Details omitted. See note on page iv.*]

Business telecommunication services

3.32. NTL said that its business communications division offered voice and data services, giving it flexible end-to-end solutions to businesses and public sector organizations such as councils, NHS trusts,

education authorities, police forces, and the Inland Revenue. Apart from offering direct and indirect access to its networks for ordinary voice telephony, it provides high-speed, private networks to connect the different sites within an organization and employees working off-site allowing data, voice, vision and Internet communications. In addition it can provide managed voice and data, Internet and other services including CCTV and call-centre solutions. It added that it managed the UK's largest digital CCTV project in west Cornwall which linked cameras in six towns to a central control room by fibre-optic cable. It was also working with Technology Colleges Trust to connect schools and colleges to the Internet via the National Supergrid for Learning, which was the first national broadband fibre network for schools in England.

3.33. It said that its networks provided the infrastructure for ISPs like Virgin.net and Which?Online and provided call-centre support for their customers. It also provides wholesale Internet services for companies which wish to offer Internet service provision without actually acquiring the necessary networks themselves.

3.34. NTL's carrier services division delivers managed bandwidth services for voice and data nationally and internationally. It provides non-exclusive carriage for Vodafone, Orange, GlobalOne and Energis. For the mobile operators it transmits signals originating with a caller on a fixed phone from the local switch to a point where they are transmitted via radio to the mobile phone of the recipient or vice versa. For the international telecommunication providers, it transmits signals from the landing point of an international undersea cable to the carrier's UK switching centre.

Broadcast transmission, tower and other services

3.35. NTL maintains and operates broadcast transmission services for ITV, Channel 4, S4C and Channel 5 making sure that their programmes reach 22 million homes. It also operates networks for two of the four DTT broadcasters, Digital 3 and 4 Limited and SDN, and provides broadcast services for many commercial radio stations. It is a partner in the new Digital One consortium to provide digital radio. Its transmitter sites also provide transmission for fixed and mobile radio systems including 70 per cent of the emergency services in England and Wales and for mobile phone operators Vodafone and Orange.

3.36. NTL said that its satellite services enabled broadcasters to transmit their channels from their playout or production centres via fibre link to one of NTL's three satellite teleports from where they were transported directly to viewers and to cable franchisees for onward transmission to their viewers. NTL's customers for this service include Turner Broadcasting Systems, Flextech Television Limited, the BBC and QVC The Shopping Channel. NTL also offers a fleet of satellite news-gathering trucks and flyaways which broadcasters and programme makers can hire to cover news or sporting events.

3.37. In May 1998 NTL obtained a one-third interest in SDN, which operates one of six DTT multiplexes serving the UK. It said that the other owners of SDN were United News & Media plc and S4C (the Welsh broadcaster) which originally obtained the tender in January 1997. Four multiplexes were open to tender and the other two were reserved for the BBC and ITV companies. Carlton Communications Plc and Granada Group plc each owns 50 per cent interest in ONdigital, the digital DTT platform which started broadcasting in late 1999 and obtained the other three multiplexes which were tendered.

3.38. NTL told us that SDN and ONdigital have announced their intention to form a 50/50 joint venture to market pay-per-view (PPV) services on DTT, and would fill the remaining capacity on the multiplex to which SDN has rights. NTL has two non-executive seats on SDN's board of directors out of two executive (of which one has been appointed) and six non-executive directors.

3.39. NTL in a joint venture with Telewest created in 1999 its own PPV movie channel, called Front Row, to rival the PPV service of BSkyB. It also has an agreement with Eurosport to support the creation of British Eurosport, a basic tier sports channel which it said puts it into a strong position to take advantage of any changes in the way sports programming is organized in the UK, and to provide a wider choice for consumers. It also purchased a 9.9 per cent interest in Newcastle United Football Club to extend its sport interests.

3.40. NTL also told us that it had entered into an agreement whereby it would act as agent for Aston Villa Football Club (Aston Villa) in relation to certain rights and will make a loan to Aston Villa repayable by shares in the club. NTL said that it would also become Aston Villa's principal sponsor.

3.41. NTL's current UK head office is located at Hook, Hampshire, and, it said, around 1,500 personnel worked at this location. It has a UK management which makes day-to-day operational decisions. Its ultimate head office where its policy is formulated is in New York, USA, where its corporate administration department is located. In paragraph 3.48 we discuss the rules relating to approval of shareholder resolutions by NTL.

Profitability and performance

3.42. Table 3.10 shows NTL's summary profit and loss accounts for the five years to 31 December 1998. Turnover increased from \$14 million in 1994 to \$747 million in 1998, and compared with operating losses of \$40 million in 1994 which increased to \$229 million in 1998. However, for 1998 NTL reported EBITDA as \$75 million, compared with \$21 million in 1997. In 1998 its interest expense was \$283 million. It has not yet paid a dividend.

TABLE 3.10 NTL: profit and loss accounts summary, 1994 to 1998

| | <i>\$ million</i> | | | | |
|---|--------------------------------|------------|--------------|--------------|-----------------|
| | <i>Years ended 31 December</i> | | | | |
| | 1994 | 1995 | 1996 | 1997 | 1998 |
| Turnover | 14 | 34 | 228 | 492 | 747 |
| Net operating costs | (54) | (127) | (386) | (684) | (976) |
| Operating loss on ordinary activities | (40) | (93) | (158) | (192) | (229) |
| Exceptional items | - | - | - | (5) | (30) |
| Gains/(losses) | <u>2</u> | <u>0</u> | <u>3</u> | <u>22</u> | <u>4</u> |
| Loss before interest | (38) | (93) | (155) | (175) | (255) |
| Net interest receivable/(payable) | <u>7</u> | <u>(7)</u> | <u>(103)</u> | <u>(174)</u> | <u>(283)</u> |
| Loss on ordinary activities before taxation | (31) | (100) | (259) | (349) | (538) |
| Taxation benefit/(charge) | <u>(2)</u> | <u>2</u> | <u>(8)</u> | <u>16</u> | <u>3</u> |
| Loss after taxation | (33) | (98) | (266) | (333) | (535) |
| Minority interests | 3 | 7 | 12 | - | - |
| Dividends | - | - | - | - | - |
| Loss for the year retained | (30) | (91) | (254) | (333) | (535) |
| EBITDA* | (13) | (48) | (31) | 21 | 75 |
| | | | | | <i>per cent</i> |
| <i>Performance indicators</i> | | | | | |
| Turnover growth | 36 | 145 | 577 | 115 | 52 |
| Operating loss as a percentage of turnover | (290) | (276) | (69) | (39) | (31) |
| Loss before tax as a percentage of turnover | (224) | (297) | (113) | (71) | (72) |
| EBITDA as a percentage of turnover | N/A | N/A | (14) | 4 | 10 |
| Average employee numbers (full-time equivalent) | 73 | 667 | 2,557 | 3,705 | 6,097 |

Source: NTL.

*This is earnings before interest, taxes, depreciation, and amortization, corporate expenses, franchise fees, non-recurring charges, other gains, minority interest and extraordinary items.

3.43. NTL told us that its total workforce at the end of 1999 was around 11,500 of which 11,156 operated in the UK. This compares with around 4,000 employees at the end of 1997, and NTL said that the increase was due to organic growth and the acquisition of companies that held a significant number of cable franchises.

3.44. Table 3.11 shows NTL's analysis of turnover, EBITDA and total assets by activity for the three years to 1998. In 1998, the local telecommunications and TV activity had turnover of \$355 million, compared with national telecommunications turnover of \$249 million and broadcast turnover of \$140 million. EBITDA was positive for all activities in 1998, against which corporate costs of

£[30] million were deductible to give net EBITDA of \$75 million. The broadcast activity showed the highest return at 66 per cent of turnover (excluding corporate overheads), an activity which, NTL said, was regulated by OFTEL.

3.45. NTL told us that its international income outside the UK for 1998 was not material and it did not start projects outside the UK until 1999.

TABLE 3.11 NTL: analysis of turnover and EBITDA, 1996 to 1998

| | <i>\$ million</i> | | |
|---|-------------------|------------|--------------|
| | 1996 | 1997 | 1998 |
| <i>Turnover</i> | | | |
| Broadcast | 84 | 131 | 140 |
| Local telecommunications and TV | 89 | 167 | 355 |
| National telecommunications | 45 | 185 | 249 |
| Corporate* | <u>10</u> | <u>9</u> | <u>3</u> |
| | 228 | 492 | 747 |
| <i>EBITDA</i> | | | |
| Broadcast | 50 | 74 | 92 |
| Local telecommunications and TV | -52 | 19 | 67 |
| National telecommunications | 11 | 13 | 36 |
| Corporate* | <u>-40</u> | <u>-85</u> | <u>-120</u> |
| | -31 | 21 | 75 |
| <i>Total assets (excluding liabilities)</i> | | | |
| Broadcast | 220 | 231 | 289 |
| Local telecommunications and TV | 1,184 | 1,324 | 3,100 |
| National telecommunications | 99 | 220 | 761 |
| Corporate | <u>952</u> | <u>647</u> | <u>2,043</u> |
| | 2,455 | 2,422 | 6,193 |
| <i>per cent</i> | | | |
| <i>EBITDA as percentage of turnover</i> | | | |
| Broadcast | 60 | 56 | 66 |
| Local telecommunications and TV | -58 | 11 | 19 |
| National telecommunications | 24 | 7 | 14 |
| Corporate* | N/A | N/A | N/A |
| All activities | -14 | 4 | 10 |

Source: NTL.

*Corporate expenses and overheads are not allocated to the three main divisions.

3.46. For 1999, NTL told us that it expected to increase its turnover and EBITDA. The principal driver of turnover growth was expected to be customer additions. EBITDA was expected to increase as a result of the costs of NTL's extensive customer service infrastructure being shared by a larger number of customers. NTL added that it was committed to maintaining its competitive position through continued investment in network and customer service infrastructure and human resources. Regarding NTL's future prospects, we noted that analyst reports gave estimates for its future income, profitability, cash flows and borrowings to 2008. They suggested that NTL could achieve significant profitability in about five years (even after deducting interest, taxation, depreciation and amortization), in part due to the suitability of cable technology to provide the broadband digital technological infrastructure used for new interactive services such as e-commerce, and access to the Internet.

Balance sheets

3.47. Table 3.12 shows NTL's balance sheet summaries over the five years to 31 December 1998. At the end of 1998, tangible fixed assets were \$3.8 billion, net operating assets were \$4.1 billion, it had net borrowings of \$4.2 billion, and it had shareholders' funds of \$355 million. EBITDA as a percentage of average net operating assets was 2 per cent in 1998, being negative until 1996.

TABLE 3.12 NTL: balance sheet summaries, 1994 to 1998

| | As at 31 December | | | | | \$ million |
|---|-------------------|-------------|--------------|--------------|--------------|-----------------|
| | 1994 | 1995 | 1996 | 1997 | 1998 | |
| Tangible fixed assets* | 192 | 640 | 1,460 | 1,757 | 3,854 | |
| Investments | - | - | - | - | 229 | |
| Other assets (non-current) | 19 | 27 | 61 | 63 | 181 | |
| Intangibles—licence and customer lists acquisition costs* | 138 | 138 | 135 | 123 | 210 | |
| Stock and debtor less creditors | <u>(27)</u> | <u>(74)</u> | <u>(204)</u> | <u>(156)</u> | <u>(372)</u> | |
| Net operating assets | 322 | 731 | 1,452 | 1,787 | 4,102 | |
| Intangibles—goodwill* | - | - | 258 | 241 | 515 | |
| Borrowings less cash | 138 | (363) | (1,287) | (2,020) | (4,195) | |
| Intangibles—deferred taxes | - | - | (95) | (70) | (67) | |
| Minority interests | <u>(23)</u> | <u>(29)</u> | <u>-</u> | <u>-</u> | <u>-</u> | |
| Net assets (equal to shareholders' funds) | 437 | 339 | 328 | (62) | 355 | |
| | | | | | | <i>per cent</i> |
| <i>Performance indicator summary</i> | | | | | | |
| EBITDA/average net operating assets | N/A | (9) | (3) | 1 | 2 | |

Source: NTL.

*The company made acquisitions in 1998 of ComTel for a total of £550 million, the outstanding stock of Comcast UK Cable Partners at a valuation of \$600 million, and Eastern Group Telcoms for £60 million in cash and issue of preferred stock valued at \$52 million. NTL said that the aggregate purchase price of \$1.7 billion exceeded the fair value of the net tangible assets acquired by \$591 million, which was allocated to goodwill, licence and customer list acquisition costs.

Constitution and governance

3.48. We asked NTL about the requirements for the approval of shareholders' resolutions under Delaware law and NTL's own constitution. Appendix 3.4 sets out the information provided to us by NTL's legal advisers. In summary, the effects of the Delaware General Corporation Law and of NTL's certificate of incorporation and bye-laws are that:

- (a) Generally, a majority of the shares entitled to vote constitutes a quorum at a meeting of stockholders and a majority vote of those represented at a meeting suffices to pass a resolution.
- (b) The maximum majority required is two-thirds of the outstanding voting shares. This is required for certain transactions (for example, a sale of 10 per cent or more of NTL's assets) between NTL and an 'interested stockholder' (generally a 15 per cent stockholder). It is also required to remove directors, to amend the bye-laws, or to make certain amendments to the certificate of incorporation relating to directors or to stockholders' meetings and consents.

The merger

Background and structure of the merger

3.49. C&W said that the change of its Chief Executive in February 1999 marked a turning point in its strategy to support all CWC's activities. C&W decided to focus on its carrier services and business customer business (ie its wholesale and retail business activities) and to divest its consumer-oriented operations in CWC. This also accorded with the new C&W group strategy of focusing on wholesale telecommunications, business customers and Internet services worldwide. C&W added that CWC's two main competitors were BT and BSkyB in telecommunications and pay-TV respectively, [

Details omitted. See note on page iv.

]. The pay-TV part of the business was not profitable, compared with its business customer and wholesale activities.

3.50. C&W said that it had many interests around the world competing for investment funds. Hence it had decided to concentrate its efforts in particular areas, and had focused on the business and wholesale sectors, and data and IP services where it had a strong position. Its view was that C&W was one of the top players in the world in IP services, and the other leading players (including the dominant company) are located in the USA. It emphasized that C&W was the only major non-US player in this very high-growth, high-tech market. The transaction was therefore fundamental to the strategy. Its intention was to own 100 per cent of its core subsidiaries rather than smaller controlling interests.

3.51. C&W told us that merger talks commenced with Telewest and MediaOne in January 1999, but were held up due to changes at the shareholder level within Telewest. First, TCI was acquired by AT&T. Then, AT&T agreed to acquire MediaOne (after a bidding war with Comcast). CWC understood that MediaOne's stake was now being sold to Microsoft. Apart from these shareholder issues, it said that the talks had been progressing well. Talks were at the point of being finalized, but the shareholders at Telewest could not agree on a final position acceptable to C&W.

3.52. NTL, having agreed to a £2.8 billion investment in itself by France Telecom, entered into discussions with C&W in June 1999. NTL bid a price that was more acceptable to C&W than that of another bid by Telewest and the proposed sale of CWC's cable business to NTL was formally announced on 26 July 1999, with completion conditional upon regulatory (and shareholder) approval.

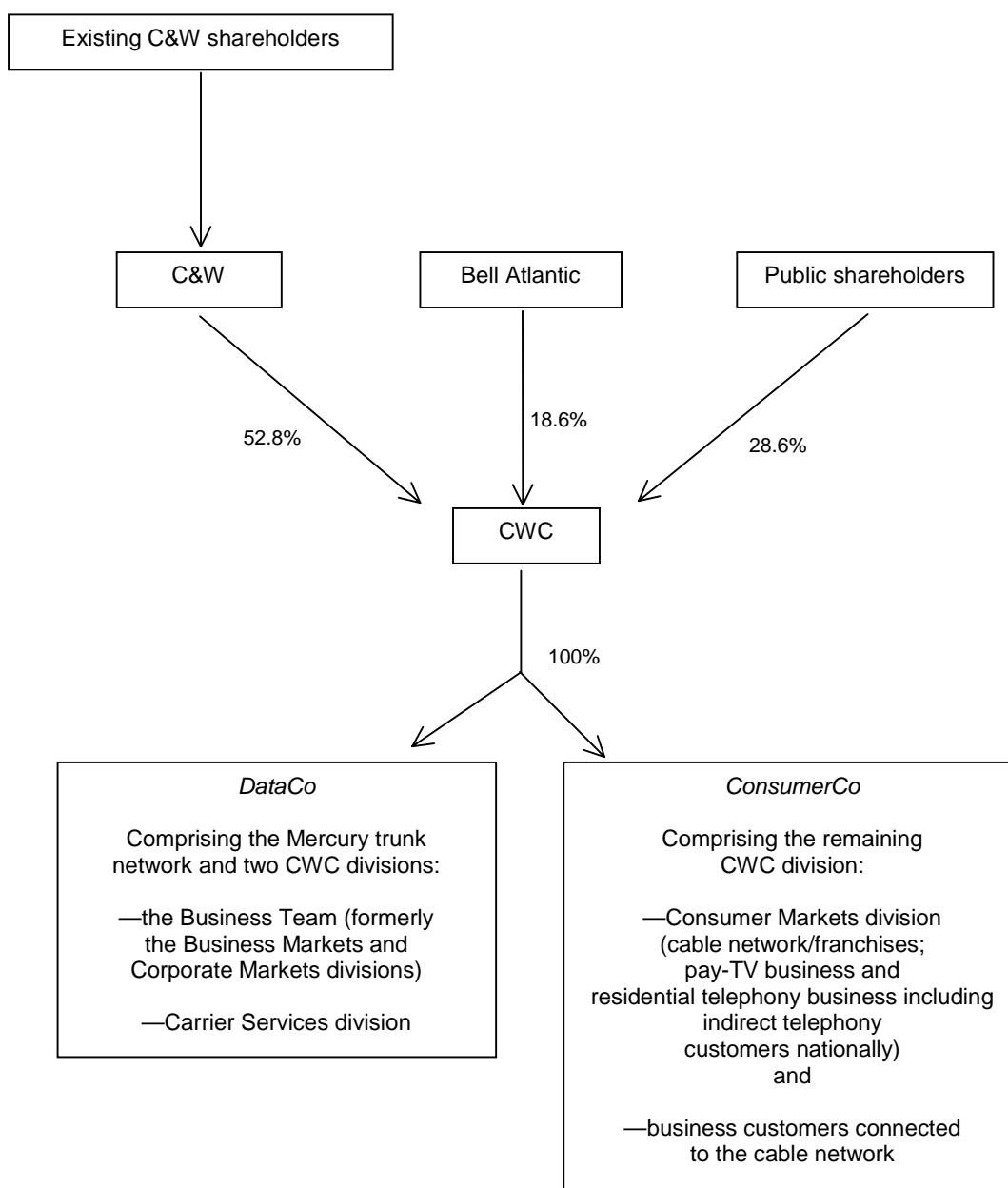
Description of the transaction

3.53. CWC said that, in essence, the transaction had involved its reorganization into two separate parts, ConsumerCo and DataCo. ConsumerCo would comprise the cable network, its associated residential telephony and pay-TV businesses, and the residential indirect telephony and Internet access business. DataCo would comprise the trunk network, the wholesale international carriers' activity and the business customer telecommunications activity. NTL was to acquire ConsumerCo, and C&W would acquire the 47.16 per cent of DataCo that it did not already own. To effect the merger, C&W shareholder and court approvals would be required for CWC's restructuring; it said that such approvals were obtained in mid-February.

3.54. Figure 3.1 shows the structure of CWC prior to the merger of ConsumerCo with NTL. The consideration payable by NTL for its acquisition of ConsumerCo was valued at approximately £8.2 billion at 26 July 1999. NTL said that this consideration would take the form of approximately 85 million NTL stocks (after adjusting for NTL's two stock splits), the payment of a fixed amount of £2.85 billion in cash, and the assumption, discharge or refinancing of £1.89 billion of CWC's net indebtedness. The net indebtedness of £1.89 billion will be adjusted for further debt to reflect an agreed level of ConsumerCo's cash outflow between 31 March 1999 and completion of the transaction. As at 4 February 2000, the net indebtedness amounted to £2.08 billion.

FIGURE 3.1

Structure of CWC prior to the merger transaction with NTL



Source: CWC.

Note: DataCo and ConsumerCo are being created to effect the split of the CWC businesses and did not exist when the merger was agreed.

3.55. France Telecom agreed with NTL that upon completion of the merger of ConsumerCo with NTL, it would invest £2.8 billion in NTL in addition to the US\$1 billion that it had previously invested in August 1999. This investment will partially fund NTL's purchase of ConsumerCo, described in the previous paragraph. The Secretary of State announced on 16 December 1999 that the proposed investment by France Telecom in NTL should be permitted, provided that France Telecom agreed to undertakings to divest its holdings in Crown Castle UK Holdings Limited, Crown Castle UK Limited and Crown Castle International Corporation, which have significant interests in the UK's terrestrial broadcasting transmission infrastructure.

3.56. CWC and NTL initially said in August 1999 that they expected the likely pre-dilution shareholdings (ie excluding convertible securities held by France Telecom, as part of its US\$1 billion investment, and by others) in NTL following the transaction to be:

- public (existing NTL shareholders): 47.5 per cent;
- public (ex-CWC shareholders): 4.4 to 17.4 per cent;
- France Telecom: 19.6 per cent;
- Bell Atlantic: 11.2 per cent; and
- C&W: 4.3 to 17.3 per cent.

3.57. However, on 10 February 2000 NTL suggested that the likely breakdown of shareholdings following the transaction could be:

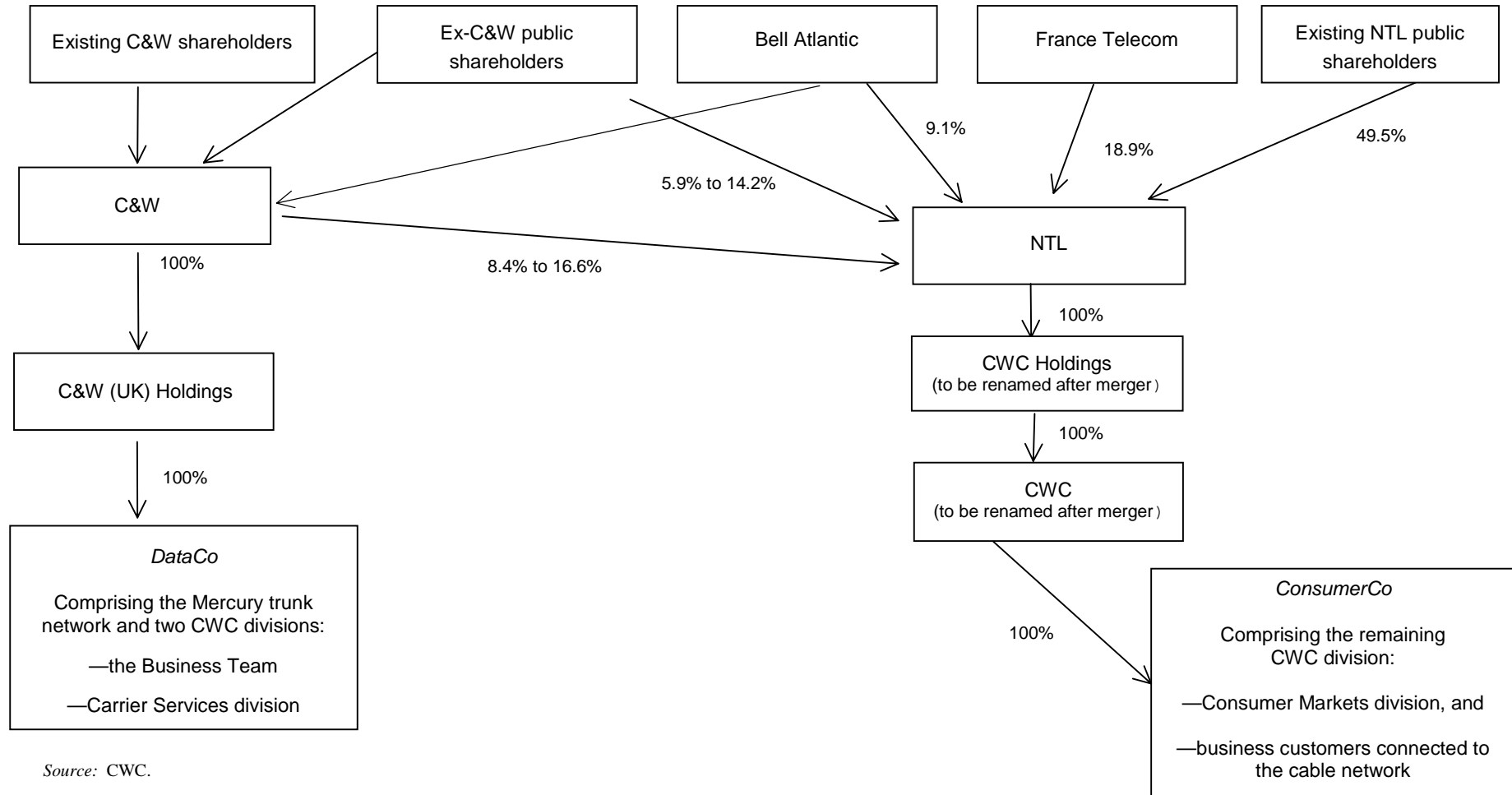
- public (existing NTL shareholders): 49.5 per cent;
- public (ex-CWC shareholders): between 5.86 and 14.16 per cent;
- France Telecom: 18.87 per cent;
- Bell Atlantic: 9.11 per cent; and
- C&W: between 8.36 and 16.66 per cent.

3.58. The parties said that the range within which the C&W and ex-CWC public shareholders' interests would fall once the transaction were complete may vary in that the ex-CWC shareholders will be offered a 'mix-and-match' facility in respect of their shares under which they will be able to elect to vary the mix of cash or NTL stocks they take in payment for their CWC shares. C&W said that the offer was sent to shareholders on 14 February 2000. C&W added that, on a fully diluted basis, its shareholding, even if it took its payment for ConsumerCo entirely in NTL stocks, would be less than 17 per cent (see paragraph 3.68 for the latest estimates on C&W's prospective interest in NTL). C&W said that the minority shareholders in CWC effectively had first choice on taking shares in NTL or cash, and therefore its holding in NTL stocks would be dependent upon such decisions which would not become clear until the offers sent to the public shareholders had been accepted and their elections became known. This would not be known until a few days prior to completion. CWC's illustrative timetable anticipates the earliest this could be as 13 April 2000. C&W emphasized that the arrangement by which it would hold shares in NTL [*Details omitted. See note on page iv.*]. NTL had agreed to put a large amount of cash into the deal, funded by an investment from France Telecom, which was a key attraction of the NTL offer, compared with that by Telewest. C&W said that it would [*Details omitted. See note on page iv.*].

3.59. Figure 3.2 presents the post-completion structure. We show in Appendix 3.5 the information presented to us on the detailed steps in this process. In effect C&W will have sold its 52.8 per cent in ConsumerCo and will have purchased the other shareholders' interests in DataCo of 47.2 per cent so that it would achieve 100 per cent ownership of that part of its business. At the same time, NTL will have purchased C&W's 52.8 per cent interest in ConsumerCo as well as the interests in ConsumerCo of the other shareholders in CWC and thereby achieved 100 per cent ownership of ConsumerCo; and C&W would obtain a minority interest in the enlarged NTL with possibly one seat on its board. NTL emphasized that its shareholders' post-completion percentages on an undiluted basis may vary according to the exercise by holders of their right to convert convertible securities or other convertible instruments in NTL into NTL common stock.

FIGURE 3.2

Ownership of CWC's businesses following the merger transaction with NTL*



Source: CWC.

*Subject to changes in NTL shareholders as noted in paragraphs 3.57 and 3.68.

3.60. We asked C&W to discuss the approach taken to value the two businesses. It said that both businesses were valued separately, ConsumerCo to enable C&W and NTL to agree a price, and DataCo so that C&W could make an offer for the shares that it did not already own. The values for the transactions were ultimately arrived at after negotiations. However, for ConsumerCo the value was compared with other cable companies with stock market valuations, for example Telewest. CWC also said that there was a valuation measure of price per subscriber, and finally other calculations such as discounted cash flow. Table 3.13 shows CWC's cash flow estimates for ConsumerCo over the ten-year period to 2008/09. Ultimately, CWC said that there was an auction between Telewest and NTL, and NTL's offer was accepted.

TABLE 3.13 CWC: ConsumerCo forecast highlights, 1999/2000 to 2008/09

| | Years ended 31 March | | | | | | | | | | £ billion |
|---------------------------------|----------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------------|
| | 1999/ 00 | 2000/ 01 | 2001/ 02 | 2002/ 03 | 2003/ 04 | 2004/ 05 | 2005/ 06 | 2006/ 07 | 2007/ 08 | 2008/ 09 | Ten-year total |
| Sales | | | | | | | | | | | |
| Gross profit | | | | | | | | | | | |
| EBITDA | | | | | | | | | | | |
| <i>Free cash flow estimates</i> | | | | | | | | | | | |
| EBIT | | | | | | | | | | | |
| Depreciation | | | | | | | | | | | |
| Capital expenditure | | | | | | | | | | | |
| Tax | | | | | | | | | | | |
| Total* | | | | | | | | | | | |

Figures omitted. See note on page iv.

Source: CWC.

*Totals may not add up because of rounding.

3.61. The cumulative EBITDA over the period was estimated at £[] billion, reaching annual levels in excess of £[] billion from 2004/05. The free cash flow after taking account of capital expenditure (capex) and tax was estimated at £[] billion over the ten-year period. CWC estimated that ConsumerCo's discounted cash flow, assuming a [] per cent discount factor and a terminal growth rate at [] per cent, would be £[] billion. The terminal growth rate was the estimate of the perpetual free cash flow growth for the business. However, at a [] per cent discount rate, the discounted cash flow value would have fallen to £[] billion, and at an [] per cent rate, increased to almost £[] billion.

3.62. We asked CWC to explain the capital expenditure estimated in the forecast to indicate the extent to which the projected expenditure of £[] billion would represent new network building, or installation of technology. CWC told us that, for example in 1999/2000, some £[] million was shown as capital expenditure in following main areas:

- (a) Digital TV: £[] million—this was to develop the processes and structures to support digital TV roll-out, upgrade the network, develop the products/services, and cover the cost of set-top boxes.
- (b) Access build to upgrade existing customer network: £[] million—this was to resolve capacity issues with regard to servicing CWC's existing homes.
- (c) Residential installations: £[] million—this was the contract labour, capitalized internal labour, materials and other costs associated with installing new residential customers and upgrading additional customers.
- (d) Capitalized internal labour on all projects: £[] million.
- (e) Access build to new areas: £[] million.
- (f) Call-centre investment: £[] million.

- (g) IT, systems infrastructure and telephony product development: £[] million.
- (h) Other costs such as investments in the network, switches and operational support systems: £[] million.

3.63. In the case of DataCo, C&W said that comparable values were more difficult to derive, and it used [*Details omitted. See note on page iv.*] as benchmarks to value DataCo because they also focused exclusively on the business telecommunication market. C&W said that such negotiations were also on an arm's length basis, and required the approval of the independent directors of CWC. C&W said that its representatives could not vote in the CWC board meeting at which the CWC board decided to accept the offers. Hence the decision was a fair one made by the independent directors of CWC, supported by advice from investment bankers. C&W said that it made three offers before its final offer was accepted. In effect, based on the values quoted in the offer documents sent to shareholders of CWC, C&W would issue approximately 328 million shares to purchase the interests of the 47.3 per cent minority in CWC's DataCo which was valued at £4.28 billion based on the C&W share price as at 4 February 2000. It would sell its 52.7 per cent interest in CWC's ConsumerCo at a value of £4.22 billion, being £1.50 billion in cash (52.7 per cent of £2.85 billion cash) and 44.8 million NTL stocks (52.7 per cent of 85 million NTL stocks to be issued) valued at £2.72 billion based on NTL's stock price as at 4 February 2000. C&W/CWC added that strictly, the final enterprise value would be determined upon completion by reference to the value of the shares at such time and the amount of net debt also at that date. CWC shareholders would, as in the case of C&W, receive a mix of cash and NTL's stocks as consideration for their CWC shares (except Bell Atlantic which has elected to receive its consideration entirely in NTL stocks). The combination that C&W would receive would depend on elections made by the public shareholders of CWC under the mix-and-match facility where they would be able to vary the proportion of NTL stock and cash they wished to receive. Based on information noted for ConsumerCo in the offer documents, the enterprise value of ConsumerCo was shown as £10.08 billion as at 4 February 2000 (being the equity value of £8.0 billion and net debt of £2.08 billion). This compares with the enterprise value of £8.2 billion for ConsumerCo as reported to the Stock Exchange as at 26 July 1999 (see also paragraph 3.54). CWC/C&W explained that the number of shares/stock to be issued by C&W/NTL respectively were fixed at 26 July 1999 and that by the time the offer was sent to the shareholders for approval in February 2000, the value had increased because of underlying share price movements.

3.64. Table 3.14 shows CWC's cash flow estimates for DataCo over the ten-year period to 2008/09. The cumulative EBITDA over the period was estimated at £[] billion, rising from £[] billion in 1999/2000 to £[] billion in 2008/09. The free cash flow after taking account of capital expenditure and tax was estimated at £[] billion over the ten-year period, and cumulative capital expenditure for the period was estimated at some £[] billion.

3.65. CWC said that its cumulative forecast of capital expenditure was £[] billion, which was equal to the cumulative EBIT (earnings before interest and tax).

TABLE 3.14 CWC: DataCo forecast highlights, 1999/2000 to 2008/09

| | Years ended 31 March | | | | | | | | | | £ billion |
|---------------------------------|----------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------------|
| | 1999/ 00 | 2000/ 01 | 2001/ 02 | 2002/ 03 | 2003/ 04 | 2004/ 05 | 2005/ 06 | 2006/ 07 | 2007/ 08 | 2008/ 09 | Ten-year total |
| Sales | | | | | | | | | | | |
| Gross profit | | | | | | | | | | | |
| EBITDA | | | | | | | | | | | |
| <i>Free cash flow estimates</i> | | | | | | | | | | | |
| EBIT | | | | | | | | | | | |
| Depreciation* | | | | | | | | | | | |
| Capital expenditure | | | | | | | | | | | |
| Tax | | | | | | | | | | | |
| Total† | | | | | | | | | | | |

Figures omitted. See note on page iv.

Source: CWC.

*Includes working capital changes, which total £[] billion over the ten years, and are less than £[] million in any one year.

†Totals may not add up because of rounding.

3.66. CWC said that because business customers were connected to the cable network being transferred, NTL would, out of necessity, acquire a relatively small proportion (6 per cent) of the revenue (or potential revenue) generated by CWC's business customers. Most of this revenue was derived from the provision of telecommunication services to individual sites of small and medium-sized enterprises (SMEs). Of the [] or so business customers served over cable network assets that would be transferred to NTL, some [] were SME telesales accounts, and [] were dormant. The remaining [] customers were larger businesses which currently received a mixture of cable services (mainly telephony but also services such as ISDN and leased lines) and services delivered over the CWC trunk network. The revenue stream from specific services to these customers would, therefore, transfer if the relevant network assets on which such services depend were also transferred, or they were residential customers which were indirectly connected to CWC's network. Upon completion of the transaction, it said that this business would [

Details omitted. See note on page iv.

].

3.67. In paragraphs 3.86 to 3.119, we discuss the interconnection agreements which NTL and CWC negotiated, in parallel with the merger transaction.

3.68. At 10 February 2000, NTL told us that its best estimate for C&W's interest in NTL following the merger could be in the range 8.36 to 16.66 per cent (assuming no dilution which was the likely outcome immediately following the acquisition), or 6.2 to 12.35 per cent on a fully diluted basis (a less likely assumption as at completion). It could therefore be entitled to appoint a director on NTL's board, assuming that its interest on a fully diluted basis exceeded 7.5 per cent. We asked NTL to confirm that a C&W director would be entitled to any information on its affairs. NTL said that both pursuant to its operating practices and Delaware Law, a C&W director would refrain from receiving information which may involve a possible conflict, and from participating in meetings of the NTL board where the NTL Chairman has determined that may involve conflicts of interest between NTL and C&W (including DataCo).

Benefits and synergies from the merger

3.69. NTL told us that it was still formulating its plan to integrate the relevant businesses of CWC into its operations. It said that a number of key benefits would come from the merger, some which it could only quantify after the event, but it was confident that it would achieve both synergies and other benefits. It said that synergies would arise from cost savings and revenue enhancements from consolidating the acquired businesses into NTL. The new scale that the enlarged NTL would attain would enable it to increase the quality and extent of its service offerings to consumers, and other benefits would flow from its applying 'best practice' processes. It said that it was confident of passing on the synergy benefits to the consumer through price reductions or improved service/offerings without a proportional increase in prices, and other service improvements for the consumer.

3.70. It added that the merger would result in greater choice for the consumer due to NTL's commitment to offer a greater choice of innovative pricing packages. It believed that as a result of its increased coverage to approximately 33 per cent of UK households, it would become a credible competitor to BSkyB, ONdigital and BT, which were the only companies to offer national products under a national brand in its markets. It expected inter-platform competition to increase from the merger as each platform would attempt to become a market leader. It added that the extent of its wider coverage would enable it following the merger better to promote and leverage its brand, which would increase its penetration to households across its network.

3.71. As we discuss in greater detail in the following paragraphs, NTL believed the merger would increase the rate of technological advancement and speed up the roll-out of digital services. This would be due to the increased return that the enlarged NTL would achieve on its research and development of new interactive services. It added that the increased customer base would enable it to justify increased funding on research and development activities.

3.72. NTL summarized synergies as lower interconnect costs, headcount efficiencies, property rationalizations, and efficiencies in purchasing, sales/marketing and programming.

3.73. It summarized the expected benefits as improved service from roll-out of digital technology, increased penetration, acquisition of indirect customers, and reduced churn because of its ability to offer potential customers attractive subscription packages for telephone/TV services.

3.74. NTL said that it constantly sought ways to reduce interconnect costs, and would enter into agreements with C&W on interconnection, which would be mutually advantageous. It said that the rates offered by C&W would be more favourable than BT and those offered by other operators, and it emphasized that it could have negotiated the agreements on similar terms, independently of the merger transaction. We discuss the interconnection agreement in paragraphs 3.86 to 3.119. After the transaction, it would be able to achieve other interconnect cost savings. For example, the enlarged NTL would be able to carry more calls on its own network without having to resort to the BT network at all. It could then offer more innovative pricing packages to customers for such calls. It also added that, even if the whole call could not be kept on its network, on average the extension to its network would reduce the number of transfers and increase the routing efficiencies of its own network. The increased scale would enable it to justify more connections to other licensed operators. In summary, the interconnect efficiencies would give it greater opportunities to offer lower-cost telephone calls and flexible calling rates to its customers, although the financial effect of such efforts was not yet known.

3.75. Regarding headcount efficiencies, NTL said that it had identified the areas of customer call-centre operatives, field operatives, risk management and other minor management roles where there was scope for rationalizations. Some 600 to 700 positions in ConsumerCo and some 500 in NTL could be affected, but it believed the losses could be offset by the need for more people in areas such as launch of digital services, and efforts to satisfy the increased customer base following the merger, for example customer care and customer retention teams. NTL emphasized that it had a consistent record of generating employment, and it did not expect any reduction in the combined headcount in the first year after the merger. It also hoped in the short term to redeploy some skilled personnel from the UK to its investments in Europe, notably Cablelink in Ireland.

3.76. Regarding property rationalizations, it expected some properties to be shared with DataCo, and others would be allocated to DataCo or ConsumerCo. It was not in a position to estimate the effect of cost savings at present but suggested that savings could amount to £5 million a year over three years.

3.77. In terms of purchasing, it hoped for supplier rationalizations, cost savings and improved working capital control, savings in procurement processing and stockholding, and enhanced purchasing power (for hardware such as set-top boxes, and programme purchasing deals). It believed these savings could contribute to reducing the overall costs of its network on a per customer basis in the longer term. It added that expectations of competition from BT, BSKyB and ONdigital would ensure that efficiency gains it achieves were passed on to the consumer.

3.78. NTL said that it had recently relaunched its brand at a national level, and aimed to compete with the national offering of BSKyB and ONdigital, which it said were the platforms of choice for content providers and ultimately advertisers.

3.79. In terms of programming savings, NTL said that it believed programming costs were unduly high in the UK, and it had tried to drive down costs, but to do so it needed increased coverage of the UK population in order to have greater bargaining power and to benefit from volume reductions which were commonly available in programming contracts. It added that increased size would enable it to resist more effectively minimum carriage or revenue obligations imposed by channel content providers. It said that such obligations forced it to include channels in its basic package which were not popular with its customers and were tied to the supply of more popular channels/programmes. It noted that the ITC discouraged such practices.

3.80. NTL suggested that the merger would serve to redress the imbalance in purchasing power between BSKyB and other operators including NTL in the wholesale market for programming. In addition, it said that its enlarged size would give it status in the market for programme content that would enable it to obtain content that was not currently available on acceptable terms, such as premium pro-

gramming rights. It noted that at present it could only improve its purchasing power by one-off joint purchasing deals with others (for example, Telewest). NTL concluded that its larger size following the merger would enable it to compete more effectively against BSkyB by obtaining comparable terms for programming. It said that the benefit for consumers would be greater choice of channels which they desired at a lower cost.

3.81. Regarding improvements in the roll-out of digital services, NTL said that it and CWC were both engaged in this activity at present, and the digital spectrum would enable it to increase bandwidth by 400 per cent, compared with analogue. Hence, digital cable would be able to provide interactive services, which NTL considered an essential element of moving the UK to the forefront of this technology with benefits to the UK economy and skillbase.

3.82. It said that the success of digital services largely depended on the speed of the roll-out and penetration of digital cable, which would require significant investment by cable franchise holders. It believed the merger would bring the impact of NTL's financial resources to CWC's consumer customers and permit a faster and more cost-efficient roll-out of digital cable. This was linked to NTL's commitment to achieve higher cable penetration in CWC's franchise areas, and thereby would increase the number of consumers who could benefit from its digital interactive technology. It concluded that the larger customer base would reduce the digital roll-out cost per customer or potential customer, and digital subscriber line (DSL) technology would be able to deliver pay-TV and compete with the other delivery mechanisms. Consequently its digital roll-out would enable NTL to compete more effectively in the area of digital interactive services, not just with BSkyB and ONdigital, but also with DSL-enabled services provided by BT, and stimulate lower prices for such services to customers.

3.83. NTL said that it was confident of increasing the penetration achieved by CWC's ConsumerCo once it was part of the enlarged NTL. It was not able at present to suggest the impact of such changes on its financial results. However, it did anticipate strong improvements in its performance, based on key assumptions for pricing, churn, homes passed and the speed at which the penetration rates in the CWC areas could be raised to levels achieved by NTL. It added that its expertise and active management would be critical to achieving the planned benefits to consumers.

3.84. NTL told us that it believed the enlarged group would be better able to convert certain indirect customers to become direct customers. Based on certain assumptions for the size of the market, conversion rates, and average revenue per customer, it estimated that the annual benefit of such conversion could be between £25 million and £45 million.

3.85. NTL also noted that reducing CWC's churn rates was important, and believed that its approach to customer care, its marketing of a common brand across a wider geographical area and applying research and development of new services would help it achieve the synergies and benefits it hoped for from the merger. NTL told us that it was unable to say where its churning customers went when they terminated its services, but suggested that some must go to BSkyB or ONdigital.

Other issues

Interconnection agreements between CWC and NTL

3.86. The parties explained that Heads of Agreement had been entered into between NTL and Cable & Wireless Communications (Mercury) Limited (DataCo) on 26 July 1999 (the Heads). The parties informed us that the Heads were subsequently amended on 9 February 2000. In essence, the amended Heads appointed DataCo as preferred supplier of certain national interconnection services for a transitional period, where NTL did not wish to, or could not, self-provide such services and subject to DataCo's rates and service levels remaining competitive. The parties said that they did not consider the Heads to raise any competition concerns, particularly given the lack of foreclosure effect, the vertical nature of the agreement and the parties' lack of market power. The parties further added that the Heads were ancillary to the proposed acquisition by NTL of CWC's consumer business, ConsumerCo. They explained that the Heads were effectively an agreement between NTL (as enlarged through the acquisition of ConsumerCo) and DataCo (which after the merger will still be known as CWC).

3.87. The parties originally requested from the OFT confirmation that the Heads were ancillary to the merger so as to benefit from an exclusion from the Chapter I prohibition in the Competition Act 1998. The OFT indicated by fax of 8 October 1999 that it would not be able to review the arrangements until they were in executed form, and by fax of 8 November 1999 that it would not be in a position to offer guidance for ancillary arrangements entered into prior to March 2000 until after 1 March 2000. In February 2000, the OFT informed the parties that it now took the view that where an agreement satisfied all the criteria in paragraph 1 of schedule 1 of the Competition Act 1998, the exclusion from the Chapter I prohibition in the Act might apply irrespective of whether the agreement was made before or after 1 March 2000. The effect of this was that there was no objection in principle to the Heads being considered as ancillary to the proposed merger.

3.88. Originally the understanding reached in negotiations between CWC and NTL was that the arrangements between them would extend not only to those national services currently covered, but also to international interconnection services. However, following negotiations with France Telecom in the course of finalizing the terms of the transaction, the parties agreed that France Telecom would replace DataCo as supplier of NTL's international interconnection services (subject to certain provisos relating to NTL's ability to carry the traffic and the need to ensure competitive rates) following completion of the merger. [

Details omitted. See note on page iv.

] Therefore the agreement between NTL and CWC (DataCo) would be confined to NTL's national traffic.

3.89. [

Details omitted. See note on page iv.

]

3.90. [

Details omitted. See note on page iv.

]

3.91. The parties said that it was not for the Commission to look at the interconnect agreement between NTL and France Telecom, which they believed was not part of the merger situation referred to the Commission, but was part of the investment by France Telecom in NTL.

3.92. A supplemental agreement amending the original Heads was entered into by CWC and NTL on 9 February 2000, the main effects being to remove provisions which required minimum annual commitments on traffic that would be carried by DataCo, and to subject DataCo's preferred supplier status to a wider market benchmark.

3.93. The parties said that the Heads (as amended) were expressed to be binding, subject to the condition that the merger was completed (except that the Internet dial-up services extension agreement referred to below took effect earlier). The Heads represented the agreed spirit and principles upon which the parties would negotiate and enter into a final agreement which would establish the terms in detail, including operational provisions. Notwithstanding the fact that the majority of the provisions were conditional on completion, one aspect of the Heads came into effect at the end of 1999, being the extension of a pre-existing agreement relating to Internet dial-up services for the [] from [].

The Heads of Agreement

3.94. The original Heads as negotiated contained two sets of obligations:

- (a) a preferred supplier arrangement (subject to a right for NTL to self-provide the service, and the service being competitive with the relevant benchmark service); and

- (b) minimum annual revenue commitments. The parties told us that the implicit assumption was that NTL would expand its infrastructure to self-provide services to itself in the next three years, which until then would be provided by C&W. However, the amended agreement dated 9 February 2000 removed the minimum annual revenue commitments and the parties said that DataCo would only be able to obtain ConsumerCo and NTL traffic if its price was better than NTL could obtain from BT or other telecommunication providers.

In this connection, NTL told us that the costs of incorporating CWC's ConsumerCo traffic to NTL's network and the new interconnection of NTL's transit network to CWC's DataCo would be around £[] million.

3.95. The parties said that the Heads provided that DataCo would be appointed preferred supplier to NTL of a number of telecommunication services for a three-year period (extendable to five in some cases) provided certain conditions were met. These conditions would ensure that the rates and service levels received by NTL remained competitive and preserved NTL's right to self-provide. The parties further explained the rationale for the agreements as providing a smooth transition, for DataCo to secure NTL's supply of interconnection traffic at best market rates for a transitional period from three to five years, thereby supporting CWC's historic investment in infrastructure and safeguarding its network utilization levels for a transitional period, and securing a revenue stream for DataCo whilst it sought to replace the ConsumerCo traffic with traffic from other sources.

3.96. CWC gave an example of how the agreements could work. In the case of a call from an NTL local network to a Telewest local network using C&W/DataCo's transit facilities, there would be an interconnection agreement between NTL and C&W/DataCo at the originating end, and between C&W/DataCo and Telewest at the terminating end. ConsumerCo's network at present was automatically linked by switches to the DataCo trunk network and the systems were integrated. The parties said that without this agreement, on completion of the transaction, DataCo would lose a significant amount of the pre-existing traffic from the ConsumerCo network as NTL could gift that traffic to other operators. At the same time, without this agreement NTL would have no guarantee that it would be able to service many of its ConsumerCo customers without severe disruption and inefficiency. Hence there was a need for a transitional period of supply, subject to DataCo's services and rates being competitive.

3.97. The services covered by the Heads were:

- (a) National double tandem long, medium and short voice telecommunication traffic for onward transmission. DataCo was the preferred supplier for [] years and agreed to deliver all NTL's national double tandem traffic unless NTL could deliver the traffic itself or could receive the equivalent service at a lower price from BT or another telecommunication operator.
- (b) Number translation services (NTS) traffic delivery (ie an interconnection service comprising transit of calls to non-geographic numbers which attract a local, national or premium rate regardless of their point of origination, for example 0800 freephone numbers, 0345 numbers for local call and national call fee access, and 0858 numbers for premium rate calls). DataCo was the preferred supplier for three years of all NTL's NTS traffic unless NTL was to deliver the services itself to the terminating operator and [*Details omitted. See note on page iv.*].
- (c) National and international directory enquiry services (a service consisting in transit to the operator services platform as well as the provision of directory enquiry services). DataCo was the preferred supplier for [] years and agreed to deliver all NTL's directory enquiry services traffic [*Details omitted. See note on page iv.*] (the parties said that BT was the only other operator able to deliver this service).

3.98. In relation to Internet dial-up services, the pre-existing agreement between DataCo and the NTL subsidiary, Cable Online Limited, has been extended to deliver traffic to NTL's Internet platform (Virgin Net) for [] with an annual commitment ([] minutes if the merger is completed and [] billion minutes if it does not), but no preferred supplier status. In

relation to indirect access services, DataCo agreed to provide indirect services to NTL in relation to all former DataCo indirect customers [*Details omitted. See note on page iv.*]; NTL's right to migrate these customers to the NTL network was preserved.

3.99. The original minimum annual revenue commitments agreed by NTL and DataCo (and subsequently removed by the amended agreement of the parties) were as follows (effective from the completion of the merger):

(*⊗*)

They totalled £[*⊗*] million, of which the parties said that £[*⊗*] million represented the former ConsumerCo traffic, and therefore the balance of some £[*⊗*] million was original NTL traffic that could be migrated to C&W. The figures were based on forecasts and various assumptions of anticipated revenue from a given mix of services (including services additional to those in paragraphs 3.97 and 3.98) and assumptions as to market growth, reduction in prices, increased self-provision by NTL and anticipated margin for DataCo over the period. CWC said that these assumptions were based on an obligation by DataCo to [*⊗*]. Following the amendment to the Heads, DataCo's preferred supplier status took effect only where [*⊗*]. It therefore suggested that the assumptions and forecast may no longer be applicable. One effect of removing the minimum revenue commitments was also to limit the number of the services covered by the agreement to those listed in paragraphs 3.97 and 3.98. *Details omitted. See note on page iv.*

3.100. We also asked the parties to confirm that no consumers were likely to suffer from discriminatory prices by being on a particular network affected by the agreements. They confirmed that this was so.

3.101. The parties said that the preferred supplier status would be subject to compliance by DataCo with service level agreements to be agreed between the parties. They said that DataCo must also ensure that the charges and service standards applied to NTL were competitive with those supplied by DataCo to NTL's competitors and other customers requiring similar services. Therefore if DataCo failed to meet the charges and service standards, NTL would be able to look elsewhere for provision of such services.

3.102. We asked the parties what was the net present value of future cash flows expected from the Heads, and what they estimated was its market value if, for example, it was offered for tender to another provider. They said that it was not possible to attribute any net present value to the agreements as the anticipated cash flows were uncertain.

3.103. The parties said that the interconnection arrangements did not form part of the merger itself because they did not lead to any permanent structural change in the market. They were subordinate, but directly related to the merger as follows:

- (a) they were conditional on completion of the merger;
- (b) their terms were negotiated with the merger;
- (c) they were designed in large part to ensure security of supply for NTL on completion and to ensure that DataCo's network utilization does not, at least for a transitional period, decline as a result of the sale of ConsumerCo; and

- (d) they were amended (on 9 February 2000) at NTL's instigation as part of the commercial negotiations of the Transaction Agreement ahead of C&W and CWC posting the offer documents to the public.

3.104. In addition, the parties said that if competition issues of a public interest nature were considered to arise then the Commission should consider whether, with effect from entry into force of the Competition Act on 1 March 2000, the provisions giving rise to competition concerns were ancillary to the merger and, therefore, to be cleared with the merger, if the merger were to be cleared. The OFT Guidelines on the Exclusion for Mergers and Ancillary Restrictions, indicated that a directly related restriction was likely to be considered 'necessary' and therefore ancillary to the merger where, in the absence of the restriction, the merger would not have gone ahead, might have less chance of succeeding if it did, or would only proceed at considerable extra cost or over a considerably longer period.

3.105. They added that the OFT guidelines also stated that purchase and supply arrangements may be acceptable where a business which has been acquired was formerly part of an integrated group of companies and relied on another company in the group for raw materials or represented a guaranteed outlet for that company's products.

3.106. CWC and NTL therefore summarized their position that the interconnection arrangements were necessary to the implementation of the merger because:

- (a) The merger was a very complex one and the interconnection arrangements were an integral part of the overall package negotiated between the parties.

- (b) In relation to the ConsumerCo traffic, NTL needed time to configure its national network to absorb the large volumes of traffic originating in ConsumerCo operating areas and to interconnect efficiently the proportion of that traffic which was destined for termination by BT and other operators.

- (c) [

Details omitted. See note on page iv.

]

- (d) In relation to the NTL traffic, and the need to continue to route ConsumerCo traffic via the DataCo network for a transitional period, it would most likely be efficient for NTL to route further amounts of similar traffic streams via the DataCo network in order to achieve greater buying power and maintain a cost-effective interconnect structure throughout, provided DataCo's rates were competitive.

3.107. They expanded their comments under the headings 'ConsumerCo traffic' and 'NTL traffic' below.

ConsumerCo traffic

3.108. The aim of the interconnection agreement in relation to traffic originating on ConsumerCo's network was to ensure continuity of DataCo's utilization levels on its core network (by maintaining an outlet for its network services) while ensuring that NTL's supply needs were met at competitive rates over a transitional period.

3.109. The parties said that for NTL's part, in addition to the commercial advantages to NTL of securing competitive supply of the wholesale inputs necessary for the activities of the ConsumerCo business over a [] period and minimizing disruption to ConsumerCo customers, there were technical reasons why NTL needed to continue to use CWC for this traffic. From NTL's perspective, the sudden addition of vastly increased traffic volumes could lead to significant problems given its existing network topology and configuration. In relation to double tandem and NTS traffic, NTL said that it did not have sufficient points of interconnection with BT to ensure that traffic originated in these areas could be routed efficiently. As an interim measure, therefore, it was necessary from a security of supply, cost control and network congestion point of view to route traffic over CWC's national network.

3.110. They added that the migration of indirect customers was an example where technical reasons required a transitional period and it would not technically be possible to move over all the ConsumerCo indirect customers immediately. Some customers could be switched to the NTL network by remote programming. However, NTL would be required to make transitional arrangements covering billing, customer service and support. Others would need to be contacted for adjustments to be made either to upgrade the smart box or to advise the customer to use a different prefix code. They added that DataCo would effectively be providing the whole indirect service for NTL, including all network services (and provisioning and bill processing for 18 months), until replacement arrangements had been put in place with the indirect ConsumerCo customers.

3.111. In relation to the provision by DataCo to NTL of operator services, CWC and NTL pointed out that the service is not an interconnection service. NTL said that it had no current plans to establish its own directory enquiries operator service. The interconnection arrangements would seek to ensure that DataCo's investment in its operator services was not undermined by the sale of ConsumerCo so as to maintain its position as a viable competitor to BT, the only other provider of operator services.

3.112. The parties also said that CWC's investment decisions in recent years, particularly the roll-out of Network 2000 (a £400 million investment programme), which contributed substantially to the quality of DataCo's network services and its viability as a competitor to BT, was predicated on assumptions as to network utilization. The carriage of ConsumerCo's retail traffic had been a significant element of these network utilization forecasts. A major effect of the sale of ConsumerCo would be that, in the absence of securing continuity of carriage of the traffic generated by ConsumerCo traffic (ie continuity of ConsumerCo as an outlet for DataCo's network services), [

Details omitted. See note on page iv.

]. It was therefore an essential component of the merger discussions to safeguard satisfactory DataCo network utilization levels for a transitional period.

NTL traffic (originating on the current NTL network)

3.113. The parties said that the revenue due to DataCo in relation to ConsumerCo traffic under the old Heads was designed to reduce year on year in order to accommodate NTL's plans to expand its own network, integrate ConsumerCo and transfer traffic to third party operators who offered lower rates. While these reduced revenues provided DataCo with a degree of continuity for its network business, [

Details omitted. See note on page iv.

]. It was therefore necessary to secure preferred supplier status in relation to the network supply needs of traffic originating on the current NTL network.

3.114. The parties said that because of the arrangements relating to the ConsumerCo traffic, it was commercially sensible for NTL, in order to deliver a rational and cost-effective interconnect structure during and after network integration, also to appoint DataCo as a preferred supplier for its existing available national traffic provided its rates remained competitive. This strategy would deliver greater buying power to NTL and enable DataCo to apply economies of scale in the pricing and supply of services to NTL, because of greater volume of traffic flowing through its network.

3.115. The parties concluded that the considerations noted above were, from C&W's perspective, such that, in the absence of the preferred supplier arrangements, the merger could not have gone ahead on the same terms or could have proceeded only with considerable uncertainty. In effect, without the continuity of outlet for DataCo's network services made possible by the preferred supplier arrangements (subject to rates remaining competitive), the core network economies necessary for DataCo to compete effectively would have been subject to much greater uncertainty. It was therefore integral to the merger that the interconnection arrangements were agreed.

3.116. From NTL's perspective, the implementation of the merger by NTL depended in part on securing, on a transitional basis, access to certain network services in relation to a substantial proportion of the ConsumerCo business transferred. The further commitment to DataCo for NTL traffic was needed

to secure the necessary network utilization and economies of scale for DataCo and secure for NTL a coherent interconnect cost structure, while enabling it to self-provide an increasing quantity of network services, and guaranteeing that rates remain competitive.

3.117. CWC and NTL therefore believed that the arrangements did not exceed the minimum necessary to achieve their stated objectives which were integral to the viability of the merger.

3.118. Although the original Heads referred to minimum revenue commitments, we asked both parties to comment on the maximum revenue that could be earned over the duration of the agreements. Both were unable to give an indication of this, but commented that the original minimum annual revenue commitments were small by comparison with ConsumerCo's purchase price. NTL added that even if it sent all its traffic via C&W rather than self-providing or via a third party, given that NTL had a small share of the fixed line retail telecommunication market (6.3 per cent), it considered that the interconnection agreements could not have a major effect on competition in the UK. We summarize the views of the parties on the agreement in paragraphs 6.94 to 6.101, 6.119 to 6.127, 6.191 to 6.209, 6.224 and 6.225.

Discriminatory terms

3.119. The original Heads provided that for national traffic terminating on the other party's network, each party agreed [Details omitted. See note on page iv.]. However, this provision was removed in the amendments of 9 February 2000. CWC told us that the OFT took the view that this provision had involved a registrable restriction under the Restrictive Trade Practices Act, a point that the parties said they were challenging.

Roll-out of ADSL

3.120. NTL said that there was a family of products which may be used to provide fast Internet access and other 'broadband' services over the next three years. ADSL is one of a family of technologies that enable broadband to be offered over the existing copper telephony network. Cable modems provide similar capabilities over the fibre network of cable companies. Wireless technologies may also appear to provide broadband capability.

3.121. NTL told us that it was currently installing an ADSL pilot in its Surrey franchise and planned to roll-out up to 1,000 ADSL lines in the year 2000 clustered in two towns at a projected cost of £1.3 million. It said that its network modems will be included at the street cabinet level, compared with BT which will have the equipment at the local exchanges. It therefore considered that its costs per customer would be more than £676 per subscriber with the current technical design. Because its connections would be closer to the customer, it felt its service could be faster than in the case of BT. It therefore said that its intention was to offer ADSL to the business sector, where customers were more likely to pay a premium for higher-speed access, but it had not yet set prices or completed the technical designs.

3.122. Under its current trials, NTL said that the price of its cable modems was a monthly charge of £40, and this gave the customer unlimited use. This was broadly comparable with prices recently announced by BT at a wholesale level, which could turn out to a retail price of £59 a month. The user also would need to acquire the modem at £149.99 under the BT proposals, which NTL said it subsidized via the distributor. The present service is configured to provide speeds greater than 512 Kb per second. It expected the price of modems to fall to £100 over the next three years.

3.123. NTL commented that the monthly subscription cost of cable modem services in the USA seemed to have fallen by 25 per cent over the past 18 months, which it suggested was a reflection of competition between ADSL and cable modems.