European General Court Hears Cisco's Appeal of the EC's Decision in Microsoft/Skype Deal

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On May 28, the European General Court in Luxembourg heard arguments on Cisco's challenge of the European Commission's ruling regarding Microsoft's $8.5 billion acquisition of Skype. The Commission decided in October 2011 not to oppose the acquisition, and the US agencies granted early termination of the deal that June. In a blog post published at the same time as its appeal before the General Court, Marthin De Beer, Cisco's Senior Vice President of the Video and Collaboration Group, noted that Cisco did not oppose the merger, but believed that the Commission should have imposed interoperability conditions on Microsoft as part of the Decision.

Cisco's appeal has two substantive bases, one relating to the "consumer unified communications market" and one relating to the "enterprise unified communications market." In each case, "unified" markets refers to the idea that the communications markets affected by the transaction comprise a number of technologies that customers might use to communicate and that are provided by the parties. The unified communications market for consumers includes voice calls, video calls and instant messaging. The unified communications market for enterprise includes those technologies and others used in the enterprise communications business such as voice and videoconferencing, advanced telephony, and collaboration tools.

But as De Beer's blog post commented, the appeal "is about one thing only: securing standards-based interoperability in the video calling space." De Beer noted that Microsoft's plan to integrate Skype with its Lync Enterprise Communications Platform "could lock-in businesses who want to reach Skype's 700 million account holders to a Microsoft-only platform."

On the consumer side, the deal did appear to significantly increase concentration in the video call market, at least on initial inspection. The Commission had noted in its decision that the transaction would provide the combined entity with a market share of eighty to ninety percent of video calls, and acknowledged that the transaction created a "market leader." The transaction left the combined company with significant market shares in the other technologies in the consumer unified communications market as well. But unlike the other technologies in the unified market, prior to the transaction both parties to the transaction had significant market shares in providing the video call service in the EU, particularly between Windows computers.

The Commission rejected the idea that this increased concentration would harm competition in the video call market based on a number of considerations. First, the Commission noted that the market shares were likely to overstate the true market power of the parties because they provide free services to consumers. The Commission seemed particularly impressed by a Skype internal document that had noted that more than seventy-five percent of its customers would switch to an alternative provider if it started charging for its services. It was not clear from the Commission Decision whether the internal memo had assumed the existence of Microsoft's competing product in its analysis, but the Commission noted that there were a number of new rivals to the merging parties in the space, including Google and Facebook (although Facebook currently uses Skype for its video calling services to consumers). The Commission also noted that firms like Facebook and Google have an advantage over Microsoft because they provide their services as part of a broader social networking service that the Commission found consumers preferred.

The Commission also noted that the use of Microsoft's video call service was declining prior to the merger, including a decline of up to thirty percent between November 2010 and May 2011. The Commission did not identify how many of those consumers had moved to Skype however, and did not identify any facts to indicate that the Microsoft product was part of a failing/flailing division or that Microsoft was thinking about cancelling or reducing the scope of its service. The Commission also indicated that consumers were increasingly moving to tablets and smartphones for video calls and that Microsoft's product did not participate in that part of the market.

In evaluating the importance of network effects in the transaction as a whole and with respect to video calls in particular, the Commission appeared to minimize the importance of network effects as a source of market power in these markets. The Commission noted with respect to network effects that consumers generally only contact their "inner circle" which is a small enough number of people to limit the costs of switching a consumer's entire network of contacts to another network. Also making switching easier, according to the Commission, is the fact that many consumers "multi-home." That is to say that many already use other services so switching requires less effort.

The Commission's decision does little to tell parties when network effects are important and when the "inner circle" effect will dominate. It is generally true that consumers' private networks are far smaller than the networks provided by the services they use. But conceptually, a user's inner circle in video calling would likely not be much different from the telephone system run by AT&T in the US prior to its break-up, or any other network. In a sense, the Decision appears to allow the exception – consumers' inner circles – to swallow the rule where network effects seem prevalent. It will be interesting to see if the court identifies factors relevant to the decision of when the inner circle effect dominates over factors that would indicate that network effects make it hard for consumers to switch.

On the enterprise side, the appeal is focused on the ability of enterprise competitors to Microsoft to interoperate with the services and allow their customers to communicate with Skype users. The Commission evaluated a number of arguments relating to the impact on markets of Microsoft's allegedly reduced incentives to interoperate as a result of the deal. Among the arguments it considered were claims by "providers of enterprise communications services" that the acquisition would reduce Microsoft's incentives to interoperate with them.

Because Skype did not appear to compete strongly in the enterprise market prior to the transaction, the most salient competitive effect seemed to be on markets where enterprise customers wanted to communicate with their customers through video calling, specifically the market to supply technology to call center operations. The Commission rejected arguments that the transaction would reduce competition in these markets, noting that Skype did not offer a call center product pre-merger, and that the services it did provide were poorly suited for call center use for a variety of reasons. Further, the ability of competitors to reach customers using Skype would not change as a result of the merger as it was likely that Microsoft would continue to freely distribute the software used for Skype calls, and even if it did not, there were a number of free options that call centers could use instead.

Given that the transaction, by allowing Microsoft to integrate its enterprise products with the user base of Skype, would appear to make Microsoft a tougher competitor against the other enterprise providers, the challenge for Cisco is to find a way to demonstrate that the transaction will lead to reduced competition and not simply a better Microsoft product against which it will be harder to compete. Since Cisco might appear to be requesting that the services affected by the transaction should be more interoperable after the order than they were in the marketplace before the deal, it will be interesting to see whether they get traction with the court.