# Then and now: The Telkom and Business Connexion merger

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In 2007, the Competition Tribunal of South Africa ("Tribunal") prohibited the merger between Telkom SOC SA Limited ("Telkom") and Business Connexion ("BCX"), following a recommendation for prohibition from the Competition Commission of South Africa ("Commission"). At this time, Telkom was the *de facto* monopoly provider of fixed line infrastructure and services and BCX was an ICT provider. The merger was prohibited on the grounds that it would result in a substantial lessening or prevention of competition in the managed network services market based on a horizontal evaluation.[1]

In 2015, a merger between the same firms has not only been approved without conditions by the COMESA Competition Commission, but has been recommended for approval with conditions by the Commission as the parties await approval by the Independent Communication Regulator of South Africa (ICASA).[2] In this article we assess the market conditions under which the merger was previously prohibited; as well as the prevailing market environment in which it has now been approved, subject to conditions.

In order to understand the context in which the merger has now been approved, it is useful to have some understanding of the structure of the ICT market, the dynamics of competition, and how these have changed over time.

The ICT market is broadly divided into four tiers, namely IT application services, IT hardware, network services, and telecommunication infrastructure. IT hardware is often managed by IT providers who resell, install and manage the hardware. In addition to the role of IT providers, IT application services operators provide software-related services, including development and support. IT network service providers connect and manage local area networks (LAN), wide network areas (WAN), internet access and other services. The last tier comprises the telecommunications infrastructure categorised as transmission services and access connections.[3]

There are instances where a managed network service (MNS) provider can own a network by acquiring a license from ICASA. These providers were called value added network services (VANS) under the Telecommunications Act (in place until 2005). The industry has undergone and continues to experience a number of changes, particularly since a technology neutral framework was introduced through the Electronic Communications Act in 2005.[4] This new framework, in addition to declining communication costs, has resulted in increased competition, and growth of the sector.[5]

### *The Tribunal's decision in 2007 - Market structure and anti-competitive concerns*

The Tribunal analysed the effects in three relevant product markets which were: Supply of telecommunication infrastructure; Managed Network Services; and Information Technology Services.[6]

Telkom was the only supplier of fixed line infrastructure, and did not face significant competition until the entry of the second network operator, Neotel in the mid-2000s. Telkom had a subsidiary in the MNS market, where BCX was also present.[7]

In 2006, Neotel secured a partial national and metropolitan backbone network independent of Telkom's network. It was offering wholesale services in the form of wholesale internet and global services through Teleglobe with a geographical coverage of approximately 0.5% of South Africa's land area which included Johannesburg, Pretoria, Cape Town and Durban. One of the great barriers that new participants faced was that there were no unbundled local loops available for lease from Telkom. New entrants are able to roll out local loops however this is challenging as it entails digging up streets and pavements which requires municipal approval and other bureaucratic requirements. The infrastructure that Neotel had was inadequate for country-wide access to companies and thus required Telkom and/or Eskom's infrastructure to cater for such needs, should they arise. Even though Neotel had the right to access Telkom and Eskom's infrastructure, this was only for a limited period. In addition, Eskom's network was incompatible for city or metro connections as it was designed to service the internal needs of Eskom's power stations. Despite these barriers, Neotel projected to gain 8-9% of Telkom's market share within 5 years, by 2012. Given this time frame, Neotel was not in a position to compete effectively at the time of the first proposed merger.[8]

The downstream MNS market includes the provision and management of enterprise WANS and VPNs including IP-VPNs and the necessary equipment such as routers, switches; but excluded Telkom's fixed access lines. In this segment, Telkom had a market share downstream of between 38.5% - 50% while that of BCX was approximately 8.7%. The only other significant rival in this market was Dimension Data (Didata) whose market share was 13% such that the merger would have increased concentration and lessened competition.[9]

The submarkets in IT services include application management, information systems outsourcing, network and desktop outsourcing, and hosted application management. BCX was primarily involved in the provision of IT services. It had between 12% and 19% market share in the ITS market, and 17.7% to 20% in the outsourcing segment, making it the

largest operator.[10]

Therefore, there were clear vertical and horizontal overlaps in the business activities of Telkom and BCX in the ICT industry. BCX and Telkom were competitors horizontally in the MNS market, and had vertical relations from the fixed line services to the IT services market. The Tribunal found that the proposed merger between these two companies in 2007 would have led to anti-competitive effects.

The telecommunications sector is characterised by high barriers to entry which include high capital requirements and economies of scale, among other factors. There are also network externalities, which imply that consumers are attracted to a network that has a large customer base where they benefit from lower on-net communication costs. The high barriers to entry, and the unwillingness of consumers to shift to new networks meant that Neotel was not a timely and sufficient entrant to counter any competitive harm by Telkom. A merger of this nature would ultimately thwart the success of Neotel, leading to its subsequent demise.[11]

The Tribunal found that the lack of a rival to Telkom would have given rise to unilateral effects. In the MNS market, Telkom would be able to raise the prices to just below that of innovative products such as VPNs that consumers are likely to switch to. Secondly, even though the bundle price in the telecommunications industry was regulated at the time, the price of one component could have been increased at the expense of another – with the bundle price still remaining the same – in order to increase the merged entity's margins.[12] Indeed, in 2008 the regulation of the bundle price was removed.[13]

The Tribunal was also of the view that Telkom, due to its dominant position, could offer discounts to secure customers, and discriminate between customers in terms of price until rival firms, who would not be able to match the effective prices, had exited the market.[14]

With respect to vertical effects, the concerns that were raised included the possibility of Telkom foreclosing its rival firms in terms of access to inputs in the downstream market.[15] In the telecommunications industry, the ITS market is unregulated while monopolies are cost regulated. As such there was an incentive for Telkom to vertically integrate into unregulated markets such as the market in which BCX operated.[16]

### *What has changed? Market structure and regulatory changes since 2007*

The telecommunications industry has changed significantly including the fact that the revenue from voice calls has declined, while revenue from data has increased which provided scope for new rivals to compete in the provision of data services. Furthermore, firms are moving towards convergence where previously separated resources such as voice, data and video can now share resources and interact with each other. This can enable businesses to better their mobility, efficiency and productivity; while individuals have more connectivity options.[17]

There has also been an increased need for IT service providers to broaden their portfolios and this has resulted in an influx of acquisitions involving firms in adjacent sectors as providers seek to meet the diverse and complex requirements of customers. Telecommunications operators are acquiring or merging with network-related services and providing cloud and data centre services, while hardware providers are pushing the benefits of integrated systems and offering specialised implementation services.[18] Most recently, Vodacom proposed the acquisition of Neotel which is set to pose competition to Telkom.[19]

In 2014, Telkom again proposed to acquire BCX, which would lead to BCX delisting from the JSE. The Commission and subsequently the Tribunal recommended the approval of the merger, with behavioural and employment conditions. The parties now await approval from ICASA. Telkom has stated that the merger will assist them in addressing the technology and communication needs of South African businesses through the creation of this ICT company. BCX has since grown their services base which enables Telkom to offer better services to customers.[20] In the IT services sector, BCX is now the largest player in this industry followed by Didata and T-Systems.[21]

Telkom still remains the *de facto* monopoly in fixed line services despite the entry of Neotel in 2006.[22] Neotel's market share is set to increase to 14-16% in the year 2016/17 from a market share of approximately 6% in 2012. Neotel is increasing its national capacity including its investment in 12 000km of fibre network around SA and the long distance links between Johannesburg and Durban, and Johannesburg and Bloemfontein. Neotel also has an international presence through access to Tata's 365 000km underwater fibre, connecting 300 cities in 200 countries across six continents.[23] Following the merger with Vodacom, Neotel is set to grow significantly in the fixed line market, and position itself as a stronger competitor to Telkom.[24] These likely developments in the market suggest that although the merged entity would be a significant player across adjacent markets, there is a greater level of rivalry at various levels of the market for the merger to have been approved subject to access conditions.

There have also been regulatory advancements with ICASA implementing asymmetrical cost-based call termination rates in September 2014. The asymmetry and lower rates led to the growth of mobile usage in the market. Neotel has indicated that the revised call termination rates assisted the firm in reducing their costs. This resulted in a decrease of their calling rates which saw them substantially increasing their consumer base.[25]

The changes in market structure and regulation have coincided with the decision of the Commission to approve the merger, with conditions. Changes in the market suggest that Telkom and BCX may face greater competition at present than they did in the past. Nonetheless, Telkom remains the largest supplier of wholesale leased lines and has the ability

to foreclose downstream rivals in terms of access to essential inputs for the provision of downstream services such as MNS, VANs and IT solutions. To deter the likelihood of input foreclosure, the Commission proposed that Telkom:

- Ensure that the prices for wholesale leased lines are based on actual lines utilised and priced at the non-discriminatory transfer price for common components.
- Ensure that the prices for the other services and/or components included in the bundle are based on actual costs incurred.
- Ensure that it does not set prices for its bundled offerings using wholesale leased lines at levels which are less than the sum of the costs of components in the bundle. In other words, the principle is that the prices for wholesale leased lines included in the bundle must exceed the cost applied in internal pricing and the revenues generated from the bundled offering and must exceed the costs associated with providing the bundle plus a positive margin.
- Ensure that when providing any bundled offering which includes wholesale leased line, the price complements for each individual service included in the bundle is clearly reflected in the overall price for the bundle.[26]

The Competition Commission also assessed the likely public interest effects on this merger. The merger would likely result in the retrenchment of maximum of 60 employees. To counter the effects of these retrenchments, the Competition Commission proposed that the losses should be limited to 20 employees per year.[27]

### *Conclusion*

The dominance of Telkom in the fixed line services continues and Didata is now the market leader in the IT services sector. However the entry of Neotel and the proposed acquisition by Vodacom are set to change the market. It remains to be seen whether other developments in the market such as the growth of rivals such as Didata are sufficient to discipline against any foreclosure or unilateral effects considered by the Tribunal in its earlier decision. Certainly, the conditions speak to the primary foreclosure concerns, however as noted in the earlier decision the pricing of the bundle of services offered by Telkom is complex and subject to manipulation by the incumbent.

## Notes

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6. See note 1.
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9. See note 1.
10. See note 1.
11. See note 1.
12. See note 1.
13. See note 4.
14. See note 1.
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16. See note 1.
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24. See note 23.
25. Parliamentary Monitoring Group. 'Costs of telecommunications: Department of Telecommunications, ICASA Vodacom, MTN, Cell C, Telkom & Neotel briefings'. Parliamentary Monitoring Group Briefings, 7 November 2014.
26. Competition Commission of South Africa. 'Commission recommends approval of Telkom/BCX merger with conditions.' (14 May 2015). Media Release on key decisions on Mergers and Acquisitions.
27. See note 26.