

COMPETITION TRIBUNAL OF SOUTH AFRICA

Case No: 51/LM/Jun06

In the matter between:

Telkom SA Limited

Acquiring Firm

And

Business Connexion Group Ltd

Target Firm

Panel : D Lewis (Presiding Member), Y Carrim (Tribunal Member) and U Bhoola (Tribunal Member)
Heard on : 12-16 March 2007, 28-30 March 2007, 02 April 2007, 18-25 May 2007 and 21-22 June 2007
Order issued on : 28 June 2007
Reasons issued on : 20 August 2007

Non-Confidential version of Reasons for Decision

Approval

[1] This transaction constitutes a large merger as defined in terms of the Act. In terms of section 16(2)(c) of the Act, the Tribunal prohibited this transaction on 28 June 2007. The reasons for our decision follow.

The parties

[2] The primary acquiring firm is Telkom SA Ltd (“Telkom”). Telkom is a telecommunications services provider and is listed on the Johannesburg Securities Exchange as well as the New York Stock Exchange.¹

¹ For a shareholding structure of Telkom please see page 2 of the Commissions report.

[3] [2] The primary target firm is Business Connexion Group Ltd (“BCX”).² BCX is an Information and Communications (“ICT”) company and is listed on the Johannesburg Securities Exchange.³

The transaction

[4] In terms of the proposed transaction, Telkom intends to acquire the issued share capital of BCX.⁴ The proposed transaction will be implemented by way of a scheme of arrangement in terms of section 311 of the Companies Act No.61 of 1973.

Activities of the parties

[5] Telkom is the incumbent provider of fixed line Public Switched Telecommunications Services (“PSTS”) and it offers fixed line voice and data services. Telkom is also a key player in the market for Value Added Network Services (“VANS”). Until recently, Telkom was the *de jure* monopoly provider of fixed line infrastructure and services.

[6] BCX is active in the Information and Communications Technology (“ICT”) sector and it provides ICT based services to a broad range of clients, including JSE-listed organizations, government and medium sized companies. BCX describes itself as a “leading integrator of competitive, innovative and practical business solutions based on Information and Communication Technology.”⁵ BCX provides network related IT services, network design and implementation services, WAN

² For the ownership structure of BCX please see a diagram on page 9 of the Commission’s report.

³ The shareholders having more than a 2% shareholding in BCX Group are: Liberty Life Association of Africa Ltd 11.19%; Shareholder Not Within Limit 8.59%; Public Investment Commission (“Stanlib”) 4.77%; Public Investment Commissioners 4.67%; Sanlam Institutional Special Opportunities Fund 3.01%; Public Investment Commission Equity (“Futam”) 2.64%; Sanlam 2.54%; Deutsche Securities Scrip Collateral Account 2.35%; Business Connexion Technology 2.22% and Comparex Holdings Share Purchase Trust 2.20%.

⁴ Other than the BCX shares held as treasury shares, shares held by the Comparex Holdings Share Purchase Trust and shares held by the BCX Share Incentive Trust

⁵ BCX website, www.bcx.co.za

management services as well as business applications to large enterprises. It is a CISCO accredited organisation.⁶

Background to hearings

- [7] The Commission had recommended that the merger be prohibited. A number of objections had been received. Three parties, namely Internet Service Providers Association (“ISPA”), Dimension Data PLC (“Didata”) and Gadlex (Pty) Ltd (“Gadlex”) were admitted as interveners in the Tribunal’s proceedings. ISPA and Didata were opposed to the merger, Gadlex was in support of it.
- [8] The hearings in the matter took place on 12-16 March 2007; 28-30 March 2007; 02 April 2007; 18-25 March 2007 and 21-22 June 2007.
- [9] The following witnesses gave evidence: Dr Giulio Federico⁷; Mr Hendrik Arnoldus Matthyser⁸; Mr Micheal Afred Sewell⁹ ; Mr Arnold Esias Van Huyssteen¹⁰; Mr Peter Anthony Watt¹¹; Dr Angus Hay¹²; Dr Setumo Mohapi¹³; Mr Derek Wilcocks¹⁴; Mr Micheal Brierley¹⁵; Mr Ewan Sutherland¹⁶; Mr James Hodge¹⁷; Professor Emanuele Giovannetti¹⁸ and Mr Stephen Bosman¹⁹.
- [10] ISPA is a voluntary industry association established to represent the interests of South African Internet Service Providers. ISPA members

⁶ For more details on BCX’s business activities see its website and the Commission’s Recommendation.

⁷ Economist CRA International

⁸ Executive: Business Integration Services, Telkom

⁹ Group Executive, Outsourcing BCX

¹⁰ Executive: Product Management-Retail Marketing, Telkom

¹¹ Chief Executive Officer, BCX

¹² Executive Head of Strategy: Neotel

¹³ Director of Telecommunications: ICT Works (Pty)Ltd

¹⁴ Services Director of Dimension Data

¹⁵ Chief Executive Officer: MTN Network Solutions (Pty)Ltd

¹⁶ Independent Telecommunications policy analyst

¹⁷ Economist: Genesis Analytics

¹⁸ Associate Professor, School of Economics, University of Cape Town

¹⁹ Chief Strategy Officer, Gijima AST

are competitors of Telkom and, in some cases, of BCX. ISPA members are also customers of Telkom.²⁰

- [11] Didata is a specialist IT services and solutions provider that assists and advises its clients in respect of the planning, building, maintenance and support of their IT infrastructures as well as rendering WAN management services. Didata is also a customer of Telkom and competes with it in the downstream MNS market.
- [12] Gadlex Holdings is BCX's black economic empowerment partner and has a 25% shareholding in this company.
- [13] The Commission's investigation revealed that the transaction has horizontal, vertical and portfolio dimensions. In its analysis of the proposed transaction the Commission found that Telkom and BCX overlap in the market for the provision of electronic communications services in the sub-market for managed network services ("MNS"). According to the Commission, the merger will lead to the removal of an effective competitor, and a high market share for the merged entity in the MNS market, which will enable it to act unilaterally without regard to its competitors' behaviour. ISPA shared this concern.
- [14] The Commission, ISPA and Didata also submitted several theories of harm in relation to the vertical and conglomerate effects of this merger. The opponents of the merger argued that post merger, the merged entity will have the ability and the incentive to -
1. Engage in input foreclosure of its rivals in the downstream MNS and ITS markets, who rely on leased lines as inputs, through raising rivals costs, refusal to supply, margin squeeze, frustration of access, quality degradation and delays in installation and fault repairs;

²⁰ See page 51 of the transcript.

2. Engage in customer foreclosure by influencing customers to divert demand away from Neotel's²¹ infrastructure and PSTS services;
3. Engage in mixed bundling of PSTS, MNS and ITS services which will give rise to anti-competitive effects.

[15] In addition the Commission submitted that the merger was taking place in an industry which had until recently been dominated by Telkom's monopoly. The introduction of competition to Telkom, in the form of Neotel, was in its nascent period and any accretion of market share by Telkom in the MNS market or any competitive advantage it acquired over its rivals across the three relevant markets would have a substantial impact on an industry plagued by high prices and bottlenecks. The Tribunal was asked to protect the first shoots of competition by prohibiting this merger. ISPA argued that the merger was taking place at a time when the industry is moving towards convergence and that the MNS market was the battleground for convergence. Any enhancement of Telkom's ability to deter entry or expansion of its rivals— through any of the strategies discussed above - would lead to a substantial lessening of competition. Didata submitted that, through this acquisition, Telkom sought to extend its monopoly into the new converged space as well as protecting its current monopoly in infrastructure and PSTS services.

[16] Gadlex, argued that Telkom no longer had a monopoly in the infrastructure market and that in any event there were technical substitutes for fixed leased lines in the MNS market. The merging parties submitted that the vertical theories of harm raised by the Commission and the objectors would not result in the effects claimed by the Commission because *inter alia*, they were either not merger specific, were mutually exclusive and would not be profitable for Telkom. They argued further that the horizontal overlap between Telkom and BCX was too small to raise competition concerns. In any

²¹ Neotel is the newly licensed competitor to Telkom. It was previously known as the second national operator (SNO).

event, they submitted, if the Tribunal had any concerns about the anti-competitive effects of the horizontal overlap, they would offer a divestiture of BCX Communications (“BCX Comms”)²², a subsidiary of BCX, as a remedy.

BACKGROUND TO THE TRANSACTION

- [17] This transaction takes place in the ICT industry which is currently undergoing rapid regulatory changes.
- [18] A common thread that runs through the opposing parties’ submissions is that the telecommunications sector has only recently experienced the introduction of competition through the licensing of Neotel and the de-regulation of the industry. However to a large extent, Telkom still remains the *de facto* monopoly supplier of infrastructure and domestic and international PSTS services. It is also a dominant player in the MNS market. All three parties suggest, in different permutations, that if Telkom were permitted to acquire BCX, this would lead to a lessening of competition in the MNS and ITS markets. In addition it would enable the merged entity to utilize a number of strategies in order to *retard* Neotel’s expansion into the PSTS and MNS markets and hence *retard competition* in the telecommunications sector. They do not suggest that the merger will prevent Neotel’s entry into the market, but argue that its expansion and therefore the introduction of competition in the sector, across all three markets, will be reduced or retarded.
- [19] It is now generally accepted that the industry is moving towards convergence. This trend towards the convergence of voice and data services, broadcasting and telecommunications, and fixed and mobile services – with a single integrated receiver and number that allows the subscriber to move seamlessly between networks – paves the way for a new complex and integrated value chain of services and service

²² BCX Communications is a subsidiary of BCX through which BCX offers an IP VPN product.

bundling opportunities which has supplanted the classically linear value chain. It is anticipated that in future all services will originate from infrastructure that may be composed of multiple and distinct networks that seamlessly integrate to create a modern information backbone known as Next generation Networks, NGNs.²³ NGNs allow for lower-cost, IP-based services to be transmitted over single platforms. These developments require that any value-chain analysis of operators, services or ICT companies be dynamic, flexible and open-ended.

[20] A major implication arising from these trends is the huge increase in available transmission capacity, historically a scarce resource. This effectively means that the marginal cost of the network capacity that is required to provide carriage services is insignificant and may even be approaching zero. Network infrastructure is increasingly being characterized as a fixed cost. The implication of these trends for the global telecoms industry is that networked business models will increasingly be based on services rendered rather than on basic connectivity. Basic connectivity in the context of convergence is the transmission of bits and bytes and is regarded as a commodity. In conjunction with the changing dynamics of the telecoms industry, the role of regulation has extended from concentrating on consumer disputes, universal services issues and price setting to much broader role of regulating the sector to enable competition.

[21] An important factor to bear in mind is that while the industry is moving towards convergence it continues to remain a network industry characterized by network externalities. In such industries, initial market leaders – whether these are in technical innovation or in high value subscribers - tend to be favoured. The communications sector, as much as it is driven by rapid technological developments still remains a *network industry*, a factor which seems to have been completely overlooked by the merging parties in their arguments and expert

²³ See 2006 South African ICT Sector Performance Review Link Public Policy Research Paper No 8, January 2007.

testimony.²⁴ Whether the industry is moving towards an information industry or convergence, driven by changes in technology, the applicable economic laws do not change. Technological advances may result in new markets or require that we define the boundaries of those markets differently, but the basic economic principles in relation to network industries remain durable over time.²⁵

[22] In this transaction we have concluded that the merger will result in a substantial lessening or prevention of competition in the MNS market, which has been described as the battleground for convergence. In our view this transaction is an attempt by an erstwhile monopolist to thwart the beneficial impact of de-regulation in the form of greater economies of scale and scope for rival MNS providers and lower costs for customers. It is also an attempt by an erstwhile monopolist to stifle innovation in order to maintain its hitherto monopoly margins in infrastructure and voice services

[23] While we note that the merger, if it had been approved, could have had some detrimental impact on Neotel in its entry or expansion in both the infrastructure and MNS market, we signal our concern that the merger is, in part for this very reason, likely to result in co-operation between Neotel and Telkom in relation to warding off the threats posed by the de-regulation of the MNS market and the consequent growth in competition and innovation in that market. We express the concern that the acquisition could have provided Telkom with an unregulated subsidiary through which it would seek to evade regulation.

[24] We also find that the merger is taking place in a pivotal segment of the ICT sector which has a significant impact on the international competitiveness of South African firms generally, and that the merger is likely to impact negatively on the public interest.

²⁴ CRA's economic arguments and calculations took no account of a dynamic market or a market characterized by network effects.

²⁵ See in this regard Shapiro & Varian "*Information Rules – A strategic guide to network economies*" Harvard Business School Press, 1999

- [25] We turn now to consider the impact of the de-regulation announced by the Minister in September 2004 and some recent regulatory developments in the sector. However as a prefatory remark, we suggest that the word “convergence” be used with a degree of caution. Convergence is the new buzzword and those that are familiar with the ICT industry tend to use it as shorthand for many things, which may not necessarily translate easily into competition law analysis. For example, in this transaction, it was often remarked that the MNS and ITS *markets* are converging. While there is a technological convergence of voice and data in the telecommunications sector which is resulting in a new integrated offering in the MNS or ITS market, this is not equivalent to saying that the MNS and ITS *markets* are converging into one market.
- [26] The de-regulation of VANS by the Minister is also referred to as convergence, not wholly inaccurately. What is meant here is that the technical convergence of voice and data, which was commercially available previously but was restricted by regulation, can now be deployed. However the sharing, sub-letting, and ceding of infrastructure is not necessarily convergence but is now possible as a result of de-regulation. Convergence of the sector does not necessarily translate into consolidation of the sector, which denotes a specific economic concept in relation to market structure.
- [27] Convergence may result in an expansion of the services that constitute the MNS market, and would include services that were previously located in the ITS market, but the markets for purposes of competition law analysis are themselves not necessarily converging. There will always be IT companies who provide equipment and hardware and utility applications but who do not provide MNS solutions to enterprises.

[28] For ease of convenience and purposes of completion, we have included in annexure A a glossary of terms used by us in these reasons.

Dynamic regulatory environment

[29] Until recently the telecommunications sector was dominated by a fixed line monopoly in the form of Telkom with limited competitive activity in the MNS market.

[30] Telkom SA Ltd started out in 1991 as a state owned enterprise housed in the then Department of Posts and Telegraphs.²⁶ Under the old Apartheid regime, it provided services to the residential and corporate market on the basis of the policies of that regime. Hence it was rare indeed to find residential telephone services in black townships. The Postmaster General and the Department of Posts and Telecommunications, retained general regulatory functions and continued to regulate the telecommunications industry until the Telecommunications Act 103 of 1996.

[31] After 1994 the democratic government embarked on the formulation of a democratic policy process for the telecommunications sector. This process culminated in the 1996 White Paper and the subsequent Telecommunications Act 103 of 1996 (“Telecommunications Act”) and led to the modernization of telecommunications in South Africa. The government adopted a policy of managed liberalization in which it envisaged that Telkom would be partially privatized and be granted a period of exclusivity in return for universal service obligations. In 1996, 30% of Telkom was sold to the Thintana Consortium LLC (“Thintana”), a partnership between Malaysia Telecom and SBC Communications (“SBC”). SBC is an experienced American telecommunications

²⁶ The Post Office Amendment Act 85 of 1991 provided for the establishment and incorporation of Telkom SA Limited and the South African Post Office Limited. Prior to that telecommunications services were rendered by the Department itself.

company which cut its teeth in the AT & T stable.²⁷ Telkom was granted a five-year period of exclusivity in its license with an option to extend it for a further year if certain conditions were met. In return Telkom was under an obligation to roll out a certain number of lines to underserved areas (which at that stage constituted the vast majority of South Africa) and to make contributions to the Universal Service Fund. In negotiation with the then Minister of Communications, Telkom agreed on a rate regime²⁸ which regulated some aspects of its retail tariffs. As part of the agreement with government Telkom also invested in the SAT-3/WASC/SAFE submarine cable system, which provides increased fibre optics transmission capability between South Africa and international destinations. It also concluded a shareholders agreement with government, the provisions of which are still secret.

[32] In that same year, in accordance with international best practice, an independent regulator, the South African Telecommunications Regulatory Authority (“SATRA”) now Independent Communications of South Africa (“ICASA”) was established to regulate the telecommunications sector. Part of its legislative mandate was to set standards, issue spectrum and service licenses, produce an annual frequency plan, approve equipment (all of which was previously done by the department), arbitrate disputes between licensees and prescribe fees and tariffs for markets in which there was insufficient competition.²⁹

[33] The effect of Telkom’s exclusivity rights was that it continued to be the sole supplier of domestic and international PSTS services in South Africa. All other telecommunications operators and service providers were required to obtain their facilities from Telkom and no other licensee could provide local, national and international voice services. The only area of competition (apart from competition in customer

²⁷ It was spun off as part of the AT& T divestiture which took place on 1 January 1984.

²⁸ This was referred to as the Minister’s Determination in the 1996 Act

²⁹ These are referred to as rate regimes.

premises equipment) was in the provision of value added network services but this was also restricted by legislation.

- [34] Value Added Network Service (VANS) was a license category in the 1996 Act. Many services could be provided under this license category, including managed network data services and internet services. VANS providers would purchase infrastructure from Telkom and render services to enterprises over networks designed and constructed by them in accordance with their clients needs. However, in terms of s40(3) of the Telecommunications Act VANS could not provide voice, could not use Voice over Internet Protocol (VoIP), and could not resell, sublet or cede the infrastructure leased from Telkom.
- [35] By 2002, Telkom had rolled out some 2.8 million lines but had disconnected some 70% of these.³⁰ While access to telephony had improved for previously disadvantaged South Africans and the country experienced improvements in teledensity, this was largely due to the success of mobile services. At the end of Telkom's five year exclusivity, South Africa had experienced a net decline in fixed line penetration and internet. Telkom's pricing structure was considered to be excessive and was widely thought to be adversely impacting growth in the South African economy.³¹
- [36] In 2002, the Minister issued an ITA³² for a second national operator, a competitor to Telkom. Telkom elected not to extend its exclusivity period.³³ The licensing of the SNO as it was known then began in 2002 and ended on 09 December 2005.

³⁰ See Telkom Annual Report 2001.

³¹ See, William H Melody, Vodacom Visiting Professor in ICT Policy & Regulation, LINK Centre, Graduate School of Public and Development Management, University of Witwatersrand, November 2002, "Assessing Telkom's 2003 Price Increase Proposal". See also report by Genesis Analytics on behalf of the South African Foundation, April 2005.

³² Invitation to Apply

³³ In 2004, Thintana sold its shares to the Public Investment Corporation ("PIC") which sold onto the Elephant Consortium.

<http://brainstorm.itweb.co.za/online/ReadStory.asp?StoryID=152675>

- [37] Neotel has the same rights in its license as Telkom does³⁴ but in addition has the right to use Telkom's infrastructure for a period of two years. In preparation for its entry and to enable it to compete in a market dominated by Telkom, ICASA promulgated a number of regulations which set out rights and obligations in relation to number portability and carrier pre-select between Telkom and Neotel.
- [38] Neotel's licensing process has been extremely drawn out and at the time of the writing of these reasons, it seemed to have experienced numerous internal and external hurdles to launching its commercial operations.³⁵
- [39] In September 2004, several announcements made by the Minister of Communications propelled the industry into probably its most dynamic phase ever. In terms of these announcements, mobile operators could utilise any fixed lines that may be required for the provision of the service including fixed lines made available by Telkom or any other person providing a PSTS. Value Added Networks Services could carry voice using any protocol; they could render their services by means of telecommunications facilities other than those provided by Telkom and the Second National Operator. They and PTNs were now entitled to cede or assign the right to use, or to sublet or part with control or otherwise dispose of telecommunications facilities used for the provision of value added network services. All of these were to be effective on 1 February 2005. The Minister explained that the two important policy objectives driving the announcements were the need *to lower the cost of doing business in South Africa* and to liberalise the ICT sector. In furtherance of these objectives, she was promoting *choice for service providers, efficient usage of bandwidth and growth in the value added network services.*³⁶

³⁴ See the definition of PSTS services in the 1996 Act.

³⁵ See Dr Hay's evidence and the debates in Parliament regarding Infraco.

³⁶ See the Minister's Announcements dated 2 September 2004.

[40] The Electronic Communications Act (“ECA”) came into effect on the 19th of July 2006. The ECA repealed the Telecommunications Act. The ECA is part of the new converged regulatory framework for the ICT sector aimed at *lowering costs* of access to the ICT sector and increasing the efficiency of telecommunications services provisioning in the country. The ECA seeks to inter alia, promote convergence in the broadcasting, broadcasting signal distribution and telecommunications sectors, provide the legal framework for convergence of these sectors, make new provision for the regulation of electronic communications services, electronic communications network services and broadcasting services, provide for the granting of new licences and new social obligations, provide for the control of the radio frequency spectrum and provide for continued existence of the Universal Service Agency and Universal Service Fund.

[41] However, despite the recent regulatory initiatives designed to liberalise the telecommunications sector, we must not lose sight of the fact that, to date, Telkom has a virtual monopoly of fixed line South African subscribers, whether these are corporate or residential. This should come as no surprise since until recently it enjoyed a *de jure* monopoly status and for all intents and purposes continues to remain the overwhelming dominant supplier of infrastructure in this market, and provider of local, national and international telecommunications in the country. Equally important, and as a consequence of its monopoly status, Telkom has the *largest footprint* of infrastructure in the country. Its network runs to some thousands of kilometres and it is able to access every small and large town through its extensive local loops. It has been, and still remains, on the one hand the sole supplier of infrastructure and connectivity to other players such as mobiles, PTNS and VANS, and, on the other hand, a competitor of VANS.

[42] We turn now to consider the impact of the de-regulation on the MNS market.

De-regulation: Dynamic MNS market

- [43] The MNS market consists of a range of services rendered by service providers to large organizations, whether these are private or public bodies. Managed network service providers as they are called provide managed data communications services to enable organizations to communicate between head offices and their branches over a wide area network (WAN).
- [44] Services that would typically be transmitted over WAN would include intranets, data communications, internet access and business applications.
- [45] WANS are constructed as physical private networks from dedicated leased lines. The infrastructure that constitutes a WAN was obtained exclusively from Telkom, and by far the overwhelming majority are still currently provided by Telkom. The manner in which infrastructure was supplied was also controlled by Telkom.³⁷
- [46] Prior to 1 February 2005, MNS services were provided to an organization in two ways. WAN service providers such as BCX did not provide their services in terms of a VANS licence (they did not provide a network) but provided these services to customers on their premises.³⁸ Such a WAN provider provided both network related and IT services for enterprises in relation to their WAN, as well as other IT services in the form of business applications and equipment. These WANS are referred to as enterprise owned WANS.

³⁷ See evidence of Mr Brierley where he explains Telkom's requirements that VANS submit agency agreements signed by their clients which required details of the customer and installation addresses. See page 1674 of the transcript.

³⁸ VANS was a license category in the now repealed Telecommunications Act of 1996. Service providers rendered MNS services to enterprises on their own networks, which they obtained from Telkom. WAN service providers provided MNS services on a client's network, which was also constructed from lines leased from Telkom.

- [47] Service providers known as VANS,³⁹ also provided WAN services to organizations but rendered these over their own networks. This is why they required a license from ICASA. Internet access services constitute a large part of the business of VANS.
- [48] The price of the leased line, whether this was an access line or a core network line, was regulated as a retail price to VANS⁴⁰ and constituted approximately 60-65% of the cost of the services rendered by VANS.⁴¹ VANS obtained the leased lines from Telkom and recovered the costs thereof from their clients, making no margin on the cost of bandwidth. The cost of leased lines for enterprise owned WANS was borne directly by the client itself.⁴²
- [49] The manner in which these lines could be utilized by VANS or the clients themselves was restricted by the Telecommunications Act which led to underutilized capacity and high communications costs. Since Telkom owned the infrastructure and to a large extent retained control over it,⁴³ service level agreements, which regulated the services associated with the bandwidth and dealt with issues of network performance levels, downtime, fault repairs etc, were also limited by the extent of the service levels Telkom would offer together with the bandwidth. VANS provided their clients with a back to back service level agreement, being limited to Telkom's undertakings and performance.
- [50] During this period, organizations obtained their communications services from a number of providers. An enterprise could - and in terms of the restrictions was compelled- to buy different components from different suppliers. All infrastructure and access lines had to be

³⁹ This license category is likely to be converted to an ECS license under the new ECA

⁴⁰ Telkom did not provide them with a wholesale price on the basis they were not public operators but service providers.

⁴¹ See evidence of Mr Brierley and Mr Van Huyssteen on page 1203 of the transcript

⁴² See evidence of Mr Sewell and Mr Brierley.

⁴³ See evidence of Mr Brierley above. Also transcript page 1722 and Hodge's witness statement on page 41.

obtained from Telkom (whether the MNS service was provided by a VAN or not), certain services could be obtained from an ITS provider, others such as internet access could be purchased from a VANS provider. In addition other communications needs, such as fixed line voice services could only be purchased from Telkom. If a large organization decided to outsource all or some of its communications requirements, it generally tended to appoint a single service aggregator, who would manage all the other service providers on behalf of it.⁴⁴

[51] Developments in technology in the VANS segment gradually permitted services to be provided in the form of shared networks.⁴⁵ The technology was known as VPN technology.⁴⁶ The early developments in this technology were legally challenged by Telkom on the basis *inter alia* that it constituted an infringement of Telkom's exclusivity and the restrictions that were in place on value added network services in terms of the Telecommunications Act of 1996.⁴⁷ In 2002, ICASA ruled that VPN technology was a value added network service, could be provided by a licensed VAN provider and was not in contravention of the Act.⁴⁸ Despite challenging ICASA's decision in the High Court and refusing to connect AT&T until a court order was sought against it, Telkom itself launched its VPN Supreme product in 2003.⁴⁹ However, the regulatory restrictions and the unfriendly framework remained in place until 1 February 2005.⁵⁰

⁴⁴ See for example the AngloGold Ashanti service agreement with BCX which requires BCX to provide a range of services to it, including services sourced from Telkom. See page 3687 of the record

⁴⁵ These were provided by VANS providers

⁴⁶ Virtual Private Network, see our discussion below on the difference between enterprise owned WANS and VPNS

⁴⁷ See *Telkom v Internet Solutions* 14 June 2002 and *Telkom v AT & T* 21 June 2002. See pages 1875-1922 ISPA Trial Bundle 5

⁴⁸ *Telkom SA Ltd v AT&T Global Network Services* 21 June 2002

⁴⁹ Telkom brought a review application against ICASA in the IS matter. AT&T brought an application in the High Court to compel Telkom to abide by ICASA's decision and to provide it with connectivity.

⁵⁰ See Mr Sewell's evidence on why BCX chose not to enter the VANS space at that time page 881 of the transcript.

- [52] On 1 February 2005, following the announcements by the Minister of Communications, the aforesaid restrictions on VANS were removed.
- [53] The de-regulation brought about regulatory certainty and immediate benefits to enterprises. VANS⁵¹ are now able to sublet, cede and re-sell infrastructure leased from Telkom and are also allowed to use VoIP, leading to economies of scale and scope. Organisations can still have their own private network but the costs of that investment could be shared with others. In addition they can transmit voice in the form of VoIP over their network. Obviously the more enterprises that can share a network the cheaper it would be. They would also benefit from the network effects of on-net calls. The consequence of this reduction in costs is that enterprises are more willing to outsource their WAN needs in order to obtain the benefits of sharing it with others.
- [54] This has led to a movement away from the strings model of WAN – where each branch of the organisation had to be connected to the other branch and head office in linear fashion - to a cloud model of WAN, ie the VPN. In the cloud model, the service provider builds a core network to which each branch connects to a VANS POP⁵², as opposed to connecting directly together. Branches and head office can then talk to each other through the core network. In addition more than one organisation can use the provider's VPN. Significantly, in addition to all the traditional services that could be transmitted over the WAN, organisations can now transmit voice in the form of VoIP.
- [55] It is not surprising therefore that the VPN model is demonstrating phenomenal growth not least because it represents an immediate cost benefit to enterprises long suffering under high communications costs. According to BMI-T⁵³ the enterprise market is ripe for a migration from WAN to outsourced VPN solutions. BMI-T estimates that the VPN

⁵¹ Which would be classified as an ECS licensee in terms of the ECA.

⁵² POP stands for Points of Presence

⁵³ BMI-T is a market analyst in IT, Telecom and Banking and arrives at industry reports through data and views obtained from industry participants as well as from reported figures.

sector will grow by 24% annually and that by 2008, will constitute 67% of the MNS market. Migration usually occurs at a time when a company is scheduled to upgrade its legacy network (due to large switching costs involved). The International Data Corporation (“IDC”)⁵⁴ estimates that “in the coming years a number of large contracts that drive growth rates sky high in the beginning of this millennium will be renewed”.⁵⁵ However not all enterprises will necessarily move to an outsourced VPN offering. Some very large enterprises may still desire to maintain a PTN/enterprise WAN or have some measure of control over their network because of security or reliability concerns.⁵⁶ Telkom’s own staggering growth in VPN suggests that this will be the predominant form of the new WAN, a more cost effective, outsourced integrated WAN.

[56] Furthermore, growth in data revenue and more so now that the convergence of voice and data is legal over the internet, is seen as the future growth segment in the telecommunications industry. Internet access and value added services such as managed data network services continue to exhibit the strongest growth rates, a trend that will continue over the forecast period.⁵⁷

[57] Since economies of scale can be achieved the cost of bandwidth for enterprises has declined and fewer leased lines need to be purchased from Telkom. Due to this, enterprises are now likely to spend more on their ICT value added services than on connectivity. However greater economies of scale and scope have also improved margins for MNS providers. With declining costs of connectivity and the consequent increase in outsourcing and spend on value added services, MNS providers have had to re-consider their offerings in the market in order to meet the challenges of de-regulation. This has encouraged entry by

⁵⁴ IDC is a subsidiary of the International Data Group which collates and analyses data for the ICT sector.

⁵⁵ See BMT-T “South African IT Services 2006-2010 Forecast and 2005 Vendor Shares” Item 29 page 1539 Telkom Discovery Bundle File 4

⁵⁶ See Telkom VPN Supreme Product Plans

⁵⁷ See 2006 BMI-T on page 1408 Telkom Discovery Bundle file 4

companies that have been involved in the MNS market into the VPN segment.

- [58] Prior to the de-regulation in the MNS market, when an enterprise decided to outsource its communications and data services, such outsourcing took place in various permutations. The enterprise could outsource any component or all of its data communications needs whether this was the network, the management thereof and its IT services. Very large organizations, such as national government departments, would issue a tender in relation to such outsourcing. The more outsourcing an enterprise did, the larger the number of service providers, the more it required the services of a single service aggregator.
- [59] The development of an integrated package such as the VPN in the converged market now enables an MNS provider to approach its customers with an offering that would include all of the components of that integrated package. The MNS provider can now offer infrastructure, managed data services, internet, voice and any other number of services that could be integrated into a VPN. A service provider could of course, continue in the same old way and procure or sub-contract those elements in the package which it itself could not provide from others. However such sub-contracting would cut into its margins.
- [60] In order for an MNS provider to compete effectively in the dynamic MNS market and to reap the benefits of de-regulation (in the form of lower connectivity costs) it needs to “own the customer” and earn as much margin as it can. MNS providers that have credibility in outsourcing and a closer client-vendor relationship are likely to more easily gain entry to a client’s decision makers. A company such as BCX with its range of skills is likely to win an outsourcing contract and own the customer. However, it would need to ensure that it keeps as much of the margin it can. BCX acquired Bidnet for precisely this reason – as long as didn’t own a VPN network itself it would always

have to rely on Telkom or other VPN players to partner with, hence giving up margin that it could otherwise retain.

[61] In the context of the dynamic MNS market, rather than a static one, the acquisition by BCX of Bidnet can be seen, *not* as a move by an ITS company into the telecommunications space but rather as an *expansion* by an MNS provider, with ITS capabilities, in the MNS market.

[62] Needless to say the de-regulation of VANS represents the greatest threat to Telkom, as it does to Neotel. It has created “arbitrage” in the market for fixed line connectivity (bandwidth) and voice.⁵⁸ MNS providers can now sell shared bandwidth, VoIP, internet and other data services. The legalization of VoIP has also introduced retail price competition in national and international voice services, which were previously part of Telkom’s PSTS monopoly services.

[63] The combination of a loss, on hitherto extremely high margins on leased lines and voice revenue in Telkom’s most lucrative market⁵⁹ – the large enterprise market – poses a far greater threat to Telkom than the entry of Neotel does. Telkom has been able to assess, on its own calculations, that Neotel is expected to gain some 8-10% of Telkom’s total fixed line market. However the loss to Telkom attributable to de-regulation in the MNS market is *is more difficult to predict and would be a function of the number of high value subscribers and the relative network size of its rivals in the MNS market.* Telkom also stands to lose revenues in the most profitable segment of the MNS market namely

⁵⁸ From a review of the Telkom strategy documents, it appears that the word “arbitrage” is used in a number of situations – it is used to describe the fact that a customer can buy a cheaper WAN & voice on a VPN rather than an enterprise owned WAN and fixed voice services; or it refers to the fact that voice services can now be provided more cheaply (in the form of VoIP) than Telkom’s fixed voice services; or that MNS rivals can now provide VoIP over bandwidth that was traditionally bought for data communications or that MNS rivals could achieve economies of scale on bandwidth thus reducing Telkom’s margins. See in general Telkom 2010 Strategic Plan. Also ISPA file 1 pages 332-334

⁵⁹ See the evidence of Wilcocks in which he explains that all the profitability of in the telecommunications sector is from the top 350 companies. See page 1517 of the transcript.

internet services. This is because enterprises, once they decide to migrate to a VPN, and in order to maximize savings, are likely to also migrate to an internet service provided by their VPN service provider.⁶⁰ This is also the segment of its business in which Telkom will experience significant retail price competition, Neotel already having indicated that it does not intend to compete with Telkom on the basis of price.⁶¹

[64] This is why Telkom needs to “own the customer” and dis-intermediate the market ie it needs to swiftly remove as many MNS rivals as possible.

[65] Mr Matthyser, on behalf of Telkom, certainly appreciates the impact of the de-regulation when he states:

*“The VANS deregulation in my opinion, has a bigger impact on the success of Neotel than what the acquisition of BCX would have on the feasibility of Neotel”.*⁶²

[66] While Mr Matthyser was making this statement to suggest that the merger will have minimal impact on Neotel, the impact of the de-regulation applies equally to Telkom.

Rationale for the transaction

[67] We start our enquiry by considering Telkom’s rationale for the transaction. In its filing papers the merging parties state that:

“Telkom’s main reason for proposing the transaction is that the proposed transaction will diversify Telkom’s revenue streams into new revenue streams that Telkom can grow in order to

⁶⁰ See evidence of Mr Brierley on pages 1682-1683 of the transcript. BCX is already providing internet services.

⁶¹ See also South African Telecommunications Sector Performance Review 2006 by Steve Esselaar, Alison Gilwald and Christoph Stock page 38

⁶² Matthyser page 531

replace voice revenues which are expected to decline as a result of increasing competition. Telkom expects revenue in the IT services sector generally to grow, and that a presence in the IT services sector will enable Telkom to benefit from this. Telkom also believes that there are ancillary benefits to be obtained from extending its range of existing services to complementary services in the IT sector. The proposed transaction will enhance Telkom's ability to offer its customers end-to-end solutions across the ICT value chain. Telkom's strength has to date been in voice, managed data networks and internet access, while BCX offers a complementary service offering.”⁶³

- [68] Mr Matthyser on behalf of Telkom, who has been integrally involved in the acquisition of BCX, submits that Telkom anticipates that it will lose revenue as a result of Neotel's entry, convergence (de-regulation of the industry) and further price regulation of Telkom by ICASA. Telkom estimates that it will lose approximately 10% of its total market share of the PSTS market to Neotel, its newly licensed competitor and needs to diversify and find alternative streams of revenue. According to Matthyser, the acquisition will enable Telkom to plug some of the revenues losses it expects with the entry of Neotel. The loss of revenue as a result of competition from Neotel is estimated at R5bn over 5 years. Matthyser says that Telkom expects to lose more revenue as a result of increased regulation by ICASA but the acquisition of an IT company will at least plug some of the revenue lost. Telkom also claims that many PSTS operators internationally

⁶³ See page 1361 item 4 of the record. According to Telkom the three main ancillary benefits that are expected to accrue to Telkom from providing a broader range of IT services are :The first benefit is that it will enable Telkom to meet the preference of some corporate customers for the convenience of having a single aggregator of their ICT inputs(commonly referred to as “single service aggregation” or “bundling”);the second ancillary benefit is that operating as a single services aggregator will result in delivery of a better service, due to improved interaction between the various providers of the different aspects of the overall service offering. The third benefit is that of efficiency, whereby the total cost of providing the overall service should be reduced through the alignment of functions between Telkom and BCX in order to avoid duplication.

have had to diversify their revenue streams in the face of de-regulation and competition and have vertically integrated into IT companies.

[69] Mr Matthyser also claims that Telkom has been trying to build its internal ITS unit with very little success.

[70] However, throughout the hearing, we were told by a number of witnesses, including the merging parties' expert witness that the margins in the ITS sector were very low. These low margins were used as a basis by the merging parties' expert witness to demonstrate why input foreclosure would not be a profitable strategy for Telkom to pursue in the downstream ITS market for which leased line is an input. We were also told by the merging parties and their expert witness that barriers to entry were very low in the ITS market and that the market was highly fragmented.

[71] Given these two factors – low margins and low entry barriers- it is difficult to believe that Telkom couldn't, with its enormous resources and deep pockets, enter the ITS market organically and why it was willing to pay a premium of approximately 25% for the acquisition of a company for such small margin gain. Mr Matthyser, when asked to explain this, could not provide a satisfactory answer but testified that "even when the deal was contemplated, it was on the basis of covering revenue losses at the acknowledgement of making very little new margin or getting small incremental margin benefits from the deal over three years".⁶⁴

[72] Mr Wilcocks on behalf of DD testified that he was not persuaded by the reasons Telkom had provided for the acquisition of BCX. In his view, the ITS industry's profits constituted only R1.3 billion, and was a low margin, highly fragmented industry.⁶⁵ This translated into a fraction of

⁶⁴ Transcript page 531

⁶⁵ Transcript page 1515

Telkom's own revenues, i.e. Telkom's return on sales is approximately 30% as opposed to that in the ITS sector of only 2.5%.

[73] Says Wilcocks:⁶⁶

"In my view if Telkom is faced with a reduction in profits that in my view are monopoly profits that it has enjoyed for many years, it really has two choices. One is that it could try and find other profits in other areas, substitutes if you will for this. And my understanding is that Telkom has publicly announced that is the reason why it wishes to acquire Business Connexion to diversify its earnings base. Now from the figures that I submitted previously it would seem to me that that is going to be incredibly difficult to achieve. It doesn't seem to be a logically coherent argument to me, because if you look at the spreadsheet that shows the company's earnings you will notice that Telkom's earnings are about R9.8 billion, Business Connexion earnings in its last reporting period were about R110 million, so even a miniscule reduction in Telkom's profits can't possibly be substituted by Business Connexion's profits."

[74] He therefore believes that Telkom's main objective is to retard the rate at which this reduction of its monopoly profits will take place.⁶⁷

[75] Mr Watt, the CEO of BCX did not testify initially, as was expected. He only appeared before the Tribunal after his retirement and resignation from BCX had been announced. In his stead Mr Sewell, testified on behalf of BCX. However Mr Sewell had not been involved in any of the negotiations around the transaction and could not provide us with any firm view of BCX's rationale for the transaction.⁶⁸

⁶⁶ Transcript page 1521

⁶⁷ Transcript page 1894

⁶⁸ At best Mr Sewell could only speculate about the strategic rationale for the transaction.

- [76] When Mr Watt eventually appeared before this Tribunal he denied any involvement by the Board in Telkom's offer to BCX and indicated that this was a direct approach to shareholders. According to him the Board was now simply implementing a decision taken by shareholders. Accordingly he expressed no view about the strategic rationale for the transaction for BCX. However correspondence between Telkom and BCX's deputy CEO show that Mr Watt, contrary to his evidence, under oath before the Tribunal, had personally indicated his willingness to negotiate a higher offer from Telkom and was familiar with the content of the discussions between Telkom and BCX shareholders.⁶⁹
- [77] A strategic document prepared by the deputy-CEO of BCX indicates that BCX considered three options for its future, in light of convergence which had increased competition in the market. It had the option to go it alone, merge with Didata or go in with Telkom. Whether or not this was presented to the BCX board was unclear. Mr Watt however conceded that "some of those issues had been discussed".⁷⁰
- [78] Telkom's own internal high level strategy documents paint a different picture of why it seeks to acquire BCX.
- [79] A constant theme that is found in Telkom's strategic documents is that it seeks to defend its core market against *competition and convergence* by offering end to end solutions, consisting of bundled products to clients, on a long term basis, at discounts. Its aim is to own the customer and to increase the costs of customers switching to rivals.⁷¹
- [80] In its internal document, Corporate Strategy document titled "2006 Update of Telkom's 2010 Strategic Plan", it states:

⁶⁹ Telkom had made an initial offer of R R7.60 per share which had been rejected by the Board. See Mr Watt's evidence on page 2308 of the transcript.

⁷⁰ See Mr Watt's evidence on page 2312 of the transcript

⁷¹ See page 990 item 6.2.3.8 of the record

*“We aim to counter arbitrage opportunities, defend fixed to mobile revenue stream and counter revenue erosion to the SNO and other competitors such as VoIP providers, through strategies including long term contracts, bundled discounts packages, calling plans as well as volume and term discounts.”
(Our emphasis)⁷²*

[81] In its document “Corporate Strategy Telkom’s 2010 Strategic Plan”, Telkom identifies as one of the benefits to be gained from acquiring an ITSP “ cross- selling opportunities: An ITSP will allow for cross selling and bundling opportunities in the Telkom segmented markets”.⁷³

[82] In its VPN Supreme Product Plan Telkom also identifies its weaknesses in customer relationship skills as well as in network administration, network support and systems integration and the urgent need to acquire these.

[83] In addition, Telkom, in anticipation of further regulation by ICASA and more competition seeks to evade regulatory scrutiny. It seeks to locate the acquired ITSP in a separate subsidiary for the following purpose --

“A separate subsidiary will allow for more flexibility in pricing as it will not be subjected to the rules of regulatory accounting and costing. This entity would also not be under close scrutiny from the Competition Commission. This will allow for more room on bundling of products and services.”⁷⁴ (Our emphasis)

[84] Further we see that all discussions of acquiring an IT company are located in Telkom’s data strategy, identified as a major driver of future

⁷² See page 331 ISPA file 1

⁷³ See page 1021 of the record

⁷⁴ See Telkom’s 2010 Strategic plan item 7.2.4.3 in page 1021 of the record

growth in the convergence space, for its *corporate or middle to large enterprise* customers.⁷⁵

[85] It identifies that the government segment is where Telkom is most at risk of losing significant market share and says that :

“It is expected that government will pass as much of their business as possible to the SNO to strengthen the new entrant and to facilitate attracting an SEP for the remaining 25% warehouse equity stake.”

[86] And further it expects the SNO to *“cherry pick corporate and business customers that are concentrated in the metropolitan areas to secure quick and profitable market share gains.”*⁷⁶

[87] Dr Federico, under cross examination, agreed that Telkom’s objective was not so much the ITS margins themselves, but what IT can do in *combination* with what Telkom already has.⁷⁷

[88] A picture thus emerges of the real rationale for the merger. Telkom is not seeking to find alternative streams of revenue.

[89] Under cover of an unregulated subsidiary, employing a range of strategies, Telkom seeks, through this transaction, to remove arbitrage opportunities in leased line and voice segments. It wants to defend its monopoly revenues in its core markets, namely fixed line voice and infrastructure, from the impact of de-regulation (convergence), competition and further price regulation in the corporate and middle to large enterprise segments of its business.

[90] Telkom, identifies that convergence presents it with the threat of arbitrage and declining voice revenues and that it needs to “own the

⁷⁵ Competition Commission Bundle 1A, Item 1, page 31

⁷⁶ Exhibit “I” page 21.

⁷⁷ Transcript 264 and 266

customer” in order to *defend* and grow its margins. It identifies the need to remove these disruptive rivals that pose the greatest threat to its margins and “dis-intermediate” the MNS market.⁷⁸ In addition, it seeks to increase the cost of switching by its customers to its rivals with various strategies.

- [91] The speed with which Telkom needs to respond to convergence is crucial for it, in light of the pending entry of Neotel and the expansion of firms in the MNS market. If Telkom does not remove credible MNS competitors and gain access to their customers, it stands to lose the most lucrative segment of its business. Alternatively it will be providing Neotel with an opportunity to partner with any of these enterprises and take a greater share of the MNS market than that predicted by Telkom.

Relevant Market Definition

The industry

- [92] Markets defined for purposes of Competition Law analysis are not necessarily the same as those understood by lay persons. Nor are they necessarily the same as those found in license categories that may be identified by regulators. In this particular transaction for example, the ECA identifies various categories of licenses, which would require authorization and a degree of regulatory oversight, depending on the nature of that license. ECNS⁷⁹ are licensees that are authorized to roll-out infrastructure. The equivalent license category in the Telecommunications Act would be both fixed line and mobile operators. ECS⁸⁰ are licensees who provide value added services over facilities ostensibly obtained from an ECNS. A sector specific regulator may elect to licence certain categories of services or equipment above others for a number of reasons such as maintaining

⁷⁸ See Telkom slide 40 of the Bain & Company presentation entitled “Telkom Data Services Strategy” dated 7 August 2002 on page 1268 Telkom Discovery Bundle 4.

⁷⁹ Electronic Communication Network Services

⁸⁰ Electronic Communication Services

technical standards, quality of services, universal service obligations, environmental or health issues and spectrum requirements. However for purposes of competition law analysis market definition relies on a number of factors *inter alia* demand side substitution, supply side substitution, functionality and nature of the product.

[93] It was common cause between all the parties that the transaction involves three relevant product markets all of which fall within the broader market for the provision of information and communications technology services to corporate or middle to large enterprises or organisations in South Africa.⁸¹ The three markets involved are the supply of telecommunications infrastructure or basic connectivity, which would correspond with the ECNS license category in the ECA and the two downstream markets referred to as the Managed Network Services Market (“MNS” market) and Information technology services, (“the ITS market”). While MNS in the form of VANS is regulated by ICASA,⁸² IT services are unregulated.⁸³

[94] It was also common cause that the relevant product markets were in relation to the provision of infrastructure and services rendered to large enterprises or organisations, whether private or public bodies, with multiple sites and which utilized wide area networks for their managed data communications.

[95] The Commission, in the course of the proceedings indicated that it wanted to define an additional downstream product market, namely hosted data centres. The Commission requested information from the merging parties in the course of the hearing. The merging parties eventually, after being ordered to do so by the Tribunal, provided the Commission with the information requested. At the end of the proceedings and after argument was heard, the Commission did not pursue the competition implications of the horizontal overlap between

⁸¹ The Commission identified other relevant markets such as network equipment. See the Commission's recommendation.

⁸² Will probably be regulated as an ECS under the ECA

⁸³ In its recommendation the Commission identified several other product markets in relation to which it found no competition concerns. See page 20 of the Commission's Recommendation

Telkom and BCX in relation to off—site data centres but made its analysis available to the Tribunal. We deal with the issue of hosted data centres later in these reasons.

- [96] We deal with each of the relevant product markets, taking into account the dynamism and changes being brought about by regulatory initiatives.

Infrastructure market (ECNS)

- [97] The first layer consists of the upstream market for the supply of telecommunications infrastructure. The basic components of a fixed line telecommunications network infrastructure are the access segment, which connects a business premise to a local exchange (POP), the back-haul to the metropolitan switching centre and the trunk segment, which provides long distance connectivity between POPs, including international trunk. The access segment, which connects the customer to the nearest exchange, is also referred to as “the last mile”. Leased lines are used by MNS providers in order to, construct their networks and access lines for their clients to connect to the nearest POP. If the MNS provider did not own a network, leased lines were used by their customers to construct a WAN.
- [98] Until May 2002, Telkom, a public switched telephone network (“PSTN”), was the *de jure* monopoly supplier of infrastructure and leased lines to the industry. All operators and MNS providers that relied on connectivity for rendering services to their clients were obliged to obtain their leased lines from Telkom, whether these lines were part of their core network or access lines. Telkom also provided national and international voice and data services.
- [99] Dr Mohapi, on behalf of Gadlex, argued that Telkom was no longer a monopoly provider of leased lines. According to him there were large competitors such as Neotel that had entered the market with a nationwide network and could provide fixed leased lines, whether these be

access or trunk. The recent de-regulation by the Minister of the supply of fixed lines meant that PTNs such as Transnet and Eskom, and mobile operators could also provide spare leased line capacity to MNS providers.⁸⁴ In addition there were a range of alternative technologies (substitutes) for fixed leased lines which should be taken into account by the Tribunal. Furthermore, both Telkom and Gadlex submitted that in their opinion ECS providers would in the future be able to self-provide leased lines and that ICASA was currently engaged in an inquiry to determine this matter.⁸⁵

[100] Hence it was argued that the market for the supply of infrastructure should include fixed leased lines such as Diginet, which could be supplied by both Telkom and Neotel (which had already entered the market) and possibly PTNs and mobile operators, as well as wireless alternatives such as WiMAX and Sentech's Biznet, and last but not least the self-provisioning of such lines by ECS providers themselves. We consider each of these in turn.

[101] Neotel a competitor to Telkom, was licensed in 2006 and enjoys the same rights as Telkom does to provide wholesale and retail infrastructure services, leased lines for access and traditional voice and data services, However, despite Neotel's entry into the market, it seems common cause between the parties, except for Gadlex, that Telkom is still *de facto* the monopoly provider of fixed telecommunications infrastructure in South Africa.

[102] Dr Federico, the merging parties' expert, testified that he had assessed this transaction on the basis that Telkom had a near monopoly position in PSTS and he had placed no emphasis on the role of Neotel. He was also of the view that Telkom had significant market power and enjoyed dominance in the markets relevant to this transaction.⁸⁶ Even Telkom itself is confident that Neotel will only be able to take 10% of its

⁸⁴ See the Minister's announcements of September 2004.

⁸⁵ See Matthyser evidence, transcript page 728.

⁸⁶ Transcript page 420

market share.⁸⁷ By inference, Telkom anticipates that at the *end* of the next 5 years, it will still have 90% of the fixed line market.

[103] Dr Hay, in his evidence, confirms that Neotel was not yet present in any substantial way as a competitor to Telkom. He states:

*“Look, I think in broad terms if one looks at the access network capabilities, essentially what one has available in the market is Telkom. There is simply no other player, ourselves included, who is able to substitute services and without making any commercial statement, Sentech is also similarly unable to do it on any scale.”*⁸⁸

[104] Neotel at this stage mainly offers wholesale services in the form of wholesale Internet and a global voice transit service through Teleglobe. Neotel’s geographic coverage presently is approximately 0.5% of South Africa’s land area which includes the four main cities Johannesburg, Pretoria, Cape Town and Durban. It aims to reach 15% coverage within ten years.⁸⁹ Neotel currently employs 120 people as opposed to Telkom’s 26000 employees. He testified that Neotel has secured a national and metropolitan backbone network entirely independent of Telkom’s network. However Neotel is not currently able to provide country- wide access to large organisations with multiple business sites and that if it is approached for such services it would have to use Telkom’s infrastructure.⁹⁰ Dr Hay testified further that despite Neotel having access to Eskom’s and Transtel’s network, through the process of integrating the various shareholdings, these networks were not appropriate for cities and metros. This is because historically those networks serviced their internal needs. Eskom’s network for example is typically connected to power stations and does not go anywhere near cities or end customers. Eskom and Transnet have been building over the last few years, a backbone within the

⁸⁷ See Telkom’s presentation to analysts in which it said it was not going to drop prices drastically because it expected Neotel to take on 10% of the fixed line market. See Exhibit “H”

⁸⁸ Transcript page 1158

⁸⁹ Transcript page 1116

⁹⁰ Transcript page 1121, 1388

metros with very few end points.⁹¹ Furthermore, while Neotel has the right to obtain network services from Infraco, the terms of that access had not yet been finalized.⁹²

[105] In addition, Neotel has no local or “last mile” infrastructure. The last mile or the local loop represented a greater barrier to entry for any new entrant. It is much more difficult to roll out a local loop than it is to roll out trunk or national capacity in the telecommunications.⁹³ While Neotel has a right to access Telkom’s last mile infrastructure for a period of 2 years, it had as yet not been able to conclude a framework agreement with Telkom for access to its local loop.

[106] Hence even though Neotel’s license entitles it to provide leased lines to any operators or downstream firms it has been unable to do so. Contrary to Dr Mohapi’s contention that Neotel represents a substantial potential competitor to Telkom, Neotel itself doesn’t regard itself as a formidable competitor to Telkom in the future. According to its business plan, Neotel expects to gain only between 8-9% of Telkom’s market share within the next 5 years. Initially it was projected that Neotel would grow its market share to 10% within 5 years but in light of the many regulatory delays and its slow entry this will not be achieved.

[107] Furthermore, MNS providers do not currently regard Neotel as an alternative supplier of last mile access to Telkom’s monopoly. Mr Brierley of MTNNS says that if had he any choice he would buy from alternative suppliers but that to date he had not found such supplier yet.⁹⁴

“...As soon as someone can offer me a competitive service of the right price, with the right SLA and the right reliability, I will buy such services, but what I don’t see in this market and I should know this market, I’ve been in this market a long time,

⁹¹ Transcript page 1166

⁹² The Infraco Bill was still being debated in Parliament.

⁹³ Rolling out a local loop meant digging up streets and pavements at a huge inconvenience to the public. It also required various authorizations from municipalities. Trunk capacity on the other hand could be rolled out above ground.

⁹⁴ Transcript page 1577 -1578

and buying transmission is a huge part of my business. I mean in our business the cost of transmission is the cost of our business. So any saving I can make in cost of transmission is very favourable to my business. I just haven't found any alternate suppliers that I can either trust, fibre price right or fibre quality of the service that they're providing correct."

[108] This was confirmed by Wilcocks when asked to assess the ability to migrate from Telkom to Neotel:⁹⁵

"Part of the difficulty I have in answering this particular question is to the best of my knowledge Neotel has yet to provide a single service to any enterprise customer. I can speak from personal experience around Internet Solutions that we have approached Neotel on several occasions with a view to obtaining services from them and we have yet to obtain such services..."

[109] Adequate and appropriate service level agreements which consist of performance obligations and warranties in relation to network reliability, downtime, repairs, etc are crucial for large organisations, in order to ensure that their data is being managed to the requisite standard

[110] Both Mr Briereley and Mr Wilcocks stated that apart from Telkom they have not been able to find an alternative source of fixed leased lines together with appropriate SLA's, whether these be from Neotel or PTNs and mobile operators.

[111] Dr Mohapi testified that various municipalities, such as Ekurhuleni, Tshwane, Johannesburg and Cape Town, were currently upgrading their infrastructure and are planning to provide fixed line services to businesses in competition with Telkom as well as looking for opportunities to establish wireless broadband networks. It was submitted in the press that Cape Town Municipality would not provide last mile services directly but would be providing the backbone so that

⁹⁵ Transcript page 1581

other telecommunications providers can lease from them. It is therefore not clear exactly what services Municipalities will in future be offering or when this will be available.

[112] Some municipalities have been awarded PTN licenses and can thus build their own private telecommunication networks. The recent announcement by the Minister suggests that PTNs can resell their spare capacity to MNS providers. A particular example of the Cape Town municipality was used by Gadlex to support both the fact that municipalities are rolling out PTNs but that they were doing so with Wi-Max to become completely “independent” of Telkom. However, the Cape Town tender has already been legally challenged by Telkom.⁹⁶ Very little detail concerning the Municipalities’ future commercial plans was submitted.

[113] Hence from a supply side of fixed line infrastructure, there is literally no other provider, apart from Telkom, that can provide leased lines with appropriate SLAs to the downstream MNS providers.

[114] The question remains whether there are any substitute products available in the market that could offer downstream service providers an alternative choice to Telkom’s fixed line infrastructure, i.e. access to the last mile.

[115] Dr Mohapi testified that wireless, in the form of WiMAX, presented a viable alternative to last mile fixed line access, for Diginet lines. The fundamental advantage of wireless technology is that it creates a local loop without the need to “dig up the earth” and lay multiple cables. Telkom, Neotel, Sentech and iBurst have been issued with a license for WiMAX services. Dr Mohapi lists these entities as competitors to Telkom or alternative suppliers of leased lines, albeit wireless.

[116] There is however, considerable uncertainty as to the ability of wireless technologies to provide reliable business class capacity on a scale that

⁹⁶ Telkom has launched legal challenges and objections against the decision of the Cape Town Municipality.

will satisfy the increasing demand of large corporate clients who need dedicated reliable links of more than 2 Mbps to connect their WANs or VPNs.

[117] Mr Brierley, Mr Wilcocks and Dr Hay all disagreed that WiMax was a suitable alternative for the needs of large organizations. They submitted that WiMax was used mainly as a complementary technology to fixed leased lines and was usually deployed in small offices and home use (SOHO) or for limited internet access. Telkom itself uses WiMax as an alternative to ADSL which is deployed as a service for SOHO organizations and consumers as opposed to Diginet lines which are used for large organisations.⁹⁷

[118] Dr Mohapi, under cross examination, agreed that WIMAX is not comparable in quality and reliability to fixed line as far as large corporate and their need for bandwidths of more than 2 Mbps, i.e. 155 Mbps, are concerned.⁹⁸

[119] There seems to be some consensus that currently WiMax, does not offer a viable alternative for fixed line infrastructure at the top end of the corporate market, i.e. where 155 Mbs is required.

[120] Other factors that render WiMAX an unsuitable substitute for fixed line access lines are limited availability to establish high sites, limited bandwidth availability, reliability and quality and large capital investments into infrastructure. WiMax also operates on the basis of a shared base station. Hence the ability for it to serve large organization's needs is limited by the number of users utilising the base station at the same time. While radio engineering can ameliorate that problem to some extent this is limited.

⁹⁷ Transcript page 1752

⁹⁸ Transcript page 1370 and Mohapi's supplementary witness statement par 101.

[121] Significantly, WiMax is not offered with the same level of warranties and Service Level Agreements that Diginet is offered because as Sewell points out:⁹⁹

“Wireless is generally not as reliable as VIVA.¹⁰⁰ It’s affected by weather to some extent. So it wouldn’t be one’s first choice as the main link that you would use in an online environment.”

[122] Mr Brierley explained that because wireless is transmitted through the air it is affected by weather and climate in ways that would not happen with a piece of copper that runs underground.¹⁰¹ Telkom, in its own documents, indicated that it does not consider, for instance, iBurst a competitive threat in the corporate market due, largely, to the WiMAX technology involved.¹⁰²

[123] From all of the above statements it is clear that WiMax is not an appropriate service for connecting the multiple sites of large corporate customers and that it would only, as technology stands today, be used as a back-up to fixed lines. Hence we do not consider it to be a substitute for the relevant market under consideration namely the large enterprise or organization.

[124] However even if we were, for purposes of argument, to share Dr Mohapi’s views and assume that Wi-Max is a suitable technical alternative to fixed line connectivity for large organizations, a further barrier to entry in relation to such alternative technologies is the availability of spectrum. To date the bulk of this spectrum has been allocated to Telkom, Neotel, Sentech and WBS. It remains to be seen how ICASA will allocate the remainder of the spectrum. Municipalities such as Cape Town who are desirous of rolling out WiMAX networks face the same difficulty of obtaining spectrum. Didata has been lobbying ICASA to allocate the entire remaining spectrum to one entity,

⁹⁹ Transcript p 773

¹⁰⁰ Mr Sewell was referring to fixed line technology.

¹⁰¹ Transcript page 1688

¹⁰² See Telkom’s Corporate Strategy document in Commission’s record page 1021.

namely itself.¹⁰³ However if ICASA did so, this would amount to granting DD the right to self-provide its infrastructure albeit in the form of wireless connectivity, which brings us to the issue of self provisioning.

[125] ICASA has been asked by the Minister to conduct an enquiry into which of the ECS licensees, if any, are to be granted the right to self-provisioning. In the hearings held by ICASA in this inquiry, Telkom made extensive submissions to ICASA opposing the granting of such rights to ECS. It was therefore surprising and downright dishonest of Mr Matthyser to submit to this Tribunal that Telkom supported self-provisioning by ECS licensees.¹⁰⁴ Dr Hay on behalf of Neotel testified that Neotel would challenge such a decision by ICASA.¹⁰⁵ Hence any granting of Wi-Max spectrum to an ECS licensee is likely to be challenged by a number of operators, including Telkom and Neotel, and ECS rivals in the event that ICASA chose to grant rights only to some and not others.

[126] As far as Sentech is concerned, it only offers one product called BizNet as an alternative to Diginet or similar fixed leased lines. However, Mr Brierley and Mr Wilcocks testified that Sentech could not provide an alternative to Telkom.¹⁰⁶ The product did not come with equivalent warranties and SLAs. So even if Biznet was a technical substitute to fixed lines, Sentech was not able to provide large customers with appropriate SLAs. Mr Wilcocks testified that Sentech in fact was in disarray and was still attempting to obtain funding from government for migration to digital broadcasting in preparation for 2010.

¹⁰³ See DD/IS submissions to ICASA on WiMax spectrum allocation. See Exhibit 1A and 1B

¹⁰⁴ Indeed Telkom maintained throughout these proceedings that it was not opposed to ECS licenses being granted the right to self-provide infrastructure. It was only towards the end of the proceedings that Telkom supplied the Tribunal with a copy of its submissions to ICASA which confirm Telkom's position to be quite contrary to that argued by its counsel and by its witnesses.

¹⁰⁵ See evidence of Dr Hay in which he states that Neotel paid a lot of money for its license and will challenge ICASA's decision since such a decision would convert an ECS licensee into an ECNS licensee. See page 1127 of the transcript.

¹⁰⁶ Mr Brierley testified that for MTN NS, out of its [confidential] leased lines, [confidential] were obtained from Telkom and only [confidential] from Sentech

- [127] We were urged, during argument, to also take judicial notice of various public statements made by mobile operators indicating their intention to enter the fixed line market. In our view, if we are to have regard to them at all, those statements confirm that wireless connectivity is not a complete substitute for wire-line connectivity –especially so in a converging market –and that mobile operators in fact did not have spare capacity to supply to MNS providers. Their decisions also confirm that Neotel was not a credible alternative supplier of fixed infrastructure.¹⁰⁷ Even if we were to consider their intentions as potential entry into the infrastructure market, such entry would hardly be timely given the length of time it takes to roll out fixed line infrastructure and provide access lines with appropriate SLAs.
- [128] Dr Mohapi, himself acknowledges that despite all the theoretical possibilities of alternatives and substitutes argued by him, there was *no certainty as to their actual availability*.¹⁰⁸
- [129] In conclusion, we find that for services provided to large enterprises or organizations that require communications between multiple sites across the country, there are no suitable technical substitutes for fixed line infrastructure. Even if for the purposes of argument, we accept that WiMAX was a perfect *technical* substitute for fixed leased lines, it is not a *commercial* substitute for fixed leased lines since it comes with no warranties and SLAs. At best it can be used as a complement to fixed lines in limited circumstances. In addition, Neotel, mobile operators and PTNs are not viable alternative suppliers of fixed lease line capacity. Telkom is thus the overwhelmingly dominant –a near monopoly - supplier of fixed line infrastructure in this market.

¹⁰⁷ Both Vodacom and MTN stated that they were planning to roll out fixed lines because of Telkom's high bandwidth prices.

¹⁰⁸ See paragraph 63.2 of his witness statement

The MNS market

Market Definition

- [130] The second relevant market is the downstream MNS market. Managed network services consist of a diverse range of value-added services which are rendered on top of the transmission of data by a leased line to an organisation over its wide area network, whether the WAN is an enterprise owned WAN or provided by a VAN provider.
- [131] It was common cause that LAN services were not included in the market definition. LANs link the various desktops in a single office to an office server while WANS allow organizations to transmit data between multiple sites in a secure and efficient way, without having to rely on the public telephone network, which is provided by Telkom. LANS are not a substitute for WANS.
- [132] A corporate can build its own WAN, referred to as a private enterprise WAN, and outsource the management thereof to service providers. Or it can outsource all of it to a provider that owns a network and can provide services to it. MNS providers that own their own network are called VANS¹⁰⁹ and require a license from ICASA.
- [133] The outsourced network is referred to as a shared Virtual Private Network (VPN). (See our discussion on the development of the VPN model). This allows MNS providers to supply WAN services to various clients using their own VPN offerings. In order to offer these services MNS providers must build their own backbone networks, referred to as a VPN cloud, using high bandwidth leased lines (i.e. Diginet lines) from Telkom. A VPN backbone network has various POPs, i.e. access points from which customers' sites can then connect into the service provider's network. Customers connect to these POPs using local Telkom access lines that connect the customers' sites to the nearest Telkom local exchange, the "last mile", which in turn connects to the

¹⁰⁹ The equivalent category in the ECA is the ECS license category.

MNS provider's POP. A further management component is then added which involves running networks so that traffic is prioritized according to the particular application, ensuring that security needs are met and to ensure good quality service. This all depends on the service level agreement (SLA) that the customer selects.

[134] Accordingly, from a supply side perspective, WANS and VPNs are substitutes for each other, the one being an enterprise owned wide area network, the other an outsourced wide area network, both providing the enterprises which have more than one site, with managed communications services. The provision of both types of wide area networks require a similar range and depth of skills such as network design and implementation, network support, management of Telkom for access lines, as well as additional management support.¹¹⁰

[135] A typical managed organizational WAN is built up using the following layers, each of which may be provided by a different service provider:

- Level 1: basic telecommunications services consisting of the provision of transmission capacity between two points (e.g. leased access lines).
- Level 2: end-to-end telecommunications services involving physical and logical layers such as routers and switches that make service available for use. This would include the provision of managed bandwidth, virtual private networks (VPN), frame relay and ATMs.
- Level 3: Physical and logical management of customer's network and premises devices, often referred to as "managed data network services" or network outsourcing services. These include services such as internet access, VPN solutions, hosting services, voice over Internet Protocol, security backup, firewall intrusion detection etc.

[136] Defining the outer boundaries and relative market shares in this market proved to be a difficult exercise indeed. The difficulty is caused to

¹¹⁰ See Hodge expert report, CRA expert report, and Commission's recommendation.

some extent by the different ways in which companies report their revenues and the complex range of services that could conceivably constitute “managed network services”. As can be seen from the layers identified above, MNS services could constitute a combination of any of the components of the three layers. The only element that is easy to exclude is layer one namely access lines. However, even this exercise can be marked with a measure of double counting because of the different ways in which companies report their revenue figures.¹¹¹ Nevertheless, it was common cause between the parties, which is also reflected in the manner in which BMI collates its figures, that at the very least the definition of MNS did not include revenue figures for access lines. This would accord with the notion that access lines did not constitute “managed services” because they are viewed as basic connectivity.

[137] The Commission defined the relevant product market as the market for the provision of WANs and VPNs including the management layer. In relation to the layers identified above, this would include layers 2 and 3. Hence the MNS market would include the rendering of services such as designing, building and implementing or configuring the WAN, the VPN shared backbone, the necessary equipment (primarily routers) and the network management element.¹¹²

[138] The merging parties, on the other hand, submitted that there were two possible market definitions for the MNS product market. They argued that the MNS market can be defined as a VPN and in particular the IP VPN market (narrow definition) or it can be defined as only the management component of all WANs, whether these were IP-VPNs, VPNs or enterprise owned WANs. In support of their arguments, they provided the Tribunal with revenue figures which were ostensibly drawn from internal Telkom and BCX management accounts.

¹¹¹ BMI –T itself points to some instances of double counting for access lines in its own estimates.

¹¹² See Ispa Heads page 27.

However, neither BCX nor Telkom, despite having had ample opportunity to do so, provided the Tribunal with any supporting documentation verifying the revenue figures utilized by their witnesses, nor did they provide the expert witnesses of the Commission or IPSA access to these internal management accounts from which it was claimed these figures were drawn. Neither did they clarify what component of layers 2 and 3 of WAN constituted their definition of “management of the network”. For example, they did not clarify whether the management component included only services such as meta-WAN services or it included the monitoring of the performance of network equipment such as that indicated in the Telkom CNC product.¹¹³

[139] Both the Commission and ISPA argued that network equipment such as Cisco routers should be included in this definition since these are integral to the design and implementation of the network, In addition the industry reports compiled by BMI-T included these in its market analysis. However the merging parties argued that necessary equipment such as Cisco routers should not be included in the definition. They pointed out that separate contracts are awarded for equipment and management services in tenders and that Telkom itself offers a management service called CNC which provides services to clients on non-Telkom VPNs.

[140] It is not surprising that the merging parties would insist that necessary equipment such as Cisco routers should be excluded from the definition since that was the basis upon which they distanced themselves, unconvincingly in our view, from the now infamous Bain slide (to which we will return). The Bain slide was relied upon by the Commission in its investigation to assess the relative market shares of Telkom and BCX in the MNS market.

¹¹³ See the features of the CNC product on the Telkom website.

- [141] In order for us to assess whether or not equipment such as routers ought to be included in the market for “managed network services” we considered the industry norms relied upon by BMI-T and the evidence of industry participants placed before us.
- [142] Mr Brierley testified that MNS providers only buy level 1, that is the dedicated leased lines or pipes, which is at the bottom of the WAN or VPN. He testifies further “As soon as there is a management component in the pipe you are in layer 2 or layer 3”.¹¹⁴
- [143] Telkom itself sells Cisco routers with its VPN Supreme product, which are programmed or configured by it.¹¹⁵ Furthermore, the Telkom website suggests that the special CNC product also includes equipment maintenance and monitoring of WAN equipment for swift restoration of configuration. This suggests that it is difficult to separate out management of necessary equipment such as routers from the management of the network itself.¹¹⁶
- [144] In its industry reports BMI excludes access line revenue to the extent that it can but includes revenue for equipment such as routers.
- [145] Telkom itself, despite distancing itself from the Bain slide seems to have relied upon the figures in an assessment of the competitive landscape in data services, excluding access line revenue figures, as stated on that slide which on their version includes relevant equipment for each type of service. The Bain slide makes a clear distinction between access lines, LAN, WAN and internet services.
- [146] We do not rely on the assertion made by Telkom that network equipment constitutes a separate relevant market on the basis of large tenders issued by organisations. An organisation may seek to issue a tender for separate aspects of a network for any number of reasons,

¹¹⁴ See Brierley page 1669

¹¹⁵ See Telkom VPN Product Plan

¹¹⁶ See Telkom’s CNC product offering on its website and its special features.

including budget management, price transparency, and improved service provider management or in furtherance of objectives of their supply chain management, which may require a promotion of BEE or small businesses.

[147] What is however clear from the evidence of the industry reports and participants in the industry, including Telkom, MTN NS and ISPA is that network equipment such as Cisco routers, is considered to be part of managed network services and is included in the revenue figures which are used as a basis for calculation of relative market shares.

[148] This is not a surprising outcome since network equipment in the context of managed network services forms an integral part of that service. Routers and switches are not sold independently of the network design or the managed bandwidth and the manipulation of data that a customer seeks to achieve over that network. Routers and switches do precisely what an organisation wants its network to do for it – they are installed and programmed according to each organisation's needs. The number of routers or switches sold to an entity will depend on the design of its WAN which in turn depends on the enterprise's geographical spread and its priorities. Configuration of the routers and switches is considered to be part of managed network services.

[149] The evidence also suggests that the management component of the service relates not only to managing the network (the managed bandwidth) but also the routers and switches.

[150] On this basis we conclude that the evidence firmly points towards the fact that the industry norm for defining MNS includes both layers 2 and 3 of the WAN organizational layers identified above. We find that the relevant MNS market includes the provision and management of enterprise WANs and VPNs including IP-VPNs and necessary network

equipment such as routers and switches, but excludes Telkom's access lines.

- [151] Both Telkom and BCX are present in the MNS market. BCX has recently entered the VPN segment of the market via its acquisition of Bidnet's VPN, now trading as BCX Comms. It therefore participates in the MNS space via two routes, through BCX Comms and also, through BCX in which its WAN management services and network services are located

Market shares in the MNS market

- [152] The Commission based its original market share estimates of Telkom and BCX on the 2002 Bain presentation, a document that had been prepared for Telkom and which had been provided to the Commission by Telkom.

- [153] According to the Commission, Telkom had a 31% share of the MNS market and BCX 9.1%. The Commission's calculations were based on the size of the MNS market of R2.2billion as reflected in the Bain slide. On the basis of this horizontal overlap the Commission concluded that the merger will give rise to competition concerns.

- [154] In the course of the hearings the relative market shares of Telkom and BCX became moving targets. The merging parties attempted to suggest that BCX's market share was less than 3% and Telkom's market share seemed to take on organic qualities. In his expert report Dr Federico states that Telkom's market share was closer to 35%. By the end of the proceedings the market share was closer to 40%.

- [155] The merging parties attempted to distance themselves from the Bain slide by insisting that the figure was inflated due to inclusion of equipment sales and hence the 9.1% calculated by the Commission was an overestimation of BCX's market share. Mr Matthyser in

response to a question as to whether the revenue figure included equipment was not able to provide a clear explanation of how he arrived at the figure of R2.2bn.¹¹⁷

[156] However a careful consideration of the Bain slide indicates that the information reflected on it was sourced from no less than four independent sources. A note on the slide indicates that the sources were BMI-T, IDC, Ovum and Bain analysis. These are reputable international companies providing research and data to the industry as well as strategic consulting services. In addition the figures, drawn from the other three different sources seem to have been analysed by Bain, rather than merely transposed. These were the figures that Telkom itself relied upon to assess its competitive position in the WAN segment of the market. In our view, the Bain slide, despite the merging parties' efforts to distance themselves from their own internal documents, represents a reliable starting point.

[157] Another source which was used was the BMI report of 2006 for Data Services. The Commission was only alerted to this document well into the hearing, although Telkom knew of the existence of this document much earlier. Based on this BMI report, the total size of the MNS market was R2.88 billion in 2005.¹¹⁸ However, it seems that even these figures are not completely accurate and may be overstated. BMI estimates that it has overstated the market by R250 million and that the total market, excluding leased lines, should be approximately R1.583 billion.¹¹⁹ BMI states that defining and estimating a market size for this market segment is considerably complicated because the terms 'IP VPN means different things to different people'.¹²⁰

¹¹⁷ See page 587 in which Matthyser gives an answer that he "must have made a mistake, must have done the wrong thing", rather than explaining how he arrived at the figure.

¹¹⁸ Telkom Bundle File 4 page 1419

¹¹⁹ Transcript page 214

¹²⁰ Exhibit F page 8.

- [158] Telkom's expert, CRA, estimated that the total MNS market is R1.45 billion, having adjusted the total BMI figure of R 2.88 billion to exclude R1.45 billion for access line revenue.¹²¹ This calculation was based on the Telkom assumption that the MNS revenue is split equally, i.e. 50:50, between access revenue and MNS revenue. CRA also submits in its report that Telkom's share of the MNS market was R810 million. However these figures were unverified. Telkom had not granted the Commission or intervenors access to its management reports and no document supporting these figures was filed by Telkom with the Tribunal.
- [159] Mr Van Huyssteen, on behalf of Telkom, in his evidence confirmed that the access and MNS revenue split is 65:35 rather than 50:50.¹²² This was corroborated by CRA in its expert report.¹²³
- [160] Mr Hodge, who had based his calculations on revenue figures submitted by the merging parties in these proceedings, estimates the total MNS market at R735 million. To arrive at this amount he adjusted the BMI figure for the Total MNS market of R2.88 billion downwards to R2.1 billion.¹²⁴ Of that 65% was deducted as the portion attributed to revenue derived from access lines (the revenue split being 65:35).¹²⁵ The Total MNS market is therefore R 735 million.¹²⁶ Hodge confirmed that the same result was obtained by working bottom up on the basis of the R810 million figure provided by Telkom.¹²⁷

¹²¹ CRA report page 85 of the witness bundle

¹²² Transcript page 1203

¹²³ CRA expert report page 50 par 127

¹²⁴ The R2.1 billion was calculated by adjusting the BMI's estimate of the total market revenue of R2.88 billion by subtracting the possible overstatement of Telkom's size (the difference between R1.33 billion as calculated from the BMI report and the unverified R810 million as supplied by Telkom), as well as the double counting of access lines. Ispa Heads page 29. Ispa also calculated the total MNS market backwards starting at Telkom's market share claim. This "bottom-up" approach is set out in the Schedule to ISPA's Heads, page 108, Driver 3.

This method calculates the total market as R 742 million.

¹²⁵ As verified by both Mr Brierley and Mr Van Huyssteen

¹²⁶ See Hodge's testimony, transcript page 2140.

¹²⁷ Transcript page 2138

- [161] Telkom criticized ISPA's R 735 million indicating that it should be much larger, namely R 2.2 billion as stated in the BMI report.¹²⁸ According to it, ISPA should have included the amount of R1.1 billion for equipment sales in respect of WANs as well as the R 400 million for the network management component of WANs undertaken by other suppliers in the market.¹²⁹ However, ISPA claims that the R1.1 billion seems to include all IT equipment such as desktops, screens laptops etc. while for purposes of the MNS market the relevant equipment would be Cisco networking equipment.¹³⁰
- [162] Neither Telkom, nor BCX made any attempt to furnish the Tribunal with any verified revenue information. Instead they attempted, once again, to distance themselves from the evidence given by their own witnesses.¹³¹ Mr Van Huyssteen's evidence that the revenue figure was 65:35 was unambiguous and corroborated by other witnesses.
- [163] The Tribunal has to consider the best evidence placed before it. It appears to us that ISPA's calculations, based on the evidence by witnesses, industry reports and the revenue figures submitted by the merging parties themselves, constitute the best estimate of the size of the MNS market. We therefore accept that the total MNS market is approximately R 735 million. This amount does not include revenue earned from the rental of access lines.

¹²⁸ See table 5 page 13 of the BMI report in Telkom's Bundle 4 page 1427.

¹²⁹ Transcript page 2649 and 2830

¹³⁰ Both Telkom and BCX supply Cisco Networking equipment and both are Cisco Gold Partners. CRA Report of 15 June page 18. CRA refers to the R 1.1 billion in its expert report on page 55 of the witness bundle.

¹³¹ The merging parties attempted to "clarify" Mr Van Huyssteen's evidence at the time when Mr Hodge made his calculations by producing a subsequent affidavit by Van Huyssteen, after he had been cross-examined, re-examined and released by the Tribunal. The contents of that affidavit were not subject to cross-examination because the merging parties did not recall the witness. Accordingly we have no regard to it.

Telkom's market share

- [164] Telkom initially estimated its MNS market share as 35% and by the end of the hearing it submitted estimates of between 35 to 40%. Telkom based its market share on Internal Management Accounts. However these calculations were never discovered to the Commission or ISPA and Telkom could therefore not be cross-examined to verify the figures. Telkom's estimate of its market share, based on more recent information produced by it in February 2007, in the management only layer is 37% and for IP-VPN 40%.¹³²
- [165] It is ISPA's contention that Telkom's market share is well in excess of 40% while the Commission estimates that it is closer to 50%.¹³³
- [166] According to the Commission BMI has estimated Telkom's 2005 market share at 55%.¹³⁴ Dr Federico however chose to ignore this estimate, stating in his expert report that BMI had over-estimated Telkom's market share as it includes revenue from leased lines provided directly by Telkom to customers using services provided by other MNS players.¹³⁵ Mr Rogers for the Commission disagreed with Dr Federico's conclusion on this indicating that Brian Neilson of BMI had told him that BMI may have overstated Telkom's MNS revenue of R1.583 billion by R 250 million, due to double counting, thereby decreasing the figure to R1.383 billion, thus representing a market share of 51%. This estimate, according to the Commission, also finds resonance in Telkom's VPN Supreme product plan for 2006/7-2007/8, apparently produced in February 2006 where it is stated that Telkom's

¹³² See Matthyser evidence, transcript p423 and Van Huyssteen evidence transcript page 981 and 1323.

¹³³ Scholars such as Theron and Boshoff indicate that since 2002, Telkom has significantly expanded its data services by moving into managed data networking services. As of 31 March 2005, according to them, Telkom was managing 11961 data sites on behalf of corporate and business customers, a 55% rise compared to March 2003. See N.M. Theron and W.H. Boshoff: *Vertical Integration in South Africa Telecommunications: A Competition Analysis*.

¹³⁴ See Telkom bundle file 4 page 1424

¹³⁵ This he derived from notes to another table, table 2 on page 5, in the BMI document.

share of the IP VPN market in South Africa was 45%.¹³⁶ Based on this the Commission argues that Telkom's overall MNS market share must be greater than 40-45% and thus closer to 50% since IP VPN is only one of many WAN products that Telkom offers.¹³⁷

[167] ISPA considered two possible methods for calculating Telkom's market share in the MNS market. It first calculated Telkom's market share as 38.5%, based on Telkom's unverified total 2005/6 MNS revenue of R283 million which it divided by the total MNS market size of R735 million. However it was of the opinion that this market share was too low if one took into consideration Telkom's internal documents. It therefore also considered what Telkom had said about its own market share based on its various MNS products. Telkom's VPN Supreme Product Plan 2007/2008, dated February 2007 estimates its market share of the IP VPN segment at between [35%-45%] and its X-25 Product Plan 2007/2008, dated 10 March 2007, state its market share in this segment as between [65%-75%]. Based on the BMI revenue figures Telkom's combined market share in the Frame/Cell segment amounts to 75%.¹³⁸ ISPA therefore concludes that based on these figures Telkom's market share in the MNS market must be in excess of 40%.

[168] All of the above suggests that Telkom's market share is likely to be higher than 40%.¹³⁹ ISPA on the basis of its earlier calculations provides us with a market share of at least 38.5%. If we have regard to all the evidence put before us, Telkom's market share seems to be in the range of 38.5% - 51%.

¹³⁶ Exhibit U page 6, par 2.1.5

¹³⁷ Others include ATM and Frame Relay.

¹³⁸ See ISPA heads page 34 par 54.3

¹³⁹ In Exhibit I, page 108 for instance Telkom indicates that it has 60% of the market while VANS and ISP's capture the balance.

BCX's market share

- [169] Telkom alleges that BCX is a very small player in the MNS market in that it has only recently entered the VPN segment. At the end of the proceedings Telkom argued that BCX's market share was between 2.2% to 3.2% in the MNS market.¹⁴⁰ Mr Sewell on behalf of BCX stated that BCX's revenue from its traditional WAN management activities amounts to only R15 million, which represents a market share of 4% of the WAN meta-management segment.¹⁴¹ This figure excludes revenue from BCX Comms for 2005/6 in the VPN segment of R70 million. However, the figure of R15million could not be found in the BCX financial documents that had been discovered. Under cross-examination Mr Sewell conceded that BCX's revenue figure for MNS could be higher than R15m depending on how MNS was defined and that the revenue figure could include revenue for network design and implementation.¹⁴²
- [170] The Commission, at the end of the proceedings seems to have suggested that BCX's market share was smaller than initially assessed but not by much more than that put forward in its recommendation.
- [171] ISPA, utilizing the evidence that had been put before the Tribunal by the merging parties themselves, and the BMI data, estimates BCX's MNS market share at 8.7%. Based on the sum of the various components as set out below, it calculates BCX's total revenue from the MNS market share as R63 million.¹⁴³

¹⁴⁰ Unterhalter in his heads at page 44 refers to the BMI report of 2006. It is however unclear exactly how he calculated these percentages.

¹⁴¹ See Telkom bundle 4 page 1419, table 2 and 1415 table 1. "WAN meta-management" which is defined as high level WAN management services provided by system integrators such as BCX and Dimension Data etc, of which the total market revenue of 2006 was estimated at R 416 million.

¹⁴² See transcript page 956- 957

¹⁴³ See ISPA heads page 30, 42 to 45

- 1) Revenue earned from designing, building and implementing WANs: 4% of R143.7 million, i.e. R6 million;¹⁴⁴ plus
- 2) BCX Comms' contribution to the MNS market through the provision of VPN services: R27 million (a proportion of the R70 million figure after access lines are deducted);¹⁴⁵ plus
- 3) BCX's WAN equipment sales (and presumably lease): 10% of R150 million, i.e. R15 million;¹⁴⁶ plus
- 4) Network Management: R15 million.¹⁴⁷

[172] It then divides the R63 million by the total MNS market of R 735 million arriving at a market share of 8.7%.¹⁴⁸

[173] Mr Hodge indicated that he had consulted with industry participants and had formed the view that BCX in the traditional WAN space was not an insignificant player and that it would accord with the estimated market share that ISPA had calculated.¹⁴⁹

[174] At the last minute of the proceedings, Mr Watt suggested that the revenue figure of BCX Comms included access line revenue. This was never suggested before by any party and indeed, once again could not be verified. Moreover this was directly contradicted by Mr Sewell who stated that in the main, BCX's clients and not BCX, had a direct relationship with Telkom regarding access lines.¹⁵⁰

[175] On the basis of industry sources, the evidence before us and the revenue figures provided by the merging parties' themselves, we conclude that ISPA's calculation of BCX's market share of 8.7% is a

¹⁴⁴ Transcript page 2621

¹⁴⁵ Transcript page 2294 and CRA report page 56 of the witness bundle.

¹⁴⁶ Transcript page 2295

¹⁴⁷ CRA report page 54 of witness bundle. ISPA argues that it is "abundantly" clear that BCX's MNS revenue of R15 million was purely the management layer and did not include the revenue earned by BCX for designing, building and implementing or configuring WANs. The amount is not verified.

¹⁴⁸ Hodge's estimate of the total MNS market as explained in the transcript pages 2138 and 2140.

¹⁴⁹ Transcript 2159

¹⁵⁰ Transcript 886.

fair estimate – and notably not too far off from that reflected in the Bain slide.

[176] In conclusion we find that Telkom’s relative market share in the MNS market is between 38.5% -50%. BCX’s market share is at least 8.7%.

[177] The Commission and ISPA identified Didata as the largest competitor to Telkom in the MNS market. Mr Brierley and Mr Wilcocks both ranked Didata as the next largest player, after Telkom, in the MNS market.¹⁵¹ Mr Brierley identified Verizon and MTN NS as the next significant competitors, after DD, to Telkom, but his evaluation was done in the context of only the VANS (VPN) segment and not the entire MNS market. None of the parties provided market share figures for these two entities in the MNS market. However neither Verizon nor MTN NS provide the range of services that DD and BCX provide, such as outsourcing, enterprise owned WAN, meta-WAN management and systems integration services.

[178] On the basis of the Commission’s calculations Didata, as the largest of these competitors, had a market share of approximately 13%. Hence BCX, with a market share of at least 8.7%, compared to the DD’s share of 13%, can hardly be considered to be an insignificant player in the MNS market.

The ITS market

Market definition

[179] The third product market is the Information Technology Services market (“ITS” market) which can be divided into several sub-markets namely Application Management, Information Systems Outsourcing, Network and Desktop Outsourcing Services, Hosted Application Management and Hosted Infrastructure Services.

¹⁵¹ See , Brierley evidence transcript page 1705, Wilcocks transcript page 1788

- [180] ITS relates to the provision of services to large corporate buyers of services such as planning, managing and supporting software and hardware required to run their computing requirements. It generally includes a central (or distributed) data centre where the organizational database and some utility and enterprise applications reside, and a number of distributed computing sites at each office location which would include the servers, personal computers and peripherals such as computers. An organization can choose to either supply all of its IT requirements internally (on-site) or it could outsource all of its requirements to a specialized ITS company (hosted infrastructure).
- [181] Some IT services are dependent on connectivity as a direct input to function namely Data Centre infrastructure management, WAN management and desktop management. It appears to be common cause that for purposes of this merger the relevant product market includes access based IT services.
- [182] BCX is an IT company that is primarily involved in the provisioning of IT services (though it also acts as a reseller of hardware and software). Its revenue is split roughly between services (69%) and products (31%).¹⁵² Its business is split into outsourcing services, technology infrastructure, business applications and communication. It conducts the majority of its activities on-site at the customer's premises but also provides remote hosting and/or infrastructure management services at its data centres.¹⁵³ Off-site or remote data centres rely on a leased line to connect an off-site data centre to a company WAN. BCX operates 4 data centres, two newly commissioned data centres at Midrand, one at Crown Mines and the other in Durban. Notwithstanding its large investment in the Midrand centres, BCX claims that the

¹⁵² See the BCX 2006 Operational Review on its website

¹⁵³ These may involve BCX hosting and managing the customer's own equipment at BCX's data centre, or the customer choosing to manage its own equipment which is merely housed at BCX's data centre, or BCX managing the customer's ITS requirements using BCX's own equipment housed at BCX's data centre.

majority of its clients in general favour on-site support over remote service provision via a centralized data centre. As a result, the off-site data centres account for a small proportion of outsourcing revenues.

Market shares in the ITS market

- [183] All the parties agree that BCX is the largest player in this market. Telkom only recently entered this market and is regarded as a small player.
- [184] Dr Federico estimates BCX's market share to be 12.2% of the total ITS market and 17.7% of the outsourcing segment.¹⁵⁴ The merging parties' concede in their Heads that BCX's market share could be as high as 19% if one removed the smaller customers from the BMI estimate.¹⁵⁵ If the same exercise is done for the Outsourcing activities BCX's market share would increase to approximately 20%.
- [185] According to the Commission BCX's market share in Outsourcing is approximately 18%. The Commission also identifies a sub segment within the Outsourcing market namely Information Systems Outsourcing, where BCX is particularly strong. It estimates that BCX's share is 33.3%. BCX itself indicates that its share of this segment has grown from 33.3% to 38.5%. Mr Sewell who is the Head of Outsourcing, in March 2006, indicated in an interview with Moneyweb of BCX's aim to grow its market share from 30% to 50% in this segment.¹⁵⁶
- [186] The BMI 2005 report on the IT sector estimates BCX's market share in the ITS market as 12.2% and 17.7% of the Outsourcing market.¹⁵⁷
- [187] Based on the above we estimate that BCX's market share in the ITS market is between 12% and 19% and a market share of between

¹⁵⁴ Table 2 and 3 of the CRA report

¹⁵⁵ See Telkom Heads page 65 par 152

¹⁵⁶ Commission's Heads page 23.

¹⁵⁷ Telkom Bundle file 4 page 1490

17.7% and 20% in the Outsourcing segment. What is however accepted by all is that BCX is the largest player in the ITS market.

- [188] The ITS market is not a concentrated market. There are other players in this market such are Dimension Data, AST, Arivia.kom, IBM, EDS CSC and BTG. BCX competes with Gijima and DD in the outsourcing market

Data Centres

- [189] The Commission in the course of the proceedings argued that there was an additional relevant market of off-site or remote data centres. MNS providers and ITS providers offer to host data centres for their clients. In the context of declining costs of connectivity and a migration to an outsourced VPN model as a result of the Minister's announcements, MNS and ITS providers now offer to host a client's data on a shared basis. This has resulted in economies of scale and lower data management costs for enterprises. The Commission had requested information from a range of providers of remote data centres, including the merging parties. Both Telkom and BCX resisted this request but eventually submitted the requested information at the direction of the Tribunal. After argument, the Commission did not pursue a prohibition of the transaction on the basis of a lessening of competition in the market for data centres. We make no finding on whether off-site data centres constitute a separate relevant market for purposes of competition evaluation. However, if this transaction would have been approved, one of the effects of the merger would have led to the merged entity being the dominant provider of off-site data centres with a market share of between 36% -42%.¹⁵⁸

- [190] Having identified the relevant markets we turn to assess the implications for competition.

- [191] At the outset we note that in this transaction the merging parties did not rely on any efficiencies as a defence. While there were some cost

¹⁵⁸ See page 3 of Commission's supplementary notes on data centres and vertical arithmetic

savings to be achieved, no dynamic efficiencies, as are required to be shown for purposes of section 12 A (2) were shown or relied upon.¹⁵⁹

Competition Evaluation: Horizontal effects

- [192] In general, relative market shares are utilized by competition authorities to assess whether a transaction between rivals would require closer scrutiny. Market shares on their own are merely a first glance of the relative market positions of rivals in that market and the levels of concentration in a market. On their own they do not conclusively tell us about competitors' ability to exert a competitive constraint on each other. However certain levels of concentration and changes in concentration as a result of a merger act as thresholds for competition authorities to scrutinize mergers more closely.¹⁶⁰
- [193] Section 12A(2) requires the Tribunal, when it determines whether a merger is likely to lead to a lessening or prevention of competition, to assess the strength of competition in the relevant market and the probability that firms will behave competitively or co-operatively, taking into account any factor relevant to competition including factors such as the dynamic characteristics of the market, including growth innovation and product differentiation, ease of entry into the market, including regulatory barriers and whether the merger will result in the removal of an effective competitor.¹⁶¹
- [194] Let us recall the arguments put forward by the parties in relation to the horizontal overlap between Telkom and BCX. The merging parties argued that the horizontal overlap between Telkom and BCX, due to BCX's allegedly small share of the MNS market, was so insignificant

¹⁵⁹ See Trident Steel (Pty) Ltd and Dorbyl Limited, Tribunal case no: 89/LM/Oct00

¹⁶⁰ For example, in the US a change in HHI above 100 points as a result of a merger in a particular market usually triggers closer scrutiny. An HHI measurement of more than 1800 usually denotes a concentrated market.

¹⁶¹ See s12A

that the merger would not lead to a substantial lessening of competition. In the event that the Tribunal was nevertheless concerned about the horizontal overlap, counsel for the merging parties indicated that his clients would divest of BCX Comms.

[195] ISPA argued that the horizontal overlap was significant and that the relative market share of 8.7% was an understatement of BCX's strengths and effectiveness as a competitor to Telkom in the convergence space. The merger would result in the removal of an effective competitor. In the convergence space, there were fewer service providers and with network externalities the merger would lead to more significant long term adverse effects than what was indicated by the initial increase in the levels of concentration.

[196] The Commission argued that while BCX had a smaller market share than was initially estimated, in its view BCX was poised to become a credible and formidable *future* rival to Telkom in the dynamic MNS market which was moving towards convergence and the VPN offering.

[197] We turn to consider whether BCX, despite its relatively small market share, is an effective actual and credible future competitor in the MNS market.

Removal of an effective competitor

[198] In this particular matter, the analysis requires us to evaluate BCX's strengths, not as a potential competitor poised to enter a new market, but its strengths in the current MNS market, as well its future prospects in a market that is moving towards a VPN offering. The assessment of BCX's credibility as a future competitor is analogous to an enquiry of sufficiency¹⁶² traditionally undertaken by competition authorities in

¹⁶² See below where we set out the enquiry to assess the entry of Neotel in the MNS market. The enquiry is undertaken by asking three critical questions, whether entry is likely, timely and sufficient.

their assessment of potential competition. The future prospects of BCX cannot be assessed on the basis of pure conjecture but necessarily requires us to take into account the intentions of the company as articulated in its projections, its business plans, its internal high level documents, the views of competitors and where available third party industry sources and any unique qualities it may possess.¹⁶³

[199] The Commission argued that there was sufficient evidence to demonstrate that, even though BCX may have a smaller share in the current MNS market than initially suggested, BCX was poised to become a formidable competitor to Telkom in the VPN segment of the market. This is because BCX has a large client base which it intends to migrate to its VPN. Its VPN is technologically more advanced than its competitors and the BCX Board has signalled its commitment to expansion in the VPN market by making a substantial investment in upgrading the network and adopting a strategic plan. The removal of BCX would thus remove a significant future or potential competitor to Telkom in the VPN segment of the market.

[200] The merging parties further urged the Tribunal to take into account, in the assessment of this merger, the intended entry of Neotel in the MNS market. They argued that the removal of a competitor such as BCX would be largely off-set by the entry of a large potential competitor such as Neotel. We deal with this issue later.

[201] On behalf of the merging parties, Mr Sewell of BCX, attempted to persuade the Tribunal that BCX as an existing MNS player in the WAN segment of the market was not a credible competitor to Telkom.¹⁶⁴ In addition, he submitted that in the VPN segment BCX was extremely small and its future prospects were not as good as Mr Van Rensburg

¹⁶³ See in this regard the EC guidelines which provide that even if a competitor has a small share of the market, any unique qualities that it may possess may be taken into account in order to assess its effectiveness or credibility as a competitive. See Exhibit "7" EU Guidelines (2004/C31/03) paragraphs 58-60.

¹⁶⁴ See the section dealing with market definition

thought. Mr Van Rensburg was the Group Executive Strategy of BCX Comms at that time. Mr Sewell and counsel for the merging parties referred to the fact that BCX Comms had only one significant client, namely Bidvest, on its VPN and that its revenues had not grown much since it had acquired the VPN from Bidvest as evidence of its meagre presence and weak prospects in the VPN segment, which was going to be the product of choice in the future MNS market.

[202] BCX's strengths in the WAN segment of the MNS are undisputed. It prides itself on its meta-WAN services and has secured contracts with large companies such as AshantiGold worth hundreds of millions of rands.¹⁶⁵ BCX itself, despite Mr Sewell's self-flagellation in support of a low market share figure, considers itself as a leading and credible organisation in network related services as reflected in its claims on its website " *Our proven track record spans over 20 years and includes the design and implementation of 6 of the largest networks in South Africa..... Business Connexion Networks has highly skilled people to provide strategic planning, thought leadership, network architecture, design, configuration and implementation skills in traditional data networks as well as in fully converged data, voice and video networks.*"¹⁶⁶

[203] BCX's credibility and reputation are known to its competitors. Mr Bosman on behalf of GijimaAST regards BCX as its strongest competitor saying " *So certainly for years and I would love that it wasn't the case, but unfortunately in competitive situations the Business Connexion communications' capability is not insignificant if I can put it that way.*"¹⁶⁷

¹⁶⁵ Mr Sewell also conceded during cross examination that BCX is offering WAN solutions to Ashanti Gold of more than R500m over 5 years – this for services only- despite his earlier claim of R15 million as the market size of BCX Comms in the Wan market. See Mr Sewell's evidence on page 905 of the transcript.

¹⁶⁶ See BCX website.

¹⁶⁷ Transcript page 2587

- [204] As far as its VPN business is concerned, BCX doesn't consider itself as a minnow. In its Annual Report of 2005 BCX claims " *The second acquisition was that of the network business of Bidvest National Network Solutions, which will enable Business Connexion to operate as a VANS provider, offering an end to end converged data and voice solution to its large outsource client base without having to rely on third parties. The acquisition gives the company a foothold in the R70 billion telecoms market and compliments its leadership status in the R 40 billion IT market.....*"¹⁶⁸
- [205] BCX's internal documents reveal it had committed an amount of R84 million to its VPN investment, over three phases.¹⁶⁹ In the first phase of the plan, R26, 229,485 was spent on upgrading the network. By the end of that upgrade, BCX could boast "the largest privately owned NGN".¹⁷⁰ In addition, BCX had formed partnerships with VANCO¹⁷¹ and Storm Telecom¹⁷² to increase its range and depth of skills. Its strategic documents reveal that it had every intention of approaching its client base with its VPN offering as an end-to-end solution for their client's communication needs.¹⁷³
- [206] By acquiring Bidnet, and upgrading the network, BCX now owns the most advanced VPN, in the country.¹⁷⁴ According to Graham Damp – Chairman of McCarthy Group IT Steering committee: "*The MPLS-VPN solution provided by BCX is not only providing advanced security features but also unmatched service levels and redundancy, aspects which are business-critical to the McCarthy Group*".¹⁷⁵ Mr Sewell himself indicated that not only does BCX offer a high level of IP in

¹⁶⁸ Transcript page 2352

¹⁶⁹ See BCX Communications NGN page 1779 ISPA trial bundle file 5

¹⁷⁰ See Exhibit "G"

¹⁷¹ It had formed a partnership with VANCO in order to obtain global reach in IP connectivity.

¹⁷² The partnership with Storm was in relation to the transmission of VoIP.

¹⁷³ See BCX Communications NGN page 1783 ISPA trial bundle file 5

¹⁷³ See Exhibit "B"

¹⁷⁴ See Mr Watt's comments that BCX owned the most advanced NGN in the country. Watt's presentation to Telkom, Commission discovery bundle 1B page 1066.

¹⁷⁵ See Competition Commission Bundle 1B page 1070

terms of networking it also has employed one of the “top guys”, as he puts it “*We have really got one of the top guys in the country in that particular business that does that.*”¹⁷⁶

[207] Despite the insistence by Mr Sewell and counsel for the merging parties that BCX had only one major client, namely Bidvest and that this demonstrated that it was a very insignificant player in the VPN market, the evidence suggests otherwise. Bidvest is one of the largest logistics organizations in the country. This is probably why we see that BCX has 15 POPs linking **1007** client sites, it has over **40** VPN clients and more than **40 000** users. Its corporate clients include companies such as Bidfreight Management Service, McCarthy Limited, Fedex, Waltons, Crown National, Excitement Stores, Island View Storage and Radiospor, to name but a few.¹⁷⁷

[208] In its business plan BCX Comms reports to its Board in April 2006 when motivating its proposed R85 million expansion programme for BCX Comms’ NGN: “*our pipeline includes Sasol, Edcon, Ellerines, SARS, Nampak, Metcash, Group 4, Santam and PHP Billiton, amongst others. These are all very significant networks that will utilize a significant portion of the new capacity being created through the capital investment in upgrading the network. We are confident that our first year’s revenue and 60% of year two’s revenue will be secured through these clients mentioned above.*”¹⁷⁸

[209] More importantly, Telkom itself considers BCX as a formidable competitor. In Telkom’s internal documents it refers to BCX’s strengths as a competitor in the VANS sector and lists as BCX’s strengths its strong customer base, including Government contracts, Outsourcing prominence, Networks (LAN/WAN management) prominence.¹⁷⁹ It also identifies BCX’s networking arm as one of the “*dominant*

¹⁷⁶ Transcript page 887

¹⁷⁷ Watt’s presentation to Telkom, Commission discovery bundle 1B page 1066, 1069.

¹⁷⁸ Also see Ispa trial bundle 5 page 1783.

¹⁷⁹ ISPA bundle file 7 page218

competitors” in the MNS sector.¹⁸⁰ In 2004 Telkom identified Comparex Africa Networks (now BCX) as one of four competitors in the MNS market saying: “all four competitors are either involved in or preparing themselves to offer next generation networks such as VPNs, voice networks, voice over IP, etc..... Order of competitive strength, first Dimension Data, second Comparex Africa Networks (BCX), third AST Networks, fourth Arivia.com.”¹⁸¹ Telkom was of the view that “Business Connexion has a strong customer base, including government contracts, outsourcing prominence, networks, LAN, WAN management prominence, strong BEE credentials, areas of competition, security, Nanotech and ERP systems.”¹⁸²

[210] Despite a vast body of high level documentary evidence suggesting that Telkom considered BCX as a formidable competitor, and BCX considered its own prospects in the new MNS space to be excellent, Mr Sewell attempted to downplay all of these activities suggesting that they were the optimistic plans of one person, namely Mr Van Rensburg, and were unrealistic.

[211] However no internal strategic documentation could be found to support Mr Sewell’s views. Nor did CRA in its report suggest this. Mr Watt himself confirmed under cross examination that it was BCX’s firm intention to enter and expand in the MNS market through the acquisition of Bidnet.¹⁸³

[212] So we see in 2006, BCX was regarded as a particularly successful company due to its strong existing relationships with clients, a large blue chip client base and the breadth and depth of its service offering. By acquiring Bidvest’s network and upgrading it to an NGN, BCX had become a significant threat to Telkom. Not only did it have the most advanced network suitable for convergence, it had access to some of

¹⁸⁰ Commission’s bundle file 1B, page 743

¹⁸¹ ISPA bundle file 7 page 217 and transcript page 922.

¹⁸² Transcript page 924 and ISPA bundle file 7 page 218.

¹⁸³ See Watt’s evidence on page 2345-2348 and 2351 of the transcript

the largest enterprises in the country, with aggressive plans to migrate these clients onto its VPN.¹⁸⁴

[213] Heavy weather was made, both by Mr Sewell and the merging parties' counsel of the fact that BCX Comms' revenues and customer base had not grown much more than the initial revenues at the time of BCX acquiring it from Bidvest. During the upgrading period of the network, it is conceivable that BCX Comms would not enjoy a rapid growth in revenues or customer base. However its subsequent difficulties seem to have been caused more by Telkom's presence and influence in the business of BCX than by BCX Comms.

[214] Prior to these hearings, Telkom and BCX had already conducted "integration meetings" attended by both BCX and Telkom employees, in which they attempted to outline areas of duplication and integration. Named persons in both organizations were given responsibilities to address identified areas that needed some form of action. Telkom was also reportedly going into customer meetings with BCX.¹⁸⁵ In the course of this, two critical complaints were raised by BCX Comms, the one being that BCX executives were promoting the Telkom VPN product above that of BCX Comms, and the other that Telkom had taken away a significant client, from BCX. The second complaint was considered of sufficient importance by the BCX Board to consider seeking damages from Telkom.¹⁸⁶ The Board agreed that the damages to BCX were a reality, a fact confirmed by Mr Watt.¹⁸⁷ Mr Watt also confirmed that the uncertainties created by the Telkom deal had put a brake on BCX Comms' progress. He also confirmed that Telkom had attempted to cut BCX Comms out and the probabilities are that Telkom used the merger as a tactic in its attempts to retard BCX Comm's expansion and gain access to its clients.¹⁸⁸

¹⁸⁴ Transcript page 131

¹⁸⁵ See Exhibit "B"

¹⁸⁶ See ISPA trial bundle file 5 page 1808

¹⁸⁷ See Watt 2374-2375

¹⁸⁸ See Watt's evidence on page 2301 and 2393 of the transcript

[215] It seems that Mr Van Rensburg's concerns came to pass. Telkom had taken clients away from BCX. By giving Telkom the extent of involvement in its business operations and holding "integration meetings" BCX executives had, unwittingly or not, let the fox into the chicken-run.

[216] While we are unable to determine what impact the presence of Telkom executives and employees had on the growth prospects of BCX Comms, we can say with certainty that at that time, Telkom seemed to know more about BCX's business than did its own Board.¹⁸⁹ Telkom's conduct in relation to BCX's clients clearly demonstrates that it sought to win the customer *by any means*, even at the risk of causing a rift between itself and its prospective subsidiary. Moreover, the merger for all intents and purposes had been *implemented* without authorization from the Tribunal.

[217] Telkom's assessment of BCX's strengths is seemingly not exaggerated. In the dynamic MNS market, BCX is considered to be better positioned than most others to become an effective and profitable competitor to Telkom. BMI-T, the leading industry analyst, forecasts that some service providers seem to be better positioned than others. In particular it states that:

*"Various high level IT services are provided by System Integrators ...including DD and BCX. These companies provide services that span the gap between IT services (application level management) and telecoms services, typically in the form of supervisory operational management of inter alia wide area networks. Didata for example provides such services to large corporate customers over and above the services provided by its subsidiary IS, Telkom and others."*¹⁹⁰

¹⁸⁹ See comment made by a BCX Board member on page 1812 ISPA Trial Bundle File 5

¹⁹⁰ Extracts from IDC/BMI –T Report: "SA Data Services Market Forecast and Analysis 2006", licensed to Telkom giving its view of the evolving market.

[218] BMI-T explains the role and distinct advantage that system integrators such as BCX and Didata have over their rivals in the dynamic MNS market. According to BMI:

“System integrators are important influencers of data services within their corporate customers, assisting them with supplier selection and drawing up specifications for service level agreements.”, and that “the opening up of the telecoms market to more competitors in future and the simultaneous extension of expanded privileges to existing players (like VANS to provide inter alia voice services) has paved the way for greater participation byIT system integrators such as Business Connexion.”

[219] And further, BMI forecasts as follows:

“The future is bright for managed services. Companies are more inclined to opt for an end-to-end solution and there are very few players able to do that in South Africa. The line between carriers and system integrators is blurring and enterprises are looking for partners that can take a holistic view of their network and application infrastructure from a tactical point of view..... System integrators are best positioned to provide bundled services, while telecom operators are not credible .. . system integrators are most likely to reap bundling benefits like churn reduction and high margins.” ¹⁹¹

[220] Hence we see that, BCX as an MNS provider is better positioned than the traditional VANS or even Telkom to own the customer and take a large slice of the margins to be earned in the MNS market. The only other firm seemingly placed better than BCX seems to be Didata which also has a similar range of skills but a larger VPN. However, BCX’s

¹⁹¹ See exhibit F: BMI T Special Study SA Managed Network Services Market 2003-2008 (released in Feb 2004) page 31

leading position in outsourcing places it in a far better position to take margin away from both Telkom and its other MNS rivals.

[221] In this dynamic market and the migration towards the VPN package, which as we discussed above requires a range of skills on the part of the service provider, it is hardly surprising that BCX is poised to take margins from the traditional VANS.

[222] BCX has credibility in outsourcing and a proven track record in network design, implementation and support. Its services have always been rendered at a client's premises, over the client's networks and hence it enjoys a closer client-vendor relationship than a traditional VAN. It has built and managed some of the largest private networks in the country.¹⁹² In addition it has been a meta-WAN or single service aggregator for very large enterprises, rendering services to them which run unto hundreds of millions of rands.¹⁹³ It is seen as a partner of choice¹⁹⁴ and is, together with Gijima and DD, often short-listed or awarded large outsourcing bids. It plays an advisory role to the client, advising it on choices in technology and applications.¹⁹⁵ The fact that it also renders IT services and business applications to its customers enables it to better understand its clients business and needs. In addition, and in order to respond to the converging offerings in the MNS environment, BCX can now offer the most advanced VPN in the country which is located in its division BCX Communications. It also stands to become a major VoIP provider in South Africa.¹⁹⁶ Last but not least it has a blue chip client base which includes some of the largest corporations in the country and government departments or institutions and which it plans to migrate to its VPN.

¹⁹² See the discussion on relevant MNS market definition and some of BCX's strengths that are dealt with there.

¹⁹³ See BCX's service agreement with AngloGold Ashanti on page 3687 of the record.

¹⁹⁴ See BCX Annual Financial Results Presentation August 2006

¹⁹⁵ See Wilcocks evidence on page 1798 of the transcript. See also exhibit F.

¹⁹⁶ BCX Presentation Aug 2006 above

- [223] In short, BCX has both the range and depth of skills that enable it to become a credible competitor to Telkom, and to any other MNS provider, in the MNS market, whether this is in the large outsourcing contracts that are put out on tender or the smaller contracts. These skills are not located only in BCX Comms but are spread across BCX's business as a whole.
- [224] BCX's strengths as described above would pose a greater threat to Telkom in an industry characterized by economies of scale and network externalities. Once BCX would have successfully migrated its large high value clients onto the most technologically advanced network in the country, Telkom would have greater difficulty, because of network effects, in winning those clients over.¹⁹⁷
- [225] Thus we conclude that BCX, with its range and depth of skills, presents a highly credible competitor to Telkom in the dynamic MNS market. BCX may only have a market share of 8.7% but industry forecasts place BCX and DD as the most likely to take margin in the convergence space. This would probably explain why Telkom in the first instance identified only two suitable acquisitions, namely DD and BCX. It attempted to acquire DD first, even though it was advised of the huge risk of competition veto before it approached BCX. DD has a larger VPN through its subsidiary IS. Indeed the overlap between Telkom and DD was estimated at that time to be very large.¹⁹⁸ Telkom was not successful in removing its largest rival namely Didata. It sought then to remove the other significant competitive threat to it in the convergence space, namely BCX.
- [226] By acquiring BCX, Telkom will have removed an effective competitor in the MNS market and a significant threat in the VPN segment of the MNS market. In addition, as noted above Telkom, by acquiring BCX, specifically, rather than any other smaller MNS rival or ITS company

¹⁹⁷ See our discussion on barriers to entry where we deal with the issue of network effects.

¹⁹⁸ See Telkom Document entitled "NDIZA" April 2005 on page 645 of the record

Telkom will be able to provide the range and depth of skills which no other rival in the MNS market possesses. It will also be able to acquire BCX's credible network design, implementation and support skills and target BCX's large blue chip client base that BCX brings with it.

- [227] Owning the customer is paramount for Telkom in the MNS market – because it is the most profitable segment of its business and it is the only market in which it faces, due to arbitrage and VoIP as a result of de-regulation, the greatest possible loss of monopoly margins in leased lines and voice. By acquiring BCX it not only has access to BCX's WAN customers, but is also placed in a far better position to win customers of its other rivals.

Neotel's entry in MNS market

- [228] We have been urged by the merging parties to consider the potential entry of Neotel into the MNS market as a factor to be considered in the evaluation of the merger. They argue that Neotel has all the same rights as Telkom, has a large national network and has experienced partners in the form of VNSL¹⁹⁹ and will be supported in its roll-out by Infracore. The merging parties argue that Neotel will be a formidable competitor in the MNS market because it will on the one hand be able to provide infrastructure to itself and other MNS rivals and will be able to leap-frog technology with its strategic partners which will enable it to cherry pick large enterprises.
- [229] It's possible that Neotel is the only potential MNS rival that could exert a competitive constraint on Telkom *provided it enters the market with as large a network as the Telkom network and an equivalent offering*. In other words, will Neotel's entry be likely, timely and sufficient.

¹⁹⁹ VNSL refers to Videsh Sanchar Nigam Limited, an Indian privatized telecoms company and a subsidiary of TATA Group. TATA Group holds 51 % in VSNL.

- [230] In the US, when competition authorities assess the impact of a merger on competition in a relevant market, they consider whether there is any likely new entrant which will post merger, exert a significant competitive constraint to off-set the reduction in competition caused by the merger. The assessment is not done in a vacuum or on the basis of mere conjecture. It is usually done by asking three critical questions, is entry by a potential competitor going to be likely, timely and sufficient.²⁰⁰
- [231] In its initial business plans, Neotel indicated that it would be seeking to target wholesale, corporate and government as clients rather than the domestic or residential market. Dr Hay confirmed that it was Neotel's intention to enter the MNS market.²⁰¹ Hence we accept that its entry is likely.
- [232] However, all the evidence seems to suggest that Neotel is far from entering the MNS market in a manner that is both sufficient and quick enough to exert a significant competitive constraint on Telkom. As far as its network is concerned, Neotel has not yet been able to develop an efficient or appropriate national network²⁰² and has yet to finalise the terms of access to the infrastructure in Infraco.²⁰³ For purposes of entry into the MNS market, *sufficient enough to pose a credible competitive constraint to Telkom*, Neotel would have to be able to provide its retail customers with a national network containing a large number of POPS, access lines with appropriate SLAs and a range of value added services. Neotel has already indicated that it does not have an appropriate national network.

²⁰⁰ The US merger guidelines examine entry by asking three questions; is it going to be timely, likely and sufficient. We have followed this approach in some of our decisions, see for instance Xstrata South Africa (Proprietary) Limited and Egalite (Proprietary) Limited and International Carbon Holdings (Proprietary), Case No: 54/LM/Jul04.

²⁰¹ It would be expected of a new entrant to cherry pick markets and target high value customers initially.

²⁰² See the section on relevant market definition and evidence of Dr Hay on page 1148 of the transcript.

²⁰³ At the time of the writing of these reasons, the Infraco Bill was still being debated in Parliament. See also evidence of Dr Hay at 1128 and 1147 of the transcript.

[233] Instead, it seems that if Neotel wanted to enter the market quickly, it will have to rely on Telkom's infrastructure to do so.²⁰⁴ The most important aspect of Telkom's infrastructure that Neotel would like access to is Telkom's local loop.²⁰⁵ Dr Hay on behalf of Neotel testified that while Neotel enjoyed this right, no special regulations were promulgated by ICASA to regulate this. Accordingly any aspect of this right was to be regulated by the Facilities Leasing Regulations of ICASA. In addition, Telkom had refused to conclude a holistic infrastructure sharing agreement with Neotel but had instead stated that it would consider Neotel's request on a case by case basis

[234] If we are to understand Dr Hay's evidence correctly, it seems that Neotel is likely not to be able to access much of Telkom's infrastructure in the local loop in the next two years. Whether the difficulties in the negotiations between Telkom and Neotel are as a result of Telkom's conduct or Neotel's internal difficulties, what is clear is that Neotel is unable to plan with certainty which geographic areas it can target (if it doesn't know whether it will access to Telkom's local loop) and is nowhere near being actually able to share Telkom's infrastructure. If it is able to share some of it, it will be doing so with difficulty. Hence, Neotel will have to roll out its own local loop, which will take much longer, or wait until the local loop is unbundled by the Minister. According to the committee convened by the Minister of Communications, local loop unbundling is scheduled to be completed at the end of the *next four years*, hardly something that is timely enough.²⁰⁶

[235] At this point in time Neotel's likely entry cannot be relied upon as presenting a competitive constraint on Telkom in the MNS market or to

²⁰⁴ See evidence of Dr Hay at 1148.

²⁰⁵ The local loop, also known as the last mile, is that part of the network that connects the customer's premises to a local exchange closest to the customer's premises. The last mile does not only include copper wires but also the ducts, the switching centres etc (Put in what it consists of) As discussed above in telecommunications, the last mile is often the single most significant barrier to entry for a new entrant.

²⁰⁶ In this regard, see the Minister's announcements and the report published by the Local Loop Unbundling Committee on the Department's website.

prevent the market from tipping towards Telkom. Indeed its prolonged difficulties suggest that it will take much longer than initially expected for Neotel to enter the MNS market and to an extent *sufficient* enough to pose a competitive constraint on Telkom. If it sought to enter the retail MNS market quickly it would, seemingly, also have to rely on Telkom's infrastructure.

[236] Hence, Neotel's entry may be likely but it is unlikely to be *timely or sufficient to off-set the likely harm to competition caused by this merger.*

Barriers to Entry

[237] As discussed above this transaction is taking place in the context of a dynamic regulatory environment and a dynamic MNS market in which enterprises are already experiencing the consequences of innovation in the form of convergence.

[238] In this market, innovation has been released from some of its regulatory restrictions and has brought lower costs of communications for enterprises and has allowed competition to emerge in the MNS market. However, MNS providers are now challenged to invest across the horizontal value chain in order to compete effectively for ownership of the customer and accordingly the margin.

[239] Mr Van Huyssteen and Mr Hodge explained that the migration towards the VPN model has resulted in a decline in the number of service providers and increased barriers to entry.²⁰⁷ This is largely because the VPN product is more complex and requires a wider range and depth of skills on the part of the MNS providers. Mr Hodge further identified that network externalities were a concern in the convergence space.

²⁰⁷ See Genesis, witness statement page 313-314 and Van Huyssteen evidence on page 1038 of the transcript.

[240] The telecommunications industry in general is characterized by high barriers to entry. In addition, it is characterized by network effects²⁰⁸ in that the value of the product to the customer increases with the number of people using the same network. A network becomes more attractive to customers as it enlarges and as it enlarges, more customers are attracted to it. The obvious reason for this is that customers can communicate with more people on the same network at a lower cost.

[241] A VPN is nothing more than a network that offers a range of services to a client. Prior to de-regulation in the MNS market the range of services were restricted to data communications services. After the de-regulation a VPN provider can now provide voice services through VoIP as well and can achieve economies of scale.

[242] While there are limitations of both economies of scale and scope to a VPN, technological innovation and de-regulation has virtually created a number of “ mini- telco’s” that can provide enterprises and organizations with most if not all of their communications needs²⁰⁹ at a *fraction of the cost to that previously incurred by them*. However, meaningful economies of scale and lower costs can only be achieved by a VPN if it has a large enough network and subscriber base and is able to provide the reliability of connectivity. As a network its initial fixed costs would be high but its average costs would decline with increasing subscribers.²¹⁰

[243] Accordingly, once a VPN provider has made the initial investment in its core network, it needs to attract more and more customers in order to recoup the cost of its investment. In essence, VPNs are private communications networks owned by MNS providers and shared

²⁰⁸ As are IT and information network industries.

²⁰⁹ Organisations may elect to have fixed line voice services in addition to VoIP for security or quality reasons

²¹⁰ See Genesis witness statement page 315 - 316

between a few large enterprises that now effectively compete with the large public network of Telkom. If Telkom does not own the customer directly, the only margin it could make is on the price of leased lines, which is already being threatened by the economies of scale achieved by de-regulation- and interconnect fees when VoIP calls from these VPNs break out of their network onto Telkom's network.

[244] The more customers that Telkom owns on its VPN in the MNS market, the greater the barriers to entry for its rivals due to network effects. In the MNS market, Telkom is already the largest MNS provider. It has both the largest number of customers and the largest physical network. It is also able to provide SLAs directly to its customers rather than through a back to back arrangement with other MNS providers. The merger will enable Telkom to add a significant share of the MNS market onto its network. At the same time, the acquisition of BCX's unique meta-WAN and customer relationship skills will enable Telkom to be able to target BCX's large client base. Customers will be attracted to the Telkom VPN offering because of its physical size, its large subscriber base, its range and depth of skills, credibility in outsourcing and the fact that it can obtain SLA's directly with Telkom rather than through an intermediary.²¹¹

[245] The merger will thus create a snowball effect, because in the first instance the merged entity, due to the economies of scale and range of depth of skills it can offer to VPN customers, will be better placed than any of its competitors to capture future growth through new customers.²¹²

[246] Telkom's additional strategy, of locking customers into long term contracts, in order to increase switching costs, will keep its subscriber locked in for a longer period of time. In other words, the MNS market is likely to 'tip' towards Telkom.

²¹¹ The ease with which Telkom could win Sasol away from BCX is an example of this.

²¹² This advantage will be increased by its ability to bundle and offer other products such as fixed line voice.

[247] A tipping of the market towards the Telkom offering would increase barriers to entry and expansion for new and existing players. A large network in itself is a high barrier to entry for competitors or new entrants. A market which is tipped towards the one major network *increases* these barriers.²¹³ It is far more difficult and at times prohibitively expensive for rivals to gain customers – and market share – away from the largest network. Such high barriers are likely to lead to smaller MNS players exiting the market, deterring the expansion of others and leading to a further concentration in the market. Thus, Telkom through the merger will gain a much larger share – if not almost all of it - of the MNS market than the nominal combined market shares of Telkom and BCX would indicate as a result of network externalities.

[248] In addition to the barriers to entry and expansion created by network effects, the MNS market is also characterized by other high barriers to entry. While some segments of the market, such as re-sale of internet services enjoy lower barriers to entry, entry barriers in the MNS market are relatively high.

[249] The first and most fundamental barrier to entry is the availability of infrastructure in the form of leased lines with appropriate SLAs. This still constitutes a bottle-neck for entry.²¹⁴ Until recently, the cost of bandwidth constituted 60—65% of the cost of rendering a VAN service and there are few credible alternatives. As discussed above, Telkom is to date the *de facto* monopoly provider of fixed line infrastructure. An MNS provider, whether an existing player or a new entrant has to rely on Telkom, its major competitor, to provide it with an essential input.²¹⁵

²¹³ See Bishop and Walker: The Economics of EC Competition Law 2nd Edition page 38. See also MCI Worldcom/Sprint – Comp/M.174 [2000] and Genesis Witness Statement page 317.

²¹⁴ This would be a barrier for the class of providers previously known as VANS and remains so for the new MNS provider in the VPN business.

²¹⁵ Telkom offered VANS a wholesale price for bandwidth in the course of these proceedings. Prior to that, VANS were charged a retail price for leased lines.

- [250] A common thread that runs through the barriers related to infrastructure is that the barriers consist not only of the lack of alternatives to Telkom, which is also a competitor to these MNS providers, or the price at which it is available but also because the SLAs associated with an alternative product or technology are not adequate for the needs of large organizations.²¹⁶ To date, there are no effective alternatives to the bandwidth and SLAs being supplied by Telkom to MNS service providers.
- [251] Barriers to entry for MNS providers servicing large organizations are higher than for those servicing smaller enterprises. Large organizations have many different branches across the country. Hence they would require a large network, reliability of connection and appropriate service level agreements. MNS providers require technical network design and implementation skills as well as skills and resources to effectively manage mission critical information for these organizations.
- [252] Costs of switching have also increased. Once an organization has outsourced all of its communications needs to a VPN provider, including its internet and intranet services, switching to another VPN provider or switching back to an enterprise WAN involves much higher switching costs than in the pre-converged environment.²¹⁷ If the customer is locked into long term agreements or has together with its VPN, obtained bundled voice and mobile services, the costs of switching would be much higher.
- [253] Regulatory barriers in the form of license requirements and spectrum scarcity continue to persist and it is uncertain to what extent these would be ameliorated by the ECA license conversion processes intended by ICASA.

²¹⁶ See evidence of Mr Brierley on page 1573 and 1578 of the transcript, Mr Wilcocks on page 1518 and 1537 to 1538 of the transcript.,

²¹⁷ See evidence of Mr Van Huyssteen on page 1206 of the transcript and Hodge expert report page 26 paragraph 64

[254] Hence, while the MNS market is dynamic and displaying growth and innovation, barriers to entry have increased. The product is more complex and requires a greater range and depth of skills on the part of the MNS provider. A large organization which intends to outsource its communications needs will require a service provider to meet all of its network and data communications needs, as well as security and fire-walling. In addition the MNS market is characterized by network effects. An acquisition of a large customer base from a rival by a large VPN provider such as Telkom is likely to tip the market towards Telkom which will result in further barriers to entry.

Unilateral effects

[255] Post merger, the merged entity will be a dominant MNS provider, with the largest physical network, the largest customer base, the ability to provide SLAs directly to customers, the ability to bundle all required services for a VPN and the ability, through the credibility of its new subsidiary to target customers of its rivals. Telkom will enjoy a distinct competitive advantage to its MNS rivals, including Neotel. Because the dynamic MNS market is analogous to a network market, it is likely that network effects will occur which will tip the market towards Telkom.

[256] In our view, post merger, Telkom will be able to act independently of its rivals in this market in a number of ways. In order to limit the impact of de-regulation and convergence on its monopoly margins on infrastructure and voice, Telkom needs to limit migration to innovative products such as virtual private networks. Telkom could, after it has gained sufficient market share of MNS customers, simply raise the price of the VPN offering without suffering any loss.

[257] As long as the total cost of the VPN offering, remains cheaper than the total cost of reverting to an enterprise WAN, including cost of switching, an organization is unlikely to switch suppliers in the face of a non-

transitory increase in price. Switching is also unlikely to occur because, in the first instance there is not yet an alternative service provider with an equivalent offering in the market – and from all accounts will not be there in the near future. Secondly an organization would prefer to stay on a larger network so that a large percentage of its usage remains on-net rather than the more expensive off-net calls. Thirdly, switching costs are high and the more of its communications needs that an organisation has outsourced to its VPN provider the higher that cost.

[258] Alternatively, Telkom could raise the prices of any of the component services selectively in order to increase its margins without running the risk of customers switching away. For example, it could raise the price of its VoIP calls to a price higher than its closest rival. Customers would be unlikely to switch away because VoIP is part of the integrated package and would still want to benefit from economies of scale of a large network. In fact it is uncertain whether a customer will be able to opt out of one of the components of an end-end solution. Telkom could apply this pricing strategy to any of the services it provides over the VPN, including internet services.

[259] Telkom could also engage in a number of other unilateral acts, without regard to its competitors' behaviour. Since Telkom is the overwhelmingly dominant supplier of infrastructure and by all accounts Neotel will only have about 10% of that market at the end of five years, Telkom, once it has captured the customer and has gained market power, through increased market share and snowball effects, could simply increase the retail price of its leased lines to its retail customers. During the course of the hearings Telkom invoked ICASA's regulation of its leased lines repeatedly saying that it couldn't raise its prices without suffering a loss on another service. This was raised by Telkom in the context of input foreclosure of its rivals in the MNS and ITS markets. However, the issue has relevance in the consideration of unilateral effects as well.

- [260] While Telkom's retail prices are regulated by a price-cap formula, the regulation applies to a bundle of services. It could easily increase the price of its leased lines and decrease the price of another service eg voice in which it is already facing declining revenue and/or recover margins from VoIP which is not part of the regulated bundle.
- [261] An important aspect of the retail price regulation is that it has a price cap. Operators are prevented from increasing their prices beyond that which is capped. However Telkom, like other regulated entities is not prevented from discounting its products provided they do not engage in undue discrimination. Telkom could sell its Diginet lines at a discount from the list price (which it clearly intends to do). Where large contracts are negotiated in private or in a bundle,²¹⁸ as happens in the South African market, discriminatory pricing is hard to detect.²¹⁹ Once it has captured the customer, and gained market share in the MNS market as it plans to do, it only needs to increase the price *to the customer* back to its list price. Indeed Telkom's bundling and discounting strategy that it intends to deploy, together with any of the others at its disposal, is aimed at obscuring prices to the customer.²²⁰
- [262] Another factor to bear in mind when assessing Telkom's ability to raise the price of leased lines to its customers is the pending regulation of Telkom's wholesale prices. ICASA intends to regulate Telkom's wholesale prices on the basis of LRIC.²²¹ Currently, Telkom's wholesale services include the supply of infrastructure to operators, as well as network services including termination services. It is likely that VANS or MNS providers will urge ICASA to include their leased lines into Telkom's wholesale services.

²¹⁸ As intended by Telkom

²¹⁹ See evidence of Wilcocks.

²²⁰ See the statements by Mr Wally Beelders, a long time senior employee of Telkom, who claims that Telkom intends to obscure its prices by bundling.

²²¹ Long run incremental costing is an economic model utilized by regulators to determine a theoretical cost of an efficient operator, using various assumptions. These processes are usually drawn out and require extensive negotiation between regulators and operators.

[263] Telkom's internal documents indicate that it in fact will seek to lobby for wholesale price regulation rather than retail price regulation.²²² While this may seem surprising conduct on the part of a monopoly seeking to maintain its monopoly margins²²³ it is not surprising in the context where the monopoly seeks to own the ultimate customer and to dis-intermediate the market. Once Telkom has been able to win customers away from its rival MNS providers its margins will be earned directly from the customer rather than from the sale of leased lines to other MNS providers. Instead of raising wholesale prices, Telkom can then simply raise retail prices to customers, namely the high value large enterprises, who will have very few alternatives in a tipped market.

[264] Telkom itself in its VPN Supreme Product Plan states its intention to **limit migration** from WAN to VPN–

“Cross elasticity will be controlled by the following mechanisms, which will limit mass migration to VPN Supreme:

*Aggressive volume and term discounts on FrameExpress
The Diginet special to provide more bandwidth at a
reduced pricing level”²²⁴*

[265] Thus we see that Telkom is already engaging in price manipulation to stifle innovation and to prevent the beneficial consequences of de-regulation from flowing to enterprises. It intends to reduce the prices of legacy bandwidth such as Diginet lines, both to the retail customer and to the wholesale customer, with the ultimate intention of *limiting the migration* to a VPN model.

²²² See Telkom's 2010 Strategic Plan on page 1017 item 7.1.3.2

²²³ Of course there is no certainty as to when ICASA will be able to regulate Telkom's wholesale services and whether or not the regulations will be contested by Telkom. See annexure A on difficulties encountered by regulators with LRIC pricing.

²²⁴ See VPN Supreme Product Plan 2006/2007 dated Feb:2006, page 13 paragraph 2.3.3.2

- [266] This seems to accord with BMI-T forecasts that Telkom is unlikely to promote VPNs in the MNS market because of economies of scale that can be achieved on infrastructure and the consequential lower margins for Telkom.²²⁵
- [267] As discussed above, the MNS market is the only segment in which Telkom stands to experience any price competition. Its attitude to price competition from Neotel has already been made clear by Telkom in the cold light of its profitability and EBIDTA projections made to analysts on 8 March 2007 when it stated that it will not engage in drastic price cuts because it expected limited competition from Neotel.²²⁶ It is in the MNS market, due to convergence and the de-regulation of VANS, that Telkom is experiencing considerable competition.²²⁷
- [268] Its attitude to competition from MNS rivals is also discernible in its high level internal documents where it records that it seeks to remove arbitrage opportunities and to *defend* its margins in its core markets, infrastructure and voice,²²⁸ and seeks to eliminate competition from independent ISPs.²²⁹ Defending a margin necessarily means ensuring its continuity as before or regaining it from rivals to whom it may have initially lost some market share. Telkom's entire business plan envisages an extension of Telkom's *monopoly* in the new environment but especially so in its core markets, namely infrastructure and voice in the middle to large enterprise segment of its business.²³⁰ Telkom can only do this by, in the immediate term, gaining customers from its rivals, increasing barriers to entry and expansion for rivals, and in the future raising prices of the VPN services to its customers.

²²⁵ See Exhibit F page 34

²²⁶ See Exhibit H

²²⁷ See for example the websites of IS, MWeb, Storm Telecom, mycostsavingscall – all of which offer VoIP calls at a considerable discount to Telkom's voice calls.

²²⁸ See above.

²²⁹ See above

²³⁰ See all the relevant documents mentioned above as well as Telkom 2010 Business Plan

[269] Customers on Telkom's VPN are unlikely to switch from it in the event of a non-transitory increase in VPN prices post merger, whether this be for the network, leased lines or the component services such as VoIP, because there would be no credible competitors to Telkom in the infrastructure market, limited competition in the MNS market, high barriers to entry in the MNS market and high switching costs for the customer. In addition, because of the likely occurrence of network effects in this market, customers would be reluctant to switch to a smaller but equivalent provider. Countervailing power, if any, on behalf of customers in the face of such dominance and lack of suitable alternatives is negligible.

[270] Hence this merger is likely to result in higher prices for the consumer and a stifling of innovation. It is also likely to lead to the exiting of smaller MNS rivals or limit the expansion of existing rivals due to network effects and increased barriers.

Co-operation with Neotel

[271] As discussed above Neotel is likely to enter both the infrastructure and MNS markets. In its initial marketing plans, Neotel revealed its intention to focus on the corporate and large enterprise market. However, Neotel's prospects in both the infrastructure and MNS markets have been affected to such an extent that it has already adjusted its market penetration projections downwards.²³¹ Telkom shares the view that Neotel's ability to compete with it has been considerably weakened.²³² In addition Neotel, an already weakened competitor, now faces robust competition from other MNS rivals in the MNS market due to de-regulation and convergence. An acquisition by Telkom in the large enterprise market is likely to add to Neotel's woes. Neotel has already been blunted and this transaction is likely to blunt it further, making Neotel a natural ally for Telkom, both in not competing

²³¹ See evidence of Dr Hay

²³² As evidenced by Telkom's statement to analysts that it will not be engaging in drastic price cuts, due to the decreased projections for Neotel.

with Telkom, and in warding off the threats they both face in the large enterprise segment of the MNS market. Neotel has already indicated that it will stand shoulder to shoulder with Telkom and will not engage in price competition at the infrastructure level. Both Neotel and Telkom have objected to the proposal that MNS providers of VPNs (who would be classified as ECS licensees in the new framework) be permitted to self-provide their infrastructure. Neotel has indicated that it will challenge a decision by ICASA if necessary.²³³ It is highly likely that Telkom and Neotel will co-ordinate their efforts to dis-intermediate the MNS market of smaller rivals. Neotel, in its position of new entrant and underdog is likely to take up the cudgels against ICASA, instituting legal challenges to protect its margins in the infrastructure and MNS markets. In return, Telkom is likely to grant Neotel favourable terms of access to Telkom's infrastructure and local loop – as it has already done in termination rates.²³⁴

Conclusion on horizontal effects.

- [272] In conclusion, we find that merger between Telkom and BCX will lead to the removal of a credible and effective competitor to Telkom in the dynamic MNS market. Despite the fact that BCX's current market shares have been significantly understated, all indications are that it is uniquely poised to become a formidable competitor in the MNS market by a combination of its range and depth of skills as well its expansion into the VPN segment of the market.
- [273] The acquisition of BCX will not only remove an effective competitor to Telkom but will enable Telkom to gain access to and target the large client base of BCX. The merger is likely to lead to network effects and a tipping of the MNS market towards Telkom. Barriers to entry and expansion will be increased and deter new entry or will lead to the exiting of smaller rivals.

²³³ See evidence of Dr Hay

²³⁴ Telkom has agreed with Neotel on termination rates for voice calls at the level that Neotel sought.

[274] The merger will result in higher prices for customers and a stifling of innovation in the MNS market.

[275] As succinctly put by ISPA's counsel –

“The merger comes at a critical time in the market for managed network services. Specifically the strong trend towards IP-VPN solutions, a service with fewer service providers, which exhibits strong scale and network effects to the benefit of initial market leaders, suggests that the longer-term impact of the merger will be more detrimental to competition than any initial increase in concentration.”²³⁵

[276] As indicated at the outset the merging parties did not rely on any efficiencies as a defence to a finding of a substantial lessening of competition. Accordingly we find on the basis of the horizontal concerns, the merger is likely to lead to a substantial lessening or prevention of competition.

Proposed divestiture of BCX Comms

[277] During the course of the proceedings, the merging parties submitted that in the event that the Tribunal found a likelihood of a substantial lessening of competition on the basis of the horizontal overlap between Telkom and BCX, they tendered the divestiture of BCX Comms, in order to alleviate any harm to competition. No formal resolutions on the part of the BCX Board were submitted. The merging parties' counsel after being pressed for a formal authorization could not provide any. On 11 June 2007 the merging parties submitted a draft divestiture order and a resolution by Telkom's executive committee.

²³⁵ ISPA heads page 49, para 83.

[278] Mr Rogers on behalf of the Commission argued that the condition is entirely unacceptable because BCX Comms' competitive potential is inextricably linked to its status as a subsidiary of BCX, South Africa's leading ITS company. Cut adrift from BCX, BCX Comms would be deprived of the advantages which BCX sought to exploit through the Bidnet acquisition and its investment in an NGN. In his view the draft order will not take the substance of the matter any further.

[279] BCX has located its VPN business in BCX Comms. While it has a large number of clients on its VPN, we have no evidence whether these clients are owned by BCX Comms or BCX. Nor does it appear that BCX Comms acts alone in servicing a client. Mr Sewell's evidence seems to suggest that when a client is approached by BCX Comms, BCX Comms would still rely on the other divisions of BCX such as network services and outsourcing to assist it in meeting the client's specific needs. Conversely when any other division approached a client it would offer a client a range of services consisting of services from other divisions, and would approach its other divisions to provide these services. In addition, BCX Comms relies on BCX to provide it with the financial resources required to upgrade and market its network. While BCX has several business units, the evidence suggests that these divisions are interdependent and all rely on each other to promote each division's business, as well as the business of BCX as a whole. No evidence was put before this Tribunal that BCX Comms had sufficient skills and resources to be a viable stand alone business, or what the prospects of finding a suitable buyer in the proposed time frame were or whether there was any serious interest expressed by independent third parties to acquire this business.²³⁶

[280] More importantly, and as the evidence has shown, BCX's strengths as a competitor and its ability to, in the converged space, take margin

²³⁶ In fact it seems to have borne a greater share of the damage caused to BCX by Telkom's offer and its involvement in the business of BCX by losing key personnel and large customers.

from Telkom, is not *only* found in BCX Comms but are to be found in the whole of BCX. BCX's network design and implementation skills, its access to customer premises, its track record in outsourcing, its meta-WAN management services and its large blue chip client base are all found across the whole of BCX, not just in BCX Comms. These are the skills and strengths that pose the largest threat to Telkom in the dynamic MNS market and which Telkom seeks to acquire for its own strategy in the MNS market.

[281] In our view a divestiture of BCX Comms will not remedy the likely harm to competition that will arise as a result of the acquisition of BCX. In fact, on the contrary, the separation of BCX Comms from BCX may achieve exactly what was intended by Telkom by this transaction. BCX Comms separated from BCX would not have the large client base nor the range and depth of skills in outsourcing and systems integration. BCX, separated from BCX Comms on the other hand, would not have the largest privately owned NGN in the country and the track record of serving one of the largest logistics companies in the country.

Vertical Effects

[282] Many arguments were put to us by the Commission, ISPA and DD on the various vertical effects of this transaction. The merging parties urged this Tribunal to disregard the opponents' arguments on the basis that these were *inter alia* mutually exclusive, not profitable or not merger specific.

[283] In our view there is no need for us to make a finding on any of these since we have already concluded that the transaction is likely to result in a substantial lessening or prevention of competition in the MNS market.

[284] However, while we make no finding on the vertical effects of this transaction, and here we must emphasise that we make no finding on these, we share Mr Rogers' concern that Telkom has already pre-

figured a number of tactics that it intends to deploy against existing and future rivals in both the upstream infrastructure market and the MNS market. A cursory glance at some of Telkom's high level documents reveals that it *inter alia* intends raising its rivals costs, eliminating competition from the SNO and VoIP providers, bundling ITS, MNS and PSTS products, cross-selling and increasing its customer's switching costs and locking customers into long term contracts. Telkom of course does not need to deploy all of these tactics or use any instruments available to it all at the same time or against all of its rivals. All it needs to do is deploy some of them some of the time against some of its rivals. This wide range of instruments available to Telkom certainly raises additional concerns. Telkom's reputation in the industry suggests that it will not hesitate to deploy any of these against existing or new rivals.²³⁷

[285] A further concern, in addition to all the tactics Telkom has stated it intends to deploy in order to defend and extend its monopoly is that it intends to maintain BCX post merger as an independent subsidiary, for purposes of regulatory evasion. While the Commission raised this as a possible concern, not much evidence was led to show the various possible ways that Telkom could achieve this.

[286] In the telecommunications space, there are strong arguments for preventing monopolies that are subject to cost regulation from entering downstream unregulated markets. Brennan argues that regulated entities that are subject to cost regulation often seek to integrate vertically into unregulated markets in order to increase the costs of the

²³⁷ See evidence of Hodge and Wilcocks in which it was alleged that Telkom was delaying in installation of its leased lines, would not let any other MNS rival inspect the network when there were technical problems and was engaging in quality degradation. See also affidavit of Weeks setting out the number of complaints lodged against Telkom. For an understanding go how easily quality degradation can occur see also MCI Worldcom – COMP/M.174 [2000] ECTComm 24

regulated entity and still make monopoly profits and thereby evading cost regulation.²³⁸

[287] The ITS market is unregulated. While some IT services rely on leased lines as an input, IT services are also an input to networks. Telkom intends to utilize BCX, located in a separate subsidiary, as the provider of all its IT services, which will be a cost to the regulated entity. The regulated entity can inflate those costs to itself which it will be able to present to the regulator as legitimate costs. BCX is unregulated and the regulator will have no oversight over its pricing policies and practices.

[288] By locating BCX as an IT subsidiary – not an MNS provider – in the highly fragmented IT industry, with relatively low barriers to entry,²³⁹ and in which ostensibly relative market shares and dominance are harder to define, it could more easily ward off allegations of exploitative and exclusionary conduct on the part of its unregulated subsidiary.

[289] It is not possible to anticipate the various strategies that would be available to Telkom to evade regulation in the limited circumstances of these proceedings. However, the acquisition of BCX would have certainly provided Telkom with a strategic enabler, a mechanism, through which it could implement any such strategies.

[290] Accordingly we find that the merger is likely to lead to a substantial lessening or prevention of competition in the MNS market on the basis of the horizontal evaluation only. However, we express the concern that Telkom may have available to it a range of instruments which it could deploy against its rivals and that it seeks to evade regulation by entering related but unregulated markets. We turn to consider whether the merger can be justified on any public interest grounds.

²³⁸ Brennan, T, "*Why regulated firms should be kept out of unregulated markets: understanding the divestiture in US v AT&T*", The Antitrust Bulletin, Fall 1987.

²³⁹ As compared to the MNS market

Public Interest

[291] Section 12A(1) of the Act mandates an examination of the impact of the merger on the public interest. Note that the public interest enquiry is mandated whether or not the preceding competition analysis finds a substantial lessening of competition. That is to say, a positive impact on the public interest may be grounds for justifying a merger that, on an analysis of the competition and efficiency impact, is likely to substantially lessen competition, just as a negative impact on the public interest may justify prohibiting a merger that passes muster on competition grounds.

[292] The public interest factors that we are required to consider are specified in Section 12A(3) which provides that

When determining whether a merger can or cannot be justified on public interest grounds, the Competition Commission or the Competition Tribunal must consider the effect that the merger will have on –

- 1. a particular industrial sector or region;*
- 2. employment;*
- 3. the ability of small businesses, or firms controlled or owned by historically disadvantaged persons, to become competitive; and*
- 4. the ability of national industries to compete in international markets.*

[293] The Commission contends that the merger impacts negatively on the public interest. However, the merging parties have not invoked public interest arguments in favour of the merger. And because we have found a likelihood of a substantial lessening of competition under, what counsel for the merging parties refers to as *'the statutory standard*

relevant to the competition issues', and because no countervailing positive public interest impact is asserted, there is, strictly speaking, no need for a further examination of possible negative public interest implications. However our decision to prohibit this merger, although, in our view, adequately grounded in the competition analysis, is bolstered by the negative impact that, we find, the merger will have on the public interest. Accordingly, we will briefly examine the Commission's contention that the merger's negative impact on the public interest, specifically its impact on 'a particular industrial sector' and on 'the ability of national industries to compete in international markets' provides additional grounds for prohibition of the merger.

[294] The Commission argues that:

Even if it were thought that the extent and likelihood of harm to Neotel is too uncertain to justify a definite finding of a substantial lessening of competition on the probabilities, the tribunal would be entitled to have regard to the fact that Neotel's successful entry and the need for increased competition in the infrastructural market are vitally important to the public interest both in respect of the telecommunications sector (s12A(3)(a)) and in respect of the international competitiveness of South African industries (s12A(3)(d)).²⁴⁰

[295] The Commission continues:

It cannot be too strongly emphasized that approval for this merger is being sought at an extremely critical and sensitive stage of the development of South Africa's ICT market.²⁴¹

[296] Counsel for the merging parties characterizes the Commission's public interest argument in the following terms:

²⁴⁰ Commission HOA para 156

²⁴¹ Commission HOA para 157

(It) would say we favour particular competitors entering markets under particular conditions, and so even if the ordinary consideration of mergers isn't met under the statutory standard relevant to the competition issues, we take a particular view about competition in this market in respect of this competitor and treat this as a residual public interest concern.²⁴²

[297] In essence the merging parties argue that a weak competition finding is not strengthened by casting the harm that it generates as harm to the public interest as defined by Section 12A(3) rather than harm to competition or, as the Act terms it, a likelihood of a substantial lessening of competition.

[298] While we agree with the merging parties' general contention, we nevertheless insist that, in this instance, there is a clear relationship between, on the one hand, our competition finding (that is, our finding of a likely substantial lessening of competition in the MNS market) and, on the other hand, harm to the public interest, specifically, as the Commission alleges, arising from the mergers' impact on a '*particular industrial sector*' (12A(3)(a)) and on '*the ability of national industries to compete in international markets*'. (12A(3)(d)). We emphasise that harm to competition does not always impact negatively on the categories of public interest specified in Section 12A(3). However, when the competition harm accrues in markets as pivotal to both the ICT sector and the overall economy as the PSTN market or the MNS market then it is reasonable to postulate that both the prospects for the sector and for the economy as a whole may well be threatened by the merger's negative impact on competition. This postulate is underlined by the timing of the merger – as we have already elaborated, the merger is, in our view, an attempt to undermine the benefits of deregulation and related introduction of new technologies. This flies directly in the face of public policy, a public policy that is intended,

²⁴² Transcript p2701, our emphasis

largely through deregulation, to promote an efficient ICT sector that would play an important role in underpinning a competitive economy. In short, in our view, the public interest impact does indeed relate to the particular markets implicated in the merger and, as the Commission's heads of argument would have it, to the '*extremely critical and sensitive stage of the development of South Africa's ICT market*'.

[299] A similar issue has arisen in a previous decision of the Tribunal. In the *Medicross/Primecure* merger the Tribunal's held that the regulatory flux and uncertainty surrounding an embryonic market segment in the broad healthcare sector demanded particular circumspection from the regulators, all the more so because of what the Tribunal characterized as the heightened 'public interest' in the healthcare sector. Our decision to prohibit this merger was influenced by these considerations.²⁴³ However, the Competition Appeal Court held that:

*It is extremely difficult to determine the weight which the Tribunal gives to these public interest grounds in its probabilistic enquiry. But, as I have already said, these issues should have been of no relevance to the first stage of its enquiry which needed to examine the evidence relating to the proposed merger's impact upon competition. These public interest considerations would have been more appropriately considered during the second phase in terms of section 12A(3), as the need to consider public interest grounds is a separate and subsequent inquiry to that of the primary determination.*²⁴⁴

[300] In short, the CAC has not held that these 'public interest' considerations have no place in merger analysis. The CAC has held that we erred in conflating the competition and public interest considerations. It has accordingly decided that broader public policy related concerns – in *Medicross* these deriving from the nature of the

²⁴³ 11/LM/March05 paras 71-2

²⁴⁴ 55/CAC/Sept05 para 23, our emphasis

product or service in question and the broader sectoral context of the transaction - are to be considered in the public interest enquiry rather than the competition enquiry.

[301] Nor is it surprising that the CAC has affirmed that these considerations have a place in merger analysis. It would be a particularly abstracted regulator that blinded itself to the broader characteristics of the market under examination - to, inter alia, the nature of the product or service rendered or to the broader policy environment. Indeed the Act has underlined their pertinence by their explicit incorporation in Section 12A(3) of the Act, the provisions of which are simply an amalgam of social and distributional concerns (e.g. employment, regional impact) and industrial policy considerations. The industrial policy considerations such as the impact upon the sector (S 12A(3)(a)) and on international competitiveness (S12A(3)(d)) require that we take a view on the nature of the product and on broader policy considerations. If the merger under examination had been in the silk scarves segment of the apparel market we may have been disinclined to consider the transaction's impact on the broader clothing sector or the knock-on effects on international competitiveness. However, the incontrovertible facts are, firstly, that the merger under examination is taking place in a pivotal segment of the ICT sector with implications for the sector as a whole, secondly, that the ICT sector has an unusually significant impact on the international competitiveness of South African firms generally, and thirdly, it is widely accepted that the character and effectiveness of the regulatory framework plays an important role in the development of the broader ICT sector, most specifically the telecommunications components thereof.

[302] It is no exaggeration to claim that barely a week passes without a major public or business figure confirming these latter assertions. No less a representative of the public interest than the President himself has strongly emphasized the importance of business process outsourcing in South Africa's industrial strategy and his frustration at

the constraining role played by telecommunication costs, and Telkom pricing in particular, in the development of this market.²⁴⁵ These views are graphically endorsed by the CEO of Reuters, one of the world's largest global financial information providers, who has explicitly and publicly attributed his company's reluctance to invest further in South Africa to the cost and quality of Telkom's service.²⁴⁶ It would be a simple matter to supplement these views with those of other public figures and business leaders.²⁴⁷

[303] We have elsewhere in this decision considered Telkom's approach to regulation. Suffice to state that it has, as commercial rationality clearly dictates, left no stone unturned in its efforts to maintain and extend its erstwhile statutory monopoly. This merger is, as we have already elaborated, another such attempt to thwart the introduction of competition. This has been a basis for prohibiting the merger on competition grounds. That the merger attempts to counter the impact of deregulation, public policy's preferred mechanism for the introduction of competition, is further ground for prohibition on public interest grounds.

[304] Thus while the competition and public interest analyses are, following the CAC decision in *Medicross*, not to be conflated, nor can they be hermetically sealed from each other in the manner contended for by the merging parties. Low levels of competition in a

²⁴⁵ See 'Interview with Thabo Mbeki', Financial Times 3rd April 2007

²⁴⁶ Business Day 17th January 2007

²⁴⁷ Note that both parties have sought to make something of the contents of a letter from the Department of Communications. (See Commission's record page 2125 - 2130) One paragraph of this letter expresses the view that competition is likely to be impaired by the transaction, while the concluding paragraph expresses the view that the sector will benefit from the transaction. While it is tempting to simply dismiss this as evidence of confusion on the DOC's part, in fact the former paragraph articulates a negative view of the transaction on competition grounds, while the latter paragraph expresses a positive view on industrial policy or public interest grounds. What is certainly manifest in these opposed contentions is a characteristic industrial policy view that conflates the health of a sector with the fortunes of the dominant player or 'national champion' and the view that these considerations should trump the lessening of competition. We disagree with the general proposition although in specific cases it may be valid. However in this instance, it is clear that the view of the policy makers is that the appropriate industrial policy with respect to the ICT sector is deregulation to promote competition, a public policy choice that is likely to be undermined by the merger.

telecommunications market impact upon the growth prospects of the broader ICT sector and on the competitiveness of the comprehensive universe of ICT users and these considerations are clearly captured in the specified public interest criteria provided for in Section 12(A)3. Contrary then to the claim of the merging parties, the manner in which we have considered the public interest implications of this transaction does not amount to a second bite at the competition cherry, they are not, in other words, invoked to support a weak competition case. Rather they demonstrate the link between impaired competition, on the one hand, and on the other, compromised national industrial policy objectives, notably the emergence of a deregulated ICT sector characterized by robust competition and underpinning a competitive South African economy.

[305] This then is the basis for our contention that our decision to prohibit this merger on competition grounds is significantly bolstered by the public interest impact. In this particular instance, should we have erred in prohibiting a merger whose anti-competitive impact may have been less than 'substantial' –the consequences of our error pale into insignificance against the implications of approving a merger whose combined consequences may be both to impair competition, and, given the particular nature of the products implicated and, given their role in economic growth and development, to harm the public interest as expressed in the health of the ICT sector and the competitiveness of the many sectors of the economy who utilize its products and services as vital inputs.

Conclusion

[306] As we have stated earlier on in these reasons, in our view an assessment of this transaction in accordance with section 12A(2) has required us to consider a number of factors. We have considered this transaction in the context of the de-regulation of the VANs industry

which has led to economies of scale and scope for both customers and MNS providers.

- [307] The de-regulation of the VANS industry has led to an immediate benefit to customers in the form of lower communications costs. It has also led to the growth of the MNS sector and increased competition in that sector. MNS providers have invested in the horizontal value chain by moving into the VPN segment in order to provide their clients with all their communications needs. Most significantly it has introduced retail price competition in national and international voice services.
- [308] We have found that it is from MNS rivals that Telkom anticipates any considerable retail price competition and threats to its hitherto monopoly margins in infrastructure and voice.
- [309] In our view this transaction is not an attempt by Telkom to plug some revenue losses or find alternative revenue streams in the face of competition and convergence. Rather it is an attempt by an erstwhile monopolist, to thwart the beneficial impact of de-regulation in the form of greater economies of scale and scope for rival MNS providers and lower costs for customers. It is an attempt by an erstwhile monopolist to stifle competition and innovation in order to maintain its hitherto monopoly margins in infrastructure and voice services and to extend its monopoly into the space of convergence.
- [310] On the basis of the horizontal overlap only, we have held that the transaction will lead to the removal of an effective competitor to Telkom in the MNS market because BCX, as an MNS provider, is uniquely poised to become a formidable competitor to Telkom in the dynamic MNS market in which the VPN is becoming the product of choice. It stands to take away margin from Telkom because it enjoys the confidence of its client's decision makers, has a track record in network design, implementation and management that spans 20 years in the

MNS market and is a credible systems integrator, being the leading outsourcing firm in the country.

[311] Due to network effects, the acquisition of BCX would have enabled Telkom to gain a much larger share of the MNS market, and would have had a more detrimental impact on competition, than that indicated by the initial increase in concentration levels. Together with Telkom's strategy to lock customers into long term contracts, this would have led to the MNS market tipping towards Telkom. The already high barriers to entry and expansion in the MNS market would have increased by this thereby constraining the expansion of rivals, even possibly leading to exiting of smaller rivals and deterring the entry of new rivals.

[312] Neotel's entry in the MNS market is likely. However due to its own internal and external difficulties, its entry is unlikely to be timely and certainly not sufficient to off-set the harm caused to competition as a result of the merger.

[313] We have also held that the acquisition will enable Telkom to engage in unilateral conduct to the detriment of its retail customers. High switching costs and network effects will discourage customers from switching away from Telkom's VPN offering in the event of a non-transitory increase in price.

[314] While we note that the merger, if it had been approved, would have had some detrimental impact on Neotel in the MNS market, and that it may have blunted an already weakened competitor even further, we find that the merger is likely to result in co-operation between Neotel and Telkom, both in relation to competition with each other and in warding off the threats posed by other MNS rivals.

[315] No efficiencies were relied upon by the merging parties and we have found the proposed divestiture of BCX Comms does not address the harm to competition arising from this merger. The divestiture of BCX

Comms, contrary to alleviating any harm to competition occasioned by this merger, may in fact allow Telkom to achieve what it sought with this merger.

[316] Accordingly we have found that the merger, on the assessment of the horizontal effects alone, will lead to a substantial lessening or prevention of competition in the MNS market.

[317] In an assessment of the impact of this transaction on the public interest as defined in s12A(3), we find that our decision to prohibit this merger on competition grounds is significantly bolstered by the impact of this merger on the public interest.

[318] We did not find it necessary to make any further findings of harm to competition arising from the vertical effects of this merger. We have however expressed the view that the number of instruments available to Telkom, its stated intention to deploy these and its current conduct towards its MNS rivals gives us more reasons to be concerned about the impact of this merger on the MNS market.

[319] We have also expressed our concern about Telkom's intention to utilize BCX as a mechanism to evade regulation, whether this is further regulation by ICASA or scrutiny by the Commission.

[320] The merger is accordingly prohibited.

Y Carrim

Date

D Lewis and U Bhoola

Tribunal Researcher: Rietsie Badenhorst and Jabulani Ngobeni

For Telkom: Adv DN Unterhalter SC with Adv J Wilson instructed by Werksmans

For Gadlex: Adv M Du P van der Nest SC with Adv H Shoji instructed by MNMR Attorneys

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For Dimension Data PLC: Adv A Subel SC and Adv R Bhana instructed by Stein Scop Inc

For the Commission: Adv O Rogers SC and Adv NH Maenetjie instructed by the Competition Commission