

SOUTH AFRICA / JUDGMENT

Telkom SA Soc Limited v Business Connexion Group Limited (Dimension Data (Proprietary) Limited Intervening) (LM065Aug14) [2015]

ZACT

112; [2015] 2 CPLR 688 (CT) (12 October 2015)

[2015] ZACT 112

COURT

Competition Tribunal

BEFORE

Yasmin Carrim, Mondo Mazwai, Imraan Valodia

CASE / FILE NUMBER

LM065Aug14

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COMPETITION TRIBUNAL OF SOUTH AFRICA

Case No: LM065Aug14

In the matter between:

TELKOM SA SOC LIMITED

Acquiring Firm

And

BUSINESS CONNEXION GROUP LIMITED

Target Firm

DIMENSION DATA (PROPRIETARY) LIMITED

Intervening Party

Panel

: Yasmin Carrim (Presiding Member)

: Mondo Mazwai (Tribunal Member)

: Imraan Valodia (Tribunal Member)

Heard on

: 30, 31 July and 3, 4 August 2015

Order Issued on

: 04 August 2015

Reasons

Issued on : 12 October 2015

Reasons

for Decision

CONDITIONAL APPROVAL

- [1] On 4 August 2015, the Competition Tribunal ("Tribunal") conditionally approved the large merger between Telkom SA SOC Limited ("Telkom") and Business Connexion Group Limited ("BCX").
- [2] The reasons for the conditional approval follow.

PARTIES TO THE TRANSACTION AND THEIR ACTIVITIES

- [3] The primary acquiring firm is Telkom, a public company incorporated in terms of the laws of the Republic of South Africa and listed on the Johannesburg Securities Exchange Limited ("JSE").[1] Telkom is a telecommunications service provider and is organised into three operating divisions, namely Telkom Consumer which includes Telkom Mobile, Telkom Business and Telkom Wholesale and Networks. Telkom Consumer offers mobile, fixed and wireless voice and data services to residential customers. Telkom Business offers mobile, fixed and wireless voice and data services to business customers. Telkom Wholesale offers wholesale fixed lease lines to mobile network operators ("MNOs"), fixed line operators and other licensed operators ("OLOs").
- [4] The target firm, BCX, is a public company listed on the JSE.[2] BCX is an ICT service provider and is organised into six operating divisions. Each division offers a wide range of fixed line services to enterprise business customers. These services include cloud infrastructure services, communication, security and network services, workspace services, professional services, application services and service integration and management.

PROPOSED TRANSACTION AND RATIONALE

- [5] The proposed transaction involves an acquisition by Telkom of the entire issued ordinary share capital of BCX. Upon implementation of the proposed merger, BCX will be delisted from the JSE and become a wholly owned subsidiary of Telkom.

- [6] In terms of rationale, Telkom submitted that its fixed line voice services are under significant pressure and that its business lacks the necessary capability to compete in the ITS market. Significantly, the strategy documents reveal that the proposed transaction would enable Telkom to enter the ITS market on a sufficient scale in circumstances where organic growth does not appear viable. Further, the proposed transaction provides Telkom with opportunities to provide bundled service offerings to enterprise customers as customers buy connectivity, network and ITS services together.
- [7] BCX's submitted rationale is that the proposed transaction is in line with its convergence strategy where communication, applications and infrastructure will become cloud based and where Telkom's infrastructure network will facilitate the delivery of these converged service offerings to business customers.

RELEVANT MARKETS AND IMPACT ON COMPETITION

- [8] The Commission assessed the impact of the proposed transaction on the following relevant markets:
- Upstream market for the supply of wholesale fixed-leased lines;
 - Downstream market for the supply of MNS;
 - Broad downstream market for the supply of MNS and VANS;
 - Downstream market for the supply of hosting services;
 - Downstream market for the supply of ITS; and
 - Market for the downstream retail supply of mobile services (voice, data and sms).
- [9] In its horizontal analysis, the Commission found there to be no horizontal overlap in the upstream market for the provision of wholesale fixed lease line services but noted that the merging parties compete with each other across all of the downstream markets listed above. However, based on market shares, the Commission found it unlikely that the proposed transaction would result in unilateral effects in any of the downstream markets. According to the Commission, in markets where Telkom was found to have a strong presence (MNS and VANS), with market shares ranging between 20%-30%, BCX was found to be weak with market shares of less than 5%. Conversely, in markets where BCX's position is strong (ITS), Telkom's is weak, with a market share of less than 5%.
- [10] According to the Commission, the only downstream market that appeared to raise competition concerns was hosting services (co-location) as the merged entity would have a market share of approximately 41% (16% accretion) based on space rented to third

parties on a commercial basis. However, as there is excess capacity available from various third parties, the Commission found that the proposed merger would not lead to unilateral effects in this segment.

[11] In its vertical analysis, the Commission considered whether Telkom's extensive fibre network, which is used to provide wholesale

fixed lease lines and which is an essential input to third parties' downstream offerings, raised any foreclosure concerns. The Commission found that Telkom has market power in the upstream market and as such would be able to engage in an input foreclosure strategy. In this regard, a settlement agreement concluded between Telkom and the Commission

which sought to resolve an enforcement case between Telkom and the Commission ("2013 Settlement Agreement") [3] is relevant as it sought to address Telkom's ability to foreclose downstream rivals through margin squeeze strategies.[4]

[12] The Commission further emphasised the need to consider Telkom's overall market position, since post-merger Telkom would be the only service provider capable of offering wholesale connectivity, coupled with the full suite of downstream services, without having to procure any component from a third party. Thus, in the Commissions' view, the proposed merger would enable Telkom to engage in bundling strategies that would potentially exclude competitors, non-vertically integrated ones in particular.

[13] Having found that the proposed transaction would give rise to anticompetitive effects in the form of input foreclosure and

bundling, the Commission invited the merging parties to propose conditions to alleviate these concerns. The merging parties contended

to the Commission that the 2013 Settlement Agreement, in its current form, would be enough to prevent the merger specific theories of harm that it had identified.

[14] The Commission was not convinced by the argument put forward by the merging parties that the 2013 Settlement Agreement, in its current form, would be enough to prevent the merger specific theories of harm that it had identified. The merging parties submitted potential remedies that would alleviate the anti-competitive effects arising from the proposed merger which the Commission accepted.

[15] The Commission accordingly recommended that the merger be approved subject to these proposed conditions. In brief terms, these proposed conditions stemmed from the 2013 Settlement Agreement and included certain extensions to the Transfer Pricing Program ("TPP") contained in the 2013 Settlement Agreement. These can be summarized as follows:

15.1 That 'Fibre Access' be added as a product for which transfer prices are to be calculated under Telkom's TPP.

15.2 That the tenure of the TPP be extended from 18 July 2018, which was the original end of the Condition Period, to 31 December 2020.

15.3 The quality of Fibre Access services provided by Telkom Wholesale to other licensed operators ("OLO's") must be substantially similar to the Fibre Access Telkom Wholesale provides to Telkom

Retail.

15.4 Where Fibre Access is included as part of a bundled offering to

Telkom's Enterprise Customers, Telkom must ensure that the prices of these bundles adhere to the TPP. In terms of monitoring and transparency, separate internal accounts must furthermore be kept for managed network services ("MNS"), value added network services ("VANS"), hosting and information technology services ("ITS") in order for the profitability of these retail products to be monitored by the Commission. Also the revenue derived from supplying bundles, which includes Fibre Access, must exceed the input costs associated therewith.

TRIBUNAL PROCEEDINGS

[16] At the pre-hearing conference on 9 June 2015, Dimension Data, a significant player in the South African ICT services market and a competitor to the merging parties, was admitted as an intervener in the proceedings. Dimension Data claimed that the Commission's

proposed conditions were insufficient to address the effects arising from the theories of harm analysed by the Commission. The scope of its intervention was limited to the adequacy of the Commission's proposed conditions in relation to the following issues:

- Input foreclosure;
- Conglomerate effects (bundling); and
- The effect of the proposed transaction on the information and technological communications ("JCT") sector as contemplated in section 12(A)(3)(a) of the Competition Act.

[17] Prior to the hearing, Dimension Data was given an opportunity to respond to the adequacy of the Commission's proposed conditions, and in so doing, submitted additional conditions which purportedly addressed its concerns.

[18] Given that no party to these proceedings was of the view that the merger should be prohibited, it was agreed that the scope of the Tribunal's hearing would be limited to the adequacy of the conditions proposed by the Commission and the appropriateness of the additional conditions proposed by Dimension Data.

[19] However, during the Tribunal hearing, which commenced on 30 July 2015, the parties were able to submit a set of revised conditions to which all parties, including Dimension Data agreed. The Tribunal considered these conditions and has approved the merger on such basis.

SUBMISSIONS

ON THE PROPOSED CONDITIONS

[20] Dimension Data raised the following competition concerns about the merger:

- That post-merger the merged entity could subsidise its retail business by charging lower prices in the retail while raising prices in the upstream market for wholesale fixed leased lines, even if these high prices are charged on a non-discriminatory basis. ("Cross Subsidisation Concern").
- That Telkom and BCX's strengths on product offerings are complementary in nature, which provides opportunities for bundling strategies which will exclude rivals, in particular non-vertically integrated firms that cannot effectively mimic the merged entities' bundles post-merger. ("Bundling").
- Dimension Data alleged that they were unable to obtain service level agreements ("SLA's") from Telkom Wholesale and were thus forced to purchase connectivity from Telkom Retail in order to get an SLA. ("SLA's").
- Dimension Data was concerned that the TPP did not provide for adequate monitoring provisions to ensure that the compliance regime is properly enforced. ("Transparency and Monitoring").
- Dimension Data was concerned that Telkom with its extensive legacy copper network could foreclose downstream competitors through its ability to rely on its copper infrastructure during the transition to fibre. Dimension Data noted that although the demand for copper links are declining with the move to fibre, copper infrastructure still plays an important role in South Africa's move to fibre. Thus Dimension Data proposed that the TPP be extended to include Telkom's copper infrastructure.

[21] As noted above, the conditions initially agreed upon between the merging parties and the Commission stemmed from the 2013 Settlement

Agreement. Following the commencement of the hearing, the parties (including Dimension Data who was instrumental in this process)

revised and supplemented the initial conditions and were able to reach agreement on such basis. The merging parties made it clear

during the hearing that they do not necessarily agree with the concerns raised by the Commission and by Dimension Data, but have

agreed to the Conditions nonetheless.

[22] We shall now turn to discuss the theories of harm raised by the Commission and Dimension Data and whether the remedies proposed

adequately address the concerns.

Cross Subsidization

[23] The merger conditions that were ultimately submitted to the Tribunal involved, inter alia a transfer pricing programme and a price freeze. The transfer pricing programme serves to ensure that Telkom Wholesale will:

- price network services it provides to both OLOs and Telkom Retail on a non- discriminatory basis for common components; and
- price non-common components to OLOs at no more than cost plus a reasonable return and non-common components to Telkom Retail at no less than cost plus a reasonable return.

[24] The 'price freeze' ensures that Telkom will not increase the prices of the affected products above the prices for those products as at the approval date.'

[25] Dimension Data and the Commission are satisfied that the pricing freeze condition which ensures that Telkom will not increase the prices of the affected products above the prices for those products as at the approval date", alleviates the concern that post-merger the merged entity could subsidise its retail business by charging lower prices in the retail while raising prices in the upstream market for wholesale fixed leased lines, even if these high prices are charged uniformly (non- discriminatory).[5]

[26] This form of cross subsidization was not previously covered by the 2013 Settlement Agreement as that agreement sought to prevent a margin squeeze through discriminatory pricing. This price freeze condition is applicable to both Diginet and Metroclear products (both copper and fibre based products) supplied by Telkom Wholesale to Telkom Retail and OLO's. The reason for including copper products is because copper would still be used as an upstream input by competitors of Telkom in the downstream market in the foreseeable

future and in remote outlying areas with low traffic volumes.

Conglomerate effects (Bundling)

[27] The Commission found, that given Telkom's upstream market power in relation to wholesale fixed leased line, and further that Telkom and BCX's strengths on product offerings are complementary in nature, this provides opportunities for bundling strategies which will exclude rivals, in particular non-vertically integrated firms that cannot effectively mimic the merged entities' bundles post-merger. The reason for this opportunity is that the merged entity would be the only party to have strengths across all three broad market segments (MNS, VANS and ITS).

[28] This concern is adequately addressed by Clause 3.2.3 of the merger conditions which provides that where Fixed Network Products are supplied as part of a bundle of other products/services supplied by Telkom Retail to Enterprise Customers (as opposed to an input in the provision of these services), Telkom will:

"Ensure that the prices for bundled offerings that include Fixed Network Products adhere to the principles of the Transfer Pricing Programme set out in Clause 3. 1.1 above.

Ensure that it keeps separate, internal accounts for its downstream retail offerings, namely MNS, VANS (including voice over internet protocol or VoIP), Hosting and ITS, in a way that permits the profitability of these retail products to be monitored by the Competition Commission.

Ensure that where Fixed Network Products are included in a bundle of products/services supplied to Enterprise Customers, the pricing is such that the revenues derived from supplying the bundle exceed the input costs associated therewith."

[29] Thus the Transfer Pricing Programme has been extended in that the non- discrimination principles shall now apply to Fixed Network Products. 6

Service level agreements ("SLA's")

[30] Dimension Data alleged that they were unable to obtain SLA's from Telkom Wholesale and were thus forced to purchase connectivity from Telkom Retail in order to get an SLA. Further, that the absence of an SLA is a severe impediment to competing effectively for enterprise business. This was denied by Telkom who nevertheless agreed to Clause 3.2.1.4 which provides as follows:

"To the extent that Telkom wholesale supplies any service level agreement on Common Components to Telkom Retail, it will offer such service level agreement on Common Components to OLO's on a non-discriminatory basis."

Transparency and monitoring

[31] Dimension Data raised a concern that the TPP in its current form did not make provision for the preparation of separate statements for Regulated/Unregulated Segments; Business; and Services. As such, Dimension Data claim that this level of disaggregation does not allow products or services to be evaluated at an individual level. While in the Commission's proposed conditions it stated that separate internal accounts be kept for MNS, VANS, hosting and ITS in order for the Commission to be able to monitor the profitability of these retail products, however Dimension Data argued, the disaggregation of products and the large variation in the profitability of the different products supplied by Telkom Retail would allow for situations where the high margins of some products will compensate

below cost margins of others, and thus be insufficient in preventing a margin squeeze.

[32] Clauses 4.2.5 and 4.2.6 are intended to alleviate these concerns as the merged entity is now required to provide external profitability reports which shall reflect not only the profitability of BCX as a whole but also BCX's profitability by segment [i.e. MNS, VANS (including VoIP), Hosting and ITS treating information technology outsourcing (ITO) as a sub-segment]. This will allow for greater transparency which will make it easier for potential complainants of alleged anticompetitive conduct to prove their case. Furthermore, because these profitability reports are to be prepared externally by an independent expert accountant,

there is now less reliance on internal assurances from the merging parties on the one hand, and on the other hand placing a less burdensome regulatory function on the Commission.

PUBLIC INTEREST

[33] In relation to employment, the merging parties anticipated that the proposed transaction would potentially result in 60 employees being retrenched. The Commission found that the potential affected employees are highly skilled and constitute a relatively small proportion of the overall Telkom employees (less than 1% of the total workforce). Nonetheless, a condition was imposed limiting the number of merger specific job losses to a maximum of 60 employees in positions and grades identified by the merging parties over a three year period. These job losses are further limited to a maximum of 20 employees per year in each of the three years.

CONCLUSION

[34] Flowing from negotiations that followed the commencement of the hearing, revised conditions were offered up by the merging parties, which the Commission and Dimension Data were satisfied addressed the competition and public interest concerns they had previously.

[35] We have approached this merger on the basis that the Commission and Dimension Data's concerns were correct. On that assumption we have considered whether the revised conditions, which will be made conditions for the approval of this merger, are sufficient to address those concerns.

[36] In our view the revised conditions proposed by the parties adequately address the concerns of both the Commission and Dimension Data and that the proposed transaction is unlikely to substantially prevent or lessen competition in the relevant markets and further alleviates any public interest concerns. Accordingly we approved the proposed transaction subject to the conditions attached hereto marked "Annexure A".

12 October 2015

DATE

Yasmin Carrim

Mondo Mazwai and Imraan Valodia concurring

Tribunal Researcher: Derrick Bowles assisted by Ammara Cachalia

For the merging parties: Mark Garden and Derushka Chetty from ENS

For the intervening party: Robert Wilson and Desmond Rudman from Webber

Wentzel

For the Commission: Grashum Mutizwa

- [1] Telkom's four largest shareholders as at 31 March 2014 are the following: The Government of the Republic of South Africa (39.76%), Government Employees Pension Fund (11.66%), Allan Gray (4.84%) and Investment Solutions (2.68%).
- [2] BCX's largest shareholders as at 30 May 2014 are as follows: Investec Asset Management (14.40%), Allan Gray Investment Council (14.11%), Visio Capital Management (ZA) (13.96%), Gadlex Proprietary Limited (9.53%) and Mazi Capital Proprietary Limited (7.30%).
- [3] Tribunal Case number: 016865. The main purpose of the Settlement Agreement was to implement functional separation between Telkom Wholesale and Telkom Retail. The underlying philosophy was that this would prevent a recurrence of the anticompetitive conduct admitted to by Telkom, i.e. margin squeeze and bundling. In this regard see paragraphs 6.2.1 and 3.2 of the Settlement Agreement.
- [4] In terms of the 2013 Settlement Agreement, Telkom agreed to a functional separation between its wholesale and retail businesses

and a Transfer Pricing Programme (TPP) which would regulate transactions relating to the provision of fixed network products between these divisions (Annexure A to the Settlement Agreement). In addition, a Retail Pricing Programme (RPP) was implemented to reduce the potential for Telkom Retail to engage in a margin squeeze of rival OLO's (Annexure B to the Settlement Agreement).

- [5] This theory of harm was referred to by the Commission in its Report in Paragraph 300 as "cross subsidization."

6 Fixed Network Products are defined at Clause 1.22 as Fibre Access or Copper Products supplied by Telkom Wholesale with or without service level agreements.

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