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Merger Control in the Telecom Industry: A Landscape Transformed

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1. Introduction

Convergence in telecommunications and the accompanying regulatory changes prompted a wave of M&As in the sector. The remarkable success of over-the-top services such as Netflix and Amazon Prime too gave substantial impetus to this wave of consolidation between the fixed, mobile and content players (hereafter, the converged telecoms sector). The rapid rise of the over-the-top services has resonated its way into strategy and business model innovation, as it led the incumbent traditional media companies to reconsider their strategic assessment of the market. The recent merger between AT&T and Time Warner and the transformed business model of the merged entity, for instance, is a direct consequence of this transforming landscape wherein the ‘spray and pray approach’ of the traditional pay-TV operators seems completely misplaced against the ‘digital, big data-led’ algorithmic approach of the OTTs.

The significance of business models and business model innovation has been well-documented in the management literature (Osterwalder & Pigneur 2010; Teece 2010). This paper seeks to validate the valuable link between business model innovation, strategy & tactics and their relationship with merger control in the converged telecoms sector.

The paper is organised as follows. Section 2 describes how technological innovation such as digitization of content and technological convergence and the accompanying regulatory changes challenged the traditional business models in the telecoms and the media sector. These changes in turn led to business model innovation, which in turn prompted a wave of consolidation between the telecoms and the content players. Section 3 discusses and distinguishes between strategy, business models and tactics and establishes how key strategic decisions at the top management level generated a need for business model innovation. These mergers create a competitive advantage for the merged entity on the one hand, but on the other, they may lead to entry barriers for potential new entrants in the market. Competition authorities across the globe use merger remedies (conditions) to alleviate these competition concerns. Section 4 elaborates how these merger remedies are in fact promising prospects for small and medium-sized firms to enter new markets. Section 5 summarizes the discussion.

2. Technological Innovations, Deregulation and M&As in the Converged Telecoms Sector

Technological advancements, convergence in telecoms and the accompanying regulatory reforms in the US and the EU led to the deregulation and privatisation of the sector. As fixed line and mobile penetration reached almost hundred percent, and the average revenue per user started to flatten, it did not take the mobile network operators as well as the content creators long to realize that a voice-only strategy or content-only strategy could no longer be the differentiating factor. A voice-only strategy led to the prisoner's dilemma whereby, network operators compete on price, with a race to the bottom in terms of revenue earned per user. Likewise, the digitization of content, followed by other innovations such as peer-to-peer sharing and the emergence of over-the-top shook the very foundations of the media sector. Consider for instance, the US market where the number of over-the-top users is expected to rise from 153 million (46.9% of the total population) in 2017 to over 197.7 million (58.2%) by 2022 (eMarketer, August 2018). Emergence of the over-the-top thus, led to 'chord-shaving' and 'thinning' that put the traditional cable provider's 'gatekeeper position' under significant threat. Chord shaving means that the consumers stop subscribing to the pay-TV all together, whereas chord thinning refers to the consumers switching from high value to the relatively inexpensive pay-TV subscriptions. Gatekeeper effects refer to the traditional distribution advantages of the incumbent cable operators that in turn create substantial barriers to market entry for potential new entrants in the market for content delivery. Further technological developments in convergence and the emergence of smartphones and high-speed internet offered unparalleled mobility to content (Peppard & Rylander, 2006, p.2). To counter this challenge, whereas some concentrated on a mobile-only strategy, others focussed on fixed/mobile concentration and yet others, looked at the fixed/mobile and content integration (Figure 2). Before proceeding further, it may be useful to clarify the meaning of fixed, mobile and content players within the context of this article. A fixed line operator is a service provider that offers voice and data services through the wired network, such as copper cables and fiber optic lines. A mobile network operator has its own radio spectrum and offers mobile voice and data services to its users over its wireless network infrastructure. A content operator refers to the traditional pay-TV provider and the OTT service providers that deliver content to the end consumer via multiple consumer devices, such as the television, and now increasingly the smart phones.

In the US, both the T-Mobile and Sprint, two of the four mobile operators, have concentrated on a mobile-only strategy, and they expect the 5G technology to be a game changer. The proposed

merger between the two is currently subject to the review of the US competition authority. AT&T and Verizon, on the other hand, have concentrated on content, as they did not want to be seen as 'dumb pipes'. Verizon thus, acquired AOL and Yahoo!, and AT&T acquired Time Warner and DirecTV. Both AT&T and Verizon thus, clearly seem to have adopted the converged mobile/content strategy. In Germany, likewise, whereas Telefónica Deutschland and E-Plus, following the European Commission's conditional approval, merged to pursue a mobile-led strategy; Vodafone, a mobile network operator and Kable Deutschland, Germany's largest cable operator that also offered digital cable and mobile services as a mobile virtual network operator pursued a more converged strategy. Service providers such as Vodafone/Kable Deutschland (in Germany), Liberty Global/Ziggo (in the Netherlands) and AT&T/Time Warner (in the US) identified that rather than the average revenue per unit, the average margin per user was a far better and sustainable metric of profitability (Herath 2008). The converged players having access to network and content found it much easier to extract higher margin per customer. In addition to better average margin per unit, this also ensured increased customer 'stickiness', as customers of multi-play services are more likely to stay longer with the service provider. These changes in strategic directions also have had implications for the business models of these players, an issue that I discuss in the following section.

3. Business Model Innovation in the Converged Telecoms Sector

A business model is the story of how an enterprise operates, whereas a competitive strategy explains how a given enterprise functions better and more successfully than its competitors (Margretta, 2002). Strategy is the key decision about the choice of a business model through which the firm decides to compete; and tactics are the residual set of choices available to the firm (Casadesus-Masanell & Ricart, 2010).

The level of accomplishment of an enterprise is determined by the degree of success with which it manages to sustainably differentiate its business model. The secret of Nespresso's triumph in the world of coffee, for instance, lies in the coherence, the uniqueness and the non-imitable nature of its business model (Matzler et al, 2013, p.31).

In the converged telecoms sector, as convergence and deregulation warranted intense competition in the downstream market for the delivery of the content, the operators felt a pressing need to re-invent and re-design their business models. The players sought growth through the inorganic route and looked for commonalities across the products in their search for

potential acquisition targets. In this search for uniqueness, they focussed on their 'key strengths' – which meant *connectivity* for the telecoms and *content* for the media operator, and together they endeavored to create a mix of products and services with a 'hedged portfolio'. At the onset, one observed an emerging 'co-opetition' between the telecom and the media companies.

Telecom companies covetously eyed upon media companies as a potential acquisition target on account of their rich content. Verizon's acquisition of Yahoo! and AOL, which Verizon hopes will offer it a foothold in the online advertising and content market as well as strengthen its mobile and online video customer base is a case in point. Many media companies likewise pursued the mobile virtual network operator strategy to compete in the converged telecoms landscape. Interesting examples include the Belgian company Medialaan and the Comcast's mobile business in the US. To counter the emerging challenge from 'chord-cutting', Comcast recently launched 'Infinity Mobile' – a service that offers both mobile phone and internet. To offer this service, Comcast will receive upstream network access from Verizon and wherever possible, will switch the customers to its 16 million plus Wi-Fi spots across the US.

Drawing parallels with Apple's iPod strategy is a good way to understand this converged strategy of offering the fixed, mobile and content services together as a bundle. Apple leveraged its innovativeness in products into its business model, by being the first to recognize music distribution as an activity (content novelty), linking its iPod hardware and software (structure novelty) and digitize the entire service and ensure legal music downloads (governance novelty) (Zott and Amit, 2010, p.4). In the following section, I will try to further elaborate this business model innovation in the context of fixed/mobile/content integration, by elucidating on M&As (which is a decision at the strategic level) in the converged telecoms sector.

4. Recent Fixed/Mobile/Content mergers

In this section, I discuss some recent mergers between the fixed, mobile and content players across Europe and the US. The principal idea is to appreciate how emerging players in the market can strategically benefit from the opportunities offered by the conditional clearance decisions of the US and the European competition authorities. This utilisation of business opportunities well aligns with the objective of these authorities as well - considering that the principle reason why they attach conditions in the first place (technically called merger remedies) is because they want to ensure that following the departure of an important player, new competitors enter and safeguard the competitiveness of the market.

Merger remedies are the set of conditions that the EU and the US competition authorities require compliance with, so that the mergers receive the regulatory approval. They may be structural, wherein the parties are required to divest some part of their business, or they may be non-structural, where the parties may be required to share access to content, the network or the pipes, or put firewalls between different business units.

In the Comcast/NBCU joint venture, Comcast, the largest video program distributor and principal high speed internet provider in the US sought to acquire NBCU, one of the big six producers of content (see *figure 2*). The US Department of Justice was concerned that since the joint venture formed a vertically integrated enterprise - where Comcast controlled the 'last mile connection' as a distributor of the content, it offered Comcast the incentives and the ability to impede the growth of over-the-top services. To ensure the latter's ability to compete meaningfully, Comcast offered the following commitments: first, to continue offering video programming of comparable quality on fair and reasonable terms; second, to offer access to its studios to develop meaningful new content and third, to accept arbitration to resolve any resulting disputes between Comcast and the over-the-top service providers (Comcast/NBCU/JV, 2011).

Liberty Global/Base was a Belgian merger between Liberty Global, a cable operator and Base, an MNO, whereby as part of the conditions, Base was required to divest its interest in two of its key mobile virtual network operating businesses - Mobile Viking and JIM (Liberty Global/Base, 2016, paras 494-533). Medialaan, a Belgian media company, that owns four radio stations and seven television channels including the very popular Flemish VRT station, identifying a growth opportunity in pursuing a mobile/content bundling strategy, purchased Base's interests in both these operations. It may also be useful to mention here that Medialaan was a long-time partner with Base and had significant investments in both - Mobile Viking and JIM. Merging the two operations was therefore relatively easy considering that the employees had in the past worked in close cooperation.

Another interesting merger is the Liberty Global/Ziggo merger in the Netherlands wherein Liberty Global's acquisition of Ziggo led to the formation of the largest cable operator that together covered over 90% of the country. The European Commission's principal concerns were two-fold: first, the merger led to the elimination of competition in the market for pay-TV films considering that before the merger, Liberty Global and Ziggo were the only two players in the

premium pay-TV film segment. The Commission's second concern related to the potential blocking of the over-the-top services, as the merger offered Liberty Global the ability to degrade the quality of the network. The remedies required that Liberty Global sell its stake in Film 1 to Sony, which in turn led to the successful entry of the latter in the Dutch market. The interconnection agreement between Liberty Global and the over-the-top services ensured that the latter could continue innovating in content creation and content delivery without fearing disconnection or receiving a feeble connection from Liberty Global (Liberty Global/Ziggo, 2018).

Five years ago, when the US and the EU competition authorities first assessed the Comcast/NBCU joint venture and the Liberty Global/Ziggo merger, respectively, over-the-top services such as Netflix and Amazon Prime were in a nascent growth stage. Non-discriminatory access to the content, access to studios of the big six and uninterrupted high network quality guaranteed through the above-discussed regulatory intervention ensured their rapid rise. Today, over-the-top services are well-established players - that offer strong competition to the incumbent media companies. According to estimates by Goldman Sachs, by the year 2022, Netflix will spend over \$22.5 billion in content creation. The rapid rise of the over-the-top services can be explained by their strategic use of merger remedies to enter the creative sphere of content creation as well as their global reach and economies. The merger remedies in Liberty Global/Base, for instance, helped Medialaan, a media company, successfully acquire access to the fixed line and the wireless network, which it is now leveraging to develop a digital platform for content in association with the leading media publisher de Persgroep.

Growth of the OTTs also influenced the strategic approach of the incumbent players in the converged telecoms sector. Technological innovations are an important trigger for business model innovation (Chesbrough, 2010, DaSilva et al, 2013). Not only do innovations lead to the emergence of newer business models, they also shape the process of innovation (Winterhalter et al., 2017, pp. 63-65). The principal reason for the recent \$ 71.3 billion acquisition of 21st Century Fox (21CF) by Disney is the latter's desire to strengthen its foothold in the market for online streaming services (Hovenkamp and Bharagava, 2018). Likewise, the \$ 85 billion merger between the AT&T and Time Warner may be justified along the lines of their need to innovate and re-design their business models. The US Department of Justice assessed both these mergers. In the 21CF/Fox deal, the Department had identified concerns about the market for regional

sports and following the parties' offer to divest 22 of Fox's regional sports channels, approved the deal. In the AT&T/Time Warner, however, the Department required the parties to divest either its most valued and must-have CNN network (network level in Fig. 3) or the DirecTV (distributor level in Fig. 3). As the parties refused to divest either of these two networks, the Department requested the US district court of Columbia to enjoin the merger. Citing business model innovation as a dramatic and unprecedented event in the history of the media sector, Judge Richard Leon at the district court refused the Department's request to prohibit the merger. The AT&T/Time Warner merger is currently pending appeal before the circuit court.

5. Summary and recommendations

At the outset, this paper distinguished between three key (and often confused) concepts – strategy, business models and tactics (section 3). This distinction is desirable as my key argument in this paper is two-fold. First, I argue that it is changes in the technological, political and legal factors in the Political, Economic, Social and Technological (PEST) framework (Hooley, 1998) that have prompted business model innovation, which I identify as a dimension of 'creative destruction'. Second, to the extent the M&As in the converged telecoms sector enhance the welfare of all the stakeholders – consumers as well as producers – it is a positive development that needs to be welcomed by the US and the European competition authorities. Changes in business models create opportunities for strategic behaviour - that is the prospect to engage in 'tactics' that should draw the attention of the policy makers, and if required, may necessitate the design of appropriate remedies.

In addition, this article also highlights that the revenue model, the pricing strategy of these firms will be the key to their eventual profitability and therefore, by engaging in such M&As, these players are engaging in a potentially profitable, nonetheless blurred terrain. Whereas a business model facilitates that the firm 'exploits a business opportunity' by creating value for all the stakeholders, the 'revenue model' determines the pricing strategy of the firm. The revenue model ensures that the opportunities created (through business model innovation) are 'translated into revenues' and profitability for the firm (Zott and Amit, 2010, p.218). Considering the typical profitability issues associated with both the telecoms as well as the media industry, it will be the revenue model innovation that will determine whether these acquisitions positively impact the bottom-line of these companies.

In the Liberty Global/Ziggo merger and the Comcast/NBCU joint venture, the European Commission and the US Department of Justice respectively acknowledged the potential adverse impact on competition resulting from vertical integration. The discussion as regards the design of remedies in these two mergers, as discussed in section 4, is particularly insightful in this context. For the management, this paper, therefore, not only sheds light on the business model innovation that is profitable and sustainable (sections 2 and 3), it also shares the best merger control practices across the Atlantic – acquiescence with which makes the innovation ethical and in compliance with the principles of the European and the US competition policy (sections 4 and 5).

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