

CRA Competition Memo



Merger control in “new markets”

In the fast-moving world of the “new economy” mergers and JVs have become a potent means for companies to develop new products and services ahead of competitors. By their very nature, such innovation-led transactions are likely to give the merged company a competitive advantage – indeed this is usually why such mergers are undertaken in the first place. When should this be a concern for competition authorities? Two recent cases – *Vodafone Airtouch/ Mannesmann* and *Microsoft/Liberty Media/Telewest* – illustrate the difficult judgements which need to be made in applying merger control to markets of this kind.

Transitory early dominance

The *Vodafone/Mannesmann* merger earlier this year brought together complementary mobile phone businesses across Europe, and in effect created the first single Europe-wide mobile network.¹ According to the Commission, the effect was to enable Vodafone/Mannesmann to provide a seamless pan-European service, allegedly superior to existing packages of unintegrated national mobile services and roaming agreements, and especially attractive to multinationals with substantial cross-border business. The Commission argued that Vodafone/Mannesmann’s proposed new service for ‘advanced pan-European mobile services’ constituted a separate market, in which Vodafone/ Mannesmann would hold a position of initial dominance by virtue of its position as first mover.²

The case is notable because the Commission (correctly) recognised that Vodafone/Mannesmann’s leadership advantage would be short-lived in the face of competitive imitation and competition from third-generation mobile technology. This view has been borne out by events – within three months of the merger, the divested UK mobile operator Orange joined with France Telecom to provide competition for Vodafone/Mannesmann’s seamless services. Despite this, the Commission concluded that Vodafone/Mannesmann would be the only supplier in this new “market” and therefore dominant at least for a period. It imposed a number of detailed conditions – accounting separation, arbitration of interconnection disputes, duties to design systems to facilitate competitors – for a

period of three years. These effectively amount to regulated access to Vodafone/Mannesmann’s network and products – imposed not via telecommunications regulation, but through the merger control process.

The *Vodafone Airtouch/Mannesmann* decision thus suggests that the Commission is prepared to oppose mergers that create even a transitory advantage in a new market. With such a transitory remedy period, and no real concern of long-run dominance or reduction in the feasibility or speed of imitation by competitors (if anything they are spurred to catch up more quickly), it is unreasonable to consider such temporary market power a position of dominance. This is a worrying precedent as it can reduce the incentive to invest or innovate through merger. In a market economy, profit opportunities play a key role in directing innovative activity and investment. Public policy should not be concerned about supernormal profits being made by the innovator for a transitory period.

Yet there are circumstances in which early leadership in a market may lead to a position of long-term dominance. The recent attempt by Microsoft to acquire joint control (with Liberty Media) of UK cable operator Telewest is a prominent recent example of a case in which the Commission recognised that network effects reinforced a position of early dominance.

Network effects

In its investigation of the *Microsoft/Liberty Media/Telewest* case, the Commission defined a new separate market for “software packages used in advanced set-top boxes for cable TV”³. This market in effect comprised of Microsoft’s newly developed MSTV software package for set-top boxes (combined with Windows software at the head-server end). The definition relied on cable’s broad bandwidth in and out of the home, which makes possible video-quality transmission to the home and high-speed transmission on the back-path.

The Commission viewed the deal as part of a strategy by Microsoft of acquiring minority stakes in cable companies worldwide (either directly or through its strategic partnership with AT&T) in order to closely monitor and influence their software adoption decisions. It accepted that increasing the adoption of the Microsoft MSTV software package in this way would in turn increase the incentive for writers of application software for advanced interactive services to write for this operating system alone. It could thus be expected that

¹ There were horizontal geographic overlaps of national mobile phone networks in some countries but these were resolved as the parties undertook to sell interests in the UK and Belgium.

² In many of these ‘new economy’ deals which bring together complementary assets to offer an innovative service, an important question is also whether the merger can be regarded as *creating a new relevant market*. The definition of markets in a world where products and technologies are changing rapidly is closely bound with issues of market power and dominance, and will be the subject of a future memo.

³ Lexecon Ltd advised Sun Microsystems Inc., an interested third party, in connection with this case.

other networks adopting new systems would find that there was more de-bugged and tested application software available to run on Microsoft's software packages than any other systems; and this could increase their willingness to pay for – and their likelihood of adopting – the Microsoft platform.

Such “network effects” would not exist if there were interoperability between systems. System interoperability would enable cable companies to substitute systems providers and thereby ensure that network effects were not provider-specific. Then any innovation would give every firm an incentive to build upon the adoption decision of others. However, the landmark US Microsoft case has shown how it is possible for a firm to pursue strategies that make interoperability impossible, and to guarantee that applications will be written specifically for its own software.

The Commission's view was that Microsoft's stake in a key UK cable network would have led to the adoption of Microsoft's MSTV software package in Telewest's new-generation set-top boxes, and to a further increase in the chances that its software would dominate the (future) market for set-top box software of the new generation. In the end, with the Commission inclined to block the deal, Microsoft abandoned its original proposal and announced it would restructure its interest in Telewest (in practice, in a way that did not require Commission approval).

Network effects can reinforce early dominance

Why were the situations in *Vodafone/Mannesmann* and *Microsoft/Liberty Media/Telewest* different? One of the reasons is the much greater importance of network effects in *Microsoft/Telewest* than in *Vodafone/Mannesmann*. In the latter, there was no doubt that competition would remain from numerous existing mobile operators, who would simply have some catching up to do and would continue to be able to interconnect with *Vodafone/Mannesmann's* expanded network. In *Microsoft/Telewest*, by contrast, the potential role of network effects raised a plausible threat of “tipping” the market towards monopolisation.

The best-known version of a network effect – the classic network externality – is where a network becomes more valuable to each user as more users are connected to it. As the fixed telephone network has grown over past decades, its value to its existing users has grown because of the ever greater possibilities for communication it has afforded – conversely, being the only person with a telephone would be of little benefit. Particularly when this effect is coupled with the substantial economies of scale which typically characterise networks, the result may be that the first mover can never be displaced by competitive entry, even if he performs poorly.

But network effects can also arise from other complementarities: in software, for example, they arise from *complementarities with applications*. The choice of a software package by users is determined largely by the number and quality of applications that can run on it. Applications providers will tend to write software that

runs over the most prevalent operating system, and in turn demand for the software will be greater, the more high-quality applications that exist or are to be expected.

Note that network effects do *not* necessarily require intervention. Their presence may simply mean that an early winner will also win in the long run. But if this is inevitable – i.e. if someone is going to win anyway – why should we be concerned? If there is to be a winner anyway, why pick on him?

In fact there *can* be a legitimate concern if one firm can simply buy through a deal a significant advantage over rivals. Here the concern lies in actions that bias the race in one firm's favour irrespective of the merits of its product. Other firms then reduce their effort to innovate if they anticipate that someone else is now sufficiently ahead *because it has increased its probability of future adoption*. Activities that “lock up” adoption decisions early on will reduce the incentive to innovate for all laggards, including those who might have been able to catch up by the time the actual adoption decision was to be made. An individual deal can thus be part of an overall monopolisation strategy through mergers or shareholdings, aimed at securing future adoption and thus at deciding the innovation race.

Limitations of merger control?

The ultimate outcome of *Microsoft/Telewest* raises however a serious question: can these deeper issues of monopolisation be effectively tackled by traditional merger control policy?

Strategic alliances do not fall under standard merger scrutiny; and each individual deal may have only a limited impact. The *Microsoft/Telewest* case is a good example: the parties withdrew the transaction and restructured the deal by reducing Microsoft's stake so that it would not fall under the merger regulation – yet the real underlying issue remained. Ultimately merger control is not an effective instrument where the issue is influence over partial decisions by a company rather than acquisition of overall control.

Conclusions

The cases of *Vodafone/Mannesmann* and *Microsoft/Telewest* illustrate how difficult a consistent and reasonable merger policy can be in cases involving new technologies in rapidly evolving markets. The danger of excessive intervention is real, as the Commission's intervention in *Vodafone/Mannesmann* showed. On the other hand, the *Microsoft/Telewest* case suggests that, while there may be legitimate concerns in some industries about limitations to innovative competition through strategic stakebuilding, it is not clear that merger policy is an effective tool to deal with them. Issues of this kind will increasingly present challenges for merger control – and indeed for competition policy more generally – in the near future.

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