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LinkEconomics

Cross submission – Sky-Vodafone proposed merger

by

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1 Introduction

I have been asked by Wigley & Company to provide comments on submissions by NERA, Sky and Vodafone in response to the Commerce Commission's Letter of Unresolved Issues (**LOUI**). Given time constraints, I have been asked to focus on statements made on the topics of:

1. the current state of competition in the relevant telecommunications markets; and
2. the effect on competition that a loss of scale could have in the factual.

Where confidential information is used it has been marked Commercial-in-Confidence [**C-I-C**]. Data has been provided by Trustpower on a confidential basis which I have drawn on in the preparation of this report.

I have been instructed to make the assumption that should the merger proceed, then, for example, the lack of incentives for the merged entity to supply a wholesale premium content service that would allow TSP rivals to compete effectively for retail customers will result in a reduction in the size of the contestable consumer base. This will reduce the scale achievable by the merged firm's TSP rivals. I note that this issue has been addressed in submissions prepared by Covec and others. In the limited time available, the scope of my report is limited in this way.

2 Current state of competition

Vodafone's response to the LOUI states at 1.2 (a) that "New Zealand's telecommunications markets are highly competitive and resilient." As discussed below, this conclusion is at odds with numerous facts regarding market outcomes and the underlying market structure (including the conditions of market entry and expansion).

2.1 Retail broadband markets

With regard to broadband, Vodafone expresses the view at para 1.12 of its response to the LOU) that:

> *(a) The New Zealand market is amongst the most competitive in the world. This is driven by structural separation, government funding of fibre networks and a regulatory regime that ensures a level playing field of all TSPs;*
> *(b) There are no barriers to entry evidenced by the fact that there are 90+ suppliers;*
> *(c) Small to medium sized competitors such as 2degrees (Snap) and Trustpower have demonstrated that they can be highly competitive and increase market share despite starting from a low base.*

As explained in the Link Economics 10 November submission on the LOUI (**Link Economics Initial Submission**), by international comparison New Zealand's broadband market is very concentrated when compared internationally. For example, section 2.2.2 of the Link Economics Initial Submission demonstrates that the 3-firm concentration ratio (the sum of market shares for the three largest firms) for fixed broadband in NZ is 92%, as compared with 69% in Australia and 74% in the UK. That submission also explains that that the HHI of greater than 3370[1] also demonstrates that the market is highly concentrated.

As also explained in the Link Economics Initial Submission: (1) international comparisons indicate that there is potential for improvement in NZ pricing outcomes relative to other countries; and (2) the price differential between large and small TSPs identified by the Commerce Commission in the Annual Telecommunications Monitoring Report 2015 have been sustained, which would point to an existence of market power.

Vodafone's conclusions that the New Zealand broadband market is amongst the most competitive in the world, and more generally that the New Zealand telecommunications markets are highly competitive and resilient is contradicted by the above facts.

Conditions of entry and expansion

With regard to Vodafone's observation that there are 90+ suppliers, which it takes to imply that there are no barriers to entry, this matter is also addressed in the Link Economics submission on the LOUI. The Link submission refers to the Statistics NZ 2015 Internet Survey which found that of the large number of ISPs, only 4% of ISPs (3-4 ISPs) had a 5% or more share of Internet subscribers (ie, 100,000 or more subscribers). A further 7% of ISPs (6 ISPs) had around 1% to 5% share and a large number of other smaller ISPs had less than 10,000 subscribers.[2] In total, more than half of ISPs had less than 1,000 subscribers. As described in the Link Economics initial submission, the more concerning issue with regard to the retail broadband market is regarding the conditions of expansion (rather than entry itself).

Vodafone asserts that small to medium sized competitors such as 2degrees (Snap) and Trustpower have demonstrated that they can be highly competitive and increase market share despite starting from a low base. These firms do appear to have been innovative and increased the extent of competition, but what is particularly relevant is the extent to which that is sustainable in the scenarios with and without the proposed merger.

As explained on page 6 of the Link Economics initial submission, the results in 2degrees' 2015 financial statements indicate that it has not yet achieved minimum efficient scale.

[1] Measured by share of subscribers.
[2] Statistics New Zealand, *Internet Service Provider Survey: 2015*, Table 8.

[**C-I-C**

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While there are a number of conditions present to facilitate the development of competition (for example, as discussed by Vodafone, structural separation, open access to fibre network services and the regulatory regime), it is apparent that competition is developing, rather than already being highly developed and resilient. The open access availability of wholesale fibre products has enabled entry and expansion by a range firms that appear to have plans to grow (for example, Stuff Fibre, Trustpower and 2degrees). However, at this point in time the market remains highly concentrated.

2.2 Mobile markets

With regard to the mobile markets, Vodafone states (para 1.15) that:

(a) The New Zealand market is highly competitive with competitive prices and amongst the best 4G speeds in the world; and

(b) Spark and 2degrees are aggressive competitors to Vodafone. 2degrees has recently announced to investors (as part of a proposed listing) that it is an "established and highly competitive challenger with strong momentum" and that the New Zealand market exhibits "attractive industry drivers, with 2degrees well positioned to benefit".

The Link Economics Initial Submission examines the mobile markets in detail. It finds that entry by 2degrees has brought significant benefits to consumers, particularly in the residential/prepay segment of the mobile market. However, its growth in share of customers ceased completely from 2012/13, and the extent of concentration in the business market segment still more closely resembles a duopoly than three-player network competition. It also highlights that prices in NZ compare least well internationally for large users and data-only plans, which indicates that there could be significant benefits that could be achieved through intensified competition, particularly for business customers.

The Link Economics Initial Submission also highlights that an effective MVNO market has failed to develop, and discusses the potential competition benefits from entry by a fourth network.

The above material discussed in the Link Economics Initial Submission demonstrates that mobile competition in both the wholesale and retail is still developing and has the potential to improve substantially in future. However, the extent to which competition is sustained and intensified will depend both on 2degrees ability to continue to grow and the ability of a new entrant to gain minimum efficient scale.

3 Development of competition under the factual

Effects of merger on scale and viability

On the topic of scale, Vodafone asserts at 1.2(d) of its response to the LOUI that "existing and potential market participants will not, in any case, be driven below competitive scale. The market will remain as competitive as ever."

NERA appears to make the incorrect assumption that smaller broadband suppliers have already reached minimum efficient scale. For example, it states in paragraph 15 of its submission on the LOUI:

> *As we set out in our 11 September 2016 report, for any bundling to result in a competition problem, the merged entity would need to first undermine the competitiveness of its rivals (for example, by reducing their market share to the point they are sub-scale or their marginal costs rise), and then exercise market power (for example, by raising price).*

As discussed above, competition is developing and a number of TSPs in a growth phase have not yet achieved efficient scale. NERA concludes the impact of reduced scale, to the extent that it occurs, will be largely on Spark. [**C-I-C**]

With regard to fixed costs, NERA states that (para 19) most of the fixed costs identified by the Commission are sunk costs, and expresses the view that sunk costs are not relevant to an exit decision. However, this is only the case where the cost has only already been incurred.[3] [C-I-C

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With regard to marketing costs, NERA states that these are relatively small and states that Vodafone has advised that across its business advertising and promotion costs account for approximately [**C-I-C**] of total cost. NERA's statement appears to support the concern raised by the Commission in the LOUI that smaller suppliers may not be able to achieve scale. Fixed costs will account for a larger proportion of total costs for a small supplier and a much smaller proportion of total costs for a large supplier. This is demonstrated in the illustrative example set out in the table below – a fixed operating cost of $10m accounts for 3% of total operating costs for a large TSP that has 500,000 customers, but 25% of operating costs for a

[3] Even then, in practice, an inability to service debt associated with sunk costs could affect a TSP's viability.

smaller TSP that has 50,000 customers, where the average variable cost for this illustrative example is $50 per month.

Table 1: Illustrative example of scale effects

Revenue per customer per month	$70
Variable costs per customer per month	$50
Fixed operating cost per annum	$10,000,000

Number of customers	50,000	100,000	200,000	300,000	500,000
Variable + fixed annual operating cost	$40,000,000	$70,000,000	$130,000,000	$190,000,000	$310,000,000
Fixed operating cost/Total operating costs	25%	14%	8%	5%	3%

Differentiated competition in the factual

Sky's submission on the LOUI (paragraphs 48 to 51) highlights Trustpower's use of utility bundling to date, and notes that this has been a successful strategy for acquiring customers. After discussing information from Trustpower's report on the number of customers that purchase utility bundles, Sky goes on to say that:

> *Based on the above, and the further evidence provided by Vodafone, it is clear that bundles that do not include SKY services have, so far, been an effective competitive constraint on the SKY/Vodafone bundles offered by Vodafone, and the rights to premium live sport content currently held by SKY are not 'must have' inputs in New Zealand's telecommunications markets.*
>
> *There is nothing to suggest that this will change in the future.*

Trustpower has a small customer base of 62,000[4] out of a total 1.82m broadband connections[5], giving it a share of around 3%. While it does appear to have effectively used bundling to acquire a very small share of the market, it is a significant leap in reasoning to conclude that this necessarily implies that the same strategy will work on a broader scale to compete with Sky bundles. The number of customers that are interested in a utility bundle could turn out to be a small niche, or a competitive response from within the retail electricity market could change the attractiveness of Trustpower's utility bundles to customers. Electricity retailing is contestable, with non-discriminatory access to network

[4] Trustpower Annual Report 2016.
[5] Statistics New Zealand *Internet Service Provider Survey 2016*.

services, a competitive wholesale market, and significantly less concentration than retail broadband supply.

It is also a leap in reasoning to suggest that the strategy of utility bundling would be effective under the factual in contesting the broader broadband market, especially for customers that purchase premium content. It is difficult to see how bundles of electricity (for which there is a separate competitive market) and broadband could compete with bundles of broadband and Sky for customers who value premium content.

Incentives and ability for 5G network investment

Vodafone characterises 5G as "simply one of many service differentiators" and asserts at Para 1.18 of its submission on the LOUI that: "Even if some parties' rollouts are delayed (which is highly unlikely to arise as a result of the Proposed Transaction), this will in no way adversely affect competition in the market."

It is evident from the customer research survey carried out by UMR for the Commission which explored the business segment of the mobile market that the reputation of the provider is important to businesses when selecting a mobile service provider (p. 29), as is offering up-to-date solutions (p. 30).[6] To the extent that 2degrees investment in 5G is delayed as a result of difficulties in achieving scale overall, while could in turn affect its reputation and ability to provide the full set of services offered by its rivals this could well impact on its ability to bring competition to the business segment of the mobile market which is currently highly concentrated.

Further, as discussed in the Link Economics Initial Submission 5G technology seems set to change the economics of 4th mobile network entry which has the potential to bring very significant benefits to consumers through strengthened competition in the wholesale and retail mobile markets. [**C-I-C]** As an open access provider of wholesale mobile services, the entry of Blue Reach has the potential to enhance competition in the fixed and mobile telecommunications markets, but this will be jeopardised if the merger proceeds and undermines the ability of small-medium TSPs (which are potential Blue Reach customers) to gain scale.

[6] UMR Research (December 2015), *Competition for Business Customers in the Mobile Industry: A Report for the Commerce Commission.*