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Report on Submissions on the Sky – Vodafone LOUI

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Contents

Executive Summary **4**

NERA Report 4

Howell and Potgieter 5

Vodafone Submission 5

1 Introduction **6**

2 Market Share Growth by the Merged Entity **7**

2.1 Field of Competition 8

2.2 Will the Competitive Fringe Remain? 8

2.3 How Many Consumers Will Switch? 9

3 Undermining of Rivals' Competitiveness **10**

3.1 What the Literature Says 10

3.2 Relevance of Sunk Costs 11

3.3 Fibre Unbundling 12

4 Howell and Potgieter **13**

4.1 Substantial Lessening of Competition 13

4.2 Commission's Analytical Approach 14

5 Incentives and Ability for the Merged Entity **16**

5.1 Must Have Content 16

5.2 Incentives and Ability for a Vertical Price Squeeze 18

5.3 Wholesale Terms for Independent TSPs 18

5.4 Substantial Lessening of Competition 19

Executive Summary

1. This report responds to submissions by NERA for the applicants, by Vodafone, and by Howell and Potgieter, on matters raised in the Commerce Commission's letter of unresolved issues (LOUI) on the proposed acquisition of Sky TV by Vodafone. Like three earlier reports on this matter, it represents the independent expert views of the author.

NERA Report

2. NERA presents two arguments. The first challenges the Commission's view that the merged entity could attract the broadband business of enough Sky subscribers to substantially lessen retail competition for consumer broadband connections. This argument contains several errors including:

    a. Wrongly assuming that rivals must exit before competitive harm can occur;

    b. Wrongly assuming that better wholesaling terms from Sky would reduce product variety; and

    c. Materially overstating the market share impact of one of the concerns expressed by the Commission in the LOUI.

3. Secondly, NERA disagrees with the Commission's view that by undermining the ability of other telecommunications service providers (TSPs) to achieve or maintain scale, the transaction would substantially lessen competition in the fixed broadband market. In advancing this argument NERA has:

    a. Misrepresented the economic literature it cites, which notes that for competitive harm to occur, there must either be exit or an increase in marginal costs (NERA incorrectly cites the literature as saying that exit is necessary);

    b. Neglected the role of sunk costs in entry decisions and the role that new entry plays in dynamic competition; and

    c. Suggested without citation, and contrary to the Commission's merger guidelines that the possibility of fibre unbundling post-2020 is the Commission's main concern.

4. We also note that the NERA report does not address the following concerns expressed in the LOUI:

    a. That the merged entity would have substantial market power over content (LOUI at ¶21 – 22);

    b. That the merged entity may have less incentive to enter into reselling arrangements (LOUI at ¶29 – 36); and

    c. That there are grounds for concern about the effect of the merger on competition in the retail market for mobile services (LOUI at ¶39).

Howell and Potgieter

5. We agree with very little of the submission by Howell & Potgieter. Our main concerns are that:

    a. Their submission opens by exaggerating the Commission's position, suggesting that the LOUI claims that a substantial lessening of competition is certain to occur, rather than that the Commission is not satisfied that it will not occur on the basis of information supplied to date;

    b. The submission contains numerous errors, including more false assertions as to the work of the Commission; and

    c. The submission concludes by criticising the statutory test that the Commission is obliged to apply.

Vodafone Submission

6. The Vodafone submission argues that the proposed merger will not substantially lessen competition because Sky content is not particularly important to consumers and because the relevant markets are highly competitive. We consider Vodafone's arguments on these and related points to be incorrect. In particular, we explain that:

    a. Current and recent market conditions are a poor predictor of the likely future, with or without the proposed merger;

    b. The merged entity will have strong incentives to implement a vertical price squeeze and/or to use service quality to discriminate against independent TSPs;

    c. The merged entity will have the ability to discriminate against independent TSPs, without necessarily increasing the stand-alone price of Sky services; and

    d. The presence of a large number of smaller TSPs increases the risk that competition will be substantially lessened because each small TSP is more vulnerable to higher unit costs from reduced scale than a larger TSP would be.

1 Introduction

7. We have supplied three previous economic reports on the proposed acquisition of Sky by Vodafone. This report is in response to submissions made in response to the LOUI by NERA[1], Howell and Potgieter[2] and Vodafone[3]. Like our previous submissions, it represents the independent views of the author.

8. The following structure is used.

   a. In section 2, we consider NERA's arguments concerning the likely market share growth in the residential broadband market if the merger proceeds.

   b. In section 3 we review NERA's arguments that the competitiveness of rivals to the applicants will not be undermined if the merger proceeds.

   c. In section 4 we outline our main concerns with the submission by Howell and Potgieter.

   d. In section 5 we comment on Vodafone's submission.

[1] NERA, Sky/Vodafone – response to the LOUI

[2] Bronwyn E. Howell and Petrus H. Potgieter, Submission to the New Zealand Commerce Commission re: Unresolved Issues: Vodafone Europe B.V. / Sky Network Television Limited

[3] Vodafone/SKY – Vodafone's Response to Letter of Unresolved Issues.

2 Market Share Growth by the Merged Entity

9. NERA says (at ¶3) that the Commission's LOUI is based on "*a static view of competition and relatedly a homogeneous view of consumers*". We disagree. There is ample evidence in the LOUI that the Commission is alive to changes in competitive dynamics in the relevant markets. For example:

   a. The Commission (at ¶14.1) considers it likely that the applicants will offer "*differentiated bundles and content to consumers*".

   b. The effects of the UFB network roll out are considered (at ¶25).

   c. The impact of relative price changes and consumer preference changes on the up take of triple- and quad play bundles is considered (at ¶27).

10. Similarly, it is clear from the LOUI that the Commission does not have "a homogenous view of consumers". In particular, the fact that some customers are more valuable than others is explicitly considered (eg at ¶28).

11. According to NERA, the Commission's neglect of competitive dynamics and customer heterogeneity has led the Commission to over-estimate the risks to competition. NERA claims (at ¶4) to show that "*the bundling strategy considered in the Commission's theory of harm is unlikely to be successful*". NERA's argument contains four main elements:

   a. *"The field of competition is wider than just Sky/broadband"* (¶7);

   b. *"Suppliers are likely to be viable without having to "match" the merged entity's offering"* (¶9);

   c. *"There is no evidence to suggest that all or even a majority of Sky Sport subscribers would shift to the merged entity if it increased its discount"* (¶10); and

   d. *"The Commission's theory would result in an unprecedented step-change in market shares"* (¶12) and is "*completely improbable*" (¶14).

12. We address each of these statements below. In summary, we consider that:

   a. It is correct to focus the competition analysis on Sky/broadband (including mobile broadband), not least because of competitive dynamics and customer heterogeneity;

   b. NERA has provided no evidence to support its view that rivals are likely to be viable without matching the merged entity, and in any case viability is not the correct standard here;

   c. Economic theory and [ ] both predict significant switching, and competitive harm can easily arise without switching by "*all or even a majority of Spy Sport subscribers*"; and

d. NERA has developed a grossly exaggerated scenario (not the Commission's theory) which NERA says involves *an unprecedented step change in market shares* and is *completely improbable*.

2.1 Field of Competition

13. The fact that Vodafone and Spark have been losing market share of broadband connections shows that smaller TSPs have been able to gain a foothold in the market, using a variety of strategies, and that customers have benefited from their activities.

14. The absence of a vertically integrated monopoly is likely to be a significant causal factor in this recent history, because the removal of vertical integration in the telecommunications sector, through structural separation, has removed the incentive for a range of strategies that could otherwise be used to lessen downstream competition. Removing vertical integration reduced the risks associated with entry and is likely to have stimulated entry.

15. This entry has occurred despite Sky not actively pursuing a wholesaling strategy, preferring instead to offer terms that are commercially unattractive to all but one TSP. Sky's terms include restrictions on the ability of TSPs to design their own innovative bundles using Sky's content. As we have noted previously, and as reflected in the explanatory memorandum and [ ], this business model is no longer working for Sky.

16. NERA (at ¶9) correctly infers that the recent emergence of a competitive fringe has created more choices for consumers. NERA does not analyse the causes of the entry of a competitive fringe, or the possibility that the transaction might reduce product variety.

2.2 Will the Competitive Fringe Remain?

17. NERA concludes that bundle variety will perform the same role post-merger: *"suppliers are likely to be viable without having to "match" the merged entity's offering"*. There are two problems with this statement.

    a. It applies an unduly high threshold (*be viable*) for assessing harm to competition. As discussed further in section 3 below, the standard previously used by NERA and embedded in NERA's citations from the literature is that competitive harm can occur if firms are forced to exit *or* their marginal costs increase due to loss of scale.

    b. It contains an error of logic. NERA is effectively assuming that the competitive position of smaller TSPs under the factual scenario can be predicted from their recent history, despite the proposed material change in market structure, and the consequent changes in incentives for the merged entity.

18. An important aim of a competition assessment is to assess how the competitive environment is likely to change post-merger. Among other things, this involves assessing the incentives acting on the merged entity and its ability to pursue those incentives. It cannot be inferred from the current existence of a competitive fringe that these firms will remain in existence post-merger, much less that they will retain whatever relative advantages they currently have. The reason for this, is that the merged entity will have very different incentives to those currently facing the applicants individually, and an

enhanced ability to pursue those incentives. We discuss these matters further in section 5 below.

19. NERA then presents (also at ¶9) a false dichotomy in the form of a choice between greater "*like-for-like bundle competition*" and "*differentiated competition*". In doing so, NERA refers to ¶42 of the LOUI, which discusses a counterfactual scenario in which Sky resells to more TSPs. This is a false dichotomy because greater like-for-like bundle competition will not reduce differentiated competition. The fact that several TSPs might offer broadly similar bundles of Sky/broadband does not prevent any TSP from also offering other bundles.

2.3 How Many Consumers Will Switch?

20. NERA challenges the Commission's concern at ¶24 of the LOUI that the merged entity *"could potentially capture the proportion of broadband customers that currently subscribe to a Sky package that includes sport (around [ ] of broadband customers)"*. Our interpretation of this statement in the LOUI is that the Commission is saying that the merged entity could potentially end up with [ ] of the fixed broadband market. This would be a significant increase over Vodafone's current market share of [ ] and the impact on competition in the retail market for fixed broadband would be all the greater for the fact that the extra [ ] would tend to be relatively high value customers.

21. NERA describes this concern (at ¶10) as "*speculative*" even though [

]. NERA then creates a scenario in which Vodafone's share of fixed broadband connections reaches [ ] in 2020, and describes this scenario (at ¶14) as being "*completely improbable*".

22. NERA's scenario is extreme and does not reflect the Commission's concerns as described in the LOUI at ¶24. Our interpretation of the LOUI described above (¶20) could more correctly and directly be modelled by simply adopting [ ] as the final market share at 2020. Instead, NERA has used a convoluted method (NERA, footnote 7) that results in a 2020 market share of [ ]. We cannot reconcile this with the LOUI.

3 Undermining of Rivals' Competitiveness

23. NERA challenges the Commission's assessment (in the LOUI) of the risk that the proposed merger will undermine competition from Vodafone's TSP rivals.

24. NERA makes three claims:

    a. The economics literature says that for the merger to "*result in a competition problem rivals… would need to be pushed out of the market*" (NERA at ¶15 – 16);

    b. "*Sunk costs are not relevant to an exit decision*" (NERA at ¶19); and

    c. The Commission's "*main concern*" is "*in the context of possible fibre unbundling post 2020*".

25. We consider the first and third of these claims to be of primary importance. The second is somewhat irrelevant since (as we show below) a competition problem can arise without exit, but we address it for completeness.

3.1 What the Literature Says

26. NERA's first report said (at ¶10B) that for competitive harm to occur, "*the merged entity would first need to undermine the competitiveness of its rivals (for example by reducing their market share to the point where they are sub-scale **or their marginal costs rise**)*" (emphasis added). This view is consistent with NERA's citations of the literature, which appear in footnote 11 of NERA's first report and almost identically in footnote 8 of NERA's second report.

27. NERA (at ¶16) appears to have changed its position and now claims that an increase in marginal cost is not sufficient to create competitive harm.

    > *Regarding the sub-scale issue, the literature actually says that the rivals would need to be pushed out of the market. For example, Carlton Greenlee and Waldman (2008, 618 – 619) state:*
    >
    >> *It is not enough to show that the rival firm was "foreclosed" from some customers or that it was foreclosed from a substantial share of them. The key to establishing competitive harm is showing the foreclosed business left insufficient scale for the firm to remain in business…*

28. This argument (that exit of rivals is the only relevant criterion) is used elsewhere in the NERA report. For example, NERA relies on it when stating (at ¶9) that "*suppliers are likely to be viable without having to match the merged entity's offering*". It also underlies NERA's argument about the difference between sunk and fixed costs, where NERA say (at ¶19) that "*sunk costs are not relevant to an exit (retrenchment) decision*".

29. NERA has misrepresented the paper it cites. By omitting the remainder of the second sentence quoted above, NERA gives the impression that the citation supports NERA's opinion that exit is necessary for competitive harm to occur. In fact, if the words which

were omitted by NERA are included (as shown below), the citation is consistent with NERA's position in its first report and with the two quotations cited in the near identical footnotes we discussed above (¶26):

> *It is not enough to show that the rival firm was "foreclosed" from some customers or that it was foreclosed from a substantial share of them. The key to establishing competitive harm is showing the foreclosed business left insufficient scale for the firm to remain in business* ***(or the denied scale led to increased marginal cost)****. (emphasis added)*

30. For completeness, we note this test (even correctly stated) is inconsistent with the established view in New Zealand and Australia that competitive harm can occur in a market if rival firms are unable to compete for some customers or a substantial share of customers. For example, the Commission's merger guidelines[4] note (at ¶5.10) that

> *A substantial lessening of competition may arise where foreclosure makes entry and expansion more difficult, or otherwise reduces a competitor's (or competitors') ability to provide a competitive constraint. Foreclosure does not need to force a competitor, or competitors, to exit the market to have this effect.*

3.2 Relevance of Sunk Costs

31. Having asserted incorrectly that exit is necessary for competitive harm to occur, NERA then argues (at ¶19) that most of the relevant fixed costs are sunk, and therefore "*not relevant*". We consider that sunk costs are relevant to the Commission's assessment for two reasons.

32. First, sunk costs act as a hurdle for potential entrants into either of the relevant retail markets (fixed broadband or mobile services). A significant number of firms have entered the fixed broadband market as retailers in recent years as the historic vertically integrated monopoly problem has been solved by direct government intervention. This entry has intensified competition, given consumers more supply options and given the entrants themselves an opportunity to grow and challenge their larger rivals.

33. When considering entry, firms weigh up their prospects of earning sufficient revenue to cover all of their costs (financial success) against the prospect of losing the sunk costs of entry (failure). As the relevant retail markets move towards triple- and quad-play bundles (as the applicants expect), entry will be deterred unless potential entrants are able to compete effectively against these bundles. Other things being equal, the presence of a vertically integrated TSP with a monopoly over premium content will deter entry by increasing the likelihood of new entrants losing their sunk costs.

34. Second, since sunk costs are also fixed costs, they increase the height of the average cost curve, contributing to economies of scale. Smaller firms with fewer customers therefore

[4] Commerce Commission, Mergers and Acquisitions Guidelines, July 2013.

have higher unit costs than larger firms. This restricts the ability of smaller firms to compete on price.

35. In the matter at hand, as the merged entity gains market share by favouring its TSP division with access to content at [ ][5], the unit costs of its rivals will increase. Competition is lessened both by the effect of this conduct (higher costs for rival TSPs) and by its cause (discrimination by a vertically integrated monopolist in favour of its downstream division).

3.3 Fibre Unbundling

36. The third leg of NERA's argument that the proposed merger will not undermine rivals' competitiveness begins with a claim that the Commission's "*main concern*" is "*actually in the context of possible fibre unbundling post-2020*". No reference or supporting citations are provided for this claim. In addition, it is implausible for two reasons.

37. First, fibre unbundling was not mentioned in the LOUI. The competition concerns that were expressed in the LOUI are independent of any commercial or policy decisions concerning fibre unbundling.

38. Second, it would be inconsistent with the Commission's own merger guidelines for it to attach material weight to what might happen post-2020. Concerning the timeframe for the Commission's analysis, the guidelines say (at ¶3.106)

> *The appropriate timeframe may vary from market to market according to the particular characteristics of the market concerned*

39. Footnote 96 elaborates:

> *In general, we consider entry and expansion within two years is sufficiently timely. However, this timeframe may vary depending on the facts of the case. For example, in Commerce Commission v New Zealand Bus Ltd … the court adopted a three year timeframe.*

40. Thus, while the Commission might well be interested in the fibre unbundling plans of TSPs as part of a complete analysis of the proposed merger, it would be very unusual for a market development that might *start* to occur after more than three years to become its "*main concern*". All the more so since it was not mentioned in the LOUI.

[5] [ ]

4 Howell and Potgieter

41. Howell and Potgieter (H&P) advance two main arguments which we discuss separately:

    a. that vertical and/or agglomeration effects will not necessarily lead to a substantial lessening of competition; and

    b. that there are errors in the Commission's analytical approach.

42. We discuss these separately.

4.1 Substantial Lessening of Competition

43. In addressing their first point, H&P begin by materially overstating the Commission's concerns. The statutory requirement for clearance is that the Commission must be satisfied that the proposed merger will not be likely to result in a substantial lessening of competition (SLC). In the LOUI, the Commission explained that it is not currently satisfied on the basis of the information supplied to date.

44. The Commission did not say that the market power of the merged entity over content will *"necessarily result"* in an SLC, or that an SLC "*is seen as inevitable*". Yet that is how H&P characterise the Commission's views. Having materially overstated the Commission's concerns, H&P explain at length why they *"do not find this argument compelling"*.

45. Like NERA, H&P argue (at ¶10a) that the recent market experience with Vodafone's existing bundling shows that there can be no reasonable concern over bundling by the merged entity. This ignores the impact of the proposed transaction on the incentives of the applicants, and the ability of the merged entity to act in pursuit of those incentives. We have discussed these issues in each of our three previous reports and will not repeat that discussion here.[6]

46. H&P also suggest (at ¶10c) that a competition problem could only arise if the merged entity "*acquir[ed] exclusive distribution rights to all paid internet content consumed by residential customers*". We disagree. For the reasons described in our previous reports we consider that the proposed merger is likely to result in a substantial lessening of competition in both retail markets identified in the LOUI. It is not necessary to control all paid content for this to occur because of the very limited substitutes for premium content. As the applicants have acknowledged, premium content is "*a key input into any pay TV service*".

47. The damage that quad-play bundling by the merged entity could cause to competition in mobile services is considered by H&P (at ¶10d) to be "*much less than indicated*" in the LOUI. Their reasoning is that mobile networks would have incentives to "*find new ways to sell services to residential consumers*" when faced with foreclosure. We note that, for other mobile networks to compete effectively post-merger, appropriate incentives are necessary

[6] Economic Analysis of Sky-Vodafone Proposal, 11 August 2016 at section 4. Review of New Material on Sky-Vodafone Proposal, 30 September 2016 at section 3.1. Confidential Response to the LOUI on Sky-Vodafone Proposal, 8 November 2016 at section 5.3.

but not sufficient. Their *ability* to find new ways to sell services to residential consumers will be materially compromised by the proposed merger.

48. As the Commission has previously recognised, there is often limited substitutability between different types of content. Thus, while H&P appear (at ¶10e) to consider that Spotify might be a reasonable substitute for Sky's premium content, there is no evidence to suggest this view is widespread or reflected in consumer buying behaviour.

49. To the contrary, as 2degrees has submitted,[7] its own experience is that

> *"a high value customer would be unlikely to consider a bundled offering including a music streaming service or electricity as substitutable for a bundled offering including premium broadcast content".*

4.2 Commission's Analytical Approach

50. We agree with H&P (at ¶12) that perfect competition is not "*the relevant basis for consideration*" of the proposed merger. We disagree that the perfect competition standard was the basis for consideration that was used by the Commission, and it is certainly not relevant to the assessments we have made in any of our reports.

51. Contrary to the assertions in H&P (at ¶12), the fact that analysts (such as the Commission, and ourselves) have paid close attention to bundles containing Sky content and telecommunications services does not mean those analysts have ignored:

    a. product differentiation;

    b. non-linear and OTT services;

    c. the fact that demand for internet access is a derived demand;

    d. customer heterogeneity; or

    e. the evolution of consumer preferences

52. Rather, it means that we have looked at the whole matrix of facts and issues, identified those relevant to the statutory test and focused our attention on what really matters if one is seeking to promote and protect the competitive process.

53. Finally, H&P criticise the statutory test, saying (at ¶15) that

> *It is at best unhelpful and at worst extremely risky to use the standard of 'substantial lessening of competition' in just one of the myriad of markets involved to assess this merger*

[7] Cross Submission by 2Degrees on Submissions by Vodafone and Sky on Responses to Submissions on the Statement of Preliminary Issues, 6 October 2016, at ¶3.23.

54. This is an argument against the law, rather than against the Commission's views as set out in the LOUI.

5 Incentives and Ability for the Merged Entity

55. As noted above (footnote 6), each of our three previous reports on this topic have discussed the incentives facing the merged entity, how they differ from those currently facing each of the applicants, and the ability of the merged entity to pursue its interests. We now expand on those discussions with reference to the Vodafone submission on the LOUI. The following issues are addressed.

    a. The claim that Sky's content is not "must have" content;

    b. Incentives and ability for a vertical price squeeze;

    c. Wholesale terms for independent TSPs; and

    d. Consumer switching and the substantial lessening of competition test.

5.1 Must Have Content

56. Vodafone argues that even if Sky has substantial market power over premium content, this is not a "must have" element of a retail bundle offered by TSPs. The evidence it presents is entirely backward looking, focusing on the following facts:

    a. Sky's customer numbers have recently begun declining;

    b. Vodafone has been performing poorly in fixed broadband market share despite offering Sky content; and

    c. Other TSPs have been gaining market share, as have OTT services.

57. These facts underline the view expressed in our first report that both parties, but particularly Sky, are in need of new sources of growth. As fixed broadband services are becoming more widely available, Sky's access network is becoming less important to pay TV service provision and both TSPs and consumers are using broadband networks to access video content.

58. These technological changes and the resulting response by consumers and TSPs show that the next few years (the relevant period for the Commission's analysis) will be different to the recent past. As the explanatory memorandum says (at p.75):

    > *The Proposed Transaction is expressly designed to address the deterioration in Sky TV's strategic position*

59. The application itself shows that the existing arrangement between Sky and Vodafone, which includes restrictions on Vodafone's ability to re-package Sky's content, are not sufficient to generate the growth both applicants seek. As the explanatory memorandum says (at p.78):

The Combined Group will be able to sell bundled fixed line and mobile, pay television and internet packages more effectively than either business under the existing alliance arrangements.

60. This does not mean that Sky's content, especially its premium content, has become less valuable, or less useful in pursing the applicants' joint goals. On the contrary, it is very clear from the Grant Samuel report that Sky's premium content is seen as a critical driver of value.[8]

61. [

]

62. Vodafone's submission on the LOUI includes the statement (at ¶1.6(c)).

Research commissioned by Vodafone to guide its internal business decisions demonstrates that the addition of Sky content in a broadband bundle is a [

].

63. This is a curious claim for two reasons. [

]

64. [

]

65. [

]

[8] Covec, Confidential Response to the LOUI on Sky – Vodafone Proposal, 8 November 2016, section 5.1.

66. [

]

5.2 Incentives and Ability for a Vertical Price Squeeze

67. An important theory of competitive harm outlined in the LOUI is that the merged entity will effectively implement a vertical price squeeze on independent TSPs seeking access to Sky's content. We now consider its incentives and ability to achieve this outcome.

68. The merged entity would have strong incentives to favour its own TSP division in respect of the terms of access to Sky's content. This arises directly from the fact that each customer switching to a fixed or mobile connection supplied by the merged entity is a source of incremental profits. The greater the number of customers switched to the merged entity, the greater its profits will be.

69. A second source of incentive is the fact that churn is reduced by the provision of triple- and quad-play bundles. Churn reduction is a powerful effect, since it could allow the applicants to recoup some or all of the discounts it may use to attract market share away from other TSPs. We note that NERA sought to undermine the credibility of this effect, arguing that neither of the parties originally mentioning it provided "*any persuasive evidence to this effect*".[9] However we have since discovered that [

].

70. Regarding the merged entity's ability to implement a vertical price squeeze, one of the actions suggested in the LOUI was an increase in the stand-alone price of Sky. While such a strategy would be helpful for a price squeeze strategy, it is not essential to such a strategy. The same effect could be created without any change in the stand-alone price of Sky services, simply through a more aggressive bundle discount.

71. Moreover, as we have mentioned previously, non-price methods could be used to help induce customer switching, either in place of or alongside a vertical price squeeze.[10] The experience in New Zealand when Telecom was a vertically integrated monopoly (and similar experiences in other countries) should leave little doubt as to the ability of the merged entity to insulate itself from the competitive threat posed by independent TSPs.

5.3 Wholesale Terms for Independent TSPs

72. Vodafone's submission on the LOUI says that "*the merged entity will (and will be incentivised to) offer wholesale Sky and retail standalone Sky*". We agree with this statement but the mere offer of such services is irrelevant. It is the *terms* of such offers that are important for the preservation of competition.

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[9] NERA, Sky/Vodafone – review of economics reports, 11 September 2016, ¶12.

[10] Covec, Confidential Response to the LOUI on Sky – Vodafone Proposal, 8 November 2016, section 5.2.

73. If there were any doubt as to the merged entity's intentions regarding independent TSPs, it should have been dispelled by the strong reliance on ECPR-like pricing that has been evident to date, and the clear statements by Sky that ECPR will be the guiding principle post-merger.[11]

74. While the ECPR concept is not necessarily in breach of s36 of the Commerce Act, it

   a. Is the highest access price that could be consistent with s36; and

   b. Is in practice subject to a range of assumptions about avoidable costs and to errors in the measurement of those costs.

75. There is an additional concern over the estimation of avoidable costs in the context of the proposed merger. As we have noted,[12] [

]

5.4 Substantial Lessening of Competition

76. Vodafone's submission on the LOUI says that the relevant telecommunications markets are "*highly competitive*" (at ¶1.3), and therefore "*the Proposed Transaction would need to result in a monumental change in telecommunications markets to risk substantially lessening competition*" (at ¶1.5).

77. While there has been considerable new entry in fixed broadband, concerns remain about the intensity and robustness of competition in the relevant fixed and mobile markets, as discussed by Link Economics. However even in the absence of these concerns we disagree with the proposition that "*a monumental change*" is needed for a substantial lessening of competition to occur.

78. As we have previously submitted,[13] it is well established that a substantial lessening of competition in a market can occur if it affects a significant section of the market. In the matter at hand, the section of the market most vulnerable to a substantial lessening of competition is the group of customers currently subscribing to Sky but not customers of Vodafone. We have previously estimated this to be approximately one third of New Zealand households, which is a significant section of the market.

79. The fact that these are likely to be relatively high value customers reinforces this view, because it increases the likelihood that there will be substantial flow-on effects on competition for all other customers.

80. In its LOUI, the Commission outlined the risk that TSPs who lose customers to the merged entity will also lose, or fail to achieve scale, and therefore provide less effective

[11] Covec, Review of New Material on Sky – Vodafone Proposal, 30 September 2016, section 2, especially 2.1.

[12] Covec, Confidential Response to the LOUI on Sky – Vodafone Proposal, 8 November 2016, at ¶27.

[13] Covec, Review of New Material on Sky – Vodafone Proposal, 30 September 2016, at section 2.

competition. This concern is all the more serious given the current market structure, since many of the fixed broadband suppliers are recent entrants operating at small scale.

81. There is no empirical information on the precise shape of the average cost curve for fixed or mobile TSPs, but it is safe to assume that there will be economies of scale for smaller firms, probably followed by a range with constant returns to scale. The competition concern is that a moderately large number of the existing TSPs may still be in the range of economies of scale or have recently hit the flat section of the average cost curve. For such firms, the loss of a few relatively valuable customers could push them back up their average cost curve, increasing the prices they would need to charge to cover total costs. This would undermine their *ability* to compete effectively against the merged entity and indeed against any other larger TSP.

82. In summary, our interpretation of the existing market structure is quite different to Vodafone's. While the moderately large number of recent entrants has been beneficial to competition, the small scale of many of these firms makes them unusually vulnerable to the loss of customers, particularly high value customers. This increases the likelihood that the proposed merger would result in a substantial lessening of competition.