Submission to the Commission by Trustpower following the LOUI

11 November 2016

Trustpower Limited welcomes the opportunity to provide a submission to the Commerce Commission in relation to the clearance application by Vodafone and Sky.

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1. Summary

1.1 Thank you for the opportunity to submit following the letter of unresolved issues (LOUI). We particularly welcome and value the LOUI being provided, and we hope that we can assist the Commission with our submissions on a better-informed basis.

1.2 Generally, we firmly support and welcome the Commission's draft views in the LOUI. Where we have issues, and suggestions for a focus in additional or other areas, we have identified that below, although our submission focusses on limited areas in the LOUI. We expect that other submitters will address the other aspects in the LOUI.

Forward looking counterfactual assessment

1.3 There is an apparent move by the Commission toward focussing on the major market and technology changes in the future, when assessing the factual and counterfactual. We support this move. However, our impression is that there remains an undue – and generally unexplained – focus on the status quo when assessing what the counterfactual will be. This is therefore a major focus of our submission, including as to identifying how the applicants and their expert do not explain why the status quo would be relevant to markets undergoing considerable and disruptive change.

1.4 One facet of this is that we see little evidence – including from the applicants and from NERA - as to why significant elements of the status quo would continue. Given the major market and technology changes, we submit that, because there is little evidence, the status quo should be disregarded on counterfactual assessment. (A key exception however is that, as the LOUI accepts in draft, premium sports are locked in for several years).

SLC in all counterfactual variants

1.5 The debate between whether one counterfactual or another is correct (eg build or buy RSP/OTT/wholesale) should not cloud the underlying position. In all counterfactual variants, the factual results in SLC.

ECPR as evidence of Sky's substantial market power as to premium content

1.6 We build on Covec's useful analysis of Sky's ECPR pricing, adding also the observations in the Data Tails judgment, to show that the ECPR pricing of itself shows that Sky has substantial market power as to premium content.

1.7 We have also included statements by the applicants' independent expert, Grant Samuel, that are only consistent with Sky having substantial market power.

Lack of competition in fixed and mobile telecommunications markets

1.8 A core feature of the applicants' submissions and of the NERA report is that the fixed and mobile telecommunications markets are fully competitive. Our extensive submissions, and Blue Reach's, to the contrary, were ignored by the applicants and NERA when responding.

1.9 We address this below.

Losing or failing to achieve scale

1.10 We particularly welcome and support the draft views on that topic at the end of the LOUI. As a smaller RSP, and without mobile capability, we are acutely aware of the challenges that exist already.

1.11 Those problems will be made substantially worse by the merger, and that is magnified, as the Commission in our view correctly notes, by the merged entity targeting high ARPU customers, leaving unsustainable low ARPU customers for the other RSPs.

1.12 But in the counterfactual, and in this scale context, genuinely viable content from Sky is more likely to be available to RSPs, large and small, making bundled offerings more viable for smaller RSPs. This goes to reducing the competition problems that exist in the mobile and fixed markets.

1.13 Given we are one of the smaller RSPs and affected most directly by the noted scale issues, please let us know if we can assist the Commission with information.

1.14 We turn now to the body of our submission.

2. Relevant markets

2.1 We remain of the view[1] that there are separate telecommunications markets for each of fixed and mobile for rural.

2.2 We also remain of the view[2] that the retail markets for the provision of residential fixed-line broadband services should be for "fixed location" not "fixed line". Fixed wireless access (FWA) – that is, wireless broadband to a fixed location as opposed to mobile - is a substitute for fixed line access.

3. The NERA report

3.1 Submissions and reports on behalf of third parties identify a number of issues arising out of the NERA report. We here deal with three aspects:

a) the retrospective focus on the counterfactual;

b) ECPR and the counterfactual;

c) Sky's use of ECPR.

4. Counterfactual: Retrospective focus by NERA (and the applicants)

4.1 The NERA conclusions and reasons are firmly dominated by the view that what has happened so far – the status quo – points to the same position continuing during the subsequent period, in the counterfactual.[3] From starting in their report with relying on "actual behaviour" thus far, and ending with the observation that "the Axiom report overlooks the most obvious counterfactual, which is the existing arrangements between Sky and Vodafone", NERA's report firmly relies on the history so far to predict the future. So do Vodafone and Sky.

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[1] Trustpower 12 August submission at Para 14.1.

[2] Trustpower 12 August submission at Para 14.2.

[3] Materially, other than that, there is only reliance on OTT developments.

4.2 That is despite the considerable evidence, including substantial detail in submissions and evidence that NERA were replying to, and strong statements by NERA's own clients, that there are major market changes that fundamentally change the market away from the current market context.

4.3 This includes as to marked declining revenues from the SKY business, of which no mention is made by NERA, despite that being a central aspect of submissions and reports against the merger, to which NERA was replying.

4.4 We welcome the Commission's greater focus in the LOUI, to the contrary, on market and technology developments in the future as being the focus for the counterfactual assessment. However, as outlined below, we consider the LOUI remains unduly focussed on assessing the future from the current position.

4.5 The approach in the LOUI recognises a key factor that will not change during the period relevant to the counterfactual (and the factual). That is Sky's long term and locked in contracts until the early 2020s for most premium sport. That those sports are up for rebidding then is not relevant to the assessment, as this occurs well past even an extended period for counterfactual analysis.

5. ECPR and the counterfactual

5.1 At Para 17, NERA state:

> Covec's argument (e.g., at [43] and [82]) is that it would be profit maximising for Sky (under the counterfactual) to drop its wholesale prices and expand its wholesale business. However, if that was the case, it would have done so already. It has to be assumed that Sky has already considered the trade-off between lowering its wholesale margins and increasing volume in this way, and determined that its existing wholesale pricing approach (based on ECPR) is profit-maximising.

5.2 This is one of a number of examples of NERA simply stating that the status quo considerations tell the Commission what the counterfactual will be in the future. NERA ignores central features of the Covec analysis, to which it is directly responding, such as that Sky's declining revenues give it no choice but to change what it is doing in the counterfactual.

6. ECPR pricing is evidence of substantial market power

6.1 The LOUI at Para 21 comes to the draft view that *"Sky has substantial market power by virtue of its ownership of key content".*

Vodafone and others' support for this conclusion

6.2 We support this view for the reasons given in the LOUI and elsewhere. Vodafone incorrectly claims that its numerous statements internationally to the same effect were made in a context that is not relevant and can be distinguished. It is apparent from reading the context in each case that in fact the statements – of which only a representative sample were quoted - are generally applicable internationally including in New Zealand.

6.3 What the applicant itself says is often the best available evidence of the correct position and Vodafone is wrong to say that overseas comments are not appropriate for the Commission to consider.

Key content using the "substantial market power" description instead of "must have"

6.4 We think it is helpful that the Commission is referring to "substantial market power" instead of "must have". The latter as a matter of language can mean something other than how it is applied in a competition context. For example, plain English may mean that an RSP cannot survive at all without that content, which is a submission that the applicants make, yet that is contrary to the use of "must have" in a competition context.

NERA, Covec, ECPR and the Data Tails case

6.5 In responding to NERA, Covec provide an analysis, with which we agree, that Sky's ECPR pricing demonstrates that Sky has substantial market power in relation to content. As Covec explain in their 30 September submission:

> 26. …The ECPR input price is the monopolist's retail price less the costs the monopolist avoids when a rival supplies the final consumer.
>
> 27. ECPR could not survive as a pricing construct if the relevant market for inputs was competitive. In that context, buyers of the input would play one supplier off against another and the input price would be pushed towards marginal cost, just as it is in any competitive market.

6.6 We add this point. The fact that Sky only wholesales at ECPR prices is strong evidence, for those reasons, that Sky has substantial market power ("must have") as to premium content. If they didn't, then, as Covec explain, the monopoly rents would be competed out.

6.7 Covec refers to the economics literature to support their conclusions. We add here, to support that conclusion as to ECPR, the analysis in 2012 by the Court of Appeal in the Data Tails case: *Telecom v Commerce Commission*.[4] That decision reflects the growing and strong criticism among economists and lawyers of the ECPR model as a competition and regulatory solution.[5] In particular, the focus in the Data Tails case was on ECPR entrenching monopoly rents.

6.8 In that context, the Court of Appeal stated:

> [81] To the extent that Telecom's argument relies on ECPR producing efficiency, ECPR is not, by itself, sufficient to ensure efficiency. If a firm obtains monopoly profits, its opportunity cost will include monopoly profits. Similarly, monopoly rents in the form of inefficiencies in a monopolist firm's provision of a service, giving rise to higher costs, will be preserved. ECPR can therefore preserve the allocative or consumption inefficiency that results from the monopolist's excessively high final product prices.[6]

6.9 That further supports the Covec conclusion. It also supports our submission above, that Sky's ECPR wholesale pricing includes monopoly rents, indicating that Sky has market power in relation to key content. ECPR does not, by itself, ensure efficiency, and typically retains monopoly rents.

6.10 To be clear, regulation relying on ECPR (such as s36 although the Data Tails case shows the model even in that context is under attack) has no place in a substantial lessening of competition assessment. This is made clear in the passage from the judgment quoted above, as it specifically distinguishes efficiencies (which are SLC concerns) from ECPR.

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[4] [2012] NZCA 278.

[5] See for example, *Albion Water Ltd v. Water Services Regulation Authority and Dŵr Cymru* [2006] CAT 36.

[6] Nicholas Economides and Lawrence White "Access and interconnection pricing: how efficient is the 'efficient component pricing rule'?" (1995) 40(3) Antitrust Bulletin 557 at 564.

7. The counterfactual in the LOUI

Undue and unexplained focus on the past

7.1 There is some difficulty in understanding the draft counterfactual in the LOUI and we therefore make some assumptions.

7.2 Mostly, only conclusions are expressed rather than underlying reasons. The absence of reasons also makes it difficult to submit. That is particularly so when the reasons for a counterfactual based on the status quo (i.e. predicting the future based on what has happened so far) are largely absent from the applicants' documents we have seen, including the NERA report, as noted above. For example, NERA largely "take it as read" that the status quo tells us what the counterfactual should be.

7.3 This is the position, despite the submissions and evidence of major change in the near to medium future, including from the applicants themselves, indicating that what is happening in the status quo is largely irrelevant.

7.4 On any assessment these changes can fairly be described as major disruptions to the status quo on multiple fronts.

7.5 Drawing those points together, there is insufficient evidence to show that the status quo considerations are relevant to a future counterfactual analysis, and a counterfactual on that basis is not and should not be available.

7.6 In particular, we have seen no reason and evidence in the material as to why the Commission might conclude in draft that the counterfactual can be based on the status quo, when there is so much change occurring during the future period under review.

7.7 Additionally, when developing the counterfactual based on future market conditions and technologies, we submit it is important to focus directly on that rather than incremental change from the past. This is illustrated by Para 26 of the LOUI:

> "…there has been a rise in the consumption of mobile data as consumers view more content on mobile networks"

7.8 While the context shows that the Commission is considering larger changes than what has in fact happened so far, as in the quote, the changes in consumption of mobile data to date are miniscule. They start from a very low base, relative to the very large quantities of mobile data and video content that are expected to be a key part of mobile and of triple and quad play.

7.9 What has happened so far is almost irrelevant in this context even though the increases are substantial. Far more relevant, for example, is what the applicant, Vodafone Europe BV, is in fact doing in Ireland and elsewhere, as outlined in Internet NZ's submissions. It is enabling its Vodafone Ireland customers to download all of Vodafone's content, at HD quality, on a zero rated basis.

7.10 That is the world of the counterfactual.

Subscription Video on Demand (SVOD) and Pay Per View (PPV)

7.11 In the LOUI summary of the counterfactual, what happens as to services such as Neon, Netflix, FanPass Lightbox, and similar later services (that is, SVOD and PPV) is not mentioned. We are assuming that the Commission has, correctly we submit, accepted the submissions[7] that they are not in the same market and are not a substitute.

Focus on what has happened so far

7.12 The part of the counterfactual described at Para 15 seems focussed on the status quo offerings, seemingly as to the services currently offered by Sky, including as to price. The impression given is that the services offered will largely remain the same as at present (other than Sky with Vodafone, but not with other RSPs, expanding the offered range of bundles).

7.13 It is difficult to reconcile that with the last part of the counterfactual description. It is also difficult to reconcile that with the known facts, particularly the changes that are occurring over the counterfactual period. It is possible this may simply result from reasons and conclusions "lost in translation" into an abbreviated summary. But it is important to be clear on the position as it is so central to this matter.

What is likely to happen in the period for counterfactual assessment

7.14 The parties, including the applicants, are clear about the move to mobile Pay TV downloads, and triple/quad play. It is a central feature, with a likely major divergence with how this plays out in each of the factual and the counterfactual.

7.15 The parties, including the applicants, are clear about the move to delivering content online, such as by UFB and DSL. The LOUI at Para 17 appears to recognise this. (We assume that the "full service" over OTT broadband means an online equivalent of the full service currently offered over satellite (including as resold by Vodafone) and over Vodafone's HFC). The outcomes of this move to online in each of the factual and the counterfactual will be substantially different in each of the factual and counterfactual. That also is a central feature, and is magnified in impact by the parallel moves to mobile downloading of content, and to triple and quad plays.

7.16 As we and other parties have submitted, this aspect has wide implications for UFB uptake and therefore innovation and investment, given the major drivers for UFB uptake are video downloads and price. UFB uptake will likely be substantially different in each of the factual and the counterfactual. That is part of the effects of the merger relative to the counterfactual and falls to be considered on the SLC assessment.

7.17 The parties, including the applicants, are clear about the move to seamless bundles and differentiated services. This is a major change from the current bundle (other than over the limited HFC footprint) by which the Sky part of the Vodafone bundle is a standalone service that is not integrated. Again, this is a central feature, and will happen to a substantially greater or lesser extent in each of the factual and the counterfactual.

7.18 Differentiation of services, and discrimination, will likely differ markedly as between factual and counterfactual. We note, in particular, that the levers to differentiate and discriminate, which will be applied in substantially different ways in the factual and the counterfactual, are far from being only about price. The LOUI recognises this by referring to both price differentiation, as well as differentiation based on services. Here, we highlight the particular importance of this point. The technology and the commercial options are developing in multiple ways, of which, say, providing

[7] See the Trustpower submission dated 12 August at Para 1.12 (despite Sky's submission to the contrary in reply, what the Sky CEO has said is the best evidence that they are not substitutes), and the InternetNZ submission and the Plum reports of the same date confirming market penetration in the US and the UK of around 5% of Pay TV revenues.

own customers over HD and wholesale customers over SD is a simple example. But there are quite a few others such as interactive channels associated with content, etc.

7.19 We submit that there cannot be a proper counterfactual analysis without carefully considering those and other matters arising in the future. However, the Commission's analysis, while now more focussed on some future aspects (e.g. OTT of the full service as an addition or alternative) remains unduly locked in the past (the status quo). It is not apparent that these major market changes, which even the applicants are saying will happen, are being sufficiently considered in the counterfactual analysis, particularly given so much focus on the status quo position in the first part of the description, as though there will be little or no change.

7.20 That is so, before considering other major forward looking issues, which appear to be strongly inconsistent with the status quo remaining. For example, there is, as Sky acknowledges too, the major decline in Sky revenues, which will substantially impact what happens in the counterfactual in ways that are quite different from the status quo.

7.21 In that regard, Para 16 of the LOUI talks of Sky being willing to enter agreements with RSPs that enable it to **increase** its own profits, when in fact the correct focus may well be to enable it to stop the **erosion** of its profits.

What Grant Samuel say about the counterfactual

7.22 The applicants outline the major marketplace changes going forward, such as at the start of the executive summary in their applications. There is also a useful overview in Sky's expert's report to Sky shareholders. At Page 90 of their report,[8] Grant Samuel say:

> "the transaction will allow the Combined Group to provide fully integrated bundled quad play and multi-play services (fixed line, broadband, mobile and pay television and/or other digital services such as OTT offerings) and to exploit more effectively the potential of Sky TV's content assets".

8. The debate about counterfactual options: SLC in all scenarios

8.1 Counterfactual scenarios that have been raised in the redacted submissions, reports, and the LOUI are:

a) Wholesaling (in various ways including via satellite and STB, via HFC, and/or via online wholesaling, etc);

b) Full service by OTT broadband (as above, we are assuming that PPV and SVOD are not seen as substitutes);

c) Sky acquires or builds an ISP other than Vodafone;

d) A combination of 2 or 3 of the above.

8.2 There are various levels of support and opposition for each of those counterfactuals, from applicants, third parties, and, in draft in the LOUI, the Commission. For example, the applicants and some third parties reject Fetch's view that Sky would build or acquire an ISP.

8.3 However, in the debate over which counterfactual applies – particularly as between the applicants (and their criticism of each of the wholesaling and ISP counterfactuals) and third party submitters – we suggest that it is important not to lose sight of the fact that, under all of the

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[8] Grant Samuel, Independent Adviser's Report and Appraisal Report to Sky, June2016

counterfactual candidates, there is substantial lessening of competition relative to the factual. It seems to us that this point has become submerged in the debate.

8.4 In the build/acquire RSP counterfactual, Sky cannot achieve scale anything like the scale with Vodafone. In the wholesaling and OTT counterfactuals, the merged entity cannot leverage the key content.

9. Grant Samuel as to Sky's market power in key content

9.1 Above we have shown why ECPR wholesale pricing means that Sky has substantial market power in key content. We noted that there is such market power, despite numerous statements by Vodafone to the contrary, and that we (and Vodafone's statements) support the Commission's draft view in that regard.

9.2 So do Sky's independent experts, Grant Samuel, when reporting to Sky's shareholders in their Independent Adviser's Report and Appraisal Report on the merger. These statements can only be consistent with Sky having and using substantial market power as to key content:

> "The availability of exclusive premium content is likely to be a further driver of differences in the impact of OTT services across markets. In particular, the availability of exclusive sports programming may be a powerful defensive opportunity for pay television operators. In some markets (such as Australia) government mandated access to sports programming via free-to-air television ("anti-siphoning legislation") limits the ability of pay television operators to secure exclusive rights over the most attractive programming. However, in other markets, such as the United Kingdom for soccer and New Zealand for rugby, exclusive sporting rights fundamentally underpin the content offerings of the incumbent pay television operators and are a driver of subscriber loyalty. Moreover, they help to support advertising revenues and can provide the basis for the incumbent pay television operators' own OTT offerings."[9]
>
> "there are no anti siphoning laws in New Zealand and Sky TV has a strong lock on the key sporting rights that are significant drivers of customer attraction and retention….
>
> ….Sky TV's sports rights holdings provide a critical competitive advantage both in terms of its core subscription service and its OTT offerings"[10]

10. Mobile and telecommunications markets have limited competition

10.1 Despite extensive submissions to the contrary by Trustpower and Blue Reach, each over 4-5 pages, both Vodafone and NERA conclude in responding submissions that the mobile and fixed telecommunications markets are fully competitive. Nowhere do they address the Trustpower and Blue Reach submissions.

10.2 The applicants and NERA rely strongly on their conclusions in this regard, as to fully competitive telecommunications markets.

10.3 The context is that some larger RSPs will not have incentives to submit that there are market failure problems due to market concentration.

10.4 To illustrate the implications, it has been pointed out that, following the recent copper input price drop of $4 per month, instead of the reduction being passed through, save as to some increased data caps, the retail price went up by a small amount. This reflects the high market concentration in the fixed market and the barriers to entry and expansion, to which we turn below. This implies

[9] Grant Samuel, Independent Adviser's Report and Appraisal Report on the merger. Page 27.
[10] Grant Samuel, Independent Adviser's Report and Appraisal Report on the merger. Page 56.

that the merged entity will be able to capture high margins not just as to the content component of bundles but also as to the fixed line component.

10.5 The problem is even more acute as to mobile given there are only three mobile network operators, with MVNO customers making up only 0.5% of the total mobile customer base. We and Blue Reach have submitted that the market concentration is such that there is market failure.

10.6 There is a related point. Given there are only three mobile network operators, with high barriers to entry, the market problems presented by the merged entity's use of key content, in a world markedly moving to fixed line and mobile content downloads, raises even greater market and competition problems.

11. Losing or failing to achieve scale: the last point in the LOUI

11.1 We firmly welcome the Commission's focus on challenges in achieving scale arising out of the merger, including by reference to both the fixed and the mobile markets. In the preceding paragraph, we addressed those challenges as to mobile services. As a provider without mobile capability, facing also the weak MVNO market, we are acutely aware of such scale challenges.

11.2 Additionally, as we are not within the group of three much larger RSPs supplying 92% of the broadband market, two of which have a mobile network, we are acutely aware of challenges in getting to and retaining sufficient scale. The Commission correctly identifies, at Para 37 of the LOUI, the significance of fixed costs.

11.3 The applicants, and NERA, rely on there being many RSPs, over open access platforms (copper, UFB, RBI) to say there is strong competition. However, the reality is that the market is highly concentrated in 3 players and one of the reasons is the relatively high fixed costs, on top of the per-customer variable input cost for local access.

11.4 The examples of fixed costs identified in the LOUI (active network assets at exchanges, and core network assets such as backhaul networks), are not relevant. Active network exchange assets would be unbundling equipment such as DSLAMs but unbundling from this point is highly unlikely for providers large or small, and never was viable for smaller RSPs. Smaller RSPs would also not build out backhaul networks etc.

11.5 The major relevant costs include:

a) Marketing costs

b) Acquisition costs (including modems/routers)

c) Operations and Business Support Systems

d) Aggregation network infrastructure

11.6 While it is possible to argue some of these fixed costs (e.g. OSS/BSS and aggregation network) can be avoided by taking a white label service from a wholesaler, Trustpower's experience with this model was unsatisfactory due to:

a) Inadequate control of product construct

b) Inability to deliver a quality service experience

c) Inadequate margin

11.7 Consequently, to establish an ISP that has the ability to operate at the scale required to be able to compete with incumbents requires a multi-million dollar up-front investment. There are many example of small ISP's (<2,000 customers) that will have invested less, but their inability to grow to a point where they provide any material competition in the marketplace should be evidence of the limitations of this approach.

11.8 The merged entity will make these scale problems substantially worse, if not fatal, for RSPs, and deter new entry. We agree that the likely targeting and acquiring of high ARPU customers by the merged entity will magnify the problem, leaving competitors unsustainably with low ARPU customers. We particularly support the last Covec report in this regard.

11.9 We agree with the draft counterfactual at Para 42 of the LOUI. In particular, in this scale context, genuinely viable content from Sky is more likely to be available to RSPs, large and small, making bundled offerings more viable for smaller RSPs. This goes to reducing the competition problems that exist in the mobile and fixed markets.