CROSS SUBMISSION BY 2DEGREES ON SUBMISSIONS BY VODAFONE AND SKY ON RESPONSES TO SUBMISSIONS ON THE STATEMENT OF PRELIMINARY ISSUES

VODAFONE EUROPE B.V. AND SKY NETWORK TELEVISION LIMITED

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SKY/VODAFONE: CROSS-SUBMISSION BY 2DEGREES

1. Introduction and summary

1.1 2degrees made an initial submission in response to the Commission's Statement of Preliminary Issues on 12 August 2016. In that submission 2degrees argued that (at para 1.15):

> *The merged entity will have both the incentive and ability to leverage its substantial market power in content markets to lock-up premium content for exclusive delivery over its own platforms, foreclosing competition in residential fixed-line and retail mobile markets.*

1.2 Nothing raised by the Applicants in their subsequent submissions casts doubt on the view that the proposed transaction is likely to substantially lessen competition in telecommunications markets compared to any likely counterfactual. In particular, the ability (and incentive) of the merged entity to leverage its monopolised content (premium sport) into telecommunications markets will restrict the ability of a late entrant like 2degrees' to continue to compete effectively with well-established incumbent operators.

1.3 In summary:

- Sky's premium content services are clearly important to New Zealand consumers - Sky is represented in over 50% of *all* households;
- RSPs not reselling Sky to date is due to high costs and low margins offered by Sky, not because premium content isn't essential to a successful triple or quad play bundle;
- in any event, the Commission is required to take a forward looking view and all parties have submitted that bundles will be the norm in future;
- open access to high ARPU customers is key to investment and competition, particularly given the high sunk costs of establishing network infrastructure;
- the applicants appear to suggest RSPs can compete with low cost alternatives – this risks confining smaller RSPs to lower revenue pools, which will harm competition;
- it is not correct to characterise telecommunications markets as fully competitive given markets are highly concentrated. Revenues remain predominantly with the two largest providers;
- there is nothing in the applications to suggest the merged entity would provide equivalent access to its monopolised content, and it will have strong incentives not to do so; and
- a conference is required to fully test the unprecedented number of issues raised by the proposed transaction.

1.4 In this cross-submission, 2degrees responds to matters raised by the Applicants in their responses to third party submissions:

(a) Vodafone's response to third party submissions dated 11 September 2016; and

(b) Buddle Findlay's letter of 9 September 2016 – Sky's full response to submissions on the Statement of Preliminary Issues.

2. **2degrees' response to specific claims made by the Applicants**

2.1 In sections 3 and 4 below we set out specific claims made by the Applicants followed by 2degrees' response.

3. **Vodafone**

3.1 At paragraph 5.6 of its 11 September submission Vodafone states:

> *"If [Sky services] were an essential input for an RSPs telecommunications offering other RSPs would be resellers of SKY's services, as Vodafone has been for many years. That they have not, and given that the market share trends reveal no meaningful impact from their decision not to do so, further reveals that access to Sky is not a must have in order to compete meaningfully as an RSP in New Zealand's telecommunications markets."*

3.2 As Covec's second report points out, the more likely explanation is that the retail margin Sky currently offers to RSPs is very small and might well be less than Sky's avoided costs. Covec states (at paragraph 93):

> *"This would be a complete explanation for other RSPs deciding not to accept the offer, as an equally efficient access seeker could not supply the service profitably on that basis."*

3.3 We also refer to our initial submission in which we commented on Snap's previous experience with seeking to resell Sky's services. High one-off costs were a prohibitive factor in that instance. High one-off costs, particularly when combined with low ongoing margins, are likely to be prohibitive for the majority of the 80 RSPs referred to by Vodafone and is the likely explanation for the low uptake of Sky's resale service.

3.4 The reference in the submission to "80+ RSPs" is also misleading given 95% of the $5.1 billion combined fixed/mobile market by revenue is generated by the 4 largest operators, with 80% generated by the 2 largest providers. With this market structure, there is a limited number of RSPs (and far less than 80) who are likely to be able to access and profitably resell Sky's services.

3.5 As international experience demonstrates and industry analysts and participants (including Vodafone) predict, competition in triple-play and quad-play bundles is the relevant future playing field in the telecommunications sector.

3.6 The triple-pay future was explicitly referred to by Vodafone New Zealand CEO Russell Stanners when the proposed merger was announced:[1]

> *"The combination with Sky will bring greater choice, enhanced viewing experiences and will better serve New Zealanders as demand for packaged television, Internet and telecoms services increases."*

3.7 Vodafone goes on to state at paragraph 5.5(b) of its submission that:

> *"Pay-TV offerings do not drive substantial changes in broadband share."*

3.8 This statement is entirely backward looking, particularly in the context of the rapidly changing and converging telecommunications, information, media and entertainment sectors. In the merger clearance context, the Commission must apply a forward looking

[1] 'Sky buys Vodafone NZ in NZ$3.44bn deal', 9/6/16, http://www.totaltele.com/view.aspx?ID=494018.

analysis to determine the likely competitive effects of a proposed transaction in the next (typically) 2-3 years. Accordingly, what is relevant is the impact that the proposed transaction will have on telecommunications markets *in the future*. Historical broadband market share trends are entirely irrelevant for the purposes of that assessment.

3.9 We note that all of the submissions and the expert reports filed with the Commission have consistently described a future competitive environment in which triple and quad play offerings will be the norm, and which will drive broadband market share.

3.10 At paragraph 5.5(b) of its submission Vodafone states:

> *"…there is nothing preventing competitors bundling their products with any number of additional services, such as WiFi, electricity or music streaming. Indeed, competitors can include free content in their bundles (as Spark currently does with Lightbox) which would strongly constrain bundles which included paid for content."*

3.11 2degrees strongly disagrees that in the future, a bundled offering containing music streaming or electricity would be competitive with a bundled offering which includes premium broadcast content. This is particularly true in respect of the all-important high ARPU customer segment. Vodafone's statement is also at odds with the commercial strategies which have been adopted by telecommunications operators in overseas markets. 2degrees is not aware of any operator that has successfully executed a strategy of the type Vodafone suggests, where for example a bundle containing telecommunications services and WiFi, electricity or music streaming was offered as an alternative to a traditional triple or quad play bundle containing premium content, and in particular premium video content.

3.12 At paragraph 5.5(d), Vodafone claims that:

> *"The importance of price in consumer decision making should also not be overlooked in the telecommunications space. In recent times New Zealand has seen a movement away from bundles and growth of 'no-frills' offerings, with a significant proportion of the 80+ broadband providers offering 'no-frills' options. For example, Bigpipe (a Spark brand) promotes itself as broadband "without the frills" and 2degrees provides a monthly $10 discount to 2degrees Pay Monthly mobile customers (i.e. with no additional value adds).* ***This observation serves to demonstrate that value-adds are not essential inputs to compete in this space*** *(emphasis added)."*

Value-adds <u>are</u> essential inputs to compete for high ARPU customers

3.13 It is surprising that Vodafone asserts that value-adds are not essential inputs to compete in telecommunications markets when its own current strategy is to offer free Sky Sport or Soho for 12 months as an incentive for customers to take-up an unlimited Vodafone broadband offering. 2degrees submits that Vodafone's own behaviour is clear evidence that value adds (i.e. premium content) are essential to offer competitive triple-play and quad-play bundles.

3.14 Further, Vodafone's claims in relation to value-adds misrepresent the importance of securing the business of high value customers (those who have shown a willingness and ability to pay for high value services (Sky) and are referred to in Covec's report as customer group B).

3.15 Vodafone's reference to a $10 discount offered by 2degrees to its Pay Monthly customers is entirely irrelevant in terms of the high value customer segment. As the

Covec report states at paragraph 33, "*retailers in these industries would prefer to serve high value customers rather than low value customers".* These high value customers are already purchasing Sky services and the inclusion of premium content in a triple-play or quad-play offering is essential to secure their business in the future. Indeed, Vodafone's current aggressive marketing of its Sky/broadband bundled offer demonstrates the importance of premium content in securing the business of high value customers.

Open access to high ARPU customers is key to investment, and generating a return on that investment given the high sunk costs of establishing mobile networks

3.16 As noted above, telecommunications markets remain dominated by two incumbent operators who together account for 80% of an estimated $5.1 billion fixed/mobile market by revenue.

3.17 Size and scale are important to an operator's ability to compete in both fixed and mobile telecommunications markets. It is therefore important that the Commission fully understands the underlying market dynamics, including the relative size of competitors and that a potential artificial barrier to expansion in the high ARPU customer segment will disproportionately restrict the ability of a late entrants and smaller RSPs to compete aggressively with established incumbent operators. The proposed merger should also be considered in the context of a number of related market structure considerations, for example spectrum disparities and existing vertical integration in areas such as national and international backhaul, both of which raise competition concerns.

3.18 Mobile networks in particular require high-cost, long-term investments to be made in national cellular infrastructure. In 2degrees' case investment in excess of $500m has been made. This investment needs to be recovered across services delivered to all market segments.

3.19 The entry of a third mobile player into the NZ mobile market duopoly in 2009 was only possible following pro-competition Government policy and regulatory intervention by the telecommunications division of the Commission. The ability of a late entrant to access all market segments, and in particular to compete on its merits for high ARPU customers is critical to build on the competition outcomes which the arrival of a third player has delivered for consumers to date.

3.20 It is therefore important that the Commission considers fully the potential for the merged entity to pursue strategies which will restrict a late entrant or smaller RSP's ability to compete for higher ARPU customers; strategies which would not otherwise be available under any likely counterfactual which includes an independent Sky TV.

3.21 Contrary to the Applicant's assertions, in the forward-looking competitive landscape of triple-play and quad-play bundles, Sky's premium content is an essential input to compete for high value customers in telecommunications markets. In a world with the proposed transaction, the merged entity would have the ability and incentive to favour its own telecommunications business at the expense of other operators.

3.22 At paragraph 7.21 of its response, Vodafone again refers to the fact that it is:

> *"… the only one out of the 80+ RSPS which currently provides the full Sky offering as part of a bundle. Yet the broadband market remains subject to vibrant competition, with RSP competing on the basis of low-cost stand-alone products, bundles with other telecommunications products (e.g. mobile, Wi-Fi), their own third party content offerings (e.g. Spark with Lightbox and Spotify, 2degrees with Tidal), electricity (Trustpower) and others."*

3.23 2degrees' Tidal offering has not generated value for 2degrees' business. Moreover, as discussed above 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. The Vodafone submission appears to suggest that RSPs will be able to compete with various "low-cost" alternatives, necessarily targeted at lower ARPU customers. This approach would confine operators to smaller revenue pools, limiting their ability to generate the revenues required to invest and compete aggressively in all segments.

3.24 The Applicants place significant weight on the fact that retail fixed and mobile telecommunications markets are currently competitive. In fact, the relevant markets are highly concentrated, have yet to mature and are undergoing very rapid convergence and change.

3.25 This reference is also a deliberate strategy to divert attention away from what the merged entity is likely to do post-transaction. Specifically, the merged entity will have both the ability and incentive to grant its telecommunications business preferential access to its monopolised content at the expense of other RSPs who will not be able to compete on a level playing field in the provision of triple-play and quad-play bundles to high value customers (described in Covec's 30 September report as customer group B). The result will be a substantial lessening of competition in retail fixed and mobile telecommunications markets.

3.26 At paragraph 5.6(e) Vodafone states:

> "*Any attempt to leverage the Combined Entity's position in pay-TV would inevitably result in substantial profit sacrifice – both in the short and long term – that could not realistically be compensated for by increased broadband subscription sales via bundles*."

3.27 The above claim begs the question why Vodafone is choosing to deeply discount Sky in its current bundled offerings. If it was not commercially rational (i.e. it would result in substantial short term and long term profit sacrifice) then Vodafone would not be engaging in its current discounting strategy. As the Applicants have stated numerous times, Vodafone is a rational commercial entity (see for example, paragraph 25(b) of Buddle Findlay letter of 9 September).

3.28 Paragraph 1.5 of Appendix 1 of Vodafone's submission makes reference to 2degrees roaming arrangement with Vodafone and states that:

> *"It could equally acquire these services from Spark, but has preferred Vodafone, presumably because Vodafone offers a more compelling commercial arrangement."*

3.29 In its initial submission, 2degrees provided information about its existing wholesale arrangements with Vodafone. The statement that 2degrees could equally acquire roaming services from Spark is incorrect. As the Commission is already aware, it has not been, nor is it currently, technically or commercially feasible for Spark to provide roaming services to 2degrees. National roaming remains a regulated service under the Telecommunications Act.

4. **Sky**

4.1 Buddle Findlay's letter of 9 September states at paragraph 6(e)(ii) that the theories of harm advanced by third party submitters are incorrect. In particular, the merged entity could not:

> *"foreclose competition in telecommunications markets by heavily discounting Sky pay-TV services when bought in a bundle with Vodafone telecommunications services, compared with the price of standalone Sky pay-TV services and/or Sky pay-TV services bundled with other telecommunications providers' services."*

4.2 2degrees submits that the merged entity will substantially lessen competition in telecommunications markets in the manner described above. Vodafone is already heavily discounting Sky pay-TV services when bought in a bundle with Vodafone unlimited broadband. This is indicative of the strategies that the merged entity is likely to pursue. Further, as stated at paragraph 32 of Covec's second report, "*Sky's past and intended future use of ECPR to set wholesale prices shows that Sky has substantial marker power over its content."*

4.3 However, the crucial issue (and the one that the Applicant's fail to address) is that while Sky's services are purported to be available to all RSPs on equivalent wholesale terms to those currently offered to Vodafone (ECPR pricing), post-transaction while those same terms might continue to be available to all RSPs, preferential access will be available to the merged entity's retail telecommunications business (Vodafone). There is nothing in the applications that suggests the merged entity would provide access to other RSPs on an equivalent basis to its own telecommunications business.

4.4 Paragraph 62 of Buddle Findlay's 9 September letter states:

> *"In Sky's view, the real benefit to a consumer of a triple play or quad play bundle is the discount that the customer receives by purchasing services in a bundle compared with individually, rather than the number of bills the consumer receives. This is consistent with the fact that 2degrees saw commercial value in entering into referral arrangements with Sky, under which 2degrees would offer discount codes for Neon and Fanpass to its customers, but 2degrees customers would contract directly with Sky. Offering a discount benefits consumers, but is not the same as engaging in foreclosure. A firm does not leverage market power from one market to another if it simply lowers the price of its products or services. Any competitor, whether the competitor offers a standalone product or a service or a bundle of products or services, is capable of competing for customers by offering a discount."*

4.5 2degrees provided a detailed summary of its previous referral arrangements with Sky in its initial submission of 12 August. In summary, 2degrees' overall experience to date is that its arrangements with NEON have not driven value to 2degrees' business.

4.6 Buddle Findlay's references to discounting are misplaced. The concern is not simply that the merged entity could lower the price of its bundled offering (notwithstanding the fact that discounting by a firm with market power may give rise to predatory pricing issues). The concern is that the merged entity will be able to leverage its market power in pay-TV markets (which is evidenced by its current and intended future use of ECPR to set wholesale prices) by offering its telecommunications business preferential access to its monopolised content and denying other operators access to that content on equivalent terms. As stated above, a triple-play or quad-play bundle that does not include premium content (or includes premium content priced significantly higher than the merged entity) would be of little if any value in the future. Absent a competitive triple/quad play bundle, 2degrees would be unable to aggressively compete for the business of high value customers.

4.7 Paragraph 63 of Buddle Findlay's 9 September letter states that:

> *"Triple play and quad play bundles that include non-Sky SVOD services are an effective competitive constraint on triple play and quad play bundles that include Sky services."*

4.8 Buddle Findlay has not provided any evidence that triple or quad play bundles including non-Sky SVOD services provide competitive constraint on bundles including Sky services. The above statement is without foundation and inconsistent with international experience in markets where triple-play and quad-play offerings are more mature.