RESPONSE TO CMA ISSUES STATEMENT RE VODAFONE-THREE MERGER 2 MAY 2024

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The Issues Statement travels familiar ground, setting out concerns over potential price rises and scepticism about touted efficiency gains. Since the quality and depth of mobile coverage is important in economic and political terms, it is crucial to be clear about what drives better outcomes and how these might be sustained over the longer term.

Productivity growth is largely determined by innovation, which in a telecoms context boils down to unit price, since it is lower unit prices (specifically the price per GB) that enable entirely new services. The provision of social media offerings, for example, or video calls/conferencing, has only been possible because of the progressive collapse in the cost of conveying packets of data across telecoms networks. These declines in unit pricing are, in turn, driven by heavy and continuous network investment. It is therefore vital that the assessment of the proposed combination properly balance the empirical evidence on the pricing effects of mergers (which suggests that they do not in fact lead to price rises), with the risk that the industry's already-impaired ability to invest suffers still further erosion. The proposed merger provides a way to improve returns and thus network investment viability, paid for out of operating efficiency gains. It should therefore be embraced.

Counterfactual

The counterfactual is clearly a pivotal element in the analysis of any merger that might potentially lead to a substantial lessening of competition (SLC). That it should be based on prevailing market conditions need not in itself be problematic, but only if those prevailing conditions are recognised as having a dynamic component. The analysis of prevailing conditions will need to reflect the fact that the competitive environment is becoming progressively more challenging for Vodafone and Three, impacting the trajectory of returns at these smaller mobile operators, and so having a knock-on effect on their ability to justify and fund further investment. Note that while the integrated nature of BT and VMED-O2 (able to combine fixed-line and mobile infrastructures and services) is now a static feature of the market structure, it can nevertheless be expected to make its effects felt progressively over time.

The quality of mobile coverage is perennially controversial. A technology the capabilities of which would, comparatively recently, have resembled science fiction is often subject to criticism for shortcomings that are inherent in radio physics. Nevertheless, the quality of provision could always be further improved by investment. It should therefore be a worry that an operator like Vodafone, which chose to channel a substantial portion of the proceeds from the sale of its US activities into network enhancement, has found it so difficult to generate an adequate return on this investment. Without a better returns environment, it is difficult to see how this largesse might be repeated.

Market definition

As is customary, the market definition separates out retail and wholesale markets. The first point to make here is the paramount importance of the retail as opposed to wholesale market. The existence of the wholesale market does provide certain benefits, especially in terms of addressing market niches that larger operators might otherwise find it difficult to adequately reach. However, to the extent that wholesale does not open up new market segments, it actually drains the pool of resources available to network operators to fund infrastructure investment.

This is not to deny that the wholesale market results in increased price competition; but short-term benefits in this regard are liable to come at the cost of reduced longer-term network investment.

In an industry that is so infrastructure intensive, it should be clear that there will be considerable operational efficiencies from providing service over fewer infrastructures, and eliminating duplicated fixed costs. The tricky part is identifying where the benefits of competition outweigh further network consolidation. Here it might be helpful to consider what Ofcom deems appropriate in the parallel fibre fixed-line access market, where the regulator deems three competing networks would enable it to withdraw from wholesale regulation. While acknowledging that Ofcom might nevertheless prefer four over three competing platforms, the point remains that three wholesale providers is seen as sufficient – and this is obviously without considering the dynamic efficiency gains that a mobile merger would deliver.

It is noteworthy that the Issues Statement should comment that, "…we do not expect market definition to be determinative in the outcome of our assessment." This is striking because, in a dynamic industry such as telecoms, market boundaries are not in fact clear cut, and the adoption of a more holistic assessment of the market's perimeter could have a pronounced impact on the analysis of the proposed combination. Past merger assessments in Europe have arguably done a poor job of reflecting the fluid boundaries of telecoms services in a marketplace characterised by rapid technological change.

Three points merit highlighting here. The first is that, though not a full substitute, nevertheless the widespread availability of WiFi plainly acts as a restraint on pricing. This brings with it a second point, the progressive integration of fixed and mobile services, with respect to which Vodafone and Three – being mobile-only players – are at a disadvantage to their competitors. However, were the merger to take place, it is certainly plausible that the stronger combined entity might exert pressure on fixed-line providers through provision of fixed radio access services. The third point is that much of the – intensive – competition that has emerged over the past two decades has come from sources entirely outside the industry, namely big tech, in the form of offerings like WhatsApp. It remains the case that there is an abundance of technologically-driven sources of enhanced competition, with examples ranging from LEO-based offerings to soft SIMs.

Horizontal unilateral effects – retail

While recognising that 'theory of harm' is the accepted term for use when discussing the potentially negative effects of a merger, it bears emphasising that these are indeed theories, and that there is now a substantial body of empirical evidence available to demonstrate that mobile mergers do not, in fact, produce higher prices. Compass Lexecon compiled an extensive summary of this data on Vodafone's and Three's behalf in November 2023.

The long-standing issue with much of the analysis raising concerns about post-merger price rises is that it is based on gross upward pricing pressure index (GUPPI)-type calculations, which fail to take into account the powerful dynamic efficiency gains that mergers unleash. Indeed, a neglected feature in so much commentary around the telecoms sector is that the primary driver of better outcomes is simply network investment. Capex translates into newer, more efficient equipment, capable of delivering more capacity for less. Competition can help to spur – though it can also work to hinder – that network investment, but it is the network investment that directly delivers, courtesy of Moore's Law, lower unit costs and prices, and thereby enables

service innovation and broader economic productivity gains. No consideration of pricing that neglects dynamic efficiency gains can be either credible or realistic.

While understanding that the analysis of something so complex as a merger must inevitably be broken down into smaller components, there is the issue here that, while *both* the theories of harm and the assessment of customer benefits (by definition) rely on conjecture, nonetheless different risk profiles will be attached to each; with the harms considered more likely than the benefits. By contrast, the aforementioned Compass Lexecon survey of mobile merger pricing analyses indicates that merger benefits are every bit as real as any concerns over pricing.

Anti-competitive impact regarding network sharing arrangements

The network sharing arrangements in the UK have led to operational efficiencies, which will have benefited UK customers in terms of improved network provision as compared with a counterfactual in which network sharing was absent. However, the context of a proposed network merger is a relevant time to consider whether the country would have been better served by MNO consolidation in preference to network sharing.

Network sharing is in essence an alternative, one which has emerged because of the difficulties faced in obtaining approval for network consolidation. In place of four-to-three MNO combinations, the UK – in common with many other European countries – has instead preserved four MNOs but at the price of the latter resolving down to two network sharing platforms. Arguably three MNOs would have been a better outcome – and one that was perfectly achievable, had earlier network mergers been granted approval.

This might serve as a salient reminder of the power of the fundamental economic drivers. Either returns in telecoms improve, or the industry must find a way to reduce its investment to a level commensurate with those returns. This reckoning can be postponed but not prevented. The best option is to permit those initiatives that can provide improved returns – and so justify and sustain longer term investment – through cost savings. The tabled merger is one such proposal.

Countervailing factors

The Issues Statement expresses the view that there is “likely” to be “a higher degree of uncertainty” in markets such as that for mobile, in view of factors including the “long time period” over which the parties’ efficiency gains will be realised and the extent of the additional investment. This raises a trio of questions.

First, it would be a concern if infrastructure-heavy industries were to face an intrinsically higher bar when proposing a merger. In sectors requiring intensive and continuous investment, consolidation is an important potential means of reducing costs in an effort to improve returns to levels that will sustain more optimal levels of investment. Such industries, by their very nature, tend to involve substantial and longer-term capex programmes. The need to sustain and justify this investment should rather be seen as a further reason not to neglect or underestimate the dynamic efficiency gains that mergers in these sectors can bring.

Second, it bears repeating that the track record has been for risk assessments to substantially underestimate the competitive risks that mobile operators face, not least from big tech via communications apps.

Third, while the details may be uncertain, certain overarching principles should not be. Productivity is driven by innovation. Innovation in services results from the lowest possible unit

costs. Lower unit costs are a function of applying as much Moore's Law as possible, through maximising efficient capex. This capital expenditure is deployed by companies in pursuit of returns, and as long as returns remain poor, investment is liable to fall short of optimal levels. A better returns environment would both justify and fund greater levels of capex. In other words, there are aspects of this analysis that should *not* be deemed uncertain: investment follows returns, and if returns are consistently poor in a market where unit price is driven by investment, then customer outcomes will ultimately be sub-optimal.

Rivalry enhancing efficiencies

The parties' claims that combining mobile spectrum and assets in a single network will yield substantial efficiencies is entirely credible – and very much the type of saving upon which a financial analyst (for instance) evaluating a company's prospects would place a high degree of confidence. Just one example would be rural network, where two separate operators would need to duplicate investment in infrastructure that would likely be relatively underutilised from a capacity standpoint, whereas a merged entity could fulfil the same coverage while deploying the capital more efficiently to address areas with capacity constraints.

Similarly, it seems entirely reasonable, given that unit price is a function of investment, that the merged entity's greater ability to invest efficiently would compel a response from competitors, and thus that the efficiencies would be rivalry enhancing. Again, though, rather than rely on theoretical modelling, a superior alternative is the data available from past mergers, which can be seen not to have brought about price increases (as per the Compass Lexecon report).

Finally, further to a previous point, the consideration of whether or not the efficiencies will be "timely" needs to be assessed within the context of the telecoms industry, given the magnitude of the investment programmes that it undertakes. To do otherwise would be to prejudice the case of mergers in infrastructure-intensive industries, where dynamic efficiency gains may be at their most pronounced and useful.