ENDERS | ANALYSIS

Tread lightly

Response to the CMA's proposed remedies to the Vodafone/Three merger

Karen Egan

27 September 2024

We view the CMA's proposed remedies to the Vodafone/Three merger as workable, but not necessary

This report sets out Enders Analysis' views on the CMA's notice of possible remedies accompanying its provisional findings on the proposed Vodafone/Three merger. We are submitting this note as an official response to the CMA on its Remedies Notice, distributing it to our subscribers, and making it freely available on our website.

We agree with the CMA's findings that structural remedies would be inappropriate in this instance. We do not see a credible business case for a new, nationwide mobile UK operator, which these structural remedies such as divesting spectrum/enforcing roaming agreements are typically designed to facilitate. Crucially, a forced divestment of a portion of the subscriber bases of the merging entities to form a new sizeable, independent MVNO would negate much of the potential merger upside, which is predicated on the parties achieving the sort of scale which is required to have a chance of earning a reasonable return in the market (and hence facilitate investment).

We were pleased to see that in its provisional findings, the CMA clearly sees considerable consumer value in the improved network quality of the merged parties, with the potential for them to go a long way towards mitigating the, quite modest, theoretical increases in consumer pricing of 1.5% overall, or £3.66 a year (on an annual bill of £244). We are of the view that it makes commercial sense for the merging operators to pursue a network strategy consistent with the £11bn spend over 10 years that they have indicated, evidence from similar mergers supports this view, and the recent deal with VMO2 to extend its network in the event that the merger is approved should provide reassurance that the operators will execute those plans. It is, however, somewhat understandable that the CMA would like to see a greater degree of commitment from the merging parties that they will follow through on such promises, however unprecedented and sizeable these promises are. It will be very important for the industry that a sensible balance is achieved between reassuring the CMA that the operators do have the full intention of pursuing the network strategy that they outlined in their submissions, but allowing the merging parties to respond to shifting demand, competitive and technological developments. We would therefore recommend that network spend commitments are expressed in quite broad terms, with just selective specific technical metrics which are deemed to be particularly instrumental in achieving the consumer outcomes that the CMA deems to be important to mitigate the potential (quite modest) pricing impacts.

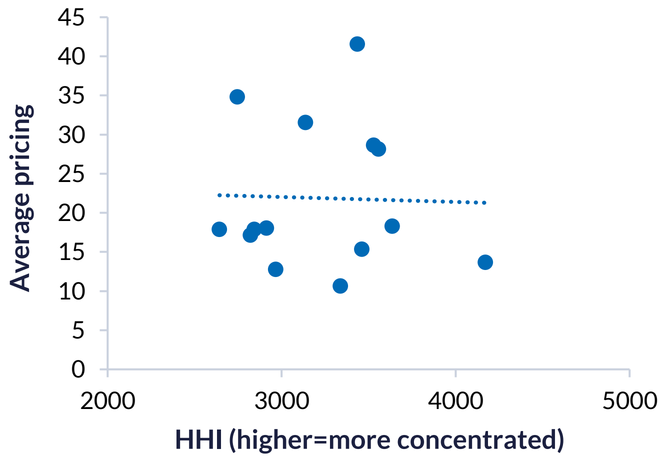
The CMA is mindful that there will be a period of time before the full range of network-quality benefits—higher-quality experience for consumers, and the competitive benefits on both the retail and wholesale sides from the expanded capacity—have their full effect. This period of time before the market enjoys all of the upside that the higher network investment implies, and before the companies fulfil the network commitments that they will be legally bound by, is when the CMA feels the need to have pricing remedies in place.

The CMA's pricing analysis is arguably inconclusive

We are of the view that pricing remedies are not required, given the conclusion from the CMA's GUPPI analysis that there may be a very small (1.5%) increase in prices as a consequence of the merger, particularly given the limitations of such analysis. We would ordinarily expect a theoretical quantitative modelling exercise that generates an expected outcome of +1.5% to be deemed inconclusive given the high degree of uncertainty inherent in these theoretical models of real-world situations.

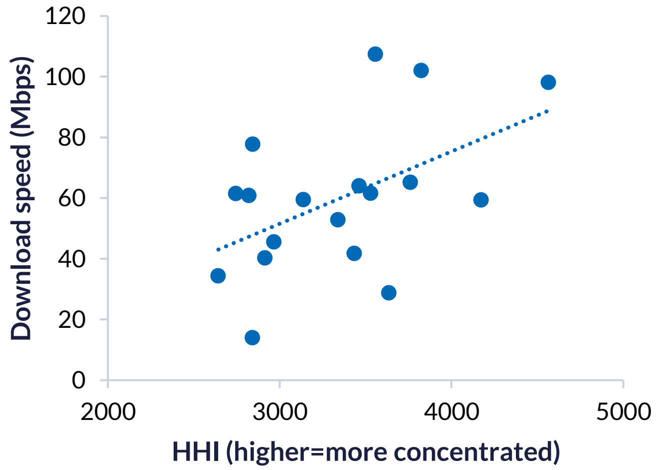
There have been various studies on the impact of telecoms mergers on consumer pricing, with some concluding that they lead to higher prices, while others find that consumer pricing lowers (typically as a consequence of the industry's lower cost-base and increased capacity). It is very difficult to extract conclusive evidence from such studies as the datasets are limited and the counter-factual is very difficult to establish. A Compass Lexecon meta study in November 2023[1] concluded that there was little to no evidence that prices rose as a consequence of mobile network operator mergers (with the increases in network quality therefore providing a positive net outcome for the consumer). Our analysis of the subject has taken a different approach, taking a snapshot of pricing levels across various developed countries with mixed levels of mobile market concentration, as measured by HHI. As with all cross-country comparisons, this also has its limitations and cannot account for the myriad of other factors which determine variations in mobile pricing between countries. Nonetheless, we consider it a useful exercise which provides some reassurance that more concentrated markets do not imply higher prices. There does however appear to be some basis for a more concentrated market leading to better network quality, with download speeds in three-player markets on average higher than those in four-player markets, although the correlation is not a strong one.

Figure 1a: Mobile market HHI versus average pricing (USD, PPP)



Pricing is for 100 calls + 2GB data.
[Source: Pricing data from Teligen (Q2 2022); HHI data from Ofcom (end 2020); Enders Analysis]

Figure 1b: HHI vs average download speed (Mbps)



[Source: Speed data from Ookla (Q2 2022); HHI data from Ofcom (end 2020); Enders Analysis]

[1] Do four-to-three mobile mergers harm consumers?, Compass Lexecon, November 2023, Commissioned by Vodafone UK and Hutchison 3G UK Ltd

While acknowledging the reassurance that short-term pricing commitments can provide, we are of the view that going too far risks distorting a highly competitive market

The proposed remedies document suggests time-limited retail pricing commitments, and wholesale pricing commitments as an interim measure in the form of a reference offer for MVNOs or ring-fencing of capacity for wholesale operators. On the retail side, the measures suggested include promises to retain the terms and conditions of social tariffs (as well as investing to encourage their take-up), and initiatives such as allowing subscribers to roll over their contracts on the same terms that they currently enjoy for a period of time. As with network commitments, unintended consequences for other players in the sector and market dynamics overall should be an important consideration, with intervention minimised to areas of very specific concern, and limited in time to the shortest possible.

Aggressive MVNO pricing commitments, in particular, could amplify a significant drain on the operators' capacity to invest, threatening the network promises that the companies are making

The CMA also cites an MVNO reference offer or ring-fenced MVNO capacity as a potential remedy, which we do not consider to be necessary because of: the MVNO's already very strong momentum in the market; our view that removing Three as a negotiating party for MVNO wholesale rates will not have a detrimental impact on their ability to secure favourable terms, and that the increase in capacity as a consequence of the merger is likely to put further downward pressure on the wholesale rates that the MVNOs pay.

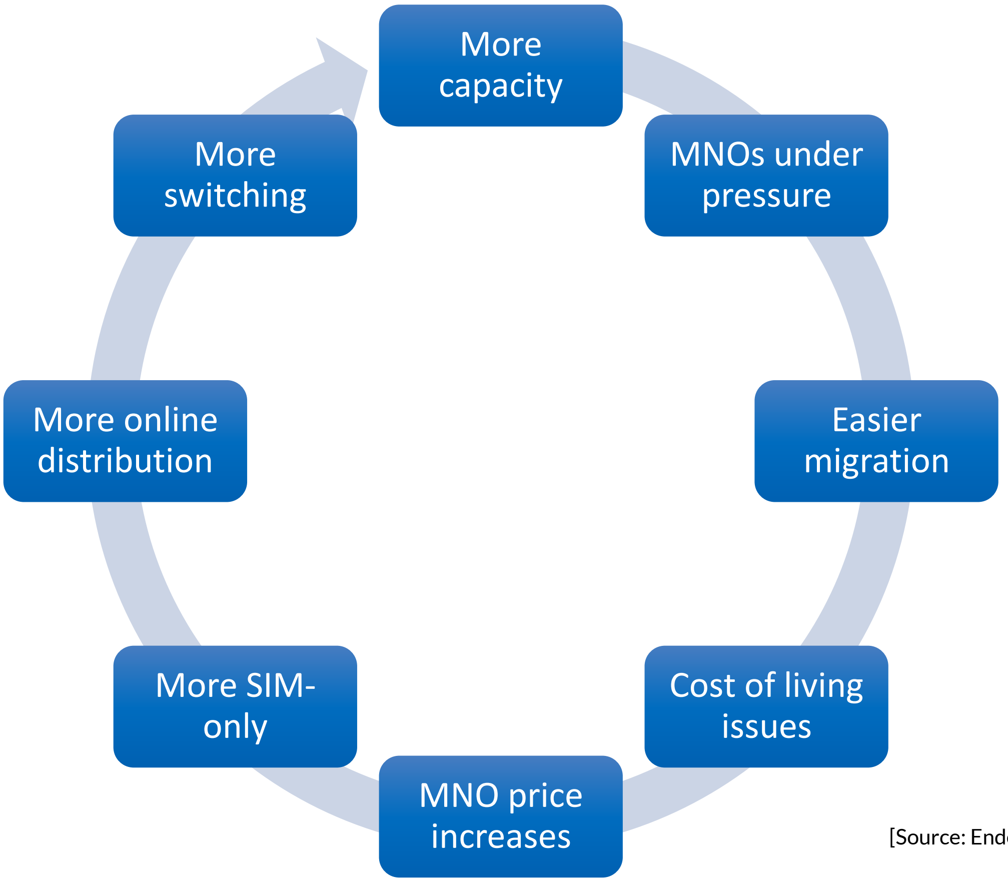
Ring-fencing of MVNO capacity in particular seems like a draconian move to us, typical only when the objective is to facilitate market entry for a new or emerging player with big ambitions, which we do not consider to be an appropriate aim in this case. It is also quite an inefficient use of spectrum and resources.

Capacity rather than the number of negotiating partners will determine MVNO prices

Although the CMA has taken a different position, we continue to be of the view that H3G does not act as a competitive constraint in the market for MVNO services. No MNVO has ever chosen to move to the H3G network and we do not believe that an MVNO would be inclined to take a chance on a network which is perceived to be inferior to the other alternatives, given the risk to the MVNO's reputation and customer base. With the other mobile operators quite conscious of this reluctance, we do not view H3G as a competitive force in wholesale negotiations, even as a realistic bargaining chip to extract better deals from the other operators.

As the strongest competitive force in the market over the past few years, taking more net adds than the network operators, MVNOs are clearly extracting sufficiently attractive wholesale rates from the mobile operators to allow them to compete aggressively in the market. There are many reasons for this strengthened hand, as outlined in our report A strengthening force: MVNOs in UK mobile [2024-018], including: excess capacity in the market from the rollout of 5G; their ability to move from one mobile network to the next with relative ease, and the mobile operators' desire for these wholesale revenues in a challenging environment.

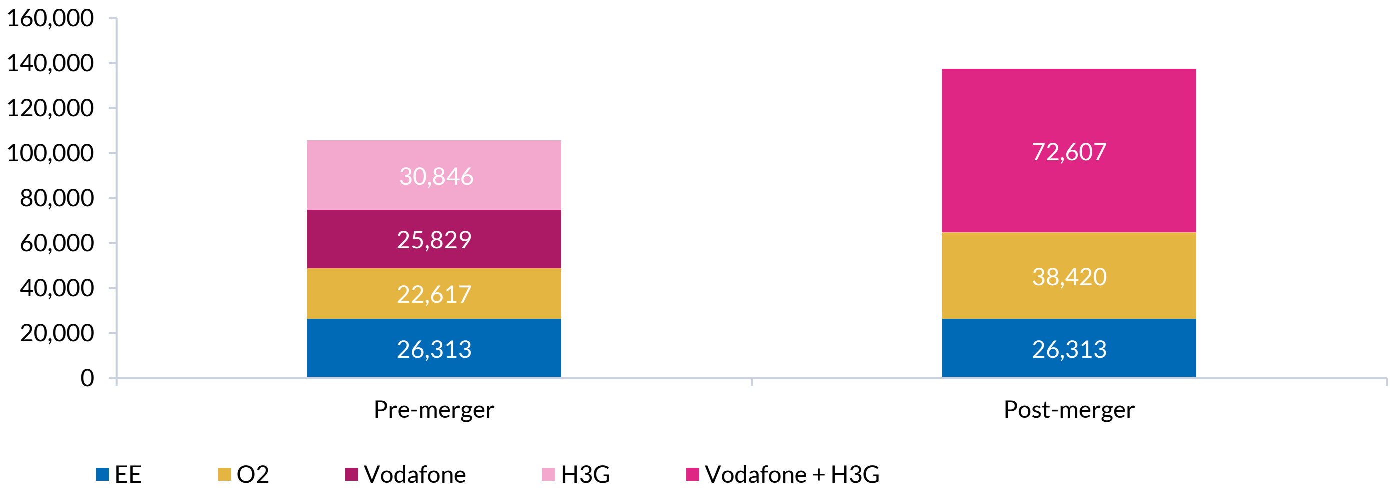
Figure 2: Market factors driving better MVNO commercial performance



[Source: Enders Analysis]

The CMA fears that this favourable environment for the MVNOs could change in the event of the Vodafone-Three merger, which would indeed have significant implications for the competitive landscape. We disagree however that this is likely to be the case given our view that Three is not a competitive force in the wholesale market currently, as discussed earlier. Indeed, to our minds spare capacity in the industry is the number one determinant of MVNOs' bargaining power, and the Vodafone-Three merger would lead to a 30% increase in capacity across the industry, and put that capacity into the hands of three operators that MVNOs would be happy to do business with, increasing their addressable capacity even further.

Figure 3: Capacity by mobile operator (PB/year)



[Source: Enders Analysis, company reports, Ofcom]

MVNO pricing is already very favourable…

Mobile operators base their business plans and customer propositions on their average cost to serve those customers, because if they don't cover their average costs then they won't be able to make a return on their investment. Wholesale pricing for MVNO business, however, faces quite different economics with a very low incremental cost to serve for the host operator (given the high *fixed* cost of the mobile network and the availability of surplus capacity on it), and at least some operators take the view that they will not suffer the consequences of the resultant cheap MVNO prices, particularly where they serve different segments of the market, as is likely the case with EE for example. The MVNOs are therefore in a position to price more aggressively than the mobile operators in the consumer market because they enjoy a lower cost base than them, and without the capital outlay, risks and frustrations of running a mobile network.

The Money Saving Expert[2] site comparing the best deals in the UK mobile market currently has 11 offers from £3.25- £5 for between 5GB and 50GB of data a month—based on the equivalent 12-month price, but with most offering rolling monthly contracts with no commitment, and as little as 99p a month for the first few months. Financial disclosure from the independent MVNOs is quite limited but from the most recent available accounts for Lyca Mobile and Lebara, they appear to be delivering expanding gross margins of 35-53% on the pricing levels that they have been offering in the UK market.

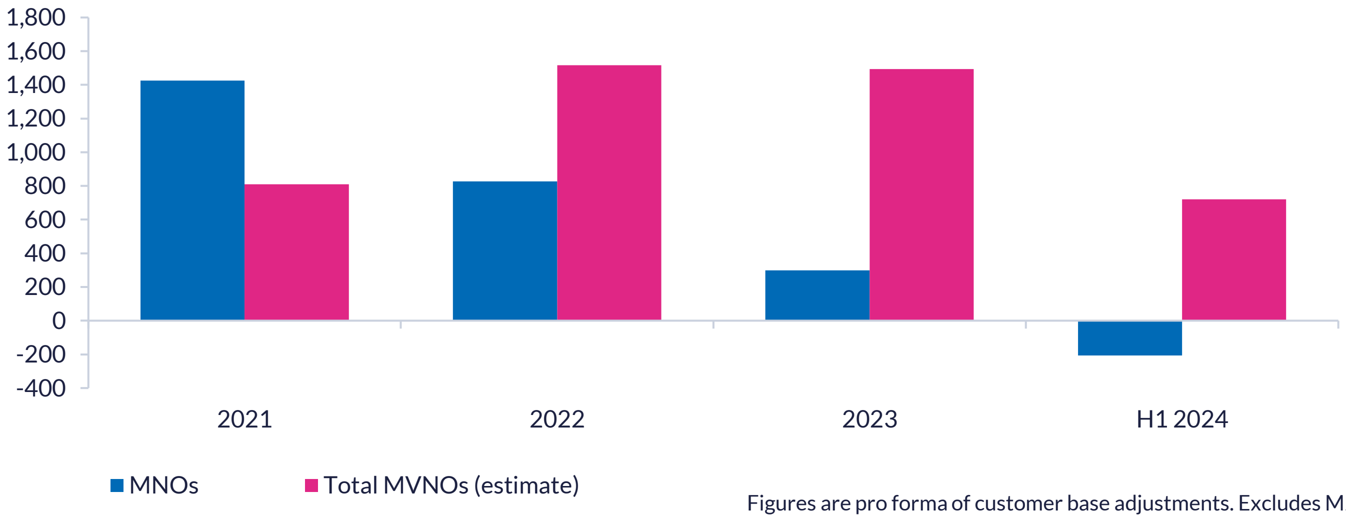
This should provide reassurance to the CMA that vulnerable customers, who are much more likely to be purchasing mobile contracts from MVNOs than they are to be interested in unlimited contracts from Vodafone and Three, can enjoy very favourable and flexible monthly tariffs from MVNOs on the back of the sort of wholesale rates that MVNOs are able to secure today. There should therefore be no requirement for any MVNO pricing remedy imposed by the CMA on the merging parties to be at lower rates than those offered to MVNOs currently. While the CMA is quite clear that the retail price restrictions would be a temporary phenomenon until the full benefits of the merged networks are enjoyed, there does not appear to be such a link between the network rollout timeline and the proposed requirement for an MVNO reference offer. The longer a reference offer is in place, the greater the likelihood that it becomes a distorting factor in the market, and that it restricts the ability of the operators to respond to the broad range of technological and demand-side factors which determine wholesale prices for MVNOs.

…and potentially quite detrimental

Given the more favourable commercial environment for MVNOs, thanks to all of the factors in Figure 2 above, their aggressively low pricing is taking its toll on the network operators both in subscriber and revenue terms. It is difficult to see how the network operators can compete effectively in a market so focused on price, where consumers' ability to readily compare prices is much improved thanks to comparison websites, their ability to switch between networks has been greatly enhanced by text to switch, and where the MVNOs can offer high quality network experiences thanks to leading operators offering them attractive rates and comparison sites citing the network hosting their low-cost offers.

[2] Money Saving Expert, 26 September 2024

Figure 4: Mobile Network Operator (MNO) contract net adds and MVNO net adds (000)



Figures are pro forma of customer base adjustments. Excludes M2M.
[Source: Enders Analysis, company reports]

As wholly owned subscribers on the networks of the mobile operators are replaced by MVNO subscribers, the network operators lose their c.£20 monthly revenue and this is replaced with wholesale rates which are as low as the incremental costs to carrying the MVNO subscribers, i.e. very low levels which appear to allow for up to 50% gross margins to be earned on retail prices (including VAT) of less than £5, i.e. around £2 per subscriber per month for 5GB+ packages. When MVNOs were a small and restricted part of the market, serving only the most cost-conscious of subscribers who were willing to put up with some inconvenience in return for low prices, this was something that the network operators could absorb. As the reach and appeal of MVNOs has extended, and the wholesale rates that they pay have fallen, the financial impact on the mobile operators has worsened significantly. Given the dynamics in the market with excess capacity and the fact that winning or losing MVNO contracts can make or break the careers of CEOs, this seems set to be something that the sector is going to have to grapple with for some time yet. This will put pressure on the operators' ability to invest in enhanced networks—Vodafone/Three in keeping their investment promises to the CMA, VMO2 in line with the commercial agreement that it signed with Vodafone/Three to buy spectrum and extend its network, and the inevitable investment that BT/EE will need to make to at least keep pace with its peers. It seems incongruous that the CMA would want to be strengthening the MVNO's already very strong hands even further.

In the longer term, a mobile market dominated by MVNOs would inevitably be more price than quality based, with individual MVNOs much more likely to market their services based on price than network quality given that they would want to retain the flexibility to switch network supplier at any time. If this is an outcome driven by consumer demands for price over quality then so be it, but the CMA should not distort the market in this direction.

As with retail price interventions, any attempts to encourage Vodafone/Three to provide more favourable MVNO prices than the market is currently willing to offer would have implications for the other network operators' ability to attract MVNO business without reducing their rates further. Any such intervention to enforce lower rates than are currently available would, by definition, be interfering with the normal functioning of the market, and to a highly uncertain end in our view given the strength and momentum that the MVNOs are currently demonstrating. The longer the duration of such offers the greater the likelihood of them distorting the market in favour of the MVNOs at the expense of inefficiencies and inflexibilities borne by the mobile networks.

Overall, the suggested remedies are workable and are well targeted to assure the CMA that consumers will enjoy the upside of the enhanced network quality implied by the merger, and not be faced with meaningful price increases as a consequence. As long as they remain within the remit of sensible safeguards and avoid being punitive, protracted, overly prescriptive and causing unintended consequences in a complex and highly competitive market, then they will have done their job and facilitated the approval of an important structural change that the market badly needs. Treading lightly is the order of the day.

Related reports:

A greenish light: Vodafone/Three merger provisional findings [2024-104]

With or without you: Vodafone-Three merger outlook [2024-096]

Spectrum and towers: Market-changing telco deal [2024-077]

Moving swiftly on: Vodafone/Three merger Phase 1 [2024-039]

No industry for the sub-scale: Mobile telecoms [2024-030]

A strengthening force: MVNOs in UK mobile [2024-018]

The end of the beginning: Vodafone/Three merger [2024-009]

And then there were three? Vodafone/H3G merger [2022-099]

The path to approval opening up? Vodafone/H3G merger [2023-041]

About Enders Analysis

Enders Analysis is a research and advisory firm based in London. We specialise in media, entertainment, mobile and fixed telecoms, with a special focus on new technologies and media, covering all sides of the market, from consumers and leading companies to regulation. For more information go to www.endersanalysis.com or contact us at info@endersanalysis.com.

If your company is an Enders Analysis subscriber and you would like to receive our research directly to your inbox, let us know at www.endersanalysis.com/subscribers